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Adding Insult to Injury: The Sad Tale of a Short Sale

By: Ezra Dyckman and Daniel W. Stahl

Finding herself in default on the mortgage loan secured by her New Jersey home, Ms. Callahan enlisted the help of a company which had sent her an unsolicited mailing, offering to help individuals in her situation save their real property from foreclosure. While the company ("REI") did successfully negotiate a discounted payoff of her mortgage loan, it also convinced her to convey her house to an affiliate and ended up keeping more than half of the purported sale proceeds for itself. Then, after a New Jersey court decision gave Ms. Callahan her house back and things were finally starting to look up for Ms. Callahan, the IRS came in and contended that she had recognized both gain and COD income. In a recent decision, the Tax Court declined to end Ms. Callahan's tale of woe, but did give her a little good news.

The Saga of Ms. Callahan's Home

The ordeal for Ms. Callahan began in 2007, when she was in default on the $1,550,000 mortgage loan secured by her New Jersey home on which she was personally liable (the "Wall Street Loan").[1] After unsuccessfully attempting to modify or refinance the loan, she turned to REI for help. Mr. Losner of REI worked out an agreement with the mortgage lender in which the mortgage lender agreed to accept $850,000 in full discharge of Ms. Callahan's $1,550,000 loan. Also, as arranged by Mr. Losner, Ms. Callahan signed a contract to sell the property to Mr. Losner's associate, Mr. Wolkowitz, for $1,750,000. (Notably, this contract price was actually greater than the full amount of the outstanding mortgage on the property.) The contract showed that the $1,750,000 purchase price would be applied as follows:

- $850,000 toward repaying the Wall Street Loan.
- $50,000 for settlement charges.
- $750,000 as cash for Ms. Callahan.

The contract stated that Mr. Wolkowitz was providing Ms. Callahan with a $450,000 deposit, and he borrowed $1,300,000 on a new mortgage loan secured by the property (the "Chase Loan") to obtain additional funds for the transaction.

At closing, $850,000 of the Chase Loan proceeds were applied toward the Wall Street Loan, and Ms. Callahan was released from further liability thereon. Ms. Callahan transferred title to the property to Mr. Wolkowitz, but the remaining portion of the Chase Loan proceeds went to affiliates of REI, and Ms. Callahan never received the deposit or any other cash.

As part of the arrangement between Ms. Callahan and Mr. Wolkowitz, Mr. Wolkowitz leased the house to Ms. Callahan for a year, and Ms. Callahan had an option to buy the house back at the end of the year. (The Tax Court found contradictory information regarding the exercise price for the option.) The lease agreement stated that Ms. Callahan prepaid a $50,000 portion of her rent for the year. Ms. Callahan did not exercise the option, but remained on the property after the one-year lease expired.

In 2009, Mr. Wolkowitz was in default on his payments under the Chase Loan, and Chase commenced a foreclosure action in New Jersey Chancery Court. Ms. Callahan intervened, arguing that the property had been taken from her by fraud, and the Chancery Court agreed to stay the proceeding. Then, Ms. Callahan commenced a separate action in Chancery Court against Mr. Wolkowitz. After Mr. Wolkowitz failed to answer Ms. Callahan's complaint, the Chancery Court entered a default judgment against Mr. Wolkowitz in 2011. The judgment voided the transfer of the property to Mr. Wolkowitz and restored legal title to Ms. Callahan subject to the Chase Loan.

Tax Court Case

The IRS determined that Ms. Callahan recognized $1,300,000 of gain upon her transfer of the property to Mr. Wolkowitz (i.e., the excess of (i) the $1,750,000 purchase price reported on the contract over (ii) Ms. Callahan's $450,000 tax basis in the property). In addition, the IRS determined that Ms. Callahan recognized $700,000 of ordinary income from cancellation of indebtedness (i.e., the excess of (i) the $1,550,000 amount due on the Wall

__Ezra Dyckman__ is a partner in, and __Daniel W. Stahl__ is an associate of, the law firm of Roberts & Holland LLP.

Street Loan, a recourse mortgage, over (ii) the $850,000 amount that the lender accepted in settlement of the debt). Ms. Callahan contended that she should be considered to have never transferred the property and, as a result, did not recognize any gain from a disposition. In addition, she also challenged the determination that she had recognized the $700,000 of cancellation of indebtedness income ("COD income").

In the recent Tax Court case of *Callahan v. Commissioner*,[2] the Tax Court acknowledged that the Chancery Court had (i) voided the transfer of the property to Mr. Wolkowitz and (ii) returned title to Ms. Callahan. However, the Tax Court explained, "[i]mplicit in the Chancery Court's order voiding the transfers subject to the existing mortgage was that Chase's mortgage interest in the property was valid" and that "[a]s a corollary, the Chancery Court did not void the transfers from the beginning." The Tax Court recognized that, under New Jersey law, equitable fraud provides a basis for a party to rescind a contract, which "voids the contract *ab initio*, meaning that it is considered 'null from the beginning' and treated as if it does not exist for any purpose." However, the Tax Court explained, the Chancery Court did not "specifically make any finding of fact or render any opinion on the merits of the fraud claim." As a result, the Tax Court agreed with the IRS that Ms. Callahan should be considered to have transferred the property to Mr. Wolkowitz.

However, the Tax Court disagreed with the IRS regarding Ms. Callahan's amount realized on the disposition. The Tax Court determined that Ms. Callahan's amount realized was equal to only the amounts that it considered Ms. Callahan to have actually received. As a result, her amount realized was equal to $950,000, which was the sum of (1) the $850,000 that was transferred to the original mortgage lender, (2) $50,000 that went toward her prepaid rent, and (3) $50,000 that went toward settlement charges. The Tax Court found that the remaining portion of the $1,750,000 purported purchase price was kept by affiliates of REI and was not considered to have been received by Ms. Callahan. Therefore, her gain was equal to only the $500,000 excess of her $950,000 amount realized over her $450,000 basis in the property.

The Tax Court agreed with the IRS's determination that Ms. Callahan had recognized $700,000 of COD income as a result of the discharged portion of the Wall Street Loan.

Analysis

On the one hand, it seems difficult to argue with the Tax Court's decision from a technical standpoint. Ms. Callahan did transfer her New Jersey home to Mr. Wolkowitz and, while the Chancery Court subsequently restored her title, it did not make a decision on the merits retroactively nullifying the sale. In addition, the mortgage lender of the Wall Street Loan did accept $850,000 in complete satisfaction of the $1,550,000 recourse mortgage (and, when a portion of a recourse debt is forgiven, the taxpayer recognizes COD income even if the property is transferred in connection with the debt forgiveness). These two points provide a simple and straightforward justification for the Tax Court's determination that Ms. Callahan (i) recognized gain on the disposition and (ii) recognized COD income upon the discounted payoff of the Wall Street Loan.

On the other hand, however, there seems to be something fundamentally unfair about the Tax Court's decision. The Tax Court appears to acknowledge that, if the Chancery Court had made a determination on the merits that the transfer to Mr. Wolkowitz was retroactively void, Ms. Callahan would not have been considered to have made a taxable disposition of her property. If there were considered to be no disposition of the property, there would be no gain on sale. It appears to be at least plausible that the Chancery Court would have retroactively nullified the sale if Mr. Wolkowitz had answered the complaint and the default judgment had not been entered. Thus, it may very well be the case that the Federal income tax consequences of the purported transfer were determined by Mr. Wolkowitz's decision not to answer the complaint. Should that be the case?

Moreover, the Tax Court's determination that Ms. Callahan had $700,000 of COD income also seems unfair. It is true that, as a technical matter, the Tax Court may not have been wrong in determining that her recognition of COD income in 2007 was unaffected by the fact that the Chancery Court restored the property to her in a subsequent year. However, while Ms. Callahan was relieved of the remaining balance on the $1,550,000 Wall Street Loan, the property was subject to the new Chase Loan when it was subsequently restored to her (which appears to have had a $1,300,000 outstanding balance). Thus, when taking into account the whole picture, she really was relieved of only an amount equal to the $250,000 excess of the $1,550,000 Wall Street Loan over the $1,300,000 Chase Loan. Nonetheless, the Tax Court held that she recognized $700,000 of COD income, which effectively caused her to have COD income for the cancellation of a portion of the debt despite the fact that she did not really benefit from the cancellation. Would it not have been more reasonable for her COD income to have been equal to only the excess of the amount of the old Wall Street Loan over the new Chase Loan?

Conclusion

Apart from the tax aspects of *Callahan v. Commissioner*, the human interest element is captivating. The case provides the reader with a real life view into the predatory actions of certain firms that offer to help people in default on their mortgage loans. In fact, while this may not be surprising to the reader, Mr. Losner of REI was disbarred as an attorney. (The Tax Court took judicial notice of this fact at Ms. Callahan's request, although the Tax Court does not find it to be relevant.)

From a tax law standpoint, one take-home message is to be careful that what is in your documents matches the transaction that is actually occurring. The IRS contended that Ms. Callahan's amount realized upon the disposition of her property was $1,750,000 based on the fact that the contract showed $1,750,000 as the purchase price—despite the fact that the evidence showed that a large portion of this amount was never delivered. While Ms. Callahan was victorious on this issue, the contract's wording caused her a lot of unnecessary aggravation. More generally, the all-out manner in which the IRS came after Ms. Callahan is disturbing and, while the Tax Court's decision may not be wrong, it leaves the reader to consider whether our tax controversy system should provide the Tax Court with a mechanism to temper its analysis with some degree of compassion in a case such as this one.

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[1] This article uses rounded numbers for simplicity.

[2] T.C. Memo 2013-131.