Real Estate Spring 2004

Exchange News

Realty Exchange Corporation
Since 1990 - Your Nationwide Qualified Intermediary for Tax Deferred Exchange of Real Estate.

Inauguration of Expanded E-mail Distribution of *Exchange News*. For a number of years this newsletter has been mailed each season to an increasingly large number of exchangors and real estate professionals. E-mail copies also have been sent to a growing number of recipients. Of course each newsletter is added with past editions to our Web site. With this Spring 2004 edition, we are adding many real estate professionals to our e-mail address list and making e-mail our primary distribution method. For those of you currently receiving this newsletter by mail, we encourage you to consider e-mail receipt in the future. Just visit our web site www.1031.us and click on the "Subscribe to *Exchange News* by E-mail" button on the left side of our Home page and you will be able to give us your e-mail address. We encourage you to switch over.

Replacement Property Holding Period. We get many questions asking, "How long do we have to hold the replacement property?" The answer depends on whether the exchangor wants to do another exchange or convert the property to personal use status. IRC Section 1031 requires that the replacement property **be held** for investment, business (including rental) or production of income. Uncertainty occurs because the IRS has not defined how long the property must be held in that status.

If, after receiving the replacement property the exchangor receives an offer he cannot refuse, he **may do another exchange** regardless of the time the property was held. Most often exchangors are asking the question because they desire to convert the property to personal use, either as a second home or principal residence. Most tax advisors suggest that if the original intent was to hold the property for investment or business purposes, a one year holding period before converting the property should be sufficient. The IRS did state in 1984 in Private Letter Ruling 8429039 that a two year holding period would be sufficient. Since then, legislative proposals have been made as far back as 1989 that for the exchange to qualify for tax deferral, the replacement property must be held in investment or business status for at least one year. After a taxpayer holds a property as a rental, then converts it to his principal residence, two years later they can sell it and exclude all the gain up to $250,000 if single, or $500,000 if married and filing jointly. For more information see **"Great Tax Break!"** on our website www.1031.us.

New Regulation for Replacement Property Depreciation. In January 2000 IRS Notice 2000-4 provided guidance on how to depreciate like kind exchange replacement property. Now the IRS has released temporary and proposed regulations on the topic. In Notice 2000-4 the IRS favorably changed the way new replacement property was to be depreciated. Under the new regulation (T.D. 9115) the general rule remains that the taxpayer must depreciate the remaining relinquished property adjusted basis over the remaining recovery period using the same depreciation method as if it were a continuation of the relinquished property depreciation schedule. Any increase in the basis will be treated as newly acquired property and will be depreciated over 27.5 or 39 years using a new separate straight line depreciation schedule. The new regulation does permit the taxpayer to **elect out of the rules** and to treat the entire replacement property as a new asset. The new regulation applies to exchanges completed after February 27, 2004. For complete details see Federal Register of March 1, 2004 (Vol. 69, Number 40), pages 9529-9547 at www.gpoaccess.gov/fr/index.html, then search for Depreciation.

Combining a 1031 Exchange and a Private Annuity Trust. Often we get a call with a scenario like this – "I want to sell my highly appreciated rental or investment property for $1 million and exchange for a $500,000 property." If the taxpayer were to do such an exchange, then he would have to pay capital gains tax on up to $500,000 of gain. A solution is for the taxpayer to combine a 1031 like kind exchange with a Private Annuity Trust (PAT).

In a PAT the taxpayer transfers (sells) an appreciated asset to a family controlled trust (the PAT) for an annuity contract. The PAT then sells the property and uses the proceeds to fund the annuity. The capital gain (depreciation and profit) is tax deferred until the taxpayer (annuitant) begins to receive payments.

When the taxpayer desires a lower priced replacement property for income, business, or maybe personal purposes, a like kind exchange and a private annuity trust can be combined to defer all of the capital gain taxes. The steps are for the taxpayer to transfer (sell) the desired percentage of the property to the PAT. The remaining taxpayer's interest and the PAT's interest are then sold to a third party buyer. The interest still belonging to the taxpayer is transferred as part of a regular like kind exchange. At settlement the proceeds are split, with part going to the PAT and the balance to the Qualified Intermediary as Exchange Escrow Funds. The replacement property is then purchased as in a regular exchange. The funds received by the PAT are used to fund the annuity. For more information on making a like kind exchange and a PAT work, contact Bill Horan at bill@1031.us. For a detailed explanation of a PAT go to www.nafep.com and select "Capital Gains tax planning." ***SEE UPDATE BELOW***

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Replacement Property Holding Period – Private Annuity Trust

***PRIVATE ANNUITY TRUST UPDATE: On October 17, 2006, the Department of Treasury and the IRS issued proposed regulations that would no longer allow the deferral of capital gains in private annuity trusts which are funded by exchanges of appreciated property. If adopted, the proposed regulations will apply to transactions not completed before October 17, 2006. View the IRS announcement of the proposed regulations at http://www.irs.gov/newsroom/article/0,,id=163570,00.html.