

REFINANCING RELINQUISHED PROPERTY PRE-EXCHANGE:

"KEY CASES AND PRIVATE LETTER RULINGS"



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Under Section 1031, cash or other non-like kind property actually or constructively received by the taxpayer in a tax deferred exchange (commonly referred to as "boot") causes the taxpayer to recognize gain to the extent of such boot. In some cases, taxpayers seek to avoid taking boot on the sale of relinquished property by borrowing against the relinquished property shortly before the exchange. Ordinarily, a taxpayer's receipt of loan proceeds is not taxable, but if the taxpayer borrows against the relinquished property in a cash-out refinance shortly before an exchange rather than simply taking sale proceeds on the sale of the relinquished property, does the taxpayer avoid recognition of gain? Maybe.

Since the only significant difference between taking boot on the sale of relinquished property and borrowing against the same property before the exchange is the tax result (in each case, the taxpayer pockets the cash received), the Internal Revenue Service (IRS) has asserted the "step transaction doctrine" in an attempt to combine the pre-exchange borrowing with the exchange in cases where it determines that tax avoidance was the taxpayer's principal motivation. The basic idea behind the step transaction is that the tax results of a series of steps in a transaction should be determined based on the overall result of a transaction if those steps are interrelated. Thus, the key issue is whether two or more transactions should be viewed as separate steps for tax purposes or combined into a single integrated transaction for tax purposes. Since a cash-out refinancing in anticipation of a tax deferred exchange will usually be paid off on the sale of the relinquished property, it may be difficult to establish that financing had an independent purpose apart from the tax result. Although the IRS has not always won these cases (in fact, it often loses), the principles described in the following cases should be considered when a taxpayer assesses the risks associated with a cash out refinancing in anticipation of a tax deferred exchange.

In [*Fredericks v. Commissioner*](#), T.C. Memo 1994-27, the taxpayer's cash out refinancing was not treated as boot because the refinancing was (i) independent of the 1031 exchange (ii) not conditioned on the closing (iii) dependent on the creditworthiness of the taxpayer and (iv) made sufficiently in advance of the 1031 exchange. Arguably, if one or more of these requirements is not met, the IRS may successfully argue that the proceeds of pre-exchange financing constitute taxable boot. The *Fredericks* court found it significant that the taxpayer had been trying to refinance the property during the two year period prior to the sale. See also PLR 8434015 in which the IRS ruled that the proceeds of a taxpayer's proposed refinancing shortly before an exchange would constitute taxable boot in the exchange. In each case, the independence of the refinancing was the critical factor. For another analysis of this issue, see [*Behrens v. Commissioner*](#), T.C. Memo 1985-195.

In several cases and rulings, taxpayers have successfully defended pre-exchange financings where the purpose of the financing was to even-up the debt on the relinquished property with debt to be assumed by the taxpayer on the replacement property. See [*Garcia v. Commissioner*](#), 80 T.C. 491 (1983) (replacement property seller increased mortgage on replacement property acquired by taxpayer in the exchange); PLR 8248039 (permitted the netting of a new mortgage on the replacement property against the existing debt on the relinquished property); PLR 9853028, (taxpayer's mortgage paid off by buyer netted against liability incurred by the taxpayer in acquiring replacement property).

In short, a taxpayer's reason for refinancing shortly before an exchange should include significant non-tax objectives independent of the anticipated exchange transaction. The timing of the transaction in relation to the exchange is another important consideration as discussed in [*Fredericks*](#).

Refinancing the replacement property is less risky. To read more about post-exchange refinancing, click on [Refinancing Replacement Property](#).