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INSTRUCTIONS FOR CANCELLATION OF DEBT ANALYSIS FORM

DO NOT USE THIS FORM UNLESS YOUR PROPERTY WAS INVOLVED IN EITHER A FORECLOSURE, A SHORT SALE OR A LOAN MODIFICATION. DO NOT USE THIS FORM FOR AN ORDINARY REFINANCE.

UPDATED FOR TAX YEAR 2022

If you contacted us with information concerning your involvement in a short sale, foreclosure or loan modification (of the ~~principal~~ ^{Introduction} of a loan), this is the form we must have completed to determine the possibility of taxable canceled debt becoming a part of your income.

This brief set of instructions will seek to clarify the form, as it may be very confusing. Unfortunately, since the entire field of canceled debt, and the interaction of federal tax law and state property law is so complex, there is no way to avoid this.

This is only an initial analysis. If we are not able to determine how to exclude canceled debt income based only on the law and the numbers given on this form, we will pursue other options, such as insolvency in an attempt to legally exclude canceled debt income. This will require yet more information beyond the scope of this form.

Current Law

Here is a brief overview of the law as it applies to various means of legally excluding canceled debt from gross income.

First, where a debt is legally considered “non-recourse,” in that a lender is not legally entitled to pursue a debtor for a deficiency judgment. A deficiency judgment is based upon the amount still owed after security has been exhausted. Many of the questions in this form are designed to identify non-recourse debt and take advantage of it. When such debt exists and there is a foreclosure or short sale, the property is legally considered to have been “swapped” for the debt. Therefore, because the debt has been surrendered by the surrender of the property there is no cancellation of debt income at all. The sales price for tax purposes is considered to be the amount of the debt for which the property was traded, regardless of the actual sales price either through a short sale or through a foreclosure. Note that even where debt secured by a mortgage is non-recourse, a loan modification will still result in canceled debt. This is because the property has not been exchanged for the debt; it is still retained by the owners. California also extended the scope of non-recourse debt by statute (Cal. Code Civil Procedure 580b(a)(3)(b)) by including refinance transaction if no equity was cashed out.

Second, there are several provisions in the Internal Revenue Code which allow for the exclusion of cancellation of debt income from gross income. The most powerful of these

are considered insolvent and may exclude canceled debt up to that amount. This requires the calculation of a personal balance sheet and the preservation of documents to support the balance sheet in the event of an IRS examination.

Next comes the federal mortgage forgiveness act of 2007, which was extended to the end of the 2016 tax year for federal tax purposes and to the end of the 2013 tax year for the State of California. This law allowed for the exclusion of canceled debt on a taxpayer's principal residence for what is termed "acquisition debt." Such debt only includes the remaining portion of the debt used to buy the residence plus the value of substantial improvements. But unless the debt in question was canceled in 2013 or a prior year (and in 2014 or a prior year for federal tax purposes) this provision will not be of any help. In both 2015 and 2016, Governor Brown vetoed provisions that would have extended the deadline for exclusion of cancellation of personal residence indebtedness in California.

For rental property, there is another very complex relief provision for debt called Qualified Real Property Business Indebtedness. If it comes to this, we will analyze the possibility of using this for our client's foreclosed or short sold properties. This is a particularly complex provision but can in many cases provide relief where none would be otherwise available.

LINE BY LINE FORM INSTRUCTIONS

Section A Questions

Is the real property located in California? – this is self-explanatory. If the property is located elsewhere please describe that location in the comments area on page three.

The property consists of one to four dwelling units. This question asks whether the property is a single family dwelling, a duplex, a triplex or a fourplex. If the property is not one of these, answer no.

The property was sold in a short sale or foreclosure and is no longer owned. – This asks whether, after the transaction we are analyzing is over, you will still own the property. Answer yes for a short sale or foreclosure but no if you are keeping the property and only have a loan modification.

All of the loans currently on the property were used to purchase the property. If all of the loans currently secured by the property were actually taken out at the time of purchase, answer yes. But if any of the current loans were refinanced, or any of the loans were added after the time of purchase, answer no.

Was the property occupied by the buyer at the time of purchase? If you bought the property and then moved in, answer yes. Otherwise, answer no.

Section B Question

Question 1 – Date of Sale, Foreclosure or Loan Modification. This is the actual date a short sale transaction closed, or the date of the trustee's sale in the event of a foreclosure, or in the case of a Loan Modification, the date the principal of the loan was reduced.

Question 2– Balance of the original loan used to buy the property. This question asks for the balance of the first trust deed on the property on the date of purchase. How much did the lender loan you on the first trust deed on that day? This number may be obtained from the HUD-1 (settlement statement) from the original purchase of the property. This question is not asking for the current balance of any loan, but the balance of the initial loan.

Question 3 is the same as question 1 but refers to the balance of a second trust deed at the time the property was purchased. This amount may also be obtained from the HUD-1 for the purchase of the property.

Question 4 asks for the value of any documented and substantial improvements to the property. By documented we mean improvements to the property for which records of expenditures exist. Examples of this are the contractor's agreement and invoices which are required under state law. Similar, though not as thorough, information on this may sometimes also be obtained from the county assessor because permits would have had to have been issued and an additional assessment made on such improvements as a rule.

By substantial improvements we mean major projects, such as large landscaping projects, additions, pool and concrete work. This does not include smaller projects such as ceiling fans.

Question 5 is asking for the fair market value on the date set forth in question 1. For a past event this will be the trustee sale price for a foreclosure or the actual sales price for a short sale. An estimate may be necessary for any loan modification or a future short sale or foreclosure.

Note that there will often be a fair market value on a Form 1099-C or Form 1099-A issued by the lender. While this may sometimes match the actual sales price of property, sometimes it will be completely different. We will take that into account but on our form we ask for real prices and values rather than what may be an inaccurate number on a Form 1099-C or 1099-A.

Question 6 asks for the current balance of all amounts owed on the current first trust deed at the time of sale, foreclosure or loan modification. This should be the amount the lender is demanding **before** any reduction due to a modification or due to forgiveness of any part of the debt.

Question 7 can be deceiving. We are not asking for the total amount owed at the time of the short sale, foreclosure or loan modification. That is Question 6. The amount referred to in question 6 will almost always include accumulated interest and penalties. What we are asking for is the balance of the principal of the underlying loan. In other words, if you had to pay off the loan today, and you were current with no late payments, what would that amount be? The reason for this is very important. The Internal Revenue Code does not include within cancelled debt any amount which may otherwise be deducted. And mortgage interest may be deducted. Even the penalty amounts are considered mortgage interest. Be aware that depending on the nature of the transaction even these amounts may ultimately become part of cancelled debt, if, for example they are forgiven along

with the principal. But for the purposes of Question 7 we want only the balance of the actual loan principal without any add-ons. If this information proves impossible to obtain then use the original balance of the loan from the date it was first funded. This can be obtained from the HUD-1 on which that loan first appeared.

Question 8 is the same as Question 6 except for a second and/or third trust deed, if there are such loans on the property. Again, this is the total amount owed as demanded by the lender **prior** to any modification or forgiveness.

Question 9 is the same as Question 7 except for a second and/or third trust deed, if there are such loans on the property. Again, what we are asking for is the current balance of the principal of the underlying loan. In other words, if you had to pay off the loan today, and you were current with no late payments, what would that amount be? If this information proves impossible to obtain then use the original balance of the loan from the date it was first funded. This can be obtained from the HUD-1 on which that loan first appeared.

Question 10 has two drop down inquiries of which you should select one. The status of the primary loan will be:

- A. The original loan used to purchase the property (the loan referred to in Question 2)
- B. An original loan added after the purchase of the property – such as a second trust deed, or a home equity line of credit which was taken out after the property had been purchased. Or where the original loan was paid off to zero, and a new loan applied to the security of the property.
- C. The first trust deed is a refinanced loan.
- D. Any loan at all discharged in bankruptcy – this option overrides all of the others

The second drop down inquiry is the same set of questions, but as they apply to a second or third trust deed, if such a loan exists.

Question 11 asks for dates, if any, the property was used as a principal residence. If there are more than one periods where this was the case, leave this section blank and put the applicable periods in the comments section on page three.

Question 12 asks for dates the property was available as a rental. When we say available that does not mean when the property was actually occupied by renters but only when the property could have been rented, even if it was vacant. This does require evidence that the rental was marketed in some way. Note that use by a family member who is paying no rent or rent below fair market value is considered personal use and should not be included in any rental periods. If there are more than one periods where the property was available for rent, leave this section blank and put the applicable periods in the comments section on page three.

Finally, feel free to use the comments section on the third page of the form for any explanations, clarifications or other items which require explanation. If you have any questions put them here as well.



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SEND FORM TO HERE

NAME(S)

DATE

CHECKLIST FOR FORECLOSURES/SHORT SALES AND LOAN MODIFICATIONS

PROPERTY ADDRESS
(include city name)

PURCHASE

PRICE OF
PROPERTY

DATE OF PURCHASE
OF PROPERTY

SECTION A - BASIC INFORMATION

YES NO

THE REAL PROPERTY IS LOCATED IN THE STATE OF CALIFORNIA

☐ ☐

THE PROPERTY CONSISTS OF ONE TO FOUR DWELLING UNITS

☐ ☐

THE PROPERTY WAS SOLD IN A SHORT SALE OR A
FORECLOSURE AND IS NO LONGER OWNED

☐ ☐

ALL OF THE LOANS CURRENTLY SECURED BY THE PROPERTY
ARE THE ORIGINAL LOANS ACTUALLY USED TO PURCHASE
THE PROPERTY AND NONE OF THESE LOANS WAS EVER
REFINANCED

☐ ☐

WAS THE PROPERTY OCCUPIED ENTIRELY OR IN PART BY
THE PURCHASER AT THE TIME OF PURCHASE?

☐ ☐

IF YOU ANSWERED "NO" TO ANY OF THE ABOVE QUESTIONS,
ANSWER THE NEXT QUESTION CONCERNING BANKRUPTCY.

YES NO

ALL OF THE LOANS CURRENTLY SECURED BY THE PROPERTY
WERE DISCHARGED IN BANKRUPTCY

☐ ☐

- GO TO PAGE 2

RESET FORM



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NAME(S) DATE

CHECKLIST FOR FORECLOSURES/SHORT SALES AND LOAN MODIFICATIONS

PROPERTY ADDRESS
(include city name)

PURCHASE

PRICE OF
PROPERTY

DATE OF
PURCHASE

SECTION B-VALUES

1 DATE OF SALE, FORECLOSURE
OR LOAN MODIFICATION

2 BALANCE OF THE ORIGINAL LOAN USED TO
BUY THE PROPERTY AT TIME PURCHASED

3 BALANCE OF ANY ADDITIONAL LOAN USED
TO BUY THE PROPERTY AT TIME PURCHASED

4 VALUE OF DOCUMENTED, SUBSTANTIAL
IMPROVEMENTS

5 FAIR MARKET VALUE/SALES PRICE ON
DATE OF ACTUAL OR PROJECTED SALE,
FORECLOSURE OR LOAN MODIFICATION

6 PRIMARY LOAN TOTAL AMOUNT OWED
AT TIME OF SALE, FORECLOSURE OR
LOAN MODIFICATION

7 BALANCE OF THE PRINCIPAL OF THE
PRIMARY LOAN IN PLACE AT THE TIME
OF SALE, FORECLOSURE OR LOAN MOD.

8 ADDITIONAL LOAN TOTAL AMOUNT
OWED AT TIME OF SALE,
FORECLOSURE OR LOAN MOD.

9 BALANCE OF THE PRINCIPAL OF ANY
ADDITIONAL LOANS

STATUS OF PRIMARY LOAN

STATUS OF ADDITIONAL LOANS

10

FROM

TO

11 DATES USED AS A
PRINCIPAL RESIDENCE

12 DATES AVAILABLE AS A
RENTAL PROPERTY

13 WHAT KIND OF TRANSACTION WAS
THIS?

☐
☐
☐

SHORT SALE FORECLOSURE LOAN MOD.



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NAME(S) DATE

CHECKLIST FOR FORECLOSURES/SHORT SALES AND LOAN MODIFICATIONS

PROPERTY ADDRESS
(include city name)

PURCHASE PRICE OF PROPERTY DATE OF PURCHASE OF PROPERTY

WARNING – THE INFORMATION ON THIS DOCUMENT, AS WELL AS ANY LEGAL ADVICE REGARDING A SHORT SALE, FORE CLOSURE, LOAN MODIFICATION OR DEED IN LIEU TRANSACTION, APPLIES ONLY TO ADVICE REGARDING FEDERAL AND CALIFORNIA INCOME TAX ISSUES AND IN NO WAY IS CONCERNED WITH THE RIGHTS AND REMEDIES OF EITHER A CLIENT OR LENDER REGARDING THE ABILITY TO SEEK REPAYMENT OF A DEBT. IN ORDER TO DETERMINE YOUR RIGHTS REGARDING THE COLLECTION OF ANY DEBT YOU MUST CONSULT AN ATTORNEY WHO PRACTICES CALIFORNIA CIVIL LAW. TIM KELLY AND KEVIN REGO DO NOT PRACTICE IN THIS AREA. IN ADDITION, PLEASE BE AWARE THERE IS NO RELATIONSHIP WHATSOEVER BETWEEN CANCELLATION OF DEBT UNDER THE INTERNAL REVENUE CODE AND THE ABILITY OF A CREDITOR TO PURSUE COLLECTION OF A DEBT UNDER STATE OR FEEDERAL LAW.

PLEASE ENTER NOTES AND COMMENTS BELOW