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Q

We are considering doing a short sale on a rental property. What things should we consider?

A

It is most important to determine whether the debt you are walking away from is “recourse” or “nonrecourse”. A bank cannot come after you personally for the shortfall on a nonrecourse debt, which is typical of debt used to purchase real property in California. However, there are certain events that may convert what is normally nonrecourse debt to recourse (e.g. purchase of real estate not used as your personal residence and refinancing a property for more than its original purchase money debt). This is important because the IRS treats the forgiveness of recourse debt (difference between the unpaid principal and the fair market value of the property) as taxable ordinary income. This gain generally cannot be offset by the capital loss incurred on the sale. Exceptions only apply if you’re insolvent or file bankruptcy.