ARTICLE
23  Workout-Driven Exchanges
    by Bradley T. Borden and Todd D. Keator

RECENT DEVELOPMENTS
35  Economic Stimulus Package To Include Tax Incentives
36  Bankruptcy of Qualified Intermediary Can Result in Adverse Tax Consequences
ARTICLE
Workout-Driven Exchanges
by Bradley T. Borden and Todd D. Keator

TABLE OF CONTENTS
I. INTRODUCTION
II. FORECLOSURES
A. The Process of Foreclosure
B. Federal Income Tax Consequences of Foreclosures
III. SECTION 1031 IN WORKOUTS
A. General Rules
B. Section 1031 and Workouts
   1. Exchange of Zero-Equity Property
   2. Use of the Safe Harbors
   3. Workout-Exchange Structure
IV. SECTION 1038 SELLER-FINANCED REACQUISITIONS
A. Seller’s Gain
B. Seller’s Basis in Reacquired Property
C. Reacquired Exchange Property
V. CONCLUSION

I. INTRODUCTION

Section 1031 allows taxpayers to defer recognition of gain on the disposition of appreciated property—typically real estate. In the usual situation, a taxpayer desires to sell appreciated realty for a profit. If the taxpayer sells the property for cash or other property, the transaction is fully taxable. But if the taxpayer structures the transaction as a §1031 exchange, the taxpayer may receive “like kind” property without immediately recognizing his gain.

In the current economic climate, real estate prices are plummeting, and foreclosures are on the rise. Economically distressed properties are being foreclosed and repossessed by lenders in transactions devoid of any cash profit to their owners. Nevertheless, federal income tax law treats these foreclosures as sales, which may have adverse tax consequences. Section 1031 may help defer phantom gain on the disposition of distressed property in foreclosure. Consider Example 1:

Several years ago, Thelia, an individual, purchased a shopping center (Promontory Point) for $1 million to hold for investment. Later, when Promontory Point was worth $3 million, Thelia refinanced it by borrowing $2.4 million from Bank. The loan from Bank is nonrecourse and is secured by a mortgage on Promontory Point. Due to a number of tenant bankruptcies, occupancy rates at Promontory Point have declined sharply, and Thelia no longer is able to service the liability to Bank. When Thelia’s adjusted tax basis in Promontory Point is $400,000 and the fair market value of Promontory Point is $2 million, Bank forecloses and purchases Promontory Point at a trustee’s auction for the face amount of the liability ($2.4 million). (Alternatively, prior to foreclosure, Thelia transfers Promontory Point to Bank pursuant to a deed in lieu of foreclosure.)

The following are the tax consequences of the foreclosure:

- Thelia’s amount realized on the disposition of Promontory Point is $2.4 million — the principal amount of the nonrecourse liability.
- Thelia realizes $2 million of gain ($2.4 million amount realized less $400,000 adjusted basis) on the disposition of Promontory Point.
- Assuming a 15% tax rate, Thelia’s resulting federal income tax liability from the disposition of Promontory Point is $300,000.
- Thelia receives no cash from the disposition of Promontory Point with which to pay the resulting tax.

---

Bradley T. Borden is an associate professor at Washburn University School of Law in Topeka, Kansas. Todd D. Keator is an associate with Thompson & Knight LLP in Dallas, Texas. The portion of this article discussing liability relief is adapted with permission from Tax-Free Like-Kind Exchanges by Bradley T. Borden, J.D., LL.M., M.B.A., C.P.A. (Copyright © 2008 Civic Research Institute, Inc., 4478 U.S. Route 27, Kingston, NJ 08758.) © 2008 Bradley T. Borden.

All section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder.

2 See II, B, below.
4 See §1001(a).
5 See §1(b). For the sake of simplicity, the analysis disregards potential §1250 gain and any possible recapture, which can only serve to increase Thelia’s tax liability in the example.
If Thelia's liability had been recourse, the consequences would be different:

- Thelia's amount realized on the disposition of Promontory Point would be $2 million — the fair market value of Promontory Point at the time of the foreclosure.\(^6\)
- Thelia would realize $1.6 million of gain ($2 million amount realized less $400,000 adjusted basis) on the disposition of Promontory Point.\(^7\)
- Assuming a 15% tax rate, Thelia's federal income tax liability from the disposition of Promontory Point would be $240,000.\(^8\)
- The additional $400,000 of liability relief (the amount by which the liability exceeds the property's value) would be income from discharge of indebtedness (DOI Income).\(^9\)
- Assuming a maximum ordinary income tax rate of 35%, Thelia's resulting federal income tax liability from the DOI Income would be $140,000.\(^10\)
- Thelia's total federal income tax liability would be $380,000.
- Thelia receives no cash from the disposition of Promontory Point with which to pay the resulting tax.

The prior example and conclusions are equally applicable to a variety of other situations. Consider Example 2 below involving the acquisition of a tenancy-in-common (TIC) interest through a §1031 exchange:

Ted, an individual, owns real property Excalibur. Excalibur has a fair market value of $2.6 million, is subject to a $2 million nonrecourse liability, and has an adjusted basis of $0. Ted desires to exchange Excalibur for a TIC interest (Partial Interest) in a large, class A commercial real estate property (Project). The minimum purchase requirement for a TIC interest in the Project is $3 million. Pursuant to the exchange, Ted sells Excalibur to an unrelated purchaser for $2.6 million. At closing, the Excalibur buyer satisfies the $2 million liability against Excalibur and pays $600,000 of exchange proceeds to a “qualified intermediary.”\(^11\) Ted instructs the QI to purchase Partial Interest from TIC Sponsor by paying $600,000 cash and assuming a $2.4 million portion of a nonrecourse liability owed to Bank, which encumbers Project. Due to misrepresentations about Project and mismanagement of Project by TIC Sponsor, Project does not generate sufficient cash to service the liability to Bank. At a time when Ted’s adjusted tax basis in Partial Interest equals $400,000 (the difference between the $2 million liability on Excalibur and the $2.4 million liability on Partial Interest) and the fair market value of Partial Interest equals $2 million, Bank forecloses on Partial Interest and purchases it from Ted at a trustee’s auction for the face amount of the liability ($2.4 million). (Alternatively, prior to foreclosure, Ted transfers Partial Interest to Bank pursuant to a deed in lieu of foreclosure.)\(^12\) Ted would recognize $2 million of gain on the transaction. Taxed at a 15% tax rate, that gain would be subject to $300,000 of tax.

In both examples, the taxpayers are subject to a large tax liability ($300,000 minimum) with no cash to pay the resulting tax. Thus, the taxpayers must look to other sources to find the necessary funds to satisfy their tax liabilities. In both examples, the taxpayers may avoid these adverse tax consequences by structuring the disposition (whether through foreclosure or a deed in lieu of foreclosure) as a §1031 exchange. If successful, rather than paying $300,000 of tax to the Treasury, the taxpayers instead may use their $300,000 as a down payment toward the acquisition of replacement property.

II. FORECLOSURES

States establish processes to govern foreclosures, but the processes are fairly standard. To structure a foreclosure as a §1031 exchange, advisors must be familiar with the foreclosure process that will apply to a specific piece of property. With that knowledge, the advisor may recommend actions to attempt to obtain favorable tax treatment.

A. The Process of Foreclosure

Two general types of foreclosure proceedings exist: judicial and nonjudicial. All states have procedures

\(^{6}\) See Regs. §1.1001-2.
\(^{7}\) See §1001(a).
\(^{8}\) See §11(b).
\(^{9}\) See §61(a)(12); Regs. §1.1001-2. This paper does not consider the applicability of any exceptions to DOI Income provided by §108.
\(^{10}\) See §11(2).
\(^{11}\) See Regs. §1.1031(k)-1(g)(4)(iii).
\(^{12}\) As this article goes to press, hundreds of investors who purchased TIC interests from DBSI Inc. face the threat of similar foreclosure actions.
for judicial foreclosure. In a judicial foreclosure, after the maturity of a liability that has been accelerated due to a default (e.g., for nonpayment), the creditor may file an action requesting that the debtor’s equity of redemption be “foreclosed.” If the creditor is successful, the court will issue a final judgment of foreclosure ordering the county sheriff to sell the property in satisfaction of the liability. The sheriff will conduct an auction (usually at the county courthouse) and sell the property to the highest bidder for cash. The cash goes to the creditor in satisfaction of the liability. After confirmation of the sale and payment of the purchase price, the sheriff will execute a “Sheriff’s Deed” granting and conveying title to the property to the purchaser. Although the sheriff executes the deed and conveys the property, legal title passes directly from the debtor to the purchaser.

About half of the states also permit a nonjudicial or “power of sale” foreclosure. In those states, the deed of trust securing the liability will contain a power of sale clause providing that in the event of a default, the trustee named in the deed of trust can sell the property and repay the loan from the proceeds. Although a foreclosure sale is still necessary, a nonjudicial foreclosure procedure does not require filing a lawsuit and obtaining a court order. Instead, after notice and a specified waiting period, the trustee may proceed to sell the property at auction to the highest bidder. Afterwards, the trustee will execute a “Trustee’s Deed” granting and conveying title to the property to the purchaser. Similar to judicial foreclosure, legal title passes directly from the debtor to the purchaser.

Finally, in all states, the debtor and creditor may agree to a direct conveyance of the collateral from the debtor to the creditor in satisfaction of the liability by means of a deed in lieu of foreclosure. Creditors typically prefer a deed in lieu of foreclosure because it reduces the time, cost, and hassle of selling the collateral through foreclosure (whether judicial or nonjudicial). As a result, debtors may be able to extract value (e.g., additional sums of money) for agreeing to transfer a deed in lieu of foreclosure. In essence, the debtor is able to sell his equity of redemption.

B. Federal Income Tax Consequences of Foreclosures

The tax consequences of a foreclosure derive from the rules governing sales and other dispositions of property. Section 1001 provides that in the case of a sale or other disposition of unencumbered property, the amount realized includes any money received plus the fair market value of any property received. Amount realized includes liabilities discharged as part of a sale or other disposition. The origins of that rule are in the common law. Common law provides that the basis of the acquired property includes the amount of liabilities that the taxpayer assumes or incurs upon acquisition, and that the amount realized from the disposition of property includes liabilities from which the transferor is relieved upon disposition.

In the property transaction context, the Supreme Court first addressed the effect of liability assumption and liability relief in Crane v. Comr. In Crane, a deceased party transferred property (an apartment building) to his wife through a will. At that time, the property’s fair market value was $262,000; however, a $262,000 nonrecourse liability encumbered the property and left the taxpayer with zero equity. Nonetheless, the taxpayer took a $262,000 basis in the property and took depreciation deductions. Seven years later, when the outstanding balance of the liability was $250,000, the taxpayer transferred the property subject to the liability for $2,500 net sale proceeds. The taxpayer claimed that she had inherited an equity interest in the property whose value was zero, and accordingly claimed a zero basis in the property. The taxpayer also claimed that her amount realized equaled the $2,500 net sales proceeds.

13 If the amount of cash exceeds the outstanding liability, the excess cash will go to the debtor.
14 See, e.g., Sandel v. Burney, 714 S.W.2d 40 (Tex. Ct. App. 1986, no writ) (“[A] foreclosure sale transfers legal title from the owner of the mortgaged property to the purchaser at the foreclosure sale. . . . The title never vests in the creditor, and the foreclosure deed is not a conveyance from the trustee to the creditor to the purchaser. In executing the foreclosure deed, the trustee does no more than effect the transfer of title from the debtor to the foreclosure purchaser.”).
Two questions were before the Court. First, should the taxpayer’s basis in the property include the liabilities assumed? The Court held that in a transfer of property by will, the recipient taxpayer acquires the entire property and the aggregate of the rights that go with ownership of the property, not simply the equity portion. Thus, the taxpayer’s basis includes the amount of liability.

In its reasoning, the Court indicated that construing “property” to mean only the equity portion was not in accord with the depreciation provisions of the tax law. If the basis were only the equity portion, the depreciation would represent only a fraction of the property’s actual physical exhaustion. To represent actual physical exhaustion more closely, the Court reasoned that basis should include any liability assumed. Further, an equity basis would require a basis recalculation with each payment on the liability, causing a tremendous accounting burden for both the government and the taxpayer. Thus, the Court held that basis includes liabilities assumed upon the acquisition of property.

Second, the Court considered whether amount realized includes liability relief. The Court held that the taxpayer’s amount realized on the disposition of the property includes liability relief. The Court further held that because the basis of property includes liability incurred on acquisition, amount realized must include liability relief. The Court stated that the buyer’s assumption of the mortgage was the same as the buyer paying the taxpayer cash for the property and the taxpayer using that amount to repay the outstanding liability. Thus, amount realized includes liabilities discharged upon disposition of property.

In its holding that basis includes the amount of liability incurred in the acquisition of property and that amount realized includes liability discharged upon disposition of the property, the Crane Court introduced the theory of symmetry. The Court also introduced a theory of economic benefit. Although the liability was nonrecourse, the Court treated the liability as recourse because it believed the taxpayer would pay it to protect the equity in the property and prevent foreclosure. The Court, however, did warn that if the value of the property is less than the amount of the liability, a taxpayer who is not personally liable cannot realize a benefit equal to the discharged liability. The Court addressed this issue 35 years later in Comr. v. Tufts.

In Tufts, the Court considered whether a seller of property had an amount realized equal to an unpaid nonrecourse liability when the amount exceeded the fair market value of the property sold. The Court held that when a taxpayer sells or otherwise disposes of encumbered property and the purchaser assumes the liability, the amount realized includes the full amount of liability relief. Because the amount of liability relief in Tufts exceeded the value of the property, the Court was unable to utilize the theory of economic benefit to hold that amount realized includes liability relief. Thus, the Court had to expand the symmetry argument first introduced in Crane.

Under the symmetry argument, if a taxpayer includes a liability in the property’s basis upon acquisition, then the taxpayer must include the same liability in the amount realized upon disposition of the property. The Tufts Court reasoned that the economic benefit theory had not been critical to the Crane hold-

21 Because §113(a)(5) of the 1938 Act (the current version is §1014 of the 1954 Code, as amended, 26 USC §1014) provided that the basis of property acquired by bequest, devise, or inheritance was the fair market value of the property at the time of acquisition, the Court indicated that the basis question depended on the meaning of the term “property.”
22 See Crane v. Comr., 331 U.S. 1 (1947). The post-Crane case law reveals the influence of that case on the important questions of whether basis and amount realized include nonrecourse debt that the taxpayer used to acquire property (through purchase as opposed to inheritance). Crane did not specifically resolve this question because the recipient taxpayer in Crane acquired the property by devise and not by purchase. Nevertheless, Crane’s legacy has been its resolution of the basis question. The Supreme Court reasoned backwards from depreciation to basis and held that nonrecourse debt must be included in amount realized. In so doing, the Court invited the conclusion reached by subsequent courts that the basis of property acquired (through purchase) with nonrecourse debt should also include such debt. George Yin, “The Story of Crane: How a Widow’s Misfortune Led to Tax Shelters,” in Tax Stories (2003). See, e.g., Blackstone Theater Co. v. Comr., 12 T.C. 801 (1949) (holding that “[f]rom Crane we can deduce the following applicable principles: (a) The basis for given property includes liens thereon, even though not personally assumed by the taxpayer . . .”).
26 See id.
28 See id.
29 See id.
30 See id.
32 See Crane, 331 U.S. at n. 37.
34 See id.
35 See id.
36 See id.
37 See id.; see also Yin, note 22 above. Although not labeled as such, the Crane Court first introduced the theory of symmetry. Ultimately, however, the Court in Crane utilized the economic benefit theory to support its holding.
38 See Tufts, 461 U.S. 300 (1983); see also Yin, note 22 above.
ing and interpreted Crane to have approved the Internal Revenue Commissioner's decision to treat a non-recourse liability as a true loan.\footnote{See Tufts, 461 U.S. 300 (1983).}

Loan proceeds are not included in gross income when received, but are included in basis of property if used to acquire the property.\footnote{See id.} The exclusion of loan proceeds from income, and the inclusion of the amount of a loan in a purchaser's basis, are both predicated on the assumption that the debtor has an obligation to repay the loan.\footnote{See id.} The taxpayer is able to take depreciation deductions based upon the use of the untaxed loan proceeds to acquire property.\footnote{See Tufts, 461 U.S. 300 (1983). See also id.} Unless the outstanding amount of the liability is included in amount realized, the debtor will have received untaxed income at the time the loan was extended and will have received an unwarranted increase in the basis of the property.\footnote{See id.} This scenario could allow the taxpayer to withdraw cash or value from property tax-free.\footnote{See Tufts, 461 U.S. 300 (1983). See also id.} Including liability relief in amount realized avoids this absurdity. Therefore, the Tufts Court held that the basis of acquired property includes the amount of liabilities that the taxpayer assumes in the acquisition, and that the amount realized on the disposition of the property includes liabilities from which the transferor is relieved.\footnote{See Geier, note 31 above. Both Crane and Tufts concerned nonrecourse obligations. However, the Court did not consider the discharge of indebtedness doctrine because it was not presented to the Court. Under this doctrine, the amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under \$61(a)(12). Thus, if the debt is recourse, the transaction should be bifurcated. Under this approach, the asset is considered sold for its fair market value (resulting in the realization of gain or loss on the disposition under \$1001), and the sale proceeds are then considered used to settle the outstanding indebtedness (resulting in the realization of income from the discharge of indebtedness under \$61(a)(12)). If the debt is nonrecourse, the government collapses the two component parts into the disposition under \$1001 by including the entire debt in amount realized). No cancellation-of-indebtedness income is deemed realized, which was the approach utilized in Tufts.}

and recourse liabilities. In general, if a debtor transfers assets securing a non recourse loan in full satisfaction of the liability, the transfer is treated as a sale or exchange of those assets.\footnote{See Helvering v. Hammel, 311 U.S. 504 (1941); Electro-Chemical Engraving Co. v. Comr., 311 U.S. 513 (1941); Freeland v. Comr., 74 T.C. 970 (1980) ("In short, we believe that . . . a reconveyance by the mortgagor to the mortgagee constitutes a sale even though the mortgagor has no personal liability on the debt."); Vrabko v. Comr., 737 F.2d 479 (5th Cir. 1984). See also Rev. Rul. 76-111, 1976-1 C.B. 214 ("It is well established that, for federal income tax purposes, the transfer of assets in consideration of a cancellation of indebtedness is equivalent to a sale upon which gain or loss is recognized in the amount of the difference between the basis of the assets transferred and the amount of the indebtedness that is cancelled in consideration of the transfer."); Rev. Rul. 90-16, 1990-1 C.B. 12; GCM 38385 (May 23, 1980) ("It is well established that a foreclosure sale, in which the property securing the debt is repossessed from the mortgagor, constitutes a taxable sale or exchange.").} As such, gain or loss must be recognized equal to the difference between the debtor's amount realized and the adjusted basis of the property foreclosed upon,\footnote{Reg. \$1.1001-2(c)(Ex. 7) ("In 1974 E purchases a herd of cattle for breeding purposes. The purchase price is $20,000 consisting of $1,000 cash and a $19,000 note. E is not personally liable for repayment of the liability and the seller's only recourse in the event of default is to the herd of cattle. In 1977 E transfers the herd back to the original seller thereby satisfying the indebtedness pursuant to a provision in the original sales agreement. At the time of the transfer the fair market value of the herd is $15,000 and the remaining principal balance on the note is $19,000. At that time E's adjusted basis in the herd is $16,500 due to a deductible loss incurred when a portion of the herd died as a result of disease. As a result of the indebtedness being satisfied, E's amount realized is $19,000 notwithstanding the fact that the fair market value of the herd was less than $19,000. E's realized gain is $2,500 ($19,000 $16,500).")} and the amount realized must include the full amount of the nonrecourse liability.\footnote{Reg. \$1.1001-2(a)(2) ("The amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under \$61(a)(12).")}

In the case of a sale or other disposition (including foreclosure) of property that is subject to a recourse liability, the amount realized also will include the amount of the recourse liabilities from which the debtor is relieved, but only up to the fair market value of the property disposed of in the exchange.\footnote{Reg. \$1.1001-2(c)(Ex. 8) ("In 1980, F transfers to a creditor an asset with a fair market value of $6,000 and the creditor discharges $7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair mar-}
That is, any excess liability forgiven over the fair market value will result in ordinary DOI Income. 51

Thus, a foreclosure (or transfer of property pursuant to a deed in lieu of foreclosure) results in a constructive sale of the property for federal income tax purposes. Such sale will result in taxable gain to the debtor if the debtor’s adjusted basis in the property is less than his amount realized. A debtor facing foreclosure may avoid adverse tax consequences through the use of a carefully tailored §1031 exchange.

III. SECTION 1031 IN WORKOUTS

Section 1031 adopts the economic substance and symmetry views of liability relief expressed in Tufts and Crane. Thus, §1031 generally treats liability relief as cash (boot) received by the exchanger. The §1031 liability-relief boot rule is the driving force behind workout-driven exchanges. Transferors of foreclosed properties should pay close attention to the rules in order to avoid gain recognition on the foreclosure.

A. General Rules

Code §1031 provides in general:

No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment. 52

If, however, the taxpayer receives any money or non-like kind property in the exchange (i.e., boot), then gain, if any, must be recognized to the extent of the amount of such boot. 53 For this purpose, consideration received in the form of liability relief is considered boot (liability-relief boot). 54 The liability-netting rules, however, provide that consideration given in the form of cash or an assumption of liabilities (or receipt of property subject to a liability) offsets liability-relief boot. 55 The liability-relief boot and liability-netting rules are equally applicable where the liability encumbering the relinquished property is repaid at closing and a new liability is obtained to finance the acquisition of the replacement property. 56

Actual or constructive receipt of money or other property instead of like-kind replacement property is a sale and not an exchange, even though the taxpayer may ultimately reinvest in like-kind property. 57 Generally, the actual and constructive receipt principles apply in the §1031 context. 58 If, however, the taxpayer falls within one of the safe harbors provided in the §1031 regulations, the taxpayer will not be considered in actual or constructive receipt of money or other property for purposes of §1031. The safe harbors generally include certain security or guarantee arrangements, qualified escrow accounts and qualified trusts, and transfers involving QIs.

B. Section 1031 and Workouts

In the examples above, the taxpayers have $2.4 million of liability relief. If the liabilities are noncourse, their resulting tax liabilities are $300,000. If the liabilities are recourse, their resulting tax liabilities are $380,000. The dispositions may qualify for §1031 nonrecognition, if part of a properly structured transaction.

1. Exchange of Zero-Equity Property

The initial inquiry is whether Ted and Thelia may use a §1031 exchange to defer gain (but not DOI Income) 59 that they otherwise would recognize on foreclosure (or on transfer of a deed in lieu of foreclosure) of their properties. The question boils down to whether the taxpayers may exchange property in which they have zero or negative equity. The question arises because, in other contexts, the IRS has issued proposed regulations imposing a “net value” requirement for certain tax-free exchanges of property. 60 For example, Prop. Regs. §1.332-2(b) provides that zero-equity property does not satisfy the property-distribution requirement in §332, while Prop. Regs. §1.351-1(a)(1)(iii) provides that zero-equity property

51 Id.; Regs. §1.1031(d)-2 (Exs. 1 and 2).
53 §1031(a).
54 §1031(b).
55 §§1.332-2(b), 1.351-1(a)(1)(iii), 1.351-1(a)(2) (Ex. 4), and 1.368-1(f).
57 See Regs. §1.1031(k)-1(f)(1).
58 See Regs. §1.1031(k)-1(f)(2).
59 Section 1031 defers only gain realized, so it would not apply to DOI income.
60 See Prop. Regs. §§1.332-2(b), 1.351-1(a)(1)(iii), 1.351-1(a)(2) (Ex. 4), and 1.368-1(f).
is not “property” for purposes of a §351 exchange. Nothing indicates, however, that these proposed regulations (all of which were issued under Subchapter C of the Code dealing with corporate tax provisions) should apply to §1031. Therefore, the legal answer is affirmative, but the practical answer is less certain.

There are no indications in §1031 or elsewhere that a taxpayer must have equity (i.e., value in excess of encumbering liabilities) in the relinquished property in order to complete a §1031 exchange with such property. Moreover, the regulations define an exchange as “a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.” The Supreme Court has been careful to hold that “property” means the gross, physical property, and not just the net equity in such property. Additionally, the regulations treat the taxpayer as transferring property to a QI if the taxpayer assigns its rights in certain contracts to the QI. Therefore, a taxpayer should be permitted to transfer zero-equity property in a §1031 exchange. As a practical matter, the taxpayer may encounter difficulty finding zero-equity replacement property or obtaining the financing needed to acquire such property.

If the exchange involves a QI, a question arises as to whether the QI is required to hold “money or other property” from the exchange in order for the exchange to be valid. The answer is negative. “No-cash” exchanges frequently occur in the following scenarios:

- Tom, who has minimal equity in his relinquished property, has zero cash to deposit with QI after payment of closing costs from the sale.

- Tom, through QI, sells relinquished property to buyer who pays cash equal to the liability on the relinquished property and provides an installment note for the balance of the purchase price. The note, but no cash, is deposited with QI.

- Tom, through QI, sells encumbered relinquished property to buyer and deposits the net equity with QI. QI uses 100% of the net equity to buy unencumbered replacement property, Alpha Apartments. To avoid liability-relief boot, Tom instructs QI to purchase replacement property, Beta Apartments, although QI has no cash to pay the purchase price. At closing, Tom funds the purchase price with a combination of cash and a new liability sufficient to avoid liability-relief boot in the exchange.

- Tom, through QI, sells encumbered relinquished property to buyer and takes all of the net equity as boot. Tom deposits nothing with QI. To avoid liability-relief boot, Tom instructs QI to purchase replacement property, although QI has no cash to pay the purchase price. At closing, Tom funds the purchase price with a combination of cash and a new liability sufficient to avoid liability-relief boot in the exchange.

These simple examples illustrate that a QI is a valid safe harbor, even if an exchange involves no cash or other property.

2. Use of the Safe Harbors

Although zero-equity §1031 exchanges are permissible, taxpayers nevertheless must be careful to structure exchanges within the confines of §1031. Upon foreclosure or a transfer of deed in lieu of foreclosure, the taxpayer immediately will receive “other property” in the form of liability relief. Moreover, the taxpayer will be in actual or constructive receipt of such property before receiving the replacement property (and before assuming any offsetting liabilities in connection with the replacement property) unless the taxpayer properly structures the foreclosure. Thus, the taxpayer must be careful to structure the foreclosure or transfer of deed in lieu of foreclosure in a manner that generally qualifies under one of the safe harbors. A foreclosure generally does not include a cash transfer by the acquiror, so the safe harbors for security or guarantee arrangements, and qualified escrow accounts, and qualified trusts will be inapplicable. Therefore, the QI safe harbor is the only viable option. If the transaction includes no cash or other property, the taxpayer will use the safe harbor merely to facilitate the transfer of property.

The QI safe harbor provides that “[i]n the case of a taxpayer’s transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a).” Thus, it is readily apparent that the QI must be an active participant in transferring the relinquished property to the purchaser. Furthermore, the regulations require that the taxpayer and the QI enter into a written “exchange agree-

61 See American Bar Association Tax Section’s Report on Open Issues in Section 1031 Like-Kind Exchanges, Q-8 (July 14, 1994).
62 Regs. §1.1002-1(d).
63 See Crane v. Comr., 331 U.S. 1 (1947), discussed above.
64 See Regs. §1.1031(k)-1(g)(4)(iv), (v).
65 See Regs. §1.1031(b)-1(c).
66 A taxpayer may be able to structure an exchange of foreclosed property with the acquiror facilitating the exchange. For example, the buyer could acquire the replacement property and transfer it to the exchangor in exchange for the relinquished property. A cooperative buyer would, however, be difficult to find, so this analysis focuses on intermediary-facilitated transactions.
67 See Regs. §1.1031(k)-1(g)(4)(i) (emphasis added).
Pursuant to the exchange agreement, the QI must (i) acquire the relinquished property from the taxpayer, (ii) transfer the relinquished property, (iii) acquire the replacement property, and (iv) transfer the replacement property to the taxpayer.  

Regardless of whether the QI acquires and transfers property under general principles of federal tax law, solely for purposes of the QI safe harbor, a QI is treated as acquiring and transferring the relinquished property if either (a) the QI acquires and transfers legal title to that property (an “Actual Title Transfer”), or (b) the QI enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is transferred to that person (a “Deemed Transfer”). For this purpose, a QI is treated as entering into an agreement for the transfer of relinquished property if the rights of a party to the agreement are assigned to the QI and all parties to that agreement are notified of the assignment in writing on or before the date of the transfer.  

Where distressed property is to be relinquished through foreclosure, the taxpayer will encounter difficulty in satisfying the requirement that the QI be involved in the transfer of the relinquished property through acquiring the relinquished property from the taxpayer and transferring it to the buyer. If distressed property is to be sold through a judicial or nonjudicial foreclosure proceeding, the taxpayer will have no direct involvement in the conveyance of the property to the buyer. The taxpayer and the buyer will not negotiate or sign any agreements. Instead, the sheriff or trustee, as applicable, will conduct the foreclosure auction and, afterwards, will execute the deed and grant and convey the relinquished property to the highest bidder. Thus, there is no buy-sell contract or other similar agreement that the taxpayer can assign to the QI pursuant to the Deemed Transfer provision.  

If the Deemed Transfer option is foreclosed, an Actual Transfer is the only remaining option, assuming the taxpayer can find a QI willing to take title to the distressed property. In an Actual Transfer, the taxpayer will transfer title to the relinquished property to the QI before the foreclosure sale. After the auction, the QI, like the taxpayer, will have no direct involvement with the conveyance of the relinquished property to the buyer. Again, the sheriff or trustee, as applicable, will execute the deed and grant and convey the relinquished property to the highest bidder. Thus, although the QI previously may have acquired legal title to the replacement property from the taxpayer, because the sheriff or trustee consummates the actual transfer, it is unclear whether the QI has satisfied the requirement that the QI acquire and transfer the relinquished property. A taxpayer in such situation may argue that because title is transferred from the QI to the buyer, the QI should be viewed as the transferor of the relinquished property. Although that argument is reasonable, no authority directly addresses such a transaction.  

Given the uncertainties of using the QI safe harbor in a judicial or non-judicial foreclosure, a taxpayer desiring to do a §1031 exchange of a distressed property would be well advised to utilize a transfer of deed in lieu of foreclosure, if possible. If the taxpayer and mortgagor agree to use a deed in lieu of foreclosure, the parties typically will execute an “Agreement in Lieu of Foreclosure” specifying the terms of the conveyance. In anticipation of a §1031 exchange, the taxpayer should include an exchange cooperation clause in such agreement. Before the conveyance, the taxpayer may assign his/hers rights under the Agreement in Lieu of Foreclosure to the QI. Provided all parties to the Agreement in Lieu of Foreclosure are timely notified of the assignment in writing, a transfer of the relinquished property to the mortgagor pursuant to the deed in lieu of foreclosure will be treated as the acquisition and transfer of such property by the QI, thus satisfying the Deemed Transfer requirements.  

Most creditors prefer a deed in lieu of foreclosure because it terminates the debtor’s equity of redemption and is faster, cheaper, and less cumbersome than a traditional foreclosure. In fact, many creditors are willing to provide additional consideration to a debtor who agrees to transfer a deed in lieu of foreclosure. Thus, a taxpayer facing foreclosure, but desiring to accomplish a §1031 exchange, is in a relatively strong bargaining position to obtain the lender’s agreement to cooperate with the §1031 exchange.  

3. WORKOUT-EXCHANGE STRUCTURE  

Consider how Thelia, in Example 1, might structure the foreclosure of Promontory Point as part of a §1031 exchange. Thelia realizes that if Bank forecloses, and the sheriff sells Promontory Point at auction, her §1031 exchange may be in jeopardy. Therefore, to avoid uncertainty about the tax consequences of her desired §1031 exchange, Thelia offers to transfer Promontory Point to Bank via a deed in lieu of foreclosure if Bank will cooperate with Thelia’s §1031 exchange. Bank readily agrees. Thereafter, Thelia and Bank enter into an Agreement in Lieu of Foreclosure containing the terms of their agreement.

---

68 See Regs. §1.1031(k)-1(g)(4)(ii)(B).  
69 See Regs. §1.1031(k)-1(g)(4)(ii)(B).  
70 See Regs. §1.1031(k)-1(g)(4)(iv)(A) and (B).  
71 See Regs. §1.1031(k)-1(g)(4)(v).  
72 A similar analysis would apply to the foreclosure of Ted’s tenancy-in-common interest.
Thelia engages QI pursuant to a written exchange agreement and assigns her rights under the Agreement in Lieu of Foreclosure to QI, and all parties to such agreement are notified of the assignment in writing. Afterwards, on Date 1, Thelia executes a deed conveying Promontory Point to Bank in satisfaction of the liability encumbering Promontory Point. For purposes of the §1031 exchange, QI is treated as acquiring Promontory Point from Thelia and transferring Promontory Point to Bank. Within 45 days, Thelia identifies replacement property Richfield, and within 180 days, Thelia (through QI) acquires Richfield using a cash down payment of $300,000 and assumption of a $2.1 million liability encumbering Richfield. Because Thelia has assumed a liability and paid cash in the total amount of $2.4 million, she recognizes no gain or loss on the exchange of Promontory Point for Richfield. Furthermore, rather than paying $300,000 to the Treasury, Thelia retains it by investing it in Richfield as her down payment.

In the alternative, if the foreclosure is imminent and Thelia does not have sufficient time to structure the transaction as the transfer of a deed in lieu of foreclosure, or if Bank is not willing to cooperate with this alternative, Thelia's best option is to transfer title to Promontory Point to QI before the foreclosure sale. After the sale, title will pass to the foreclosure buyer (Bank) directly from QI. If the IRS or a court respects the transfer to QI and from QI to the buyer, the transaction should satisfy the §1031 transfer requirement.

IV. SECTION 1038 SELLER-FINANCED REACQUISITIONS

An exchanger who reacquires exchanger-financed relinquished property must consider whether such reacquisition triggers gain and the basis of the reacquired property. The seller-financed reacquisition rules should govern the reacquisition of exchanger-financed transfers. Seller-financed reacquisitions present the debtor with tax consequences that are the same as those discussed above in the third-party-financed transactions. Special rules apply, however, to the reacquiring seller who finances a property acquisition. For example, assume Sam sold Driggs Ranch to Donna for $20,000 cash and an $80,000 note from Donna secured by Driggs Ranch. At the time of the sale, Sam had a $50,000 basis in Driggs Ranch. Sam later reacquired Driggs Ranch from Donna after Donna defaulted on the note. By that time, Donna had paid three $10,000 installments on the note, and Sam had recognized $25,000 on the money received from Donna.73 Sam paid $5,000 in legal and other fees to reacquire Driggs Ranch from Donna and to cancel the outstanding balance on the note in exchange for taking back the property.

Section 1038(a) provides generally that Sam would recognize no gain or loss on such reacquisition, but exceptions to the general rule complicate matters.74 Furthermore, the tax consequences would become more complicated if Sam had transferred the property to Donna as part of a §1031 exchange, or if Donna were an exchange accommodation titleholder (EAT) holding Driggs Ranch as part of an exchange-first title-parking reverse exchange.75 Section 1038 is important to the extent it affects the computation of gain or loss on property reacquisitions and the seller’s basis in the reacquired property.

A. Seller’s Gain

Section 1038(a) provides generally that a seller does not recognize gain or loss on the reacquisition of real property encumbered by indebtedness issued to the seller and that no debt becomes worthless as part of the reacquisition. For that provision to apply, the seller must reacquire the property in partial or full satisfaction of the indebtedness.76 The seller recognizes gain on the reacquisition, however, if the seller receives money or other property from the debtor before the reacquisition and the amount of money and property received exceeds the amount of gain that the seller has already recognized.77 The amount of gain recognized by the seller on the reacquisition cannot exceed the difference between the sales price and seller’s basis in the property.78 Gain recognized by the seller before the reacquisition and money the seller pays to reacquire the property further reduces the

73 This example assumes that Sam uses the installment method to report gain from the sale of Driggs Ranch. Sam had received the $20,000 down payment and three $10,000 installments.
75 For a discussion of title-parking reverse exchanges, see Borden, note 16 above, at ¶§5.3—5.5, and 567 T.M., Taxfree Exchanges Under Section 1031, at VII, A, 1.
76 §1038(a)(2).
77 §1038(b).
78 §1038(b)(2).
amount of gain the seller recognizes on the reacquisition.\textsuperscript{79}

Section 1038 will apply to Sam’s reacquisition of Driggs Ranch because he took back a note from Donna on the sale of Driggs Ranch, Driggs Ranch secured the note, and Sam reacquired Driggs Ranch from Donna in full satisfaction of the note. Because Sam had received money from Donna before the reacquisition, however, the §1038(b) exception to the general nonrecognition rule will apply, and Sam will recognize gain on the reacquisition. Before the reacquisition, Sam recognized $25,000 of gain on $50,000 of cash he received. The §1038(b) exception provides that Sam must recognize gain on the reacquisition because the amount of money ($50,000) he received prior to the reacquisition exceeds the amount of gain he had recognized ($25,000). The gain he recognizes on the reacquisition ($50,000) is the difference between the sales price ($100,000) and Sam’s adjusted basis ($50,000). That amount is reduced by the gain Sam recognized prior to the reacquisition ($25,000) and the amount he paid in connection to the reacquisition of the property ($5,000).\textsuperscript{80} Thus, Sam must recognize $20,000 on the reacquisition. Because Sam recognized gain under the installment method on the original sale, §453 determines the character of gain he recognizes on the reacquisition.\textsuperscript{81} Under §453, Sam’s gain should be capital gain, assuming he held Driggs Ranch as a capital asset.\textsuperscript{82}

B. Seller’s Basis in Reacquired Property

Section 1038 in a sense nullifies the original sale.\textsuperscript{83} Thus, the basis the seller takes in the reacquired property should generally reflect the basis the seller would have had in the property, had the sale never occurred, but the basis must reflect changes that result from transfers of money. To get to that point, §1038(c) starts with the basis the seller has in the indebtedness and increases it by the amount of gain the seller recognizes on the reacquisition and the amount the seller pays to reacquire the property. Sam’s basis in the note from Donna should have been $25,000 on the date of reacquisition.\textsuperscript{84} Section 1031(c) requires him to increase that amount by the $20,000 of gain he recognizes on the reacquisition and the $5,000 he pays to reacquire the property. Thus, his basis in the reacquired Driggs Ranch will be the $50,000 basis he had in it at the time of sale.

The §1038 basis rules create an interesting situation for Sam. Sam had sold Driggs Ranch once and recognized $25,000 on that sale. He recognized another $20,000 on the reacquisition of Riggs Ranch. The §1038 basis rules in a sense nullify the original sale, and leave Sam in a position that he would have been in had he not sold the property. Consequently, if Sam were to sell Driggs Ranch immediately after reacquisition for $100,000, he would recognize the $50,000 of gain again. Thus, the rules require Sam to recognize the gain twice on a single piece of property. The result appears to treat the gain Sam recognizes on the original sale and reacquisition as a form of rent or other income from the property, with a character determined by his holding intent. That appears to be the only explanation for the double gain recognition.

C. Reacquired Exchange Property

Section 1038 becomes important in the §1031 context if an exchanger finances the acquisition of the relinquished property or if an intended exchange-first reverse exchange fails. In either situation, if both §1031 and §1038 apply, the exchanger could potentially be left with one low-basis property and one high-basis property after the acquisition. That result would be similar to the result that would obtain if the exchanger had never transferred the relinquished property. Exchanger-financed transactions may not be common, but they do occur. For example, an exchanger may lend to the relinquished property buyer, who transfers the proceeds to the qualified intermediary. In such a transaction, the exchanger will take a note from the buyer secured by the relinquished property.\textsuperscript{85} If the exchange satisfies all of the requirements of §1031, the exchanger will recognize no gain or loss.

\textsuperscript{79} §1038(b)(A), (B).

\textsuperscript{80} The sales price “is the gross sales price reduced by the selling commissions, legal fees, and other expenses incident to the sale of such property which are properly taken into account in determining gain or loss on such sale.” §138(b) (flush language). For purposes of this analysis, assume that the sales price equals the sum of money Donna pays plus the amount of her note.

\textsuperscript{81} Regs. §1.1038-1(d).

\textsuperscript{82} Regs. §1.453-9(a) (attribution gain on the disposition of an installment not received in exchange for property to the property).

\textsuperscript{83} S. Rep. No. 1361, 88th Cong., 2d Sess. 5 (1964) (“Apart from any payments [the seller] may have received, [the seller] is in no better position than he was before he made the sale. As a result, your committee has concluded that instead of the reposition of the property being treated as a second sale of the property back to its original holder, it is desirable to consider instead that the first sale has been nullified.”); Regs. §1.1038-1(g)(3) (“The reacquisition . . . is in a sense considered a nullification of the original sale.”).

\textsuperscript{84} Sam’s original basis in the note should have been $40,000 ($50,000 face amount of the note minus the $10,000 Sam recognized on the sale and receipt of the $20,000 down payment). §453(b). The gain that Sam recognized on the three $10,000 installments would have reduced his basis in the note by $15,000.

\textsuperscript{85} See 124 Front St. v. Comr., 65 T.C. 6 (1975); Borden, note 16 above, at ¶2.6[2].
on the transfer of the relinquished property and will take a basis in the replacement property equal to the relinquished property basis.\footnote{86}

To illustrate an exchanger-financed exchange, Sam transfers Driggs Ranch to Donna as part of a §1031 exchange. To help Donna finance the transaction, Sam lends Donna $80,000, which Donna transfers, along with $20,000 of her own money, to QI and takes title to Driggs Ranch, subject to the $80,000 liability. Sam takes an $80,000 note from Donna and a security interest in Driggs Ranch. Sam directs QI to use the $100,000 to acquire Rirey Ranch. Assuming the transaction qualifies for §1031 nonrecognition, Sam would take a $50,000 basis in Wiry Ranch and an $80,000 basis in the note from Donna.\footnote{87} He would recognize no gain or loss as Donna makes payments on the note because the note represents a loan, not consideration for Driggs Ranch. Payments on the note would reduce Sam’s basis in the note, so after receiving $30,000 from Donna, Sam’s basis in the note would be $50,000. Section 1038 would appear to apply if Donna later defaulted on the note and Sam reacquired Driggs Ranch in satisfaction of the note.

Section 1038 applies if the sale of the property gives rise to indebtedness to the seller that is secured by the property.\footnote{88} Sam’s loan to Donna and transfer of Driggs Ranch through a QI raises the question of whether the sale gave rise to the indebtedness.\footnote{89} As stated above, the §1031 regulations treat QI as acquiring Driggs Ranch from Sam and transferring it to Donna. The regulations also generally limit that fiction to §1031.\footnote{90} If the §1031 regulations do not apply for §1038 purposes, Donna should be the §1038 acquirer of Driggs Ranch,\footnote{91} and the law should treat the sale as giving rise to the indebtedness. Consequently, §1038 should apply when Sam reacquires the property from Donna in satisfaction of the note. As the examples below demonstrate, the application of §1038 helps prevent the creation of multiple gains and difficult accounting situations.

Upon reacquisition, Sam would recognize no gain or loss under the §1038(a) general rule. If §1038 disregards the §1031 safe harbors, Sam will likely be in constructive receipt of the $20,000 that Donna transferred to the QI. If Sam is in constructive receipt of the $20,000 for §1038 purposes, he would recognize $45,000 of gain on the reacquisition of Driggs Ranch, which would include the payments he received under the note.\footnote{92} If §1038 ignores the §1031 transaction, Sam’s basis in the note should be $50,000 — the §453 basis. Based on that assumption, Sam would take a $100,000 basis in Driggs Ranch, which would include the $50,000 basis he would have had in the note from Donna plus the $45,000 gain and the $5,000 he paid to reacquire the property.\footnote{93}

That result is consistent with §1038 and respects the §1031 exchange. The basis Sam had in Driggs Ranch carries over to Rirey Ranch under §1031(d). If Sam were to sell Rirey Ranch, he would recognize the $50,000 of deferred gain. The reacquisition of Driggs Ranch should create §1038 gain, but Sam’s basis in Driggs Ranch should not reflect any additional latent gain. Thus, Sam should take a $100,000 basis in Driggs Ranch. Even though the reacquisition nullifies the transfer of Driggs Ranch, it should not nullify the exchange. Nullifying the exchange would create a similar result, but Sam’s basis in Rirey Ranch would become its $100,000 cost basis, and his basis in Driggs would be the $50,000 basis computed in the non-exchange context.\footnote{94} That result complicates matters, however, because Sam would have to recompute any depreciation he had taken with respect to Rirey Ranch. Furthermore, if Sam had sold Rirey Ranch before reacquiring Driggs Ranch, nullifying the exchange would require Sam to recompute the gain he recognized on the sale of Rirey Ranch. Nullifying the Driggs Ranch transfer without nullifying the exchange helps Sam avoid those complexities without significantly altering his overall tax situation.

Section 1038 may come up in §1031 exchanges most often in failed reverse exchanges. For example, as part of an intended exchange-first reverse exchange, Sam might transfer Driggs Ranch to Donna, who acted as an exchange accommodation titleholder...

\footnote{86} §1031(a), (b).
\footnote{87} §§1031(b), 453B(b).
\footnote{88} §1038(a)(1).
\footnote{89} Adam Handler warns that §1038 “may not be available if the indebtedness arose out of an exchange of property facilitated by the use of a qualified intermediary.” Adam M. Handler, “Proposed Regs. Coordinate Deferred Exchanges and Installment Sale Rules,” 79 J. Tax’n 44 (Jul. 1993).
\footnote{90} Regs. §1.1031(k)-1(g)(4) (“In the case of a taxpayer’s transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a).”); Regs. §1.1031(k)-1(n) (providing that no inference should be drawn outside of §1031 about the application of the safe harbors). Section 453 is one area of law, however, that recognizes the qualified intermediary as the relinquished property acquirer. See Regs. §1.1031(k)-1(g)(2)(ii). The specific mention of §453 indicates that absent references to other provisions of the law, the qualified intermediary will apply only for §1031 purposes.
\footnote{91} Even if she is not the purchaser for §1038 purposes, §1038 applies to reacquisitions from persons who purchase property from the original purchaser. Regs. §1.1038-1(a)(4).
\footnote{92} §1038(b). Sam would have received three $10,000 installments on the note, and if the safe harbor did not apply, she probably would have constructively received the $20,000 that Donna transferred to the QI.
\footnote{93} §1038(c).
\footnote{94} See IV, A, and B, above.
(EAT). Sam would lend Donna the $100,000 needed to acquire Driggs Ranch and carry back a note and mortgage in Driggs Ranch. Sam would acquire Rivery Ranch as part of a §1031 exchange and take a $50,000 basis in Rivery Ranch. After transferring the property to Donna, Sam may have been unable to find an interested buyer for the property because of a market downturn. As a consequence, Donna would likely exercise her option to transfer the Driggs Ranch back to Sam in full satisfaction of the note.

Although the law does not clearly provide so, §1038 should govern Sam’s reacquisition of Driggs Ranch. The result that obtained in the deferred exchange context should also obtain in the reverse exchange context. Thus, Sam should recognize gain to the extent that he received any payments from Donna on indebtedness. If Driggs Ranch was not income-producing property, Donna probably would not have made payments on the note. As a consequence, Sam would likely recognize no gain on the reacquisition of Driggs Ranch. In that situation, his basis in the note should be $100,000 and should carry over to Driggs Ranch on the reacquisition. That would help ensure that the transaction does not create duplicate gains, and the result is the same as the result in the deferred exchange context and appears to produce the best outcome.

The application of §1038 to reacquired relinquished property does present opportunities for abuse. For example, if Driggs Ranch was depreciable property and Rivery Ranch was raw land, given the choice, Sam would generally prefer to have high basis on Driggs Ranch and low basis on Rivery Ranch. Therefore, if Sam were considering acquiring Rivery Ranch and retaining Driggs Ranch, he may structure an exchange-first transaction and hire Donna to take title to Driggs Ranch as part of a title-parking transaction. Later, when Sam reacquired Driggs Ranch from Donna, he would take a high basis in it under §1038. If Sam structured the transaction under Rev. Proc. 2000-37, the IRS could challenge the treatment of Donna as the beneficial owner of the property. Rev. Proc. 2000-37 provides that, at the time the EAT takes title to the property, the exchangor must intend the property to be relinquished property. If Sam structures the transaction for the sole purpose of transferring high basis to the Driggs Ranch, Rev. Proc. 2000-37 should not apply, and tax law most likely will never treat Donna as the beneficial owner of the property. Thus, the reverse exchange safe harbor provides the IRS the means to challenge abusive uses of §§1031 and 1038.

V. CONCLUSION

Transfers of distressed property raise significant tax consequences. Tax law may add proverbial salt to the foreclosure wound if the foreclosure satisfies an amount of liability that exceeds the property’s basis. To avoid such tax pain, taxpayers may consider structuring a foreclosure sale as part of a §1031 exchange. If the taxpayer can arrange financing for a suitable replacement property, §1031 will help the taxpayer avoid recognition of gain on a foreclosure sale.

The liability-satisfying transfer may be of property encumbered by a security interest held by an exchangor of property. Section 1038 should govern such transfers, and the reacquiring exchangor should not recognize gain on the transaction. To ensure that gain is not taxed twice and to simplify the accounting for the replacement property, the exchangor should take a §1038 basis in reacquired relinquished property.


96 Sam’s basis in the note should equal the amount that Donna borrowed, and it would not decrease because Donna would make no payments on the note.