

Virginia Exchange Facilitators Act. To ensure security of exchange funds, the Virginia Legislature has passed and the Governor has signed VA House Bill 417, Exchange Facilitators Act in early April. The bill becomes effective July 1, 2010. We, along with the national Federation of Exchange Accommodators and Virginia Association of Realtors, have been promoting this bill and are thankful it has become law. Realty Exchange Corporation is in full compliance with the law and fully supported its passage. If you have a potential exchange on a VA property, please make sure your qualified intermediary is in full compliance with this new VA law. A copy of the bill can be found here: www.1031.us/VA/VA.htm

Conversion to a Principal Residence, Goolsby Case Lessons Learned. Many of our clients are following a strategy to convert their investment properties to their principal residence and are using the principal residence exclusion to avoid paying taxes. We recently wrote an article explained the rules for converting a rental property into a primary residence and the rules for claiming this great tax exclusion when you eventually sell the property as a primary residence. The full article can be found here: www.1031.us/Articles/Converting.html. Section 1031(a) of the tax code provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for a like-kind property that is to be held either for productive use in a trade or business or for investment. How do you prove the property you are going to exchange into is to be held for productive use in a trade or business? It all depends on your intent and your actions.

In April of 2010 a tax court decision was issued in the case of Goolsby v. the IRS Commissioner, and there are lessons to be learned from this case. The Goolsby family moved from CA to GA in 2003. They set up a 1031 exchange for a CA investment property, and exchanged into two properties in GA. The Goolsby family then moved into one of the GA exchange properties two months later (uh-oh). The IRS challenged that the property did not qualify as an investment property as defined by Section 1031(a). Mr. Goolsby argued that he had tried to rent out the property by putting an ad in the local paper for a couple months but was unsuccessful in renting the property.

The court dug a little further and discovered that the Goolsbys made the purchase of the exchange property in GA contingent on the sale of their personal residence in CA, and never researched rental opportunities in the area or determined if the neighborhood association would allow them to rent the property. They also learned Mr. Goolsby contracted to have the basement finished two weeks after taking title and that he also discussed with the qualified intermediary if he needed to rent the property out before moving into it. The court determined that the Goolsbys never intended to hold the property as an investment and had every intent to move in. The activities the Goolsbys undertook (making the purchase of the property in question contingent on their home sale, adding a new basement two weeks after they purchased, and inquiring if they needed to rent out the new property), along with their lack of other logical investment activity (not exploring rental opportunities in the area, not checking with the HOA if they could even rent, and minimal effort to attempt to rent) all combined to clearly show their intent was to make the new property a home right away. Activity to prove intent to hold the new replacement property as an investment before converting the property to a primary residence was clearly shown as critical in this court case. We are always asked, as Mr. Goolsby asked his qualified intermediary, whether the exchanger has to rent out his new property before moving in. Technically the answer is no, but the exchanger must have all the activity that goes along with buying and holding an investment property. To be safe, this would mean holding it for two years without personal use.

Claiming Losses

As part of the same case, the Goolsbys claimed all their rental activity losses against their income. Mrs. Goolsby's only activity was manager of their real estate holdings. They claimed she spent the required 750 hours managing the properties to meet the requirements for being a real estate professional (Section 469(c)(7)(B)). The Goolsbys didn't keep very good records and created activity records after their tax return was selected for audit. There was no other evidence to back up the activity logs - no appointment books, calendars, or summaries.

The court decided that the Goolsbys did not meet the requirements of 469(c)(7)(B).

The court found the Goolsbys liable for the accuracy-related penalty due to a substantial underpayment of tax. Not only did they owe the taxes due, they also had to pay a large penalty.

The lessons learned from this case are that you must show and prove intent to hold the replacement property as investment, business or rental property before you convert the property to a new primary residence. These cases take forever -- this case was about 2003 and 2004 tax returns but wasn't decided until April 2010.

IRS Rev. Procedure 2010-14. The purpose of this new revenue procedure is to provide a safe harbor method of reporting gain or loss for certain taxpayers who initiate deferred like-kind exchanges under §1031 of the Internal Revenue Code but fail to complete the exchange because a qualified intermediary (QI) defaults on its obligation to acquire and transfer replacement property to the taxpayer. This revenue procedure is effective for taxpayers whose like-kind exchanges fail due to QI default occurring on or after **January 1, 2009**. Taxpayers effected prior to that date may file an original or amended return. A copy of the Revenue Procedure is available at <http://www.1031.us/PDF/RevProc2010-14.pdf> and was included in [IRB 2010-12](#), dated March 22, 2010.

Capital Gain Tax Rate Increases after Jan. 1, 2011. Unless Congress does otherwise, the current capital gain tax rate of 15% will "sunset" at the end of 2010. The capital gain tax rate on the sale of real estate will revert to 20% on January 1, 2011. Also, beginning in 2013, there will be a 3.8% Medicare tax on certain investment income, including capital gains subject to income tax. The new tax will apply to single taxpayers with taxable income over \$200,000 and married ones with income over \$250,000.

Taxpayers doing a like-kind exchange, regardless of income, will be able to defer capital gains of 20% starting in 2011 along with the depreciation recapture tax of 25%. And beginning in 2013, affected taxpayers can defer their capital gain and Medicare Contribution tax (imposed by the 2010 Reconciliation Act) by deferring the gain through a 1031 like-kind exchange for which Realty Exchange Corporation acts as the qualified intermediary.



Bill Horan, bill@1031.us
7400 Heritage Village Plaza #102
Gainesville, VA 20155
703-754-9411 or 800-795-0769
Fax 703-754-0754
www.1031.us

Certified Exchange Specialist® on Staff
Member of the Federation of Exchange Accommodators

This publication is designed to provide accurate information on tax-deferred exchanges. The publisher is not engaged in rendering legal or accounting services. If legal or tax advice is required, the services of a competent professional should be sought.