

Related Party Exchanges

Exchanges between related parties are allowed but the Exchanger must follow specific rules for the exchange to qualify for tax deferral. Related party exchanges must be disclosed on IRS Form 8824.

Related Parties: Related parties are defined in IRC §267(b) and §707(b)(1) as persons or entities 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 common ownership in the entities.

Two-Year Holding Period: 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. Exceptions to the two-year holding period are allowed only if the subsequent disposition of the property is due to 1) the death of the Exchanger or related person, 2) the compulsory or involuntary conversion of one of the properties under IRC §1033 (if the exchange occurred before the threat of conversion), or 3) 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.

Related Seller: Exchanges in which the Replacement Property seller is the related party are not likely to qualify for tax deferral unless the related party seller also does an exchange. Under Revenue Ruling 2002-83, exchange treatment will be denied to an Exchanger who, through a Qualified Intermediary, acquires Replacement Property from a related party seller that 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. The related party rules of §1031(f) cannot be avoided by interposing an unrelated Qualified Intermediary.

Following Rev. Rul. 2002-83, the IRS ruled that §1031(f) would not trigger gain recognition in a series of exchanges involving related partnerships that used an unrelated Qualified Intermediary since 1) neither related party was cashing out of their investment in real estate and 2) each related party represented that they would hold their Replacement Property for the required two years following their exchange. PLRs 200440002, 200616005. The IRS has issued several rulings permitting a “daisy chain” of exchanges in which Exchanger acquired Replacement Property from a related seller who also acquired Replacement Property from another related seller, as long as the last related seller acquired its Replacement Property from an unrelated seller, and all held their respective Replacement Properties for at least two years. The IRS has ruled that a small amount of boot (5% or less) received by any of the related Replacement Property sellers, will not destroy all of the other related exchanges. PLRs 201220012, 201216007, 201048025, 200820025, 200820017.

Related Buyer: The IRS has clarified 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 likely 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 buyer did not own property prior to the exchange, its subsequent disposal would not result in cashing out or basis-shifting by the taxpayer. PLRs 200709036, 200712013, 200728008, 201027036.

Avoidance of Federal Income Tax: Under IRC §1031(f)(2)(C) and (f)(4), a related party exchange will be disallowed if it is part of a transaction (or series of transactions) structured to avoid payment of Federal income tax or the purposes of the related party rules. In determining whether these sections apply, the IRS and the Tax Court tend to look at the overall tax result of the transactions to the related parties as a consolidated unit. Even if there is no basis shifting or a prearranged plan, an exchange in which Replacement Property is purchased from a related party seller (that does not also do an exchange) will be disallowed if the related seller ultimately pays less tax on the sale of the Replacement Property than the Exchanger would have paid on the sale its Relinquished Property, due to factors such as net operating losses or lower tax rate available to the related seller. *Ocmulgee Fields, Inc. v. CIR*, 132 T.C. No 6 aff’d 613 F.3d 1360 (11th Cir. 2010), *Teruya Brothers, Ltd. v. CIR*, 124 T.C. No. 4, aff’d 580 F.3d 1038 (9th Cir. 2009), PLR 201013038, *The Malulani Group, Limited v. C.I.R.*, T.C. Memo. 2016-209, aff’d, 2019 WL2453908 (9th Cir. 2019). Conversely, the IRS has upheld exchanges 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 then the related buyer voluntarily disposed of the property it had acquired from the taxpayer shortly after the exchange. PLRs 200706001 and 200730002.