The Connection

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Short Sale and Debt Forgiveness Are One Transaction

In *K.F. Simonsen* (150 TC No. 8, Dec. 61,134 (2018)), the Tax Court concluded that taxpayers' short sale of their principal residence converted to a rental property and the bank's forgiveness of a nonrecourse mortgage were all part of one sale or exchange rather than two separate transactions. The amount realized was greater than the taxpayers' loss basis in the property under Reg. §1.165-9(b)(2) but less than the taxpayers' gain basis in the property under that regulation. When property is sold for an amount between those bases, there is neither a gain nor a loss on the sale. Therefore, the court concluded that the amount realized included the discharged nonrecourse debt but that there was no cancelation of indebtedness income.

Facts

The taxpayers, Karl and Christina Simonsen, purchased a home in 2005 with nonrecourse financing. Five years later, they moved out and converted the home to a rental property. One year later, with a mortgage debt much greater than the value of the home, they were unable to keep up with their loan payments. Therefore, they negotiated a short sale of the rental property, and the bank forgave the remaining loan balance.

In January 2012, the bank sent the Simonsens a Form 1099-C, *Cancellation of Debt*, showing that the bank canceled the Simonsens' debt on Nov. 21, 2011. The Simonsens also received a Form 1099-S, *Proceeds from Real Estate Transactions*, which reported the sale proceeds.

Tax Return Treatment

On their 2011 tax return, the Simonsens claimed that the sale and consequent debt forgiveness were two separate transactions resulting in both a substantial deductible loss and excludable cancelation-of-indebtedness (COI) income. They took the position that the COI was not taxable because of Code Sec. 108(a)(1)(E), which provides an income exclusion for discharged "qualified principal residence indebtedness."

IRS Challenge

The IRS audited the return and disagreed with the taxpayers' treatment of the transaction. The IRS found that the short sale and debt forgiveness were part of one sale or exchange, and the amount realized included the discharged debt. According to the IRS, the short sale did not generate a deductible loss, and there was no COI income to exclude from the taxpayers' income.

Legal Background

In a short sale of real property, the borrower sells the home to a third party for an amount that falls short of the outstanding loan balance, the lender agrees to release its lien on the property to facilitate the sale, and the borrower agrees to give all the proceeds to the lender. When a taxpayer's obligation to repay a nonrecourse mortgage is extinguished, he or she includes the amount of the extinguished debt in his or her amount realized under Code Sec. 1001(b) (Reg. §1.1001-2(a)(1)). Under Reg. §1.165-9(b)(2), a loss on the disposition of rental property that had previously been the seller's personal residence is computed using an adjusted basis that is the lesser of the taxpayer's existing adjusted basis or the property's fair market value at the time of conversion to rental property. The taxpayer's adjusted basis is generally his or her cost basis in the property (Code Sec. 1012(a)).

Court's Analysis and Conclusion

The Tax Court relied on similar facts found in *2925 Briarpark, Ltd.* (CA-5, 99-1 ustc ¶50,209, 163 F3d 313) to agree with the IRS. In that case, a partnership owed a bank more than $25 million of nonrecourse debt secured by a property worth only about $10 million. The partnership defaulted on the loan but found someone to buy the property for less than the outstanding debt (short sale) so long as the bank forgave the rest. The Fifth Circuit found that the sale and the debt discharge were one transaction.

The court reasoned that the sale of the property, the transfer of cash and the assignment of the sale proceeds had the same practical effect as several other transactions which have been held to be a sale or exchange, including foreclosures, repossessions and abandonments. The court noted that a short sale "is the functional equivalent of a foreclosure, reconveyance in lieu of foreclosure, abandonment or repossession," and any differences are in form, not substance. The court therefore found that the sale and the debt discharge were one sale or exchange for purposes of Code Sec. 1001 because, like those other transactions, the loans were discharged as a result of a single transaction involving the sale of encumbered property.

Relevant to the court's analysis was determining the amount realized from the sale of property and the taxpayer's adjusted basis in the property, because there would only be a loss if the amount realized was less than the Simonsens' adjusted basis.

Code Sec. 1001(b) defines amount realized from the sale of property as "the sum of any money received plus the fair market value of the property (other than money) received." When there is debt, the general rule is "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" (Reg. §1.1001-2(a)(1)). Additionally, "the sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability."

Because the amount realized was nonrecourse debt, the court found that the amount realized on the sale of property included the full amount of the debt. In computing the amount of gain or loss on the sale, the court was faced with a dilemma. The taxpayers realized $555,960, which fell between the basis that would be used to calculate a loss under Reg. §1.165-9(b)(2) ($495,000, the fair market value when the residence was converted to a rental property) and the basis to calculate a gain (the $695,000 adjusted basis of the property). Thus, using the basis for calculating a loss would result in a gain, but using the basis for calculating a gain would result in a loss. As a result, the court turned to the gift tax rules, under which a donee uses the lower fair market value to compute a loss but the donor's basis to compute a gain. If a donee sells the gift at a price between these two possible bases, Reg. §1.1015-1(a)(2) provides that there is no gain or loss on sale of the gift. The court therefore concluded that the Simonsens realized neither a gain nor a loss on the short sale of their home.

The court further found that the amount realized was greater than the taxpayers' loss basis in the property under Reg. §1.165-9(b)(2) but less than the taxpayers' gain basis in the property under that regulation. The court concluded that when the taxpayers' property was sold for an amount between those bases, there was neither a gain nor a loss on the short sale. ◆

Trust's Charitable Deduction Limited to Property's Adjusted Basis

In *M.D. Green* (CA-10, 2018-1 ustc ¶50,126, 880 F3d 519, *rev'g* DC Okla., 2015-2 ustc ¶50,549), the Court of Appeals for the 10th Circuit reversed a decision from a federal district court in Oklahoma to hold that a charitable trust's deduction for its donation of real property must be limited to its adjusted basis in the donated properties rather than the fair market value of the property. The court reasoned that because the trust never sold or exchanged the property, the trust never realized or paid taxes on the gains associated with the increase in their fair market value.

Charitable Contributions of Trust

In 1993, David M. Green, Barbara A. Green and Mart D. Green created The David and Barbara Green 1993 Dynasty Trust (GDT). In 2003, the trust's wholly owned limited liability company made three separate purchases of land and buildings. The purchases were made with distributions from a partnership in which the trust was a 99% limited partner. In 2004, GDT donated the purchases to three charitable organizations. In each case, the fair market value (FMV) of the donated property exceeded the property's adjusted basis.

Tax Return Treatment

On the trust's 2004 tax return, the trust claimed a charitable deduction of more than $20 million. On an amended return, the trust increased the charitable deduction to about $30 million, the FMV of the donated property, and claimed a refund from the IRS. The trustee contended that the trust's charitable deduction under Code Sec. 642(c)(1) for donated real property should be calculated based on the property's FMV. The trustee argued that the FMV standard should apply to the charitable deduction because Congress did not specify a different valuation standard in Code Sec. 642(c)(1).

IRS Challenge

The IRS disallowed the refund claim based on the theory that the trust's charitable contribution deduction for donated real property should have been limited to the basis of the real property contributed.

Legal Background

Code Sec. 642(c)(1) provides that a trust's calculation of taxable income may deduct any amount of the gross income paid during the tax year for a charitable purpose under the terms of the governing instrument. However, Code Sec. 642(c)(1) is unclear on the question of the amount that a trust may claim as a charitable deduction because the statute does not provide a specific valuation standard.

District Court's Decision

The district court concluded the trust could deduct the appreciated value of properties donated to various charitable organizations under the plain language of Code Sec. 642(c)(1). The court found that Code Sec. 642(c)(1) authorized the trust's charitable deduction without limitation, and that the FMV was the appropriate valuation standard for the donated properties.

> "In each case, the fair market value (FMV) of the donated property exceeded the property's adjusted basis."

Tenth Circuit Analysis and Holding

The Court of Appeals for the 10th Circuit reversed the district court holding that the trust's deduction was limited to the adjusted bases of the donated properties. The court explained that the central question in the case was the authorized amount of a trust charitable deduction under Code Sec. 642(c)(1). The court explained that the answer to that question can be found in the statutory phrase "any amount of the gross income." After extensive analysis, the court concluded that the statutory phrase as employed in Code Sec. 642(c)(1) was ambiguous. Nevertheless, the court found that the term "any amount of the gross income" limited the deduction to the trust's adjusted basis or the amount of gross income that the trust originally paid for the properties. ◆

IRS Releases Guidance on Nondeductible Fines and Penalties

The Tax Cuts and Jobs Act (TCJA) increased the number of nondeductible fines and penalties under Code Sec. 162(f). The TCJA also added Code Sec. 6050X, which generally requires government officials to report to the IRS, and each party to a settlement, the amount and nature of any payments over $600. The IRS has recently announced that it intends to publish proposed regulations under both Code Secs. 162(f) and 6050X (Notice 2018-23, 2018-15 IRB 474).

Tax Treatment of Fines and Penalties

Fines and penalties paid or incurred after Dec. 21, 2017, except under any binding order agreement entered into before Dec. 22, 2017, are not deductible as business expenses if paid or incurred to, or at the direction of, any federal, state or foreign government or governmental entity due to the violation of a law or investigation into potential violation of a law (Code Sec. 162(f)(1)).

> "For the restitution or compliance exceptions to apply, the payment must be identified as restitution or compliance in a court order or settlement agreement."

Exceptions to this rule include:

- Amounts paid that constitute restitution (including the remediation of property) for damages due to the violation (or potential violation) of a law (Code Sec. 162(f)(2)(A)(i)(I))
- Amounts paid to attain compliance with a violated law, or the inquiry into potential violation of a law (Code Sec. 162(f)(2)(A)(i)(II))
- Amounts paid to satisfy a court order where the government is not a party (Code Sec. 162(f)(3))
- Amounts paid for taxes due (Code Sec. 162(f)(4))

For the restitution or compliance exceptions to apply, the payment must be identified as restitution or compliance in a court order or settlement agreement. In addition, restitution for the failure to pay a tax is deductible only to the extent that deduction for the tax would have been allowable if it had been paid on time (Code Sec. 162(f)(2)(A)(ii) and (iii)).

Reporting Requirements

The officer or employee who has control over the suit or agreement, or the individual designated by the government or entity, must file a return with the IRS (Code Sec. 6050X(a) and (c)). This return must state:

- The total amount to be paid due to the suit or agreement
- Any amount to be paid for restitution or remediation of property
- Any amount to be paid for compliance (Code Sec. 6050X(a)(1))

The return must be filed at the time the agreement is entered into (Code Sec. 6050X(a)(3)).

The individual filing the return must also simultaneously provide a statement to each person or entity that is a party to the suit or agreement. The statement must provide the name of the government or entity and the information included in the return that the individual filed with the IRS (Code Sec. 6050X(b)).

These changes generally apply to amounts paid or incurred on or after Dec. 22, 2017, except that they will not apply to amounts paid or incurred under any binding order or agreement entered into before Dec. 22, 2017. ◆

Significant Individual Extender Provisions

The Bipartisan Budget Act of 2018 contains numerous tax-related measures, including the retroactive extension of over 30 expiring tax provisions through the 2017 tax year.

Exclusion for Discharged Home Mortgage Debt

In tax years prior to Jan. 1, 2017, taxpayers could exclude from gross income up to $2 million ($1 million for married individuals filing separately) any discharge of indebtedness income received from qualified principal residence debt. The Budget Act extends this exclusion for one year so that it applies to home mortgage debt discharged before Jan. 1, 2018 (Code Sec. 108(a)(1)(E)).

Mortgage Insurance Premiums as Deductible Qualified Residence Interest

Prior to the Budget Act, mortgage insurance premiums paid or accrued before Jan. 1, 2017, in connection with acquisition indebtedness regarding the taxpayer's qualified residence were treated as deductible qualified residence interest, subject to a phase-out based on the taxpayer's adjusted gross income (AGI). The amount allowable as a deduction was phased out ratably by 10% for each $1,000 by which the taxpayer's AGI exceeded $100,000 ($500 and $50,000, respectively, in the case of a married individual filing a separate return). Thus, the deduction was not allowed if the taxpayer's AGI exceeded $110,000 ($55,000 in the case of a married individual filing a separate return).

Effective for amounts paid or accrued after Dec. 31, 2016, the Budget Act retroactively extends this provision for one year so that a taxpayer can deduct, as qualified residence interest, mortgage insurance premiums paid or accrued before Jan. 1, 2018 (and not properly allocable to any period after 2017) (Code Sec. 163(h)(3)(E)(iv)).

Above-the-line Deduction for Higher Education Expenses

Eligible individuals could, for tax years beginning before Jan. 1, 2017, deduct higher education expenses (qualified tuition and related expenses of the taxpayer, his or her spouse, or dependents) as an adjustment to gross income to arrive at AGI. The maximum deduction was $4,000 for an individual whose AGI for the tax year did not exceed $65,000 ($130,000 in the case of a joint return), or $2,000 for individuals who did not meet the above AGI limit, but whose AGI did not exceed $80,000 ($160,000 in the case of a joint return). No deduction was allowed for an individual whose AGI exceeded the relevant limitations, for a married individual who did not file a joint return or for an individual for whom a personal exemption deduction could have been claimed by another taxpayer for the tax year.

Effective for tax years beginning after Dec. 31, 2016, the Budget Act retroactively extends through 2017 the above-the-line deduction for qualified tuition and related expenses for higher education (Code Sec. 222(e)). ◆

Employers without SHOP Marketplace Plans Receive Health Insurance Credit Relief

The IRS has provided guidance which allows certain small employers to claim the small business health care tax credit under Code Sec. 45R in situations where no Small Business Health Options Program (SHOP) marketplace plans are offered in the employer's county (Notice 2018-27, IR-2018-108). Although the credit requires that the employer offer qualified health plans through the SHOP marketplace, numerous counties no longer provide SHOP marketplace plans.

This relief is only available to employers that properly claimed a credit for all or part of the 2016 tax year, or that properly claim the credit for all or part of a later tax year, but are unable to offer employees a qualified SHOP exchange health plan for all or part of the remainder of the credit period because the employer's principal business address is in a county in which a qualified SHOP exchange plan is not available.

Small employers may only claim the credit for two consecutive years. The relief allows qualifying employers to claim the credit for the period in which there is no available SHOP marketplace coverage if the non-SHOP coverage qualifies for the credit under rules that were applicable before Jan. 1, 2014, when SHOP marketplace plans were generally unavailable. ◆

Penalty Sustained Because No Reasonable Reliance on Professional Advice

In *RB-1 Investment Partners* (Dec. 61,174(M) (May 15, 2018)), a partnership was liable for an accuracy-related penalty because it failed to show it relied in good faith on professional advice.

The partnership participated in a "Son-of-BOSS" deal. The deal manufactured tax losses to offset the partners' gains from the sale of their family concrete business. However, the IRS determined that the partnership was a sham. Therefore, it was liable for an accuracy-related penalty. The partnership argued that the penalty should not apply because it relied in good faith on professional advice.

The Tax Court concluded the partnership had no reasonable reliance on professional advice. It could not rely on the law firm's advice because the law firm was the promoter. Moreover, it knew, or should have known, that the law firm was selling the tax shelter.

The partnership could not rely on the accounting firm, which did not give any advice on the deal. The accounting firm's engagement letter stated that it would rely on the law firm's opinion and guidance when preparing the return. In fact, the partnership filed the return only after the law firm approved it. Therefore, only the law firm provided professional advice and the partnership could not meet the reasonable-cause-and-good-faith defense by relying on the advice of a promoter. ◆

State's Compensation Plan Qualifies as Eligible Deferred Compensation Plan

A nonqualified deferred compensation plan and related trust, adopted by a state for the benefit of its employees or any of its political subdivisions, constitutes an eligible deferred compensation plan as defined in Code Sec. 457(e)(1)(A). Amounts of compensation deferred in accordance with the plan, which include any income attributable to the deferred compensation, are includible under Code Sec. 457(a)(1)(A) in the recipient's gross income for the tax year or years in which amounts are paid to a participant or beneficiary in accordance with the terms of the plan. Further, the trust established as part of the plan meets the requirements of Code Sec. 457(g)(1) and is an organization exempt from tax under Code Sec. 501(a).

Moreover, maintaining an eligible automatic contribution arrangement through the plan does not cause the plan to fail to satisfy Code Secs. 457(b)(4) and 457(d)(1)(A). In addition, the amounts distributed from the plan in an eligible rollover distribution (within the meaning of Code Sec. 402(c)(4)) are not includible in gross income for the tax year in which paid as provided in Code Sec. 457(e)(16). Finally, the deemed IRA under the plan constitutes a valid deemed IRA program in accordance with Code Sec. 408(q), including the provisions related to a deemed Roth IRA (IRS Letter Ruling 201817004). ◆

Building a Team of Professionals to Help Provide Solutions for Our Clients

At Edward Jones, we believe that when it comes to financial matters, the value of professional advice cannot be overestimated. In fact, in most situations we recommend that clients assemble a team of professionals to provide guidance regarding their financial affairs: an attorney, a tax professional and a financial advisor.

We want to work together as a team and offer value for your practice and clients. Using complementary skills and philosophies, we can help save time, money and resources while assisting mutual clients in planning for today's financial and tax challenges.

Tax Harvesting Opportunities for 2018 with Edward Jones

Although Edward Jones cannot provide tax advice, financial advisors can use a team approach to help investors understand the impact of capital gains on their investments and where they may have opportunities for tax harvesting before the end of 2018. Here are three ways tax professionals and Edward Jones financial advisors can help clients plan for capital gains in their investment accounts:

1. Financial advisors can **identify investors who may have substantial gains and losses** before the end of 2018 and, with permission, share this information with their tax professionals.
2. Financial advisors can **identify current holdings** these investors own that may have high capital gains or losses.
3. Financial advisors and tax professionals can use a team approach to **share tax harvesting opportunities** with these investors.

To learn more about working together to inform mutual clients about tax harvesting opportunities, contact an Edward Jones financial advisor today. ◆