Planning Ahead with a Like-Kind Exchange in Anticipation of Foreclosure

BY MIKE ROSENBERG, CPA, MBA

Distressed properties are working their way through the workout and foreclosure process. In certain deals, owners of commercial and residential properties with distressed debt will find ways to restructure the debt. In others, a foreclosure is inevitable.

If the debtor owns property subject to nonrecourse loan that is in default, and foreclosure is imminent, the debtor should consider planning ahead with a like-kind exchange of the troubled property prior to the foreclosure.

If the exchange is properly structured, the debtor could avoid recognition of gain that would otherwise result if the foreclosure occurred without the like-kind exchange of the troubled property prior to the foreclosure.

Gain on foreclosure results when the foreclosure satisfies an amount of debt that exceeds the property’s tax basis. Of course, the exchange only defers the foreclosure gain until such time as the replacement property is disposed of in a taxable transaction.

As a practical matter, in order to avoid gain on the foreclosure, the debtor will need to acquire replacement property subject to an amount of debt at least equal to the troubled debt.

If the purchase of the replacement property involves new debt that is less than the troubled loan, the debtor will be required to put up fresh capital to bridge the gap. The debtor may be willing to do so if the money would otherwise go to pay tax on foreclosure gain.

Aside from having to identify suitable replacement property, the exchange must be structured within a certain time frame and employ a suitable intermediary that will serve as a facilitator for the exchange. This means that the debtor will have 45 days from the date the foreclosed property (subject to the troubled debt) is transferred to the intermediary to identify the replacement property. Then the transfer of the replacement property must close within 180 days of the transfer of the foreclosed property. The intermediary temporarily owns the foreclosed property, which is then transferred to the lender in satisfaction of its debt. The intermediary is also the acquirer of the replacement property on behalf of the debtor.

A workout-driven like-kind exchange may be a useful planning technique that avoids immediate tax on a foreclosure sale, which to many a debtor is added salt to a foreclosure wound.

Like-kind exchanges are complex transactions and in the context of a foreclosure sale there are added complexities and tax considerations. Each transaction requires careful planning and preparation as well as tax and legal expertise.

About Mike Rosenberg, CPA, MBA

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