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Watch Out for IRS Penalties in Short Sales

As the housing market continues to cool, more and more homeowners (especially those with subprime or poor credit mortgages) are finding themselves facing sticky situations as their adjustable rate mortgage reset and the monthly mortgage payments become unmanageable. The unfortunate consequence is that these trouble home loan borrowers are filling for foreclosure in record numbers. The interest-only and pay option ARM loans that seemed to be the miracles that allowed people to buy homes have turned out to be the home owning death sentence for many now that the housing market has fallen.

Some homeowners try a different approach to their mortgage woes – they turn to short sales to avoid foreclosure. A short sale is when the house is sold for less than what the owner still owes on the current mortgage. Many of these will make an agreement with their mortgage lender whereby the lender agrees to forgive the balance of the loan. Many lenders accept this deal because they will get much more money back this way than if the borrower goes into foreclosure.

Here is a sample short sale scenario: A borrower owes $250,000 on a house. The borrower gets behind on mortgage payments and his financial situation does not allow for refinancing. The market has slowed since the borrower bought the home and now similar homes are only selling for $220,000. The borrower sells his home at the market value and then has to take out $15,000 of that sale money to pay the real estate agent and appropriate taxes. At this point he still owes his mortgage lender $45,000. The lender agrees to forgive that remaining balance because he would rather get $205,000 back rather than have to go through the expensive and time-consuming process of foreclosure.

This seems like a great deal for the borrower as well. Even though he didn’t make any money on the deal and lost any built-up equity, at least he broke even and came out with no further mortgage debt. Yet, even while the lender was willing to be forgiving, the IRS is not so compassionate.

Under current federal law, the lender is required to report the forgiven debt to the IRS and the IRS will count that amount as income to be taxed! That rule applies to the cancellation of any personal debt over $600. In the scenario above, assuming the borrower is in the 28 percent tax bracket, the borrower will be liable to pay 28 percent of that supposed $45,000 worth of “income” on his taxes. That means an extra $12,600 in taxes!

So if you are considering saving yourself from foreclosure with a short sale, be sure you can afford to pay the associated taxes. The good news is that if you can hold out a while longer, you may not have to pay those taxes. With the current flood of homeowners unable to hold on to their homes in their current ARM loans, some lawmakers have realized the necessity of not “kicking them when they are down” with this extra tax. The Mortgage Cancellation Tax Relief Act of 2007 (H.R. 1876) is currently before the House Ways and Means Committee and it would eliminate that clause of the tax code in regards to debt forgiveness on primary home mortgages. The present state of market affairs means the act will have a good chance of being passed!