

Tax Tips

Repossession of Real Property

In general, you won't be able to deduct any loss from the repossession of real estate which you have previously sold to a buyer in the form of a loan secured by the property. However, as explained below, in certain circumstances, you may have to report some gain.

Gain recognition rules. You will have to report gain to the extent the amount of money and the value of other property you were paid by the buyer before the repossession is greater than the amount of gain you have already reported on the sale. (Unfortunately, however, if the amount you received is less than your previously reported gain, you cannot report a loss.)

Example. Ron sells real estate for \$100,000. His basis was \$20,000 (thus his gain on the sale was \$80,000). He was paid a \$10,000 down payment and was to receive nine more \$10,000 payments, under an installment note he took from the buyer. After the first two payments were made, however, the buyer defaulted and Ron repossessed the property. He had \$5,000 in expenses in connection with the repossession.

Ron was reporting his gain from the sale on the installment method. His gain percentage was 80% (sale price \$100,000; gain \$80,000), so he reported \$24,000 of gain on the \$30,000 in payments he received before default (the \$10,000 down payment plus the first two \$10,000 installment payments). When the property is repossessed, Ron reports \$6,000 of gain: the excess of cash received before the repossession (\$30,000) over the amount of gain previously reported (\$24,000).

Gain limitation. Note that under a gain limitation rule, the gain to be reported on the repossession of real property can never exceed the original sale price minus (1) your original basis in the property, (2) the gain you recognized, and (3) your expenses of repossession. In the above example, this would be \$100,000 minus \$49,000 (\$20,000 + \$24,000 + \$5,000), which equals \$51,000. So in the example, Ron would report the \$6,000 gain without the limitation having an impact.

Basis of repossessed property. The basis of the repossessed property will be the basis you had in the debt, plus any gain you reported on the repossession, plus any expenses you incurred in connection with the repossession.

In the above example, Ron's basis in the outstanding debt of \$70,000 (\$90,000 – two \$10,000 payments) was \$14,000. This is because the gain portion of the debt was 80%, as noted above. Thus, the remainder (20% of \$70,000, or \$14,000) represents Ron's basis in the debt. So, Ron's basis in the repossessed property is \$25,000: \$14,000 + \$6,000 (gain recognized) + \$5,000 (expenses of repossession). Of course, Ron may have gain or loss if and when he resells the property.

If you have any questions regarding the above discussed topic or any other tax matter, please feel free to give me a call at (562) 698-9891.

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