

Legal and Tax Implications of Real Estate Transactions

Jeffrey C. O'Brien
Attorney at Law



Mansfield Tanick & Cohen P.A.

In today's real estate market, there are many ways in which a sale can be structured. Below are summaries of the most common real estate transaction structures and the legal and tax ramifications of each.

Outright Sale

The most common sale structure today is still the outright sale. In an outright sale, the seller sells all right, title and interest in the property to the buyer, who in turn pays to the seller at closing the full purchase price as negotiated between the parties in the purchase agreement. The buyer either pays the purchase price from its own funds or finances the purchase through a lender and grants a mortgage as security for repayment of the loan.

Contract for Deed

A contract for deed is, simply put, the seller financed acquisition of real estate. Instead of a bank loaning the money to the buyer to pay the seller in full at a closing, the seller agrees to accept some amount of a down payment (to be negotiated between the parties) and periodic (usually monthly) installments of principal and interest for an agreed upon duration of time. Many contracts for deed cover a shorter period of time than the typical, thirty year fixed rate mortgage, with a balloon payment due at the end of the contract term. At the end of the contract term, if all payments are made, the seller (also known as the contract "vendor") delivers a deed to the buyer (the contract "vendee"), which deed conveys fee title to the subject property to the buyer.

If a buyer and seller desire to enter into such a contract, it is highly recommended that they use the uniform statutory form contract for deed (and applicable addenda). Furthermore, using an attorney to assist on the transaction is imperative due to the many legal requirements surrounding contracts for deed. Once signed, the contract for deed must be recorded with the county recording office.

The buyer on a contract for deed is said to own "equitable title" to the subject property. Hence, in the event that the buyer defaults on the payment obligations under the contract for deed, the seller must follow a cancellation process set forth in Minnesota Statutes Section 559.21. This statute requires a sixty (60) day written notice of cancellation be served upon the buyer. If the buyer objects to the grounds for cancellation, the buyer can proceed with a court action and an injunction to stop the cancellation from becoming effective. If the buyer takes no action, the contract is cancelled, the seller may retain any payments previously received by the buyer, and equitable title to the property reverts to the seller.

Rent to Own/Lease With Option

In a "rent to own" arrangement, the parties enter into a lease agreement for the property, together with an option to purchase agreement (alternatively, the parties can include purchase option provisions within the lease agreement itself). Under this structure, the landlord retains all title to the property and the tenant pays

monthly rent for a specified term. If the tenant remains current on his/her obligations under the lease agreement, the tenant has the right to purchase the property upon the conditions set forth within the option to purchase agreement (or the option provisions of the lease).

It is important to note that, when entering into a lease with an option to purchase, Minnesota courts do not enforce “agreements to agree.” Hence, it is vitally important that the parties agree to all material terms of the purchase at the time the lease is entered into in order to avoid future uncertainty. In fact, it is highly recommended that the parties agree on the form of the purchase agreement to be used in the event the tenant exercises the option to purchase, and to attach that form to the lease or option to purchase agreement, as applicable.

Under Minnesota law, an option to purchase must be supported by valuable consideration (meaning that the party receiving the option must pay something to the party granting the option). While the facts and circumstances are the driving force behind determining what is a reasonable option price, it is a good practice to require payment of at least \$1,000.00 from the tenant/optionee to the landlord/optionor.

Distressed Properties

Homeowners who are unable to continue to make their monthly mortgage payment(s) should be aware of the legal and tax consequences of the options available to them, which are as follows:

Short Sale

A “short sale” is a sale of real property at a price which results in insufficient proceeds to pay all existing mortgages on the property in full. Each lender who is being asked to accept less than the full amount of their loan balance must consent to the short sale in order for the sale to close. Otherwise, the mortgage lien against the property will not be removed at closing.

There are advantages to both the property owner and the lender(s) in a short sale. For owners, a short sale avoids a foreclosure by the lender and typically extinguishes any deficiency(ies) which the lender could otherwise enforce. For the lenders, a short sale results in funds paid to the lender, albeit less than the full amount of its loan, without the lender being required to complete the foreclosure, wait through the redemption period (six to twelve months, depending upon the nature of the property being foreclosed upon) and list the property for sale.

Practitioners who are involved with negotiating short sales with their clients’ lender(s) must be aware of several pitfalls in the process. First, as part of the short sale consent, the lender should be asked to extinguish its rights to a deficiency judgment for the unpaid balance of the loan. Some lenders will require a certain percentage of the loan to be paid in order to extinguish a deficiency, and thus a payment plan for a portion of the balance following the short sale may be negotiated between owner and lender.

Additionally, there are tax issues to be considered in a short sale. To the extent that the lender discharges any amount of the remaining mortgage debt against the borrower, Section 61(a)(12) of the Internal Revenue Code of 1986 (the “IRC”) requires that such “cancellation of indebtedness income” be included in the borrower’s taxable income unless certain exceptions apply. If the property in question is the borrower’s principal residence, then The Mortgage Forgiveness Debt Relief Act of 2007 provides an exception to Section 61(a)(12) which does not require the borrower to include the discharged debt as taxable income in the year of the short sale.

If the property subject to the short sale is investment property, however, the analysis of whether the discharged debt is included in taxable income under IRC Section 61(a)(12) focuses on whether the borrower is insolvent (i.e., the borrower’s total debts exceed the fair market value of total assets). This analysis can be complex and the advice of a tax professional is recommended.

Foreclosure

In Minnesota, non-judicial foreclosures are referred to as “foreclosures by advertisement.” Minnesota also provides a method of judicial foreclosure, known as “foreclosures by action.”

In a non-judicial foreclosure, also known as “foreclosure by advertisement”, the lender schedules a sheriff’s sale and publishes and serves notice of said sale. At the sheriff’s sale, the lender is typically the winning

bidder as it can bid up to 100% of the amount of its mortgage debt against the property, while all other bidders must pay in certified funds. After the sale, there is a six (6) month "owner's redemption period" during which the owner/borrower can redeem the property (i.e., buy it back) from the lender by paying the sale price plus any costs associated with the foreclosure, including a statutorily determined amount of attorney fees. If the owner/borrower does not redeem, and no junior lienholders exercise their redemption rights, the lender owns the property free and clear of any liens.

The key aspect of a foreclosure by advertisement from the perspective of the owner/borrower is that the lender, by electing this more expeditious method of foreclosure, gives up any right to seek a judgment against the borrower(s) for any deficiency between the sale price and the mortgage balance. Instead, the lender is said to have elected its remedy in taking the property and is left to recover any unpaid amounts through its sale of the property to a third party once all redemption rights have expired.

A foreclosure by action, by contrast, is a foreclosure that is accomplished through a district court lawsuit. The lender initiates this type of foreclosure by serving a summons and complaint on the borrower(s). A court order is required for the lender to schedule the sheriff's sale and the lender must return to court for approval of the sale price before the sheriff's certificate of sale is issued and the owner's redemption period begins to run.

For the owner/borrower, a foreclosure by action will result in a deficiency judgment against them. The lender not only can recover the property, but it can also levy upon other assets in order to satisfy the judgment. Very often, a foreclosure by action forces the owner/borrower to file bankruptcy to discharge the deficiency judgment.

Deed in Lieu of Foreclosure

A deed in lieu of foreclosure, referred to in short as a "deed-in-lieu," describes a situation where the borrower transfers the property to the lender via a deed in satisfaction of the loan. In order for a deed-in-lieu to work, the borrower has to be able to deliver clear and marketable title to the lender, and the existence of junior liens will make this transaction unworkable as the senior lienholder, by accepting the deed from the borrower, would thus take title to the property subject to the junior liens.

Jeffrey C. O'Brien is a Partner with Mansfield Tanick & Cohen, P.A., practicing in the areas of business law, real estate law and estate and business succession planning. He has significant experience with the formation of new businesses and he oversees the Firm's INCubation Center®, a program designed to provide new and developing businesses with the essential legal and non-legal services in their formative years. Admitted to practice in Minnesota and Wisconsin, Jeffrey has been named to the Minnesota SuperLawyers "Rising Stars" list for 2008, 2009 and 2010 and is a MSBA Board Certified Real Property Law Specialist. He is also a member of the Board of Directors for the American Association of Microbusinesses, author of the blog "The Business Man's Lawyer", a contributing author to the "Vanilla Shell" blog, and the voice of the "Legal Minute" on the Real Estate Radio Hour.

Phone: 612.341.1263 | Email:

jobrien@mansfieldtanick.com

<http://www.mansfieldtanick.com>

<http://www.jeffreyobrienesq.com>

<http://vanillashell.net>

