

California Association of Realtors

May 23, 2014

NEW IRS LETTER

IRS Issues Short Sale Tax Clarification

After receiving comments from California tax practitioners and its own review of California law, the IRS has issued a clarification to its September 19, 2013 letter to Senator Barbara Boxer concerning short sales and taxes on the forgiven debt. The new IRS letter indicates that forgiven short sale debt is not subject to cancellation of debt (COD) income only if it is non-recourse at its inception and that their prior letter was overly broad.

In their new April 29, 2014 letter, the IRS states that in order for a debt to be non-recourse at the time of the short sale, the original debt must be used to purchase or build a 1-4 principal residence or a refinance of such debt. As in the prior letter the IRS affirms that a lender's forgiveness of such debt in a short sale will not result in COD income, but instead will be treated as capital gains. And as before, single or joint tax filers selling a principal residence can use the appropriate \$250,000 or \$500,000 capital gains exclusion.

What changed is that a loan used to substantially improve the taxpayer's principal residence may now be treated as COD income instead of capital gains. Additionally, the IRS clarified that an investor's short sale debt will also be characterized by the nature of the debt at inception. If it was recourse debt (non principal residence purchase) originally, it will remain recourse debt at the time of the short sale. This may be somewhat good news for investors who may prefer to have short sale debt treated as COD income rather than capital gains. COD income may be avoided under a claim of insolvency where capital gains cannot.

C.A.R. will continue to seek additional clarification about some issues not addressed, such as a taxpayer's reliance on the IRS's prior letter, and whether forgiven home improvement debt should not also be excluded from COD income. As always REALTORS® must advise their clients that they cannot give tax advice and that the client should seek tax advice from a qualified tax professional. A copy of the letter from the IRS is available for reference.

<http://www.car.org/legal/taxfolder/IRS.pdf>