Refinancing Before and After Exchanges

Refinancing to pull equity out of a property prior to or after completing a tax deferred exchange can result in a taxable transaction under the "step transaction doctrine." The IRS can argue that a "cash-back" refinancing, immediately before or after the exchange is completed, is just one step in the many steps of an exchange transaction and, therefore, the refinance loan proceeds should be taxable as boot in the exchange. This "step transaction" doctrine allows the IRS to recharacterize seemingly separate transactions into one transaction for tax purposes. The result is an unfortunate outcome for the Exchanger if the IRS believes that there was no independent business purpose for the refinance loan. In other words, the threshold question is "was the purpose of the loan nothing more than the Exchanger's desire to take cash out of the equity of either the relinquished or replacement properties without paying the capital gain tax?" Prior to the enactment of the current Treasury Regulations for IRC §1031, the proposed Regulations in 1990 prohibited “refinancing in anticipation of an exchange.” The final Regulations in 1991, however, omitted any reference to this refinancing prohibition because the IRS believed that it would create “substantial uncertainty in the tax results of an exchange transaction involving liabilities.” *Preamble to TD 8343*, 56 Fed Reg 14851 (April 12, 1991).

Although there is a mixed case law history on refinancing in conjunction with an exchange, current case law favors the position that the Exchanger can obtain cash by increasing debt on the property prior to or after completing an exchange. In *Fred L. Fredericks v. Commissioner*, TC Memo 1994-27, 67 TCM 2005 (1994), the Exchanger refinanced the relinquished property two weeks after executing a contract to sell the property less than a month prior to the resulting exchange. Using the step transaction doctrine, the IRS argued that the refinance proceeds should be considered taxable boot. The Exchanger prevailed by showing that he had attempted to refinance the property over a two-year period. In this instance the Court concluded that the refinance transaction: (a) had an independent business purpose; (b) was not entered into solely for the purpose of tax avoidance; and (c) had its own economic substance which was not interdependent with the sale and exchange of the relinquished property.

In *Phillip Garcia v. Commissioner*, 80 TC 491 (1983), aff’d. 1984-2 CB 1, the seller of a replacement property increased the debt on the property just prior to exchanging with the Exchanger. The increased debt was incurred to equalize the liabilities on the replacement property with the liabilities on the Exchanger’s relinquished property. In this case the IRS took the position that the increase in the mortgage by the seller should be deemed as boot to the Exchanger because it artificially reallocated the liabilities for the purpose of avoiding taxes. The Court rejected the IRS’s position finding that the increase in the debt had “independent economic substance.”

In *Behrens v. Commissioner*, TC Memo 1985-195, 49 TMC 1284 (1984), the Exchanger was held to have received taxable boot when he received cash at the closing of his replacement property because he had increased the amount of the purchase money financing to the seller of the replacement property, thereby reducing the amount of down payment required from the Exchanger. In the Court’s dicta the Court opined that this adverse result could have been avoided if the Exchanger had borrowed the cash from a third party lender secured by the property either before or after the exchange occurred. For further discussion on the factors used by Courts in determining whether there was an “independent economic substance’ of the refinancing, see Private Letter Rulings 8248039, 8434015 and 200131014.

Exchangers should carefully consider the following issues to avoid the pitfalls of the "step transaction doctrine":

- The refinance loan should not appear to be solely for the purpose of "pulling out equity," thereby avoiding the capital gain tax that is otherwise attributable to non-exchange transactions.
- As a rule of thumb, the refinance transaction should be separated from the exchange sale or purchase transaction to help separate the exchange from the refinance.
- At a minimum, the Exchanger should attempt to complete the refinancing transaction prior to listing the relinquished property for sale.
- The refinance loan and the sale or purchase in the exchange should be documented as separate transactions to avoid any "interdependence" of the transactions.

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