Section 121.—Exclusion of gain from sale of principal residence

26 CFR 1.121-1: Exclusion of gain from sale or exchange of a principal residence.
(Also: §§ 61, 165, 691, 1001; 1.61-6, 1.165-1, 1.691(a)-1, 1.1001-1.)

Rev. Rul. 2014-2

ISSUES

1. If a taxpayer receives a payment pursuant to the National Mortgage Settlement due to the foreclosure of the taxpayer's principal residence ("NMS Payment"), what is the proper tax characterization of the payment?

2. If the NMS Payment is characterized as part of the amount realized on the foreclosure and if that characterization creates or increases a gain on the foreclosure of the principal residence, are there grounds for the taxpayer to exclude from gross income some or all of that gain?

3. If the property for which a taxpayer receives an NMS Payment contained one or more additional dwelling units that were not used as the taxpayer's principal residence, how should the NMS Payment be allocated between the portion of the property that the taxpayer used as a principal residence and the rest of the property?

4. If a borrower who was eligible for an NMS Payment died before receiving it, what is the tax treatment of the person who receives that payment?

BACKGROUND

In 2012, the United States government and the attorneys general of 49 states and the District of Columbia entered into settlement agreements with five bank mortgage servicers to address mortgage loan servicing and foreclosure abuses ("National Mortgage Settlement").[1] One component of the National Mortgage Settlement is the Borrower Payment Fund (Fund), which the parties intend to be structured as a qualified settlement fund under § 1.468B-1 of the Income Tax Regulations. The terms of the settlement agreements provide that:

(1) The five mortgage servicers collectively will pay approximately $1.5 billion into the Fund.

(2) The Fund will make NMS Payments to certain borrowers who lost their principal residences in foreclosure on or after January 1, 2008, and on or before December 31, 2011.

(3) Each borrower's transaction must meet the following requirements for the borrower to receive an NMS Payment:[2]

   (i) The borrower's first-lien mortgage loan was secured by a one-to-four-unit residential property that the borrower had indicated at the time of loan origination was to be used as the borrower's principal residence;

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[1] Oklahoma did not join in the National Mortgage Settlement, and borrowers in Oklahoma are not eligible for its direct relief measures to borrowers. Borrowers with property in Puerto Rico and other American territories also are not eligible.

[2] The servicers provided lists of loans that met these five criteria.

(ii) The borrower's mortgage loan was serviced by one of the five bank mortgage servicers;

(iii) The borrower made at least three payments on the first-lien mortgage loan;

(iv) The loan went to foreclosure sale on or after January 1, 2008, and on or before December 31, 2011; and

(v) The unpaid principal balance of the first-lien mortgage loan did not exceed the government sponsored enterprise (GSE) loan limit for the property securing the loan (for example, $729,750 for a one-unit residence).

(4) For each NMS Payment, there must be certification by (or for) the borrower under penalties of perjury that—

(i) The borrower owned and occupied (or intended to own and occupy) the property (or a unit thereof) as his or her principal residence at the time the borrower obtained the mortgage loan;

(ii) The borrower lost the principal residence in foreclosure on or after January 1, 2008, and on or before December 31, 2011; and

(iii) The borrower lost the principal residence in foreclosure because—

(a) The borrower was unable to make payments on the first-lien mortgage loan due to a financial hardship; and/or

(b) The mortgage servicer mishandled the borrower's application for a loan modification or other foreclosure alternative or pursued foreclosure while the application was pending or after it was approved; and/or

(c) The mortgage servicer, foreclosure trustee, or their attorneys made errors in, or leading up to, the foreclosure process.

The NMS Payment for each loan is the same amount (approximately $1,400). (If more than one of the co-borrowers on a loan filed claims, they share a single NMS Payment from the Fund.) A borrower could receive the NMS Payment without having to prove financial harm and without having to release any claims. However, under the terms of the National Mortgage Settlement, the NMS Payment offsets and reduces any other obligation that a servicer has to the borrower to provide compensation or other payments.

The National Mortgage Settlement agreements provide that an NMS Payment is remedial and relates to the reduced proceeds a borrower is deemed to have realized in a foreclosure because of the servicers' allegedly unlawful conduct. The agreements do not consider the NMS Payment to be forgiven debt.

The Fund began making the NMS Payments to eligible borrowers in the summer of 2013.[3] In the case of a deceased eligible borrower, the Fund generally issues payment for the claim in the name of the borrower.[4]

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[3] The National Mortgage Settlement also requires the servicers to make other payments to the federal and state governments. Each state has the option of using a portion of those other funds to increase the amount paid to borrowers from that state who lost their homes in foreclosure. This revenue ruling does not address payments of these additional amounts.

[4] There are two exceptions—

- In the case of the death of one spouse, the NMS payment is made in the sole name of the surviving spouse.

FACTS

*Situation 1—Loss on a single-unit home.* In 2006, Borrower *A* purchased a property for its fair market value of $230,000. *A* financed $200,000 of the purchase price with a recourse first-lien mortgage loan that was secured by the property, and *A* used the property as *A*'s principal residence. During 2011, *A*'s principal residence was foreclosed on when its fair market value was $125,000. The lender subsequently sold the principal residence and applied the proceeds in final satisfaction of the principal balance of the first-lien mortgage loan, which was $185,000. *A*'s adjusted basis in the principal residence at the time of the foreclosure was $230,000. In 2013, *A* received an NMS Payment of $1,400 from the Fund.

*Situation 2—Loss on a multiple-unit home.* The facts are the same as in *Situation 1*, except that the borrower was *B*, and the property has two identical dwelling units. *B* used one unit as a principal residence and leased the other to a third party at fair rental value. *B*'s entire property was foreclosed on and subsequently sold by the lender. *B*'s adjusted basis in the entire property at the time of the foreclosure was $200,000, of which $115,000 was allocable to the portion of the property *B* used as a principal residence. Half of the property's fair market value at the time of the foreclosure ($62,500) was allocable to the portion of the property that *B* used as a principal residence. In 2013, *B* received an NMS Payment of $1,400 from the Fund.

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- If an affidavit, an indemnity agreement, and a death certificate are submitted, the NMS payment is made in the name of the submitter.

*Situation 3—Gain on a multiple-unit home*. The facts are the same as in *Situation 2*, except that the purchase price was $155,000; and, at the time of the foreclosure—

- The property's fair market value was $160,000;
- Half of the property's fair market value ($80,000) was allocable to the portion of the property that *B* used as a principal residence;
- *B*'s adjusted basis in the entire property was $125,000; and
- $77,500 of the total adjusted basis was allocable to the portion of the property that *B* used as a principal residence.

*Situation 4—Gain on a single-unit home.* In 1980, Borrower *C* purchased a property for $155,000. *C* financed $130,000 of the purchase price with a recourse first-lien mortgage loan secured by the property. *C* continuously used the property as *C*'s principal residence. *C* refinanced the mortgage loan for an amount in excess of its outstanding principal balance with a new recourse first-lien mortgage loan secured by the principal residence, and used the proceeds to pay for educational expenses of *C's* children and to purchase a boat for personal use.

In 2009, *C's* principal residence was foreclosed on when its fair market value was $160,000. The lender subsequently sold the principal residence and applied the proceeds in final satisfaction of the principal balance of the new loan, which was $215,000. *C*'s adjusted basis in the principal residence at the time of the foreclosure was $155,000. In 2013, *C* received an NMS Payment of $1,400 from the Fund.

*Situation 5—Single-unit home with gain less than prior depreciation.* In 2000, Borrower *D* purchased a property for $155,000. *D* financed $130,000 of the purchase price with a recourse first-lien mortgage loan secured by the property. *D* used a portion of the principal residence as an office in *D's* business and claimed depreciation deductions of $10,000.

In 2009, *D*'s principal residence was foreclosed on when its fair market value was $149,000. The lender subsequently sold the principal residence and applied the proceeds in final satisfaction of the principal balance of the loan, which was $175,000 due to subsequent refinancings. D's adjusted basis in the principal residence at the time of the foreclosure was $145,000. *D* did not sell any other property during 2009. In 2013, *D* received an NMS Payment of $1,400 from the Fund.

*Situation 6—Single-unit home with gain greater than prior depreciation.* The facts are the same as in Situation 5, except that the fair market value of the property at the time of the foreclosure was $154,500.

*Situation 7—Deceased borrower.* The facts are the same as in Situation 5, except that *D* died before the NMS Payment was made.

LAW AND ANALYSIS

Section 61(a)(3) of the Internal Revenue Code provides that, except as otherwise provided in subtitle A, gross income includes gains derived from dealings in property.

Section 121(a) generally provides, with certain limitations and exceptions, that gross income does not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, the taxpayer has owned and used the property as the taxpayer's principal residence for periods aggregating 2 years or more.

Section 121(d)(6) provides that the exclusion from income under § 121(a) does not apply to that part of the gain from the sale of any property that does not exceed the depreciation adjustments (as defined in § 1250(b)(3)) attributable to the property for periods after May 6, 1997. See § 1.121-1(d) for an example that illustrates this rule.

Section 1.121-1(e)(1) provides that § 121 does not apply to the gain allocable to any portion of the property (separate from the dwelling unit) sold or exchanged for which a taxpayer does not satisfy the use requirement. Thus, if a portion of the property was used for residential purposes and a portion of the property (separate from the dwelling unit) was used for nonresidential purposes, only the gain for the residential portion is excludable under § 121.

Section 1.121-1(e)(3) provides that for purposes of determining the amount of gain allocable to the residential and non-residential portions of the property, the taxpayer must allocate the basis and the amount realized between the residential and the non-residential portions of the property using the same method of allocation that the taxpayer used to determine depreciation adjustments (as defined in § 1250(b)(3)), if applicable.

Under § 1.121-1(e)(1), no allocation of the gain from the sale or exchange of property is required if both the residential and non-residential portions of the property are within the same dwelling unit. However, § 121 does not apply to the gain allocable to the residential portion of the property to the extent provided by § 121(d)(6) and

§ 1.121-1(d). Thus, if the taxpayer's adjusted basis in the dwelling unit reflects any prior depreciation deductions allowed or allowable on the dwelling unit, then the exclusion under § 121 is limited to the gain in excess of the depreciation deductions allowed or allowable. *See* § 1250(b)(3).

Section 165(a) allows as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

For an individual, § 165(c) generally limits the deduction for losses to—

- losses incurred in a trade or business;
- losses incurred in any transaction entered into for profit, though not connected with a trade or business; and
- losses of property not connected with a trade or business or a transaction entered into for profit that arise from fire, storm, shipwreck, or other casualty, or from theft.

Section 691(a)(1) provides that the amount of all items of gross income in respect of a decedent that are not properly includible in respect of the taxable period in which falls the date of the decedent's death or a prior period (including the amount of all items of gross income in respect of a prior decedent, if the right to receive such amount was acquired by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent) shall be included in the gross income, for the taxable year in which received, of—

- the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;

- the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or
- the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

Section 1.691(a)-1(b) provides that the term “income in respect of a decedent” refers to those amounts to which a decedent was entitled as gross income, but which were not properly includible in computing the decedent's taxable income for the taxable year ending with the date of the decedent's death or for a previous taxable year under the method of accounting employed by the decedent.

Section 691(a)(3) provides that the right to receive an amount of income in respect of a decedent shall be treated, in the hands of the estate of the decedent or any person who acquired such right by reason of the death of the decedent, or by bequest, devise, or inheritance from the decedent, as if it had been acquired by the estate or such person in the transaction in which the right to receive the income was originally derived and the amount includible in gross income shall be considered, in the hands of the estate or such person to have the character which it would have had in the hands of the decedent if the decedent had lived and received such income.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in § 1011 for determining gain, and the loss is the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized.

Section 1.1001-1(a) states that the amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received.

Section 1.1001-2(a)(1) generally provides that the amount realized on a sale or disposition of property includes the amount of the liabilities from which the transferor is discharged as a result of the sale or disposition. Under § 1.1001-2(a)(2), however, the amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under § 61(a)(12).

In each situation in this revenue ruling, the borrower incurred recourse debt secured by property used (in whole or in part) as the borrower's principal residence, and the foreclosure of the property resulted in final satisfaction of the outstanding balance of the recourse debt. Thus, under § 1001 and its regulations, the amount realized by each borrower on the disposition of the property in the foreclosure equals the fair market value of the property.[5]

To determine the federal income tax treatment of a settlement payment, "the test is not whether the action was one in tort or contract, but rather the question to be asked is 'In lieu of what were the damages awarded?'" *See Raytheon Production Corp. v.*

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[5] This revenue ruling addresses recourse mortgage loans. If the borrower's mortgage loan was a nonrecourse loan, the debt that was discharged in the foreclosure would be included in the borrower's amount realized from the disposition of the property. Regardless of whether the mortgage loan was recourse or nonrecourse, the NMS Payment is an additional amount realized from the foreclosure.

*Commissioner*, 144 F.2d 110, 113 (1st Cir. 1944), *aff'g* 1 T.C. 952 (1943). Here, as reflected in the settlement documents, the NMS Payment from the Fund is an additional amount realized on the foreclosure of the borrower's principal residence. That amount realized is used to determine any gain or loss realized under § 1001, including gain that may be excluded under § 121.

In addition, an NMS Payment is intended to compensate a borrower for loss of a principal residence rather than for loss on other property. This intention is indicated by the fact that only borrowers who lost their principal residence may receive the payment. Consequently, for purposes of § 1001, § 121, and § 1.121-1(e), if a taxpayer receives an NMS Payment for loss of a multiple-unit property a portion of which was used as the taxpayer's principal residence, then the entire NMS Payment is allocable to the portion of the property used as a principal residence.

A taxpayer that receives a deceased eligible borrower's NMS Payment "stands in the shoes" of the borrower for purposes of determining the tax consequences of that payment. Any gain not excluded from gross income under § 121 is income in respect of a decedent within the meaning of § 691(a).

*Situation 1—Loss on a single-unit home.* In 2011, *A*'s amount realized on the foreclosure of the principal residence was $125,000, its fair market value. *A*'s adjusted basis in the principal residence ($230,000) exceeded *A's* amount realized ($125,000). Thus, *A* realized a $105,000 ($230,000 – $125,000) loss on the foreclosure. Under § 165(c), this loss is not deductible because *A*, an individual, did not incur the loss in a trade or business, a transaction entered into for profit, or as a result of a casualty. The

NMS Payment of $1,400 that *A* received in 2013 reduces *A*'s nondeductible loss to $103,600 and thus does not increase *A*'s taxable income.

*Situation 2—Loss on a multiple-unit home.* In 2011, *B*'s adjusted basis in the portion of the property that *B* used as a principal residence ($115,000) exceeded *B*'s amount realized from the foreclosure of that portion of the property ($62,500). Thus, *B* realized a loss of $52,500 ($115,000 - $62,500) on the portion of the property *B* used as a principal residence, which is not deductible under § 165(c). The entire NMS Payment of $1,400 that *B* received in 2013 is allocable to the portion of the property *B* used as a principal residence. The allocated amount reduces *B*'s nondeductible loss to $51,100 and thus does not increase B's taxable income.

*Situation 3—Gain on a multiple-unit home.* In 2009, *B*'s amount realized on the foreclosure of the portion of the property *B* used as a principal residence ($80,000) exceeded *B*'s adjusted basis ($77,500) in that portion of the property. Thus, *B* had a $2,500 ($80,000 – $77,500) gain on the foreclosure of the principal residence. *B* excludes this gain from gross income under § 121 because *B* owned and used that portion of the property as a principal residence for at least two of the five years preceding the sale. The entire NMS Payment of $1,400 that *B* received in 2013 is allocable to the portion of the property *B* used as a principal residence, thus increasing *B's* gain (and the amount excluded under § 121) on the foreclosure of the principal residence to $3,900.

*Situation 4—Gain on a single-unit home.* In 2009, *C*'s amount realized on the foreclosure of the principal residence was $160,000, its fair market value. *C*'s amount realized ($160,000) exceeded *C*'s adjusted basis ($155,000). Thus, *C* had a $5,000 ($160,000 – $155,000) gain on the foreclosure of the principal residence. *C* excludes this gain from gross income under § 121 because *C* owned and used the property as a principal residence for at least two of the five years preceding the sale. The NMS Payment of $1,400 that *C* received from the Fund in 2013 increases *C's* gain (and the amount excluded under § 121) on the foreclosure to $6,400.

*Situation 5—Single-unit home with gain less than prior depreciation.* In 2009, *D*'s amount realized on the foreclosure of the principal residence ($149,000) exceeded *D*'s adjusted basis in the principal residence ($145,000). Thus, *D* realized a gain of $4,000 ($149,000 – $145,000) on the foreclosure of the principal residence. Under § 121(d)(6), however, because the $4,000 gain did not exceed *D*'s depreciation deductions of $10,000, *D* could not exclude that gain from income under § 121, and *D* includes the $4,000 gain in income under § 61(a)(3) in 2009. Similarly, under § 121(d)(6), *D* may not exclude from income the additional $1,400 gain that D realizes as a result of the NMS Payment of $1,400 that *D* receives in 2013. The NMS Payment increases the gain on the property to $5,400, which does not exceed *D*'s depreciation deductions. Thus, none of the $5,400 gain is excludable from gross income. Under § 61(a)(3), *D* must include the NMS Payment of $1,400 in income on *D*'s federal income tax return for 2013, the year in which *D* received the NMS Payment. See § 1.121–1(d) for rules on determining the character of this income.

*Situation 6—Single-unit home with gain greater than prior depreciation.* Because the amount realized on the foreclosure was $154,500, the NMS Payment of $1,400 increased the gain to $10,900 (($154,500 – $145,000) + $1,400), which exceeds the depreciation deductions by $900.  Thus, *D* includes $500 of the additional gain resulting from the NMS Payment in gross income under § 121(d)(6) on *D*'s federal income tax return for 2013, and excludes the remaining $900 from gross income under § 121(a). See § 1.121-1(d) for rules on determining the character of the amount that is included in income.

*Situation 7—Deceased borrower.*  Because *D* died before payment was made, the person(s) with a right to *D*'s NMS Payment must treat the entire amount received as income in respect of a decedent under § 691(a) because, if *D* had lived, *D* could not have excluded any of the NMS Payment from income pursuant to § 121(d)(6).  See § 691(a)(3) and § 1.121-1(d) for rules on determining the character of the amount that is included in income.

HOLDINGS

1.  A taxpayer who receives an NMS Payment pursuant to the National Mortgage Settlement due to the foreclosure of the taxpayer's principal residence includes the payment in the amount realized on the foreclosure under § 1001.

2.  If a taxpayer includes an NMS Payment in the amount realized and, as a result, creates or increases a gain on the foreclosure of the principal residence, the taxpayer may exclude the resulting gain from gross income to the extent permitted under § 121, including the limitation in § 121(d)(6) that gain attributable to depreciation cannot be excluded from gross income.

3. If the property for which a taxpayer receives an NMS Payment contained one or more additional dwelling units that were not used as the taxpayer's principal residence, the entire NMS Payment is allocable to the portion of the property that the taxpayer used as a principal residence.

4. A taxpayer who receives any portion of a deceased borrower's NMS Payment stands in the shoes of the borrower to determine the taxable portion, if any, of the NMS Payment. Any taxable amount is income in respect of a decedent under § 691(a).

DRAFTING INFORMATION

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