COD 1031 Tips

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In the current turbulent economic environment, many investors are being confronted with a new type of tax created by having debt forgiven, or the cancellation of debt. Situations that generate this negative result are foreclosures, deed back in lieu of foreclosure, and short sales. The rules vary depending on whether the loan is recourse or non-recourse, and it can be helpful for real estate professionals to understand scenarios in which this negative consequence can occur as well as some potential solutions to minimize tax ramifications.

Some investors who have non-recourse loans are giving their properties back to their lenders, but are doing so without considering the potential tax consequences. Because their attention has been focused on damage control, they may have forgotten that the basis in the property is less than the loan balance, particularly if the property was originally acquired as part of an exchange. And now tax is due.

In cases where investors have recourse loans, COD income is triggered when a properties market value is less than the loan balance (there is no COD income with non-recourse financing because the tax code assumes the properties value is the same as the loan balance). The tax rate for COD income is the higher ordinary income rate and not the lower long-term capital gain rate. In a short sale or a deed back in lieu of foreclosure scenario, investors may be able to establish in advance the amount of COD income that would be created. But in scenarios in which property is being foreclosed, the market value won't be established until the foreclosure sale many months later.

The following example illustrates how a Section 1031 exchange transaction may provide a viable solution for taxpayers. An investor group buys a high-occupancy office building for $69 million with 100 percent financing. A tenant that occupies 50 percent of the space unexpectedly goes out of business. Attempts to lease up the space are unsuccessful and the investors approach the lender who agrees to a friendly deed back in lieu of foreclosure. An appraisal of the property establishes a fair-market value of $42 million, which creates $27 million of COD income, resulting in more than $10 million of tax due.

Under the guidance of tax advisers, the transaction is adjusted to insert the use of a qualified intermediary and accommodation titleholder. The AT buys the property from the investors for $1,000 cash and takes the property subject to the debt. Because a QI is used, the relinquished sale shows $1,000 of cash proceeds and $69 million of debt relief. The investor group, a partnership, adds several additional partners who have capital. The investors identify and acquire a $110 million building, putting $40 million down and getting a $70 million loan as the replacement property. A $69 million portion of the debt is then allocated to the exchanging partners. The final result is that no tax is triggered because they replaced all $69 million in debt and used the $1,000 cash.

When considering 1031 exchange solutions in the current climate, investors should be certain that debt forgiveness and COD income are on their radar screens and remember to seek qualified tax counsel to evaluate all potential solutions.

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