

In the Know...

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Defer Tax on Rental Property Foreclosure

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How to Defer Capital Gains Tax Liability on a Foreclosure

Many Investors may be heading to the bank to turn in their keys on projects that did not work out as originally planned. Could those same investors wake up the following tax year with an unexpected tax headache. The discharge of the loan may very well result in a capital gains tax liability. Not only does the Investor lose the equity they have worked hard to earn in the property, but they are confronted with a capital gains tax liability due to how they negotiated the transfer of the property back to their bank or lending institution.

Often we find that individuals confuse the property's tax implications with the property's economics. However, these are two distinct calculations and they are often very different. For tax purposes gain or loss always equals the difference between the transfer price to the bank and the adjusted basis. Thus, if you bought a property in 2004 for 800k (your cost basis) and it has been depreciated and now has an adjusted basis of \$500K, and it is foreclosed with a 850k loan, this transfer without a 1031 exchange results in a taxable gain on \$350K, i.e. \$850k transfer price minus the \$500K adjusted basis.



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 the loan amount minus the adjusted basis. To clarify, for nonrecourse debt fair market value of the property is not taken into consideration as is pointed out clearly in Commissioner v. Tufts. The Court pointed out that taxpayers receive value when they are relieved of a nonrecourse debt obligation.

Leverage Exchange Group can assist by outlining solutions for property owners faced with 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 utilized for an asset rather than simply to pay a tax obligation.

To execute this strategy contact our office prior to the foreclosure date. Even if you are unsuccessful and end up with a "failed exchange", perhaps your exchange will carry over to another tax year, you could then elect installment sale treatment and push the tax liability to the following tax year.

To conclude, this market will undoubtedly continue to pose each of us challenges but it is how we overcome the adversities we face which helps each of us to Leverage our monies and that is what sets us apart from others. The above may or may not be a solution for your situation but now you have an option to consider.

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