Does a Non-Judicial Foreclosure Convert Debt from Recourse to Non-Recourse?

By David M. Fogel, CPA[1]

I. INTRODUCTION

Consider the following situation: In 2005, Albert and Betty Cobb buy vacant land in Stockton to hold for appreciation because they have heard a rumor that the County plans to approve a large residential subdivision on this land. The purchase price of the land is $400,000. They pay $80,000 as a down payment and obtain a recourse mortgage loan of $320,000. By 2010, the fair market value (FMV) of the land has dropped substantially. The Cobbs stop making the mortgage payments, and the lender forecloses using the non-judicial foreclosure process (notice of default, period of redemption, trustee's sale). The land's FMV at the time of the foreclosure is $60,000, and the principal balance owed on the mortgage loan is $300,000. Assume that under California law, the lender is deemed to cancel the loan ($300,000) in excess of the property's FMV ($60,000).

Under well-settled principles involving the taxation of foreclosures involving recourse debt (discussed below), the transaction is split into two parts: $240,000 of ordinary income from discharge of indebtedness equal to the excess of the debt ($300,000) over the property's FMV ($60,000); and $340,000 capital loss equal to the FMV of the property ($60,000) minus the Cobbs' basis ($400,000), of which they can deduct a maximum of $3,000 per year.[2] Due to the addition of $237,000 to their income, the Cobbs owe an additional $90,000 in Federal and California income tax for 2010.

Now what if there was a way to eliminate the $90,000 in income tax? What if the debt were somehow magically transformed into a nonrecourse debt? Then the Cobbs wouldn't have any income from discharge of indebtedness because, as discussed below, a nonrecourse debt that is canceled in exchange for the property securing the debt is treated as a sale or exchange resulting in gain or loss. Instead, the Cobbs would have a $100,000 capital loss ($300,000 debt minus $400,000 basis).

Enter the non-judicial foreclosure argument. A few California lawyers contend that a non-judicial foreclosure converts a recourse debt into a nonrecourse debt.[3] If these lawyers are right, then none of the foreclosures in California would result in ordinary income from discharge of indebtedness because nearly all foreclosures in California are accomplished using the non-judicial foreclosure process. This article examines this argument.

II. BACKGROUND

A debt is nonrecourse if the lender cannot hold the borrower personally liable for it and may go only against the value of the property that is securing the debt in order to collect the debt. In California, an example of a nonrecourse debt for an owner-occupied personal residence is a purchase money mortgage, where the borrowed funds are used to purchase the property.[4]

A debt is recourse if the lender can hold the borrower personally liable for it beyond the value of the property that is securing the debt. In California, examples of recourse debts that are secured by a personal residence may include a second mortgage, a refinance loan, and a line-of-credit loan. Debts on non-owner-occupied properties in most cases are also considered to be recourse debts.

If a lender discharges part of a debt, then the borrower must recognize the amount of the discharged debt as ordinary income.[5] Where the property is not transferred, a reduction in the principal amount of the debt results in cancellation of debt income (COD income) whether the debt is recourse or nonrecourse.[6]

However, where the property is transferred in connection with discharge of the debt, such as in a foreclosure, the income tax consequences depend upon whether the debt is nonrecourse or recourse. If a nonrecourse debt is canceled in exchange for a transfer of the property securing the debt, the transfer is treated as a sale or exchange of the property, and the amount realized from the sale is the principal amount of the debt, even if the amount of the debt is more than the fair market value of the property.[7]

On the other hand, if the debt is recourse, then the transaction is split into two parts: COD income equal to the outstanding principal amount of the debt minus the FMV of the property; and gain or loss equal to the FMV of the property minus its adjusted basis.[8]

Section 726(a) of the California Code of Civil Procedure is California's "one form of action rule." Put simply, this section provides that a lender may only choose one action to collect on a mortgage or deed of trust that is secured by real property. The two foreclosure options are judicial and non-judicial.

Under the judicial foreclosure process, when the borrower is in default, the lender sues the borrower in court to obtain title to the property. In California, if a lender wants to collect the deficiency from the borrower, the lender must use the judicial foreclosure process to obtain a deficiency judgment. It is unlikely that a lender would use this process unless there is evidence that the borrower has significant assets to pay the deficiency judgment. It is much easier and less expensive for a lender to use the non-judicial foreclosure process.

Under the non-judicial foreclosure process, if the loan document or Deed of Trust contains a "power of sale" clause, this clause allows the lender to sell the property at auction when the borrower is in default. To begin this process, the lender files a "Notice of Default" with the County Recorder's office. Before selling the property at auction (also called a trustee's sale), the lender must wait 3 months plus 21 days (the "period of redemption") for the borrower to pay past due amounts. This is the procedure used most often by lenders to foreclose on real property in California.

III. THE NON-JUDICIAL FORECLOSURE ARGUMENT

According to the lawyers' articles, if a lender uses the non-judicial process to foreclose on property in California, an otherwise recourse debt is converted into a nonrecourse debt. This argument is based on section 580d of the California Code of Civil Procedure (CCP § 580d), which states in relevant part:

> No judgment shall be rendered for any deficiency upon a note secured by a deed of trust or mortgage upon real property or an estate for years therein hereafter executed in any case in which the real property or estate for years therein has been sold by the mortgagee or trustee under power of sale contained in the mortgage or deed of trust.

If the amount of the debt is more than the FMV of the property, CCP § 580d prevents the lender from obtaining a judgment against the borrower for the "deficiency" (the difference between the amount of the debt and the FMV of the property). Therefore, what this section actually does is to cancel the balance of the debt that the borrower owes to the foreclosing lender. But does it *convert* the nature of the debt from recourse to nonrecourse?

The articles contend that since CCP § 580d operates to prevent a foreclosing lender from obtaining a deficiency judgment, the borrower is no longer personally liable for the debt, and therefore, the debt has been converted from a recourse debt to a nonrecourse debt. This is a novel argument, and it has widespread implications since so many property owners in California have lost their properties to non-judicial foreclosure and have had to deal with COD income on their tax returns.

I do not agree with this argument. In my opinion, the borrower remains personally liable for a recourse debt, and CCP § 580d simply makes the debt that remains after the non-judicial foreclosure uncollectible.

In order to put this argument into its proper context, I think you need to look at the purpose of why CCP § 580d was enacted. The court in *Roseleaf Corp. v. Chierighino*[9] provides a good summary:

> The purpose of section 580d is apparent from the fact that it applies if the property is sold under a power of sale, but not if the property is foreclosed and sold by judicial action. Before the section was enacted in 1939, it was to the creditor's advantage to exercise a power of sale rather than to foreclose by judicial action. His right to a deficiency judgment after either was the same, but judicial foreclosure was subject to the debtor's statutory right of redemption, whereas the debtor had no right to redeem from a sale under the power. It seems clear, as Professor Hetland, amicus curiae herein, contends, that section 580d was enacted to put judicial enforcement on a parity with private enforcement. This result could be accomplished by giving the debtor a right to redeem after a sale under the power. The right to redeem, like proscription of a deficiency judgment, has the effect of making the security satisfy a realistic share of the debt. By choosing instead to bar a deficiency judgment after

> private sale, the Legislature achieved its purpose without denying the creditor his election of remedies. If the creditor wishes a deficiency judgment, his sale is subject to statutory redemption rights. If he wishes a sale resulting in nonredeemable title, he must forego the right to a deficiency judgment. In either case the debtor is protected.[10]

CCP § 580d was enacted to place a judicial foreclosure on a parity with a non-judicial foreclosure, not to change the nature of the debtor's personal liability for the debt. As stated above, CCP § 580d simply makes the debt that remains after a non-judicial foreclosure uncollectible. By choosing non-judicial foreclosure, the lender waives the right to a deficiency judgment and has a duty to cancel the underlying debt.[11]

IV. IS THE NON-JUDICIAL FORECLOSURE ARGUMENT SUPPORTED BY CASE LAW?

Two of the articles argue that several cases[12] in which a non-judicial foreclosure of property securing recourse debt was held to result in a gain or loss rather than COD income support the non-judicial foreclosure argument. The articles contend that these cases support the notion that the non-judicial foreclosure process converted the debt from recourse to nonrecourse.

Let's examine the facts and rulings in these cases. In *Chilingirian v. Commissioner*, a non-judicial foreclosure occurred with respect to property known as Crocker Center. The taxpayers had acquired the property from a partnership in which they were partners. They got new financing, consisting of a first mortgage of $110,000, and a second mortgage of $60,000, both of which were recourse debts. They lost the property in a non-judicial foreclosure when their adjusted basis was $124,275. The IRS determined a gain of $45,725, which was sustained.

This case does not support the non-judicial foreclosure argument. The court did not rule that the non-judicial foreclosure converted the nature of the debt from recourse to nonrecourse. The articles appear to infer this from the fact that the IRS and the court determined a gain on the foreclosure rather than to split the transaction into COD income and gain/loss as is required when the debt is recourse. But the opinions do not disclose what the FMV of the property was at the time of the foreclosure. If the FMV of the property was more than the $170,000 debt, then there would not be any COD income, which would explain why the IRS and the court determined gain.

In *R. O'Dell & Sons Co., Inc. v. Commissioner*, the taxpayers owned property in New Jersey with a $150,000 mortgage and an adjusted basis of $114,142. The lender acquired the property in a judicial foreclosure. The lender took no action afterwards to collect the deficiency from the taxpayers. The court ruled that the taxpayers had a gain equal to the mortgage ($150,000) minus their basis ($114,142). This case does not support the non-judicial foreclosure argument because there was no discussion of COD income, and the case involved a judicial foreclosure.

In *Diamond v. Commissioner*, the taxpayer held land in Oklahoma with an adjusted basis of $64,332. The land secured a mortgage debt of $26,000. Due to nonpayment, the lender instituted foreclosure proceedings and obtained a deficiency judgment against the taxpayer of $20,000. The taxpayer settled the deficiency judgment by paying $4,500. On his return, the taxpayer claimed an ordinary loss of $38,332 ($26,000 debt minus $64,332 adjusted basis), and an ordinary deduction for the $4,500 payment. The IRS determined that the $38,332 loss and $4,500 payment were capital rather than ordinary losses. The Tax Court sustained the IRS. This case does not support the non-judicial foreclosure argument because there was no discussion of COD income, and the case involved a judicial foreclosure.

And in *Wicker v. Commissioner*, the taxpayer owned all of the stock of a corporation known as Franklin Auto Body Company, Inc. ("FAB"). In 1976, FAB borrowed $195,000 from a bank using ten properties as collateral, and in 1978, the bank foreclosed on seven of the properties. At the time of the foreclosure, the amount owed on the note was $175,206, and FAB's adjusted basis in the seven properties was $76,372. The IRS determined a gain of $98,834 ($175,206 debt minus $76,372 basis) on the foreclosure. There was nothing in the record to indicate the FMV of the properties, whether the debt was recourse or nonrecourse, whether the foreclosure was judicial or non-judicial, or whether the lender canceled the remainder of the debt after the foreclosure, and as a result, the Tax Court rejected the IRS's determination of gain. Again, this case does not support the non-judicial foreclosure argument because there was no discussion of COD income, nor did the record indicate whether the foreclosure was judicial or non-judicial.

Surprisingly, the articles do not cite the two instances in federal tax law where CCP § 580d was discussed—*Fung v. Commissioner*, 117 T.C. 247 (2001) and General Counsel Memorandum 35627 (Jan. 16, 1974).

In *Fung v. Commissioner*, a nonresident alien died holding a one-half interest in three properties in California. One property was a 3-story apartment building in Oakland. The FMV of the property was $885,000, and the balance owed on the mortgage (a recourse debt) was $649,948. The issue was whether, for estate tax purposes, the debt should be used to reduce the FMV of the property, or whether it should be taken as a deduction subject to the limitations on deductions for estates of nonresident aliens. The IRS argued that the debt should not reduce the FMV of the property per Treasury Regulation section 20.2053-7 because the decedent was personally liable for the debt. The estate argued there was no personal liability due to CCP § 580d. Relying upon *Cornelison v. Kornbluth* (1975) 15 Cal. 3d 590, the Tax Court ruled that CCP § 580d "does not eradicate the possibility of a personal liability."[13]

And in General Counsel Memorandum 35627, the issue was whether a loan obtained in California by a Texas limited partnership on property located in Texas was a nonrecourse liability. The IRS analyzed California and Texas law and concluded that CCP § 580d did not operate to convert the recourse liability to a nonrecourse liability.

V. CONCLUSION

CCP § 580d does not convert an otherwise recourse debt to nonrecourse. Rather, it prevents the foreclosing lender from obtaining a deficiency judgment after a non-judicial foreclosure, thereby canceling the debt remaining, if any.

ENDNOTES

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2 An individual taxpayer is limited to a $3,000 deduction per year for net capital losses. *See* IRC § 1211(b).

3 Basil Boutris and Zachary Epstein, "Tax Consequences of Non-Judicial Foreclosures," Tax Network, Newsletter of the Tax Procedure and Litigation Committee, Taxation Section of the State Bar of California, Jan. 2011; Marc Ericsson, "Taxation of Short Sales and Foreclosures," Contra Costa Lawyer Magazine, Sept. 28, 2010 (http://www.cccba.org/attorney/cclawyer-articles/2010-09-28.php); Gordon L. Gerson, "Fear and Loathing California Law: Non-Recourse Carve-Outs on California Loans" (http://www.gersonlaw.com/images/content/fear_and_loathing_california_law.pdf)

4 *See* Cal. Code Civ. Proc. § 580b.

5 IRC § 61(a)(12).

6 *See United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931); *Gershkowitz v. Comm'r*, 88 T.C. 984 (1987); Rev. Rul. 82-202, 1982-2 C.B. 35, amplified by Rev. Rul. 91-31, 1991-1 C.B. 19.

7 *See Comm'r v. Tufts*, 461 U.S. 300 (1983); Treas. Reg. § 1.1001-2(a)(1); *2925 Briarpark Ltd. v. Comm'r*, 163 F.3d 313 (5th Cir. 1990); *L&C Springs Assocs. v. Comm'r*, 188 F.3d 866 (7th Cir. 1999); Rev. Rul. 76-111, 1976-1 C.B. 214.

8 *See* Treas. Reg. § 1.1001-2(a)(2), (c) Example (8), Rev. Rul. 90-16, 1990-1 C.B. 12; *Frazier v. Comm'r*, 111 T.C. 243 (1998).

9 *Roseleaf Corp. v. Chierighino* (1963) 59 Cal. 2d 35, 43-44.

10 *Id.* (citations omitted).

11 *Kerivan v. Title Ins. & Trust Co.* (1983) 147 Cal. App. 3d 225, 230-231.

12 Boutris and Epstein cite the cases of *Chilingirian v. Comm'r*, 918 F.2d 1251 (6th Cir. 1990), affg. T.C. Memo. 1986-463; *R. O'Dell & Sons Co., Inc. v. Comm'r*, 8 T.C. 1165 (1947), affd. 169 F.2d 247 (3d Cir. 1948); *Diamond v. Comm'r*, 43 B.T.A. 809 (1941); and *Wicker v. Comm'r*, T.C. Memo. 1993-431. Ericsson cites the *Chilingirian* and *Wicker* cases, and Gerson does not cite any cases.

13 *Fung v. Comm'r*, 117 T.C. 247 (2001).