

## Taxation of Foreclosures And Short Sales in California



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# Taxation of Foreclosures And Short Sales in California

by Richard B. Malamud

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Homeowners are losing their homes to foreclosure or are resorting to short sales when default is imminent. That often creates potential taxable gain or forgiveness of indebtedness income. Some taxpayers fall within the statutory exception (up to \$500,000 if married) for gains on their principal residence.<sup>1</sup> Others may have income because the property is not their principal residence or they exceed the exclusion limitation. This article will discuss how debt forgiveness is taxed if a recourse loan is "forgiven" under a state's anti-deficiency provision.

In general, the tax treatment of foreclosures or short sales depends on whether the loan securing the property is recourse or nonrecourse. Cases, articles, and an IRS publication cover the general rules and those applicable to short sales.<sup>2</sup> Established rules provide that for recourse debt, the discharge for less than full value generally results in a combination of cancellation of indebtedness in-

come and gain on the sale depending on the amount of the loan and the basis of the property.<sup>3</sup> With nonrecourse debt, the discharge of the debt is treated as the amount realized on the sale of the property<sup>4</sup> and the transaction is treated as a sale or exchange rather than part cancellation of indebtedness income. That results in a capital gain or loss.<sup>5</sup>

Cases, articles, rulings, and even IRS publications presume that the reader knows if a debt is recourse or nonrecourse. Nothing could be further from the truth both for state law and for tax purposes. In some states, "purchase money" loans used to buy a principal residence are nonrecourse.<sup>6</sup> Those laws exist in Alaska, Arizona, California, Connecticut, Florida, Idaho, Minnesota, North Carolina, North Dakota, Texas, Utah, and Washington.<sup>7</sup> Tax

<sup>3</sup>IRC section 108. See also Adam Leamon, "Section 108 of the I.R.C. and the Inclusion of Trusts Gain: A Proposal for Reform," 50 *B.C. L. Rev.* 1243, 1249 (2009). See also David M. Fogel, "Tax Aspects of Foreclosures and 'Short Sales,'" *California CPA*, Jan./Feb. 2009, which summarizes the treatment of recourse debt forgiveness as: "Where the debt is recourse, the transaction is split into two parts:

- 1.) A taxable disposition of the property; and
- 2.) To the extent the fair market value (FMV) of the property is less than the unpaid debt, either a continuing debt obligation is owed to the lender or the remainder of the debt is discharged [reg. sec. 1.1001-2(a)(2)]. The gain or loss on the taxable disposition portion is the difference between the property's FMV and the taxpayer's adjusted basis. If the lender cancels the remainder of the debt, the borrower will have cancellation of debt income (CODI) equal to the difference between the amount of the debt and the property's FMV."

<sup>4</sup>*Allan v. Comm.*, 86 T.C. 655, 661 (1986), *aff'd*, 856 F.2d 1169 (8th Cir. 1988).

<sup>5</sup>See Martin J. McMahon and Daniel Simmons, "A Field Guide to Cancellation of Debt Income," 63 *Tax Lawyer* 415 (2010). See also, C. Barrett Pasquini, "The Tax Consequences of the Statutory Right of Redemption in Property Foreclosures," 48 *Wm. & Mary L. Rev.* 1497, 1504 (2007).

<sup>6</sup>See *Catalano v. Comm.*, T.C. Memo. 2000-82, 79 T.C.M. (CCH) 1632, footnote 6.

<sup>7</sup>See <http://www.loansafe.org/forum/foreclosure-laws/4130-recourse-v-non-recourse-states.html> for a list of states. See also Mariana E. Gomez, "Strategic Default in Anti-Deficiency

<sup>1</sup>See IRC section 108(h)(2) regarding the nonrecognition of up to \$2 million of acquisition indebtedness incurred on a principal residence which applies to both recourse and nonrecourse debt. The Mortgage Forgiveness Debt Relief Act of 2007 was extended until 2012 by the Emergency Economic Stabilization Act of 2008.

<sup>2</sup>"Tax consequences may vary depending upon whether the debt is recourse or nonrecourse, particularly in determining whether any amount realized from the foreclosure sale represents income from discharge of indebtedness." See *Great Plains Gasification Ass'n. v. Comm.*, T.C. Memo 2006-276; 92 T.C.M. (CCH) 534 (footnote 25). See also, Daniel N. Shaviv, "Risk and Accrual: The Tax Treatment of Nonrecourse Debt," 44 *Tax L. Rev.* 401, 404 (1989), Bill Bischoff, "Taxing Consequences of Short Sales: Tips for Homeowners Forced to Sell at a Price Below What Is Owed on the Mortgage," available at <http://www.SmartMoney.com>, Dec. 7, 2011, and Treasury Publication 4681, "Canceled Debts, Foreclosures, Repossessions, and Abandonments."

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law follows those statutes and treats those loans as nonrecourse loans for tax purposes. What is unclear is how to treat state “one action” laws. Those statutes prevent personal liability on recourse loans by imposing an anti-deficiency provision if a foreclosure is under the trust deed sale rather than by judicial foreclosure.<sup>8</sup> Those laws exist in California, Idaho, Montana, Nevada, New York, and Utah.<sup>9</sup> California recently enacted a statute that prevents lawsuits against a borrower if the lender agrees to a short sale.<sup>10</sup> The unanswered question for tax purposes is, do those anti-deficiency provisions make the (original) recourse loans nonrecourse for tax purposes?<sup>11</sup>

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In California the legal recourse of a trust deed lender depends on the nature of the loan and the property being secured. The following is a list of possible ways property can change hands and the legal implications based on the transaction.<sup>12</sup> Some involve recourse loans, some nonrecourse, and some are forgiven under the state’s anti-deficiency statutes:

- “Purchase money” loan of a personal residence (up to four units) in California is nonrecourse.<sup>13</sup>

States,” which discusses the legal, but not tax questions involved, available at <http://apps.americanbar.org/buslaw/committees/CL230000pub/newsletter/201004/gomez.pdf> (last accessed July 29, 2012).

<sup>8</sup>Darren Conley, Comment, “The Sanction for Violation of California’s One-Action Rule,” 79 *Cal. L. Rev.* 1601, 1607 (1991).

<sup>9</sup>See <http://www.securedloanshelp.com/non-recourse-loans.html>.

<sup>10</sup>California CCP section 580e, effective Jan. 1, 2011.

<sup>11</sup>Belan Wagner, Minna Yang, and Jordan Lui, “Home Mortgage Forgiveness in California and the Related Income Tax Consequences,” *Cal. Tax Law.*, Spring 2012, 4, 6.

<sup>12</sup>This is not intended to be a complete list of possibilities, but rather a list of common situations that illustrate various tax possibilities.

<sup>13</sup>California CCP section 580b provides in part:

Section 580b. Conditions under which deficiency judgment forbidden

No deficiency judgment shall lie in any event after a sale of real property . . . for failure of the purchaser to complete his or her contract of sale, or under a deed of trust or mortgage given to the vendor to secure payment of the balance of the purchase price of that real property . . . under a deed of trust or mortgage on a dwelling for not more than four families given to a lender to secure repayment of a loan which was in fact

(Footnote continued in next column.)

- Refinancing of a purchase money loan converts it into a recourse loan.<sup>14</sup>
- If the loan isn’t on a personal residence it is generally a recourse loan, even if it is purchase money, unless the contract states that it is nonrecourse.
- If the lender forecloses on a recourse loan there are several possibilities:
  - The lender goes through a judicial foreclosure and it is treated as a recourse loan, and a deficiency judgment can be obtained against the borrower.
  - The lender takes the property (not just residences) under the deed of trust — California’s anti-deficiency statute, California Code of Civil Procedure (CCP) section 580d, prevents a deficiency judgment, in effect making the loan a nonrecourse loan.<sup>15</sup>
- If a lender agrees to the borrower’s short sale proceeds as the exclusive remedy, California’s new anti-deficiency statute makes the loan, in effect, a nonrecourse loan.<sup>16</sup> To qualify as a

used to pay all or part of the purchase price of that dwelling occupied, entirely or in part, by the purchaser.

See also Jamie O. Harris, “California Code of Civil Procedure Section 580b Revisited: Freedom of Contract in Real Estate Purchase Agreements,” 30 *San Diego L. Rev.* 509, (1993). See also *Larson v. Comm.*, 66 T.C. 159, 167 (1976), stating that the loan was nonrecourse under section 580b.

<sup>14</sup>See Carol Burns, “Will Refinancing Your Home Mortgage Risk Your Life Savings?: Refinancing and California Code of Civil Procedure Section 580b,” 43 *UCLA L. Rev.* 2077 (1996). Many borrowers are unaware of the nonrecourse nature of the purchase money loan or the recourse nature of the refinancing. They learn about it only when the property is foreclosed and they are told of the different tax treatments.

<sup>15</sup>California CCP section 580d provides:

Section 580d. Deficiency judgment after foreclosure under power of sale

No judgment shall be rendered for any deficiency upon a note secured by a deed of trust or mortgage upon real property or an estate for years therein hereafter executed in any case in which the real property or estate for years therein has been sold by the mortgagee or trustee under power of sale contained in the mortgage or deed of trust. . . .

Those types of laws are known as one action laws, because the lender has one action, either judicial foreclosure or taking under the trust deed. The lender can’t do both.

<sup>16</sup>California CCP section 580e provides in part:

Section 580e. Deficiency under note secured solely by deed of trust or mortgage; Sale for less than remaining amount of indebtedness due; Written consent of holder . . . Waiver (a)

(1) No deficiency shall be owed or collected, and no deficiency judgment shall be requested or rendered for any deficiency upon a note secured solely by a deed of trust or mortgage for a dwelling of not more than four units, in any case in which the trustor or mortgagor sells the dwelling for a sale price less than the remaining amount of the indebtedness outstanding at the time of sale, in accordance with the written consent of the

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nonrecourse short sale, CCP section 580e provides effective January 1, 2011, that no deficiency judgment can be rendered on short sales if the written consent of the “holder of the deed of trust or mortgage” is obtained as long as:

- the loan is secured by a dwelling<sup>17</sup> of not more than four units,
- the title is transferred by recorded conveyance, and
- the proceeds are tendered to the mortgagee.

Should those two anti-deficiency statutes be treated for federal income tax purposes as the forgiveness of nonrecourse or recourse loans? That is an issue because although there is no personal liability after the sale, immediately before the trust deed action or short sale, the loans are recourse loans. Afterward, no recourse is permitted. Because the tax treatment differs depending on whether the borrower is personally liable, the question seems to be, when is that determination made — immediately before the transaction or immediately after?

***The tax status of the debtor's personal liability is important because the different tax treatment benefits some and hurts others.***

The tax status of the debtor's personal liability is important because the different tax treatment benefits some and hurts others. When recourse debt is canceled, the resulting cancellation of indebtedness income<sup>18</sup> generally is taxed as ordinary income up to the highest marginal tax rates, unless it is not

taxable because the taxpayer is bankrupt or insolvent.<sup>19</sup> That is a good thing if the debtor is broke or nearly so.<sup>20</sup> Nonrecourse debt forgiveness may be preferable if the taxpayer isn't insolvent or bankrupt, because it results in long-term capital gain income that is currently taxed at much lower rates (15 percent) than ordinary income (35 percent) for federal purposes.<sup>21</sup> Also, if the taxpayer has capital losses, they can be used to offset capital gains but they cannot be used to offset cancellation of indebtedness income. Whether a taxpayer would prefer the debt to be recourse or nonrecourse will depend on whether the taxpayer is bankrupt or insolvent, unless it is the sale of a principal residence for which other exclusions may apply<sup>22</sup> or investment property for which it may not matter.<sup>23</sup>

In trying to determine if anti-deficiency provisions should be treated as recourse or nonrecourse, the history of nonrecourse loans for tax purposes is not very helpful. In the 1960s nonrecourse financing

<sup>19</sup>IRC section 108(a)(1)(A) and (B).

<sup>20</sup>Even an incomplete discussion of cancellation of indebtedness income and the exceptions is beyond the scope of this article. For more details, see IRS Publication 4681, “Canceled Debts, Foreclosures, Repossessions, and Abandonments,” available at <http://www.irs.gov/pub/irs-pdf/p4681.pdf>.

<sup>21</sup>California capital gains are taxed at the same rate as ordinary income. See “The California FTB Tax News for Tax Professionals, Foreclosure and Short Sales,” available at [https://www.ftb.ca.gov/professionals/taxnews/2009/July/Article\\_9.shtml](https://www.ftb.ca.gov/professionals/taxnews/2009/July/Article_9.shtml).

<sup>22</sup>The Mortgage Forgiveness Debt Relief Act of 2007 was enacted on December 20, 2007, and it is scheduled to expire on Dec. 31, 2012. It provides for the exclusion of up to \$2 million of “qualified principal residence indebtedness” when there are modifications of the terms of the mortgage or foreclosure on a principal residence. See also IRC section 121, which provides an exclusion of \$250,000 if single and \$500,000 if married filing jointly on the sale of a principal residence if its conditions are met.

<sup>23</sup>The distinction is probably not relevant if a foreclosure involves business or investment property, such as an investor's apartment house. Suppose an apartment house is bought for \$1 million with \$100,000 down and a loan of \$900,000. Several years later, when the accumulated depreciation is \$50,000 and the property is worth \$700,000, there is a foreclosure. If the loan is treated as a recourse loan, the forgiveness of indebtedness income is \$200,000 but the section 1231 loss is \$250,000. The net taxable loss is \$50,000. If instead the loan is treated as a nonrecourse loan under the anti-deficiency statute, the sales price is \$900,000 less the basis of \$950,000, resulting in a section 1231 loss of \$50,000. In either case, the net result is a \$50,000 deductible loss. The same is not true when the asset is a personal rather than an investment asset. If the property were a second home, no loss would be allowed because losses are not allowed if the property is not business or investment property. Thus, cancellation of indebtedness income would be taxable, but no loss would be allowed to offset it.

holder of the deed of trust or mortgage, provided that both of the following have occurred:

(A) Title has been voluntarily transferred to a buyer by grant deed or by other document of conveyance that has been recorded in the county where all or part of the real property is located.

(B) The proceeds of the sale have been tendered to the mortgagee, beneficiary, or the agent of the mortgagee or beneficiary, in accordance with the parties' agreement.

<sup>17</sup>It does not appear that the term “dwelling” is defined. In another Chapter of California law, CC section 1940(c) states that “Dwelling unit” means “a structure or the part of a structure that is used as a home, residence, or sleeping place by one person who maintains a household or by two or more persons who maintain a common household.” It would seem that a second home or a rental property would meet that definition if used, even occasionally as a (part-time) household. If the Legislature had intended another meaning it could have used the term “principal residence” or made a reference to full-time residents.

<sup>18</sup>IRC section 61(a)(12). If there is cancellation of indebtedness income (COD), it may be nontaxable under the forgiveness of indebtedness exceptions under IRC section 108. See Jack F. Williams, “Rethinking Bankruptcy and Tax Policy,” 3 *Am. Bankr. Inst. L. Rev.* 153, 156-158 (1995).

began to appear in tax shelters.<sup>24</sup> The first mention of the term was in 1976 with the introduction of the at-risk rules of section 465.<sup>25</sup> It wasn't until 1983 that the U.S. Supreme Court decided *Comm. v. Tufts*,<sup>26</sup> which increased the awareness of the recourse and nonrecourse loan forgiveness issues and made them a planning tool.<sup>27</sup>

The Internal Revenue Code does not provide a definition of recourse or nonrecourse loans. The partnership regulations are unhelpful, even if relevant (because they probably apply only to partnership issues). Section 1.752-1(a) provides that:

- (1) Recourse liability defined. A partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability . . .
- (2) Nonrecourse liability defined. A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability.

The IRS has published some guidance on its website. "Non-recourse loans: A non-recourse loan is a loan for which the lender's only remedy in case of default is to repossess the property being financed or used as collateral. That is, the lender cannot pursue you personally in case of default."<sup>28</sup> The problem is that the timing of that determination is not mentioned. If it is before the nonjudicial foreclosure or agreed-to short sale, the loan is recourse. If it is simultaneous with the event, the loan is nonrecourse.

Another less than helpful regulation is reg. section 1.1001-2, example 8, which states that if a taxpayer transfers an asset worth \$6,000 to the creditor in satisfaction of a recourse debt of \$7,500, there is discharge of indebtedness income of \$1,500. What doesn't follow is an example with an anti-deficiency statute. There also appear to be no revenue rulings or even private letter rulings on the subject, even though those situations occur fairly often.

A similar situation to an anti-deficiency statute is when a recourse loan is converted into a nonrecourse loan by mutual agreement of the parties. One article states:

It is not uncommon to find that a lender is willing to convert a recourse loan into a nonrecourse loan. . . . The proper result, however, is

that the debtor has realized a financial benefit or "accession to wealth" only to the extent the amount of the debt exceeds the fair market value of the property securing the debt. Thus, in effect, the debt has been satisfied to the extent of the fair market value of property received in exchange therefor.<sup>29</sup>

That analysis is consistent with reg. section 1.1001-3, which provides rules for determining whether a modification of the terms of a debt instrument results in an exchange for purposes of IRC section 1001. It states that a change in the nature of a debt instrument from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse) is a significant modification, which therefore makes that a taxable event.<sup>30</sup> If applicable, that would appear to create two taxable events. The first would be the ordinary income resulting from the conversion of the loan from recourse to nonrecourse. The second would be the sale or exchange of the underlying property for the amount of the nonrecourse debt.<sup>31</sup>

There are two reasons why that may not be the correct tax treatment. First, anti-deficiency statutes are different from restructuring a loan because the parties have not agreed to make a recourse loan nonrecourse. The loan becomes nonrecourse by operation of law when judicial foreclosure is not used or when a qualifying short sale is approved by the lender. Although possibly instructive, the regulation doesn't specifically cover anti-deficiency statutes. Second, the regulation does not apply if the instrument continues to be secured only by the original collateral, if the change does not result in a modification in payment expectations.<sup>32</sup> That is often the case in California, where CCP section 580d provides that "a creditor who resorts to his real property security by exercising the power of sale contained in a deed of trust may not obtain a deficiency judgment."<sup>33</sup> Thus, the creditor gives up nothing by converting a recourse loan to nonrecourse when the lender never looked to the personal liability of the lender in the first place or didn't at the time of the conversion.<sup>34</sup>

One article seems to say that the anti-deficiency statutory protection doesn't change the tax nature of

<sup>24</sup>Joseph W. Blackburn, "Important Common Law Developments for Nonrecourse Notes: Tufting It Out," 18 *Ga. L. Rev.* 1, 1 (1983).

<sup>25</sup>See Fredrick H. Robinson, "Nonrecourse Indebtedness," 11 *Va. Tax Rev.* 1, 3 (1991).

<sup>26</sup>*Comm. v. Tufts*, 461 U.S. 300 (1983).

<sup>27</sup>Blackburn, *supra* note 23 at 2.

<sup>28</sup>See <http://www.irs.gov/uac/Home-Foreclosure-and-Debt-Cancellation> (last accessed Aug. 30, 2012).

<sup>29</sup>Fred T. Witt and William H. Lyons, "An Examination of the Tax Consequences of Discharge of Indebtedness," 10 *Va. Tax Rev.* 1, 20-21 (1990). Footnotes omitted.

<sup>30</sup>Reg. section 1.1001-3(f).

<sup>31</sup>Calculation of the income, gain, or loss and basis of the new loan are beyond the scope of this article.

<sup>32</sup>Reg. section 1.1001-3(f)(2).

<sup>33</sup>*Walker v. Community Bank*, 10 Cal. 3d 729; 736, 111 Cal. Rptr. 897, 901 (1974). Cal Code Civ Proc section 580d.

<sup>34</sup>If the debtor had assets worth pursuing, why would the debtor agree to proceed under the anti-deficiency provision? The answer may be that the time and cost of a judicial

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the debt. It concludes: “it will probably be recourse debt” for tax purposes, even though a sale will prevent a deficiency judgment personally against the debtor.<sup>35</sup> Coming to the same conclusion, another article states: “the better view is that CCP section 580e does not convert the note from recourse to non-recourse, but merely extinguishes the debt on completion of the short sale.”<sup>36</sup> It is interesting that the footnote to that quote says that the difference in sections 580d and 580e “could lead to the conclusion that CCP section 580e converts the Home Mortgage to a non-recourse debt. There are no decided cases on this point.”<sup>37</sup>

One author comes to the opposite conclusion, stating, without citation to authority, “If the anti-deficiency statutes (in Arizona) apply to preclude the lender from pursuing the borrower for a deficiency, the debt is nonrecourse and in that case no COD income is recognized. Instead, the borrower is treated as having sold the property for the amount of

the nonrecourse indebtedness, realizing gain or loss.” Later the author may have backed off a bit, stating, “Where the lender is barred from suing under Arizona’s anti-deficiency statutes, the debt would presumably be treated as nonrecourse for tax purposes, . . . but surprisingly there is no direct authority for this in the Internal Revenue Code or regulations.”<sup>38</sup>

### Conclusion

Foreclosures and short sales in California are often subject to the state’s anti-deficiency provisions. The effect is that the borrower has, for legal purposes, nonrecourse debt at the time of the foreclosure. What isn’t clear is whether the forgiveness is also treated as nonrecourse for tax purposes. Those who have potential taxable income from debt forgiveness and want better guidance will have to wait for Congress or the IRS to act or more likely for a court decision. Unfortunately, the best answer for now is probably, “This should be discussed with your tax adviser.” ☆

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foreclosure exceeds the amount of the debtor’s personal assets. If that’s the case, it is unclear how that would affect this provision.

<sup>35</sup>See <http://www.timkelly.com/COD%20DISCUSSION.htm>.

<sup>36</sup>Wagner, et al., *supra* note 10 at 8.

<sup>37</sup>*Id.* at 8.

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<sup>38</sup>See Robert E. Ciancola, “Income Tax Effects of Foreclosures and Short Sales in Arizona (2011),” available at <http://ciancolaw.net/INCOME%20TAX%20EFFECTS%20OF%20FORECLOSURES%20AND%20SHORT%20SALES%20IN%20ARIZONA.html>.