

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 the exchange is completed, is just one step in many steps that results in not reinvesting all of the equity from the Relinquished Property. It follows that the refinance loan proceeds would be taxable as boot. This “step transaction” doctrine allows the IRS to re-characterize 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. 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 tax?”

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 and 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.

Exchangers should discuss their plans to refinance with their tax advisors and carefully consider the following issues to help avoid the pitfalls of the “step transaction doctrine”:

- As a rule of thumb, the refinance transaction should be separate from the exchange sale or purchase transaction to support the position that they are not interconnected
- The refinance loan and sale or purchase in the exchange should be documented as separate transactions to avoid any “interdependence“ of the transactions
- It is generally considered less risky to refinance the Replacement Property (rather than the Relinquished Property) through a separate post-closing transaction
- It may be beneficial to be able to demonstrate an independent business purpose for a refinance loan on the Relinquished Property