

BANKRUPTCY BEAGLE

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Surrendering Investment Property in Bankruptcy, What are Tax Consequences?

Question:

I am filing chapter 7 bankruptcy tomorrow. I am surrendering my owner occupied 4-plex as part of that process; I lived in one of the units and own no other property. If I surrender my owner occupied 4-plex in bankruptcy, does a tax event occur on the day the bankruptcy is discharged or the day the property is foreclosed? What confuses me is that the way things are now with the banks, it is entirely possible that the foreclosure might not occur until a year after the surrender which would put it after the year I filed bankruptcy.

I also cannot figure out what my capital gains exposure?. I'm by definition insolvent when I surrender my property and declare chapter 7 but if it languishes without foreclosure for a year—do I have to prove insolvency on the date of the foreclosure?

Answer:

You will want to seek the advice of a tax professional to understand the full extent of your potential tax liability. However, when it comes to real estate, the taxable event occurs upon transfer. As such, the taxable event would not occur until the lender forecloses on the property.

When it comes to investment properties in chapter 7 bankruptcy there are two potential tax issues, (1) forgiven debt income, and (2) capital gains. The bankruptcy eliminates the forgiven debt income (if the bankruptcy takes place prior to the foreclosure); bankruptcy is an exception to paying tax on forgiven debt in the event the property is worth less than the amount owed. In your question, you are confusing the issue of forgiven debt income with capital gains. Insolvency is an exception to paying tax on forgiven debt, but insolvency is not an exception to capital gains.

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<p>Although rare, it is factually possible to have a capital gain on foreclosed property. To determine if there will be capital gains in your circumstance, you should seek the advice of a tax professional. If you have been depreciating the property on your taxes, doing so adjusts your tax basis for that property. Therefore, if the sale amount at foreclosure is more than your tax basis, you will have a capital gain.</p>	
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But, the taxable event is the foreclosure, not bankruptcy discharge. You will not need to worry about being taxed on any mortgage deficiency balance, but there is some risk of capital gains tax.

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