OLD REPUBLIC EXCHANGE

1031 EXCHANGES:
FORECLOSURES, SHORT SALES AND DEEDS IN LIEU

While most people understand that foreclosures, short sales and deeds in lieu of foreclosure have significant economic consequences (loss of property; loss of equity; and loss of credit rating), what is not apparent to most people is that there are significant taxable consequences even if the owner walks away with no cash. While an IRC §1031 tax deferred exchange can, in theory, be utilized under these circumstances to defer the capital gain tax consequences, certain practical and technical challenges may make a tax deferred exchange problematic for many taxpayers.

Foreclosures, Short Sales and Deeds in Lieu, are defined, as follows:

Foreclosure: Foreclosure is an involuntary process whereby a lender repossesses property that was pledged as collateral for mortgage debt. Foreclosure can occur judicially (i.e. through a court action) or non-judicially, where a third party, such as a trustee, has the power to conduct a sale of the property after the lender has declared a default of the loan.

Short Sale: A short sale occurs when an owner sells property for less than the debt owed on the property. The lender must consent to the sale, agree to accept less than the full loan amount, and agree to release the property from the mortgage lien.

Deed in Lieu of Foreclosure: A deed in lieu of foreclosure occurs when an owner conveys property to the existing lender in exchange for cancellation of the mortgage debt—i.e. "in lieu" of a foreclosure by the lender.

Taxable Consequences of Foreclosures, Short Sales and Deeds in Lieu: Each of the above circumstances results in two potential taxable consequences to the owner; (1) tax on gain; and/or (2) tax on cancelled or forgiven debt. Whether the debt is recourse or non recourse dictates whether there is one or both of these tax consequences.

Non-Recourse Debt: (borrower not personally liable)? There is one tax consequence. Capital gain is taxed at the applicable capital gains rate—either 5% (for those in the 10% and 15% income tax brackets) or 15% (for those in the 25% or higher income tax brackets). The amount taxed is the difference between the debt and the adjusted basis. There is no tax on cancellation or forgiveness of debt.

Recourse Debt: (personal liability to borrower)? There are two tax consequences:

(1) Cancellation or forgiveness of debt is taxed as ordinary income. The amount taxed is the difference between the debt and the fair market value ("FMV"); and

(2) Capital gain is taxed at the applicable capital gains rate—either 5% (for those in the 10% and 15% income tax brackets) or 15% (for those in the 25% or higher income tax brackets). The amount taxed is the difference between the adjusted basis and the FMV. Given the foregoing, there is always the possibility that there is a taxable gain even when the owner receives no cash.

For example: Smith buys an apartment building in 1978 for $400,000 cash. The property appreciates in value, and in 1992, heobtains a loan of $350,000. The property continues to appreciate and—by 2004—the building's FMV is $2 million. Smith obtains a second loan of $850,000. However, in 2010, the property diminishes in value to $1 million, but his outstanding loans total $1.2 million and he is struggling to make the payments. Smith considers a short sale for the FMV of $1 million. Since Smith has owned the building for over 33 years, he has fully depreciated it and the adjusted basis is $0.

Tax consequences if debt is non-recourse:
If the debt which is the subject of the foreclosure, short sale or deed in lieu of foreclosure, is non-recourse, capital gain must be recognized to the extent the debt exceeds the owner's adjusted basis.

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In the example above, Smith's debt is $1.2 million and his adjusted basis is $0. Hence, he must pay federal capital gains tax (either 5% or 15%, depending on his income tax bracket) on $1,200,000 (5% would be $60,000—15% would be $180,000). Additionally, unless he lives in a state with no income tax, he will pay state income tax on his capital gain.

Tax consequences if debt is recourse: If the debt which is the subject of the foreclosure, short sale or deed in lieu of foreclosure, is recourse, capital gain must be recognized to the extent of the difference between the FMV of the property (here, $1 million) and the adjusted basis (here, $0). Hence, Mr. Smith must pay capital gains tax (either 5% or 15%) on $1 million.

In addition, there is a second tax consequence—i.e. cancellationof debt income. Mr. Smith must pay ordinary income tax (anywhere between 10% and 35%, depending on his income) on the difference between the FMV ($1 million) and the existing debt ($1.2 million). Thus, he must pay income tax on $200,000.

In sum, if the debt is non-recourse, Mr. Smith pays capital gains tax on $1.2 million. Alternatively, if Mr. Smith's debt is recourse, he will pay capital gains tax on $1 million and he will pay ordinary income tax on $200,000.

Can the tax consequences of a foreclosure, short sale or deed in lieu be ameliorated by a §1031 exchange?
In theory, although structuring a foreclosure, short sale or deed in lieu in the context of an exchange may ameliorate the capital gain tax consequences, these transactions present practical and technical difficulties—if not, complete obstacles – to including them as part of a tax deferred exchange, such as:

- No cash is available to complete acquisition of replacement property;

- Credit is adversely impacted and thus financing to purchase replacement property is unlikely;

- In a foreclosure there is no contract of sale for the taxpayer to assign to the Qualified Intermediary (required by the Treasury Regulations for an exchange);

- A short sale or deed in lieu may have a written agreement to assign to the Qualified Intermediary, but it is questionable as to whether the IRS would accept such an assignment.

In sum, owners should recognize that even though their property is under water and they will receive no cash from its disposition, the tax consequences remain significant.

Owners facing foreclosure, short sale or a deed in lieu should plan as far in advance as possible for the taxable consequence resulting from the transaction.

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