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INFORMATION LETTER NOTICE 2013-0036 AND WHY CALIFORNIA'S ANTI-DEFICIENCY STATUTES CONVERT RECOURSE DEBT TO NONRECOURSE DEBT[1]

This proposal was written by Douglas L. Youmans and N. Aaron Johnson. The authors wish to thank reviewers, Layton L. Pace and Theresa R. Clardy, for their valuable insight and thoughtful comments and assistance.

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[1] The comments contained in this paper are the individual views of the authors who prepared them, and do not represent the position of the State Bar of California, the Los Angeles County Bar Association, or Wagner Kirkman Blaine Klomparens & Youmans, LLP.

[2] Although the authors and/or presenters of this paper may have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been engaged by a client to participate on this paper.

EXECUTIVE SUMMARY

In response to a letter Senator Boxer sent to the Internal Revenue Service (the "Service") last year, requesting clarification as to whether a short sale conducted pursuant to California Code of Civil Procedure ("CCP") §580e resulted in cancellation of indebtedness ("COI") income, the Service issued Information Letter Number 2013-0036 ("ILN 2013-0036"). ILN 2013-0036 states, "We believe that a homeowner's obligation under the anti-deficiency provision of section 580e of the CCP would be a nonrecourse obligation to the extent that, for federal income tax purposes, the homeowner will not have cancellation of indebtedness income. Instead, the homeowner must include the full amount of the nonrecourse indebtedness in amount realized."[3]

On April 29, 2014, the Service issued a clarification of ILN 2013-0036 ("4/29 Clarification") which stated that they had been overly broad in, "… extending our analysis of the federal tax treatment of obligations beyond those [purchase money obligations] described in section 580b(a)(3)."

The authors believe that the position the Service took in ILN 2013-0036 is supported by a plethora of cases following *Crane*[4] and *Tufts*[5] which distinguish *recourse* from *nonrecourse* debt based on whether the debtor is subject to a deficiency judgment at the time the debt is discharged.

The authors further believe that the position adopted in ILN 2013-0036 should not be limited to short sales conducted pursuant to CCP §580e. Rather, ILN 2013-0036's analysis should be extended to other anti-deficiency statutes and "reinforced" by issuance of some sort of "substantial authority" concluding that, to the extent an anti-deficiency statute eliminates a debtor's personal liability with respect to a debt following the disposition of any collateral securing that debt, the debt should be treated as *nonrecourse* at the time of the disposition which triggers application of the anti-deficiency statute.

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[3] ILN 2013-0036.
[4] *Crane v. Comm'r*, 331 U.S. 1 (1947).
[5] *Comm'r v. Tufts*, 461 U.S. 300 (1983).

DISCUSSION

I. BACKGROUND

As evidenced by Senator Boxer's August 28, 2013 letter to Daniel Werful, acting Commissioner of the Internal Revenue Service (the "Service"), taxpayers, their tax return preparers and counsel (collectively, the "Tax Practitioner Community") and others have long struggled with the tax consequences flowing from the discharge of debt secured by real property, particularly if there is a disposition of any real property security in conjunction with and as consideration for all or any portion of that discharge of debt (hereinafter, property held as security for a debt may be referred to as "Collateral"). Part of the confusion could be attributable to the fact that, for purposes of ascertaining the tax consequences of such a discharge, different rules apply depending on, among other things, whether the debtor is personally liable for the debt, whether the debtor disposes of all or any portion of the Collateral in conjunction with and as consideration for all or any portion of that discharge and whether the outstanding loan balance immediately preceding the discharge exceeds the value of the Collateral at the time of its disposition.[6]

Adding to the confusion created by the alternative outcomes which could flow from any particular "mix" of the aforementioned variables is the fact that a number of states, California being one of them, have adopted what are often referred to as "anti-deficiency" statutes. Those statutes effectively preclude a creditor from pursuing a debtor for collection of any "deficiency judgment" if the value of any Collateral ends up being less than the outstanding loan balance at the time the debt is discharged.[7] Moreover, the mortgage crisis and dramatically declining home prices prompted Congress to enact the Mortgage Forgiveness Debt Relief Act of 2007,[8] which added §108(a)(1)(E) to the Internal Revenue Code of 1986 (as amended, the

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[6] *See Comm'r v. Tufts*, 461 U.S. 300, 307, 310 (1983); *Gershkowitz v. Comm'r*, 88 T.C. 984 (1987); 2925 *Briarpark, Ltd. v. Comm'r*, 73 T.C.M. (CCH) 3218 (1997); and *Danenberg, v. Comm'r*, 73 T.C. 370 (1979).

[7] A "deficiency judgment" is a personal judgment against the debtor-mortgagor for the difference between the fair market value of the property held as security and the outstanding indebtedness. *Cornelison v. Kornbluth*, 15 Cal. 3d 590, 542 P.2d 981, 125 Cal. Rptr. 557 (1975), *citing* Cal. C.C.P. §726.

[8] Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142.

"IRC"). IRC §108(a)(1)(E) excluded from gross income, income realized prior to January 1, 2010, as a result of the discharge of "qualified principal residence indebtedness ("QPRI"),"[9] regardless of whether any such discharge occurred as a result of a short sale, deed in lieu, foreclosure, or simply a refinance. Because the housing market took longer than expected to "recover," the Emergency Economic Stabilization Act of 2008,[10] extended the original January 1, 2010 sunset date to January 1, 2013, and the American Taxpayer Relief Act of 2012,[11] further extended it to January 1, 2014.[12]

Questions with respect to how IRC §108(a)(1)(E) interacts with one of California's anti-deficiency statutes (California Code of Civil Procedure ("CCP") §580e) appear to have prompted Senator Boxer to send the aforementioned August 28, 2013 letter (the "Boxer Letter"), requesting an answer to the following question: "Would a household realize a cancellation of debt if a lender elected to approve a short sale, which by operation of the state's law would mandate a discharge of recourse debt (as California's Civil Code Section 580e does), and at which time the borrower is released from personal liability on the indebtedness secured by the mortgage?"

On September 19, 2013**,** Michael J. Montemurro, Associate Chief Counsel of the Service, responded to the Boxer Letter (the "9/19 Response"), stating that, "We believe that a homeowner's obligation under the anti-deficiency provision of section 580e of the CCP would be a nonrecourse obligation to the extent that, for federal income tax purposes, the homeowner will not have cancellation of indebtedness income. Instead, the homeowner must include the full amount of the nonrecourse indebtedness in amount realized."

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[9] Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, §2, 121 Stat. 1803, 1803-04 (2007).

[10] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, §303, 122 Stat. 3765, 3807 (2008).

[11] American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313 (2013).

[12] As so amended, IRC §108(a)(1)(E) now reads as follows: "(a)(1) Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if . . . (E) the indebtedness discharged is qualified residence indebtedness which is discharged before January 1, 2014." I.R.C. §108(a)(1)(E). There had already been an amendment extending the sunset date of the provision to January 1, 2013. *See* Pub. L. No. 110-343, §303(a), (2008).

The Service released the 9/19 Response to the public in November 2013, and adopted it as Information Letter Number 2013-0036 on December 27, 2013 ("ILN 2013-0036").

While the California Tax Practitioner Community has debated the impact of ILN 2013-0036, and the soundness of the logic on which it is premised, groups such as the California Association of Realtors have circulated it among their members and questioned whether the statement contained therein that CCP §580e has effectively "converted" what might have appeared to be *recourse* debt to *nonrecourse* debt can and should be "extended" to all anti-deficiency legislation.[13]

On April 29, 2014, Mr. Montemurro, on behalf of the Service, issued a clarification of ILN 2013-0036 ("4/29 Clarification") which stated that the analysis in ILN 2013-0036 was "overly broad." Correctly reading CCP §580b(a)(3) to mean that, ". . . a lender has no recourse against a homeowner for a deficiency following either a foreclosure or a lender-approved short sale when the mortgage secures a purchase money loan described in section 580(b)(3)" (emphasis added), the 4/29 Clarification goes on to say,

> "Consequently, for federal income tax purposes, a purchase money loan between a lender and mortgagor that is described in section 580b(a)(3) is, from its inception, a nonrecourse loan. Therefore, upon the foreclosure or short sale of a principal residence when a mortgage secures such a purchase-money loan, the amount realized on the sale is determined under *Commissioner v. Tufts*, 461 U.S. 300 (1983).… Section 580b(a)(3) of the CCP applies only to purchase-money loans to acquire a principal residence. Section 580e, however, applies to both purchase-money loans and non-purchase-money loans, and applies to property that may or may not be the taxpayer's principal residence. Non-purchase-money loans subject to California's anti-

[13] On December 4, 2013, California Franchise Tax Board ("FTB") Chief Counsel Jozel Brunett sent a letter to California State Board of Equalization ("BOE") member George Runner, stating that the FTB would conform to the Service's position set forth in the 9/19 Response, enhancing the debate.

> deficiency statutes generally appear to be recourse loans from their inception. We were overly broad in our prior response in extending our analysis of the federal tax treatment of obligations beyond those described in section 580b(a)(3)." (Emphasis added.)

Senator Boxer responded to the 4/29 Clarification on May 21, 2014 ("Boxer Letter #2"), seeking further clarification, particularly with respect to the Service's change of position.[14] As of the date of this paper's submission, the Service has not responded to Boxer Letter #2.

Since the authors believe ILN 2013-0036 clearly follows *Crane*,[15] *Tufts*[16] and their progeny,[17] and the 4/29 Clarification inappropriately and unreasonably narrows ILN 2013-0036's scope (purportedly by distinguishing among anti-deficiency statutes that are not really different), this paper is intended to explain not only how ILN 2013-0036 is supported by both California's anti-deficiency legislation and federal tax law, but why the position the Service took in ILN 2013-0036 should be expanded and expressed in some format which is considered "Substantial Authority" (such as a Revenue Ruling).[18]

II. TREATMENT OF RECOURSE AND NONRECOURSE DEBTS

To understand why the authors believe ILN 2013-0036 clearly follows *Crane*,[19] *Tufts*[20] and their progeny,[21] one must understand the

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[14] Boxer Letter #2 sought clarification with respect to: (i) whether "purchase-money" debt is the same as "acquisition" debt; (ii) whether a reduction in principal balance of a purchase money loan would result in COI; and (iii) the Service's position with respect to homeowners who completed a short sale in reliance on ILN 2013-0036 before its scope was narrowed by the 4/29 Clarification.

[15] *Crane v. Comm'r,* 331 U.S. 1, 67 S.Ct. 1047 (1947).

[16] *Comm'r v. Tufts,* 461 U.S. 300 (1983).

[17] *See Briarpark,* 73 T.C.M. (CCH) 3218; *see also Danenberg,* 73 T.C. 370 (1979), among numerous others.

[18] With formal guidance, the Tax Practitioner Community and the Service can more efficiently and cost effectively prepare and process tax returns reporting the income realized when debt is discharged on the closing of a transaction subject to any one of California's anti-deficiency statutes (which statutes effectively preclude creditors from obtaining deficiency judgments after any such closing).

[19] *Crane,* 331 U.S. 1, 67 S.Ct. 1047 (1947).

[20] *Tufts,* 461 U.S. 300 (1983).

various factors impacting the determination of the amount and character of any income realized as a result of a discharge of debt. Accordingly, this paper shall analyze the rules which apply: (i) when a debtor is nongratuitously discharged from all or a portion of a debt and retains the Collateral; (ii) when a debtor sells or disposes of Collateral in conjunction with the discharge of a debt; (iii) when the FMV of any Collateral transferred in connection with a discharge of debt becomes relevant; (iv) when the character of the debt discharged in conjunction with a disposition of Collateral becomes relevant; and (v) when some of California's anti-deficiency statutes (like CCP §580e) become relevant.[22] That analysis shall begin with a review of the definitions of the terms "*recourse*" and "*nonrecourse*."

Historically, the Service and the Tax Practitioner Community have distinguished "*recourse*" debt from "*nonrecourse*" debt based on whether the debtor is personally responsible to repay the underlying obligation. If the debtor is personally responsible to repay the obligation, the debt is characterized as *recourse* debt.[23] Alternatively, a debt the debtor is not personally responsible to repay is characterized as *nonrecourse* debt.[24] As shall be discussed in greater detail below,[25] the authors believe that this "shorthand" approach to the characterization of debt as *recourse* or *nonrecourse* causes confusion when one attempts to determine the amount and character of the income realized when debt is discharged. Possibly more significantly, the authors believe that all those who have seriously considered the issue distinguish *recourse* from *nonrecourse* debt

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[21] *See Briarpark,* 73 T.C.M. (CCH) 3218 (1997); *see also Danenberg,* 73 T.C. 370 (1979), among numerous others.

[22] Anti-deficiency statutes in other states which operate the same way as California's should give rise to the same tax analysis/treatment. As the authors practice in California, they have not undertaken an analysis of any other state's anti-deficiency statutes. Hence, they offer no comment with respect to whether any such statutes operate the same way California's do, or whether the implementation/operation of any such other affiliates will give rise to a similar tax analysis or result.

[23] Although §1001 and its regulations do not define the terms "recourse" or "nonrecourse," these are the generally accepted definitions. By contrast, these terms are defined for purposes of §752 where a partnership liability is "recourse" to the extent that any partner or related person bears the economic risk of loss for that liability. However, the concepts under §752 do not necessarily apply to §1001.

[24] *Tufts*, 461 U.S. 300, 302 (1983) ("[N]either the partnership nor its partners assumed any personal liability for repayment of the loan."); *Gershkowitz*, 88 T.C. 984 (1987) ("Generally, a debtor defaulting on a nonrecourse loan would merely surrender the collateral to the creditor in exchange for cancellation of the debt.")

[25] See section IV, *infra*, regarding California's anti-deficiency legislation.

based on whether the debtor is subject to a "deficiency judgment" at the time the debt is being discharged. If the debtor is subject to a deficiency judgment at the time the debt is discharged, the debt should be characterized as "*recourse*." If the debtor is not subject to a deficiency judgment at the time the debt is discharged, the debt should be characterized as "*nonrecourse*."[26]

The next step of our analysis involves a review of the "Rules" used to determine the amount and character of the income realized when debt is discharged:

> ***A. Rule 1:*** *When a debtor is nongratuitously discharged from all or a portion of a debt but retains the Collateral securing repayment of the debt, the debtor realizes COI income unless the creditor sold the Collateral to the debtor in the transaction giving rise to the debt and the creditor's security interest in the Collateral.*[27]

Kirby Lumber set the precedent that cancelled debt (freed assets) must be included in a taxpayer's gross income.[28] In *Kirby,* a corporation issued bonds to raise capital, then bought some of the bonds back at a discount. The Supreme Court found the corporation realized a "clear gain" by freeing assets that would have otherwise had to have been used to pay off the bonds.[29]

Under IRC §61(a)(12), a taxpayer realizes income when a creditor nongratuitously discharges all or a portion of a taxpayer's debt.[30]

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[26] *See Aozora Bank, Ltd. v. 1333 North Cal. Blvd*., 119 Cal.App.4th 1291, 1295 (2004): "In a nonrecourse loan . . . the borrower has no personal liability and the lender's sole recourse is against the security for the obligation;" *see also* Cal. Health & Safety Code §50960: "[A] loan that is not secured by real property and is made to a person, not including a firm, association, partnership, organization, corporation, limited liability company, or other group, however formed, . . . is a recourse obligation and the personal property of the borrower may be subject to or sold pursuant to a lien in order to pay the obligation."

[27] *U.S. v. Kirby Lumber Co.,* 284 U.S. 1 (1931); *Gershkowitz v. Comm'r*, 88 T.C. 984 (1987).

[28] *Kirby Lumber Co.,* 284 U.S. 1 (1931).

[29] *Id.* at 3.

[30] *See Briarpark,* 73 T.C.M. (CCH) 3218 (1997); *see also* Treas. Regs. §1.61–12(a).

In *Gershkowitz,* a reviewed opinion following the *Tufts* holding (that income results when a taxpayer is discharged from liability for an undersecured *nonrecourse* obligation upon the disposition of the Collateral), the Tax Court held that the discharge of a portion of the liability for an undersecured *nonrecourse* obligation through a cash settlement results in income. However, the Board of Tax Appeals had consistently held that, when a debtor held Collateral subject to *nonrecourse* debt incurred in consideration of the purchase of the Collateral, discharge of that debt did not result in income. Instead, the Collateral's basis was reduced by the amount of debt discharged.[31] This "purchase price/basis reduction exception" applied only where the debtor retained the Collateral following the discharge of the debt.[32]

Even though the Tax Court has generally rejected the "purchase price/basis reduction exception" in cases where the creditor was not the seller of the Collateral securing the *nonrecourse* debt,[33] the authors have been unable to find a case where a debtor who was the buyer of the Collateral securing a *nonrecourse* debt must recognize COI income on a partial discharge of that debt (in lieu of making a purchase price/basis adjustment). In fact, to the contrary, dicta in several cases has suggested that, while the current case law rejects the "purchase price/basis reduction exception," the rejection does not apply to debtors who finance the purchase of Collateral securing a *nonrecourse* debt.[34]

Moreover, while the Service cited *Gershkowitz* in Revenue Ruling 91-31, holding that COI income results when a debtor is discharged from all or part of a *nonrecourse* liability by a creditor who was not the seller of the Collateral, the Service was careful to note that the discharge was realized by a debtor who had not bought the Collateral from the creditor, presumably because the "reduction in

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[31] *Hotel Astoria, Inc. v. Comm'r*, 42 B.T.A. 759 (1940); *Fulton Gold Corp. v. Comm'r*, 31 B.T.A. 519 (1934); *American Seating Co. v. Comm'r*, 14 B.T.A. 328 (1928), rev'd on other grounds, 50 F.2d 681 (7th Cir. 1931).

[32] Contrast situations where the debtor transferred the Collateral in satisfaction of the debt, under which circumstances the courts have consistently required the debtor to realize gain or loss from that sale or exchange, rather than COI income or a purchase price/basis reduction**.** *See also Tufts*, 461 U.S. 300 1983); *Delman Est. v. Comm'r*, 73 T.C. 15 (1979).

[33] *Gershkowitz v. Comm'r* 88, T.C. 984 (1987); *Comm'r v. Tufts,* 461 U.S. 300 (1983). Accord, *Cozzi v. Comm'r*, 88 T.C. 435 (1987).

[34] *Parker Props. Joint Venture v. Comm'r*, T.C. Memo 1996-283; *Gershkowitz*, 88 T.C. 984 (1987)**.**

purchase price exception" applies when a discharge is realized by a debtor who bought the Collateral for a *nonrecourse* loan from the creditor/seller at the time the debt was incurred.[35]

In summary, unless the "purchase price/basis reduction exception" applies, if the debtor retains the Collateral at the time of the discharge, all debt discharged is generally treated as COI income.[36] Conversely, if the "purchase price/basis reduction exception" applies, the Collateral's basis is reduced by the amount of debt discharged.[37] While that seems simple enough, what happens if the debtor disposes of the Collateral at the time of the discharge?

> ***B.*** ***<u>Rule 2</u>:*** *When a debtor sells or disposes of Collateral in conjunction with the discharge of a debt, IRC §1001 applies and the taxpayer may realize a gain or loss from the transaction.*[38]
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> "Gross income includes discharge of indebtedness, sec. 61(a)(12), and gains derived from dealings in property, sec. 61(a)(3) . . .) For purposes of section 61(a)(3), section 1001 and the regulations thereunder govern the method by which the amount of gain or loss realized upon a sale or disposition of property is calculated. The amount of gain realized is the excess of the amount realized over the taxpayer's adjusted basis in the property, and the amount of loss realized is the excess of the adjusted basis over the amount realized. Sec. 1001(a). The '*amount realized*' is defined by section 1001(b) as the sum of any money received plus the fair market value of the property received. Section 1.1001-2(a)(1), Income Tax Regs., further defines '*amount realized*':

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[35] Rev. Rul. 91-31, 1991-1 C.B. 19.

[36] While COI income is usually ordinary income, because IRC §1001 is inapplicable where an asset is retained upon the discharge of a debt, I.R.C. §108 may allow a taxpayer to defer the recognition of COI income generated by the transaction. *See* I.R.C. §108(a).

[37] *See note 24, supra*.

[38] I.R.C. §1001(a); *see Tufts,* 461 U.S. at 317.

> Except as provided in paragraph (a)(2) and (3) of this section, the *amount realized* from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.
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> Various methods exist by which indebtedness may be satisfied, each method producing a different tax consequence. *Danenberg v. Commissioner*, 73 T.C. 370, 381 (1979). Whether the realized income is gain on the disposition of property or COI income depends on the particular facts. *Id.*"[39] (Emphasis added.)

According to *Briarpark* and *Danenberg*, where a taxpayer sells or disposes of Collateral upon the discharge of a debt the analysis is not as simple as calculating gain or loss under IRC §1001. Rather, one must look at all the facts and circumstances and analyze the other factors alluded to above because the characterization of the income realized (as either IRC §61(a)(3) gain or IRC §61(a)(12) COI) can depend on whether the borrower is personally liable for the debt (i.e., whether the debt is *recourse* or *nonrecourse*) and, if so, whether the fair market value ("FMV") of the Collateral is more or less than the loan balance at the time of the discharge.[40]

> ***C. Rule 3:*** *When a debtor transfers Collateral in connection with a discharge of debt and the FMV of the Collateral is not less than the amount of debt being discharged, the debtor does not realize COI income (under IRC §61(a)(12)). Instead, the "deemed" sale of the Collateral gives rise to IRC §61(a)(3) gain (or loss) calculated under IRC §1001.*[41]

Generally, because the debt can be satisfied by a sale of the Collateral when the Collateral's FMV is not less than the debt, the debtor does not realize COI income when debt is discharged in conjunction with/as part of a sale or other disposition of the Collateral

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[39] *Briarpark,* 73 T.C.M. (CCH) 3218 (1997), at 10-11.
[40] *Id.; see also Danenberg,* 73 T.C. 370 (1979).
[41] *See Tufts,* 461 U.S. at 307-10; I.R.C. §1001(a); *Briarpark,* 73 T.C.M. (CCH) 3218 (1997); *and Danenberg,* 73 T.C. 370 (1979).

irrespective of whether the debt is *recourse* or *nonrecourse*. In other words, regardless of whether the debtor is personally liable for repayment of the debt, the "deemed" sale which occurs when the debtor disposes of the Collateral in discharging the debt gives rise to IRC §61(a)(3) gain (or loss) calculated under IRC §1001.[42]

> ***D. Rule 4:*** *When a debtor disposes of Collateral encumbered by nonrecourse debt, the debtor does not realize COI income (under IRC §61(a)(12)). Instead, the "deemed sale" of the Collateral gives rise to IRC §61(a)(3) gain (or loss) calculated under IRC §1001.*[43]

The origins for this treatment of *nonrecourse* debt lie in the U.S. Supreme Court's 1947 decision in *Crane v. Commissioner,*[44] which established that the value of a *nonrecourse* debt must be included in both the taxpayer's basis on acquisition of an asset and the amount realized on disposition of that asset.[45] A question left unanswered by *Crane* was how to treat the disposition of debt encumbered property having a value less than the outstanding value of the *nonrecourse* debt.[46] The U.S. Supreme Court addressed that issue in *Commissioner v. Tufts*,[47] which held that the amount realized upon a sale or other disposition of Collateral subject to a *nonrecourse* debt included the outstanding balance due on the *nonrecourse* obligation, notwithstanding the FMV of the Collateral.[48] The *Tufts* Court concluded that when a debtor sells or disposes of Collateral to a purchaser who assumes the debt, the extinguishment of that debt must be accounted for in the computation of the amount realized on the disposition because the debtor who has been relieved of responsibility to repay the debt and has realized value to the extent of the relieved debt.[49] And because the amount realized bears a functional relation to

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[42] *See* I.R.C. §1001(a); *Tufts,* 461 U.S. at 307-10.
[43] *See Crane,* 331 U.S. 1; *Tufts,* 461 U.S. at 307-10; I.R.C. §1001(a); *Briarpark,* 73 T.C.M. (CCH) 3218 (1997); *and Danenberg,* 73 T.C. 370 (1979).
[44] *Crane,* 331 U.S. 1.
[45] *Id.* at 6-11, 13-14.
[46] *See Tufts,* 461 U.S. at 307-310.
[47] *Id.* at 307.
[48] *See Tufts,* 461 U.S. at 309.
[49] *Id.* at 308-09; I.R.C. §1001(b).

basis, the *Tufts* Court concluded that any debt included in basis must be included in the amount realized on disposition of the property.[50]

In contrast, when a debtor disposes of Collateral encumbered by *recourse* debt, the Collateral's FMV will affect the way the Service characterizes the income realized.[51] We learned from Rule 3, above, that when Collateral is disposed of and its FMV is not less than the amount of debt being discharged, the debtor does not realize COI income. Rule 5 provides the corollary.

> ***E. Rule 5:*** *A debtor disposing of Collateral encumbered by a recourse debt which is in excess of the FMV of the Collateral will realize part IRC §61(a)(12) COI income and part IRC §61(a)(3) gain (or loss) calculated under IRC §1001.*[52]

With *recourse* debt, the Service bifurcates the transaction into a taxable disposition of property and a separate disposition of debt.[53] The taxpayer's amount realized upon disposition of the Collateral is limited to the property's FMV.[54] Pursuant to IRC §1001, the taxpayer's adjusted basis is then subtracted from the amount realized to produce gain or loss.[55] The taxpayer also realizes COI income in that amount equal to the difference between the outstanding debt and the lesser FMV of the Collateral.[56]

Now that we have reviewed the "Rules," let's look at how they interact with and are impacted by California's anti-deficiency statutes.

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[50] *See Tufts,* 461 U.S. at 307-309.
[51] *Id.* at 310.
[52] *Tufts,* 461 U.S. at 307-10; *Briarpark,* 73 T.C.M. (CCH) 3218; *and Danenberg,* 73 T.C. 370.
[53] *See Tufts*, 461 U.S. at 307-10; Treas. Regs. §1.1001-2(a)(2) & (c)(ex. 8).
[54] *See Tufts,* 461 U.S. at 307-10; *Est. of Delman v. Comm'r*, 73 T.C.15, 27-28 (1979); Treas. Regs. §1.1001-2(a)(2) & (c)(ex. 8).
[55] *See* I.R.C. §1001 (2006); *Tufts,* 461 U.S. at 307-10; *Delman,* 73 T.C. at 27-28.
[56] *See* I.R.C. §108(a)(1)(B); *Tufts,* 461 U.S. at 310; *Delman,* 73 T.C. at 27-28; Treas. Regs. §1.1001-2(c)(ex.8). As we saw under Rule 3, above, if the FMV of the Collateral equals or exceeds the amount of debt discharged, no COI results because the Collateral "repays" the creditor in full.

III. CALIFORNIA'S ANTI-DEFICIENCY STATUTES

California, like other states, has a "one form of action" rule.[57] Put simply, California's "one form of action" rule requires a creditor to choose only one form of legal "action" to collect a debt which is secured by real property. The effect is that, in general, if a creditor elects to proceed against any real property Collateral (i.e., collect the debt by foreclosing on the Collateral), at the closing of the (foreclosure) sale, the creditor will be precluded from pursuing a deficiency judgment against the debtor unless the creditor has elected to pursue the foreclosure judicially.[58] As described in somewhat greater detail below, California's anti-deficiency statutes generally preclude certain creditors from pursuing deficiency judgments with respect to certain purchase money mortgages, seller-finance mortgages, nonjudicial foreclosures, and short sales.

A. Purchase Money Mortgages--CCP §580b

Under CCP §580b as it was originally enacted, a creditor was prohibited from seeking a deficiency judgment against a debtor after a sale if the debtor incurred the loan for the sole purpose of purchasing a dwelling of not more than four units and occupied at least one of those four units as a principal residence (a "dwelling"). Such loans are referred to in California and herein as "purchase money mortgages." For credit transactions executed on or after January 1, 2013,[59] CCP §580b(b) was enacted, similarly precluding deficiency judgments after any sale with respect to a loan, refinance or other credit transaction used to refinance a purchase money mortgage except to the extent that the creditor advances "new" principal ("new" meaning principal which is in excess of the amounts necessary to pay off the prior (purchase money) loan and all fees, costs, or related expenses of the refinancing).

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[57] Cal. Civ. Proc. Code §726.

[58] Alternatively, if the creditor elects to proceed against the debtor, the sanction for violating the "one form of action" rule is forfeiture of the lien on the [real property] security. However, the violation does not discharge the debt and the creditor may pursue recovery of the debt as an unsecured creditor. Edmund L. Regalia, Deeds of Trusts and Mortgages, 4 MILLER & STARR CALIFORNIA REAL ESTATE, § 10:178 at 544-545 (3rd ed. 2003).

[59] Cal. Civ. Proc. Code §580b(c).

B. Seller Financing--CCP §580b

Section 580b also prevents a seller/lender from seeking a deficiency judgment against a buyer/debtor after a sale where the seller/lender both: (i) sold property to the buyer/debtor on installment payment terms; and (ii) secured the loan by the property sold. The effect of this part of CCP §580b is that, while a seller/lender can pursue recovery of the Collateral if there is a default, if they opt to do so, their rights to recovery are limited to the Collateral.

C. Nonjudicial Foreclosures--CCP §580d

CCP §580d prohibits a creditor from pursuing a deficiency judgment after that creditor forecloses on real property Collateral through a nonjudicial foreclosure process.

In order to understand how CCP §580d operates, one must understand that a lender looking to foreclose can usually do so in either one of two ways: (i) by way of nonjudicial foreclosure pursuant to a private power of sale; or (ii) by judicial foreclosure. In a nonjudicial foreclosure, the creditor does not have to go to court because the debtor has typically signed two documents, a promissory note and a deed of trust. The deed of trust creates a lien securing the debt and, if the debtor defaults, authorizes the creditor to foreclose on the Collateral (outside of court) pursuant to a private power of sale. Lenders usually foreclose by way of private power of sale not only because it is quicker and less expensive than undertaking the sort of lawsuit required to conduct a judicial foreclosure, but because the debtor has a right to redeem the Collateral (buy it back) if the lender judicially forecloses, whereas no such right of redemption exists if the lender pursues a nonjudicial foreclosure (through a private power of sale).

D. Short Sales[60]--CCP §580e

To extend anti-deficiency protections beyond the purchase money mortgages covered by CCP §580b and afford similar protection to nonpurchase money mortgages,[61] in September 2010, California enacted CCP §580e, which prohibits deficiency judgments following short sales of dwellings involving first deeds of trust when those short sales are conducted by an individual debtor[62] with the written consent of the creditor.[63] In July 2011, CCP §580e was amended to prohibit deficiency judgments following short sales of dwellings where any deed of trust is released with the consent of the lender.[64]

IV. TAX EFFECTS OF THE CALIFORNIA ANTI-DEFICIENCY STATUTES

ILN 2013-0036 essentially states that, because CCP §580e causes the debt to be a *nonrecourse* obligation for federal income tax purposes, the debtor would not have COI income as a result of a short

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[60] In short sales, homeowners bargain for a settlement whereby a lender accepts less than the full amount owed on a sale to a third party (or for the relinquishment of the Collateral). *See* Francie Cohen Spahn, *Deeds in Lieu of Foreclosure*, 26 No. 4 Prac. Real Est. Law. 47, 47-48 (July 2010). In return for generating such a sale or for returning the Collateral to the lender in acceptable condition, lenders often waive their right to collect the difference between the amount owed on the debt at the time of the sale and the amount actually realized through a short sale or foreclosure auction (that difference being referred to as a "deficiency"). Some states limit a lender's ability to pursue a homeowner personally to collect a deficiency. *See* GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW §8.3 (5th ed. 2007); *see also* Weinstein v. Rocha, 145 Cal. Rptr. 3d 93, 95-97 (Ct. App. 2012) (discussing California's anti-deficiency statute). Possibly because of the volume of defaults during the recent housing crisis, lenders have opted to use short sales in lieu of foreclosing because foreclosures often result in higher carrying costs and, in some cases where the property lies vacant, vandalism and waste. In contrast, the debtor usually continues to occupy the dwelling during the short sale process, paying for utilities, taxes and insurance, maintaining the property and minimizing exposure to vandalism and waste, etc. because the property is not vacant.

[61] Stats. 2010, ch. 701 (SB 931). As the Assembly floor analysis expressly states: "According to the author … [t]he purpose of this proposed legislation is primarily to protect distressed homeowners who have non-purchase money recourse loans on residential property..." Sen. Bill No. 931, 2 (2009-2010 Reg. Sess.) (Sen. Floor Analyses, 3rd reading) (as amended June 2, 2010). The Legislature further made clear that Senate Bill No. 931 "seeks to clear up any legal confusion between purchase money and non-purchase money loans in regards to short sales … ." *Id.* at 4.

[62] Cal. Civ. Proc. Code §580e does not apply if the debtor is a corporation, limited liability company, limited partnership, or political subdivision.

[63] Stats. 2010, ch. 701 (SB 931).

[64] Stats. 2011, ch. 82 (SB 458). The original enactment of CCP §580e only afforded anti-deficiency protection to "first" deeds of trust. The July 2011 amendment extended it to "any" deed of trust, comprehensively including "seconds," "thirds," etc.

sale conducted under that anti-deficiency statute (i.e., after the short sale is completed). As any analysis of the tax consequences of a discharge of debt has to start at the time of the discharge (i.e., at the time of the event giving rise to the income), whether the position taken in ILN 2013-0036 is correct will depend on the rights of the debtor and the creditor at the time the short sale closes, as that sale is the taxable event giving rise to the income to be characterized. Under CCP §580e, after a short sale has closed the creditor cannot pursue a deficiency judgment, meaning that the debtor no longer has any personal liability. Using the aforementioned "shorthand" definitions of *recourse* and *nonrecourse* debt, a debt with respect to which a debtor no longer has any personal liability is *nonrecourse*. Noteworthy in this analysis is that whether a debt being discharged in a short sale was *recourse* immediately before the closing of the short sale is irrelevant—it is the rights and obligations of the parties upon the closing (at the time the taxable event takes place) which dictate how any income realized as a result of that taxable event should be characterized and reported.[65] In other words, the determination of whether a loan is *recourse* or *nonrecourse* must be made at the time a taxable event has taken place; not at the time the loan is made.

Under the facts presented in ILN 2013-0036, the debt in question is discharged on the closing of the short sale.[66] That closing

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[65] Under IRC §451(a), for cash method taxpayers, the amount of any item of income is included as gross income for the taxable year in which it was received. If the taxpayer uses the accrual method of accounting, income is includible in gross income in the tax year in which all events have occurred that determine a taxpayer's right to receive it, and the amount thereof can be determined with reasonable accuracy. Treas. Regs. §1.451-1(a).

[66] The determination of whether a loan is *recourse* or *nonrecourse* must be made at the time a taxable event has taken place; not at the time the loan is made. The Tax Court has stated that whether a debt has been discharged is dependent upon the substance of the transaction. *See Briarpark,* 73 T.C.M. (CCH) 3218, *citing Cozzi v. Comm'r*, 88 T.C. 435, 445 (1987). A debt is considered to be discharged at the point when it becomes clear that it will never have to be paid. *Id.* This reasoning is in line with courts which have held that, in determining whether an asset is capital, one of the relevant questions is whether the taxpayer, at the time of the sale, held the property for sale in the ordinary course of his business. *See Martin v. U.S.*, (1971, DC GA) 28 AFTR 2d 71-5001, 330 F. Supp. 681, 71-1 USTC ¶9468. In *Thompson v. Comm'r*, the court stated that what may start out as a liquidation of an investment may become something else. *Thompson v. Comm'r*, 322 F2d 122, 63-2 USTC ¶9676, (1963). In essence, what matters is the character of the gain at the time when the transaction occurred that gave rise to the tax. (*Id.*) If at the end of the day, the debt is treated as *nonrecourse* because the debtor is no longer personally liable to pay it, it is immaterial how the debt may have been treated when loan was made. (Prior to the enactment of CCP §580b(c), the California Tax Practitioner Community clearly understood that, if a debtor refinanced a purchase money loan with a new lender that had been the

is the taxable event giving rise to the income to be characterized, and that income should be characterized at the time that taxable event occurs.[67] Stated conversely, if there is no taxable event, there is no income tax impact. More specifically in the context of a short sale, if a short sale is not closed (and debt is not discharged as a result thereof), there is no income to report (no IRC §61(a)(3) gain, nor any IRC §61(a)(12) COI).

This logic is supported by *Crane*, *Tufts* and their progeny, and applies with equal force to any taxable event subject to any and all of California's anti-deficiency statutes as they are all "structured" the same in the sense that not one of them precludes a deficiency judgment until after some sort of sale has occurred. In other words: (i) the Service's suggestion in the 4/29 Clarification that CCP §580b(a)(3)'s prohibition against pursuit of deficiency judgments after a sale should be treated differently than any of the other anti-deficiency statutes' prohibitions against pursuit of deficiency judgments after sales or foreclosures draws a distinction in tax effect when there is no substantive difference in the statutes; and (ii) the logic and analysis behind ILN 2013-0036 should not be limited in its application to those CCP §580e short sales involving CCP §580b purchase money loans when the same prohibition against pursuit of deficiency judgments exists in all of California's anti-deficiency statutes (all of which are similarly structured in that they all prohibit deficiency judgments after some sort of sale or foreclosure).

Although ILN 2013-0036 specifically addresses only CCP §580e (short sales), it states that, because a debtor cannot be held personally liable for the difference between the loan balance and the sale price a lender realizes on a short sale of the Collateral, the Service will consider the debt a *nonrecourse* obligation. Because creditors cannot obtain deficiency judgments after the closing of transactions subject to any of California's (other) anti-deficiency statutes, no debtor can be held personally liable to repay any debt subject to any such anti-deficiency statute after the closing of the event triggering the application of the statute. This implies that purchase money

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"stereotypical" *nonrecourse* loan it's converted to a *recourse* loan. What the authors are now asking is why this concept cannot be applied "in reverse.")

[67] I.R.C. §451(a).

mortgages, seller-financed debts, and debt discharged in nonjudicial foreclosures should all be treated as involving *nonrecourse* debt at the closing of the transaction triggering the application of the pertinent anti-deficiency statute and bolsters the proposition that ILN 2013-0036's logic and analysis should be extended and applied to each of those sorts of transactions, not narrowed in accordance with the 4/29 Clarification.

While the authors believe that ILN 2013-0036's logic should be extended to all transactions triggering the application of any one of California's anti-deficiency statutes, it must be noted that CCP §580b(b) transactions must be subjected to a "bifurcated" analysis as, unlike the other anti-deficiency statutes, CCP §580b(b) transactions can be associated with two separate and distinct taxable event scenarios: Scenario 1, where the taxable event relates to any discharge of debt which occurs on a refinancing covered by the statute; and Scenario 2, where the taxable event relates to any discharge of debt which occurs on a sale of Collateral securing a loan covered by CCP §580b(b). Under Scenario 1, Rule 1 dictates that, as the debtor has retained the Collateral (there has been no sale, just a refinancing, all debt discharged is treated as COI income, unless the "purchase price/basis reduction exception" applies.[68]

Under Scenario 2, because CCP §580b(b) dictates that the debtor is not subject to a deficiency judgment for any portion of the "old" debt after the sale, the "old" debt is *nonrecourse*, and under Rule 4, the debtor does not realize COI income (under IRC §61(a)(12)) on a discharge of any of that "old" debt. Instead, the "deemed sale" of the Collateral gives rise to IRC §61(a)(3) gain (or loss) calculated under IRC §1001.[69] However, to the extent there is any "new" debt, that "new" debt is not "protected" by CCP §580b(b). Hence, which Rule will dictate the tax consequence of the discharge of any of that "new" debt will depend on whether it is *nonrecourse* by contract and, if not, whether any of it would be subject to any other anti-deficiency statute.

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[68] Conversely, if the "purchase price/basis reduction exception" applies, the Collateral's basis is reduced by the amount of debt discharged—see Rule 1, above.

[69] *See Crane*, 331 U.S. 1; *Tufts*, 461 U.S. at 307-10; I.R.C. §1001(a); *Briarpark,* 73 T.C.M. (CCH) 3218; *and Danenberg,* 73 T.C. 370.

V. SUBSTANTIAL AUTHORITY

An Information Letter provides general statements of well-defined law without applying them to a specific set of facts.[70] They are furnished in response to requests for general information by taxpayers or by members of Congress.[71] An Information Letter is not generally considered to be substantial authority. As Information Letters are not binding on the Service, they should not be relied upon.[72]

In the context of short sales and CCP §580e, if a taxpayer followed ILN 2013-0036, but is now beyond its scope as narrowed by the 4/29 Clarification, unless the taxpayer "adequately disclosed" the position in the context of IRC §6662(d)(2)(B)(ii), or they can otherwise prove "reasonable cause" and "good faith" under Treas. Regs. §1.6664-4, it would appear that they cannot even treat ILN 2013-0036 as "erroneous written advice" for purposes of penalty abatement under IRC §6404(f) because ILN 2013-0036 was not written to them. Rather, that "advice" was addressed to Senator Boxer. (This would appear to be at least part of what motivated Senator Boxer to send Boxer Letter #2 seeking further clarification from the Service with respect to how it will be dealing with any of the taxpayers who have taken return positions based on ILN 2013-0036 which are no longer "supportable" in light of the 4/29 Clarification.)

In contrast to an Information Letter, a Revenue Ruling is an official interpretation by the Service,[73] the sort of guidance the Tax Practitioner Community (and the Service) likes to have when determining how returns can and should be prepared and processed. Particularly in light of any "confusion" the Service might have caused by "backing off" of the position it took in ILN 2013-0036, there is now an even greater need for some more formal guidance, not just with respect to how the Service will deal with any of the taxpayers who have taken return positions based on ILN 2013-0036, which

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[70] See Rev. Proc. 2013-1, §2.04, 2013-1 IRB 1 (Jan. 2, 2013); *Information Letters*, Service, http://apps.irs.gov/app/picklist/list/informationLetters (last visited Feb 16, 2014).

[71] *More About Information Letters,* Service, http://www.irs.gov/uac/More-About-Information-Letters (last visited Feb. 16, 2014).

[72] Rev. Proc. 2014-1 §2.04, 2014-1 I.R.B. 7.

[73] Internal Revenue Manual 32.2.2.3.1, 2007 WL 8069901, 1.

positions are no longer "supportable" in light of the 4/29 Clarification, but with respect to how taxpayers who have had debt discharged in a transaction giving rise to the application of any of California's anti-deficiency statutes should report the tax effects of that COI. Such guidance would facilitate the preparation and processing of returns reporting the tax consequences of the COI occurring not just as a result of the anti-deficiency statutes in California, but as a result of similar anti-deficiency statutes in other states, making life simpler for both the Tax Practitioner Community and the Service.

VI. CONCLUSION/PROPOSAL

ILN 2013-0036 accurately concludes that a debt discharged pursuant to a short sale under CCP §580e should be treated as *nonrecourse*, leading to its conclusion that the debtor will not recognize any COI income on any such sale.[74] Because it is a clear and accurate statement of the law which applies to all of the aforementioned California anti-deficiency statutes which absolve debtors of personal liability as of the closing of a disposition of Collateral giving rise to a discharge of debt, the authors believe it should be extended and reinforced, and the 4/29 Clarification should be withdrawn. More pointedly, the authors propose that the Service issue a Revenue Ruling with multiple fact patterns involving taxpayers disposing of Collateral in transactions subject to each of California's anti-deficiency statutes, and concluding that, because the taxable event giving rise to the COI is the closing of the transaction in question, the determination of the *recourse* or *nonrecourse* character of the income realized as a result of that COI should be made at that closing (i.e. on the occurrence of that taxable event) AFTER application of any pertinent anti-deficiency statute triggered by that closing. Such a Revenue Ruling would allow the Tax Practitioner Community and the Service to more efficiently and cost effectively prepare and process tax returns reporting the income realized when debt is discharged on the closing of transactions subject to not just California's anti-deficiency statutes, but any similar anti-deficiency statute in effect in any other states.

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[74] *See* Rule 4, *supra.*