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Don't Turn Your Loan Problem into a Tax Problem

Deed in Lieu of Foreclosure Could Have Tax Implications

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Although the Federal Reserve recently cut the federal funds rate to between 3.5 percent and 3.75 percent, the lowest in three years, the future landscape of commercial real estate remains uncertain.

Reports indicate increased activity in the office market heading into 2026, but the stark decline in property values highlighted by such recent activity cannot be ignored. An office tower in Denver recently sold for \$5.3 million, down from its \$176 million purchase price in 2013.

While many lenders have granted generous extensions on outstanding loans, the prospects of refinancing many projects are low, given the plummeting valuations.

But debtors exploring their options in connection with an underperforming mortgaged property should be aware of the possible tax implications of such a decision. A deed in lieu of foreclosure may be a valuable option for a debtor, but it is essential to understand how the IRS will view such a transaction and debtor's potential tax liability.

How Does the IRS View Your Loan?

A deed in lieu of foreclosure is an arrangement that allows a debtor to cancel its loan obligations in exchange for handing back the keys by conveying the mortgaged property to the lender.

If a debtor is unable to pay debt service and perform other loan obligations, this option gives debtor an opportunity to wipe the slate clean and avoid a costly and time-consuming foreclosure proceeding.

As an alternative to a deed in lieu transaction, a lender may ask debtor to sell the property in a short sale transaction in which the proceeds from the sale are less than the outstanding debt. A short sale may be more advantageous for the lender since the borrower may be able to receive a higher purchase price for the distressed property than the lender could obtain by taking possession of the property through foreclosure or a deed in lieu of foreclosure.

In either situation, lender will be viewed as having forgiven a portion of the debt (and for purposes of this article, the discussion about deed in lieu transactions applies equally to short sale transactions).

IRS treatment of such forgiveness depends on whether the IRS views the loan as recourse or non-recourse against the debtor.

Cancelled Debt Is Taxable Income

Generally, the IRS views cancelled debt as taxable income to debtor.

The analysis relevant to a deed in lieu (or short sale) is slightly more nuanced and requires an understanding of whether the debt to be cancelled is non-recourse debt or recourse debt.

Non-recourse debt means that lender has recourse solely to the loan collateral and may not pursue debtor personally, including debtor's other assets or income, for repayment of the loan.

Commercial real estate loans are often structured as non-recourse debt, unless and until debtor engages in certain "bad acts." A debtor engaging in certain "bad acts", such as failure to pay property taxes, voluntarily filing for bankruptcy,

or committing fraud, triggers personal liability and transforms the debt into recourse debt.

Because a non-recourse debtor does not have personal liability for the loan, when non-recourse debt is cancelled by a deed in lieu of foreclosure, the debtor is not deemed to have cancellation of debt income.

Instead, debtor's conveyance of the property to lender is deemed a sale and the tax implications hinge on whether there is a recognized gain or loss from such "sale."

First, debtor must calculate the amount realized, which is the greater of: (a) the amount of outstanding debt immediately prior to the deed in lieu, and (b) the fair market value of the property plus any proceeds received.

The adjusted basis immediately prior to the deed in lieu is then subtracted from the amount realized to determine whether there is a resulting gain or loss.

If recourse debt is forgiven, the debtor has cancellation of debt income equal to the amount of the outstanding debt immediately prior to the deed in lieu less fair market value of the property.

Debtors must review their loan obligations to understand the nature of their debt and whether it is non-recourse or recourse. Determining whether the loan is recourse or non-recourse is just the first step of the necessary tax planning as other exceptions and rules apply.

A deed in lieu of foreclosure may be a useful tool, but debtors must plan appropriately with their legal and tax advisors to avoid unforeseen tax liabilities. ◀

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