Debt Instrument Liquidation Options

What do you do with a mortgage, promissory note or deed of trust when the debtor stops paying? After the probability of payment in full and resell at a discount are exhausted, there are still three options available to debt instrument holders.

- Donation to a charity,
- Write off as a loss on income tax returns, or
- Abandonment.

~ The blue text is quoted directly from IRS publications ~

Capital Assets
Almost everything owned and used for personal or investment purposes is a capital asset. When a capital asset is sold, the difference between the basis in the asset and the amount it is sold for is a capital gain or a capital loss. Capital gains and deductible capital losses are reported on Form 1040, Schedule D.

If your capital losses are more than your capital gains, you can claim a capital loss deduction. Report the deduction on line 13 of Form 1040, enclosed in parentheses.

Limit on Deduction
Your allowable capital loss deduction, figured on Schedule D, is the lesser of:
$3,000 ($1,500 if you are married and file a separate return), or
Your total net loss as shown on line 16 of Schedule D.
You can use your total net loss to reduce your income dollar for dollar, up to the $3,000 limit.

Capital Loss Carryover
If you have a total net loss on line 16 of Schedule D that is more than the yearly limit on capital loss deductions, you can carry over the unused part to the next year and treat it as if you had incurred it in that next year. If part of the loss is still unused, you can carry it over to later years until it is completely used up.

With a promissory note, mortgage, or trust deed by whatever name it's called, the IRS considers it a capital asset. As such it must be handled according to the rules. If the final result is to end the instrument by any means and it results in a loss you can deduct that loss from income generated from other sources. However, there are limits.

The limits are clear. Once the actual loss amount is determined you can deduct a maximum of $3,000 from this year's income. Any extra is a carry over and can be deducted with the same limit each year. The actual tax savings or return to you from that $3,000 loss is based on your tax bracket.

For example. Mortgage Amount = $60,000 (for ease of computation)

Write Off as Bad Debt

	Income Tax Bracket	Maximum Loss Credit per year	Yearly Tax Savings with $3,000 Loss Limitation	Term of Years to Fully Deduct a Total Loss	Total Tax Return over Life of Term
Single					
$9,526 to $38,700	12%	$3,000	$360	20	$7,200
$38,700 to $82,500	22%	$3,000	$660	20	$13,200
$82,500 to $157,500	24%	$3,000	$720	20	$14,400
$157,500 to $200,000	32%	$3,000	$960	20	$19,200
Married					
$19,050 to $77,400	12%	$3,000	$360	20	$7,200
$77,400 to $165,000	22%	$3,000	$660	20	$13,200
$165,000 to $315,000	24%	$3,000	$720	20	$14,400
$315,000 to $400,000	32%	$3,000	$960	20	$19,200
Corporate					
Flat Tax	21%	$3,000	$630	20	$12,600

Because this is considering a charitable donation limits on such deduction anything more than the initial $5,000 requires an IRS Qualified Appraisal. Also, because we are considered a Private Foundation under 501(c)(3) a donor can not take more than 30% of their Adjusted Gross Income as a deduction. The balance can be carried over to future years. Based on these points we are showing a discount of 25% on the appraised value ($45,000) and only a 30% deduction from AGI for the year.

How to handle the IRS Qualified Appraisal.

Donation to Victims Relief, Inc.

This example is based on a 30% credit to a private foundation NPO					
Considere an IRS Qualified Appraisal value of 75% x $60,000 = $45,000 capital loss valuation					
	Income Tax Bracket	Maximum Loss Credit per year	Tax Savings on Donation Credit 1st Year	Term of Years to Fully Deduct Total Donation	Total Tax Return over Life of Term
Single					

$9,526 to $38,700	12%	$11,610	$1,393	4	$5,400
$38,700 to $82,500	22%	24,750	$5,445	2	$9,900
$82,500 to $157,500	24%	$45,000	$10,800	1	$10,800
$157,500 to $200,000	32%	$45,000	$14,400	1	$14,400
Married					
$19,050 to $77,400	12%	$15,000	$1,800	3	$5,400
$77,400 to $165,000	22%	$30,000	$6,600	2	$9,900
$165,000 to $315,000	24%	$45,000	$10,800	1	$10,800
$315,000 to $400,000	32%	$45,000	$14,400	1	$14,400
Corporate					
Flat Tax	21%	$15,000	$3,150	3	$9,450

Comparing the full $60,000 write off versus the $45,000 donation the actual dollar amounts received back on taxes may be a little different, but the speed of payback is hugely in favor of donation. Also, look at the difference of how much can be recovered in taxes in the first year. Keep in mind that it's based on your current tax bracket each year your file. What will your tax bracket be in 15 years?

Limits on Deductions
The amount of your deduction for charitable contributions is limited to 50% of your adjusted gross income, and may be limited to 30% or 20% of your adjusted gross income, depending on the type of property you give and the type of organization you give it to.

Your adjusted gross income is the amount on Form 1040, line 38.

If your contributions are more than any of the limits that apply, see Capital Loss Carryover above,

50% Limit
The 50% limit applies to the total of all charitable contributions you make during the year. This means that your deduction for charitable contributions cannot be more than 50% of your adjusted gross income for the year.

30% Limit
A 30% limit applies to the following gifts.
Gifts to all qualified organizations other than 50% limit organizations. This includes gifts to veterans' organizations, fraternal societies, nonprofit cemeteries, and certain private non operating foundations.

For Example. If your income is $100,000 you can claim a maximum of $50,000 donation credit from all sources. However, only $30,000 of that can come from a Code 4 organization. The $20,000 of additional donations must be to non-limited charities

Deductibility Code
Publication 78 uses a coding system to identify each organization listed by type and limitation on deductibility of charitable contributions to the organization. The code(s) displayed depend(s) on the code for which the organization qualifies. In cases where an organization has multiple deductibility codes, only the definition for each applicable deductibility code is displayed.

Uncoded organizations are in the 50% limitation group and are described as:

- Religious
- Charitable
- Educational
- Scientific
- Literary
- The prevention of cruelty to children or animals
- Certain organizations that foster national or international amateur sports
- War veterans' organizations
- Domestic fraternal societies, orders, and associations operating under the lodge system

Code Meaning

4	**A private foundation, generally with a 30% deductibility limitation.**
	Victims Relief, Inc. Is a Code 4 private foundation.

How To Figure Your Deduction When Limits Apply
If your contributions are subject to more than one of the limits just discussed, you can deduct them as follows.

Contributions subject only to the 50% limit, up to 50% of your adjusted gross income.

Contributions subject to the 30% limit, up to the lesser of:

30% of adjusted gross income, or

50% of adjusted gross income minus your contributions to 50% limit organizations, including contributions of capital gain property subject to the special 30% limit.

What To Do?
The choice should be clear. Donation to a charity gives the same cash return in tax savings as a capital gain loss, but at a much faster return. Do all charities accept debt instruments as donations? No. If they can't expect to gain any income on it, they won't want it either. Without a regularly expected income the charity can only gain if they can sell it for cash. However that places the donor at a very great risk.

The IRS requires charities that accept non-cash donations to use Form 8282 if the asset is disposed of within three years.

Dispositions of Donated Property

If an organization receives charitable deduction property and within three years sells, exchanges, or disposes of the property, the organization must file Form 8282, Donee Information Return. However, an organization is not required to file Form 8282 if:

The property is valued at $500 or less, or
The property is distributed for charitable purposes.

Form 8282 must be filed within 125 days after the disposition. A copy of Form 8282 must be given to the previous donor. If the organization fails to file the required information return, penalties may apply.

This form is designed to notify the IRS if the value of a donated item changes due to the sale of the item with three years. In other words, if you receive a Form 8283 for $60,000 for the donation of a mortgage and the charity sells it for $500 to generate cash, they must notify the IRS that you are required to file an amended return removing the excess donation credit.

If the mortgage is held for more than 36 months this requirement lapses. It is difficult to find a charity that will hold the mortgage that long without compensation. Victims Relief, Inc. is one of the rare authorized charities that does.

Dr. Kenneth Rich

Victims Relief, Inc.

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