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Tax Watch

IRS Clarifies Related-Party Rule in 1031 Exchanges

by Ronald L. Raitz, CCIM

Last December, the Internal Revenue Service published Revenue Ruling 2002-83, which clarifies its position on taxpayers buying replacement property from related parties under Internal Revenue Code Section 1031. Due to the considerable confusion about such exchanges, real estate professionals shoul welcome this ruling as it helps them better advise clients engaging in these transactions.

History of Related-Party Exchanges

A related party is a family member, such as a spouse, ancestor, or lineal descendant, or one who is defi as related under IRC Section 707(b) or 267(b). For example, an individual is considered related to an en for tax purposes if he owns more than 50 percent of that entity. Also under this definition, an estate's executor is deemed related to the estate's beneficiaries.

Historically, taxpayers bought and sold property from related parties with no specific restrictions. Over ti the IRS discovered that many related-party transactions were executed to shift basis, giving taxpayers a advantage when disposing of property.

To understand basis shifting, consider a taxpayer owning more than two properties who decides to sell a low-basis property. To avoid the steep tax consequences of the low-basis property sale, he selects one his higher-basis properties and contributes it to a new corporation for 100 percent of the stock. The taxpayer then executes an old-fashioned exchange by trading his individually owned, low-basis property the high-basis property his corporation owns. The basis remains with the owner — it doesn't transfer wit the property — so the corporation now owns a high-basis property that will result in minor tax consequences when sold. In this scenario, the taxpayer shifted basis immediately before the sale and simply cashed out; therefore, an exchange wasn't necessary due to the minor tax consequences.

Tightening the Rules

In 1989, the IRS recognized this loophole and added an anti-abuse provision: Section 1031(f) — Specia Rules for Exchanges Between Related Persons. In Section 1031(f)(1), the IRS restricted related-party exchanges by mandating that the property acquired by the related party could not be sold for a minimum two years. There were several exceptions to the rule, including the taxpayer's or the related party's deat and cases of compulsory or involuntary conversions, such as seizure by eminent domain or the property destruction.

However, the primary objective of Section 1031(f) was to end abusive basis shifting. Since the IRS's requirements seemed clear, no distinction was made between selling a relinquished property *to* or buyin replacement property *from* a related party.

Eight years after enacting Section 1031(f), the IRS surprised many tax professionals with Tax Advisory Memorandum 9748006, which stipulated that replacement property could not be purchased from a relat party. The memorandum stated that tax avoidance was the primary motivation for buying replacement property in such situations.

The following illustrates the IRS' reasons for issuing TAM 9748006. A mother and son jointly owned property that they decided to sell. The mother did not structure her part of the sale as an exchange and intended to use her portion of the proceeds to buy a primary residence. The son structured his part of th sale as a tax-deferred exchange and identified three potential replacement properties, one of which was home that his mother had just purchased. The son unsuccessfully tried to negotiate contracts on the firs two replacement properties and ultimately bought his mother's house.

In this situation, the IRS found the exchange to be invalid and the son's gain was triggered because he purchased the replacement property from a related party. The taxpayer argued that he had not tried to circumvent the rules since he did not have a prearranged plan to buy his mother's house. However, the stated that a prearranged plan between related parties was not necessary for there to be a violation of Section 1031(f)(4), which invalidates any exchange that is part of a transaction structured to avoid the purposes of the related-party rule.

Analysis of New Ruling

With Rev. Ruling 2002-83, the IRS further clarifies the rules governing related-party transactions. The ru clearly states that an acquisition of replacement property from a related party violates both Section 1031 (1) and 1031(f)(4).

The author of Rev. Ruling 2002-83 used a taxpayer's sale of a low-basis property and acquisition of a hi basis property from a related party as an example of a violation under 1031(f), thereby illustrating the IR intent to place substantial restrictions on related-party transactions.

To test whether an abuse has taken place, the IRS interprets transactions without the use of a qualified intermediary. First, a diagram of the exchange is crafted to illustrate the taxpayer and the related party executing a direct trade or "swap" of their properties. Next, the transaction is examined as if the related party sold the property it just received to an independent third party for cash. In this instance, the IRS wo infer abuse of the rule because the related party did not hold the property for two years, thereby violating the Section 1031(f)(1) rules. Using this methodology, almost any transaction involving an acquisition fro related party would not qualify.

Does this ruling permanently eliminate the purchase of property from a related party? Probably. Does th related party's basis matter in the analysis? Possibly. It appears that the IRS practically has eliminated t option of buying replacement property from a related party; essentially, taxpayers only can sell property related parties in exchanges as long as they abide by the two-year holding period.

In addition, planned basis shifting is not dead. A taxpayer recently received a favorable opinion from the IRS in Field Service Advisory 200137003 wherein the taxpayer planned to do a related-party basis shift, exchanging low-basis property for high-basis property, and then selling the high-basis property. This is a classic example of the basis shifting scheme with one exception — the sale of the high-basis property d not occur for two years.

In summary, taxpayers should be careful: Not all related-party transactions are alike. Consult a tax professional before executing a related-party exchange.

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