

# REALESTATETAXLAW.COM TAX & ASSET PROTECTION NEWSLETTER FOR REAL ESTATE INVESTORS

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(Yes, we are taking clients, large and small)

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### **Taxation of Short Sales, Deeds-in-Lieu and Foreclosures: Some Basic Points**

Given the current rough economy, many homeowners find themselves facing foreclosure. Fortunately, there are options available, options that are less painful than going all the way to a sale of one’s home on the courthouse steps. For example, a homeowner, bank and investor may agree to a so-called “short sale” where the homeowner agrees to sell the home to the investor for less than is owed on the loan.

Why would the bank or homeowner agree to a short sale?

- The bank might agree to sell for less than is owed on the loan (and usually forgive the balance of the loan) to avoid the high costs of foreclosing on, holding, repairing, renting and selling the property. The bank is still taking a loss, but it is a smaller loss when compared to a full-blown foreclosure.
- The homeowner might agree to a short sale to avoid foreclosure, which has three main benefits:
  - A short sale is normally less damaging to credit scores than a foreclosure;
  - In a foreclosure, the bank can often go after the homeowner *after* the foreclosure to make up its losses on the loan (a.k.a. a “deficiency judgment”), whereas most short sales only work if the bank agrees to “call it even” and not attempt to collect any more money from the homeowner; and
  - Short sales generally result in smaller losses to the bank, which in turns implies a smaller income tax consequence (if any, see below) to the seller.

Because a short sale can allow an investor to acquire a property for far below the amount owed on it, investors can often pick up bargains. However, a common obstacle to closing on a short sale is the seller’s fear of taxes. Such a fear is often unfounded, because short-sellers are quite often able to

completely avoid taxation on a sale. Even where there is some taxation, the amount can often be reduced to next to small, comfortable numbers. Specifically:

Banks sometimes issue a 1099 (similar to a W-2) to the homeowner after a short sale or foreclosure equal to the difference between the sales price of the home and the total loan amount, also known as debt forgiveness income. For example, if a home sold (via short sale or at the courthouse) for \$80,000 and the loan balance was \$100,000, the bank could issue a 1099 showing “Cancellation of Debt Income (COD Income)” of \$20,000 to the homeowner. **The good news: In our example, a good tax professional would normally be able to get the IRS to ignore the 1099 and the \$20,000 of debt forgiveness income, resulting in NO extra taxes to the homeowner.** There are several ways to get the IRS out of the picture:

- 1) Homeowners who live in the home are usually protected: If the property is a taxpayer’s principal residence (basically, he lives there most of the time), any mortgage used to acquire or improve the property<sup>1</sup> (up to \$2 million if married filing jointly, otherwise up to \$1 million) will not create COD income, even if the property sells for less than the amount owed on the loan. This protection for homeowners only applies to refinanced loans to the extent the “refi” is less than or equal to the original mortgage. For example, if you bought your primary residence using a \$100,000 mortgage and later refinanced it for \$120,000, you may have to show \$20,000 in income on the short sale (unless we can find another loophole to get rid of that \$20,000 income....an excellent tax advisor can often can do exactly that). In short: If you own and reside in the home that is sold “short” (or foreclosed on or disposed of with a deed in lieu), the IRS is usually out of the picture IF the tax returns are correctly filed<sup>2</sup> and take advantage of tax laws that are friendly to homeowners.
- 2) Insolvency: Any 1099 COD income will be waived by the IRS to the extent that a taxpayer can show insolvency. “Insolvency” equals total debts minus total assets. For example, a taxpayer who has total debts of \$45,000 and total assets worth \$20,000 is insolvent to the tune of \$25,000. As long as the COD income was less than \$25,000, the taxpayer would owe no taxes due to foreclosure or short sale. This “insolvency exception” applies to *any* taxpayer losing a property to short sale or foreclosure, and not just to those using the property as a residence. In short, landlords and investors can apply this loophole to avoid or reduce taxes on COD income. It is extremely important to work with a tax advisor to create a statement documenting assets and liabilities in case the IRS comes looking for proof that the property owner was entitled to take the “insolvency” tax break.
  - a. The “Catch”: If the IRS forgives COD Income based on the insolvency exception, it will “claw back” or “recapture” the COD income by reducing the taxpayer’s basis in other

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<sup>1</sup> Words matter – COD income arising from debt used to acquire or improve the home is easily avoided. COD income arising from debt used to cash-out and buy plasma screen TV’s is another story. Sometimes we can get around it – and sometimes not, see the Insolvency and bankruptcy exceptions.

<sup>2</sup> Many preparers *think* that they know what they are doing with these rules. Most of them are mistaken. Of key importance: A statement added to the return explaining what happened and why the taxpayer does not owe the income reported on the Form 1099, including legal citations. The object is to persuade the IRS employee who is reviewing the return (after the computer flags it because it cannot find where the 1099 income was reported) that the income is exempt from taxation. Without an explanation, the IRS has a tendency to come looking. Even with an explanation attached to the return, a computer may generate an automatic letter, looking for the 1099 income. In the event such a letter arrives, a prompt and cogent explanation will normally put the matter to rest.

properties, reducing Net Operating Losses, or reducing Passive Activity Losses, etc. As such, the insolvency exception sometimes functions to defer COD income instead of completely exempting it.

- 3) **Bankruptcy:** 1099 debt forgiveness income is not taxed by the IRS if the debt is forgiven as part of a bankruptcy. The same “catch” described under the insolvency exception also applies for the bankruptcy exception to COD income.

ALL of the above techniques depend on having a competent tax professional prepare the tax return. **As long as the return is prepared correctly, most short sales result in little or no extra taxes.** Even when there is a tax issue, a short sale will generally minimize the tax issue when compared to a foreclosure. In addition, a short sale normally beats a foreclosure because it tends to reduce the impact on the taxpayer’s credit and keeps the bank from pursuing the homeowner for more money. We routinely prepare taxes for taxpayers who have been through a foreclosure, short sale or deed in lieu. If the property in question was a personal residence, we will generally prepare the tax return for \$500, including any subsequent follow-up that is required with the IRS.

### **REI Tax Lessons: Pay Your Freaking Taxes! Lessons from Obama’s Best Picks:**

Now I know why Democrats are always in a hurry to raise taxes: they do not figure that they will be the ones who pay them! We’ve heard a bit about this in the news. Here’s a recap, with some opinionating by a very partisan guy with knowledge about the laws in question:

**Tim Geithner:** Just in case you missed it, he is in charge of Treasury, which runs the IRS. If there is one guy in the country for whom “ignorance of the tax law” is no excuse, Tim is that guy. Tim did not pay his social security/self-employment taxes for several years even though his employer explicitly reimbursed him for those exact taxes. Now, REI who buy/sell properties (or read my December newsletter on the topic) know that SS/SE taxes are an issue for certain types of income – and that the IRS will not accept “gee, if only I had known” as an excuse. This guy is the IRS’ ultimate boss and was reimbursed for SE/SS taxes (wouldn’t you love to get a deal that sweet?) – and knowingly failed to pay those taxes. What kind of message does that send to America? Taxes for thee, but not for me.

**Tom Daschle:** Big proponent of high taxes *for others*. Here’s a 1998 quote "Make no mistake, tax cheaters cheat us all, and the IRS should enforce our laws to the letter." What happened:

1. Taxpayers need not receive cash to have taxable “income”. If someone pays you in real estate, candy bars or complimentary legal services, you have “income” for tax purposes and you need to report it on your return. Daschle had received hundreds of thousands of dollars worth of free wheels (limo service) from an employer (in other words, not a “gift”) which he failed to report on his tax returns. In short, he did not follow the law that he expects us to understand and follow. One law for thee, another law for me.
2. This incident was not Tom’s first problem with the tax laws. In 2004, he claimed DC residence to get a property tax exemption on his \$1.9M Washington mansion. At the same time, he also claimed South Dakota residence in order to vote there and, oh yes, represent that state in the Senate. Later, the records seemed to have changed<sup>3</sup> to state that only his wife declared the DC residence. One residence for thee, two for me!

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<sup>3</sup> Now there’s some change we can believe in!

Charlie Rangel: Chairman of the very powerful House Ways and Means Committee. For those of you unfamiliar with congressional arcana - that is the committee that writes the tax laws that we plebes must follow under pain of civil and criminal penalties. Charlie received upwards of \$75,000 of rental income on a beachfront villa in the Caribbean and – you guessed it – did not pay taxes on it. To you landlords who know that “rental income” is in fact “income” and reportable to the IRS: Do you think that any of the following excuses, all made by Rangel, would fly in your case:

1. My wife and accountant handle the finances on my property;
2. The company failed to provide me timely and regular statements;<sup>4</sup>
3. Did not know that someone paying the mortgage on my behalf (instead of direct cash to me) counted as income;<sup>5</sup>
4. Those silly Dominicans (who managed and paid the mortgage on the property) never explained it me;<sup>6</sup>
5. "Every time I thought I was getting through, they started talking Spanish." The mind reels at what would have happened to a white Republican who said that. Positively *reels*.

I literally write these laws, I just do not understand them. One law for me, one law for thee.

Nancy Killefer: Was to be Obama’s “Chief Performance Officer”. If that means cutting expenses, one of her strategies might have been (you guessed it) “don’t pay the taxes”. Specifically, she didn’t pay unemployment taxes of about \$900 on income paid to domestic help. If you remember Clinton’s first two nominations for Attorney General (Zoe Baird and Kimba Wood), they fell out based on failing to pay “Nanny Tax”, which is similar to the tax in question here. Nancy clearly didn’t get that memo. I actually have a small amount of sympathy in the case – the tax system is very obtuse and maddeningly hard to follow. To lose a plum position over a \$900 technical snafu must rankle. On the other hand, Nancy’s governing philosophy is one that favors imposition of this expensive and hard-to-follow multitude of rules on all of us. There goes my sympathy. I cannot fathom or follow the law, but you should!

Bill Clinton: You didn’t really think I could resist, did you? As part of Whitewater, it came out that McDougal had forgiven a \$50,000 loan made to Clinton that Clinton had never paid on.<sup>7</sup> That COD income was never declared on the Clintons’ returns. In addition, Bill contributed used underwear to charity and wrote off each pair at \$5. I cannot, indeed, *must not*, say what I am thinking in that regard.

I did Google “Republican Tax Scandals”. Pretty slim pickings. They must be too busy water-boarding some terrorist, I mean, some innocent bystander randomly picked up by our fascist military. In the meantime, learn from these little anecdotes. If you do what our ruling class has done, I suspect that the IRS would not be very understanding.

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<sup>4</sup> Like many of the excuses described here, this one was phrased as a “non-excuse” excuse, a political specialty: “The company’s failure to provide timely and regular statement [sic] does not excuse any failure to be more diligently pursued [sic] the actual terms of the arrangement and respond appropriately.”

<sup>5</sup> See our discussion of Daschle above. When you get something (free limo, mortgage payments made) in exchange for something else (lobbying services, use of the property), that “something” is income. A true gift (basically, no direct or indirect quid-pro-quo) is not taxable for income tax purposes.

<sup>6</sup> Really? Do mean to say that if they had stopped paying the mortgage, you never would have noticed? THIS is the guy in charge of the nation’s finances – makes a perverse kind of sense, when you think about it.

<sup>7</sup> Looks like he didn’t limit himself to screwing the interns.

## Your Tax Advisor's Most Recent Deal

We mailed some very simple postcards to all mobile home park (MHP) owners in Indiana with MHP < 50 lots and within three hours of Columbus, Ohio. The method to the madness:

- 1) MHP with fewer than 50 units are much more likely to sell with owner financing;
- 2) MHP with fewer than 50 units sell at lower prices per unit than larger parks due to the efficiencies of scale associated with the larger parks;
- 3) A 3 hour drive makes for easier management, we can get out there quickly if need be;
- 4) Indiana has better law than Ohio in most things,<sup>8</sup> especially MHP-related things. For example, moving a MH from Columbus to Toledo costs nearly double than a move from Columbus to Ft. Wayne. The vast bulk of that difference is attributable to Ohio fees and regulation. Notably, there is no significant difference between MH accident rates (etc) in Ohio and Indiana, so that extra regulation is largely for nothing. Typical Ohio.
- 5) Our response rate on the post cards was 4%. This is HUGE, better than dared hope for.

After screening through about 10 deals (most would-be sellers were fishing for retail prices), we came upon a classic motivated seller.<sup>9</sup> In fact, he is the best seller I have ever dealt with, primarily because he did everything he said he would do. I'm really not used to that! Here's the deal in a nutshell:

- 1) Initially, we were going to buy 48 MHP lots + a brick duplex + double-wide MH on land + 3BR SFH for \$380,000. After BS'ing with seller and his spouse, it came out that we did not really want the three buildings, but they actually wouldn't mind keeping them. We agreed that taking those properties out of the deal would drop the price to \$280,000.
  - a. Lesson: TALK to people. Ask open-ended questions and shut up. Let them know your needs, do not assume that they understand what you are after.
- 2) So, we were now looking at buying 48 lots for \$280,000 – that's \$5,833 per lot. The deal included approximately 29 empty or rented MH's. Of these homes, the owner agreed to demolish 5 before we closed – and he did exactly that. That left 24 homes. 13 of the homes had people in them. The remaining homes were empty. Of the empties, 3 were worth salvaging. The others, while technically salvageable, were small, old, 2BR homes of the sort that would attract the wrong sorts of people and also increase liability exposure (e.g. – old 1960/70's era wiring, etc.).
- 3) As you've noticed, this park was filled primarily with rental units. The owner was kept quite busy maintaining those units and charged very low rents (\$350 for most rentals, \$150 lot rent). Did I mention "high liability"? One reason he was interested in selling: There was a fire in one BR of a rental trailer and three people died. Now does that sound a little odd.....a fire in only one room, did not touch the remainder of the trailer, and three people died? Let me add some facts – they were likely high as kites, likely started the fire while in said state, and likely died of smoke inhalation, and too high to save themselves. Fortunately, the insurance company was on the ball and had a forensic specialist on top of the situation. The inevitable lawsuit will likely

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<sup>8</sup> Indiana does have very high water bills and very high property taxes on commercial property. It is better than Ohio, but certainly not paradise. And what the heck is a "Hoosier"?

<sup>9</sup> He's a really good guy with whom I still work, so I will spare you the details.

settle for little or even zero, and will almost certainly settle below the high insurance limit. Ask me again why I prefer to SELL the MH's as opposed to renting them.<sup>10</sup>

- 4) We did get owner carry on this deal, for a variety of reasons:
  - a. The litigation would cloud title enough to spook a bank;
  - b. In the present environment (from 2007 on, I'd say), banks were not lending much in general;
  - c. Banks do not tend to favor oddball assets such as small MHP
  - d. As such, we negotiated owner carry – \$80,000 down, \$200,000 carried for the first year at 0%, after that at 7.5% amortized over 11 years (on average), ½ balloon in three years, remainder of loan carried over full 11 year term.
- 5) The park was a bit more than half-full when we bought it. We did a bit better than break even on the cash flow. Since then, we have lost tenants for the following reasons:
  - a. One bald, tattoo'ed, earring'ed, pitbull-owning, wife beating<sup>11</sup> "tough guy" was asked to get rid of the pit bulls or leave. He chose to leave. He did rip the trailer down (I was happy to see him do it) and moved his immense store of junk and 3 partial cars out. He still left enough of a mess that we will bill him for it and ultimately reduce it to a judgment. Getting rid of one "tough guy" (and his visitors) and all of his junk made a HUGE difference in the park. I have to admit, he did do me one favor: After we had the "no pit bulls" talk, he told all of the other tenants what an SOB I am. Priceless advertising for free!
  - b. Two other pit bull owners elected to lose the dogs;<sup>12</sup>
  - c. One tenant, disgusted at having to pay her rent, in full and on time. Here's what she did....

**\*\*\*\* To be continued in March. See how we are turning it around. \*\*\*\***

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**Our contact data is on the first page, HINT!**

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<sup>10</sup> Many REI are under the mistaken impression that lease-optioning a home absolves the landlord of liability, due to the tenant's duty to maintain and repair the home, which duty is usually spelled in the "option" portion of the lease option agreement. This belief is mistaken. Under state law, a landlord cannot waive or delegate its duties to the tenants. More specifically, a landlord can be liable to the tenant for repairs performed by the tenant. All of the contract language in world, no matter how cleverly drafted, will not serve to alter state law. THAT is why I sell the trailers and do not rent them, except in very limited, special circumstances.

<sup>11</sup> Last I looked, he is still in the can over that episode. I hope some huge con serving a life sentence is using him as a girlfriend.

<sup>12</sup> Insurance will not normally cover damage caused by pit bulls. YOU are liable! Plus, many pit-bull owners keep the creatures to augment their "tough-guy" personas. We do not need tough-guys in the parks, they chase off the decent people. Good riddance.