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to:
(Small Business/Self-Employed)
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subject: Interaction of Sections 108 and 469(g) of the Internal Revenue Code

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ISSUE

Does a foreclosure on real property subject to recourse debt comprising a taxpayer's entire interest in a passive (or former passive) activity qualify as a fully taxable disposition for purposes of § 469(g)(1)(A) if the foreclosure triggers cancellation of indebtedness (COD) income that is excluded from gross income under § 108(a)(1)(B)?

CONCLUSION

A foreclosure on real property subject to recourse debt comprising the taxpayer's entire interest in a passive (or former passive) activity is a fully taxable transaction for purposes of §§ 1001 and 469(g)(1)(A), regardless of whether any COD income from the cancellation of recourse debt is excluded under § 108(a)(1)(B). Thus, the losses from the activity are treated as not from a passive activity under §469(g)(1)(A). Additionally, these losses are not reduced by any excluded COD income under § 108(b)(2)(F).

FACTS

In Year 1, A purchases real property for $1,000,000 and A finances the purchase with a recourse mortgage of $1,000,000. A leases the property to a third party. This rental

activity is a passive activity of A within the meaning of § 469(c), and the real property constitutes A's entire interest in the passive activity. A has no other passive activities. The rental property accumulates net losses of $100,000 over three years that are suspended under § 469(a) and carried forward to year 4 under § 469(b). In Year 4, A defaults on the debt and the lender forecloses the mortgage. The fair market value of the property at the time of foreclosure is $825,000. A's adjusted basis in the property is $800,000, and the remaining balance on the debt is $900,000 at the time of the foreclosure. Also, A is insolvent with liabilities exceeding assets by $200,000 at the time of the foreclosure. The mortgagee cancels the remaining $75,000 debt after the foreclosure. As a result, A has $25,000 gain on the foreclosure ($825, 000 FMV - $800,000 adjusted basis), and A has $75,000 COD income ($900,000 debt - $825,000 FMV) that is excludable from gross income under §108(a)(1)(B).

LAW

Section 61(a)(3) of the Code provides that gross income includes gains derived from dealings in property.

Section 1.61-6(a) of the Income Tax Regulations provides that the specific rules for computing the amount of gain or loss from dealings in property under section 61(a)(3) are contained in section 1001 and the regulations thereunder.

Section 1001(a) provides that gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain.

Section 1001(b) provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

Section 1001(c) provides that, except as otherwise provided in subtitle A, the entire amount of the gain or loss, determined under section 1001, on the sale or exchange of property shall be recognized.

Section 1.1001-2(a)(1) provides that, except as provided in section 1.1001-2(a)(2) and (3), the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. Section 1.1001-2(a)(2) provides that the amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under section 61(a)(12). Example (8) under section 1.1001-2(c) illustrates these rules as follows:

Example (8). In 1980, F transfers to a creditor an asset with a fair market value of $6,000 and the creditor discharges $7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value

($6,000). In addition, F has income from the discharge of indebtedness of $1,500 ($7,500 - $6,000).

Section 61(a)(12) provides that gross income includes income from the discharge of indebtedness. See also U.S. v. Kirby Lumber Co., 284 U.S. 1, 2 (1931).

Section 108(a)(1)(B) provides, in general, that gross income does not include any amount which (but for § 108(a)(1)(B)) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if the discharge occurs when the taxpayer is insolvent.

Section 108(a)(3) provides that, in the case of a discharge to which § 108(a)(1)(B) applies, the amount excluded shall not exceed the amount by which the taxpayer is insolvent.

Section 108(b)(1) provides that, in general, amounts excluded from gross income under § 108(a)(1)(A), (B), or (C) shall be applied to reduce certain tax attributes of the taxpayer.

Section 108(b)(2)(F) provides that the taxpayer's passive activity loss or credit carryover under § 469(b) from the taxable year of the discharge is a tax attribute subject to reduction.

Section 108(b)(4) provides that reductions to tax attributes required by § 108(b) are made after determination of tax for the year of discharge.

Section 469(a)(1) provides that, if for any taxable year the taxpayer is described in § 469(a)(2), neither the passive activity loss, nor the passive activity credit, for the taxable year shall be allowed.

Section 469(b) provides that, except as otherwise provided in § 469, any loss or credit from an activity which is disallowed under § 469(a) shall be treated as a deduction or credit allocable to such activity in the next taxable year.

Section 469(d)(1) provides that, for purposes of § 469, the term "passive activity loss" means the amount (if any) by which the aggregate losses from all passive activities for the taxable year exceed the aggregate income from all passive activities for such year.

Section 469(g)(1)(A) provides that, if during the taxable year a taxpayer disposes of his entire interest in any passive activity (or former passive activity), the following rule shall apply: if all gain or loss realized on such disposition is recognized, the excess of (i) any loss from such activity for such taxable year (determined after the application of § 469(b)), over (ii) any net income or gain for such taxable year from all other passive activities (determined after the application of § 469(b)), shall be treated as a loss which is not from a passive activity.

ANALYSIS

Section 469(g)(1)(A) requires a taxpayer to dispose of his entire interest in a passive activity in a “fully taxable transaction” to an unrelated party in order for any disallowed (“suspended”) passive losses from that activity to be “freed up” and become deductible against non-passive income of the taxpayer. Section 469(g)(1)(A) characterizes a fully taxable transaction as one in which all of the gain or loss realized on a disposition of a taxpayer’s entire interest in an activity is recognized. The statute does not provide any additional guidance on what constitutes a fully taxable disposition, and there are no regulations providing any rules on this issue under § 469(g). However, the legislative history for § 469 provides helpful guidance.

The Senate Report accompanying the Tax Reform Act of 1986 states, generally, that:

> When a taxpayer disposes of his entire interest in a passive activity, the actual economic gain or loss on his investment can be finally determined. Thus, under the passive loss rule, upon a fully taxable disposition, any overall loss from the activity realized by the taxpayer is recognized and allowed against income (whether active or passive income). This result is accomplished by triggering suspended losses upon disposition.
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> The reason for this rule is that, prior to a disposition of a taxpayer’s interest, it is difficult to determine whether there has actually been gain or loss with respect to the activity. For example, allowable deductions may exceed actual economic costs, or may be exceeded by untaxed appreciation. Upon a taxable disposition, net appreciation or depreciation with respect to the activity can be finally ascertained. Since the purpose of the disposition rule is to allow real economic losses of the taxpayer to be deducted, credits, which are not related to the measurement of such a loss, are not specifically allowable by reason of a disposition.
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> The type of disposition that triggers full recognition of any loss from a passive activity is a fully taxable disposition of the taxpayer’s entire interest in the activity. A fully taxable disposition generally includes a sale of the property to a third party at arm’s length, and thus, presumably, for a price equal to its fair market value. Gain realized upon a transfer of an interest in a passive activity generally is treated as passive, and is first offset by the suspended losses from that activity. This accomplishes the purpose of the rule to recognize net income or loss with respect to the activity when it can be finally determined.

> Where the taxpayer transfers an interest in a passive activity in a transaction which the form of ownership merely changes, suspended losses generally are not allowed, because the gain or loss he has realized with respect to the activity has not been finally determined. (Such suspended losses are allowed, however, to the extent that any gain recognized on such a transfer, together with other income from passive activities for the year, exceeds losses from passive activities for the year.) Special rules are provided for gifts, death of a taxpayer, and other circumstances in which the taxpayer becomes no longer subject to the passive loss rule with respect to the activity.
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> The taxpayer must dispose of his entire interest in the activity in order to trigger the recognition of loss. If he disposes of less than his entire interest, then the issue of ultimate economic gain or loss on his investment in the activity remains unresolved. A disposition of the taxpayer's entire interest involves a disposition of the taxpayer's interest in all entities that are engaged in the activity, and to the extent held in proprietorship form, of all assets used or created in the activity. . . . If the taxpayer has adequate records of the suspended losses that are allocable to that activity, and includes in income the gain (if any) allocable to his entire interest in the activity, such losses are allowed in full upon the disposition.

S. Rep. No. 99-313, at 725-27 (1986). Accordingly, the legislative history indicates that Congress intended the term "fully taxable transaction" to refer to a transaction constituting a final disposition of all property used in a passive activity that allows for a full accounting of all income, gains, and losses resulting from the ownership and use of such property in the activity over time. While not explicit in either the statute or legislative history, it is generally understood that Congress did not intend § 469 to be a permanent loss disallowance provision. Rather, taxpayers should be able to deduct net losses from a passive activity at a time when the ultimate economic gains and losses derived from a passive activity are finally ascertainable.

It is well established that a foreclosure is a sale or exchange for federal tax purposes from which a taxpayer realizes gain or loss. See Helvering v. Hammel, 311 U.S. 504 (1941), Aizawa v. Commissioner, 99 T.C. 197 (1992). Therefore, a foreclosure qualifies as a fully taxable transaction for purposes of § 1001(a). Foreclosure is also a fully taxable transaction for purposes of § 469(g)(1)(A) where the taxpayer no longer possesses, after the foreclosure, any remaining interest in the activity that generated the suspended passive losses.

In this case, A realizes and recognizes, at the time of the foreclosure, all of the gains and losses that A will ever realize from the activity. Therefore, a foreclosure on real property comprising A's entire interest in a passive (or former passive) activity is a fully

taxable transaction for purposes of § 469(g)(1)(A). This result is not affected by whether or not the taxpayer also has COD income excludable from income under § 108(a)(1)(B).

Based on the foregoing analysis, Taxpayer A has disposed of the property in a fully taxable transaction under § 1001 and realizes and recognizes $25,000 of gain on the foreclosure. Thus, the transaction is a fully taxable transaction for purposes of § 469(g)(1)(A), and the $100,000 of suspended passive losses are treated as losses not from a passive activity under § 469(g)(1)(A). Additionally, Taxpayer A may exclude the $75,000 COD income from the cancellation of the recourse mortgage under § 108(a)(1)(B) because A is insolvent to the extent of $200,000.

Taxpayer A does not reduce the $100,000 of non-passive losses by the $75,000 COD income excludable under § 108(a)(1)(B). Under § 108(b)(2)(F) any COD income from the taxable year of the discharge reduces any passive activity loss and credit carryover of the taxpayer under § 469(b) from the year of the discharge. However, under § 108(b)(4), reductions to tax attributes required by § 108(b) are made after determination of tax for the year of discharge.

In this case, in determining Taxpayer A’s tax for the year of the discharge, all previously suspended losses under § 469(b) are freed-up and fully allowable upon the taxable foreclosure. Therefore, there are no remaining § 469(b) suspended loss carryovers that are reduced under section § 108(b)(2)(F).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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