



REAL ESTATE SHORT SALES MAY AVOID FORECLOSURE BUT THIS DOES NOT MEAN IT IS A BETTER SOLUTION FROM A TAX PERSPECTIVE.

In case you have been sleeping through the real estate “crisis,” then no doubt you have probably heard about the increasing rate of home foreclosures nationwide resulting from the sub-prime loan debacle.

A foreclosure occurs when a property owner who can't keep up with the mortgage payments, finally gets so behind in payments they are “foreclosed” upon by their lender/bank. They have the option of handing over the property voluntarily or the bank will institute eviction proceedings against the owner and any tenants. A foreclosure will have long lasting negative impacts on a borrower/property owner's credit score, thus making it difficult to purchase any other property in the near future. Moreover, the cancellation of the mortgage by the bank upon foreclosure will also trigger taxable income to the borrower/home owner.

Given these negative impacts, many property owners facing foreclosure are seeking alternative ways to ease the impacts of their situation, as well as avoid any negative effects on their credit ratings. Many people can't or don't want to go through the difficulty of refinancing or trying to get the lender to modify the terms of their loan. As such, another option often examined is the short sale.

Short Sale Arrangements:

A short sale, occurs when a homeowner seeks the lender's approval to sell his or her property for less than what is owed on the mortgage. Although lender's don't tend to like approving short sales many of them will do so, rather than have to take the property back and risk selling it for even less in a foreclosure sale. Homeowners are required to prove their hardship in order to obtain a short sale and the approval process can take weeks and sometimes months.

A homeowner should remember that the lender can report a short sale transaction to the credit bureaus just as they do with a foreclosure. While the outcome may be better than a foreclosure, a short sale transaction can have also long lasting impacts on your credit rating. Moreover, the homeowner may still face a sizeable tax bill under Internal Revenue Service (IRS) rules.

Under the IRS rules the homeowner who sells his home in a short sale may get a Form 1099 from the lender/bank for the total amount of the mortgage balance “forgiven” – even if the lender agrees to “forgive” the debt by agreeing to the short sale. The property is therefore treated by the IRS as if it were sold for the total outstanding balance of the loan, or the sale price if it is higher. Taxability of the gain and deductibility of the loss depend on the nature of the property sold.

Example If Personally Liable For Mortgage Debt (i.e., Recourse Debt):

John Doe buys a house and uses it as his personal residence. He pays \$500,000, for the house with a down payment of \$50,000 and takes out a mortgage loan of \$450,000. *He is personally liable for the mortgage.* When the remaining balance of the mortgage is \$400,000 John Doe defaults and the lender bank accepts his voluntary conveyance of the home, cancelling the loan. Similar comparable homes at the time are selling for \$300,000.

The Tax Code treats this transaction as a sale whether it is a foreclosure or a short sale arrangement. John Doe incurs a nondeductible loss of \$200,000, the amount by which his house’s adjusted basis (purchase price including adjustments over time) of \$500,000 exceeds its market value of \$300,000. No deduction for the loss because John Doe uses the house as a personal residence. (If John had used the house as a rental or commercial property the loss would be deductible.)

John Doe also has reportable (taxable) income of \$100,000 when the bank cancels the loan. The \$100,000 is the amount by which the debt of \$400,000 exceeds the market value of \$300,000.

The bank will send an IRS Form 1099-A to John Doe and the IRS reporting the numbers in the example. The 1099-A indicates the foreclosure bid price (\$300,000), the amount of John Doe’s debt (\$400,000), and the fact that he was personally liable. Debt cancellation (in this example, \$100,000) is taxed at the individual’s tax rate for ordinary income.

Note that the outcome is exactly the same from a tax perspective whether the property was foreclosed upon or whether the owner engaged in a short sale arrangement with the bank/lender.

Does Lack Of Personal Liability On The Mortgage Change The Tax Outcome (i.e., Non Recourse Debt)?

Yes. The IRS says sellers who are not personally liable for a debt will realize an amount that includes the full cancelled debt, even if the value of the property that is security for the debt is less, which can be offset depending on your adjusted basis in the property. Note that many items can effect the final calculation on basis. For instance a casualty loss suffered by flood damage or fire will adjust your basis upward (and therefore reduce your taxes) if the money to pay for the repairs does not come out of insurance proceeds.

Note that most people have personally liability on their mortgage. The only groups that may not are pension plans or non profit entities.

Example If Not Personally Liable For Mortgage:

Jane Doe buys a home valued at \$300,000 and puts \$30,000 down. She takes out a mortgage of \$270,000. Ms. Doe stops making payments. The bank forecloses on a loan balance of \$260,000, and the market value of the home has fallen to \$250,000.

Jane Doe has an adjusted basis of \$265,000 due to a casualty loss of \$5,000 (this represents the \$270,000 mortgage less the \$5,000 casualty loss). The amount she realizes on the foreclosure is \$260,000.

Jane Doe figures her gain and/or loss, for debt cancellation purposes, by comparing \$260,000. (the amount realized) to her basis of \$270,000. Jane Doe has debt-forgiveness income of \$10,000, however because of the increase in her basis by the \$5,000 casualty loss, only \$5,000 is now taxable.

Exception To The General IRS Tax Rules For Insolvent Homeowners:

Homeowners who can prove they are insolvent can avoid taxation, if the sum of your debts (including the mortgage) is greater than the value of your assets. However, you will need to prove this to the IRS and must submit an IRS form to establish to the IRS that you meet the qualifications. It is therefore well advised to seek proper representation when seeking settlement with the IRS. Also, anyone seeking to claim insolvency must do so quickly, as the Internal Revenue Code specifically limits the amount of time a taxpayer may approach the IRS making insolvency claims. As such, don't wait to seek a tax professional to represent you when seeking a settlement.

Remember that insolvency is not bankruptcy. In bankruptcy proceedings people are able to keep qualified retirement accounts up to 2 million dollars. In bankruptcy people may also be able to keep their homes if the equity in the home is under the state homestead exemption amount. Each state has a different homestead exemption found under the state statute. Avoiding taxation via bankruptcy proceedings is not guaranteed. Thus, it again becomes incredibly important to discuss these matters with a tax and bankruptcy professional.

Tax Relief For Only Some Homeowners Facing Foreclosure.

The Mortgage Forgiveness Debt Relief Act of 2007 (H.R. 3648) passed the House and Senate in late 2007 and was signed into law by President Bush in December 2007.

Many people are under the false impression that this law gives relief to all homeowners on their primary residence from the cancelation of indebtedness income tax we discussed above. However the details of the law make it so many homeowners will **not** qualify for this tax relief.

The New Laws Limitations:

The new law first requires that the property must be a principal residence (rental properties do not qualify) and the law only excludes taxation for homeowners that are foreclosed upon (or engage in short sale transactions) during a three year window (from January 1, 2007 through December 31, 2009). Additionally, mortgages that have been refinanced, provided the refinanced loan does not exceed the original amount of the loan, are included in the legislation. . However, the legislation only excludes from taxation mortgages that were used to purchase, build or improve property. Thus, home equity lines of credit used to buy a new car or vacation are not included under this legislation. . This means that anyone who took out a new mortgage, for larger than their original mortgage, will not qualify for the tax relief unless the additional loan money went back into the home to improve it. The burden of proof is on the taxpayer to prove that the money went back into the personal residence. In sum, these limitations make it difficult for many homeowners to actually get any tax relief from this new law.

Foreclosure vs. Short Sale:

Short sale provides a better option if you are facing a foreclosure. First, the short sale option will most probably reduce your tax liability because in foreclosures properties are sold at rock bottom prices. If the short sale means that the bank recovers more against the original mortgage amount, then you pay less in taxes on the cancellation of indebtedness income tax discussed in article above. Second, in a short sale you will be able to apply for an FHA home loan within 3 years of the closing of the short sale. This is because of new government guidance released from the FHA within the past few months. These two factors make the short sale a much better option long-term.

Are There Other Immediate Options Available To Homeowners Facing Foreclosure?

Yes, if you are facing foreclosure, or thinking of a short sale it is better to put the property up for rent (if you are able) even if the monthly rental income does not completely cover the full mortgage payment. The loss generated monthly between the mortgage payment and rental income is deductible, which will help offset your overall losses. The plan here is to generate enough rental income to survive financially until property values recover and then sell when the market has recovered.

There are many different ways you can accomplish the rental option. Perhaps a 2 year lease with an option to purchase at the end of the 2 year lease term. If you are able you should also consider seller-financing options. Many people can't qualify for loans or are having trouble getting financing to buy homes. If you wish to create incentive for someone to purchase you can offer seller financing. Or combine all the options above with a 2 year lease, include an option to buy and seller financing as a possibility.

Remember, the foreclosure and/or short sale option will hurt your credit rating for many years to come. Moreover, from a tax perspective, a foreclosure and/or a short sale arrangement can result in huge income tax liability.

All these options above must be discussed with your tax professional. There are many factors that may increase or decrease the deductibility of rental losses and no one should offer seller financing without doing due diligence on the prospective buyer. Working with a good tax attorney can assure that you avoid the possible problems involved in any option, even if the option is foreclosure or short sale.

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