TAX PLANNING FOR CONDUIT LOAN DEFEASANCE TRANSACTIONS, INCLUDING LIKE-KIND EXCHANGES

By
Blake D. Rubin, Andrea Macintosh Whiteway and Jon G. Finkelstein
Arnold & Porter LLP, Washington, D.C.
www. aporter.com

August 1, 2006

The defeasance of loans that have been included in "pools" of commercial mortgage-back securities, also referred to as securitized or conduit loans (collectively "Conduit Loans"), has become increasingly common over the last several years. According to a study conducted by Moody's Investors Service, as of December 31, 2005, $29.7 billion of Conduit Loans have been defeased, which is an amount equal to 12.4% of outstanding Conduit Loans.[1]

This article summarizes the basic mechanics of a defeasance transaction, and analyzes the Federal tax treatment of payments made by a Conduit Loan borrower in connection with a loan defeasance. In addition, this article examines various structures for accomplishing a defeasance in connection with a Code Sec. 1031[2] like-kind exchange of property encumbered by a Conduit Loan.

Conduit Loans Generally

Conduit Loans are generally pooled together in real estate mortgage investment conduits ("REMICS") within the meaning of Code Sec. 860D. The REMIC issues bonds to investors and

---

Copyright 2006 Blake D. Rubin, Andrea Macintosh Whiteway and Jon G. Finkelstein. All rights reserved.

[1] *See* Moody's Special Report, "U.S. CMBS: Defeasance Benefits Borrowers and Investors," April 1, 2005.

[2] Unless otherwise indicated or clear from context, section references are to the Internal Revenue Code of 1986, as amended (the "Code"), or to the Treasury Regulations promulgated thereunder.

the returns on the bonds are tied to the mortgage payments on the underlying loans in the REMIC pool. Provided the REMIC qualifies as such under Code Sec. 860D, the REMIC is not taxable on payments it receives from the Conduit Loan borrowers. Rather, the bond investors are taxable on the payments they receive from the bonds issued by the REMIC. Investors in the bonds issued by a REMIC expect to earn a certain yield on their investments, based on fixed mortgage payments. As a result, Conduit Loans generally prohibit the borrower from prepaying the Conduit Loan because a prepayment on any of the underlying loans in the REMIC pool would affect the yield on the bonds issued by the REMIC and frustrate the bond investors' expectations.

In order to balance the bond investors' yield requirements with the Conduit Loan borrowers' need for flexibility, particularly when the real property securing a Conduit Loan is to be sold or refinanced, Conduit Loans often provide that they can be defeased. Defeasance generally means that the original real estate securing the Conduit Loan is released as collateral and new collateral is substituted that will generate cash flow that closely matches the timing and amounts of payments due under the Conduit Loan. The substitute collateral is intended to ensure that payments due under the Conduit Loan continue to be made on schedule, thereby allowing the REMIC to maintain the promised yield on its bonds.

Defeasance Generally

As noted above, defeasance involves the substitution of the collateral securing a Conduit Loan with new collateral that will generate sufficient cash flow to make the remaining payments due under the Conduit Loan.

The REMIC rules limit the timing of a defeasance and the type of substitute collateral that can be used in connection with a defeasance. Code Sec. 860D(a)(4) defines a REMIC in

pertinent part as an entity substantially all of the assets of which consist of "qualified mortgages" and permitted investments as of the close of the third month beginning after the startup day and at all times thereafter. Code Sec. 860G(a)(3)(A) requires that an obligation be principally secured by an interest in real property to be considered a qualified mortgage. Reg. § 1.860-2(a)(8) provides that a mortgage ceases to be a qualified mortgage if a REMIC releases its lien on real property that secures it unless certain requirements are met, including (a) the mortgagor must pledge substitute collateral that consists solely of government securities (as defined in section 2(a)(16) of the Investment Company Act of 1940 as amended (15 U.S.C. 80a-1)), (b) the mortgage documents must allow such substitution; (iii) the lien must be released to facilitate the disposition of the property or any other customary commercial transaction, and not as part of an arrangement to collateralize a REMIC offering with obligations that are not real estate mortgages, and (c) the release must not be within two years of the startup day.

In order to comply with the REMIC rules, Conduit Loans generally provide that a defeasance cannot occur until after an initial lock-out period of at least two years. In addition, Conduit Loans generally provide that the substitute collateral must consist of U.S. Government securities.

In order to avoid recognizing income as a result of an early repayment of the loan, Conduit Loan lenders[3] must not be in "constructive receipt" of the defeasance collateral. Reg. § 1.451-2(a) provides that a taxpayer is in constructive receipt of income:

> in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he may have drawn upon it during the taxable year if notice or intention to withdraw had been given.

---

[3] The term "Conduit Loan lender" is used in this article to refer to both the original lender of a Conduit Loan and any successor lender, including a REMIC.

> However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

As a result, the Conduit Loan lender will not take title to the U.S. Government securities. Instead, Conduit Loans generally require the borrower to acquire the U.S. Government securities and assign them to a special purpose, bankruptcy remote entity (an "SPE") in order to shield the securities from any liabilities of the borrower associated with the original collateral. The SPE must typically be owned by a trustee or custodian who agrees to cause the SPE to pledge the U.S. Government securities for the benefit of the Conduit Loan lender.

There are two general types of defeasance transactions, a "legal defeasance," and an "in-substance" defeasance. In a legal defeasance, the borrower is legally released from any continuing liability on the debt. In addition, funds generated by the defeasance collateral that exceed the amount needed to repay the defeased loan at maturity revert to the trustee or custodian rather than the borrower.

In an in-substance defeasance, the original borrower remains legally liable to the lender to make required payments under the loan in the event there is a shortfall in cash flow generated by the substitute collateral. Any excess cash flow from the substitute collateral generally reverts to the borrower.

If interest rates remain approximately the same or decline from the time the Conduit Loan is made to the time it is defeased, the yield earned on U.S. Government securities purchased to defease the Conduit Loan will generally be lower than the interest rate on the Conduit Loan. As a result, the purchase price of the U.S. Government securities sufficient to provide cash flows to make payments on a Conduit Loan will exceed the outstanding principal amount of the Conduit Loan. This excess is generally referred to as a "defeasance premium."

As discussed below, whether the borrower retains any obligations under the Conduit Loan after the defeasance may impact the deductibility for tax purposes of the defeasance premium.

In contrast, when interest rates increase after the Conduit Loan is made, the purchase price of the U.S. Government securities sufficient to provide cash flows to make payments on a Conduit Loan may be less than the outstanding principal balance of the Conduit Loan, and a "defeasance discount" results.

Tax Characterization of Defeasance Premium

A significant issue confronted by Conduit Loan borrowers pursuing a defeasance transaction is whether a defeasance premium is deductible for Federal income tax purposes, and if the defeasance premium is deductible, whether it is fully deductible in the year of defeasance or whether it must be deducted over the remaining term of the Conduit Loan.

Deductibility In General

There is currently little direct guidance regarding the deductibility of a defeasance premium. Code Sec. 163(a) provides that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness. Accordingly, if a defeasance premium can be characterized as a payment of interest, it would be deductible under Code Sec. 163(a).

In *General American Life Insurance Co. v. Commissioner*, 25 T.C. 1265 (1956), *acq.,* 1956-2 C.B. 5, the Tax Court held that charges incurred by a taxpayer in connection with the prepayment of a loan are an additional fee for the use of money, and therefore are deductible as additional interest. Consistent with *General American Life Insurance Co.*, the Internal Revenue Service (the "Service") has consistently ruled that prepayment penalties are deductible by borrowers as an interest expense under Code Sec. 163. In Rev. Rul. 57-198, 1957-1 C.B. 94, the Service held that penalty payments paid by mortgagors in connection with a prepayment of their

mortgage indebtedness are deductible as interest payments. Similarly, in Rev. Rul. 73-137, 1973-1 C.B. 68, the Service held that fees charged for the privilege of prepaying a retail installment contract constitute interest paid by the retail customer. *See also* Priv. Ltr. Rul. 199951038 (holding that a prepayment penalty paid pursuant to a construction financing agreement is deductible as interest); FSA 1998-410 (June 23, 1998) (stating that "[t]he Service has taken an unequivocal, unqualified position in Rev. Rul. 57-198, 1957-1 C.B. 94, that penalty payments made by a taxpayer to his creditor for the privilege of prepaying his indebtedness are deductible as interest.").

Consistent with the characterization of prepayment penalties as interest for Federal tax purposes as described above, Reg. § 1.163-7(c) provides that, "except to the extent disallowed by any other section of the Internal Revenue Code (e.g., section 249) or this paragraph (c), if a debt instrument is repurchased by the issuer for a price in excess of its adjusted issue price (as defined in § 1.1275-1(b)), the excess (repurchase premium) is deductible as interest for the taxable year in which the repurchase occurs." *See also* Reg. § 1.163-4(c) (providing that, upon the repurchase of bonds by an issuing corporation at a price in excess of the issue price plus any amount of original issue discount deducted prior to repurchase, or minus any amount of premium returned as income prior to repurchase, the excess of the repurchase price over the issue price adjusted for amortized premium or deducted discount is deductible as interest for the taxable year.)

Timing of Deduction

Assuming the defeasance premium is treated as interest for tax purposes, the structure of the defeasance transaction may control the timing of the deduction.

Similar to debt prepayment penalties and repurchase premiums described above, a defeasance premium incurred in connection with the retirement of a Conduit Loan should be

characterized as additional interest incurred for the use of money because it is a payment that must be made by the borrower to retire the borrower's obligations under the loan. In that case, the defeasance premium would be deductible under Code Sec. 163 in the year of the defeasance. As discussed below, however, to the extent that the defeasance premium is not incurred in connection with the retirement of the loan, it is likely that the defeasance premium would not be immediately deductible.

Whether a defeasance premium is characterized as paid in connection with a retirement of a Conduit Loan depends on whether the defeasance transaction is characterized as a legal defeasance or an in-substance defeasance. In Rev. Rul. 85-42, 1985-1 C.B. 36, a corporation bought U.S. Government securities and contributed the securities to an irrevocable trust in connection with a defeasance of the corporation's outstanding bonds. The trust instrument directed the trustee to apply the trust corpus and the interest thereon solely to satisfy the scheduled payments of principal and interest on the corporation's outstanding bonds. The trust instrument also provided that neither the corporation nor its creditors could rescind or revoke the trust or otherwise obtain access to the trust assets, and that any amount remaining in the trust after the bonds were retired would revert to the corporation. The yield on the government securities purchased by the corporation exceeded the yield on the bonds and the cash flows from the government securities approximately coincided with the interest and principal payments on the bonds. Thus, there was a defeasance discount. Because the yield and cash flow from the government securities was sufficient to cover the payments on the corporation's outstanding bonds, the possibility that the corporation would be required to make a payment on the bonds was remote. Nevertheless, the corporation was not legally released as the primary obligor on the bonds.

The Service analyzed whether the corporation should be treated as the owner of the government securities for tax purposes. Reg. § 1.61-13(b) provides that if a corporation, for the sole purpose of securing the payment of its bonds or other indebtedness, places property in trust or sets aside certain amounts in a sinking fund under control of a trustee who may be authorized to invest and reinvest such sums from time to time, the property or sinking fund set aside by the corporation and held by the trustee is an asset of the corporation, and any gain arising therefrom is income of the corporation and is included as such in its gross income. Based on Reg. § 1.61-13(b), in Rev. Rul. 85-42 the Service held that, because the corporation continued to have a payment obligation with respect to the bonds, for federal income tax purposes, the corporation was not considered to have discharged the debt owed to its bondholders upon the transfer of assets to the trust. Presumably, such a discharge would have resulted in cancellation of indebtedness income under Code Sec. 61(a)(12) to the corporation in an amount equal to the defeasance discount. Rather, the Service held that the corporation continued to be the owner of the assets held in trust and any income generated by the trust assets was includable in the gross income of the corporation.

As described above, in an in-substance defeasance, the borrower remains legally liable to the lender in the event that the cash flow generated by the defeasance collateral is insufficient to satisfy the payments under the Conduit Loan. In addition, the borrower retains the right to any funds generated by the defeasance collateral in excess of what is required to satisfy the Conduit Loan at maturity. Accordingly, based on Rev. Rul. 85-42 and the regulations under Code Sec. 163, it appears that a borrower may not be entitled to an immediate deduction for the defeasance premium attributable to an in-substance defeasance because the debt is not legally discharged. Instead, the defeasance premium may only be deductible over the remaining term of the Conduit

Loan in the form of an excess of interest paid on the Conduit Loan over interest earned on the defeasance collateral.

In contrast, although there is no authority directly on point, a legal defeasance should be treated as a repayment of the Conduit Loan for an amount equal to the fair market value of the defeasance collateral purchased to defease the loan. Because the debt is retired from the perspective of the Conduit Loan borrower, the defeasance premium paid in connection with the repayment of the Conduit Loan should be treated as a prepayment premium for Federal income tax purposes and, in that case, would be deductible as a payment of interest in the taxable year of the defeasance.

Defeasance in Connection with a Code Sec. 1031 Exchange

As described above, Conduit Loans generally provide that the loan cannot be prepaid. As a result, in order to sell the property securing the Conduit Loan, the seller/borrower generally must defease the loan and incur a defeasance premium. Generally, the seller/borrower will pay the defeasance premium at closing of the sale of the property out of funds put in escrow by the buyer. However, if the seller/borrower intends to engage in a like-kind exchange of the property pursuant to Code Sec. 1031, the seller/borrower must confront the issue of whether the defeasance of the Conduit Loan will result in taxable boot to the seller/borrower.

Code Sec. 1031 Generally

Code Sec. 1031(a) generally provides that no gain or loss is recognized upon 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.

Pursuant to Reg. § 1.1031(k)-1(a), a like-kind exchange may be in the form of a "deferred exchange," which means an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property"). Reg. § 1.1031(k)-1(a) further provides that the transfer of relinquished property in a deferred exchange is not within the provisions of Code Sec. 1031(a) if, as part of the consideration, the taxpayer receives money or other property which does not meet the requirements of Code Sec. 1031(a), but the transfer, if otherwise qualified, will be within the provisions of either Code Sec. 1031(b) or (c).

Code. Sec. 1031(b) and (c) provide that if an exchange would be within the provisions of Code Sec. 1031(a) if it were not for the fact that the property received in exchange consists not only of property permitted by such provision to be received without the recognition of gain, but also of other property or money, then the gain, but not loss, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

Reg. § 1.1031(k)-1(a) further provides that, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or property which does not meet the requirements of Code Sec. 1031(a) before the taxpayer actually receives like-kind replacement property.

Reg. § 1.1031(b)-1(c) provides that, where, on an exchange described in Code Sec. 1031(b), each party to the exchange either assumes a liability of the other party or acquires property subject to a liability, then, in determining the amount of "other property or money" for purposes of Code Sec. 1031(b), consideration given in the form of an assumption of liabilities (or

a receipt of property subject to a liability) shall be offset against consideration received in the form of an assumption of liabilities (or a transfer subject to a liability).

However, Reg. § 1.1031(d)-2, *Example (2)(c)* provides that consideration received in the form of cash or other property is not offset by consideration given in the form of an assumption of a liability or receipt of property subject to a liability.

The tax issues raised by defeasance in connection with a Code Sec. 1031 exchange will be explored using a series of examples.

Example 1 - Pre-Exchange Legal Defeasance

X owns Property A with a fair market value of $100, a tax basis of $50, subject to a Conduit Loan of $85. The terms of the Conduit Loan do not permit X to prepay the loan; however the loan can be assumed by a third party with consent of the lender and payment of an assumption fee. In addition, the Conduit Loan permits X to defease the loan with U.S. Government securities. X intends to sell the property to Y for $100 in connection with a deferred like-kind exchange under Code Sec. 1031 and Reg. § 1.1031(k)-1. Y does not want to assume the debt. Assume that X enters into an exchange agreement with a qualified intermediary within the meaning of Reg. § 1.1031(k)-1(g)(4) (the "QI"), and assigns its rights under the purchase and sale agreement with Y to the QI. Based on the prevailing interest rates, in order for X to defease the Conduit Loan, X must purchase $90 worth of U.S. Government securities, which includes a $5 defeasance premium.

Prior to exchanging the property, X defeases the Conduit Loan by purchasing $90 worth of U.S. Government securities using other cash on hand and transferring them to an SPE owned

by a third party trustee.[4] The trustee assumes all of X's obligations under the Conduit Loan, and causes the SPE to pledge the U.S. Government securities to the Conduit Loan lender. The lender then releases its lien on Property A. Immediately after the "legal" defeasance, pursuant to the exchange agreement with the QI, X transfers unencumbered Property A to the QI, and the QI transfers unencumbered Property A to Y for $100 cash, which is held by the QI, or deposited by the QI into a "qualified escrow account" within the meaning of Reg. § 1.1031(k)-1(g)(3)(iii).

Because X has legally defeased the Conduit Loan, from X's perspective, the Conduit Loan should be treated as retired and X can report a $5 ordinary interest expense deduction attributable to the defeasance premium under Code Sec. 163(a). X must acquire replacement property with the $100 of cash in order to avoid any gain on the exchange. If X acquired property with a value of $100 subject to $90 of debt, X would receive $90 of the cash proceeds from the sale of Property A to Y (in effect reimbursing itself for the $90 outlay to defease the Conduit Loan). Pursuant to Reg. § 1.1031(d)-2, *Example (2)(C)*, X could not offset the $90 of cash boot received with the $90 of liability boot paid, and X would recognize $50 of gain as a result of the exchange.[5]

<u>Example 2 - Simultaneous In-Substance Defeasance and Exchange</u>

The facts are the same as in Example 1, except that instead of legally defeasing the Conduit Loan prior to the exchange of Property A, X and Y agree that the Conduit Loan will be defeased as part of the sale transaction. X transfers Property A to Y "subject to" the Conduit

---

[4] Note that, to achieve the form of the transaction set forth in Example 1, the taxpayer cannot use the proceeds from the sale of Property A to purchase the government securities, but rather must have access to other cash, at least in the short term.

[5] X may be able to avoid this result if, instead of acquiring property subject to $90 of debt, X acquires property with the $100 of exchange proceeds, and shortly thereafter, X leverages up the replacement property with $90 of debt and retains the $90 of cash proceeds (in effect, reimbursing itself for the $90 of its separate funds used to purchase the U.S. Government securities).

Loan, but X does not obtain consent from the lender for the assumption of the Conduit Loan by Y and does not pay the required assumption fee. Rather, simultaneously and in the same closing, Y transfers $100 into escrow with the closing agent, $90 of which is used to purchase U.S. Government securities in connection with the defeasance of the Conduit Loan. Although the U.S. Government securities will generate sufficient cash flow to pay the interest payments and repayment of principal due over the term of the Conduit Loan, X is not released from legal liability on the loan. In addition, X will benefit from any excess cash flow derived from the U.S. Government securities over the amount used to make payments on the Conduit Loan.

The defeasance transaction outlined in Example 2 is an "in-substance" defeasance, which, as discussed above, should not be treated as a repayment or discharge of the Conduit Loan for Federal income tax purposes because X continues to bear the risk of loss for the liability and enjoys the benefit of any excess proceeds from the U.S. Government securities. Thus, X is the owner of the U.S. Government securities for Federal income tax purposes. As a result, there is a serious risk that X will be treated as receiving $90 of cash boot pursuant to the exchange transaction, either in the form of $90 cash (used to purchase the U.S. Government securities) or in the form of the U.S. Government securities themselves.

In *Barker v. Commissioner*, 74 T.C. 555 (June 10, 1980), taxpayer owned property (the "Demion Property"). Taxpayer wanted to exchange the Demion Property for replacement property (the "Casa El Camino Property"), which was owned by a third party unrelated to the taxpayer, pursuant to Code Sec. 1031(a). The Casa El Camino Property had a higher fair market value than the Demion Property. In connection with the taxpayer's acquisition of the Casa El Camino Property, the taxpayer agreed to assume approximately $67,900 of debt from the seller. A purchaser ("Goodyear") offered to purchase the Demion Property from the taxpayer free and

clear of the approximately $62,000 debt encumbering the Demion Property. Pursuant to a series of escrow arrangements arranged by a real estate company, Covington Brothers, Inc. ("Covington"), Covington acquired the Casa El Camino Property, the taxpayer exchanged the Demion Property for the Casa El Camino Property, assuming approximately $67,900 of debt, and Covington sold the Demion Property to Goodyear. The escrow arrangements provided that a portion of the purchase price paid by Goodyear had to be used to repay the debt encumbering the Demion Property.

The Service challenged the transaction as not qualifying as an exchange under Code Sec. 1031(a). One of the Service's arguments was that the satisfaction of the debt encumbering the Demion Property in connection with the exchange should be characterized as cash boot paid to the taxpayer, which the taxpayer then used to repay the debt. The Tax Court noted that cash boot received by a taxpayer in connection with a like-kind exchange cannot be offset with liability assumption boot paid by the taxpayer to complete the exchange, and stated that, where "the taxpayer has an unfettered right to do with the cash as he pleases . . . the taxpayer can exit the transaction with non-like kind property -- the cash [and, i]t seems appropriate to trigger the recognition of gain . . . ." However, the Tax Court held that the taxpayer should not be treated as receiving cash boot because, pursuant to the escrow arrangements that effectuated the like-kind exchange transaction, the proceeds from the sale of the Demion Property to Goodyear were required to be used to repay the debt encumbering Demion Property. The Tax Court in effect treated the repayment of the debt encumbering the Demion Property as an assumption of the debt by Goodyear or Covington, followed by an immediate repayment of the debt by Goodyear or Covington. The $62,000 of boot received by the taxpayer attributable to the debt encumbering the Demion Property could be netted with the $67,000 of boot paid by the taxpayer attributable

to its debt assumption and, accordingly, the Tax Court held that the taxpayer did not recognize any gain from the transaction. *See also* Priv. Ltr. Rul. 9853028 (holding that taxpayer's exchange of encumbered property, where purchaser did not assume the debt and purchaser advanced sales proceeds directly to bank in repayment of debt, did not constitute the receipt of cash boot by the taxpayer).

Although in Example 2 the proceeds of the sale of Property A to Y had to be used to defease the Conduit Loan, because the defeasance is an in-substance defeasance with X owning the defeasance collateral and remaining legally obligated to the lender, it is difficult to treat Y (or the QI) as assuming the loan.[6] Rather, the transaction would likely be characterized as a payment of cash to X, which X used to purchase U.S. Government securities, or as a transfer of the U.S. Government securities to X. In either case, X likely will be considered to have received $90 of boot in the form of cash or other property prior to the acquisition of replacement property, causing X to recognize $50 of Code Sec. 1231 gain or 25% "unrecaptured section 1250 gain"[7] as a result of the transaction pursuant to Reg. § 1.1031(k)-1(a). Even if X subsequently acquires $100 of replacement property, using the remaining $10 of exchange proceeds and $90 of cash boot paid by X, it appears that the gain would be recognized. *See* Reg. § 1.1031(k)-1(g)(8), *Example 2*.

In addition, as discussed above, although X should be treated as the party that defeased the Conduit Loan, X likely could not deduct the $5 defeasance premium in full in the year of the defeasance because X remains the ultimate obligor under the loan. Rather, X will deduct the

---

[6] Pursuant to Reg. § 1.1031(k)-1(g)(4), the QI is generally treated as engaging in the exchange with the taxpayer.

[7] *See* Code Sec. 1(h)(1)(D).

defeasance premium over the remaining term of the Conduit Loan in the form of an excess of interest expense on the Conduit Loan over interest income on the defeasance collateral.

<u>Example 3- Simultaneous Legal Defeasance and Exchange</u>

The facts are the same as in Example 2, except the defeasance transaction is a legal defeasance rather than an in-substance defeasance. Specifically, $90 of the cash proceeds from the sale by X of Property A to Y are used to purchase U.S. Government securities, which are transferred to an SPE owned by a third-party trustee who causes the SPE to pledge the securities for the benefit of the Conduit Loan lender. The SPE assumes all of X's obligations under the Conduit Loan, and the lien on Property A is released by the Conduit Loan lender.

Under these facts, because X's obligations under the Conduit Loan are extinguished, the Conduit Loan likely would be treated as retired for Federal income tax purposes. Consistent with *Barker*, although Y did not assume X's obligations under the loan, X could be deemed to have transferred Property A to Y (or the QI) subject to the $85 Conduit Loan, and Y (or the QI) could be deemed to defease the loan rather than X.

There is at least some risk, however, that the *Barker* analysis would not be applied under the facts of Example 3 because, in practice, the typical defeasance documentation would not support a deemed assumption of the Conduit Loan by Y (or the QI). In *Barker*, the escrow documents did not clearly identify the party to the transaction that would fund the repayment of the debt encumbering the Demion Property. Rather, the escrow arrangements simply provided that cash in escrow would be used to repay the debt encumbering the Demion Property. In contrast, in the authors' experience, the typical defeasance documents in a situation like Example 3 would clearly identify X as the borrower under the Conduit Loan and as the party funding the purchase of the U.S. Government securities that would be used to defease the Conduit Loan. In

addition, the SPE would assume X's obligations under the Conduit Loan and there would be no mention of Y.

If Y is not deemed to assume the Conduit Loan, as discussed in Example 2, X could be deemed to receive $90 of cash boot prior to the acquisition of replacement property. As a result, X could recognize $50 of Code Sec. 1231 gain or 25% rate "unrecaptured section 1250 gain" as a result of the transaction pursuant to Reg. § 1.1031(k)-1(a). However, assuming the defeasance premium is treated as an interest payment for purposes of Code Sec. 163(a), X would be entitled to an immediate $5 ordinary interest expense deduction attributable to the payment of the defeasance premium.

Regardless of whether the *Barker* analysis applies to the transaction, Y should have a tax basis in Property A equal to the $100 of consideration paid by Y. Even if Y is deemed to pay the defeasance premium under *Barker*, Y should capitalize the defeasance premium into its basis in Property A. *See Illinois Tool Works, Inc. v. Commissioner*, 117 T.C. 39 (2001), *aff'd,* 355 F.3d 997 (7th Cir. 2004) (holding that an asset purchaser's payment of a court judgment related to the purchased property, which was an obligation of the seller and acquired by purchaser, was not a deductible expense of the purchaser whether or not the obligation was fixed, contingent, or even known at the time the property was acquired, but rather was a capital expenditure that became part of the cost basis of the acquired property); *Pacific Transport Company v. Commissioner*, 483 F.2d 209 (9th Cir. 1973) (holding that a payment of a contested tort liability asserted against seller by the purchaser of seller's assets is not the discharge of a liability by the purchaser, but is a payment of additional purchase price for the assets).

Assuming that the *Barker* analysis applies to the transaction, in our view, the tax consequences to X of the transaction described in Example 3 could be analyzed three different ways.

a. Defeasance Premium Not Treated as a Liability or Contingent Liability from X's Perspective

First, if the defeasance premium is not treated as a liability or contingent liability for Federal income tax purposes from X's perspective, X could be deemed to transfer Property A to Y subject to the $85 Conduit Loan plus $10 of cash, or $95 of total consideration paid to X. Although there is no single definition of a "liability" for Federal income tax purposes, in general, it appears that a liability only includes an obligation, the incurrence of which (1) creates or increases the basis of the obligor's assets, (2) gives rise to an immediate deduction to the obligor, or (3) gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly charged to capital. *See*, *e.g.*, Code Sec. 357(c)(3); Reg. § 1.752-1(a)(4). Under this definition of a liability, the defeasance premium in Example 3 may not be treated as a liability of X for Federal income tax purposes because it would not create basis in any asset owned by X and would not produce an immediate deduction to X. The requirement that Y pay a defeasance premium to refinance the Conduit Loan, however, presumably lowers the value of Property A by an amount equal to the $5 defeasance premium. Accordingly, Y would be willing to pay only $95 for Property A even though Property A would have a value of $100 if it were unencumbered by the Conduit Loan. Under this analysis, X would receive $85 of liability assumption boot and $10 of cash proceeds (held by the QI) from the sale of Property A to Y. Accordingly, X would have to purchase replacement property with a value of at least $95 subject to $85 of debt in order to avoid any gain recognition on the exchange.

b. Defeasance Premium Treated as a Contingent Liability from X's Perspective

Second, the transaction could be characterized as a transfer of Property A to Y subject to an $85 liability in exchange for $10 of cash (held by the QI), with X being further deemed to receive an additional $5 of cash boot that is used by X to pay a contingent liability in the form of a defeasance premium. Thus, X would be deemed to receive $100 of total consideration for Property X, but to pay a $5 contingent liability in the form of a defeasance premium.

The Federal income tax characterization of a sale of property subject to a contingent liability was analyzed in *Commercial Security Bank v. Commissioner*, 77 T.C. 145 (1981). In that case, a cash basis corporation sold all of its assets in exchange for cash and the assumption of accrued liabilities that would be deductible by the corporation only when paid. The purchase price for the assets was reduced by the amount of the accrued liabilities. The corporation reported a deduction for the accrued liabilities in connection with the sale of its assets. The Tax Court allowed the deduction because "by accepting less cash for its assets in exchange for the assumption of its liabilities, [the corporation] effectively paid the accrued liabilities at the time of the sale." Under this analysis, the corporation's amount realized on the sale of its assets was increased by the amount of the accrued liabilities, and the corporation was then deemed to have paid the accrued liabilities. Similarly, in *James M. Pierce Corporation v. Commissioner*, 326 F.2d 67 (8th Cir. 1964), the Eighth Circuit held that upon the sale of all of a magazine publisher's assets, the magazine publisher was required to recognize income on account of reserves previously set aside for prepaid subscriptions. However, because the sale price of the magazine publisher's assets was reduced by an amount equal to the prepaid subscription liability, the magazine publisher was also entitled to an offsetting deduction. The Eighth Circuit stated that the reduction in the purchase price for the magazine publisher's assets was "just as much an out-

of-pocket payment by the taxpayer as if it had first received the gross amount from the [purchaser] and then repaid [purchaser] cash equal to the amount of the reserves" and "just as much of an out-of-pocket payment by the taxpayer as if . . . it had used other available cash of its own and on its own initiative refunded the subscribers the amounts of their unearned or redeemable subscriptions." *See also* Priv. Ltr. Rul. 8741001 (June 16, 1987) (holding that the reduction in the sales price for a corporation's assets attributable to the assumption of the corporation's vacation pay liability should be characterized as a deductible payment of the liability by the corporation).

Under this analysis, X presumably would be deemed to receive $5 cash boot used to purchase $5 of U.S. Government securities (or would be deemed to receive $5 of U.S. Government securities directly) attributable to the defeasance premium. Accordingly, X would recognize $5 of Code Sec. 1231 gain or 25% rate "unrecaptured section 1250 gain" attributable to the cash boot (or the U.S. Government securities). However, assuming the payment of the defeasance premium in connection with a legal defeasance is treated as a payment of interest for Federal income tax purposes as discussed above, X would be entitled to an offsetting $5 ordinary interest expense deduction. In order to avoid any further gain recognition on the exchange, X would have to purchase replacement property with a value of at least $95, subject to $85 of debt.

This analysis is patterned after the analysis that many practitioners believe would apply if Property A were transferred in a Code Sec. 1031 exchange subject to an $85 debt that had a $5 prepayment penalty, and the loan were prepaid at closing. In the defeasance case, while it seems appropriate to allow X an ordinary deduction for the defeasance premium because X has borne the burden of the premium through reduced net proceeds, the fact that X is only deemed to purchase 5/90 of the entire amount of fungible U.S. Government securities used for the

defeasance may create an analytical hurdle to allowing X to deduct the entire amount of the defeasance premium.

c. Defeasance Premium Treated as Accrued Liability

Suppose X is an accrual method taxpayer and in advance of closing on the Code Sec. 1031 exchange, X gives the Conduit Loan lender irrevocable notice of its intention to defease the Conduit Loan. Can X argue that, as an accrual method taxpayer, X should be allowed a $5 interest deduction for the defeasance premium, and should then be treated as transferring the property in a Code Sec. 1031 exchange subject to a $90 liability? Again, this is the treatment that many practitioners believe would result if Property A were transferred subject to an $85 loan with a $5 prepayment penalty, and the $5 prepayment penalty had "ripened" into a liability because X (an accrual method taxpayer) had become irrevocably committed to pay the prepayment penalty.

For Federal income tax purposes, an accrual method taxpayer is generally entitled to a deduction for a liability in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Reg. § 1.461-1(a)(2)(i). Reg. § 1.461-4(e) provides that, in the case of interest, economic performance occurs as the interest cost economically accrues in accordance with the principles of relevant provisions of the Code. The legislative history of section 461(h) indicates that economic performance occurs with respect to interest "with the passage of time (that is, as the borrower uses, and the lender forgoes use of, the lender's money) rather than as payments are made." H. Rep. No. 861, 98th Cong., 2d Sess., 875 (1984). In this case, assuming the defeasance premium is deductible as an interest expense for Federal income tax purposes, X could be entitled to a $5 deduction for the

defeasance premium if, in connection with the sale of Property A, X gives the Conduit Loan lender notice of the impending sale and defeasance. At that point, the fact of the defeasance premium would be established, the amount of the defeasance premium could be determined with reasonable accuracy, and the debt would be retired in the current taxable year from the perspective of X.

The transfer of Property A to Y would then be characterized as a transfer of Property A subject to a $90 liability in exchange for $10 cash (held by the QI). X would not recognize any gain on the exchange if X acquires replacement property with a value of at least $100 subject to at least $90 of debt.

Example 4* - *Simultaneous Assumption by Purchaser, Legal Defeasance and Exchange

The facts are the same as in Example 3, except Y assumes the Conduit Loan in connection with the exchange of Property A and agrees to pay the defeasance premium.[8] Y uses $90 of its own funds to purchase U.S. Government securities, which are transferred to an SPE owned by a third party trustee. The SPE assumes all of Y's obligations under the Conduit Loan, the SPE pledges the U.S. Government securities to the Conduit Loan lender, and the Conduit Loan lender releases its lien on Property A. Y transfers an additional $10 to the QI in connection with Y's purchase of Property A. Example 4 presents the clearest case for application of the *Barker* rule to the Code Sec. 1031 exchange. Thus, to repeat a phrase known to many tax

[8] This example assumes that the lender is willing to consent to the assumption of the Conduit Loan by Y and to forego any assumption fees because the assumption and defeasance will occur in a single closing. In practice, it may be difficult to get a lender comfortable that it can forego its standard loan assumption mechanics and waive the assumption fee because a defeasance does not occur in a single, simultaneous transaction. Rather, a defeasance typically occurs over a three day closing. On day one, the U.S. Government securities are purchased, usually with funds advanced by a defeasance accommodator. On day two, the borrower's refinancing or sale transaction is closed and sales proceeds are put into escrow. Finally, on day three, the securities are delivered to the SPE for the benefit of the lender, the sales proceeds are wired to the defeasance accommodator, and the lender releases its lien on the original collateral.

cognoscenti, there should be "little or no chance"[9] that X is deemed to receive cash boot used to purchase the U.S. Government securities or in the form of the U.S. Government securities themselves.

As in Example 3, Y should take a basis in Property A equal to the $100 of consideration paid by Y. Further, as in Example 3, in our view the Federal income tax consequences of the transaction described in Example 4 could be analyzed in three different ways.

a. Defeasance Premium Not Treated as a Liability or Contingent Liability from X's Perspective

First, as in Example 3, the defeasance premium could be characterized as an obligation that is not a liability or contingent liability from X's perspective for Federal income tax purposes. Under this analysis, X would be deemed to receive a total of $95 of consideration from the transaction, consisting of $85 of liability assumption boot and $10 of cash (held by the QI). As long as X acquires replacement property with a value of at least $95 subject to $85 of debt, X should not recognize any gain from the exchange.

b. Defeasance Premium Treated as a Contingent Liability from X's Perspective

Second, as in Example 3, the defeasance premium could be characterized as a contingent liability for Federal income tax purposes. Under the *Commercial Security Bank* analysis described above, X would be treated as if it received $85 of liability assumption boot and $10 of cash (held by the QI), with X being deemed to receive an additional $5 cash boot that is used by X to pay a contingent liability in the form of the defeasance premium. X would recognize $5 of Code Sec. 1231 gain or 25% rate "unrecaptured section 1250 gain" attributable to the $5 of cash boot that X received, and, assuming the defeasance premium is deductible as a payment of

9 *See Campbell v. Comm'r*, 59 T.C. Memo 236 (1990), *rev'd*, 943 F.2d 815 (8th Cir. 1991).

interest, X would be entitled to an offsetting $5 ordinary interest expense deduction. X would not recognize gain on the exchange as long as X acquires replacement property with a value of at least $95, subject to $85 of debt.

c. Defeasance Premium Treated as Accrued Liability from X's Perspective

Finally, as in Example 3, if X is an accrual basis taxpayer and the defeasance premium is considered to have accrued for Federal income tax purposes, then X could be entitled to an immediate $5 ordinary interest expense deduction. X would then transfer Property A to Y subject to the $90 Conduit Loan and $10 of cash. Under this analysis, X would not recognize gain on the exchange as long as X acquires replacement property with a value of at least $100 subject to $90 of debt.

Conclusion

As the prevalence of Conduit Loans in real estate transactions has grown, understanding the tax treatment of a defeasance transaction has become critical. As discussed above, although no guidance has been issued by the Service regarding the tax characterization of a defeasance, it is likely that a defeasance premium is deductible as a payment of interest under Code Sec. 163(a). The timing of the deduction, however, will depend on whether the defeasance is structured as an in-substance defeasance or a legal defeasance. In addition, if the borrower is engaging in a like-kind exchange involving property encumbered by a Conduit Loan, the structure of the defeasance will control whether and how the taxpayer can avoid recognizing gain on the exchange.