

RELATED PARTY EXCHANGES

Section 1031 Exchanges are a powerful tool in the deferment of capital gains tax from the sale of business or investment property. However, there is a prohibition for transactions with related parties. The general rule is that you can sell property to a related party but you cannot purchase related party property. The theory is that a third-party transaction is necessary to avoid basis shifting between related parties. The term "Related Party" will be defined below.

The first leg of an exchange is the sale of the business/investment property. The funds are directed to a Qualified Intermediary (QI) for the acquisition of Replacement Property. Within 45 days an identification letter is delivered to the QI, using the simple rules, three potential properties are identified. Any one, two or three of the properties can be acquired within 180 days. If a related party owns any one of the properties identified, the exchange will run the risk of being disallowed.

Revenue procedure 2002-83 codified related party transactions in Section 1031 Exchanges. There are two possible solutions that will comply with the safe harbor requirements. The first provides that if the related party selling to you is also conducting an exchange and both parties hold their new properties for a minimum of two years, then the exchange will be valid. This presupposes that the property you are acquiring has been business/investment property in the hands of your relative prior to sale. For example, if you identified target property owned by your grandparents and it has been a rental property in their hands and they will also conduct an exchange using a QI by acquiring other like-kind property, then your exchange will be successful. Both parties must file IRS Form 8824 for the year of the exchange and two additional years.

The second solution is to arrange for a direct swap of the properties currently owned by the related parties. The challenge in a direct swap is to equalize the values so that neither party receives unlike kind property, typically cash, or "boot". Often, related parties are trying to unwind joint ownership when they receive property in an estate, or co-own several properties together. Partial interests may be exchanged and they may immediately resell what they receive; no 2-Year Rule applies, provided the overall objective of the transaction is to enlarge or unify ownership of particular pieces of property. Once the parties reach agreement on who will retain the respective pieces, the next step is to have the interests appraised by an independent party to establish the values. Lastly, a transaction commences with some of the relatives giving up interests in property they no longer want in exchange for larger or complete interests in property owned by other relatives. If cash is received, for equalizations, it is taxed.

Another common situation arises when a relative wishes to buy your business or investment property. You conduct the sale using a Section 1031 Exchange and direct the proceeds to a QI for your acquisition of property from a non-relative **and** both you and the relative who purchased your old property agree not to resell for a period of 2 additional years, again filing Form 8824 as noted above.

So just who are your relatives anyway? Here is a partial list, taken from Section 267(b) of the IRS Code.

These *people* are Related Parties (to you):

Any of your lineal **ancestors**; any of your lineal **descendants**; any of your **siblings**, by whole or half blood; your **spouse**; and lastly, **yourself**.

And these *people* are **not** Related Parties (to you):

Any of your **aunts** or **uncles**; any of your **cousins**, any of your **nieces** or **nephews**, and any of your **in-laws**.

In *business*, these entities are Related Parties (to you; partial list).

You and any corporation (S-type or C-type) are Related Parties when you (and persons related to you) collectively own **more than 50%** of the capital stock of the corporation. Your shares and those of your wife (for example) are added together for purposes of the greater than 50% test.

You and any partnership or LLC are Related Parties when you (and persons related to you) collectively own **more than 50%** of the capital or profits interest in such entity. See example above.

A corporation (of either type) in which you (and persons related to you) are a stockholder, and another corporation in which you (and persons related to you) are also a stockholder are Related Parties if your collective stockholding in either corporation **exceeds 50%**.

Two Partnerships or LLC's are Related Parties when you (and persons related to you) collectively own **more than 50%** of the capital or profits interests in either entity.

The Settlor (Grantor) and any Trustee of the **same trust** are Related Parties.

Trustees of two different trusts are Related Parties if the **same person** Settled (Granted) both.

A Trustee of a trust is a Related Party to any **beneficiary** of that trust.

A Trustee of a trust is a Related Party to a beneficiary of another trust provided the **same person** Settled (Granted) both.

And in *business*, the following are **not** Related Parties (to you; partial list).

If you and your relatives collectively own 50% or less of the shares of a corporation, or 50% or less of the capital or profits interests in a partnership or LLC; you are still not related if you collectively own exactly 50%.

And with trusts, it's easy to see that if you are not among the group described above, then you are not Related Parties.

This list is not meant to be exhaustive. Please see IRC Section(s): 267(b); and 707(b)(1) and the supporting Regulations for the complete rules.

Section 1031 Exchanges involving Related Parties are always problematic, but not impossible to resolve. Good planning and sufficient time will resolve most related party issues.