

**TAX TALK**  
**BY JEFFREY D. SKOLNICK, CPA, M.S. TAXATION**

**I'M CONSIDERING SELLING PROPERTY IN A SHORT SALE, WHAT ARE MY TAX RAMIFICATIONS?**

Unfortunately as I've stated in past articles the current economic conditions have created special situations. One of the situations that has become more prevalent in the past few years are short sales.

**What exactly is a short sale?**

A short sales occurs when the value of a piece of real estate has fallen below its corresponding outstanding mortgage balance. The lender comes to an agreement with the borrower which allows the mortgage to be satisfied at less than the outstanding balance. The property is then sold and the mortgage is paid to the agreed upon extent. This process avoids foreclosure and saves the lender money and the borrower avoids having a foreclosure that would show up on their credit report.

**Cancellation of debt income**

Under normal circumstances when a taxpayer is allowed to extinguish a debt for less than its full face value, that taxpayer is required to report the amount of debt forgiven as "cancellation of debt" income. The taxpayer would receive a form 1099-C from the lender, which would also be sent by the lender to the IRS.

**Exceptions to cancellation of debt income**

While there are specific regulations on how to treat foreclosures, repossessions, cancellation of student loans and debts cancelled in bankruptcy, they go beyond the scope of this article. I am strictly concentrating on short sales of principal residences and business real estate.

**Qualified Principal Residence Indebtedness**

The "Mortgage Forgiveness Debt Relief Act of 2007" as well as "The Emergency Economic Stabilization Act of 2008" created an exception to picking up income on the discharge of "qualified principal residence indebtedness".

Qualified principal residence indebtedness is debt incurred in the acquisition, construction or substantial improvements of your principal residence. It does not include home equity debt incurred for purposes other than to improve your home and

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may not include part of refinanced debt if additional money was borrowed upon the refinancing of the original mortgage.

The overall limit on income that may be excluded is \$2,000,000 by joint taxpayers (\$1,000,000 for married individuals filing separately).

**Business real estate**

The exception for business real estate debt closely mirrors the rules of qualified principal residence indebtedness. In order for the taxpayer to be able to avoid picking up cancellation of debt income when a short sale occurs on a piece of business real estate, the debt must have been incurred or assumed in connection with the business real property. The debt must be secured by such property and the debt must be incurred to buy, construct, substantially improve or refinance such property. There are also additional rules concerning business real estate that relate to basis adjustments and possible depreciation ramifications. In addition, there may be limitations on the amount of cancellation of debt income allowed to be excluded relating to the basis of the property itself.

**Conclusion**

This article gives a very brief summary of some very complicated regulations. I certainly would encourage anyone who feels these exceptions may apply to them to contact a tax professional.