

# Installment Sale and Repossessed Principal Residence

The tax situation in the sale of a principal residence can become more challenging if the taxpayer holds the mortgage on the property and takes the residence back after the buyer defaults on the mortgage—especially if part or all of the gain is excluded by IRC §121.

The tax code provides a simple reporting procedure for most taxpayers selling a principal residence. If there is no capital gain on the sale, the taxpayer doesn't have to report it. If there is a capital gain, Internal Revenue Code (IRC) §121(b) provides the opportunity to exclude from gross income up to \$250,000 (\$500,000 if married filing jointly) of realized gain on the sale if certain requirements are met. Generally, the gain may be excluded only if the taxpayer owned the home for at least two years during the five-year period ending on the date of the sale and lived in the home as the principal residence for at least two years during that same period. Only if the taxpayer doesn't qualify to exclude all of the capital gain under IRC §121(b)—or chooses not to—must the sale be reported. For example, a couple married filing jointly who purchased their principal residence in 2001 for \$200,000 and sell it in 2014 for

\$700,000 or less wouldn't be required to report the sale because their gain is totally excluded by IRC §121.

The sale of the principal residence can become more challenging if the taxpayer sells the property but holds the mortgage on it after the sale. In this case, it's an installment sale, which requires the taxpayer to report the interest and any taxable capital gains from each installment payment received in the year of the payment. One potential problem is handling the tax situation if the buyer defaults and the taxpayer takes back the property in satisfaction of the debt. In this case, the seller turns to IRC §1038 for guidance.

IRC §1038 provides rules for computing the gain attributable to the seller of property that is repossessed in satisfaction of a debt (i.e., mortgage or loan) secured by the property. In general, the rules restore the seller to his or her original position before the sale by ignoring any gains or losses resulting from the repossession.

## Installment Gain Example

Assume an individual sells his primary residence for \$500,000, with an adjusted basis of \$100,000. The buyer agrees to pay the seller

\$50,000 per year for 10 years. The seller has a capital gain of \$150,000, which is the sale price of \$500,000 minus the adjusted basis of the property of \$100,000 and the IRC §121 exclusion of \$250,000. The seller would recognize a capital gain of \$15,000 ( $\$150,000 \times (\$50,000 / \$500,000)$ ) in each year that a payment of \$50,000 is received.

If the buyer defaults on the installment loan and returns the property to the seller, two issues arise for the seller. First, what gain does the seller incur from the reacquired property? Second, what is the basis of the reacquired property? With respect to the first issue, IRC §1038 provides that no gain or loss shall result to the seller from the reacquisition except for the amount of money and fair market value of other property received by the seller prior to the reacquisition. Therefore, the appreciated value in the reacquired property isn't subject to tax. For the second issue, let's look at a more detailed example.

## Gain on Reacquisition Example

Suppose the buyer defaults on the loan after making the first two payments of \$50,000. Further assume that the seller incurs \$5,000

**Figure 1. Calculating the Adjusted Basis of a Reacquired Principal Residence**

Adjusted basis of buyer's indebtedness to seller	
$(\$400,000 - [\$400,000 \times (\$400,000 / \$500,000)])$	\$ 80,000
+ Gain resulting from reacquisition	70,000
+ Reacquisition costs	5,000
Basis of reacquired property	\$155,000

Note that \$50,000 of the increased basis of \$55,000 is attributable to the recognized income from the excluded capital gains under IRC §121.

**Figure 2. Calculating the Adjusted Basis of a Reacquired Secondary Residence**

Adjusted basis of buyer's indebtedness to seller	
$(\$400,000 - [\$400,000 \times (\$400,000 / \$500,000)])$	\$ 80,000
+ Gain resulting from reacquisition	20,000
+ Reacquisition costs	5,000
Basis of reacquired property	\$105,000

of costs in connection with the reacquisition of the property in full satisfaction of the defaulted debt. The seller is returned to his same property ownership position prior to the sale. That is, he has his residence and any possible gains attributable to the real estate market reflected in the property's value (which would have occurred had the taxpayer not sold the property). Even better, the seller is financially better off because he has received \$100,000 from the buyer, from which the seller would have recognized a \$30,000 taxable long-term capital gain, a \$20,000 nontaxable return of investment, and a \$50,000 long-term capital gain that is excluded under IRC §121. These payments constitute cash being received by the seller prior to the reacquisition. Under IRC §1038(b), the seller must recognize any amounts received from the installment sale that weren't previously taxed. In *DeBough v. Commissioner* (142 T.C. No. 17, May 19, 2014), the Court held that amounts excluded by IRC §121 are taken into account as not pre-

viously taxed on the reacquisition. Hence, the seller must recognize \$70,000 as a long-term capital gain. The seller would take no action on the \$30,000 since it was taxed in the year received.

So the question remains: What is the basis of the reacquired property? IRC §1038(c) also addresses this issue, though it is a bit convoluted. The basis of the reacquired residence is the adjusted basis of the buyer's indebtedness to the seller increased by the sum of the amount of the gain from reacquisition and any reacquisition costs. The adjusted basis of the buyer's indebtedness is the unpaid debt at the time of reacquisition less that amount of the unpaid debt multiplied by the gross profit divided by the total contract price (i.e., gross profit percentage). In the situation discussed so far, the seller's basis in the reacquired residence is \$155,000 (see Figure 1 for the calculation).

**Exceptions**

As noted in the *DeBough* case, Congress was aware of the interplay between IRC §1038 and §121

and thus inserted §1038(e). This subsection provides that no gain is recognized on the reacquisition of a principal residence whereby gain is excluded under IRC §121 and the seller resells the property within one year of its reacquisition. Thus the seller is able to collapse the initial sale and subsequent resale into one transaction. The catch is simple: The seller has *one year* from the date of the reacquisition to complete the resale.

**Secondary Residence Example**

In the examples so far, the key fact is that the residence being sold is the seller's principal residence. If the seller's property were a second home, he wouldn't be eligible to claim the IRC §121 exclusion. The results would differ. Specifically, the seller would have a gain from the sale of \$400,000 ( $\$500,000 - \$100,000$ ) and therefore recognize a capital gain of \$40,000 ( $\$400,000 \times (\$50,000 / \$500,000)$ ) in each year that a payment of \$50,000 is received. Upon reacquisition, the seller would recognize \$20,000 as a long-term capital gain, which is the difference between the payments received (\$100,000) and the recognized gain prior to reacquisition (\$80,000). Finally, the reacquired property would have a basis of \$105,000 (see Figure 2 for the calculation). **SF**

*Anthony P. Curatola is the Joseph F. Ford Professor of Accounting at Drexel University in Philadelphia, Pa., and a member of IMA's Greater Philadelphia Chapter. You can reach Tony at (215) 895-1453 or [curatola@drexel.edu](mailto:curatola@drexel.edu).*

©2014 A.P. Curatola