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Section 1031 may relieve some of the tax bite of a deed-in-lieu of foreclosure transaction

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In the current phase of the real estate cycle, a number of leveraged commercial real estate investors will experience foreclosure or a deed-in-lieu of foreclosure transaction. For many it will be unfamiliar territory, especially as it relates to tax considerations. These issues require a level and type of analysis not necessary during better economic times.

Foreclosures and deeds-in-lieu of foreclosure are dispositions of real estate generally constituting a sale or exchange for federal income tax purposes. The invisible tail on the dog, if you will, is that while the foreclosed real estate investor rarely has any equity to take away from the table, he or she may have gain on the sale for federal income tax purposes. This adds insult to the injury. However, under certain scenarios, an IRC Â§ 1031 exchange might offer some relief.

The taxable gain may be one or more of the following: (1) so-called IRC Â§1001 gain; (2) Cancellation or Discharge of Indebtedness Income (COD); and (3) what is known as Qualified Real Property Business Indebtedness (in essence a subset of COD available to non-corporate taxpayers regardless of solvency). The type or mix of types of gain that result varies according to whether and how much of the debt is recourse, and according to the amount of the debt in relation to the property's adjusted basis, and FMV. The type of gain is relevant because COD is generally excludable from income for insolvent or bankrupt taxpayers, while Â§1001 gain is generally included in income even where the taxpayer is insolvent.

While there is unfortunately no guidance regarding whether the deemed sale or exchange that occurs in a foreclosure or deed-in-lieu can constitute the first leg of an IRC Â§1031 exchange, it is popularly, though not universally, believed that a Â§1031 exchange employing a qualified intermediary (QI) may defer such of the Â§1001 type of foreclosure or deed-in-lieu gain that is not otherwise excludable under separate tax analysis.

While a foreclosure or a deed-in-lieu gives rise to the same federal income tax results, a deed-in-lieu appears to raise fewer issues when structuring a like kind exchange. Consider that the common practice in accomplishing a Â§1031 exchange is to employ a QI which attains its status in one of three ways: by coming into title and transferring both the relinquished and replacement properties; by acting as agent in connection with the transfer of such properties; or, by receiving an assignment of rights under the contracts pursuant to which both the properties are transferred with all parties receiving written notice of the relevant assignment at or before the closing. Of those, the preferred practice is the third, i.e., the assignment of rights with written notice to all parties. A deed-in-lieu would appear to dovetail nicely with this assignment and notice method, with the agreement for deed-in-lieu being assigned to the QI and all the parties to that agreement receiving timely written

notice.
Foreclosures, on the other hand, raise a host of unanswered questions, such as: Under the related state's foreclosure law what agreement, if any, is to be assigned to the QI? Who are all the parties to the agreement if the foreclosure involves an auction? Does a judge need to modify his or her order to allow an assignment and/or receive notice?
In sum, while not certain, many believe that if properly structured, a Â§1031 exchange may mitigate the "economic hurt" of unexpected taxes from Â§1001 gain in a below-water transfer of the taxpayer's property.

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