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Refinancing and section 1031 exchanges: Planning considerations

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A taxpayer should make every effort to avoid refinancing close in time to the date of an exchange because the IRS may view any recent re-adjustment of debt as a tax avoidance mechanism and treat any loan proceeds received by the taxpayer as taxable. In other words, any new loan could be viewed as an artificial attempt to reallocate liabilities for the purpose of tax avoidance.

For example, a taxpayer anticipating re-ceipt of $150,000 in proceeds might want to only reinvest $100,000 into replace-ment property. The $50,000 that he does not wish to reinvest will be taxed at the applicable capital gains rate. However, in many cases, a refinance loan arranged just prior to the exchange might be used to attempt to avoid this taxable result - i.e. just before exchanging, the taxpayer increases his existing loan balance by $50,000, puts the $50,000 cash into his pocket and proceeds with the exchange, thereby reducing his anticipated cash proceeds. This re-adjustment of existing debt would be deemed an impermissible tax avoidance mechanism.

Likewise, if a loan is refinanced just after replacement property is acquired or during the exchange transaction, the same result may occur. For example, a taxpayer who exchanges into replacement property with a loan of $100,000 (as required by the equities on the property he exchanged out of) shortly thereafter increases that new loan to $125,000 to obtain $25,000 cash. The result is what the taxpayer intended-i.e. $25,000 cash in his pocket and a higher loan amount, but again, not what the IRS may allow. The IRS may treat this as equivalent to a taxpayer failing to invest all of his net cash proceeds in the replacement prop-erty and instead obtaining a higher loan amount to put cash in his pocket.

If avoiding the refinance is not possible, with careful planning, a taxpayer may structure the refinance to minimize the risk of a potential unfavorable tax conse-quence.

Careful Planning Tips

A taxpayer refinancing close in time to an exchange should consider the following criteria in structuring the loan transaction:

1. Avoid integrating the refinance trans-action with the exchange transaction.

i. Complete any pre-exchange refinance as far in advance as possible of the exchange - preferably before listing the property or entering into any agree-ment related to the sale/exchange of the property.

ii. Any post-exchange refinance should be a completely separate transaction from the exchange. Make sure that no agreements related to or in anticipa-tion of the refinance are entered into or negotiated during the pendency of the exchange.

2. When the refinance is close in time to the exchange, scrutinize the docu-ments and the transaction as a whole to make sure that the form accurately reflects the substance of the transaction.

3. Make sure the loan has an economic significance independent of the ex-change (e.g., lower interest rate, more favorable terms, pre-existing need to refinance).
4. Never use refinancing to reallocate existing liabilities for the sole purpose of tax avoidance.

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