



Real Estate Report

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Credit Scores and Short Sales

By: Brad Gai, Audit Stockholder

There are individuals and communities in the Greater Bay Area that have been especially hard hit by the economy and the decline in real estate values. All real estate markets have been impacted. The percentage of the decline has varied significantly from community to community. The economic impact on individuals has varied significantly as well. The federal government has promoted programs to help the borrower that has defaulted on their loan. If you can still afford to pay your mortgage even though your home's value is less than the debt on the property there is no federal or state program in place for you that I am aware of. Oh yes, there is the loan modification program that the federal government has encouraged lenders to provide to borrowers, but if the borrower is making their payments why is the lender going to agree to lower the loan principal amount and the payment amount? While there have been some loan modifications, this option does not seem to be a solution for most borrowers. There are no real rules to follow as it is up to each lender to create their own guidelines and practices.

How about the credit score and short sale? This article will explain the impacts of a short sale on your credit score. I will summarize some of the information provided by the editorial staff of *first tuesday* in their article "The FICO Score Delusion" published June 3, 2010. (The FICO score is a mathematical grade that is meant to gauge a borrower's likelihood of debt repayment, provided by Fair Isaac Company or "FICO")

My theoretical couple, Mr. and Mrs. John Doe, own a home in an East Bay city with a

mortgage of \$350,000 and a current market value for the home of \$250,000. The Doe's are employed and making their loan payments on time. They are considering a "strategic" short sale of their home and evaluating what the impact will be on their credit report and consequently their ability to purchase another home. The Doe's purchased their home for \$390,000. Their home loan represents purchase money debt.

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California has nonrecourse, anti deficiency laws that have been around for 75 years. These laws affect purchase money loans for one to four unit properties. Refinance loans and home equity loans are recourse loans. The lender can pursue a deficiency judgment against the borrower but only through a judicial foreclosure. The judicial foreclosure is more expensive to pursue and takes more time than the more efficient trustee's sale. The Doe's do not have to worry about a deficiency judgment in their situation.

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payments. There are consequences for not making payments however. Will this be a personal economic disaster that will have implications for the next 10 years or more?

Foreclosures are reported on a credit report for seven years. The initial impact on the FICO score is estimated to be between 85 and 160 points. If the borrower pays all of their bills on time with respect to the rest of their credit, their credit score will rebound significantly in as little as two years. The Doe's could be eligible for a mortgage with a 20% down payment after two years. The Doe's don't want to default on their home loan and force a foreclosure of their home. They would like to arrange a short sale. The lender must approve the short sale and the time involved is much longer than a traditional sale. The impact on the Doe's credit report from a short sale is the same as if their property is sold in foreclosure. Here is the information from MyFICO.com on the impact of a short sale on the credit score.

"Credit bureau reports are limited in how they represent foreclosures today, so it's generally not possible to tell from the credit report if a reported foreclosure is a short sale, deed in lieu of foreclosure, settled account, regular foreclosure, or some other variation.

The FICO® score treats all of these descriptions that appear on credit reports as serious delinquencies, so they have an impact on the score similar to the impact from a charge off, tax lien or account included in bankruptcy."

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Capital Gains Rates

By: Jim Kohles
Audit Stockholder

The potential increase in income tax rates in 2011, particularly the capital gains rates, has created a great deal of discussion among those that analyze these things. Among the considerations is a predicted increase in the capital gains rate from 15% to at least 20%, and it could be higher. This predicted increase gives rise to the possibility of accelerating the recognition of capital gains into this year, 2010 instead of waiting until 2011 or later. The savings in the rate can exceed or at least offset the acceleration of the tax due if you assume a number of things. This is where the real conundrum begins.

If an acceleration in the payment of the tax is contemplated, how long will it take before you "break-even" on the acceleration argument? In other words, how many years must you assume you would have to wait until the time value of money exceeds the rate savings? That depends on the interest rate assumption you make and that rate has taken a dive in the last few years as rates have dropped dramatically. However, most planners will use a rate around 7%. Using that rate, it will take at least seven years to reach that magic break-even point. That means if you believe that you can defer the gain recognition for at least seven years, it is better to hold onto the asset and not sell in 2010 to take advantage of the lower rate. That is a long time to try to make the assumption about the rates remaining constant.

The situation that is very open to this analysis is an investment account with a lot of liquid stocks that generally turnover in the short run. Therefore, if you have a trading account which is managed by someone or self managed, it would be a very viable decision to "clean out" your long term capital gains toward the end of 2010 to take advantage of the lower rate. The other situations that could benefit from this analysis are long term assets that you know will have to be liquidated in the near future. For example, if you know you are going to have to liquidate an investment to cover a known expense such as tuition or a note that is coming due. Then you would benefit from an early sale at a lower rate.



Information Reporting for Rental Property Expense Payment

By: Nicholas Lawrence, Tax Senior

Did you know that hidden in the Small Business Jobs Act of 2010 is a reporting requirement that will affect most everyone who receives rental income from real estate after December 31, 2010?

This new law effectively considers an individual receiving rental income from real estate to be engaged in a trade or business of renting property. Therefore, any individual receiving rental income from real estate would be required to follow the reporting requirements of being engaged in a trade or business. This includes reporting to the government, via the appropriate information return (i.e., Form 1099), all payments made greater than \$600 in any tax year to any person and/or corporation. These payments may include payments to a gardener, maintenance person, maid, or even to a store for the purchase of supplies.

Undoubtedly, this law will increase the paperwork and filing burdens of all businesses. The general business community has been calling for the repeal of this expanded reporting provision but has yet to have any success. In an attempt to mitigate the burden and duplication of this expanded reporting, the IRS and the Treasury have proposed to exempt credit card payment purchases from the requirement.

Time will only tell if Congress will actually keep this new law in place but in the meantime anyone receiving rental income from real estate after December 31, 2010 should maintain accurate records as well as begin to gather pertinent information sooner rather than later (i.e. payees SSN and addresses). Gathering information now along with accurate record keeping will alleviate stress and make it easier to comply with the new filing requirements come tax time.

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I will not attempt to deal with the moral questions raised by a strategic default on a home loan when the borrower has the ability to continue to make the loan payments. There is also the tax implications from forgiveness of debt that should be evaluated before implementing a strategic loan default.

If the Doe's decide to just stop paying their home loan they could continue to live in their home for many months "rent free", save for a down payment on another home, and eventually locate a place to rent at what is likely to be less than their current loan payment. If they maintain their payments on all other credit obligations, do not increase their credit obligations, and generally manage their credit well, they could be in line to buy another home, perhaps in the same neighborhood, in 2 to 3 years.



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