Foreclosures

1031 Knowledge

1031 EXCHANGES MAY BENEFIT INVESTORS THREATENED WITH FORECLOSURE

A taxpayer facing the prospect of foreclosure or a short sale arrangement with their lender may have a multitude of concerns ranging from a deteriorating credit rating to loss of their equity. Unfortunately, the taxpayer may also have a significant tax liability that arises out of foreclosure or short sale.

LOSE PROPERTY IN FORECLOSURE BUT OWE CAPITAL GAIN TAXES

A tax liability could occur if the indebtedness encumbering the property is greater than the taxpayer's adjusted basis for income tax purposes. This happens because the transfer of the property to the lender or short sale buyer results in debt forgiveness. This usually happens in cases where the relinquished property is highly leveraged through cash-out refinancing, has declined in value or has been significantly depreciated. The capital gain is recognized whether the property is conveyed through foreclosure, short sale or a deed in lieu of foreclosure. In these instances, taxpayers have a capital gain tax liability even though they will not receive cash with which to pay the tax liability.

Remarkably, all is not lost to a taxpayer who has some cash and would like to continue to invest in real estate. If the transaction is properly structured, the taxpayer could elect to complete a 1031 exchange treating the mortgaged property as the relinquished property. In order to qualify, the transaction should be structured as either a short sale or a deed in lieu of foreclosure. If the property is foreclosed the transaction is not easily converted into an exchange because the transfer of the relinquished property occurs by operation of law. This leaves no room for an exchange agreement and the integration of a qualified intermediary into the transaction.

With a deed in lieu of foreclosure, it is critical that exchange documents be signed by the taxpayer prior to the property being deeded to the lender. This deed commences the running of the 45-day identification and the 180-day exchange periods. During the exchange period, the taxpayer must acquire replacement property of equal or greater net sales price to the relinquished property in order to defer 100% of their capital gain tax liability. The obvious hurdle to performing such an exchange is that the taxpayer must have enough cash available to make a down payment on the replacement property and be able to finance the remainder of the purchase price.

The above consequences highlight the need to involve legal and/or tax advisors in connection with all investment decisions. Failure to do so may result in a taxpayer incurring unintended tax liabilities which may have been deferred had the transaction been reviewed early on by the right professionals.

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HQ 800.282.1031 | NY 866.394.1031
apiexchange.com | info@apiexchange.com