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

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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 at .

Sincerely,

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