

# The Reporter

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## TAX DEFERRED EXCHANGES

Like-Kind Exchanges under Section 1031 of the Internal Revenue Code continue to become more and more popular.

While very common in California, tax deferred exchanges have not been seen as frequently in New England. That seems to be changing. Lynne Bagby is the Massachusetts Representative for our subsidiary, Old Republic Exchange Facilitator Company (OREXCO). She can help you or your clients set up and successfully complete an exchange with ease. You can reach Lynne at the number listed below.

Lynne submitted the following article outlining some of the dangers in refinancing a property immediately after or before an exchange. We thought this article would be of interest to our agents.

## Refinancing Before or After an Exchange: Can It Be Done?



Submitted by Lynne Bagby, Old Republic Exchange (OREXCO)

For taxpayers intending to refinance either before or after exchanging property, it is extremely important to recognize that refinance proceeds could be considered taxable boot, unless the taxpayer can establish that the refinancing had an economic significance independent of the exchange and was not for tax avoidance.

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## Refinancing Before Exchanging

If a loan is refinanced just before property is exchanged, the IRS could argue that any cash received from the refinance constitutes cash boot received. In other words, a loan obtained just prior to exchanging property, which results in cash to a taxpayer, might be viewed simply as a mechanism to cash out some equity and decrease the cash required for the acquisition of the replacement property.

For example, what if a taxpayer intends to exchange property and anticipates receiving \$150,000 in cash proceeds? However, he only wants to reinvest \$100,000 cash into new replacement property. In anticipation of this situation, the taxpayer arranges a refinance before exchanging to increase the mortgage on his property by \$50,000 and thereby reduce his required cash infusion to the replacement property. The result may be what the taxpayer intended – i.e. \$50,000 cash in his pocket and a higher loan amount – but certainly not what the IRS will allow.

## Refinancing After Exchanging

If a loan is refinanced just after the exchange property is acquired, the same result may occur. For example, if a taxpayer exchanges into replacement property with a loan of \$100,000, but shortly thereafter increases the loan to \$125,000 simply to obtain \$25,000 cash, the IRS will consider the refinance proceeds as cash boot. The circumstances are equivalent to a taxpayer failing to invest all of his net cash proceeds and instead obtaining a higher loan amount on the replacement property.

## What the IRS and the Tax Courts Say about Refinancing in Conjunction with an Exchange

In considering the validity of any mortgage adjustment close in time to the date of the exchange, the documents and the transaction as a whole should be carefully scrutinized to make sure that the form accurately reflects the substance. Long v. Commission, 77 T.C. 1045, @ p.1077 (1981). Any reallocation of existing liabilities prior to the exchange must have economic substance and must not be undertaken solely for tax-avoidance purposes. 77 T.C. at 1080.

In, Private Letter Ruling 109817-99, the taxpayers at issue were six limited partnerships all with the same general and limited partners. The partnerships' relinquished property consisted of several mobile home parks.

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## MARKETING TIPS/REMINDERS :



Call Old Republic Title or ask your sales representative for information and/or brochures regarding 1031 Exchanges;



Contact Lynne Bagby, Regional Account Manager, Old Republic Exchange (OREXCO), to learn more about 1031 Exchanges. Toll Free: 866-663-1031



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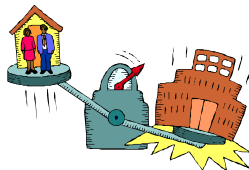
Approximately seven months prior to contemplating the exchange, the taxpayers refinanced the mortgages on the relinquished properties to take advantage of lower interest rates and some of the proceeds of the refinancing were distributed to the partners who purchased more properties.

In reviewing the transaction, the IRS determined that the refinancing had an "economic significance independent from the exchange" (i.e. the taxpayers received lower interest rates on the loans and the refinance proceeds were used by the partners to purchase more properties). Thus, the IRS determined that it would not treat the proceeds of the refinancing as payment of boot in the exchange transaction.

The IRS relied upon two U.S. Tax Court cases for its determination as to whether the refinancing had an economic significance independent of the exchange. Those two cases are Garcia v. Commissioner, 80 T.C. 491 (1983) and Fredericks v. Commissioner, T.C. Memo. 1994-27

In Garcia v. Commissioner, 80 T.C. 491 (1983) the taxpayers required the sellers of the replacement property to obtain a higher mortgage (for the 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 which 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 v. Commissioner, 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, which is done close in time to an exchange and that refinancing may be permissible where the taxpayer meets the following criteria:

- (1) Avoid integrating the refinance transaction with the exchange transaction;
- (2) Wait as long as possible before refinancing before or after exchanging;



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(3) 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;

(4) 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);

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

We at Old Republic Title extend to you our best wishes for a happy, healthy and prosperous 2003!!!!



### Employee Spotlight - Travis Conway



Travis Conway joined Old Republic Title's Policy Production Department in October of 2001, after having worked at an international consulting company designing presentations.

His main responsibility at ORT is processing income, but he also handles inventory requests, rate questions and policy detailing.

Travis grew up in the small town of Skowhegan, Maine and, as fate would have it, he enjoys hunting, fishing and snowmobiling. He presently lives in Somerville and is taking classes at Wentworth Institute of Technology's Computer Information Systems Program -- which makes him handy to have around when we experience computer problems!

Despite his youthful appearance, he enjoys "classic rock" and is a huge fan of "The Allman Brothers Band". And, although his name is "Travis", he is almost daily referred to as: Troy, Trevor, Travers and, occasionally, Tim Conway.

