HOME MORTGAGE FORGIVENESS IN CALIFORNIA AND THE RELATED INCOME TAX CONSEQUENCES

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I. INTRODUCTION

This article addresses the tax consequences arising from the relief or cancellation of debt ("Mortgage Relief") arising from a foreclosure, short sale or deed in lieu of foreclosure ("PR Disposition") or loan workout with respect to a debt ("Home Mortgage") secured by a taxpayer's principal residence ("PR").

Cancellation of debt income ("CODI")[1] is income that a taxpayer realizes from discharge of indebtedness (IRC §61(a)(12); Reg §1.61-12(a); U.S. v. Kirby Lumber Co. (1931) 284 U.S. 1.) Discharge of indebtedness occurs when a taxpayer is released (in whole or in part) from personal liability for a debt in a transaction which does not constitute a sale or exchange under §1001. In order to determine the income tax consequences of CODI, the amount and timing of the income, as well as whether it may be subject to exclusion under IRC §108, must be determined.

Not all Mortgage Relief results in CODI. Mortgage Relief may also result in gain or loss from the sale or exchange of a capital asset ("Sale Gain").[2] Sale Gain may be subject to the exclusion pursuant to IRC §121. Loss from the sale of a PR is a non-deductible loss under IRC §165 because it is personal.

The character of the income resulting from Mortgage Relief arising as a result of a PR Disposition will largely depend on whether or not the Home Mortgage is recourse or non-recourse. If the Home Mortgage is recourse, then a PR Disposition may result in both CODI and Sale Gain. To the extent that both: (a) the principal amount of the Home Mortgage; and (b) the fair market value ("FMV") of the PR exceeds the PR's basis, capital gain on the PR Disposition will result. The amount of gain is determined by subtracting the owner's basis in the PR from the lesser of: (a) the FMV of the property at the time of the PR Disposition; or (b) the principal amount of the Home Mortgage. To the extent that the principal amount of the Home Mortgage exceeds the FMV of the PR, and the taxpayer's personal liability for that debt is extinguished, CODI results. If the Home Mortgage is non-recourse, to the extent that the principal amount of the debt[3] exceeds the basis of the PR, Sale Gain will result. These rules are demonstrated by the following examples:

Example 1:

X borrows $100,000 from Bank 1 to buy a PR for $150,000. X also pays $50,000 out of X's own pocket. X later refinances the PR for $225,000 from Bank 2 and the entire loan is therefore a

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[1] CODI generally arises in the context of PR Dispositions involving recourse Home Mortgages. It may also arise when the principal amount of a non-recourse loan is reduced by a third party lender as a result of a loan workout agreement. (IRC §108(d)(1).)

[2] Because sale loss is irrelevant for this analysis, the terminology "Sale Gain" is used, but this term presupposes that the amount realized exceeds the adjusted bases of the PR.

[3] See IRC §7701(g).

recourse debt.[4] Bank 2 forecloses by bidding $200,000 at a time when the FMV of the PR is $200,000. There is $50,000 of Sale Gain. Assuming that Bank 2 cancelled the balance due under the note or it was otherwise uncollectible, there is $25,000 of CODI. If the FMV and bid price of the PR is $125,000, there is a nondeductible loss of $25,000 and CODI of $100,000.

Example 2:

Assume the same facts as Example 1 except the entire loan is non-recourse. The Sale Gain would be $75,000, the difference between $225,000 and $150,000.

There are two important, but somewhat subtle points to notice in Example 1. The first is that the amount realized in a PR Disposition of a PR encumbered with recourse debt depends on the FMV of the PR, not the bid price at foreclosure.[5] While often this may be the same, it is not necessarily the same in all cases. In Frazier v. Commissioner, 111 T.C. 243 (1998), the Tax Court found that the taxpayers properly based their "amount realized" on foreclosure sale of property subject to recourse mortgage on the property's appraised FMV, not the bid price where the bid price was arbitrary and clearly did not reflect economic realities.

In the context of judicial foreclosures, the bid price at the foreclosure is irrelevant in determining the amount of a deficiency. The court must hold a fair market value hearing after the foreclosure to determine if a deficiency exists. This procedural safeguard was adopted by the California legislature to protect debtors from artificially low bid prices which may arise in the context of a foreclosure proceeding. For tax purposes, the FMV as determined at the fair value hearing must be used, rather than the bid price.

Although there is no legal requirement in California that a fair value hearing be held in the context of a foreclosure under a private power of sale for the simple reason that no deficiency may be obtained by the lender under those circumstances (CCP §580d[6]), there is no reason why the bid price is determinative of the fair market value of the PR in this context. Therefore, if the tax consequences are more favorable if the FMV of the PR is used rather than the bid price, it may be worthwhile to obtain an appraisal of the PR.

The second subtle point in Example 1 is that due to the non-deductibility of personal losses, it is possible that the amount of CODI generated in a PR Disposition will be greater than the amount of gain determined by subtracting the basis of the PR from the amount of the Home Mortgage. In Example 1, notice that the potential gain is $75,000 and is measured by the difference between the amount of the Home Mortgage ($225,000) and the basis of the PR ($150,000). The amount of the CODI, however, is $100,000, using the assumption that the bid price of $125,000 equals the FMV of the PR. This disparity arises because the $25,000

[4] See discussion below at II.B.
[5] While often cited in the context of calculation of the amount realized, Regs §1.166-6(b)(2), stating that in absence of clear and convincing proof to the contrary, the FMV of the property bid in by a creditor on foreclosure is assumed to be the bid price, this citation has to do with a creditor's calculation of bad debt reduction, and does not directly pertain to the calculation of the amount realized to the debtor upon foreclosure.
[6] "CCP" refers to California Code of Civil Procedure.

of capital loss [($125,000 (bid price) - $150,000 (basis of PR) = ($25,000)] is non-deductible as a personal loss and therefore is disregarded for tax purposes.

II. DETERMINING WHETHER A NOTE SECURED BY A PR IS RECOURSE OR NON-RECOURSE UNDER CALIFORNIA LAW

A Home Mortgage is recourse if the borrower remains personally liable for any deficiency on the debt after the PR Disposition. Conversely, if the lender's only remedy in the event of default is to foreclose on the PR, with the borrower having no further liability for a deficiency, the Home Mortgage is non-recourse. For income tax purposes, state law determines whether a loan is recourse or non-recourse.

Determining whether or not a Home Mortgage is recourse or non-recourse is confusing at best. In the context of a PR, it is possible that the terms of the Home Mortgage may specify that it is non-recourse by containing language similar to the following:

> "The debtor shall not have any personal liability for repayment of this note. The lender's sole remedy in the event of a default is foreclosure."

The inclusion of such language in a Home Mortgage would be highly unusual because most Home Mortgages contain standard language which is designed to permit resale in secondary markets. The absence of such unequivocal language in a Home Mortgage does not, however, necessarily mean that Home Mortgage is recourse. In many cases, governing state law overrides the contractual language of the loan instruments and makes an otherwise recourse note non-recourse. California has adopted various statutes governing this area, which can roughly be parsed out as follows:

(1) "Purchase-Money Rule." Precludes lenders from obtaining personal judgments against debtors where the loan is made to effectuate the purchase of a PR. (CCP §580b.)

(3) "Seller-Financing Rule." Prevents a seller/lender from seeking recourse against the buyer/debtor beyond foreclosure where the seller/lender both sold: (i) the property to the buyer/debtor on installment payment terms; and (ii) secured the loan by the property sold. (CCP §580b.)

(3) Election of Remedy Rule. Prevents a lender from pursuing personal liability against a borrower if the lender elects to foreclose under a private power of sale contained in the Home Mortgage, rather than judicially. (CCP §580d.)

The legal sobriquet used to describe all of these rules is the "Anti-deficiency Rules."[7] As is typical of all good laws, the Anti-deficiency Rules have exceptions, exceptions to exceptions and so forth, such that even the best

[7] For a more complete discussion of the Anti-deficiency Rules, see Miller & Starr, 4 Cal. Real Estate 3d at § 10:266 (2003).

legal minds must acknowledge that the rules are byzantine. This article will review the more prominent rules, but the professional must recall that any specific case may be subject to an arcane exception, so beware.[8]

A. CCP §580b

The Purchase Money Rule and Seller Financing Rule have both received a fair share of judicial interpretation over the years such that, except in the simplest situations, it is often difficult to conjure whether either one or both rules apply in a particular case. For example, the protection of the Seller Financing Rule will usually be abrogated if the Seller's deed of trust is subordinated to other financing at the request of the buyer/debtor. (Spangler v. Memel, 7 Cal. 3d 603, 604 (Cal. 1972).) Similarly, when there is a substitution of security and the note becomes secured by some real property other than the real property purchased, there is an effective waiver of the purchase money characteristics and the debtor becomes personally liable on the note. (Syrek v. Gould, 244 Cal. App. 2d 149, 153 (1966).

The "standard" situations where Home Mortgages are non-recourse under CCP §580b are exemplified as follows:

> ***Example 3:***
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> X purchases a PR by making a down payment of $20,000 and borrowing $180,000 from a bank. The loan, by its terms, is recourse. In California, under the Purchase Money Rule, the loan is non-recourse, despite the fact that the loan provides otherwise. This is because the loan is a "purchase money loan" under California law.
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> ***Example 4:***
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> A sells a PR to B for $100,000. A receives a $20,000 down payment and A carries back a note for $80,000 secured by a first deed of trust on the PR. The note does not contain any non-recourse language. In California, the note is non-recourse under the Seller Financing Rule. Because the seller carried back the note secured by the PR, the risk of loss is placed on the seller under California law and consequently the loan is a non-recourse debt as a "seller financed loan."

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[8] For example, the Purchase Money Rule does not apply to VA or other federally guaranteed loans. Connelly v. J. Derwinski, 961 F.2d 129 (9th Cir. 1992).

B. Refinancing a Purchase Money Debt

A common question is whether the refinancing of a loan secured by a PR which was originally non-recourse under the Purchase Money Rule becomes recourse as a result of refinancing. More specifically, the issue is whether the new loan carries with it the protection offered by the Purchase Money Rule. Because refinancings are currently prevalent due to both the spiraling decline in interest rates and various loan restructuring programs offered by banks, this subject deserves special mention and is addressed below.

1. Refinancing with Original Lender

The creditor under a secured note which is subject to the Purchase Money Rule may alter or modify its terms, or extend or renew the terms of the note, but as long as the obligation is secured by the same property, the Purchase Money Rule continues to apply. (DeBerard Properties, Ltd. v. Lim, 20 Cal. 4th 659, 667-668 (1999); (Ghirardo v. Antonioli*)* 14 Cal. 4th 39, 49-50 (1996).[9]

2. Refinancing with a Different Lender

If an owner refinances[10] a note that was originally non-recourse under the Purchase Money Rule through a different lender, the non-recourse protection is lost and the note becomes recourse. The courts have held that the policy of protecting the buyer does not apply in this situation because a new loan by a new lender is not a purchase-money loan. (Union Bank v. Wendland, 126 Cal. Rptr. 549, 554 (1976).)

C. CCP §580d

If a lender elects to foreclose, the lender can usually do so in either one of two ways: a) by way of non-judicial foreclosure, i.e., a private power of sale; or b) by judicial foreclosure. If the loan is recourse, then the only way a lender can hold the borrower liable after the foreclosure is to foreclose by way of a judicial foreclosure. CCP §580d specifically provides that if a lender elects to foreclose by way of a private power of sale, that lender cannot pursue a deficiency against the borrower.

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[9] Several other cases suggest that when a loan subject to the Purchase Money Rule is refinanced by the same lender in an amount in excess of the original amount of the loan, the new loan may retain its non-recourse character to the extent of the original purchase money mortgage and the excess may be recourse. (See Palm v. Schilling, 199 Cal. App. 3d 63, 244 Cal. Rptr. 600 (1988); Ziegler v. Barnes, 200 Cal. App. 3d 224, 246 Cal. Rptr. 69, 72 (1988); Lucky Invs., Inc. v. Adams (1900) 183 Cal. App. 2d 462, 466-467. This is not, however, a settled point and the courts may ultimately decide that the loan, in its entirety, remains non-recourse or is converted to recourse.

[10] Although it is clear that a "refinance" involving a new lender whereby the new lender pays off the original purchase money deed of trust is not subject to the purchase money anti-deficiency protection (See Union Bank v. Wendland, *supra*), the law is less clear with respect to a new lender taking over the pre-existing beneficiary's note and deed of trust and simply agreeing to modify the terms of the note, such as the interest rate. Although the law is not clear on this point, it is our opinion that the likely result in such a situation would be that a court would find that the purchase money anti-deficiency protection would still apply, since the deed of trust would still technically be securing the original loan which was used to purchase the property.

Since the characterization of a loan as recourse versus non-recourse determines the tax consequences arising under a PR Disposition, a determination of whether a lender's election to foreclose by a private power of sale causes a recourse loan to become non-recourse is crucial. The question of whether a recourse loan essentially "converts" to a non-recourse loan if the lender chooses non-judicial foreclosure is a subject of debate. While some commentators believe that the lender's election to foreclose by private power of sale does, in fact, change the character of the debt from recourse to non-recourse, others have questioned that conclusion and contend that a loan which was originally recourse remains recourse after foreclosure is consummated through a private power of sale even though the lender is thereafter barred from pursuing the additional remedy of suing on the note for any deficiency.

An instructive case on this point is Kerivan v. Title Ins. & Trust Co., 147 Cal. App. 3d 225, 231, 195 Cal. Rptr. 53 (2d Dist. 1983). In Kerivan, the promissory note specified that Colorado law applied and the deed of trust specified that California law applied. The court found that the lender, who foreclosed by private power of sale in California, was allowed to sue on the note and obtain a deficiency judgment in Colorado against the borrowers and then enforce the judgment in California under the full faith and credit clause of the U.S. Constitution. Although the court found that the lender was precluded from seeking a deficiency judgment against the borrowers pursuant to California law, the note was not extinguished, thereby allowing the lender to pursue a deficiency lawsuit in Colorado and later enforce the judgment in California. The basis of this decision is that CCP §580d does not extinguish the debtor's liability, but merely limits the lender's remedies under California law so that the lender cannot sue on the note after a private foreclosure is completed. (Kerivan citing Martin v. Midgett, 100 Ariz. 284, 413 P.2d 754 (1966) and Bayside-Flushing Gardens Inc. v. Beuremann, 36 F. Supp. 706 (D.D.C. 1941).)[11] Under this line of reasoning, when a private power of sale is used to foreclose on a PR that is secured by a recourse debt, the tax rules relating to foreclosure of a recourse debt will still be applied and either or both CODI and/or Sale Gain may result. If the exercise of a private power of sale converts a loan from recourse to non-recourse, then CODI cannot be generated: only Sale Gain may result. The authors of this article believe the correct answer is that a lender's election to foreclose by private power of sale does not convert a recourse note to a non-recourse note.

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[11] The decision in Kerivan to apply Colorado law concerning deficiency judgments, rather than the borrower friendly California law, was based upon a clause in the deed of trust whereby the borrower and lender agreed to apply Colorado law in the event of a dispute between borrower and lender. Kerivan v. Title Ins. & Trust Co., 147 Cal. App. 3d 225, 228 (1983). Such clauses are known as "choice-of-law provisions." Although Kerivan stands for the proposition that a choice of law provision in a deed of trust or promissory note could result in the application of another state's rules concerning deficiencies, the analysis does not end here. Kerivan was decided before California courts came to unanimously agree that the anti-deficiency protections contained in CCP §580b-e cannot be waived by the borrower. Arguably, a choice-of-law provision is simply a disguised waiver. In light of the foregoing, California courts have decided that, as is consistent with determining the validity of a choice-of-law provision, a choice-of-law provision that results in the waiver of a borrower's rights to California's anti-deficiency protections will only be upheld if the state to which the choice-of-law provision applies has a substantial interest in the subject matter of the lawsuit. Guardian Savings & Loan Assn. v. MD Assoc., 64 Cal.App.4th 309, 316 (1998). As such, it is likely that if the subject property is located in a state other than California, or the borrower obtained the loan from a lender located in another state, and there is a choice of law provision in either the deed of trust or promissory note, the other state's law should apply. Although Kerivan and its progeny only technically relate to CCP §580d, concerning deficiencies following trustee sales, it is possible that this same analysis should apply to the other anti-deficiency protections contained in CCP §580b, §580c, and §580e.

Accordingly, if the note and deed of trust both use California law and the lender elects to use a private power of sale after the debtor's default, the amount of any Sale Gain and the amount of any CODI should be realized on the date of the foreclosure. If the law of a different state is stipulated and that state permits deficiency judgments, then the amount of any Sale Gain would be realized on the date of the foreclosure but the amount of CODI realized may be deferred until a later time when the note becomes uncollectible due to the expiration of the statute of limitations or the lender's forgiveness of the debt.

Example 5:

Y purchases a PR with a purchase money loan from Bank A for $300,000. Y then refinances the loan with Bank B for $500,000, thereby converting the loan to a recourse loan. Later, Y is unable to afford the monthly loan payments and defaults on the loan. Bank B forecloses on the loan through a private power of sale. The FMV of the PR is $300,000 and the basis of the PR is $300,000. Therefore, Sale Gain sale would be zero. Y will also have realized CODI in the amount of $200,000 in the year of the foreclosure sale that may be excluded under IRC §108. If a different state's law is required to be used, the timing of realization of the CODI may be deferred until the debt is cancelled by the lender or barred under a rule of law.

D. CCP §580e

What happens in a short sale? As to a recourse Home Mortgage, does the lender retain the right to seek a deficiency judgment? In other words, does a short sale convert a recourse note to a non-recourse note? Over the last several years, lenders have preferred to use short sales, rather than foreclosing after default by the debtor. Foreclosure often results in carrying cost expense and vacancy leading to vandalism and waste of the PR. If the lender's bid results in the lender taking ownership of the PR, then the lender inherits the responsibilities of ownership such as the obligations to repair, insure, pay taxes and maintain the PR. In contrast, a short sale has the advantage of retaining the owner as an occupant during the process of effectuating a sale and the owner often continues to pay for utilities, taxes, etc. Lenders who choose to cooperate in short sales would often admonish the borrower that "no rights to obtain a deficiency are being waived." These lenders were trying to obtain the best of both worlds: maximizing the sales price and receiving the benefits of having the owner/borrower maintain the PR by paying utilities, taxes, etc. Often the owner/borrower did not realize that he or she might be better off by refusing to cooperate in a short sale and by forcing foreclosure, either because the loan was not recourse under the Purchase Money Rule or the lender would most likely use a private power of sale, thereby eliminating the debtor's personal liability.

It was in this context that the California legislature intervened and adopted CCP §580e. CCP §580e precludes a lender from seeking a deficiency in certain short sales. Whether or not a lender can maintain a right to seek a deficiency depends largely upon the date when the short sale is completed and whether the loan is secured by a first deed of trust or a junior deed of trust. To this end, there are three relevant periods: (1) prior to January 1, 2011; (2) January 1, 2011, through July 15, 2011; and (3) post July 15, 2011.

1. Prior to January 1, 2011: The Terms of the Short Sale Agreement Controls

Prior to January 1, 2011, CCP §580e was not operative. Any short sale that occurred prior to January 1, 2011 was governed entirely under principles of contract law.[12] As such, unless the borrower and lender reached a specific agreement regarding the lender's ability to pursue a deficiency after the short sale, the determination of whether the borrower remained liable for a deficiency was governed by the general rules heretofore described.

2. January 1, 2011 to July 14, 2011: Written Consent by a Lender to a Short Sale is a Waiver of the Lender's Right to Seek a Deficiency Against the Borrower Only as to the *First Deed of Trust or Mortgage* on a Dwelling of Not More Than Four Units

As of January 1, 2011, CCP §580e became effective. CCP §580e provides that no deficiency judgment is allowed under a note secured by a first deed of trust on a PR if the lender agrees to the short sale in writing.[13] CCP §580e, as originally enacted, did not, by its terms, apply to second deeds of trust, third deeds of trust, etc. Therefore, from January 1, 2011, through July 14, 2011, if a senior lienholder and a junior lienholder both agreed to a short-sale in writing, the senior lienholder would be barred from seeking a deficiency against the borrower, but the junior lienholder would still be entitled to seek a deficiency against the borrower (assuming the junior lienholder otherwise had a right to seek a deficiency against the borrower in the first place).

3. As of July 15, 2011: Consent in Writing by the Lender to a Short Sale Results in a Waiver of the Lender's Right to Seek a Deficiency Against the Buyer on *Any* Deed of Trust or Mortgage of a Dwelling Not More Than Four Units

Since it is usually the junior lienholder who is under-secured, the legislature realized the language of CCP §580e left a loophole and therefore amended it on July 15, 2011. Senate Bill 458 amended CCP §580e by deleting the language which limited its application to first deeds of trust so that it now applies as well to junior deeds of trust secured by a PR. CCP §580e now provides:

> "No deficiency shall be owed or collected…for ***any*** deficiency upon a note secured ***solely*** by a deed of trust or mortgage for a dwelling of not more than four units...." CCP §580e(a) (*emphasis added*).

In light of the amendment to CCP §580e, from and after July 15, 2011, a written agreement by any lender to a short sale on a dwelling of not more than four units whose note is secured solely by that property, whether or not that lender holds the first, second, third, fourth, etc., deed of trust, waives that lender's right to seek a

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[12] CCP §580e has been held not to apply retroactively to short sales closing prior to January 1, 2011 (see e.g., Espinoza v. Bank of Am., N.A. (2011, SD Cal) 2011 US Dist LEXIS 118820).

[13] CCP §580e has only two exceptions. The first exception is that CCP §580e does not apply if the trustor or mortgagor (borrower) is a political subdivision of the state. CCP §580e(c). The second exception is that if a borrower commits fraud with respect to the short-sale, or commits a waste with respect to the real property, the lender may still seek damages against the borrower. CCP §580e(d). It is worth noting that the exception concerning fraud or waste only speaks in terms of "damages" against the borrower, it does not revoke the anti-deficiency protection entirely. Therefore, if a borrower commits fraud or waste, and the holder of the first deed of trust agrees to a short sale in writing, then it is likely that the senior lender would still not be able to seek a "deficiency" against the borrower, but would be entitled to seek "damages" against the borrower for fraud and waste.

deficiency against the borrower. This amendment to CCP §580e further prohibits a lender from requiring the borrower to pay any additional compensation, aside from the proceeds of the sale, in exchange for its written consent to a short sale. This latter rule effectively prohibits a lender from side-stepping §580e by requiring the debtor to "pay" for the lender's consent to the short sale.

4. Does the Application of CCP §580e Simply Limit the Remedy of Lender or does it Convert the Loan from Recourse to Non-Recourse?

The application of CCP §580e raises the same question as the application of §580d: Is the loan converted from a recourse loan to a non-recourse loan or is the lender merely barred from exercising the remedy of suing on the note? In analyzing this issue, the wording of the respective statutes must be compared. CCP §580d states, in the relevant part:

> No judgment shall be rendered for any deficiency . . . in which . . . the real property by the mortgagee . . . .

In contrast, CCP §580e provides, in the relevant part:

> No deficiency shall be owed or collected . . . for any deficiency . . . .

A comparison of the two statutes clearly indicates that CCP §580e extinguishes the liability under the note, whereas CCP §580d simply bars the lender from suing on the note. Section 580e is only effective if the lender executes a short sale agreement in writing and if the short sale is completed. It is not the execution of the short sale agreement alone which eliminates the debtor's liability under the loan. Therefore, the authors of this article believe that the application of CCP §580e is indistinguishable from a foreclosure under a private power of sale; both require the conveyance of the PR and the applicable Anti-deficiency Rules preclude further recourse against the borrower. Accordingly, the authors of this article conclude that the better view is that CCP §580e does not convert the note from recourse to non-recourse, but merely extinguishes the debt on completion of the short sale.[14]

[14] The reader should note, however, that the difference in the wording of CCP §580d and CCP §580e could lead to the conclusion that CCP §580e converts the Home Mortgage to a non-recourse debt. There are no decided cases on this point.

Example 6:

Big Bank has a recourse note for $100,000 secured by a first deed of trust against Y's PR. Y wants to effectuate a short sale and on December 1, 2010, Big Bank agrees to a short sale for $80,000. The basis of the PR is $50,000. The short sale closes on December 22, 2010, for $80,000 (the FMV). Absent an express waiver of its right to seek a deficiency by Big Bank in the short sale documents, Big Bank has not waived any deficiency claim. The transaction results in $30,000 of Sale Gain subject to possible exclusion under IRC §121. The lender retains the right to seek a deficiency. If the lender is unable to collect the remaining $20,000, at some point CODI will be realized and, if IRC §108 does not apply, it will be recognized as income.

Example 7:

Assume the same facts as in Example 6 with the exception being that the short sale closed on January 2, 2011. Pursuant to CCP §580e, Big Bank would have waived the right to seek a deficiency. Sale Gain of $30,000 would be realized and there would be $20,000 of CODI.

Example 8:

Assume the same facts as in Example 6, but further assume that there is also a junior recourse equity loan encumbering the PR in the amount of $25,000. The junior lender does not agree to the short sale. Because the junior lender does not agree, the short sale cannot be completed because clear title cannot be transferred. The alternatives are for the senior lender to foreclose or for the junior lienholder to agree to release the deed of trust but not waive any deficiency claims (which is an unlikely event), either one of which would allow the junior lienholder to seek personal recourse against the borrower.

Example 9:

Assume the same facts as in Example 6, but further assume that there is also recourse equity loan encumbering the PR in the amount of $25,000 and the junior lender does agree to the short sale. The senior lienholder has waived any deficiency but the junior lienholder has not, despite its agreement to the short-sale, and the junior lender may still seek a deficiency from the borrower. Therefore, there would be $30,000 of Sale Gain and $20,000 of CODI realized. The junior lienholder debt would be recourse and the normal rules above-described would be applied to determine the amount, timing and recognition of income associated with the junior lien.

Example 10:

Assume the same facts as in Example 6, but further assume that the short-sale closed on July 22, 2011. Both the senior lienholder and the junior lienholder have waived the right to seek a deficiency. The junior lienholder cannot demand any additional consideration as a creditor to agree to the short sale: the junior lienholder must simply agree or not agree. If the lenders

agree, the amount of Sale Gain would be $30,000 and there would be $45,000 of CODI upon completion of the short sale.

III. TIMING OF REALIZATION OF CODI

A. In General

The question of when a debt is actually "cancelled" for the purpose of CODI realization is always an issue. Just because a lender forecloses on a Home Mortgage and is prevented from seeking deficiency on a loan, does not mean that the debt is necessarily cancelled for the purpose of determining when CODI is realized. As illustrated above in Kerivan, the fact that a debt is uncollectible pursuant to California law does not necessarily mean that the debt is extinguished. Thus, the timing of the realization of CODI may not be as straightforward as it appears.

One way to think about this issue is to analogize to when a lender may deduct a debt as "bad debt" pursuant to IRC §166. To take a deduction for a bad debt requires the lender to establish that during the year for which the deduction is sought, an event took place which, in the exercise of sound, objective business judgment, evidences there is no realistic prospect that the debt would be paid. (Washington Inst. v. Commissioner, 10 TCM 17 (CCH) (1951).) If a Home Mortgage is recourse and the lender forecloses by way of private power of sale or agrees to a deed in lieu with no recourse, the lender should be able to write-off, as a bad debt, a portion of the loan consisting of the excess of the debt over the FMV of the PR. The debtor should likewise realize CODI at the same time.

A frequently cited case in the area of when CODI is realized for income tax purposes is Cozzi v. Commissioner, 74 T.C. 1062 (1987). The Cozzi court stated that CODI must be recognized and is deemed discharged "the moment it becomes clear that a debt will never have to be repaid." The court went on to state that the "test of determining such moment requires a practical assessment of the facts and circumstances relating to the likelihood of payment."

It is only in those circumstances where the lender is entitled to pursue a deficiency judgment after foreclosure that timing issues arise. Normally this is when: (i) the lender forecloses by judicial foreclosure; (ii) there is a choice of law issue such as in Kerivan; or (iii) there is a short sale and CCP §580e does not apply. In these situations, realization of CODI will most likely depend on when the debt becomes uncollectible, either by the expiration of the statute of limitations, bankruptcy, or lender agreement. One indication of a lender agreement is when a Form 1099 is issued by the lender for CODI. The issuance of a Form 1099 indicating that the borrower is in receipt of CODI is good evidence that the lender has elected to forego collection action against the debtor, particularly if the debtor relies on the Form 1099 and reports the CODI as realized income.

B. The Debt Modification Regs

The application of Reg §1.1001-3 (the "Debt Modification Regs") and IRC §108(e)(10) to loan workouts involving Home Mortgages does not seem to have garnered much attention by the IRS or commentators.

Under the Debt Modification Regs, if terms of a debt instrument (the "DI") are significantly modified, then there is a constructive exchange of the old DI for the new DI. The lender recognizes gain or loss based on the difference between the FMV of the new DI as compared with the basis of the old DI. The borrower may recognize CODI if the FMV of the new DI is less than the face value of the old DI (IRC §108(e)(10).

In the context of this article, there are a few instances in which the Debt Modification Regs might apply. If a loan is converted from recourse loan to non-recourse by agreement of the lender and/or if there is a substantial modification of the payment terms and/or principal balance of the Home Mortgage as part of loan workout, there may be a deemed taxable exchange of debt instruments.

For example, assume that there is a loan workout which provides that the loan will be converted from recourse or non-recourse and no other modifications. Does this result in a taxable exchange of DIs? The probable answer is no. The Debt Modification Regs clearly indicate that the conversion of a recourse debt to non-recourse debt is a significant modification which will normally result in a taxable exchange of DIs (Reg. Section 1.1001-3(e)(5)(ii)). There is an exception to this rule which is applicable to modifications after July 6, 2011, which states that if the collateral remains the same and there is no change in payment expectations, then the conversion from recourse to non-recourse is not significant (Reg §1.1001-3T(e)(5)(ii)(B)(2)). While the definition of "change in payment expectations" is not entirely clear (Reg §1.1001-3(e)(4)(vi)), unless other terms of the loan are also changed, the conversion from recourse to non-recourse should probably not be treated as a taxable exchange of DIs in most cases; therefore, IRC §108(e)(10) should not apply. Of course, this temporary regulation does not mean that loan modifications that took place prior to July 6, 2011, will be similarly treated.

The more problematic question arises when there are material modifications to the repayment terms of the Home Mortgage either with or without a conversion of the debt from recourse to non-recourse. It is beyond the scope of this Article to review all of the Debt Modification Regs, so for simplicity, assume that the modifications are significant and amount to a taxable exchange of DIs. Once this assumption is made, the question becomes how the new DI is valued to determine if it is worth less than the old DI thereby resulting in CODI. The simple cases are when: (i) the face amount of the new DI is less than the old DI; or (ii) the face amount of the new DI equals the principal balance of the old DI, but there is not adequately stated interest. CODI would equal the reduction in the face amount assuming there is adequately stated interest. In either case, CODI may result.

It is not, however, entirely clear that these simple cases are the only instances in which CODI may result. The FMV of the new DI is determined under IRC §1273. If the new DI is issued for property (the old "DI") and if the new DI is publicly traded, then the FMV of the new DI is the FMV of the new DI, as opposed to its face value. On the other hand, if the new DI is not publicly traded, then the FMV of the new DI is its face value (assuming adequately stated interest). The question is therefore, whether the new DI is publicly traded. While one might intuitively think that Home Mortgages are not publicly traded, the definition contained in regulations promulgated under IRC §1273 (Reg §1.1273-(f)(4)) is so broad that the secondary market for Home Mortgages that follow federal guidelines <u>may</u> be encompassed as a publicly traded market. There has not been any definitive interpretation of these regulations as relates to Home Mortgages, but the authors of this article

have called several knowledgeable sources and the consensus seems to be that the secondary market for Home Mortgages does not amount to an established market. Therefore, so long as the interest rate is adequately stated, any CODI arising from a PR loan modification should equal the difference between the face amount of the new mortgage and the principal balance due under the old mortgage.

IV. IRC §108

A. Qualified Principal Residence Indebtedness

IRC §108(a)(1)(E) provides an exclusion for qualified principal residence indebtedness ("QPRI") discharged on or after January 1, 2007, and before January 1, 2013. Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, may qualify for relief. Under this provision, up to $2,000,000 of debt is eligible for exclusion ($1,000,000 if married filing separately).

It should be noted that the exclusion for QPRI, and any other exclusion available under §108, do not apply to Sale Gain. This means that if a Home Mortgage is a non-recourse loan and there is a PR Disposition, the exclusion for QPRI will not apply as any gain is Sale Gain, not CODI. The question therefore arises as to when the exclusion for QPRI will apply in California because PR purchase money mortgages are generally non-recourse.

Under IRC §108, QPRI is defined as applying to "acquisition indebtedness" as defined under IRC §163(h)(3)(B) which reads as follows:

> (B) Acquisition Indebtedness:
>
> (i) In general. The term "acquisition indebtedness" means any indebtedness which—
>
> (I) is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and
>
> (II) is secured by such residence.
>
> Such term also includes any indebtedness secured by such residence resulting from the refinancing of indebtedness meeting the requirements of the preceding sentence (or this sentence); but only to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness.

Based on the definition of "acquisition indebtedness," some factual situations in which "acquisition indebtedness" may be recourse financing in California and therefore may qualify for the QPRI exclusion in the event of a PR Disposition are as follows:

1. A PR Disposition after a purchase money mortgage has been refinanced with a lender under circumstances in which the purchase money mortgage is converted from non-recourse to recourse debt in whole or in part.

2. A PR Disposition in which there is secondary financing for the construction of improvements on the PR. The secondary financing may be recourse and may qualify for the QPRI exclusion.

3. A PR Disposition involving VA financing (or other federal guaranteed loans) which is recourse debt.

4. A reduction in the principal amount of a Home Mortgage by way of restructuring the loan with the lender.

The following examples demonstrate the application of the QPRI exclusion.

Example 11:

Assume that Y owns a PR with a purchase money debt of $100,000 and a basis of $125,000. Y refinances the purchase money debt to $200,000 with a new lender. The loan would be recourse. The PR is lost in foreclosure and the FMV and the bid price is $150,000. There would be Sale Gain of $25,000 and CODI of $50,000. The CODI may be excluded under the QPRI rules but the Sale Gain of $25,000 may only be excluded under §121.

Example 12:

Assume that the taxpayer purchased a PR for $200,000 paying $50,000 down and obtaining a $150,000 purchase money mortgage. Under a mortgage restructuring program, the lender agrees to reduce the principal amount of the mortgage to $125,000. There is $25,000 of CODI which may be excluded under a QPRI exclusion subject to a basis reduction in the PR from $200,000 to $175,000. (IRC §108(h)(1).) When the lender reduces the principal amount of acquisition indebtedness secured by a PR, the reduction will qualify for the QPRI exclusion without regard to whether the loan is recourse or non-recourse.

B. <u>All of the Debt Might Not be Eligible for Exclusion as QPRI</u>

IRC §108 includes an “ordering rule” that is used when a portion of the cancelled debt on a PR is not excludable under the QPRI rules because the debt exceeds the $2,000,000 limit or it is attributable to proceeds that do not qualify as “acquisition indebtedness.” The portion of the CODI that does not qualify for the QPRI exclusion is treated as discharged first (IRC §108(h)(4)).

Example 13:

Y purchases a home with a loan in the amount of $800,000, secured by a first deed of trust on the home. Y refinances the home with a new lender and receives equity proceeds in the

amount of $200,000 which are used by Y for personal expenditures including Y's child's college education. By refinancing with a different lender, the loan becomes recourse. Upon foreclosure by private power of sale, the home's FMV is $700,000 and $300,000 of debt is discharged. The first $200,000 is CODI which does not qualify for the QPRI exclusion because it is not "acquisition indebtedness." The next $100,000 of CODI qualifies for the QPRI exclusion because it is acquisition indebtedness. Unless another CODI exclusion applies, Y will have $200,000 of taxable income.

C. California Mortgage Forgiveness Debt Relief – the California Twist

On April 12, 2010, the Conformity Act of 2010 was enacted, resulting in partial conformity with the federal exclusion for a QPRI under IRC §108. The new law applies to discharges of debt on or after January 1, 2009, and before January 1, 2013.[15] California only partially conforms to IRC §108(a)(1)(E); therefore, a taxpayer may have to recognize CODI for state, but not federal, tax purposes.

Under California law there are two separate limitations on qualifying for exclusion as QPRI. First, instead of the $2,000,000 debt limit, California limits the amount of debt which can qualify for the QPRI exclusion to $800,000 for taxpayers who file as married/registered domestic partners ("RDP") filing jointly, single, head of household, or widow/widower, and to $400,000 for taxpayers who file as married/RDP filing separately. Second, the amount of income attributable to cancellation of debt which can be excluded as QPRI is limited to $500,000 for taxpayers who file as married/RDP filing jointly, single, head of household, or widow/widower, and $250,000 for taxpayers who file as married/RDP filing separately.

To the extent the amount of the Home Mortgage exceeds the $800,000/$400,000 limit, the amount of the excess debt which is cancelled will not qualify for the QPRI exclusion.

Example 14:

Assume that Y is a married individual living in California and in 2010 purchases a PR for $1,000,000, secured by a first deed of trust on the home. Y refinances the home with a new lender for $1,200,000, thereby receiving equity proceeds in the amount of $200,000 which were used by Y for personal expenditures. The loan instruments specify that California law is to apply. The loan is recourse as a result of the refinancing. Upon foreclosure by private power of sale, the bid price (and FMV of the PR) is $700,000 and $500,000 of debt is discharged because the lender cannot sue for the deficiency. The $500,000 which is discharged is CODI.

Federal Result: Under Federal law, the first $200,000 of CODI does not qualify for the QPRI exclusion as it is not "acquisition indebtedness" and $300,000 is excludable under IRC §108(a)(1)(E). Unless another CODI exclusion applies, Y will have $200,000 of taxable income.

[15] A similar provision applies to the taxable years 2007 and 2008, but there are different limitations.

California Result: Under California tax law, since the amount of the debt exceeds $800,000, the availability of the California QPRI exclusion is limited. For California purposes, the first $400,000 does not qualify for the QPRI exclusion [$1,200,000 - $800,000 (the California limit) = $400,000]. The remaining $100,000 does qualify and is excludable as QPRI. Unless another CODI exclusion applies, Y will have $400,000 of taxable income.

***Example 15*:**

Assume that Y is a married individual living in California and in 2010 purchases a PR for $800,000, secured by a first deed of trust on the home. The loan states California law applies. Y refinances the home with a new lender for $1,000,000 and receives equity proceeds in the amount of $200,000 that was used by Y for personal expenditures. The loan is recourse as a result of the refinancing. Upon foreclosure by private power of sale, the bid price (and FMV of the PR) is $100,000 and $900,000 of debt is discharged.

Federal Result: Under Federal law, the first $200,000 is not "acquisition indebtedness." Unless another CODI exclusion applies, Y will have $200,000 of taxable income. The remaining $700,000 of cancelled debt is acquisition indebtedness and qualifies for the QPRI exclusion.

California Result: Under California tax law, the first $200,000 of debt is above the limit of $800,000 and is not acquisition indebtedness and, therefore, cannot qualify for the QPRI exclusion. The next $700,000 of CODI qualifies for the QPRI exclusion but since the amount of the CODI exceeds $500,000, the availability of the California QPRI exclusion is limited. Therefore, for California purposes, the first $200,000 of CODI not qualify as QPRI, $500,000 qualifies as QPRI and another $200,000 of CODI does not qualify. Unless another CODI exclusion applies, Y will have $400,000 of taxable income.

D. Bankruptcy

IRC §108(a)(1)(A) provides that gross income does not include CODI if the discharge occurs in a Title 11 case. Under IRC §108(d)(2), the term "Title 11 case" means a case under the Bankruptcy Code if: (1) the taxpayer is under the jurisdiction of the court; and (2) the discharge of indebtedness is granted by the court or pursuant to a plan approved by the court ("Bankruptcy").

***Example 16*:**

Assume that Y files for protection of the Bankruptcy Court. After filing, Y's PR, which is encumbered by a recourse debt, is foreclosed upon pursuant to a private power of sale. The loan amount and basis of the PR is $100,000. The bid price and FMV of the PR is $80,000. The CODI would be $100,000 - $80,000 = $20,000. Because the $20,000 is discharged during a Title 11 case, the $20,000 will be excluded from Y's income. The loss of $20,000 would be a nondeductible personal loss.

E. Insolvency

IRC §108(a)(1)(B) excludes CODI if the discharge occurs when the taxpayer is insolvent.[16] Under IRC §108(a)(3), the amount excluded from gross income by reason of the insolvency exclusion cannot exceed the amount by which the taxpayer is insolvent. IRC §108(b) provides that the amount excluded by reason of insolvency must be applied to the reduction of tax attributes. To determine insolvency, IRC §108(d)(3) defines the term "insolvent" as the excess of liabilities over the FMV of assets. Whether and by how much a taxpayer is insolvent is determined on the basis of the taxpayer's assets and liabilities immediately before the discharge.

***Example 17*:**

This example assumes no other exclusions are available other than the insolvency exception. Assume that Y's assets consist of cash in the amount of $5,000, an individual retirement account (IRA) in the amount of $5,000, and a PR with the FMV of $200,000. Y's total assets equal $210,000. Y has liabilities in the total amount of $250,000, which consist of a $25,000 credit card debt and a $225,000 mortgage on his PR. Y's excess of liabilities over the value of his assets is $40,000, meaning that Y is insolvent by $40,000.

Upon foreclosure, the bid price and FMV of the PR is $200,000, which results in $25,000 of CODI. The $25,000 of CODI will be excluded pursuant to §108(a)(1)(B) because Y's insolvency exceeds the amount of CODI.

Assume instead that Y's total assets equal $300,000. Y is not insolvent; therefore, the entire amount of the CODI is taxable.

V. IRC SECTION 121

Under IRC §121, gross income does not include Sale Gain if, during the five-year period ending on the date of the sale or exchange, the PR was owned and used by the taxpayer as his principal residence for periods aggregating two or more years. (IRC §121(a); Reg §1.121-1(a).) The amount of gain excluded is usually limited to $250,000 for single individuals and $500,000 for qualified married couples. (Reg §§ 1.121-2(a)(1) and (b)(2)(A).)[17]

Example 18:

Y purchased a home six years earlier and since then, has lived in this home as his only residence. The purchase price of Y's home was $200,000. He refinanced and now has a $300,000 loan on the house. Y defaults on the loan and his home is sold through foreclosure

[16] Under IRC §108(a)(2)(A), the insolvency exclusion does not apply to a discharge that occurs in a bankruptcy case.

[17] The exclusion, however, will not apply if, during the two-year period ending on the date of the sale or exchange, there was any other Sale Gain by the taxpayer to which the exclusion applied. (IRC §121(b)(3)(A); Reg §1.121-2(b).)

under a private power of sale. At foreclosure, the PR sells for $250,000. Assuming Y's adjusted basis in his home was $200,000, Y would have Sale Gain in the amount of $50,000. This amount may be excluded from Y's income pursuant to IRC §121. The balance of $50,000 is treated as CODI and may be excluded under IRC §108.

VI. COMPARISON OF TAX EFFECTS OF RECOURSE OR NON-RECOURSE DEBT UPON FORECLOSURE, SHORT SALE, DEED IN LIEU, OR LOAN MODIFICATION

Once it is determined whether a loan is recourse or non-recourse, or both recourse and non-recourse, the consequent tax ramifications can be determined.

A. Recourse Debt

1. Foreclosure

If a Home Mortgage is recourse, then, upon foreclosure by private power of sale, the difference between: (a) the lesser of: (i) the FMV of the PR; or (ii) the amount of the debt; and (b) the adjusted basis of the PR, results in Sale Gain (loss is disregarded). If the amount of the debt is greater than the FMV of the PR, then the difference between the amount of the debt and the FMV of the PR will be treated as CODI at such time the debt is volitionally cancelled or collection is barred by an applicable law.

Example 19:

Assume a loan on a PR is $100,000 and the basis of the PR is $100,000. The PR is sold in a short sale approved by the lender in writing in 2010 for $80,000 (CCP §580e was not enacted and does not apply). If the loan is recourse, a loss of $20,000 arises from the sale of the PR and is disregarded. The balance of the debt is cancelled by the lender, and there is $20,000 of CODI. The CODI may be excludable under IRC §108.

Example 20:

Assume that the basis of the PR is $50,000, the FMV of the PR is $80,000 and the loan is $100,000. The lender forecloses in a judicial foreclosure and the credit bid and FMV of the PR is $80,000. If the loan is a recourse loan, then there would be Sale Gain of $30,000 and potential CODI of $20,000 subject to exclusion under IRC §108. In this example, assuming that the requirements of IRC §121 have been satisfied the gain would be excluded and the $20,000 deficiency will result in realization of CODI when the debt is cancelled or otherwise barred from collection. Whether the CODI is subject to exclusion under IRC §108 will depend on the application of the QPRI, insolvency or Title 11 rules.

2. Short Sale

If there is a short sale using the same facts as in the examples above, then the tax result may be different depending on when the short sale took place and the terms of the short sale agreement.[18] Assuming that the short sale occurs after July 14, 2011, then the lender agreeing to the short sale waives any claim for deficiency. There would be zero (-0-) Sale Gain and $20,000 of CODI in Example 19. In Example 20, there would be $30,000 of Sale Gain and $20,000 of CODI.

3. Deed in Lieu

If the lender elects to accept a deed in lieu, then the terms of the deed in lieu agreement must be reviewed to determine if the lender waived any deficiency in whole or in part.

If the loan is non-recourse to begin with, then most likely there would be no agreement to pay a deficiency and the rules relating to relief of non-recourse debt would apply. If the loan is recourse, then some unanswered questions exist. If the lender agrees to waive any deficiency, does that effectively convert the loan to a non-recourse debt? These authors believe that it does not.[19] Therefore, the authors believe the normal rules relating to computing the Sale Gain and CODI with respect to recourse loans should apply.

Example 21:

Assume that there is a recourse loan of $150,000, a basis of $100,000 and FMV of $125,000. There is a deed of lieu agreement which provides that the lender takes back the PR plus $10,000 in cash. Since the loan is recourse, there is Sale Gain of $25,000 and CODI of $15,000.

B. <u>Non-Recourse Debt</u>

With respect to a non-recourse debt the Sale Gain is equal to the difference between the full amount of the debt (IRC §7701(g)) and the basis of the property. As the entire amount of the debt is included in the calculation of the gain or loss, CODI does not result from a PR Disposition subject to a non-recourse debt. In the case of a non-recourse Home Mortgage, it makes no difference whether the PR Disposition is a foreclosure, short sale, or deed in lieu.

Example 22:

Assume a non-recourse loan on a PR is $100,000 and the basis of the PR is $100,000. The PR is sold in a short sale for $80,000. If the loan is non-recourse, there is no CODI and the Sale Gain would be zero.

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[18] See discussion at Section II.D. above.

[19] This issue has not been litigated and, in any particular case, an argument may be made that the specific terms of the deed-in-lieu agreement may result in the Home Mortgage being treated as non-recourse.

Example 23:

Assume that the basis of the PR is $50,000, the FMV is $80,000 and the non-recourse loan is $100,000. The lender forecloses and the bid is $80,000. The Sale Gain would be $50,000 and the gain may be excluded under IRC §121 if all of the applicable requirements are satisfied.

C. <u>Loan Modification</u>

What if a lender agrees to a loan modification and reduces the principal balance of the debt? Whether the loan is recourse or non-recourse, CODI will result, and the CODI may be subject to exclusion under IRC §108. The year of inclusion would be the year in which the modification was finalized. If a Home Mortgage is modified to reduce the interest rate below adequately stated interest, but the principal balance remains unchanged, CODI may also result.

Example 24:

Assume that Y purchased a PR with a $500,000 loan. Because of the current economic climate, Y is unable to make the monthly payments on the loan. Y negotiates a loan modification with the lender where the lender agrees to reduce the principal balance of the loan by $50,000. Whether this is a recourse or non-recourse loan, Y will have CODI in the amount of $50,000. This amount may be excluded from income pursuant to §108.

VII. CONCLUSION

The rules allowing exclusion of CODI attributable to relief of debt secured by a PR under IRC §108 and Sale Gain under IRC §121 are, at best, a patchwork quilt. The complexity of these rules is exacerbated by the arcane rules relating to characterization of debt secured by a PR as recourse or non-recourse under state law. Since each state has different rules relating to these issues, a tremendous amount of uncertainty is created in determining the tax consequences of a foreclosure, short sale, deed in lieu or loan modification relating to a PR. Given the dire economic times that currently exist, a uniform Federal rule should be adopted, clearly defining the tax consequences of debt relief with respect to PRs. The states should then conform to the Federal rules. The existing law is simply too complex to expect compliance from an average home owner.