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Piling on: Foreclosure sales can trigger unexpected capital gains tax for owners

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Foreclosure rates have increased dramatically recently, and the trend is expected to continue through the last quarter of 2007. Many foreclosed owners suffer a second indignity when they discover that they owe a substantial capital gains tax resulting from the foreclosure. The final straw comes when they learn that the gain could have been deferred through a 1031 exchange despite the fact that there was zero equity from the foreclosed property.

When appreciated real estate is to be sold, many taxpayers are aware that they can defer income tax on the gain by entering into a like-kind exchange under Section 1031 of the internal Revenue Code. When real estate is to be foreclosed on, however, few taxpayers are aware that they too may need a 1031 exchange since they may have "phantom income" if the debt encumbering the foreclosed property exceeds the fair market value of the property.

For income tax purposes, a foreclosure (and a deed in lieu of foreclosure) is treated as a sale despite the involuntary nature of the proceeding. Gain from the "sale" is equal to the amount realized over the adjusted basis of the property.

With nonrecourse debt, the amount realized is equal to the outstanding amount of the nonrecourse debt, regardless of the current fair market value ("FMV") of the asset (i.e. the "phantom gain"). When recourse debt is discharged through a foreclosure, the transaction is treated as (i) a sale of the real estate for its FMV (with gain equal to the difference between the FMV and adjusted basis) and (ii) cancellation of debt ("COD") income, taxed at ordinary rates, for the amount of the debt relieved that exceeds the FMV. The tax code does provide some exceptions to recognition of COD income for insolvent and bankrupt taxpayers, in exchange for reduction of certain tax attributes.

IRC§ 1031 provides that no gain or loss will be recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged for property of a like kind. The regulations which define the term "like kind real property" generally consider US real property to be of like kind to all other US real property. There is no requirement in the Code or the Regulations that a taxpayer must have equity in the property being transferred for the exchange to be valid.

A taxpayer engaging in an otherwise valid like kind exchange will recognize gain if "boot" is received. Boot includes cash and the fair market value of any property other than qualifying like kind property. Boot also includes any relief from debt on the property-being sold, unless the taxpayer acquires a property with an equal amount of debt.

If a foreclosure or deed in lieu of foreclosure is inevitable, then the real estate owner can opt to enter into a deferred exchange transferring the distressed property to a qualified intermediary ("QI"). The QI disposes of the property by allowing the lender to complete the foreclosure. The QI would receive no proceeds from the sale, and would therefore not be required to spend any funds on the

replacement property. The replacement property would, however, need to have a FMV equal or greater than the foreclosed property, and debt equal to or greater than the debt on the foreclosed property in order to avoid the receipt of boot.

Since it is doubtful that the real estate owner will be able to obtain 100% financing for the replacement property, it will be necessary for the owner to invest additional capital into the replacement property. The taxpayer and the QI would effectuate the purchase like a traditional exchange, with the exception being that the taxpayer would bring any required equity to the closing. The cost of expending additional capital, however, should be weighed against the tax resulting from the phantom income that would otherwise be due. In most cases, it makes sense to do the exchange. A taxpayer thinking about entering into this type of exchange should consult with a tax professional.

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