TAX-DEFERRED EXCHANGE RULES AND CONDUIT LENDER REQUIREMENTS – A SHOTGUN WEDDING

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Introduction. Strong value growth in commercial real estate over the past decade has prompted many owners to attempt to structure their property sales as tax-deferred exchanges under §1031 of the Internal Revenue Code. This general interest has been enhanced by the growth of an industry of agents and accommodator companies with the objective of promoting these sales and assisting owners in structuring their transactions in a qualifying manner.

Frequently, however, conflicts have arisen between the basic tenets of conduit lender requirements (e.g., SPE ownership, bankruptcy-remoteness, etc.) with those of a qualifying tax-deferred exchange (e.g., like-kind properties, held for investment requirements, etc.). Reconciliation between these requirements is complicated by a variety of possible exchange structures and newly issued revenue procedures by the IRS over the last couple of years (including a Revenue Procedure published as recently as April 8, 2002). The significance of an appropriate reconciliation is magnified by REMIC considerations which generally prohibit any re-engineering of an ownership structure once the conduit loan acquisition financing has been securitized.

The Basics. Sellers of real property can defer the payment of capital gains taxes by acquiring a "replacement property" in accordance with very specific IRS requirements. When successfully done the replacement property would inherit the existing basis from the property that was sold and the tax-liability is postponed. These transactions may be legally done sequentially such that the tax liability would be postponed until the last replacement property is sold without the proceeds being reinvested in a new property.

A prospective conduit lender comes into the picture as a provider of acquisition financing for the replacement property. Thus, the conduit borrower and conduit lender must balance the structural imperatives created by the tax-deferred exchange with the securitization driven imperatives of the conduit lender. This reconciliation process will differ depending on the precise exchange structure which the borrower is undertaking.

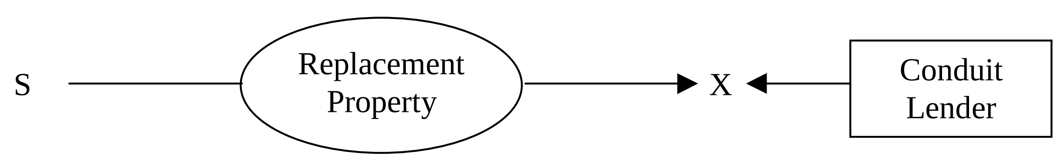
COMMON EXCHANGE SCENARIOS

Tax-deferred exchanges can come in an infinite variety. Some of the more common variations are described below together with a description of some of the major issues that result from each such arrangement. The structures of the exchanges may be simplified somewhat in this article in order to focus on the resultant ownership structure of the replacement property which will be the concern of the conduit lender.

The following structures can be divided (i) between traditional or "forward" tax-deferred exchanges (the conduit-borrower sells a property and then uses the proceeds from that sale to acquire the replacement property) and so-called "reverse" exchanges (the conduit-borrower effectively acquires the replacement property first and subsequently sells another property for the purpose of generating proceeds for such prior acquisition), and (ii) between those exchanges in which a tenant-in-common structure is undertaken and those in which one is not. It is also common to differentiate exchanges between those being simultaneous (the sale and purchase occur at once) and non-simultaneous. This last differentiation is not typically relevant to the structuring issues which are the subject of this article and thus is not frequently used in this discussion.

In each of these scenarios the "Replacement Property" is ultimately the conduit lender's collateral and is acquired, in part, using proceeds generated from the sale of a "Sale Property". In each of the scenarios the party indicated as "**X**" is the party which ultimately becomes the conduit borrower.

1. Forward Exchange-Simple: This classic exchange simply involves the conduit-borrower's acquisition of the Replacement Property using, in part, proceeds from a sale of another property:

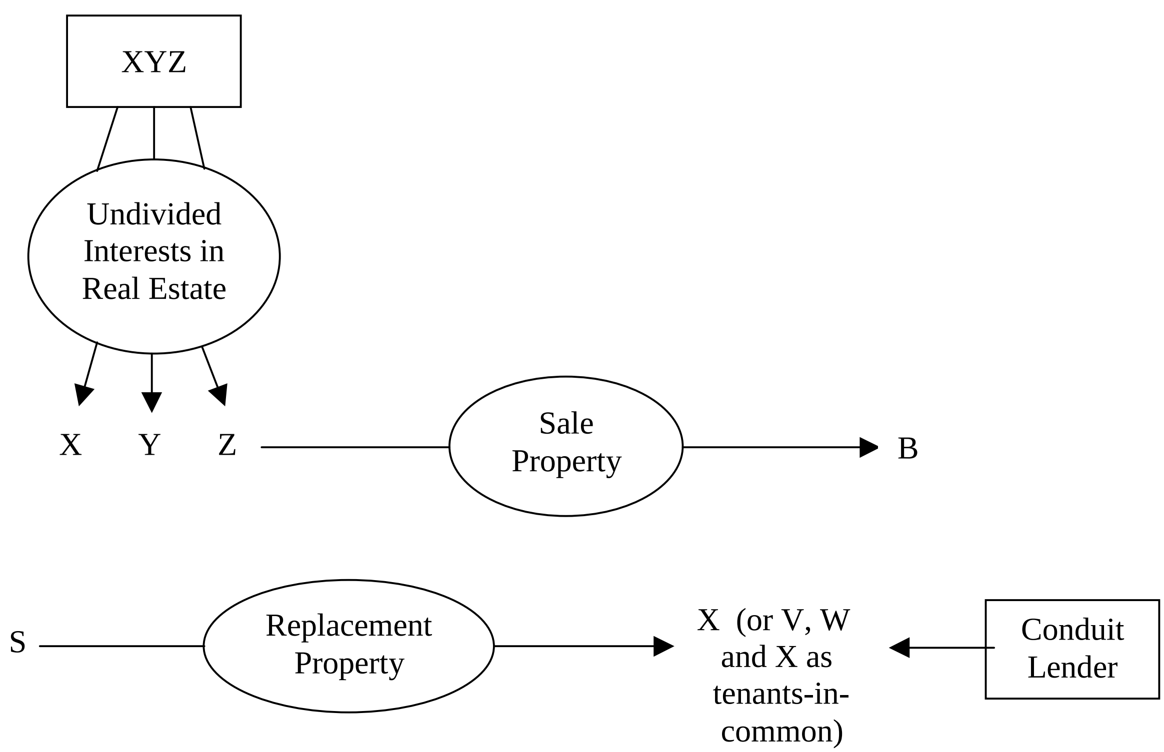


Note: A simple non-simultaneous forward exchange will involve the use of a "qualified intermediary" in order to properly accommodate the exchange and maintain the fiction that the transaction actually is an exchange. However, the involvement of the qualified intermediary in this structure does not include taking title to either property and is typically irrelevant to any acquisition financing concerns (compare to scenarios 3 and 4 below where title is held by an intermediary).

Issues: This exchange structure is largely invisible to the conduit lender and thus generates the fewest concerns. The conduit-borrower must, however, satisfy the "commonality of entity" requirement (see Issue No. 1 under "Discussion of Issues" below).

2. Forward Exchange – Tenants-in-Common: A very common dilemma facing property owners wishing to take advantage of a tax-deferred exchange occurs when certain of the investors in the selling property wish to participate in the tax-deferred exchange while others do not. For example, a selling limited liability company owner may have certain of its members wishing to reinvest and other members wishing to cash out. Alternatively, certain of its members may wish to reinvest in a particular property and other members may wish to reinvest in a different property. A difficulty arises in that the tax exchange rules prohibit exchanges of partnership interests or limited liability company interests for either similar interests or a fee interest in real estate.

This dilemma is frequently addressed by the sale property being deeded out to the separate members who would then own, rather than a membership interest in an LLC, a direct undivided interest in the real estate as tenants-in-common (*in the diagram below, the conveyance by entity XYZ to its members X, Y and Z*). These tenant-in-common owners would then be able to separately undertake a sale transaction(s) and separately use their sales proceeds (some acquiring replacement properties and some in simply being cashed out). Tenant-in-common interests acquired as replacement properties may be done in tandem with entirely different investment groups than those which were involved with the sale property. (*In the diagram below, X may well take its sales proceeds and acquire a tenant-in-common interest in the Replacement Property with V and W, despite the fact that V and W had no involvement with respect to the Sale Property*).

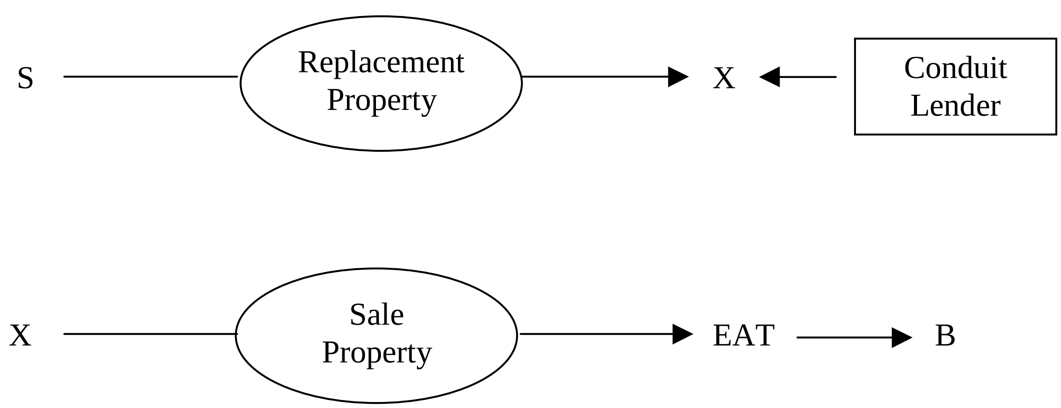


Note: Again, this non-simultaneous forward exchange will involve the use of a "qualified intermediary" in order to properly accommodate the exchange and maintain the fiction that the transaction actually is an exchange. However, the involvement of the qualified intermediary in this structure does not include taking title to the tenancies in common and is typically irrelevant to any acquisition financing concerns.

Issues: Frequently this structure will result in individual tenants-in-common which raise the commonality of entity concern (see Issue No. 1 below). Additionally, the conduit lender will have a number of requirements relative to the tenant-in-common ownership structure including addressing the right of partition (see Issue No. 3) requiring singular management (see Issue No. 2), addressing bankruptcy concerns (see Issue No. 4) and, perhaps, requiring a roll up of ownership in the future (see Issue No. 5).

3. Reverse Exchange (Swap First). For years, taxpayers have entered into so-called "parking" arrangements to accommodate circumstances where the sequence of selling the Sale Property and acquiring the Replacement Property needed to be reversed. In Rev. Proc. 2000-37, the IRS provided for a safe harbor for taxpayers to structure these "reverse exchanges" effective for transactions entered into after September 14, 2000.

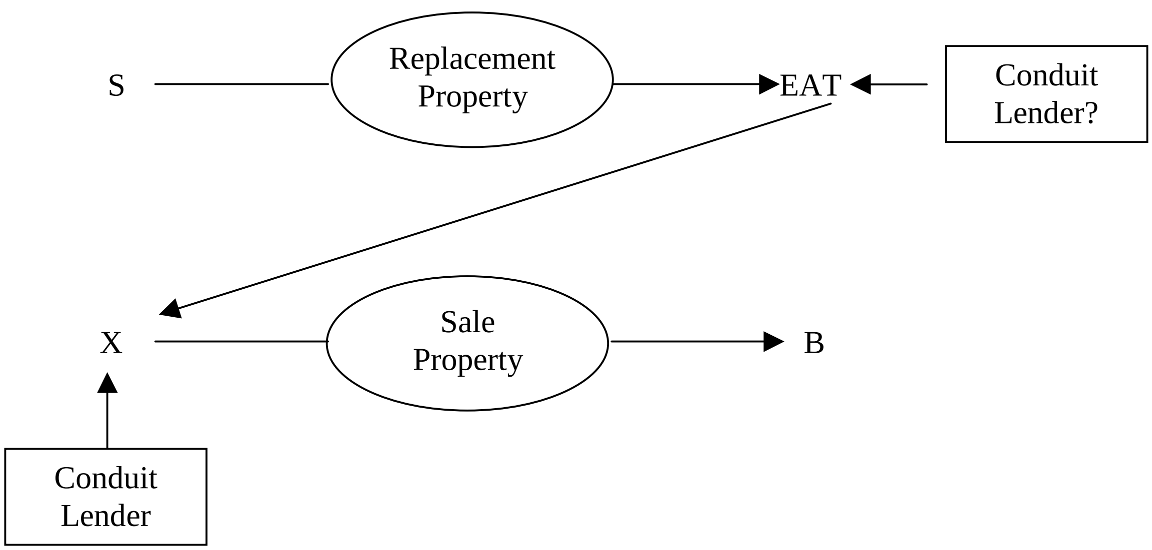
Two critical components of the safe harbor procedure are (i) the taxpayer enters into a Qualified Exchange Accommodation Agreement (a "QEAA"), and (ii) the taxpayer engages the services of an exchange accommodation titleholder (an "EAT"). In a "Swap First" reverse exchange (illustrated below) the conduit-borrower (again shown as **X**) first both acquires the Replacement Property and conveys the Sale Property to the EAT. Within 180-days the EAT conveys the Sale Property to the ultimate purchaser. As indicated below, the Conduit Loan will be made to X in order to finance X's acquisition of the Replacement Property.



Note: The reverse exchange will require the use of a QEAA, including certain assignments of contractual interests in funds, all toward satisfying the safe harbor requirements of Rev. Proc. 2000-37. While the diagram above indicates a "direct deed" of the Replacement Property into X, the QEAA and attendant assignments will validate the fiction of the exchange as if title to the Replacement Property passed through the qualified intermediary.

Issues: In a Swap First transaction, X holds title to the Replacement Property and typically has ongoing obligations (directly or through the EAT) with respect to the Sale Property. Any ongoing obligations with respect to the Sale Property will need to be carefully examined in light of the conduit lender's SPE requirements. Frequently, this issue can be reconciled by all ongoing obligations with respect to the Sale Property being handled by affiliates or principals of the conduit borrower rather than by the conduit borrower itself.

4. Reverse Exchange (Swap Last). In this more common scenario, the EAT first acquires the Replacement Property and then, within 180 days, the Sale Property shall be sold and the Replacement Property conveyed to "X". In this scenario, the conduit loan can be made to either X or to EAT (and later assumed by X).



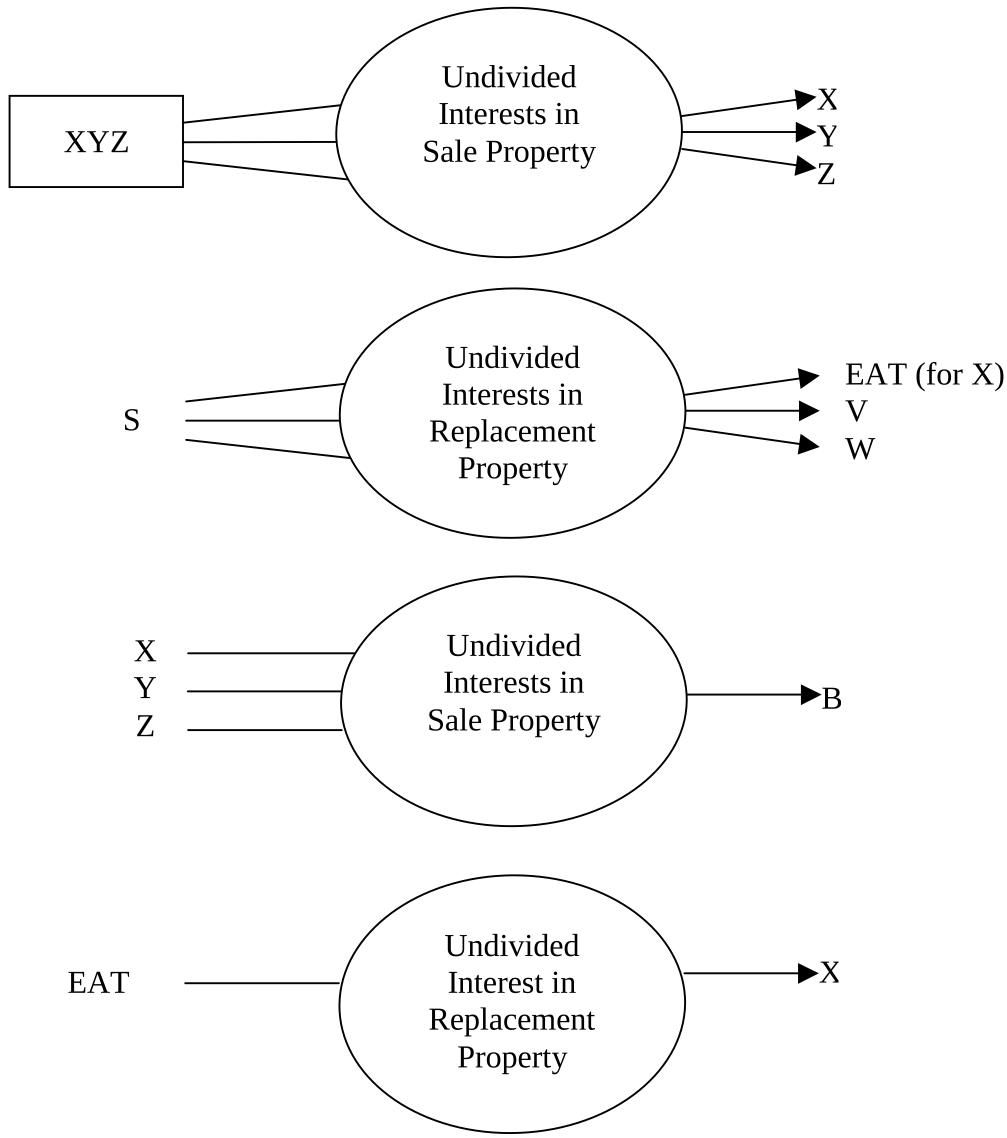
Note: This reverse exchange will also require the use of a QEAA, including certain assignments of contractual interests in funds, all toward satisfying the safe harbor requirements of Rev. Proc. 2000-37. While the diagram above indicates a "direct deed" by X of the Sale Property, the QEAA and attendant assignments will validate the fiction of the exchange as if title to the Sale Property passed through the qualified intermediary.

Issues: In this structure, the threshold question is whether the conduit loan will be (i) made initially to the EAT and later assumed by the ultimate owner of the Replacement Property (X in the diagram), or (ii) made directly to the ultimate owner (X) upon its acquisition of the Replacement Property.

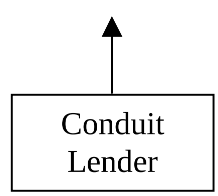
Rev. Proc. 2000-37 provides great flexibility for the ultimate owner to set up the EAT with financing such that its interim ownership is feasible. Thus, in a conduit scenario, the EAT could be structured as a single member LLC satisfying the usual SPE requirements with the recourse indemnitor being the ultimate intended owner (or the principals of the ultimate intended owner). Through the use of leases and management arrangements effective control over the property during the interim period could also be properly diverted to this ultimate intended owner. This arrangement is still likely to be problematic in that actual ownership of the property during the interim period (as opposed to management and operational control) is still held by the EAT and not the borrower that the conduit lender probably examined in its underwriting. If this structure is to be used, the conduit lender must be given plenty of time early on to become comfortable with the ownership of the EAT and with the certainty of the ownership by the EAT being only an interim maneuver. The conveyance by EAT to the ultimate owner will need to be described as a permitted conveyance (perhaps a required conveyance) in the loan documents and should be subject to an assumption agreement at that time.

From the conduit lender's perspective, this transaction is much simpler if the conduit loan is initiated after X acquires the Replacement Property. In that instance, the exchange transaction will be essentially invisible to the conduit lender (but note the commonality of entity requirement described as Issue No. 1 below will still need to be addressed). Obviously, bridge financing or another interim source of funds will be required in this circumstance to allow the EAT to undertake the acquisition.

5. Reverse Exchange – Tenants-in-Common. Of course, property owners may wish to take advantage of both a reverse exchange and the divergence of investment options which a tenant-in-common structure allows. The diagram below indicates a scenario where investor X is a member of limited liability company XYZ and desires to undertake a reverse tax-deferred exchange resulting in X being a corresponding owner in a Replacement Property but with different investors V and W. In this scenario the conduit loan would be made to X, V and W as tenant-in-common owners of the Replacement Property.



<u>Result</u>: X, V & W are tenants-in-common in Replacement Property (and collectively are conduit loan borrower)



Issues: In this exchange scenario, the conduit lender and borrower will need to focus on the issues described above with respect to any "swap last" reverse exchange and also the issues described below with respect to a tenant-in-common structure. Although elaborate in appearance, this structure involves no new issues other than those indicated by the more simpler structures described above.

DISCUSSION OF ISSUES.

Issue No. 1. Commonality of Entity. The most basic issue is mandated by the tax requirement that the conduit borrower acquiring the Replacement Property be the same entity (for tax purposes) as the one that sold the Sale Property. There are no prohibitions, however, against the organizational documents of the entity being amended, contemporaneously with the purchase, to accommodate the conduit lender's various SPE requirements (e.g., "single purpose" language, separateness covenants and the imposition of an independent director).

The "bankruptcy-remoteness" of a newly formed SPE borrower is obviously preferable to a conduit borrower which has historically owned multiple properties, but is being amended contemporaneously with loan closing, to be single-property and single purpose going forward. To the extent a borrower is proposing an entity with other historical activities, the conduit lender will need to undertake a certain amount of due diligence with respect to the nature of those activities, any pending liabilities, and related concerns. An entity which historically owned a number of nursing homes might be viewed very differently from an entity which historically owned only a small retail center. Even in the best case, however, the conduit lender will need to get comfortable with a lack of pending liabilities or claims and may, ultimately, insist on a newly formed entity.

Another concern arises if the mandated entity from the tax exchange is inherently a non-conduit friendly entity (an individual, a general partnership, etc.). In order to accommodate the borrower's tax objectives, that entity will, for tax purposes, still need to be the acquiring entity.

Each of these concerns can usually be addressed by creating a new single member LLC whose sole member is the mandated entity. The LLC will be disregarded for tax purposes (so that its sole member is treated as the owner of the property) but, subject to all of the usual single member LLC concerns, satisfy the conduit lender's SPE requirements. (See Issue No. 6 below regarding single-member LLC's).

Issue No. 2. Managing Tenant-in-Common. When a tax-deferred exchange mandates a tenant-in-common borrower structure, conduit lenders will require an acceptable tenant-in-common agreement amongst the co-owners. One of the purposes is to establish a "managing tenant-in-common" or equivalent designation such that one of the tenants-in-common serves as the "lead" with respect to operational and management concerns at the property. This requirement is intended to establish a practical operating mechanism both for property operation and for interface with the lender as well as to allow the conduit lender to thoroughly examine the tenant-in-common which essentially serves as the managing entity for the entire property. This requirement would typically include a conduit lender's ability to provide singular notice to the managing tenant-in-common on behalf of the entire group.

The borrower's objective, however, will be to avoid characterization of the collective tenant-in-common ownership structure as a partnership. Characterization of this group as a partnership would necessarily define the ownership interest of the conduit borrower as that of a partner rather than that of a fee owner as a tenant-in-common. If such recharacterization should occur, the IRS would take the position that the tax-deferred exchange would fail since the Replacement Property was determined to be a prohibited partnership interest or based upon the ownership not meeting the "held for investment" test (as described in <u>Issue No. 5</u> below).

These conflicting requirements have sometimes been reconciled by (i) a single "contact tenant-in-common" for purposes of notice and similar administrative matters, (ii) the designation of a property management company by the tenants-in-common, collectively, for day-to-day management and operational functions, and (iii) the conduit lender taking some solace in the prohibitions and control features already in effect pursuant to the conduit loan documents relative to sales, refinancings, subordinate debt, large leases and similar major events. A great deal of negotiation still frequently occurs with respect to the precise power of any managing tenant-in-common to act on behalf of the group with respect to leasing, modification matters and property decisions of medium significance.

The IRS has very recently spoken to this issue in its Rev. Proc. 2002-22, in Internal Revenue Bulletin 2002-14 of April 8, 2002. While not hard precedent, Section 6.05 indicates the circumstances when the IRS would consider a ruling that a tenant-in-common structure does not constitute a partnership:

> .05 <u>Voting</u>. The co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the Property, any leases of a portion of all of the Property, or the creation or modification of a blanket lien. Any sale, lease, or re-lease of a portion or all of the Property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the Property. A co-owner who has consented to an action in conformance with this section 6.05 may provide the manager or other person a power of attorney to execute a specific document with respect to that action, but may not provide the manager or other person with a global power of attorney.

<u>Issue No. 3</u>. <u>Waiver of Right to Partition</u>. Tenant-in-common ownership is a creature of state law. Typically tenants-in-common have an equitable or statutory right to partition the property in which they hold an interest. In that circumstance a court would be entitled to divide the property causing each co-owner to obtain fee simple ownership as to a portion of the property rather than an undivided interest in the entire property. Frequently, due to subdivision act requirements and many practical concerns, such a division would not be feasible and, in many states, courts may respond to a petition for partition by ordering a sale of the property as a whole causing a division of the proceeds in accordance with the tenant-in-common

interests. Understandably, all of these partition possibilities are very undesirable from the perspective of the holder of a securitized loan on the property as a whole.

From the conduit lender's viewpoint, the simplest solution is an enforceable waiver of partition by each tenant-in-common owner. This simple solution faces, however, two hurdles: (i) such waiver, taken together with all other aspects of the tenant-in-common agreement, must not cause the borrowing entity to be recharacterized for tax purposes as a partnership; and (ii) such a waiver must be enforceable under the applicable state's laws.

With respect to a recharacterization as a partnership, the conduit lenders have seemingly been helped by the new Rev. Proc. 2002-22, which indicates, in Section 6.06 thereof, that ". . . restrictions on the right to transfer, partition, or encumber interests in the Property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited."

To the extent that an absolute waiver of partition is not feasible, the conduit lender and conduit borrower may attempt to mitigate the partition concern by the use of an appropriate buy-sell agreement. These buy-sell arrangements can take many forms including a mandatory purchase of the otherwise partitioning interest by the managing tenant-in-common or another tenant-in-common which has been preapproved by the lender. These buy-sells will typically be at a fair market value price determined by a current appraisal. Section 6.10 of Rev. Proc. 2002-22 also seems supportive of these sorts of buy-sell arrangements:

> "A co-owner may issue an option to purchase the co-owner's undivided interest (call option), provided that the exercise for the call option represents the fair market value of the Property determined as of the time the option is exercised. For this purpose, the fair market value of an undivided interest in the Property is equal to the co-owner's percentage interest in the Property multiplied by the fair market value of the Property as a whole..."

<u>Issue No. 4</u>. <u>Bankruptcy of Tenant-in-Common</u>. Since each tenant-in-common by definition directly owns an undivided interest in the real estate itself, the conduit lender will seek some protection from the bankruptcy or insolvency of a tenant-in-common. Ideally, each of the tenants-in-common will themselves be required to be an SPE and, thus, the bankruptcy concern effectively mitigated. The conduit lender may also require that buy-sell arrangements be imposed within the tenant-in-common agreement similar to those described in Issue No. 3 above (i.e., fair market value price determined by then current appraisal) to mitigate against the potential for a bankrupt tenant-in-common.

<u>Issue No. 5</u>. <u>Roll-Up of Ownership</u>. In light of the complications and issues which are inherently present when collateral property is owned by multiple tenants-in-common, conduit lenders frequently require that ownership be "rolled up" into a partnership or LLC entity at some point after closing. This requirement has the advantage of limiting the duration of the less desirable tenant-in-common structure and, perhaps, resolving the structure altogether prior to a securitization of the conduit loan. However, in negotiating any roll-up provision, the conduit borrower will want to navigate around two potential legal pitfalls.

The tax-deferred exchange will fail unless the Replacement Property is deemed to be "held for investment" as opposed to being acquired with the intent to resell the Property. Thus a tenant-in-common structure which is "rolled up" at closing such that the conduit lender could directly make its loan to the more desirable partnership or LLC entity would likely not be characterized as properly "held for investment". Unfortunately, the held for investment test is based on the intent of the parties and the IRS has not provided a safe harbor holding period beyond which conduit lenders and conduit borrowers could confidently undertake a roll-up transaction. Common practice seems to dictate a roll-up somewhere in the timeframe between (i) the earliest date in which such roll-up transaction would be reported on the taxpayer's next year's tax return, and (ii) one year following the conduit borrower's acquisition of the tenant-in-common interest.

The other legal hurdle is to avoid the tenant-in-common ownership structure from being recharacterized as a partnership. The conduit borrower's concern in a roll-up agreement would be that an agreement amongst the co-owners to reaffiliate themselves in a partnership in the near term might indicate an intent to be, in reality, currently a partnership. The IRS has not provided direct guidance on this point and Rev. Proc. 2002-22 does not speak to this precise issue.

Issue No. 6. The Use of Single-Member LLC's. Single member LLC's are frequently touted as a sort of fix-all for a variety of concerns that arise during an exchange transaction. These entities are disregarded for tax purposes but still generally enjoy a separate legal status for most other purposes. These entities were discussed above (Issue No. 1) relative to circumstances where the entity selling the Sale Property was not desirable from a conduit perspective.

Certain states impose significant conveyance, transfer or stamp taxes when real estate is conveyed. An assignment of the entirety of the ownership interests in a single-member LLC (or for that matter, any LLC or partnership) is, for tax purposes, given the same effect as a deed of the real estate. In a multi-step exchange, this transfer methodology can sometimes result in significant savings.

However, when using a single member LLC, the conduit lender will typically impose a number of additional requirements, which, themselves, can be at least a minor burden. An insistence upon a Delaware entity, the use of a second springing member or non-economic member and the provision of additional non-dissolution and related opinions (frequently from Delaware) are often part of the program. (*See*: Revised Legal Criteria for Multi-and Single-Member LLC's, Standard & Poor's Structured Finance, October 1999.)

LOAN DOCUMENT PROVISIONS

Many of the concerns described above should be further addressed by appropriate provisions in the loan documents for the conduit loan. Issues which are not susceptible to being fully resolved may be partially mitigated by structural mechanisms added by the conduit lender. All of these items will likely be subject to some negotiation but can be helpful when examining the final collateral package.

Recourse Spring. It is common for conduit lenders to use a "springing recourse" provision to both police against more egregious borrower defaults and to ensure borrower compliance with significant post-closing covenants. Conduit lenders will sometimes propose using the recourse spring device to safeguard against (i) failure of tenant-in-common borrowers to timely effectuate an agreed upon rollup by a post-closing deadline, (ii) bankruptcy or insolvency of a tenant-in-common, (iii) wrongful amendment or termination of the tenant-in-common agreement, and (iv) wrongful attempts to convey a tenant-in-common interest or effectuate a partition.

Tenant-in-Common Agreement. The conduit lender will require the execution and approval of a tenant-in-common agreement as a condition to closing. The loan documents will typically prohibit a termination of this tenant-in-common agreement or a material modification of the agreement absent obtaining lender's consent. The loan documents should further ratify that no tenant-in-common shall be entitled to pursue any rights or remedies against any other tenants-in-common under the tenant-in-common agreement unless the conduit lender has been provided notice and an opportunity to cure such default. Even absent a cure, the available remedies against a defaulting tenant-in-common should be strictly limited.

Joint-and-Several Responsibility. Each tenant-in-common's liability for the indebtedness (and specifically including any recourse component of the indebtedness) is typically joint and several amongst all the tenants-in-common. Responsibility likewise for representations and warranties should be joint-and-several amongst the tenants-in-common.

Due-on-Sale Provisions. The conduit lender's typical due-on-sale provisions will need to be customized in circumstances where the borrowing entity consists of multiple tenants-in-common. The sale of a singular tenant-in-common interest should be prohibited or at least directly addressed. To the extent the loan documents are assumable upon payment of an assumption fee or similar conditions, additional conditions will need to be added to require a simultaneous conveyance by all of the tenants-in-common. Alternatively, to the extent a borrower is entitled to replace tenants-in-common with substitute tenants-in-common, such right should be strictly defined and limited and subject to the execution of an appropriate assumption agreement by the substitute tenant-in-common.

Singular Notice/Service. Consistent with Issue No. 2 described above, the loan documents should allow notice or service to a representative tenant-in-common to satisfy all notice and service requirements required under the loan documents. It should be noted that, in certain default or foreclosure circumstances, local state law may mandate direct notice or service to a tenant-in-common irrespective of provisions otherwise in the loan documents.

Cash Management/Lock Box. Given undivided interest ownership, many conduit lenders will be tempted to impose the additional discipline of cash management or a lockbox arrangement on the revenue from the collateral property. This sort of structure dovetails with the frequently enhanced position of the property manager as described in Issue No. 2 above.

CONCLUSION

As competitive pressures mount, successful conduit lenders will be making loans which are compatible with tax-deferred exchange objectives. From the lender's perspective, a number of additional structural and documentary safeguards are necessary in order to accommodate a successful securitization of the loan. The conduit borrower must realize that, irrespective of mitigating factors, an elaborate tax-deferred exchange structure is inherently less desirable (and more difficult to explain) than a single-entity SPE arrangement and may justify an increased spread.

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