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Don't get caught "short" in a declining market

In a thriving home-sale market, employers who have home-sale programs for their transferees rarely encounter terms such as "short sale," "loss on sale" and "negative equity." However, these terms are increasingly relevant in a declining market, particularly one like today's that follows a period in which prices escalated quickly and various forms of "exotic" mortgages were easily available.

In the January issue of *Policy Matters*, we discussed loss on sale and negative equity, which are key concerns in today's economic environment. In this issue, we'll discuss a short sale, an option a transferee must consider when home-sale proceeds do not satisfy outstanding mortgage costs.

What Is a Short Sale?

In a short sale, a financial institution or lender forgives a portion of a mortgage debt when the sale price of a borrower's home is less than the amount of the home's outstanding mortgage debt. Transferees in this situation have several options to consider. However, a short sale, or seeking financial assistance through their mortgage lenders, should be considered as a last resort due to the significant implications for the transferee.

Historically, in situations where the seller was unable to recoup the amount of the mortgage through the home sale, lenders have not allowed a short sale. Instead, lenders were willing to allow a property to proceed to foreclosure because property values were always increasing and could support a resale sufficient to recover the loan balance. Even when a short sale was denied, it was not generally the case that the seller would default. Typically, the seller

would just choose not to sell his or her home. Short sales were permitted only in extraordinary situations when default was imminent and the resale value would not support the loan value.

Times have changed. Due to across-the-board extraordinary declines in property values and increases in mortgage loan defaults and foreclosures, lenders are more inclined, *as a matter of policy*, to consider a short-sale transaction.

A Typical Case Scenario

Here is a typical scenario in today's real estate market that might lead to a short-sale transaction for a transferee with a home valued at \$300,000.

Home Sale Under an Employer Home-Sale Program

- A transferee owes \$300,000 on the mortgage (or commonly on the mortgage plus an associated home equity loan or second mortgage).
- Due to market conditions, the home can be sold for only \$250,000. Under an employer home-sale program in which the employer will be absorbing the costs of sale, the result is a \$50,000 "shortage" for the transferee.

This shortage would be higher when an employer home-sale program is not in place, as the seller (transferee) would also incur sale costs, thus reducing the net amount realized from the sale.

Regardless of the transferees' shortage, the difference between the amount owed on the mortgage and the home-sale price is known as negative equity. That is, the transferee's equity in the home is less than zero. Generally, employers require the transferee to pay them the negative equity before they will close their purchase of the home; otherwise, the employer will be responsible for settling the mortgage after acquiring the home and will absorb the negative equity.

One option negotiated strictly between the employer and transferee to resolve this negative equity is a loan to the transferee. This type of transaction does not involve the lender, nor does it involve any forgiveness, restructuring or other modification of the mortgage debt. Employer assistance to the employee, however, results in the creation of taxable income to the transferee, as well as the added potential burden on the employer if the employer chooses to gross-up the transferee. To help avoid this situation, many companies are now encouraging transferees to seek relief from the lender to settle the negative equity, consequently bringing into play the tax issues associated with debt relief discussed below.

The True Short Sale

Unlike the process described above, a true short sale will always involve negotiations between the lender and the homeowner (transferee). In a true short sale, the transferee works with a lender to identify alternate means to make up negative equity. The transferee, or borrower, must agree to either pay the excess of the mortgage debt from other funds or seek the lender's agreement to accept less on the debt. For the latter to occur, the lender will need to be convinced that the current sale price offered on the home is the highest that can be achieved and have proof that the borrower does not have available funds from any other source to satisfy the mortgage debt. This situation can be an involved and time-consuming process for both the lender and the borrower.

Financial Implications to the Transferee

The net result of a true short sale is that a portion of a mortgage debt is forgiven or canceled by the lender who agreed to accept less than full payment. This agreement by the lender has Internal Revenue Service (IRS) tax consequences.

The amount of the debt forgiven by the lender resulting from the short-sale transaction is taxable to the transferee under section 61(a)(12) of the Internal Revenue Code. This amount is usually referred to as cancellation of debt (COD) income, and it is taxable whether debt relief is full or only partial. Some states also treat debt forgiveness as creating income for the transferee.

Effective for debts canceled between Jan. 1, 2007 and Dec. 31, 2009, the Mortgage Forgiveness Debt Relief Act of 2007 amended section 108 to provide an exclusion for “qualified principal residence indebtedness.”¹ Section 108(h)(2) defines qualified principal residence indebtedness as up to \$2 million of mortgage debt incurred to acquire a principal residence. While this new law will alleviate much of the tax pain associated with forgiveness of home mortgage debt, it does not apply to home equity loans, which are not considered acquisition indebtedness, nor would it apply to any increment of a refinanced mortgage that was incurred to take cash out of the home. For example, if the original mortgage was \$300,000, the home increased in value to \$600,000, and the borrower refinanced into a \$400,000 mortgage with \$100,000 of cash out, only the original \$300,000 mortgage amount would qualify for exclusion if canceled. Under section 108(h)(4), it is the additional non-qualifying \$100,000 of debt that is considered canceled first.

The lender is required by section 6050P to report the amount of cancellation of indebtedness income to the IRS and the borrower. Even with the new exclusion, lenders will have to compute and report COD income on Form 1099-C, as Congress has not made changes to this requirement.

In addition, borrowers should be aware that lenders report short sales differently to the credit reporting agencies. Depending on the way the short sale is reported, there could be additional impacts to a borrower’s credit score.

A Last Resort

Because of the financial implications of a short sale, it should be considered as a last resort to solving a negative-equity situation. Lenders will require evidence that the sale price cannot support the current loan value and look for evidence of potential default as well as ample support to prove a short sale is the last viable option for the borrower. Therefore, the borrower must be able to demonstrate that he or she has considered other alternatives such as credit card advances, family gifts and relocation employer benefits before requesting a short sale.

Many lenders also require evidence that all reasonable steps have been taken to minimize the transaction costs. Many lenders will look to reduce broker commissions and other closing charges to maximize the amount of funds available for the loan payoff. It is important to explain to a lender that in a relocation transaction, the employee/borrower has no transaction costs. Therefore, reducing such costs will not provide more funds to the lender.

¹This exclusion was extended through 2012 by the Emergency Economic Stabilization Act of 2008.

Lenders are more inclined to entertain a short sale depending upon current real estate market conditions and the likelihood that the property value will not support loan value for the foreseeable future.

A Short Sale but Lengthy Process

Lenders have historically required anywhere from 30 to 60 days to complete a short-sale transaction. Although many larger lenders are establishing departments to address short-sale transactions, reduced time frames are not expected due to the increase in negative-equity situations.

Since the process can take up to 60 days to gain approval, transferees should contact their lender as soon as possible if they believe they could fall into a negative-equity position or need to pursue short-sale options. Although a lender will not approve a short sale until the terms of the sales transaction are known, the lender can begin to investigate the borrower's request, set the proper parameters for approval and be prepared to make a decision when an actual offer to purchase is presented. Because a lender must consider a significant amount of data and several factors, the sooner the lender can evaluate the situation, the higher the likelihood for a smooth and successful short-sale transaction. If a transferee waits until he or she receives an offer from an outside buyer to explore a short sale with his or her lender, the possibility exists that the transferee will lose the transaction during the short-sale approval process.

Lenders vary as to transactional involvement. Some will review only the data presented, and others will actively engage in the home-sale process. SIRVA has experience with lenders requiring regular marketing updates as well as those that wish to manage the listing process, listing price and any listing price reductions. Other lenders require special financing be offered to the prospective buyer or incentives be included on the property to enhance a sale opportunity. All of these possibilities are lender specific and vary significantly based upon the borrower's position, the facts surrounding the transaction and the transaction terms themselves, thereby providing additional reason to contact the lender as soon as a short-sale situation becomes a possibility.

Conclusion

Despite the complications and time involved, short sales must be considered as a viable alternative in dealing with negative-equity situations in relocation transactions until the real estate market recovers and home values stabilize.

To learn more about the short-sale process or how SIRVA can help your company further reduce the risks of a down market, please contact your client service director (CSD). Questions pertaining to issues discussed in this edition of *Policy Matters* can also be directed to article contributors Hank Roth or Jeff Margolis as noted below.

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