

# Real Estate Owned (REO)

A Look at Issues from The Lender's Perspective

1031

Knowledge



Short sales, foreclosures and deed-in-lieu transfers of distressed real estate have potential tax implications for the transferor and can present an investment opportunity for the transferee. To learn more about the benefits of a 1031 exchange transaction involving the disposition of distressed real estate, see [1031 Exchanges in a Foreclosure: Sometimes Your Loss Really is Your Gain](#).

From the viewpoint of the secured bank lender, the receipt of the real estate pledged as collateral for the borrower's repayment obligation is a payment event. If the lender acquired the note at a significant discount, the receipt of the collateral can generate a capital gain if the value of the real estate exceeds the lender's investment in the secured note. If the collateral is worth less than the investment in the note (as is usually the case), the difference generates a loss. The loss is characterized for income tax purposes as an ordinary loss if the lender is actively engaged in the business of lending. A private party that is not in the business of lending will realize a capital loss.

If the collateral is not sold to a third party in a foreclosure sale, the lender ends up taking ownership of the collateral which is classified under GAAP rules as "other real estate owned" or REO property. Since a regulated bank is not in the business of owning and managing real estate assets, bank regulations generally require that the bank dispose of REO property expeditiously but in accordance with prudent business judgment. The accounting standards governing the disposition of REO Property are set forth in Financial Accounting Standards No. 66 relating to Accounting for Sales of Real Estate. To satisfy regulators, banks must maintain documentation evidencing sales efforts.

If a bank sells its REO property at a loss, the bank must recognize the actual loss which affects its balance sheet and reserve requirements. By timing the sale of REO property, the bank may be able to manage its balance sheet.

## CAN A BANK SELL AN REO PROPERTY TO COMPLETE A 1031 EXCHANGE?

A fundamental requirement of a 1031 exchange is that both the relinquished property sold and the replacement property acquired be held by the taxpayer for investment or for use in a trade or business. Section 1031(a)(2) excludes property held by the taxpayer primarily for sale. Property held for sale is generally classified as inventory under tax accounting rules. REO property is just that, inventory held by a bank for sale and would not qualify as held for investment. Even if REO property could be characterized as held for investment, however, the need to acquire replacement property is inconsistent with bank regulations requiring the bank to liquidate REO property. Of course, real estate owned by the bank for use in its trade or business, such as the bank's headquarters or branch offices is not inventory and may be exchanged for other like-kind property in a 1031 exchange.

## Compliments of:



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