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10 RULES TO TEST YOUR INSOLVENCY

By Victor Sy, CPA, MBA

Let's list a summary of rules to test your insolvency:

1. Assets that are exempted from creditors are not counted as assets for the solvency test. The most important exemptions generally apply to personal residences and retirement plans.
2. A solvent spouse's separate assets can be excluded from the determination of an insolvent spouse's net worth even if you file a joint return.
3. Non-recourse debt is treated as a liability to the extent of the fair market value (FMV) of the property securing the debt. Non-recourse debt in excess of the property's FMV is treated as a liability to the extent of its discharge; otherwise, it is ignored. The reason is that the excess non-recourse debt that is not discharged has no effect on your solvency.
4. Contingent liabilities may not be counted as liabilities depending on the facts and circumstances of each case. You have to prove that it is more probable than not that you will be called on to pay the liability.
5. Your insolvency is determined immediately before the date of debt discharge. According to the Tax Court, this means the day before the debt forgiveness is realized.
6. You must determine the fair market value of assets. The usual definition of FMV is the price at which a property would change hands between a willing buyer and a willing seller. However, a different standard is used for the solvency test. Deduct selling costs from the FMV so that you are left with only the net proceeds, the net realizable value, and the amount recoverable, rather than the gross fair market value.
7. In the case of a partnership, the Code specifically provides that insolvencies are determined at the partner level, rather than at the partnership level.
8. If you voluntarily transfer property to a creditor in satisfaction of a debt, taxable gain is recognized to the extent that the property's FMV exceeds your adjusted basis. In such a case of deed in lieu of foreclosure, attempt to maximize COD income and minimize capital gain. It is, therefore, to your advantage to seek the lowest FMV possible through appraisal.
9. The timing of foreclosure is critical when you have multiple properties being foreclosed, some securing recourse debts and others securing non-recourse debts. It is usually to your benefit to time foreclosures so that non-recourse debts occur ahead of recourse debt foreclosures. The strategy is to use NOLs and other loss carryovers to offset gains realized from non-recourse foreclosures before those attributes are reduced by COD income excluded in connection with recourse debts. For example, if you own two parcels of land, one secured by non-recourse and the other by recourse debts, time the non-recourse foreclosure to occur first so you can offset such non-recourse debts with NOLs and then exclude the COD income from the recourse debt later.
10. An analysis of your situation before foreclosure could save you from having to pay large amounts of taxes through planning and strategy with respect to insolvency and the timing of multiple foreclosures. Consult your own Enrolled Agent, CPA, or Tax Lawyer. Good luck.