VALUATION OBSERVATIONS

Some practical observations from a practicing business appraiser.

VLC

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SHORT SALE – THE NEW EXIT STRATEGY?

Not so new. But unlike California, our local market has seen little of it. What is this Short Sale? It is the end result of a sale of real estate in which the proceeds from the sale fall short of the balanced owed on the loan secured by the property sold. There are advantages to a Short Sale versus a foreclosure. But, those advantages come with difficulties in completing the deal.

In a Short Sale, the bank or mortgage lender agrees to discount a loan balance because of an economic or financial hardship on the part of the mortgagor. The lender has the right to approve or disapprove of a proposed sale. This negotiation is done through communication with the bank's loss mitigation or workout department. Why would a bank take less than they are owed? Often a bank will allow a Short Sale if they believe that it will result in a smaller financial loss than foreclosing, as there are carrying costs that are associated with a foreclosure. The bank really does not want to own and sell real estate. Owning real estate is not their business, and owning too much real estate has a negative impact on their balance sheet. So how does this work?

The basic requirements for a Short Sale are a Listing Agreement with a Realtor and a Sales Contract from a Buyer which are submitted to the Lender along with a Hardship letter from the Seller explaining why they cannot continue to pay the mortgage and supporting documents such as tax returns, bank statements, information and photos of the home and comps supporting the offer. If the package is complete, the Lender will order a Broker's Price Opinion (BPO) from an independent Realtor. This BPO is key. If it is too high, the Lender will not accept a low offer without additional information supporting the offer, such as the average time on market of comparable homes, recent selling prices and point out any defects in the home.

The sales contract needs to specifically state that the offer is contingent on the Lender accepting the purchase price in full and forgiving the Seller the deficiency on the mortgage. It is important that the Seller hire someone experienced in Short Sales. Whoever is negotiating with the bank should be proficient in the short sale process and proficient in the rules of banking. The last thing a bank will do is speak with or negotiate with someone who does not speak their language, or someone who submits an incomplete file.

Lenders have a varying tolerance for short sales and mitigated losses. And, there can be multiple levels of approvals and conditions. For example, junior lien holders for liens such as second mortgages, HELOC lenders, and special assessment liens may need to approve the Short Sale as well. It is possible for a junior lien holder to prevent the Short Sale. And if the lender required mortgage insurance on the loan, the insurer will likely also be party to negotiations as they may be asked to pay out a claim to offset the lender's loss on the Short Sale. The wide array of parties, parameters and processes involved in a Short Sale makes it a relatively complex and highly specialized type of real estate transaction, which is precisely why short sale deals have a high failure rate. According to short sale negotiation specialists, the success rate is 50% or less even when the offer is fair.

The approval process is cumbersome. And on average, it has been taking loan servicers 9 ½ weeks to respond to a short sale. The Obama administration is aware of the frustrations and in mid-May 2009 announced plans to streamline the process by offering financial incentives to mortgage servicers and investors that accept short sales, much in the same way that they are rewarded for refinancing or modifying troubled mortgages. But five months later, we still await the specific details of how the plan will work.

So, the upside to the homeowner is release and forgiveness of the debt in excess of the sale price. What's the downside? For starters, it is a lengthy process that the buyer may not have the patience for. Additionally, it does negatively affect the seller's credit score (albeit not has badly as a foreclosure). But most importantly, there are tax implications.

Whenever real estate is sold, whether in a standard transaction, a short sale or a foreclosure auction, there are potential tax consequences for the seller – both in the form of capital gains on the home and on the unpaid portion of the mortgage. The IRS considers any canceled mortgage debt ordinary income, taxed at a rate somewhere between 15% and 30%. Additionally, the amount of forgiven debt reduces the basis on the property, thereby increasing potential for capital gains.

The lender is required to issue a Form 1099-C to document the amount. It is the seller's responsibility to notify the IRS as to why the stated amount should not be considered ordinary income on Form 982. The most common exceptions to taxability are Bankruptcy and documentation of Insolvency.

You have probably heard rumblings of a new rule that avoids taxation on these types of transactions. The Mortgage Forgiveness Debt Relief Act of 2007 was enacted on December 20, 2007. Under this new law, taxpayers may exclude debt forgiven on their principal residence if the balance of their loan is $2 million or less without having to qualify for either the bankruptcy or insolvency exceptions. Originally the law applied to debt forgiven in 2007 through 2009, but has since been extended through 2012.

There is a huge caveat that many people overlook. To qualify for non-taxation, the forgiven debt must be "***qualified principal residence indebtedness***"; i.e. the debt must have been used to buy, build or substantially improve the taxpayer's principal residence and must have been secured by that residence. Debt used to refinance qualifying debt is also eligible for the exclusion, but only up to the amount of the old mortgage principal just before the refinancing. Debt forgiven on second homes, rental property, business property, credit cards or car loans does not qualify for the new tax-relief provision.

If only a part of a loan is qualified principal residence indebtedness, the exclusion applies only to the extent the amount discharged exceeds the amount of the loan (immediately before the discharge) that is not qualified principal residence indebtedness. For example, assume your principal residence is secured by a debt of $1 million, of which $800,000 is qualified principal residence indebtedness. If your residence is sold for $700,000 and the remaining $300,000 of debt is discharged, only $100,000 of the debt discharged can be excluded (the $300,000 that was discharged minus the $100,000 of nonqualified debt). The remaining $200,000 of nonqualified debt may qualify in whole or in part for one of the other exclusions, such as the insolvency exclusion.

What advice should be given to a client contemplating a Short Sale?

1. Have the situation evaluated by a professional experience in Short Sales in advance of the deal to see if they qualify in the first place.

2. Consult with a tax professional as to the potential tax consequences.

3. Hire a realtor or real estate attorney or company that specializes in this, who has done these types of deals in the past and can demonstrate success in negotiating with multiple lenders simultaneously to ensure that the deal closes. An inexperienced realtor can cause irreparable harm. There must be proper evaluation of all mortgages/liens/judgments on the property. If these are not evaluated and addressed early in the process, your Short Sale will fail. Even when the Short Sale is approved by the lender, if not all the liens on the property are addressed the deal will not close.

4. Consider additional resources like www.shortsalecenter.com or www.housingassist.com

If you would like additional information, or have a question, please do not hesitate to call.

Very truly yours,

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Terri Lastovka is the founder of Valuation & Litigation Consulting, LLC. Her practice focuses on business valuations and litigation consulting in the areas of domestic relations, gift and estate tax, probate, shareholder disputes, economic damages, and forensic accounting. She draws from a wide range of experiences, including public accounting, law, banking, and CFO. She has received extensive training from the American Society of Appraisers in the area of business valuation and works closely with members of the bar to effectuate practical settlements. Terri also serves as the Director of Legal & Finance for Journey of Hope, a grass roots non-profit organization providing financial support to cancer survivors and sits on the Board of Trustees of the Center for Principled Family Advocacy.