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# FEDERAL & STATE INCOME TAX CONSEQUENCES OF SHORT SALES OF PRINCIPAL RESIDENCES

By
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A “short sale” takes place when a taxpayer sells the home for less than the loan balance then owed. In certain situations, the taxpayer/homeowner will have to negotiate with the lender to “forgive” the unpaid balance of the loan. This is desirable since the taxpayer does not want to be liable for such balance after the taxpayer no longer has use of the home.

## Traditional Income vs. COD Income

With the short sale, the taxpayer has entered into a taxable transaction with the sale of the home to a third party. The short sale, because it is a sale for less than the outstanding mortgage, may result in two separate and distinct categories of income. The first category is what might be referred to as “traditional income.” This would be income realized when an asset is sold for more than the original purchase price (often referred to as “cost basis”). The second category is referred to as “COD income,” or “cancellation of indebtedness income,” i.e. income arising when some or all of a debt is cancelled or forgiven. This COD income is realized when the taxpayer is relieved of part of the outstanding loan as a result of the short sale and, therefore, no longer has any personal liability regarding the unpaid balance of the loan.

Since short sales occur when the home is sold for less than the mortgage, the sale price is almost certainly less than the basis or original purchase price. Consequently, there will not be any “traditional income” realized. Rather, the taxpayer will realize a “loss” since the home was sold for less than the purchase price/cost basis. This “loss” is a personal loss and cannot be used as a deduction to offset any other income.

Nonrecourse vs. Recourse Loan

Then the question is whether the short sale will result in COD income to the taxpayer. This is dependent on one very important factor. Is the loan secured by the home a "nonrecourse" loan or a "recourse" loan? The difference determines whether the taxpayer is personally liable for the mortgage debt or is not personally liable. In California most loans used to purchase a primary residence are nonrecourse loans. This means that the loan is only secured by the home and the taxpayer/borrower is not personally liable for any part of the loan. In this case the lender can only look to a "sale" of the home as a way to receive at least a partial payment of the outstanding loan balance. This "sale" can either be a foreclosure sale or a short sale. While similar, this article will remain focused on the tax consequences of a short sale.

When a short sale involves a nonrecourse loan, then, pursuant to the relevant federal tax regulations, the "amount realized" on the sale equals exactly the amount of the outstanding loan (Note: the FMV of the home is irrelevant). Consequently, for tax purposes, the loan is deemed to be completely paid off with the short sale. The result is that there cannot be any COD income to the taxpayer.

Refinancing a Home Loan

But most homeowners, over the years, have refinanced the original loan with a new loan. The principal balance of the new loan, upon refinancing, has typically been greater than the outstanding balance of the original loan since the homeowner wanted to "take out" some of the equity of the home (i.e. equity equaling the difference between the then FMV of the home and the balance of the loan). Unfortunately, this type of refinancing results in the new loan being a "recourse" loan and not a nonrecourse loan.

When a recourse loan is involved with a short sale, the amount realized is limited to the current FMV of the home. The difference between the "amount realized" on the sale (i.e. the current FMV) and the balance of the loan will result in COD income to the taxpayer if the lender agrees to forgive this difference in the short sale.

When the lender does agree to "forgive" this difference between FMV and loan balance, the lender will then issue a Form 1099-C to the taxpayer and file a copy with the IRS. The Form 1099-C reflects the amount of the loan forgiven and thus the COD income that the taxpayer must

report on his or her Form 1040.

Exclusions For COD Income

At this point, it is important to note that Congress has authorized over the years certain "exclusions" of COD income. If the COD income was covered by one of the exclusions, then the taxpayer did not have to pay tax on the COD income. These "exclusions" are contained in Section 108 of the Internal Revenue Code.

Exclusion for Qualified Personal Residence Indebtedness

Section 108(a)(1)(E), dealing with the cancellation of home mortgage debt, was added by the Mortgage Forgiveness Debt Relief Act of 2007 and was subsequently amended by the Emergency Economic Stabilization Act of 2008. This section excludes from gross income the cancellation of "qualified principal residence indebtedness" if the cancellation occurs on or after January 1, 2007 and before January 1, 2013. Congress provided for this exclusion primarily in response to the subprime mortgage loan crisis and the specter of thousands of homeowners restructuring their mortgage debts or in fact losing their homes in foreclosures and then having to recognize cancellation of indebtedness income as a result.

"Qualified principal residence indebtedness" is limited to acquisition indebtedness[i] with respect to the taxpayer's principal residence[ii] that does not exceed $2,000,000 for married couples filing joint returns and $1,000,000 for other taxpayers.[iii] Very importantly this exclusion does not apply to (1) indebtedness on a home that is not the taxpayer's principal residence, or (2) home equity indebtedness. With the exclusion not applying to home equity indebtedness, many home owners may find that the exclusion only applies to a relatively small percentage of the total income arising from the cancellation of the debt when a foreclosure or short sales occurs. Moreover, the exclusion will apply only if the debt cancellation was on account of either (1) a decline in the value of the home, or (2) the taxpayer's deteriorating financial condition.

Once the excluded amount of the cancellation of debt income is determined, then the cost basis of the taxpayer's residence must be reduced by the excluded amount. But this basis reduction will not likely result in taxable income upon a subsequent sale of the residence since the taxpayer will likely be able to exclude all or part of the realized gain since there is an exclusion of realized gain on a sale of a principal residence.[iv] This exclusion is completely separate and apart from the exclusion being discussed for income arising from the cancellation of

indebtedness income.

However, when a short sale occurs the above basis reduction rule will not apply. The original purchase price of the home will continue to serve as the basis in determining whether there is income (very unlikely) or a loss (very likely).

Conclusion

The above is a relatively brief description of the likely income tax consequences when a homeowner pursues a short sale. Because of the significance, each homeowner considering a short sale should determine if the current loan is "recourse" or "nonrecourse." Only then will the homeowner be able to determine the full tax consequences of the short sale.

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[i] The term "acquisition indebtedness" is defined in IRC section 163(h)(3)(B).
[ii] The term "principal residence" is defined in IRC section 121.
[iii] IRC section 108(h)(2)
[iv] IRC section 121