ARE UNDERWATER LIKE-KIND EXCHANGES THE ANSWER?

BY RICHARD M. LIPTON

In situations where a property owner owes more to a cooperating lender than the property is worth, a Section 1031 exchange achieved through a deed in lieu of foreclosure may be worth considering, and should pass muster with IRS. Achieving a like-kind exchange with a non-cooperating lender may depend on the degree of non-cooperation and the terms of the loan document.

In today's economy, in which many properties are "under water" (i.e., the indebtedness related to the property exceeds the FMV of the property), a taxpayer who is thinking about relinquishing the property to her lender also will be concerned about the tax consequences of the transaction. With careful planning, it may be possible for such taxpayers to take advantage of Section 1031 to defer the recognition of income from such transactions.

BACKGROUND

Under Section 1031(a), no gain or loss is recognized on 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 that is to be held either for productive use in a trade or business or for investment. Thus, there are four requirements for a tax-free exchange:

1. There must be an "exchange."
2. The "property" must be of a type that qualifies under Section 1031.
3. The replacement property must be "of like-kind" to the property relinquished.
4. Both the relinquished property and the replacement property must be held for productive use in a trade or business or for investment.

The general rule in Section 1031(a) requires that qualifying property must be exchanged *solely* for other qualifying property. Section 1031(b) provides, however, that if an exchange otherwise would be eligible for tax-free treatment under Section 1031(a) but for the receipt of cash or nonqualifying property ("boot"), any gain realized on the exchange is recognized to the extent of the boot received.

Liabilities. Taxable boot includes relief from liabilities. Reg. 1.1031(d)-2 expressly permits a taxpayer to use a "netting" concept to determine whether liabilities have been relieved. That is, the taxpayer's liabilities that are assumed or taken "subject to" by the other party to the exchange may be offset against liabilities encumbering the replacement property or taken subject to by the taxpayer. Liabilities of the taxpayer encumbering his relinquished property also may be offset by cash given by the taxpayer to the other party.

In considering the treatment of liabilities in an exchange, another factor that must be considered is whether the liability is a recourse debt or not. If the debt secured by the property is a nonrecourse liability, the taxpayer will recognize gain on a foreclosure to the extent that the taxpayer's adjusted basis in the property is less than the outstanding principal amount of the debt. If the debt is a recourse liability, however, the amount of recognized gain is limited by the FMV of the property, i.e., gain is equal to FMV minus the tax basis of the property foreclosed on. To the extent that the principal amount of the debt exceeds the FMV of the property, such excess is treated as cancellation of debt (COD) income.

Like-kind. One of the important requirements of a like-kind exchange is that the replacement property must be

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of "like-kind" with the relinquished property. It now seems clear and indisputable that entities that are disregarded for federal income tax purposes are disregarded for purposes of Section 1031. Therefore, a transfer of all of the membership interests in a single-member LLC (SMLLC), or all of the interests in a partnership or any other disregarded entity, to a taxpayer will be treated for purposes of Section 1031 as the acquisition of all of the property owned by that entity. Thus, it is the entity's property that will have to satisfy the like-kind requirement.

This rule applies even if the taxpayer owned some of the interests in the entity immediately before the transfer. Under Rev. Rul. 99-6, 1999-1 CB 432, an acquisition of all of the interests in a disregarded entity is still treated as an acquisition of property by a taxpayer.

Basis. Like-kind exchanges result in tax deferral, not tax elimination. To preserve the deferred gain, Section 1031(d) provides that the basis of the replacement property received in a Section 1031 exchange equals the basis of the property transferred, reduced by any cash received and any loss recognized, and increased by any gain recognized. The basis of property received by a taxpayer in a like-kind exchange also may be increased by any cash paid by the taxpayer.

The taxpayer's holding period for the replacement property will include the period during which the taxpayer held the relinquished property, i.e., the holding periods are tacked.

Related parties. Under Section 1031(f), nonrecognition treatment on an exchange of property with a related person will be lost if the taxpayer or the related person disposes of either property within two years. The running of the two-year period will be suspended under Section 1031(g) during any period in which any of the exchanged properties is subject to a put, a call, a short sale, or a transaction with similar effect.

Multiparty and deferred exchanges. While Congress probably initially intended that deferral treatment would apply only to simultaneous transfers between two persons, the law quickly evolved. Both multiparty exchanges as well as deferred exchanges became permissible.

In a typical multiparty exchange, the taxpayer holds relinquished property that is sold to a buyer. The buyer in turn acquires the replacement property desired by the taxpayer. The seller of the replacement property conveys it to the taxpayer at the direction of the buyer. Although the IRS initially argued that such three-party exchanges did not satisfy Section 1031, after losing in court the Service eventually capitulated.

A significant outgrowth of the rules permitting multiparty exchanges was the concept of the deferred exchange. These exchanges are often referred to as *Starker* transactions after the Ninth Circuit decision that first sanctioned such arrangements. In *Starker,* 602 F.2d 1341, 44 AFTR2d 79-5525 (CA-9, 1979), the taxpayer transferred property in exchange for a promise by the recipient to convey like-kind property chosen by the taxpayer at a later date.

Like-kind exchanges result in tax deferral, not tax elimination. The gain is preserved through adjustments to carried-over basis.

Congress responded in 1984 by enacting Section 1031(a)(3), which allows the transferor of the relinquished property up to 45 days to identify the replacement property and 180 days to close on the acquisition of the replacement property. In 1991, Regulations interpreting this provision provided that a taxpayer may identify any three properties or multiple properties with an FMV not in excess of 200% of the FMV of the relinquished property in the same deferred exchange. Most taxpayers prefer to use the three-property rule because of the certainty it engenders.

These Regulations set forth detailed (and generally taxpayer-friendly) guidance concerning how a taxpayer can comply with the deferred-exchange requirements in Section 1031(a)(3). Most important, the Regulations contain safe harbors that taxpayers can use to structure exchanges when the buyer of relinquished property and seller of replacement property will not serve as cooperating parties in an exchange and to avoid constructive receipt of the proceeds from the relinquished property. These safe harbors have resulted in the creation of an entire industry—qualified intermediaries (QIs) and title companies that stand ready, willing, and able to assist taxpayers in completing deferred exchanges that are nontaxable under Section 1031.

In structuring an underwater exchange, however, it is necessary to consider the strict requirements of the QI safe harbor in regard to both the QI's participation as a party to the exchange and the QI's status, i.e., the QI must not be acting as an agent of the taxpayer when receiving and holding funds from a relinquished property sale. With respect to the first of these concerns, Reg. 1.1031(k)-1(g)(4) provides two alternative methods to engage in an exchange with a QI.

First, the taxpayer can assign its rights under a real property transfer agreement to the QI and all parties to that agreement must be notified in writing of the assignment on or before the date of the transfer of the property.[1] This rule is used in most "regular" (non-underwater) exchanges because it simply involves an assignment of the rights to proceeds derived from the sale contract to the QI.

Alternatively, the QI can acquire and transfer legal title to the relinquished property.[2] This approach is used less frequently in a "regular" exchange because of the added recordation and transfer tax costs, as well as QI reluctance to enter the chain of title to property that may give rise to liabilities of varying sorts.

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[1] Reg. 1.1031(k)-1(c)(4)(v).

[2] Reg. 1.1031(k)-1(c)(4)(iv).

Reverse exchanges. In a reverse exchange, replacement property is acquired before the sale of the taxpayer's relinquished property. To the extent that there was uncertainty, the IRS provided very useful guidance in Rev. Proc. 2000-37, 2000-2 CB 308.

The Service recognized that taxpayers had been using a wide variety of "parking" transactions to facilitate reverse exchanges. In the interest of sound tax administration, the IRS wanted to provide a workable means of qualifying a reverse exchange under Section 1031 if there was a genuine intent to accomplish a like-kind exchange at the time the taxpayer arranged for the acquisition of the replacement property, so long as the taxpayer actually accomplished the exchange within a short time thereafter. Accordingly, Rev. Proc. 2000-37 provides a safe harbor that allows a taxpayer to treat the exchange accommodation titleholder (EAT) as the owner of property for federal income tax purposes, thereby enabling the taxpayer to accomplish a reverse exchange.[3]

A TYPICAL UNDERWATER SITUATION

Assume that Leah acquired a residential rental property for $1 million in 2001. She used $100,000 of her own funds for equity, and borrowed $900,000 on a nonrecourse basis, with the property serving as the sole collateral for the loan. The lender insisted that Leah hold title to the property through a bankruptcy-remote single-purpose entity, so she formed an SMLLC ("Propco") to hold the property.

Leah claimed total depreciation of $300,000 during the past ten years, so her current tax basis in the property is $700,000. Leah has paid only $50,000 of principal on the loan, so the debt that encumbers the property is now $850,000.

Leah's problem is that due to market declines, the FMV of her property is now only $600,000. Therefore, the property is under water by $250,000. She does not believe that the value of the property will likely recover quickly enough to ever repay the lender, so she is thinking of simply relinquishing title to the lender.

To make matters a little more complicated, the relationship between Leah and her lender is cloudy. She had borrowed from one of the numerous banks that disappeared during the financial crisis in 2008, and she believes that the loan was syndicated and is now being handled by a special servicer located in a city far away. She has spoken to the special servicer several times, but it is not clear whether or not the special servicer will cooperate.

Although the loan is a nonrecourse obligation, Leah knows that the note contains "nonrecourse carveouts" (also referred to as "bad boy" clauses), under which she could have personal liability if certain things occur. One of the nonrecourse carveouts would trigger full recourse liability to Leah if Propco were to file a voluntary petition in bankruptcy. The loan also provides that failure to pay local property taxes is a nonrecourse carveout, although the loan documents are not completely clear whether there would be a violation of this provision if the property failed to generate sufficient gross revenue to pay the real estate taxes.

At this time, all of the gross rent from the property is transferred directly to a lock box for the benefit of the lender, which pays debt service and real property taxes from the funds available. Although the real property taxes have been covered to date, Leah is worried that the loss of tenants due to increased local unemployment may in the future result in rental income that is less than the sum of the debt service plus real property taxes related to the property.

Leah's tax advisor has explained that a simple foreclosure will result in $150,000 of gain, because the basis in the property is $700,000 while the debt is $850,000. Furthermore, this gain will be taxable at a 25% rate because of depreciation recapture. When state and local taxes are taken into account, Leah would likely have to come out of pocket for $60,000 to satisfy the tax bill related to a foreclosure on her property.

Leah's tax advisor pointed out one other important issue for her to consider, which is whether the debt is a recourse or a nonrecourse obligation. If a borrower conveys property to a lender in satisfaction of a nonrecourse obligation, the transaction is treated as a sale or exchange in which the taxpayer is treated as having sold the property for an amount equal to the indebtedness. In Leah's case, that would result in gain of $150,000, as noted above.

The property is under water, the owner does not believe the value will likely recover to ever repay the lender, and so she is thinking of simply relinquishing title.

If the obligation is a recourse liability, however, the taxpayer is treated as (1) exchanging property with a value equal to the FMV of the property for an equal amount of the obligation, and (2) benefiting from the cancellation of the balance of the debt. In Leah's case, this would result in a sale of the property for a loss of $100,000 (FMV of $600,000, basis of $700,000) and $250,000 of COD income ($850,000 of debt vs. $600,000 FMV). This would not be conducive to a like-kind exchange.

This difference in treatment leads to a threshold question, which is whether nonrecourse carveouts cause an obligation to be treated as a recourse liability. Although there is no clear law on this issue, the better view is that a nonrecourse carveout is a contingent obligation that should not be treated as a liability unless and until the predicate events have occurred, i.e., the borrower has taken an action giving rise to a recourse liability to the borrower. Therefore, a nonrecourse debt should not be converted into a recourse liability unless the lender has successfully made a claim

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[3] See generally Lipton, "New Revenue Procedure on Reverse Like-Kind Exchanges Replaces Tax Risk With Tax Certainty," 93 JTAX 327 (December 2000).

against the taxpayer pursuant to the nonrecourse carveouts. In Leah's case, where no such claim has been filed (and where, as of the date of the conveyance of the property to the lender, there was no basis for such a claim), the obligation should be treated as a nonrecourse debt, so that a conveyance of the property to the lender could give rise to an exchange.

This answer leads to the second threshold question, which is whether an underwater property can be the subject of a like-kind exchange, because the borrower has no equity in the property. Again, there is no clear law on the topic, but it seems that the better view is that the "phantom gain" that arises from a foreclosure qualifies for nonrecognition under Section 1031 just as any other gain from the conveyance of property.

Although the loan is a nonrecourse obligation, the note contains 'bad boy' clauses under which the borrower could have personal liability.

Under *Tufts,* 461 U.S. 300, 51 AFTR2d 83-1132 (1983), the conveyance of property to the lender is a sale or exchange of the property, and Section 1031 does not require that the taxpayer have equity in the property—it only requires a sale or exchange. Furthermore, the IRS has taken the position that Section 1031 applies when property is sold at either a gain or a loss, implying that the key element to the application of Section 1031 is the sale or exchange and not the amount of the proceeds from the sale.

Further support for this view is found in Section 1031(d), which states that the assumption of a liability in connection with an exchange constitutes part of the consideration to the taxpayer resulting from the exchange. This provision does not state that additional consideration must be provided, so it seems logical that the transfer of property in satisfaction of a liability would be an exchange for purposes of Section 1031, even if there were no other consideration provided to the taxpayer in connection with a foreclosure on her property.

Nonetheless, it is not completely clear that an exchange of underwater property qualifies for nonrecognition under Section 1031. It is possible that the IRS will take the position that a taxpayer cannot exchange property which has no equity. The Service could possibly support this view by making an analogy to Section 357(d), which limits the amount of debt taken into account on a transfer of property to a corporation to the FMV of the property. Similarly, Reg. 1.368-1(f) limits debt to the FMV of property in a reorganization.

These analogies notwithstanding, the better view seems to be that a taxpayer can engage in an exchange involving underwater property, provided that the requirements of Section 1031 are otherwise satisfied.

If, however, the transaction will involve a QI, it still is necessary for the taxpayer to satisfy the requirements of the QI safe harbor relating to the QI's role as an exchange counterparty in order for Section 1031 to apply. Thus, the taxpayer who owns the underwater property must either transfer title to the underwater property to the QI or, alternatively, assign the transfer agreement to the QI.

A FRIENDLY LENDER

Notwithstanding that the law does not seem to require Leah to have any equity in her property in order to complete a like-kind exchange in a foreclosure context, if Leah is very conservative she will want to receive consideration from the lender as part of the transaction. For example, Leah could transfer the property to the lender as part of a transaction in which:

1. Leah enters into a deed in lieu of foreclosure ("deed-in-lieu") agreement with the lender,
2. She assigns her obligations under such agreement to a QI,
3. She transfers the property to the lender directly in satisfaction of her obligation, and
4. The lender conveys a small amount of consideration (say, $1,000) to the QI in consideration for Leah's transfer of the property to the lender.

Why would the lender be willing to give a small amount of money to Leah when the property is under water? The lender may have concluded that it would save substantially more money by having a cooperative borrower rather than a contentious one. Or the lender may have concluded that it has some potential exposure in connection with the underwriting and issuance of the loan, so that a friendly foreclosure is in the lender's best interest. Or the lender may just have decided that a payment that avoids a long, drawn-out foreclosure process is worthwhile. In any event, experience has shown that some lenders are willing to pay a small amount of consideration in order to induce a borrower to engage in a deed-in-lieu transaction.

For purposes of a Section 1031 exchange, this is the best possible alternative, because the taxpayer would have an agreement that she could assign to the QI, and the QI would receive consideration from the "buyer" of the property, i.e., the lender. Although the transfer is taking place in the foreclosure context, it still would constitute a willing exchange between a buyer (the lender) and a seller (the borrower). Thus, it appears that as long as the taxpayer receives any consideration from the lender and otherwise follows the form of a like-kind exchange by entering into the appropriate agreements with a QI who participates in the exchange, the IRS would not have a decent argument that the transfer did not satisfy the requirements of Section 1031.

The taxpayer also would have to timely acquire replacement property. In Leah's case, assuming that the lender was willing to give her $1,000 of cash to engage in a deed-in-lieu transaction, she would still need to buy a replacement property costing

at least $851,000 to avoid gain on the exchange (in the exchange, Leah received consideration equal to the debt of $850,000 plus $1,000 in cash). It is clear that Leah can use new equity in acquiring a replacement property to replace the debt that encumbered the relinquished property, but Leah still would have to come up with a lot of money to do so. If the replacement property is not encumbered, this could be difficult to do.

Leah also could acquire a property with moderate leverage, e.g., she could buy a property costing $851,000 using $600,000 of new debt plus $251,000 of equity. The problem, of course, is that this transaction would require Leah to come up with $250,000 of new money to avoid paying a current tax of approximately $60,000. Many taxpayers would avoid this economic tradeoff.

Suppose Leah had acquired the relinquished property through a prior like-kind exchange, so that her basis in the relinquished property were lower, say $200,000 instead of $700,000. Now, she would be staring at gain of $650,000 on the foreclosure. In that event, instead of paying a tax bill in excess of $200,000, Leah might consider it worthwhile to acquire a replacement property using a significant amount of new equity.

The better view is that a nonrecourse carveout is a contingent obligation that should not be treated as a liability unless and until the predicate events occur.

Zero cash flow replacement property. It also is possible that Leah would be able to use the $1,000 received from the lender, together with a small amount of additional equity, to acquire a so-called "zero cash flow" property. Property that is subject to a triple net lease to a creditworthy tenant will sometimes be sold subject to a loan that consumes all of the cash flow from the property. Because of the secure nature of the cash flow, plus the fact that nothing is paid to the borrower until the debt is repaid in full, lenders frequently will lend a much higher percentage of the FMV of the property in such transactions.

In that situation, the owner of the property (Leah) will not receive any cash flow from the property, because all of the cash will be used for debt service. For purposes of completing a like-kind exchange, however, the entire debt that encumbers the property will be treated as part of the consideration paid for the property.

If Leah acquires a zero cash flow property, she should be aware that the transaction will not permanently defer gain recognition—the deferred gain would be recognized as the debt is amortized from cash flow. In other words, the taxable gain deferred through the acquisition of a zero cash flow property will be effectively "recaptured" as principal is paid on the debt. (The taxpayer will have taxable income as rent is used to pay principal on the debt, but unless the taxpayer has depreciation or other non-cash deductions, the taxpayer will not be able to offset this taxable income. As a practical matter, assuming the taxpayer had a low basis in the relinquished property, the taxpayer will suffer recapture as the principal on the debt is repaid.)

The taxpayer can avoid this result only by virtue of the basis step-up that occurs on death. There will be no immediate tax consequences to Leah, however, assuming that the debt on the replacement property is as large (or larger) than the liability that encumbered the relinquished property.

Other possibilities. Leah also may want to consider alternative ways to acquire a replacement property. In addition to a traditional purchase, Leah might want to consider acquiring a note that encumbers the property that Leah wants. The problem, of course, is that the note itself does not constitute a suitable replacement property for purposes of a like-kind exchange under Section 1031(a)(2)(C). Instead of directly acquiring the note, however, Leah could provide funds to the QI; the QI could acquire the note for Leah's benefit. The QI then would foreclose on the note and obtain direct ownership of the property, which would be conveyed to Leah to complete the exchange.

In some situations, the taxpayer already may own a note that encumbers property that the taxpayer thinks would make a suitable replacement property. In that event, the taxpayer has two options:

1. The taxpayer could assign the note to the QI and have the QI acquire the note as a replacement property. Since the QI and the taxpayer are not related, this transaction should not run afoul of Section 1031(f).

2. Instead, the taxpayer simply may want to engage in a reverse exchange, using an EAT to acquire the property by foreclosure on the note. Rev. Proc. 2004-51, 2004-2 CB 294, prohibits a taxpayer from using a reverse exchange to acquire a replacement property in which the taxpayer had an interest during the preceding six months.[4] This rule would not be applicable in this situation, however, because the taxpayer owned only a note and not the property during that period. Therefore, a taxpayer who owns an underwater property that may be subject to foreclosure may want to consider acquiring the

Practice Notes

To induce a lender to engage in a foreclosure, a borrower can enter into an agreement waiving any claims of lender liability. Many lenders are concerned about the true expense of lawsuits, so a waiver of the right to sue is "valuable consideration" that has no tax consequences to anyone.

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[4] See generally Lipton, "IRS Bars Taxpayers From Building Replacement Property on Their Own Land—Or Does It?," 101 JTAX 222 (October 2004).

note that encumbers another property as a potential replacement property for the underwater asset.

A MODERATELY FRIENDLY LENDER

What if the lender is not willing to make any payment to Leah?

In that event, Leah still should be comfortable engaging in a deed-in-lieu transaction with the lender in which she enters into an agreement providing for the conveyance of the property to the lender. This deed-in-lieu agreement can be assigned to the QI, and the QI can then use funds received from Leah to acquire replacement property from a third party. Assuming that a replacement property cannot be acquired subject to 100% leverage, the amount of the new equity that Leah will have to contribute will increase, but this should not be a significant change given the small amount of consideration that would have been received from a friendly lender in any event. The "friendly lender" transaction in which the lender makes a payment to the borrower is preferable, of course, because there is consideration received by the QI from the lender directly, but the risk in the "moderately friendly" scenario appears to be quite low.

The practical implication of these two alternatives is that a deed in lieu of foreclosure is the best scenario for a taxpayer who wants to use Section 1031 to avoid gain recognition as a result of the foreclosure on a relinquished property. A deed-in-lieu is a "voluntary" transaction in which it is easy to see that an exchange has occurred. Furthermore, there usually will be a deed-in-lieu agreement that can be assigned by the taxpayer to a QI as part of the exchange. Thus, the risk to the taxpayer in such a transaction, if it is properly implemented, appears to be quite low.

AN UNFRIENDLY LENDER

What if the lender is not willing to enter into a deed-in-lieu agreement? Some lenders, particularly special servicers who have no relationship with the borrower, will not engage in any negotiations with the borrower and will not consider entering into a deed-in-lieu agreement. These lenders will simply want to foreclose by auctioning the property off to the highest bidder (usually the lender will be the highest bidder in a foreclosure sale by bidding in the debt). In that situation, our borrower still has some options.

Leah still may be able to engage in a like-kind exchange by entering into an exchange agreement with a QI and assigning either the property or the interests in Propco to the QI. Ideally, Leah simply would convey the property (subject to the debt that encumbers it) to the QI, and the QI could then allow the foreclosure to occur. From Leah's perspective, this transaction would be treated as a sale of the property for an amount equal to the debt. Leah could then acquire a replacement property (through the QI) with a purchase price at least equal to the amount of the debt that encumbered the relinquished property. As discussed above, Leah would need to either contribute equity into the exchange, although the amount of equity could be decreased if Leah can locate a zero cash flow property.

It is possible, however, that Leah will not be able to transfer the property to the QI directly because the loan contains a non-assignment clause that would prevent her from transferring "clean title" to the property to the QI. In that event, Leah needs to determine whether the loan agreement also contains a prohibition against the transfer of the interests in the SMLLC that owns the property (Propco).

It seems that the phantom gain that arises from a foreclosure qualifies for nonrecognition just as any other gain from the conveyance of property.

Leah may be able to convey all of the interests in Propco to the QI as the first step in the like-kind exchange. Assuming that Propco is a disregarded entity, the transaction would be treated as a conveyance of the property held by Propco for purposes of Section 1031. As a result, Leah would again simply need to acquire a replacement property through an exchange involving the QI.

Nevertheless, it might be that Leah will not be able to transfer to the QI either the property itself or the interests in the SMLLC that owns the property because of the nonrecourse carveouts that are associated with the loan. As discussed above, violation of the nonrecourse carveouts is a "worst case" scenario for the borrower, because it gives rise to a personal recourse obligation and makes it difficult to engage in a like-kind exchange (by potentially converting the debt from a nonrecourse obligation into a recourse one). Therefore, before engaging in any transaction involving property en-

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[5] See Lipton, "How to Avoid Capital Loss Treatment on the Abandonment of a Partnership Interest," 80 JTAX 158 (March 1994). Several decisions addressed the abandonment of a partnership interest. See Pickron, "Some Partners Will Find That Abandonment of Partnership Interests Accelerates Gain," 77 JTAX 268 (November 1992).

In Echols, 93 TC 553 (1989), *rev'd* 935 F.2d 703, 68 AFTR2d 91-5157 (CA-5, 1991), the taxpayer started out as a 37.5% partner in a partnership that owned undeveloped real property purchased in anticipation of an adjacent highway project. Another partner subsequently transferred an additional 37.5% interest to the taxpayer, so that the taxpayer owned 75% of the partnership. The taxpayer and the remaining 25% partner first attempted to sell the real estate. When that effort was not successful, the taxpayer met with the other partner and informed him that the taxpayer would no longer pay his 75% portion of the mortgage and taxes on the property. The taxpayer also offered to convey his interest to anyone who would assume his portion of the partnership debt. The taxpayer did nothing more during that year and claimed a capital loss. The Tax Court concluded that the taxpayer failed to manifest abandonment and disallowed the loss. The court of appeals concluded, however, that the taxpayer's actions were sufficient to abandon his interest.

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cumbered by a loan from an unfriendly lender, the borrower must first check to make certain that the borrower's actions will not give rise to a recourse obligation.

Abandonment

If a direct conveyance of either the property or the SMLLC that owns the property to a QI is not possible, there is one other alternative that could be pursued by the borrower—an abandonment of the property. In Rev. Rul. 93-80, 1993-2 CB 239, the IRS concluded that an abandonment of a property that is subject to a liability is treated as a sale or exchange. As a result, if a taxpayer can abandon a property that is subject to debt, the taxpayer will have undertaken the first step in a transaction qualifying under Section 1031.[5]

The problem that must be considered by the taxpayer who needs to abandon a property, however, is that an exchange requires two parties, and the non-cooperating lender is unlikely to be willing to convey a replacement property to a taxpayer who has abandoned the property. Therefore, the taxpayer needs to find a counterparty with which an exchange can be arranged, i.e., the taxpayer needs to convey the relinquished property to a person and receive the replacement property from the same person. The question is whether a QI could fulfill this role.

For example, assuming that Leah's lender is uncooperative, Leah would need to find a way to abandon her property to the QI. Assuming that the loan agreement prohibits the transfer of either title to the property or the ownership interests in Propco to the lender, Leah still could consider entering into a transaction in which she transfers the benefits and burdens of ownership (but not legal title) to the property to a QI through an assignment agreement between Leah and the QI. The problem is that this approach does not appear to satisfy the technical requirements of Reg. 1.1031(k)-4(g)(4), which requires that legal title must be transferred to the QI to qualify for safe harbor treatment.

An argument could be made that a formal transfer of title to the property is not required in order to satisfy this safe harbor. As noted above, it is widely accepted that in lieu of transferring legal title to a property to a QI in an exchange, the taxpayer can transfer all of the ownership in-

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After Echols, abandonment of a partnership interest was again an issue in Citron, 97 TC 200 (1991). There, the taxpayer was one of the limited partners in a partnership formed to produce a movie. He personally borrowed money to finance his partnership contribution. Subsequently, the taxpayer was informed that the movie would have to be converted into an X-rated film in order for the partnership to recover more of its costs. The taxpayer was not interested in participating in the production of an X-rated movie, and he communicated to the general partner and other limited partners that he no longer had any interest in the partnership or the movie. The Service contended that the taxpayer's communication with the general partner was not sufficient to be an abandonment of the taxpayer's partnership interest. In a reviewed opinion, the Tax Court disagreed, concluding that the taxpayer manifested his intent to abandon his partnership interest by an overt act of abandonment to the parties in interest (the general partner and all limited partners).

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terests in a SMLLC that owns the property. These transfers are respected for purposes of the QI safe harbor because the QI has all of the benefits and burdens of ownership of the property, even if legal title has not been transferred. By analogy, if a transfer of the benefits and burdens of ownership is sufficient when the ownership interests in a QI are transferred, similarly an assignment of the benefits and burdens of ownership of the property could qualify in an underwater exchange.

This approach is arguably consistent with the Service's treatment of an abandonment, which is treated as an exchange under Rev. Rul. 93-80. If there is a sale or exchange, it must be a sale or exchange *with someone.* If a taxpayer can assign the benefits and burdens of ownership of an entity that owns property to a QI, and the QI then abandons the property to the lender, the taxpayer can contend that there was an exchange with the QI; the QI could then be used to acquire replacement property for the taxpayer.

In this transaction, it is important for the taxpayer to engage in an exchange with the QI. For example, Leah could assign the benefits and burdens of the ownership of Propco to the QI, and the QI would then notify the lender that the QI was abandoning the property. (Simultaneously, Leah would notify the lender of abandonment and abandon her bare legal title to Propco.)

The issue that this transaction will raise for Leah is whether there has been a transfer to the QI that satisfies Reg. 1.1031(k)-1(g)(4)(v). The answer to this question is not clear under current law. Since the transfer of the benefits and burdens of the ownership of Propco normally will be treated for tax purposes as a transfer of Propco, and since the taxpayer will have no legal right to receive Propco back, the taxpayer can argue that there has been an exchange with the QI in which the economic equivalent of legal title to the property has been transferred to the QI. There are no authorities, however, that directly support this argument.

If the assignment of the benefits and burdens of the ownership of Propco does not satisfy the safe harbor, the next question is whether it is necessary to comply with the safe harbor in order to have a valid exchange. Usually, the QI is acting as the agent for the taxpayer, which is why the safe harbor must be complied with (because otherwise the receipt of cash by an agent would result in constructive receipt, which would spoil an exchange). If there is no cash being received by the QI, however, there cannot be constructive receipt by an agent.

Accordingly, a taxpayer who has abandoned property to a QI might take the position that an exchange through the QI should be respected even though the QI could be viewed as an agent of the taxpayer. The exchange could simply be seen as a deferred exchange entered into by the taxpayer, in which relinquished property is sold and replacement property is acquired by the taxpayer within the requisite 180 days, even though the QI is treated as the taxpayer's agent. In other words, the taxpayer (through its agent) directly sold the relinquished property and, within 180 days, the taxpayer (through its agent) acquired the replacement property—these are the only steps that the Code requires. Again, there are no authorities that directly support this argument, although a taxpayer could contend that the transaction is within the "spirit" of Section 1031.

There is no certainty that the IRS will agree with these interpretations of Section 1031 in the abandonment context. Indeed, there are no cases or rulings addressing how Section 1031 applies (if at all) to an abandonment, so Leah would need to consider carefully the tax risk before entering into such a transaction. Nevertheless, in light of the Service's view that every abandonment of encumbered property is a sale or exchange, she should be able to argue that an abandonment of property to a QI can be treated as the first step in a deferred like-kind exchange.

CONCLUSION

If a taxpayer owns property that is under water, the taxpayer will need to consider whether a like-kind exchange is appropriate to defer recognition of the gain that will arise in the event of a foreclosure by the lender. A cooperative lender will make for an easy transaction, and a taxpayer should be able to obtain tax deferral, provided that the taxpayer can come up with the equity needed to acquire a replacement property. Even if the lender is not cooperative, however, a taxpayer might be able to take advantage of Section 1031—although the transaction would have less certain tax consequences than an underwater exchange implemented through a foreclosure. ■