



SHORT SALE TAX INFORMATION

Law creates a 3-year fix for troubled homeowners

At first blush, the rule seems so unfair that it must be a cruel hoax. First, you lose your house in a foreclosure—perhaps you fell behind in the payments after you lost your job, you got sick or your husband or wife died. Then the law orders the IRS to pile on the emotional and financial grief by charging you extra income tax.

Outlandish...perhaps. But until foreclosures became the symbol of the national financial crisis in late 2007, that was the law.

A look at the rule, then the fix

Under general tax law, if the bank forecloses and sells your home for less than the amount left on your mortgage—and forgives the excess debt—the amount forgiven is treated as taxable income to you. That's right, as far as the income tax is concerned, money you don't have to pay back is treated the same way as money paid to you: taxable in your top bracket.

The IRS even has a special form for reporting this "windfall": the 1099-C. The *C* stands for *cancellation of debt* and the law says cancelled debt is taxable as income. (There are exceptions, which we'll get into later.)

As a wave of foreclosures began sweeping across the nation in 2007—fueled by the risky loans, rising rates and a slowing housing market—this arcane rule began to get more and more attention. So did other efforts by strapped homeowners—such as "short sales" or loan restructuring—that can also trigger 1099-Cs reporting taxable income. If a lender agrees to freeze an adjustable interest rate for a period of time rather than allow it to rise as called for in the mortgage, for example, the change can result in forgiven debt that would be taxable under the regular rules.

Congress provides relief

To protect homeowners from this double-whammy, Congress has declared that when a taxpayer's principal residence is involved, forgiven debt will *not* be treated as income. For now, this break applies only for 2007, 2008 and 2009. After that, the old rule is scheduled to come back into play. This is a big deal for affected taxpayers. There are limits, of course.

What's covered and what's not

- **This relief applies only to principal residences, that is, the home you live in.** If a lender forgives debt after a foreclosure, short sale or loan restructuring for a vacation home or investment property, for example, the old rule still applies: The amount of debt cancelled is considered taxable income to you (unless you qualify for one of the exceptions discussed later). Congress didn't want to offer a helping hand to speculators who helped fuel the housing boom by buying properties in hopes of "flipping" them quickly for hefty profits.
- **No more than \$2 million of forgiven debt can be excluded from income.**
- **To be eligible for the break, the loan must be secured by your principal residence and the money must have been used to buy, build or substantially improve the property.** If part of the forgiven debt was a home equity loan used for other purposes, for example, that part would be considered taxable income.
- **The tax basis of the home is reduced by the amount of cancelled debt excluded from income.** The basis is the amount you compare to the selling price of the home to determine if you have a profit or loss. (And for tax purposes, a foreclosure is treated the same as a sale.) If a loan restructuring results in cancellation of \$25,000 of debt, for example, your basis would be reduced by \$25,000—potentially increasing by up to \$25,000 the amount of profit you realize when you later sell. (The basis reduction will usually have no tax impact, though, because most home sale profit is tax-free.)

1099-C confusion

While the new law offers important relief for strapped homeowners, it won't prevent lenders who forgive debt from sending out 1099-C forms to taxpayers, with copies to the IRS. It will be up to you to know whether or not the discharged debt reported on the form is taxable or tax-free.

The 1099-C must show the amount of debt forgiven and the fair market value of property given up through foreclosure. The IRS urges borrowers to check the form carefully and notify the lender immediately if any of the information shown on their form is incorrect. Pay particular attention to the amount of debt forgiven (Box 2) and the value listed for your home (Box 7).

How short sales work

Sometimes, rather than pursuing the costly and time-consuming process of foreclosure, a lender will allow a delinquent borrower to sell the house for less than the mortgage amount and turn the proceeds over to the bank as payment-in-full.

Say you lost your job and can't keep up the payments on your home. You still owe \$300,000 on your mortgage, but the house value has dropped to \$275,000. If the bank agrees to a short sale, you'd sell the place, pay the commission and other selling costs—let's assume \$15,000—and turn the remaining \$260,000 over to the bank. The \$40,000 gap between the payment and the amount due would show up on a 1099-C form. That's right, even the \$15,000 of selling expenses gets tossed in with the amount of forgiven debt.

Thanks to the new law, when the short sale in 2007, 2008 or 2009 involves a principal residence, the cancelled debt is not considered taxable income.

Banks don't always agree to a short sale—among other things, they look at the gap between the balance on the loan and the expected proceeds of the sale and the homeowner's other assets. Basically, they weigh the cost of a short sale against the cost of foreclosing and selling the property themselves.

Dodging the tax bullet

Even if you're not covered by the new tax-relief rule—say the house you lost was a vacation home rather than a principal residence—there's a very important exception to the debt-relief-equals-taxable-income rule.

Although lenders must send 1099-C forms reporting taxable income whenever cancelled debt is \$600 or more, the tax bill itself is forgiven if you are in bankruptcy or are insolvent.

Insolvency means your debts (including that mortgage) exceed the value of all your assets. You use IRS Form 982 to claim the exclusion.

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