

Deferring phantom gain

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During recent years, real estate prices have dropped and foreclosures/deeds in lieu have increased. Economically distressed properties have been repossessed by lenders in transactions void of any cash profit to their owners. Nevertheless, federal income tax law treats these transactions as sales, which may have adverse tax consequences. Section 1031 may help defer phantom gain on the disposition of distressed property in these situations.

Where the loan is nonrecourse, the amount realized on the disposition of the property would be the principal amount of the nonrecourse liability. The realized gain is the difference between the basis in the property and the amount realized on the loan. The use of a qualified intermediary (QI) is a valid safe harbor in a tax deferred exchange which involves no cash or other property.

In a deed in lieu situation, the borrower and lender will execute an "agreement in lieu of foreclosure" specifying the terms of the conveyance. In anticipation of a Section 1031 exchange, the taxpayer should include an exchange cooperation clause in such agreement.

Prior to the conveyance, the taxpayer may assign his rights under the agreement in lieu of foreclosure to the QI and all parties are notified of the assignment in writing. The exchange timelines begin as of the date of the deed in lieu: taxpayer now has 180 days to acquire property(ies) with value equal to or greater than the principal amount of the recourse loan, the first 45 days being the identification period.

At the replacement property acquisition, the taxpayer will need to come to the closing with the entire amount of proceeds required, as there are no funds being held by the QI. Transfers of distressed property raise significant tax consequences. To avoid such tax pain, taxpayers may consider structuring a foreclosure/deed in lieu as part of an IRC 1031 Exchange. If the taxpayer can arrange financing for a suitable replacement property, Section 1031 will help the taxpayer avoid recognition of gain on a foreclosure/deed in lieu.

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