

FLORIDA FORECLOSURES AND SHORT SALES: TAX IMPLICATIONS, EFFECT ON CREDIT RATING, AND DEFICIENCY JUDGMENTS

The distressed homeowner in Florida, and throughout the country, often has several options to consider, which may include a mortgage adjustment, refinance through a government-insured program (e.g. Hope for Homeowners), deferral, etc. Where those options are not viable, the distressed homeowner usually has to decide whether to attempt a short sale or go through a foreclosure. This article is intended to aid in that decision. The bottom line is the homeowner in that situation must weigh the following factors: damaged credit rating, potential tax liability, and likelihood of a deficiency judgment.

Short Sales: Tax Implications

A short sale is where the lender agrees to sale the distressed property for less than the borrower owes on the mortgage. Since the lender accepts the short sale net¹ proceeds as full satisfaction of the mortgage, the borrower is “forgiven” the difference between what was owed on the mortgage and the net proceeds of the short sale. That difference will be considered income by the IRS and taxed accordingly unless an exception applies.

Under the Mortgage Forgiveness Debt Relief Act (2007), taxpayers who were forgiven part of their mortgage on their *primary residence* can likely avoid tax liability by including Form 982 with their tax return. See IRS Form 982 instructions for full explanation of qualifying criteria.

Foreclosures: Tax Implications

After a lender goes through the foreclosure process and obtains a final judgment, the next step is usually a “sheriff sale” of the property. In this scenario, the taxpayer is not considered to have been forgiven any portion of the mortgage debt even if the property sells for less than what is owed on the mortgage; therefore, there is no tax liability. The presumed logic behind this difference is that a sheriff sale is a forced sale rather than the result of negotiation with the lender.

Short Sales: Effect on Credit Rating

Contrary to popular belief, the effect of a short sale on the homeowner’s credit is virtually identical to that of a foreclosure—a dip of 200 to 300 points. There is a notable difference, however. The owner who goes through a short sale may qualify to purchase a subsequent home in less time than someone who goes through a foreclosure. The waiting period after a foreclosure is 24 - 72 months,² whereas the wait after a short sale is about 24 months. Also, in the case of a short sale, there may be fewer months of non-payment on the mortgage,³ which will result in less damage to the homeowner’s credit score.

¹ Sale price less closing costs

² Under the new Fannie Mae guidelines, the waiting period after a foreclosure is five (5) years.

³ Or partial payments.

Foreclosure: Effect on Credit Rating

A foreclosure has a significant negative impact on the homeowner's credit rating, the effects of which will endure for at least seven years. There is no legitimate means of erasing a foreclosure from the individual's credit rating until the full seven years have elapsed.⁴ It is estimated that the foreclosure will result in a reduced credit rating of 200 - 300 points, depending on overall condition of credit. This means if a FICO score of 680 before foreclosure could dip as low as 380.⁵ Also, where a deficiency judgment is awarded to the lender, the borrower's credit rating will be affected until the judgment is satisfied. See below.

Deficiency Judgments

Where a home is sold for less than what is owed on the mortgage, there is the potential that the borrower will be liable for the deficient amount. In the case of virtually all Florida foreclosures,⁶ the lender is entitled to petition for a deficiency judgment if the sale of the home does not cover the balance due on the mortgage. Since foreclosure in Florida is a judicial process, the lender is already obligated to pay attorney fees and court costs. As a result, the lender may choose to request a deficiency judgment unless the discrepancy is relatively minimal.

In the case of a short sale, the matter is not as clear. Whether the lender is entitled to a deficiency judgment may depend upon the terms negotiated with the borrower. In some cases, the lender will waive its right to a deficiency judgment in exchange for the borrower's cooperation. If the lender does not waive this entitlement, whether it seeks a deficiency judgment or not will be a business decision based on the amount of the deficiency, costs of litigation, etc.

Because state laws vary and each homeowner's circumstances are different, it is important that homeowners in distress consult a mortgage broker they trust and a local real estate attorney.

Jeffrey Harrington, Esq.

⁴ That is not to say that a skillful credit repair firm could not erase the mark by illegitimate means.

⁵ According to David Steep, division manager at Vitek Mortgage.

⁶ The only exception is where the mortgage is "non-recourse." Most mortgages do not fall in this category and there would have to be specific language in the mortgage or promissory note indicating the debt in non-recourse in order to raise this argument.