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DEBT RELIEF EXCLUSION FOR RENTAL PROPERTIES

By Victor Sy, CPA

Last month, we discussed tax consequences of foreclosures, short sales, and abandonments of homes. Let's now discuss tax consequences of cancelled debt on **qualified real property – including rental units**.

As you read from the prior article, debt forgiven from foreclosures, short sales, and abandonments produce debt relief income – taxable income. Unfortunately, this type of income is taxed at high ordinary rates, rather than the low capital gains rates. This is quite hard for property owners who lose their homes to foreclosures, then find themselves paying **tax on debts that are forgiven, reduced, or cancelled**.

Fortunately, there are laws that protect property owners, first under bankruptcy and insolvency rules. Second, the Mortgage Forgiveness Act of 2007 comes to the aid of homeowners. Third, the Revenue Reconciliation Act helps rental owners. Let's explore **how you, as rentals owners, can exclude income from debt relief**.

Qualified acquisition indebtedness: Landlords can exclude debt relief income from **qualified acquisition debt**. This is debt incurred or assumed to **acquire, construct, reconstruct, or substantially improve** real property. It also includes debt resulting from refinancing, as long as the new loan does not exceed the amount of old loan. It does **not cover funds used to pay off car loans, credit cards, travel, or college costs**. It does **not apply to bankruptcy cases**. It does not immediately apply to **insolvency** cases when your assets are less than your debts immediately before the cancellation. You must apply the insolvency exclusion before seeking relief for cancelled qualified real property business debt.

Qualified Real Property Business Debt: Taxpayers other than corporations may exclude debt forgiveness from qualified real property business indebtedness. The question is – can rental properties qualify for the Qualified Real Property Business Debt Exclusion? The debt must be incurred or assumed in connection with a trade or business. It is based on the taxpayer's involvement in the rental activity. For this purpose, **rentals are “trade or business property.”** This is true even if a management company is hired. However, rentals conducted as **net leases do not qualify**.

Exclusion limit: Your exclusion is limited to the excess of the **outstanding principal amount** over the **fair market value** of the realty securing such debt, reduced by the outstanding principal.

How to elect the qualified real property business debt exclusion: You must make an **election** to exclude cancelled qualified real property business debt. The election must be made on a timely-filed (including extensions) federal income tax return. The election is made by completing Form 982. Attach Form 982 to your federal income tax return and check the box on line 1d. Include the amount of canceled qualified real property business debt on line 2 of Form 982. Reduce your tax attributes in Part II of Form 982. If you filed but missed this election, you can still make the election by filing an **amended** return within 6 months of the due date of the return. Enter “Filed pursuant to Section 301.9100-2” on the amended return and file it at the same place you filed the original return.

Example: Let's assume that you own a fourplex that is worth \$550K (\$550,000) with a first mortgage of \$510K and a second of \$90K. The second trust deed holder agrees to reduce the second loan from \$90K to \$30K. Your debt discharged is \$60K. The maximum debt that you can exclude from income tax is loan balance immediately before the discharge of \$600K minus the fair market value of \$550K. **You may elect to exclude \$50K from your income.**