



## **Klein of Shanholt Glassman Klein Kramer & Co. discusses tax advantageous of a deed in lieu of foreclosure**

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In these difficult economic times, it is not uncommon to see foreclosures and other modifications on real property indebtedness. Mortgages are either nonrecourse where the debt is secured only by the property or recourse where the debt is secured by the property and guaranteed by the borrower. When a taxpayer voluntarily transfers real property to the mortgagee in satisfaction of the non-recourse mortgage, the transaction is treated as a sale by the mortgagor and the amount realized is the amount of the mortgage balance, and the gain or loss is capital in nature. If the mortgagee has recourse to the mortgagor and the mortgagor is relieved of liability, the excess of the mortgage balance over the market value of the property is treated as cancellation of debt (taxable as ordinary income) and the difference between the basis in the property and fair market value is a capital gain or loss. Under certain circumstances, there is relief available for income from cancellation of indebtedness. If the property is used in a trade or business it is a Section 1231 transaction and gains are treated as long term capital gains while losses are treated as ordinary losses. There is often a significant difference between the mortgage balance at the time the mortgagor ceases making mortgage payments and the amount treated as satisfied by the mortgagee upon transfer of the property. The mortgagee usually adds interest due but unpaid to the mortgage balance along with other items such as prepayment penalty and real estate tax. If these items are added to the mortgage balance according to the terms of the note, they become part of a non recourse liability. A question arises whether the proceeds of the sale includes the amounts added to the mortgage balance and if it does, is the portion of the amount realized relating to the added expenses treated as ordinary income?

In *Allan, James A., et ux., et al. v. commissioner* U.S. Court of Appeals for the Eighth Circuit Docket No. 86-2268 Doc 1988-7832 decided September 16, 1988, the appellate court affirmed the tax court decision in favor of the taxpayer that the expenses added to the mortgage balance were included in the amount realized in the sale. The IRS had argued that the interest and real estate taxes had not been paid by the mortgagee and that the transaction should be bifurcated into two components: relief from the mortgage principal and relief from the liability for interest and real estate taxes. This would have required that the mortgagor recognize ordinary income upon the relief from liability for the expenses. The tax court had held and the appellate court affirmed that the unpaid interest and real estate taxes were deemed paid by the mortgagee through their addition to the outstanding mortgage balance. Both courts agreed that the mortgagor effectively borrowed the money and paid the expenses. The IRS also argued in defense of their position that the transaction should be split under the tax benefit rule and that the mortgagee should not receive capital gain treatment for amounts which were treated as ordinary expense. Both courts also ruled that there was only one mortgage note and that therefore the transaction cannot be broken up. The tax treatment would be

different if the accrued but unpaid interest is not added to the mortgage balance. If the fair market value exceeds the mortgage balance then the expenses would be recognized to that extent but when the fair market value is less than the mortgage balance, the accrued but unpaid expenses would be recaptured as ordinary income. It is important to review the mortgage document to determine how accrued but unpaid interest, penalty interest and other charges are treated.

In these types of cases, the taxpayer will get the benefit of deductions at ordinary income rates while recognizing an equal amount of gain at capital gain rates. The appellate court specifically addressed the operation of the tax benefit rule and ruled that it did not affect the court's opinion.

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