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 members of a family (brothers, sisters, spouse, ancestors and lineal descendants); a grantor or fiduciary of any trust; two corporations which are members of the same controlled group or individuals; 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 onto 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 with the intended purpose of avoiding paying taxes.

The more typical related party exchange scenarios have the Exchanger using a Qualified Intermediary to create the 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. There is some uncertainty, however, as to whether or not the IRS will treat these types of related party exchanges favorably. Most tax advisors agree that exchanges in which the Exchanger sells relinquished property to a related party buyer will have better success in qualifying for tax deferral, but only if both the buyer and the Exchanger hold onto the properties they receive in the exchange for the two-year holding period. 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 latter 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. In fact, 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.

There are many important issues regarding related party exchanges that are not clearly defined by the IRS. These issues present important tax considerations for the Exchanger that should be reviewed by tax or legal counsel to weigh the risks involved.

Investment Property Exchange Services, Inc. cannot provide advice regarding specific tax consequences. Investors considering an IRC §1031 tax deferred exchange should seek the counsel of their accountant and attorney to obtain professional and legal advice. © 2003 Investment Property Exchange Services, Inc.