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## The deductibility of defeasance premium in the current tax year

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In order for a borrower to sell or refinance commercial real estate that is encumbered by a conduit loan, the loan usually must be defeased. Defeasance is a substitution of collateral in which (i) the borrower purchases and pledges to the lender a portfolio of government securities, and (ii) the lender releases the real estate from the lien of the mortgage. The portfolio is structured so that the proceeds from the government securities are sufficient to make all remaining principal and interest payments as and when they come due under the borrower's note. Typically, the defeasance and the real estate transaction are coordinated so the proceeds of the sale or refinance may be used to purchase the government securities.

The defeasance provisions in most loan documents will require that a special purpose, bankruptcy-remote entity (a "successor borrower") take an assignment of the government securities and assume the borrower's obligations under the defeased loan. However, the borrower typically remains responsible for making up any shortfall if the portfolio of government securities later turns out to be insufficient. The retention of this shortfall liability may seem inconsequential because an accountant issues an agreed upon procedures letter confirming sufficiency on every conduit loan defeasance. However, the retention of the shortfall liability may have significant tax implications for the borrower.

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In the current low interest rate environment, the interest rate on a borrower's loan usually exceeds the average yield on the portfolio of government securities purchased to defease the loan. Accordingly, this disparity results in the cost of the securities exceeding the outstanding principal balance on the loan by as much as twenty percent. A twenty percent defeasance premium on a loan with a \$5,000,000 balance equates to a \$1,000,000 defeasance premium! An important question, then, is whether the borrower may deduct that premium in the year in which the defeasance occurred or must allocate it over the remaining term of the loan? The answer should depend upon whether the shortfall liability is retained by the borrower or is shifted to the successor borrower.

Although the Internal Revenue Service has not ruled on the tax implications of a conduit loan defeasance, Revenue Ruling 57-198 allows penalty payments made by a taxpayer for the privilege of prepaying mortgage indebtedness to be deducted as interest under Internal Revenue Code ("Code") §163. See also Rev. Rul. 73-137, 1973-1 C.B.68. Because the defeasance premium is a necessary cost of the defeasance in excess of the outstanding balance on the loan, it appears to be in the nature of a prepayment penalty that is deductible from the borrower's taxable income.

If the defeasance premium is deductible, when may the borrower take

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the deduction? While there are no authorities directly on point, Revenue Rulings on the defeasance of corporate bonds provide some guidance. In Revenue Ruling 85-42, the IRS ruled that when a corporation (i) transferred assets to an irrevocable trust for the sole purpose of making principal and interest payments on outstanding debt, and (ii) remained liable if the pledged securities were insufficient to make the debt service payments, the corporation could not claim to have fully discharged the debt and, therefore, was still considered the owner of the trust assets for income tax purposes. Based upon this Revenue Ruling, and Treas. Reg. §1.61-13(b) cited by the ruling, one may reasonably infer that, when a borrower retains the shortfall liability with respect to a defeased conduit loan, the debt cannot be said to be fully discharged.

If the debt is not fully discharged, Treas. Reg. §1.163-7(c) requires that the defeasance premium be deducted over the remaining term of the loan. Depending upon the borrower's tax situation, the borrower may actually prefer this result. For example, the shareholders or partners of an entity might not have sufficient basis to deduct a sizable defeasance premium in one year or the passive activity rules might be a concern for certain borrowers with a substantial one-year loss.

However, if a borrower wants to deduct the entire defeasance premium in the current tax year, Code §163-

7(c) indicates that the borrower must be relieved of the shortfall liability. But where can a borrower find someone else that is willing to assume the shortfall liability? The only party involved in the defeasance process that is in a good position to do it is the successor borrower that assumes the defeased loan. Not all third-party service providers permit their successor borrowers to assume the shortfall liability, but if a borrower engages Commercial Defeasance, LLC as its defeasance consultant, Defeasance Holding Co., an affiliate, will provide a successor borrower that is willing to assume the shortfall liability.

Once the shortfall liability is shifted to the successor borrower, the remaining obligations of the borrower are essentially the same obligations that would remain if the loan were paid in full on the maturity date without an intervening defeasance. The borrower may treat the defeasance as a complete discharge of debt, and the borrower should be able to deduct the entire defeasance premium in the year in which the defeasance occurs. See Rev. Rul. 73-137 and Code § 163.

The conclusions in this article are based upon interpretations of various authorities. Individual tax authorities and advisors might reach different conclusions. Borrowers should consult competent tax and legal advisors regarding their specific situation.

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