PERSONAL INCOME TAX BULLETIN 2009-03

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Cancellation of Indebtedness Secured by a Principal Residence

I. Introduction.

This bulletin addresses the Pennsylvania personal income tax implications of cancellation of indebtedness secured by a principal residence. This bulletin also discusses the Pennsylvania implications of The Mortgage Forgiveness Debt Relief Act of 2007 and The Housing and Economic Recovery Act of 2008 (collectively “the Federal Acts”).

When you borrow money secured by your residence, you are not required to include the loan proceeds in income because you had an obligation to repay the lender. When that obligation is subsequently forgiven, the amount you received as loan proceeds is income because you no longer have an obligation to repay the lender. Cancellation of indebtedness may result in reportable, taxable income for Pennsylvania personal income tax purposes to the extent it represents a substitute for gain from the sale, exchange, or disposition of property.

When the home securing a debt is taken by the lender in full or partial satisfaction of that debt, the taxpayer will be treated as having sold that property and may have gain or loss as a result. For this purpose, it does not matter whether the lender took the property in foreclosure, repossession, voluntary conveyance to the lender by the taxpayer, or abandonment.

If you are insolvent or in bankruptcy you may be eligible to exclude cancelled indebtedness from income. Generally speaking, you are insolvent when your total debts exceed the total fair market value of all of your assets. Assets include everything you own, *e.g.*, your car, house, condominium, furniture, life insurance policies, stocks, other investments, or your pension and other retirement accounts. Please see PIT Tax Bulletin 2009- (forthcoming) for further details on the insolvency and bankruptcy exceptions.

A taxpayer will not be taxed on gain or loss realized on the transaction to the extent that he or she qualifies for an exclusion of gain from the sale, exchange or disposition of a principal residence under 72 P.S. § 7303(a)(3)(vii). Section IV of this bulletin sets forth the criteria a taxpayer must meet to qualify for this exclusion. Also, a taxpayer will not be taxed on a reduction in the amount of purchase-money indebtedness, as described in Section VII.

If you depreciated any portion of the property or deducted interest on any portion of the property, you may be entitled to only a partial exclusion. Section V of this bulletin sets forth the rules for calculating the exclusion of gain for mixed-use property and for indebtedness on which a portion of the interest was deducted as a business expense.

Limitations apply to the exclusion from gain, as discussed in Section V of this bulletin. If a taxpayer does not qualify for the exclusion from gain, the taxpayer must report as income the amount equal to the value received by taxpayer in the foreclosure, minus the taxpayer's basis in the principal residence, as described in Section VI. Any gain recognized in the transaction must be reported on Schedule D of Form PA-40.

II. Comparison to Federal law.

Generally speaking, if your home qualifies as a principal residence for Federal tax purposes, your home is presumed to qualify as a principal residence for Pennsylvania personal income tax purposes.

With respect to cancellation of indebtedness, the Pennsylvania exclusion from gain for principal residences is broader than the exclusion of gain available for Federal purposes under **The Mortgage Forgiveness Debt Relief Act of 2007 and The Housing and Economic Recovery Act of 2008** (collectively "the Federal Acts").

1. Under the Federal Acts, a taxpayer is eligible for the exclusion from income for cancelled debt up to $2 million. No such ceiling exists for Pennsylvania tax purposes.
2. Under the Federal Acts, a taxpayer is not eligible for the exclusion from income for cancelled second mortgages or home equity loans, except to the extent the loan proceeds were used to acquire, construct, or substantially improve the taxpayer's principal residence. For Pennsylvania purposes, a taxpayer is eligible for an exclusion from income from *any* cancelled obligation secured by a principal residence. (However, see special rules for mixed-use property and other exceptions).
3. Under the Federal Acts, a taxpayer may deduct qualified mortgage insurance as home mortgage interest. You may not deduct qualified mortgage insurance, although you may increase your adjusted basis in the personal residence by the amount of qualified mortgage insurance.

Please note that a taxpayer realizing cancellation of indebtedness that is excluded from income for Pennsylvania purposes must reduce his or her basis in the principal residence by the amount of debt cancelled.

A basis reduction is also required for a modification of principal or a "success incentive" that reduces the balance of a taxpayer's loan, under the **Federal Making Home Affordable Program**.

III. Definitions.

Cancellation: Cancellation occurs when a debtor is legally discharged from primary liability for an indebtedness and it is probable that the debtor will not be required to make future payments as guarantor of the indebtedness. A debtor is legally discharged on the occurrence of one of the following identifiable events:

1. Discharge of indebtedness in bankruptcy.
2. Discharge of indebtedness in receivership.
3. Expiration of the statute of limitations for collecting the indebtedness.
4. Discharge of indebtedness arising from the creditor's election to pursue foreclosure which statutorily extinguishes its right to pursue further collection.
5. Extinguishment of an indebtedness under a probate proceeding.
6. Discharge pursuant to an agreement between the creditor and debtor for less than full consideration.
7. Discharge according to a decision by the creditor, and under a defined policy of the creditor, to discontinue collection activity and to cancel the indebtedness.

A liability is not forgiven or discharged merely because it is temporarily uncollectible or unenforceable as a matter of fact. However, it is the position of the Department that, when a 36-month testing period during which there has been no payment made expires, the 36-month period provides a rebuttable presumption that the indebtedness has been discharged.

If a debtor is partially discharged of a liability and retains the property subject to the liability, he or she must reduce the adjusted basis of the property to the extent the discharged amount was not included in income.

Indebtedness: An obligation, absolute and not contingent, to pay on demand or within a given time, in cash or another medium, a fixed amount. The term includes principal, interest, penalties, fines, and administrative fees.

Principal residence: Your principal residence is the home where you ordinarily live most of the time. It can be a house, lodging or place of habitation, including a trailer or condominium, which has independent or self-contained cooking, sleeping and sanitation facilities, and which is physically occupied and used for residential purposes by the taxpayer.

The term includes personal property which is a fixture under the law of the state in which the property is located.

A residence which is a principal residence for Federal tax purposes is presumed to be a principal residence for Pennsylvania tax purposes.

Indebtedness secured by a principal residence: A mortgage, a junior mortgage, or any other indebtedness which is secured by a taxpayer's principal residence.

IV. Qualifying for the exclusion.

A taxpayer may qualify for the exclusion of gain if all of the following are true:

1. The indebtedness which was discharged was secured by a principal residence;
2. The date of disposition occurred after December 31, 1997;
3. The taxpayer used or had used the residence as a principal residence for a total of at least two years during the five-year period ending on the date of sale;
4. The taxpayer owned or had owned the residence as a principal residence for a total of at least two years during the five-year period preceding the date of sale; and,
5. The taxpayer did not sell another principal residence during the two years preceding the date of sale.

If a taxpayer meets the requirements of 72 P.S. § 7303(a)(3)(vii), he or she may exclude from his or her Pennsylvania income the entire amount stated on the Form 1099-C, although the taxpayer must reduce his or her basis in the principal residence by the amount of the discharge. Please see PA Schedule 19 for more information regarding the principal residence exclusion.

Note: If a widow or widower does not independently meet all the requirements of the statute, he or she will qualify for the exclusion if the deceased spouse met all the requirements, so long as the widow or widower has not remarried.

V. Exceptions to exclusion from gain.

A. **Mixed-use property**: The exclusion does not apply and gain is taxable to the extent the property is used in part for business or rental purposes or to the extent the land surrounding the residence is in excess of that which is reasonably necessary for the use of the dwelling as a home. The department applies a rebuttable presumption that reasonable use does not exceed five acres.

1. **Examples of mixed-use property**: Examples of mixed-use property include, but are not limited to, an in-home office, a duplex where one unit is rented, and a farm or acreage which is used in part for farming purposes.

2. **How to calculate gain from mixed-use depreciable property**: The amount of gain excluded is equal to the ratio that the value of the portion used as a principal residence bears to the value of the entire property.

3. **Mixed-use depreciable property**: If a portion of the principal residence was ever subject to the allowance for depreciation, only the gain from the non-depreciable portion of the principal residence is excluded from income.

4. **Example 1:** A sole proprietor's residence is located above the sole proprietor's store. The value of the residence is one-half of the value of the entire property. The sole proprietor is entitled to exclude one-half of the gain realized on the disposition.

5. **Example 2:** Taxpayer H buys a house in 1998. For 10 years, H uses a portion of the property as his principal residence and a portion of the property for business purposes. H claims depreciation deductions of $15,000 for the business use of the property. The lender forecloses on H's property in 2008; H realizes a gain of $50,000. H had no other Schedule D gains or losses for 2008. H determines that $15,000 of the gain is allocable to the business-use portion of the property and that $35,000 of the gain is allocable to the portion of the property used as his residence. H must recognize $15,000 of the gain allocable to the business-use portion of the property.

B. **Multiple dispositions within two-year period**: If, during the two-year period ending upon the date of the sale, exchange or disposition, there was a prior sale, exchange, or disposition by the taxpayer of a principal residence, the taxpayer is not entitled to exclude gain realized upon the foreclosure. The taxpayer may exclude gain, however, if the later sale, exchange, or disposition to occur is by reason of a change in employment or health.

VI. How to calculate gain if you do not qualify for exclusion.

If a taxpayer does not meet the requirements for excluding gain under 72 P.S. § 7303(a)(3)(vii), he or she will report the gain on Form PA-40, calculated as follows:

1. Add the following items

   i. The amount of discharged principal on the mortgage, second mortgage, or other obligation secured by the principal residence, plus
   ii. The amount of discharged interest, penalties, fees, administrative costs, and fines, plus
   iii. The amount of any additional consideration received, including cash or other property.

The sum of (i)-(iii) is your **amount realized**. (The amount realized is reported as the "gross sales price" on PA Schedule D, Line 1, Column (d) and on the section above Line 7 at the bottom of the schedule where taxable gain from the sale of a principal residence is reported. PA Schedule 19 refers to it as "Gross Proceeds.")

2. From the amount realized as calculated in Step 1 above, subtract your **adjusted basis** in the home.

Your adjusted basis is equal to the amount you paid to purchase the residence, including closing costs, realty transfer taxes, and one-time costs incurred to finance the property. The adjusted basis also includes the cost of any permanent improvements made to the property after purchase. You should not add property taxes, periodic interest expenses, or other recurring expenses not properly chargeable to the basis of the property.

3. The result of the amount realized in Step 1 above, minus the adjusted basis in Step 2 above, is the amount of gain that you must report on your Form PA-40 if you do not qualify for the exclusion from gain on the disposition of a principal residence.

VII. Cancellation of purchase-money indebtedness.

If indebtedness arising in a sale financed by the seller is cancelled or reduced, the amount cancelled is usually treated as an adjustment of the purchase price, to be applied in reduction of the buyer's adjusted basis for the property, rather than included in gross income as cancellation of indebtedness income.

An indebtedness reduction is treated as a reduction of purchase price, rather than indebtedness cancellation income, if:

(1) The cancelled or reduced obligation is indebtedness of a purchaser of property to the seller of such property, arising out of the purchase of such property;
(2) The taxpayer is not insolvent or in bankruptcy when the reduction occurs; and
(3) The reduction would, apart from this rule, be cancellation of indebtedness income.

This rule applies only to reductions by agreement between buyer and seller and not, for example, to a cancellation resulting when an obligation is unenforceable on account of the running of the statute of limitations on enforcement.

Example 1: A home is purchased for $200,000 and the seller finances the sale. The buyer subsequently refuses to pay because of a contract claim such as an alleged misrepresentation or breach of warranty. A settlement of the indebtedness for $150,000 is non-taxable. Instead, this is treated as a retroactive reduction of the purchase price to $150,000. The taxpayer must reduce his basis in the home to $150,000.

This rule does not apply when the indebtedness has been transferred by the seller to a third party or when the property has been transferred by the buyer to a third party.

This rule does not apply if the indebtedness was never owed to the person from whom the taxpayer purchased the property. For example, if A buys property from B, financing the purchase with a mortgage loan from C, the purchase-price reduction rule is inapplicable to any reduction of the mortgage liability.

Example 2: A buys property from B and finances the purchase with a mortgage loan from C. The purchase-price reduction rule is inapplicable to any reduction of the mortgage liability because the obligation is not indebtedness of a purchaser of property owed to the seller of such property.