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.1 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.2 Established rules provide that for recourse debt, the discharge for less than full value generally results in a combination of cancellation of indebtedness income and gain on the sale depending on the amount of the loan and the basis of the property.3 With nonrecourse debt, the discharge of the debt is treated as the amount realized on the sale of the property4 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.5

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.6 Those laws exist in Alaska, Arizona, California, Connecticut, Florida, Idaho, Minnesota, North Carolina, North Dakota, Texas, Utah, and Washington.7 Tax

1See 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.


4See http://www.loansafe.org/forum/foreclosure-laws/1137-recourse-v-non-recourse-states.html or for a list of states. See also Mariana E. Gomez, “Strategic Default in Anti-Deficiency (Footnote continued on next page.)
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. Those laws exist in California, Idaho, Montana, Nevada, New York, and Utah. California recently enacted a statute that prevents lawsuits against a borrower if the lender agrees to a short sale. The unanswered question for tax purposes is, do those anti-deficiency provisions make the (original) recourse loans nonrecourse for tax purposes?

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. 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.
- Refinancing of a purchase money loan converts it into a recourse loan.
- 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.

- 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. 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.

- 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.

- California CCP section 580e 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.

- 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

(Footnote continued in next column.)

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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 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. When recourse debt is canceled, the resulting cancellation of indebtedness income 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. That is a good thing if the debtor is broke or nearly so. 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. 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 or investment property for which it may not matter.

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

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.”

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.

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. 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.

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. 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.”

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.

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

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27 Blackburn, supra note 23 at 2.
30 Reg. section 1.1001-3(f).
31 Calculation of the income, gain, or loss and basis of the new loan are beyond the scope of this article.
32 Reg. section 1.1001-3(f)(2).
34 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 (Footnote continued on next page.)
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.35 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.”36 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.”37

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 foreclosure exceeds the amount of the debtor’s personal assets. If that’s the case, it is unclear how that would affect this provision.38 See http://www.timkelly.com/COD%20DISCUSSION.htm.

36Wagner, et al., supra note 10 at 8.
37Id. at 8.

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.”