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Summer2006

Tax Alert

From the Tax Services Group at Hodes, Ulman, Pessin & Katz, P.A.

Like-Kind Exchange Treatment Approved for Related Party Transfers Through Qualified Intermediary PLR 200616005

The IRS recently ruled that the exchange of like-kind properties between two related parties via a qualified intermediary results in non-recognition treatment under Internal Revenue Service Code Sec. 1031 for each party if they hold their respective replacement properties for 2 years.

In general, no gain or loss is recognized on a “Like-kind Exchange” when qualified intermediaries (QIs) are used to structure like-kind exchanges.

Gain or loss on an exchange between related persons (as defined by Internal Revenue Code Secs. 267(b) or 707(b) such as family members, related corporations, etc.) must generally be recognized if either the property transferred or the property received is disposed of within 2 years after the exchange. Further, non-recognition doesn’t apply to any exchange that is part of a transaction or series of transactions structured to avoid the purposes of the related-party exchange rules. However, a disposition won’t trigger the related-party bar if it is established to the IRS’s satisfaction that neither the original transaction nor the later disposition had as one of its principal purposes the avoidance of federal tax.

This recent ruling is a departure from previous positions taken by the IRS with respect to related-party like-kind exchange. For example, in Revenue Ruling 2002-83, 2002-2 CB 927, the IRS ruled that an exchange of property between related parties did not qualify for like-kind exchange non-recognition treatment because the taxpayer used a QI to avoid the application of the related-party exchange rules. In Rev. Rul. 2002-83, A and B, related parties, used an unrelated QI, to skirt the “tax avoidance” prohibition by exchanging, in the case of A, property with a low tax basis which was transferred by the QI to an unrelated buyer and the proceeds from which were delivered to B. The property transfers took place within weeks of one another. The IRS ruled that the exchange-sale was an attempt to avoid gain on the part of A which A could not have done directly under the related-party rules.

PLR 200616005 clarified that under the right set of circumstances related-party like-kind exchanges could receive IRS approval. In PLR 200616005, the IRS ruled that neither related-party (a trust and a Subchapter “S” Corporation) would recognize gain realized on their exchange of property if they did not dispose of their respective replacement property within 2 years of its receipt. The IRS ruled the transactions were not an

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SPECIAL NOTE:

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attempt to avoid taxation since there was no "cashing out" of either party's investment in real estate. On completion of the transactions, both related parties would own property like-kind to the property they exchanged, and neither related party would be in receipt of cash or other non-like kind property (other than boot received in the exchange) in return for the relinquished property.

By keeping up to date on recent developments reflected in PLR 200616005, Hodes, Ulman, Pessin & Katz, P.A. can help you properly structure your next like-kind exchange.

What Are Your Chances of Being Audited by the IRS?

As tax practitioners, this is a question we are frequently asked by clients. To assist with answering this question, the IRS has issued its annual data book, which provides statistical data on its fiscal year 2005 activities. The 2005 IRS Data Book, a publication that contains tables on such subjects as revenue collections, audits (examinations) conducted, and refunds issued in fiscal year 2005, is now available online. The book also includes tables on appeals, criminal investigations, employee plans and exempt organizations, taxpayer assistance, information reporting, and administrative costs and personnel summaries. In addition, it has state-by-state statistics on electronic filing and other subjects. The Data Book can be found at http://www.irs.gov.

What are the chances of being examined? A total of 1,215,308 individual income tax returns were audited during fiscal year 2005 (Oct. 1, 2004 through Sept. 30, 2005) out of a total of 130.6 million individual returns that were filed in calendar year 2004. This works out to 0.93% of all individual returns that were filed. In the prior fiscal year, 1,007,874 returns were audited; the audit rate was about 0.77%. The IRS News Release announcing the Data Book points out that the number of audits rose almost 21% year-over-year.

The bulk of the audits (almost 80%) were "correspondence audits" where written inquiry is made of the taxpayer to explain details of a return rather than pure "matching" inquiries or "mathematical errors".

Almost 600,000 individual returns showed gross receipts from farming (Schedule F). Of this group, only 4,229 (0.71%) were audited in 2005. In 2004, the audit rate was significantly higher.

The audit rates for corporate returns are up, however. The rate for returns other than Form 1120S jumped to 1.24% from the .71% rate for 2004; and the audit rate for S corporations jumped to .30% from .19% for the year before. The audit rate for large corporations ($10 million and over) was 20.02% versus 16.74% for the year before.

The chances of being examined in fiscal year 2005 as compared to fiscal year 2004 for taxpayers with Total Positive Income (the sum of all income items on a return) of $100,000 and over was 1.19% versus. 1.39% of total returns filed in that category. The figures include correspondence examinations, office examinations and field examinations. The chances for audits of individuals filing Schedule C showing gross receipts of $100,000 and over was 3.65% versus 1.86%; S corporations 0.30% versus 0.19%; partnerships 0.33% versus 0.26%.

Year-over-year, audit rates in 2005 rose in all categories of individual returns except for farmers and individuals with Total Positive Income of $100,000 and over.

Not only can the experienced tax team at HUP&K provide tax advice to avoid an audit, we can help you deal with one. Low percentage statistics do not mask the individual serious nature and expense involved of an audit of any nature, a fact that compels solid legal and tax representation.

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