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Dear ,

This issue of the WKBK&Y newsletter addresses:

1. Like-Kind Exchanges Involving Foreclosures
2. Nonrecourse Debt and Like-Kind Exchanges

1. **Like-Kind Exchanges Involving Foreclosures**

Introduction

The like-kind exchange rules allow a taxpayer to defer paying taxes on gains when a taxpayer uses the proceeds from disposed of property to purchase similar property if certain procedures are followed. In the case of real estate, the rules are very broad and define almost any kind of real estate as like-kind to other real estate, i.e. a dirt lot is like-kind to a shopping center. The benefits of like-kind exchanges serve as a mainstay for many business and investors that take advantage of like-kind exchanges to defer taxes and then use the cash that would have gone to pay taxes to provide additional capital for their businesses and investments.

The current economy has brought to the mainstream some lesser known aspects of like-kind exchanges, specifically the idea of a like-kind exchange involving a foreclosure, deed in lieu, short sale or similar situation. Foreclosure-type exchanges present certain unique attributes to a like-kind exchange such as the process of disposition/acquisition and the fact that the exchanger often does not have equity in the property. This article discusses aspects of both exchanging out of a foreclosure-type property and exchanging into such a property.

Exchanging Out of a Foreclosure

In the minds of many clients a foreclosure, short sale, etc. ends their concerns in connection with the property. However, these clients often become shocked when they learn that the disposition of their property resulted in income taxation. Capital gains from the disposition of a foreclosure-type of property may be deferred through a like-kind exchange while cancellation of debt income (CODI) cannot.

The difficulty of exchanging out of a foreclosure generally arises when the basis of the property is less than the debt. In such cases where the seller has no equity in the relinquished property (RQ), the seller may be transferring the property to the lender as a deed in lieu, by way of foreclosure to the lender or a third party bidder, or as a short sale.

Some of the larger qualified intermediaries (QI) are generally aware of the rules in connection with exchanging out of like-kind property and are will to participate and can satisfy the QI requirements under Reg. Section 1.1031(k)-1(g)(4)(iii) which, while allowing direct deeding, requires a contractual arrangement of some sort for the QI to sell the RQ and to buy the replacement property (RP.) However, even if the QI safe harbor rules are not satisfied, it doesn't mean that the exchange automatically fails, it just means that the IRS can challenge the transaction on an agency basis.

If a QI will not take title to the property, below are several options to satisfy the QI requirements.

In the deed in lieu context, the lender may be willing to enter into a contract to buy the property from the debtor for nominal consideration. This contract then could be assigned to the QI to satisfy the safe harbor requirements.

In a short sale transaction the same structure could be used as there would be a contract with the short sale buyer; however, there would be the additional complexity that the purchase price under contract of short sale will be for less than the debt. How will the excess be treated? If the debt is nonrecourse it is likely that the excess will nonetheless be treated as sale or exchange income to the seller (i.e. boot). This could result in a partially taxable exchange. The result might be different if the QI would accept title to the property subject to the debt because under IRC 7701(g) the FMV of the property is presumed to equal the amount of nonrecourse debt. Therefore, there would be the opportunity for the seller to cover the "boot received" in the form of assumption of debt by the QI by debt assumed in connection with the RP. If the debt is recourse, the difference between the sale price and the debt will probably be forgiven as part of the short sale and that difference will be treated as CODI subject to Internal Revenue Code section (IRC) 108 and the exclusions from gross income available under that section.

In a foreclosure situation the problem is more difficult as there is no "contract" for sale. The property is sold to the highest bidder as part of the foreclosure process. While an argument might be made that the exchange agreement coupled with the agreement by the QI to acquire the property subject to the note and deed of trust is sufficient to satisfy the requirement that the "intermediary is treated as acquiring and transferring the relinquished property if the intermediary. . . enter into an agreement with a person other than the taxpayer for the transfer of the relinquished property. . ." These are uncharted waters and the probability of success is uncertain.

The same issues will arise where the bid price is less than the loan as to recourse and nonrecourse debt which were addressed above in connection with a short sale.

Exchanging Into a Foreclosure

Some of the same issues surround the situation where the RP is property which is acquired by way of short sale or a foreclosure proceeding. If we assume that the QI will not want to acquire title, then we are faced with a similar problem concerning a contract to acquire the RP. The Treasury Regulations provide that the "intermediary is treated as acquiring and

transferring replacement property if the intermediary. . . enters into an agreement with the owner of the replacement property for the transfer of that property . . . "

In the case of a deed in lieu, there should not be any problem with entering into an agreement between the lender and the taxpayer for the purchase of the property and then assignment of that contract to the QI. The same would be true of a short sale.

The problem will arise in the context of a foreclosure, the issue will again be whether there is a contract to acquire the property even if the QI is the successful bidder at the foreclosure and instructs the trustee to deed the property to the taxpayer.

Again, remember that the fact that the QI safe harbor rules do not apply does not mean that the exchange is disqualified, it may simply mean that the taxpayer will have risked a dispute over the "agency" issue with the IRS.

WKBKY Takeaway

To avoid many of the issues discussed above, it is recommended to have the QI take title to the RQ and RP; however, if one is not able to do so, it is also important to remember that the exchange is not dead but will have additional exposure on an agency basis. It is also important to inform clients of the potential ramifications of foreclosures, deeds in lieu, short sales, etc. since many clients will not be aware of both the tax implications and their options to defer such taxes.

2. Nonrecourse Debt and Like-Kind Exchanges

Introduction

In 2003 the IRS issued an advance notice of proposed regulations, REG 100818-01 (May 6, 2003), to Internal Revenue Code section (IRC) 357(d) in regard to liabilities assumed by a transferee. While the proposed regulations never came about, the advance notice gave additional insight into the IRS's thoughts regarding IRC 357(d) and its relation to like-kind exchanges, IRC 1031.

Background

Among other things, IRC 357(d) was promulgated to address the problem that when multiple transferees are treated as assuming the same liability, taxpayers might assert that the basis of multiple assets reflects the assumption of the same liability, resulting in assets having a basis in excess of their value and, thus, excessive depreciation deductions and mismeasurements of income.

Generally, IRC 357(d) presumes that the transferee of a nonrecourse liability assumes the entirety of such liability. The amount of the liability assumed is then reduced by the amount of such liability that other owners of assets, also subject to the same liability, have agreed or are expected to satisfy, but only up to the fair market value of such owners' assets.

Discussion

While IRC 357 does not specifically state that such section applies to like-kind exchanges, the IRS does specify such in paragraph 37 of the advance notice which states that IRC 357 applies to like-kind exchanges.

The IRS also provides further insight into its thoughts regarding IRC 357 as the point of the advance notice was to point out the IRS's following concerns regarding IRC 357(d):

1) Whether absent an agreement between the parties it should be presumed that a transferee assumes the entire nonrecourse liability when such transferee assumes assets subject to a nonrecourse liability. For instance, if P owns Asset A with a FMV of \$100 and Asset B with a FMV of \$400 and both are secured by a nonrecourse liability of \$500. If P transfers Asset A to a newly created corporation in exchange for 100 percent of the stock, P will recognize \$500 gain pursuant to IRC 357(c). In addition, the newly formed corporation only has an incentive to pay off up to \$100 of Asset A and not the entirety of the liability. The IRS contemplated whether in a transfer, such as the above, if the transferee should be treated as assuming a pro rata portion of the nonrecourse liability based on the FMV of those assets that secure the nonrecourse liability that are transferred to the transferee.

2) Whether agreements between the transferor and the transferee regarding the satisfaction of nonrecourse liabilities should be respected. If P transfers Asset A to S and S also assumes the nonrecourse liability of Asset B, IRC 357(d) appears to not treat S as assuming the nonrecourse liability of Asset B since S did not receive Asset B. The IRS contemplated whether there was a sufficient difference between recourse and nonrecourse liabilities to warrant such treatment.

3) Whether the amount of a nonrecourse liability treated as assumed by a transferee should be based solely on the agreement of the parties and their expectations as to which party will satisfy the nonrecourse liability. Similar to the above number 2, the IRS considered a rule that would reduce the amount of a nonrecourse liability treated as received by a transferee by the amount that another person has agreed to satisfy even if such amount is in excess of the FMV of assets subject to such liability. The IRS was also concerned regarding whether such a rule would be appropriate where the nonrecourse liability exceeds the value of the assets securing it.

WKBKY Takeaway

While there does not appear to have been any action taken by the IRS in connection with the advance notice, such advance notice does provide useful guidance by both linking IRC 357 with like-kind exchanges and giving insight into the IRS's contemplated concerns with the section and possible modifications we could see down the road.

We hope that you find these items of interest to you. If you need further information or would like to discuss a particular issue, feel free to call any one of the lawyers listed below. We will get you to the right person.

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