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Like-Kind Exchange Corner

By Mary B. Foster

Exchanging Coffins: Foreclosures and Code Sec. 1031

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A taxpayer who loses a property through a foreclosure sale (or deed in lieu of foreclosure) can recognize taxable gain, even though the taxpayer receives no cash from the sale. If the taxpayer has mortgage or debt relief in excess of the property's tax basis, then this excess will give rise to taxable gain upon the foreclosure.[1] The taxpayer will unfortunately have no equity in the property to pay the tax on the gain. While most taxpayers going through a foreclosure do not have the means or the courage to acquire more property, the gain from the foreclosure and the resulting tax can be deferred by structuring the foreclosure as an exchange under Code Sec. 1031 for like-kind replacement property.

Gain upon Foreclosure

If the debt secured by the property is nonrecourse, the taxpayer will realize taxable gain from the foreclosure to the extent that the taxpayer's adjusted tax basis in the property is less than the outstanding principal amount of the debt being satisfied by the foreclosure.[2] For example, if the taxpayer's nonrecourse debt is $5 million, and the adjusted tax basis in the property is $2 million, the taxpayer will realize $3 million of taxable gain from the foreclosure. The taxpayer will owe tax on this gain for the year in which the foreclosure occurs.

For nonrecourse debt, the amount recognized will equal the principal amount of the debt, even if the fair market value of the property is lower than the principal amount.[3] For recourse debt, however, the recognized gain is limited to the fair market value of the property at the time of the foreclosure. Any income from debt relief in excess of the fair market value would be cancellation of indebtedness (COD) income, and not gain from the disposition of the property.[4] Thus, if the taxpayer's recourse debt is $5 million, the fair market value of the property is $3 million, and the adjusted tax basis in the property is $2 million, the taxpayer will recognize $1 million of taxable gain from the foreclosure, and $2 million of COD.[5]

Can Foreclosure Gain be Deferred Through an Exchange?

In a "normal" tax-deferred exchange, the relinquished property disposition will typically result in some cash proceeds as well as some debt relief. Can a taxpayer exchange out of a foreclosure sale, if the only consideration is debt relief? No case law or other authority exists directly on the issue of exchanges with no equity. Code Sec. 1031 generally provides that no gain is recognized on the exchange of relinquished property for replacement property of like-kind. The statutory language does not explicitly require that either the relinquished property or the replacement property have equity in excess of the liabilities related to the property. Code Sec. 1031(d) states that liability assumption may be "part of the consideration" to the taxpayer. It would be overly conservative to conclude that this statement requires that liability assumption can only be part of but not the only consideration received by the taxpayer in the exchange.[6]

Further, the regulations under Code Sec. 1031 do not specifically require that either the relinquished property or replacement property have equity. In computing recognized gain in an exchange, these regulations provide that liabilities in the exchange are treated as "money or other property" and liabilities assumed by the taxpayer in the exchange offset the taxpayer's liabilities that are assumed by the other party to the exchange.[7] In a foreclosure with nonrecourse debt (or recourse debt up to the fair market value of the property), the lender is deemed to assume the taxpayer's debt as the purchase price of the property. Thus, the taxpayer receives consideration in the form a debt assumption, which the taxpayer can offset with debt assumption on the replacement property. Alternatively, if the taxpayer does not want to assume new debt in the amount of the relinquished property debt, the regulations make it clear that the taxpayer may offset the relinquished property debt relief with an investment of nonexchange cash in the replacement property.[8]

> [A] foreclosure sale can be structured as a tax-deferred exchange if the taxpayer has realized gain due to a mortgage balance in excess of the adjusted tax basis.

In summary, no authority seems to prevent a taxpayer from deferring gain recognition (but not COD income) from the foreclosure if it is structured as an exchange.[9] The taxpayer will need to acquire replacement property at least equal to the amount of the debt relief treated as gain realized from the foreclosure. Because new cash or cash "boot" also offsets liability relief, the taxpayer may replace some or all of the debt with equity. In the above example, the taxpayer would need to acquire a replacement property valued at least at $5 million to offset the debt relief of $5 million from the relinquished property. The taxpayer could acquire this replacement property with new debt of $5 million, equity of $5 million, or any combination of debt or equity. The normal 1031 time limitations would apply (*i.e.*, the taxpayer would have 45 days from the date of the foreclosure to identify the replacement property and 180 days from the date of the foreclosure to acquire the replacement property).

Structuring an Exchange

The "qualified intermediary" or QI safe harbor in Reg. 1.1031(k)-1(g)(4) allows a taxpayer selling property in a cash sale to structure the sale as an exchange, with minimal involvement of the buyer of the relinquished property. The QI safe harbor also can be used when the relinquished property is being transferred to a lender through foreclosure. To meet the QI safe harbor in a foreclosure, the QI must first enter into a written exchange agreement with the taxpayer. Then, as required by the exchange agreement, the QI must acquire the relinquished property from the taxpayer and then transfer the relinquished property to the transferee.[10]

The QI safe harbor provides two methods that could possibly be used for the QI to meet the requirement of acquiring the relinquished property from the taxpayer and transferring it to the lender, as the transferee in the case of a foreclosure. The first method is the "Assignment Safe Harbor," in which the taxpayer's rights under the transfer agreement with the transferee are assigned to the QI and all parties to that agreement are notified in writing of the assignment on or before the date of the transfer of property.[11] The Assignment Safe Harbor is used in almost all "normal" deferred exchange transactions because it involves the least amount of cost and disruption to the actual sale of the property to the buyer. The taxpayer's rights in the sale agreement are simply assigned to the QI at closing and the buyer receives a written notice of this assignment. In a foreclosure, however, there typically is no sale agreement to assign to the QI. The Assignment Safe Harbor could be used if the taxpayer has a written agreement with the lender for a deed in lieu of foreclosure for the relinquished property. However, some tax advisors are uncomfortable with the Assignment Safe Harbor in such a circumstance because the taxpayer is not receiving any cash from the transfer and thus may not really have any rights to assign.

Under the other possible method, the QI acquires and transfers legal title to the relinquished property.[12] This method will work in a foreclosure sale if the relinquished property is deeded to the QI prior to the foreclosure, but this transfer can increase the cost of an exchange because of the additional deed recording fees or real property transfer taxes. Often, however, the real property is owned in a special purpose entity, and this entity is also a disregarded entity for federal tax purposes, such as a single-member LLC. A transfer of the LLC interest is considered a transfer of the relinquished property in the exchange.[13] Thus, the taxpayer can assign the membership interest in the LLC to the QI, effective immediately prior to the foreclosure, and this assignment will be treated as the transfer of the relinquished property to the QI for the QI safe harbor. This will avoid transfer taxes in many, but not all, jurisdictions. The assignment of the membership interest in the LLC and the exchange agreement must be executed before the foreclosure actually occurs, so the taxpayer will need to set up the exchange in anticipation of the foreclosure if the actual date is not known. The lender then forecloses on the property while the QI owns the LLC, and the QI has met the requirement that it transfer the relinquished property to the transferee.

As a variance on the second method, the taxpayer could transfer the relinquished property prior to the foreclosure to an "exchange accommodation titleholder" (EAT) under Rev. Proc. 2007-37,[14] or a related party to the taxpayer,[15] for a nominal cash payment in addition to the debt relief. A QI would then be assigned the rights under the transfer agreement with the EAT or related party in accordance with the Assignment Safe Harbor and hold the nominal cash payment in an exchange account.

Completing the Exchange

The replacement property can be identified in writing within 45 days after the foreclosure. As with a "normal" exchange, the taxpayer can identify up to three alternative properties, or any number so long as the total fair market value of the identified properties does not exceed 200 percent of the amount of the debt relief.[16] As discussed above, however, the taxpayer will need to obtain new debt or invest new capital towards the purchase of the replacement property because there will be no exchange proceeds from the foreclosure of the relinquished property.

Finally, the taxpayer must remember that the replacement property has to be acquired in accordance with the QI safe harbor to complete the exchange. Because the QI holds no exchange funds and the taxpayer must supply the financing and/or cash investment for the replacement property, the taxpayer may erroneously think the QI's role is over after the foreclosure of the relinquished property. Typically, the Assignment Safe Harbor will be used for the replacement property. The taxpayer will enter into a purchase agreement for the replacement property, the taxpayer's rights under the purchase agreement will be assigned to the QI, and the seller will be notified of the assignment.

As outlined above, a foreclosure sale can be structured as a tax-deferred exchange if the taxpayer has realized gain due to a mortgage balance in excess of the adjusted tax basis. However, the taxpayer will still need to have other cash to invest, or readily available financing for the replacement property.

ENDNOTES

1 The taxpayer may also have cancellation of indebtedness income, if the debt is recourse and the debt amount exceeds the fair market value of the property.

2 Code Sec. 1001; Reg. §1.1001-2(a)(1).

3 *J.F. Tufts,* SCt, 83-1 USTC ¶9328, 461 US 300, 103 SCt 1826.

4 Rev. Rul. 90-16, 1990-1 CB 12.

5 *See* Code Sec. 108 for treatment of COD income and the relief available.

6 Note that while the regulations use the term "assumed," nonrecourse debt is treated as "assumed" for the purposes of the liability netting rules of Code Sec. 1031. Code Sec. 1031(d) provides that the amount of liabilities assumed under Code Sec. 1031 is determined by Code Sec. 357(d). Code Sec. 357(d) provides that liabilities assumed includes nonrecourse debt secured by the property.

7 Reg. §1.1031(b)-1(c); Reg. §1.1031(d)-2; see example 2(b).

8 Reg. §1.1031(d)-2 example 2(c).

9 COD income is ordinary income and not gain from the sale or exchange of property, and thus would not be eligible for deferral under Code Sec. 1031, but may be eligible for other favorable tax treatment under Code Sec. 108

10 Reg. §1.1031(k)-1(c)(4)(iii)(B).

11 Reg. §1.1031(k)-1(c)(4)(v).

12 Reg. §1.1031(k)-1(c)(4)(iv)(A).

13 *See, e.g.,* LTR 200118023 (Jan. 31, 2001).

14 Rev. Proc. 2007-37,

15 *See* LTR 200709036 (Nov. 28, 2006), and Mary B. Foster, *Related Parties and Code Sec. 1031(f): The Do's and Don'ts*, J. PASSTHROUGH ENTITIES, July-Aug. 2007, at 29.

16 Reg. §1.1031(k)-1(c)(4).