Utilizing a 1031 Exchange in a Workout Situation

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 would be the difference between the basis in the property and the amount realized on the loan. The use of a Qualified Intermediary is a valid safe harbor in an exchange which involves no cash or other property.

To facilitate a 1031 exchange, the taxpayer and the Qualified Intermediary, QI, enter into a written exchange agreement. Pursuant to that agreement, the QI must: (i) acquire the relinquished property from the taxpayer; (ii) transfer the relinquished property; (iii) acquire the replacement property; and (iv) transfer the replacement property to the taxpayer. 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 to such agreement are notified of the assignment in writing. Taxpayer now has a total of 180 days from the date of the Deed in Lieu to acquire property or properties whose value is equal to or greater than the amount of the principal amount of the recourse loan. The first forty five (45) days of the 180 days is the time frame that the Taxpayer must identify the property or properties to be acquired. At the time of acquiring the Replacement Property, the taxpayer will need to come to the closing table 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 a Section 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.