A SHORT COURSE ON SHORT SALES

A “short sale” happens when a parcel of real estate is sold for less than what the current owner owes against the property.

Example:

Fair Market Value	$200,000
Mortgage Balance	$215,000
Sale Price	$202,000
Short Amount	$ 13,000

Why do short sales occur? When two things happen (and almost always both are required): First, the borrower is in default, in serious financial trouble, and can’t pay the mortgage. Second, the bank and the borrower both believe that each would be better off if the property were sold short to a third party as an alternative to the bank foreclosing.

Why would a bank agree to accept less than the mortgage balance? Because foreclosing a bad loan costs money. Not only are there costs to foreclose, but not until the bank repossesses the property and sells it will the bank get any money back. Since there is no guarantee that the property will sell for what was owed plus the costs of getting the property to market, the bank may make a business decision that accepting a short sale will net more and risk less than foreclosing.

Why would a property owner agree to sell short? Because the property owner is going to lose the property anyway and believes that a short sell—a pre-foreclosure sale—will affect the owner’s credit rating less adversely than a foreclosure.

Who has to agree to a short sale? The bank, the owner, all lienholders, and a new buyer.

How short can a property be sold? Generally, the bank will not accept a short sale for significantly less than the current appraised value.

What happens to the deficiency? The deficiency, which is the amount the bank ends up short, can be forgiven by the bank; covered by a new, unsecured loan to the defaulting homeowner; or the bank may try and sue the defaulting homeowner for the deficiency. It all depends on the deal negotiated, what the bank is willing to do, and what the law allows the bank to do.

Are taxes owed on the deficiency? It depends. In most contexts, if a bank forgives a portion of a loan, the IRS counts that as income to the borrower. However, if the deficiency resulted from the short sale of the borrower’s primary residence and if the borrower is insolvent, then the Home Affordable Foreclosure Assistance act may give the borrower relief. (There are other exceptions—talk to a good tax advisor.)

How do I get a bank to agree to a short sale? If the bank will consider a short sale at all, you must prove you are insolvent, prove that the sale will be at or near appraised value, and convince the bank that it will net more and risk less by a short sale.

What documents are involved in a short sale? Think of a short sale as involving two transactions. The first transfers the property back to the bank free and clear so the bank can sell to a new buyer. The second documents the new buyer's purchase, which might include a new mortgage to another bank. A short sale agreement is used to memorialize the whole matter. A deed in lieu of foreclosure is signed by the borrower to pass the property back to the bank. An appraisal estimates fair market value. A closing statement lists all closing costs and who will pay them. A new deed transfers the property to the new buyer. And a new mortgage is given by the new buyer to that buyer's bank to secure the new loan. If the bank is forgiving the original borrower's deficiency, a document establishing that should also be obtained.

If I am interested in a short sale, who should I contact? A real estate attorney, your tax advisor, and a real estate agent familiar with short sales. You will also have to approach the bank, of course.

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