



TaxNewsFlash

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U.S. Tax Court: “Short sale” of residence and debt forgiveness held one transaction

The U.S. Tax Court today held that a “short sale” and debt forgiveness with respect to a nonrecourse loan on the taxpayers’ residential real estate were parts of one transaction. The court found the transaction did not generate cancellation-of-indebtedness (COI) income or gain or loss.

The case is: *Simonsen v. Commissioner*, 150 T.C. No. 8 (March 14, 2018). Read the Tax Court’s [opinion](#) [PDF 131 KB]

Background

The taxpayers (husband and wife) in 2005 bought a home in northern California and financed the purchase with nonrecourse debt. Following the downturn in the economy, the couple in 2010 moved out of the house and converted it to rental property.

The taxpayers eventually faced a mortgage debt much greater than the value of the home. They were unable to keep up with their loan payments, and negotiated a “short sale.” The bank discharged the debt.

The taxpayers believed the short sale and the debt forgiveness were two separate transactions that resulted in both a substantial deductible loss and excludable COI income.

The IRS, however, determined that this was one sale or exchange; that there was no COI income; and that there was no deductible loss. The IRS assessed a tax deficiency of approximately \$70,000 and imposed an accuracy-related penalty of almost \$14,000.

Tax Court's opinion

The Tax Court today held that the short sale and debt forgiveness were part of one sale or exchange, and that the amount realized included the discharged nonrecourse debt. The court found no COI income.

As the court further explained, because the home loan was nonrecourse debt, the amount realized on the sale included the discharged debt. The taxpayers received no consideration in addition to the bank's forgiveness cancelling the loan balance. Accordingly, the amount realized was greater than their loss basis in the property, but less than their gain basis in the property (pursuant to Reg. section 1.165-9(b)(2)). The court thus concluded when property is sold for an amount between those bases, there is neither a gain nor a loss on the sale.

The Tax Court held that the taxpayers were not liable for the accuracy-related penalty under section 6662(a).

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