Before You Give Back the Keys: Tax Traps in Deed-in-Lieu Transactions

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The common perception of a nonrecourse commercial real estate loan is that the worst consequence of default is simply "tossing the keys" back to the lender with no further liability to worry about. The loan agreement may even explicitly limit the borrower's liability to the secured property, subject only to a few recourse carveouts signed by the guarantor. However, depending on how a lender takes possession of the property, the process itself may trigger unexpected tax consequences the borrower never anticipated. This article identifies some key tax issues a borrower should consider when conveying title to a lender through a deed in lieu of foreclosure.

This article is part of a series on borrower considerations in deed-in-lieu transactions; for a comprehensive overview of the process and the full range of issues borrowers face, see the introductory article in this series, "Deed in Lieu of Foreclosure: An Overview in Process and Logic for Borrowers to Consider."

Recap on How a Deed in Lieu Works

A deed in lieu of foreclosure is simply a borrower voluntarily conveying its property to the lender as an alternative to formal foreclosure. A traditional foreclosure is conducted through the courts and is often a lengthy, costly, and public process. A deed in lieu, by contrast, offers a fast, efficient, and private means of transferring the collateral to the lender. This can benefit the borrower by avoiding substantial legal fees and limiting the public exposure that comes with a foreclosure, which can significantly damage a borrower's reputation.

As described in the introductory article, there are many issues a borrower should consider when negotiating a deed-in-lieu transaction with its lender, some of which are discussed in greater detail below. However, as in any negotiation, the borrower must keep in mind that its BATNA (i.e., "best alternative to a negotiated

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agreement") is a standard foreclosure. While foreclosure may be a long, public process with high legal fees, it does carry certain borrower-side advantages over a deed in lieu. Those advantages can be leveraged against a lender that has a strong interest in avoiding the time and expense of a formal foreclosure proceeding.

Hidden Tax Consequences for the Borrower

There are two tax trap scenarios for borrowers to consider when forfeiting property through a deed in lieu. Each depends on whether the underlying mortgage is discharged at the time of transfer.

Scenario 1: When a Mortgage Is Not Discharged

Fundamentally, a mortgage recorded against a property grants the mortgagee the right to foreclose on that property as compensation for certain obligations. Upon foreclosure, the property will remain subject to all liens and encumbrances recorded prior to the mortgage, but all encumbrances recorded after the mortgage will be wiped clean from title. When a lender takes title via a deed-in-lieu agreement, however, it is not exercising its foreclosure right under the recorded mortgage. As a result, all encumbrances recorded after the mortgage will remain in place, and the lender's property rights will be subject to any intervening lien.

Some lenders protect themselves from intervening liens by using a non-merger structure that keeps the mortgage alive rather than extinguishing it, which preserves the foreclosure remedy as a backup against intervening liens if needed. In this structure, title is typically transferred to an affiliate entity so that the affiliate becomes the new owner (mortgagor) while the lender remains the mortgagee. This approach is especially common in jurisdictions like New York, where mortgages are frequently reassigned to avoid future recording taxes.

The problem lenders face is that assuming a property subject to an existing mortgage obligation can trigger a hefty transfer tax. In New Jersey, for example, a transfer tax is imposed on the seller and is calculated based on the amount of consideration for the transfer. "Consideration" is defined to include the remaining balance of any

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mortgage to which the transfer is subject, as well as any lien or encumbrance not paid, satisfied, or removed in connection with the transfer of title. Although the borrower, in its capacity as seller, would typically bear legal responsibility for this transfer tax, borrowers often negotiate for the lender to assume that liability.

Scenario 2: When a Mortgage Is Discharged

Due to the transfer tax trap discussed above, some lenders may choose to discharge the mortgage prior to the transfer of title via a deed-in-lieu transaction, forgoing any remedy against intervening liens. This decision, however, may trigger income tax considerations for the borrower.

Under applicable tax regulations, the amount of liabilities from which a transferor is discharged is included as consideration realized on a sale or other disposition of property subject to federal income tax (Treas. Reg. § 1.1001-2(a)(1)). This is consistent with U.S. Supreme Court precedent holding that on the transfer of property subject to nonrecourse debt exceeding the property's fair market value, the realized gain equals the difference between the full amount of the debt and the property's adjusted basis (*Commissioner v. Tufts*, 461 U.S. 300 (1983)). The regulations further provide that, for purposes of this rule, "the sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability" (Treas. Reg. § 1.1001-2(a)(4)(i)).

If a borrower proceeds and is taxed on the discharge as income, it should structure the transaction so that the discharge is treated as capital gain rather than ordinary income. Generally, when a borrower is relieved of mortgage debt as part of a sale or transfer of the property securing that debt, the debt relief is included in the amount realized and taxed as capital gain. In contrast, when a debt is forgiven or cancelled separately from any disposition of the underlying property (meaning the borrower keeps the property but the lender simply writes off the obligation), the relief is treated as ordinary cancellation-of-debt income. (See *Gershkowitz v. Commissioner*, 88 T.C. 984 (1987) (holding that a debt release occurring three months before the property disposition constituted ordinary cancellation-of-debt income because the two events were

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not part of a single transaction)).

To achieve capital gain treatment in a deed-in-lieu transaction, the borrower should ensure that the mortgage release and the property transfer are structured as a single, integrated transaction. Ideally, the deed-in-lieu agreement should expressly condition the debt relief on the contemporaneous conveyance of the property to the lender. (See *2925 Briarpark, Ltd. v. Commissioner*, 163 F.3d 313 (5th Cir. 1999) (holding that a mortgage release conditioned upon and occurring simultaneously with the property transfer was the functional equivalent of a foreclosure sale, resulting in capital gain rather than ordinary income)). As a practical matter, both the deed-in-lieu agreement and the closing mechanics should reflect a single integrated transaction, with the discharge of the debt expressly conditioned on the conveyance of the property. Borrowers should also note that capital gain treatment does not necessarily mean the standard long-term capital gain rate applies to the entire gain: gain attributable to prior depreciation deductions may be taxed at the 25% rate applicable to unrecaptured Section 1250 gain.

Even where a deed in lieu results in cancellation-of-debt income, the borrower may be able to exclude some or all of it under Section 108 of the Internal Revenue Code. In particular, the insolvency exclusion (IRC § 108(a)(1)(B)) and the exclusion for qualified real property business indebtedness (IRC § 108(a)(1)(D)) can significantly reduce or eliminate cancellation-of-debt income in many deed-in-lieu situations. But these exclusions are subject to limitations and generally require a reduction of the borrower's tax attributes.

Finally, because commercial real estate is often held through partnerships or disregarded entities, borrowers should consider the consequences at the partner level. The resulting gain or income generally flows through to the partners, and under IRC § 752 a reduction in a partner's share of partnership liabilities is treated as a distribution of money to that partner. These liability shifts can create taxable income for partners without any corresponding cash proceeds.

Key Takeaways

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A deed in lieu of foreclosure can be a smart exit strategy for a borrower in default, but it is not as simple as handing over the keys. Whether the mortgage remains in place or is discharged, the transaction can trigger significant transfer tax or income tax exposure that borrowers must anticipate and negotiate around. The key is to understand your leverage, structure the transaction carefully, and engage tax counsel early in the process.

Subsequent articles in this series focus on the role title insurance, guarantor obligations, and conveyance risk can play in deed-in-lieu transactions. Should you have questions about the tax implications of such transactions, please contact the authors or any attorney with FBT Gibbons' Commercial Real Estate Finance team.

The Carveout

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