



# The Default News™

Tax Implications — Part 2

Defaulting on an investment property

By Karla Dennis

In Part One I pointed out how the tax implications of defaulting on a primary residence are different than the tax implications associated with defaulting on investment property.

The tax code defines investment property as “any real property held for other than the use of a primary residence.” This definition includes vacation rentals, second homes and any other income producing real estate that one does not occupy as their principal home.

In Part One I also discussed the December 2007 law that grants tax relief to individuals who default on the primary residence and who met certain qualifications. However, this same relief does not apply to investment property holders. Yet defaulting on investment property causes a taxable event, which must be reported as though you sold the property.

Let’s use this lending example:



- You own a rental with a loan value of \$200,000
- The purchase price was \$300,000
- The Fair Market Value is Now \$250,000

In this case, you report the sale as though you sold it for \$250,000; however, because you bought it for \$300,000, you also have a loss to report. The sales price of \$250,000 less the purchase price of \$300,000 gives you a \$50,000 loss.

Of course, we must take into consideration the investment property’s depreciation, if any. That calculation yields investor a tax favorable position, because this loss will help off-set the taxable income associated with debt relief reporting.

Prior to making any financial moves associated with investment property, review the tax implications from both sides of the equation.

**Side 1** reports the debt cancellation income.

**Side 2** determines the taxable gain or loss on the disposition of the property.

Knowing you have two angles to review can help you make prudent tax planning decisions.

***Did you ever notice  
that when you put  
“The” and IRS” together,  
it spells “THEIRS?”***

~ Author Unknown

Reporting income from debt relief is only one aspect of the transaction. The other aspect is reviewing the total picture of all your real estate investment records, which may yield you a completely different tax picture.

It is vital to review all real estate transactions with a tax professional. When gathering your data, sharing the following insight with them can make a difference in your tax calculations.



## **6 elements to share with your accountant. It might save you money.**

1. Is there principal mortgage insurance on the loan?
2. Did you make improvements to the property? If so, over what time period? And if so, they need to be added to the gain or loss on the sale transaction.
3. Show your tax professional your purchase closing statement.
4. Know the balances on all mortgage loans.
5. Did you refinance the property? If so have the statements available.
6. Was the purchase part of a prior tax deferred exchange?

Advance tax planning minimizes your taxable income and assists you in making prudent tax decisions. When tough choices have to be made, having the right knowledge can mean the difference in a key decision.

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