

# Tax Issues for Real Estate Investors Considering a Mortgage Defeasance as Part of a Section 1031 Exchange

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*This article considers the tax treatment of mortgage defeasances and mortgage defeasances that occur as part of a Section 1031 exchange. It provides a general overview of the mortgage securitization and defeasance processes. It then examines how tax law should treat defeasance discounts and defeasance premiums on the sale of property as part of a mortgage defeasance. Drawing from those principles, the article considers how exchangers might structure an exchange of property that occurs as part of a mortgage defeasance to avoid the adverse tax consequences that may otherwise result from such transactions.*

## Introduction

**Understanding the Mortgage Securitization Process.** Disposing of property subject to a securitized mortgage can be complicated, and the tax issues of such dispositions can be intricate. Before considering such dispositions, it is useful to consider the process of securitizing a mortgage and the tax rules governing a significant portion of securitized mortgages. Mortgages secured by property ranging from personal residences to large commercial buildings can be securitized. The process of securitizing a mortgage may follow a few general steps. First, a lending institution (the loan originator) makes a loan to a mortgagor, who uses the proceeds to acquire property. The loan originator takes back a mortgage on property securing the loan. Second, the loan originator transfers the mortgage to a special purpose vehicle (e.g., a trust or tax-exempt entity) that pools the mortgage with other mortgages. Securitized mortgages are often pooled in real estate mortgage investment conduits (REMICs). (Because REMICs provide special tax advantages, they

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are the common vehicle for securitizing mortgages. Therefore, this discussion considers only mortgages held in REMICs, even though other arrangements are conceivable.) Third, the REMIC issues to investors securities that represent interests in the pooled mortgages. Figure 1 illustrates the general steps of securitizing a loan.

**Objectives of REMIC Investors.** REMIC investors are often drawn to the fixed returns that pooled mortgages generate. Unscheduled payments related to the pooled mortgages, such as early repayment of a loan, would frustrate the fixed-return objectives of the REMIC. Consequently, the loan documents require the mortgagor to agree to pay the loan back as scheduled and would impose a penalty for early repayment. The loan documents may generally prevent another party from acquiring the property or assuming the loan. Those restrictions complicate the transfer of the property subject to a pooled mortgage, but loan defeasance strategies and careful planning may allow transfers of property subject to a pooled mortgage. If the transfer of such property will result in realized gain, the mortgagor may attempt to structure the disposition as part of a Section 1031 exchange.

The key to transferring property subject to a pooled mortgage is defeasing the mortgage. Mortgage defeasance requires replacing the original collateral with substitute collateral. To satisfy the fixed-return objective of REMIC securities, substitute collateral must be some type of property that will generate predictable cash flow and meet the interest and principal repayment obligations due under the original loan. In fact, the REMIC rules require the substitute collateral to be government securities.<sup>1</sup> The substitute collateral is therefore usually a portfolio of government securities that meet the required cash-flow needs of the mortgage.<sup>2</sup>

REMICs are not subject to federal income tax.<sup>3</sup> Instead, the income of a REMIC flows through to REMIC investors, and they pay tax on the REMIC's income.<sup>4</sup> The REMIC thus creates a tax conduit, and loans held by REMICs are also known as conduit loans and the process of lending and pooling mortgages is known as conduit financing. The flow-through treatment makes the REMIC structure attractive. The REMIC rules do not restrict the type of entity that may be a REMIC, so corporations, trusts, and other unincorporated arrangements may become REMICs. The REMIC rules require the arrangement to (1) make an election, (2) limit the types of interests the REMIC may distribute,

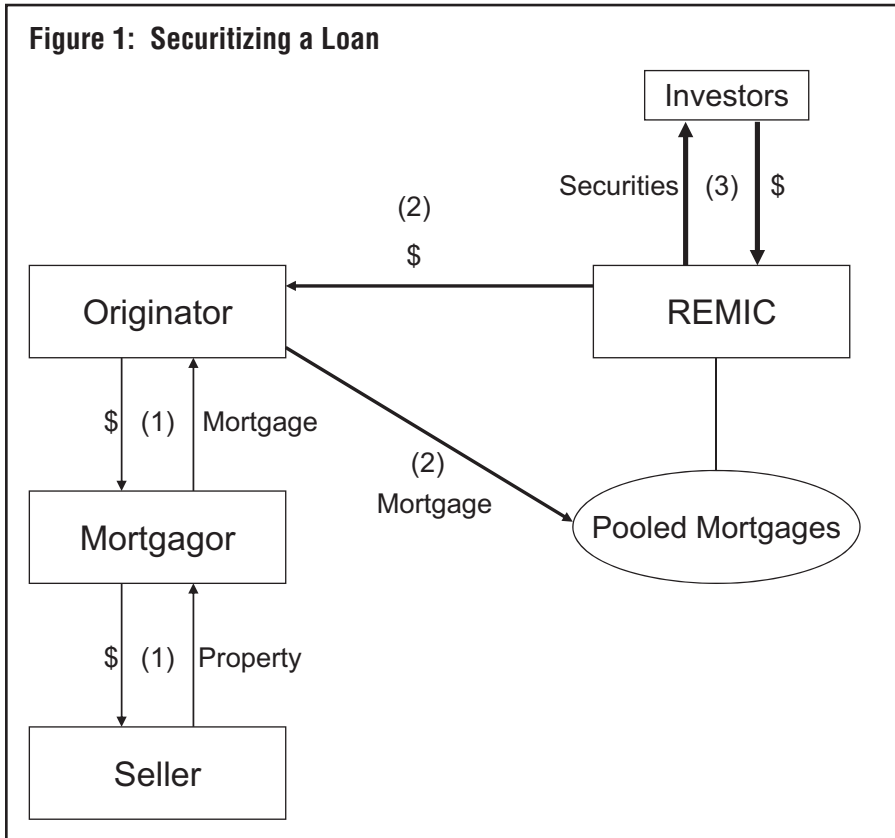
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<sup>1</sup> See Treas. Reg. § 1.860G-2(a)(8)(ii)(A) (using the definition of government securities in § 2(a)(16) of the Investment Act of 1940).

<sup>2</sup> See Timothy J. Boyce, "So Long, Mortgage: A Primer on Loan Defeasance," 16 Bus. L. Today 57 (Sept./Oct. 2006).

<sup>3</sup> See IRC § 860A(a).

<sup>4</sup> See IRC § 860A(b).



(3) mandate that the REMIC adopt the calendar year, and (4) restrict the types of entities that may hold interests in the REMIC.<sup>5</sup> Finally, the rules provide that a REMIC can only hold qualified mortgages and permitted investments.<sup>6</sup> This discussion is concerned with exchanges of property subject to mortgages held by REMICs, so it focuses on the definition of qualified mortgage.<sup>7</sup>

A qualified mortgage is “any obligation . . . that is secured by an interest in real property” and meets certain acquisition requirements.<sup>8</sup> The REMIC rules also restrict the manner in which the REMIC may release the lien. This discussion assumes that the mortgage held by a REMIC is secured by an interest in real property and satisfies the acquisition requirements. The focus instead is on whether the release of a lien causes a mortgage to cease to be a

<sup>5</sup> See IRC § 860D(a)(1), (2), (3), (5), (6).

<sup>6</sup> See IRC § 860D(a)(4).

<sup>7</sup> Permitted investments generally will not raise issues in the exchange context. See IRC § 860G(a)(5)–(8) (defining permitted investments).

<sup>8</sup> See IRC § 860G(a)(3).

qualified mortgage. Generally, “[i]f a REMIC releases its lien on an interest in real property that secures a qualified mortgage, that mortgage ceases to be a qualified mortgage on the date the lien is released.”<sup>9</sup> That general rule is subject to two exceptions, one of which allows for the release of a lien as part of a properly executed defeasance.<sup>10</sup> Under that exception, a mortgage is properly defeased if (1) the mortgagor pledges substitute collateral that consists solely of government securities,<sup>11</sup> (2) the mortgage documents allow such a substitution,<sup>12</sup> (3) the purpose for releasing the lien is to facilitate the disposition of the collateral,<sup>13</sup> and (4) the release occurs more than two years after the REMIC’s startup day.<sup>14</sup> Most property owners wishing to defease a pooled mortgage will generally have to satisfy these requirements, and the following discussion assumes that defeasances satisfy them.

## General Defeasance Structures

Mortgagors generally use the following basic structure to defease a mortgage. The mortgagor acquires and transfers government securities to a defeasance trust (a special purpose entity formed to assist with the mortgage defeasance). The defeasance trust accepts the securities and assumes responsibility for servicing the mortgagor’s loan. The defeasance releases the lien on the mortgagor’s property, and the mortgagor transfers the property to the buyer free of the defeased mortgage. Figure 2 depicts a simple mortgage defeasance. In practice, however, a defeasance is complicated and generally requires the services of specialists with experience defeasing mortgages.<sup>15</sup>

**Financial Aspects of Mortgage Defeasance.** Property owners use one of two general methods to defease a mortgage: a legal defeasance and an in-substance defeasance.<sup>16</sup> The form of defeasance is important in the tax context because it can affect the amount realized by the mortgagor on the disposition of property and determine whether a transfer may qualify as part of a

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<sup>9</sup> See Treas. Reg. § 1.860G-2(a)(8).

<sup>10</sup> See Treas. Reg. § 1.860G-2(a)(8)(ii). The other exception is for certain lien modifications, which are not relevant to this discussion. See Treas. Reg. § 1.860G-2(a)(8)(i).

<sup>11</sup> The securities must satisfy the definition in § 2(a)(16) of the Investment Company Act of 1940, as amended. See Treas. Reg. § 1.860G-2(a)(8)(ii)(A).

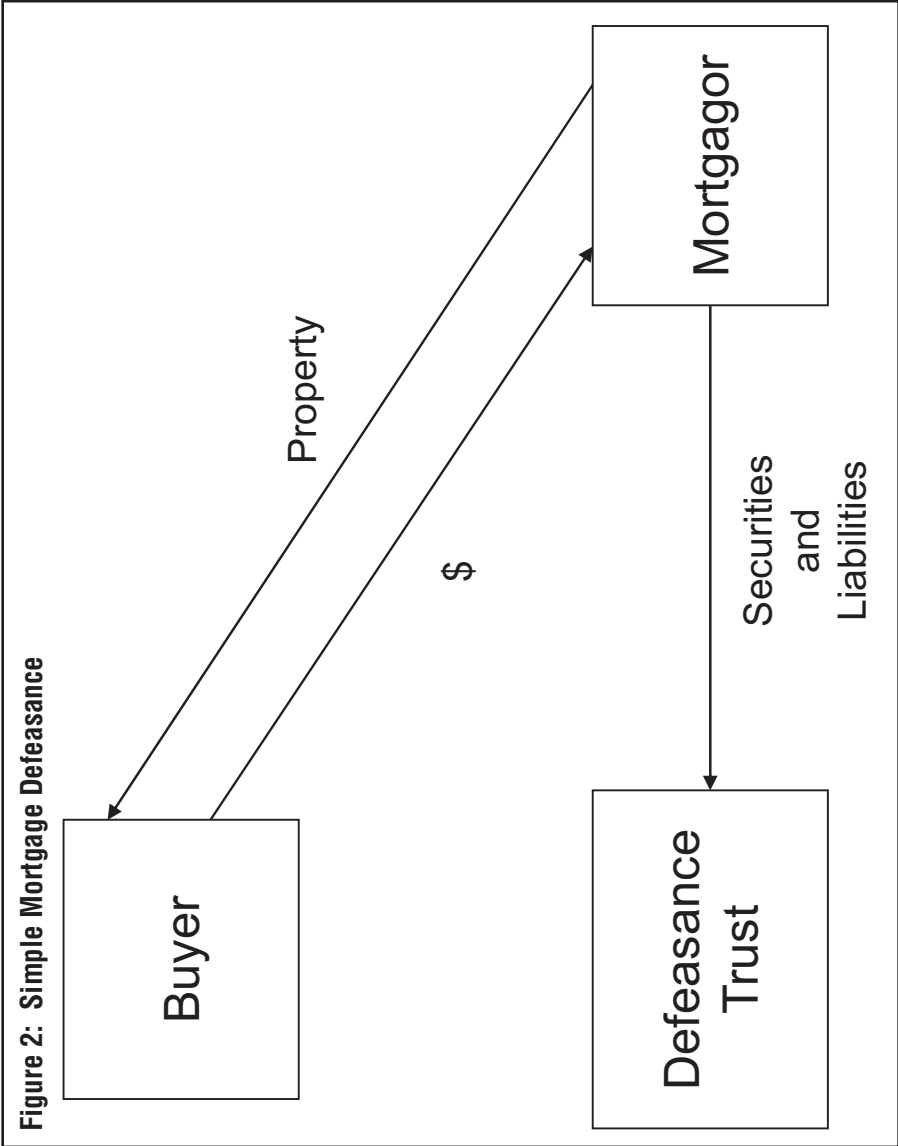
<sup>12</sup> See Treas. Reg. § 1.860G-2(a)(8)(ii)(B).

<sup>13</sup> The purpose of the release could also be for any other customary commercial transaction, but the release cannot be part of an arrangement to collateralize a REMIC offering with obligations that are not real estate mortgages. See Treas. Reg. § 1.860G-2(a)(8)(ii)(C).

<sup>14</sup> See Treas. Reg. § 1.860G-2(a)(8)(ii)(D).

<sup>15</sup> See Boyce, *supra* note 2.

<sup>16</sup> See Blake D. Rubin et al., “Tax Issues in Defeating a Conduit Loan, Including in a Like-Kind Exchange,” 67 N.Y.U. Fed. Tax Inst. ch. 5 (2009).



Section 1031 exchange. A legal defeasance releases the mortgagor from any continuing legal liability on the loan, and if the substitute collateral generates more income than the original collateral, the additional income reverts to the defeasance trustee, not the mortgagor. By contrast, an in-substance defeasance does not release the mortgagor, so (1) the mortgagor remains liable to make payments on the loan the substitute collateral does not cover, and (2) any cash flow the substitute collateral generates in excess of the loan obligation reverts to the mortgagor. The mortgage documents generally establish whether a legal defeasance or in-substance defeasance is possible.

The trick with a mortgage defeasance is matching the income from the substitute collateral and the installments due under the loan. Mortgagors can hire defeasance experts to help assemble a portfolio of securities that will generate the appropriate return.<sup>17</sup> Because defeasances occur after the original loan, the market interest rate may differ from the rate of the original loan. Because the goal is to have the substitute collateral generate income sufficient to service the loan, different interest rates may cause the cost of the substitute collateral to differ from the outstanding principal of the loan. If the cost of the substitute collateral is less than the balance of the loan, the mortgagor would have a defeasance discount. If the cost of substitute collateral is greater than the outstanding balance of the loan, the mortgagor would have a defeasance premium. A defeasance discount occurs if the interest rates at the time of the defeasance exceed the interest on the loan, and a defeasance premium exists if the market interest is less than the interest on the loan.<sup>18</sup> Example 1 illustrates how discrepancies between the outstanding loan balance and the cost of substitute collateral may arise.

**Example 1:** Assume Mandy's original loan was for \$120,000, to be repaid over 30 years with a 5 percent interest rate. Mandy's monthly payment would therefore be approximately \$644. Four years after acquiring the property, Mandy decides to defease the mortgage and sell the property. At that time, the outstanding principal of the loan would be approximately \$112,530. To defease the mortgage, Mandy must acquire substitute collateral that will pay approximately \$644 for the 26 years remaining on the loan.

Consequently, if the market interest rate is 7 percent at the time she defeases the mortgage, she would likely acquire the substitute collateral for approximately \$92,500. The approximately \$20,000 difference that separates the \$112,530 of outstanding principal of the loan from the \$92,500 cost of the substitute collateral is a defeasance discount.

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<sup>17</sup> See Boyce, *supra* note 2.

<sup>18</sup> See *id.*

On the other hand, if the interest rate is only 4 percent at the time of the defeasance, Mandy might have to pay approximately \$124,750 to acquire the substitute collateral that would pay \$644 per month. The \$12,220 difference between what Mandy paid for the substitute collateral and the outstanding principal of the note would be a defeasance premium.

This example illustrates how a defeasance can cause a defeasance discount or defeasance premium. Defeasance discounts and premiums can affect the tax results of the disposition of property. Whether the defeasance is legal or in-substance can also affect the tax results. Consider the different tax results that derive from the different types of defeasances.

**Legal Defeasance.** As stated above, when there is a legal defeasance, the mortgagor is absolved of liability on the loan. Because the REMIC rules generally allow a defeasance only if the property owner is transferring property,<sup>19</sup> the defeasance occurs as part of the transfer, and the tax consequences of the defeasance result from the transfer.

**Defeasance Discount.** Consequently, in the case of a legal defeasance, the defeasance discount should represent liability relief and be part of the amount realized on the disposition of the property.<sup>20</sup> Example 2 illustrates that the manner in which the legal defeasance occurs should not affect that result.

**Example 2:** Assume Mandy's property is worth \$200,000 and has a \$150,000 adjusted basis. If she were to simply sell it for \$200,000 and use a portion of the proceeds to pay off the \$112,530 balance of the loan, she would recognize \$50,000 of gain.<sup>21</sup> Similarly, if the buyer assumed the \$112,530 liability and paid \$87,470 to Mandy, her amount realized would remain \$200,000,<sup>22</sup> and she would have \$50,000 of gain. Those results obtain only if Mandy does not have to defease the mortgage or the defeasance does not have a premium or discount.

Now consider the result that would obtain if Mandy were able to defease the mortgage at a discount. Assume Mandy pays

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<sup>19</sup> See Treas. Reg. § 1.860G-2(a)(8)(ii)(c).

<sup>20</sup> See Treas. Reg. § 1.1001-2(a)(1).

<sup>21</sup> See IRC § 1001(a) (providing that gain is the excess of the \$200,000 amount realized over the \$150,000 adjusted basis).

<sup>22</sup> See Treas. Reg. § 1.1001-2(a)(1) (providing that amount realized includes discharge of liability).

\$92,500 to acquire substitute collateral and defease the mortgage. She would in effect spend \$92,500 to eliminate \$112,530 of liability. Because a defeasance occurs as part of a transfer of property, the amount of liability relief resulting from the defeasance should be included in Mandy's amount realized. If Mandy sold the property to the buyer for \$200,000, her total amount realized would be \$312,530 (i.e., \$200,000 received from the buyer plus \$112,530 of liability relief). Mandy also paid \$92,500 as part of the exchange, so that amount should reduce her gain realized.<sup>23</sup> With an adjusted basis of \$150,000 in the property, she would recognize \$70,030 on the disposition. She would compute the gain realized as follows:

**Gain Realized (Mortgagor Acquires Substitute Collateral)**

Cash received		\$200,000
Liability relief		<u>\$112,530</u>
Amount realized		\$312,530
Adjusted basis		
Property's basis	\$150,000	
Cash paid	<u>\$92,500</u>	
Adjusted basis		<u>(\$242,500)</u>
Gain realized		\$70,030

Alternatively, Mandy and the buyer could structure the transaction to require the buyer to acquire the substitute collateral and transfer it to the defeasance trust. Under this alternative structure, Mandy would receive \$107,500 from the buyer and be relieved of \$112,530 of liability. Mandy would therefore have \$112,530 of liability relief as part of the transfer, and she should include that in her amount realized. Thus, her total amount realized would equal \$220,030, and her gain would be the \$70,030 difference between the amount realized and her \$150,000 adjusted basis.<sup>24</sup> Mandy should compute her gain realized as follows:

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<sup>23</sup> See Treas. Reg. § 1.1031(d)-2, *Ex. (2)(c)* (subtracting cash paid from amount realized to compute gain realized).

<sup>24</sup> These example alternatives assume that the fair market value of the property is greater than the loan balance, so all of the liability relief will be amount realized, not COD income. See Treas. Reg. § 1.1001-2(c), *Ex. 8*. In the case of a foreclosure, the amount of liability could exceed the fair market value of the property, and the property owner could have COD income. See *id.* In such a case, the principles discussed above should apply.

**Gain Realized (Buyer Acquires Substitute Collateral)**

Money received	\$107,500
Liability relief	<u>\$112,530</u>
Amount realized	\$220,030
Adjusted basis	<u>(\$150,000)</u>
Gain realized	\$70,030

**Defeasance Premium.** Next consider the result that might obtain if interest rates had gone down and the property owner had to pay a defeasance premium to transfer the property. Some commentators argue that a mortgagor should be able to deduct a defeasance premium as an interest expense.<sup>25</sup> Under that theory, if Mandy had to pay \$124,750 to acquire the substitute collateral, she should have an interest deduction of \$12,220 (\$124,750 paid for the substitute collateral minus the \$112,530 principal balance of the loan) when she defeased the mortgage. She would also have \$50,000 of gain when she sold the property for \$200,000. That theory, however, fails to recognize that the REMIC rules generally allow a defeasance only if it occurs as part of the disposition of property.<sup>26</sup> The defeasance premium is thus a cost to dispose of the property. The mortgagor could not defease the loan without the transfer, so the premium is actually an amount paid to transfer the property.

The defeasance premium in effect causes the buyer to pay one amount and the seller to receive some smaller amount. In an arm's length transaction, a seller would accept a smaller amount than the buyer pays only if the difference between amount paid and amount received facilitated the transfer of property. In fact, sellers often receive less than the buyer pays because most transactions have transaction costs, which reduce the amount the seller receives. Tax law therefore reduces a seller's amount realized by the amount of the transaction costs.<sup>27</sup> The defeasance premium is economically equivalent

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<sup>25</sup> See Rubin et al., *supra* note 16 (citing IRC § 163(a) (allowing a deduction for interest)); *General Am. Life Ins. Co. v. Comm'r*, 25 TC 1265 (1956), *acq.*, 1956-2 CB 5 (holding that prepayment charges are additional fees for the use of money and deductible as interest); Treas. Reg. § 1.163-4(c) (providing that the excess of the repurchase price over the issue price (adjusted form amortized premium or deducted discount) is deductible interest upon a corporation's repurchase of bonds it issued); Treas. Reg. § 1.163-7(c) (providing that the repurchase premium of a debt instrument is deductible as interest); Rev. Rul. 57-198, 1957-1 CB 94; Rev. Rul. 73-137, 1973-1 CB 68 (ruling that prepayment fees are interest payments).

<sup>26</sup> See Treas. Reg. § 1.860G-2(a)(8)(ii)(c).

<sup>27</sup> See Treas. Reg. § 1.263(a)-2(e) ("Commissions paid in selling securities are an offset against the selling price."); Prop. Reg. § 1.263(a)-1(d)(1), (2) (2008) (providing that commissions and other transaction costs paid to facilitate the sale of property generally must be capitalized and treated as a reduction in the amount realized on sale of the property); Bradley T. Borden, *Tax-Free Like-Kind Exchanges* (Civic Research Institute, 2008), at ¶ 2.1[2].

to a transaction cost because it is a cost the seller incurs to transfer property. Example 3 illustrates how a defeasance premium should affect the seller.

**Example 3:** Assume the buyer agrees to pay \$200,000 for the property. Mandy pays \$124,750 to acquire the substitute collateral and defease the loan. As a consequence, Mandy is relieved of \$112,530 of liability. The buyer pays Mandy \$200,000 for the property with a \$150,000 adjusted basis. The \$12,220 defeasance premium is subsumed in the amount Mandy pays for the substitute collateral. It offsets the amount realized and Mandy realizes \$37,780 of gain.<sup>28</sup> The following computation demonstrates how she derives the gain realized.

**Gain Realized With Defeasance Premium  
(Seller Acquires Substitute Collateral)**

Cash received	\$200,000
Liability relief	<u>\$112,530</u>
Amount realized	\$312,530
Basis of property	\$150,000
Cash paid	<u>\$124,750</u>
Adjusted basis	( <u>\$274,750</u> )
Gain realized	\$37,780

Alternatively, assume alternatively that the buyer agrees to acquire the substitute collateral for \$124,250 and transfer the balance of the \$200,000 contract price to Mandy. Under this set of facts, Mandy would compute her gain realized as follows:

**Gain Realized With Defeasance Premium  
(Buyer Acquires Substitute Collateral)**

Cash received	\$75,250
Liability relief	<u>\$112,530</u>
Amount realized	\$187,780
Adjusted basis of property	( <u>\$150,000</u> )
Gain realized	\$37,780

Example 3 illustrates that the defeasance premium reduces the amount realized, if the buyer acquires the substitute collateral. The end result (i.e.,

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<sup>28</sup> Closing costs generally reduce amount realized. This example includes all cash paid in the adjusted basis computation, in conformity with the method used in the Section 1031 regulations. See Treas. Reg. §1.1031(d)-2, Ex. (2)(c).

\$37,780 of gain realized) is the same result that obtained when Mandy acquired the substitute collateral. The similar results are not surprising because the transactions are economically equivalent.<sup>29</sup>

The same net result would obtain if the law were to treat the defeasance premium as an interest deduction (i.e., Mandy would have taxable income of \$37,750). The classification of the premium can nonetheless be important. A reduction of amount realized reduces gain, which may be taxed at favorable capital-gain rates, while an interest deduction could offset income taxed at ordinary rates.<sup>30</sup> Consequently, taxpayers may generally prefer to treat the defeasance premium as an interest deduction. Because the defeasance premium is a cost incurred to transfer the property, however, treating it as an interest deduction appears to be improper.

**In-Substance Defeasance.** In the case of an in-substance defeasance, the mortgagor remains liable for the loan and receives any portion of the income or principal left after the loan has been satisfied. Because the mortgagor remains liable for the loan, the mortgagor should not have income or an amount realized at the time of an in-substance defeasance, nor should the mortgagor be able to deduct a defeasance premium at that time. Furthermore, because the mortgagor will receive any excess income from the substitute collateral, the mortgagor will own the substitute collateral for tax purposes.<sup>31</sup> Thus, the mortgagor must consider the income tax consequences of owning the substitute collateral and making payments on the defeased loan. From a transactional perspective, an in-substance defeasance is a non-event for tax purposes and would not affect the gain a mortgagor realizes on the disposition of property. The gain on the disposition of the property would equal money or other property the mortgagor received in excess of the adjusted basis the mortgagor had in the property.

## Defeasance as Part of a Like-Kind Exchange

Because mortgage defeasance and disposition of property may cause a mortgagor to recognize gain, the mortgagor may seek to structure the defeasance and disposition as part of a Section 1031 exchange. A mortgagor must

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<sup>29</sup> This is how the regulations under IRC § 1031 treat cash paid. See Treas. Reg. § 1.1031(d)-2, *Ex. (2)(c)*.

<sup>30</sup> See IRC § 1(h)(C) (providing a favorable rate for adjusted net capital gain); IRC § 163(a) (allowing a deduction for interest).

<sup>31</sup> See Treas. Reg. § 1.61-13 (providing that assets a corporation places in a sinking fund under the control of a trustee are assets of the corporation and any gain arising from the assets is gross income to the corporation); Rev. Rul. 85-42, 1985-1 CB 36 (ruling that a corporation is the owner of assets placed in trust as part of an in-substance defeasance, and any income from the assets is included in the corporation's gross income).

consider several issues when attempting to structure a defeasance and disposition as part of a Section 1031 exchange. The issues differ depending upon whether the defeasance is legal or in-substance, whether the exchanger or buyer acquires the substitute collateral, and whether the defeasance is subject to a premium or discount.

**Legal Defeasance as Part of an Exchange.** First consider an exchange and legal defeasance. A legal defeasance may occur as part of an exchange in one of two ways:

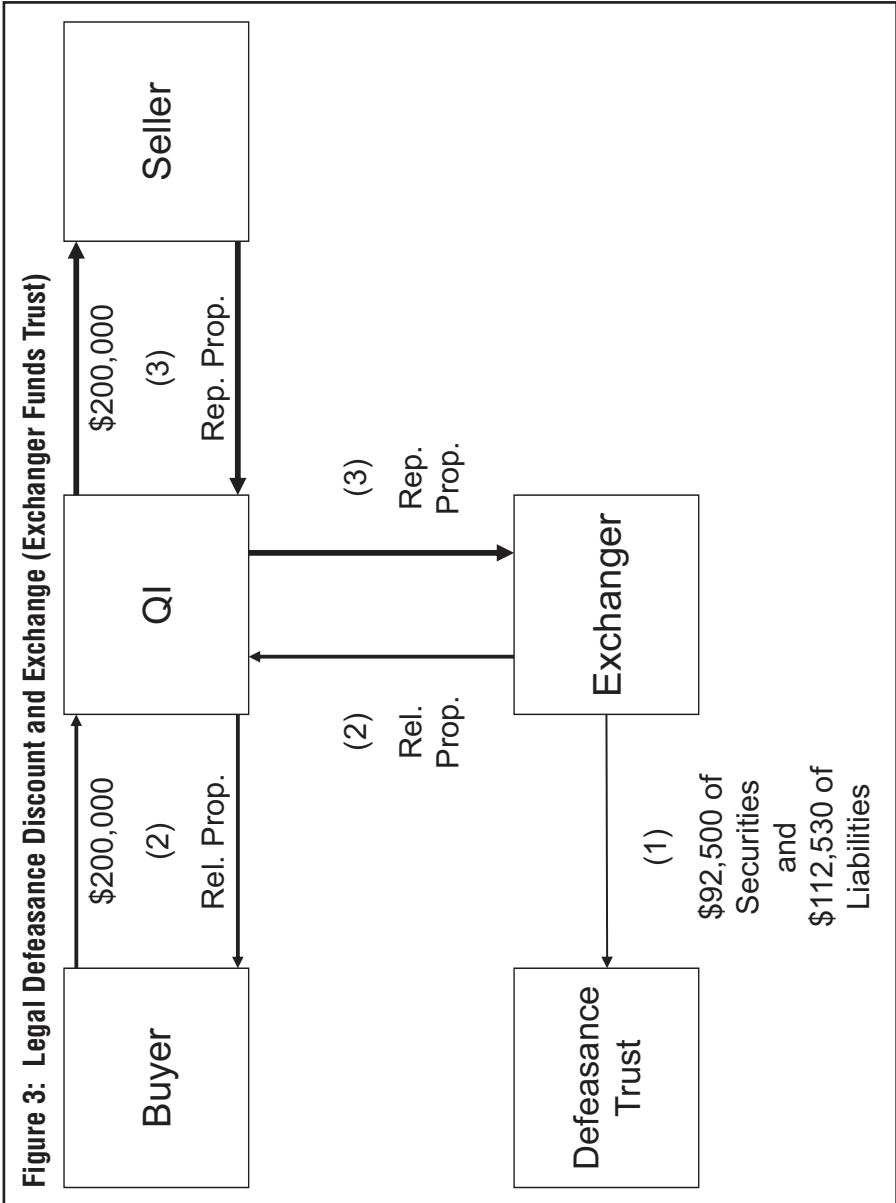
1. The exchanger may acquire the substitute collateral and transfer it to the defeasance trust.
2. The exchanger may direct that a portion of the exchange proceeds be used to acquire the substitute collateral and transfer it to the defeasance trust.

***Exchange With Defeasance Discount.*** A legal defeasance that occurs as part of an exchange may be subject to a defeasance discount. If that is the case, the structure will affect the amount of boot, if any, the exchanger has on the transaction. As with the sale transactions discussed earlier, the defeasance is treated as part of the disposition of the property. In the exchange context, the disposition and defeasance become part of the exchange. Thus, the general rules for computing gain or loss on an exchange should apply, and the exchanger should compute the basis in the replacement property using Section 1031(d). Example 4 illustrates the application of the rules. (Figure 3 depicts the transaction.)

***Example 4:*** Assume that Mandy plans to sell her property to Burke and use the proceeds to acquire replacement property from Simone. Assume also that the property is subject to the same \$112,530 of liability and that the loan documents allow for a legal defeasance. Prior to transferring the property to Burke, Mandy pays \$92,500 to acquire substitute collateral and transfers it to a defeasance trust which assumes the liability. The REMIC releases Mandy of all liability associated with the loan and releases its lien on the property. Mandy transfers the property through a qualified intermediary to Burke, free of any liability, and Burke transfers \$200,000 to a qualified intermediary as directed by Mandy. Later, Mandy directs the qualified intermediary to use the proceeds to acquire replacement property from Simone for \$200,000.<sup>32</sup>

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<sup>32</sup> For purposes of isolating the issue, assume that the structures in this discussion about the exchanges and defeasances satisfy all of the IRC § 1031 requirements and the qualified intermediary safe harbor, other than those raised specifically by the defeasance.



Because the defeasance can occur only as part of a transfer of property, tax law should treat the defeasance as part of the exchange. Consequently, the law should treat Mandy as transferring property worth \$200,000 subject to a \$112,530 mortgage and paying \$92,500 in order to acquire the replacement property worth \$200,000, which is subject to no liability.<sup>33</sup> As a consequence, Mandy should have \$20,030 of liability-relief boot, which would trigger gain recognition. Mandy would compute her gain realized as follows.

### Gain Realized

FMV of replacement property	\$200,000
Liability relief	<u>\$112,530</u>
Amount realized	\$312,530
Basis of relinquished property	\$150,000
Cash paid	<u>\$92,500</u>
Adjusted basis	( <u>\$242,500</u> )
Gain realized	\$70,030

The \$70,030 of gain realized is the same gain Mandy realized on the cash sale with similar facts (see Example 2), so it appears to be correct. To determine Mandy's boot, the law should treat Mandy as having \$112,530 of liability relief, and offset that with the \$92,500 she paid as part of the exchange.<sup>34</sup> Because the \$20,030 of liability-relief boot is less than the gain realized, Mandy should recognize only \$20,030 of gain on the transaction.<sup>35</sup>

### Gain Recognized

Gain realized	\$70,030
Boot	\$20,030
Gain recognized (lesser of boot & gain realized)	\$20,030

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<sup>33</sup> Treating several aspects of a transaction as part of the exchange is consistent with the treatment granted by the Tax Court and IRS. In *Barker v. Comm'r*, 74 TC 555 (1980), the court held that use of sale proceeds to pay off a liability encumbering the relinquished property was not boot, but it was similar to the liability assumed by the purchaser of relinquished property. See also PLR 9853028 (Sept. 30, 1998) (ruling privately that payment of a liability by the purchaser of relinquished property was liability relief to the exchanger on transfer of the property).

<sup>34</sup> See Treas. Reg. § 1.1031(d)-2, Ex. (2)(c).

<sup>35</sup> See IRC § 1031(d).

The mortgagor's basis in the replacement property should equal the basis the mortgagor had in the relinquished property, increased by (1) the cash the mortgagor paid, (2) gain the mortgagor recognized, and (3) liability the mortgagor assumed. Any cash the mortgagor receives or liability relief the mortgagor experiences should reduce that amount.<sup>36</sup> Example 5 illustrates the basis computation.

**Example 5:** Mandy's basis in the replacement property should equal the \$150,000 basis she had in the relinquished property, increased by the \$92,500 cash she paid and the \$20,030 of gain she recognized, and decreased by the \$112,530 of liability relief.<sup>37</sup> That would give the replacement property a \$150,000 basis, calculated as follows:

#### **Basis in Replacement Property**

Basis in relinquished property	\$150,000
Cash paid	\$92,500
Gain recognized	\$20,030
Liability relief	<u>(\$112,530)</u>
Basis in replacement property	\$150,000

An exchanger can avoid liability-relief boot by offsetting the liability relief with cash paid or by assuming liability on the acquisition of replacement property.<sup>38</sup> In the case of a discounted legal defeasance, the mortgagor is able to eliminate the liability for less than the loan's principal balance. Thus, to avoid liability-relief boot, the mortgagor must acquire replacement property worth more than the relinquished property to offset the liability relief. To acquire more valuable replacement property, the exchanger must either pay more cash or borrow additional funds. The additional funds would have to equal or exceed the liability-relief boot to avoid gain recognition. Example 6 illustrates this point.

**Example 6:** Assume that, instead of acquiring a \$200,000 piece of replacement property, Mandy acquires replacement property worth \$220,030. Recall that the qualified intermediary holds only \$200,000 of proceeds from the disposition of the relinquished property; therefore, Mandy must either borrow or pay \$20,030 to acquire the more expensive property. If she borrows the extra amount, the liability she assumes will offset the liability relief,

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<sup>36</sup> See Treas. Reg. § 1.1031(d)-2, Ex. (2)(c).

<sup>37</sup> See IRC § 1031(d); Treas. Reg. § 1.1031(d)-2, Ex. (2)(c).

<sup>38</sup> See Treas. Reg. § 1.1031(d)-2, Ex. (2)(c).

and she will have no gain recognized. She would compute her gain realized as follows:

### Gain Realized

FMV of replacement property		\$220,030
Liability relief		<u>\$112,530</u>
Amount realized		\$332,560
Basis of relinquished property	\$150,000	
Cash paid	\$92,500	
Liability assumed	<u>\$20,030</u>	
Adjusted basis		<u>(\$262,530)</u>
Gain realized		\$70,030

### Gain Recognized

Gain realized		\$70,030
Boot		\$0
Gain recognized (lesser of boot & gain realized)		\$0

Although Mandy's gain realized is the same with these changed facts as it was in Example 4, she has no boot on the transaction because the \$92,500 she paid and the \$20,030 of liability she assumed offset her \$112,530 of liability relief. Even with these changed facts, however, Mandy's basis in the replacement property will be \$150,000, computed as follows:

### Basis in Replacement Property

Basis in relinquished property		\$150,000
Cash paid		\$92,500
Liabilities assumed		\$20,030
Gain recognized		\$0
Reduced liabilities		<u>(\$112,530)</u>
Basis in replacement property		\$150,000

Mandy can verify the legitimacy of these results by examining whether she has preserved the deferred gain in the new property. Mandy had \$70,030 of gain realized. Thus, when she exchanges the property, the amount of gain recognized on the exchange plus the deferred gain should equal \$70,030. In Example 4, Mandy acquired property worth \$200,000 and recognized \$20,030 of gain. Her deferred gain was therefore \$50,000. She took a \$150,000 basis in the replacement property, so if she had sold the replacement property immediately, she would have recognized \$50,000 of gain (the deferred gain). The sum of the \$20,030 of recognized gain and the \$50,000 of deferred gain equals the \$70,030 of gain realized, so that scenario appears to reach the correct result. In Example 6, Mandy recognized no gain but

acquired property worth \$220,030 with a \$150,000 basis. If she had sold that property immediately following the exchange, she would have recognized the \$70,030 of gain realized. That also appears to be the correct result.

Property owners can structure legal defeasances differently. For example, instead of purchasing and transferring the securities to the trust, a mortgagor could direct the qualified intermediary or the buyer to purchase the substitute collateral and transfer it to the trust. A transaction structured in that manner should produce the same tax result as described above, if the exchanger does not actually or constructively receive either the purchase proceeds or the substitute collateral. The focus with this structure is on ensuring that the mortgagor is not in actual or constructive receipt of the substitute collateral or sales proceeds. As a precaution, the exchanger might require the defeasance trust documents to include (g)(6) restrictions in the Section 1031 regulations,<sup>39</sup> even though the trust documents probably include even stricter restrictions than those in the (g)(6) restrictions. If the exchanger avoids the actual or constructive receipt of exchange proceeds and substitute collateral, the results should mirror those above. Example 7, which elaborates on the transaction depicted in Figure 4, illustrates the similarity.

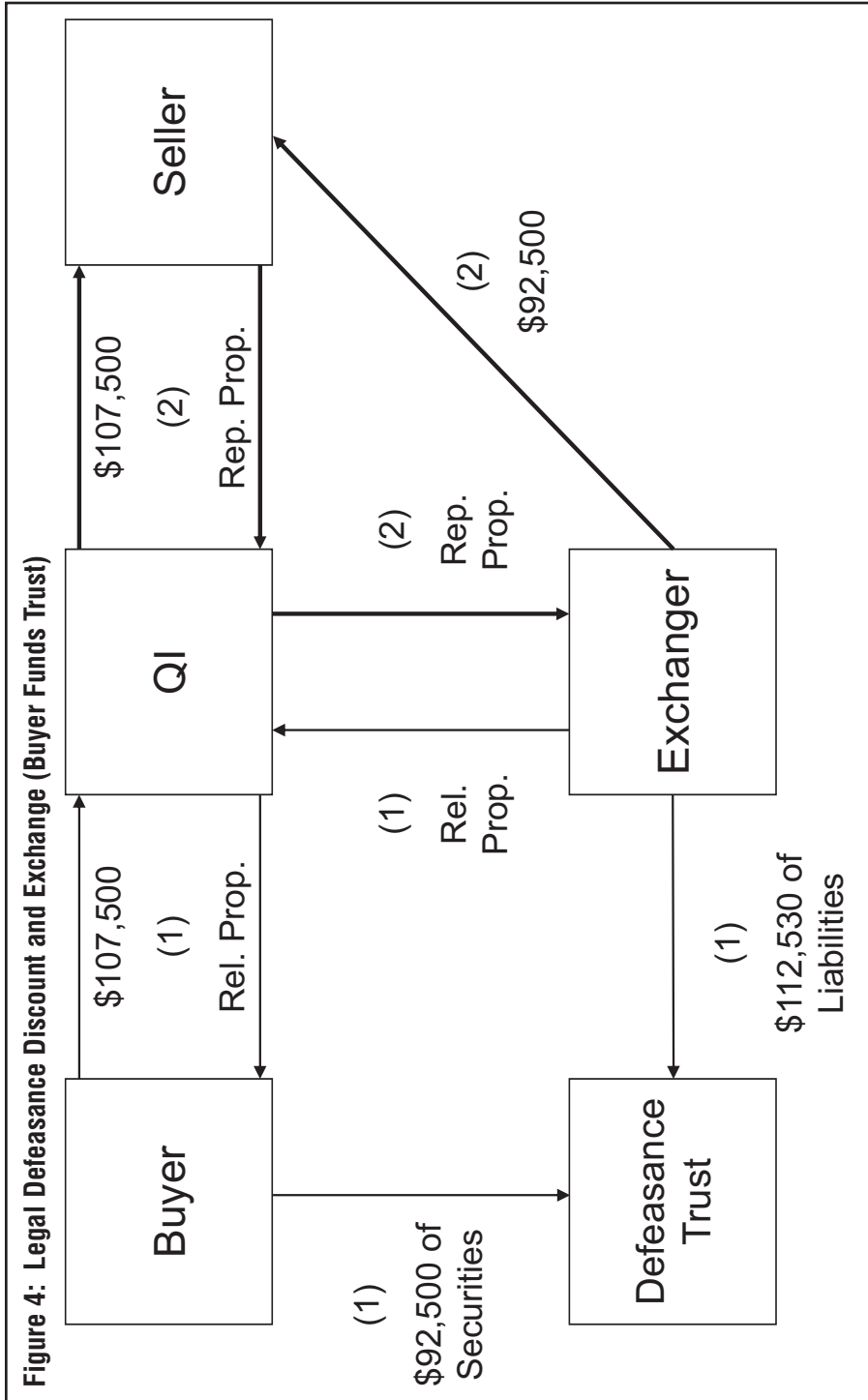
**Example 7:** Assume Burke agrees to acquire substitute collateral and transfer it to the defeasance trust. At the time of the exchange, the defeasance trust would assume \$112,530 of Mandy's liability. Burke would transfer \$92,500 worth of securities to the trust and \$107,500 to the qualified intermediary. To acquire the \$200,000 replacement property, Mandy would have to pay \$92,500, in addition to the money held by the qualified intermediary (or take the replacement property subject to a \$92,500 liability). The additional amount Mandy invests would be \$20,030 less than the liability the trust assumed. Consequently, Mandy would have \$20,030 of liability-relief boot and gain recognition.

To avoid gain recognition, Mandy would have to pay or borrow \$112,530 to offset her liability relief. Consequently, to avoid gain recognition, Mandy would have to acquire replacement property worth at least \$220,030. The results are thus similar to those in the scenario that had Mandy purchasing the substitute collateral.

**Exchange With Defeasance Premium.** In the case of a legal defeasance, the payment of a defeasance premium should be treated as part of the exchange. The premium should therefore be a cost paid to facilitate the exchange, even if the buyer acquires the substitute collateral. If the buyer

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<sup>39</sup> See Treas. Reg. § 1.1031(k)-1(g)(6); Borden, *supra* note 27, at ¶ 4.4[6] (describing the (g)(6) restrictions).



acquires the substitute collateral, the fair market value of the replacement property will reflect the defeasance premium, and the exchanger does not include it in the computation of gain realized or the basis of the replacement property.<sup>40</sup> If the mortgagor acquires the substitute collateral, the defeasance premium should be treated as part of the exchange and should increase the basis the mortgagor takes in the replacement property.<sup>41</sup> The mortgagor generally should not recognize gain on such a transaction. Example 8 elaborates on the exchange with a defeasance premium that is illustrated in Figure 5.

**Example 8:** Assume Mandy pays \$124,750 to acquire and transfer substitute collateral to the defeasance trust, which also assumes \$112,530 of the liability to which the relinquished property is subject. Mandy transfers the property to Burke through a qualified intermediary, and Burke pays \$200,000 to the qualified intermediary. Later, Mandy directs the qualified intermediary to acquire replacement property for \$200,000.

Burke pays \$200,000 and Mandy has \$112,530 of liability relief, so her amount realized should be \$312,530.<sup>42</sup> Mandy should subtract (1) the \$124,750 cash she paid and (2) the \$150,000 adjusted basis of the relinquished property from her amount realized to compute her gain realized.<sup>43</sup> Because the property has a basis of \$150,000, Mandy's gain realized on the transaction is \$37,780. She would have no liability-relief boot because the amount she paid offsets the liability relief. Consequently, Mandy will recognize no gain on the transaction, and she will defer all \$37,780 of gain realized.

### Gain Realized

Value of replacement property		\$200,000
Liability relief		<u>\$112,530</u>
Amount realized		\$312,530
Basis of relinquished property	\$150,000	
Cash paid	<u>\$124,750</u>	
Adjusted basis		<u>(\$274,750)</u>
Gain realized		\$37,780

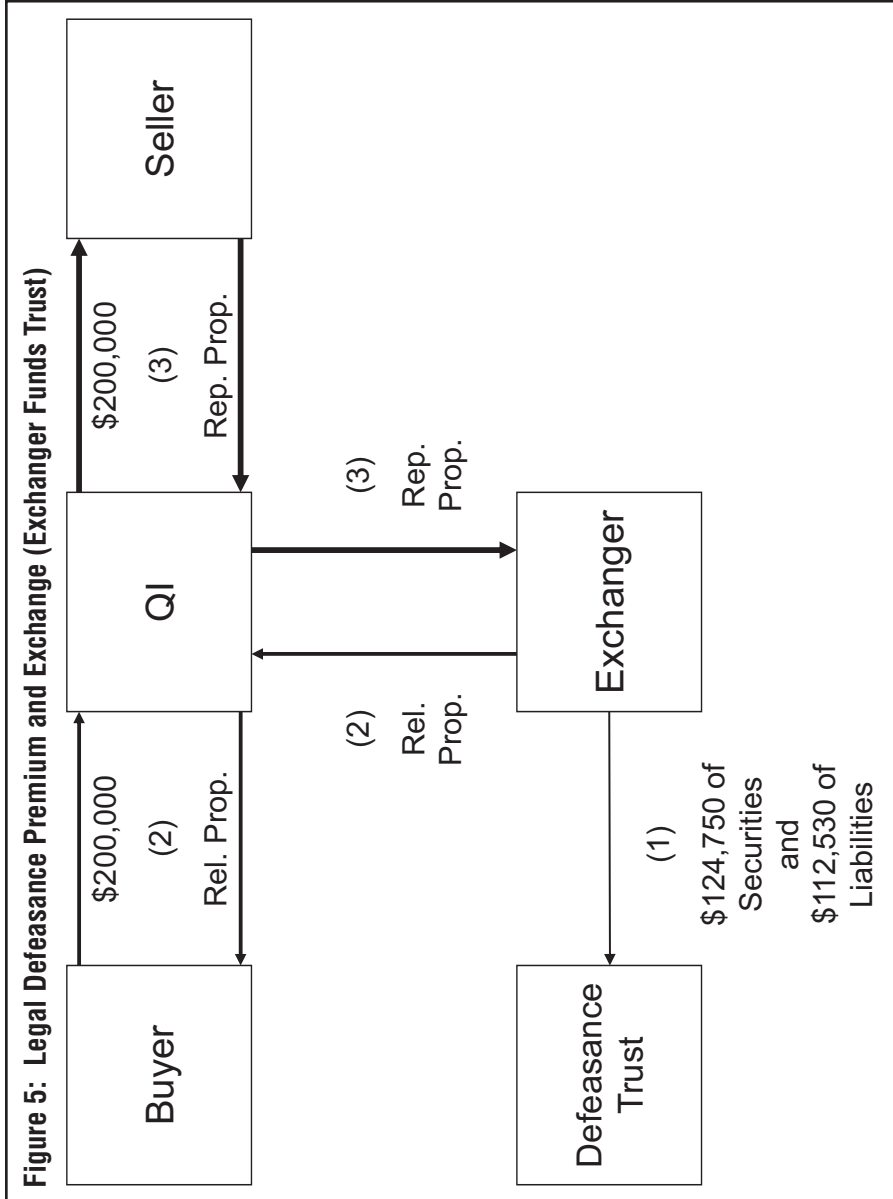
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<sup>40</sup> See Prop. Reg. § 1.263(a)-1(d); Borden, *supra* note 27, at ¶ 2.1[2] (the forthcoming Supplement to Borden will discuss this issue further at ¶ 2.9A).

<sup>41</sup> See Treas. Reg. § 1.263(a)-2(a) (providing that the cost of acquiring property is an example of a capital expenditure); Treas. Reg. § 1.263(a)-2(e) (providing that commissions paid to acquire property are capital expenditures); Treas. Reg. § 1.1031(d)-1(a); Treas. Reg. § 1.1031(d)-2, *Ex. (2)(c)*.

<sup>42</sup> See IRC § 1001(b); Treas. Reg. § 1.1001-2(a).

<sup>43</sup> See Treas. Reg. § 1.1031(d)-2, *Ex. (2)(c)*.



### Gain Recognized

Gain realized	\$37,780
Boot	\$0
Gain recognized (lesser of boot & gain realized)	\$0

Mandy's basis in the replacement property will equal the \$150,000 basis she had in the relinquished property increased by the \$124,750 she paid and reduced by the \$112,530 liability from which she was relieved. Her basis in the replacement property should thus be \$162,220, computed as follows.

#### Mandy's Basis in Replacement Property

Basis in relinquished property	\$150,000
Cash paid	\$124,750
Liability relief	<u>(\$112,530)</u>
Basis in replacement property	\$162,220

The replacement property is worth \$200,000 so the \$162,220 adjusted basis Mandy takes in the replacement property preserves her \$37,780 deferred gain. That provides assurance that the computations are correct.

The same end result should obtain if, alternatively, the buyer acquires the substitute collateral and transfers it to the defeasance trust in a manner that ensures that Mandy does not actually or constructively receive either sale proceeds or the substitute collateral. This scenario is depicted in Figure 6, and the tax treatment is explained in Example 9.

**Example 9:** Assume Burke acquires \$124,750 of securities and transfers them to the defeasance trust. He transfers \$75,250 (i.e., the balance of the \$200,000 contract price) to the qualified intermediary in exchange for the relinquished property. The defeasance trust assumes the \$112,530 of liabilities on the relinquished property, and Mandy transfers the property through the qualified intermediary to Burke. Later Mandy selects replacement property and directs the qualified intermediary to pay the \$75,250 of exchange proceeds to Simone. Mandy transfers \$112,530 to Simone to acquire property worth \$187,780.

Mandy's amount realized will include the \$187,780 of property she receives plus the \$112,530 of liability relief that occurs as part of the transaction. She transferred property with a basis of \$150,000 and paid \$112,530 to acquire the replacement property,

so her gain realized is \$37,780. The \$112,530 of cash Mandy pays offsets her liability relief; thus she has no boot on the transaction and will recognize no gain. She will therefore defer all \$37,780 of gain realized.

### Gain Realized

Value of replacement property		\$187,780
Liability relief		<u>\$112,530</u>
Amount realized		\$300,310
Basis of relinquished property	\$150,000	
Cash paid	<u>\$112,530</u>	
Adjusted basis		<u>(\$262,530)</u>
Gain realized		\$37,780

### Gain Recognized

Gain realized		\$37,780
Boot		\$0
Gain recognized (lesser of boot & gain realized)		\$0

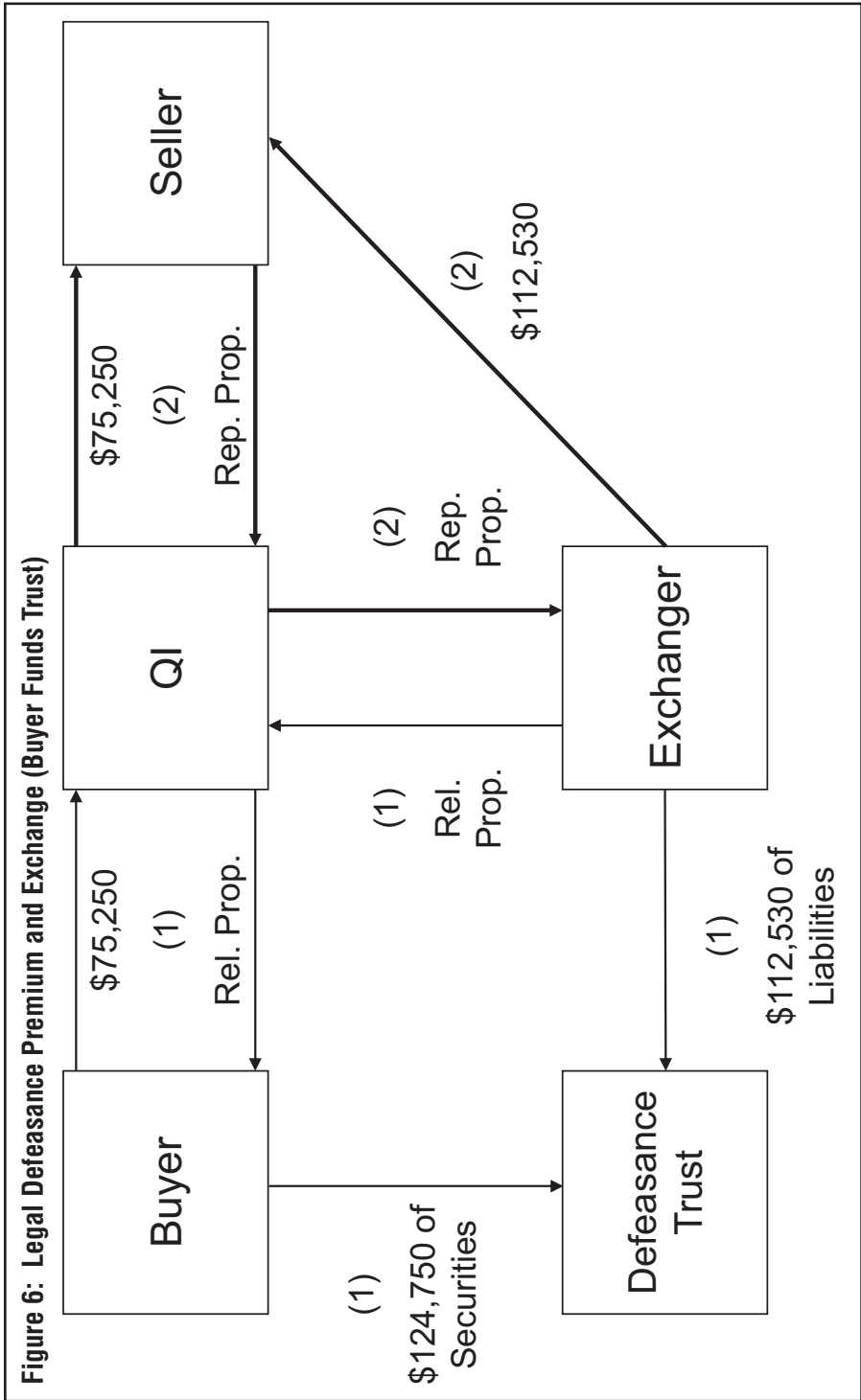
Mandy will take a \$150,000 basis in the replacement property. That basis derives from the \$150,000 basis she had in the relinquished property, increased by the \$112,530 cash she paid to acquire the replacement property and reduced by the \$112,530 of liability relief.

### Mandy's Basis in Replacement Property

Basis in relinquished property		\$150,000
Cash paid		\$112,530
Liability relief		<u>(\$112,530)</u>
Basis in replacement property		\$150,000

That basis also preserves the deferred gain because the replacement property is worth \$187,780. Thus, if she sold it immediately, she would recognize the \$37,780 of deferred gain. The result therefore suggests the computations are correct.

**In-Substance Defeasance as Part of an Exchange.** As stated above, a mortgagor does not experience liability relief as part of an in-substance defeasance. Consequently, a mortgagor who does an in-substance defeasance as part of an exchange should not have liability-relief boot as a result of the in-substance defeasance. Tax law also deems the mortgagor to own the



substitute collateral placed in the defeasance trust. Consequently, if the buyer of the replacement property provides the substitute collateral, the exchanger would likely have boot at the time the buyer transfers the substitute collateral to the defeasance trust. To avoid boot, the exchanger would therefore have to acquire the substitute collateral with funds that do not come from the buyer. Example 10 illustrates the tax consequence of an in-substance defeasance that occurs as part of an exchange.

**Example 10:** Assume Mandy uses an in-substance defeasance when she transferred the property as part of a transaction she intended to have qualify for Section 1031 nonrecognition. She pays \$124,750 to acquire and transfer substitute collateral to the defeasance trust, and the trust agrees to service the \$112,530 of liability. Mandy owns the securities and remains liable for the loan for tax purposes, so she will not be deemed to have paid anything, and she will have no liability-relief boot. Mandy transfers the property to the buyer through the qualified intermediary, free of the defeased mortgage, and the buyer transfers \$200,000 to the qualified intermediary. Later, the qualified intermediary uses those proceeds to acquire and transfer replacement property to Mandy at her direction.

The transaction in Example 10 appears to qualify for Section 1031 nonrecognition, so Mandy should recognize no gain or loss. She should take a basis in the replacement property equal to the \$150,000 basis she had in the relinquished property. The in-substance defeasance was a non-event for federal income tax purposes, so it does not figure into the tax treatment. The exchange merely becomes a transfer of unencumbered property in exchange for other unencumbered property.

The outcome would change, however, if the buyer were to fund the defeasance trust. Consider, for example, the transaction in Example 11.

**Example 11:** Assume that Burke pays \$124,750 for substitute collateral and transfers it to the defeasance trust, and the trust agrees to service the \$112,530 loan. Mandy transfers the property to Burke through a qualified intermediary, and Burke transfers \$75,250 (the difference between the \$200,000 value of the property and the \$124,750 the buyer paid for the securities) to the qualified intermediary. Later, Mandy pays \$112,530 to Simone and directs the qualified intermediary to pay the \$75,250 to acquire the replacement property and transfer it to Mandy.

The law would most likely treat Mandy as receiving the \$124,750 of substitute collateral as part of the exchange. Because the substitute collateral is not like kind to the property Mandy transferred,

it would be boot to her. She would therefore realize \$50,000 of gain on the exchange, and she would recognize all of that gain.

### Gain Realized

Value of replacement property	\$200,000
Securities received	<u>\$124,750</u>
Amount realized	\$324,750
Basis of relinquished property	\$150,000
Cash paid	<u>\$124,750</u>
Adjusted basis	( <u>\$274,750</u> )
Gain realized	\$50,000

### Gain Recognized

Gain realized	\$50,000
Boot	\$127,750
Gain recognized (lesser of boot & gain realized)	\$50,000

Mandy would take a basis in the replacement property equal to \$200,000. She would compute that basis by adding (1) the \$50,000 of gain she recognizes and (2) the \$124,750 she paid to the \$150,000 adjusted basis she had in the relinquished property.<sup>44</sup> She would then allocate \$124,750 to the securities held in the defeasance trust, leaving \$200,000 as the basis of the replacement property.<sup>45</sup>

### Basis in Replacement Property

Basis in relinquished property	\$150,000
Gain recognized	\$50,000
Cash paid	<u>\$124,750</u>
Basis of property acquired	\$324,750
Basis allocated to the securities	\$124,750
Basis allocated to the replacement property	\$200,000

Examples 10 and 11 illustrate that the structure used to carry out an in-substance defeasance and exchange affects whether the exchanger recognizes gain on the transaction. Because the mortgagor is the tax owner of collateral held in the defeasance trust, the mortgagor will have boot if the buyer or qualified intermediary transfers the collateral to the defeasance trust. Thus,

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<sup>44</sup> See IRC § 1031(d); Treas. Reg. § 1.1031(d)-1(a).

<sup>45</sup> See *id.*

in the case of an in-substance defeasance, the mortgagor must acquire the substitute collateral to avoid gain recognition on the exchange.

## **Conclusion**

Section 1031 exchanges arise in many different contexts. When they arise as part of a mortgage defeasance, exchangers must carefully examine the transaction to determine what the tax results will be. To avoid gain recognition, the exchanger may have to invest additional funds in the replacement property. With sufficient resources to reinvest, an exchanger should be able to structure a defeasance and exchange to avoid gain recognition on the transaction.



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