



SEN. GEORGE RUNNER (RET.)

MEMBER  
STATE BOARD OF EQUALIZATION  
**CALIFORNIA'S TAX BOARD**

September 16, 2013

Jozel Brunett, Chief Counsel  
Franchise Tax Board  
P.O. Box 1720  
Rancho Cordova, CA 95741-1720

Re: Requested Chief Counsel Opinion regarding Cancellation of Debt Income

Dear Ms. Brunett:

I am requesting a legal opinion from the Franchise Tax Board as to the potential tax consequences for a California resident who completes a short sale under existing California law.

The fact scenario of a typical short sale is as follows:

A homeowner finds himself or herself “upside-down” in the financing of his or her personal principal residence, may no longer be able to maintain the mortgage, and wants to divest himself or herself of the property via a short sale rather than defaulting and suffering a foreclosure. For purposes of discussion, let's assume a mortgage of \$400,000, on a home purchased in 2008, but a fair market value sales price to a bona fide purchaser of only \$300,000. The lender or holder of the note agrees to accept the \$300,000 “short” payoff and allows the sale to proceed and escrow to close.

Obviously, forgiveness of some or all of an existing debt can result in taxable cancellation of debt income to the borrower. However, it appears that the decision (under federal law as well as California law) as to whether taxable income occurs turns on whether there is personal recourse to the borrower on the forgiven debt obligation. In FTB's own Tax News article of June 2010, discussing short sales and foreclosures, tax professionals are advised, “If the lender is able to pursue the borrower for payment of the remaining balance of the debt after the property is sold, the loan is recourse.”

California law contains a number of nearly unique borrower protections that prevent a lender from pursuing personal liability against homeowners, and which do not generate cancellation of debt income attributable to the borrower.

For example, Code of Civil Procedure Section 580b prevents any personal recourse (deficiency) on a purchase money debt for a qualified property. Similarly, under Section 580d of the same code a lender that forecloses on the property via a non-judicial foreclosure or trustee's sale has no recourse against the borrower even if the note might otherwise have allowed personal recourse, and even if the foreclosure sale yields less than the face amount of the note.

My question arises in the context of the very recently enacted section 580e which says that, "no deficiency shall be owed or collected," on a mortgage after a lender has approved a short sale and received the agreed upon payment. That section tracks the same protections for borrowers under the pre-existing sections that currently prohibit recourse against the borrower and avoid cancellation of debt tax liability. Indeed, under Senator Corbett's SB 426 (Chapter 65, Statutes of 2013) the borrower protections of each statute have been conformed to one another.

By operation of law, there can be no recourse against a borrower after a lender-approved short sale. Doesn't this mean that there is also no cancellation of debt income as a result of a short sale, just as there is no cancellation of debt income after the foreclosure sale?

Should you have any questions, please feel free to contact my Senior Legal Advisor, Elizabeth Maeng, at (916) 445-2961. Thank you very much for your help, I look forward to FTB's analysis.

Kindest Regards,

A handwritten signature in black ink, appearing to read "G. Runner". The signature is fluid and cursive, with a large initial "G" and "R".

George Runner  
Board of Equalization, Second District

cc: Selvi Stanislaus, Executive Officer, Franchise Tax Board