Should I Short Sale My Home?

A common question we receive from our Clients is whether they should short sell their home. The question is more complex than it may initially seem and the Client should weigh the pros and cons of a short sale before making a decision.

This report is for informational purposes and is not meant to provide legal advice. Terminology has been changed or substituted for ease of reading and in order to get broad concepts across simply. It is a general overview and may not contain all nuances.

The following topics in regards to short sales are discussed:

- Definition of Short Sale
- Process of Short Sale
- Result of Short Sale
- Effect of Short Sale On Credit and Purchasing a Home
- Conclusion: Short Sale, Foreclosure, and Bankruptcy

Definition of Short Sale

A short sale is when you sell your home for less than what is owed. A short sale may also be referred to as a preforeclosure sale.

For example, you owe your mortgage company $200,000 and you sell your house for $150,000. You are short (i.e. deficient) $50,000 in the sale.

Process of Short Sale

The process of a short sale is similar to a regular home sale. You are selling and a buyer is purchasing your home. All of the usual home sale processes are followed.

The main difference is that you or a representative for you, such as a realtor or an attorney, will negotiate how much you will owe the lender after the closing of the sale.

The amount owed and the terms agreed upon for payback will be formalized in a contract. If you have multiple mortgages receiving less than full payment, then more than one contract with separate terms may need to be negotiated.

The payback terms of each contract are going to define your benefits and detriments from the short sale. The contracts are written legal documents that bind you to the negotiated terms.

Additionally, a standard real estate transaction is generally completed through a realtor on state approved real estate forms. A short sale contract is not completed on state approved forms.

The short sale contract is often created by the mortgage company, through their attorney or staff, and written to the mortgage company's benefit. It is advisable an attorney review your contract prior to agreeing to the short sale.

There are other perils to short sales depending upon the terms of the contract that is negotiated. These range from possible fraud if you agree to make payment on some of the debt and never do, to later litigation to collect the debt, and other contract issues that may arise. You should weigh all the factors and make the decision you believe will be best for you.

IMPORTANT NOTE: The contract agreed to before the sale defines what benefit you hope to receive from the short sale. Not all realtors understand what the terms of a contract mean or can adequately explain the consequences of the contract as this is a legal document. Consider seeking legal counsel from an attorney before agreeing on contract terms.

Result of Short Sale

A short sale results in a deficiency owed to the mortgage company. The deficiency may result in collection of the debt owed, tax consequences, or both. The terms of your agreed upon short sale contract determine how the deficiency will be handled. Generally, you will have agreed that the deficiency will be handled by one or a combination of the options below:

1. Lump sum payment at closing
2. Payment plan
3. Forgiveness of debt

The first 2 options require money to be paid on the remaining debt. The final option, forgiveness of debt, is when the mortgage company discharges the debt (26 U.S.C. § 6050P) and may no longer collect the debt or does not discharge the debt and may continue to collect the forgiven amount (Debt Buyers Association V. John W. Snow).

The lender must issue a 1099-C if over $600 of the forgiven debt is discharged by the lender (26 U.S.C. § 6050P and IRS 2008 Instructions Form 1099 A-C) or a triggering event, as determined by the IRS, has occurred (26 C.F.R. § 1.6050P-2).

Discharge of the debt precludes further collection activity, but a triggering event does not. A 1099-C may be required to be issued by your lender regardless of whether they plan on collecting in the future or not (Debt Buyers Association V. John W. Snow)..

Also, if your lender sends a 1099-C or specifies in the short sale documents that there will be a charge-off this does not mean they have discharged the debt. A charge-off may still be collected for applicable state and federal time periods.

You, as an individual, must generally report income from forgiven debt (26 U.S.C. § 61(a)(12)). The 1099-C is sent to you and the IRS (Form 1099-C). The amount shown on the 1099-C in Box 2 is the amount you generally must include as gross income on your taxes (IRS Publication 908).

You may request the Company not report the debt forgiveness as income on a 1099-C provided it is not taxable for such reasons as the debt is contested, the settlement is a non-taxable purchase price reduction, or you are insolvent.

Your short sale contract should include a provision stating debt forgiveness should not be reported as income if it is not taxable and a follow-up letter should be sent stating the reasons the debt forgiveness is not income and that the letter itself serves to show that failure of the company to file the 1099-C "is due to reasonable cause and not to willful neglect" (26 U.S.C. Section 6651).

Even if your lender issues the 1099-C, you may not have to include the forgiven amount listed on the 1099-C as gross income if you meet one of the following:

- The debt was discharged in bankruptcy (26 U.S.C. 108; IRS Form 982);
- You can demonstrate insolvency at the time the 1099-C was issued (26 U.S.C. 108; IRS Form 982); or
- You fall within the narrow provisions of The Mortgage Forgiveness Debt Relief Act of 2007 (The Mortgage Forgiveness Debt Relief Act of 2007; IRS Form 982).
- You fall within other exclusions, such as those listed in IRS Form 982.

There are a few other tax issues of concern. You may no longer have mortgage interest to deduct on your taxes and may need to change your tax withholding, the forgiven debt may send you into a higher tax bracket, and if your house sells for more than you purchased or forgiven debt reduces the tax basis, then you may owe capital gains taxes on the sale.

IMPORTANT NOTE: Forgiveness of debt is often the selling point to get you to agree to a short sale. A 1099-C will generally be issued for forgiven debt over $600 regardless of what someone may promise you and you still may be collected upon for the forgiven amount if it is not discharged. Speak to a tax professional to estimate the amount you may owe to the IRS. A filed bankruptcy in the year of the short sale will eliminate any tax consequences due to 1099-C income.

Effect of Short Sale On Credit and Purchasing a Home

Foreclosures are often assumed to be worse than a short sale on your credit and for purchasing a future home. The differences are subtle and arguably a short sale is no better for you than a foreclosure in the long term.

Three of the main components on your credit report are your payment history, balance owed, and your public records. Each of these components may have an impact on your creditworthiness and ability to purchase a home in the future.

Both short sales and foreclosures may show such negative facts as a delinquent payment history, a balance remaining owed on an unpaid mortgage, or charge-off. The main difference between short sale and foreclosure is that a foreclosure will be a public record on the credit report that lasts for 7 years, while the short sale is not listed as a public record.

Despite the difference in listing the foreclosure as a public record, the result is often the same whether you have a short sale or foreclosure when purchasing a future home for most mortgage underwriters. In both scenarios you have lost your home and you have negative credit reporting evidencing the loss. However, Fannie Mae as of June 25, 2008 has an updated guideline, which states that a short sale will be viewed as less of a negative than a foreclosure (Fannie Mae Selling Guidelines Announcement 08-16).

Based on discussions with Colorado Mortgage Broker James Spray (Bankruptcy Mortgage Specialist Since 1993; Mortgage Lending since 1976) you may qualify for:

- HUD/FHA insured mortgage 3 years post short sale or foreclosure (FHA Web Site);
- Fannie Mae 2 years post short sale and 5 years post foreclosure (Fannie Mae Selling Guidelines Announcement 08-16); and
- Freddie Mac underwritten mortgages 5 years post short sale or foreclosure.

You may qualify earlier than the time periods listed above, if you are able to show mitigating circumstances beyond your control that created the short sale or foreclosure and meet other credit requirements, such as not incurring further negative reporting on your credit and establishing new positive credit.

Continued collections may plague your credit report and keep you from purchasing another home. If you are still collected upon after the short sale and it shows as a charge-off or if you end-up with IRS debt on your credit report you may not receive the benefit of reduced time to purchasing another home. The short sale contract and actions of the lender will determine this.

If you did not stop the reporting of negative information with your short sale or have other debt problems, then a bankruptcy may get you into a house faster than a short sale alone. You may stop further collections and create a point for a fresh start to rebuild credit by filing a bankruptcy.

IMPORTANT NOTE: The main differences between a short sale and foreclosure is that in a short sale you negotiated your own deficiency, foreclosure shows on your credit report for 7 years, and except in the case of a Fannie Mae underwritten loan, the difference between a short sale and a foreclosure is currently viewed the same by most underwriters.

Conclusion: Short Sale, Foreclosure, and Bankruptcy

A short sale or foreclosure may result in a deficiency you may have to pay back, tax consequences, or both; you will not have to pay back the debt if the lender forgives and discharges the amount; you may be able to limit or eliminate the taxes owed if you meet certain requirements; a short sale may not allow you to purchase another home faster than a foreclosure; and a well prepared short sale contract reduces your risks, but does not eliminate them, and is the key to your best short sale deal.

Additionally, there are benefits to foreclosure you should consider, such as the ability to live mortgage and rent free through the foreclosure process. Even after the foreclosure process you would be able to stay in the premises until an eviction. If you short sale then you generally will leave upon the completion of the sale.

A bankruptcy may extend your time in the house beyond the foreclosure date, so you may live mortgage and rent free longer. During all of this time you may be able to save thousands of dollars you would be paying in rent in order to stabilize your financial life, aggregate a down payment, plan your move, and buy necessities.

If your goal is to purchase a new home as quickly as possible a bankruptcy may be more effective as it stops further collection activity, discharges debt, and eliminates tax issues if filed in the year of the short sale.

If a bankruptcy is not filed or you cannot pay back the short sale deficiency, then any amount that was being collected may continue to plague your credit report and keep you from purchasing another home.

Keep in mind that people who can afford to pay their mortgage, but not other unsecured debts, such as credit cards, may qualify to save their home with their current lender through a Chapter13 bankruptcy.

Also, in certain circumstances a bankruptcy may allow you to get rid of your 2^{nd} or higher mortgage in order to bring your home loans closer to the houses real value. Speak to a bankruptcy attorney for more information.

Another avenue to consider is a mortgage workout. Many lenders are working with individuals directly to modify their mortgages and help them stay in their homes. Contact your lender to see if they can help.

IMPORTANT NOTE: Many people may have a financial interest in your actions. A realtor stands to make thousands of dollars in commissions and fees off a short sale and may desire to pursue this avenue even if your best interest is to live mortgage and rent free until foreclosure. Choose the option you believe is best for your situation and pursue all possible options as soon as possible, so you do not lose them.