Real Estate Short Sales

What is a Real Estate "Short Sale?"

As foreclosure rates hit record levels, more sellers are turning to short sales as a way to deal with their housing situation and avoid foreclosure. So, what is a “short sale” and how does a short sale work?

“What is a short sale?” is a question on many people’s minds these days. A real estate short sale is a real estate transaction where a mortgage company looks to cut their losses by agreeing to a reduced payoff of their loan in exchange for not having to foreclose on the property. This is accomplished by the seller arranging with their mortgage lender to accept a price that's less than the amount they owe on the property. As part of this arrangement, the lender typically agrees to forgive the rest of the loan. As a result, the seller isn't responsible to the lender for the additional amount owed. But the forgiven amount may be viewed as income by the IRS for income tax purposes. If so, it will be reported to the IRS on form 1099-C. It may be possible that the borrower negotiates not to receive a 1099-C at the end of the year showing the mortgage shortfall as additional income, although this is on a case-by-case basis (see below).

In summary, in a short sale, the seller doesn't have to go through a foreclosure, the buyer picks up a property at a discount, and the lender avoids taking on the burden of unloading a property.

Why are Short Sales so common?

Short Sales are prevalent today because of the decline in real estate values/prices. In many cases, the value of the mortgage is higher than the market value of the house. This creates a situation where funds acquired from selling the home are less than the mortgage amount owed to the lender. In this case, the seller is “short” funds to cover the debt. Some now estimate that nearly 10 million Americans owe lenders more than the value of their homes. This is commonly referred to as the mortgage being “underwater.”

Additionally, today’s stricter borrowing guidelines are causing a decrease in the number of buyers qualified to purchase a home. With a lowering demand for homes and a large supply on the market, housing prices are “bottoming out.”

Lastly, with the employment rate is lower than normal, some unemployed workers are being re-employed at lower incomes. This is also affecting many people’s affordability when it comes to housing.

All of the above conditions are contributing to the lower demand for housing and the record high foreclosure rate. Thus the need for selling “short.”

What are the Benefits of a Short Sale?

Benefits for the Seller

In a short sale, the seller (borrower) retains ownership of the property. Unlike a foreclosed property where the mortgage company becomes the owner, in a short sale, the person selling the property is the homeowner. However, the homeowner must obtain advance approval from the mortgage company in order for the transaction to be completed. This creates a dual approval process because both the homeowner and their mortgage company must agree to the terms of the offer the buyer makes in order for the deal to consummate. Obtaining efficient approvals from mortgage companies is an art in and of itself which is why most borrowers seek competent short sale specialists.

The good news for these homeowners is that they have a way out; the short sale. And a short sale helps the homeowner avoid foreclosure, it helps the lender save money, it helps the buyer get a great deal on a house. It can also help all the professionals involved in the transaction. It's one of the few win-win deals in the current real estate market.

Benefits for the Buyer

In general, in a short sale transaction, the buyer benefits from the lower price required to purchase the home. Also, with the seller retaining possession of the home and, in many cases still residing in the property, the house is generally in better repair than if the lender foreclosed on the property.

The buyer will also know that the property is approved by the lender for a short sale. This creates a scenario where the buyer knows the conditions for sale before entering in to the contract.

Benefits for the Lender

The lender benefits from a short sale in a number of ways:

- First, the short sale reduces the transaction costs of the lender. No maintenance costs are incurred by the lender as in foreclosure.
- Next, the seller pays the real estate commissions at an agreed upon rate before the closing.
- Third, the lender avoids taxes and fees. A mortgage company experiences substantial losses when they become a property owner through the foreclosure process. Fees may include maintenance fees if the property is a townhome or condo, transfer taxes where applicable, utility fees, etc.
- Last, lenders are not in the real estate business. Keeping foreclosed properties "off the books" of the lender benefits the overall financial condition of the bank.

What are the Potential Pitfalls of a Short Sale??

Good question! So far the short sale sounds pretty good, right?

Sellers considering a short sale must understand a few important things. First, not all lenders accept requests from homeowners to relieve them of the responsibility of paying off the balance of the loan. So, sellers should get a *solid commitment* from lenders that states this is part of the deal. Also, even though the seller is avoiding a foreclosure, a short sale may damage their credit report and score, though probably not as much as a foreclosure. So, sellers should discuss this issue with their lender to understand how the process will be reported to the credit agencies.

Most importantly, not all sellers qualify for entering into a short sale. For example, few lenders will enter into a short sale agreement with sellers who have not yet missed multiple payments. So, if you're a seller thinking about a short sale, talk to your lender about the options they have available.

Buyers need to be wary too. While buyers may get a great property at a discount, they also will need to go through some extra paperwork too, since getting a deal on a short sale is not as easy as it may sound. In fact, there are some extra steps that buyers need to take when entering into a short sale, which can require doing some additional homework and assembling the right paperwork. In addition, if two lenders are involved because there are two loans secured to the property, it could take longer to satisfy the demands of the second lender. Depending on when the Notice of Default was filed, it could take anywhere from two weeks to two months just to get a response.

Not to mention, buyers also need to be prepared to roll up their sleeves if that new property needs fixing up.

If you are a buyer considering entering into a short sale, it would be wise to consult a real estate professional who can thoroughly answer your questions and help you navigate through the process. This way, you can be better prepared to pull together all the appropriate information you need to complete the transaction and move into your new home.

Is a Short Sale Better Than a Foreclosure?

Generally speaking, yes!

There are at least three areas where a short sale is a more favorable approach to dealing with an "under water" property vs. foreclosing:

1. The **credit report impact**. In a short sale the seller has the option of keeping payments as current as possible which can minimize credit score degradation. Also, after a short sale, the credit report usually reflects language that is less serious than the word "Foreclosure." (Most lenders agree that the word "foreclosure" on a credit report is as bad as it gets when the seller goes for future borrowing.) Instead, the report may show,

"Settled as Agreed" (or others – see below), which sometimes appears with a short sale. Although not as good-looking as "paid in full", this terminology is better than the word "foreclosure." This terminology looks upon the transaction as a settlement, which can take 2-3 years to overcome, while a foreclosure lasts 7-10 years.

2. The **market price** of the house. When a property becomes a foreclosure, it typically carries a lower market value because the word foreclosure is attached to the listing. Buyers often interpret a foreclosure as a distressed property and will generally offer less money for it. Consequently, the less the property sells for, the larger the deficiency and the more the borrower is responsible for paying back.
3. With a short sale, **most lenders do not attempt to collect on the deficiency**. Instead, they usually issue the borrower a 1099-C - Forgiveness of Debt form. This is an IRS requirement. Any lender who forgives debt above $600 must issue the forgiven party a 1099-C. However, for most borrowers, the Mortgage Forgiveness Debt Relief Act of 2007 generally releases the seller from this responsibility for their primary residence.

In summary, a short sale is much better than a foreclosure for three reasons:

1. most lenders report a phrase other than "foreclosure" to the credit bureaus.
2. the typical short sale results in a "1099" as opposed to deficiency, and
3. the amount the lender loses is usually far more with a foreclosure.

When you combine these three major items, it's clear to see that a short sale really is preferable to foreclosure. Below is a chart which compares the two options.

Short sale vs. Foreclosure

Item	Short Sale	Foreclosure
• Ownership	Homeowner	Lender
• Credit Score	Decrease	Derogatory
• Additional "1099" Income	Possible – see exceptions	None
• Lender	No "REO"	Expensive to sell and maintain the property
• Process	Proactive	Reactive
• Result	1099-C	Deficiency

How Does a Short Sale Affect a Credit Report?

When a short sale transaction completes, the lender reports the sale to the three credit bureaus (Equifax, TransUnion and Experian). Some examples of the language that lenders use to report the transaction are:

- settled as agreed,
- account settled,
- settlement in full, and
- account legally paid in full for less than the full balance.

You may recognize that this terminology is very similar to what credit card companies report when a borrower settles an account for less than the total amount owed.

In most cases, the short sale approval letter specifies the exact wording the lender is going to use when reporting to the bureaus. In isolated cases, you may find where the short sale approval letter does not specify how the short sale will be reported. In those cases, contact the lender handling the short sale to determine the language they will use to report it.

Be careful when embarking on the short sale process too. If your account is more than 120 days past due, it may automatically show up as a "foreclosure" on the credit report. Therefore, be diligent to follow up with all three credit reporting bureaus a month or two after the short sale is complete to verify the wording that the lender is using. In these cases, you may have to provide evidence to each credit bureau proving that the property was sold prior to a foreclosure.

Score

The initial decrease in a credit score after a short sale is estimated to be about 100-200 points on the credit reporting scale of 300 to 850. The higher the original credit score the greater the impact. Despite the score reduction, the report itself looks far better than if the lender foreclosed. Most loan underwriters agree that a short sale looks better on a credit report than a foreclosure. When you're doing a short sale it's viewed that you've actually been proactive in the situation as opposed to reactive and letting it go to foreclosure.

Will I Get a 1099-C?

Most short sale transactions result in the seller receiving a 1099-C - Forgiveness of Debt form at the end of the transaction. The 1099-C reports imputed income to the IRS for income tax purposes. You might avoid paying taxes on the imputed income indicated in the 1099-C as per the "Mortgage Forgiveness Debt Relief Act of 2007 (HR 3648)." Mortgage Debt Relief Act will save some homeowners facing short-sales or foreclosures from paying federal taxes on the "forgiven" debt. There are very specific requirements--

- The mortgage is for the homeowner's principal residence. The relief does not apply to any debt forgiveness for any vacation or investment home.

- Forgiveness is only for the "acquisition indebtedness" of the principal residence. Acquisition Indebtedness is defined as the debt used to acquire, construct or rehabilitate the home.
- No relief is available for cash-out mortgages whether the cash-out takes the form of a refinanced first mortgage, a second mortgage, a home equity line of credit or a similar arrangement. There is an exception--if the cash-out was specifically used to improve the home and the homeowner has adequate records to prove it.

This bill relieves the specific homeowner of their federal tax liability but does NOT relieve the homeowner of their state income tax liability.

Adapted from: http://realestate.aol.com/information/short-sale. Special thanks to information acquired from http://www.shortsalespecialistnj.com.

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