Not Your Father’s 1031 Exchange: Related Party Transactions

One of the biggest obstacles in doing a 1031 exchange is finding a suitable replacement property. Property owners, and the brokers and agents that they work with, often complain that there is no inventory: there are more buyers than there are investment properties for sale, the valuations are inflated, and the economics of the transactions just do not make sense.

That is when the light bulb flickers — why not purchase that property their LLC or their corporation owns? Or how about dad’s office building? It seems to make sense — the investor is familiar with the building, warts and all, so why not buy what they know?

Not so fast. IRC §1031(f) governs exchanges involving related parties, and such transactions are subject to particular scrutiny by the IRS. When a taxpayer reports a tax deferred exchange on their tax return, they need to file Form 8824, which asks specific questions about related party transactions. These are not transactions that just slip through the audit cracks. The information is reported directly to the IRS.

The concern with these transactions is “basis shifting”: through the use of a related party exchange, a taxpayer could defer the gain on low basis property by acquiring a property from a related party who has a high basis and thus has less tax exposure. As an economic unit, the related parties could just cash out and pay less taxes than if the property had been sold to an unrelated third party.

Definition

For purposes of IRC §1031(f), related persons are those referenced in IRC §§267(b) and 707(b)(1). The list includes:

1. Members of the same family (siblings, spouse, ancestors, and lineal descendants);
2. Two corporations that are members of the same controlled group;
3. A grantor and a fiduciary of any trust;
4. The fiduciaries of two different trusts that have the same grantor;
5. A fiduciary of a trust and a beneficiary of such trust;
6. The fiduciary of a trust and the beneficiary of another trust if both trusts share the same grantor;
7. The fiduciary of a trust and a corporation, if 50% of the outstanding stock of the corporation is owned directly or indirectly by or for the trust or by or for the grantor of the trust;
8. A corporation and an individual who directly or indirectly owns more than 50% of the outstanding stock of the corporation;
9. A person and an IRC §501 tax exempt organization controlled directly or indirectly by the person or the person’s family;
10. A corporation and a partnership if the same person owns more than 50% of the stock of the corporation and 50% of the capital interests or profits of the partnership;
11. Two S corporations if the same persons own more than 50% of the stock of each;
12. An S corporation and a C corporation if the same persons own more than 50% of the stock of each;
13. The executor and the beneficiaries of an estate.
14. A partnership and a person owning directly or indirectly more than 50% of the capital or profits interest of the partnership;
15. Two partnerships where the same persons directly or indirectly own more than 50% of the capital or profits interest.

Under the attribution rules of IRC §267(c), corporate stock owned by a related party will be viewed as being constructively owned by the taxpayer. Stock owned by a corporation, partnership, trust or estate is deemed to be owned by the shareholders, partners, or beneficiaries, respectively. Likewise, an individual is considered as owning stock that is owned by his family. For example, if a father acquires replacement property from a corporation of which his son owns 52% of the shares, because the son’s stock ownership is attributed to the father, and because the son’s ownership exceeds 50%, the father is considered to be acquiring property from a related party.

Two-Year Holding Period

IRC §1031(f)(1) requires that property acquired from or transferred to a related party in a 1031 exchange be owned by the relevant party for two years after the exchange is completed. If either party sells their property, the exchange could be invalidated. Exceptions to this rule include the death of either party, involuntary conversion or condemnation of the property, or “with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax.”

Anti-Abuse Provision

Congress recognized that transactions could be structured to circumvent the related party rules. To prevent this, they included an anti-abuse provision, providing that IRC §1031 “shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection.”

And therein lies the rub. IRC §1031 contemplates transactions involving the exchange of properties between two parties. In an exchange involving a qualified intermediary, the transaction is viewed, for tax purposes, as a taxpayer exchanging properties with the qualified intermediary, even though the qualified intermediary generally does not acquire title to either property, and the properties are deemed directly to the respective buyers.

But under IRC §1031(d)(4), a taxpayer may not insert the qualified intermediary into the transaction to shield the transaction from the related party rules. Where a taxpayer acquires property from a related party, it is viewed as if the related party is receiving the relinquished property from the taxpayer and then subsequently transferring it in violation of the two year holding period.

Case Law

Two recent cases addressed related party exchanges. In Teruya Bros. Ltd. v. Commissioner, the tax court disallowed an exchange where a corporation sold multiple properties to third parties through a qualified intermediary and used the proceeds to acquire replacement property from a related corporation through a qualified intermediary. While the related corporation recognized more gain than the exchanger deferred, the related corporation had significant net operating losses that offset the gain, and therefore the court found that the transactions were structured for “un warranted tax avoidance purposes.”

Ocmulgee Fields Inc. v. Commissioner had similar facts to Teruya Bros. and involved the acquisition of replacement property by the qualified intermediary from a person related to the exchanger. The tax court disallowed the exchange, finding that the taxpayer reduced taxable gain by $1.8 million and lowered the tax rate to 15% (individual) from 34% (corporate).

General Guidance for Related Party Transactions

1. It appears to be acceptable for a taxpayer to sell their relinquished property to a related party in a 1031 exchange.
and acquire replacement property from an unrelated third party. Since no funds would be received by a related party, there would be no opportunity for basis shifting. While IRC §1031(f)(1)(C) would seem to require that each related party hold the property they acquire for two years after the exchange, in three separate private letter rulings, the IRS approved exchanges where a related party acquire the relinquished property from the Exchanger, and then planned to transfer it within two years after the exchange. In each case, it was noted that the transactions were not structured to avoid the related party rule, nor was basis shifting involved.

2. Purchasing replacement property from a related party could also pass muster, provided that the related party themselves will be exchanging that property for other like kind property, and provided each party holds their respective properties for two years subsequent to the exchange. Again, the rationale is that since the related party is also exchanging its property, no funds are being received and basis shifting will not be possible.

3. Purchasing replacement property from a related party who is “cashing out” of their investment and not exchanging their property is generally discouraged, unless the taxpayer can demonstrate that IRC §1031(f)(2)(C) should apply, because tax avoidance is not the principal purpose of the transactions.

In one private letter ruling, the IRS accepted the taxpayer’s argument. The transaction involved the swap of properties between a trust beneficiary on one side and the trust and the beneficiary’s siblings on the other side. The trust and the siblings soon sold the property they acquired in the exchange. The IRS issued the ruling in the parties’ favor because they represented that the basis of the properties were the same, so basis shifting was not involved. The representation seems to be true, since the properties were all inherited from the same decedent.

Otherwise, the main purpose of such related party transactions is often to place the taxpayer and the related party as economic unit in a better tax position than if they hadn’t completed the exchange, such as in Teruya Bros. and Ocmulgee Fields Inc. If the transaction will result in less tax than if the exchange had sold the property to a third party without an exchange, it will be extremely difficult to prove that such exchanges do not violate the anti-abuse provision of IRC §1031(f)(4). In such circumstances, the acquisition of replacement property from a related party should be avoided.

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