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Avoiding tax in foreclosures: Some strategies to consider

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A like-kind exchange defers both gains and losses. Normal tax strategy involves accelerating losses and deferring gains. When a taxpayer is "upside down" on the property (value is less than the debt), having a significant potential gain, a like kind exchange may be a possible strategy. A taxpayer need not have equity in a property in order to exchange it. The opportunity to complete an exchange may occur when:

- * The taxpayer is upside down, and the lender will accept a "short sale."
- * The taxpayer is doing a deed in lieu of foreclosure (DIL).

In either situation, the taxpayer enters into a sale contract, and then assigns its rights in the contract to its qualified intermediary. Irrespective of how the funds are paid, the parties' exchange agreement should clearly address how funds are handled. After executing the required exchange documentation, the short sale or DIL occurs as it normally would, with title transferring directly to the third party buyer in the short sale or to the bank or its subsidiary in a DIL.

As with any exchange, the taxpayer in a short sale or DIL has 45 days to identify and 180 days to close upon replacement property, both measured from the transfer of the old property. To fully defer the gain, the taxpayer must acquire replacement property of equal or greater value to the old property. In a short sale or DIL, the intermediary would not ordinarily have proceeds to reinvest, so the replacement property would by necessity be purchased from other cash or borrowed funds. The debt on the replacement property could be typical recourse mortgage debt or non-recourse debt (such as is the case with single tenant, triple net leased property).

An important point: A like kind exchange can defer capital gains; it cannot defer cancellation of indebtedness (COD) income. A discussion of avoiding tax on COD income is beyond the scope of this article. COD income occurs when a taxpayer is discharged from its debt for less than the principal amount. COD income is not taxed when the taxpayer files bankruptcy or is insolvent. In certain circumstances, a taxpayer can reduce the basis of depreciable property to avoid COD income. Even if there is COD income, or the taxpayer does a partial exchange involving acquiring property less than the value of the one sold, there can be a significant tax benefit to doing an exchange.

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