

Volume 2, 2008 Edition

April-June 2008



Newsletter

April—June 2008

Corporate Title Exchange Services *Est. 1995*



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Did you know?

The Michigan capital gains tax rate has risen from 3.9% to 4.35%, which is the same as the ordinary income rate.

§1031 has been amended by the Farm Bill to provide that mutual ditch, reservoir or irrigation company stock is not excluded under §1031(a) as “stocks”. However, the Bill did not indicate whether these types of stock may be exchanged for other types of real estate, just that it is not included in the definition of “stocks”. Therefore, until clarified, it may be prudent to exchange those types of stocks for the same type of stock to ensure tax-deferral of the gain.

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

Acquisition of partners’ interests in a partnership qualifies for tax-deferral.

The IRS issued a very interesting Private Letter Ruling in LTR 200807005, regarding the acquisition of 100% of the interests of the partners in a limited partnership. In this scenario, the Taxpayer was a limited partnership that owned real property and wanted to exchange that real property in exchange for 100% of the partners’ interests in a different limited partnership. Further, Taxpayer wanted to acquire the interests in the name of a single member LLC.

As you may know, a single member (wholly-owned) limited liability company, is disregarded for federal tax purposes, so a taxpayer may sell in his individual name or entity name and purchase in the name of a single member LLC in which he or it is the sole member.

Further, the IRS stated that, pursuant to Rev. Ruling 99-6, the Seller partnership is considered terminated under §708(b)(1)(A) and to have made a liquidating distribution of its real property assets to its partners & the Taxpayer is treated as having acquired such real property assets for federal tax purposes. Since the Taxpayer acquired 100% of the partners’ interests in the seller Partnership, the Taxpayer was treated as having acquired the real property assets of the seller Partnership rather than acquiring the partnership interests from the partners.

Thus, the IRS ruled relative to this Taxpayer’s exchange, for purposes of §1031(a)(1), the Taxpayer’s receipt of 100% of the interests of the partners in a partnership that hold real property, by a disregarded entity created by the Taxpayer to receive the real property will be treated as the receipt of property that is like kind to the real property of which the Taxpayer disposed, so long as all other §1031 requirements are met.

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Related Party Exchange allowed. In another Private Letter Ruling (200810016), the IRS addressed a taxpayer entity's acquisition of replacement property from a related party. The Taxpayer LLC (TP) and the seller entity of the Replacement Property (Seller LLC) were related parties as defined in §1031(f)(3). TP wanted to convey its Relinquished Property to an unrelated buyer, then acquire Replacement Property from related Seller LLC. Further, Seller LLC wanted to also effectuate a §1031 exchange and sell the Relinquished Property to TP in exchange for Replacement Property from an unrelated seller. The IRS ruled that since both TP and Seller LLC had structured their transactions as like-kind exchanges, there was no "cashing out" of either party's investment in real estate, neither party would receive cash or non like-kind property (except for some possible boot) in return for the Relinquished Property and both parties were going to retain their Replacement Property for at least two (2) years after receipt, §1031(f) will not apply to require gain recognition by either TP or Seller LLC.

A similar decision was made in Private Letter Ruling 133907-07. The IRS had focused on the fact that both the Taxpayer and Related Party were effectuating a §1031 exchange and were not "cashing out" and both were going to meet the two-year holding period.

Foreclosure Property:

With the current state of the economy and job market, we are, unfortunately, not only seeing a slow down of closings and exchanges (with many companies closing its doors or significantly reducing its workforce), but also numerous foreclosures. Thus, it is a good time to address how a foreclosure works in connection with a §1031 exchange.

If a taxpayer has a property which is about to go into foreclosure, they may have zero or even negative equity. Since a foreclosure is a taxable event and for income tax purposes, it is treated as a sale even due to its involuntary nature, the taxpayer may have to pay gain on the foreclosure. If non-recourse debt is involved, the amount realized would be equal to the outstanding amount of such debt, regardless of the current fair market value ("FMV") of the asset. If recourse debt is discharged through a foreclosure, the transaction is treated as (i) a sale of the real estate for its FMV (with gain equal to the difference between the FMV and adjusted basis) and (ii) cancellation of debt income, taxed at ordinary rates, for the amount of the debt relieved that exceeds the FMV. There are some exceptions to recognition of the cancellation of debt income in the tax code for insolvent and bankrupt taxpayers, on which a taxpayer would want to check with his CPA or accountant.

Therefore, the taxpayer may want to effectuate a §1031 exchange to defer capital gains taxes, since he would have a tax liability but no cash to pay the tax. The transaction would be structured by having the taxpayer convey the relinquished property to an intermediary ("QI") prior to the foreclosure. The lender would then foreclose on the relinquished property owned by the QI or would accept a deed in lieu of foreclosure. The QI would receive no proceeds from the sale and would not be required to spend any funds to acquire replacement property. The replacement property would, however, need to have a FMV equal or greater than the foreclosed property, and debt equal to or greater than the debt on the foreclosed property in order to avoid the receipt of boot. The taxpayer attempting to use a 1031 exchange to defer income that would otherwise be recognized on a foreclosure would have to take on a debt of equal to or greater than the debt on the relinquished property or put up the taxpayer's own cash in order to create offsetting boot given in the exchange. Further, there may be problems with transferring the legal title to the relinquished property to the QI prior to foreclosure if the lender is not willing to cooperate. In most cases, it makes sense to do the exchange. A taxpayer thinking about entering into this type of exchange should always consult with a tax professional to determine the best solution for his/her particular situation.

"Your 1031 Exchange Specialist"



Certified Exchange Specialist on Staff

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.

Should you have any items which you would like to see addressed, we welcome your feedback.

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