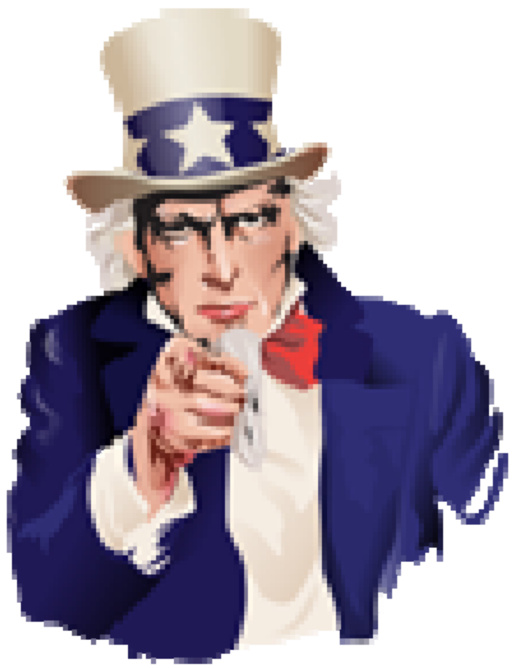
THE TAX MAN NO COMETH ON SHORT SALES



By: Kenneth B. Schwartz, Attorney
555 Westbury Avenue
Carle Place, N.Y. 11514
Tel: 516-333-7020

Library of Congress Card Number: Pending

First Printing: April 2010

Additional copies of this book are available by mail. Send $ 9.95 to:

Kenneth B. Schwartz, Esq.
555 Westbury Avenue
Carle Place, N.Y. 11514
516-333-7020

Printed in the U.S.A. by
X Treme Mortgage Publishing
555 Westbury Avenue
Carle Place, N.Y. 11514

The Tax Man No Cometh
On Short Sales

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555 Westbury Avenue
Carle Place, N.Y. 11514
Tel: 516-333-7020

Say the short sale gets approved and your first lender waives bye-bye to tens of thousands while your second lender goes bibble-bibble but eventually comes around for a few thou in hand – and sends the rest to that very special place where big debts go when nobody wants to pay or collect. So sad sometimes, but hey, you never know. To each his own.

To get everything done you'll just show up and sign till your mortgages split and crumble with no lasting signs, almost like a microwave out of control with no remorse as it buzzes and shines till the ding goes off. But wait, not so fast that little voice says. You thought he'd go away after ten solid weeks and one fifty a shot, but he's back, this time with visions of momma that you better take a few steps back and think tens and forties, green eye shades and mechanical pencils with big white erasers, the kind that tend to always leave their mark with fumes and messy dust. And now some uncle guy in red, white and blue with his big finger out – says he wants you.

Took a few sec's but now you get it, right? Taxes. Plain, unadulterated federal and state income taxes. What will become of your debt that never gets paid? "Forgiveness of debt," goes the little voice in a gentle whisper, this time a bit stronger with a few pangs or pings – or maybe even pongs to keep things moving.

Imagine that, your lender lets you slide and just as you're getting warm and comfy, IRS steps in and makes you pay ten, twenty, thirty percent of what you saved – hard cash that's not around because sellers in short sales almost never walk away with money. Lenders always say no, not very lender like.

And so, no cash means no money for taxes. And no money for taxes means pings, pongs and pangs, especially when that big white finger gets ever so close with penalties and interest that may often run circles around the tax number itself.

So … where does that leave you? Must every short seller become a tax cheat and live on the lam with IRS right behind as men in black converge in limos, dark sunglasses and three D whatever, kind of like an every second of every day reminder that nobody can ever mess with them and walk away.

Oooh… can't go back, huh? And don't even think about a three day binge and wake me up when it's over. No cash, right?

Well, how about this? Like an off button to bad rap, we're about to make your aches go away, contrary to all the bad press that short sales tend to get from all the bad info. In truth, most folks won't have to pay income taxes when they walk away from their mortgage. So the problems's normally not a problem – imagine that.

Here's how it works.

In legal mumbo jumbo we say that if your lender lets you slide for all or part of a debt, like for instance something you can't afford to pay on a mortgage because your house isn't worth enough to cover what you owe, that's called "forgiveness of indebtedness," one type of income that may sometimes become taxable. And like everything else in life, IRS has specific rules to say when it's taxable, when it's not and what you'll need to show on your tax return if you're lucky enough to walk away from what you owe.

Short Sales on Principal Residences Generally Not Taxable

If the short sale involves your principal residence for at least two out of five years and you borrowed to either purchase or substantially renovate, then IRS makes everything nice, neat and easy by simply saying that no income tax generally applies and you don't have to show anything on your tax return – can't get any easier, right?

Short Sales Not Taxable On Other Properties if Seller Insolvent

But what happens if we're talk'n vacation home or investment property, will the same rules apply to exempt the whole shebang from tax or reporting? The answer's no, but not to panic – steady as she goes.

Though all deals are generally reportable, meaning your lender will issue a federal form 1099 for any part of your debt being forgiven, most deals will end up being exempt from income tax anyway because they'll fall within – and here we go again with that legal talk – the insolvency exception to the forgiveness of indebtedness rules.

Huh? Come back one more time.

Sure, this means that if you qualify as being insolvent, then your income's exempt and you won't have to pay income taxes. Hmm… sounds great and wonderful but how can you tell if you're insolvent? And why will most folks in short sales qualify as being insolvent and exempt from tax?

Insolvency means that if you add the fair value of everything you own and compare that to the dollar amount of everything you owe, you'll come up with a negative number. Don't go to sleep – no, not yet. Just getting to the juicy part. So, for instance, say Shorty owns two houses, owes two mortgages and owes three credit cards – and his balance sheet looks like this:

Fair Value of Assets:

Principal Residence	$ 500,000
Vacation Home	400,000
Total Assets	$900,000

Liabilities:

Mortgage-Principal Residence	$ 500,000
Mortgage-Vacation Home	500,000
Credit Cards	100,000
Total Liabilities	$1,100,000

Shorty's insolvent to the tune of $200,000, a number that takes into account all assets and all liabilities, not just the house being sold on a short payoff. And given an overall insolvency of $200,000, no income taxes will apply if Shorty were to sell his vacation home in a short sale that involved a complete forgiveness of his deficiency – the mortgage amount of $500,000 less a selling price for the property's fair value of $400,000, or $100,000.

Yet, if we play with the numbers and turn an overall insolvency of $200,000 into a positive equity of say $300,000, then all bets are off as to an exemption and the $200,000 of forgiveness of indebtedness income would become taxable. Ouch.

But, don't sweat too many bullets over the potential for income taxes on a short sale since in most cases, no lender would ever agree to a short payoff if the borrower's got any real equity in his name, liquid or not. If a borrower's got liquid assets like brokerage accounts, then most lenders would say, use what you got and then we'll talk forgiveness if any deficiency remains. If a borrower lacks liquidity but he's got significant equity in other properties like a commercial building with next to no mortgage, qualified retirement accounts or a partnership interest that's not easily transferable, then many lenders would say no to a short payoff but they might consider a promissory note for the repayment of any deficiency over time. And if that happens no forgiveness of debt would take place, just a swap of one note for another in an equal face amount – and for all intents and purposes, not taxable.

Conclusion

And so, because of lender policies that normally prohibit short sales if a borrower's got equity, it's pretty safe to say that in the vast majority of cases where short sales involve vacation or investment properties, the transaction will end up being reportable but not taxable under the insolvency exemption. Or in other words, show it on your tax return but don't pay any tax.

And as for principal residences, usually IRS won't even say hi so don't get offended if you hear nothing. It's not you. No tax. No reporting.

See you at the short sale.

About the Author

The author Kenneth B. Schwartz is a practicing attorney who maintains offices at 555 Westbury Avenue, Carle Place, N.Y. (Tel. 516-333-7020). After becoming a certified public accountant in 1980, Mr. Schwartz earned his JD in Law from St. John's University Law School in 1983, and a Masters in Tax Law from New York University in 1991. Mr. Schwartz now devotes his law practice to the representation of buyers, sellers and lending institutions in connection with real estate closings.

Mr. Schwartz resides on Long Island together with his wife and three children.

Mr. Schwartz's prior publications on the real estate industry include Mortgages to Music (Morris Publishing, 2004), CEMA's, a Tale of Two Mortgages (Xtreme Publishing, 2006); Cooperatives and Sandcastles in the Sky (XTreme Publishing, 2007); CEMA's and Darwinian Evolution (Mortgage Press, October 2007); Short Sales, Our Secret to the Universe (Mortgage Press, December 2007); Mortgage Closing Resolutions for 2008 (Mortgage Press, January 2008); The Shady Short Seller (Mortgage Press, February 2008); Should Have Done A Short Sale, Bankruptcy vs. Short Sale (Mortgage Press, March 2008); Short Sale Scams Alive and Well and Living in Scamsville USA (Mortgage Press, June 2008), Let's Talk the F Word, an unabridged Crisis (XTreme Publishing, 2008); Just a Glimmer – Short Refi's, Hope for Homeowners under the New Housing Bill (Mortgage Press, 2008); Just a Few Bil (XTreme Publishing, 2008); Thou Shall not Pump and Dump (Mortgage Press, 2008); Stuck in the Spirit of Holiday Giving (XTreme Publishing, 2008); The Perfect Deal (XTreme Publishing, 2009); Pre-Approving the Short Sale (XTreme Publishing, 2010).

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Some say, big income tax problems on short sales so don't even go there unless you're willing to cough up ten of thousands in tax money if your bank says yes and let's you walk away. What to do? Settle with your lender and get clobbered by IRS, or pay lender and toss money into the wind as your house keeps shrinking in value.

So behold the real deal. When the IRS will take aim and when they'll lay low and go about their merry way without giving you a second thought. Now you can hold your head up high and sign without the IRS moving in and taking over.

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