1031 Exchange

1031 Exchange: Refinancing Issues

Internal Revenue Code Section 1031 allows deferment of capital gains taxes on real property used in trade or business or held for investment

Although the case law regarding refinancing in conjunction with a **1031 exchange** has been mixed, more recent decisions generally support the position that an exchanger may obtain cash by increasing the debt on the property either **before or after** completing the exchange.

In **Fred L. Fredericks v. Commissioner**, T.C. Memo 1994-27, 67 T.C.M. 2005 (1994), the exchanger refinanced the relinquished property approximately two weeks after entering into a contract to sell the property and less than one month before completing the exchange. Using the **step transaction doctrine**, the IRS argued that the refinance proceeds should be treated as taxable boot. The taxpayer prevailed by demonstrating that he had been attempting to refinance the property over a two-year period. The Court concluded that the refinancing:

- had an independent business purpose;
- was not entered into solely for tax avoidance; and
- possessed independent economic substance and was not interdependent with the sale and exchange of the relinquished property.

In **Phillip Garcia v. Commissioner**, 80 T.C. 491 (1983), aff'd, 1984-2 C.B. 1, the seller of the replacement property increased the debt on the property immediately before the exchange. The additional financing was intended to equalize the liabilities between the replacement property and the exchanger's relinquished property. In this case, the IRS argued that the increase in the mortgage should be treated 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**, T.C. Memo 1985-195, 49 T.C.M. 1284 (1984), the exchanger was held to have received taxable boot when cash was received at the closing of the replacement property after increasing the amount of seller financing, thereby reducing the amount of cash required as the down payment. In its discussion, the Court suggested that this unfavorable result may have been avoided had the exchanger borrowed the funds from an unrelated third-party lender, secured by the property either before or after the exchange.

For additional discussion of the factors courts consider in determining whether a refinancing has independent economic substance, see **Private Letter Rulings 8248039, 8434015, and 200131014**.

Practical Considerations

Exchangers should carefully consider the following issues to minimize the risk that the IRS could apply the **step transaction doctrine**:

- The refinancing should not appear to have been undertaken solely to extract equity while avoiding the capital gains tax that would otherwise result from a non-exchange transaction.
- As a general rule, separate the refinancing transaction from the exchange sale or purchase as much as practical.
- Whenever possible, complete the refinancing before listing the relinquished property for sale.
- Document the refinancing and the exchange as separate, independent transactions to avoid the appearance that they are interdependent.