

TO SELL OR NOT TO SELL – THAT IS THE QUESTION

BY

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I'm overwhelmed! I just can't afford this house anymore. What do I do?

These words are spoken all too often these days. The lending practices of financial institutions in the last decade resulted in disaster for many homeowners. Even the financially secure over-extended themselves and are now facing foreclosures on their dream homes. For the majority of us, our home mortgage is the largest debt we will ever incur. It was once easy to obtain a home loan; now we find it difficult to rid ourselves of that debt. Lower home values mean that sale prices are insufficient to pay existing mortgages. Lower incomes mean that mortgage defaults are increasing. So, what can the homeowner do?

Bankruptcy is an option, but it may not be the right option if the only debt you have is a mortgage. Refinancing to reduce your monthly payment is viable, but lenders are tight with their funds. Loan modifications are granted sparingly. The homeowner could simply allow the lender to foreclose on the property, but the real property inventories of lenders are alarmingly high. Banks manage money, not property, so foreclosures are not necessarily their preferred course of action. Nevertheless, the foregoing options are all available to homeowners.

However, the up-and-coming approach is the short sale. Short sales are sales in which the amount a buyer pays for a property is less than that owed on the seller's mortgage. The process is not overly complex, but it does require the lender's approval. Realtors provide sound advice on how to initiate and consummate the short sale process. However, short sales involve legalities that extend well beyond real estate law and the homeowner should be fully informed on all consequences of short sales before entering into one.

In that regard, there are two primary areas of concern. First, what happens to the amount that is owed to the lender but remains unpaid? Secondly, what tax consequences are associated with the short sale? The answers to these questions are fact dependent and an article cannot address every situation. However, there are general principals applicable to all transactions.

The unpaid balance that remains after a short sale is called a deficiency, and the lender may or may not be able to pursue the homeowner for that amount. Arizona has one of the most homeowner favorable anti-deficiency laws. If a lender forecloses on its mortgage, and certain property and loan conditions are satisfied, the homeowner need not pay any deficiency. This protection does not, however, apply to short sales. In short sale transactions, the homeowner must negotiate a waiver of the lender's right to pursue the deficiency. If the lender refuses, the homeowner is at risk of being sued for up to six years after the short sale transaction closes. Nevertheless, Arizona courts have suggested that when a lender releases its security in

exchange for partial payment, it implicitly waives its right to sue for a deficiency. This court fashioned law has not, however, been applied specifically to short sales or to situations where the lender has reserved its right to pursue the deficiency. How the courts will respond to these situations is unknown, so exercise caution when considering whether to accept the risk of being sued for a deficiency. Judgments can haunt homeowners for many years after their property has been sold.

As if deficiency concerns were not enough, tax consequences also attach to short sales. You may not have heard of IRS Form 1099-c, but you certainly will if you participate in a short sale. When a lender is not paid the full amount owed, the unpaid balance can be written off against the lender's income. The amount of this deduction is then considered taxable income to the short sale seller. IRS Form 1099-c is the document by which the lender notifies the IRS and the seller of the amount of the income imputed. Taxes may or may not be due on this amount. In 2007, Congress passed The Mortgage Forgiveness Debt Relief Act which provides that debt forgiven in a short sale will not result in imputed income if certain criteria are satisfied. Discussions of those criteria are complex and best left to in-person meetings with your advisors.

Short sales have become an acceptable solution to a growing problem. Although the short sale process is relatively straight-forward, the decision to enter into a short sale is not. If you need additional information about the short sale process or its legalities, contact your real estate advisor or your attorney. Investing a small amount today in advice can save you a large amount tomorrow.

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