Originally published in the:
New York Law Journal ***June 22, 2022***

IRS Comes Up Short: Ninth Circuit Case Allows Interest Deduction for Short Sale

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The income tax consequences of a foreclosure or short sale of real property depend on whether the mortgage debt is recourse or nonrecourse to the taxpayer. If the mortgage debt is recourse, then the taxpayer is personally liable for any deficiency on the loan. If the lender forgives such a deficiency, the taxpayer recognizes cancellation-of-indebtedness income, which is taxed as ordinary income. In contrast, if the mortgage debt is nonrecourse, then the entire balance of the debt is treated as proceeds from the sale of the property, even if it exceeds the fair market value or actual sales price of the property.

As an example, assume that a taxpayer owned a property with a tax basis of $40, subject to mortgage debt of $100, and that the property is sold in a short sale for $75. If the mortgage debt is recourse, then the taxpayer will recognize $35 of capital gain from the sale, and if the lender forgives the $25 deficiency, then the taxpayer will also recognize $25 of cancellation-of-indebtedness income. In contrast, if the mortgage debt is nonrecourse, the taxpayer will recognize $60 of capital gain and no cancellation-of-indebtedness income.

A recent U.S. Court of Appeals for the Ninth Circuit case illustrates these rules and raises a number of interesting issues relating to distressed debt. In *Milkovich v. United States*, 28 F. 4th 1 (9th Cir. 2022), the taxpayers originally purchased a home with mortgage debt for which they were personally liable. The debt was subsequently refinanced with another recourse loan, and several years later, the home was underwater and the taxpayers stopped making payments on the loan.

The taxpayers filed for bankruptcy, and as part of the bankruptcy proceedings, the court discharged the taxpayers, which had the effect of converting the mortgage loan from a recourse loan to a nonrecourse loan. The mortgage lender then agreed to a short sale of the property, and the property was eventually sold, with the lender applying part of the proceeds to accrued and unpaid interest. The lender applied the balance of the proceeds to principal.

The taxpayers then deducted the portion of the proceeds that was applied to interest on their federal income tax return for the year of the sale.

The IRS disallowed the interest deduction, and the taxpayers paid the resulting tax and sued for a refund. The District Court dismissed their complaint on the grounds that, because the mortgage debt exceeded the fair market value of the property, the transaction lacked economic substance and therefore any interest deduction was disallowed.

The Ninth Circuit reversed, holding that the taxpayers were entitled to the interest deductions. The court distinguished this case from precedent relating to transactions lacking economic substance, reasoning that in this case, the original mortgage loan was a bona fide debt at the time it was incurred, and that the subsequent decline in the value of the property should not change its character.

The Ninth Circuit also rejected an alternative argument put forward by the government. The IRS had argued that the taxpayers recognized cancellation-of-indebtedness income as a result of the transaction, which was excludable from income under a special exception relating to bankruptcies, and that because the interest expense related to this tax-exempt income, it should be disallowed. In rejecting this argument, the Ninth Circuit reiterated the distinction between the treatment of recourse debt and nonrecourse debt on a foreclosure or short sale. If, as here, the debt was nonrecourse, then the entire gain or loss (including the excess of the mortgage balance over the sales price) is treated as a capital gain or loss, and the taxpayer recognizes no cancellation-of-indebtedness income. The court held that the fact that the debt in this case was originally recourse debt and became nonrecourse solely as a result of a bankruptcy proceeding should not change this result, and that the bankruptcy proceeding (which only had the effect of converting the debt from recourse to nonrecourse) did not in itself cause the taxpayers to realize income.

The court found that the taxpayers paid all of the accrued interest on the loan as a result of the sale proceeds being applied by the lender first against accrued interest. This was the case even though the total sale proceeds were not sufficient to repay the loan in full. Thus, having rejected all of the government's arguments for the non-deductibility of the interest, the court allowed the taxpayers' deduction.

This case serves as a reminder of the importance of the distinction between cancellation-of-indebtedness income and gain from the sale of property. As illustrated in the case, in a foreclosure or short sale, nonrecourse debt usually results in capital gain (or loss), whereas recourse debt can result in a combination of cancellation-of-indebtedness income and capital gain (or loss), depending on the particular facts. Moreover, cancellation-of-indebtedness income can sometimes be excluded under several exceptions in the Code (such as when it arises from bankruptcy), but if an exception does not apply, it is taxable as ordinary income. There are no such exclusions for gain from the sale of property, but such gain is generally taxed at preferential capital gain rates, and the taxpayer can apply his basis in the property against the gain. Thus, the tax consequences from a sale can differ dramatically depending on whether mortgage debt is recourse or nonrecourse, and whether one is preferable to the other will depend on the taxpayer's particular circumstances.

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