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Burdens of Proof
—Calculating a Borrower's Gain Recognition Upon Foreclosure

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A recent decision of the Tax Court provides an opportunity to review the rules regarding the recognition of gain or loss and of income from cancellation of indebtedness by a borrower when its mortgaged property is acquired by the lender pursuant to a foreclosure sale. The case (*Frazier v. Commissioner*, 111 T.C. No. 11 (1998)) reaches what appears to be the correct result based on the record, but has some language regarding the burden of proof that may prove troublesome to similarly situated borrowers.

Background

The basic rules regarding the consequences to a borrower of a foreclosure sale, as applied in *Frazier*, are well established. If property is transferred by a borrower to the creditor in consideration of the reduction or discharge of debt, the property is considered to have been sold. The borrower must therefore recognize gain to the extent of the excess, if any, of the amount realized from the transfer over the borrower's adjusted basis in the property. If the borrower's adjusted basis exceeds the amount realized, that excess is recognized as a loss.

Where the fair market value of the property is less than the amount of debt discharged, the determination of the amount realized depends in part on whether the lender's recourse with respect to the debt is limited to the property that secures the debt. If the lender is without recourse to the borrower's other assets (*i.e.*, the debt is nonrecourse), the borrower's amount realized includes the entire debt outstanding immediately before the transfer.

By contrast, if the lender has full recourse to the borrower's other assets, the amount realized by the borrower from the transfer is the fair market value of the property, and any excess of the debt discharged over the fair market value of the property constitutes income from the discharge of indebtedness (also known as "cancellation of debt" or "COD" income). Such income is generally required to be recognized by the borrower as ordinary income when the debt is discharged, but may be excluded from gross income under certain circumstances, such as where the borrower is insolvent (the so-called "insolvency exception").

Given the special rules applicable to COD income, and the different tax rates now applicable to ordinary income and capital gain realized by individuals, the determination of the portion (if any) of a debt discharge that gives rise to COD income, and the portion (if any) that is considered to be gain from the sale of property, can have a substantial impact on the borrower's tax liabilities.

The “Frazier” Case

In *Frazier*, the petitioners owned real property in Texas that was subject to a mortgage which secured their recourse obligation. The mortgage was foreclosed in 1989, at a time when real estate prices had dropped sharply throughout Texas. The lender bid in the property for $571,000, slightly less than the $586,000 outstanding principal balance of the debt. (Dollar amounts have been rounded to the nearest thousand for ease of presentation.)

The borrowers were insolvent at the time of the foreclosure and remained insolvent after the foreclosure sale, and the lender did not attempt to collect the difference between the outstanding balance of the debt and the bid price.

The borrowers’ adjusted basis in the property was $496,000, computed by subtracting accumulated depreciation of $187,000 from a cost basis of $683,000. According to an appraisal introduced into evidence by the borrowers, the fair market value of the property at the time of the foreclosure sale was $375,000.

Under the general rules described above, the borrower did not realize any gain, because the amount realized—limited to the fair market value of the property ($375,000)—was less than the borrower’s adjusted basis in the property ($496,000). The excess of the debt discharged over the amount so realized was COD income, subject to possible exclusion from the borrowers’ income under section 108 of the Internal Revenue Code.

The Commissioner asserted a tax deficiency, however, arguing that the amount realized by the borrowers included the entire bid price and that the excess of the bid price over the adjusted basis of the property must therefore be recognized as gain from the sale of property. In doing so, the Commissioner did not offer any expert testimony as to fair market value or challenge the accuracy of the appraisal introduced by the borrowers, but simply argued that the amount bid for the property must be used to determine the amount realized regardless of the actual fair market value of the property.

Presumption Rebutted

The court observed that, “[a]bsent clear and convincing proof to the contrary, the sale price of the property at a foreclosure sale is presumed to be its fair market value,” citing two Tax Court cases. Those cases in turn cite a Treasury regulation (Reg. Search7RH1.166-6(b)) that addresses the consequences to a creditor of its acquisition of property through foreclosure. The court found, however, that the borrowers had rebutted this presumption through clear and convincing proof of a lower value.

The borrowers then argued (consistently with the general rules described above) for a bifurcation of the foreclosure sale into (i) a transfer of the property for its fair market value and (ii) a cancellation of the balance of the debt for no additional consideration. As support, the borrowers cited Revenue Ruling 90-16 (1990-1 C.B. 12), an IRS ruling that discusses the consequences to a borrower of a transfer of its property to a lender in satisfaction of a recourse debt, through a deed in lieu of foreclosure or pursuant to a foreclosure. The ruling supports a bifurcation approach in each case, albeit without any reference to a bid price.

In *Frazier*, the Commissioner argued against the revenue ruling, asserting (as frequently proclaimed by taxpayers and courts, but rarely by the government) that a revenue ruling has limited precedential value.

The court agreed that the revenue ruling was not binding on it but nonetheless concluded that the bifurcation sought by the borrowers was appropriate, citing the regulations under Code section 1001 and case law. Thus, the court concluded, the borrowers recognized a capital loss of $121,000 (the excess of the borrowers' adjusted basis in the property over its fair market value).

The borrowers also realized income from the discharge of indebtedness to the extent the principal amount of the debt discharged exceeded its fair market value. The COD amount, however, was excluded from the borrowers' gross income by reason of insolvency, pursuant to Code section 108(a)(1)(B).

Observations

Based on the record as described in the opinion, the court reached the right result. Indeed, it is not apparent how the Commissioner could have had any reasonable expectation of winning the case, absent a challenge, which the Commissioner was apparently not prepared to mount, to the accuracy of the appraisal introduced by the borrowers.

The court's assertion, however, that the borrowers had to produce "clear and convincing proof" that the fair market value of the property was not equal to the bid price, is subject to question.

The regulation under IRC Search7RH166 referred to above, and one of the two cases cited by *Frazier* as calling for such proof in the foreclosure context, both deal with consequences to creditors. Given that the creditor sets the bid price and therefore may determine the portion of its claims against the borrower that is to be surrendered in exchange for the property, the statement in Reg. Search7RH1.166-6(b)(2) that "[t]he fair market value of the property for this purpose shall, in the absence of clear and convincing proof to the contrary, be presumed to be the amount for which it is bid in by the taxpayer" appears to be a sensible rule for determining the creditor's tax consequences.

The borrower, however, typically has little influence in determining the bid price. Therefore, in determining the tax consequences of a foreclosure to the borrower, there appears to be no reason to hold the borrower to a standard of proof of fair market value that is more stringent than the burden of proof that would otherwise apply in challenging an asserted tax deficiency.

Frazier cites one case that refers to a standard of clear and convincing proof in addressing the consequences of a foreclosure to the borrower, a joint venture, and one of its members (*Marcaccio v. Commissioner*, TC Memo 1995-174). In that case, however, the petitioner apparently lacked substantial evidence of the fair market value of the property, and the parties and the court may not have given careful consideration to the burden of proof.

As a planning matter, of course, a borrower faced with a foreclosure action should consider at that time the tax consequences of foreclosure, and, specifically, whether contemporaneous evidence of fair market value may be necessary or desirable to buttress positions that the borrower may wish to adopt to minimize any adverse tax consequences of the foreclosure.