January 13, 2009

Dear Interested Parties:

RE: Application of the Real Estate Excise Tax on “Short Sales”

Concern has been expressed about the proper application of Real Estate Excise Tax (REET) to transactions involving “short sales.” In these situations, a property owner in jeopardy of foreclosure sells his/her property to a willing buyer for less than the amount owed on the outstanding mortgage, and negotiates with the financial institution to accept the net proceeds of the sale in forgiveness of the lien against the property and, sometimes, in forgiveness of the debt owed by the seller. The Department has previously ruled that the amount of the debt forgiven by the lender must be included in the measure of the REET. After receiving extensive input from interested stakeholders and industry representatives about the nature of these transactions, we have carefully reconsidered how the REET statutes apply to these unique transactions.

Our previous interpretation focused on the fact that the forgiveness of debt can be valuable consideration in the sale of property. After considerable input from stakeholders, however, we now see that these short sales are distinguishable from other transactions involving the forgiveness of debt because the seller negotiates separately with the lender for any debt reduction/forgiveness, apart from the actual purchase and sale of the property. As a result, the loan forgiveness is not “paid or delivered in return for the sale” of the property, as required by RCW 82.45.030.

Background

Chapter 82.45 RCW imposes an excise tax on every sale of real estate in the State of Washington. All sales of real property are subject to the real estate excise tax unless specifically exempted by statute. The measure of the tax is based on the total selling price of the property conveyed. The incidence of the tax is usually on the seller. However, if the tax is not paid in full, RCW 82.45.070 provides that the tax (together with any interest and penalties) becomes a lien on the real property.

RCW 82.45.030 defines “selling price” as the “true and fair value of the property conveyed.” If property has been conveyed in an arm’s length transaction between unrelated persons for a valuable consideration, a rebuttable presumption exists that the selling price is equal to the total consideration paid or contracted to be paid to the transferor, or to another for the transferor’s
Interested Parties
January 13, 2009
Page 2

benefit. The same statute goes on to define the term “total consideration paid or contracted” to be paid as including “money or anything of value, paid or delivered or contracted to be paid or delivered in return for the sale, and shall include the amount of any lien, mortgage, contract indebtedness, or other encumbrance, either given to secure the purchase price, or any part thereof, or remaining unpaid on such property at the time of sale.” (Emphasis added.)

Stakeholder Input

On January 9, 2009, the Department held a stakeholder meeting involving more than 40 representatives of escrow agencies, title companies, realtors, attorneys, and short sale exchange facilitators. They walked us through how these transactions actually work. The seller/listing agent finds a buyer, but the lender must approve the “short sale.” Then it becomes a very complicated process. The lender will not accept a sales price below Fair Market Value, so the lender has a valuation/appraisal completed. The lender (often an out-of-state, national company) approves/disapproves of every cost and step along the way. The seller separately negotiates with the lender for any reduction/forgiveness of debt. According to the people in the industry, only about 12% of the sellers in our state actually have their debt forgiven (the rest sign a note to the bank, which is not secured by the property). Even if there is forgiveness of debt, that may not be agreed to by the lender until quite some time after the sale has closed. The terms of the agreement between the seller and the lender require that the seller receive no further consideration for the sale beyond the purchase price (which, of course, is paid over to the lender).

Therefore, these are really two separate transactions: one a purchase and sale of the real property (between buyer and seller), and one a negotiation of debt obligation between the lender and the seller. In other words, the seller did not receive debt relief in return for the sale of the property, so it is outside the definition of consideration.

Application to Short Sale Transactions

Ordinarily, if a homeowner owed $350,000 on his/her mortgage, but sold the house for $300,000, he/she would still be liable for the remaining amount due on the debt. However, in the “short sale” situation, the financial institution may agree to forgive the remaining amount it is owed. The seller has been spared upwards of $50,000 in personal liability. Alternatively, the financial institution may simply release its lien on the property, but require a personal note from the seller for repayment of the balance.
Interested Parties
January 13, 2009
Page 3

In either scenario, if the purchase price in a short sale transaction is the fair market value for the
property, the amount of the debt owed by the seller exceeding the purchase price is not deemed
consideration, because it is not paid or delivered in return for the sale of the property. The
forgiveness of debt in this case is a negotiated transaction between the seller and the financial
institution independent of the sale of the property. This important element distinguishes these
transactions from other transfers of property involving the forgiveness of debt.

This analysis is based on the facts as presented to us and if transactions involve different facts,
there may be a different result.

Refund Process

Persons who have previously paid REET on the amount of the forgiven debt in a short sale
transaction may be entitled to a refund of the excess tax paid. Forms and instructions for
requesting a refund can be found on the Department’s web site at:
http://dor.wa.gov/Docs/forms/RealEstExcsTx/RealEstExTxRefundReq.pdf

Sincerely,

Margaret J. Partlow

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