

Short Sale vs. Bankruptcy

By Attorney John Skiba

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Many people in Arizona are being faced with the tough question of how to let their home go — short sale, foreclosure, or surrendering the home through bankruptcy. It is never an easy decision and sometimes the decision making process is clouded by the sentimental feelings we have for our homes. Most people I meet with are concerned not only with their financial well being but with doing the “right thing” as it pertains to their home.

Many believe that doing the “right thing” is to short sell the home rather than let it go to foreclosure or surrender it through bankruptcy. Surprisingly, it may be in your best interest to surrender the home through bankruptcy rather than go the short sale route. Here’s why:

1. If you have a second mortgage or line of credit on your home, you may still be liable for that debt even after the short sale has taken place. Unless the bank that holds the loan on your second mortgage agrees to waive the balance of what’s owed, you will likely get a demand letter shortly after your short sale demanding payment of the outstanding balance. Even worse, you will likely get sued over this balance. If you do decide to short sell your home make sure that there is language in the closing documents that relieves you of any liability on the balance. It is worth your time and money to pay for a consultation (at a place like Jackson White!) for a real estate attorney to review your closing documents. If not you may get the unpleasant surprise of a law suit after your short sale.
2. If the bank agrees to cancel or waive its right to pursue you for the balance, there is a potential for you to incur tax liability on the cancelled debt. This is particularly true if the loan was a Home Equity Line of Credit (HELOC) or a cash out refinance. Whatever the amount of debt on the loan cancelled as part of the short sale will likely show up on a 1099 form next January. The amount of debt cancelled will be treated as income for tax purposes. For instance, if the bank agrees to waive or cancel \$50,000 of the second mortgage as part of the short sale, you may have to treat that \$50,000 as income for tax purposes.

One important caveat is if the second mortgage or loan on which the debt was cancelled was actually used to purchase the home (*not* a HELOC or cash out refinance), then you may have protection from The Mortgage Forgiveness Debt Relief Act of 2007. To qualify the short sale must occur prior to December 31, 2012 and the loan must have been purchase money.

Bankruptcy can provide options that eliminate the chance to additional liability down the road.

Chapter 7 Bankruptcy

If you file for chapter 7 bankruptcy you can surrender your home through the bankruptcy case and will not have any exposure for additional amounts owed nor will you have any exposure for tax liability. If you have other debts that you need to eliminate and you plan on leaving your home a chapter 7 bankruptcy is a good option.

Chapter 13 Bankruptcy

In a chapter 13 bankruptcy you can also surrender the home and will not have any problems with future liabilities or tax consequences, and if you want to try and save your home it will allow you to bring your monthly payments current over a three to five year period. Even better, you may be able to remove a second mortgage on an upside down house completely. I have addressed that in more detail in a prior post.

Bankruptcy is by no means the solution to all problems, however you may find that it is the best option in returning your house back to the bank.

Arizona bankruptcy attorney John Skiba offers free bankruptcy consultation to discuss your specific situation. He can be contacted via email at jskiba@jacksonwhitelaw.com or at (480) 464-1111.