1031 Exchange FOCUS

SECTION 1031 OF THE INTERNAL REVENUE CODE IS ONE OF THE GREATEST WEALTH BUILDING TOOLS AVAILABLE TO INVESTORS

> 1031 Exchange - Refinancing Issues

Internal Revenue Code Section 1031 allows investors to defer the payment of capital gains taxes when selling investment property.

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

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 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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