



Seller's Legal and Tax Liability In Short Sales

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With the increase in short sales over the last 1 to 2 years, a variety of issues has arisen with respect to implementing short sales and the legal and tax ramifications of those short sales. The term "short sales" as used in this article means that the mortgage related to property indebtedness exceeds the projected sales price and costs of sale necessitating a discount of the mortgage balance to effectuate a sale.

The most common question asked by consumers and real estate agents concerns the liability or tax consequences involved in a short sale.

With respect to liability issues, one of the biggest concerns is whether a seller is free from any further liability to a lender when the short sale transaction is closed. The very nature of a short sale involves the lender discounting the debt and therefore losing money in an amount equal to the discount. What rights if any does the lender have to pursue a claim against the borrower after the lender has consented to a short sale? The answer to that question lies in the nature of the documentation that a lender provides at the time of the closing.

In the best of all worlds, the lender provides a satisfaction of the mortgage as well as an agreement that it will not pursue any further claims against the borrower for any outstanding balances on the promissory note. If the lender only provides a satisfaction of mortgage, the borrower certainly has a claim that with the satisfaction of the mortgage the indebtedness represented by the underlying promissory note is satisfied. Notwithstanding that argument, the ideal is to get a specific release from the lender with regard to further liability on the note.

If the bank gives a release of the mortgage rather than a satisfaction, and no other document specifically grants a release of liability on the underlying note, the lender has a strong argument that the borrower is still liable for the unpaid balance on the promissory note and the lender can pursue a lawsuit against the borrower for that deficiency.

With respect to the tax consequences to a borrower arising out of the lender discounting the mortgage debt, a recent federal law was passed providing that an individual relieved of his or her obligation to pay a portion of a mortgage debt on a principal residence between January 1, 2007 and December 31, 2009 will not be required to pay federal income tax on any amount that is forgiven with some exceptions as spelled out in the law. HR 3658-Public Law 110-142. Indebtedness forgiven before January 1, 2007 could well give rise to taxable income to the borrower on the amount of the debt forgiven.

Real estate agents should advise their clients to consult with an attorney or accountant on the liability and tax issues raised in this article. Real estate agents should avoid giving legal advice or tax advice at the risk of becoming engaged in the unauthorized practice of law or giving incorrect advice.

