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NH DRA taxing 1031 Exchanges that meet IRS guidelines

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The N.H. Department of Revenue Administration (DRA) is presently opening and taxing closed Section 1031 Exchanges using unpublished and unannounced audit tactics just dreamed up in April 2008. Not only has the DRA admitted this, but in a recent submission to the New Hampshire legislature, it requested statutory authority for its tactics, which have the effect of entrapping hapless taxpayers.

In this post, you will read the moving letter of a New Hampshire couple who are caught up in this situation. These folks timely filed their taxes for 2005, and have just learned that New Hampshire will assess them, four years later.

Preface: This email was drafted by one of our clients to a state representative in NH discussing the recent position of the NH DRA to ignore the federal statute on disregarded entities. This case goes back to 2005 (the last year before the Statute of Limitations kicks in). This issue is effecting people all over the state of NH. The authors just learned of their pending liability this spring.

Date: Wed, 17 Jun 2009 03:28:23

From: client

To: NH State Representative

Subject: NH Department of Revenue Admin. Tax audit

Good afternoon:

My husband and I have a question for you in your capacity as our state representative. We're hoping that you can help us understand the NH Dept of Revenue Administration's audit of our 1031 exchange conducted in 2005. The audit and proposed tax assessment need some explanation. I will try to keep to the point, but give the basics to you in this letter.

My husband and I met you in 2005 while looking for a property in the area. We were doing a 1031 exchange from a 5-unit rental property, which we had just sold, and looking to replace that property with something less labor/management intensive. You showed us some of the lovely condo units, one of which we ended up putting on our list of 3 properties we were considering for the exchange.

In the end, we chose to exchange into a TIC interest in a large apartment complex in Dallas. Though we loved the condos, we were looking for a property that would carry us into retirement with a reliable, steady monthly income stream. The investment has worked out just as we planned until April, when we received a phone call from NH Department of Revenue telling us that our 2005 Business Profits Tax return was being audited due to that exchange. Because of the lateness of the audit, they requested an extension of time (1 year) to the statute of limitations on our tax return. We granted the extension because we were told that we would be issued a tax assessment without all the facts otherwise. We were confident that our taxes were filed properly, as they always had been before.

The Department of Revenue Administration position on exchanges:

We sent the DRA the extension as well as all of the documents requested (P and S agreements, closing statements, deeds, etc.). They recently responded with a substantial proposed tax assessment on the capital gain of our sale. They are not imposing penalties, but most likely, interest back to 2005. Though the exchange was conducted correctly according to all known guidelines, we have since learned that the DRA has begun finding many exchanges invalid in NH. The issue in our case (as in most others) is that our old property was in our names (our Inter Vivos Trust names), and the replacement property was deeded into Single Member LLCs (the Inter Vivos Trusts being the sole members of the LLCs). DRA's position is that we did not take possession in "exactly" the same name we sold in, therefore, we created a new entity, and are thus required to pay an 8-1/2% tax on our NH gain. We were astonished to learn this.

Back in 2005, we spent considerable time researching exchanges and the Dallas TIC. We followed every rule to the letter and asked every question we could think of to avoid any problems later (including questions about taking possession in LLCs). Now, again, we have poured over the statutes, rules, technical info releases and conducted searches on the DRA site; we have contacted all of the professionals we worked with on the exchange (accountant, attorney, exchange intermediary, TIC sponsor, TIC broker), and have found across the board that this is a revelation to all. The only person who had heard of the new DRA position was our TIC sponsor who had a client first audited in late 2008 for a similar reason. At this point, there is still nothing on the DRA website or in the statutes, rulings or taxpayer summaries regarding this issue that would warn an ordinary, reasonable NH taxpayer of this potential tax liability.

Our Situation:

The proposed BP tax assessment would create a great hardship to us at this point. The proceeds from our 2005 sale were rolled almost entirely into the Dallas property, as planned, and we do not have the funds available to pay the large proposed tax bill. We will be requesting a face-to-face meeting with our auditor in the next week or so. We will bring our accountant with us, but no attorney (the cost of litigating this would exceed our tax bill). We hope to convince DRA that we had no intention of creating a "separate entity" upon closing in Dallas. Single Member LLCs are widely held to be "disregarded entities" for tax purposes federally, and throughout the states, according to our conversations with exchange professionals. New Hampshire seems to be taking a position on SMLLCs that is unique and contrary to that widely held position.

Our question is, was this the intent of the NH legislature when the BP tax statute and revisions were written? Or, is DRA reading something into the statute that really isn't there? Our auditor told us in a phone call that there is no written guidance on this topic anywhere, but rather; this is DRA's "interpretation" of the language in the BPTax statute. Unfortunately, their interpretation has belated, devastating consequences for us. I am forwarding to you separately an e-mail recently received from our exchange intermediary, Edmund & Wheeler, outlining the issue for your information. If it would be helpful for you to see any of the correspondence from DRA to us, we would be happy to forward that as well. We would welcome any thoughts or suggestions you might have regarding this tax situation. As you can imagine, we're quite distressed about it. We feel that ordinary NH taxpayers should readily find guidance from the state on taxes due, without being tricked or muscled into paying a hidden tax long after the fact.

Further implications:

This situation not only affects us, but from what we understand, at least 20 other taxpayers who are also being audited for exchanges. We assume it will affect others who are in process or

contemplating exchanges today, since DRA has still not gotten the word out. If the DRA position holds fast, realtors, exchange intermediaries and TIC sponsors will also be impacted. We assume that the issue will be litigated, but not by us. We can't afford to do that. We are interested in trying to resolve our case separately and reasonably if possible, so as to avoid the unknown of awaiting a Superior Court case outcome to the problem. We hope that you can help get the word out and perhaps, bring this issue up in the legislature for some resolution and clarity so that NH citizens can make informed decisions.

We look forward to hearing your thoughts as our NH representative. Sorry for the lengthy note. This is not an easy issue for us to explain. Thank you very much for listening.

Sincerely,

Client

And what did we learn today?

That about 2 weeks ago, the NH Legislature asked the DRA for a "Wish List" of possible revenue enhancements (Translate: New Taxes), and guess what they came back with? A multi-page list of ideas, including a statement that what they began doing to taxpayers in April, 2008, be made legal by rule yet to be adopted!

What this amounts to is that the DRA itself does not think it has the proper statutory authority for an audit policy it has been pursuing for 14 months, randomly issuing Notices of Assessment to selected NH taxpayers, for tax years 2005 through 2008.

And just how are these taxpayers being chosen? Is everybody who did a Section 1031 Exchange during the affected years being audited and assessed? We think not. Evidence shows that the DRA is using some sort of "filter" to screen out certain transactions and audit others. This is wrong; we are a nation of laws and rules, so how can a government agency selectively enforce policies that have not even been written down, much less announced to the public?

And now the hang together part:

Attorneys representing several of the taxpayers have requested that the DRA combine the cases and have the merged case litigated, with all parties bound to the result. That's the hang together approach, but the DRA would rather not do that, perhaps because of its lack of authority, as above, or perhaps because it's easier to hang the taxpayers separately, and that's just what they are doing, one by one.

George Foss III is a qualified intermediary and principal with Edmund & Wheeler, Inc., Littleton, NH.

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