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State of California
Franchise Tax Board

12.04.2013

George Runner, Member
State Board of Equalization
500 Capitol Mall, Suite 1750
Sacramento, CA 95814

Dear Mr. Runner

In your September 16, 2013 letter, your office inquired as to, in respect to California Code of Civil Procedure ("CCP") section 580e, whether a California taxpayer, who was a party to a short sale of their residence in 2013, would be subject to cancellation of debt income for the portion of their mortgage that was not satisfied by the proceeds from the short sale. In short, based on recent guidance from the Internal Revenue Service ("IRS"), a California taxpayer would not have cancellation of indebtedness where the taxpayer was involved in a short sale pursuant to CCP section 580e. However, the taxpayer may have gain on the short sale of the residence.

For federal and California income tax purposes, if a loan is nonrecourse, meaning that the lender has no recourse against the borrower for any deficiency in satisfying the full amount of the indebtedness other than taking possession of the underlying property. The borrower will be treated as having sold the property for the amount of the outstanding debt or the fair market value of the property, whichever is greater. Therefore, the borrower may have gain to the extent the outstanding debt or fair market value exceeds the borrower's basis in the property.

If a loan is recourse, meaning that the borrower may also be personally liable for the obligation and the borrower is relieved of all or a portion of the obligation, the borrower may have a taxable income in two respects. The borrower may have a gain on the short sale to the extent the fair market value of the property exceeds the borrower's basis in the property sold. The borrower may also have cancellation of indebtedness income equal to the forgiven amount of the loan.

Effective January 1, 2011, CCP section 580e(a)(2) provides that if a lender agrees to a short sale of property, which acts as the security of the underlying debt, the lender may not be entitled to a judgment for the outstanding debt that remains after the short sale of the property is completed. In other words, the short sale proceeds will satisfy the outstanding debt obligation and the borrower is no longer personally liable.

In a September 19, 2013 letter from the IRS to Senator Barbara Boxer (which she released to the public in a November 15, 2013 press release), the IRS found that an obligation involved in a sale pursuant to CCP section 580e would be treated as a nonrecourse obligation for federal income tax purposes. (See attached) The IRS has informed us that a redacted version of the letter to Senator Boxer will be available on the IRS website (www.irs.gov) in the near future. Therefore, a homeowner that entered into a short sale

pursuant to CCP section 580e would be treated as having been relieved of a nonrecourse obligation. Please note that the homeowner may have gain to the extent that the outstanding debt or the fair market value of the property, whichever is greater, exceeds their basis in the property sold. For additional information regarding the federal tax treatment of the discharge of nonrecourse loans, please refer to IRS Publication 4681.

Since California conforms to the relevant portions of the federal tax law governing the forgiveness of nonrecourse and recourse indebtedness, California would follow the federal treatment for the CCP section 580e transactions. As such, the homeowner may have gain on the short sale, but would not have cancellation of indebtedness income.

Sincerely,



Jozel Brunett
Chief Counsel

Attachment



OFFICE OF THE CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

September 19, 2013

The Honorable Barbara Boxer
United States Senate
Washington, DC 20510

Dear Senator Boxer:

I am responding to your letter dated August 28, 2013, to Acting Commissioner Daniel Werfel. You asked whether a homeowner would have taxable cancellation of indebtedness income on a lender approved short sale that qualifies under section 580e of the California Code of Civil Procedure (CCP).

A short sale involves a sale of property for less than the outstanding mortgage loan balance. When an owner of property enters into a short sale, the lender may hold the owner personally liable for the difference between the loan balance and the sales price. This is the nature of a recourse obligation. If the lender forgives the personal liability, the owner generally must include the forgiven amount of the loan in income unless an exception applies (Section 61(a)(12) of the Internal Revenue Code (the Code)). Congress has provided an exception that allows homeowners who have cancellation of indebtedness income on the sale of their principal residence to exclude the cancelled debt from income if it is qualified principal residence indebtedness. However, this exception will expire at the end of 2013 (Sections 108(a)(1)(E) and 108(h) of the Code).

On the other hand, if a property owner cannot be held personally liable for the difference between the loan balance and the sales price, we would consider the obligation a nonrecourse obligation. In this situation, the owner would not treat the cancelled debt as income. Instead, the owner must report the entire amount of the nonrecourse debt as an amount realized on the sale of the property. If the owner realizes a gain on the sale of the property, the owner generally must include the gain in gross income (Section 61(a)(3) of the Code). However, if the property was the owner's principal residence, the owner may qualify to exclude all or part of the gain from income (Section 121 of the Code).

In 2011, California enacted an anti-deficiency provision under section 580e of the CCP, which generally prohibits a lender who holds a deed of trust on a homeowner's principal residence from either claiming a deficiency or obtaining a deficiency judgment from the homeowner after agreeing to a short sale. The statute effectively limits the homeowner's liability to the amount the lender received on the sale of the principal residence, and the

homeowner is not personally liable for the deficiency balance (the difference between the loan balance and the sales price).

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. (We do not express an opinion on whether an indebtedness described in section 580e of the CCP is treated as nonrecourse debt for other federal income tax purposes.)

Section 580e has certain exceptions to its anti-deficiency provisions. Also, federal law may override California's anti-deficiency provisions in certain circumstances. If any state or federal law would have the effect of nullifying an obligation's nonrecourse status, we would generally consider the obligation a recourse obligation subject to the application of the cancellation of indebtedness provisions of section 61(a)(12) of the Code.

Other states have enacted anti-deficiency statutes. However, this information letter is limited to the consequences under section 580e of the CCP.

I hope this information is helpful. If you have any additional questions, please call me or Craig Wojay at (202) 622-4920.

Sincerely,



Michael J. Montemurro
Chief, Branch 4,
Office of Associate Chief Counsel,
Income Tax and Accounting