

- [SMART MONEY](#)
- APRIL 30, 2009

# Tax Hits on Property Short Sales

By [BILL BISCHOFF](#)

It's not so unusual these days to have mortgage debt that exceeds the current value of your principal residence. If you hang on to the property long enough, you have a reasonably good chance of riding out the storm with little or no harm done. On the other hand, if you have to sell now, you face what's called a "short sale" -- which means selling for a net sales price (after subtracting commissions and other closing costs) that's less than the outstanding mortgage debt.

What are the tax consequences of a short sale? The easiest way to explain it is with some examples.

**Tax gain on a short sale.** Say you paid \$200,000 years ago for a principal residence that you could now sell for a net sales price of \$300,000. Unfortunately, you also have \$350,000 of first and second mortgages against the property because you took out a big home-equity loan a couple of years ago at the top of the market when the home was worth \$500,000.

Believe it or not, you'll have a \$100,000 gain for tax purposes if you sell. Why? Because the net sales price exceeds the tax basis of the home: \$300,000 sales price minus \$200,000 basis equals a \$100,000 gain. (Your tax basis equals what you paid for the property plus the cost of any improvements made over the years, minus any past depreciation writeoffs if you rented the property out or used part of it for deductible business purposes.)

While it doesn't seem fair that you could have a \$100,000 tax gain from a sale that leaves you \$50,000 in the red with your mortgage lenders, that's the way the law works. Mortgage debts don't enter into the gain-on-sale calculation.

## [More at WSJ.com/RealEstate](#)

[Not Home Free:](#) Some homeowners are finding that when they sell their homes in a short sale their mortgage companies are going after them for some or all of the difference. (Keep reading at [WSJ.com/RealEstate](#).)

Now for the good news: You'll probably be able to exclude the \$100,000 gain for federal income-tax purposes, thanks to the federal home-sale-gain exclusion break. If so, you won't have to report the \$100,000 gain on your Form 1040. You may or may not qualify for the same favorable treatment on your state income-tax return.

**Tax loss on short sale.** Of course, you can also have a short sale where the net sales price is less than your tax basis in the property.

Say you paid \$415,000 for a principal residence that you could now sell for a net sales price of \$300,000. You also have \$350,000 of first and second mortgages against the property. For tax purposes, you'll have a \$115,000 loss if you sell because the sales price is lower than your tax basis in the home: \$300,000 sales price minus \$415,000 basis equals a \$115,000 loss.

Will the IRS let you claim a writeoff for that loss? Nope. You can only claim a federal income tax loss on investment or business property. A loss on a personal residence is considered a nondeductible personal expense. Most states follow the same principle.

**Excess debt.** In both the preceding examples, the mortgage debt exceeded the net sales price by \$50,000. If the lender won't let you off the hook for any of that excess, you'll have to figure out a way to pay it, and you won't get any tax break for doing so.

If you're more fortunate, the lender will forgive some or all of the excess \$50,000. To the extent debt is forgiven, you have so-called debt-discharge income, or DDI. The general rule is that DDI is taxable income. For the year that DDI occurs, the lender should report the amount to you (and to the IRS) on Form 1099-C. Happily enough, there are some taxpayer-friendly exceptions to the general rule that DDI is taxable. Here they are:

Up to \$2 million of DDI from mortgage debt that was originally taken out to acquire, build or improve the borrower's principal residence is tax-free (you must reduce the basis of the residence by the tax-free amount). This super-favorable rule is not available for DDI from debt that was not used to acquire, build or improve the principal residence, such as DDI from a home-equity loan used for other purposes.

If the borrower is in bankruptcy proceedings when the DDI occurs, the DDI is tax-free.

If the borrower is insolvent (that is, has debts in excess of assets), the DDI is tax-free as long as the borrower is still insolvent after the DDI occurs. If the DDI causes the borrower to become solvent, part of the DDI will be taxable (to the extent it causes solvency). The rest will be tax-free.

To the extent DDI consists of unpaid mortgage interest that was added to the loan principal and then forgiven, the forgiven interest that could have been deducted (had it been paid) is tax-free.

If the DDI is from seller-financed mortgage debt owed to the previous owner of the property, it's tax-free. However, the basis of the property must be reduced by the tax-free DDI amount.

The important thing to understand is that a real-estate short sale can potentially result in a taxable gain and/or taxable DDI. Thankfully, you can probably exclude the gain from taxation under the federal home-sale-gain exclusion deal, and you might be able to exclude some or all of the DDI, too, under the favorable exceptions explained above.

**Courtesy of JB Goodwin**