

1031 Exchange in a Foreclosure

Sometimes Your Loss Really is Your Gain

1031

Knowledge

Sometimes a taxpayer might be faced with the prospect of a short sale or a lender's foreclosure. Taxpayers in this situation have a multitude of concerns ranging from the loss of equity invested in their property to a reduced credit rating. Unfortunately, there is often another consequence: the short sale or lender's foreclosure can sometimes result in an income tax gain that must be recognized. This is especially true where the investment property was originally acquired in a 1031 exchange.

A gain for tax purposes would occur in the context of a short sale or foreclosure if the mortgage debt encumbering the property is greater than the taxpayer's adjusted basis for income tax purposes. This happens because the transfer of the property to the lender is treated in part as if the investment property is sold to the lender for its *fair market value*. The determination of how much gain is recognized and the character of the gain in this context depends on whether the mortgage debt is recourse (e.g., a loan for which the borrower is personally liable) or nonrecourse (e.g., a loan for which the borrower is not personally liable). If the mortgage secures a *recourse* loan, the investor is treated for income tax purposes as: (i) having cancellation of indebtedness income to the extent that the mortgage debt exceeds the fair market value of the property; and, (ii) a capital gain or loss equal to the difference between the actual value of the property and the taxpayer's adjusted basis for income tax purposes. In the case of a *nonrecourse* loan, the taxpayer recognizes capital gain equal to the difference between the mortgage debt and the taxpayer's basis in the property. In a nonrecourse analysis, the fair market value of the property is treated as not less than the nonrecourse debt.

As previously mentioned, the tax consequences of a short sale or foreclosure are often considered only after the property is gone and the dust has settled. As it turns out, a savvy investor may be able to defer the gain resulting from the short sale or foreclosure. For example, the cash that would otherwise be needed to pay the tax liability could be used to acquire replacement property in a 1031 exchange. For practical reasons, this option will not be available to all of the investors, but in some cases it works quite well. The following is an example of how some taxpayers are using this strategy in a fractional ownership foreclosure: The investor completes a 1031 exchange in which a tenant-in-common interest in commercial real property (TIC interest) is acquired. The TIC interest is managed under a master lease under which the taxpayer receives a percentage of the net rent received by the master lessee on the property. The taxpayer's "exchange basis" in the TIC interest is \$70. The TIC interest is originally acquired with a value of \$200 and secures an interest only nonrecourse mortgage in the amount of \$170. Three years later, the TIC interest is worth only \$160 and the loan term has expired. As a result of the diminished value of the TIC Property, the TIC taxpayers are unable to refinance the TIC Property and the lender elects to foreclose. If nothing is done, the taxpayer will recognize a tax gain on the foreclosure in the amount of $\$170 - \$70 = \$100$. The capital gain will result in a tax due in the amount of approximately \$28 (including state and federal capital gains taxes). Keep in mind that the foreclosed taxpayer received no cash in the foreclosure process.

Faced with this scenario, some taxpayers have opted to explore deferring the gain by performing a 1031 exchange and entering into an Exchange Agreement with a qualified intermediary, prior to the foreclosure. In this case, the foreclosed property is treated as the relinquished property in the exchange and transferred in a "[parking arrangement]" transaction just prior to foreclosure. The taxpayer thereafter identifies like-kind replacement property in the usual manner with a value equal to or greater than \$170. The replacement property is acquired by using the \$28 as a down payment and obtaining a loan for the balance of the \$170 purchase price. The \$28 would otherwise have been used to pay the capital gain tax liability. If the exchange is completed, the \$100 gain will be deferred and the taxpayer ends up with equity in another investment property rather than paying taxes.

Although the exchange example cited above is fairly simple, there are some transactional challenges relating to the foreclosure process that must be overcome, not to mention issues relating to the replacement property financing. For this reason, any exchange structure must be planned well in advance of the actual foreclosure. It is critical that qualified legal and tax advisors be consulted in connection with the planned exchange.

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