



# Exchange News

## *Realty Exchange Corporation*

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**Revenue Procedure 2008-16.** Last year the IRS promised to give us more guidance on vacation homes. Revenue Procedure 2008-16 is an effort in this direction. The purpose of the Revenue Procedure is to provide a Safe Harbor under which the IRS will not challenge whether a dwelling unit with limited personal use qualifies as property held for productive use in a trade or business or for investment.

This Revenue Procedure is just a Safe Harbor. An exchange may fall outside these specific parameters and yet still meet the statutory requirements for an exchange. A taxpayer utilizing the Safe Harbor in this Revenue Procedure also must satisfy all other requirements for a like-kind exchange under Section 1031 and the regulations there under. The revenue procedure is effective for exchanges of dwelling units occurring on or after March 10, 2008. We have the revenue procedure 2008-16 on our web site at [www.1031.us/IRS](http://www.1031.us/IRS).

**Related Party Private Letter Rulings.** The IRS has been busy over the past few years issuing several Private Letter Rulings (PLRs) pertaining to related parties. Going back to 2004, the IRS provided taxpayers with PLR 2004-0002, and more recently, PLR 2006-16005 and PLR 2008-10016 reaffirming the same position. Under these rulings, if an exchanger sells to an unrelated party and buys from a related party seller who is also doing an exchange and not cashing out, Section 1031(f) (the related party rules) will not make the exchange immediately taxable because the transaction does not have a tax avoidance purpose.

Taken together the PLRs emphasize two basic principles. The first principle is that if the related party also does an exchange of his or her relinquished property (which is also the taxpayer's replacement property), then the taxpayer may do an exchange with the related party. The second principle is that while 1031(f) does not apply immediately, the two-year holding period still applies to both parties, and they must hold their replacement properties for two years after the acquisition. The most important test to determine if 1031(f) applies is if there is a basis shift along with a cashing out by one of the parties in the related party group. In addition, in PLR 2006-16005, the IRS has ruled that if the taxpayer receives cash boot in the transaction from the QI, only the excess cash received would be taxed. As with any PLR, the holdings only apply to the specific taxpayer and the specific set of facts.

**Basis Shifting.** Section 1031(f) was added to the Internal Revenue Code by Congress in 1989 to avoid basis shifting between related parties in an exchange. What is basis shifting? Let's use an example of a basis shift between Father and Son. Father has owned an apartment building for many years which is now worth \$1 million. The apartment building has a low tax basis of \$300,000 (cost less depreciation). If Father sold the property today, he would recognize gain and have a very large tax bill. Father does not like to pay taxes. Son just bought an office building for \$1 million. Father wants to sell the apartment building but does not want to pay taxes, and among the family, they know the office building is a great investment. Father exchanges the apartment building worth \$1 million directly with Son for the office building worth \$1 million. Father now owns an office building worth \$1 million with a \$300,000 basis. Son now owns an apartment with a \$1 million basis. Son immediately sells the apartment for \$1 million. Son would have no taxes due since his basis was \$1 million and the sale was \$1 million. Father exchanged the \$1 million apartment with son for the \$1 million office building and defers all the tax. Among the family they shifted the basis. They kept the office building, got rid of the apartment building, and didn't pay taxes. Section 1031(f)(1) of the Code provides that a taxpayer can exchange with a related person and there will be no recognition of gain if both parties hold the properties for two years. Section 1031(f)(2)(C) of the Code provides "with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of federal income tax." By doing an exchange among related parties, they sold the property they wanted to sell and kept the property they wanted to keep and didn't pay taxes. If Son had kept the apartment building for two years everything would have been fine. In a recent PLR 2007-30002, the IRS analysis was revealed on a basis shift. To modify our example, if Son had a very low basis in the office and exchanged with Father, who also had a very low basis, and then Son immediately sold the property – what would the tax bill be? If Son had a larger tax bill

than Father would have paid if Father had sold – the IRS would allow the transaction – i.e. there was no tax avoidance purpose. Among the related parties, they paid just as much tax as if Father had just sold the property.

**Two Years After Spouse Dies.** Under the previous rules, a surviving spouse only had until the end of the year of death to sell the primary residence and claim the \$500,000 exemption. In late December 2007, the President signed H.R. 3648. This legislation includes a section which allows a surviving spouse to claim the maximum \$500,000 if the home is sold within two years after the date of the spouse's death. Other tests have to be met as well. This section applies to sales after December 31, 2007.

**Exchangor and LLC, PLR 2008-07005.** In this PLR, the IRS explicitly approved an agreement in which the taxpayer/exchangor proposed to acquire replacement property as a single member LLC in a like-kind exchange by acquiring 100% of the interest in a multimember limited partnership (LP) that owned the replacement property. The IRS ruled that the taxpayer would be treated as having acquired the real property owned by the LP. The taxpayer will own the LP as a disregarded entity.

This information has been copied from the FEA Capital Update, dated Feb. 27, 2008. As always with any PLR, the ruling cannot be cited as a precedent. However, the ruling is useful for the purpose of demonstrating the current thinking of the IRS on this important subject.

**Tax Free Exchanges Computer Course.** Have you thought about taking a like-kind exchange computer course? For a number of years Ed Horan's Tax Free Exchanges on-line course has been available from CompuTaught and through local real estate schools. A recently updated version is now available -- go to [www.careerwebschool.com](http://www.careerwebschool.com) and select the state you desire. The course is available on-line or in CD-ROM format. This course is also included in some on-line state renewal packages available for real estate agents to meet their continuing education requirements. For more information on the computer course, call CompuTaught at 1-888-553-1267.

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