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FORECLOSURE, SHORT SALE, LOAN MODIFICATION OF RENTAL PROPERTY

By Victor Sy, CPA

Let's discuss rules on foreclosures and debt relief and how these apply to rental owners.

Overview:

- The foreclosure, short sale, or loan modification of a rental property results in debt relief.
- Debt relief results in taxable income.
- However, there are several exclusions from this debt discharge rule.
- One of them is the qualified real property business debt exclusion.
- Your rental property loan is considered qualified real property business debt. ☺

Here Are Some General Rules On Real Property Business Indebtedness Exclusion:

- Use exclusion that applies to real property business debts.
- Exclusion is limited to acquisition debts.
- Exclusion is limited to basis in depreciable property.
- Reduction of basis in depreciable property is required.
- If you are insolvent, use that insolvency exclusion first.

Insolvency:

- Insolvency means an excess of liabilities over fair market value (FMV) of assets.
- Fair market values are determined immediately before the discharge.
- This means that insolvency is determined just before the discharge.
- Your financial status immediately after the discharge is irrelevant.

Definition Of Qualified Real Property Business Indebtedness:

Qualified Real Property Business Indebtedness is indebtedness:

- That you incurred or assumed in connection with real property used in a trade or business;
- That is secured by the real property, at the time the debt is incurred or assumed;
- That is qualified acquisition indebtedness (including refinanced acquisition debt); and
- Which the taxpayer elects to treat as qualified real property business indebtedness.

Definition of Qualified Acquisition Indebtedness:

- Qualified acquisition indebtedness means indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve such property.

Discharge of Qualified Real Property Business Indebtedness:

- The exclusion of income from the discharge of qualified real property business indebtedness applies to you as an individual owner.
- It also applies to LLCs and partnerships.
- It does not apply to C corporations.
- The exclusion is limited to the taxpayer's equity in depreciable properties.