

## EXCHANGING WITH RELATED PARTIES

There has been considerable abuse over the years by investors who have used various “related party” strategies or techniques to improperly defer, avoid and even evade the payment of income taxes liabilities. Given the potential for abuse, and the opportunity to create a more favorable tax result than if an exchange is performed between unrelated parties, purchasing a replacement property from a related party is usually frowned upon by the IRS. This has resulted in the IRS developing guidelines for Exchangers entering into 1031 exchanges with related parties. The related party 1031 exchange rules and guidance are intended to prevent Exchangers from using a tax-deferred exchange to shift tax basis between properties owned by related parties in order to reduce the actual amount of depreciation recapture and capital gain taxes recognized and paid on the sale of a specific property.

That being said, related party exchanges are permitted provided the investor follows the rules and guidelines issued by the Internal Revenue Service, as well as guidance provided by the case law. It does mean, however, that when dealing with a related party it is especially prudent to consult with your tax advisor well in advance of taking any steps to commence an exchange or even making any moves in anticipation of an exchange.

For the purposes of Section 1031, related parties are defined in Sections 267(b) and 707(b)(1) of the Code, and include: blood relatives, spouses and siblings but do not include in-laws or cousins, step-parents, uncles, aunts, nephews, nieces and ex-spouses. Related parties also include entities where the Exchanger or the related party has greater than 50% interest in that entity thus having control over that entity, or corporations where a controlling interest is owned by, or attributed to, the Exchanger or related parties.

IRC Section 1031(f) provides special rules for property exchanges between related parties. Under §1031(f)(1), a taxpayer exchanging like-kind property with a related person cannot utilize the nonrecognition provisions of §1031 if, within 2 years of the date of the last transfer, either the related person disposes of the Relinquished Property or the taxpayer disposes of the Replacement Property. If violated, §1031(f) provides that the Exchanger would recognize any gain or loss in the taxable year in which the disposition occurs. Section 1031(f) is intended to deny nonrecognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property. The legislative history underlying §1031(f) states that “if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, ‘cashed out’ of the investment, and the original exchange should not be accorded nonrecognition treatment.” H.R. Rep. No. 247, 101st Cong. 1st Sess. 1340 (1989). To prevent related parties from circumventing the rules of § 1031(f)(1), § 1031(f)(4) provides that the nonrecognition provisions of § 1031 do not apply to any exchange that is part of a transaction (or a series of transactions) structured to avoid the purposes of § 1031(f)(1). Tax Court cases have

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### DISCLAIMER

Attorneys & Accountants 1031 Services, LLC is available to assist Exchangers and their advisors with exchange strategies and technical support, however Attorneys and Accountants 1031 Services, LLC cannot provide legal or tax services or advice and the Exchanger must consult with their legal and tax professionals as to the intended exchange and any legal or tax implications

similarly denied non-recognition treatment for exchanges where the principal purpose of such exchange was the avoidance of income taxes.

In order to have a successful exchange between related parties, the exchange should not result in one of the related parties cashing out. Therefore, the Exchangor cannot obtain replacement property from a related party unless the related party also participates in an exchange. The Courts and the Service have recognized exceptions to the strict enforcement of the 2 year timeframe, but such exceptions generally relate to unforeseeable circumstances compelling a party to sell an exchanged property within the two-year period. If an Exchangor, pursuant to a pre-arranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the Exchangor within 2 years of the previous transfer in a transaction otherwise qualifying under Section 1031, the related party will not be entitled to non-recognition treatment under Section 1031.

One very important exception to the general propositions outlined above, is where with regard to tax liability, the exchange does not result in a more favorable result to the Exchangor or related party.

There have been recent cases where the IRS is displaying a willingness to be more lenient towards exchanges between related parties provided the Exchangor can show that the intent of the exchange is not to avoid taxes. The IRS recently issued two Private Letter Rulings (PLR200728008 & PLR200712013) suggesting that, depending on the circumstances, a sale to a related party may not be subject to the two-year rule.

Related party transactions are receiving a lot of attention, as private letter rulings are increasingly being sought on transactions between related parties. A number of these ruling have found exchanges to be valid under an ever increasing set of circumstances. Given the recent spate of cases coming down from the Courts, it is recommended that Exchangors seek out counsel that is up to date on the latest rulings on related party exchanges. Attorneys & Accountants 1031 Services, LLC works to provide professionals with up to date material as soon as it becomes available.

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