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LENDERS AND THE CODE SECTION 1031 "(g)(6)" RESTRICTIONS

This note provides summary guidance to a lender whose customer is engaged in an Internal Revenue Code Section 1031 like-kind exchange, when the lender desires to take a security interest in cash proceeds of sale of the customer's old property, pending reinvestment of those proceeds in new property.

In order for a taxpayer (the lender's customer) to do a valid like-kind exchange, net proceeds of sale, after payment of closing costs and mortgage debt, are generally deposited into an "exchange account" with a Code Section 1031 "qualified intermediary." If the customer takes the funds from closing or uses it to settle other debts, the like-kind exchange may be wholly or partially invalidated.

Lenders often seek to take hold of the proceeds, usually in circumstances in which the old property collateralized other debt (such as other mortgage loans, or a credit line in the case of a corporate customer). So it will often occur to the lender to request a pledge of the funds in the exchange account.

Under the terms of the qualified intermediary arrangement, however, the customer must have no right to receive, pledge, borrow or otherwise obtain the benefits of funds in the exchange account. In order not to be taxed, the funds can only be used to acquire qualifying replacement property and cannot be used to secure other debts of the customer. This would appear to leave the lender without recourse to the funds in the exchange account.

We have utilized one or more of the following techniques to mitigate the lender's risk:

1. ***Standing Disbursement Instruction***. The exchange agreement with the intermediary might be modified (directly or by side letter) to say:

> "Notwithstanding anything in this exchange agreement to the contrary, all funds in this exchange account that would otherwise be payable to [customer] at the end of the exchange period or otherwise in accordance with this exchange agreement or Treasury Regulations Section 1.1031(k)-1(g)(6) shall instead be paid to [lender]. This clause is intended to benefit and may be enforced by [lender]. This clause may not be modified without [lender's] written consent." [1]

2. ***Irrevocable Right to Approve***. While the rules prohibit the taxpayer/customer from receiving or pledging funds in an exchange account, the rules do not expressly prohibit third party restrictions on the disbursement of funds, so long as the restrictions are not

[1] This is sample language only. We recommend that lender's counsel review the exchange agreement in order to tailor the sample language to the specific circumstances.

tantamount to a security interest or pledge. Thus, the exchange agreement with the intermediary might be modified (directly or by side letter) to say:

> "No notice of identification of replacement property given by [customer] pursuant to this exchange agreement shall be valid unless the same has been countersigned by [lender] signifying its approval of the identified replacement property. Further, no disbursement of exchange funds shall be made by intermediary except with the prior written approval of [lender]. This clause is intended to benefit and may be enforced by [lender]. This clause may not be modified without [lender's] written consent." [2]

Although this language does not give the lender a security interest in the exchange account or funds, it gives the lender a measure of control over disbursement and the leverage to require that the replacement property, once acquired, be mortgaged in favor of lender.

3. *Pledge of Interests in Customer's New Subsidiary*. The third technique we sometimes recommend to lenders involves some pre-sale structuring. Before the sale, the customer deeds the property to a newly formed wholly owned "single member" subsidiary limited liability company.[3] The lender takes a collateral pledge/security interest in the ownership interests of the new subsidiary. The lender does not have a security interest in the exchange account (which is prohibited by the exchange rules), but does have a security interest in the subsidiary, whose principal asset (after the sale) is the exchange account. By tailoring pertinent loan document provisions, the lender can achieve better control and a heightened level of security in relation to other creditors.

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Techniques 1, 2 and 3 may be used alone or in combination. Most lenders will use a combination of techniques 1 and 2, with 3 reserved for larger exposures. All of these techniques should be implemented with the assistance of counsel familiar with the issues presented. Lenders should anticipate that a customer's tax advisors may view these techniques as creating some tax risk for the customer (that is, the taxpayer may believe that the IRS will assert that these techniques create a prohibited pledge). These techniques are intended to balance, in a reasonable way, a customer's tax objectives with the lender's desire for security.

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[2] See footnote 1, above.

[3] The subsidiary would generally be a "disregarded entity' for Federal income tax purposes, meaning that the property can usually be transferred into the subsidiary tax-free. The subsidiary would not have to file a separate tax return.