

Related Party Issues

Buying From a Related Party - Revenue Ruling 2002-83

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CLARIFICATION OF THE RULES WHEN PURCHASING FROM A RELATED PARTY

Section 1031(f)(4) of the IRS Code adds special rules for transactions between related persons. For purposes of §1031(f), the term “related person” means any person bearing a relationship to a taxpayer described in §267(b) or 707(b)(1). Essentially, §1031(f) denies tax deferral when related parties perform an exchange of low basis property for high basis property in anticipation of the sale of the high basis property. The rationale for §1031(f) is that if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have essentially “cashed out” of the investment and the original exchange should not receive 1031 exchange tax deferral treatment. The IRS tends to look at related parties as a single economic unit and 1031 exchange treatment will be disallowed if it is a part of a transaction or series of transactions structured to avoid the purposes of the related party provisions.

LEGAL DEVELOPMENTS

TAM 102519-97: IRS ruled that an individual is not entitled to 1031 exchange deferral when purchasing a replacement property owned by a related party, even though a qualified intermediary (QI) purchased the replacement property.

TAM 200126007: IRS denies 1031 exchange deferral when a taxpayer wanted to sell residential property with a low basis and exchange for replacement property owned by a party related to the taxpayer. The IRS felt this transaction involved “basis shifting” and a cashing out of the investment by an exchange between related parties.

FSA 199931002: Taxpayer should not exchange into a property owned by a related party when transferring the relinquished property to an unrelated party.

FSA 2001137003: Taxpayer can acquire a replacement property from a related party if the taxpayer and the related party are involved in a ‘swap’ and each holds their property for at least two years.

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REVENUE RULING 2002-83

Revenue Ruling 2002-83 addresses the situation wherein a taxpayer transfers a relinquished property to a qualified intermediary in exchange for a replacement property owned by a related party. The Revenue Ruling specifies that a taxpayer, under the facts shown below, is not entitled to nonrecognition treatment under §1031(a) if, as part of the transaction, the related party received cash or other non-like-kind property for the replacement property.

Facts:

- Taxpayer A wants tax deferral under §1031;
- B is an entity related to Taxpayer A;
- C wants to buy A's property.

The Issue:

- Taxpayer transfers low basis relinquished property to qualified intermediary;
- Qualified intermediary sells relinquished property to C for cash;
- Qualified intermediary acquires high-basis replacement property from B, transfer this property to A and pays B the cash received from C.

Result: 1031 Exchange Tax-Deferral Denied

In essence, Taxpayer A enters into a 1031 exchange with the qualified intermediary, an unrelated third-party. The problem is that the end result is the same as if Taxpayer A had exchanged property with B followed by a sale from B to C.

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