Foreclosures and Short Sales: How to Determine if the Debt is Recourse or Nonrecourse

By David M. Fogel, EA, CPA

Introduction

In previous articles published in the California Enrolled Agent, I discussed the income tax consequences of foreclosures and short sales. This article answers the question of how to determine whether the debt(s) involved are recourse or nonrecourse.

Background

In determining the income tax consequences of a foreclosure, short sale or deed in lieu of foreclosure, it is necessary to determine if the debt is nonrecourse or recourse. A debt is nonrecourse if the lender can’t hold the borrower personally liable for it and may go only against the value of the property to collect. A debt is recourse if the lender can hold the borrower personally liable for it beyond the value of the property.

The importance of this distinction is that where title to the property is transferred, such as in a foreclosure, short sale or deed in lieu of foreclosure, if the debt is nonrecourse, then there is no cancellation of debt income (“COD income”). Instead, the principal amount of the debt is treated as the “amount realized” in computing gain or loss. But if the debt is recourse, then the transaction is split into two parts: (1) COD income equal to the principal balance of the debt minus the fair market value (FMV) of the property, and (2) gain or loss equal to the FMV of the property minus its adjusted basis.

General Rules

In general, a debt is recourse unless (1) the loan documents contain language indicating that the loan is nonrecourse, either in full or in part, or (2) state law makes the loan nonrecourse.

Follow these steps to determine if the debt is recourse or nonrecourse:

- Obtain a loan history from either county records or a real estate reporting service such as www.HomInfoMax.com or www.RealQuest.com.
- The loan history will show the loans obtained at the time of the original purchase, all title changes, all refinance loans, etc.
- Examine the loan documents (mortgage, promissory note, deed of trust). If they contain a promise to pay, then the loan is usually recourse. Rarely, the loan documents will contain a provision that applies in the event of default, limiting the lender’s remedy only to the property without any ability to sue the borrower for a deficiency. If this is the case, the loan is probably nonrecourse.
- Apply state law to determine if the loans at the time of the foreclosure, short sale, or deed in lieu of foreclosure were recourse or nonrecourse. State law that classifies the loan as nonrecourse usually trumps the provisions in the loan documents.

Are Debts Secured by California Real Estate Recourse or Nonrecourse?

Section 580b of the California Code of Civil Procedure (CCP) essentially provides that a debt that was obtained to purchase real property ("purchase-money loan") is nonrecourse if the purchaser occupies the property, entirely or in part, and the property is a dwelling for not more than four families. A purchase-money junior loan is also nonrecourse.

Before January 1, 2013, an original nonrecourse debt that is refinanced with the same lender retains its nonrecourse status to the extent of the amount of the original debt. Before January 1, 2013, an original nonrecourse debt that is refinanced with a different lender converts the debt to recourse.

For refinances on or after January 1, 2013, for owner-occupied property, if the original loan was nonrecourse, then the refinance loan retains its nonrecourse status to the extent of the unpaid principal balance of the original purchase-money loan that was paid off. The portion of the refinance loan distributed to the borrower and used to pay for costs of the refinance is a recourse loan.

Converting the property to rental use doesn’t convert a nonrecourse loan into a recourse loan because the character of the loan as a purchase-money loan covered by CCP §580b is determined by the facts and circumstances which existed at the time it was created.

continued on p. 8
Do CCP Sections 580d or 580e Convert a Debt From Recourse to Nonrecourse?

In California, if a lender forecloses using the non-judicial foreclosure process (notice of default, period of redemption, trustee’s sale), then that lender is prohibited from obtaining a deficiency judgment against the borrower.  

Some have argued that because the lender is prohibited from obtaining a deficiency judgment, a non-judicial foreclosure “converts” a recourse loan into a nonrecourse loan. But I believe that they are incorrect. Rather, the balance of the loan remaining after the foreclosure is discharged.

If California property is disposed of in a short sale that occurred after December 31, 2010 but before July 15, 2011, the lender holding the first mortgage loan is prohibited from obtaining a deficiency judgment. After July 14, 2011, this provision applies to any lender that approved the short sale, not just the first mortgage holder.

Last year, in a letter sent to U.S. Senator Barbara Boxer, the IRS concluded that a short sale of California residential property doesn’t result in any COD income whether the debt is recourse or nonrecourse. However, the IRS later retracted that conclusion. The IRS indicated that a short sale doesn’t result in any COD income if the debt immediately before the short sale was nonrecourse. If the debt was recourse, then the short sale resulted in COD income.

How Do You Determine Whether Debt is Recourse or Nonrecourse for Property Located Outside of California?

As stated above, review the loan documents for any nonrecourse language.

Visit the following website, which is one of the best sources of information about the real estate laws of the various states and whether deficiency judgments are allowed or not, which may give a clue as to whether the debts are recourse or nonrecourse: www.alllaw.com/articles/nolo/foreclosure/anti-deficiency-laws.html.

Is a Debt Owed by a Limited Liability Company Nonrecourse Because No Member isPersonally Liable?

Suppose that a California Limited Liability Company (LLC) that files as a partnership holds real estate that is secured by a mortgage loan, and that under the terms of the promissory note, in the event of default, the LLC is obligated for any deficiency if sale of the property is insufficient to satisfy the loan (i.e., it’s a recourse debt owed by the LLC).

Under Internal Revenue Code (IRC) §108(d)(6), COD income of a partnership is determined and realized at the partnership level while any applicable exclusions are determined at the partner level. COD income is treated as an item of income which is allocated separately to each partner.

Whether a partnership’s debt is recourse or nonrecourse is properly determined at the partnership level.

All states have laws regarding LLCs, and these laws provide that no member of the LLC is personally liable for the debts of the LLC. Does this fact, alone, mean that the debt is nonrecourse? No. The LLC is personally liable for the debt. The debt is recourse to the LLC.

What about the impact of Treasury Regulation §1.752-1(a) (2), which states that a partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability under §1.752-2? That particular provision applies only for purposes of IRC §752, and not for other purposes, such as IRC §1001.

Therefore, for purposes of determining the income tax consequences of a foreclosure, short sale or deed in lieu of foreclosure, unless the loan documents state that the debt is nonrecourse, a debt of an LLC is usually recourse with respect to the LLC.

Illustration

Here’s a typical example that illustrates the principles discussed above.

On March 17, 2004, Mr. and Mrs. Jones purchased their principal residence in Sacramento, California. The purchase price was $250,000. They financed the purchase with a first mortgage loan in the amount of $200,000, and a second mortgage loan in the amount of $50,000. Both loans were obtained from ABC Mortgage Company.

On July 14, 2005, the $50,000 second mortgage loan was paid off in a refinance. The new loan, obtained from XYZ Mortgage Company, was for $95,000.

On March 28, 2013, Mr. and Mrs. Jones disposed of the residence in a short sale. The sales price was $175,000. The short sale resulted in proceeds of $160,000. $150,000 of the proceeds went to ABC Mortgage Company and was applied against the first mortgage loan. $10,000 of the proceeds went to XYZ Mortgage Company and was applied against the second mortgage loan. Both lenders consented to the short sale, and canceled the remaining debt.

Under CCP §580b, initially, both the first and second mortgage loans were nonrecourse because they were purchase-money loans. But the second mortgage loan was refinanced with a different lender, so the second mortgage loan was a recourse loan.

As a result, the short sale resulted in COD income from cancellation of the second mortgage loan. If, for example, before the short sale, the principal balance of the second mortgage loan was $90,000, and the lender received $10,000 in proceeds, the lender canceled $80,000, which would constitute COD income. Since the first mortgage loan was nonrecourse, its principal balance would be the amount realized in calculating gain or loss on the short sale.

continued on p. 9
Conclusion

In order to determine the income tax consequences of a foreclosure, short sale or deed in lieu of foreclosure, it is crucial to find out whether the debts immediately before the short sale were recourse or nonrecourse. The rules discussed above should help you with this.

David M. Fogel, EA, CPA, is a self-employed tax consultant and frequent contributor to the California Enrolled Agent. He provides tax consulting services to other tax practitioners and represents clients before the various tax agencies. David has more than 40 years of experience in tax controversies, including 26 years working for the IRS (8 years as a Tax Auditor and Revenue Agent, 18 years as an Appeals Officer), and 6 years as a tax advisor for law firms in Sacramento. David is an Enrolled Agent, a CPA, and is also admitted to practice before the United States Tax Court. He can be reached by email at dfogel@surewest.net or on the Internet at www.fogelcpa.com.

1. See “Tax Aspects of Foreclosures and ‘Short Sales’” (Jan. 2009); “Tax Aspects of Rental Property Foreclosures and ‘Short Sales’” (Aug. 2009); “Tax Consequences of Foreclosures and Short Sales — Debunking the Myths” (Nov. 2010); “Reducing Tax Attributes Due to Canceled Debt Income Exclusion” (May-June 2011); “Ten More Myths About the Tax Consequences of Foreclosures and Short Sales” (May-June 2012).


3. Frazier v. Commissioner, 111 T.C. 243 (1998); Treas. Reg. §1.1001-2(a)(2); Example (B) at Treas. Reg. §1.1001-2(c); Rev. Rul. 90-16, 1990-1 C.B. 12. COD income for a short sale is the principal amount of the debt that the lender cancels after applying the proceeds of the short sale against the amount owed.


8. SB 1069, Chap. 64, adding subsec. (c) to CCP §580b.


12. I discussed this issue, along with the history and purpose of CCP §580d in “Does a Non-Judicial Foreclosure Convert Debt From Recourse to Non-Recourse?” California Tax Lawyer (Vol. 20, No. 2, Winter 2011, p. 35).

13. CCP §§806c, added by SB 931, Chap. 701.

14. SB 458, Chap. 82.


19. For example, see Calif. Corporation Code §17703.04.