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When Cancellation of Debt (COD) Income Can Be Tax-Free

Sometimes debts can pile up beyond a borrower's ability to repay, especially if we are heading into a recession.

But lenders are sometimes willing to cancel (forgive) debts that are owed by financially challenged borrowers.

While a debt cancellation can help a beleaguered borrower survive, it can also trigger negative tax consequences. Or it can be a tax-free event.

General Rule: COD Income Is Taxable

When a lender forgives part or all of your debt, it results in so-called cancellation of debt (COD) income. The general federal income tax rule is that COD income counts as gross income that you must report on your federal income tax return for the year the debt cancellation occurs.

Fortunately, there are a number of exceptions to the general rule that COD income is taxable. You can find the exceptions in Section 108 of our beloved

Internal Revenue Code, and they are generally mandatory rather than elective. The two common exceptions are:

- Bankruptcy
- Insolvency

The cost of being allowed to exclude COD income from taxation under the bankruptcy or insolvency exception is a reduction of the borrower's so-called tax attributes.

You generally reduce these tax attributes (future tax benefits) by one dollar for each dollar of excluded COD income. But you reduce tax credits by one dollar for every three dollars of excluded COD income. You reduce these attributes only after calculating your taxable income for the year the debt cancellation occurs, and you reduce them in the following order:

1. Net operating losses
2. General business credits
3. Minimum tax credits
4. Capital loss carryovers
5. Tax basis of property
6. Passive activity losses and credits
7. Foreign tax credits

As mentioned above, any tax attribute reductions are deemed to occur *after* calculating the borrower's federal taxable income and federal income tax liability for the year of the debt cancellation.

This taxpayer-friendly rule allows the borrower to take full advantage of any tax attributes available for the year of the debt cancellation *before* those attributes are reduced.

Principal Residence Mortgage Debt Exception

A temporary exception created years ago and then repeatedly extended by Congress applies to COD income from qualifying cancellations of home mortgage debts that occur through 2025.

Under the current rules for this exception, the borrower can have up to \$750,000 of federal-income-tax-free COD income—or \$375,000 if the borrower uses married-filing-separately status—from the cancellation of *qualified principal residence indebtedness*. That means debt that was used to acquire, build, or improve the borrower's principal residence and that is secured by that residence.

Is Airbnb Rental Income Subject to Self-Employment Tax?

Do you owe self-employment tax on Airbnb rental income?

That's a good question.

In Chief Counsel Advice (CCA) 202151005, the IRS opined on this issue.

But before we get to what the IRS said, understand that the CCA's conclusions cannot be cited as

precedent or authority by others, such as you or your tax professional.

Even so, we always consider what the CCA says as semi-useful information, so here's some analysis that goes beyond what the IRS came up with.

The Exact Question

To be specific, the CCA asks whether net income from renting out living quarters is excluded from self-employment income under Section 1402(a)(1) when you're not classified as a real estate dealer.

If excluded under IRC Section 1402(a)(1), you don't owe self-employment tax on your net rental income. Needless to say, that's the outcome you want to see, and I'm here to help.

The taxpayer addressed in this CCA was an individual who owned and rented out a furnished beachfront vacation property via an online rental marketplace (such as Airbnb or VRBO).

The taxpayer provided kitchen items, linens, daily maid service, Wi-Fi, access to the beach, recreational equipment, and prepaid vouchers for rideshare services between the rental property and a nearby business district.

The CCA's Conclusions

According to the CCA, when you're not a real estate dealer, net rental income from renting out living quarters is considered rental from real estate and is therefore *excluded from self-employment income*—as long as you don't provide services to rental occupants.

The self-employment income exclusion for net rental income collected by a non-dealer is a statutory provision. The statute itself doesn't say anything about providing services.

But IRS regulations state that providing services to renters can potentially cause you to lose the exclusion from self-employment income.

According to the CCA, you must include the net rental income in calculating your net self-employment income—which could cause you to owe the dreaded self-employment tax (ugh!)—if you provide services to renters and the services

- are not clearly required to maintain the living quarters in a condition for occupancy *and*
- are so substantial that compensation for the services constitutes a material portion of the rent.

So, according to the CCA, determining whether providing services to renters will trigger exposure to the self-employment tax is the big issue for folks who rent out living quarters.

The CCA's anti-taxpayer conclusion rests on the giant assumption that the services provided by the taxpayer were above and beyond what was required. But were they? Probably not!

The Customarily Issue

According to IRS regulations, services are generally considered above and beyond the norm only if they exceed the services that are *customarily* provided to renters of living quarters.

Therefore, services that simply maintain a vacation rental property in a condition that is customary for rental occupancy should not be considered above and beyond and therefore should not trigger exposure to the self-employment tax.

In assessing whether services provided to renters are above and beyond what's customary, circumstances obviously matter.

In the real world of vacation rentals in expensive resort areas, renters customarily expect and receive lots of

services that might be considered above and beyond in other circumstances.

For instance, in resort areas, renters customarily expect and receive cable service; Wi-Fi access; periodic housekeeping services, including changing bedding and towels; repair of failed appliances; replacement of burned-out lightbulbs; replacement of dead smoke alarm batteries; access to recreational equipment such as bicycles, kayaks, beach chairs, umbrellas, and coolers; and so forth and so on. That's a lot of services!

Why are lots of services provided in expensive resort areas? Because rental charges in expensive resort areas are—wait for it—expensive! The cost may be \$2,000 or more per week or \$5,000 or more per month, or even higher during peak periods—maybe much higher! So, rental amounts that could be attributed to the provision of all the aforementioned services would almost always be a small fraction of the overall rental charges.

In the context of expensive resort area vacation rentals, it's hard to imagine what services would be so above and beyond the norm that the property owner's net rental income would be exposed to the self-employment tax.

It shouldn't matter if the services are provided directly by the owner of the property (unlikely) or indirectly by a rental management agency and included as part of the fee paid by the owner of the property (likely).

The Substantiality Issue

In assessing whether services provided to renters are above and beyond the norm, *substantiality* also matters.

A Tax Court decision addressed a situation where the taxpayer rented out trailer park spaces and furnished laundry services to tenants. The laundry services were clearly provided for the convenience of the tenants and not to maintain the trailer park spaces in a condition for rental occupancy. Tenants were not separately

billed for the laundry services, and they were not separately paid for.

The Tax Court concluded that any portion of the rental payments that was attributable to the laundry services was not substantial enough to trigger exposure to the self-employment tax. Accordingly, the Tax Court opined that all of the trailer park owner's net rental income was excluded from self-employment income.

As stated above, in the context of the rental of expensive vacation properties, any portion of rental charges that could be attributed to the provision of services would likely be insubstantial in relation to the overall rental charges. If so, according to the Tax Court, the provision of such services would not expose the property owner to the self-employment tax.

How to Section 1031 Exchange into a Delaware Statutory Trust

As you likely know, the Section 1031 tax-deferred like-kind exchange is one of the greatest wealth-building mechanisms for real estate investors.

With Section 1031, you can avoid taxes on all your property upgrades during your lifetime and then pass the property to your heirs when you die. The heirs receive the property with a step-up to fair market value, and they can likely sell the property and pay no taxes.

But what if you want to get off the landlord bandwagon? There are options. For example:

- You could use an UPREIT.
- You could invest in an opportunity zone fund.
- You could invest in a Delaware statutory trust as we explain here.

1031 Exchange Overview

The 1031 exchange, or like-kind exchange, has been around since the Revenue Act of 1921. Its purpose is simple: allowing you to swap a business asset without there being a taxable event, because your economic position hasn't really changed.

The basics of a 1031 exchange are pretty straightforward:

- Before you sell the old asset, you must begin the exchange by contracting with a qualified intermediary.
- You may list up to three potential replacement assets within 45 days of the sale of your qualified asset.
- You must close on at least one of those three identified assets within 180 days of the sale.
- For the exchange to be fully tax-free, you must acquire a new asset of greater value than the one you're selling. If you don't trade up, you'll likely have some taxable gain.

IRC Section 1031(a) provides that no gain or loss is recognized on the exchange of real property held for productive use in a trade or business or for investment (relinquished real property) if the relinquished real property is exchanged solely for real property of a like kind that is to be held either for productive use in a trade or business or for investment (replacement real property).

Such Section 1031 assets include, among others:

- Residential or commercial real estate held for investment, rental, or business use
- Raw land held for investment
- Tenant-in-common-held real estate
- Delaware statutory trust interests

Assets that don't qualify for Section 1031 include:

- Securities, stocks, and bonds
- Partnership interests
- Assets held as inventory
- Personal-use real estate
- Foreign real estate

- your income is \$200,000 or more (\$300,000 with your spouse) over the past two years, and you reasonably expect such income for the current year; or
- your net worth exceeds \$1 million excluding the value of your primary residence.

Lack of control. Unlike with property you own yourself, you don't have control over the property in the Delaware statutory trust. Of course, you also don't have the day-to-day landlord headaches.

Leverage. You have heard the saying that you should use other people's money to increase your rate of return. In the real estate investment world, this is common—and it can work. But if you had no mortgage on your 1031 property, you should consider investing in a non-leveraged Delaware statutory trust to reduce the risk that you could lose your investment.

Backup for the 45-day rule. When you have to identify up to three properties under the 45-day rule and then buy one of them within 180 days, you play with fire. Consider naming two properties and using the Delaware statutory trust as a backup. Should the other properties fail, you would use the Delaware statutory trust to preserve your tax-deferred status and live to play the Section 1031 card another day.

Park your investment. If you think the market for buying property will be better seven to 10 years down the road, you could do a Section 1031 exchange into a Delaware statutory trust as a way to park your investment.

What Is a Delaware Statutory Trust?

The Delaware statutory trust property ownership structure allows you (as a smaller investor) to own a fractional interest in large, institutional-quality, and professionally managed commercial property along with other investors. Note that with the Delaware statutory trust, you are an owner.

And it's that ownership interest that makes an investment in a Delaware statutory trust a qualifying replacement asset for purposes of a 1031 exchange. Revenue Ruling 2004-86 confirms the Delaware statutory trust ownership and its qualification for a 1031 exchange.

Some Thoughts on Delaware Statutory Trust Investments

Liquidity. Delaware statutory trusts do not have a secondary market. This means your money is locked up in this investment, perhaps for up to 10 years.

Minimum investment. In general, most Delaware statutory trusts require that you be an accredited investor. Such trusts do their own due diligence on your status, but in general you meet the requirements for classification as an accredited investor when