1031 Exchanges & Refinancing

With Proper Timing, Use Your Equity For Whatever You Want

1031 Knowledge

Many real estate investors never consider an exchange because they mistakenly believe their equity must always remain tied up in real estate. Believe it or not, an investor can exchange into a more desirable property, thus preserving all their equity — and then refinance the replacement property to obtain cash. The cash received from the refinancing of the replacement property can then be used for whatever the investor chooses, whether that is buying more real estate, investing in the stock market or taking a long vacation in Europe.

THE TIMING IS IMPORTANT

A real estate investor should not refinance the relinquished property and shortly thereafter perform a tax-deferred exchange unless it can be established that the debt incurred prior to the exchange had "independent economic substance." If the taxpayer cannot support they had a valid business reason incurring addition debt prior to the sale, the IRS could easily characterize this as a "step transaction" (where they determine the steps leading up to the exchange show the investor's original intent was merely to obtain the cash in an attempt to avoid the reinvestment rules of IRC § 1031.) For example, in *Private Letter Ruling 8434015,* the IRS ruled that cash proceeds refinanced immediately prior to closing an exchange constituted taxable boot.

CONSULT WITH ADVISORS

It is important to consult with your personal tax/legal advisors and an experienced IRC § 1031 "Qualified Intermediary" on the timing of the refinance.

POST EXCHANGE REFINANCING

In most circumstances, an attorney or CPA will recommend refinancing the replacement property after completing the exchange transaction. Any refinancing should be done later and off the replacement property closing statement.

USE REFINANCED PROCEEDS TO PAY BILLS OR INVEST IN STOCKS

Refinanced proceeds can be used for anything the investor chooses and these funds do not have to be invested back into real estate. The money can go toward paying bills or meeting immediate cash flow requirements.

Through a refinance of the replacement property, an investor can diversify their investments and/or take advantage of excellent returns currently available in many stocks, thus providing the taxpayer the ability to meet two important objectives: (1) Preserve equity through full tax deferral; (2) After refinancing the replacement property, diversifying investments into the stock market or any other attractive investment opportunities.

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