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INSIDE

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Recent District Court decision signals growing concensus on Rapanos

The United States District for the District of Minnesota recently decided a case that necessitated an application of the muddled opinions in *Rapanos v. United States,* 126 S.Ct. 2208 (2006). The court's well-reasoned and detailed opinion in *United States v. Bailey*, 2007 WL 2791173 (Sept. 25, 2007, D.Minn.) provides perhaps the best guidance to date, along with *United States v. Johnson*, 467 F.3d 56, 66 (1st Cir. 2006) on how to analyze wetlands cases under Section 404 of the Clean Water Act. This article summarizes the facts of the case and the analysis of the district court.

Facts

Bailey owns a 13-acre parcel of land located along the shore of Lake of the Woods in northern Minnesota. The site consists mostly of wetlands. Bailey planned to develop the site as a residential development. In 1998, he hired a contractor to construct an access road through the site. In May and June of that year, a road sixty-six feet wide and about a quarter of a mile long was built along the portion of the lot furthest from the lake.

Bailey dug a ditch on each side of the road and used excavated material to build the road itself. Culverts were installed beneath the north and south ends of the road. On December 22, 1998, Lake of the Woods County accepted a plat of the property, including a dedication of the road to the county.

Bailey had previously attempted to develop the site in 1993 and the United States Army Corps of Engineers ("the Corps") informed him that he would need a permit before placing any dredged or fill material on the site. The Corps received a copy of Bailey's June 1998 Local-State-Federal Project Notification Form with the County proposing to construct an access road for logging the site and treated the form as an after-the-fact application for a permit under Section 404 of the Clean Water Act ("CWA"). On June 12, 1998, the Corps denied the application. On October 22, 1998, after a period of public notice and comment, the Corps ordered Bailey to restore the property, specifically ordering Bailey to: (1) remove the dredged and fill material used to construct the road; (2) fill in the ditches; (3) seed the restored area with a specified seed mixture; and (4) control certain weed species for three years following the restoration.

Bailey refused to comply with the order and the United States filed suit in the United States District Court for the District of Minnesota to enforce it. Bailey brought in the County (now arguably the lawful owner of the road) as a third party defendant and claimed that the Corps lacked jurisdiction. Bailey, the County, and the Corps all filed motions for summary judgment. The District Court granted summary judgment to the County, stating that Bailey had "identified no cognizable legal theory under which he has a right of indemnity or contribution against the County". *Bailey* at 19.

Analysis

The CWA defines "navigable waters" as "the waters of the United States, including the territorial seas." 33 U.S.C. § 1362(7). Under the Corps's regulations, "navigable waters" is not restricted to waters that are navigable. Indeed, it is not even restricted to waters. Rather, "navigable waters" is defined to include "navigable-in-fact" or "traditionally navigable" waters and the wetlands that are adjacent to such waters. 33 C.F.R. § 328.3(a)(7). The district court turned to *Rapanos v. United States,* 126 S.Ct. 2208 (2006) to determine whether the Corps held jurisdiction over Bailey's actions.

Rapanos *analysis*

The district court reviewed and analyzed the *Rapanos* decision. The United States Supreme Court "clearly rejected the Corps' argument that it could regulate all wetlands that were anywhere near navigable-in-fact waters". *Bailey* at 4. However, beyond that, the scope of the Corps' wetlands jurisdiction remains unclear, in part since no majority decision emerged from *Rapanos*.

Writing for the plurality in *Rapanos*, Justice Scalia held that the Corps could exercise jurisdiction over wetlands when, "[f]irst, … the adjacent channel contains a 'wate[r] of the

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United States,' (i.e., a relatively permanent body of water connected to traditional interstate navigable waters); and second, ... the wetland has a continuous surface connection with that water, making it difficult to determine where the 'water' ends and the 'wetland' begins." *Rapanos* at 2227. Applying this test to the Bailey parcel, the district court found that the *Rapanos* plurality would not find that the Corps has jurisdiction.

Justice Kennedy's separate opinion in *Rapanos* would find jurisdiction where there is a "significant nexus" between the wetlands in question and navigable-in-fact waters. *Rapanos*, 126 S.Ct. at 2248. The test for whether wetlands possess a "significant nexus" to navigable-in-fact waters is whether "the wetlands, either alone or in combination with similarly situated lands in the region, significantly affect the chemical, physical, and biological integrity of other covered waters more readily understood as 'navigable.' " *Id*. The district court interpreted Justice Kennedy's test as giving jurisdiction over the site as long as the site has a "significant [e]ffect" on the "chemical, physical, and biological integrity" of Lake of the Woods.

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The *Rapanos* dissenters would have found that CWA jurisdiction existed over the wetlands at issue in the *Rapanos* case itself. Writing for the dissenters, Justice Stevens stated that the dissenters would find jurisdiction when either the plurality's or Justice Kennedy's test is met. *Id*. at 2265. In other words, if the plurality would find CWA jurisdiction over a particular wetland, so would the four dissenters, meaning that at least eight justices would deem jurisdiction to exist. And if Justice Kennedy would find CWA jurisdiction over a particular wetland, so, too, would the four dissenters, meaning that at least five justices would deem jurisdiction to exist. The district court found, therefore, that if either the plurality or Justice Kennedy would find that the Corps has jurisdiction over Bailey's property, then the Corps holds jurisdiction.

Marks v. United States

Bailey argued that under the approach sanctioned by the United States Supreme Court in *Marks v. United States*, 430 U.S. 188 (1977), the Corps holds jurisdiction only where the criteria set out by the *Rapanos* plurality are met (*Bailey*, page 5). In *Marks*, the Supreme Court said that "[w]hen a fragmented Court decides a case and no single rationale explaining the result enjoys the assent of five Justices, 'the holding of the Court may be viewed as that position taken by those Members who concurred in the judgments on the narrowest grounds [.]' " *Marks*, 430 U.S. at 193 (quoting *Gregg v. Georgia*, 428 U.S. 153, 169 n. 15 (1976) (opinion of Stewart, Powell, and Stevens, JJ.)). According to Bailey, the *Rapanos* plurality's test is the "narrowest ground" because the scope of wetlands jurisdiction that it recognized was narrower than the scope of wetlands jurisdiction recognized by Justice Kennedy.

The district court noted that every court to address the question since *Rapanos*, however, has either (1) held that Justice Kennedy's opinion is controlling under *Marks* or (2) found that the *Marks* approach is unworkable as applied to *Rapanos* and held instead that the Corps has jurisdiction if either the plurality's test or Justice Kennedy's test is met. *Bailey*, page 5 (citing *United States v. Johnson*, 467 F.3d 56, 66 (1st Cir.2006); *United States v. Gerke Excavating, Inc*., 464 F.3d 723, 724 (7th Cir.2006) (per curiam), petition for cert. filed, No. 06-1331, 75 U.S.L.W. 3556 (Apr. 2, 2007); *N. Cal. River Watch v. City of Healdsburg*, No. 04-15442, 2007 WL 2230186, at *6 (9th Cir. Aug. 6, 2007); *United States v. Cundiff*, 480 F.Supp.2d 940, 944 (W.D.Ky.2007); *Simsbury-Avon Preservation Soc., LLC v. Metacon Gun Club, Inc*., 472 F.Supp.2d 219, 226-27 (D.Conn.2007); *United States v. Chevron Pipe Line Co*., 437 F.Supp.2d 605, 613 (N.D.Tex.2006)).

The District Court favorably cited *Johnson* as "the most cogent defense of the latter approach" (*Bailey*, page 6). The First Circuit's opinion in *Johnson* describes the shortcomings of using *Marks* to determine the controlling opinion in a case like *Rapanos*:

> Marks is workable–one opinion can be meaningfully regarded as 'narrower' than another–only when one opinion is a logical subset of other, broader opinions.... This understanding of "narrowest grounds" as used in Marks does not translate easily to [*Rapanos*]. The cases in which Justice Kennedy would limit federal jurisdiction are not a subset of the cases in which the plurality would limit jurisdiction."

Johnson, 467 F.3d at 63-64 (quoting *King v. Palmer*, 950 F.2d 771, 781 (D.C. Cir. 1991) (en banc)).

Noting that the Supreme Court has moved away from the *Marks* formula, the First Circuit held that, rather than following a literal reading of *Marks*, the better approach is to examine *Rapanos* for a legal standard that, when applied, will produce results with which a majority of the Court would agree. *Id*. at 64-66.

In *Rapanos*, at least eight Justices would find wetlands jurisdiction under the CWA when the plurality's test is met, and that at least five justices would find wetlands jurisdiction under the CWA when Justice Kennedy's test is met. See *Rapanos*, 126 S.Ct. at 2265 (Stevens, J., dissenting) (stating that "[g]iven that all four Justices who have joined this opinion would uphold the Corps' jurisdiction in both of these cases–and in all other cases in which either the plurality's or Justice Kennedy's test is satisfied–on remand each of the judgments should be reinstated if either of those tests is met."). The district court therefore followed the lead of *Johnson* and adopted the approach suggested by Justice Stevens: The United States may establish jurisdiction under either Justice Kennedy's test or the plurality's test.

Applying Justice Kennedy's test to Bailey's parcel

The District Court began by noting that Justice Kennedy's opinion made clear that when a wetland is "adjacent" to the navigable-in-fact waters, a significant nexus exists as a matter of law (*Bailey*, page 6, citing *Rapanos* at 2248). All parties in the case agreed that Lake of the Woods is a navigable-in-fact water. The question became whether the road built on the wetlands was "adjacent" to Lake of the Woods for purpose of CWA jurisdiction. *Bailey* at 7.

The District Court found that the Road was built on wetlands "adjacent" to Lake of the Woods for two reasons. First, the Corps presented evidence that the wetlands extended to the edge of the Lake. Thus, the wetland "borders" or is "contiguous" to the

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Federal Register summary from September 24, 2007 to October 5, 2007

CROP INSURANCE. The FCIC has adopted as final regulations amending the fresh market sweet corn crop insurance provisions of the common crop policy to allow for the expansion of fresh market sweet corn coverage into more areas where the crop is produced, when provided in the actuarial documents and when it is marketed through direct marketing. This change will be applicable for the 2008 and succeeding crop years for all counties with a contract change date on or after the effective date of this rule and for the 2009 and succeeding crop years for counties with a contract change date prior to the effective date of this rule. 72 Fed. Reg. 54519 (Sept 26, 2007).

FARM CREDIT SYSTEM. The FCA has adopted as final regulations which provide that, when the assets of a Farm Credit System institution in liquidation are distributed, the claims of holders of subordinated debt will be paid after all general creditor claims. 72 Fed. Reg. 54525 (Sept. 26, 2007).

FARM LEASES. The CCC and FSA have announced that they intend to issue proposed regulations governing the treatment of so-called "combination" or "flex" leases for purposes of programs administered by the FSA, CCC, and the FCIC. The CCC and FSA are seeking comments prior to issuing the new regulations. 72 Fed. Reg. 55105 (Sept. 28, 2007).

FARM LOANS. The FCA has adopted as final regulations amending the priority of claims regulations to provide priority of claims rights to Farm Credit System banks if they make payments under a reallocation agreement to holders of consolidated and system-wide obligations on behalf of a defaulting system bank. The final rule also clarifies that payments to a class of claims will be on a pro rata basis. 72 Fed. Reg. 54527 (Sept. 26, 2007).

PEANUTS. The CCC has announced the uniform rates that CCC will pay for storage, handling, and other associated costs for 2007 crop of peanuts for warehouse operators operating under a CCC Peanut Storage Agreement. CCC will pay $8.00 per ton in-elevation charges to the receiving warehouse, only in cases where CCC directs delivery of CCC-owned peanuts from one warehouse to another location. In cases where the producer did not prepay the in-elevation charges, CCC will pay the CCC-approved in-elevation charge at a rate of $8.00 per ton to the warehouse operator and collect the amount from the producer after loan forfeiture. Storage amounts may be earned at the rate of $.089 per ton per day beginning on the day following the loan maturity date, based on a monthly storage rate of $2.71 per ton. CCC will pay a load-out rate of $8.00 per ton which includes all items associated with loading out CCC-owned peanuts, such as weighing and placing peanuts aboard railcars or trucks, when ordered by CCC. 72 Fed. Reg. 54426 (Sept. 25, 2007).

–Robert P. Achenbach, Jr., AALA Executive Director

Clean Water Act/Cont. from page 2

Lake. *Id*. The court openly expressed its disdain for Bailey, finding that he failed to support his position that the site does not consist primarily of wetlands "with anything like competent evidence". *Bailey* at 1. Second, assuming that the wetland is not adjacent to the Lake, the Corps presented sufficient evidence that the wetland is nevertheless "adjacent" since any strip of dry upland separating the wetland and the Lake is "akin to the "man-made dikes or barriers, natural river berms, beach dune and the like" that do not destroy adjacency under 33 C.F.R. § 328.3(c).

Holding

The district court held that the Corps holds jurisdiction of the site under the CWA. The Corps' motion for summary judgment was granted, while Bailey's motion for summary judgment was denied. Further, the court enjoined Bailey to comply with the restoration order.

Conclusions

The United States District Court for the District of Minnesota provides a cogent analysis of the application of *Rapanos* to future wetlands cases. Following the lead of the First Circuit in *United States v. Johnson*, 467 F.3d 56, 66 (1st Cir.2006), the district court rejects the application of *Marks v. United States*, 430 U.S. 188 (1977) to *Rapanos* and, in essence, adopts the view of the *Rapanos* dissenters with respect to future application of the case. Although Justice Kennedy's "significant nexus" test remains amorphous, the *Bailey* decision appears to signal a growing consensus on the application of *Rapanos*.

–Jesse J. Richardson, Jr., Virginia Tech

STATE ROUNDUP

IOWA. *Adverse possession*. The parties owned neighboring rural land tracts. In one corner of the plaintiff's land existed an "indentation" belonging to the defendant's land. The plaintiff treated the disputed land as part of the plaintiff's property and maintained it until the previous owner of the defendant's land planted trees. At the time of the planting, neither neighbor knew the correct boundary but mutually agreed to the tree planting. The previous neighbor erected a fence on the neighbor's side of the disputed strip to fence in livestock. When the defendant purchased the neighbor's land, the fence was removed and the disputed property included in development plans. The plaintiff argued that the boundary line was established by the planting of the trees or the fence by acquiescence or practical location. The court held that the doctrine of practical location did not apply because, at the time the trees were planted or the fence erected, the neighboring land owners were not intending to settle a dispute of a boundary which could not be otherwise determined. The court also held that the doctrine of acquiescence did not apply because the plaintiff failed to prove that any particular boundary had been agreed upon for at least 10 years. *Jager v. Bracker West Farm Corp.*, 2007 Iowa App. LEXIS 995 (Iowa Ct. App. 2007).

–Robert P. Achenbach, Jr., AALA Executive Director

NORTH CAROLINA. *Boundary*. The land owned by the parties was originally owned by one family which had split the land between family members. A road ran between the properties and the deeds splitting the property granted a six foot easement to each side of the road to the neighboring landowner. Thus, the boundary line ran down the center of the road. Later owners, the defendants, of one parcel paved the road, and the other owners, the plaintiffs, alleged that the paved road did not follow the original property line. The plaintiffs commissioned a survey of the property and constructed a fence on what they claimed was the true property line. The fence blocked the road in several places and the defendants counter-sued for trespass. The defendants claimed a prescriptive easement for the road but the court held that the claim was properly denied because the defendants could not show 20 years of adverse use. The court held that the trial court improperly granted judgment notwithstanding the jury verdict as to the boundary line, because the plaintiffs had presented sufficient evidence to place the issue in question so as to allow the jury to find the boundary line to be other than that determined by the survey. In addition, the court held that the trial court improperly granted judgment notwithstanding the jury verdict as to the trespass claims in favor of the plaintiffs in that the defendant had presented sufficient evidence that the fence was placed on the easement road in violation of the defendants' easement rights. *Jones v. Popper*, 2007 N.C. App. LEXIS 1887 (N.C. Ct. App. 2007).

–Robert P. Achenbach, Jr., AALA Executive Director

Mortgage foreclosure tax issues

By Roger A. McEowen

Numerous factors have contributed to the current problems in the mortgage and housing industries. In large part, many of the problems stem from home buyers, mortgage companies, and investors making bad decisions and either not understanding clearly or misusing some of the new and valuable financial innovations that have become available in recent years.[1] Consequently, credit and housing markets are going through a period of painful adjustment, with the result that some homeowners will face foreclosure.

Foreclosure can result in unexpected tax consequences to the debtor, with the precise impact depending on the type of debt involved, state law, and whether the foreclosure is structured as a "short sale." In addition, mortgage foreclosure can have tax consequences to the lender.

On September 17, 2007, IRS issued a news release announcing that it has added a frequently asked questions (FAQ's) section on its website devoted to tax issues facing taxpayers who lose their homes due to foreclosure.[2] In the news release, IRS also reassured homeowners that while mortgage workouts and foreclosures can have tax consequences, special relief provisions exist to "reduce or eliminate the tax bite for financially strapped taxpayers who lose their homes." In addition, there may be viable alternatives to foreclosure that do not carry the same negative tax consequences.

The current problems in the credit and housing markets have also caught the attention of the Congress and the Administration. Legislation has been proposed that would alter the tax consequences of mortgage foreclosure.

Tax consequences to the debtor

Classification of the indebtedness

An important part of debt resolution is the income tax consequences to the debtor. Gross income generally includes "all income from whatever source derived."[3] This includes cancellation of debt income (CODI).[4] When a foreclosure occurs, there are two major categories of income tax consequences – (1) gain or loss if the property is transferred to the lender in satisfaction of indebtedness; and (2) possible CODI to the extent debt discharged exceeds the fair market value of property that the debtor gives up.

As a starting point, the tax impact of mortgage foreclosure is heavily dependent on the type of debt involved. If the debt is "recourse," the collateral serves as security on the loan. If the collateral is insufficient, the debtor is personally liable for the obligation and the debtor's non-exempt assets are reachable to satisfy any deficiency. If the debt is nonrecourse, the collateral again serves as security on the loan. But, if the collateral is worth less than the balance on the debt, the debtor is not personally liable for the balance. So, the creditor must look solely to the collateral in the event of default.

State law determines the type of indebtedness involved. In many states, home mortgages are classified as recourse debt, but California, for example, treats mortgages that are used to purchase a residence as nonrecourse (but, mortgages from refinancing a previous mortgage are usually recourse).

Nonrecourse debt

When a nonrecourse mortgage is foreclosed, a simple one-step process is involved. The property is treated as being sold for the balance of the mortgage.[5] Thus, the entire difference between the income tax basis of the property (that is transferred to the creditor) and the amount of the debt discharged is gain (or loss). There is no CODI.[6]

Note: In the IRS FAQ, Q and A No. 3, IRS states, incorrectly, that CODI is "not taxable in the case of non-recourse loans." The correct statement should be that foreclosure of a nonrecourse loan does not result in CODI.

Recourse debt

The income tax consequence on foreclosure of a recourse mortgage is treated taxwise as if the property is sold to the creditor with the sale proceeds applied on the debt. Thus, a two-step process is involved – (1) there is no gain or loss (and no other income tax consequence) up to the income tax basis on the property, but the difference between fair market value and the income tax basis is gain or loss;[7] and (2) if the indebtedness exceeds the property's fair market value, the difference is CODI.[8] So, the foreclosure of a recourse mortgage (as well as a transfer as a result of an agreement between the parties) is treated as a sale up to the point of the property's fair market value.[9] If the lender forgives the balance of the mortgage, that amount is CODI.[10]

For recourse debt, the tax consequences of mortgage foreclosure are heavily dependent on a determination of the property's fair market value (FMV). But, determining exactly what the FMV of the property is may not be an easy task. If the taxpayer surrenders property to a creditor in exchange for cancellation of debt in a foreclosure sale, absent clear and convincing proof to the contrary, the FMV will be presumed to be the sale price at the foreclosure sale.[11]

Note: Unless a taxpayer rebuts this presumption, the amount bid at the foreclosure sale will be deemed to be the property's fair market value. Lenders frequently bid an amount higher than the property's fair market value. A taxpayer in an appropriate case should obtain appraisal evidence at the time of sale if the value of property is less than the amount bid at foreclosure.[12]

However, if the transfer is in lieu of foreclosure and the creditor sells the home shortly thereafter, the taxpayer will have to determine the property's selling price.[13]

Nonrecognition of gain

Any taxable gain triggered on foreclosure of the taxpayer's principal residence is eligible for exclusion under I.R.C. §121 – that is up to $250,000 for a taxpayer filing as a single person and $500,000 on a joint return.[14] The taxpayer must satisfy the occupancy and use requirements of the statute–the taxpayer must own the home and use it as the taxpayer's principal residence for at least two out of the previous five years.[15] There are exceptions from the two-year rule if the sale of the residence is on account of a change in the taxpayer's employment, health or "unforeseen circumstances." IRS, in its FAQ, did not say whether it would treat foreclosure of a residence as an "unforeseen circumstance."[16]

As is the case with foreclosure of nonrecourse debt, if the holding period requirement is met and the residence was the taxpayer's principal residence, the foreclosure amount representing gain is tax-free (up to $250,000 on a single return, $500,000 on a joint return), but the cancellation of debt would generally be taxable as ordinary income.[17]

Nonrecognition of CODI[18]

CODI is not automatically included in income. There are several ways in which CODI may not trigger income.

Insolvency

CODI is not taxable if the debtor is insolvent (both before and after the transfer of property and transfer of indebtedness) and not in bankruptcy.[19] But, the amount of CODI that can be excluded from income is limited to the extent of the debtor's insolvency–if the amount of debt discharged exceeds the amount of the insolvency, income is triggered as to the excess.

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The determination of the taxpayer's solvency is made immediately before the discharge of indebtedness. "Insolvency" is defined as the excess of liabilities over the fair market value of the debtor's assets. Both tangible and intangible assets are included in the calculation. Likewise, both recourse and nonrecourse liabilities are included in the calculation, but contingent liabilities are not. The separate assets of the debtor's spouse are not included in determining the extent of the taxpayer's insolvency. Historically, the courts have held that property exempt from creditors under state law is not included in the insolvency calculation. However, the IRS has ruled to the contrary,[20] and the Tax Court has agreed.[21]

Bankruptcy

A debtor in bankruptcy need not report CODI,[22] but must reduce tax attributes and reduce income tax basis.[23] However, it is critical that the mortgage is foreclosed and the property is completely out of the debtor's name *before* the bankruptcy discharge occurs.

Deductible items

Any portion of a cancelled debt, including interest, which would have been deductible if paid, is not subject to federal income tax. Thus, the portion of cancelled debt that is attributable to accumulated deductible mortgage interest is not taxable.

"Short-sale" transactions

A "short sale" occurs when a homeowner sells the home for less than the existing mortgage balance. The seller then tries to get the lender to forgive the unpaid balance.[24] Typically, a debtor considers the use of a short sale in lieu of foreclosure in an attempt to protect his or her credit history.

A short sale is taxed under the same rules as foreclosures are taxed. If the underlying debt is recourse, the cancelled debt is not satisfied with the surrender of the property. Thus, any debt not satisfied with the sale proceeds is taxable as CODI.[25] That means that the tax consequences would be the same as mortgage foreclosure involving a recourse debt.[26] If the short sale involves nonrecourse debt, and the seller and the buyer require cancellation of the debt by the lender as a condition of the sale, the debt cancellation is included in the sale proceeds, like for a foreclosure.[27] So, a short sale can be a viable alternative to a foreclosure for debtors with nonrecourse debt and who qualify for the exclusion from income of the gain from the sale of a principal residence.

Drop in value of home–deductibility and timing of a loss

In the present real estate market, it is entirely possible that the fair market value of a home may have dropped beneath its purchase price if the purchase occurred relatively recently. If foreclosure then occurs (or a short sale transaction is entered into), and the underlying debt is nonrecourse, the difference between the mortgage balance at the time of foreclosure and the taxpayer's basis in the home[28] is a nondeductible personal loss if the residence is the taxpayer's principal residence.[29] If the debt is recourse and a foreclosure or short sale occurs, CODI results on the difference between the fair market value of the home and the existing mortgage balance, and a non-deductible personal loss (if the home is the taxpayer's personal residence) is triggered as to the difference between the taxpayer's basis in the home and the home's fair market value.

Regardless of whether the debtor is an accrual-basis or cash basis taxpayer, any loss resulting from the foreclosure is treated as occurring when the foreclosure (or transfer in lieu of foreclosure) takes place.[30] If the debtor exercises the right to redeem and recovers possession of the property, no gain or loss is realized.[31] Also, if state law provides for redemption rights, the debtor may avoid postponement of any foreclosure gain or loss by quitclaiming the redemption rights.[32]

If the fair market value of the foreclosed property is less than the outstanding mortgage and the mortgagee releases the mortgagor from his obligation to pay the deficiency, any CODI which the mortgagor realizes is reported in the year the mortgagee provides the release.

Tax consequences to the mortgagee

In general

A mortgagee may face two possible tax impacts when property is foreclosed. First, assuming the mortgage is a bad debt, the mortgagee may have a bad debt deduction in the year of foreclosure on the outstanding portion of the mortgage,[33] and can take a partial bad debt deduction if the mortgage is partially worthless and the mortgagee charges off the worthless portion.[34] Second, the mortgagee may recognize gain or loss on the final disposition of the property.

To the extent that amounts received from a foreclosure sale of mortgaged property to a third party exceed the mortgagee's total claim, (including all costs associated with the foreclosure), the excess is normally paid to the mortgagor. So, it is unusual for a mortgagee to realize a gain from a foreclosure sale.[35] However, the mortgagee could experience gain if the mortgagee originally purchased the mortgage debt at a discount or had previously taken a partial bad debt deduction which reduced the mortgagee's basis in the loan.

Nonrecourse debt

In the case of a nonrecourse mortgage where the mortgagee purchases the mortgaged property in a foreclosure sale, the mortgagee has a taxable gain or loss to the extent of the difference between the bid price[36] and the mortgagee's basis in the mortgage.[37]

Recourse debt

If the mortgagee purchases mortgaged property in a foreclosure sale, and the mortgage is recourse, the mortgagee has the right to try to recover the deficiency from the mortgagor. Since recovery on a deficiency judgment would make the mortgagee whole, any loss which the mortgagee might have can only be taken in the foreclosure year if it can be shown in that year that the deficiency is uncollectible.[38] Otherwise, the mortgagee subtracts the foreclosure recovery from its original debt basis to determine its basis in the deficiency. The mortgagee then defers reporting gain or loss until the collectibility (or uncollectibility) of the deficiency is determined.[39] Accrued interest may be included as part of the deduction allowable with respect to a mortgage foreclosure, but only if the interest has been reported as income.[40]

Handling expenses of foreclosures and repossessions

Court costs, legal fees, and other foreclosure costs related to property sold at foreclosure reduce the proceeds that the mortgagee receives. Any expenses and liens the mortgagee pays to protect the mortgaged property before the foreclosure sale will be added either to the mortgagee's basis for the loan or to its basis for the acquired property, depending upon when they are paid. Amounts paid *before* foreclosure are added to the mortgagee's loan basis, while outlays *during* the foreclosure proceedings are added to the mortgagee's property basis or to the deficiency judgment if the mortgagee does not acquire the property.[41]

A foreclosure by a prior lien holder generally eliminates a mortgagee as a secured creditor, but any resulting loss is not deductible by the mortgagee until the junior note (previously secured by the foreclosed property) is proven to be worthless.[42]

Alternatives to foreclosure

In any given situation, there may be some alternatives to foreclosure that can be utilized that may, depending on the circumstances, have a better tax consequence.

Restructuring the debt

It may be mutually beneficial for the parties to restructure the debt. A substitution of a new debt instrument in satisfaction of outstanding indebtedness is treated as satisfaction of the outstanding indebtedness for an amount equal to the issue price of the new debt instrument.[43] That may trigger CODI for the debtor equal to the difference between the new debt instrument's issue price and the adjusted issue price of the old debt instrument. Alternatively, if the debt is actually cancelled, the debtor may realize

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Tax issues/ cont. from p. 5
ordinary income to the extent of the discharge.

Modifications of the indebtedness

Other restructuring alternatives may include an extension of the mortgage term, waiver of current debt service payments, and addition of unpaid interest to the principal balance of the mortgage. If the modification is not material, these types of adjustments have historically been treated as nonrecognition events.[44] But, the U.S. Supreme Court has created a rather low threshold in determining whether a modification of terms of an outstanding debt obligation is material enough to be treated as a deemed exchange of old debt for new debt with resulting tax consequences.[45] Likewise, the regulations specify that there is a realization event if there is a ''modification'' in the debt instrument which is a ''significant modification.''[46] Most temporary forbearances of a mortgagor's failure to perform are not considered significant modifications and, therefore, do not result in a realization event.[47]

The bottom line is that the restructuring of an existing loan by entering into a loan modification agreement may cause the lender to be treated as having disposed of the original mortgage, and the borrower may have CODI if the principal amount of the old loan exceeds the principal amount of the new one. The modification may also trigger the original issue discount rules that would treat a portion of the new debt principal as imputed interest. If the principal of the old debt is greater than the imputed principal of the new debt, a solvent borrower generally realizes CODI.[48]

Installment sale

Installment sale reporting may be used to defer recognition of a part of the gain until the installment payments are collected in the future. But, the major limitation is that any excess of the mortgage balance over the adjusted basis of the property is treated as payment received in the year of sale.

Like-kind exchanges

Like-kind exchanges may be used as an alternative to foreclosure.[49] However, it may be difficult to find property suitable for exchange. In addition, the debtor's property typically has a relatively high outstanding mortgage balance, along with a low equity value. So, the debtor would have to include some cash along with the property in the trade and trade up to a higher-value property. That may not be possible.

Constructive receipt issues in debt restructurings

Constructive receipt of income may occur when a mortgage or other debt is extended or restructured. Constructive receipt of income occurs when the taxpayer has an unrestricted right to receive the income, is able to collect it, and the failure to do so results from the exercise of the taxpayer's own choice.[50] If the debtor is unable to pay a mortgage note when due, the mortgagee has not constructively received income. If, however, a note is extended or restructured as an accommodation to a debtor who is otherwise able to pay, constructive receipt of the entire principal due may occur on the due date of the note.[51] To avoid constructive receipt in this situation, any extension or superseding agreement with respect to the loan must be agreed to before the existing mortgage note or loan becomes due.[52]

Proposed legislation

Legislation has been proposed that would exclude CODI from gross income that is triggered by the discharge (after December 31, 2006) of "qualified principal residence indebtedness."[53] The House bill, which would permanently exclude CODI from gross income, passed by a wide margin on October 4, 2007.[54] Under the bill, "qualified principal residence indebtedness" is defined as acquisition indebtedness (as defined by I.R.C. §163(h)(3)(B), but without regard to any dollar limitation) with respect to the debtor's principal residence (as defined for purposes of I.R.C. §121).[55] The debtor's basis in the residence would be reduced by the amount excluded from income. Also, the exclusion would not apply to debtors in bankruptcy, but it would apply to insolvent debtors unless the debtor elects to have the exclusion for insolvent debtors apply. But, the exclusion would not apply to the discharge of a loan if the discharge is on account of services performed for the lender.

The legislation would also extend the existing deduction for private mortgage insurance to amounts paid or accrued after 2007, but only with respect to contracts entered into after 2006 and before 2015.[56]

To pay for the new tax break, beginning in 2008, the legislation limits the existing I.R.C. §121 exclusion for gain attributable to the sale of a principal residence to only those periods during which the taxpayer actually used the residence as the taxpayer's principal residence.[57]

Policy implications of the proposed legislation

Completely eliminating the tax on CODI attributable to a debtor's principal residence is not the correct policy approach. The value of the cancelled mortgage is a beneficial gain to the former borrower which should be subject to tax–it is an accession to wealth. Thus, complete elimination of the tax on CODI amounts to a windfall (at taxpayer expense) for debtors who, in many respects, made poor economic decisions.[58] Existing tax law already provides an incentive for homebuyers to borrow too much for mortgage indebtedness, and making mortgage debt tax free would only further increase that incentive.[59] Perhaps a better approach would be to tax CODI at long-term capital gain rates rather than ordinary income rates. When a lender cancels a mortgage debt, the lender suffers a capital loss. It logically follows that the borrower has received a capital gain and should be taxed accordingly.[60]

From a broader perspective, requiring loan applicants to undergo an approval process based on genuine ability to pay might go a long way to avoiding a similar problem in the future.[61]

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[1] Also involved are homeowners who borrowed against the perceived equity in their residence (often via 125 percent home equity loans and adjustable rate mortgages that are contractually beginning to adjust the interest upward) to buy consumable, non-necessary goods – in effect, attempting to "monetize" their home through borrowing (or repay unsecured credit card obligations). Likewise, some lenders were overly eager to extend credit at relatively higher interest rates to people with not-so-good creditworthiness (so-called "subprime loans"), and borrowers who bought properties to "fix and flip" on the expectation that the real estate market would only continue to go up

[2] IRS News Release 2007-159 (Sept. 17, 2007).

[3] I.R.C. §61(a).

[4] I.R.C. §61(a)(12). Under I.R.C. §1001(a), gain realized from the sale of property equals the excess of the amount realized over the taxpayer's adjusted income tax basis in the property. The amount realized from the 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.

[5] *See Comm'r v. Tufts*, 461 U.S. 300 (1983), *rev'g, sub. nom., Tufts v. Comm'r*, 651 F.2d 1058 (5th cir. 1981); *Helvering v. Hammel*, 311 U.S. 504 (1941).

[6] One significant difference between nonrecourse and recourse mortgages is that, with a nonrecourse mortgage, the amount realized on foreclosure, or a transfer in lieu of foreclosure, is never less than the outstanding debt. I.R.C. §7701(g). Thus, the debt is not treated as ''canceled'' and the debtor does not have CODI.

[7] *See, e.g., Emmons v. Comm'r, T.C. Memo*. 1998-173.

[8] Treas. Reg. §1.1001-2(a)(1).

[9] For recourse debt, the amount realized generally cannot exceed the fair market value of the property. Rev. Rul. 90-16, 1990-1 C.B. 12; Treas Reg. § 1.1001-2(c). This limitation applies even if the amount bid at the foreclosure sale exceeds the property's fair market value. *Frazier v. Comm'r*, 111 T.C. 243 (1998).

[10] Treas. Reg. §1.61-12. That amount is reported to the taxpayer on Form 1099-C, Box 7.

[11] *See Community Bank v. Comm'r*, 819 F.2d 940 (9th Cir. 1987), *aff'g*, 79 T.C. 789 (1982); *Frazier v. Comm'r*, 111 T.C. 243 (1998);

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Maracaccio v. Comm'r, T.C. Memo. 1995-174.

[12] *See, e.g., Frazier v. Comm'r*, 111 T.C. 243 (1998).

[13] One of the IRS FAQs suggests that taxpayers who do not agree with the information on a Form 1099-C should contact the creditor and have the creditor issue a corrected form if the information is incorrect.

[14] I.R.C. §121(b)(1)-(2).

[15] I.R.C. §121(a).

[16] While IRS has liberally interpreted "unforeseen circumstances" in recent years, a drop in market value of a home would likely not meet the test, and neither would readjustment of the interest rate of an adjustable rate mortgage.

[17] I.R.C. §61(a)(12).

[18] The amount of CODI that is not taxable is claimed on IRS Form 982 (Reduction of Tax Attibutes Due to Discharge of Indebtedness) by checking the box at Line 1(b) in Part I and indicating the amount of debt forgiveness that is exempt from federal income tax on Line 2. Form 982 must be attached to the taxpayer's Form 1040 for the year in which the debt is cancelled.

[19] I.R.C. §108(a)(1)(B). But, insolvent debtors must reduce tax attributes and reduce the income tax basis of property. *See* I.R.C. §108(b).

[20] Priv. Ltr. Rul. 199932013 (May 4, 1999), *revoking*, Priv. Ltr. Rul. 9125010 (Mar. 19, 1991); Tech. Adv. Memo. 199935002 (May 3, 1999).

[21] *Carlson v. Comm'r*, 116 T.C. No. 9 (2001).

[22] *See, e.g.,* I.R.C. §§108(a)(1)(A).

[23] It is noted, however, that under The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub. L. 109-8, 119 Stat. 23, it is more difficult for individuals to file bankruptcy than under pre-BAPCPA law.

[24] The "short sale" technique refers to a technique that has arisen out of the current mortgage foreclosure climate and is a new use of the term – it does not refer to the Internal Revenue Code definition of the term. Under the Code, a "short sale" involves the sale of a borrowed item to be replaced at a future date, usually a security. IRS has never applied the term "short sale" to a real estate sale transaction.

[25] Rev. Rul. 92-99, 1992-2 C.B. 35. *See also*, Treas. Reg. §1.1001-2(a)(2).

[26] In addition, it is questionable whether the lender would consent to the transaction and, in fact, forgive the debt.

[27] *2925 Briarpark Ltd. v. Comm'r*, 163 F.3d 313 (5th Cir. 1999), *aff'g*, T.C. Memo. 1997-298.

[28] The fair market value of the property is disregarded for a non-recourse mortgage.

[29] The loss incurred is deductible only if the mortgage indebtedness was incurred in connection with property either held for investment or used in the debtor's trade or business. But, if the foreclosure proceeds are used to pay outstanding interest or property tax obligations, they will typically be deductible. *See, e.g., Malmstedt v. Comm'r*, 578 F.2d 520 (4th Cir. 1978).

[30] *Lamm v. Comm'r*, 873 F.2d 194 (8th Cir. 1989). That is also the case if the debtor has a right of redemption under state law. *See, e.g., Securities Mortgage Co. v. Comm'r*, 58 T.C. 667 (1972); *William C Heinemann & Co. v. Comm'r*, 40 B.T.A. 1090 (1939). But, IRS has taken the position that if the debtor has a statutory right to reaquire the property following foreclosure (i.e., redemption), the debtor's ability to deduct a loss is postponed until the right of redemption expires. Rev. Rul. 70-63, 1970-1 C.B. 36. However, if the foreclosure matter is in litigation, the year in which the litigation terminates is the year in which tax items are taken into account. *Great Plains Gasification Associates, et al. v. Comm'r*, T.C. Memo. 2006-276.

[31] *Hotz v. Comm'r*, 42 B.T.A. 432 (1940).

[32] *Atmore Realty Co. v. Comm'r*, B.T.A. Memo. 1942-248 (1948).

[3]3 I.R.C. §166(a). *See, e.g., Comm'r v. Spreckels*, 120 F.2d 517 (9th Cir. 1941). If the mortgage is a nonbusiness bad debt, subject to I.R.C. §166(d), the loss is a short-term capital loss.

[34] *See* generally I.R.C. §166(a)(2) and Treas. Reg. §1.166-3.

[35] A loss may be recognized for tax purposes in the year of foreclosure, even though the mortgagor has a right of redemption. *See Securities Mortgage Co. v. Comm'r*, 58 T.C. 667 (1972); *William C Heinemann & Co. v. Comm'r*, 40 B.T.A. 1090 (1939).

[36] The bid price usually is presumed to the the fair market value of the property. *See, e.g., Community Bank v. Comm'r*, 62 T.C. 503 (1974), acq., 1975-2 C.B. (presumption upheld even where IRS claimed that bid price less than fair market value). *See also* Treas. Reg. §1.166-6(b)(2). But, the presumption does not apply when the mortgagee is the seller and is also the party foreclosing on the property. I.R.C. §1038 provides that when the seller/mortgagee repossesses property in satisfaction of the indebtedness, no loss is recognized and, under certain circumstances, gain may be recognized.

[37] The result is the same with a recourse mortgage if the bid price equals or exceeds the outstanding debt. The mortgagee's basis is determined by subtracting principal paid from the loan's face amount. I.R.C. §166(b); Treas. Reg. §1.166-1(d).

[38] Treas. Reg. §§ 1.166-6(a); 1.165-5(e). See also *Estate of Jewett v. Comm'r*, T.C. Memo. 1949-163 (1949); *Havemeyer v. Comm'r*, 45 B.T.A. 329 (1941), *acq* 1942-1 CB 8.

[39] *See* Treas. Reg. §1.166-6(a)(1).

[40] Treas. Reg. §1.166-6(a)(2); *Federal Home Loan Mortgage Corporation v. Comm'r*, 121 T.C. 279 (2003) (in computing gain or loss from a mortgage foreclosure, taxpayer cannot increase adjusted cost basis in the mortgage by interest that accrued while taxpayer was tax-exempt).

[41] *But see Heger v. Comm'r*, T.C. Memo. 1993-408, *aff'd*, 35 F.3d 561 (5th Cir. 1994), where payments made to avoid foreclosure were *not* allowed to be added to basis.

[42] *Berenson v. Comm'r*, 39 B.T.A. 77 (1939), *aff'd* 113 F.2d 113 (2d Cir. 1940).

[43] I.R.C. §108(e)(10).

[44] Rev. Rul. 73-160, 1973-1 C.B. 365 (extension of maturity date of notes not a taxable transaction); *Soter v. Comm'r*, T.C. Memo. 1968-43; Rev. Rul. 68-419, 1968-2 C.B. 196 (modification of purchaser's note to defer principal payment dates and increase interest rate not disposition or satisfaction of an installment obligation); Rev. Rul. 55-429, 1955-2 C.B. 252.

[45] *Cottage Savings Assoc. v. Comm'r*, 499 U.S. 554 (1991), *rev'g and rem'g*, 890 F.2d 848 (6th Cir. 1989).

[46] Treas. Reg. §1.1001-3. For this purpose, a modification is ''any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.'' Treas. Reg. §1.1001-3(c)(1).

[47] *See* Treas. Reg. §1.1001-3(c)(4)(ii), providing that a forbearance of under two years (and sometimes longer) is temporary for these purposes.

[48] I.R.C. §108(e)(11).

[49] I.R.C. §1031.

[50] Treas. Reg. §1.451-2(a); *Saint Claire Corp. v. Comm'r*, T.C. Memo. 1997-171.

[51] This type of situation is likely to occur when real property is sold to related parties, to controlled entities, or to parties who are well-known to the seller.

[52] *Martin v. Comm'r*, 96 T.C. 814 (1991); *Oates v. Comm'r*, 18 T.C. 570 (1952), *aff'd*, 207 F.2d 711 (7th Cir 1953); *Saint Claire Corp. v. Comm'r*, T.C. Memo. 1997-171 (constructive receipt of entire remaining principal occurred when mortgage note was extended on the date it became due and obligor was otherwise able to pay).

[53] *See* S. 1394, "The Mortgage Cancellation Relief Act of 2007," introduced May 15, 2007, and H.R. 3648, "The Mortgage Forgiveness Debt Relief Act of 2007," introduced on September 25, 2007, and passed by the House on October 4, 2007.

[54] H.R. 3648 passed by a vote of 386-27. If the legislation is being enacted to address the current situation in the mortgage and housing industries, a question is raised as to why the House deemed it necessary to craft permanent relief.

[55] Thus, loans for purchasing and improving a residence would qualify, but equity loans would not.

[56] This relief would apply (at least partially) to taxpayers with adjusted gross income of less than $55,000 (single return) or $110,000 (joint return).

[57] Thus, the I.R.C. §121 exclusion of gain attributable to the sale of a rental or vacation property would be reduced beginning in 2008. So, even if the legislation passes, the reduction in the exclusion would only be for "nonqualified" use after 2007. That would give taxpayers the remainder of 2007 to move into a vacation home or rental property, live there for the minimum two-year period, and qualify for the full exclusion.

[58] On October 3, 2007, the Administration, while expressing support for H.R. 3648, also urged lawmakers to narrow the scope of the bill. Such narrowing, the Administration noted, should be in the form of temporary relief and should not put in place tax policy that would influence future borrowing behavior.

[59] A related economic effect of increased debt financing would be an increase in the market price of new and existing homes.

[60] It is noted that the alternative minimum tax (AMT) may be imposed on the portion of capital gains that is excluded from income. Thus, reclassifying CODI as capital gain income which is then excluded under I.R.C. § 108 could create an AMT preference item. The Congress, from a policy perspective, would have to consider whether an amendment to the AMT statute would be in order.

[61] Clearly, there is a need for additional emphasis on education concerning financial matters. To this end, the Bush administration announced on August 31, 2007, that it would create a Presidential Council on Financial Literacy to help raise awareness of the financial issues surrounding home buying and financing.

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