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Seller may face tax and credit troubles in a short sale

An owner can sell a house for less than its value and the lender can forgive the loss – but that's not all.

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BUYERS AND sellers who choose the short-sale option need to understand the choppy waters they're entering, lenders and agents say.

Buyers complain, justifiably, that the wait for bank approvals of short sales -- typically 60 to 90 days, but sometimes considerably longer -- seems endless and the transactions often fall apart.

Sellers, on the other hand, may face tax and credit problems.

Although sellers walk away from short sales without a dime from the transaction, they have, in a manner of speaking, "gained" by not fully paying off the loan. Where there are gains, the tax man is never far behind.

But the devil is in the details: If a bank accepts a lower payoff from the short sale of a principal residence, that debt relief may be considered income by the Internal Revenue Service, said Bill Ahern, a tax partner at Allen Matkins in Irvine.

Under federal legislation recently passed to help distressed sellers in this type of situation, however, certain owners may not be taxed on that debt relief. This legislation applies only to the debt that the homeowner acquired to buy or improve the property, Ahern said. It does not shield taxpayers from income derived from cash-out borrowings.

To avoid such legal action and to complete the short sale, some sellers take out a loan with their lenders -- banks sometimes make it a condition of the sale -- for a part of the amount the bank is owed. The terms often are excellent, including zero interest and 10-year amortization, lenders say.

Mark Shandrow, a Keller Williams Realty agent in Long Beach, is representing a seller with an outstanding home loan of $600,000. A buyer recently offered $430,000 for the home. The lender has agreed to the short sale, on the condition that the seller take an unsecured loan for $50,000 to offset part of the $170,000 the bank is forgiving.

"I think she's going to do it," Shandrow said. "If not, the bank could go after her for the other $170,000. This way, the deal is done. The bank won't touch her."

The credit fallout

But the credit bureaus will take note, and future lenders too. Although many sellers choose short sales instead of foreclosures because they think the credit fallout will be less, that's a fallacy. The effect on their credit scores typically is just as negative, said Maxine Sweet, vice president of public education for Experian, a leading credit-reporting company.

Settled accounts, such as short sales, deeds in lieu of foreclosure (when the seller signs over the deed of trust to the bank) and foreclosures result in a "risky" rating on credit reports for seven years, Sweet said. That makes car and other credit purchases more difficult. Also, borrowers with a short sale or foreclosure on their records now have to wait five years, instead of four, to get a Fannie Mae-backed loan. The increase went into effect June 1. The wait for Federal Housing Administration loans is three years.

A possible silver lining is that mortgage lenders sometimes include factors other than credit scoring to determine whether to approve a loan, such as a borrower's assets and investments and the fact that the borrower didn't walk away from the home. But those factors count only when a lender manually reviews an application, experts say. Most are not going the time-consum- ing manual-application route these days, however.

So why not just let the bank foreclose on a property and avoid the hassles of a short sale?

"With a short sale, owners can end the bad nightmare . . . and move on," Sweet said. "They'll have problems getting another loan for a while, but it's better than a foreclosure, where they risk an eviction."

A better alternative to a short sale or a foreclosure, lenders say, is a "loan modification," which sometimes allows owners to stay in their homes.

Result: affordable

Here's how it works: When monthly payments become unaffordable, the bank reviews the owner's income, expenses and other variables, then offers to lower the interest rate and extend the term of the loan. The end result is a monthly payment the owner can afford, according to a loss-mitigation- department spokesman at GMAC Mortgage.

Sherri Frost, a senior loan officer with Metrocities Mortgage, represents a seller whose monthly mortgage payment on a $525,000 loan was $3,000. With his loan modification, he's now paying 2% fixed interest for two years, then 4% for the following two years and a bit over 5% for the five years after that. His monthly payment is $1,700 for the first two years. "He can swing that," she said.

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