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CHAPTER 22

Refinancing Real Estate

by

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¶ 2200 INTRODUCTION

The Tax Reform Act of 1986 (TRA 86)[1] made extensive changes to the manner in which real estate investments are taxed. Notwithstanding TRA 86, the ability to refinance real estate still has significant income tax advantages. This article focuses on the income tax consequences of refinancing real estate. This Article considers the rules that apply when refinancing a residence, the relative advantages of refinancing versus selling real estate, refinancing in connection with installment sales and exchanges of real estate and refinancing real estate owned by corporations and partnerships.

¶ 2201 BACKGROUND CONSIDERATIONS

¶ 2201.1 Why Refinance Real Estate?

A number of non-tax reasons exist for refinancing real estate. First, the value of real estate owned by a taxpayer may have appreciated, thus allowing the taxpayer to borrow more. Second, current interest rates may have declined compared to the interest rate on the existing loan. Third, the existing loan may be due and the taxpayer may lack sufficient funds to pay it off.

¶ 2201.2 Non-Tax Concerns in Refinancing Real Estate

Even though refinancing real estate has various income tax advantages, refinancing should not be undertaken without consideration of certain non-tax questions. First, a taxpayer should ask whether the old or new loan prohibits prepayment. Under California law, unless a note specifically

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[1] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (*codified at* scattered sections of 26 U.S.C.) [hereinafter TRA 86]. All references to the Code or sections are to the current Code, I.R.C. (1987).

permits prepayment, the lender has no obligation to accept any payment earlier than its due date.[2]

Considerations should also be given to the question of whether there exists a prepayment penalty. If so, does its cost justify the new refinancing?

A third question is whether the taxpayer's new loan should be fixed rate or variable. If the taxpayer believes that interest rates will decline, then a variable-rate loan may be advantageous. Also, variable-rate loans usually do not contain prepayment penalties. Finally, variable-rate loans usually permit owners of commercial real estate to borrow more money than with a fixed-rate loan. On the other hand, if the taxpayer believes that interest rates are increasing, then a fixed-rate loan may be advantageous. However, fixed-rate loans usually contain a prepayment penalty.

Finally, a taxpayer should inquire as to whether the new loan limits the lender's rights, in the event of default, to nonjudicial foreclosure. The answer to this question also has significant tax consequences.

¶ 2202 GENERAL INCOME TAX RULES GOVERNING REFINANCING

The income tax rules governing refinancing of real estate come from a variety of sources. These sources are discussed below.

¶ 2202.1 Treatment of Prepayment Penalty

A loan prepayment penalty is deductible against ordinary income, as an interest expense, in the year the loan is prepaid.[3] This expense is a cost for using the lender's money for less time than was agreed upon and represents the generally higher cost of a short-term, rather than a long-term, loan.[4]

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[2] Smiddy v. Grafton, 163 Cal. 16, 124 P. 433 (Cal. 1912); James Talcott, Inc. v. Gee, 266 Cal. App. 2d 384, 72 Cal. Rptr. 168 (1968).

[3] Rev. Rul. 57–198, 1957–1 C.B. 94.

[4] General American Life Ins. Co. v. Commissioner, 25 T.C. 1265 (1956), *acq.* 1956–2 C.B. 5.

The deduction must be claimed in the year of payment.[5] The prepayment penalty may be viewed as a payment made to extinguish indebtedness. If the prepayment penalty is paid to the same lender who furnishes both the old and new loan, it may not be deductible.[6] Rather, it is probably amortizable over the terms of the new loan. Finally, a prepayment penalty is only deductible with respect to a primary or secondary residence to the same extent that interest is deductible.[7]

¶ 2202.2 Fees for New Loans

The costs of obtaining a new loan, including points and fees such as closing, title, escrow, and legal fees, are capital expenditures that are amortized on a straight-line basis over the term of the loan.[8] The same rule applies to cash basis taxpayers; consequently, points are treated as prepaid interest, deductible over the period to which they relate.[9]

The points relating to a refinanced principal residence are subject to the general rule of amortization over the life of the loan unless and to the extent a portion of the proceeds are used to improve the residence. Under section 461(g)(2), points paid in connection with the purchase or improvement of a principal residence can only be deducted when paid. Further, the Internal Revenue Service has taken the position that section 461(g)(2) means what it says and does not apply to points related to refinancing.[10]

¶ 2202.3 Treatment of Borrowed Money

In general, borrowed money is excluded from gross income pursuant to section 61 because of the offsetting liability to

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[5] The 12701 Shaker Blvd. Co. v. Commissioner, 36 T.C. 255 (1961), *aff'd,* 312 F.2d 749 (6th Cir. 1963).

[6] H. K. Francis v. Commissioner, 36 T.C.M. (CCH) 704, 46 T.C.M. (P-H) ¶ 77, 170 (1977).

[7] I.R.C. § 163(h), *added by* TRA 86, *supra* note 1, § 511(a), (b), 100 Stat. at 2244–48.

[8] Rev. Rul. 75–172, 1975–1 C.B. 145.

[9] I.R.C. § 461(g)(1) (1987). This does not address the issue of whether "points" are paid with respect to a separate construction and permanent loan from the same lender and, therefore, may be required to be amortized over one loan.

[10] *See* Rev. Rul. 87-22, 1987-12 I.R.B. 14.

repay such amounts. Conversely, when borrowed amounts are repaid, there is no deduction.[11] This rule applies even if the property is refinanced for more than its original cost and the loan is non-recourse, meaning it is secured only by the property.[12]

¶ 2202.4 Interest Deduction

In general, interest paid on indebtedness is deductible.[13] TRA 86 establishes six categories of interest expense:

1. Interest related to the conduct of a trade or business, other than the trade or business of performing services as an employee, is fully deductible.[14]

2. Investment interest is deductible as set forth in section 163(d). This section excludes qualified residence interest and interest associated with a passive activity. Therefore, the investment interest expense rules no longer apply to rental real estate, because the passive activity rules of new section 469[15] apply to it.

3. Interest expense taken into account in calculating income or loss from a passive activity is deductible as provided in new section 469.[16] Passive activities include any "rental activity."[17] Therefore, for purposes of determining whether interest expense is deductible, rental activities are no longer considered a trade or business, and the concepts of "net lease" and "guaranty" associated with old section 163(d)[18] no longer apply. It is questionable as to whether the deductibility of interest expense associated with non-rental property is governed by

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[11] Eisner v. Macomber, 252 U.S. 189 (1920). Income is "the gain derived from capital, from labor, or from both combined." *Id.* at 207.

[12] Woodsam Assocs., Inc. v. Commissioner, 198 F.2d 357 (2d Cir. 1952), *aff'g* 16 T.C. 649 (1951).

[13] I.R.C. § 163 (1987).

[14] *Id.* § 163(h)(2)(A).

[15] I.R.C. § 469, *amended by* TRA 86, *supra* note 1, § 501(a), 100 Stat. at 2233–43.

[16] *Id.*

[17] I.R.C. § 469(c)(2), (j)(8) (1987).

[18] I.R.C. § 163(d) 1986 (pre-TRA 86).

section 163(d) of the Code.[19]

4. Qualified residence interest is deductible.[20]

5. Interest payable in connection with certain deferred payments of estate taxes is fully deductible.[21]

6. Personal interest in general is not deductible.[22]

¶ 2203 DEDUCTIBILITY OF POINTS AND INTEREST WHEN REFINANCING A RESIDENCE

¶ 2203.1 Deductibility of Points

As discussed above,[23] points are treated as prepaid interest and are deductible to the extent interest on the residence is deductible.

¶ 2203.2 Deductibility of Interest

The rules governing the deductibility of interest paid on a residence mortgage are contained in section 163(h)(3), (4), (5) and (6). To be deductible, such interest must be paid with respect to a "qualified residence."[24] The term "qualified residence" includes the taxpayer's "principal residence" as defined in section 1034.[25] Such term also includes one other residence selected by the taxpayer for the year and used as a residence within the meaning of section 280A(d)(1).[26] This is a "second" residence, whether or not rented. Further, special rules apply to married couples who do not file joint returns[27] and to cooperatives.[28]

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[19] *See* Rev. Rul. 79–136, 1979–1 C.B. 94.

[20] I.R.C. § 163(h)(2)(D), (h)(3) (1987). *See infra* text accompanying notes 23–33.

[21] I.R.C. § 163(a) (1987).

[22] *Id.* § 163(h)(2)(E). This disallowance will be phased-in. *Id.* § 163(h)(6).

[23] *See* text accompanying notes 8–12.

[24] I.R.C. § 163(h)(2)(D) (1987).

[25] *Id.* § 163(h)(5)(A).

[26] *Id.*

[27] *Id.* § 163(h)(5)(A)(ii).

[28] *Id.* § 163(h)(5)(B).

To be deductible, such interest must also be paid with respect to "qualified indebtedness."[29] Eligible indebtedness includes the debt secured by a qualified residence that does not exceed the lesser of (a) the fair market value of such qualified residence, or (b) the sum of (1) the taxpayer's "basis" in such qualified residence and the cost of improvements, plus (2) the amount of any "qualified indebtedness."[30] The amount determined by the foregoing sentence cannot be less than the outstanding debt secured by such residence on August 16, 1986.[31] Further, the "basis" is the cost of the qualified residence, not the carryover basis calculated under section 1034(e), relating to rollovers, or section 1033(b), relating to involuntary conversions. The cost of a qualified residence acquired from a decedent is determined under section 1014 and is generally the fair market value on the date of death. Further, depreciation deductions are ignored for these purposes, even if otherwise permitted for the property. Qualified indebtedness also includes debt incurred after August 16, 1986 for "qualified medical expenses" and "qualified educational expenses" for the taxpayer, his spouse, or dependent.[32]

The foregoing rules are effective for taxable years beginning after December 31, 1986. These rules are subject to a phase-in rule permitting the deduction of 65% of the otherwise disallowed interest expense in 1987, 40% in 1988, 20% in 1989 and 10% in 1990.[33]

¶ 2204 REFINANCING VERSUS SALE

¶ 2204.1 Reason to Refinance

Often, it is more advantageous to refinance a property than to sell it. Refinancing proceeds may be less than sales proceeds, but the net amount of sales proceeds will have to be reduced by income taxes. This reduction narrows or eliminates any difference. For purposes of this analysis, taxes will

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[29] *Id.* § 163(h)(4).
[30] *Id.* § 163(h)(3)(B).
[31] *Id.* § 163(h)(3)(C).
[32] *Id.* § 163(h)(4)(A).
[33] *Id.* § 163(h)(6).

be calculated on the amount of the mortgage in excess of its basis. Moreover, refinancing will permit a taxpayer to retain future appreciation from his or her existing investment and use the refinancing proceeds to make another investment. This factor creates leverage.

¶ 2204.2 Is It Possible for the Internal Revenue Service To Treat a Refinancing as a Disguised Sale and Require the Taxpayer To Report Gain?

In a case where the loan is made with recourse against the maker, it is unlikely that the IRS would treat a refinancing as a sale. This is true even if the loan is secured by real property. Further, even if the loan is non–recourse, the IRS should have a difficult time treating the transaction as a disguised sale. This is true only as long as the loan does not exceed the property's then fair market value.

In *Woodsam Assocs., Inc. v. Commissioner,*[34] a shareholder of the taxpayer acquired the property in question in 1922 for $298,400. The property was refinanced in 1931 with a $400,000 mortgage that was non-recourse to the shareholder and, therefore, also to the taxpayer. In 1936, the property was contributed by the shareholder to the corporation under the predecessor to section 351. By 1943, when the foreclosure occurred, the mortgage had been paid down to $381,000 and the adjusted basis of the property was $235,000. The court held that the taxpayer recognized $146,000 of gain on the foreclosure.[35]

The taxpayer argued that the taxable event was the 1931 refinancing for $400,000, that gain should have been recognized in that year, and that the basis in the property should have been increased to $400,000. In spite of such assertion, the court held that the refinancing was not a disposition.[36] The lender was a creditor and not an owner, even though its recourse on default was limited to the property. The taxpayer still had the right to refinance in the future. Citing

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[34] 198 F.2d 357 (2d Cir. 1952), *aff'g* 16 T.C. 649 (1951).

[35] 198 F.2d at 359.

[36] *Id.*

Crane v. Commissioner,[37] the court held that the mortgage lien did not make the lender a co-tenant. The owner of the property still had the right to income from the property, to manage it, to sell it and to enjoy further appreciation.

A bona fide third-party lender has no incentive to make a non-recourse loan for an amount exceeding the value of the property at the time of the loan. Thus, the abuse found in *Estate of Franklin v. Commissioner*[38] is not present. The borrower does, indeed, face a situation in which it is economically reasonable to presently make a capital investment equal to the unpaid amount of the loan.

¶ 2205 REFINANCING BEFORE AN INSTALLMENT SALE

¶ 2205.1 Background of Problem

If the proceeds of a refinancing are tax-free, then why not refinance a property before it is sold on an installment sale basis? One reason is that at the time of the sale, the seller has gain to the extent that the unpaid balance of the mortgage or deed of trust exceeds the adjusted basis of the property at the time of sale.[39] On the other hand, such refinancing is otherwise consistent with the holding of *Woodsam Assocs.*

¶ 2205.2 The Internal Revenue Service's Position

Under Temporary Regulation section 15A.453–1(b)(2)(iv),[40] a mortgage or deed of trust created in *contemplation* of the disposition of the property is not qualifying indebtedness and, therefore, constitutes payment in the year of sale. This applies only if the arrangement results in accelerating the recovery of the taxpayer's basis in the installment sale. If this temporary regulation applies, then it probably applies only to the excess of the later mortgage or deed of trust over the prior one. Further, the IRS has held that the liabilities of a seller incurred in the ordinary course of the seller's busi-

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[37] 331 U.S. 1 (1946).

[38] 544 F.2d 1045 (9th Cir. 1976), *aff'g* 64 T.C. 752 (1975).

[39] Temp. Treas. Reg. § 15A.453–1(b)(3)(i), T.D. 7768, 1981–1 C.B. 296.

[40] *Id.* § 15A.453–1(b)(2)(iv).

ness, and assumed by the buyer, are not treated as payments in the year of sale.[41]

¶ 2205.3 Case Law

In general, under case law, whether loan proceeds in excess of the old loan balance are treated as payments in the year of sale depends upon whether the loan is incurred for a business purpose. In several earlier cases, the courts held that if a mortgage or deed of trust is given to a third party through an installment sale, with the seller receiving the proceeds of the loan, then the loan proceeds are treated as payment.[42] In *Denco Lumber Company, Inc. v. Commissioner*,[43] however, the court held that a home loan arranged by the seller, which was assumed by the buyers, did not create a "payment" to the seller under the installment sale rules. In *Denco*, the buyers also gave the seller a note and second mortgage for the balance of the purchase price. In holding for the taxpayer, the court provided that there was a "good business reason" for the taxpayer to obtain the first mortgage loan; the buyers could not obtain such loans because they made no down payment and had poor credit.[44] Without such loans, the taxpayer could not sell its houses.

In *Albert W. Turner v. Commissioner*,[45] the court held that a $275,000 second mortgage was held not to constitute payment. The court held that the mortgage had "economic reality."[46] The court noted that the loan proceeds were used for a bona fide business purpose, that the seller was deemed by the lender to be creditworthy, that the loan preceded the sale by three months, and that the seller paid interest on the mortgage prior to the sale.

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[41] Rev. Rul. 73–555, 1973–2 C.B. 159.

[42] *See* Shubin v. Commissioner, 67 F.2d 199 (3d Cir. 1933); McConnnell v. Commissioner, 29 BTA 32 (1933).

[43] 39 T.C. 8 (1962), *acq.* 1963–2 C.B. 4.

[44] *Id.* at 15.

[45] 33 T.C.M. (CCH) 1167, 43 T.C.M. (P-H) ¶ 74,264 (1974).

[46] *Id.* at 1186, 43 T.C.M. (P-H) ¶ 74,264 at 1109.

¶ 2206 REFINANCING BY A SELLER AFTER AN INSTALLMENT SALE

¶ 2206.1 Example of Refinancing by a Seller After a Sale

Example: Assume a seller sells a parcel of real estate for $1,000,000. The property is encumbered by a $500,000 first trust deed due in ten years and has a $600,000 basis. The terms of the sale call for a $250,000 cash down payment and an all-inclusive promissory note, secured by an all-inclusive trust deed "wrapping" around the $500,000 first trust deed. The all-inclusive promissory note is due in five years and is payable interest only monthly at an interest rate exceeding the applicable federal rate. The all-inclusive promissory note and all-inclusive trust deed permit the seller to refinance the underlying first trust deed.

If the seller refinances the first trust deed in a year following the year of sale with a $700,000 new first trust deed, the seller will recognize gain based on Temporary Regulation section 15A.453–1(b),[47] as set forth below. This regulation contains the internal IRS' current rules for calculating gain, as follows:

Gain in Year of Sale:

Gross Profit:	
Selling price	$ 1,000,000
Less: Adjusted basis	< 600,000 >
Gross Profit	$ 400,000
Contract Price:	
Selling price	$ 1,000,000
Less: Qualifying indebtedness not in excess of basis	< 500,000 >
Contract Price	$ 500,000

Gross Profit Ratio:

$$\frac{\text{Gross profit}}{\text{Contract price}} = \frac{400,000}{500,000} = 80\%$$

[47] Temp. Treas. Reg. § 15A.453–1(b), T.D. 7768, 1981–1 C.B. 296, *amended by* T.D. 7788, 1981–2 C.B. 110.

Therefore, of the $250,000 cash down payment, 80%, or $200,000, is recognized as gain. Furthermore, an additional $200,000 of gain remains unrecognized. The relevant calculations are as follows:

Gain With Respect to All-Inclusive Promissory Note:

Basis in All-Inclusive Promissory Note:

Seller's basis in property	$ 600,000
Add: Gain recognized in year of sale	200,000
Less: Cash received in year of sale	< 250,000 >
Basis in all-inclusive promissory note	$ 550,000

Gross Profit Ratio With Respect to All-Inclusive Promissory Note:

Face value of all-inclusive promissory note	$ 750,000
Less: Basis in all-inclusive promissory note	< 550,000 >
Balance:	$ 200,000
Divided by face value of all-inclusive promissory note	750,000
Gross profit ratio	26.67%

Check: 26.67% × $750,000 = $200,000 = deferred gain.

What is unanswered is whether the 26.67% applies to the net loan proceeds or to the entire new loan. If the latter is true, then the tax cost may be too great to make refinancing worthwhile. Fortunately, the entire issue may be avoided by putting a new second trust deed on the property for $150,000. The new second trust deed will be junior to the first trust deed and senior to the all-inclusive trust deed. In this case, only 26.67%, or $40,000, should be taxable.

If the seller received $100,000 of cash in the year of sale and an all-inclusive promissory note secured by an all-inclusive trust deed for $900,000, and placed a $150,000 second trust deed on the property after the year of sale, the after-tax results would be improved compared to those described in the previous example. The following example illustrates the difference:

Example:

Year of Sale:

Gross profit: Still $400,000.
Contract price: Still $500,000.
Gross profit ratio: Still 80%.

Therefore, $80,000 of gain is recognized with respect to $100,000 (80% × $100,000).

Gain With Respect to All-Inclusive Promissory Note:
Basis in all-inclusive promissory note:

Seller's basis in property	$	600,000
Add: Gain recognized in year of sale		80,000
Less: Cash received in year of sale		< 100,000 >
Basis in all-inclusive promissory note	$	580,000

Gross Profit Ratio With Respect to All-Inclusive Promissory Note:

Face value of all-inclusive promissory note	$	900,000
Less: Basis in all-inclusive promissory note		< 580,000 >
Balance	$	320,000
Divided by face value of all-inclusive promissory note		900,000
Gross profit ratio		35.55%

Check: 35.55% × $900,000 = $320,000 = deferred gain.

The gain recognized with respect to the $150,000 of second trust deed proceeds is $53,325 (35.55% × $150,000). Therefore, gain on the $250,000 received ($100,000 as a cash down payment and $150,000 as new loan proceeds) is $133,325

($80,000 + $53,325) compared to $200,000 gain since the entire $250,000 amount is received as a down payment.

¶ 2207 REFINANCING AFTER AN EXCHANGE

Example: Assume a taxpayer owns real estate, property *A*, with a basis of $500,000 and a fair market value of $1.6 million. Assume further that property *A* is subject to a trust deed securing repayment of a note with a $400,000 balance, (property *A*, has $1.1 million of deferred gain and $1.2 million of equity). Assume further that this taxpayer exchanges property *A* for another parcel of real property, property *B*. Property *B* is subject to a trust deed securing repayment of a note with a $1.66 million balance. Therefore, property *B* has a fair market value of $2.86 million. The taxpayer's basis in property *B* is $1.76 million.

If the taxpayer had sold property *A* for $1.6 million cash, he or she would have a taxable gain of $1.1 million. Assuming a combined federal and state income tax rate of 35%, the taxpayer would have $715,000 left to invest ($1,100,000 × 65% = $715,000). If this taxpayer customarily makes a 25% down payment when buying property, the taxpayer could purchase new property for $2.86 million and have no cash left.

Now assume that the taxpayer refinances property *B* for 75% of its fair market value. The taxpayer would have $485,000 of excess loan proceeds ($2,860,000 × 75% = $2,145,000 − $1,660,000 = $485,000), ignoring costs. Using the $485,000 of excess loan proceeds, the taxpayer can now acquire a property with a value of $1.94 million.

This procedure permits taxpayers to maximize gain deferral and property reinvestment, by adding the extra step of refinancing. One should note, however, that there is no direct authority on point. Therefore, it is probably advantageous to begin the refinancing *after* completing the exchange.

¶ 2208 REFINANCING REAL ESTATE OWNED BY A CORPORATION

In some instances, refinancing corporate-owned, appreciated real estate and distributing the excess cash may be preferable to distributing such real estate to the corporation's shareholders.

¶ 2208.1 Tax Consequences of a Distribution of Appreciated Real Estate

Under the general rule of section 311(b)(1), the distributing corporation will recognize gain to the extent of the difference between the property's fair market value and its adjusted basis in the hands of such corporation. This rule applies to "C" corporations.

A number of exceptions to this general rule apply. These include exceptions for distributions in connection with a partial liquidation under section 302(d)(4), payment of "qualified dividends", as defined by section 311(e)(3) (related to property used in the active conduct of a qualified business), distributions in connection with certain types of divisive reorganizations under section 311(e)(2), redemptions to pay death taxes under section 303(a), and certain other types of distributions. For this Article, assume that the general rule applies.

Pursuant to section 1363(d), a rule of recognition similar to section 311(b)(1) applies to "S" corporations. Although section 1363(e) contains some exceptions to this general rule, those exceptions are more limited than the exceptions that apply to section 311(b)(1). This gain will pass through to the shareholders.

The recipient of a distribution of appreciated property from a "C" corporation will be taxed depending on the nature of the recipient. Individuals will be taxed on the fair market value of the distribution.[48] Domestic corporations will be taxed on the lesser of the fair market value or the distributing corporation's basis increased by the gain it recog-

[48] I.R.C. § 301(b)(1)(A) (1987).

nizes.[49] The amount of any such distribution will be decreased, but not below zero, by the encumbrances to which the property is subject.[50]

Recipients will realize dividend treatment to the extent of the distributing corporation's earnings and profits. Next the shareholders' adjusted basis in the stock of the distributing corporation will be reduced. The excess over the adjusted basis will be treated as gain to the shareholders.

The recipient of a distribution from an "S" corporation will likewise be taxed depending upon whether the "S" corporation has accumulated earnings and profits attributable to the period prior to its "S" corporation status. If there were *no* accumulated earnings and profits, then the distribution is non-taxable to the extent of the recipient's adjusted basis in his/her stock (which is reduced by the amount of the distribution, but not below zero); any excess is treated as gain from the sale of stock.[52] If the "S" corporation *has* accumulated earnings and profits, the rules for determining the amount of the distribution to an "S" corporation's shareholders are essentially the same as the rules for distributions to "C" corporation shareholders.[53]

¶ 2208.2 Refinancing Versus Distribution

If a corporation's earnings and profits are small compared to the deferred gain inherent in the real estate it owns, the shareholders may be better off if the corporation refinances the real estate and distributes cash rather than the real estate. The following example explains this.

> **Example:** Assume a "C" corporation has $100,000 of earnings and profits. The corporation owns real estate with a $1 million basis and a $2 million fair market value. The real estate is subject to a trust deed securing repayment of $1 million; the property can be refinanced for $1.5 million,

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[49] *Id.* § 301(b)(1)(B).

[50] *Id.* § 301(b)(2).

[52] *Id.* § 1368(b).

[53] *Id.* § 1368(c).

leaving $500,000 of cash proceeds. The shareholders' aggregate basis in the shares of the corporation is $100,000.

If the real estate is distributed to the corporation's shareholders, the corporation will recognize gain of $1 million the difference between the fair market value of the real estate, $2 million and its adjusted basis $1 million.[54] The corporation will bear a tax of approximately $400,000 and its earnings and profits will be increased by $600,000, to $700,000. Assume that the corporation borrows $400,000 to pay the taxes on the distribution and secures such loan with a $400,000 trust deed encumbering the property.

If the property is distributed to the shareholders, the entire value will be taxed as a dividend and bear approximately $270,000 of tax, leaving a net of $330,000. Thus, the $1 million of appreciated value bears approximately $670,000 of tax.

If the real estate is refinanced for $1.5 million and the $500,000 of cash is distributed, no tax will be due from the corporation. Furthermore, the corporation still owns the real estate and may not be subject to the passive activities limitations.[55] The shareholders will receive a dividend of $100,000 and pay tax of approximately $45,000; the shareholders will have a return of capital of $100,000; and, the shareholders will have capital gain of $300,000. The shareholders will pay a tax of approximately $105,000. Therefore, the shareholders will have $350,000 of cash left, net of taxes, compared to $330,000 when the entire property was distributed.

¶ 2209 REFINANCING REAL ESTATE OWNED BY A PARTNERSHIP

¶ 2209.1 Basic Considerations

When refinancing real estate owned by a partnership, there are two important considerations. First, with respect to a limited partnership, if the old loan was non-recourse and the new loan is recourse, the limited partners could realize

[54] *Id.* § 311.
[55] *Id.* § 469.

so-called "phantom" income and/or not have sufficient basis for reporting future losses.[56] Second, deemed distributions[57] may be treated as including "unrealized receivables"[58] and result in ordinary income.

¶ 2209.2 Switch From a Non-Recourse to a Recourse Loan

Liabilities are included in a partner's basis in his or her partnership interest according to two relevant general rules. First, non-recourse liabilities are included in the basis of partnership interests of general and limited partners according to their respective interests in profits at the end of the year.[59] Second, recourse liabilities are included only in the basis of the partnership interests of general partners, according to their respective interests in losses at the end of the year.[60]

In a limited partnership, if the existing mortgage or trust deed secures a non-recourse note and the new mortgage secures a recourse note, the limited partners will have a deemed distribution under section 752(b). To illustrate, if the limited partnership has a $1 million non-recourse liability, the limited partners have a 75% interest in profits and the limited partners have a $300,000 negative capital account, the limited partners will have $300,000 of gain if the new loan is recourse, even if it is only for $1 million. The switch from non-recourse to recourse is treated as a distribution.[61] Accordingly, before the refinancing, the limited partners, as a group, had a basis in their partnership interests of $450,000 (75% × $1,000,000, less $300,000). As a result of the refinancing, they are deemed to have a $750,000 distribution, resulting in $300,000 of gain.

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[56] *See generally id.* §§ 704, 752.

[57] *Id.* § 752.

[58] *Id.* § 751.

[59] Treas. Reg. § 1.752–1(g), T.D. 6175, 1956–1 C.B. 211.

[60] *Id.* § 1.752–1(e).

[61] I.R.C. § 752(b) (1987).

¶ 2209.3 Character of the Gain

There is authority that the gain on the switch from non-recourse to recourse is ordinary income.[62] In Revenue Ruling 84–102 *A, B* and *C* were equal partners of partnership *P.* The partnership had $40x of unrealized receivables under section 751, and $100x of liabilities. *D* contributed sufficient cash to *P* so that he became an equal partner. The ruling holds that pursuant to sections 752(b), 751(b)(1)(B), and 731, *A, B* and *C* each have $8.3x gain (25% × $100x of liabilities divided by 3), of which $3.3x is gain under sections 731(c) and 751(b)(1)(B) and the balance is taxed pursuant to section 731(a). *D* has no gain or loss. By analogy, a switch from non-recourse to recourse liabilities is a similar deemed distribution to the limited partners and could give rise to ordinary income.

¶ 2210 DOES IT PAY TO REFINANCE UNDER TRA 86?

If a taxpayer has a lot of cash, it may *not* be a good idea, tax-wise, to refinance. By increasing the loan amount, the taxpayer increases the amount of passive losses.[63] The taxpayer may not be able to utilize those passive losses on a current basis to reduce the portfolio income earned by the existing cash. With additional cash from refinancing, the taxpayer's portfolio income will increase, and so will the amount of unsheltered portfolio income.

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[62] Rev. Rul. 84–102, 1984–2 C.B. 119.

[63] I.R.C. § 469 (1987).