



## Foreclosure and the §1031 Exchange

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Some circumstances may leave a taxpayer in a zero or “negative” equity situation. The property may have debt equal to the fair market value of the property with an adjusted basis well below the property’s fair market value. To avoid gain on the foreclosure, which is a taxable event, the taxpayer can enter into an exchange.

For Example: The Relinquished Property has a fair market value of \$500,000 and a debt of \$500,000, but the basis is \$300,000. If the property is foreclosed upon or if the Taxpayer gives the lender a deed in lieu of foreclosure, the Taxpayer would face a tax liability of 25% of the difference between the adjusted basis and the sales price (equaling \$50,000 in this case), assuming the lender bids the property in at the amount of the underlying debt or accepts a deed in lieu of foreclosure. The Taxpayer is now in a situation with a tax liability.

Rather than incurring the tax liability, the Taxpayer can exchange the Relinquished Property for Replacement Property that is valued at more than the Relinquished Property. Using the previous example, if the Taxpayer purchases a property for \$650,000 and pays \$150,000 down, obtained from other sources, on the Replacement Property and assumes a debt of \$500,000 or places a new debt on the Replacement Property of \$500,000, the transaction can be eligible for a Tax-Deferred Exchange.

This scenario would be structured by the Taxpayer conveying the Relinquished Property to the Qualified Intermediary before foreclosure. The lender then forecloses on the Relinquished Property (now owned by the Qualified Intermediary) or accepts the deed in lieu of the foreclosure. There is no requirement that the Taxpayer have equity in the Relinquished Property, however, the Taxpayer may encounter problems transferring legal title to the Relinquished Property to the Qualified Intermediary prior to the foreclosure if the lender is not willing to cooperate and there may be transfer taxes in some jurisdictions. It is advised that an individual seek legal and tax advice from their accountant and attorney.

Example:

### Relinquished Property

(Property about to go into foreclosure)

\$500,000	Sales Price (Fair Market Value)
\$ - 0 -	Equity
\$500,000	Debt

### Replacement Property

\$650,000	Sales Price
\$150,000	Equity
\$500,000	Debt

## COMPLIMENTS OF

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*NCS Exchange Professionals cannot provide advice regarding specific tax*