# Like-Kind Exchange Corner

## Cash-Out Strategies in Code Sec. 1031 Exchanges

*By Mary B. Foster*

Taxpayers sometimes want to cash out a portion of their relinquished-property equity in an exchange rather than reinvest it all in replacement property. In many cases, they are trading down in value and plan to pay the tax on the cash received as taxable boot in the exchange. However, in other situations, they are exchanging into replacement property of at least equal value, but they want to increase their debt and keep a portion of their equity for other investments or expenses.

**Example:** Alice has a $6 million relinquished property with no debt. She will acquire a $6 million replacement property, but she would like to invest only $2 million of the equity in the replacement property and to finance the remaining $4 million. If she receives the $4 million of excess equity as exchange proceeds, this amount will be taxable cash boot in the exchange.

Most taxpayers in Alice's situation would like to both obtain the cash and avoid the taxable gain on it. But under the boot-offsetting rules of Code Sec. 1031, the receipt of relinquished-property cash is not offset by the assumption of a liability on the replacement property.[1] Therefore, taxpayers must use strategies to avoid the tax on the receipt of relinquished-property equity. This column examines some of the popular cash-out strategies.

## New Financing Before or After an Exchange

Under general tax principles, loan proceeds are not taxable income because the loan must be repaid.[2] Therefore, a taxpayer may consider avoiding taxable cash boot in the exchange by instead obtaining the cash through nontaxable loan proceeds. This possibly can be done by obtaining the cash from either: (1) new financing on the replacement property after the exchange is completed; or (2) new financing on the relinquished property prior to the closing of the exchange (if the new debt is treated as liability relief in the exchange, then it will be offset by a new debt on the replacement property).

**Example of Post-Exchange Financing:** Alice, the taxpayer in the example above, acquires a $6 million replacement property with all equity. She later obtains a $4 million loan on the replacement property.

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**Example of Pre-Exchange Financing:** Alice obtains a line of credit (LOC) on the relinquished property for $4 million. Prior to entering into a purchase and sale agreement for the property, she draws down the LOC by the full $4 million. She later disposes of the relinquished property in an exchange, and the LOC is paid off at closing. She then acquires a $6 million replacement property with a $4 million loan and $2 million of equity.

Alice is basically in the same economic position in these post- and pre-exchange financing examples as she would have been had she received the $4 million in exchange proceeds at the closing of the relinquished property. Yet, the loan proceeds are not taxable while the exchange proceeds are taxable. Therefore, the risk is that loan proceeds received shortly before or after the exchange might be deemed to be taxable cash boot under a step-transaction or tax-avoidance theory. There are some cases and rulings on this issue, as well as proposed regulations and an American Bar Association (ABA) report.

## Case Law

All of the court decisions on this issue involve a pre-exchange refinancing of the relinquished property. They appear to favor the position that the taxpayer can obtain nontaxable cash by increasing the debt on the relinquished property prior to the exchange. While there are no decisions on post-exchange financing, the same rationale should apply to placing new debt on the replacement property after the closing of an exchange.

*P.M. Garcia*[3] is often cited in support of the taxpayer position that a refinancing before or after an exchange does not result in taxable boot. The taxpayer's relinquished property had a mortgage of approximately $100,000; the taxpayer's replacement property had a mortgage of approximately $75,000. The other party increased the mortgage on the replacement property to $100,000 to equalize the debt and equity of the relinquished property and the replacement property. The IRS argued that the increase in the mortgage by the other party should be deemed taxable boot to the taxpayer because it was an artificial reallocation of liabilities for the purpose of tax avoidance. The court rejected the IRS's argument, finding instead that the debt should be respected because it had "independent economic substance," although the only reason for the debt appeared to be balancing the mortgages in the exchange.

Note that the IRS's argument in *Garcia* was misguided because the taxpayer did not receive cash prior to or after an exchange and thus there was no cashing out of exchange equity. Instead, the other party received the cash from the refinancing. If the other party had not increased the debt on the replacement property, the taxpayer would have had to *pay* additional cash to obtain the replacement property or given the other party a promissory note. This additional cash or note paid would have offset the taxpayer's liability relief from the relinquished property. The IRS did not appear to have anything to gain in *Garcia.*

*S. Long*[4] is the only case involving a pre-exchange refinancing in which the taxpayer lost. Some of the partners structuring a pre-1984 partnership exchange wanted to avoid taxable mortgage boot from the exchange because they would be relieved of more liabilities than they would assume.[5] In order to even out the mortgages, the partners simply amended the partnership agreement six weeks prior to closing to reallocate liabilities among themselves. One of the partnerships also incurred new debt of $400,000 two days prior to closing the exchange. The court found that the reallocation of existing debt resulted in taxable boot but not the new debt incurred prior to the exchange.

Note that the court in *Garcia* distinguished its facts from those in *Long* because the debt reallocation in *Long* lacked economic substance and was made solely for tax-avoidance purposes. Further, *Long* involved a reallocation of existing debt among partners rather than an assumption of new liabilities in connection with the exchange.

*F.W. Behrens*[6] did not involve a refinancing before or after an exchange. Instead, the taxpayer was found to have taxable boot in the exchange when he cashed out relinquished-property equity by increasing the amount of the seller financing for the replacement property. Nevertheless, the case supports the argument that nontaxable cash can be obtained before or after an exchange because the court, *in dicta*, stated that the taxpayer could have avoided the taxable boot if he had borrowed cash secured by his property from a third-party lender before or after the exchange.

*F.L. Fredericks*[7] is the one case involving a multiparty exchange rather than a two-party swap. The taxpayer refinanced the relinquished property one week after he entered into an agreement to convey the relinquished property and 25 days prior to the disposition of the relinquished property. The taxpayer received $2 million of excess proceeds from the refinancing, and the IRS argued these proceeds were taxable boot in the exchange. The court disagreed, finding that the taxpayer received the proceeds from a third-party lender and not as part of the exchange. The court also noted that the taxpayer had independent reasons for the refinancing. He had been attempting to refinance the existing loan on the relinquished property for some time prior to the exchange because the due date on the loan was approaching. He would also have needed to refinance the existing loan if the exchange failed to close.

Finally, a 2011 Tax Court case perhaps provides some insight into the current IRS position on post-exchange financing. The case involved a sophisticated series of transactions for C corporations that included a Code Sec. 1031 component with a post-exchange financing occurring one day after the taxpayer's receipt of the replacement property. The IRS initially asserted the financing proceeds were taxable boot in an exchange but conceded the case in 2012.[8] The financing was clearly prearranged, and it appeared that the taxpayer would not have structured the exchange unless there was financing lined up to fund immediately after the exchange.

## IRS Rulings

There are two early private letter rulings on the issue of pre-exchange refinancing. In a favorable 1982 ruling involving a two-party swap,[9] one of the taxpayers increased the mortgage on its relinquished property to an amount equal to the mortgage on the other party's property. The proceeds derived from this increase in the mortgage loan were retained by the taxpayer and used to acquire new machinery for its business. The facts in this ruling are similar to *Garcia* because both situations involved a two-party swap in which the parties were balancing out the equities in the properties. In *Garcia*, the taxpayer did not cash out any exchange equity. In this ruling, however, the taxpayer did cash out some of its equity with the pre-exchange increase in its mortgage.

The IRS appeared to change its opinion on pre-exchange refinancing shortly thereafter in a 1984 private letter ruling involving similar facts.[10] In this ruling, the taxpayer increased the mortgage on its relinquished property by $250,000 prior to the exchange in order to partially equalize the relinquished property mortgage with the replacement property mortgage. The taxpayer took a promissory note from the other party to equalize the balance. The IRS ruled that the $250,000 of loan proceeds constituted taxable boot to the taxpayer because the debt in question did not have independent economic substance. It is hard to reconcile this ruling with the 1982 ruling. Perhaps, the taxpayer would have obtained a favorable ruling if it represented that the $250,000 of loan proceeds would be used for business purposes in addition to balancing the mortgages.

These two rulings, like *Garcia,* involve a simultaneous, two-party swap in which the existing mortgages are actually assumed. If there is an imbalance in equities in a two-party swap, one of the parties can increase the mortgage on his or her relinquished property to make the equities balance in the exchange so the other party does not need to come up with cash to make up the difference.

By contrast, present-day exchanges are almost never two-party swaps. They involve a separate sale of the relinquished property and purchase of the replacement property and a qualified intermediary (QI) to tie them together into an exchange. Furthermore, the buyer does not assume the mortgage on the relinquished property, and thus there is no need to balance the equities between the taxpayer and the buyer through a pre-exchange refinance. Thus, an independent business reason for the new financing appears to be important in a multiparty exchange. It was cited as support for the taxpayer-favorable holdings in *Fredericks* and the two private letter rulings discussed above.

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A private letter ruling issued in 2000 did not involve a two-party swap, and thus there was no balancing of the equities. There was a pre-exchange refinancing, but the taxpayer represented that it had an independent business reason for the refinancing. The relinquished property was refinanced in July of Year 1, and proceeds were distributed to the partners.[11] The taxpayer represented that no exchange was contemplated at that time, and the refinance was done to take advantage of lower interest rates. Also, some of the proceeds were used to purchase more properties by the partners of the taxpayer. The exchange took place over six months later in February of Year 2. The IRS found that the refinancing had independent economic significance from the exchange due to the lower interest rates and the purchase of the other properties with the loan proceeds.

The only ruling on a post-exchange refinancing is a 2001 private letter ruling.[12] The taxpayer borrowed money after the exchange using the replacement properties as collateral. The ruling held that the loan proceeds were not taxable, noting that the borrowing would occur in the tax year subsequent to the exchange and the proceeds would be used exclusively to advance the taxpayer's business objectives.

Finally, a 2013 memorandum ruling also sheds light on the IRS's thinking about refinancing before or after an exchange.[13] The relinquished property and replacement property in the exchange were secured by an LOC that could be used for business purposes unrelated to the relinquished property or replacement property. While the memorandum does not specifically involve a refinance before or after an exchange, presumably the LOC was being drawn upon immediately before and after the exchanges in question, and apparently this did not concern the IRS.

## Proposed Regulations on Pre-Exchange Financing

The 1990 proposed regulations under Code Sec. 1031 contained a provision that liabilities incurred by the taxpayer "in anticipation of an exchange" would not offset liabilities assumed by the taxpayer.[14] Treasury dropped this restriction in the final regulations, however, because it could create "substantial uncertainty in the tax results of an exchange transaction involving liabilities" on both the relinquished property and the replacement property.[15]

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This language in the proposed Code Sec. 1031 regulations is similar to language in the Code Sec. 453 regulations on installment sale reporting. The regulations under Code Sec. 453 include a provision that debt placed on the taxpayer's property "in contemplation of disposition of the property" and then assumed by the buyer will not be qualifying indebtedness and thus will be a payment in the year of sale.[16] In general, the authorities in the installment sale area provide that the taxpayer must have a valid business reason for incurring pre-installment sale debt.[17]

Given that the IRS dropped the "in anticipation of an exchange" language in the final regulations, it is not clear that this business purpose requirement applies to Code Sec. 1031. Nevertheless, many of the taxpayers in the cases and rulings discussed above had an independent business purpose for the pre-exchange refinancing. Thus, it is wise to establish a motive for a pre-exchange refinancing other than avoiding taxable boot in the exchange.

## ABA Report

In 1995, the ABA Tax Section issued a Report on Open Issues in Section 1031 Like-Kind Exchanges (the "Report").[18] The Report makes a significant distinction between pre-exchange refinancing and post-exchange refinancing. Question A-2a discusses the authorities on pre-exchange refinancing and concludes that if a pre-exchange financing is completed as part of an integrated transaction that includes an exchange, cash received by the taxpayer from a lender will be treated as taxable boot from the disposition of the relinquished property. The Report states that the key distinction should be whether the taxpayer ever bore the risk of repayment of a debt for more than the time needed to close subsequent parts of the exchange. It concludes that refinancings should occur as separate, independent transactions from the exchange and neither be conditioned on the completion of a relinquished property transfer nor be part of the same escrow or settlement process. Further, the lender should look to the credit of taxpayer and not the credit of the buyer of the relinquished property. The Report appears to be more conservative on pre-exchange refinancing than the current case law and rulings.

The Report finds that post-exchange refinancing should be less of a concern from a tax perspective than pre-exchange refinancing. Question A-2b states that a post-exchange refinancing is different from a pre-exchange refinancing because the taxpayer will remain responsible for repaying the post-exchange debt whereas the taxpayer will be relieved of the debt in a pre-exchange refinancing. The borrowing does not create income because the money must be repaid and therefore is not a net increase in wealth. It then concludes that the integration of the refinancing with the acquisition of the replacement property should not matter, and the taxpayer's receipt of cash from the lender is not taxable boot.

## The "Nanosecond" Refinancing: Rule or Theory?

Some commentators agree with the Report's position on post-exchange refinancing and believe that taxable boot can be avoided by separating the replacement property acquisition and the refinancing of the replacement property by no more than a nanosecond. This position is not unreasonable given that none of the case authorities discussed above address post-exchange refinancing, and the IRS does not appear to have a strong opposition to it. Nevertheless, it is wise for a taxpayer to be cautious and avoid signing a loan application until after the replacement property closing. Perhaps this will avoid a challenge on an audit, or the IRS may decide that a nanosecond is just not long enough. Also, the California Franchise Tax Board has stated that it is challenging post-exchange refinancings that are pre-arranged at the time of the acquisition of the replacement property.

## Current "Pay-Down/Re-Advance" Structures

Prepackaged replacement properties are available from sponsor organizations. These include tenancy-in-common arrangements, Delaware Statutory Trusts and zero-cash-flow properties (ZCFs). They generally involve credit tenant net leased (CTL) properties that involve no true landlord responsibilities and are more like a bond-type investment. A quick search of the Internet will yield several sites offering these products.

With a CTL and a ZCF, the property will be subject to an existing high level of debt matched to the rent stream. The taxpayer might have too much exchange equity for the given debt amount, so the debt must be reduced to avoid taxable cash boot.

> **Example:** Jack needs $1 million of replacement property with $500,000 of equity to defer gain on the exchange. He wants to acquire only $1 million ZCF replacement property, with $100,000 equity and $900,000 mortgage. QI pays $500,000 to seller/sponsor of replacement property, and seller pays down the mortgage to $500,000 prior to transfer to Jack. He receives $1 million property with $500,000 of debt but thereafter reborrows $400,000. The lender will be paid a fee equal to the foregone interest on the $400,000 during the period it is paid down.

The lender may be unwilling to have the debt paid down permanently because it has made a long-term investment and will not accept prepayment without substantial yield-maintenance penalties. The loan may be securitized, and a reduction in the principal is not possible. The taxpayer may want the existing mortgage if it has a favorable interest rate and other terms. Therefore, the parties intend that the taxpayer will immediately reborrow the pay down amount after closing, usually within a short period such as two weeks. Thus, this structure is known as a "pay-down/re-advance" or a "pay-down/pay-up."

Opinions vary widely on the validity of these structures. However, many tax advisors agree that some factors are important to counter an argument that the taxpayer received taxable boot from the re-advance. First, there should be a clear break between the acquisition of the replacement property and the refinancing, even if for only two weeks. Second, the taxpayer should not be legally required or economically compelled to take the re-advance, such as by punitive prepayment penalties. Third, the exchange proceeds should be used to actually pay down the debt and not just escrowed and later released to the taxpayer. The principal reduction amount should not continue to bear interest. Further, new funds should be used to make the re-advance to the taxpayer. The transaction should be documented correctly, and the lender should reflect the pay-down on its books.

## Multiple Replacement Property Issues

A taxpayer who has acquired the first of multiple replacement properties may want to refinance the first replacement property prior to the acquisition of the additional replacement properties. The taxpayer is thus taking out financing proceeds prior to the expiration of the limitations found in Reg. §1.1031(k)-1(g)(6). The exchange period has not expired, and the taxpayer is still entitled to more replacement property. If the loan on the first replacement property is from a third-party lender and was a separate transaction from the acquisition of the first replacement property, it does not seem like the loan should affect the ongoing exchange or be considered boot in the exchange.

The taxpayer may consider using the refinancing proceeds from the first replacement property to avoid taxable boot from a note from the buyer of relinquished property. The taxpayer would need to be comfortable with a preplanned refinancing of the replacement property.

> **Example:** Bob had a $1 million relinquished property, and his buyer paid $600,000 down and gave a note of $400,000 to the QI. Bob acquires a $600,000 first replacement property. Shortly thereafter, he refinances the first replacement property and borrows $400,000. He then uses the $400K to purchase the buyer note from the QI. QI uses this $400,000 to purchase additional replacement property to complete Bob's exchange.

## Financing the Relinquished Property in a Reverse Exchange

A taxpayer may need to refinance the relinquished property in order to obtain funds for the acquisition of the replacement property by an exchange accommodation titleholder (EAT) in a reverse exchange under Rev. Proc. 2000-37.[19] This should be an adequate business reason for the financing, but the loan proceeds should be treated as relinquished-property equity in the exchange that must be invested in the replacement property. The loan proceeds should not be treated as proceeds of a separate borrowing by the taxpayer, unrelated to the exchange. While there are no rulings on this issue, the taxpayer is in the same position that he or she would be in if the relinquished property sold first and the proceeds invested in the replacement property.

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**Example:** Cindy's relinquished property, valued at $900,000, is owned free and clear. She wants to have an EAT acquire a $2 million replacement property in a parking arrangement. The lender will loan $1.5 million to the EAT secured by the replacement property. Cindy does not have sufficient funds for the $500,000 down payment, but the lender will loan her $500,000 secured by the relinquished property. She will then loan the $500,000 to the EAT to purchase the replacement property. When the relinquished property sells for $900,000, the $500,000 relinquished property loan is paid off, and the balance of $400,000 is applied to reduce the replacement property debt to $1.1 million. Cindy has thus reinvested the full $900,000 of relinquished-property equity into the $2 million replacement property.

## Conclusion

A taxpayer may want to cash out some of the relinquished-property equity when exchanging under Code Sec. 1031 and to replace the cash with new debt on the replacement property. This can be done as either a taxable transaction or a tax-free refinancing. Most taxpayers will choose to avoid the taxable boot and refinance before or after the exchange. The law is generally favorable, but a taxpayer would be wise to have a nontax reason for the refinance and to do it before putting the relinquished property on the market. Better yet, the taxpayer can refinance the replacement property after its acquisition. There are differences of opinion on how long to wait after the acquisition.

### ENDNOTES

1 Liabilities and Code Sec. 1031 were discussed in my column in the July–August 2015 edition of the Journal of Passthrough Entities. Note that cash received in an exchange can be offset by cash paid at the same time or earlier than the receipt of the cash, but that is a fairly narrow exception.

2 *J.A. Michaels*, 87 TC 1412, Dec. 43,555 (1986); *J.F. Tufts,* SCt, 83-1 ustc ¶9328, 461 US 300, 103 SCt 1826 (1983).

3 *P.M. Garcia,* 80 TC 491, Dec. 39,937 (1983), *acq.,* 1984-2 CB 1.

4 *S. Long,* 77 TC 1045, Dec. 38,402 (1981).

5 Partnership interest exchanges were excluded from Code Sec. 1031 by the Tax Reform Act of 1984.

6 *F.W. Behrens*, 49 TCM 1284, Dec. 42,044(M), TC Memo. 1985-195. This case is discussed in detail in my column in the July–August 2015 edition.

7 *F.L. Fredericks,* 67 TCM 2005, Dec. 49,629(M), TC Memo. 1994-27.

8 *Dulles World Property, LLC* (Docket No. 13098-11, filed Aug. 18, 2011).

9 LTR 8248039 (Aug. 27, 1982); note the related-party swap occurred before the enactment of Code Sec. 1031(f).

10 LTR 8434015 (May 16, 1984).

11 LTR 200019014 (Feb. 10, 2000).

12 LTR 200131014 (May 2, 2001).

13 CCA 201325011 (Sept. 10, 2012); this ruling is discussed in detail in my column in the July–August 2015 edition of the Journal.

14 Former Proposed Reg. §1.1031(b)-1(c).

15 Preamble to T.D. 8343, 56 FR 14851 (Apr. 12, 1991).

16 Temporary Reg. §15A.453-1(b)(2)(iv).

17 *See Denco Lumber Co.,* 39 TC 8, Dec. 25,688 (1962); Rev. Rul. 73-555, 1973-2 CB 159.

18 *American Bar Association's Report on Open Issues in Section 1031 Like-Kind Exchanges* (July 14, 1995).

19 Rev. Proc. 2000-37, 2000-2 CB 308.