

RELATED PARTY EXCHANGES

"CAUTION NEEDED IN THESE TRANSACTIONS"



INTENT OF THE RELATED PARTY RULES

The related party rules were enacted to prevent related parties from "cashing out" of an investment and avoiding tax if either party's property is disposed of within two years of the exchange. In addition, Section 1031(f) states that the Internal Revenue Service reserves the right to invalidate any exchange in which the taxpayer can't prove that the "exchange" did not have a principal purpose of avoiding taxes that would otherwise be due or avoiding the purposes of the related party rules.

WHO IS A RELATED PARTY?

A related party is any person or entity bearing a relationship with the taxpayer. Although not an exhaustive definition, this includes:

- Family members such as brothers, sisters, spouses, ancestors and lineal descendants. (Stepparents, uncles, in-laws, cousins, nephews and ex-spouses are not considered related.)
- A corporation or partnership in which more than 50% of the stock or more than 50% of the capital interest is owned by the taxpayer.

LET'S LOOK AT SEVERAL SCENARIOS

Although it is important to consult with tax or legal advisors before attempting any exchange with a related party, some guidelines exist which are useful in analyzing related party exchanges.

Simultaneous Exchange

In the rare case where related parties trade deeds with each other (e.g., swap real property), both parties must hold the property acquired for two (2) years following the exchange. If either party disposes of their property within the subsequent two year holding period, then both related parties will recognize capital gains unless the subsequent disposition meets certain limited exceptions provided in IRC § 1031(f).

Selling to a Related Party Through a Qualified Intermediary

A taxpayer can sell relinquished property to a related party as part of an exchange in which the relinquished property sale proceeds are held by a qualified intermediary and used to acquire like kind replacement property. In that case, there is no exchange "between related parties" since the intermediary is unrelated to the exchanger and no related party "cashes out." A number of Private Letter Rulings indicate that the two-year rule does not apply to a delayed exchange in which the relinquished property is sold to a related party (See PLR 200706001, PLR 200712013, PLR 200728008).

Purchasing from a Related Party Through a Qualified Intermediary

A taxpayer should generally not purchase replacement property from a related party in a delayed exchange in which the related seller receives cash. See, e.g., TAM 9748006, the IRS disallowed tax deferral to a taxpayer who purchased his mother's property. Revenue Ruling 2002-83 also denied tax deferral treatment to an Exchanger using a Qualified Intermediary to ultimately purchase replacement property from a related party. More recent cases emphasize that point.

Purchasing from a Related Party Where the Related Party Performs a 1031 Exchange

If a taxpayer is purchasing a replacement property from a related party and the related party, through a qualified intermediary, uses the sales proceeds to acquire like kind replacement property, then the transactions may qualify for tax deferral. (See PLR 200440002 and PLR 2000616005). This sort of transaction should be carefully reviewed by tax counsel.)

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