



## Refinancing Before and After an Exchange *continued from page 2—*

taxpayer's later assumption) for the purpose of evening up the liabilities on both sides of the exchange. The IRS argued that the new loan was an artificial attempt to reallocate liabilities for the purpose of tax avoidance. The U.S. Tax Court disagreed with the IRS and found that there was an assumption of debt that had an independent economic substance aside from tax avoidance (i.e., to even up the liabilities in the exchange), and the fact that the debt was created at the taxpayers' request was simply irrelevant.

In Fredericks, Fred L., T.C. Memo. 1994-27, the taxpayer refinanced the relinquished property one week after entering into an agreement to sell it and

received cash. The IRS argued that the taxpayer "cashed out" of his exchange property. The Tax Court disagreed with the IRS and found that the taxpayer had reasons for refinancing the mortgage that were unrelated to the exchange. The taxpayer was attempting to secure permanent long-term financing and a more favorable interest rate because his current loan was coming due.

What the foregoing authorities establish is the necessity of carefully structuring any refinance that is done close in time to an exchange; and that refinancing may be permissible where the taxpayer meets the following criteria:

Avoid integrating the refinance transaction with the exchange transaction;

Wait as long as possible before refinancing before or after exchanging;

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;

Make sure that the loan has an *economic significance independent of the exchange* (e.g., lower interest rate, more favorable terms, pre-existing need to refinance); and

Never reallocate existing liabilities for the sole purpose of tax avoidance.

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## Check 21 *continued from page 1—*

bears an MICR line containing all the information appearing on the MICR line of the original check, conforms in paper stock, dimension and other aspects with generally applicable industry standards for substitute checks, and is suitable for automated processing in the same manner as the original check.

The Act allows a substitute check meeting these standards to be considered the legal equivalent of the original check "for all purposes, including any provision of any Federal or State law, and for all persons." Such a check is subject to Federal and state laws protecting customers, including the Uniform Commercial Code.

According to the Federal Reserve, the use of substitute checks should facilitate the collection and return of checks in electronic form by permitting, for example, a depository bank in California that receives a check drawn on a bank in New York to transfer check information electronically to a collecting bank in New York which, in turn, would create a substitute check to present to the New York paying bank. Under the Act, the New York paying bank would be required to take presentment of the substitute check that

met all the legal equivalence requirements. Thus, instead of processing and transporting the original check across the country, the California bank could collect the substitute check using only local New York transportation. While banks would not be required to create electronic checks or substitute checks, they would be required to accept substitute checks from other banks instead of the original checks.

The Act does not directly affect the time periods set under the Expedited Funds Availability Act ("EFAA") and the Federal Reserve's Regulation CC for cashing local and non-local checks (e.g., providing funds to a customer in one day for a cashiers check, two days for a local check and five days for a non-local check). However, the Federal Reserve expects that Check 21 "ultimately will decrease the time needed to collect checks." The time periods under EFAA for providing funds on checks is not expected to change quickly because Check 21 implementation by banks will require some time. Bank trade groups estimate it will take up to two years for broad implementation of Check 21 standards because adoption is not required, but is optional for the processing bank.

Because adoption may be slow,

banking organizations have also indicated that the possibility that float will significantly and suddenly be reduced is not likely to occur. For banks that engage in image processing, banks believe that float may shrink for processing out-of-town checks, but local checks will clear in virtually the same time as today.

### COMMENTS:

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