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THE MESS LEFT BEHIND: TAXATION OF POST-DEATH FORECLOSURES

*By James P. Lamping, Esq.**

"A man who pays his bills on time is soon forgotten." – Oscar Wilde

I. INTRODUCTION

The foreclosure of real property raises a number of income tax issues. These issues may become more complicated when they arise during the administration of a decedent's estate.[1] Personal representatives who think they may simply walk away from real property secured by a mortgage may be in for a rude surprise when the tax bill arrives. It therefore is imperative that the attorney recognize and advise the personal representative on the tax implications of a foreclosure, so that the fiduciary charged with administering the estate can make educated decisions.

This article begins with an analysis of the tax issues arising from foreclosures generally, and then turns to the operation of the applicable tax laws in the post-death administration context. Finally, there is a discussion regarding the rules pertaining to the priority for payment of creditors, illustrating why it may make sense to undertake the administration of an insolvent estate holding property subject to foreclosure. The discussion focuses on residential property, although many of the same tax rules (but not the special homeowner relief provisions) apply to investment property as well.

II. TAX CONSIDERATIONS GENERALLY

A. Overview: Capital Gains or Ordinary Income

The tax law pertaining to foreclosures was developed mostly with the living individual in mind. The extension of the rules developed in this context to the post-death administration are not always clear. This article therefore provides some background regarding the law in this area generally, before turning to a discussion of foreclosure in a post-death administration.

The starting point is to ascertain whether the lender has recourse against the debtor personally, or whether the lender is limited to taking possession of the real property. In addition to defining the extent to which the debtor's other assets are exposed for the debt, this distinction also may determine whether the foreclosure will generate capital gains, ordinary income, or both, for income tax purposes. Since the exclusions from income relating to capital gains and ordinary income are different, this is a critical branch in the analysis.

B. Nonrecourse Debt

1. Purchase Money Rule

California law generally provides that debt used to purchase a personal residence will be non-recourse, whether the financing is provided by the seller or by another lender. The Code of Civil Procedure provides:

> No deficiency judgment shall lie in any event after a sale of real property or an estate for years therein for failure of the purchaser to complete his or her contract of sale, or under a deed of trust or mortgage given to the vendor to secure payment of the balance of the purchase price of that real property or estate for years therein, or under a deed of trust or mortgage on a dwelling for not more than four families given to a lender to secure repayment of a loan which was in fact used to pay all or part of the purchase price of that dwelling occupied, entirely or in part, by the purchaser.
>
> Where both a chattel mortgage and a deed of trust or mortgage have been given to secure payment of the balance of the combined purchase price of both real and personal property, no deficiency judgment shall lie at any time under any one thereof if no deficiency judgment would lie under the deed of trust or mortgage on the real property or estate for years therein. [2]

The protection offered by a purchase money loan generally cannot be waived at the time the debt is created or renewed.[3] However it may be waived if it is not raised in litigation, because it is an affirmative defense.[4] While a refinancing by a third party lender will remove the purchase money protection,[5] this protection may remain following a refinancing or loan modification by the original lender.[6]

2. Capital Gains

The relinquishment of real property subject to a nonrecourse debt through foreclosure or a deed in lieu of foreclosure is treated as a sale or exchange for capital gains tax purposes.[7] In explaining the rationale for this principle, the court in *Yarbro v. Commissioner* stated:

> The term "exchange," in its most common, ordinary meaning implies an act of giving one thing in return for another thing regarded as an equivalent. Webster's New International Dictionary (2d ed. 1954). Thus, three things are required: a giving, a receipt, and a causal connection between the two. In the case of abandonment of property subject to nonrecourse debt, the owner gives up legal title to the property. The mortgagee, who has a legal interest in the property, is the beneficiary of this gift, because the mortgagee's interest is no longer subject to the abandoning owner's rights.
>
> In *Middleton*, as in this case, the taxpayer argued that, because the debt was nonrecourse and he therefore had no personal liability for the debt, he received nothing in exchange for his relinquish-

ment of title. In essence, the argument is that because the taxpayer personally had no obligation to repay the debt, the abandonment could not have relieved him of any obligation. This argument is inconsistent with several Supreme Court decisions.

The Supreme Court has held that regardless of the nonrecourse nature of the debt, the taxpayer does receive a benefit from the disposition of the property: he is relieved of his obligation to pay the debt and taxes and assessments against the property. In *Crane v. Commissioner*, 331 U.S. 1, 67 S. Ct. 1047, 91 L. Ed. 1301 (1947), the Supreme Court established that, in computing the *amount* of gain on the disposition, the outstanding debt must be included in the "amount realized" by the taxpayer, whether the debt is recourse or non-recourse.[8]

The gain or loss upon foreclosure is the difference between the adjusted basis of the property and the principal balance of the nonrecourse debt.[9] For example, suppose that a residence encumbered by a $180,000 nonrecourse mortgage has a fair market value of $170,000 and a basis of $175,000 at the time of foreclosure. The capital gain would be $5,000 ($180,000 minus $175,000).[10] It should be emphasized that the fair market value of the property is not used in this calculation. Indeed, the principal balance of the mortgage is treated as the amount realized, even where it exceeds the fair market value of the property.[11]

3. *Exclusion from Income of Capital Gains on Sale of Residence*

If capital gains are realized upon the foreclosure of residential property subject to nonrecourse debt, the taxpayer must rely upon the exclusion from gain with respect to a principal residence under Internal Revenue Service (IRC) section 121 to avoid taxation.[12] The general application of this statute has been well documented and will not be analyzed at length here.[13] Rather, it is mentioned as a precursor to a discussion of its unique application in the post-death context that is addressed below.

Other exclusions, such as the insolvency exclusion discussed below, may be available to avoid the imposition of income tax on ordinary income arising from the discharge of debt under certain circumstances. However, these exclusions do not apply to avoid the imposition of capital gains taxes upon foreclosure.[14]

C. Recourse Debt

1. *Capital Gains and Ordinary Income*

A foreclosure involving a recourse debt may result in both ordinary income and capital gains. This involves a two-step analysis. Capital gains are first calculated by comparing the fair market value of the property to the taxpayer's adjusted basis. Second, ordinary

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income results to the extent that the debt exceeds the fair market value of the property. These rules were summarized in Revenue Ruling 90-16 as follows:

> Section 1.1001-2 (a)(1) of the regulations provides that, except as provided in section 1.1001-2 (a)(2) and (3), the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. Section 1.1001-2 (a)(2) provides that the amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under section 61(a)(12). *Example (8)* under section 1.1001-2(c) illustrates these rules as follows:
>
> *Example (8)*. In 1980, F transfers to a creditor an asset with a fair market value of $6,000 and the creditor discharges $7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value ($6,000). In addition, F has income from the discharge of indebtedness of $1,500 ($7,500 - $6,000). [15]

It is possible that a taxpayer will have ordinary income combined with a capital loss. For example, suppose that a residence encumbered by a $180,000 recourse mortgage has a fair market value of $170,000 and a basis of $175,000 at the time of foreclosure. The taxpayer first computes gain or loss on the foreclosure by comparing the amount realized ($170,000) with the adjusted basis ($175,000), resulting in a $5,000 capital loss. Next, the taxpayer deducts the fair market value of the residence ($170,000) from the principal balance of the mortgage ($180,000), which results in $10,000 in ordinary income from the discharge of debt.[16]

2. *Exclusions From Income of Ordinary Income Arising from Discharge of Indebtedness*

If a taxpayer realizes ordinary income from the cancellation of indebtedness, the taxpayer nonetheless will not be taxed if (1) the cancellation of indebtedness arises from a bankruptcy discharge;[17] (2) the taxpayer is insolvent;[18] (3) the debt is qualified farm debt;[19] (4) the debt is qualified real property business debt;[20] (5) the debt is qualified principal residence indebtedness;[21] or, (6) the cancellation is intended as a gift by the lender.[22] Where more than one exclusion applies, their application is coordinated by IRC section 108(a)(2). The exclusions most relevant to a foreclosure of residential real property will ordinarily be the insolvency and principal residence exclusions.[23]

For purposes of determining whether a taxpayer qualifies under the insolvency exclusion, "the term 'insolvent' means the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge."[24] Assets exempt from creditors' claims under state law are included in determining a taxpayer's insolvency in this context.[25] The insolvency exclusion has proven more complicated in practice than in theory, and is a topic worthy of an article in and of itself.[26] However, it is mentioned here in order to lay the groundwork for a discussion of its application in a post-death administration.

The Mortgage Forgiveness Debt Relief Act of 2007[27] permits taxpayers to avoid the immediate recognition of ordinary income from qualified principal residence indebtedness for discharges on or after January 1, 2007 and before January 1, 2013.[28] In order to qualify, the indebtedness must be "acquisition indebtedness" with respect to the principal residence of the taxpayer.[29] "Principal residence" has the same meaning as in IRC section 121.[30] The maximum amount that may be excluded from income is $2 million, or $1 million for a married taxpayer filing separately.[31] If the indebtedness consists only partly of qualified principal residence indebtedness, the ordering rules require that the discharged obligation be first attributed to the non-qualified portion.[32] (That non-qualified portion may still be non-taxable under the insolvency exclusion if it is applicable.)

In the event that the taxpayer retains the residence following a debt forgiveness, the taxpayer's basis in the residence is reduced by the amount of the debt forgiven.[33] Similarly, the general insolvency exclusion requires the taxpayer to reduce his or her basis in other assets.[34] The net result may be that the payment of tax is deferred, not forgiven. Of course, current law provides for a step up (or down) in basis upon death.[35] Consequently, where the asset receives a step up in basis upon death, it is possible that the lifetime reduction in basis that otherwise would trigger a gain will have no effect.

California adopted a counterpart to the Mortgage Relief Act for state income tax purposes; however, its protection was due to expire as of January 1, 2009.[36] Even when it does apply, its relief is limited to $250,000 ($125,000 if married filing separately).[37] Consequently, it is possible that a taxpayer will have to pay state income taxes as the result of debt forgiveness, even if no federal taxes are owed. As of publication, however, an amendment is under consideration that would extend this protection and increase the amount of relief provided.

III. APPLICATION TO A POST-DEATH ADMINISTRATION

A. Overview

As noted above, the laws pertaining to the income tax consequences of foreclosures were largely developed with the living individual in mind, and their application in the context of post-death administration appears to have been an afterthought at best. Historically, the step up in basis upon death and the relatively constant appreciation of real estate often made these issues moot in post-death administrations. However, in light of the recent real estate crash, that may no longer be the case.

B. Basis Decrease

Subject to certain significant exceptions, a taxpayer's basis in inherited property will generally be its date of death value.[38] While this is typically thought of as a step up in basis, it may also result in a step down in basis. The result may be that a foreclosure following death may be much worse than a foreclosure immediately prior to death.

For example, suppose that Taxpayer purchases a home for $200,000 using nonrecourse one hundred percent financing and an interest only note. Two years later, the value of the property declines to $100,000. No capital gains tax will be imposed if the property goes through foreclosure, because the taxpayer's basis is equal to the amount of the debt. By contrast, if Taxpayer dies, his estate's basis in the property will be stepped down to its fair market value of $100,000. This means that $100,000 in capital gains will be generated by a foreclosure following death, whereas no capital gains would have resulted from a foreclosure prior to death.

In these circumstances, if death is expected in the near future it may be preferable to try to complete a foreclosure, short sale or deed in lieu of foreclosure before the client's death, rather than to try to delay an inevitable foreclosure.

C. Capital Gains

If there is capital gain as a result of a foreclosure after the taxpayer's death against the taxpayer's principal residence, the exclusion under IRC section 121 may be available in some circumstances to avoid or reduce the tax payable.

1. Surviving Spouse

A surviving spouse may qualify for tax relief in several ways.

First, spouses filing a joint return may exclude up to $500,000 of capital gains on the sale of a personal residence if (1) either spouse meets the two-year ownership requirement and (2) both spouses meet the two-year use requirement.[39] This rule applies to a joint return filed for the deceased spouse's year of death.[40] Thus the surviving spouse who realizes capital gains as a result of foreclosure in the year of the decedent's death may be able to exclude up to $500,000 of gain under this rule.

Second, even if the surviving spouse cannot sell the residence in the year of death, if the surviving spouse disposes of the residence within two years after the death of the deceased spouse, the surviving spouse still may exclude up to $500,000 in capital gains from the disposition of the property so long as both spouses otherwise would have qualified under IRC section 121(b)(2)(A) immediately before the deceased spouse's death.[41] This rule was added by the Mortgage Relief Act and is applicable for tax years beginning after 2007.[42]

In addition, the surviving spouse's holding period for purposes of IRC section 121 includes the holding period of the deceased spouse.[43] The regulations provide the following example:

> Taxpayer H has owned and used a house as his principal residence since 1987. H and W marry on July 1, 1999 and from that date they use H's house as their principal residence. H dies on August 15, 2000, and W inherits the property. W sells the property on September 1, 2000, at which time she has not remarried. Although W has owned and used the house for less than 2 years, W will be considered to have satisfied the ownership and use requirements of section 121 because W's period of ownership and use includes the period that H owned and used the property before death.[44]

All of these exceptions are conditioned upon the surviving spouse not having remarried,[45] and upon the spouses not having already used the IRC section 121 exception within the preceding two years.[46]

While their application is subject to satisfying a number of technical requirements, these rules may permit a surviving spouse to avoid the imposition of capital gains tax upon foreclosure, even if the property previously stood in the deceased spouse's name alone.[47]

2. Section 121(d)(11)

IRC section 121(d)(11) was enacted as part of the sweeping changes to the basis rules that were enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), for decedents dying after December 31, 2009.[48] While the step up in basis is reduced or eliminated to a large extent, it is still possible to have a step down in basis where the date of death value is lower than the decedent's basis before death.[49] However, the same law provided that the decedent's $250,000 exclusion from gain attributable to the sale of a principal residence is carried over to the decedent's estate and its beneficiaries.

The following applies to decedents dying after December 31, 2009:

> The exclusion under this section [Section 121] shall apply to property sold by–
>
> (A) the estate of a decedent,
>
> (B) any individual who acquired such property from the decedent (within the meaning of section 1022), and
>
> (C) a trust which, immediately before the death of the decedent, was a qualified revocable trust (as defined in section 645(b)(1)) established by the decedent,
>
> determined by taking into account the ownership and use by the decedent.[50]

There has been a great deal of speculation regarding whether the estate tax repeal – and the associated changes in the basis rules – scheduled to occur in 2010 will actually take effect.[51] As of this

writing, this issue remains unresolved. Even if the provisions of EGTRRA in general are eliminated or deferred, it is possible that Congress could modify the law providing for estate tax repeal and carryover basis that are scheduled to take effect in 2010, but retain IRC section 121(d)(11) in its current form. That would be a significant development for cases in which the decedent's residence is subject to foreclosure.

For example, suppose that a decedent purchased a home for $450,000 using nonrecourse one hundred percent financing and an interest only note, and that the date of death value was $200,000. Regardless of whether the decedent dies on or before December 31, 2009,[52] or after,[53] the property will receive a step down in basis to $200,000. A foreclosure would produce a $250,000 capital gain ($450,000 realized - $200,000 basis). If the decedent died before December 31, 2009, the decedent's estate would be required to pay capital gains tax unless another exclusion were available. By contrast, if the decedent died after December 31, 2009, and IRC section 121(d)(11) were in effect, the decedent's Section 121 exclusion could prevent the imposition of capital gains tax.

3. Unforeseen Circumstances

Even when a sale does not meet the terms of IRC section 121 because the taxpayer fails the two-year ownership and use requirements or has used the exclusion already within the previous two years, a reduced exclusion may be allowed if

> "A sale or exchange is by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances."[54] The regulations, in turn, provide the following safe harbor for situations constituting "unforeseen circumstances":
>
> A sale or exchange is deemed to be by reason of unforeseen circumstances (within the meaning of paragraph (e)(1) of this section) if any of the events specified in paragraphs (e)(2)(i) through (iii) of this section occur during the period of the taxpayer's ownership and use of the residence as the taxpayer's principal residence:
>
> . . . .
>
> (iii) *In the case of a qualified individual* described in paragraph (f) of this section –
>
> (A) Death;
>
> (B) The cessation of employment as a result of which the qualified individual is eligible for unemployment compensation (as defined in section 85(b);
>
> (C) A change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household (including amounts for food, clothing, medical expenses, taxes, transportation, court-ordered payments, and expenses reasonably necessary to the production of income, but not for the maintenance of an affluent or luxurious standard of living);
>
> (D) Divorce or legal separation under a decree of divorce or separate maintenance; or
>
> (E) Multiple births resulting from the same pregnancy. (Italics added.)[55]

Consequently, the exception for death only applies "in the case of a qualified individual." The regulations go on to define that term as follows:

> For purposes of this section, qualified individual means –
>
> (1) The taxpayer;
>
> (2) The taxpayer's spouse;
>
> (3) A co-owner of the residence;
>
> (4) A person whose principal place of abode is in the same household as the taxpayer; or
>
> (5) For purposes of paragraph (d) of this section, a person bearing a relationship specified in sections 152(a)(1) through 152(a)(8) (without regard to qualification as a dependent) to a qualified individual described in paragraphs (f)(1) through (4) of this section, or a descendant of the taxpayer's grandparent.[56]

While death is listed as an unforeseen circumstance in the case of a qualified individual, and the taxpayer is a qualified individual, it does not necessarily follow that the death of a homeowner is an unforeseen circumstance within the meaning of the safe harbor. Following the homeowner's death, the homeowner's estate is a separate taxable entity for income tax purposes.[57] Consequently, the "taxpayer" for purposes of the safe harbor is not the deceased homeowner, but rather the deceased homeowner's estate. Inasmuch as an estate cannot have a principal residence, the safe harbor would not apply.

This reading is consistent with the IRC section 121(d)(11) exclusion for sales by the estates of decedents dying after December 31, 2009. When Congress wanted the protections of IRC section 121 to apply to a sale by a homeowner's estate following death, it specifically added that protection. Indeed, the fact that Congress felt the need to add IRC section 121(d)(11) implies that a sale by a homeowner's estate would not be protected under IRC section 121 unless subdivision (d)(11) were added to the statute.

That is not to say that all is necessarily lost. The specific occurrences listed in the regulations are safe harbors,[58] and the Internal Revenue Service (IRS) retains the authority to grant relief for situations outside of the safe harbors through the issuance of private

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letter rulings.[59] The IRS has issued a number of private letter rulings interpreting the meaning of "unforeseen circumstances" relatively liberally.[60] For example, in Private Letter Ruling (PLR) 200504012 a police officer who became a K-9 officer was permitted a reduced exclusion after he sold his home because the required maintenance of his dog in his home was forbidden by his homeowner's association. It remains to be seen whether the IRS would grant relief to an estate holding real property subject to a foreclosure, but seeking a private letter ruling may be appropriate in the right set of circumstances, if the estate otherwise would have to pay income tax as a result of the foreclosure.

4. Deduction of Capital Loss

If a capital loss is incurred upon a foreclosure,[61] whether or not the capital loss is deductible may depend upon a variety of factors. A sale at a loss by a beneficiary following distribution may be deductible where the property was held exclusively for sale or rent, but not if the beneficiary used it as a personal residence.[62] However, "[w]here the real property is subject to administration, then the estate will recognize the income and deductions attributable to such property until the property is transferred."[63] Inasmuch as the estate is a taxable entity separate and distinct from the decedent, the capital loss should be recognizable by the estate to the extent it can be shown that the property was held by the estate for the purpose of selling it, similar to the treatment afforded a beneficiary who inherits a decedent's residence. The IRS has issued a Significant Service Center Advice acknowledging that an estate may deduct a loss on the sale of a decedent's residence if the residence "has been converted to an income-producing purpose."[64]

D. Ordinary Income

1. Insolvency

The insolvency exclusion generally applies to estates in the post-death administration context.[65] The insolvency exclusion may at first appear to be of little assistance in the post-death administration. To the extent the estate is insolvent, the foreclosure of real property secured by a recourse debt may avoid the imposition of income taxes, but nothing will be left for beneficiaries upon final distribution. In other words, in an insolvent estate it seems that the only issue is which creditor, the holder of the recourse debt or the IRS, will receive the entire estate.

While that indeed might be the situation, because of the rules establishing priority for the payment of creditors, that will not always be the case. In some instances, it may be possible to transfer at least some assets to the family of the decedent, as discussed below.

2. The Mortgage Relief Act

It does not appear that the exclusion provisions of the Mortgage Relief Act that apply to recourse loans are likely to be of much assistance to a decedent's estate. In order to qualify, the debt must be "qualified principal residence indebtedness."[66] "For purposes of this section, the term 'qualified principal residence indebtedness' means acquisition indebtedness ... *with respect to the principal residence of the tax-*

payer." (Italics added.)[67] "Principal residence" has the same meaning as when used in IRC section 121.[68] In the post-death administration context, the "taxpayer" is the decedent's estate, not the decedent. Inasmuch as an estate does not have a principal residence, the recourse debt cannot be qualified principal residence indebtedness.[69]

This conclusion is consistent with the fact that Congress added a special provision for a sale of a decedent's residence by the decedent's estate after death.[70] There is no suggestion that the decedent's principal residence otherwise becomes the estate's principal residence after the decedent's death.[71]

Again, the rules establishing the priority of claims may give some relief to the decedent's beneficiaries and heirs, even if the statutory exclusion is not available.

IV. PRIORITY FOR PAYMENT OF CLAIMS

When an attorney discovers during the initial consultation that an estate is insolvent and that it holds property that may be subject to foreclosure, the first reaction may be to decline the case. However, that may be shortsighted. In some instances, the attorney, personal representative, and family will be paid at least something despite the fact that the estate faces financial difficulties.

The statutory priority for the payment of obligations from a decedent's estate is as follows:

> (a) Debts shall be paid in the following order of priority among classes of debts, except that debts owed to the United States or to this state that have preference under the laws of the United States or of this state shall be given the preference required by such laws:
>
> (1) Expenses of administration. With respect to obligations secured by mortgage, deed of trust, or other lien, including, but not limited to, a judgment lien, only those expenses of administration incurred that are reasonably related to the administration of that property by which obligations are secured shall be given priority over these obligations.
>
> (2) Obligations secured by a mortgage, deed of trust, or other lien, including, but not limited to, a judgment lien, in the order of their priority, so far as they may be paid out of the proceeds of the property subject to the lien. If the proceeds are insufficient, the part of the obligation remaining unsatisfied shall be classed with general debts.
>
> (3) Funeral expenses.
>
> (4) Expenses of last illness.
>
> (5) Family allowance.
>
> (6) Wage claims.
>
> (7) General debts, including judgments not secured by a lien and all other debts not included in a prior class.[72]

To the extent that a decedent's estate is insolvent, debts within the same class are paid on a pro rata basis, as follows:

> (b) Except as otherwise provided by statute, the debts of each class are without preference or priority one over another. No debt of any class may be paid until all those of prior classes are paid in full. If property in the estate is insufficient to pay all debts of any class in full, each debt in that class shall be paid a proportionate share.[73]

If there are sufficient assets to pay the expenses of administration (and even a family allowance), it may still make sense to administer the estate due to the subordination of unsecured creditors. The compensation paid to the personal representative and his or her attorney is based upon the value of the estate "without reference to encumbrances or other obligations on estate property."[74] In the case of an intestate decedent, a family member will typically be entitled to priority for appointment as administrator.[75] Moreover, a family allowance takes priority over general unsecured claims.[76] Indeed, even federal tax claims will generally be subordinated to administration expenses, funeral expenses, and a family allowance.[77]

Where real property is secured by a recourse obligation in excess of its value, the deficiency will be relegated to the class of unsecured creditors.[78] This means that the deficiency will receive lower priority than administration expenses (including compensation to the personal representative),[79] funeral expenses,[80] and a family allowance.[81] In other words, family members and the attorney may be entitled to payments from the estate that take priority over creditors, including the IRS.

Once these claims have been satisfied, it is critical that the attorney carefully review the tax implications of a foreclosure or other forgiveness of debt. To the extent that such transactions have produced a tax obligation, the failure to pay the IRS before other creditors may subject the personal representative to personal liability if those taxes remain unpaid.[82] Of course, the tax obligations will not be paid if the personal representative is not made aware that a foreclosure has tax implications.

V. CONCLUSION

The foreclosure of real property can carry with it a number of income tax implications. These issues can be especially complicated when they arise in the context of a post-death administration, as the usual considerations are compounded by additional factors such as basis adjustments upon death and the entitlement of different classes of creditors to the assets of the estate. It is therefore imperative that the attorney representing the fiduciary charged with administering the estate carefully analyze the impact of a foreclosure in order to accurately advise the client.

**Gaw Van Male, Napa, California*

Appendix "A"
Discharge of Debt
Federal Income Tax Consequences
Basic Rules

Recourse Debt	Nonrecourse Debt
Ordinary income to the extent discharged debt exceeds fair market value Capital gain to the extent that fair market value exceeds basis No ordinary income from discharge of debt	No ordinary income from discharge of debt Capital gain to the extent that the discharged debt exceeds basis
Example: Debt: $180,000 FMV: $170,000 Basis: $175,000 Result: $10,000 ordinary income ($180,000 - $170,000) $5,000 capital loss ($175,000 - $170,000)	Example: Debt: $180,000 FMV: $170,000 Basis: $175,000 Result: No ordinary income because debt is nonrecourse $5,000 capital gain ($180,000 - $175,000)
Example: Debt: $200,000 FMV: $125,000 Basis: $100,000 $75,000 ordinary income ($200,000 - $125,000) $25,000 capital gain ($125,000 - $100,000)	Example: Debt: $200,000 FMV: $125,000 Basis: $100,000 No ordinary income because debt is nonrecourse $100,000 capital gain ($200,000 - $100,000)

Major Exceptions

Capital Gains	Ordinary Income
Section 121 exclusion from gain on sale of residence	Debtor is insolvent or bankrupt The debt is qualified farm debt The debt is qualified real property business debt The cancellation is intended as a gift
	The Mortgage Forgiveness Debt Relief Act of 2007 if all of the following conditions apply: 1. The property is the taxpayer's principal residence within the meaning of Section 121 2. The debt is qualified principal residence indebtedness (see below) 3. The indebtedness is discharged after January 1, 2007 and before January 1, 2013
	"Qualified principal residence indebtedness" is defined as: 1. A loan secured by the residence and used to acquire, construct or substantially improve the residence 2. Limited to $2 million ($1 million if married filing separately)

ENDNOTES

1. While the focus of this article is the tax issues arising from foreclosure, the person charged with administering the estate should not overlook his or her fiduciary duties. In many instances it will be advisable for the trustee or personal representative to request the approval of the court before permitting real property to be foreclosed upon, in order to avoid breach of fiduciary duty claims by beneficiaries in the future.

2. Code Civ. Proc., § 580b.

3. Civil Code Section 2953 provides:

   Any express agreement made or entered into by a borrower at the time of or in connection with the making of or renewing of any loan secured by a deed of trust, mortgage or other instrument creating a lien on real property, whereby the borrower agrees to waive the rights, or privileges conferred upon him by Sections 2924, 2924b, 2924c of the Civil Code or by Sections 580a or 726 of the Code of Civil Procedure, shall be void and of no effect. The provisions of this section shall not apply to any deed of trust, mortgage or other liens given to secure the payment of bonds or other evidences of indebtedness authorized or permitted to be issued by the Commissioner of Corporations, or is made by a public utility subject to the provisions of the Public Utilities Act.

4. See discussion at 4 Miller & Starr, Cal. Real Est. (3d ed. 2000) § 10:237, p. 784.

5. As summarized at 4 Miller & Starr, *supra*, § 10:253, p. 822, "A new loan by a new lender, other than the former seller, that refinances the prior purchase-money loan is not a purchase-money loan."

6. 4 Miller & Starr, *supra*, §§ 10:240, 10:237, pp. 786-787; *DeBerard Properties, Ltd. v. Lim* (1999) 20 Cal.4th 659.

7. Treas. Regs. § 1.1001-2; *Middleton v. Comr.* (1981) 77 T.C. 310 [293], affd. (11th Cir.1982) 693 F.2d 124.

8. *Yarbro v. Comr*. (5th Cir. 1984) 737 F.2d 479, 483-484.

9. Treas. Regs. § 1.1001-2(c), *Ex*s. (2) and (7).

10. IRS Publication 544, p. 5, Example 2.

11. Treas. Regs. § 1.1001-2(b); *Comr. v. Tufts* (1983) 461 U.S. 300, 307.

12. IRC Section 121 provides that a taxpayer may exclude up to $250,000 of gain ($500,000 for a qualifying married couple) "if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more." IRC, § 121(a).

13. See, e.g., Edwards, 594-2nd Tax Mgmt., "Tax Implications of Home Ownership," Part IV.

14. Treas. Regs. § 1.1001-2(a)(2); *Danenberg v. Comr*. (1979) 73 T.C. 370, 384-

386, acq. 1980-2 C.B. 1; TAM 9302001.

15. Rev. Rul. 91-16, 1990-C.B. 12.
16. IRS Publication 544, p. 5, Example 2.
17. IRC, § 108(a)(1)(A).
18. IRC, § 108(a)(1)(B).
19. IRC, § 108(a)(1)(C).
20. IRC, § 108(a)(1)(D).
21. IRC, § 108(a)(1)(E).
22. IRC, § 102(a) ("Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance."); see PLR 9240003.
23. The bankruptcy exclusion also will often apply to a residential foreclosure, if the taxpayer is living. However, this analysis is intended to lay the foundation for the application of these principles in the postmortem situation, and for that reason the bankruptcy exclusion will not be addressed here.
24. IRC, § 108(d)(3).
25. See TAM 199935002; *Carlson v. Comr.* (2001) 116 T.C. 87.
26. See Note & Comment, *Measuring Assets and Liabilities under the Insolvency Exclusion* (2003) 19 Bankr. Dev. J. 429.
27. Pub. L. No. 110-42, hereafter "Mortgage Relief Act."
28. IRC, § 108(a)(1)(E), as added by the Mortgage Relief Act and extended by the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343.
29. IRC, § 108(h)(2).
30. IRC, § 108(h)(5).
31. IRC, § 108(h)(2).
32. IRC, § 108 (h)(4).
33. IRC, § 108 (h)(1).
34. IRC, § 108(b).
35. IRC, § 1014.
36. Rev & Tax Code, § 17144.5.
37. Rev & Tax Code, § 17144.5(c).
38. IRC, § 1014(a)(1).
39. IRC § 121(b)(2); Treas. Regs. § 1.121-2(a)(3).
40. Treas. Regs. § 1.121-2(a)(4), *Ex. 5*.
41. IRC, § 121(b)(4). That section states:

    In the case of a sale or exchange of property by an unmarried individual whose spouse is deceased on the date of such sale, paragraph (1) shall be applied by substituting "$500,000" for "$250,000" if such sale occurs not later than 2 years after the date of death of such spouse and the requirements of paragraph (2)(A) were met immediately before such date of death.

42. Mortgage Relief Act, *supra*, § 7.
43. IRC, § 121(d)(2). That section states:

    For purposes of this section, in the case of an unmarried individual whose spouse is deceased on the date of the sale or exchange of property, the period such unmarried individual owned and used such property shall include the period such deceased spouse owned and used such property before death.

44. Treas. Regs. § 1.121-4(a)(2).
45. The statutes refer to an "unmarried person." See IRC, §§ 121(b)(4) and (d)(2).
46. IRC, § 121(b)(3).
47. Of course, the surviving spouse may qualify in his or her own right under IRC Section 121 to the extent the surviving spouse owns a principal residence for more than two years following the death of the deceased spouse, albeit at the lesser exclusion amount of $250,000. IRC, §§ 121(a) and (b)(1).
48. Pub. L. No. 107-16.
49. IRC, § 1022(a)(2) provides (with respect to decedents dying after December 31, 2009):

    [T]he basis of the person acquiring property from such a decedent shall be the *lesser* of–

    (A) the adjusted basis of the decedent, or

    (B) the fair market value of the property at the date of the decedent's death. (Italics added.)

50. IRC, § 121(d)(11).
51. See e.g. Zaritsky, Waiting Out EGTRRA's Sunset Period: Practical Planning While Congress Debates Estate Tax Repeal (WG&L 2004) ¶2.02.
52. IRC, § 1014.
53. IRC, § 1022(a)(2).
54. IRC, § 121(c)(2)(B).
55. Treas. Regs. § 1.121-3(e)(2).
56. Treas. Regs. § 1.121-3(f).
57. IRC, §§ 641, 7701; Rev. Rul. 75-61, 1975-1 C.B. 180.
58. Treas. Regs. § 1.121-3(b).
59. Treas. Regs. § 1.121-3(e)(3) states: "The Commissioner may designate other events or situations as unforeseen circumstances in published guidance of general applicability and may issue rulings addressed to specific taxpayers identifying other events or situations as unforeseen circumstances with regard to those taxpayers."
60. See PLRs 200820016, 200826024, 200725018, 200702032, 200652041, 200630004, 200615011, 200613009, 200601023, 200601009, 200504012, 200403049.
61. See, e.g., the text accompanying fn. 16.
62. See *Assmann Est*. (1951) 16 TC 632; *Horrmann* (1951) 17 TC 903; *Williams* (1925) 1 BTA 1101.
63. Acker, 852-3rd Tax Mgmt., "Income Taxation of Trusts and Estates" III, B, 1, p. A-10, citing Rev. Ruls. 75-61, 1975-1 C.B. 180, 57-133, 1957-1 C.B. 200; *McKay v. U.S.* (S.D. Fla. 1974) 74-2 USTC ¶ 9536; *Anderson v. Wilson* (1933) 289 U.S. 20.
64. SCA 1998-012 (5/29/1998).
65. See PLR 8348001; *Estate of Marcus* (1975) T.C. Memo 1975-9.
66. IRC, § 108 (a)(1)(E).
67. IRC, § 108 (h)(2).
68. IRC, § 108(h)(5).
69. The determination of whether a residence is the taxpayer's principal residence depends on an examination of the facts and circumstances, including the taxpayer's place of employment and mailing address. Treas. Regs. § 1.121-1.
70. IRC, § 121(d)(11).
71. See the discussion immediately following fn. 52, *supra*. In contrast, IRC, § 163(h)(4)(D) provides:

    For purposes of determining whether any interest paid or accrued by an estate

or trust is qualified residence interest, any residence held by such estate or trust *shall be treated as a qualified residence of such estate or trust* if such estate or trust establishes that such residence is a qualified residence of a beneficiary who has a present interest in such estate or trust or an interest in the residuary of such estate or trust. (Italics added.)

72. Prob. Code, § 11420(a).

73. Prob. Code, § 11420(b).

74. Prob. Code, §§ 10800(b) and 10810(b).

75. Prob. Code, § 8461. Of course, if an executor is named in a will, that person will be entitled to appointment as personal representative. Prob. Code, § 8420. However, this often is a family member as well.

76. Prob. Code, §§ 11420(a)(5) and (a)(7).

77. Rev. Rul. 80-112, 1980-1 C.B. 306; see California Decedent Estate Practice (Cont.Ed.Bar 2d ed. 2009) § 14.62.

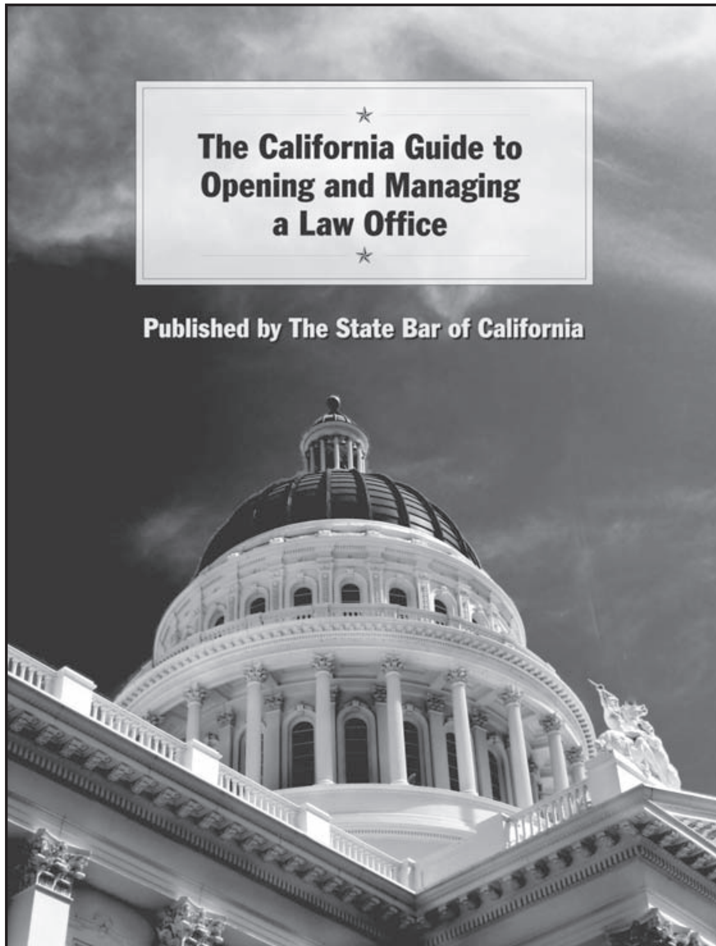
78. Prob. Code, § 11420(a)(2).

79. Prob. Code, § 11420(a)(2).

80. Prob. Code, § 11420(a)(3).

81. Prob. Code, § 11420(a)(5).

82. See discussion in California Decedent Estate Practice (Cont.Ed.Bar 2d ed. 2009) § 14.64.



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