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LEGAL & TAX ASPECTS OF DISPOSITION OF DISTRESSED PROPERTIES

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(This Outline is Written Assuming that the Reader is Disposing of a Distressed Property.)

1. KNOW YOUR FACTS AND GATHER DOCUMENTS BEFORE MEETING WITH A PROFESSIONAL FOR ADVICE:

   a. Is the property your personal residence, investment property or a conversion in either direction?

   b. Is the debt secured by the property one or more Purchase Money Mortgages (original mortgage from time of purchase of property) or subsequent encumbrance from re-financing or adding a HELOC (home equity line of credit)?

   c. Is the debt a first mortgage or subsequent encumbrance and how much is due on all encumbrances?

   d. What is the fair market value of the property? How did you determine that number?

   e. What is the payment status of the encumbrances (current or delinquent)? If delinquent, by how much? Are the property taxes paid current or are they delinquent? Are homeowners' association fees current or delinquent?

   f. What communications have been made to or received from the Lenders/tax collector/homeowners' association?

   g. What is the purchase cost and improvement costs for the property?

   h. What is the income tax basis of the property? Has any depreciation been taken on the property?

   i. What are your personal financial hardship factors that you can tell the Lender when asked to provide them?

   j. Who owns the loan(s)? Who is servicing the loan(s)? Can the Lender produce the original Note?

2. UNDERSTANDING THE LENDER'S MOTIVATIONS:

   a. Collect as much as possible on the obligation;

   b. Avoid taking title to the property (REO) if possible; and

   c. Minimize its costs.

3. SHORT SALES (NOT FULLY REPAYING ENCUMBRANCE(S))

a. Lenders prefer this approach because they do not get property back and generally end up with more money than through a foreclosure or deed in lieu of foreclosure

b. You will need to provide a hardship letter to the letter when presenting them the offer, so start working on it as soon as you list the property for sale.

c. When you receive an offer, be sure the following are included as terms or put them into a counter-offer:

(1) The Contract is subject to your Lenders' acceptance of the Terms of the Offer; and

(2) The Contract is subject to your acceptance of any conditions your Lenders put on acceptance of the sale.

d. Effective Jan. 1, 2011, a first mortgage Lender in California cannot obtain any deficiency judgment when it accepts the terms of a short-sale.

e. Other Lenders not fully paid through a short-sale can come back against the Borrower for the deficiency unless the loan is a purchase money mortgage on the Borrower's primary residence consisting of 1 to 4 residential units. Effectively, they have become unsecured creditors.

f. Attempt to negotiate the amount payable to other Lenders prior to accepting the short-sale conditions before close of escrow. If the junior Lenders will not negotiate, then try immediately after closing to negotiate a pay off. You will need a hardship letter for this also.

4. FORECLOSURES:

a. Usually the Lender holding the senior encumbrance (first mortgage) forecloses because the junior Lenders do not want to risk payment responsibility for the first mortgage which may be close to or greater than the fair market value of the property.

b. Trustee Sale (under terms in Deed of Trust) vs. Judicial Sale (Court proceeding):

(1) 99+% of foreclosures are Trustee Sales because of cost of judicial proceeding.

(a) The Lender is precluded from getting a deficiency judgment because of California's "single action rule".

(b) Lender records Notice of Default, and then after 90 days can have foreclosure sale on Court House or City Hall steps to highest bidder. Proceeds are paid in following priority to the extent of funds received:

(i) Costs of Sale

(ii) First Lender's lien balance

(iii) Junior Lender(s)' lien balance(s)

(iv) Borrower

(c) If there is no bidder, the Lender takes title to property as an REO.

(d) The process usually takes a minimum of 6 months from the date of default in payment of mortgage and frequently a lot longer.

(2) Judicial Sale used if:

(a) Lender believes it can get balance due from Borrower because of financial information about Borrower in Lender's possession.

(b) The property has been substantially damaged without insurance proceeds available for repair (only land value available) and there is a likelihood of the Borrower has the resources to pay off or pay down the obligation.

(3) The Lender cannot get a deficiency judgment if the loan is a purchase money mortgage on the Borrower's primary residence consisting of 1 to 4 residential units.

c. Non-foreclosing junior Lender becomes unsecured and can pursue Borrower for payment of obligation unless the loan was a purchase money mortgage on the Borrower's primary residence consisting of 1 to 4 residential units.

5. DEED IN LIEU OF FORECLOSURE:

a. Borrower deeds property to Lender in lieu of going through foreclosure process and the property becomes an REO for the Lender.

b. This is rarely acceptable to a Lender because:

(1) The property has not been exposed to the market for sale, which will normally reduce the Lender's overall loss from the loan.

(2) There are other financial obligations associated with the property that the Lender may avoid by going through the Short Sale or Foreclosures process.

c. If a Deed in Lieu is acceptable to the Lender in principle, negotiate with the Lender so that there is full satisfaction of the loan by the Lender, and there is no issue of the Lender seeking a deficiency after receiving the property. Receipt of the property is not considered an action by the Lender under the "Single Action Rule". There can be no deficiency judgment if the loan is a purchase money mortgage on the Borrower's primary residence consisting of 1 to 4 residential units.

d. Junior lenders are still secured. This could be a factor for the senior Lender being willing to accept the Deed in Lieu.

(1) If the loan was a purchase money mortgage on the Borrower's primary residence consisting of 1 to 4 residential units, the junior Lender cannot pursue the Borrower.

(2) If this is a refinance or a non-purchase loan, the junior Lender can pursue the Borrower and forego the property as a source of payment under the "single action rule".

6. BANKRUPTCY:

a. If you meet the requirements to be able to file bankruptcy and chose that path, best to file before:

(1) There are any deficiency judgments where issues of fraud could be raised (fraudulent acts are not dischargeable in bankruptcy), and

(2) Before any tax events have occurred (i.e. Short-Sale or Foreclosure) where there may be a tax due that is not covered by the debt cancellation exceptions of Internal Revenue Code section 108. A tax lien is not dischargeable until 3 years after the return is filed and assessed by tax authority.

b. This needs to be well planned and coordinated with whatever other action you intend to take—Short Sale, Foreclosure, or Deed in Lieu of Foreclosure.

7. IMPACTS ON CREDIT:

a. Late payments each month hurt credit more than other factors.

b. Short-Sale impacts credit reports for 2 to 3 years and is noted that the debt was repaid for less than the full amount due.

c. Foreclosure or Deed in Lieu of Foreclosure (if reported) impacts credit reports for 5 to 7 years.

d. Bankruptcy impacts credit reports for 7 years.

e. Lenders can always ask if you ever had a Foreclosure or a Deed in Lieu of Foreclosures or a Short-Sale or a Bankruptcy regardless if it is reported on your credit report.

You sign loan applications under penalty of perjury, and if Lenders find out you have lied, they are becoming more apt to cause prosecution for perjury.

f. Use your credit for what you will need before it is impacted by late payments, Short-Sales or Foreclosures.

8. INCOME TAX CONSIDERATIONS: There are two possible sources of taxable income for distressed real property:

a. The disposition of the property is a taxable event with a potential capital gain / loss or IRC §1231 gain / loss, and with possible recapture of depreciation.

(1) If the deemed sale price of the property is less than the income tax basis of the taxpayer in the property plus transfer costs, then the taxpayer has a loss that will be treated as a capital loss or ordinary loss depending upon the type of property. If the property was the principal or second residence of the taxpayer, the loss is not deductible. If the property was subject to depreciation, then under IRC §1231 the loss would be treated as an ordinary loss which could be available to offset cancellation of debt income discussed below in b. Otherwise, the loss would be treated as a capital loss, which limits the amount of loss deductible in any year to $3,000 in excess of capital gains for the year.

(2) If the deemed sale price is more than the income tax basis of the taxpayer in the property plus transfer costs, and if the taxpayer has held the property for over one year, the gain will be treated as a capital gain subject to the possible recapture of depreciation (see (3) below) on a portion of the gain. If the property is held for one year or less, the gain is treated as ordinary gain for income taxes.

(3) If the taxpayer has taken accelerated depreciation on the property, then there will be recapture of depreciation to the extent the accelerated depreciation exceeds straight line depreciation at the time of the transfer. The recapture rate of tax is 25% for Federal Income Tax purposes.

(4) If the property was the principal residence of the taxpayer as defined under IRC §121, then up to $250,000 of the gain if single or $500,000 of the gain if married may be excluded from income. To qualify, the taxpayer or spouse must have owned the property for at least 2 years and resided in the property 2 of the last 5 years. If the property was acquired under a 1031 exchange, then the property must have been owned for at least 5 years. This exclusion may not be used more than once in any 2 year period.

b Cancellation of Debt (hereinafter "COD") by a lender is taxable income unless exempted under the provisions of the Internal Revenue Code (hereafter "IRC"). The following discusses circumstances under which COD is not taxable. California follows these provisions except as noted.

(1) If the debt was a "purchase money mortgage" (see 1 b above), then the debt is considered "non-recourse" and the taxpayer has no personal liability for the debt. Because the debt is not "indebtedness of the taxpayer" under IRC § 108, there is no taxable discharge of the debt. If the taxpayer receives a 1099-A or C (depending upon circumstances) reflecting the COD as taxable, it should be reported on the taxpayer's income tax return, but also be treated as non-taxable with an appropriate explanation.

(2) If a taxpayer files bankruptcy, then the COD incurred after the bankruptcy in which the debt was discharged is not taxable income (IRC § 108 (a)(1)(A)).

(3) If a taxpayer is insolvent, the COD is not taxable to the extent of insolvency at the date of the COD (IRC § 108 (a)(1)(B)). It is important for tax filing purposes that you create a list of all your assets and liabilities immediately prior to the COD. The list should include assets that are exempt from creditors such as retirement plans, and should include the full amount of the debt before partial or complete discharge. When this exclusion is used, then certain tax attributes of other assets or losses are adjusted for future use. First preference is reduction of income tax basis of other real property.

(4) If the taxpayer is a farmer, and the indebtedness discharged is farm related, the COD exclusion may be excluded under the provisions of (IRC § 108 (a)(1)(C)).

(5) If the taxpayer is not a C Corporation and is in the real estate business, then if the debt is "qualified real property business indebtedness", the COD is not taxable income (IRC § 108 (a)(1)(D)). The concept "real estate business" is not defined in the IRC or its Regulations. Taxpayers with rental properties that have COD should consider this and work with the tax advisor to determine if this provision is a basis for exclusion of the income from taxation.

(6) If the taxpayer is transferring his/her primary residence, then there is an exclusion for COD used to purchase or remodel the property up to $2,000,000 (IRC § 108 (a)(1)(E)). Any portion of that debt not used for purchase or remodel is not covered by this exclusion. California has a reduced version of this exclusion limiting it to $500,000 for married couples and $250,000 for single persons and married or RDPs filing separately.

Internal Revenue Service Circular 230 requires that I inform you as follows: Any U.S. federal tax advice contained in this communication (including any attachments) is not intended to be used and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or tax-related matter(s).