



U.S. Department of Housing and Urban Development

Office of Inspector General

451 7th St., S.W.

Washington, D.C. 20410-4500

September 27, 2001

**Audit Memorandum
No. 2001-HQ-0801**

MEMORANDUM FOR: Frederick Tombar, Deputy Assistant Secretary for Multifamily Programs, HT

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FROM: Stanley J. McLeod, Director, Planning and Research Division, GAP

SUBJECT: Review of HUD's Procedures for Notifying Internal Revenue Service of Foreclosures

We completed a review of the Department of Housing and Urban Development's (HUD) procedures for notifying the Internal Revenue Service (IRS) of multifamily mortgage foreclosures. HUD did not properly report debt forgiven at foreclosure to the IRS. This reportable event may result in a taxable event to the property owners. HUD needs to improve the guidance and oversight of the contractor performing this function.

BACKGROUND

HUD provides mortgage insurance and direct loans for multifamily mortgages under a variety of Federal Housing Administration (FHA) programs. HUD also assumes the role of mortgagee when an owner defaults on a mortgage and the loan is assigned to HUD by a private lender.

For tax purposes, the foreclosure of a loan is treated as a sale from which a borrower may realize a gain or loss. The gain or loss is the difference between the borrower's adjusted basis in the property and the amount realized. On a non-recourse debt, such as with FHA insured properties, the amount realized includes the full debt cancelled by the foreclosure. The full cancelled debt is included as the amount realized even if the fair market value of the property is less than the canceled debt.

The foreclosure of a defaulted loan by HUD represents the forgiveness of debt, a taxable event that should be reported to the IRS with the filing of Forms 1099-A (Acquisition or Abandonment of Secured Property) and 1099-C (Cancellation of Debt). In addition to the balance of the mortgage, HUD may report other funds advanced by HUD on behalf of the owner, including costs such as payments for interest, taxes, and repairs. HUD awarded a contract to DP Services, Inc. (the contractor), to provide mortgage loan and property management services for HUD-held multifamily mortgages, including filing 1099s to IRS.

OBJECTIVE, SCOPE AND METHODOLOGY

The objective of our review was to identify and evaluate the procedures employed by HUD to ensure the IRS is notified of debt forgiveness when HUD forecloses on a multifamily housing project. We selected a non-statistical sample of 27 properties from a total of 98 properties foreclosed in FY 1999 and FY 2000 for review. That sample included 15 of the 47 foreclosures in 1999 and 12 of the 51 foreclosures in FY 2000. The unpaid principal on the 27 properties reviewed totaled about \$67 million.

In conducting the audit, we:

- Interviewed contractor personnel to identify foreclosure reporting procedures,
- Reviewed contractor property files to obtain supporting documentation for foreclosed properties,
- Researched Internal Revenue Service (IRS) instructions and publications for foreclosure reporting requirements, and
- Queried the Real Estate Management System (REMS) database to identify Tax Identification Numbers (TIN) for property owners.

RESULTS OF OUR REVIEW

HUD's contractor did not properly notify the IRS of debt forgiven. The contractor filed only Forms 1099-A and not Forms 1099-C, which reports the amount of any debt forgiveness. As a result, owners of foreclosed properties may not be accurately reporting taxable income on their individual tax returns. In some cases, the contractor was also not using the proper taxpayer identification number (TIN) according to other HUD records. The results of our review have been discussed with representatives from the Office of Housing.

Forgiven Debt Not Reported to IRS

The IRS instructions for Form 1099-A, Acquisition or Abandonment of Secured Property, requires a lender file for each borrower a Form 1099-A, if in full or partial satisfaction of the debt, the lender acquires an interest in property that is security for the debt. Form 1099-C, Cancellation of Debt requires that if in the same year, a lender cancels a debt in connection with a foreclosure or abandonment of secured property, the lender may file the Form 1099-C **only**.

Our review of the 27 foreclosed multifamily properties indicated that debt had been cancelled in connection with each of the foreclosures and HUD should have filed Forms 1099-C, rather than Forms 1099-A. The debt forgiven in these cases including interest, foreclosure costs, and other fees amounted to \$145 million (see Schedule 1).

The contractor's position was that each foreclosure was a non-recourse loan, and as a result it was not a taxable event. Therefore, filing a 1099-A was correct, and a 1099-C was not required. However, we do not agree with the contractor's position because IRS instructions for 1099-A and 1099-C (Acquisition or Abandonment of Secured Property) state that a foreclosure is a

reportable event that must be reported on Form 1099-C. There is no requirement that the foreclosure meet the test of being a taxable event.

Incorrect Taxpayer Identification Numbers

In accordance with IRS instructions for filing Forms 1099-A and 1099-C, the filer must make a reasonable effort to obtain the correct name and TIN of the person whose debt was canceled. The request must clearly notify the debtor that the IRS requires the debtor to furnish its TIN and that failure to furnish such TIN subjects the debtor to a \$50 penalty imposed by the IRS. The reporting entity may use Form W-9, Request for Taxpayer Identification Number and Certification, to request the TIN.

We reviewed documentation for 27 out of 98 multifamily properties foreclosed during Fiscal Years 1999 and 2000, and determined that HUD's contractor submitted a 1099-A to IRS and to the debtor for each property foreclosed. However, of the 27 properties reviewed, we identified 16 cases with discrepancies between the TIN on the Form 1099-A and HUD's property files and/or the Real Estate Management System (REMS) (see Schedule 2). Nine files did not have Form 1099-A documentation in the files. Only four of the 27 project files contained evidence that the contractor had made requests (Form W-9) to property owners to obtain correct TINs. Therefore, there is little assurance that the contractor accurately reported tax information to the IRS for the proper individual or entity.

RECOMMENDATIONS

We recommend the Deputy Assistant Secretary for Multifamily Programs:

- A. Provide specific guidance to the contractor for the proper filing of forms 1099-A and 1099-C, and seek the guidance of the IRS to ascertain the need for the filing of past 1099-C Forms, which were not filed properly.
- B. Take action to ensure that complete and accurate documentation is maintained in the property files maintained by the contractor.
- C. Require the contractor to issue a Form W-9 to each debtor requesting a correct TIN, and maintain a copy in the project's property file.
- D. Provide oversight of the contractor, to ensure that established foreclosure and IRS reporting policies are consistently followed.

Although you accepted and agreed to implement our recommendations during our exit conference held on July 12, 2001, within 60 days please give us, for each recommendation in this report, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; (3) why action is considered unnecessary.