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Can a Section 1031 exchange be performed with the acquisition of an underwater property? - by Sandy Klein

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Sandy Klein
Shanholt Glassman Klein Kramer & Co.

When a taxpayer is faced with a pending foreclosure or a deed-in-lieu sale on investment or trade or business property, the taxpayer may be faced with a potential taxable gain when the property is "underwater." A property is deemed to be "underwater" when its debt exceeds the fair market value of the property securing the debt. In a situation where the debt is nonrecourse and the taxpayer transfers the property in a foreclosure sale or a deed-in-lieu sale, the taxpayer will be required to recognize gain based on a Sec. 1001 deemed sale, which treats the relief of the nonrecourse debt as gross proceeds or boot received. The tax gain will be the excess of the relieved nonrecourse debt over the tax basis in the property. This tax treatment is specific to nonrecourse debt. If the debt that is secured by property is recourse, the tax rules are different. The deemed sales price will be the fair market value of the property and not the amount of debt relief. The transaction will create a taxable gain to the extent the fair market value of the property exceeds the tax basis in the property transferred. The difference between the FMV of the transferred property and the remaining outstanding debt will be treated as Cancelation of Debt or COD income. Generally, COD income is taxable income subject to ordinary income tax rates.

Can a taxpayer utilize Section 1031 to defer the taxable gain from the deemed sale on a foreclosed property? For many years, the IRS had not given any guidance on this issue, and tax professionals have struggled with this question and were unable to give a "more-likely-than-not" tax opinion. The main concern focused on Section 1031(a)(1) which requires an exchange of "property." When a property is underwater and the taxpayer has no equity in the property, is the taxpayer actually exchanging "property?" Moreover, there was a concern that if the qualified intermediary (QI) does not actually receive any proceeds from the deemed sale of the relinquished property, the 1031 exchange will be void.

In 2012, the IRS issued Private Letter Ruling 201302009 which permitted an investor to structure a 1031 exchange on a deed-in-lieu sale.

In this ruling, the taxpayer owned real property used in a trade or business, refinanced an existing mortgage, and used the property as security for the nonrecourse loan. Over time, the property lost value, and the taxpayer negotiated to transfer the title of the property, subject to the debt, to the lenders. Instead of transferring the property directly to the lender, the taxpayer entered into an agreement with a QI and transferred the property and the debt to the QI, who then transferred it to the lender. The QI went ahead and acquired replacement property equal to the value of the nonrecourse debt on the relinquished property, using funds that were transferred or borrowed by the taxpayer, and transferred the title of the property to the taxpayer. The IRS ruled that the assignment of the taxpayer's rights in the relinquished property to the QI will be treated as a transfer of relinquished property for purposes of determining whether there is an "exchange of property held for productive use in a trade or business or for investment" under Sec. 1031(a)(1). Although the taxpayer received "boot" on the relief of the debt on the relinquished property, it was completely offset by the cash paid or the debt incurred for the replacement property per the rules of Regs. Sec. 1.1031(d)-2.

This letter ruling only addresses a situation where there is nonrecourse debt, and it does not address a situation where there is recourse debt with COD income. A 1031 exchange will not work to defer COD income from a taxpayer's gross income. However, there are a number of statutory exemptions that could apply to COD income which would work to defer or avoid the tax on COD income. For example, Sec 108(a)(1) exempts taxpayers from including COD income as part of their gross income if they have filed for bankruptcy or are insolvent or the indebtedness discharged is Qualified Real Property Indebtedness. Based on the availability of statutory exclusions to COD income, it may be possible to combine the exclusions and the 1031 exchange to completely defer and/or avoid taxable income currently.

Although this Private Letter Ruling cannot be relied upon as precedent, it has provided tax practitioners with a very positive insight into how the IRS is viewing these transactions. This ruling may enable tax practitioners to conclude that Section 1031 exchanges may be effectively utilized in underwater situations.

Sandy Klein, CPA, is a partner at Shanholt Glassman Klein Kramer & Co., New York, N.Y.