



OFFICE OF THE CHIEF COUNSEL

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
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The Honorable Senator Boxer  
United States Senate  
Washington, DC 20510

Dear Senator Boxer:

This letter clarifies our previous letter to you dated September 19, 2013, which addressed the question of whether a California homeowner would have taxable cancellation of indebtedness income on a lender-approved short sale.

In a letter to us dated August 28, 2013, you expressed concern that sections 108(a)(1)(E) and 108(h) of the Internal Revenue Code were scheduled to expire at the end of 2013. These sections provided that a homeowner would not have taxable income due to forgiveness of a loan that the homeowner used to purchase a principal residence (that is, a "purchase-money loan" to acquire a principal residence). You indicated that California homeowners who otherwise would have qualified for this exclusion after 2013 might be taxed on the amount of the forgiven loan if Congress did not extend the exclusion. As a result, you asked whether we would treat nonrecourse debt in a short sale the same way we treat nonrecourse debt in a foreclosure.<sup>1</sup>

We indicated in our earlier letter that a homeowner whose purchase-money loan on his or her principal residence was forgiven would not recognize cancellation of debt income. However, this analysis was overly broad. Following that letter, various California practitioners contacted us and provided a further explanation of how California property and foreclosure laws operate. Based on that information, as well as our reexamination of California's foreclosure laws, we are providing this clarification.

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<sup>1</sup> The cancellation of a nonrecourse loan upon disposition of property does not result in cancellation of indebtedness income. Thus, sections 108(a)(1)(E) and 108(h) never applied to nonrecourse purchase-money home loans.

Section 580b(a)(3) of the California Code of Civil Procedure (CCP) provides that:

- A deficiency judgment will not apply in any event after a sale of real property under a mortgage that secures a purchase-money loan.
- A purchase-money loan is a loan that was used to pay all or part of the purchase price of an owner-occupied dwelling for not more than four families and that is secured by that property.

We understand this to mean that under section 580b(a)(3), a lender has no recourse against a mortgagor for a deficiency under any circumstance. Two recent cases, *Rex v. Chase Home Finance LLC*, 905 F.Supp.2d 1111 (C.D. Cal. 2012), and *Coker v. JP Morgan Chase Bank, N.A.*, 159 Cal.Rptr.3d 555 (Cal. App. 2013), *petition for review granted*, 312 P.3d 829 (2013), hold that the section 580b protection applies to short sales when a mortgage secures a purchase-money loan described in section 580b(a)(3). Therefore, as we understand California law, a lender has no recourse against a homeowner for a deficiency following either a foreclosure or a lender-approved short sale when the mortgage secures a purchase-money loan described in section 580b(a)(3).<sup>2</sup>

Consequently, for federal income tax purposes, a purchase-money loan between a lender and mortgagor that is described in section 580b(a)(3) is, from its inception, a nonrecourse loan. Therefore, upon the foreclosure or short sale of a principal residence when a mortgage secures such a purchase-money loan, the amount realized on the sale is determined under *Commissioner v. Tufts*, 461 U.S. 300 (1983). That is, if the mortgage balance exceeds the fair market value of the home, the owner must report the entire amount of the nonrecourse debt as an amount realized on the disposition of the home. Although gain on the disposition of a residence generally is gross income, the owner may qualify to exclude all or part of the gain from income if the residence was the owner's principal residence (section 121 of the Code). Therefore, cancellation of indebtedness income does not arise in this situation.

Section 580b(a)(3) of the CCP applies only to purchase-money loans to acquire a principal residence. Section 580e, however, applies to both purchase-money loans and non-purchase-money loans, and applies to property that may or may not be the taxpayer's principal residence. Non-purchase-money loans subject to California's anti-deficiency statutes generally appear to be recourse loans from their inception. We were overly broad in our prior response in extending our analysis of the federal tax treatment of obligations beyond those described in section 580b(a)(3).

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<sup>2</sup> In addition, under section 580b(a)(3) of the CCP a "purchase-money loan" includes a loan used to refinance a purchase-money loan, or subsequent refinances of a purchase-money loan, except to the extent that lender lends new principal that is not applied to an obligation owed or to be owed under the purchase-money loan.

I hope this information is helpful. If you have additional questions, please call me or  
at .

Sincerely,

Michael J. Montemurro  
Chief, Branch 4  
Office of Associate Chief Counsel  
(Income Tax & Accounting)