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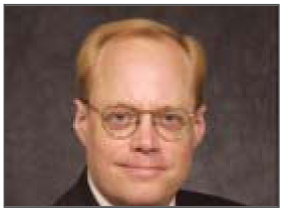

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Apr. 26 2011 — 8:25 am

Short Sale Tax Problems

A short sale isn't a new reality TV show about midget sellers. It's just a house sale where the sales proceeds are not enough to pay off the mortgage. Often the lender will cancel the rest of the loan. The tax code generally taxes you when you are relieved of paying back a debt, treating it like cash paid to you. See 10 Things About COD Income.

Fortunately, there's an exception for debt relieved in this circumstance, but it's limited and can be tricky. Note that you can't claim a loss deduction when you lose money on the short sale of a personal residence. But you may be able to avoid the normal discharge of debt income when your lender loses money.

For debt discharged between Jan. 1, 2007 and Jan. 1, 2013, the tax code allows you to exclude up to $2 million of mortgage debt forgiveness on your principal residence. To qualify, it must be "qualified principal residence debt." You can use the tax exclusion if you restructure the acquisition debt on your principal residence, lose it in a foreclosure, or sell it in a short sale.

Even if you qualify, though, the relief isn't automatic. You must file IRS Form 982, "Reduction Of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)," and attach it to your return.

> ***Example 1:*** Allen's house is subject to an $850,000 mortgage for which he is personally liable. It has declined in value to $700,000. The lender agrees to a short sale for $700,000 and will cancel the

remaining $150,000 of debt. Allen has $150,000 of debt discharge income, but as long as the debt was qualified principal residence debt, he pays no tax.

Example 2: Sallie bought a main home for $315,000, using a $300,000 mortgage loan. She later took out a $50,000 second mortgage to add a garage. Both the first and second mortgages qualify for the exclusion. But if Sallie used the second loan proceeds to pay credit card bills or college tuition, they wouldn't qualify. See IRS Publication 4681.

Note that this exclusion applies to canceled debt, not gain. In some short sales you may have gain from the sale instead of, or in addition to, income from discharge of debt.

Other Relief Provisions? Don't forget other tax relief provisions. You can exclude up to $250,000 of gain ($500,000 for joint return filers) from selling a home that's your principal residence for two of the last five years. If you fail this two-out-of-five-year rule, you still might get relief if the sale was because of a change in your place of employment, health, or unforeseen circumstances.

Watch Out for Refis. Refinanced qualified principal residence debt is eligible for the exclusion up to the amount of the old mortgage principal just before the refinancing.

For more, see:

Home Foreclosures And Tax Returns

IRS: Ten Facts for Mortgage Debt Forgiveness

IRS: Home Foreclosures and Debt Cancellation

Foreclosed? The tax man may want his cut

Mortgage forgiveness tax relief differs from home-sale loss

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