the Property report

SUMMER 2010 A PUBLICATION OF THE PROPERTY LEDGER

Tax Consequences of a Foreclosure or Short Sale

– By Jay Kloster, CPA

*This issue's **Feature Wealth Team Member™** article is by Jay Kloster, CPA of the accounting firm Erickson, Brown and Kloster of Colorado Springs, Colorado.*

The recent and current economic conditions have significantly lowered the value of real estate, increased real estate inventories and altered the way financial institutions will loan money for real estate transactions. Numerous financially troubled borrowers have had debt forgiven or cancelled in the past year. Many individuals are relieved to no longer have the outstanding debt, but are unaware of the potential tax consequences.

The tax consequence for a foreclosure or short sale will depend on if the debt secured by the property is nonrecourse or recourse. Nonrecourse debt is when the lender's only option, upon the borrower's default, is against the property securing the debt. Recourse debt is when the lender can hold the borrower personally responsible. To determine if a loan is recourse or nonrecourse, it may be stated in the loan document or dictated based on state laws.

A foreclosure or short sale by a borrower with a nonrecourse note is deemed a sale by the owner to the creditor. The sales price is determined by using the greater of the fair market value of the property or the outstanding balance of the debt. The owner recognizes gain or loss equal to the difference between the sales price (the greater of the fair market value of the property or the debt discharged) and the tax basis of the property, and no cancellation of debt income is recognized.

A foreclosure or short sale by a borrower with a recourse note is considered sold to the creditor for its fair market value. The fair market value is presumed to be the sale price, resulting in capital gain or loss equal to the difference between the fair market value and the tax basis. If the indebtedness exceeds the fair market value of the property, the difference is cancellation of debt income, which may be taxed as ordinary income.

Generally, the tax law treats calculation of debt income (COD) as taxable income. However, several exclusions are available which may exempt COD income from tax or allow a deferral of tax to future years as follows:

- Cancellation of debt through bankruptcy
- Cancellation of debt where the taxpayer is insolvent
- Discharge of "qualified real property business debt," and
- Discharge of "qualified principal residence debt"

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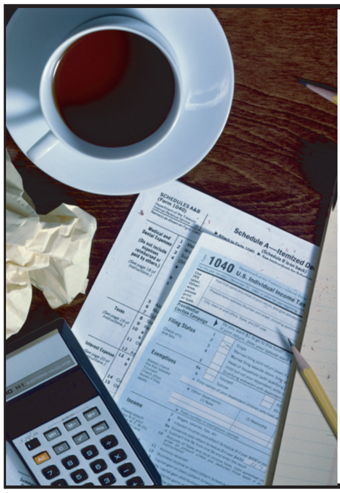

The Tax Corner

Installment Sales – If you are considering selling a property and want to spread the amount of taxes you will have to pay on the sale over a long period of time, you may want to consider an Installment Sale.

An Installment Sales occurs when you sell a property and carry back a promissory note. Under the Installment Sales method you pay taxes on the gain when you receive payments. For instance, assume that you have a basis in a property of $150,000 and sell the property for $200,000, you will receive a gross profit of $50,000 ($200,000 - $150,000). For every dollar of the $200,000 which you receive over time, 25% ($50,000/$200,000) will be profit. For each payment you receive a portion of the payment will be related to interest and a portion related to principal. The interest portion is taxable as regular interest income while 25% of the principal portion will be taxable at capital gains tax rates. While this represents a "big picture" explanation of the Installment Sale concept, you will want to discuss Installment Sales with your CPA.

(cont. Pg. 1)

Tax Consequences

COD income is not included in gross income if the discharge is part of a bankruptcy proceeding. If a taxpayer is insolvent immediately prior to the discharge of debt the income may not be included in gross income. If the taxpayer is in bankruptcy or deemed to be insolvent and does not recognize cancellation of debt income, then the taxpayer is required to reduce various tax attributes and basis of remaining property. This has the effect of deferring any potential tax to future years.

Taxpayers may elect to exclude from income, the income realized as a result of the cancellation of qualified real property business indebtedness. This debt must have been incurred in connection with real property business indebtedness and is secured by that real property, is qualified acquisition indebtedness, is indebtedness incurred to acquire, construct, or substantially improve the property, and the taxpayer elects treatment as qualified real property business indebtedness. Under this election, the taxpayer does not recognize income, but is required to reduce the basis of the depreciable real property. (Note: The election is not applicable for nonrecourse debts, since nonrecourse debt does not result in COD income.)

Example: *An individual owns a building that is used in a trade or business and has a fair market value of $200,000. The property is subject to a first mortgage of $150,000 and a second mortgage of $100,000. The individual and lender agree to reduce the second mortgage to $20,000, which results in an $80,000 discharge of indebtedness. If the individual has basis in the property to absorb the reduction, they may elect to exclude $50,000 of the discharge of indebtedness from gross income. That is based on the principal amount of the discharged debt immediately before the discharge exceeds the fair market value of the property minus the first mortgage debt by $50,000 ($100,000 – ($200,000 – $150,000) = $50,000). The remaining $30,000 of discharge is included in gross income. The $50,000 excluded from gross income will reduce the basis in the property.*

A discharge of debt from qualified principal residence indebtedness is excluded from gross income up to two million dollars. Qualified principal residence is acquisition indebtedness with respect to the taxpayer's principal residence and the debt must have been used to acquire, construct, or substantially improve the taxpayer's principal residence, or to refinance the debt, and must have been secured by the residence. The basis of the residence is reduced by the amount excluded, but not below zero.

Example: *The lender forecloses on a married couple who owes $2,250,000 on their personal residence, with a basis of $1,250,000 and a fair market value of $1,750,000. The borrower will have $500,000 of cancellation of debt income that will not be taxable based on the qualified principal residence debt exclusion. The basis will be reduced to $750,000 due to not recognizing the cancellation of debt income, which will result in a capital gain of $1,000,000. $500,000 of the capital gain will be excludable under the home sale exclusion rules, but the remaining $500,000 will be reported as a capital gain. (Note: If a loss on the sale of a personal residence is realized, the loss is not allowed due to the home being classified as a personal asset.)*

These transactions are complicated and can have many different scenarios. Before going through a short sale or foreclosure, we recommend that you seek advice from a Certified Public Accountant and an attorney that are knowledgeable in this area.

Erickson, Brown & Kloster, P.C. was formed in 1984 and is experienced in auditing, accounting, tax and management advisory services for a diverse range of clients. Contact information for Erickson, Brown & Kloster, P.C.: Toll Free: 888-733-3345 or Email: ebk@ebkcpa.com

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Know Your Market

– Carter Froelich

In the sport of real estate investment it is absolutely imperative that you understand the dynamics of your real estate market. This knowledge not only relates to the sales prices of homes and multiplexes in your area but also capitalization rates, rental rates, vacancy rates, rental concessions, lease terms, security deposit requirements, amenities, pet policies, favored units by the market place, etc.

The only way that I know how to gather this information is to develop and maintain on-going discipline around the study of your real estate market through conversations with realtors and investors, inspection of sold properties, inspection of units/properties for rent and continual hunting in your selected markets. This topic is so important that in my opinion if your not willing to spend the time to understand your market ***you should not be a real estate investor***, because you make money in real estate on the buy not on the sale and to purchase property correctly you have to know market value, rental rates, vacancy rates, operating costs and the costs to improve properties.

Because of the importance of this topic we at The Property Ledger™ will be creating two new Property Strategies™ surrounding the determination of market value and the determination of rental rates. We expect The Property Strategies™ to be available over the next two months so watch your email for the announcement that they are available at our website ***www.thepropertyledger.com.***

Current Macro Real Estate Market Trends

Overall information related to market conditions as reported by Mark Mackenzie show with some exceptions that real estate inventories are continuing to drop as banks work through the supply of REO.

MARK MACKENZIE
REAL ESTATE PLANNING

PERSONAL REAL ESTATE INVESTOR MAGAZINE
BUILDING WEALTH THROUGH PROPERTY INVESTMENT

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Data through May 2010

Region/City	% Change Month over Month	% Change Year over Year	2010 May	2010 Apr	2010 Mar	2009 May
			Month's Supply of Active Properties			
Northeast						
Baltimore, MD	-3.82%	-15.05%	12.08	12.56	11.42	14.22
Boston, MA	-6.53%	-42.11%	5.87	6.28	5.77	10.14
Manhattan, NY	-3.37%	-27.18%	5.44	5.63	5.25	7.47
Philadelphia, PA	-4.00%	-15.59%	7.69	8.01	7.31	9.11
Rochester, NY	-4.95%	-6.11%	6.15	6.47	5.89	6.55
Washington, DC	-3.12%	-31.26%	4.97	5.13	4.83	7.23
Midwest						
Chicago, IL	-7.56%	-17.33%	9.78	10.58	9.73	11.83
Dallas, TX	-6.18%	3.93%	9.26	9.87	9.17	8.91
Detroit, MI	-8.89%	-35.86%	8.30	9.11	8.28	12.94
Houston, TX	-6.80%	-2.02%	8.23	8.83	8.24	8.40
Indianapolis, IN	-7.94%	-2.70%	10.09	10.96	10.06	10.37
Oklahoma City, OK	-7.34%	-12.53%	6.56	7.08	6.67	7.50
South						
Atlanta, GA	-7.51%	-19.65%	13.17	14.24	12.93	16.39
Baton Rouge, LA	-6.03%	-11.57%	7.64	8.13	7.44	8.64
Birmingham, AL	-19.04%	3.70%	11.78	14.55	13.34	11.36
Charlotte, NC	-5.61%	-12.79%	7.91	8.38	7.75	9.07
Jacksonville, FL	-7.93%	-28.68%	9.40	10.21	9.49	13.18
Miami, FL	-9.22%	-49.23%	11.52	12.69	12.08	22.69
West						
Denver, CO	-3.49%	-14.89%	5.26	5.45	5.32	6.18
Las Vegas, NV	3.42%	-29.60%	3.02	2.92	3.10	4.29
Los Angeles, CA	5.41%	-24.82%	4.09	3.88	4.06	5.44
Phoenix, AZ	0.78%	-2.76%	3.88	3.85	4.12	3.99
San Diego, CA	4.74%	-18.18%	2.43	2.32	2.37	2.97
Seattle, WA	-4.84%	-12.20%	5.11	5.37	5.21	5.82

This document can be viewed at www.RealEstatePlanning.biz/PREIM.html in a fuller form.

The Property Ledger Tip – Tracking Actual Operating Results

While we are currently in the process of updating the programming related to the tracking of actual operating expenses, the following represents the way in which operating results may be input .

The Property Ledger™ not only projects anticipated pro-forma operating results from an anticipated property purchase; but it can also be utilized to track the actual operating results of the property once purchased. One tracks actual revenue and expense operating results as follows:

Actual Revenues

1) Click on "Rental Income"
2) Click on "Add Actual Income"
3) Insert year in which actual income is to be reported. Hit *Return*
4) Insert actual income amount of the fiscal year.
5) Hit *Return*

Actual Expenses

1) Click on "Operating Expense"
2) Click on "Add Actual Operating Expense"
3) Insert year in which actual income is to be reported. Hit *Return*
4) Insert actual income amount of the fiscal year.

Note: This will now change so that you can input the actual expense amount related to each operating expense category(i.e. property taxes, repairs, utilities, etc.) so that your CPA may have an accurate record of your expenses. Expect the change in program to occur by October/November 2010.

We suggest that you monitor the actual results you achieve so as to check the reasonableness of your operating assumptions as well as your actual results to date.

The Property Ledger™ Update – CPAs Love The Property Ledger™!

Based upon feedback we are getting from real estate investors who are using The Property Ledger™ to monitor and manage their real estate portfolios; their CPAs who prepare their tax returns are ecstatic that they are utilizing a sophisticated (yet easy to use) financial analysis tool which allows them to better understand their client's properties operational issues and to better their advise their clients on tax savings strategies. We had one investor who commented that because his CPA now had a bird's eye view of this real estate holding and the returns that he was generating, they were able to devise tax, operational and disposition strategies which will add $75,000 to his bottom line next year! That equates to a ***600% cash-on-cash return***, not bad for an annual investment of $124.95 for The Property Ledger™!

Additionally, the CPAs have requested that we consider revising how The Property Ledger™ replaces proforma operating expenses with actual expenses so that they may see the detail related to the actual operating expenses rather than an aggregate figure. We thought that this is a great idea and as such, we are beginning to change the programming of The Property Ledger™ to include this suggestion. The programming is underway and should be completed and up and running by October-November 2010 in time for the 2010 tax year. ***As always updates to The Property Ledger™ are done at no cost to subscribers.***