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Corporate Title Exchange Services Est. 1995



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Did you know?

Corporate Title Exchange Services is updating its website to include a "Frequently asked questions and their answers" link. This will assist anyone new to the 1031 exchange process with the most commonly asked questions regarding a 1031 exchange. Please be sure to visit www.CTExchange.com to view the latest changes.

Recent Letter Rulings, Regulations, Announcements, etc...

Vacation Homes qualification alert! In *Barry E. Moore et ux, v Commissioner*: T.C. Memo. 2007-134; No. 11002-03 on May 30, 2007, the Tax Court found that a vacation home that was held primarily for personal use would **not** qualify for 1031 tax-deferral, since the taxpayer's use was not consistent with the intent to hold the property as an investment.

The taxpayer used their relinquished property approximately 2-3 weekends per month from April to Labor Day for many years, solely for recreational purposes and less in the time before they sold. They used the replacement property even more often for personal and recreational use. While the Internal Revenue Service argued that the Taxpayers' *primary* purpose in holding the properties should control any such "held for" determination, the Taxpayers argued that the holding requirement of §1031 is satisfied if investment is one of several purposes in holding the properties. The Tax court agreed with the Service that the Taxpayers' primary intent of ownership for both properties was for personal use, not for investment. The ruling mentioned the following aspects:

- Taxpayers' primary use of the property was personal enjoyment and recreation
- Taxpayers' mere hope or expectation of appreciation cannot in and of itself establish an investment intent
- Taxpayers neither rented, nor attempted to rent the properties at any point;
- Taxpayers failed to claim any tax deductions for maintenance expenses or depreciation connected with the properties
- Taxpayers treated all of their interest deductions for 1996-1999, and most of those deductions for 2000-2002 as home mortgage interest rather than investment interest
- Taxpayers' lack of upkeep of the relinquished property is inconsistent with an intent to protect and maximize an investment, and such upkeep was tied to Taxpayers' personal use of the property

So, although it is possible for a Second/Investment home to qualify, this is just another example that vacation homes and second homes held primarily for personal use do **not** qualify for exchange treatment. And, any properties that a taxpayer purports to hold primarily for investment purposes may find the intent compromised by significant personal use of the property.

Proposal to increase the amount of time to identify/acquire property

There is currently a proposed bill in the House of Representatives, which would amend the Internal Revenue Code to increase the time that taxpayers may use to make a tax-free exchange of like-kind property. The proposal seeks to change the 45 day identification period to 90 days and the acquisition period of 180 days to 360 days. Further updates will follow as more information becomes available.

Refinancing

Taxpayers often question whether it is possible to refinance or place a mortgage on the Relinquished or Replacement properties without creating any type of "boot" scenario. Both can be done, although it appears as though post-exchange refinancing is viewed more favorably by the IRS.

Pre-Exchange Refinancing: The IRS will look at whether the pre-exchange refinancing is part of the exchange itself, or whether it has separate merit and basis. Some of the items the IRS will look at when making the determination as to whether to construe the financing as boot include:

- Whether the taxpayer ever bore the risk of repayment of debt so as to permit the normal non-realization

treatment of a refinance transaction;

- If the debt "came to rest";
- If the refinancing was not conditioned upon completion of a relinquished property transfer or part of the same closing or escrow process;
- If credit evaluation is involved, it should be the taxpayer's credit, not the new buyer's.
- If the pre-exchange refinancing is completed as part of an integrated transaction that includes the exchange, any cash received by the taxpayer from a lender will be treated as cash received upon the disposition of the relinquished property.

Post-Exchange Refinancing: These seem to be of less concern

from a tax perspective. Here, the taxpayer remains liable for repayment of the debt and so it is not necessarily an increase in wealth. Thus, even where a new loan is obtained at the time of acquisition or immediately thereafter, receipt of cash by the taxpayer should not be treated as boot.

Another factor which may help in either scenario is TIME: Where the refinancing on Relinquished Property is done well before any exchange, there is a greater likelihood the IRS will view the refinancing as a separate independent transaction. And, doing a post-refinance transaction when "the exchange is old and cold", will only increase the likelihood that the IRS will not treat the refinance proceeds as cash boot.

A Brief History of the Tax-Deferred Exchange

Income taxes were first imposed in 1918 and a provision for the nonrecognition of gain or loss on the exchange of property was introduced in 1921. The nonrecognition provisions of the Revenue Act of 1921 remained relatively the same between 1928 and 1984. In the Tax Reform Act of 1984, there were two major substantive changes: 1) interests in a partnership were added to the list of assets that were not eligible for nonrecognition treatment and 2) time restrictions were provided for delayed/non-simultaneous exchanges. The next change with respect to 1031 exchanges occurred in the Omnibus Budget Reconciliation Act of 1989 (OBRA 89), which provided for

new rules in dealing with related parties and adopted a special rule for foreign property. Since 1989 there have been a few changes, including providing a detailed process for identifying replacement property, providing for four safe harbors to deal with the constructive receipt issue and the treatment of interest, and in 2000, providing for reverse exchanges. Although 1031s were once only used by the most aggressive taxpayers, as a result of all of the changes that have occurred over the years, the 1031 exchange has become a vehicle that is now used by even the most conservative taxpayer in the deferment of capital gains taxes.

The above is merely an overview and is not to be construed as tax advice. A taxpayer should always consult his/her tax advisor to determine the treatment of all of your costs associated with the relinquished and replacement property closings and to determine the exact amount the taxpayer needs to reinvest to fully defer his/her gain.



Certified Exchange Specialist on Staff



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