The good news about related party section 1031 exchanges for taxpayers

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Most taxpayers are now aware that a taxpayer's receipt of replacement property from a related person is a risky business from an Internal Revenue Code Section 1031(f) perspective. Section 1031(f)(1) provides that if a taxpayer exchanges property with a related person, the taxpayer has nonrecognition of gain or loss from treatment as a like-kind exchange, and within two years of the last transfer either the taxpayer or the related person disposes of the property received in the exchange, then there is no nonrecognition of gain or loss on the taxpayer's exchange. Section 1031(f) adopts the related person definitions of IRC section 267(b) and IRC Section 707(b). Section 1031(f) has its own specific anti-avoidance rule, section 1031(f)(4), which provides that section 1031 will not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of Section 1031(f). The IRS has consistently ruled that these types of transactions violate section 1031(f)(4) by enabling pre-sale basis shifting and cashing-out, and the tax court in Teruya Brothers, Ltd., 124 T.C. 45 (2005) (on appeal, 9th Cir.), held that the litigated transaction involving the receipt of replacement property by a related person violated Section 1031(f)(4).

However, a fundamental question regarding the application of related person exchange rules remained unresolved: whether a related person's acquisition of relinquished property from the exchanger for cash is a transaction affected by section 1031(f) where the exchanger then acquires replacement property from an unrelated person and the related person disposes of some or all of the acquired relinquished property within two years following its acquisition from the exchanger. In three recent private letter rulings, the IRS ruled that this type of related party like-kind exchange did not violate section 1031(f). A review of the abuse at which section 1031(f) is designed to prevent - a pre-sale basis shifting transaction - shows why the IRS came to the opposite conclusion in these rulings.

As articulated in the legislative history to section 1031(f):

Because a like-kind exchange results in the substitution of the basis of the exchanged property for the property received, related parties have engaged in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low-basis property in order to reduce or avoid the recognition of gain on the subsequent sale. Basis shifting also can be used to accelerate a loss on retained property. The committee believes that if a related person exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, "cashed out" of the investment, and the original exchange should not be accorded nonrecognition treatment. H.R. Rep. No. 247, 101st Cong., 1st Sess. 1340 (1989); S. Print No. 56, 101st Cong. 151 (1989).

This statement of the abuse was formally adopted by the IRS in Rev. Rul. 2002-83, 2002-2 C.B. 927, which held that the taxpayer's receipt of replacement property from a related party violated

Section 1031(f).
The vulnerability of an indirect (non-two-party) exchange to the application of section 1031(f)(4) is easily understood when it is recast into the form that the exchange would have taken but for the related parties' desire to avoid the application of section 1031(f)(1). For example, in the absence of section 1031(f)(1), A, holding low basis property (property 1) worth $100x, and related person B holding high basis property (property 2) also worth $100x could exchange these properties in a like-kind exchange and then B could sell property 1 to a third party without recognizing the gain from property 1 because the high basis of property 2 carried over to property 1 as a consequence of the like-kind exchange. In an attempt to avoid application of Section 1031(f)(1), the related parties engage a QI who, as the exchange counterparty with A, sells property 1 to the third party buyer and buys the replacement property Property 2 from B.

The elements common to the exchanges which violate Section 1031(f) are the exchanger's acquisition of the replacement property from a related person and the exchanger's sale of the relinquished property to a third party. However, when the transaction is transposed and the related person acquires the relinquished property from the exchanger and the exchanger then acquires the replacement property from the third party, the abuse disappears and the exchange is not a related person exchange within the parameters of section 1031(f). The IRS confirmed the permissibility of this type of transaction in PLRs 200709036, 200712013, and 200728008, all of which involved exchanges facilitated by a QI.

In these rulings, the IRS conceded that section 1031(f)(1) did not apply to the exchanges because the taxpayer exchanged property with the QI, the true exchange counterparty in the exchange pursuant to the deferred exchange regulations, and the QI is not a related person. It concluded that Section 1031(f)(4) did not apply because the taxpayer and the related party were not exchanging properties either directly or indirectly through the QI. The IRS pointedly noted that the related party did not own, prior to the exchange, any property that the taxpayer would acquire in the exchange. Thus, unlike the Rev. Rul. 2002-83 case, there could be no deemed reciprocal transfer of properties between the taxpayer and the related party and therefore no exchange. The IRS also made the further observation in the case of the ruling involving a Rev. Proc. 2000-37 safe harbor reverse exchange that because only the taxpayer held property before the reverse like-kind exchange and continued to hold like-kind property after the exchange, the related person's proposed disposal of the relinquished property within two years of its acquisition would not result in a "cashing-out" of an investment or a shifting of basis between the taxpayer and the related person. Further, the IRS came to this conclusion even where it was specifically represented in the ruling request that the related person intended to dispose of the relinquished property within two years of its receipt.

This is very good news for taxpayers who may want to exchange property with a related party. Taxpayers should bear in mind that the IRS ruled on specific fact situations and that the rulings are limited to those fact situations. Nevertheless, these rulings signal that the IRS has recognized that there is a fundamental difference between the two types of related party like-kind exchanges and that many sales of relinquished property to a related party will be permissible under section 1031(f).

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