1031 Exchanges Between Related Parties

Historically, real estate transactions were not uncommon amongst family and other related parties. Given this and prior history of taxpayers utilizing family or related parties to manipulate the existing IRS regulations on 1031 exchanges, Congress amended the code section to include Related Party rules in relation to 1031 exchanges. Due to today's booming real estate market, it is even more popular for family to try to help the younger generation start their real estate investment journey, which makes it more important than ever to understand the Related Party rules outlined below.

Background to the Related Party rules

Tax deferral under section 1031 of the U.S. tax code is very taxpayer-friendly, potentially allowing taxpayers to defer capital gain, depreciation recapture, healthcare tax, and state tax. However, to take advantage of this code section, taxpayers have to play fair and strictly follow the rules. In the past, it was possible to manipulate the rules to achieve a favorable outcome by bringing a party related to the taxpayer into the transaction. In 1989, Congress amended the code section to stop this abuse. The amendment prohibits taxpayers from entering into transactions with related parties, subject to a few limited exceptions. According to the legislative history of §1031(f) “if a related party exchange is followed shortly by a disposition of the property, the related parties, have in effect, cashed out of the investment.”

This new section, 1031(f), added “special rules for exchanges between related persons” and essentially provided that such related party exchanges would not be allowed when, ”before the date 2 years after the date of the last transfer which was part of such exchange—

(i) the related person disposes of such property, or

(ii) the taxpayer disposes of the property received in the exchange from the related person which was of like kind to the property transferred by the taxpayer”

What was the abuse that gave rise to the Related Party rules?

Take as an example “Parent Company” which has Property A for sale with a lot of built-in gain and no need to acquire a replacement property. Its affiliate, “Subsidiary Company” owns Property B of similar value with a high basis. In any exchange, the basis is carried over from the relinquished property to the replacement property. So rather than sell the properties outright, the two companies enter into an exchange with one another to defer taxes. Parent Company holds Property B indefinitely, but shortly after the exchange, Subsidiary Company sells Property A. Since Subsidiary Company has a high basis in Property A, there is little tax effect to it upon the sale. This was a common occurrence prior to the 1989 Related Party rules addition to section 1031.

Can any part of a taxpayer’s exchange transaction involve a related party?

Often a taxpayer will sell the relinquished property to a related party while acquiring replacement property from an unrelated party. This structure is not prohibited by the Related Party rules since it does not involve the taxpayer carrying over tax basis into the property sold (it is carried over into the property being purchased), and therefore there is no opportunity for the tax abuse that the rules seek to curb. Between 2007 and 2010 there were a series of IRS Private Letter Rulings confirming this position.

However, when a taxpayer sells relinquished property to a third party and acquires replacement property from a related party, the tax abuse opportunity is present, despite the fact that the related parties are not exchanging with one another. By purchasing property from a related party, the taxpayer can potentially dispose of low basis property without recognizing the gain.

What relationships constitute related parties?

Rather than reinventing the wheel, the drafters of the Related Party rules chose to refer to existing code sections which already defined "related persons" for other purposes. Section 1031(f) states that "For purposes of this subsection, the term "related person" means any person bearing a relationship to the taxpayer described in section 267 (b) or 707 (b)(1)." Those relationships in these code sections include:

- Members of the same family unit (siblings, spouse, ancestors, and lineal descendants);
- Corporation where more than 50% of the value of the stock is owned directly or indirectly by or for one particular individual;
- Two (2) corporations that are in the same controlled group (as defined in subsection (f);
- A grantor and a fiduciary of any trust;
- A fiduciary of one trust and the fiduciary and/or beneficiary of another trust where the same person is the grantor for both trusts;
- A fiduciary of a trust and a beneficiary of the same trust;
- Corporation where more than 50% of the value of the stock is owned directly or indirectly by or for one particular trust or by or for the grantor or fiduciary of the trust;
- An organization qualified under Section 501 of the Internal Revenue Code (relating to certain educational or charitable non-profit organizations) which is controlled directly or indirectly by a specific person or (if such person is an individual) by members of the family of such individual;
- A corporation and a partnership if the same person or persons own: more than 50% in value of the outstanding stock of the corporation, and more than 50% of the capital interest, or the profits interest, in the partnership;
- An S corporation and another S corporation or a C corporation if the same person or persons own more than 50% in value of the outstanding stock of each corporation;
- A partnership and a person owning, directly or indirectly, more than a 50% capital interest or a 50% profits interest, in such partnership;
- Two partnerships in which the same person or persons own, directly or indirectly, more than a 50% capital interest or a 50% profits interest, in both partnerships;
- An executor of an estate and the beneficiaries of the estate.

There are sometimes opportunities for transactions that may involve relatives, although not defined as related parties. Exchanges with aunts, uncles, nieces, nephews, in-laws may fall into that category. Additionally, oftentimes parties hold 50% interests in partnerships, LLCs or company stock, as opposed to more than 50%.

Summary

The underlying rational for a tax deferred exchange is the continuity of investment without a cashing out. Prior to the Related Party rules, the taxpayer could use a related party to effectively cash out of an investment, while technically abiding by the requirements of a deferred exchange. Next, we examine exceptions to and misconceptions of the Related Party rules for 1031 exchanges.