

## EXCHANGING WITH A RELATED PARTY

Exchanges between related parties are allowed but the Exchanger must follow specific rules before the exchange will qualify for tax deferral. Related parties are defined in IRC §267(b) and §707(b)(1) as any person or entity bearing a relationship to the Exchanger, such as certain members of a family (brothers, sisters, spouse, ancestors and lineal descendants); a grantor and fiduciary of any trust; two corporations which are members of the same controlled group; and corporations and partnerships with more than 50% direct or indirect ownership of the stock, capital or profits in these entities. Under IRC §1031(f) it is clear that two related parties, owning separate properties, may “swap” those properties with one another and defer the recognition of gain as long as both parties hold their replacement properties for two years following the exchange. This rule was imposed to prevent taxpayers from using exchanges to shift the tax basis between the properties to avoid paying taxes upon the subsequent sale of one of the properties.

Typically an Exchanger uses a Qualified Intermediary to facilitate an exchange with either a related party buyer who purchases the Exchanger’s relinquished property or a related party seller from whom the Exchanger acquires the replacement property. Exchanges in which the seller of replacement property is the related party are less likely to qualify for tax deferral unless the related party seller also does an exchange. Under Rev. Rul. 2002-83, exchange treatment will be denied to an Exchanger who, through a Qualified Intermediary, acquires replacement property from a related party seller, if the related party seller receives cash or other non-like-kind property, regardless of whether the Exchanger holds the replacement property for the requisite two years. The IRS will generally view this transaction as yielding the same result as if the Exchanger swapped properties with a related party, and then the related party immediately sold the property acquired, violating the two-year holding requirement.

Exceptions to the two-year holding period are allowed only if the subsequent disposition of the property is due to (a) the death of the Exchanger or related person, (b) the compulsory or involuntary conversion of one of the properties under IRC §1033 (if the exchange occurred before the threat of conversion), or (c) the Exchanger can establish that neither the exchange nor the disposition of the property was designed to avoid the payment of Federal income tax as one of its principal purposes. Under IRC §1031(f)(4) a related party exchange will be disallowed if it “is a part of a transaction (or series of transactions) structured to avoid the purposes of the related party provisions.” It is also important to note that under IRC §1031(g) the two-year holding period is “tolled” for the period of time that (a) either party’s risk of loss with respect to their respective property is substantially diminished because either party holds a *put right* to sell their property, (b) either property is subject to a *call right* to be purchased by another party, or (c) either party engages in a *short sale* or any other transaction.

In PLR 200440002 the IRS ruled that §1031(f) would not trigger gain recognition in a series of exchanges involving two related partnerships that used an unrelated Qualified Intermediary since neither related party was cashing out of their investment in real estate and each related party represented that they would hold their replacement property for the required two years following their exchange. In the transaction, Partnership A sold its relinquished property to an unrelated third party buyer and purchased its replacement property from Partnership B, a related party. Partnership B then completed its exchange by purchasing replacement property from an unrelated third party seller. Upon completion of the two exchanges each party owned like-kind property and neither party received cash or other non-like kind property (other than boot received in the exchange) in return for the relinquished property. In the IRS analysis §1031(f)(1) did not apply because the Qualified Intermediary was an unrelated party, and §1031(f)(4) and Rev. Rul. 2002-83 also did not apply because the series of transactions were not set up to avoid the purposes of §1031(f). The IRS reached the same conclusion in PLR 200616005 with similar facts, except that Trust acquired Building 2 from related party S Corporation and planned to acquire additional replacement property from unrelated seller(s), or recognize boot only in the amount of cash received. The IRS permitted exchange treatment as long as Trust held Building 2 and S Corporation held its replacement property received in exchange for Building 2 for two years.

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## EXCHANGING WITH A RELATED PARTY *(Continued)*

The Tax Court confirmed the IRS position in Rev. Rul. 2002-83 that the related party rules of §1031(f) cannot be avoided by interposing an unrelated Qualified Intermediary and that these types of related party transactions are within the recharacterization rule of §1031(f)(4). The Tax Court denied exchange treatment in *Teruya Brothers, Ltd.*, 124 T.C. No. 4 (2005) because it found that a principal purpose of the transaction was the avoidance of income taxes, notwithstanding that there was no basis shifting between the related parties. When the related party sold the property it had acquired from the Exchanger within two years of acquisition, it was able to take advantage of net operating losses to offset the gain recognized on sale, resulting in less tax paid than if the Exchanger had sold the property outright.

Conversely, the IRS clarified in PLRs 200709036, 200712013 and 200728008 that there is no basis shifting or tax avoidance when the taxpayer, through an unrelated Qualified Intermediary, transfers relinquished property to a related buyer, but acquires replacement property from an unrelated seller. The exchange will be respected even if the related buyer voluntarily disposes of the property it acquired from the taxpayer within two years of acquisition. The Service's rationale was that only the taxpayer owned property before the exchange and the taxpayer continued to be invested in like-kind property following the exchange. Because the related party did not own property prior to the exchange, its subsequent disposal would not result in cashing out or basis-shifting by the taxpayer. Based upon this indication of the IRS' thinking, it appears that in a four-party exchange involving the taxpayer, a related buyer of relinquished property, an unrelated seller of replacement property and an unrelated Qualified Intermediary, that there is no requirement that the related buyer hold the asset received from the Exchanger for two years following the exchange.

The IRS also confirmed in PLR 200706001 and 200730002 that an exchange would be upheld where it could be demonstrated that there was no basis shifting and that avoidance of Federal income tax was not a principal purpose of the transaction, notwithstanding that the taxpayer and related parties swapped properties, and the related buyer voluntarily disposed of the property it had acquired from the taxpayer shortly after the exchange.

Private letter rulings are directed only to the requesting taxpayers and may not be cited as precedent. However, they are a good indication of the IRS' interpretation of this complicated section of the tax code.

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