Real Estate Fall/2008

Exchange News

Realty Exchange Corporation

Your Nationwide Qualified Intermediary for Tax-Deferred Exchanges Since 1990

SECTION 468B REGULATIONS For some years the exchange industry has been waiting for the IRS and the Treasury to modify regulations Sections 468B and 7872 to cover exchange escrow funds and below market loans. The new regulations will be effective for exchanges and relinquished property sold on or after October 8, 2008. The final published regulations have minimal impact on exchangors and follow the positions advocated by the Federation of Exchange Accommodators and small independent Qualified Intermediaries (QIs). In summary it will be business as usual for most exchangors and QIs.

The final regulations exempt exchanges from Section 7872 if the escrow funds are $2 million or less and the funds are held for 6 months or less. In addition, exchange escrow funds over $2 million are not treated as a loan to the QI if, in accordance with the exchange and escrow agreement, all the interest earned in the account is paid to the exchangor, and if the exchange funds are held in a separately identified account with the exchangors tax identification number. As before the exchangor must treat interest funds earned on the escrow account as interest income and pay taxes as required. Realty Exchange Corporation (REC) will, through our Exchange and Escrow Agreement, insure strict compliance with the new regulations.

INCLUSION OF PEACE CORPS AND INTELLIGENCE OFFICERS IN THE SECTION 121 TAX BREAK
After a long hard battle in 2003, H.R. 3365 became law and amended IRC §121 to suspend for a maximum of ten years the running of the five-year period while the taxpayer or their spouse is "serving on qualified official duty as a member of the uniformed services or the Foreign Service". It now includes certain members of the intelligence community. Under the recent '2008 Heroes Act,' a new rule was created for Peace Corps volunteers and certain employees that is similar to the rules that already apply to the military, Foreign Service and intelligence community. The new rules are effective for tax years after December 31, 2007.

SECTION 121 CHANGE MAY AFFECT YOUR SECOND HOME PLANNING Under IRC §121 a taxpayer can exclude up to $250,000 ($500,000 for married couples filing jointly) of the gain realized on the sale of a principal (primary) residence if they have owned and occupied the residence for any two years during the five-year period preceding the date of sale (settlement). If a property converted to a principal residence was received in a Section 1031 like-kind exchange, it must be owned for at least five years to be eligible for the exclusion. The taxpayer still must have used the property as a principal residence for two of the past five years. Many exchangors do a 1031 exchange and then, after qualifying the replacement property, convert the property to their principal residence. When they sell the property after five years of ownership, they use IRC Section 121 to exclude their gain up to $500,000 (including the gain deferred by the exchange and when the property was a rental). However, due to an amendment to IRC Section 121 effective January 1, 2009, this will all change.

Before the President signed H.R. 3221, the Housing Assistance Tax Act of 2008, on July 30, 2008, a revenue-raising provision first promoted by Representative Charlie Rangel (D, N.Y.) was included by the conference committee as Section 3092 of the bill. This provision is an amendment to Section 121 and has a major impact on small landlords and taxpayers who were planning to convert their rental or second home to a principal residence and then exclude any gain from their income when they sell the property.

The term **Period of Non-Qualified Use** is very important and means any period during which the property is not used as the principal residence of the taxpayer, the taxpayer's spouse, or a former spouse. Importantly, the period before January 1, 2009, is excluded. In addition, subsection (4)(C)(ii) of the amendment provides additional exceptions to Period of Non-Qualified Use. These exceptions are (1) any portion of the five-year period (as defined in Section 121(a)) which is after the last date that such property is used as the principal residence of the taxpayer or spouse, (2) any period not exceeding 10 years during which the military or foreign service taxpayer, or spouse, is serving on qualified official extended duty as already defined, and (3) any other period of temporary absence (not to exceed a total of two years) due to change of employment, health conditions, or such other unforeseen circumstances as may be specified by the HUD Secretary.

The amendment states "gain shall be allocated to periods of non-qualified use based on the ratio which (i) the aggregate periods of non-qualified use during the period such property was owned by the taxpayer, bears to (ii) the period such property was owned by the taxpayer." How does this affect your second home planning? Suppose the taxpayer exchanged into a residence and rented it for four years, and then moved into it and lived in it for two years. The taxpayer then sold the residence and realized $300,000 of gain. Under prior law, the taxpayer would be eligible for the full $250,000 exclusion and would pay tax on $50,000.

Under the new law, the exclusion would have to be prorated as follows:

- Four-sixths (4 out of 6 years) of the gain, or $200,000 would be taxable and thus would be ineligible for the $250,000 exclusion.

Importantly, non-qualified use prior to January 1, 2009, is not taken into account in the allocation for the non-qualified use period, but is taken into account for the ownership period. Thus, suppose the taxpayer had exchanged into the property in 2007, and rented for 3 years till 2010 prior to the conversion to a primary residence. If the taxpayer sold the residence in 2013 after three years of primary residential use, only the 2009 rental period would be considered in the allocation for the non-qualified use. Thus, only one-sixth (1 out of 6 years) of the gain would be ineligible for the exclusion (1/6 * $300,000 = $50,000 ineligible).

In general, the allocation rules only apply to time periods prior to the conversion into a principal residence and not to time periods after the conversion out of personal residence use. Thus, if a taxpayer converts a primary residence to a rental and never moves back in and otherwise meets the two-out-of-five year test under Section 121, the taxpayer is eligible for the full $250,000 exclusion when the rental is sold. This rule only applies to non-qualified use periods within the 5-year look-back period of Section 121(a) after the last date the property is used as a principal residence.

This section of the bill will have a negative impact on millions of second home owners of both rental and vacation homes who had planned to turn the property into their principal residence. Investors and real estate agents must become familiar with the impact of this legislation and the impact on their own and their customers' planning.

FARM BILL CHANGES TO SECTION 1031 LAW The Farm Bill which became law on May 22, 2008, amended IRS §1031(a)(2)(B) to exclude from the term "stocks," mutual ditch, reservoir, or irrigation company stock. Otherwise they would not be eligible for a 1031 exchange. The stock has to be recognized as real property or interest in real property under state law where the company is located. Exchangors should be very cautious and get legal advice before trying to use the provision of the amendment.

FTC REJECTS FEA REQUEST FOR RULE As we have mentioned in a previous newsletter, the Federation of Exchange Accommodators (FEA) petitioned the Federal Trade Commission (FTC) to develop a rule relating to Qualifying Intermediaries (QIs). The FEA rule proposed in the petition would establish a mandatory registration process and operational standards for QIs. The Commission (FTC) concluded 4 to 0 that the proposed rule is not likely to reduce any harm, that the potential costs of the rule making and proposed registration process would outweigh the likely benefits of the proposed remedy, and that the overall incidence of the problem does not warrant a rulemaking proceeding. The Commission therefore determined that rulemaking proceeding would not be in the public interest at this time. However, FEA members continue to follow ethical and fidelity policies set forth in the proposed rule.

CREDIT OF $7,500 FOR NEW BUYERS MIGHT HELP SELL INVESTMENT PROPERTY Investors should be aware that in the thick documentation of the Housing and Economic Recovery Act of 2008 it states that new buyers may claim a tax credit of up to $7,500 if they or their spouse have not owned a home as a principal residence for the past three years. If you sell to or do an exchange of a relinquished property this year or before June 30, 2009, with a taxpayer who qualifies as not having owned a home for three years, the buyers may claim the tax credit of up to $7,500 on their federal income tax filings. This is being pushed nationwide by Realtors®. Make sure they all know that you have a residential property on the market for sale and will be doing an exchange. The Section covering the $7,500 credit is Subtitle B, Section 3011 of H.R.3221.

IRS GUIDANCE ON REVERSE AND REGULAR EXCHANGE In a situation that will apply to few of us, the IRS has issued a Legal Memorandum (ILM 200836024) that basically says that a single property could be a relinquished property in both a reverse exchange (covered under Revenue Procedure 2000-37) and a regular deferred exchange under IRC §1031(a). Since the ruling and transaction are very complex and the transactions stretches over a two year period, the actual IRS Legal Memorandum is available to you if you will request a copy from ed@1031.us.

IRS PRIORITY GUIDANCE PLAN Each year the IRS publishes a list of activities on which they will concentrate their work during the coming fiscal year. With suggestions from the exchange industry, they have included one 1031 item for the upcoming year that is of concern to exchangors: "Guidance under §1031 regarding the treatment of accounts held jointly by the taxpayer and a qualified intermediary."

TREASURY INSPECTOR GENERAL REPORT After 10 months of hard work the Treasury Inspector General for Tax Administration published his report in September 2008 on the 1031 industry, FEA and QI member efforts to promote security of exchange funds. The report recommends two specific actions by the IRS. These were that the IRS Publication 544, Sales and Other Dispositions of Assets, be expanded to include a fuller explanation of IRC §1031 and the risks involved and to more fully explain the safe harbor provisions contained in the 1031 regulations pertaining to the escrow procedures and options as they are set forth in Section 1.1031(k)-1(g) Safe Harbors. The IRS reported that the number of exchanges more than doubled between tax years 2001 and 2005. It reported that in tax year 2005 alone over $101.3 billion was recorded in deferred gains in over 429,000 like-kind exchanges. It is important to note that the report did not recommend increased oversight of QIs and the exchange industry.

WE ARE MOVING! Our new address is 7400 Heritage Village Plaza, Suite 102, Gainesville, VA 20155. Everything else remains the same. Same 800#, same main phone number & same fax number.

Realty Exchange Corporation

Call Bill Horan, CES® or Cindy Dove, CES®

800-795-0769

Email Bill or Cindy directly from our website:

www.1031.us/ContactUs/

7400 Heritage Village Plaza, Suite 102
Gainesville, VA 20155