

## What Is A Short Sale?

Home sellers should consider a Short Sale when the value of their home is LESS than the amount of their outstanding loans. For example, if your home is worth \$250,000 but you have a loan of \$260,000 then a short sale is a consideration. Obviously, if you do not have to sell your home, you could wait out the market and hope for a turnaround in real estate values.

However, if you do have to sell your home you basically have three options. First, you can bring cash to the table. In the example above you would sell your home for \$250,000 and pay another \$10,000 to the lender out of your pocket to pay off the loan on your property. Second, you could let the home go into foreclosure. The lender will go through the foreclosure process, force you out of your home and then auction it off to the highest bidder at a foreclosure or Trustee's auction. The third option is to pursue a short sale. You contact the lender, explain the circumstances and convince them to take less than full value of their loan.

In the case above you may tell them you have a buyer for \$250,000 and it's very unlikely there will be a buyer at a higher price. If they will accept \$250,000 for their \$260,000 loan then you can proceed with a short sale. Sometimes the lender will consider a short sale before you have a buyer and you can market your property and, if you find a buyer, take their offer to the lender for consideration. The lender may or may not accept the offer.

## Steps In A Short Sale

Short sales are not necessarily complicated but do require some work on your part and your agent's part if one is involved.

- . Figure out the true value of your property. Many times a real estate agent can provide a ?market analysis? and give you a good idea of what your home might sell for. You can also use Zillow or other real estate related sites to determine the rough value of your home. If the market is moving down keep in mind that your homes value may be moving down as well and estimated valuations may be valid for only a short time.
- . You also need to calculate your estimated closing costs. Items such as a title report, escrow, appraisal, attorney fees, agent commissions, unpaid property taxes etc. may add up to a substantial amount of money.
- . You'll need to know how much you owe on your property. Include all loans on the property in your calculation.
- . Calculate your equity. Normally the value of your home is more than the total of the loans and closing costs. If your closing cost estimate plus your loan amounts are higher than the value of your property then a short sale is a possibility.
- . You'll need to contact your lender and explain your situation. Be sure you talk to someone who has the authority to make the required decisions. Usually lenders have a ?loss mitigation department? that you can contact. Lenders are under no obligation to accept a short sale but many times it is in their best interests to do so. Some lenders will

not consider a short sale until you have missed a payment or two. Some will not accept short sales at all. You'll need to know where your lender stands with regard to short sales so contact them as soon as possible.

- Consider your tax obligations! Do not underestimate this! Many times there can be a substantial tax obligation after a short sale has occurred. Be sure to talk with an accountant or tax attorney to figure out how much money you may owe the IRS if you proceed with a short sale.
- Find a buyer and sell your property. The lender will still have to approve the buyer's offer but once they do you can sell your property.

### Beware The IRS!

Many homeowners do not realize that they may be in store for a large tax bill from the IRS after the short sale of their home. Every situation is different and you should absolutely contact an accountant or tax advisor before conducting a short sale to determine your potential liability.

As an example assume you purchased your home for \$400,000 in 2003. Since that time it has appreciated to \$500,000 and you refinanced and now owe \$450,000. You need to sell your home now but due to the bad market you can only get \$400,000 for it. Your lender accepts a short sale since you owe them \$450,000 but they are accepting only \$400,000. The IRS considers the \$50,000 that was "forgiven" by the lender as "debt relief" income.

Your lender will probably send you a 1099-C in the amount of \$50,000 and the IRS will want you to pay taxes on that amount. What are the odds that you have that kind of money laying around after you just went through a short sale on your home? Be very careful regarding your tax obligations BEFORE you consider a short sale, deed-in-lieu-of-foreclosure or foreclosure.

The IRS will use your tax basis on your property to determine your tax obligations so you must be able to figure this amount out.

See our article on IRS Form 982. The form is used to request a "reduction in tax attributes" due to insolvency. This may allow you to avoid having to pay taxes on the debt relief you experience with a short sale. Definitely worth talking to a tax attorney or accountant about!

### RS Form 982 - Avoid Debt-Relief Taxes

We are not tax experts so what we've written here is only for informational purposes and should be used as a starting point to further investigate the potential tax savings involved. It is absolutely worth your time and money to consult with an expert in these matters as it could save you thousands of dollars.

As we mentioned in another article, 'Beware The IRS', you could be in for a large tax bill

if you utilize a short sale, foreclosure, or deed in lieu of foreclosure. The amount of debt that is 'forgiven' by your lender may be viewed as income for that tax year by the IRS. If you owed \$450,000 on your home and you received an offer for \$400,000 and your lender accepted the offer ( a short sale) then the IRS would view the \$50,000 difference as ordinary income in that tax year. So, you would owe taxes on \$50,000. This is a simplistic example and most cases are more complex but the bottom line is that you need to be aware of the potential tax liabilities involved in a short sale.

Is there a way to avoid paying that tax? Possibly. IRS form 982 says, "Generally, the amount by which you benefit from the discharge of indebtedness is included in your gross income. However, under certain circumstances described in section 108, you may exclude the amount of discharged indebtedness from your gross income". The specific instructions are contained in section 108 of the Internal Revenue Code.

One of the 'circumstances' they are referring to is that if you are insolvent before you conduct a short sale then you may be able to 'exclude' the forgiven indebtedness (the amount the lender forgave on the loan) from being added to your gross income for that year. Here are some questions you will need to ask an expert:

- . Can I avoid paying taxes on the forgiven debt if I was insolvent at the time of the short sale?
- . Do I have to file bankruptcy to be considered insolvent?
- . If you already used a short sale and paid taxes can you file an amended return and get a refund?
- . Does your real estate agent understand any of this?
- . Do you have to surrender your property in bankruptcy to be eligible for relief?
- . Does a form 982 have to be filed in order to be eligible for tax relief?

### Why A Lender Might Accept A Short Sale

While most lenders will not be thrilled at the prospect of a short sale they are acutely aware that a foreclosure is usually a far more time consuming and costly option. In a real estate market where housing values are going down it is in the best interests of the lender to liquidate their problem loans as quickly as possible.

With a short sale a property can be sold and the loan taken off their books fairly quickly. If they pursue a foreclosure they run the risk of the process taking a substantial amount of time during which the value of the property is depreciating. Also, buyers will tend to write low ball offers when they know that a bank or lending institution owns the property. The property will also be left vacant which can result in vandalism and deterioration. Some owners will even gut the house just before the foreclosure sale as a way to 'get back' at the lender. This is illegal but nonetheless happens on occasion. So, you can see why a lender might want to go the short sale route and get the loan off of their books with minimal hassle.

## The Short Sale Package

All of the documentation needed to start a short sale is commonly called a "Short Sale Package" and is usually submitted by the investor interested in the property, the agent representing the seller, or the seller of the property. The package usually includes the following items:

Sample Short Sale Package (items may vary depending upon the lender):

- . Cover Letter
- . Authorization to Release Information
- . Sellers Hardship Letter
- . Seller's Financial information
- . 2 years w2's
- . 2 months pay stubs
- . 2 months bank statements
- . Supporting Hardship Info - HOA liens, medical/disability statements etc.
- . Repair Estimate for the property
- . Comparable sales for the property
- . Contract
- . Net Sheet
- . First mortgage holder may ask for a payoff amount from the 2nd
- . Second mortgage holder may ask for a payoff amount from the 1st
- . Lender may ask for an Initial Title Report
- . FHA and VA may have their own forms and special requirements as well

## Broker's Price Opinion

The Lender will want to see a Broker's Price Opinion (BPO) to get an idea of what the property is worth. The BPO is usually produced by either the agent for the seller or sometimes by an agent or appraiser working for the lender. The BPO will contain comparable sales of similar houses in the neighborhood, with adjustments made for condition and attributes, to determine what the market value of the subject property is.

## The Short Sale Hardship Letter

The Hardship Letter is usually part of the short sale package and is written by the seller or their representative. It is used to explain to the lender the reasons for the borrower's need for a short sale. Reasons such as divorce, job loss, medical issues, etc. can and should be included. Usually just a one page letter with the pertinent information will suffice.

A simple letter in the following form should suffice:

Date

Lender Name  
Address  
Loan Number

Dear Sir/Madam,

{In this section explain your hardship and why you must utilize a short sale - some example hardship reasons are listed below}

- . Unemployment
- . Reduced Income
- . Divorce
- . Separation
- . Medical Bills
- . Too Much Debt
- . Death of my Spouse
- . Death of a family member
- . Payment Increase
- . Business Failure
- . Job Relocation
- . Illness
- . Damage to Property
- . Military Service
- . Incarceration
- . Other (Please Specify)

Borrower's Signature

Date

Co-Borrower's Signature

Date

#### The Credit Consequences of a Short Sale

The credit consequences of a short sale and foreclosure vary slightly. The general consensus is that a short sale will show up on your credit report as a 'settlement', 'settlement for less than owed' or a "pre-foreclosure in redemption". Also, since most lenders will not consider allowing a short sale until a few payments have actually been missed you may also have a few 'lates' on your credit report. Neither of these marks is a good thing to have but it's possible to get them off of your credit report within a few years or less. A short sale can drop your credit score by 80-100 points. There is also the possibility that through negotiation with the lender you can avoid having the short sale reported to a credit agency.

A foreclosure on your credit report can take 7-10 years to remove and can cost your credit rating (FICO) up to 200-280 points which is a very big hit.

So, if you have no better alternatives, pursue a short sale aggressively and avoid foreclosure.

### The Mortgage Relief Act

Here is the press release from one of the Senators that is sponsoring the Mortgage Relief Act that may provide some relief for homeowners that are in a short sale position and may owe the IRS taxes on debt relief.

U.S. Senator Debbie Stabenow (D-MI) today announced that President Bush will include the Mortgage Relief Act in his initiative to assist homeowners damaged by troubled mortgages. The Mortgage Relief Act, introduced in May by Senator Stabenow, would change current law that forces individuals to pay an income tax when they have had a part of their mortgage loan forgiven or have been forced to foreclose because of their inability to pay their mortgage. The bill is also sponsored by Senator Carl Levin (D-MI), George Voinovich (R-OH) and John Kerry (D-MA).

"People in Michigan and across America are suffering, and it is wrong to unfairly tax families when they are faced with the prospect of losing their home," said Stabenow. "I look forward to working with the President and my colleagues to prevent additional, unfair economic hardship in the lives of those who find themselves in truly unfortunate circumstances. We need to make it easier, not harder, for Americans to keep their homes. "

Declining home prices and rising foreclosure rates have left some families having to sell their homes for less than they paid for them, and sometimes for less than the outstanding debt. The IRS currently taxes any loan forgiveness as 'income'. The Mortgage Relief Act will relieve families of a tax burden when their lender forgives part of the mortgage on a principal residence.

Under current law there are a number of situations in which homeowners are unfairly taxed when trying to responsibly address their inability to meet their mortgage. For instance, if a family owns a home with a \$100,000 mortgage and can't afford to make their payments the bank can step in and refinance the house at a lower value to better reflect the decreased market value. Under current law, if the bank values the home at \$80,000 the family would have to pay taxes on the \$20,000 difference between the new and the original mortgages.

In addition, the President's plan will urge Congress to reform current laws to make it easier for the Federal Housing Administration to offer aid to mortgage holders with subprime mortgages. His proposal will also include an increased effort to enforce predatory lending laws and strengthen lending practices.

From 2005 to 2006, the Detroit metropolitan area had the highest percentage of

households in foreclosure in the 150 largest metropolitan areas, with an average of more than 10,000 foreclosures in each quarter. The foreclosures affected 1 out of every 21 households, nearly five times the national average. Over the first quarter of 2007, Michigan had over 29,000 foreclosures and Detroit was on pace to record 11,000 for that same time period. The Mortgage Relief Act, is companion legislation to H.R. 1876 introduced in the House by Rep. Rob Andrews (D-NJ) and Ron Lewis (R-KY).

### Obama's Loan Modification Program

You've probably heard about President Barack Obama's plan to rescue the housing market. He believes that restructuring distressed mortgages will help to keep struggling home owners in their homes. He also believes that this will help slow or stop the decline in housing prices. To this point \$75 billion has been allocated toward modifying distressed loans and the Administration claims that it can help up to 4 million homeowners. Unfortunately, over half of those loans that have been modified have re-defaulted within six months.

Can Obama's plan help you? Well, let's look at it's main components:

First, the Obama administrations loan modification plan focuses on payments, not prices. They assume that home owners will want to stay in their homes as long as they can make the monthly payment regardless of the value of their home. This may or may not be the case. Evidence has shown that some homeowners will walk away from their homes even if they could make the payment only because the value of their home has fallen far below what it was once worth.

Second, Obama's loan modification program requires loan servicers to lower the borrower's monthly payments to no more than 38 percent of the borrower's gross monthly income. The federal government would then subsidize a portion of the payment so that the borrower would only be paying 31 percent of their gross monthly income. Obama's plan does not require loan servicers to reduce the principal amount of the loan. The servicer can reduce the interest rate to as low as 2 percent, extend the loan to a 40 year amortization, or forbear a part of the principal at no interest. So, if these terms would help you stay in your home then you should take a serious look at the Obama Loan Modification Program.

Why would loan servicers want to participate in this program? Well, for one, they will get \$1000 for every modification plus an additional \$1000 each year for up to three years if the borrower continues to make the payments on the loan. The borrower too can get up to \$1000 knocked off of their loan principal each year for up to five years if they make their payments on time.

Of course, in the Obama Loan Modification Program only owner-occupied primary residences will be considered and only those with loan balances less than \$729,750. Applicants will have to sign an affidavit of financial hardship and verify their income and only loans originated on or before January 1, 2009 will be eligible for the program.

So, does the Obama Loan Modification Program sound like it could help you? If so, then give your lender or loan servicer and call and see if you qualify.

### Home Affordable Modification Program (HAMP) Eligibility

Are you eligible for the government's Home Affordable Modification Program or HAMP? Well, there are a few questions that you'll need to answer.

First, is your home your primary residence? You cannot use HAMP on second homes or vacation homes so your home will need to be your primary residence in order to be eligible.

Second, you need to owe less than \$729,750 on your home loan. Any more than that and you are not eligible for HAMP.

Third, are you having difficulty making your house payment? The difficulty could be caused by a significant increase in your loan's interest rate, an increase in the payment, a reduction in your income or some hardship such as medical bills.

Did you get your home loan before January 1, 2009? Mortgages originated after that date are not eligible.

Is your loan payment on your first mortgage more than 31% of your current gross income? Your payment would include principle, interest, taxes, insurance and home owner's association dues if applicable. Add those up and then divide your monthly payment by your monthly gross income (payment/gross income). If it is under 31% then you are not eligible for HAMP.

After answering these questions you should be able to tell if you are eligible to apply for a HAMP modification. You will still have to show that you have adequate income to make the reduced payments if your loan is modified.

### Home Affordable Refinance Program (HARP) Eligibility

Do you know if you are eligible for a Home Affordable Refinance Program or HARP? This type of refinancing can be useful to someone who is able to make payments on their home loan but cannot refinance because their home's value is now less than the outstanding loan amount. To determine whether you are eligible for the Home Affordable Refinancing Program you need to answer these questions.

First, do you own a 1 to 4 unit home? Anything larger than four units is not eligible for HARP.

Second, is your loan guaranteed by Fannie Mae or Freddie Mac? If you're not sure then you'll need to contact them to find out. If it is then you may be eligible. You can call FMNA at 1-800-7FANNIE and FreddieMac at 1-800-FREDDIE

Third, are you current on your mortgage payments? In other words, you haven't missed

any payments or been more than 30 days late on your payments in the last 12 months. If you are current then you may be eligible. If you are not current or have missed payments then you will probably need to look at other options

Fourth, is the amount you owe on your home more than or roughly equal to what your home is actually worth? As long as your first mortgage does not exceed 125% of your homes current value then you may be eligible for the Home Affordable Refinance.

Even if you answered these questions and feel you are eligible for the Home Affordable Refinance Program you will still need to show that you could make the payments under the refinanced terms as well as show that the refinance would improve your long term affordability and stability of your loan.

If you have more than one loan on your property then you'll need to meet a few other conditions for eligibility. The first loan alone cannot exceed 125% of your homes value. Whoever holds the second lien or loan on your property must agree to stay in the second position. If they do not agree then you will not be eligible.

A HARP refinance will not lower your loan balance but rather refinance your current loan to a lower interest rate thereby lowering your monthly payment. Currently the HARP program is set to expire on June 10, 2010.

Information from <http://www.shortsalehelp.com/>