

RELATED PARTY TRANSACTIONS

Exchanges between related parties present special problems. A common misconception is that exchanges can occur between related parties as long as the dealings are at "arms length". Such is not the case. The IRS has been especially vigorous in challenging related party transactions.

Section 1031 (f) imposes special rules for transactions between related parties. Section 1031 (f) picks up the definition of related parties in Code Section 267 (b) and Code Section 707 (b). Through the interplay of these three Code Sections the following are treated as related parties:

A. Family- An Exchangor and a member of the Exchangor's family. Exchanges between the Exchangor and the following relatives are affected:

- Great Grandparents
- Grandparents
- Parents
- Spouse
- Brothers and Sisters
- Children
- Grandchildren
- Great Grandchildren

B. Corporations- An Exchangor and a Corporation in which the Exchangor owns more than 50% in value of the outstanding stock either directly or constructively under 267 (c).

Two Corporations under common ownership or control.

A Partnership and a Corporation in which the Exchangor owns a majority interest.

C. Trusts- A trust where the Exchangor is a fiduciary, and one of the related parties is a grantor or beneficiary of the same trust, the fiduciary or beneficiary of a related trust, or a related corporation.

D. Estates- An estate where the Exchangor is either the executor of an estate or the beneficiary of the estate except where the sale is in satisfaction of a pecuniary bequest of the estate.

E. Partnerships- A partnership where the Exchangor owns directly or indirectly more than 50% of the capital interest or profits interest in such partnership. Two partnerships in which the same persons own directly or indirectly, more than 50% of the capital interests or profits interests.



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The definitions of related parties under Sections A-D above, can be found in Code Section 267 (b). The definitions of related parties under Section E above, can be found in Code Section 707 (b).

For 1031 exchanges involving related parties, non recognition treatment is denied unless the Exchangor holds the Replacement property for a period of at least two years and the related party holds the Relinquished property for a period of at least two years. The two year period is measured from the date of the last transfer of property in the exchange transaction.

If either the Exchangor disposes of the Replacement Property or the related party disposes of the Relinquished Property within the two year period, the Exchangor (and the related party) must recognize the gain or loss from the transaction.

There is limited relief from the two year holding period under Code Section 1031 (f)(2). The most helpful of the relief provisions allows an exception if the property disposition is due to the death of the Exchangor or the related party.

Section 1031 (g) tolls the two year period during any period in which either the Exchangor or the related person has a substantially diminished risk of loss for either property through an option, put, short sale, or any other transaction.

The practical effect of the related party rules is to knock out deferral treatment for many related party exchange transactions. The two year holding period rule eliminates the possibility of selling Relinquished Property to a third party and acquiring the Replacement Property from a related party, except in limited circumstances.

Examples of how these rules work is illustrated below:

Example 1: The Exchangor and the related Party actually "swap" properties with each other. As long as the Exchangor and the related Party hold the respective properties each received from the other for at least two years, without any substantially diminished risk of loss, the exchange works.

Example 2: The related party buys the Exchangor's Relinquished Property and the Exchangor acquires Replacement Property from a third party either simultaneously or under the 1031 delayed exchange rules. Based on recent letter rulings issued by the IRS, this type of transaction does not result in a 2-year holding period for either the Exchangor or the related party buyer. The "relief" under these letter rulings is based on the notion that the related party buyer does not have property of its own to exchange (it is merely bringing money to the table to buy the Exchangor's property).



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Example 3: The Exchangor sells low basis Relinquished Property to a third party and acquires Replacement Property from a related party. This exchange does not work even if the Exchangor holds the Replacement Property for more than two years, except in limited circumstances. The exchange is re characterized as a “swap” between the related parties as shown in Example 1. The related party is deemed to have received the Relinquished Property and to have immediately sold the Relinquished Property to the third party. The related party cashes out and pays little or no tax, while the Exchangor defers his gain.

Often, the Exchangor has sound motives to sell to a third party and acquire Replacement Property from a related party:

The Exchangor does not want to enter the 45 day identification “lottery” and would be content to identify only the related party’s property.

The Exchangor wants to acquire the related party’s property to “help” the related party.

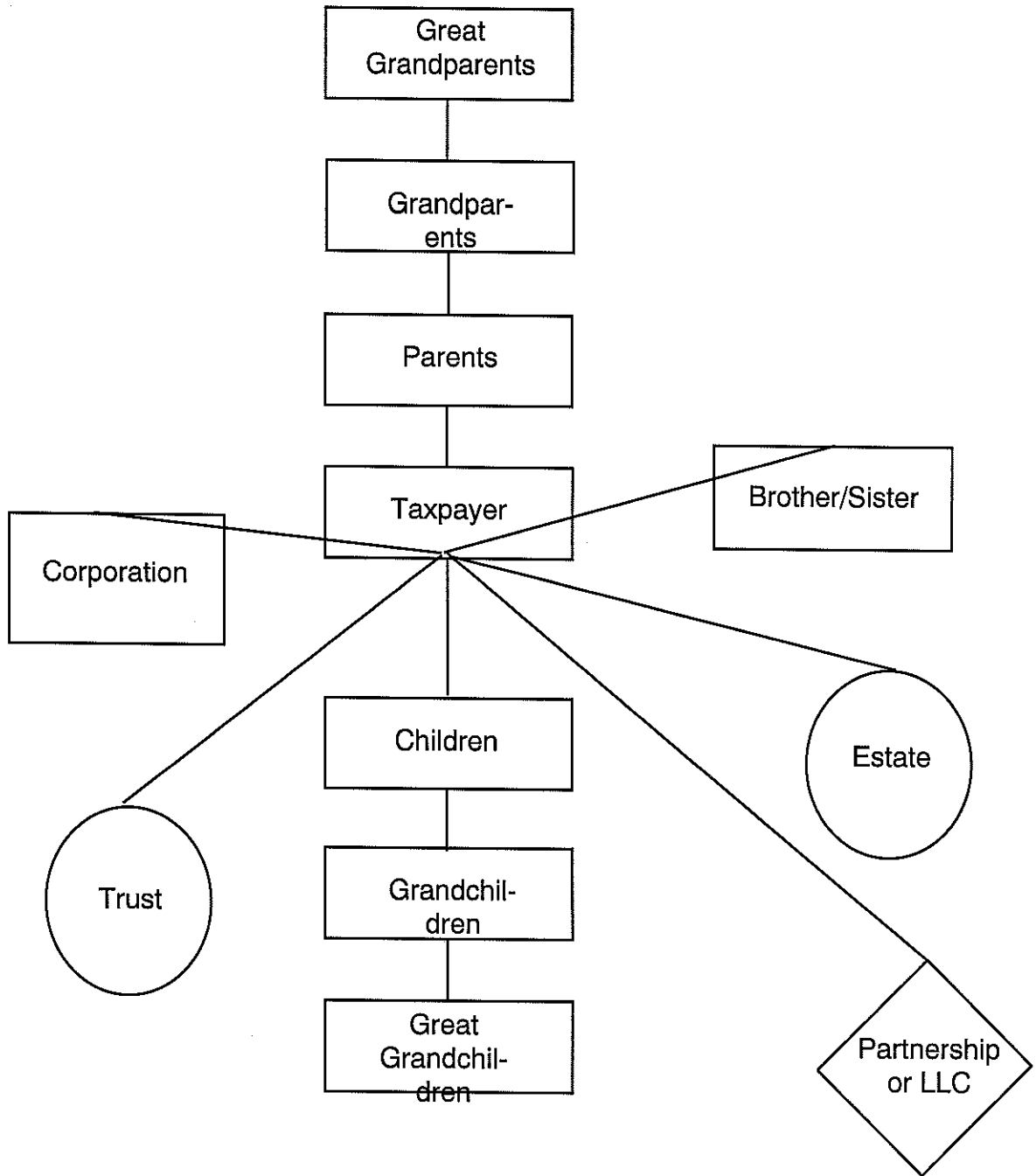
Unfortunately, the related party rules frustrate these motives. An Exchangor cannot sell low basis relinquished property to a third party and buy high basis replacement property from a related party and get non recognition benefits. It may well be possible to accomplish an exchange into property owned by a related party if the related party seller pays more tax than the Exchangor is deferring in the exchange. In other words, the Exchangor is exchanging high basis property for low basis property owned by a related party. Although there is a basis shifting occurring, it can be argued it is not a tax-avoidance basis shift. It may also be possible to trade into a replacement property owned by a related party if the related party also does an exchange and receives property (which should also be held for two years). The 2-year holding period for both the Exchangor and the related party starts when the related party acquires its replacement property.

Related party transactions need to be approached with a great deal of caution. The related party should agree in writing not to dispose of their property within the 2-year window without the Exchangor’s consent.



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