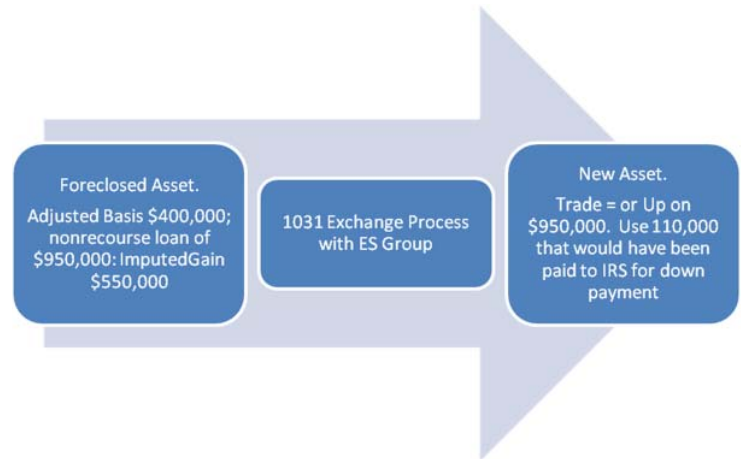


# MAKING THE BEST OF A BAD SITUATION:

## How to Defer Capital Gains Tax Liability on a Commercial Foreclosure

Unsuspecting commercial investors are driving to the bank to turn in their keys on projects that did not workout as planned and waking up the following year with an unexpected tax headache. The discharge of the loan can result in a capital gains tax liability. Not only did the clients lose whatever equity they had in the property, but they also face capital gains tax liability for simply how they transferred the property to the bank!

Individuals confuse the property's tax impacts with the property's economics. However, these two calculations are different. For tax purposes gain or loss equals the difference between the transfer price to the bank and the adjusted basis. Thus, if you bought a property in 1987 for 700k (your cost basis) and it has been depreciated and now has an adjusted basis of \$400K, and it is foreclosed with a 950k loan, this transfer without a 1031 exchange results in a taxable gain of \$550K, i.e. \$950k transfer price minus the \$400K adjusted basis.



Drilling down, the amount of gain for tax purposes depends on whether or not the debt is recourse or nonrecourse. With nonrecourse debt, the taxpayer is charged with gain equal to the difference between the outstanding mortgage amount and the adjusted basis. Thus, the taxable gain equals loan amount minus adjusted basis. To clarify, for nonrecourse debt fair market value of the property is not taken into consideration<sup>1</sup> In Commissioner v. Tufts, the Court pointed out that taxpayers receive value when they are relieved of a nonrecourse debt obligation.

For this problem, there is a solution. Exchange Solutions Group designs solutions for property owners facing foreclosure and related imputed gains. By purchasing another property of equal or greater value to the transfer price on the foreclosed property, a like-kind exchange can be used to delay the capital gain. The cash that would have been used to pay the tax liability can alternatively be redeployed into an asset rather than simply used to pay an expense.

To execute this strategy all 1031 exchange procedures need to be followed including preparing exchange agreements, identifying replacement property(ies), and closing within 180 days. Recall, that even if you are unsuccessful and end up with a "failed exchange" in the next year, you can elect installment sale treatment and push the tax liability to the following tax year, if you structured this as part of a 1031 exchange. To conclude, this market will undoubtedly have challenges but it is how we deal with adversity that defines us!

<sup>1</sup> Reg §1.1001-2(b) See also Woodsam Associates Inc. v Comm., 16 TC 649.



Group

### TAX PLANNING:

**Robert M. Ercole**  
**Neuberger, Quinn, Gielen, Rubin**  
**& Gibber, P.A.**

One South Street  
27th Floor  
Baltimore, MD 21202  
Direct 410.332.8559  
Fax 410.332.8563  
rme@nqgrg.com  
www.nqrgr.com

### 1031 QI SERVICES:

**James Brennan Esq.,LL.M.**  
**Principal/Corporate Counsel**  
**Exchange Solutions Group**

11150 Sunset Hills Road  
Suite 300  
Reston, VA 20190  
Direct 703.801.4178  
Fax 703.663.9889  
jbrennan@1031esgroup.com  
www.1031esgroup.com

**Tyler Jay King, Esq.**  
**Commercial Exchange Consultant**  
**Exchange Solutions Group**

1420 N St NW  
Suite 706  
Washington DC 20005  
Direct 202.436.2641  
Fax 703.663.9889  
tking@1031esgroup.com  
www.1031esgroup.com