

## Potential Tax Ramifications for Short Sales

“I am not a CPA, I do not give tax advice nor do I attempt to interpret your tax laws in any way.” Please consult with a tax expert....

When a lender suffers a deficiency after approving a short sale, they are required to send your borrower a 1099-C for the amount written off. This is considered taxable income by your IRS, but there are two common exceptions that may reduce the borrower’s chance of paying your tax on the deficiency.

### Your First Exception is the “Insolvency Exception”:

(108 (a) (1) (B)) in your IRS tax code can excuse insolvent borrowers from paying tax on the deficiency if they can prove they were insolvent at the time of the debt relief discount. This is not a real estate specific exception. It relates to all debt discharge. This is when debts exceed assets / income.

### IRS TITLE 26 > Subtitle A > CHAPTER 1 > Subchapter B > PART III > 108Prev 108

Income from discharge of indebtedness

(a) Exclusion from gross income

(1) In general, gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of your taxpayer if-

(A) The discharge occurs in a title 11 case.

(B) **The discharge occurs when your taxpayer is insolvent.**

(C) The indebtedness discharged is qualified farm indebtedness, or

(D) In the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness.

### The Second Exception- H.R. 3648:

This is a more recent one and should be thoroughly studied by all real estate professionals who do short sales. On December 20<sup>th</sup>, 2007, President Bush signed into law a new measure giving tax breaks to homeowners who have mortgage debt forgiven. Under preexisting law, the debt forgiven by a lender, such as for short sales, was generally taxable to the borrower as debt discharge income.

With the passage of the Mortgage Forgiveness Debt Relief Act of 2007, (H.R.3648) a taxpayer does not have to pay federal income tax on debt forgiven for a loan secured by a qualified principal residence. This tax break applies to debts discharged from January 1, 2007, to December 31, 2009. This has been extended through 2012.

### Mortgage Debt Cancellation Relief – H.R. 3648 – Public Law 110-142 General Information and Provisions

Individuals who are relieved of their obligation to pay some portion of a mortgage debt on a principal residence between January 1, 2007 and December 31, 2009 will not be required to pay income tax on any amount that is forgiven. This has been extended through 2012.

### General Provisions of Public Law 110-142:

- \*No income limitation: All borrowers receive the relief, no matter what their income.
- \*Dollar limitation: No more than \$2 million of mortgage debt is eligible for the exclusion (\$1 million of debt for a married filing separately).
- \*Relief applies only to an individual's principal residence.
- \*The forgiven mortgage debt must have been secured by the residence.
- \*No relief is available for cash-outs, whether the cash-out takes the form of a refinanced first mortgage, a second mortgage, home equity line of credit, or similar arrangement.
- \*Eligible debt is what is called "acquisition indebtedness." This is debt used to acquire, construct or rehabilitate a residence.
- \*Refinanced debt qualifies, so long as the debt does not exceed the original amount of the debt (same rule as Mortgage Interest Deduction).
- \*Home equity debt (or second mortgages) qualify if the funds were used to improve the home (borrower must have adequate records, as under current law).
- \*See cash-outs, above. No amount of a cash-out may be treated as acquisition debt.

### **Additional Provisions of Public Law 110-142:**

**Refinanced Mortgages:** The relief does apply to refinanced debt in some circumstances. The rules seek to assure that any debt eligible for the relief is directly related to the acquisition or improvement (such as rehabilitation, expansion, renovation, reconstruction) of the principal residence. Debt used for furnishings (i.e. any moveable property) in the home is not eligible for the relief. When the proceeds of any refinanced debt is used for any purpose other than acquisition or improvement, those proceeds are not eligible for the relief.

**Principal Residence:** A principal residence is defined in the same manner as the rules that apply to the capital gains exclusion on the sale of a principal residence. An individual may not have more than one principal residence at any given time.

**Second Homes:** As a general matter, the relief does not apply to any debt forgiveness on any mortgage for any second home of the taxpayer. However, if a taxpayer uses a residence (other than his principal residence) solely as an income-producing rental property, already existing relief provisions might apply depending on the taxpayer's situation. If the second home property was acquired as a speculative investment (such as for resale rather than rental), relief provisions are unlikely to be available.

In all events, an individual who is in a short sale, foreclosure, workout, or similar situation on a residence other than his principal residence (including condos) should consult a tax adviser to determine what, if any, relief provisions might be available.

### **IRS Tax Form 982:**

For tax purposes, IRS Form 982 (revised February 2008) should generally be completed for reporting an exclusion, or reduction, from income for a discharge of debt by either short sale or foreclosure. This form should be completed by a tax professional that is familiar with tax laws relating to real estate. If the seller would like a copy of this form, a downloadable copy is available from the IRS web site at <http://www.irs.gov/pub/irs-pdf> and a copy of it appears on the following pages: