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## The Tax Consequences of the Statutory Right of Redemption in Property Foreclosures

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# THE TAX CONSEQUENCES OF THE STATUTORY RIGHT OF REDEMPTION IN PROPERTY FORECLOSURES

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## INTRODUCTION

In November of 2001, the National Bureau of Economic Research officially declared the U.S. economy in recession.<sup>1</sup> To counter this lull and restore strength to a struggling economy, the Federal Reserve began a series of interest rate reductions<sup>2</sup> that would lead to the lowest mortgage lending rates in forty years.<sup>3</sup> Almost immediately, the housing market responded. From 2002 to 2005, the U.S. economy moved from recession to expansion, sustained primarily with the aid of a housing boom.<sup>4</sup>

It is no secret that market conditions over the past five years have made it easier than ever to own a home.<sup>5</sup> What is not so well known is that these same conditions have also compounded the problem of foreclosures. In recent years, foreclosure rates have increased dramatically.<sup>6</sup> But, should the housing market contract,

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1. *U.S. Officially Enters Recession*, BBC NEWS, Nov. 26, 2001, <http://news.bbc.co.uk/1/hi/business/1677224.stm>.

2. *U.S. Interest Rates Cut Sharply*, BBC NEWS, Nov. 7, 2001, <http://news.bbc.co.uk/2/hi/business/1641722.stm>; see also *Monetary Policy and the State of the Economy: Hearing Before the H. Comm. on Financial Servs.*, 108th Cong. 49-50 (2003) (statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System) (characterizing lower interest rates, including “historically low mortgage interest rates” as significant among the “steps taken in the private sector over the past couple of years to restructure and strengthen balance sheets” that have enhanced “[t]he prospects for a resumption of strong economic growth”).

3. According to the Joint Center for Housing Studies at Harvard, mortgage interest rates were at forty-six-year lows in 2004. *The State of the Nation's Housing 2005*, 2005 JOINT CENTER FOR HOUSING STUD. HARV. U. 1, 5, <http://www.jchs.harvard.edu/publications/markets/son2005/son2005.pdf> [hereinafter *The State of the Nation's Housing*].

4. *Monetary Policy and the State of the Economy: Hearing Before the H. Comm. on Financial Servs.*, 108th Cong. 59 (2004) (statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System) [hereinafter *2004 Hearing*] (“The lowest home mortgage rates in decades were a major contributor to record sales of existing residences .... [T]he low mortgage rates spurred sales and starts of new homes to very high levels.”).

5. See *id.* at 50-51; see also *The State of the Nation's Housing 2005*, *supra* note 3, at 1 (“[H]omeownership posted an all-time high of 69 percent [in 2004] ....”).

6. See *infra* notes 17-24 and accompanying text.

or in other words, should the proverbial housing bubble burst,<sup>7</sup> foreclosures could reach record levels.<sup>8</sup>

With foreclosures come statutory redemptions. The statutory right of redemption allows a borrower who lost her home at foreclosure to buy back her home within an allotted period of time, which ranges from thirty days to two years depending on the state redemption statute.<sup>9</sup> Because conditions are primed for a foreclosure boom, the need to address statutory redemptions is both relevant and timely.

This Note looks at one unaddressed aspect of statutory redemptions, namely the tax consequences and treatment of property redeemed after foreclosure. More specifically, this Note focuses on statutory redemption's effect on income, income recognition, and depreciation.

Part I will begin by discussing the housing market and the factors that have contributed to the current state of foreclosures. Part II will then provide a background of those principles relevant to property ownership and taxation, including mortgages, foreclosures, and the statutory right of redemption. Part III will discuss the effect of the statutory right of redemption on income as it applies to taxation. Part III will also address the element of income recognition, focusing on when income arising from the discharge of indebtedness as a result of statutory redemption should be recognized. Part IV will then analyze the effect of the statutory right of redemption on property depreciation. Part IV's analysis will first address the arguments for "breaking the chain" of depreciation in statutory redemptions, then address the arguments for "bridging the gap" in such depreciation, and finally conclude that "bridging the gap" should be preferred over "breaking the chain."

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7. Recent comments from Federal Reserve Chairman Ben Bernanke that "a number of indicators point to a slowing in the housing market," suggest that the housing market is already starting to contract. *Monetary Policy and the State of the Economy: Hearing Before the H. Comm. on Financial Servs.*, 109th Cong. 68 (2006) (statement of Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System) [hereinafter *2006 Hearing*]. Another indicator that the bubble may be deflating was evident recently in housing data from Toll Brothers, a national homebuilder, which saw a twenty-one percent first-quarter decline in signed contracts from 2005. Bill Fleckenstein, *Notes from a Housing Bubble's Bust*, MSN MONEY, Feb. 13, 2006, <http://moneycentral.msn.com/content/p143794.asp>.

8. See *infra* note 24 and accompanying text.

9. See *infra* text accompanying notes 55-56.

To help illustrate the principles discussed herein, this Note will use the following hypothetical as a reference throughout the text: Borrower (*B*) buys a house from Seller (*S*) for \$100,000; and *B* finances the purchase through Lender (*L*) who loans *B* \$90,000, with *B* using her own money to pay the remaining \$10,000.<sup>10</sup>

## I. THE HOUSING AND FORECLOSURE BOOM

Low interest rates over the past five years have resulted in a boom in both the housing and lending industries.<sup>11</sup> Borrowers have taken advantage of low rates by purchasing homes at record pace, by refinancing, by taking out home equity loans, and by purchasing additional properties as investments.<sup>12</sup> Lenders have also sought to capitalize on low rates by offering a variety of new loan products<sup>13</sup> and by lowering the requirements for obtaining loans.<sup>14</sup> The result

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10. The numbers in this hypothetical represent a typical lending scenario in which the mortgage covers ninety percent of the property's appraised value, and the remaining ten percent is paid by the buyer as a down payment. See Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489, 509 & n.68 (1991) (choosing to use data from ninety percent loan-to-value ratio, "conventional" mortgages because these have a higher likelihood of default and would be more relevant to a discussion of foreclosure than seventy-five percent loan-to-value ratio mortgages).

11. *The State of the Nation's Housing*, *supra* note 3, at 1, 5 ("[H]omeownership posted an all-time high of 69 percent last year, with households of all ages, races, and ethnicities joining in the home-buying boom.").

12. 2004 *Hearing*, *supra* note 4, at 59 (statement of Alan Greenspan) ("In addition, many households took out cash in the process of refinancing .... That refinancing also permitted some households to lower the monthly carrying costs for their homes and thus freed up funds for other expenditures."); *The State of the Nation's Housing*, *supra* note 3, at 5 ("New and existing home sales, single-family starts, residential fixed investment, remodeling expenditures, home equity, and total mortgage debt all hit new highs.").

13. *Housing Boom or Bubble?*, PBS, Aug. 26, 2005, <http://www.pbs.org/now/politics/mortgages.html> (listing four general categories of popular new loan products including interest-only loans, option adjustable mortgages, piggyback loans, and no-documentation and low-documentation loans).

14. *The State of the Nation's Housing*, *supra* note 3, at 17 ("Credit standards have been eased especially in the areas of minimum downpayments, debt-to-income ratios, and credit history."); *id.* ("The mortgage industry has been loosening [its] standards in a variety of ways—reducing minimum credit scores; allowing borrowers to finance more of a home's value; permitting borrowers to carry a higher debt load."). A special report in *The Economist* also notes that "[a]ccording to the [National Association of Realtors], 42% of all first-time buyers and 25% of all buyers made no down-payment on their home purchase last year." *The Global Housing Boom: In Come the Waves*, *ECONOMIST*, June 18, 2005, at 67 [hereinafter *The Global Housing Boom*], available at [http://www.economist.com/finance/displayStory.cfm?story\\_id=](http://www.economist.com/finance/displayStory.cfm?story_id=)

is an increasingly large population of borrowers with an increasingly large amount of debt.<sup>15</sup> When these two conditions meet, foreclosures abound.<sup>16</sup>

For the past twenty years, property foreclosures have been steadily escalating.<sup>17</sup> Although part of this escalation may be attributed to factors such as an increasing number of homeowners, the primary cause of this rise in foreclosures is the degree to which borrowers are financially extended.<sup>18</sup> Yet this is only half the story. With every ebb in the cycle of interest rates comes a corresponding flow. As the trend has demonstrated over the past year and a half, rates are again on the rise.<sup>19</sup>

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4079027. The report goes on to state that "little or no documentation of a borrower's assets, employment and income is required for a loan." *Id.*

15. Michael Powell, *A Bane Amid the Housing Boom: Rising Foreclosures*, WASH. POST, May 30, 2005, at A10 ("Americans now shoulder record levels of housing debt."); see also *The State of the Nation's Housing*, *supra* note 3, at 3-4 (noting that "nearly one in three American households spends more than 30 percent of income on housing, and more than one in eight spend upwards of 50 percent," and that "[f]rom 2000 to 2003, the number of middle-income households with severe housing cost burdens shot up by nearly one million"); *The Global Housing Boom*, *supra* note 14 ("New, riskier forms of mortgage finance also allow buyers to borrow more.").

16. Jim Day, *High Foreclosures Drive Fight over Lending Practices*, CHI. LAW., June 2004, at 80 ("[T]he rise in foreclosures has followed a rise in home ownership as credit has become available to people who, in the past, could not have gotten a mortgage."); Richard Deitz & Ramon Garcia, *Examining the Rising Foreclosure Rate*, REGIONAL ECON. UPSTATE N.Y. (Fed. Reserve Bank of N.Y., Buffalo Branch), Spring 2003, at 1, available at [http://www.newyorkfed.org/research/regional\\_economy/spring2003.pdf](http://www.newyorkfed.org/research/regional_economy/spring2003.pdf) ("While the causes of the escalating foreclosure rates remain unclear, we suggest a link to the increasing number of residential mortgages in which the amount of the loan is high relative to the value of the property.").

17. Deitz & Garcia, *supra* note 16, at 1; Powell, *supra* note 15 (stating that "[f]oreclosure rates rose in 47 states in March [2005]"). In addition, the chief economist for the National Multi-Housing Council in Washington, D.C., has noted that "there have been rising, even record, defaults in a number of cities this year, including Philadelphia, Denver, and Houston." Mark Obrinsky, *Will Rise in Foreclosures Derail the Housing Market?*, Nov. 1, 2005, NAT'L REAL EST. INVESTOR, available at [http://www.nreionline.com/mag/real\\_estate\\_rise\\_foreclosures\\_derail/](http://www.nreionline.com/mag/real_estate_rise_foreclosures_derail/).

18. See Deitz & Garcia, *supra* note 16, at 2 ("Virtually every loan study finds a positive relationship between LTV [loan-to-value ratios] and loan payment delinquencies, defaults, and foreclosures. The higher the LTV, the less equity a borrower has in the property and therefore the less to lose by defaulting on the loan and losing possession.").

19. 2006 *Hearing*, *supra* note 7, at 69 (statement of Ben S. Bernanke) (noting that "[i]nterest rates on thirty-year, fixed-rate mortgages ... rose noticeably in the final months of the year"); *The State of the Nation's Housing*, *supra* note 3, at 15 (stating that "[a]fter years of uninterrupted growth, the home buying market is now [beginning in 2004] feeling the pinch of higher short-term interest rates").

What, then, does this mean for borrowers? For those with fixed-rate loans, rising interest rates mean nothing.<sup>20</sup> But for those with adjustable-rate or interest-only loans, which both have vastly increased in popularity,<sup>21</sup> this trend means that the low rates, which enticed or allowed them to borrow money in the first place, will also begin to rise.<sup>22</sup> Because rate increases exert financial pressure on the borrower,<sup>23</sup> it is fair to assume that residential foreclosures will at least continue at their current elevated rates, or possibly rise to unprecedented levels.<sup>24</sup>

The cycle of rising foreclosures could extend to commercial property as well. The Federal Reserve Board noted in a summary of

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20. This conclusion assumes that there are no outside influences that may, for example, require a borrower to refinance into an adjustable-rate loan, a fixed-rate loan is generally not affected by fluctuations in interest rates.

21. *The State of the Nation's Housing*, *supra* note 3, at 16 (stating that in 2004, "homebuyers increasingly turned to adjustable-rate mortgages"); *The Global Housing Boom*, *supra* note 14, at 67 (noting that "[i]nterest-only mortgages are all the rage," and that "[i]n California, over 60% of all new mortgages this year are interest-only or negative-amortisation, up from 8% in 2002"); *see also* Obrinsky, *supra* note 17 ("Recently, there has been a proliferation of creative mortgage products unlike anything since the early 1980s."); Powell, *supra* note 15 ("Interest-only and adjustable-rate mortgages account for 63 percent of new mortgages.").

22. *2006 Hearing*, *supra* note 7, at 69 (statement of Ben S. Bernanke) ("Rates on adjustable-rate mortgages have climbed more considerably [in 2005]."). It is important to note that adjustable-rate mortgage payments will rise in accordance with the rise in interest rates, whereas interest-only mortgage payments will rise after the interest-only period expires and the loan is reformulated over a new amortization schedule.

23. Federal Reserve Governor Mark Olson has noted that "households stretching to qualify for loans will be severely challenged if, for example, interest rates rise." Obrinsky, *supra* note 17 (quoting Governor Olson); *see also* *The State of the Nation's Housing*, *supra* note 3, at 16 ("Home buyers choosing an adjustable-rate mortgage could be in for payment shock if interest rates take off.").

24. Powell, *supra* note 15 ("Should the nation's housing bubbles deflate, as many economists and federal officials expect, the foreclosures could prefigure a national crisis."); *see also* *Monetary Policy and the State of the Economy: Hearing Before the H. Comm. on Financial Servs.*, 109th Cong. 63 (2005) (statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System) ("The increase in the prevalence of interest-only loans and the introduction of more exotic forms of adjustable-rate mortgages are developments of particular concern.... [T]hese contracts may leave some mortgagors vulnerable to adverse events. It is important that lenders fully appreciate the risk that some households may have trouble meeting monthly payments as interest rates and the macroeconomic climate change.").

This trend is already underway in Sydney, Australia, where a housing boom that began in the mid-1990s has recently come to a halt. In 2005, Sydney saw a record number of foreclosures, up fifty-nine percent from 2004, and more than double the foreclosures in 2003. *Slump Hits Home*, SYDNEY MORNING HERALD, Feb. 7, 2006, at 12, available at <http://www.smh.com.au/news/national/slump-hits-home/2006/02/06/1139074171442.html>.

reports from businesses and other contacts that a “[r]ising demand for commercial mortgages was reported in New York, Cleveland, Richmond, and Kansas City.”<sup>25</sup> As the demand for commercial mortgages increases and is met, the number of commercial borrowers—and the number of potential commercial defaulters—also increases. This cycle may in fact be underway in places like Dallas, which is already experiencing an increase in commercial foreclosures.<sup>26</sup>

## II. FUNDAMENTALS OF PROPERTY OWNERSHIP

### A. Mortgages

A mortgage is an agreement between a borrower and lender that creates a legal right for the lender to recover the loan amount from the assets of the borrower should the borrower default or fail to make the required payments.<sup>27</sup> When a borrower defaults, the loan amount is usually recovered from the property for which the loan was originally given.<sup>28</sup> The loan can also be recovered, however, from the borrower’s personal assets.<sup>29</sup> Mortgages thus act as security instruments by which lenders can recover some, if not all, of the original loan amount in the event the buyer defaults.<sup>30</sup>

#### 1. Recourse Lending

As mentioned above, there are two ways a lender can recover the loan amount from the borrower in the case of default.<sup>31</sup> The first

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25. THE FEDERAL RESERVE BOARD, THE BEIGE BOOK (Mar. 9, 2005), available at <http://www.federalreserve.gov/fomc/beigebook/2005/20050309/default.htm>.

26. *Id.*

27. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 1.1 cmt. (1997) (“Unless it secures an obligation, a mortgage is a nullity. Most often the obligation is the payment of money under the terms of a promissory note or other debt instrument, although many other forms of obligation may also be secured.”).

28. *See, e.g., id.* § 1.1 & illus. 1 & 2.

29. *Id.* § 1.1 cmt. (“Commonly the mortgagor or some other person is personally liable for performance of the obligation in question.”).

30. *Id.* § 1.1 (“A mortgage is a conveyance or retention of an interest in real property as security for performance of an obligation.”).

31. *See supra* text accompanying notes 28-29.



way is for the lender to recover the loan amount from the total assets of the borrower, including the property purchased with the loan as well as any other of the borrower's assets that may legally be used to pay off the debt.<sup>32</sup> This is known as recourse lending, and the specific debt instrument is known as a recourse loan.<sup>33</sup>

Recourse lending is most commonly employed in residential lending, with recourse loans securing the vast majority of homes in this country.<sup>34</sup> In practice, a recourse loan ensures that the borrower is liable for the full loan amount.<sup>35</sup> If the proceeds from the sale of property secured by a mortgage are not sufficient to satisfy the original loan amount, then the recourse lender can look to the personal assets of the borrower to fulfill the debt.

For example, in the hypothetical, if *B* defaults on the mortgage with *L*, and the loan was a recourse loan, then *B* is liable for the full \$90,000 to *L*.<sup>36</sup> So if *L* recovers only \$80,000 from the sale of the property, then *L* can seek a deficiency judgment to recover the remaining \$10,000 from *B*'s personal assets.<sup>37</sup>

## 2. Nonrecourse Lending

The second way a lender can recover a defaulted loan is to look solely to the property secured by the loan. This is known as nonrecourse lending, and the debt instrument is known as a

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32. See *supra* note 27 and accompanying text.

33. *E.g.*, *United States v. Moran*, 312 F.3d 480, 483 (1st Cir. 2002) (contrasting nonrecourse loans with recourse loans, which do not "insulate borrowers from personal liability for the amount of the loans").

34. See Dale A. Whitman, *Chinese Mortgage Law: An American Perspective*, 15 COLUM. J. ASIAN L. 35, 44 (2001) ("[R]esidential loans [in the United States], secured by one-to-four-family homes, almost never contain [nonrecourse] clauses, and hence give rise to personal liability on the part of the borrower.").

35. *Id.* at 45 ("[T]he ... buyer who defaults on the mortgage debt payments risks both losing the property and being held personally liable for the debt or a deficiency.").

36. See *Moran*, 312 F.3d at 483, 485.

37. See RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 8.4 (1997); Whitman, *supra* note 34, at 44-46.

nonrecourse loan.<sup>38</sup> Nonrecourse loans are most commonly employed in commercial lending.<sup>39</sup>

For practical purposes, in a nonrecourse loan the borrower is not liable for any portion of the loan that exceeds the amount recovered from the sale or disposition of the property securing the loan.<sup>40</sup> Referring back to the hypothetical, if *B* defaults on the mortgage with *L*, and the loan is a nonrecourse loan, then *B* is liable solely for the amount received from the sale or disposition of the property secured by the mortgage.<sup>41</sup> If *L* recovers only \$80,000 from the sale of the property, then *B* is no longer liable for the remaining \$10,000. *L* has, in effect, lost this money.<sup>42</sup>

### *B. Foreclosures*

When a borrower fails to make payments on a loan, the lender has the legal right to recover the loan amount from the borrower.<sup>43</sup> The lender exercises this right by taking over the secured property through foreclosure.<sup>44</sup>

The process of foreclosure by way of judicial sale takes place as follows: The lender first notifies the borrower that the loan is in default and files a foreclosure complaint with the court.<sup>45</sup> If the loan continues in default, the lender then serves the complaint on the

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38. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 1.1, cmt. & illus. 1 (1997) (“[I]t is not unusual for the parties to the mortgage to agree that there shall be no personal liability for the performance, or that personal liability is to be limited. This is often termed a ‘nonrecourse’ or ‘limited recourse’ mortgage.”).

39. Whitman, *supra* note 34, at 44 (“It is possible for the lender and borrower to agree ... that the borrower will have no ... personal liability. Such loans are termed ‘non-recourse’ loans. It is fairly common for mortgage loans on commercial real estate in the United States to contain ‘non-recourse’ clauses.” (footnote omitted)).

40. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 8.2 cmt. a (1997) (“[I]f the mortgage obligation is ‘non-recourse,’ the mortgagee’s only remedy is foreclosure and the mortgagee is barred from obtaining a personal judgment prior to foreclosure or a deficiency judgment following foreclosure.”).

41. *Id.*

42. Although the term “nonrecourse” may seem to imply that the lender has no recourse at all, this is not the case. As the hypothetical illustrates, the lender has recourse equal to the amount secured by the property. The lender literally has no recourse, however, for any amount above that secured by the property in a nonrecourse loan.

43. See *supra* notes 27-29 and accompanying text.

44. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 8.2(a) (1997).

45. *Id.* § 8.2 cmt. a.

borrower.<sup>46</sup> A judicial hearing is ordered, the foreclosure decreed, and notice posted that a foreclosure sale is pending.<sup>47</sup> The property is then sold at a foreclosure auction open to the public and conducted by a local court officer.<sup>48</sup>

The amount paid at auction is used to pay off the original loan amount.<sup>49</sup> As a result, lenders will normally bid up to the amount they have invested in the property to ensure that they are either paid in full or that they end up with the property itself.<sup>50</sup>

Returning to the hypothetical, if *L* ordered a sale of *B*'s property at foreclosure, *L* would likely bid at least \$90,000, an amount equal to the remaining balance. That way, *L* either gets the property for \$90,000,<sup>51</sup> an amount that *L* already has invested in the property, or, if someone bids higher than *L*, the proceeds from the sale will be used to pay off the remaining balance to *L*.<sup>52</sup>

Under the common law, if a borrower in default can pay off the outstanding balance—including all principal, interest, late fees, and any other charges that may have accumulated during default—before the foreclosure process is concluded, then the borrower retains possession of the property. This common law practice is

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46. *Id.*

47. *Id.*

48. *Id.* In addition to judicial foreclosures, some states permit nonjudicial foreclosures. This Note focuses solely on judicial foreclosures because they are recognized in all fifty states, and because some states allow statutory redemptions only if the property was foreclosed through a judicial sale. See Brian M. Heaton, Note, *Hoosier Inhospitability: Examining Excessive Foreclosure Rates in Indiana*, 39 IND. L. REV. 87, 87-88 (2005) ("The two primary forms of foreclosure in the United States are judicial foreclosure, which all fifty states recognize, and nonjudicial foreclosure, which only some states permit by statute."); Georgina W. Kwan, Comment, *Mortgagor Protection Laws: A Proposal for Mortgage Foreclosure Reform in Hawai'i*, 24 U. HAW. L. REV. 245, 270-71 (2001) (noting that "California's statutory right of redemption is limited to borrowers whose homes were sold at a judicial foreclosure").

49. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 8.2(a) (1997) (stating that "the mortgagee may ... foreclose the mortgage on the real estate for the balance").

50. For a detailed look at the mortgage foreclosure and subsequent resale process, see generally Steven Wechsler, *Through the Looking Glass: Foreclosure by Sale as De Facto Strict Foreclosure—An Empirical Study of Mortgage Foreclosure and Subsequent Resale*, 70 CORNELL L. REV. 850 (1985) (suggesting modifications for improvement to the foreclosure resale process).

51. Occasionally lenders can profit from the resale of property after they acquire it at a foreclosure sale. *Id.* at 851 (detailing a case in which the lender made a profit from the resale of the foreclosed property).

52. See *supra* notes 49-50 and accompanying text.

known as “equity of redemption.”<sup>53</sup> Its purpose is to protect property owners who may be temporarily unable to make a payment, or who may have inadvertently missed a payment, from losing the property altogether.<sup>54</sup>

### C. Statutory Right of Redemption

Some states have taken the principle of equity redemption a step further and created a statutory right of redemption.<sup>55</sup> This right, created by state law, allows a borrower to buy back her property after it has already been sold at foreclosure. Depending on the state, the redemption period can last from thirty days to two years after the property is sold.<sup>56</sup>

Approximately half the states have adopted some form of a statutory right of redemption.<sup>57</sup> As required by state legislatures,

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53. *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 541 (1994) (“The history of foreclosure law also begins in England, where courts of chancery developed the ‘equity of redemption’—the equitable right of a borrower to buy back, or redeem, property conveyed as security by paying the secured debt on a later date than ‘law day,’ the original due date.”).

54. *Id.*; see also Heaton, *supra* note 48, at 92 n.30.

55. Joseph E. Gotch, Jr., Note, *Creditors’ vs. Debtors’ Rights Under Alaska Foreclosure Law: Which Way Does the Balance Swing?*, 14 ALASKA L. REV. 77, 82 (1997) (“In addition to equitable redemption and reinstatement, about one-half of the states have established statutory rights of redemption that allow the mortgagor to redeem the property for a set period after a valid foreclosure sale.”).

56. Arizona, for example, has a thirty-day statutory redemption period, whereas Tennessee has a two-year statutory redemption period. James B. Hughes, Jr., *Taking Personal Responsibility: A Different View of Mortgage Anti-deficiency and Redemption Statutes*, 39 ARIZ. L. REV. 117, 131 & nn.86-88 (1997).

57. See, e.g., ALA. CODE § 6-5-248 (LEXIS through 2005 1st Spec. Sess.); ALASKA STAT. § 09.35.250 (LEXIS through 2005 legislation); ARIZ. REV. STAT. §§ 12-1281 to -1283 (LEXIS through 2005 legislation, 47th Leg., 1st Reg. Sess.); ARK. CODE ANN. § 18-49-106 (LEXIS through 2006 1st Extraordinary Sess.); CAL. CIV. PROC. CODE §§ 729.010 to .030 (West Supp. 2006); COLO. REV. STAT. § 38-38-302(1)(a) (2005); IDAHO CODE ANN. §§ 11-401 to -402 (LEXIS through 2006 Reg. Sess.); 735 ILL. COMP. STAT. ANN. 5/15-1603 (West 2003 & Supp. 2006); IOWA CODE §§ 628.3, 654.5 (LEXIS through 2005 legislation); KAN. STAT. ANN. §§ 60-2410, -2414 (LEXIS through 2005 Supp.); KY. REV. STAT. ANN. § 426.220 (LexisNexis 2005); ME. REV. STAT. ANN. tit. 14, § 6204 (LEXIS through 2006 Ch. 552); MICH. COMP. LAWS ANN. § 600.3140 (West 2000 & Supp. 2006); MINN. STAT. ANN. §§ 580.23, 581.10 (West 2000 & Supp. 2006); MO. REV. STAT. § 443.410 (LEXIS through 2005 legislation); MONT. CODE ANN. §§ 25-13-710, -801 (LEXIS through 2005 Spec. Sess.); NEV. REV. STAT. ANN. §§ 21.200, 21.210, 107.080 (LEXIS through 73d (2005) Sess.); N.J. STAT. ANN. §§ 2A:50-4, -5, -8, -9 (West 2000) (allowing right of redemption after foreclosure except in certain circumstances); N.M. Stat. Ann. §§ 39-5-18, -21 (LEXIS through 2d Sess. of the 47th Leg.); N.D. CENT. CODE §§ 28-24-01

the borrower must restore the buyer at foreclosure to the position she was in prior to purchasing the property, taking into account the purchase price, fees, and other similar transaction costs.<sup>58</sup> This requirement serves to protect the buyer at foreclosure and ensures that the only thing she could lose by purchasing the property is time.<sup>59</sup>

As the statutory right of redemption is used today, it requires the mortgagor, that is, the original borrower (*B* in the hypothetical), to reimburse the purchaser at foreclosure the amount paid at auction.<sup>60</sup> This distinguishes the statutory right of redemption from equity of redemption, in which, *before foreclosure*, the borrower reimburses the lender the total amount still owed on the original mortgage.<sup>61</sup>

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to -02, 32-19-18, 35-22-20 (LEXIS through 2005 Sess.); OR. REV. STAT. §§ 18.962 to .964, 88.080 (LEXIS through 2005 Reg. Sess. of 73d Legis. Assemb.); S.D. CODIFIED LAWS §§ 21-52-1 to -5 (LEXIS through 2006 legislation); TENN. CODE ANN. §§ 66-8-101 to -106 (2004); UTAH CODE ANN. § 78-37-6 (LEXIS through 2006 3d Spec. Sess.); UTAH R. CIV. P. 69C (LEXIS through Apr. 1, 2006); WASH. REV. CODE ANN. § 6.23.020 (LEXIS through 2005 Gen. Election); WYO. STAT. ANN. § 1-18-103 (LEXIS through 2006 legislation); Patrick B. Bauer, *Statutory Redemption Reconsidered: The Operation of Iowa's Redemption Statute in Two Counties Between 1881 and 1980*, 70 IOWA L. REV. 343, 345 n.11 (1985) (listing states with statutory redemption for both foreclosures and judgment execution sales). States with statutory redemption for judgment execution sales but not foreclosures are not included in the list of statutes above and are outside the scope of this Note.

58. Hughes, *supra* note 56, at 132 ("When a mortgagor exercises her statutory right of redemption, the mortgagee, or other foreclosure sale purchaser, usually receives only the foreclosure sale purchase price, a statutorily prescribed rate of interest on its temporary investment in the property, and reimbursement of certain other necessary expenses incurred in holding the property."); Gotch, *supra* note 55, at 82 ("To redeem the property under [the statutory right of redemption], the debtor must pay the purchaser the foreclosure sale price plus any taxes or other costs paid by the purchaser due to the sale.").

59. Because the redemption period can last as long as two years, losing time could still be costly, but the purchaser at foreclosure does receive interest from the mortgagor to compensate for the time value of money. See *supra* note 58.

60. Hughes, *supra* note 56, at 130-31.

61. *Id.* In statutory redemption, "[t]he mortgagor is not required to pay the unpaid balance of the debt originally secured by the foreclosed mortgage, even if that unpaid balance exceeds the foreclosure sale purchase price." *Id.* at 131. Some states have recognized or codified this common law form of redemption. *E.g.*, MASS. GEN. LAWS ANN. ch. 244, § 18 (West 2004 & Supp. 2006) (right to redeem before, but not after, foreclosure sale); VT. STAT. ANN. tit. 12, § 4529 (2002 & Supp. 2006) (recognizing that equity of redemption expires upon the property's sale at foreclosure); *W. Allis Sav. Bank v. Kromanaker*, 527 N.W.2d 400, 1994 WL 637246, at \*2 (Wis. Ct. App. 1994) (unpublished table decision) (holding that two Wisconsin statutes, when read together, made clear that the right of redemption exists only until sale at foreclosure).

The most comprehensive empirical study on the statutory right of redemption was conducted by Professor Patrick Bauer, who analyzed ninety-nine years of courthouse records from two counties in Iowa.<sup>62</sup> Bauer's data showed that from 1881 to 1980, 191 out of 1832 foreclosures, or approximately 10.4%, were statutorily redeemed.<sup>63</sup> Although Bauer's figures are in line with those of a study conducted shortly before his, he points out that his figures are "from almost five to more than eleven times greater than the frequencies of redemption observed in ... older studies."<sup>64</sup> This difference, he surmises, may be attributable to limitations of the earlier studies<sup>65</sup> or to features of the Iowa Statute that might make redemption more effective and therefore more significant in Iowa than in other states.<sup>66</sup>

If the studies finding one-fifth the 10.4% rate of redemption that Bauer found were indeed accurate, then a rough estimate of redemptions should be based on a rate of 2.1%. Projected against the total number of foreclosures in 2005 in the states that provide a statutory right of redemption (252,026),<sup>67</sup> a 2.1% redemption rate results in an estimated 5293 redemptions in 2005. If the studies finding one-eleventh of the 10.4% figure are the most accurate, then the adjusted percentage rate would be 0.95%, and the estimated redemptions in 2005 would be 2394. Leaving Bauer's 10.4% figure unchanged would yield 26,211 redemptions. Although these figures are rough estimates at best,<sup>68</sup> they provide some objective basis for

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62. See Bauer, *supra* note 57, at 350; see also Debra Pogrud Stark, *Facing the Facts: An Empirical Study of the Fairness and Efficiency of Foreclosures and a Proposal for Reform*, 30 U. MICH. J.L. REFORM 639, 640 & n.3 (1997) (citing Bauer's article in a list of the "few" studies that "have accumulated and analyzed hard data on the [foreclosure] process"). Bauer's was the only work in the list addressing the right of redemption, and Stark later used Bauer's data to draw conclusions about the statutory right of redemption. See Stark, *supra*, at 640 n.3, 674.

63. Bauer, *supra* note 57, at 351.

64. *Id.* at 351.

65. See *id.* at 349 & n.30.

66. See *id.* at 350 n.31.

67. See Press Release, RealtyTrac, National Foreclosures Increase in Every Quarter of 2005 According to RealtyTrac™ U.S. Foreclosure Market Report (Jan. 23, 2006), <http://www.realty.com/news/press/pressRelease.asp?PressReleaseID=86> (listing foreclosures by state). The 252,026 figure is the sum of foreclosures in all the twenty-five states that offer a statutory right of redemption. See *supra* note 57.

68. Nationwide estimates are difficult, and necessarily only approximate, because the statutory right of redemption varies from state to state. See Bauer, *supra* note 57, at 345 n.11 (noting that some statutes allow redemption in all mortgage foreclosure sales, some allow it

the state of foreclosures and redemptions in the United States today. And whatever the actual number of redemptions, it is likely on the rise because, from August 2005 to August 2006, foreclosures nationwide increased by 53%.<sup>69</sup>

### III. INCOME AND THE STATUTORY RIGHT OF REDEMPTION

#### A. Income

When calculating the tax consequences of any transaction, one of the most important determinations is whether the transaction produces income. If there is income, it is usually subject to taxation.<sup>70</sup>

Income is defined in the Internal Revenue Code as “all income from whatever source derived.”<sup>71</sup> In 1955, the Supreme Court expounded upon this definition in *Commissioner v. Glenshaw Glass Co.*, referring to income as “accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.”<sup>72</sup> This definition is used throughout tax jurisprudence as an acknowledged definition of income.<sup>73</sup> This Note will refer to those definitions of income used in *Glenshaw Glass* and the Internal Revenue Code.

Income includes not only affirmative accessions to wealth, such as monetary gains or increases,<sup>74</sup> but also includes debt

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only if the mortgage was foreclosed by judicial action, and some only if it was foreclosed by nonjudicial action, among other variations); *supra* note 56 and accompanying text (noting variation in time periods for exercising statutory redemption).

69. Press Release, RealtyTrac, National Foreclosures Increase 24 Percent in August (Sept. 13, 2006), [http://www.realestateproguides.com/Article\\_02\\_RealtyTrac\\_Report\\_06.pdf](http://www.realestateproguides.com/Article_02_RealtyTrac_Report_06.pdf). Of the ten states with the highest foreclosure rates in August 2006, five—Colorado, Michigan, Nevada, Illinois, and Utah—have a statutory right of redemption. *See id.* Of the five states with the greatest number of new foreclosures, accounting for half the country’s foreclosures in August, two—California and Illinois—have a statutory right of redemption. *See id.*

70. Not all income is taxed. Some provisions of the Internal Revenue Code allow certain types of income to be excluded from taxation. *See, e.g.*, I.R.C. §§ 101-39 (2000). This Note is concerned primarily with whether redemption transactions can actually produce income.

71. I.R.C. § 61(a) (2000).

72. *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

73. *See, e.g.*, *Comm’r v. Indianapolis Power & Light Co.*, 493 U.S. 203, 209 (1990) (“In determining what sort of economic benefits qualify as income, this Court has invoked various formulations. It has referred, for example, to ‘undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.’”).

74. I.R.C. § 61(a)(1)-(2) (2000).

forgiveness.<sup>75</sup> This Note will focus specifically on those affirmative accessions to wealth or discharges of indebtedness that arise from the sale or exchange of property.<sup>76</sup> For tax purposes, a foreclosure is treated as a “sale or other disposition of property”<sup>77</sup> in accordance with *Helvering v. Hammel*.<sup>78</sup>

### *B. Basis and Debt*

In order to avoid taxing the same income twice, Congress allows taxpayers to recognize as income only the amount received in excess of what the taxpayer has put into the property in the form of mortgage payments and other expenditures such as improvements.<sup>79</sup> The amount that a taxpayer has invested in property is referred to as “basis.”<sup>80</sup> In the hypothetical, because *B* paid \$10,000 as a down payment, and because *B* has presumably already paid income tax on this \$10,000,<sup>81</sup> the \$10,000 is part of her basis. If *B* were to sell the house, she would not be required to pay taxes on that \$10,000.

The down payment, though, is not all that *B*'s basis includes. Basis also includes the debt that a borrower may accumulate in the purchase of a home by way of loans and mortgages.<sup>82</sup> The rationale for treating debt as basis rests on the assumption that the borrower will eventually pay off the debt with taxed-once-already dollars.<sup>83</sup>

The Internal Revenue Code defines the “basis of property” as the cost of such property adjusted for expenditures, receipts, losses, or

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75. I.R.C. § 61(a)(12) (2000).

76. I.R.C. § 61(a)(3) (2000).

77. I.R.C. § 1001(b) (2000).

78. 311 U.S. 504, 511-12 (1941); *see, e.g.*, 2925 Briarpark, Ltd. v. Comm'r, 163 F.3d 313, 318 (5th Cir. 1999) (recognizing that *Helvering* established that foreclosure sales are dispositions of property within the meaning of § 1001(b)).

79. *See* I.R.C. §§ 1001(a), 1011(a), 1016(a)(1) (2000).

80. *See* I.R.C. §§ 1011(a), 1012, 1016(a)(1) (2000).

81. The presumption is that when *B* earned the money used to make the down payment, it was taxed at the time of earning (or in the appropriate tax year) and need not be taxed again when the property is sold.

82. *See* Comm'r v. Tufts, 461 U.S. 300, 307-08 (1983) (“Because of the obligation to repay, the taxpayer is entitled to include the amount of the loan in computing his basis in the property; the loan, under § 1012, is part of the taxpayer's cost of the property.”).

83. TONI ROBINSON & MARY FERRARI, FEDERAL INCOME TAX: AN INTERACTIVE TRANSACTIONAL APPROACH (forthcoming 2006) (manuscript at 79 & n.38) (using the acronym “TOAD” to refer to “taxed-once-already dollars”).



other items that qualify under I.R.C. § 1016.<sup>84</sup> This calculation yields the adjusted basis used in determining whether money received from the sale of property is income.<sup>85</sup> In the hypothetical, the cost of the property was \$100,000. Under § 1012, this price represents *B*'s basis in the property, which means that *B* will not be taxed on the first \$100,000 of income from the sale of the house.<sup>86</sup> If *B* were to sell the house for \$120,000, \$100,000 of the sale amount would not be taxed because it represents *B*'s basis, or taxed-once-already dollars.<sup>87</sup> The remaining \$20,000, however, would be subject to income taxation.<sup>88</sup>

### *C. Statutory Redemption's Effect on Income*

#### *1. Recourse Scenarios*

When a borrower redeems her home lost through foreclosure,<sup>89</sup> and the loan securing the home was a recourse loan, the tax consequences are as follows.

If the price at the foreclosure sale is equal to the outstanding amount of the original loan, then there has been no change in the amount owed, acquisition cost, or basis, and thus, no income is recognized.<sup>90</sup>

If the price paid by the purchaser at the foreclosure auction is less than the amount that the original borrower owes the lender, and the borrower redeems the house at that lower price, then the borrower now has bought the house for a price lower than what she owed prior to foreclosure. Because this is a recourse loan, however, the

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84. I.R.C. §§ 1011-1012 (2000).

85. See, e.g., I.R.C. § 1001(a) ("The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 ....").

86. See *supra* note 84 and accompanying text.

87. See *supra* note 79 and accompanying text.

88. See I.R.C. § 61(a)(3) (2006).

89. As stated above, the borrower exercises the statutory right of redemption by reimbursing the price paid at foreclosure plus other expenses. See *supra* notes 58-60 and accompanying text. Although these other expenses are not to be overlooked, they will be assumed to be zero in the examples that follow, for ease of calculation.

90. See *supra* notes 85-86 and accompanying text.

borrower is still liable for the original, full mortgage amount.<sup>91</sup> And because the borrower is still liable for the full amount, the borrower's basis in the home has not changed.<sup>92</sup> There has been no discharge of indebtedness, and thus no income as a result.<sup>93</sup>

Returning to the hypothetical, if the house sells at foreclosure for \$80,000, and that \$80,000 is used to pay off *L*, then *B* still owes *L* the remaining \$10,000 of the original \$90,000 loan. *B* remains liable for this debt because this is a recourse loan.<sup>94</sup> If *B* then redeems the house for \$80,000, she owes \$80,000 to the purchaser at foreclosure and \$10,000 to *L*, both of which represent acquisition costs and her basis in the house under § 1011(a).<sup>95</sup>

On the other hand, if the price at the foreclosure sale exceeds that of the outstanding amount of the original loan, and the borrower redeems the house at that higher price, then the borrower's basis in the house increases from what it was prior to foreclosure.<sup>96</sup> This creates no immediate tax consequences; but when the borrower later sells or disposes of the house, then her greater basis will result in lower tax liability in the future.<sup>97</sup>

For example, if *B*'s house sells at foreclosure for \$110,000, because the new price is greater than the previous amount owed to *L*, the proceeds from the foreclosure sale will likely pay off *L* in full.<sup>98</sup> If *B* goes on to redeem the house at the \$110,000 price, then this price represents *B*'s new basis in the home, and the amount for which *B* is exempt from paying taxes. *B* is allowed to exempt the additional \$10,000 from income taxation because, like her previous basis of \$100,000, it is an acquisition cost.

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91. See *supra* Part II.A.1.

92. See *Crane v. Comm'r*, 331 U.S. 1, 10-11 (1947); see also *Comm'r v. Tufts*, 461 U.S. 300, 305-07 (1983) (summarizing and explaining *Crane*'s holding).

93. See ROBINSON & FERRARI, *supra* note 83 (manuscript at 1026).

94. See *supra* Part II.A.1.

95. I.R.C. §§ 1011(a), 1012 (2000).

96. See *supra* notes 80-85 and accompanying text.

97. See *supra* Part III.B.

98. See *supra* notes 49-50 and accompanying text.

## 2. *Nonrecourse Scenarios*

When a borrower redeems property secured by a nonrecourse loan, and the redemption amount is equal to or greater than the original loan amount, then the tax consequences will be the same as those for the corresponding recourse scenarios listed above.

A more important issue arises, however, when the redemption amount is *less than* the original loan amount.<sup>99</sup> If the price paid at the foreclosure auction is less than the amount owed to the lender, and the borrower redeems the house at that lower price, then the borrower now owns the home with less debt—and consequently a lower basis—than she owed at the time of the foreclosure. Because the loan is a nonrecourse loan, the original lender will not be able to recover that portion of the loan that exceeds the price paid at auction, which means the borrower is no longer liable for the difference between the new and old loan amounts.<sup>100</sup> As a result, the borrower has been constructively discharged of that portion of the debt not paid by the proceeds of the auction sale price to the original lender. The discharge of the borrower's indebtedness thus constitutes income.<sup>101</sup>

The discharge is illustrated as follows in the hypothetical: If the house sells at foreclosure for \$80,000, that \$80,000 will be used to pay off the original loan amount to *L*. That leaves \$10,000 still not paid to *L*. But because this is a nonrecourse loan, *L* cannot recover the \$10,000 from *B*.<sup>102</sup> If *B* were to then redeem the house for the purchase price of \$80,000, *B* would own the house for \$10,000 less than the original purchase price. *B* would have been constructively discharged of \$10,000 of indebtedness, which would mean *B* has \$10,000 of income under section I.R.C. § 61(a)(12).<sup>103</sup>

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99. This issue is particularly relevant because, in the event that the housing market does contract, property values will fall, decreasing foreclosure sale and statutory redemption prices.

100. See *supra* Part II.A.2.

101. I.R.C. § 61(a)(12) (2000); see also ROBINSON & FERRARI, *supra* note 83 (manuscript at 1026).

102. See *supra* text accompanying notes 40-42.

103. See *Comm'r v. Tufts*, 461 U.S. 300, 308-10 (1983). *B*'s basis would be the new acquisition cost, or \$80,000. See *supra* note 82 and accompanying text.

### 3. *Income Recognition*

The key question, however, is: When do such discharges of indebtedness actually take place? Or in other words, should the income be recognized when the home is sold at auction or when the borrower redeems the home?<sup>104</sup> If the discharge takes place when the home is sold at auction, then the borrower will be required to recognize the income on the date of the auction sale. If the discharge takes place when the home is redeemed, then the borrower will be required to recognize the income on the date of redemption. Because the difference between the date of foreclosure and the date of redemption can be as much as two years,<sup>105</sup> the recognition date can have a substantial effect on both the taxpayer and the IRS.

One argument is that a borrower should be allowed to recognize the income on the date of redemption because income is recognized as "clearly realized" only when the borrower has access to it or dominion over it.<sup>106</sup> The argument would conclude that the borrower cannot exercise complete dominion over the income until she has actually redeemed the property.

The counter argument contends that the borrower realized the discharge of indebtedness once the property was sold at auction, regardless of whether she would go on to exercise the right of redemption, and thus the borrower should be required to recognize the income on the date of foreclosure. This is the more convincing argument for two reasons.

First, recognizing the income on the date of foreclosure would be more administratively efficient. If the original borrower is required to report the income once it is discharged, or in other words, at the foreclosure sale, the income records will coincide with the public sale records. If, however, the original borrower is required to report the income after the redemption, then there could be up to two years' difference between the sale records and the reporting of the income.<sup>107</sup>

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104. This question is raised in Robinson's *Federal Income Tax*, but is not answered. See ROBINSON & FERRARI, *supra* note 83 (manuscript at 1026).

105. See *supra* note 56 and accompanying text.

106. See *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955); *supra* notes 71-73 and accompanying text.

107. See *supra* note 56 and accompanying text.

Second, recognizing the income on the date of redemption would infringe on Congress's desire to tax income to the full extent of its constitutional privilege.<sup>108</sup> As noted above, the difference between the foreclosure sale date and the redemption date can be as much as two years. If the borrower were not required to recognize the income until the date of redemption, the borrower would have the full benefit of the discharged indebtedness income for up to two years, without having to pay income tax on it. At the same time, Congress would lose up to two years of earning power from the delayed payment of this income tax.

#### IV. DEPRECIATION AND THE STATUTORY RIGHT OF REDEMPTION

For tax purposes, the Internal Revenue Code recognizes four types of property.<sup>109</sup> This Note, however, focuses on only two: property held for personal use and property held for the production of income.<sup>110</sup> One primary difference in the tax treatment of the two types of property is the ability to deduct depreciation.<sup>111</sup> Taxpayers owning property for personal use are not allowed depreciation deductions whereas taxpayers holding property for the production of income are allowed depreciation deductions.<sup>112</sup> For this reason, property held for the production of income is known as depreciable property. The recent trends in real estate investing and tax awareness have seen a marked increase in the market for depreciable property, such as investment properties.<sup>113</sup>

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108. *Glenshaw Glass Co.*, 348 U.S. at 429-30 (stating that Congress intends to tax income to the full extent permitted by the Constitution).

109. See ROBINSON & FERRARI, *supra* note 83 (manuscript at 917) (listing the four classifications of property ownership as "(1) property held for personal use; (2) property held for the production of income; (3) property held for use in a trade or business; and (4) property held as inventory").

110. The analysis with regard to depreciation would likely be the same for property held for use in a trade or business.

111. See generally I.R.C. §§ 167-168 (2000 & Supp. III 2001-2004) (defining depreciation and the methods by which it is calculated).

112. I.R.C. § 167(a)(2) (2000).

113. These trends include the popular practice of buying foreclosed properties. See generally Glen Creno, *Foreclosed Family Tragedy Is a Reseller's Boon*, ARIZ. REPUBLIC, Oct. 6, 2003, at 1A, available at <http://www.azcentral.com/specials/special37/articles/1006 foreclosurebiz06.html> (describing the market for buying and reselling foreclosed properties in Phoenix, Arizona).

Depreciation is a deduction allowed to compensate for “the exhaustion, [and] wear and tear” of assets over time.<sup>114</sup> The rationale for allowing depreciation deductions is to spread out the cost of the property over a period roughly equivalent to the property’s useful life, as opposed to allowing a one-time, up-front deduction.<sup>115</sup>

Depreciation is calculated by first determining the applicable depreciation method, recovery period, and convention.<sup>116</sup> For real property, the IRS uses the straight line depreciation method;<sup>117</sup> recognizes a 27.5 year recovery period for residential rental property, and a 39 year period for nonresidential real property;<sup>118</sup> and applies the “mid-month” convention.<sup>119</sup> Returning to the hypothetical, assume *B*’s house is now residential rental property. Because *B*’s basis in the house is \$100,000, the annual depreciation allowed as a deduction from *B*’s income is calculated by dividing \$100,000 by 27.5, which equals \$3636 (rounded). *B*, therefore, can deduct \$3636 each year from her income calculations, effectively meaning *B* does not have to pay taxes on \$3636 of income, in order to offset the “wear and tear” of the property.<sup>120</sup>

The underlying assumption is that these deductions continue uninterrupted for the life of the applicable recovery period, either 27.5 or 39 years.<sup>121</sup> The statutory right of redemption, however, can create gaps in depreciation that last up to two years.<sup>122</sup> The question then arises, how should these depreciation gaps be treated? The purchaser could be allowed to use the statutory right of redemption to effectively start the depreciation calendar all over again, an approach this Note will refer to as “breaking the chain” of deprecia-

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For an entertaining report on the extent of the recent trend of real estate investing seminars, see generally Joan Caplin & Scott Medintz, *No-money-down Mania*, MONEY, June 2005, at 133 (noting “[i]n April [of 2005] an estimated 40,000 people flocked to the Learning Annex Real Estate Wealth Expo in Los Angeles. In New York, the same event attracted 25,000, up from 1000 the year before”).

114. I.R.C. § 167(a) (2000).

115. See ROBINSON & FERRARI, *supra* note 83 (manuscript at 434).

116. I.R.C. § 168(a)(1)-(3) (2000).

117. I.R.C. § 168(b)(3)(A)-(B) (2000).

118. I.R.C. § 168(c) (2000).

119. I.R.C. § 168(d)(2)(A)-(B) (2000).

120. See *supra* notes 114-15 and accompanying text.

121. See I.R.C. § 168(c) (2000).

122. See *supra* note 56 and accompanying text.

tion deductions. Or, the IRS could require taxpayers to treat the redemption and intermediary lag period as if they never occurred, which this Note will refer to as "bridging the gap" in depreciation.

A. "*Breaking the Chain*"

The first way to address gaps in depreciation due to statutory redemptions is to treat them as if they break the chain of depreciation deductions. In the hypothetical, if *B* had been taking yearly depreciation deductions of \$3636 for the first two years of ownership, by the end of year two her adjusted basis in the property would be \$92,728.<sup>123</sup> In addition, *B* would only have 25.5 years of applicable recovery period left in which to take depreciation deductions.<sup>124</sup> If *B* then lost the home to foreclosure, and redeemed it one year later, breaking the chain would reset *B*'s basis to \$100,000<sup>125</sup> and the applicable recovery period to 27.5 years. In effect, breaking the chain would create two separate transaction events, the first being the original purchase and subsequent transfer through foreclosure, and the second being a new purchase that coincides with the statutory redemption.

The main argument in support of breaking the chain is similar to that discussed in association with income recognition, namely that creating two separate transactions would be more administratively efficient.<sup>126</sup> Two separate transactions would make it easier to associate depreciation interruptions with corresponding transfer events that are already recorded. This benefit, however, is only cursory, as effectively keeping track of depreciation payments in a bridging-the-gap scenario would impose only marginally greater costs.

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123. This adjusted basis is calculated by subtracting the total amount of deduction already taken from *B*'s original basis in the property, which was equal to the cost, \$100,000, in accordance with I.R.C. § 1011(a).

124. This is calculated by subtracting the two years of deductions already taken from the applicable recovery period of 27.5 years as determined by I.R.C. § 168(c).

125. This assumes *B* either redeemed the house for the same amount that was owed on her mortgage or, if she had a recourse loan, for a lower amount—situations that would leave her unadjusted basis unchanged at \$100,000. See *supra* text accompanying notes 84-88, 91-92. The deduction analysis applies in other situations as well, but the \$100,000 unadjusted basis example has been chosen for the sake of simplicity.

126. See *supra* text accompanying note 107.

*B. "Bridging the Gap"*

The second way to address these gaps in depreciation is to bridge the gap in deductions and treat the foreclosure and loss of possession as if they never occurred. In the hypothetical, if *B* had been taking yearly depreciation deductions for two years, and had the same adjusted basis of \$92,728 because of the deductions,<sup>127</sup> bridging the gap would allow *B* to pick up where she left off. In other words, assuming *B* redeemed the house for the same price as the original cost, *B*'s basis after the redemption would be the same as it was prior to foreclosure, or \$92,728. Similarly, *B* would continue at the same place on the deduction calendar, leaving *B* with only 25.5 years left on the applicable recovery period.<sup>128</sup>

The first argument for bridging the gap instead of breaking the chain is based on the fact that statutory redemptions create gaps in possession. During these lags, which can last up to two years, the purchaser at foreclosure has full access to and use of the property, and can rightfully take depreciation deductions for wear and tear. To break the chain would allow the original owner to reclaim possession of the property with \$100,000 basis and to take depreciation deductions for wear and tear that had already been deducted—by the original owner during her first two years of ownership and by the foreclosure purchaser during the period before redemption. Breaking the chain would thus amount to a double tax benefit, and would take away from the IRS's taxation revenue.

The second, more theoretical, argument in favor of bridging the gap is that the statutory right of redemption is considered a property right.<sup>129</sup> The statutory right of redemption thus places a restriction or limitation on the rights of the subsequent owner who purchased the property through foreclosure. Because the original owner always maintained at least a minor interest in the property, there never was an actual break in the chain, merely a suspension

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127. See *supra* note 123 and accompanying text.

128. See *supra* note 124 and accompanying text.

129. Michael H. Rubin & E. Keith Carter, *Notice of Seizure in Mortgage Foreclosures and Tax Sale Proceedings: The Ramifications of Mennonite*, 48 LA. L. REV. 535, 557 (1988) (noting that the Eleventh Circuit in the case of *Federal Deposit Insurance Corp. v. Morrison* agreed that Alabama's equity and statutory right of redemption constituted "property" protected by the Fifth Amendment).



of certain rights. Because the original owner never completely forfeited her interests in the property, she is justified in resuming the latter restoration of interests as if they were a continuation of her former interests.

### *C. Bridging the Gap over Breaking the Chain*

Bridging the gap should be the preferred method of treating gaps in depreciation caused by statutory redemptions in order to vindicate the property interests discussed above,<sup>130</sup> and to deter those who might abuse the opportunity to obtain a double tax benefit by breaking the chain.<sup>131</sup>

If property owners were allowed to break the chain of depreciation, then breaking the chain could become a depreciation renewal device. In other words, suppose in the hypothetical that *B*'s property had been the primary means for deductions to offset income for *B*'s small business. If the applicable depreciation recovery period ended, meaning *B* could no longer offset this income against depreciation deductions, *B* might have an incentive to enter into foreclosure and then redeem the property in order to renew her ability to take depreciation deductions. This would go against the IRS's specific limits on depreciation and would allow deductions that no longer correlated with the useful life of the property.<sup>132</sup> Although this concern that breaking the chain could be used as a depreciation renewal device may seem insignificant in common residential investments, where in which property values and depreciation deductions are relatively insignificant, the concern is legitimate in the corporate context where property values and depreciation deductions extend well into the millions.

### CONCLUSION

The state of the economy over the past few years created a substantial increase in the number of borrowers with large amounts of debt. These conditions are largely responsible for the current high

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130. See *supra* text accompanying note 129.

131. See *supra* text accompanying notes 128-29.

132. See *supra* notes 114-15 and accompanying text.

foreclosure rates, and may even lead to their increase. High foreclosure rates increase the opportunities to exercise the statutory right of redemption.

The statutory right of redemption allows a property owner who lost her property at foreclosure to buy back the property. There are significant tax consequences when a buyer exercises this right of redemption. If, in a nonrecourse loan scenario, the owner buys back the property for less than the original loan amount, then it is possible that the owner has realized income from the discharge of indebtedness. This income from the discharge of indebtedness should be realized at the date of foreclosure, rather than the subsequent date of redemption, because the date of foreclosure is when the actual discharge takes place—regardless of when the property is redeemed. In addition, recognition of income on the date of foreclosure is in accordance with Congress's desire to tax citizens to the full extent of its constitutional power.

Further, when the property redeemed is depreciable property, foreclosure and redemption interrupt the chain of depreciation deductions. This interruption in the chain of depreciation payments should be treated as though the break never occurred so that property owners will not purposely foreclose their properties with the intent of renewing depreciation. Applying the "bridging the gap" approach would, as a practical matter, eliminate owners' ability to renew the depreciation process and, from a theoretical standpoint, ensure that taxation of redeemed property is consistent with an understanding of the statutory right of redemption as a property right.

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