

Short Sales

find the article at: "<http://www.car.org/legal/2008articles/short-sales/>"

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Introduction

Increasingly, lenders are making loans in amounts that become too difficult for borrowers to repay. Some of these borrowers may not be able to fulfill their mortgage obligations. When a borrower is no longer in a position to make the mortgage payments, is facing foreclosure and the current market value of the property--including escrow costs--is less than the loan on the property, the borrower may consider a short sale. This could save the lender the expenses of foreclosure proceedings and from having another REO property on its books. From the borrower's perspective, the short sale prevents having the foreclosure on the borrower's credit history, and releases the borrower from an obligation that he or she can no longer afford.

In essence, a short sale is a sale transaction subject to a lender's approval in which the lender consents to a sale of the security interest for less than what is owed on the note and accepts the proceeds in full satisfaction of the loan amount. A short sale requires much paperwork and preparation on behalf of the borrower. Typically, before applying for a short sale, the seller must have a ready buyer and all the paper work prepared to present to the lender. The buyer of the property must also be prepared for a protracted time period to conclude the purchase of the property.

I. Lender's Options Upon Borrower's Loan Default

Q 1. *What options does a lender have on a debt secured by California real property if the borrower does not make the payments on the loan?*

A A lender may foreclose on the defaulting borrower's real property which secures the loan. There are two types of "foreclosures" available to a lender: a trustee's sale and a judicial foreclosure. (*Bank of Italy National Trust & Savings Assoc. v. Bentley*, 217 Cal. 644 (1933).) Technically, a trustee's sale is not a "foreclosure" but the term has been used for both a trustee's sale as well as a

judicial foreclosure.

For certain loans, a lender has no choice and must conduct a trustee's sale. With a trustee's sale, a lender cannot go after a deficiency judgment. A deficiency occurs when the current market value of the property is less than the loan on the property. See Questions 3 and 4 for more details.

The lender may also be able to pursue "guarantors" of the debt who have signed written guarantee agreements (not including the borrowers).

Q 2. What other options may the lender consider instead of foreclosure when the borrower is delinquent?

A Depending on the situation, a lender may consider one of the following:

Loan Workout: Basically, a loan workout is any resolution of a problem loan between the lender and borrower that modifies the original loan agreement. Some of these options include forbearance (e.g. forgiving a portion of the debt or late charges); deferment; renegotiating interest rate, monthly payment amount, principal amount, maturity date; or the enforcement an acceleration clause in the loan.

Deed in Lieu of Foreclosure: After the borrower is in default, the borrower voluntarily delivers title to the lender for consideration and the lender accepts the conveyance of the property in full satisfaction of the mortgage debt. Using this method, the lender saves the costs of foreclosure and the borrower avoids having a notice of default on his/her records. (*Hamud v. Hawthorne*, 52 Cal.2d 78 (1959).)

Short Sale*: A short sale is a transaction in which a lender allows the real property securing the loan to be sold for less than the remaining mortgage amount due and accepts the proceeds as full payment of the loan. A lender may accept a short sale when the borrower is in severe financial straits and market conditions make a short sale the best choice to mitigate the lender's damages. Like a deed in lieu of foreclosure, this saves the lender the costs of foreclosure and the borrower avoids having a foreclosure on his or her credit report.

Short Payoff*: With a short payoff, the lender accepts less than the remaining mortgage amount as full payment of the loan. The property need not be sold.

*Note: Some lenders do not differentiate between a short sale and a short payoff.

Q 3. What is a deficiency judgment?

A A deficiency judgment is a judgment obtained by the lender in court against the borrower for the difference between the unpaid balance of the secured debt and the amount produced by sale or the fair market value of the security, whichever is greater, in a judicial foreclosure. (Cal. Code Civ. Proc. § 726 (b).) A lender may obtain a deficiency judgment only with a judicial foreclosure. With a trustee's sale foreclosure, the lender cannot go after a deficiency judgment. See Question 4 for more details.

Q 4. Can a real estate lender obtain a deficiency judgment against a defaulting borrower following foreclosure?

A It depends. California has "anti-deficiency statutes" that protect certain borrowers from deficiency judgments. Under those circumstances, a lender would opt for a trustee's sale foreclosure which is quicker and less expensive than a judicial foreclosure. A trustee's sale

foreclosure does not involve the courts. Generally, there are five situations in which a deficiency judgment is prohibited:

1) Purchase Money. If the loan is obtained to purchase a residential 1-4 unit dwelling all or part of which is owner occupied and the loan is secured by that property, the lender may not obtain a deficiency judgment against the defaulting borrower. This loan is entitled to "purchase money" protection. (Cal. Code Civ. Proc. § 580b.) Note, however, that should the buyer refinance the home, the new loan is no longer "purchase money." Thus, the buyer would lose the protection against a deficiency judgment in the event of a default.

2) Seller Carryback. If the purchase money loan for any type of real property is financed by the seller and secured by that same property, the lender/seller may not obtain a deficiency judgment against the defaulting borrower/buyer. (Cal. Code Civ. Proc. § 580b.)

3) Trustee's Sale. A lender may not pursue a deficiency judgment against the borrower should the lender opt to foreclose by a trustee's sale foreclosure (a non-judicial action). (Cal. Code Civ. Proc. § 580d.)

4) 3 Month Time Limit. An action for a deficiency judgment must be brought within 3 months from the time of judicially-ordered sale. (Cal. Code Civ. Proc. § 580a.)

5) Fair Value Limitations. A deficiency judgment is limited by the difference between the amount of the indebtedness and the fair market value of the property, unless the actual sale price exceeds that value. (Cal. Code Civ. Proc. §§ 580a, 726 (b).)

When a deficiency judgment is permitted, the lender may obtain one only following a judicial foreclosure, or when the security has become valueless (such as when security for a second trust deed loan is wiped out when the first trust deed lender completes its foreclosure). Holders of a junior deed of trust (second, third, etc.) should note that if the "wiped-out" junior lien is not purchase money or seller carryback, then the junior lien holder may sue on the note and the borrower on the junior loan may be personally liable. (*Roseleaf Corp. v. Chierighino*, 59 Cal. 2d 35 (1963).)

Q 5. *Can a lender avoid the foreclosure process and just sue the borrower on the note (i.e., treat it as an unsecured note)?*

A No. A lender cannot sue on a debt secured by a mortgage or trust deed except for a judicial foreclosure. This is called the "one action rule" or "one form of action rule." (Cal. Code Civ. Proc. § 726.) One exception to this rule is if the security for the loan has become "valueless" after the lender's security interest was recorded (e.g., a "wiped out" junior lien holder). In this case, the lender can sue directly on the debt (note) unless the borrower's loan falls into category 1) or 2) in Question 4.

Q 6. *Why would a lender agree to accept a short sale?*

A Lenders may have ample incentive to negotiate a short sale with a distressed borrower. For example, should the lender take back a property pursuant to a foreclosure sale, the lender would become responsible for a variety of costs, including property maintenance, utilities, HOA fees, and might risk destruction of the property by vandalism. Furthermore, lender-owned properties (REO) may take a long time to sell, in part because so many REO properties are now for sale.

A lender will typically evaluate the financial situation of the borrower as well as current market conditions to determine whether or not to agree to a short sale. It is really a business decision for the lender to determine whether it would receive more money by accepting the short sale, or completing a foreclosure, reselling the property, and pursuing personal liability (i.e., deficiency judgment against the borrower and/or claims against guarantors, for loans on which those remedies are available.)

II. Effect On Borrowers of Short Sales

Q 7. Does a short sale adversely affect a defaulting borrower's credit rating?

A Yes. Lenders will report the short sale as being settled for less than the full balance. This would show up on the borrower's credit report as a negative mark for seven years. (Cal. Civ. Code § 1785.13.)

Q 8. Suppose the borrower is late with his/her mortgage payments, causing the lender to begin the foreclosure process by filing a notice of default. Before the foreclosure sale occurs, the borrower pays the lender what is owed on the note. Could these activities appear on the borrower's credit report?

A Yes. The lender can report to a credit bureau receipt of any payments made 30, 60, 90 or more days after their due date. This may appear on a borrower's credit report as a "foreclosure in process," "foreclosure proceedings," "current was 30," or in some other way. Any such terms, or other similar reporting comments, harm that individual's overall credit rating.

Q 9. Is the method by which lenders report a short sale a negotiable item?

A Typically, no. The short sale is usually reported to credit reporting agencies as settled for less than the full balance. However, a borrower may try to negotiate this at the time the short sale is being arranged.

Q 10. Are there any special risks to borrowers when negotiating a short sale with their lender?

A Yes. In particular, REALTORS® who assist borrowers should be aware and warn their clients of one particular risk. If the borrower was less than completely honest when using the stated income method in applying for the loan, this information may become apparent to the lender when the documentation listed in Question 17 (such as tax returns and paycheck stubs) are submitted to the lender in the application for short sale approval. This may put the borrower at great risk of potential liability for their dishonesty.

Q 11. Are there any tax effects of a short sale?

A Yes. The tax implications for the borrower could be so significant that a short sale would not be in the borrower's best interest. Before a short sale is contemplated, it is strongly recommended that the borrower seek the advice of a professional tax advisor.

Generally speaking, any relief of indebtedness from a short sale, regardless of whether the loan is a recourse or nonrecourse loan, is taxed as ordinary income. There are, however, some exceptions to this rule that may benefit a taxpayer involved in a short sale. For more information on the tax implications of short sales, see the CAR legal article, [Taxation of Foreclosures, Deeds in Lieu of Foreclosure, and Short Sales](#).

III. Licensing Requirements for Short Sales

Q 12. What is a short sale consultant?

A A short sale consultant is someone who advises on short sales. Depending on the agreement between the parties involved, the typical short sale consultant assists a homeowner or listing agent

to prepare a short sale application package, submit it to the homeowner's lender, and negotiate with the lender on the homeowner's behalf to approve the short sale.

Q 13. Does a short sale consultant have to be a real estate licensee?

A Yes. Generally, if a short sale consultant negotiates real estate loans or performs services for borrowers or lenders, both the short sale consultant and the short sale consulting company must be properly licensed with the California Department of Real Estate (DRE). More specifically, unless an exemption applies, a real estate license is required for someone who, for compensation or in expectation of compensation, does or negotiates to do any of the following acts on behalf of another:

- Solicits borrowers or lenders for loans secured by real property;
- Negotiates loans secured by real property;
- Performs services for borrowers, lenders or note holders for loans secured by real property; or
- Collects payments for loans secured by real property.

(Cal. Bus. & Prof. Code § 10131(d).)

To check someone's license status with the DRE, go to its Web site at <http://www2.dre.ca.gov/PublicASP/pplinfo.asp>.

Certain exemptions to the licensing laws may apply. For example, a real estate license is not required if someone merely performs clerical or administrative services, such as assembling a short sale package as long as final determination as to its completeness is made by the broker (see 10 Cal. Code of Reg. § 2841 which lists other permissible clerical activities). For other exemptions to the licensing laws, see C.A.R.'s legal articles, [Licensing Guide for REALTORS®](#) and [Licensing Chart for REALTORS®](#).

Q 14. Can a licensed short sale consultant collect an advance fee?

A No, unless certain requirements are met. An advance fee is a fee charged upfront for services not yet performed. An advance fee is broadly defined to include a fee claimed, demanded, charged, received, collected or contracted from a principal for negotiating real estate loans (Cal. Bus. & Prof. Code § 10026). Among other things, no less than ten calendar days before collecting an advance fee, a real estate broker must submit to the DRE the advance fee agreement and all other materials to be used for advertising, promoting, soliciting, or negotiating the advance fee (10 Cal. Code of Reg. § 2970). Furthermore, if a Notice of Default has been recorded against a property involving one-to-four owner occupied residential units, an advance fee is prohibited for foreclosure-related consulting services under the foreclosure consultant law (Cal. Civ. Code § 2945 et seq.). For a list of real estate brokers who have received "no objection" letters for their advance fee agreements, go to the DRE Web site at http://www.dre.ca.gov/mlb_adv_fees_list.html.

Q 15. If a real estate broker collects an advance fee, does it have to be handled in a special way?

A Yes. A real estate broker who collects an advance fee must deposit it in a trust account with a bank or other recognized depository. Amounts may not be withdrawn for the agent's behalf until actually expended for the benefit of the principal or five days after a verified accounting as specified is mailed to the principal in compliance with Section 2972 of Title 10 of the California Code of Regulations. (Cal. Bus. & Prof. Code § 10146.)

IV. Disclosure Requirements in Short Sales

Q 16. *Must a real estate transfer disclosure statement be given to a buyer in a short sale transaction?*

A Yes, if the property being sold is a residential 1-4 unit dwelling and the transaction doesn't fall into one of the regular TDS exemption categories. No exemption exists for a short sale transaction in which the borrower sells the property to an outside buyer, using the sale proceeds to pay off the lender. See the C.A.R. legal article, [Exemptions from the Transfer Disclosure Statement \(TDS and MHTDS\) Law](#), for a list of all the exemptions from the TDS requirement.

Q 17. *Must other disclosures be given to a buyer (or seller) pursuant to a short sale?*

A Yes. Short sales are treated just like any other sales transaction. See C.A.R. legal article, [Sales Disclosure Chart for REALTORS®](#), for a summary of the disclosure requirements.

Q 18. *Suppose a distressed seller enters into a contract to sell his/her home to a buyer pursuant to a short sale. Should the listing agent inform the lender if and when other offers are made on the property?*

A Probably. Although the lender is technically not a party to the real estate contract, lender approval is nearly always a contingency of the agreement. Therefore, REALTORS® should obtain the client's permission to keep the lender apprised of any relevant developments, including the presentation of other offers.

Q 19. *Should a listing agent working with a distressed seller attempt to negotiate a future listing agreement with the lender?*

A No. Listing agents working with distressed sellers owe them a fiduciary duty. Since in a short sale situation a lender could choose to foreclose on the seller, the lender's interests are potentially adverse to the seller's interests. Attempting to negotiate a future listing agreement with the lender raises the issues of "to whom is the agent's loyalty devoted" and "has the agent violated the fiduciary duty he/she owes the seller." The safer practice is to avoid putting oneself in such a position.

V. Short Sale Application Process and Other Issues

Q 20. *What is the process for applying for a short sale?*

A It is always in the best interest of the borrower to keep the lender informed. If the borrower is in default of the loan and is contemplating a short sale, it would be best for the borrower to let the lender know before the foreclosure proceedings are well under way. The lender may or may not grant more time to the borrower to find a buyer. In general, the process goes as follows:

- First, the borrower must find a buyer for the property.
- Second, the borrower must prepare all the necessary documents (See Question 17).
- Third, the borrower must submit all documents to the lender.
- Fourth, the lender will send out their own appraiser to make sure that the buyer's offer is at fair market value.

- Fifth, the lender will make a determination on whether or not to agree to the short sale.

Q 21. *What documentation will a lender typically require?*

A Lenders will typically require a distressed borrower to furnish a variety of documents, which could include the following:

- Written explanation (and proof) of the hardship the borrower is experiencing;
- Copy of the purchase contract signed by both the buyer and seller (borrower);
- Copy of the TDS;
- Proof of the buyer's ability to purchase the property, i.e., a completed loan application, pre-approval by another lender, or evidence of cash on hand (bank statement);
- Copy of the certified escrow instructions;
- Preliminary title report;
- Estimated net/closing statement certified by an escrow officer acceptable to the lender;
- Completed and signed IRS Form 4506, "Request for Copy of Tax Form;"
- Completed and signed personal financial worksheet;
- Previous two years tax returns;
- Employment paycheck stubs for the past two months;
- Profit and loss statement (if the borrower is self-employed);
- Past three months bank statements.

Q 22. *Does C.A.R. provide any special forms for short sales?*

A Yes. REALTORS® may use C.A.R. form SSL (Short Sale Listing Addendum) when they take the listing and C.A.R. form SSA (Short Sale Addendum) should be available shortly to be used with a purchase agreement.

Q 23. *Where can I obtain additional information?*

A You may consult the seller's lender directly about their policies and what is required to apply for a short sale of a property. The internal departments that handle short sales differ by lender. You may try asking for the problem loan department, loan workout department, loss mitigation department, or foreclosure department.

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The information contained herein is believed accurate as of October 27, 2008. It is intended to provide general answers to general questions and is not intended as a substitute for individual legal advice. Advice in specific situations may differ depending upon a wide variety of factors. Therefore, readers with specific legal questions should seek the advice of an attorney.


HAFA Short Sales Fact Sheet

find the article at: "<http://www.car.org/legal/legal-questions-answers/2010-qa/hafa-short-sales/>"

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May 10, 2010 (revised)

<p>What is HAFA?</p>	<p>HAFA is a government-subsidized Home Affordable Foreclosure Alternatives program for distressed homeowners to sell their homes to avoid foreclosure, even if the sales price is not enough to pay off their existing mortgage loans. Under HAFA, a participating lender will pre-approve the terms of a short sale and give the borrower at least 4 months to market and sell the property using a licensed real estate professional.</p>
<p>Eligibility</p>	<p>The eligibility requirements for a HAFA short sale include the following:</p> <ul style="list-style-type: none"> • Property must be borrower's principal residence; • Loan must be a first trust deed originated before 2009; • Loan must be delinquent or default must be reasonably foreseeable; • Current unpaid principal balance must be \$729,750 or less for single-family home (or higher amounts for 2-to-4 units); and • Borrower must be eligible for, but unable to complete, a loan modification under the Home Affordable Modification Program (HAMP).
<p>Financial Incentives</p>	<p>The government incentives under HAFA are as follows:</p> <ul style="list-style-type: none"> • \$3,000 to borrower for relocation expenses; • \$1,500 to servicer for each successful short sale; and • \$1 reimbursement to investor for every \$3 paid to extinguish junior liens, up to \$2,000 maximum, and not to exceed 6% of unpaid balance.
<p>Effective Dates</p>	<p>April 5, 2010 to Dec. 31, 2012.</p>

<p>HAFAs Procedures</p>	<p>The general standardized procedures for HAFAs short sales are as follows:</p> <p>Step 1: Lender evaluates borrower for a loan modification under HAMP.</p> <p>Step 2: Lender evaluates borrower unable to complete HAMP modification for short sale.</p> <p>Step 3: Lender issues Short Sale Agreement (HAFAs SSA).</p> <p>Step 4: Borrower lists the property for sale using a licensed real estate agent.</p> <p>Step 5: Borrower and agent market and sell the property.</p> <p>Step 6: Borrower submits to lender a Request for Approval of Short Sale (RASS).</p> <p>Step 7: Lender approves RASS within 10 business days.</p> <p>Step 8: Sale closes escrow.</p>
<p>Lender's Evaluation</p>	<p>Each participating lender will have its own written policy for approving or rejecting a HAFAs short sale, based on factors such as the severity of the loss, market conditions, the borrower's motivation and cooperation, property valuation, and title review.</p>
<p>Short Sale Agreement (HAFAs SSA)</p>	<p>The Short Sale Agreement (HAFAs SSA) will include, among other things, the following:</p> <ul style="list-style-type: none"> • Either a list price or net proceeds acceptable to the lender; • An agreement to fully release borrower from all liability for repayment of the loan; • An agreement not to complete a foreclosure sale if borrower complies with SSA; • Amount of acceptable closing costs and up to 6% real estate commission. • Notice that the sale must be an arm's length transaction; and • Notice that the buyer must agree not to resell the property within 90 days of closing.
<p>Tax, Credit, and Other Consequences</p>	<p>A HAFAs short sale may have serious tax, credit, financial, legal, and other consequences. A homeowner is strongly encouraged to seek the advice of a qualified professional regarding these consequences.</p>

Participating Lenders	A list of lenders participating in the HAMP program is available at http://makinghomeaffordable.gov/contact_servicer.html . Fannie Mae and Freddie Mac have their own HAFA guidelines for their loans.
More Information	http://makinghomeaffordable.gov/hafa.html . See also, Supplemental Directive 09-09 dated March 26, 2010 available at https://www.hmpadmin.com/portal/docs/hafa/sd0909r.pdf . 

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Taxation of Foreclosures and Short Sales

find the article at: "<http://www.car.org/legal/legal-questions-answers/2010-qa/taxation-foreclosures-shortsales/>"

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Introduction

The real estate industry, on a large-scale basis, has been flooded with foreclosures, deeds-in-lieu of foreclosure, and short sales of real property. These distress sales and foreclosures are the result of a convergence of tightening credit, falling property values, and the consequences of prior lending practices.

Adding insult to injury, owners of real property facing these circumstances, and generally already under financial strain, may be unpleasantly surprised to learn that two types of taxable income can result from a foreclosure, deed-in-lieu of foreclosure, or short sale: capital gains and forgiveness of debt income (also known as cancellation of debt—COD income). COD income has also been referred to as “phantom income.” Both types of income can trigger unexpected taxes for the owner.

This legal article discusses the income tax consequences to the borrower in the event of foreclosure, in the event the borrower simply transfers title to the lender (deed-in-lieu of foreclosure), and if the borrower sells the property to another in a short sale in which a lender accepts less than the balance due on the loan as payment in full. This article has been updated to reflect the recent California Mortgage Debt Forgiveness Tax law signed by the governor on April 12, 2010 as part of the California Conformity Act of 2010.

Q 1. Are foreclosures, deeds-in-lieu of foreclosure, and short sales subject to federal tax income taxation?

A Yes. However, the income is taxed differently depending on several factors, including whether there was a foreclosure, a deed-in-lieu of foreclosure given to the lender, or a short sale (a sale where the lender agrees to reduce the amount owed in order to facilitate a sale), and whether the underlying debt is "recourse" (the borrower is personally liable for the debt) or "nonrecourse" (the borrower is not personally liable for the debt).

For federal income taxation as a result of foreclosure, see generally 26 U.S.C. §§ 1001 through 1016. For federal income taxation of short sales, see generally 26 U.S.C. §§ 61, 108 and 1001 through 1016.

TAXATION OF FORECLOSURES OR DEEDS-IN-LIEU OF FORECLOSURE

Q 2. What is the difference between a foreclosure and a deed-in-lieu of foreclosure?

A A foreclosure refers either to a trustee's sale foreclosure (not a judicial proceeding) or to a judicial foreclosure (a judicial proceeding). A deed-in-lieu of foreclosure means that the lender has agreed to accept title to the property and the borrower transfers title to the lender rather than waiting until the lender forecloses on the property. A deed-in-lieu of foreclosure is not a special instrument. It is simply a conveyance of the property to the lender by grant deed or quitclaim deed; and, in exchange, the lender cancels the promissory note secured by the real property. In this way the lender can avoid the foreclosure process to regain title to the property.

However, a borrower cannot simply transfer title to the lender without the lender's permission. Because some lenders have refused to negotiate and accept the deed-in-lieu of foreclosure, some creative homeowners have quitclaimed the property to the lender anyway, and have recorded the instrument without the lender's permission.

In 1993, the California legislature passed a statute to protect lenders from involuntary (and invalid) transfers of real property to the lender. The lender must record a "notice of nonacceptance of a recorded deed" in the county where the real property is located. Redelivering a grant of the real property back to the original homeowner (e.g., borrower) does not legally retransfer the title. (Cal. Civ. Code § 1058.5.)

A lender may not want to take a deed-in-lieu of foreclosure because taking title in this manner does not extinguish any junior liens. A foreclosure by a senior lienholder essentially wipes out all junior liens.

Q 3. *How does the owner receive "income" from a foreclosure or a deed-in-lieu of foreclosure?*

A A foreclosure proceeding, whether through a trustee's sale or judicial foreclosure, and a deed-in-lieu of foreclosure given to the lender are treated the same as a sale for income tax purposes. The foreclosure or deed-in-lieu of foreclosure is reported on the taxpayer's tax return as a sale or exchange in the year the foreclosure is finalized or the deed-in-lieu of foreclosure is given to the lender.

In a foreclosure or deed-in-lieu of foreclosure, the owner can receive "capital gain or loss" as in any other sale of real property (i.e., be subject to capital gains taxation or receive a credit for a capital loss). Additionally, the owner can receive "forgiveness of debt" income. This is also referred to as "cancellation of debt" (COD) income. Whether the owner is subject to taxation on COD income may depend on whether the debt is "recourse" or "nonrecourse." If the debt is a recourse debt, the owner may be deemed to have received taxable income in the amount of debt that is forgiven by the lender (except in certain situations discussed below where the owner will not be taxed). If the debt is nonrecourse debt, there is no taxable income from forgiveness (or cancellation) of debt, but the owner may be still be subject to capital gains taxation.

Q 4. *What is "nonrecourse" debt?*

A Under California law, a debt is considered "nonrecourse" when a loan is made under either one of the following two circumstances:

- (1) When the loan is made to purchase a one-to-four unit property and the borrower intends to occupy at least one of the units, or
- (2) When the seller carries back financing for all or a portion of the purchase price of any real property.

(Cal. Code Civ. Proc. § 580b.)

In the event of default by the borrower, the lender, or financing seller, is restricted to recovering the property with no right to proceed against the borrower for any deficiency should the property be worth less than the loan amount.

Q 5. What is "recourse" debt?

A Under California law, a "recourse" debt is one in which neither of the two exemptions in Question 4 occurs.

Examples of recourse debt are refinances of existing mortgages, home improvement loans, equity lines of credit, and loans other than seller financing, securing a debt for purchase of property that is not an owner-occupied one-to-four unit property. The lender is not limited to taking the property back and the borrower may be personally liable on the debt. If the lender chooses to foreclose using a trustee's sale, then the lender waives the right to go after the borrower for the deficiency despite the fact that the loan was a recourse debt. In order to go after a deficiency judgment, the lender must go through a judicial foreclosure process.

Q 6. How is the amount realized (taxable income) calculated for a "recourse" debt in a foreclosure?

A If the debt is recourse debt, meaning the owner may be personally liable for the debt, the amount realized is calculated in a two-step approach.

First, you take the difference between the Fair Market Value (FMV) of the property (usually the sales proceeds at the judicial foreclosure or trustee's sale) and the Adjusted Basis in the property. Generally, the Adjusted Basis consists of the purchase price of the property plus any capital improvements (less depreciation, if the property is investment property). This difference is the capital gain or loss. If the FMV exceeds the amount of the Adjusted Basis, then the borrower has realized a capital gain at the time of the transfer (foreclosure). If the Adjusted Basis exceeds the FMV, then the borrower has a capital loss.

Second, you take the difference between the amount of the cancelled debt (e.g., unpaid loan amount) and the sales proceeds at the foreclosure (FMV). This is the forgiveness of debt (cancellation of debt) income and it is treated by the IRS as ordinary income despite the fact that the borrower has received no cash at the time of the foreclosure.

However, if the cancelled debt amount is considered "qualified principal residence indebtedness" pursuant to the Mortgage Forgiveness Debt Relief Act of 2007(federal law) and SB 401 (the Conformity Act of 2010—California law), there will be no taxation on this forgiveness of debt (COD income). See Question 9 for a definition of "qualified principal residence indebtedness."

RECOURSE DEBT

Example One:

1. The unpaid balance of the loan is \$300,000.
2. The FMV of the property is \$250,000.
3. The taxpayer's adjusted basis in the property is \$200,000.

Assume the lender forecloses and will forgive the underlying debt.

Step one:

FMV (\$250,000) less taxpayer's adjusted basis (\$200,000) results in capital gains for the taxpayer.

FMV	\$250,000
Less Adjusted Basis	\$200,000
Capital Gains	\$ 50,000

Step two:

Amount of cancelled debt (amount owed on \$300,000 loan) less FMV (\$250,000) is ordinary income to the taxpayer.

Amount Owed	\$300,000
Less FMV	\$250,000
Ordinary Income	\$50,000

Note: If a lender chooses to foreclose through a trustee's sale and is barred from obtaining a deficiency judgment by the one action rule under California Code of Civil Procedure Section 580d, it is likely the IRS will still consider that the underlying debt as a recourse debt and it will be subject to debt forgiveness income. (See Rev. Rul. 90-16.) However, there may be no taxation of this income under The Mortgage Forgiveness Debt Relief Act of 2007.

RECOURSE DEBT

Example Two:

If the FMV at the foreclosure sale is more than what the lender is owed, there will be no forgiveness of debt and, thus, no ordinary income to the taxpayer.

1. The unpaid balance of the recourse debt is \$300,000;
2. The FMV of the property is \$400,000;
3. The taxpayer's adjusted basis in the property is \$200,000.

Step one:

FMV (\$400,000) less taxpayer's adjusted basis (\$200,000) results in capital gains for the taxpayer.

FMV	\$400,000
Less Adjusted Basis	\$200,000
Capital Gains	\$200,000

Step two:

The debt is fully paid (since the FMV of \$400,000 exceeds the unpaid loan amount of \$300,000) resulting in no forgiveness of debt.

Q 7. How is the amount realized (taxable income) calculated for a "nonrecourse" debt in a foreclosure?

A If the debt is nonrecourse, meaning the owner is not personally liable for any deficiency (beyond the value of the property), the amount realized is the difference between

- (a) the greater of: (i) the FMV or (ii) the entire outstanding debt; and

(b) the adjusted basis of the property.

This amount is treated as capital gains and there is no taxation for forgiveness of debt income.

Even though the adjusted basis might exceed the FMV and the outstanding debt, generally no capital loss would be allowed because nearly all nonrecourse debt is associated with a principal residence. (Capital losses are applicable only to investment property.)

NONRECOURSE DEBT

Example:

1. The unpaid balance of the loan is \$300,000;
2. The FMV of the property is \$250,000;
3. The taxpayer's adjusted basis in the property is \$200,000.

Greater of FMV (\$250,000) or entire unpaid debt (\$300,000) minus taxpayer's adjusted basis (\$200,000) results in capital gains to the taxpayer.

Greater of
FMV (\$250,000)
OR
Unpaid Debt (\$300,000)

Greater of the above	\$300,000
Less Adjusted Basis	\$200,000
Capital Gains	\$100,000

Q 8. How is a deed-in-lieu of foreclosure treated for tax purposes?

A A deed-in-lieu of foreclosure is treated as a sale and taxed just like a foreclosure. See Questions 6 and 7 above.

TAXATION OF SHORT SALES

Q 9. What are the tax implications of a short sale?

A

Cancellation of Debt (COD) Income

A short sale, where the lender agrees to reduce some or all of the outstanding debt, may give rise to forgiveness of debt income (also called "cancellation of debt" or COD income). The amount of the debt that the lender agrees to write off is treated as "ordinary income" (as opposed to capital gains income which is taxed at a lower rate). Even though the lender may be taking this action to facilitate

the sale by the owner who is under a notice of default and facing a foreclosure, the agreement between the owner and the lender is considered voluntary and the amount of the loan written off by the lender is treated as forgiveness of debt (cancellation of debt--COD). The taxpayer will generally receive a 1099 tax form from the lender in the amount of the cancellation of debt.

This forgiveness or cancellation of debt which is treated as "ordinary income" under certain circumstances may or may not be subject to taxation.

Federal Mortgage Forgiveness Debt Relief

Under the Mortgage Forgiveness Debt Relief Act of 2007 (H.R. 3648) signed by the President on December 20, 2007, Internal Revenue Code §108(a)(1)(E) was added and provides that a taxpayer will not be taxed upon cancellation of debt income if the following conditions are met:

- The property sold in the short sale is the taxpayer's principal residence, as that term is used in IRC §121.
- The cancellation of debt is **Qualified Principal Residence Indebtedness**** under IRC Section 163(h)(3)(B).
- The indebtedness is discharged after January 1, 2007 and before January 1, 2013. (The end date was increased by three years from 2010 to 2013 pursuant to H.R. 1424, the Emergency Economic Stabilization Act of 2008).

****Qualified Principal Residence Indebtedness** is a loan secured by the residence used to acquire, construct or substantially improve the residence. The income relief provided is capped at \$1,000,000 in the case of a married person filing a separate return and \$2,000,000 for all others.

Any reduction of indebtedness excluded by IRC §108(a)(1)(E) will be applied to reduce the basis of the taxpayer's principal residence, but not below zero. This could result in a higher amount of capital gains tax owed by the taxpayer.

California Mortgage Debt Forgiveness Relief

California law, SB 401, conforms California Revenue and Tax Code Section 17144.5 to federal law, but with the following changes:

- (1) The maximum amount of qualified principal residence indebtedness is \$800,000 for married couples filing jointly, registered domestic partners filing jointly, single persons, head of household, widow/widower; and \$400,000 for married couples or registered domestic partners filing separately; and
- (2) The maximum amount of debt relief income that can be forgiven is \$500,000 for married couples filing jointly, registered domestic partners filing jointly, single persons, head of household, widow/widower; and \$250,000 for married couples or registered domestic partners filing separately; and
- (3) California's debt relief statute applies to property sold on or after Jan. 1, 2009 and before Jan. 1, 2013.

Qualifying taxpayers who have already filed their 2009 California tax returns should file [Form 540X, Amended Individual Income Tax Return](#), to subtract the amount of debt relief from income. To expedite processing, write "[Mortgage Debt Relief](#)" in red across the top of the amended tax return. Taxpayers must attach a copy of their federal return, including [Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness \(and Section 1082 Basis Adjustment\)](#), with their state tax return.

Capital Gains Income

Finally, if the owner has owned the property for some time and has refinanced to take out some of the equity, the owner could be subject to capital gains taxation when selling the property as well. For example, the borrower has a remaining loan on the property when the borrower refinances in order to buy an investment property (or to buy a car, to take a vacation, consolidate credit card debt, etc.) and now owes \$300,000 to the lender. Thus, the taxpayer's adjusted basis may be lower than the outstanding balance on the loan (see the example below).

The tax calculation for any capital gains income looks just like step one when calculating capital gains income for a foreclosure sale of recourse debt.

Example:

1. The unpaid balance of the loan is \$300,000;
2. The sales price (FMV) is \$250,000;
3. The taxpayer's adjusted basis in the property is \$50,000.

Sales price (FMV \$250,000) less taxpayer's adjusted basis (\$50,000) results in capital gains for the taxpayer.

Sales Price (FMV)	\$250,000
Less Adjusted Basis	\$50,000
Capital Gains	\$200,000

Additionally, the taxpayer will have ordinary income from the lender's write off of any debt, which in this example would be \$50,000 (** See the discussion above in this question to determine whether or not this would be taxable)

Loan Balance	\$300,000
Less Sales Price	\$250,000
Ordinary Income	\$50,000

TAX EXEMPTIONS

Q 10. Are there any other exemptions from the taxation of cancellation of debt income?

A Yes. There are four other circumstances, in addition to what was discussed in Question 9, where the taxpayer can get relief from taxation on cancellation of debt income:

- (1) The taxpayer is insolvent (the taxpayer's debts exceed their assets, but the cancellation of debt is forgiven only to the extent of the insolvency);
- (2) The debt is discharged as part of a bankruptcy proceeding;
- (3) The debt discharged is qualified farm indebtedness; or
- (4) The debt discharged is qualified business indebtedness.

For all of the above, any reduction in indebtedness will be applied to reduce the taxpayer's basis in the property.

(26 U.S.C. §§ 108(a), 108(b), 108(c) and IRS publication 908.)

Note, however, it is likely that many taxpayers currently subject to cancellation of debt income will qualify for the insolvency exemption from taxation. Taxpayers should be advised to speak with their own tax advisors as to whether they meet the insolvency exemption.

Q 11. Are there any exemptions from the capital gains taxation in a foreclosure, deed-in-lieu of foreclosure or short sale if the property is a principal residence?

A Yes. If the sale, whether through a foreclosure or deed-in-lieu or short sale, generates capital gains and if the property was the seller's principal residence, the seller may be able to use the capital gains exclusion of \$250,000 if single and \$500,000 if married filing a joint return. This exclusion does not apply to ordinary income from cancellation of debt.

MISCELLANEOUS

Q 12. Which is better for an owner facing a distress sale: a foreclosure, a deed-in-lieu of foreclosure or a short sale?

A Any of these situations will impact the owner's credit negatively. Additionally, the owner may have a significantly different tax liability depending on the disposition of the property. Consequently, this is a question that the owner needs to discuss with their own tax advisor.

Q 13. What is a quick summary of these taxation rules?

	Recourse Foreclosure/ Deed-in-Lieu	Nonrecourse Foreclosure/ Deed-in-Lieu	Short Sale
Capital Gains	FMV Less Adjusted Basis	Greater of FMV or Outstanding Debt Less Adjusted Basis	FMV Less Adjusted Basis
Ordinary Income	Outstanding Debt Less FMV *	No Ordinary Income	Amount of Debt Forgiven*

*No Ordinary Income if property is considered a "Qualified Principal Residence Indebtedness" (See the discussion in Question 9).

Q 14. Does California follow the federal COD debt relief rules set forth above?

A Not exactly. California law, SB 401, conforms California Revenue and Tax Code Section 17144.5 to federal law, but with the following changes:

(1) The maximum amount of qualified principal residence indebtedness is \$800,000 for married couples filing jointly, registered domestic partners filing jointly, single persons, head of household, widow/widower; and \$400,000 for married couples or registered domestic partners filing separately; and

(2) The maximum amount of debt relief income that can be forgiven is \$500,000 for married couples filing jointly, registered domestic partners filing jointly, single persons, head of household, widow/widower; and \$250,000 for married couples or registered domestic partners filing separately; and

(3) California's debt relief statute applies to property sold on or after Jan. 1, 2009 and before Jan. 1, 2013.

Q 15. *Where can readers obtain more information on the subjects covered above?*

A Information is available from a variety of sources, including:

- The Internal Revenue Service (IRS) (<http://www.irs.gov/>), which has detailed publications available for free on many tax related subjects. For more information, see [IRS Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments](#), and IRS Web page, [The Mortgage Forgiveness Debt Relief Act and Debt Cancellation](#).
- The IRS Tele-Tax system, which is an automated voice message information system with recorded information on many commonly asked tax questions. Tele-Tax can be reached by calling (800) 829-4477.
- A tax professional, such as a certified public accountant, tax attorney, or enrolled agent.

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