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Related parties and 1031 exchanges: Some of the special rules that apply in these cases

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All States 1031

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Special rules apply to 1031 exchanges between related parties. The rules are intended to eliminate the benefits that related parties

To avoid this "shifting of basis," IRC section 1031(f) requires a two-year holding period after an exchange between related parties. If either the taxpayer or the related party disposes of the exchanged property within two years, then the taxpayer's exchange with the related party becomes taxable.

could receive by exchanging low-basis property for high-basis property in anticipation of the profitable sale of the low-basis property. In other words, some taxpayers (prior to the rules being put in place) would sell their low basis property to a third party and then purchase high basis replacement property from a related party, thereby fully deferring their taxable gain (the high basis taxpayer would recognize a minimal gain).

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In practice, few related party exchanges involve a direct "swapping" of deeds. Most involve the use of a qualified intermediary and an unrelated third party buyer. This is where the opportunity for a basis shift could occur.

1. Purchase of Replacement Property from Related Party that Cashes Out

Revenue Ruling 2002-83 prevents related parties from deferring recognition of gain by using a qualified intermediary when the related party receives cash or non–like-kind property.

The revenue procedure used an example of a taxpayer selling low-basis relinquished property through a qualified intermediary to an unrelated third party and then buying high-basis property through an intermediary from a related party. (The use of a qualified intermediary or accommodator was considered immaterial.) The IRS concluded that buying replacement property from a related party violated section 1031(f)(4) because it was part of a transaction structured to avoid the purpose of the related-party rules. The proposed rationale of the abusive nature of this transaction was that the taxpayer was selling low-basis property and receiving in return high-basis property owned by a related party.

2. Purchase of Replacement Property from Related Party that also Exchanges

The IRS has determined (in PLR 20040002) that a taxpayer could acquire replacement property from a related party if the related party was also doing an exchange, and not cashing out of its position. The IRS reaffirmed this position (in PLR 200616005), and allowing for the possibility of some cash boot. In the latter ruling, the taxpayer represented that it was trying to obtain additional replacement property from an unrelated seller, and the taxpayer would pay tax on the cash received if the taxpayer was unable to find additional replacement property. The Service ruled that this taxable boot would not blow the whole related party exchange.

3. Sale of Relinquished Property to a Related Party.

It is permissible for a taxpayer to sell to a related party as part of a 1031 exchange and acquire replacement from an unrelated party. This is because neither the related party nor the taxpayer is receiving a basis shift from the other. Most practitioners believe that the two year rule would still apply however.

Due to the uncertainty in the law and the complexities involved, any taxpayer considering a related party exchange should contact a tax professional experienced in analyzing the issues involved.

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