

Short Sale Seminar Real Estate Council FLIP FLOPS

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What is a Short Sale?

- "The sale of a real estate property for a price that is less than the total amount necessary to fully satisfy the actual present encumbrance (mortgage) indebtedness on the real estate property."
- Borrowing a security from a broker and selling it, with the understanding that it must later be bought back (hopefully at a lower price) and returned to the broker.

Encumbrances Can Include:

- Mortgages, money judgments, IRS liens and other similar financial obligations that are only partially paid in return for a release of lien upon the real estate.

Lender Participation

- A short sale requires not only a buyer and a seller, but inclusion of the lien holder(s) in the acceptance of the terms of the transaction.
- If there is more than one lien holder, then all of the lien holders need to supply releases.

Lender Participation



- Practical aspects
 - Seller is to net zero consideration from transaction, inclusive of any escrows or advance deposits or refunds.
 - Primary lien holder needs to approve all payments to subordinate lien holders.
 - Secondary and other junior lienholders will want knowledge of what all other lienholders are getting from the transaction.
 - Timing – coordinating all the lienholders and pushing them for their analysis of their positions for the subject sale can take several months.

A Short Sale is More Than a Bi-lateral Transaction



- The short sale transaction requires special documentation to bind all of the parties. If there is one lender and no junior encumbrances to be released, it is a Tri-Party Transaction.
 - If there are junior encumbrances, then more parties are added.

Short Sale Contract Addenda are necessary- FAR short sale addenda forms

- Lienor approval documents usually include some sort of estoppel letter and can include a modification of the existing promissory note, or a new promissory note, or even a consent to judgment.

FAR Short Sale Documents

- www.activerain.com/blogsvieiw/769613/W-HATS-WRONG-WITH-THE-FAR-SHORT-SALE-LISTING-AND-CONTRACT-ADDENDA-AND-HOW-YOU-CAN-FIX-IT
- The Florida Association of Realtors Documents (October 2007 and July 2008) consist of the Short Sale Addenda to the Exclusive Listing Agreement and Contract for Purchase and Sale.

FAR Short Sale Document Practical Problems:

- No option for the seller to negotiate with the lien holders – or to reject a lien holder demand for payment of the loan in full under terms set by the lender.
- Notwithstanding the inability of the seller to perform under the lender demand, the seller is obligated to sell to the buyer and is obligated to pay the Realtor commissions if a qualified buyer is introduced to the seller and the lender(s) approve the contract between the seller and the buyer.

FAR Short Sale Document Solutions:

- The fix for the Listing Agreement Addendum and Short Sale Contract Addendum is to include language that *opens up the ability of the Seller to make good faith negotiations with the Lender(s) for the terms of the release of the lien on the real estate, without a penalty or payment obligation to the broker if the negotiations fail.*
- Leave open in any “fix” language the ability for the seller to negotiate the terms of any repayment of all or a portion of the deficiency.

Preliminary HUD-1 and Other Submission Documents



- Each lender has its own requirements for analyzing whether to accept a short sale, but general parameters include:

Preliminary HUD-1 and Other Submission Documents



- Preliminary HUD-1 – although this is “Preliminary” it should NOT be submitted without all known payments, including prorated real estate taxes and assessments, condo or HOA unpaid fees, closing costs and broker commissions, city liens, judgments and junior lienors **IN FULL.**

Preliminary HUD-1 and Other Submission Documents



- Fully executed contract including short sale addendum, Exclusive Listing Agreement from the Realtor, and any addenda, and financial qualification letter or commitment for the buyer.

Preliminary HUD-1 and Other Submission Documents



- Financial Statement for the seller along with last two months' credit card bills and other regular expenses and bank account statements and last year's 1040.
- Don't take a position without supporting documentation.

Preliminary HUD-1 and Other Submission Documents

- Hardship letter from the seller explaining why the sale must occur as a short sale (loss of job, health, divorce, death, severely adjusted interest, etc).
- There is no such thing as “being entitled” to a short sale.

Investor Methods of Flipping Short Sale Properties

- The Flip from when properties were appreciating is not dead, just morphing.
- Is it a “real” Contract?
- Purchase and Sale Contracts – how to deal with illusory issues
 - Amount of deposit
 - Deposit contingencies
 - Inspection contingencies
 - Start date of contingencies

Investor Methods of Flipping Short Sale Properties

- Foreclosure Scams and Methods
- Trusts and Powers of Attorney – What legitimate business purpose?
 - Divests owner of right to deal with property
 - Used to hide “flip” from the view of the seller’s lender and buyer’s lender
 - If no secondary buyer, the “savior” walks away and property ends up being foreclosed.

Lender Conditions of Short Sale Approval

- Typical conditions:
 - Forgiveness of all of deficiency not repaid from short sale
 - Forgiveness of a portion of deficiency and payment plan for remainder
 - No forgiveness of deficiency and negotiated payback
 - No forgiveness of deficiency and no plan of payback
 - No decision by lender
 - Statute of limitations on enforcement of promissory note (5 years from date of later of transaction or default)

1099 and Short Sale Ordinary Income

- While it is true that a lender need not report cancellation of debt, whether or not a *lender* reports forgiven or canceled debt is not the trigger for the obligation of the taxpayer to include that forgiven debt on his or her income tax return in the year the debt was forgiven.
- <http://activerain.com/blogsview/473945/S-HORT-SELLER-STILL-MUST-DECLARE-INCOME-ON-SALE>

1099 and Short Sale Ordinary Income

- A taxpayer has two opportunities to avoid the inclusion of the forgiven debt and thus the payment of income tax on that forgiven debt:
 - The 2007 Mortgage Forgiveness Debt Relief Act provides non-recognition of the income otherwise recognized as includable in income of the taxpayer for forgiven or cancelled debt.
 - Non-recognition of income can also be achieved when immediately before the short sale (and forgiveness of the debt), the taxpayer is "insolvent".

Mortgage Foreclosure Consultant Act

- §501.1377 Violations involving homeowners during the course of residential foreclosure proceedings
- Attorney not a consultant when providing legal representation of a client in respect to a foreclosure – Attorney General McCollum, July 8, 2008

FIRPTA and the Short Sale

- www.activerain.com/blogsview/856989/FIRPTA-and-SHORT-SALES-DANGEROUS-LIABILITY-TO-BUYER-AND-CLOSING-AGENT
- FIRPTA requires that the “buyer” (inclusive) withhold 10% of the “**amount realized**” from property sale.
- “Foreign Seller” - Non-US citizen / non-US income tax resident

FIRPTA and the Short Sale



- The *IRS Regulations* say, "The *amount realized* by the transferor (seller) for the transfer of a U.S. real property interest is the sum of:
 - The cash paid, or to be paid
 - The fair market value of other property transferred, or to be transferred
 - The outstanding amount of any liability assumed by the transferee or to which the U.S. real property interest is subject immediately before and after the transfer.

FIRPTA and the Short Sale



- Remember, the seller is not the lender - it is the owner of the real estate.

FIRPTA and the Short Sale

- The prospect of being liable to the IRS for someone else's income taxes is obviously not a position for which any person wants to volunteer.
- The relevant question then becomes: "What is the *amount realized* in a short sale?" Is it the amount paid by the buyer? Is it the amount paid by the buyer PLUS the amount of the debt that may or may not be forgiven by the lender? Does it matter if the debt is forgiven at closing or several years later (by letting enforcement of the debt lapse through the statute of limitations)?

FIRPTA and the Short Sale

- Example: Assume a U.S. income tax non-resident alien (or "NRA") bought a home for \$500,000 cash and thereafter borrowed \$800,000 when the value increased to \$1,000,000 (80% LTV). Due to the changed market conditions, the NRA owner short sells the property and the sale is consummated for \$750,000.

FIRPTA and the Short Sale

- One Theory:
 - Based on the \$750,000 sale price, the HUD will show a net amount to the lender LESS 10% (\$75,000) held by the closing agent or the IRS.
 - The ultimate receipt of the \$75,000 or any portion of it by the lender will be dependent on the taxpayer's receipt of the Withholding Certificate from the IRS (or if the money was already sent to the IRS, the application for any relevant refund).

FIRPTA and the Short Sale

- Another Theory:
 - The Withholding Certificate could be based on gain of \$250,000 ($\$750K - \$500K$ purchase price)
 - Reduces the withholding (if qualifying for long-term capital gains rate) to \$37,500 (i.e., 15% of \$250K, or the NRA seller's estimated maximum U.S. income tax liability).

FIRPTA and the Short Sale

- Under either scenario the lender will not receive the full \$750,000.

FIRPTA and the Short Sale

- Assuming the NRA seller's maximum U.S. income tax liability is $< 10\%$ withholding (possibly with debt forgiveness to show the "maximum withholding")
 - A "Withholding Certificate" application should be submitted to the IRS on or prior to the date of closing.
 - Purpose is for the IRS to determine the amount of funds to be remitted with Form 8288. The Withholding Certificate application is IRS Form 8288B.

FIRPTA and the Short Sale

- If the NRA seller's maximum U.S. income tax liability exceeds the 10% withholding amount (again, possibly computed with debt forgiveness to show the "maximum withholding") there is no benefit to applying for a Withholding Certificate.