

# Foreclosure vs. Short Sale

## Homeowner Consequences

Issue	Foreclosure	Successful Short Sale
<b>Future Fannie Mae Loan-Primary Residence</b>	A homeowner who loses a home to foreclosure is ineligible for a Fannie Mae backed mortgage for a period of <b>5 years.</b>	A homeowner who successfully negotiates and closes a short sale will be eligible for a Fannie Mae backed mortgage after only <b>2 years.</b>
<b>Future Fannie Mae Loan-Non Primary Residence</b>	An investor who allows a property to go into Foreclosure is ineligible for a Fannie Mae backed investment mortgage for a period of <b>7 years.</b>	An investor who successfully negotiates and closes a short sale will be eligible for a Fannie Mae backed mortgage after only <b>2 years.</b>
<b>Future Loan with any Mortgage Company</b>	On any future 1003 application, a prospective borrower will have to <b>answer YES to Question C in Section VIII of the standard 1003</b> that asks, "Have you had property foreclosed upon or given title or deed in lieu thereof in the last 7 years?" This will affect future rates.	There is <b>no similar declaration</b> or question regarding a short sale.
<b>Credit Score</b>	Score may be lowered anywhere from <b>250 to over 300 points.</b> Typically will affect score for <b>over 3 years.</b>	Only late payments on mortgage will show and after sale mortgage will be reported as paid or negotiated. This will lower to score <b>as little as 50 points</b> if all other payments are being made. A short sale's affect can be as brief as <b>12 to 18 months.</b>
<b>Credit History</b>	Foreclosure will remain as a public record on a person's credit history for <b>10 years or more.</b>	Short Sale is <b>not reported</b> on a credit history. There is no specific reporting item for a short sale. The loan is typically reported "paid in full" or "settled."
<b>Current Employment</b>	Employers have the right and are actively checking the credit of all employees who are in sensitive positions regularly. A foreclosure in many cases is ground for immediate <b>reassignment or termination.</b>	A short sale is not reported on a credit report and is therefore <b>not a challenge to employment.</b>
<b>Future Employment</b>	Many employers are requiring credit checks on all job applicants. A foreclosure is one of the most detrimental credit items an applicant can have and in most cases <b>will challenge employment.</b>	A short sale is not reported on a credit report and is therefore <b>not a challenge to employment.</b>
<b>Deficiency Judgment</b>	In <b>100% of foreclosures</b> (except in those states where there is no deficiency) the bank has the right to pursue a deficiency judgment.	In many successful short sales it is possible to convince the lender to <b>waive their right to pursue a deficiency judgment against the homeowner.</b>
<b>Deficiency Judgment (amount)</b>	In a foreclosure the home will have to go through an REO process if it does not sell at auction. In most cases this will result in a lower sales price and longer time to sell in a declining market. This will result in a <b>higher possible deficiency judgment.</b>	In a properly managed short sale, the home is sold at a price that should be close to market value and in almost all cases will be better than an REO sale resulting in a <b>lower deficiency.</b>
<b>Security Clearances</b>	Foreclosure is the <b>most challenging issue against a security clearance</b> outside of a conviction of a serious misdemeanor or felony. If a client has a foreclosure and is a police officer, in the military, in the CIA, Security, or any other position that requires a security clearance in almost all cases clearance <b>will be revoked and position will be terminated.</b>	A short sale on its own <b>does not challenge most security clearances.</b>

## What to Do When You Default On Your Mortgage

No lender wants to foreclose on a mortgage. Foreclosure costs them more money than they can make back from the foreclosure sale. Therefore, lenders do not foreclose in order to make money, but only reluctantly as a way of limiting losses on a defaulted loan. This is why, if you get behind on your mortgage payments, your lender will work with you to devise a practical plan to cure the default and bring the loan current. In order to do so, however, you must stay in communication with your lender and be honest in evaluating your financial situation.

If you are falling behind in your payments, or know that you are likely to in the immediate future, there are some steps that you should take before talking with the lender about alternative payment arrangements.

First, you need to prepare a monthly list of your income and expenses, using realistic figures based on your current financial situation. You will also need to put together a complete financial disclosure package, showing your assets and liabilities, including all debts and monthly payments and when they are due. Pay stubs, unemployment check stubs or other proof of current income should be in the package, along with two years' tax returns. Prepare a written explanation of your situation for the lender and offer any plan or suggestion you may have on how you can bring the loan current.

Listed below are examples of "Loss Mitigation" options you can speak with your lender about in order to resolve your delinquent mortgage payments. Remember, you need to ask for your lender's "Loss Mitigation" Department.

**Reinstatement or Repayment Plan:** A reinstatement or repayment plan might be used for borrowers who have fallen behind on their mortgage payments but are able to subsequently resume making their monthly payments. Under this arrangement, the lender increases the regular monthly payment until the delinquency is repaid.

**Partial Mortgage Insurance Advance Claim Payment:** This approach might be used if a mortgage insurer is involved (either the Federal Housing Administration or a private mortgage insurer). Under this approach, a one-time payment is made by the mortgage insurer to the lender to cover all or a portion of the default. In these cases the borrower is required to sign an interest free note for the amount of the advance claim payment payable to the insurer of the mortgage. The repayment of the note is scheduled to coincide with the borrower's ability to pay when they get back on their feet and structured to the individual's circumstance. At the latest, the note is usually due on the sale or transfer of the property. The details on this program may vary among mortgage insurers.

**Forbearance Agreement:** A repayment plan based on the borrower's financial situation that may include a temporary reduction or suspension of payments for a specific length of time. Often used when the borrower has a reduction in income or increase in expenses that is not expected to be permanent.

**Mortgage Modification:** A refinancing of the debt and/or extension in the term of the mortgage loan that allows the borrower to catch up by reducing the monthly payments to a more affordable level. Used for borrowers who have recovered from a financial problem and can afford the new payment amount. Modifications could include lowering interest rates, adding payments to the end of the loan term, paying off small amounts of arrearages each month, adding a lump sum payment due at pay-off, or simply lowering payments for a set period of time.

**Loan Assumption:** An arrangement where a qualified borrower agrees to assume responsibility for repayment of the mortgage.

**Pre-foreclosure or Short Sale:** This is where a lender can agree to accept the proceeds of a pre-foreclosure sale in satisfaction of the loan even though the proceeds may be less than the amount owed on the mortgage.

**Deed-in-Lieu of Foreclosure:** The borrower voluntarily deeds the property to the lender in order to avoid a lengthy foreclosure, additional accrued interest, and expenses. Typically used when attempts fail to sell the house prior to foreclosure.

## Mortgage Forgiveness Debt Relief Act

### What is the Mortgage Forgiveness Debt Relief Act of 2007?

The Mortgage Forgiveness Debt Relief Act of 2007 was enacted on December 20, 2007 (see News Release IR-2008-17). Generally, the Act allows exclusion of income realized as a result of modification of the terms of the mortgage, or foreclosure on your principal residence.

### What does that mean?

Usually, debt that is forgiven or cancelled by a lender must be included as income on your tax return and is taxable. The Mortgage Forgiveness Debt Relief Act of 2007 allows you to exclude certain cancelled debt on your principal residence from income.

### Does the Mortgage Forgiveness Debt Relief Act of 2007 apply to all forgiven or cancelled debts?

No, the Act applies only to forgiven or cancelled debt used to buy, build or substantially improve your principal residence, or to refinance debt incurred for those purposes.

### What about refinanced homes?

Debt used to refinance your home qualifies for this exclusion, but only up to the extent that the principal balance of the old mortgage, immediately before the refinancing, would have qualified.

### Does this provision apply for the 2007 tax year only?

It applies to qualified debt forgiven in 2007, 2008 or 2009.

### If the forgiven debt is excluded from income, do I have to report it on my tax return?

Yes. The amount of debt forgiven must be reported on Form 982 and the Form 982 must be attached to your tax return.

### Do I have to complete the entire Form 982?

Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Adjustment)*, is used for other purposes in addition to reporting the exclusion of forgiveness of qualified principal residence indebtedness. If you are using the form only to report the exclusion of forgiveness of qualified principal residence indebtedness as the result of foreclosure on your principal residence, you only need to complete lines 1a and 2. If you kept ownership of your home and modification of the terms of your mortgage resulted in the forgiveness of qualified principal residence indebtedness, complete lines 1a, 2, and 10b. Attach the Form 982 to your tax return.

### Where can I get this form?

You can download the form at [IRS.gov](http://IRS.gov), or call 1-800-829-3676. If you call to order, please allow 7-10 days for delivery.

### How do I know or find out how much was forgiven?

Your lender should send a Form 1099-C, Cancellation of Debt, by January 31, 2008. The amount of debt forgiven or cancelled will be shown in box 2. If this debt is all qualified principal residence indebtedness, the amount shown in box 2 will generally be the amount that you enter on lines 2 and 10b, if applicable, on Form 982.

### Can I exclude debt forgiven on my second home, credit card or car loans?

Not under this provision. Only cancelled debt used to buy, build or improve your principal residence or refinance debt incurred for those purposes qualifies for this exclusion.

### If part of the forgiven debt doesn't qualify for exclusion from income under this provision, is it possible that it may qualify for exclusion under a different provision?

Yes. The forgiven debt may qualify under the "insolvency" exclusion. Normally, a taxpayer is not required to include forgiven debts in income to the extent that the taxpayer is insolvent. A taxpayer is insolvent when his or her total liabilities exceed his or her total assets. The forgiven debt may also qualify for exclusion if the debt was discharged in a Title 11 bankruptcy proceeding or if the debt is qualified farm indebtedness or qualified real property business indebtedness. If you believe you qualify for any of these exceptions, see the instructions for Form 982.

### Is there a limit on the amount of forgiven qualified principal residence indebtedness that can be excluded from income?

There is no dollar limit if the principal balance of the loan was less than \$2 million (\$1 million if married filing separately for the tax year) at the time the loan was forgiven. If the balance was greater, see the instructions to Form 982, page 4.

### Is there anything else I need to know before filing?

Yes. Because the Mortgage Forgiveness Debt Relief Act of 2007 was passed so late in the year, the software systems used by tax preparers and at the Internal Revenue Service need to be updated to accept the revised Form 982. The IRS expects to be able to process the new Form 982 electronically on March 3, 2008.

The information provided above comes from the U.S. Department of Treasury, Internal Revenue Service web site: <http://www.irs.gov/individuals/article/0,,id=179414,00.html>. If you have questions regarding the Mortgage Forgiveness Debt Relief Act and how it applies to you, please contact the Internal Revenue Service or a tax attorney or tax consultant.

## 1099 vs. Deficiency Judgment

There is no such thing as a deficiency on a short sale. We find realtors **ALWAYS** miss this. Or get terms interchanged.

**Forgiveness of Debt** and a deficiency are two separate and distinct situations and the terms do not mean the same thing whatsoever and the distinction is **VERY.....VERY.....Important**.

A short sale is a negotiated settlement, short payoff on a mortgage. **PAYOFF**. When a short sale is completed, the bank issues a **SATISFACTION** of the mortgage **AND RELEASES** the borrower from all obligations. Once a Satisfaction of Mortgage is filed and the Release of Mortgage is obtained, there is **NOTHING** from which a deficiency **JUDGMENT** can be obtained. The mortgage has been **SATISFIED** and the Borrower **RELEASED**.

In this instance a homeowner may get a 1099 and may be liable for taxes on the debt which was forgiven. However, if a home is actually foreclosed, and the bank sells the home as a REO and they sell it for less than what is owed, then the bank, in certain states, can obtain a deficiency judgment for the balance. In Illinois, it's actually written in the Final Summary Judgment of Foreclosure.

Now here's the big difference **MOST** realtors don't grasp and have a problem relaying to their clients.

Let's say that the mortgage balance with fees and costs is \$300,000. The short sale is completed on the house for \$200,000. The amount of debt forgiven is \$100,000.00. The 1099, if issued, would be for \$100,000.00. Does this mean the homeowner owes the IRS \$100,000.00? **NO OF COURSE NOT!!**

This is treated as ordinary income in most cases and the homeowner would have to pay taxes on this new found "income" according to their tax rate. Let's say they are in a 33% tax bracket...then they would owe the IRS \$33,000 theoretically...I say theoretically because there are a **NUMBER** of maneuvers and strategies that any half decent accountant can do to reduce this IRS debt.

Now, on the other hand...the same house is actually foreclosed on by the bank: Same \$300,000 outstanding debt, same price on re-sale of \$200,000.00. Now the bank has what is termed a deficiency of \$100,000.00. Based upon their Final Summary Judgment in some states, they can simply go back to Court and they are entitled to a **DEFICIENCY JUDGMENT** for the **ENTIRE \$100,000.00!!**

So as you can see...there is a **HUGE** difference here. By the way.....check with your state, but here in Illinois, this judgment, once certified, has a potential lifespan of twenty years and will continue to grow as statutory interest is applied and compounded while not being paid.

Other than bankruptcy and expiration this \$100,000 judgment will continue to grow and grow over the years. So when talking to a homeowner, explain their options and which is the best situation for them.

Real estate agents need to know the difference. There is a **HUGE** difference.

## **Bankruptcy - Essential facts and tools**

### **I ESSENTIAL FACTS ABOUT BANKRUPTCY**

In no way is this presentation designed to be a comprehensive discussion about bankruptcy as it relates to foreclosure. Instead, the purpose here is to give you the essential facts that you need to know so that you become knowledgeable when dealing with people who are in foreclosure and bankruptcy or who are in foreclosure and contemplating bankruptcy. You will deal with bankruptcy issues while doing short sales because homeowners will have filed bankruptcy in an effort to save their house, before they contact you about selling the house.

The first and most important thing you need to know is that filing bankruptcy does not permanently stop or prevent a foreclosure from occurring, it can only stall or temporarily freeze a foreclosure action.

#### **A. Federal Law Controls**

All bankruptcy law is federal law that is legislation passed by the United States Congress. In October of 2005, major bankruptcy reform legislation that had been passed by Congress took effect. Today, over a year later, the bankruptcy court system is still getting a handle on the changes because of the vast influx of new cases filed just before the new legislation took place. The reform legislation that was passed made changes to the two types of bankruptcies that individuals can file. Those two types of bankruptcies are referred to various chapters in the code, chapters 7 and 13.

#### **Chapter 13 - repayment plan.**

The reform legislation has made chapter 13 the more common type of bankruptcy. Essentially, chapter 13 is a Court-supervised and Court-monitored repayment plan where the debtor provides the Court with a listing of all of their debts, a budget for their monthly needs, and all extra money per month is applied to pay the arrearage owed on the debts. One of the benefits of a chapter 13 repayment program is that a lot of the outrageous late fees, interest rates, and other charges can no longer apply on these kind of debts. The typical repayment program usually lasts between 48 and 60 months.

The vast majority of chapter 13 repayment plans falter and eventually fail. Plans can falter even where the debtor gets a grace period from the Court due to unusual and unexpected circumstances to get additional time added to the plan and they can get a break in order to try and catch up for missed payments to the trustee.

The typical chapter 13 plan is that the debtor wages are automatically sent to the Court appointed trustee and paid out to all of the creditors according to a plan presented by the debtor and agreed to by the creditors.

After the bankruptcy reform act of 2005, chapter 13 repayment plans also include partial

repayments in what used to be a complete discharge. Chapter 13 bankruptcies can be filed again within a shorter period of time after the last plan, either failed or terminated. However, to prevent abuse, if a chapter 13 plan is dismissed by the Court due to the debtor's noncompliance, the debtor cannot file a new chapter 13 for at least one year.

Several new rules exist about automatic stays and refiling, they are:

- 1) Automatic stay is terminated 30 days after petition in case filed by individual under chapters 7, 11 or 13 if case pending within 1 year preceding was dismissed other than that refiled under dismissal under 7078; may be continued if Court finds refiling in good faith.
- 2) No automatic stay is in effect in cases filed by individual under chapters 7, 11, or 13 if two or more cases pending in 1 year preceding were dismissed other than that refiled under dismissal under 70; Court may impose stay is established later filing in good faith.
- 3) Stay automatically terminates 60 days after sec. 362(d) motion filed in case filed by individual under 7, 11, or 13 unless there is final decision or extension reached.
- 4) Automatic stay does not apply to enforcement of residential eviction judgment entered prepetition. Provision not effective until 30 days after petition is filed if certain requirements met. Exception may not apply under certain circumstances.
- 5) Automatic stay does not apply to continuation of residential eviction action based on endangerment of property or illegal use of drugs on property if certain requirements met.

Many times people will not include their house payment in the chapter 13 plan. This is frequently the result of individual preferences of the attorneys that they hire to represent them as well as the characteristics of the trustees appointed by the probate Court to administer chapter 13 plans. Even if a house is not included in any chapter 13 bankruptcy, the bankruptcy does protect the house by filing a stay on the foreclosure action and that stay remains in effect as long as the homeowner then gets and remains current on their house payments.

#### **Chapter 7 - discharge debts**

Chapter 7 bankruptcies provide for the total discharge and liquidation of debts. Because of this powerful debt relief tool, individuals are only able to file a chapter 7 bankruptcy once every eight years. In a chapter 7 bankruptcy, people may list their home and mortgage as one of the debts that they are seeking to discharge. If this is the case, and it is clear intention that they have abandoned all hopes of saving the property and continuing to live in the property. If an individual chooses not to include their house in a chapter 7 bankruptcy, then they are still intending to keep the house, and must stay current on the payments on the house while the other debts are being discharged.

Many people think that if they can discharge their other debts, then they will have enough available cash to get caught up on their house payments and stay current. More often than not, they are wrong. Even if the house is not included in a chapter 7 bankruptcy, the stay granted by

the filing of the bankruptcy will apply to the mortgage and the foreclosure action. If the homeowner can then bring the mortgage current, then the foreclosure action goes away.

Most of the time though the homeowner is unable to bring or keep the mortgage current and the bank then files a motion for relief of stay. Chapter 7 is a valuable tool and a homeowner who realizes that they are going to lose their house may be best served by waiting until after the foreclosure action is completed or until after the short sale is done and then using the chapter 7 bankruptcy to wipe out any deficiency judgment that may remain.

## **B. State Options**

While bankruptcy law is federal law, each state has its own characteristics and additional pieces of legislation affecting bankruptcy. Furthermore, each bankruptcy Court is located within certain areas of the state and based upon the political makeup of that area of the state it can influence the character and nature of the trustees serving chapter 13. Additionally each state has various options as to the amount and type of exclusion of certain assets that are exempt from being included in the bankruptcy and that the debtor can continue to own after the completion of the bankruptcy. The most common of these is a homestead exemption. For many years, Florida had a very generous homestead exemption, and so did the state of Texas, while Ohio has had a very meager homestead exemption. If a homeowner is contemplating using the do it yourself bankruptcy forms, they are probably headed for a rude surprise because they will not be aware of the various state options and considerations as to the exclusions and exemptions of certain assets.

## **C. Key terms**

For the purposes of understanding bankruptcy in the context of foreclosures and short sales, the following key terms need to be learned:

### **1) Bankruptcy Stay**

A Bankruptcy stay is likened to an immediate freeze halting all legal action in an effort to collect money or assets from a debtor. This means that a Bankruptcy filed even less than one hour before the foreclosure auction, serves the purpose of stopping the foreclosure and allowing the homeowner additional time to try to do something else with the house.

### **2) Motion for Relief of Stay**

Creditors, particularly lenders, who are seeking to foreclose on a house will frequently file motions for relief of stay with the Bankruptcy Court in an effort to get the bankruptcy trustee in a chapter 13 case or the Judge in a chapter 7 case to agree to let them pursue or restart the foreclosure action. The two most frequent reasons for filing a motion for relief of stay are i) that the value of the house is equal to or less than the amount of the debt owed on the house, therefore there is no equity in the house that can be used to pay other creditors and no other creditor will be harmed if the mortgage holder proceeds to foreclose on the house; ii) the homeowner has fallen behind in the payment program

established in the Bankruptcy Court and as a result of falling behind in the payment program, protection that they are entitled to in bankruptcy is withdrawn from them and the creditor is allowed to proceed after the asset.

3) Abandonment of assets

In some instances, people who file bankruptcy will discuss with their attorneys the nature of their financial condition and they and their attorneys will agree that the house is worth less than what is owed on the house and they will agree with the Court that the asset should be abandoned which means that they no longer believe there is any value in the asset or home that could be used to pay creditors other than the secured lien holders.

4) Bankruptcy Discharge

Bankruptcy discharge is the Court order at the end of chapter 7 proceeding or a chapter 13 proceeding which indicates that all of the debts that were owed by the individual filing bankruptcy have either been paid in full or the individual is no longer responsible for the debt. The debt has been wiped out or discharged.

5) Bankruptcy Dismissal

This term is frequently used in a chapter 13 bankruptcy because the individual filing Bankruptcy has failed to comply with the regularly scheduled payment program established by the Bankruptcy Trustee, or they have failed to file the necessary information with the Court at the beginning of the process. In this case the Bankruptcy is automatically dismissed and the stay that goes with it is lifted. The legislative reforms that became effective on October of 2005 limited individuals ability to refile bankruptcy if it has been dismissed due to their failure to either file documents or comply with the plan.

## II POTENTIAL TOOLS

A. Bankruptcy is a serious legal event involving usage of the Federal Courts and is not something to be taken lightly. However, certain homeowners may find various strategic advantages to filing bankruptcy at key times during a foreclosure process. A bankruptcy filing, chapter 7 or chapter 13, stops (stays) a foreclosure action even if the bankruptcy is filed just before the foreclosure sale is scheduled to begin. Under the electronic filing system used by all Federal Courts now in bankruptcy cases, there will be a time stamped filing notice from the bankruptcy Court indicating the date, hour and minute of the Bankruptcy filing. This is significant because sales of properties have gone to auction because the auctioning authority was unaware of the Bankruptcy being filed moments before, are null and void.

If the homeowner has relocated to a different state, the Bankruptcy can be filed in the state where they now live and still stop the foreclosure auction on the house even if the house is in a different state thousands of miles away. However, the filing of a bankruptcy action even



though it stops a foreclosure action does not automatically clear the way to do a short sale. Once the house comes under the protection of the Bankruptcy Court, not only does the Bankruptcy Stay stop the foreclosure action, but it also prevents purchase and sale of the property. Therefore, it prevents the bank's loss mitigation department from dealing with the homeowner or someone else to try to negotiate a short sale on the property.

The bankruptcy reform that came into effect October 2005 contained provisions to punish people who had a history of filing Bankruptcies and then allowing them to be dismissed shortly thereafter because it was believed that they were merely doing this in order to prevent the house from going to foreclosure sale.

**B. Appropriate disclosure.** Due to the bankruptcy reform legislation that became effective October 2005 whenever you are dealing with anyone who is in bankruptcy or contemplating bankruptcy, you need to make sure that you have a written disclosure to them stating, "you (or your company) are not a debt relief agency and that you (or your company) do not help people file for bankruptcy relief under the Bankruptcy Laws of the United States or provide Bankruptcy assistance. Any written or verbal statement made by you (or your company) about the subject of Bankruptcy are only our opinions, since you (or your company) are not Attorneys at Law, you must consult an Attorney at Law to obtain Bankruptcy advice."

**C. PACER,** the web site at <http://www.pacer.uscourts.gov/> provides excellent online access to bankruptcy filings. PACER is an incredibly valuable and important tool to anyone doing short sales for the following reasons. You can get information online regarding what is happening in bankruptcy cases involving the properties you are working on. You can download Court orders granting motions for the relief of stay, the abandonment of assets letters, so that you can then go forward with purchasing the property. Other ways that PACER can be valuable is that you have insight into all of the assets and overall financial picture of the homeowner that you are dealing with. You will be able to also use PACER as a way of skip tracing individuals who have filed for Bankruptcy and abandoned their property. I would not try to deal with a homeowner in a high end property who is in foreclosure without determining what types of bankruptcy they have filed and reviewing everything through PACER. In summary, PACER gives you information. Information is power when dealing with homeowners who are in foreclosure.