Short Sales as Nonrecourse Mortgages

by Kathleen K. Wright

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In this article, Wright describes the tax benefits that new state and federal guidance on short sales could have for taxpayers who have a nonrecourse mortgage.

Short sales in states that have enacted anti-deficiency statutes can now be treated as nonrecourse mortgages if the state statute bars collection of a deficiency balance by the lender after the borrower and lender agree that the lender will accept a loan payoff for less than what is owed on the mortgage and release the lender’s security interest in the property. In a letter from the IRS to U.S. Sen. Barbara Boxer, D-Calif., released to the public in November 2013, the IRS concluded that an obligation involved in a short sale would be treated as a nonrecourse obligation under California Code of Civil Procedure (CCP) section 580e for federal income tax purposes.1 This disclosure was followed by a letter from California Franchise Tax Board Chief Counsel Jozel Brunett to California State Board of Equalization member George Runner, dated December 4, 2013, wherein the FTB stated that they would conform to the federal guidance. This result could provide significant tax benefits to clients who engaged in a short sale of their homes.

The Tax Benefits of Default On a Nonrecourse Mortgage

The tax treatment of a default on a mortgage depends on whether the loan is characterized as recourse or nonrecourse. For federal and California purposes, a nonrecourse loan means that the lender has no recourse against the borrower for any deficiency in satisfying the full amount of the indebtedness other than taking possession of the underlying property. In this case for both federal and California tax purposes, the borrower will be treated as having sold the property for the amount of the outstanding debt or the fair market value of the property, whichever is greater. Therefore, if the borrower has gain on the transaction, the borrower must include the gain in gross income unless the borrower qualifies for the exclusion that applies to the gain on the sale of some principal residences. If borrowers qualify for the exclusion that applies to gain realized on the sale of a principal residence, they would be able to exclude the gain on sale if the amount is less than $500,000 (married filing joint) or $250,000 (single).2

If the loan is recourse, meaning that the borrower may be personally liable for the deficiency that remains after the sale of the property, the borrower may have gain on the short sale to the extent that the fair market value exceeds the borrower’s basis in the property sold. The borrower may also have cancellation of indebtedness income to the extent that the debt balance exceeds the FMV of the property.

Under IRC section 61(a)(12), cancellation of indebtedness income is fully taxable as ordinary income, unless an exception applies. Congress has provided an exception that allows homeowners who have cancellation of indebtedness income on the sale of a principal residence to exclude the canceled debt from income if it is qualified principal residence indebtedness. However, this exception will expire for federal purposes at the end of 2013.3 California also enacted a similar exception; however, the California exception expired at the end of 2012 and has not been extended through 2013.4 For federal purposes, if the borrower does not qualify under the qualified principal residence exception in 2013, the insolvency exception may be the next best alternative.

The California Anti-Deficiency Statutes

The California Anti-Deficiency statutes are located in CCP sections 580b, 580d, 580e, and 726. Those statutes preclude a lender from collecting a deficiency from the borrower in excess of the value of the real property that secures the loan.

CCP Section 580b: Purchase Money Mortgages

Under CCP section 580b, a lender is prohibited from seeking a deficiency judgment against a borrower if the borrower incurred the loan for the sole purpose of purchasing a home that is a “dwelling” of not more than four units and that is occupied by the borrower as a principal residence.

1California Code of Civil Procedure section 580e.
2IRC section 121 and Calif. Revenue and Taxation Code section 17152.
3IRC section 108(a)(1)(E) and 108(h).
4Calif. Revenue and Taxation Code section 17144.5.
States of Mind

The “anti-deficiency” statute was expanded for credit transactions executed on or after January 1, 2013, with the enactment of CCP section 580b(c). This provision states that no deficiency judgment shall be allowed for any loan, refinance, or other credit transaction that is used to refinance a purchase money loan, except to the extent that the lender advances new principal that is not applied to pay off the original mortgage. Previously, CCP section 580b did not exempt borrowers from personal liability for real property-secured loans made to refinance purchase money loans. Section 580b now provides this protection to homeowners for loans executed on or after January 1, 2013, to refinance purchase money loans; however, such protection does not extend to any money taken out of the refinancing (that is, new principal) that is not applied to the preexisting debt on the prior purchase money loan or to fees, costs, or related expenses of the refinancing.

Although the IRS letter addresses CCP section 580e (short sales), the letter does state that if a property owner can’t be held personally liable for the difference between the loan balance and the sales price, the IRS would consider the obligation a nonrecourse obligation. This implies that purchase money mortgages that have been refinanced will continue to be viewed as nonrecourse mortgages at least up to the amount of the original mortgage.

**CCP Section 580d: Nonjudicial Foreclosure**

CCP section 580d prohibits a lender from pursuing a deficiency judgment after that lender forecloses on the property through a nonjudicial foreclosure process. In a nonjudicial foreclosure, the lender does not have to go to court in order to foreclose on the property. This is because the borrower has typically signed two documents, a promissory note and a deed of trust. The deed of trust turns the borrower’s obligation over to the lender in order to foreclose the property. The deed of trust authorizes the lender to foreclose on the property if the borrower defaults. The deed of trust typically allows the foreclosure to proceed outside court, under state law. The lender gives the borrower notice and then places the property up for sale.

**Example:** Joey purchased his home many years ago for $100,000 in San Francisco. He has owned the home for more than 20 years and has refinanced his original mortgage several times and used the money for home improvements, debt repayment, college tuition, a car, and numerous other expenditures. As of December 2013, Joey owes approximately $475,000 and the house is worth approximately $200,000. Joey has been laid off from his job and has gone into default on his mortgage. In a few months, Joey’s lender will begin the foreclosure process. More likely than not, the lender will pursue a nonjudicial foreclosure and may well have the home sold a few months later. If the home sells for $375,000, the lender is prohibited from pursuing collection of the deficiency against the borrower (under CCP section 580d).

Because the lender is prohibited by state law from proceeding against the borrower for the deficiency, the loan should be treated as a nonrecourse loan for federal and state tax purposes.

**CCP Section 580e: Short Sales**

In September 2010, the California State Legislature added CCP section 580e that prohibited any deficiency judgment for a short sale involving a first deed of trust. In July 2011, the Legislature expanded that prohibition to include short sales of dwellings regarding any deed of trust. The statute is limited to a short sale of a dwelling of not more than four units and applies only when the short sale is in accordance with the written consent of the lender. The provision does not apply if the borrower is a corporation, limited liability company, limited partnership, or political subdivision of the state.

Since the original version of CCP section 580e did not address second mortgages or home equity lines of credit, California enacted SB 458, which extended the anti-deficiency provisions to second mortgages. Therefore, secondary lien holders are prohibited from pursuing a deficiency judgment against any homeowner that receives written pre-approval for a short sale on a residence of one to four units that closes escrow after July 15, 2011. The anti-deficiency protection for short sales now applies to purchase money loans, refinance loans, and home equity credit lines secured by one to four residential unit properties. For such refinances, the anti-deficiency protection for short sales applies to all types of refinance loans, regardless of whether the borrower refinanced to obtain a lower interest rate only or took cash out to make home improvements, to pay off credit cards, or for any other purpose.

It is this situation that was addressed in the letter sent by the IRS Office of Associate Chief Counsel to Boxer, which stated that the homeowner’s obligation under the anti-deficiency provision of CCP section 580e is a nonrecourse obligation for federal income tax purposes, clarifying that the homeowner will not have cancellation of indebtedness income on the short sale.

**Effective Date**

In general, short sale agreements executed before January 1, 2011 (the effective date of CCP section 580e), and its subsequent amendment on July 11, 2011, would not be covered under the anti-deficiency protection provided by those provisions. Therefore, tax returns that may have reported short sales as recourse debt (with cancellation of indebtedness income) could file amended returns and report as nonrecourse debt for short sales agreed to after January 1, 2011 (or July 11, 2011).

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Stats. 2010, ch. 701 (SB 931).
Stats. 2011, ch. 82 (SB 458).
However, taxpayers who entered into short sales before January 1, 2011, may still be able to treat the release from liability on the mortgage as a nonrecourse debt under *Coker v. JP Morgan Chase Bank, N.A.*,7 a case of first impression.

In *Coker*, the Fourth District Court of Appeal held that CCP section 580b protects the defaulting borrower following a short sale, and that the lender could not enforce an agreement that purported to allow it to hold the borrower liable for a deficiency. The court of appeal reversed a San Diego Superior Court judgment dismissing Carol Coker’s declaratory action against JPMorgan Chase Bank (Chase). The California Supreme Court has agreed to hear this case.

Coker purchased a San Diego home with a $452,000 loan from a now-defunct mortgage company, whose interest was succeeded to by Chase. After the housing bubble burst in 2008, she defaulted. Coker found a willing buyer and asked Chase to approve a short sale. Chase agreed to release its security interest on condition that Coker remain liable for any deficiency.

After the sale closed, the bank sent a letter demanding that Coker pay more than $116,000 to satisfy the loan. Coker responded by filing the declaratory action, asking the court to determine that CCP section 580b and 580e, as well as common law, barred the bank from collecting any deficiency.

The superior court dismissed the action, finding that section 580b — barring any deficiency judgment “after a sale of real property . . . under a deed of trust or mortgage given to the vendor to secure payment of the balance of the purchase price” — does not apply to short sales, and that section 580e — barria deficiency judgment in the case of a short sale of a residence — does not apply if the sale took place before that section became operative in July 2011. The judge also rejected the argument that deficiency judgments in such cases violate the common law.

But Justice Richard Huffman, in his July 23 opinion for the court of appeal, said the trial judge’s interpretation of section 580b was incorrect. The language of section 580b applies to “a sale” and does not suggest any legislative intent to limit its application to foreclosures. Applying the law to short sales, he added, serves the twin purposes behind the Depression-era legislation — stabilizing home prices and encouraging home purchases by protecting buyers against the risk of losing assets, other than the home itself, if values drop.

The Legislature, he said, recognized this three years ago when it enacted section 580e, the purpose of which — according to legislative history — was to clarify that a deficiency judgment is not permissible following a short sale, even if the loan was not for purchase money. The protections of CCP section 580e (specific to short sales) did not apply to this borrower because the statute is not retroactive, and the borrower’s agreement predated its effective date. However, the borrower’s loan was a purchase money loan.

The court of appeal concluded that section 580b applies and that Coker’s agreement to remain liable for any deficiency is unenforceable. It interpreted the existing statute broadly, as a matter of public policy to shift the risk of falling property values onto the lender. It believed the protection is needed to stabilize property sales and keep from aggravating an economic downturn. Further, the court held that a borrower cannot agree to waive anti-deficiency protections. Allowing a borrower to waive anti-deficiency protection, the court explained, would be contrary to the statute and to public policy.

If this case is upheld, taxpayers with short sales on purchase money mortgages in years before 2011 in which the statute of limitations is still open might also consider filing amended returns and reporting short sales under the provisions that govern nonrecourse loans.

### Filing Amended Returns

In the immediate time frame, it may be appropriate to file amended returns both for federal and state purposes for tax years beginning on or after January 1, 2011. This is because the qualified principal residence exclusion did not exclude all debt forgiveness if the loan was treated as a recourse loan.

The federal exclusion applies to qualified discharges occurring on or after January 1, 2007, and before January 1, 2014.8 In order to be qualified, the indebtedness must be acquisition indebtedness with a $2 million dollar limit (MFJ). The limit is $1 million for a married taxpayer filing a separate return.

Acquisition indebtedness is indebtedness incurred in the acquisition, construction, or substantial improvement of the residence. The indebtedness must be secured by the residence. Refinancing of this indebtedness is also considered acquisition indebtedness but only to the extent that the amount of refinancing does not exceed the debt being paid off.9 Principal residence means, in general, being owned and used by the taxpayer as a principal residence for periods aggregating two years or more during a relevant five-year period.10

If only part of the discharged loan was qualified principal residence indebtedness, the exclusion from gross income is limited. The amount excluded is limited to the excess of the amount discharged over the amount of indebtedness that was not qualified.11

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8IRC section 108(a)(1)(E).
9IRC section 163(h)(3)(B).
10IRC section 108(h)(5).
11IRC section 108(h)(4).
California conformed to IRC section 108(a)(1)(E) with some exceptions. For tax years beginning on or after January 1, 2007, and before January 1, 2013, a taxpayer could exclude qualified principal residence indebtedness up to $800,000 ($400,000 MFS) instead of the federal limit of $2 million; and the maximum cancellation of debt income exclusion was limited to $500,000 ($250,000 for MFS). The federal exclusion did not have a limit on the amount of canceled debt that could be excluded.

**Example:** In 2005 Nancy (single) purchased a principal residence for $435,000. Nancy took out a $420,000 mortgage loan to buy the principal residence and made a down payment of $15,000. The loan was secured by the principal residence. In 2006 Nancy took out a second mortgage loan in the amount of $30,000 that was used to substantially improve her kitchen. In 2010, when the outstanding principal of the first and second mortgage loans was $440,000, Nancy refinanced into one recourse loan in the amount of $475,000. She used the excess $35,000 to pay off personal credit card debt. Nancy has qualified principal residence indebtedness in the amount of $440,000 because the refinanced debt is qualified principal residence indebtedness only to the extent the amount of debt does not exceed the amount of refinanced debt.

In 2011, when the FMV of the property dropped to $325,000, Nancy decided to stop making payments on her mortgage and move to a smaller place because she was having trouble meeting expenses, though she was not insolvent. Ultimately, the lender agreed to allow a short sale of the property for its FMV of $325,000 and to cancel the remaining $150,000 of debt.

For federal tax purposes, Nancy reported the transaction as a short sale with recourse debt. Therefore, she reported the following:

| Amount realized | $475,000 |
| Basis of the property | ($465,000) |
| Gain on sale | $10,000 |

The gain on sale could be excluded for both federal and state purposes because Nancy lived in the house as a principal residence for more than two out of the last five years. Nancy should file an amended return and claim a refund for the tax year 2011 for both federal and state purposes. The transaction qualifies under CCP section 580e that applies to deficiency on a note secured solely by a deed of trust or mortgage for a dwelling of not more than four units.

**Example:** Several years ago, Kathy and Frank got married and entered into a contract to build for $3 million a house in California, to be used as their principal residence. They took out a $2.6 million mortgage loan to build the home and put down the remaining $400,000. In 2011 they refinanced the mortgage for $2.6 million to get a better interest rate. In November 2012, when the outstanding principal balance on the mortgage loan was $2.5 million, the FMV of the property fell to $1.75 million and they decided to sell the property and take their losses.

Because they could not sell the property for the amount of the mortgage, they approached their lender to see if the lender would release their mortgage lien on the property for less than full payment of the mortgage. The lender agreed to take $1.75 million and cancel the remaining debt balance. Kathy and Frank sell their house for $1.75 million in 2013 and remit the sales price to the lender.

The portion of the debt reduction that can be excluded is the excess of the amount that does not qualify as qualified principal residence debt (or $35,000). This is not qualified principal residence debt, because it was used to pay off personal credit cards. Thus, Nancy can exclude only $115,000 of the canceled debt as qualified principal residence debt ($150,000 - $35,000) and must recognize $35,000 as canceled debt income.

The result will be the same for California income tax purposes. The amount of qualified residence debt is less than $800,000, and the amount of debt forgiveness excluded is less than $500,000.

If the loan were treated as a nonrecourse loan for tax purposes (under the IRS letter described above and CCP section 580e), the result would be as follows:

| Amount realized | $475,000 |
| Basis of the property | ($465,000) |
| Gain on sale | $10,000 |

The gain on sale could be excluded for both federal and state purposes because Kathy and Frank lived in the house as a principal residence for more than two out of the last five years. Kathy should file an amended return and claim a refund for the tax year 2011 for both federal and state purposes. The transaction qualifies under CCP section 580e that applies to deficiency on a note secured solely by a deed of trust or mortgage for a dwelling of not more than four units.

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If the debt forgiveness were viewed as the release from liability from a recourse mortgage, a problem ensues because the amount of the mortgage exceeds the maximum mortgage amount allowable as qualified residence indebtedness.

The amount of the mortgage ($2.5 million) exceeds the maximum mortgage balance eligible for exclusion under

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12Calif. Revenue and Taxation Code section 17144.5.

13IRC section 121.
IRC section 108(h)(2) or $2 million. Under IRC section 108(h)(4), the portion of the discharged debt that does not qualify as qualified principal residence debt is treated as being discharged first. In this example, $500,000 does not qualify as qualified principal residence debt; therefore, $250,000 (750,000 - $500,000) is eligible for exclusion under the qualified principal residence debt exclusion.

For California purposes, there is no exclusion because Calif. Revenue and Taxation Code section 17144.5 has expired and has not been renewed for 2013. Further, even if the exclusion were reinstated for 2013, Calif. Revenue and Taxation Code section 17144.5 provided that the maximum exclusion is based on debt of no more than $800,000. California conformed to IRC section 108(h)(4), which required that the nonqualified debt be deemed to be discharged first. This means that the COD income of $750,000 is reduced by $1.7 million ($2.5 million - $800,000). The result would be that none of the debt forgiveness would be eligible for the exclusion provided under Calif. Revenue and Taxation Code section 17144.5.

If the transaction qualifies as a release from liability from a nonrecourse debt, the result changes dramatically.

<table>
<thead>
<tr>
<th>Amount realized on sale</th>
<th>$2,500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis in the property</td>
<td>($3,000,000)</td>
</tr>
<tr>
<td>Loss on sale</td>
<td>($500,000)</td>
</tr>
</tbody>
</table>

Although the loss on sale of a principal residence is not deductible, there is no income recognition under this alternative for either federal or state purposes.

**Other States**

Not all states have anti-deficiency statutes. There are 11 states that are classified as “non-recourse,” in that there is a bar on collection of a deficiency balance after a foreclosure. None of those state statutes appear to be as broad as the statute enacted by California. Each states statute is different and has to be closely analyzed to determine what it covers and how much protection is afforded borrowers. The states that have anti-deficiency statutes include Alaska, Arizona, Iowa, Minnesota, Montana, North Carolina, North Dakota, Oregon, Washington, and Wisconsin.

**Conclusion**

The IRS has indicated that a redacted version of the letter to Boxer will be posted on the IRS website soon. However, the format of this type of guidance (an informal letter from the IRS to a U.S. senator) leaves something to be desired as a reliance document that constitutes “substantial authority.” Nonetheless, the document should provide a reasonable basis for taking the position that a short sale involves a nonrecourse loan on both the federal and California return (coupled with disclosure).

14Alaska Stat. Ch. 09.45.
16Iowa Ch. 654.6.
17Minn. Stat. 582.
18Montana Code Ann. Tit. 71, Ch. 1.
20N.D. Cent. Code Ch. 32-19-01.
21Ore. Ch. 88.
22Wash. Stat. Tit. 61, Ch. 61-12.