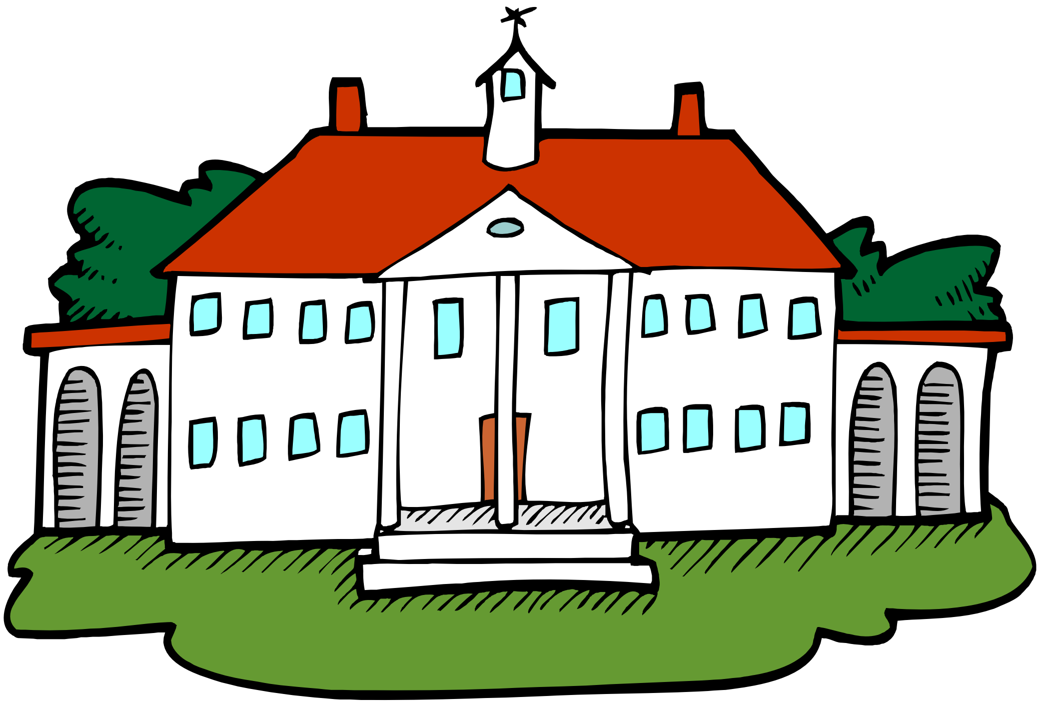
NOT MY HOUSE

SHORT SALES AND THE LUXURY HOUSE



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"Not my house" many will say as values head south and home equity becomes an artifact that you can see and wave to behind the glass, sometimes with a few words up front to better understand how it was, once upon a time, when values would grow and foreclosures would only happen to a select few that either got in over their head or had a real crisis going on like something medical or a marriage gone bad. Times are different you try and tell yourself much like autos and horse drawn carriages or pumpkins, but your house stands apart from every other house within a radius of 500 square miles since your place has five roomy bedrooms, none of that dormer stuff where you got a watch your head, five bathrooms – all with genuine linoleum tile, none of those prefab sheets that you'll see in schoolhouses with yellowed out corners, stains, old spider webs with dust balls that won't go away.

All in total, six thousand square feet of living space if you include the two car garage and basement that someone halfway finished, way before you, with oak panels right out of Happy Days. Your TLC worked magic when it came to that pocket door in the downstairs bathroom or those Evergreens out front that you planted as little babies three years back with that pricey miracle stuff to make them really grow like in one of those techie labs you'd only see in Disney. Well worth every dollar. Things like that always come back in spades when you sell, right? And it's a good thing that you went the extra yard now that you're ready to sell in this crazy market with everyone dropping like flies and those mortgages now three months behind, tens of thousands bigger today than when you closed on your purchase. But at least you got value, true value – folks will come from far and wide for a glimpse of your place, right? School district's second to none. Private police, just like Mayberry RFD. Sure you got heavy debt but no big deal, home equity will save the day, so you'll do the responsible thing and cash in, find something a bit more manageable.

Or will you?

Or maybe, the unthinkable happened and bad times actually did come knocking, to your front door perhaps.

A few percent here or there could make all the difference, particularly when we're talking big values where every five percent could mean fifty thou give or take. Numbers mean everything. Five percent on a value of one and a half mil, can mean seventy five grand and the difference between equity and deficiency. A few steps to the left or right and there you have it, do the mortgage minuet, maybe in the black with equity and maybe in the red with no equity and a deficiency, mortgage debt that you can't cover from the sales proceeds.

And so, selling a luxury home in today's market may require lots of special considerations, especially if the mortgages aren't current or if you made your purchase within the last four years without a heavy downpayment, say something less than twenty percent of the purchase price

Personal Liability for Deficiency on Mortgage

Folks in today's day and age who find themselves in hard times may say "hey, what's the big deal if I'm behind on my mortgage … let them foreclose. I'm here rent free for the next two years or whatever, till the sale takes place, so why should I care? My credit's shot anyway, so I'll save my pennies till the bitter end and then say goodbye."

And what about that? Why help your lender if they turned their back on you and you're in crisis management. Every dollar counts and better in your pocket than theirs. Lenders after all – they caused this mess, didn't they?

Hmm …. not so fast.

Big houses mean big deficiencies since that's what big mortgage will generally tend to do, much more so than smaller, less pricey homes. It's all in the numbers … bing, bang, boom.

That said, big deficiencies on a foreclosure sale can potentially generate big defiency judgments and that's where the problem may lie – personal liability to you, if your lender decides to take a deficiency judgment and enforce. Ouch.

Deficiency judgments are optional, much like an extra shot in your latte. Lenders don't have to go that route. Put simply, lenders have ninety days after a foreclosure sale to move for a deficiency judgment, a personal judgment against the borrower – good for twenty years. If they let four months pass without bringing a motion, then ce la vie, you're off the hook.

Deficiency judgments can also come about in a different form as simply money judgments, prior to a foreclosure sale. Lenders have a choice when it comes to enforcing payment. They can either bring a foreclosure proceeding as lenders normally do, or, they can sue on a note without ever mentioning the mortgage. Occasionally subordinate lenders will do just that, given the almost nonexistent collateral that may exist when properties are not even worth the mortgage. They sue. They get a money judgment. They enforce. And they will do that before a sale ever takes place at the courthouse steps.

So you may ask, will they or won't they? And who knows … no hard and fast rule.

Nobody likes to throw good money at bad so that should pretty much rule out situations that involve relatively low sums like something less than $25,000, or debtors with no likelihood of recovery like those in personal bankruptcy or folks who are caught in a serious hardship, medical or financial.

But what about a deficiency of one million plus or someone who earned seven figures a few years ago who may well rise again over the next twenty years – a judgment's shelf life. Might a collection attorney show interest and do it on a contingency – twenty five percent of one mil. Not a bad pay day to some. And if so, might they push you into bankruptcy or force a settlement for way more than you want to pay? Perhaps.

Short Sales Can Defeat Deficiencies

You can often get rid of a deficiency in full by doing a short sale, giving your lender the bottom line and moving on. Yes this will mean leaving your home early and allowing the new buyer to take over, but it will also offer the fresh start that most folks are looking for.

Multiple Mortgages Not an Obstacle to Getting Short Sale Done

Multiple mortgages are somewhat common on luxury homes given the values a few years back and the usual practice at that point, among subordinate lenders, to make easy money available on a stated income basis with loan to value ratios that often approached ninety percent. Many folks knew that if you wanted capital from your house, you didn't have to go through a whole big process and refinance your first mortgage. Just add a second, and if that wasn't enough, do a third.

And so, today's environment on luxury homes will often involve two or three mortgages for several hundred thousand each – and an ability to pay the first mortgage from closing proceeds, but not enough to fully satisfy the second and third lenders. This in turn, has often led to short sales where a first lender will get fully paid and the subordinate lenders will get something less after the usual short sale negotiations.

Or, despite having more than enough proceeds to pay the first lender, you may need to force a "short payoff" in order to make enough capital available for the subordinate lenders so they'll waive further recourse. So for instance, say you have $1,000,000 in net closing proceeds, a $990,000 payoff to the first lender and a mere $10,000 to the second lender for a debt of $500,000. Second lender may say, fine, we'll take the $10,000 to release our lien and allow your closing to go forward, but, we'll reserve all rights to enforce the balance. And if you'd like us to walk from the balance, pay $50,000 and we'll call it a day.

To get this done it may become a matter of short paying the first lender by $40,000 – and a full short sale package with all the heartache of negotiations and approvals. But, a very doable request.

Watch for Income Taxes from Forgiveness of Indebtedness

Because of all the mortgage debt that we generally see on luxury homes, the subject of income taxes will almost always come up. So here we go.

Two questions are important:

1. Reportability - Must a lender report the “forgiveness of indebtedness (“FOI”)” to IRS; and
2. Taxability – Must a borrower pay income taxes on FOI.

On short sales of luxury homes, at least some portion of FOI will often get reported on Federal Form 1099 since the question of reporting will normally depend on whether the debt qualifies as “Acquisition Indebtedness” as defined by IRS, or in other words, debt used to purchase a principal residence, not in excess of $2,000,000. These days it’s common for at least some portion of the debt to have come about after a home was acquired, like for example, from a refinance or equity line mortgage. And that, in and of itself, would disqualify a debt as “Acquisition Indebtedness” and render it reportable on a seller’s income tax return – but not necessarily taxable.

Taxability will depend on whether a seller can meet the definition of “insolvency” and if so, whether his FOI Income exceeds his insolvency. If not, FOI Income will not become part of gross income. If so, the excess FOI will get reported as gross income and possibly taxable depending upon other transactions.

“Insolvency” in this context means the excess of all liabilities over the fair value of all assets – and that includes everything the seller owes or owns, not just the property being sold.

To take the simplest case, if a seller owns nothing apart from his principal residence, then nothing will get taxed, even if reported, since it would all qualify as exempt under the insolvency exception.

Avoid Cross Defaults on Credit Cards

Just like candy canes and water shoes, debts come in lots of shapes and sizes with mortgages being one example only, as to what's out there. Folks with mortgages – most of us – often have other debts like credit cards, that will play into each other in subtle ways that'll sneak into your budget almost like a cash eating plant with molars and jowls.

Consider this. Folks who are thinking short sale may need to live their life in crisis management, at least for a while, by picking and choosing which debts to pay and which ones to put aside all in the interest of saving enough cash to find another place to live and relocate once the short sale closes. And many folks have found themselves in precisely this position given the almost universal policy among lenders to flatly prohibit sellers from getting any cash from a short sale.

So let's say you decide to stop paying your mortgage, knowing that a short sale's around the corner and you don't have any cash to move. You're planning to live off credit cards, perhaps for a time. All cards are current. And they'll stay current as long as you can continue borrowing on one to pay the other. Eventually you'll either find another job and pay them off, or you'll go Chapter 7 and start over.

Sound like a good, short term plan?

Hmm … not quite.

Once you stop paying the mortgage your credit scores will drop and your credit cards will find out within days, almost like ants on freshly melted ice cream. They're good that way – always on the credit scores. Then the zingers. They'll either cut your lines to a thread and leave you hanging, or close the lines altogether because you're too much a risk, kind of like white powder in the water supply. Hours later, thirty days notice to pay in full, or suffer the consequences of new terms to include *over the limit fees* of $35 or more and an annual percentage rate exceeding thirty some odd percent. Can the credit cards do all that? Sure, your government says it's fine and that's exactly what they'll do.

And once you stop paying, your credit lines will go bye-bye and your phones will ring off the hook as they hound you hourly for all that you can't afford to pay. So … whatever you do, don't count on your cards.

Have Patience for Finicky Buyers and Sellers

Yes it’s true, as the stakes go up folks tend to get more finicky at all ends of a transaction as to what they’ll absolutely, positively need to make it happen. The baseline. Sellers want more time to move after the short sale gets approved. Rarely will sellers say sure, no problem, give me thirty days and I’m out. Usually it’s thirty plus thirty plus thirty and then if I haven’t found the right school district or painter for the new place, expect another thirty. Almost nobody works off a date certain no matter what a contract may say, and sure, that often pushes deals to the limit. Often it’s a challenge to keep folks in line.

From a buyer’s end it’s no great shake either as folks try to keep their finances together for a great deal that’s bound to take place at some elusive point, right around the corner. Folks get frustrated, impatient, as sellers struggle to figure it out. But when the dust finally settles, a great deal will come their way that’s well worth the wait.

About the Author

The author Kenneth B. Schwartz is a practicing attorney who maintains offices at 555 Westbury Avenue, Carle Place, N.Y. (Tel. 516-333-7020). After becoming a certified public accountant in 1980, Mr. Schwartz earned his JD in Law from St. John's University Law School in 1983, and a Masters in Tax Law from New York University in 1991. Mr. Schwartz now devotes his law practice to the representation of buyers, sellers and lending institutions in connection with real estate closings.

Mr. Schwartz resides on Long Island together with his wife and three children.

Mr. Schwartz's prior publications on the real estate industry include Mortgages to Music (Morris Publishing, 2004), CEMA's, a Tale of Two Mortgages (Xtreme Publishing, 2006); Cooperatives and Sandcastles in the Sky (XTreme Publishing, 2007); CEMA's and Darwinian Evolution (Mortgage Press, October 2007); Short Sales, Our Secret to the Universe (Mortgage Press, December 2007); Mortgage Closing Resolutions for 2008 (Mortgage Press, January 2008); The Shady Short Seller (Mortgage Press, February 2008); Should Have Done A Short Sale, Bankruptcy vs. Short Sale (Mortgage Press, March 2008); Short Sale Scams Alive and Well and Living in Scamsville USA (Mortgage Press, June 2008), Let's Talk the F Word, an unabridged Crisis (XTreme Publishing, 2008); Just a Glimmer – Short Refi's, Hope for Homeowners under the New Housing Bill (Mortgage Press, 2008); Just a Few Bil (XTreme Publishing, 2008); Thou Shall not Pump and Dump (Mortgage Press, 2008); Stuck in the Spirit of Holiday Giving (XTreme Publishing, 2008); Short Sales in the Ancient City of New York (XTreme Publishing, 2009); Don't Pay Your Debts, "The Financial Vigilante" (XTreme Publishing, 2009); Pre-Approving the Short Sale (The Corridor, 2010); The Tax Man No Cometh on Short Sales (The Corridor, 2010); Honey I Shrunk the Mortgage (XTreme Publishing, 2010).

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DIDN'T THINK THE DOWN MARKET WOULD EVER MAKE ITS WAY TO YOUR FRONT DOOR WITH ALL THAT SWEAT EQUITY AND THOSE AMAZING IDEAS THAT ONLY YOU COULD POSSIBLY COME UP WITH. NOTHING SHORT OF BRILLIANT. SURELY A PIECE OF YOU WENT INTO THIS PLACE AND THAT'S GOT VALUE, BIG TIME VALUE.

BUT NOW IT'S TIME TO SELL. MORTGAGE TOO HIGH AND VALUE NOT THERE. WILL YOUR LENDERS BACK OFF? WHAT ABOUT IRS? AND WHAT ABOUT A SHORT SALE TO MAKE EVERYTHING BETTER?

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