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## Debt Characterization in a 'Short Payoff' Transaction

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### Abstract

The continued depression of the Southern California real estate market of the early nineties has taken many homeowners from what were once substantial equity positions to a position of 'negative' equity. This is particularly true with respect to the owners of 'single-family' dwellings. Those homeowners with 'negative equity' are opting for a transaction known as 'short payoff.' Homeowners may not fully understand the tax, legal and financial ramifications of such a transaction, and consequently, may find themselves in serious trouble. Policymakers, lenders and creditors may find it necessary to educate the general public about potential pitfalls of the 'abusive' kind of short payoff, which is becoming commonplace among owners with negative equity. This paper attempts to clarify the pertinent legal and tax issues surrounding this transaction with the help of a case study. We conclude that the 'abusive' short payoff transaction may not be the solution a homeowner with negative equity is looking for.

**Key words:** payoff, COD, UPB, non-recourse.

### Introduction

The continued depression of the Southern California real estate market of the early nineties has taken many homeowners from what were once substantial equity positions to a position of 'negative' equity. This is particularly true with respect to the owners of 'single-family' dwellings.

Single-family homeowners who now find themselves holding title to an asset having such 'negative' equity ultimately seek options from their financial advisors, lawyers, accountants, or financial planners. The option of interest to many homeowners today has come to be known as a 'short payoff'. A 'short payoff' is a sale transaction in which a third party buys the property at fair market value, but for less than the balance owing. Once a buyer is found and the offer is made, the seller's lender will either agree to accept such offer or refuse to sign off on the deal. If the lender accepts such offer, and the deal is consummated, the resulting transaction is called a 'short payoff'. However, before an advisor can discuss this option and explain the federal income tax consequences, it is necessary to 'properly' characterize the debts encumbering the property. Characterization of debt is a state law question. After characterizing the debt, an advisor must evaluate the sale transaction in the light of many changes in the law regarding the application of the debt forgiveness rules.

### Character of the Debt under California Law

The California legislature has provided a good framework within which to characterize debt that encumbers a single-family dwelling. Characterization of such debt depends upon the use of the borrowed funds and remedies available to the lender in the event of default by the borrower<sup>3</sup>. The general rule is if the borrower uses the monies to finance part of the purchase price of the property, then the resulting loan is called a "purchase money" loan<sup>4</sup>. A Lender's sole remedy in the event of default by the borrower is limited to foreclosure against the property; no deficiency judgment is available<sup>5</sup>. Consequently, the borrower is not personally liable for repayment of a "purchase money" loan and, for purposes of federal income taxation, the loan is called a "non-recourse" debt<sup>6</sup>.

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<sup>3</sup> Cal.Civ.Proc.Code S 726 (West 1994).

<sup>4</sup> Bernhardt, California Mortgage and Deed of Trust Practice. Chapter 4, at 204 (CEB 2nd Ed.1990).

<sup>5</sup> Cal.Civ.Proc.Code S 580b (West 1994).

<sup>6</sup> See e.g., Treas.Reg. 5 1.1001-2(c) (1994), ex. (2).

## Exceptions to the General Rule

The general rules of debt characterization stated above may not apply under all circumstances. For example, the debt can be converted from one form to another, as in the case of a “purchase money” loan which has been re-financed. Another example involves borrowing against one’s equity to finance a college education. In cases such as these, the borrower has become “personally liable” for repayment of the debt because a refinanced loan and home equity loan both lie outside the definition of the “purchase money” loan.

Under California law, a refinanced loan, or a home equity loan secured by the borrower’s single-family dwelling, will be subject to a deficiency judgment<sup>1</sup>. Consequently, the borrower will be held “personally liable” for repayment of the loan and, for purposes of federal income taxation, the loan is called a “recourse” debt. Finally, the rules underlying many loans guaranteed by the FHA/VA provide that, in its capacity as a Guarantor, the United States government automatically has a deficiency right against a defaulted borrower. Thus, regardless of how state law characterizes the debt in such a case, federal law overrides the characterization when the VA has guaranteed the contractual performance of the borrower, and the borrower defaults. Consequently, for purposes of federal income taxation, the loan is a “recourse” debt.

## Summary of Income Tax Consequences of a ‘Traditional’ Sale

A ‘short’ payoff transaction is the modern paradigm of a sale. A sale usually results in gain or loss<sup>2</sup>. However, treatment of the transaction may require additional considerations under the so-called ‘cancellation of indebtedness’ (“COD”) rules, depending on the character of the debt being disposed of in the transaction<sup>3</sup>. Consequently, the income tax consequences of the ‘traditional’ sale transaction have depended upon the character of the debt involved.

If the debt was non-recourse, sale transactions ‘historically’ (disregarding exotic tax events, such as the modification of a non-recourse instrument) have resulted in gain/loss to the borrower and the fair market value of the borrower’s property had absolutely no relevance<sup>4</sup>. However, this was not true in sales that disposed of recourse debt.

If the debt was recourse, then the transaction received the so-called ‘bifurcation’ treatment<sup>5</sup>. The relevant principles require a borrower to bifurcate the sale transaction into part COD and part gain/loss, this time depending on the fair market value (“FMV”) of the property. The borrower will have COD income to the extent that the unpaid principal balance (“UPB”) of the recourse debt ‘exceeds’ the FMV of the property<sup>6</sup>. However, this increment of the UPB must be forgiven and the obligation to repay discharged by the lender<sup>7</sup>. The rules described above, regarding determination of gain or loss, also apply in the bifurcated transaction.

Bifurcated tax treatment will arise if the borrower refinanced a ‘purchase money’ loan or borrowed against the equity when the FMV was high. In a depressed market, the value falls and equity turns ‘upside down’. In these negative equity situations, a borrower is exposed to potentially high tax liability arising from COD income.

## Income Tax Regulations and Current Ruling Position of the IRS

The Income Tax Regulations (“REGULATIONS”) validate the above analysis. The REGULATIONS require that gain/loss be determined by taking into account the full amount of the

<sup>1</sup> Strictly speaking, such loans fall squarely outside the scope of the protection afforded by Section 580b, and the case law which has interpreted/applied Section 580b has recognized very few variations on the ‘standard purchase money’ transaction that shall qualify for anti-deficiency protection. See e.g., *Spangler v. Memel*, 7 Cal.3d 603, 102 Cal.Rptr. 807 (1972), and its progeny.

<sup>2</sup> I.R.C. 5 1001 (1994).

<sup>3</sup> Treas.Reg. S 1.1001-2(a)(2) (1994).

<sup>4</sup> See *Crane v. Commissioner*, 331 U.S. 1 (1947), and its progeny; see *Commissioner v. Tufts*, 461 U.S. 300 (1983), and its progeny.

<sup>5</sup> Treas.Reg. S 1.1001-2(a)(2) (1994).

<sup>6</sup> See e.g., Treas.Reg. S 1.1001-2(c) (1994), ex. (8).

<sup>7</sup> I.R.C. 5 61(1994).

liabilities disposed of in the sale transaction<sup>1</sup>. Further, the REGULATIONS specifically exempt from this procedure the portion of recourse debt includible as COD<sup>2</sup>. Non-recourse debt, however, is omitted from the “carve-out”. Thus, the REGULATIONS suggest that disposition of non-recourse debt is not subject to the bifurcation treatment required of recourse debt. Consequently, under the REGULATIONS, disposition of non-recourse debt at less than the balance due appears not to be the subject of COD income recognition, and this should apply to all sale transactions, a “short payoff” as well as the traditional type of sale transaction.

The IRS, however, has published Revenue Rulings (“RULINGS”) in the past several years (based on recent Court decisions) suggesting that the sale provisions of the CODE might be superseded by the COD provisions in transactions involving a disposition of non-recourse debt<sup>3</sup>. In each case, though, the decisions and RULINGS addressed dispositions of non-recourse debt in a non-sale transaction, or in a transactional context in which a borrower retained possession of the collateral after the transaction. Consequently, application of the COD rules in the ‘short payoff’ transaction is unclear, and the IRS has not (nor have the Courts) specifically addressed the issue.

### A Case Study

The Smiths purchased a home in 1975 at a cost of \$300,000, and made a cash payment of \$50,000 and borrowed \$250,000 from Bank of X. In February 1987, the home was worth \$950,000, and had equity of \$ 850,000. To finance the college education of their three children, the Smiths borrowed \$450,000 against the equity in their home.

In December 1992, Mr. Smith was laid off. In July 1993, they fell five months behind in their home loan payments and Bank of X threatened foreclosure. The house was worth \$350,000, the UPB of the first trust deed was \$125,000, and that of their equity loan was \$400,000. Because of their equity loan, the Smiths must bifurcate their proposed transaction into part COD and part gain/loss. Results of their sale would be as follows:

$$\text{COD} = \text{Unpaid Balance} - \text{Fair Market Value}$$

$$\text{Gain} = \text{Adjusted Revenue (AR)} - \text{Adjusted Basis (AB)}, \text{ or Loss} = \text{AB} - \text{AR}$$

Recall that UPB = \$400,000, FMV = 350,000, and AB is \$300,000. AR is the full amount of the non-recourse debt remaining, or \$125,000.

First, the recourse part determines the amount of COD income, in this case, \$50,000 (\$400,000 - \$350,000), and is ordinary gross income the Smiths must report on their Form 1040. Second, the non-recourse part determines the loss, in this case, \$175,000 (\$125,000 - \$300,000), and is a “capital” loss that the Smiths cannot claim.

Consequently, the Smiths have realized ordinary COD income as well as a non-deductible capital loss. Even if their loss had been deductible, it could not be used to offset the ordinary income from the forgiveness of the equity-based indebtedness. The Smiths are thus placed in the worst possible tax position in this transaction.

<sup>1</sup> Treas.Reg. S 1.1001-2(a)(1) (1994).

<sup>2</sup> Treas.Reg. S 1.1001-2(a)(2) (1994); Michaels v. Commissioner. 87 T.C. 1412 (1987) (the Regulation effectively bifurcates a ‘sale’ transaction by recognizing that the amount of recourse debt, which is expressly forgiven, constitutes a separate tax event thus giving rise to a separate item of gross income, determined separately from the gross income resulting from the gain (or loss) upon the sale).

<sup>3</sup> See Rev.Rul. 82-202 1982-2 C.B. 36 (Tax payer charged with COD income on settlement of a non-recourse note at less than UPB while retaining possession of collateral); Rev.Rul. 91-31. 199 1-1 C.B. 19 (Taxpayer charged with COD income on the reduction in UPB of a non-recourse note down to FMV of collateral while retaining possession of the collateral); Gershkowitz v. Commissioner. 88 T.C. 984 (1987) (Taxpayer charged with COD income on settlement of the non-recourse note at less than UPB rather than surrendering collateral that had substantially fallen in value); Estate Of Newman v. Commissioner. 934 F.2d 426 (2nd Cir. 1991) (Taxpayer charged with COD income on cancellation of non-recourse debt without any payment or return of collateral).

## Conclusion

With regard to tax consequences of disposing of an encumbered single-family dwelling in a 'short-payoff' transaction, debt is classified as non-recourse or recourse, depending upon state law, but with limited exceptions at the federal-level.

Disposition of a non-recourse debt has traditionally given rise to gain or loss, whereas that of recourse debt results in COD income. Gain incurred on the sale of a personal residence (capital asset) is capital in character, whereas COD income is ordinary. In each case, though, gain and COD give rise to items of gross income which a borrower must report, unless properly deferred or excluded. A capital loss suffered on the disposition of a principal residence is nondeductible. Consequently, income tax consequences of misclassifying a debt could be devastating to the client.

Although, the REGULATIONS suggest that disposition of non-recourse debt is not the subject of COD income in a 'short payoff' transaction, neither the IRS's recent RULINGS nor the Courts have addressed this issue. There is, however, a growing judicial trend toward decaying the traditional tax treatment of non-recourse debt in an effort to 'equalize' the tax treatment of the disposition of both formats of debt. The RULINGS and judicial decisions, however, rest on a logic that does not apply to the historical sale and the modern 'short payoff' transactions, in which underlying collateral is given up. Nevertheless, the IRS may assert that the RULINGS and Court decisions do apply to the traditional sale transaction and 'short payoff'. Only after the Courts have decided the issue, will the fate of the proper tax treatment of non-recourse debt in the sale context be laid to rest.