Beware of the Dangers of the "Short Sale"

As the real estate market has slowed down, you are faced with two different types of sellers. There are those who want to sell, whether they think they are at the "peak" of the market or simply want to move on to another home. Then, there are those who MUST sell for a variety of reasons. Perhaps they have been laid off their job, been transferred or the adjustable interest rate on their loan just skyrocketed, and they cannot afford the payments.

What happens to those in the last group if their loan amounts, along with selling expenses, exceed the value of the property they are selling? They have two choices … either write a check for the difference or get the lender to authorize a "Short Sale".

What is a "Short Sale?"

A short sale occurs when there are not enough funds available from the sale of the property to pay commissions, selling costs, property taxes and the amount due on the loan. It requires that the lender (or lenders) accept less than full payment on their notes that are secured by the property. Obviously, the lenders do not want to do this, so you can't just call them up the week before escrow is going to close, and ask them to accept less money for their note. There is a process that one must go through in order to obtain an authorization for a short sale.

Generally speaking, the lender will not even consider a Short Sale when the loan is current. So, if the seller has been making their payments all along, but now needs to sell the property, a phone call to the lender will be fruitless. He can tell them his problem until he is blue in the face, and they will just ignore his request. Basically, the lender is saying "Call me when you have missed two payments!" The reason for this is that if they made it easy, everyone would do it, and no one would take the responsibility of paying the difference between market value and the obligation amount.

Danger Number One

Obviously, the first problem that will face the seller is the fact that their credit will be ruined. In order for the lender to consider the request for a short sale, the seller must have missed at least 2 payments by 30 days. This means they have two 30-day late's reported on their credit report, which will make it difficult for them to purchase another home in the near future.

Danger Number Two

Time is always a factor in negotiating a short sale. The lender will require that the seller supply detailed information regarding their finances, including wage statements, bank statements, verification of their other obligations, opinions of value of the property, etc. After reviewing this information, they may or may not accept a short sale amount that was requested, or they may come back with a different amount that they will accept. This

process could go on for as much as 2-3 months before a dollar amount is agreed upon. In that time, the seller has received additional late payments reported to the credit reporting companies, and perhaps a Notice of Default being filed as a start of the foreclosure process. The bottom line is that their credit is further destroyed by the delay.

Danger Number Three

There are many loans that have been generated through "stated income" loan processing. A stated income loan is actually designed to help people who may show lower income levels on their tax returns because of depreciation and other deductions, than they actually receive. A "stated Income" is supposed to be an amount that actually reflects the income at the time of purchase, rather than what was needed to qualify for the loan. If, during the review of the various documents requested, the lender determines that the "stated income" was blatantly false, there could be accusations of lender fraud at the inception of the loan, which could make the seller criminally liable.

Danger Number Four

The final danger, and perhaps the biggest of all, has to do with our friends at the IRS. If a lender loses money through a Short Sale, they will want to deduct that loss from their income for the year. The IRS requires a balancing of this loss for the lender to be charged to someone else as income. The lender, therefore, will issue a 1099 to the seller in the amount of the loss the lender experienced. The seller will then be required to report that as ordinary income on their tax return for that year. This amount is called "debt relief" by IRS, and is considered to be income to the seller of the home.

Let's say that Seller purchased a home for $600,000 one year ago with 100% financing. Unfortunately, that market slowed, and he needs to sell, but the most he could hope to receive is $585,000. Now we add selling expenses of about $35,000, and we have a shortfall of $50,000. If the lender agrees to accept $550,000 against their loan of $600,000 (assuming no reduction of principle), they will send a 1099 to the seller in the amount of $50,000. The seller will need to add that to his income for the year when he does his taxes and that could result in additional state and federal tax obligation of $15,000 to $20,000. Now he is suffering from a huge tax obligation and horrendous credit. He may be in worse shape now than he was before.

There are ways to avoid the short sale through the creative financing ideas that I discussed in last month's article. Before recommending a Short Sale to your clients, I would suggest that you have them obtain legal and tax advice as to the ramifications that they may be facing.

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