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Related Party Transactions — Overview and Summary of Rules

The related party rules under Internal Revenue Code (“IRC”) §1031(f) are designed to prevent planned exchanges between related parties seeking to cash out property and avoid paying capital gains tax. The IRS continues to strictly scrutinize related party exchanges, but has recently indicated a greater willingness to allow exchanges between related parties when the parties establish that there was no basis shifting and no tax avoidance motive.

Basis shifting with a related party to avoid capital gains tax – How it works: If a taxpayer purchases a property for \$100,000, his tax basis is \$100,000. If he later sells the property for more than his basis, he will be taxed on the difference – i.e. his gain. Under IRC §1031, however, the taxpayer may defer paying taxes on the gain by exchanging the property for another property of equal or greater value.

Some taxpayers have attempted to cash out their property and avoid paying taxes on their gain by exchanging with a related party, as illustrated by the following example:

Taxpayer Tom owns Low Acre—a property with a \$100,000 basis which he would like to sell to Smith for \$500,000. Tom does not want to pay the capital gains tax on his \$400,000 gain (est. \$100,000 combined state/federal taxes). To avoid this result, Tom swaps Low Acre for High Acre, which is owned by Mother. Mother’s basis in High Acre is \$500,000. Tom now owns High Acre with a basis of \$100,000 and Mother owns Low Acre with a basis of \$500,000. Mother now sells Low Acre to Smith for \$500,000 with no gain and therefore no tax. Mother can now hand over \$500,000 in tax-free cash to Tom. The related party rules are designed to prevent this result.

For anyone contemplating an exchange with a related party, they should first understand the definition of a “related party” according to the IRC. And, second, they should also understand the rules and restrictions on transactions involving related parties.

Definition of Related Parties: A related party is anyone who bears a relationship to the taxpayer, as described in IRC Section 267(b). Related parties include members of the same family—parents, siblings, ancestors (e.g. parents and grandparents) and lineal descendants (e.g. children and grandchildren) and spouses, but do not include step-parents, uncles, aunts,

in-laws, cousins, nephews, nieces and former spouses. A taxpayer will be treated as related to an entity, such as a corporation or partnership, if the taxpayer either directly or indirectly (through family members) owns more than 50% of the shares or capital interest in such entities. Related parties also include certain fiduciary relationships described in Section 267(b).

Summary of the Related Party Rules

Buying from or swapping with a related party: An exchanger may buy from or swap with a related party if the related party also does an exchange and both parties hold their respective replacement properties for two years. See Revenue Procedure 2002-83. However, the IRS has also issued private letter rulings (“PLRs”) that are inconsistent with Rev. Proc 2002-83. See PLR 200440002 and PLR 200616005. Note, however, that PLRs are not legal precedent and should not be relied upon as such—unlike a Revenue Procedure which may be relied upon for guidance.

Selling to a related party: An exchanger may sell to a related party if the related party holds the property for two years and the exchanger holds the replacement property for two years. IRC §1031(f).

Exception to two year hold: Under any of the above scenarios, there will be no two year holding violation if the disposition is caused by the death of either the taxpayer or related party; involuntary conversion of one of the subject properties; or if the taxpayer can establish that the exchange or disposition did not have as its principal purpose the avoidance of Federal income tax. IRC §1031(f) (2); and see PLR 200709036, PLR 200712013, PLR 200728008 and PLR 200706001.

Be aware of the “catch all” provision of §1031(f)(4): Under all of the above scenarios, the exchange will nonetheless be disallowed if a transaction or series of transactions was designed to avoid the application of the related party rules under IRC §1031(f). In other words the exchange will be disallowed if it is established that the transaction was structured to avoid the related party rules.

Summary: The related party rules can be complex and any violation of the rules could result in an exchange being disallowed. Any taxpayer considering an exchange involving a related party should seek the advice of their tax or legal advisor.