

1031 Exchange Related Party Rules: Exceptions and Misconceptions

Why is it Necessary to Identify Replacement Property?

In a typical Internal Revenue Code (IRC) §1031 delayed exchange, commonly known as a 1031 Exchange or tax-deferred exchange, an Exchanger has 45 days from the date of sale of the Relinquished Property to identify potential Replacement Property. This 45-day window is known as the identification period. The Exchanger has 180 days (shorter in some circumstances) to acquire one or more of the identified properties, which is known as the exchange period. Property(ies) actually acquired within the 45-day identification period do not have to be specifically identified, however they do count toward the 3-Property and 200% Rules discussed below.

These rules are a direct result of the Starker case where for the first time an Exchanger was found to be able to sell Relinquished Property on one day and acquire Replacement Property at a different point in time. In fact, the Starker case involved a five-year gap between the sale and purchase. Prior to the decision in the Starker case, it was believed that an exchange had to be simultaneous. As a result of the open-endedness of this decision, as part of the Tax Reform Act of 1984, Congress added the 45/180 day limitation to the delayed exchange. These time limitations were a compromise between allowing an exchange to be non-simultaneous while at the same time having some temporal continuity between the sale and the purchase.

Section 1031(f) of the Internal Revenue Code, the Related Party Rules, was introduced by Congress in 1989 to prevent Exchangers from manipulating the 1031 Exchange rules to achieve a favorable outcome by entering into an exchange with a party related to them. 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”

Abuse of 1031 Exchange rules gave rise to the Related Party Rules and at which relationships are considered related parties. We will examine common misconceptions of and exceptions to the Related Party Rules.

Common Misconceptions

“I can get around the Related Party rules using a Qualified Intermediary.”

Transacting an exchange through a Qualified Intermediary (QI) who is not a party related to the Exchanger does not “cleanse” the transaction when the Seller is a related party. If the QI acquires the property from a party related to the Exchanger, the abuse is present, just as it would be if the Exchanger traded directly with the related party. The catch-all provisions of §1031(f)(4) make clear that “This section shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection.” Simply acquiring the related party’s property through the unrelated QI does not change the outcome. The IRS position on this scenario was the subject of Revenue Ruling 2002-83.

“I looked it up and discovered it’s ok as long as I hold the Replacement Property for two years”.

Many people, including professional advisers, see the two year holding exception to the application of the related party rules and believe that, should the Exchanger acquire Replacement Property from a related party and hold the property for at least two years, the prohibition is nullified. Unfortunately, this exception only applies if both the Exchanger and the related party hold the respective properties received in the exchange with one another for a minimum of two years.

In a more typical related party scenario, the Exchanger’s Relinquished Property is sold to a third party and the Replacement Property acquired from a related party. Since they are not exchanging with one another, the exception by its terms does not apply. The related party cannot hold the Exchanger’s Relinquished Property since that property was transferred to a third party buyer. Only in the very narrow instance in which two related parties are exchanging with one another and they each hold the properties for two years or more does this exception apply.

Are There Any Other Exceptions to Related Party Rules?

As indicated above, the two year holding exception has limited applicability, applying only to exchanges between Exchangers who receive (and hold) each other’s property. Under this exception, if the properties are held for a minimum of two years, there is a presumption that the trade was motivated by reasons other than “abusive basis shifting.”

Another exception, under Section §1031(f)(2)(C), provides for an earlier than two year disposition of a property that is part of a related party transaction. This section states that the transaction will not be disqualified if, “with respect to which it is established to the satisfaction of the [Treasury] Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax.” Most exchanges involve tax deferral so it is difficult to make this case. There have, however, been favorable IRS rulings in which family members exchanged undivided interests in several properties in order to allow each to own a

whole. This is a perfect example of this exception.

An additional exception is based upon a series of private letter rulings beginning with PLR 201220012 which pertained to a Exchanger's disposal of Replacement Property within the two year period. The ruling concluded since the related party did an exchange from that property into another, there was no cashing out and therefore no tax abuse.

Finally, a seldom-used exception to the requirement of both parties retaining the property for two years or more occurs in the event of the death of the Exchanger or the related person. Such an event will allow for the exchanged property being sold within the two year period while maintaining the original deferral. Exchangers will do just about anything to avoid paying tax, but this is clearly not a strategy that anyone will want to employ.

Summary

The exceptions to the prohibitions of the Related Party Rules have in common the notion that the involvement of the related party is attributable to reasons other than allowing the Exchanger to cash out while selling a low basis property to a third party.