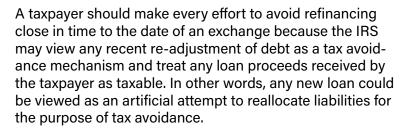
## \*\*\*\*\*\* \* OLD REPUBLIC EXCHANGE

## **REFINANCING AND SECTION 1031**

## PLANNING CONSIDERATIONS



For example, a taxpayer anticipating receipt of \$150,000 in proceeds might want to only reinvest \$100,000 into replacement 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 tax-payer 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 property 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 consequence.



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

- (1) Avoid integrating the refinance transaction 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 agreement 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 anticipation 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 documents 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 exchange (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.

To learn more, please contact

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