

REAL ESTATE



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myth vs. truth

SHORT SALES FROM A TAX PERSPECTIVE

Short sales, loan modifications and foreclosures all present unique tax consequences that vary from person to person. Many of the misconceptions we hear from clients stem from a grain of truth. But that does not mean it's true for everyone.

Myth No.1

"I won't owe any income tax because this is homestead property."

This myth began with the passage of the Mortgage Debt Forgiveness Relief Act (MDFRA) in December 2007. However, there are significant limits to this relief.

The debt forgiven applies to a principal residence, which for IRS purposes is not the same as homestead property. You must have owned and used the property as your primary residence for at least two years of the past five years.

Also, the debt forgiven must have been used to acquire, construct or substantially improve the principal residence. If you refinanced to access cash for other reasons – starting a business or paying off credit cards – those funds remain taxable. However, if you added a pool or replaced the roof, that portion of the debt will be excluded from taxable income.

Only the first \$2 million of forgiven debt is excluded from income.



Myth No.2

“I’ll have a loss on the property, so I don’t need to worry about tax.”

Capital losses from the sale of the property will not necessarily offset the income resulting from the forgiveness of debt. Selling the property for less than you owe is not the test. If your basis is less than the debt forgiven, you can actually have a gain.

Myth No.3

“I can use the \$500,000 capital gain exclusion to wipe out any taxable income from the short sale.”

The \$500,000 exclusion for married filing joint (\$250,000 for single taxpayers) is a capital gain exclusion only. Income from debt forgiveness is ordinary income, not capital gain. This exclusion is only helpful if a capital gain results from the reduction in the basis of the property. Beware, the amount of the forgiven debt reduces the amount of gain that can be excluded under this provision, dollar for dollar.

Myth No.4

“I’m in a low tax bracket, so the tax won’t be that much.”

Before the transaction, you probably *were* in a low tax bracket. However, the debt forgiven increases your taxable income by that amount and can push you into a higher tax bracket.

Myth No.5

“I have no assets, so I’m insolvent and don’t need to worry about the tax consequences of a short sale.”

It is true IRS code excludes forgiven debt from income to the extent you are insolvent. However, just because you are upside down on your property does not mean you are insolvent. The extent of insolvency is the difference between the outstanding liabilities and fair market value of the assets (including protected assets such as retirement accounts). It is virtually impossible to reach a conclusion on insolvency without a detailed analysis of all your assets and liabilities, as well as the basis reduction that would occur in the short sale.

The good news on this one is that, unlike the MDFRA, the insolvency exclusion applies to investors. This is an important aspect for investors to explore.

Myth No.6 “The IRS isn’t going after people due to the

Okay, this one does not stem from a grain of truth; it is just wishful thinking. The primary purpose of the IRS is to collect revenue, and the government needs revenue as much as anyone else these days.

Myth No.7 “I’ll just let the property go into foreclosure, rather than do a short sale, to avoid the taxes.”

The tax is the same regardless of how the debt forgiveness comes about. A short sale, loan modification, deed in lieu of foreclosure or foreclosure all have the same effect. The only potential difference is the amount of the debt forgiven. For example, default interest, attorney’s fees and costs continue to add up during a foreclosure, which might be avoided or reduced in a short sale, typically making the unpaid balance of the loan (and resulting debt forgiveness) in a foreclosure higher than if a short sale were completed.

Myth No.8 “If I end up owing tax, I’ll just file bankruptcy.”

Chances are you will still owe the tax. With a few exceptions, Income tax is not typically discharged in bankruptcy.

The tax implications of foreclosures and short sales are complex. Anyone facing this situation should consult first with a tax professional.



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