Related Party Exchanges

Lack of a Prearranged Plan Does Not Allow for 1031 Deferral

1031 Knowledge

Section 1031(f) restricts tax-deferred exchange treatment where there is a 1031 exchange between related parties. Moreover, Section 1031(f)(4) states that non-recognition treatments does 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 Scenario: MBL is the taxpayer and a wholly-owned subsidiary of Malulani Group, Limited (MIL). Pursuant to Section 1031(f), MIL was a related corporation to MBL. On January 10, 2007 and following Section 1031 regulations, MBL transferred a Maryland relinquished property to a qualified intermediary who sold the property to a buyer. MBL began actively looking for replacement property with real estate brokers working on their behalf to provide many potential properties which were owned by unrelated parties to MBL. In fact, MBL negotiated on the purchase of an office building and also an apartment complex from unrelated parties prior to MBL's 45-day identification deadline. However, ultimately MBL chose not to proceed with any of these potential purchases from non-related parties. Instead, on February 24, 2007, 45 days after the sale of the relinquished property, MBL identified three potential replacement properties all belonging to MIL, a related party. Eventually, the qualified intermediary purchased a property in Hawaii as MBL's replacement property that was owned by MIL.

The Outcome: The Court determined that MBL received replacement property from a related party. Because MBL did not meet the requirements of Section 1031(f)(4) and thereby was not eligible for tax deferral treatment under Section 1031(a). The Court found MBL's transactions similar to those involved in *Ocmulgee* and *Teruya*. Essentially, even though the purchase was made by a qualified intermediary, the transactions were really the economic equivalent of direct exchanges of property between the taxpayer and a related party where the related party received cash proceeds.

The taxpayer attempted to argue that the exchange of the properties were not structured to avoid the purposes of Section 1031(f) since MBL had no prearranged plan to purchase property from the related party. MBL argued that it first sought to acquire replacement property from only unrelated parties and only chose to identify property from a related party near the end of the 45-day identification deadline. MBL also argued that the decision to acquire replacement property from a related party was made after having a qualified intermediary in place to facilitate their 1031 exchange. The Court found that the lack of existence of a prearranged plan to acquire property from a related party was not a significant enough factor to avoid a Section 1031(f)(4) violation. The Court has historically looked at the actual tax consequences to the taxpayer and the related party as an economic unit, that is, the Court viewed them together in the aggregate compared to the hypothetical tax consequences of a taxable sale of property by the taxpayer. The Court found substantial financial benefits to the economic unit of MBL and MIL as a result of structuring the transaction as a Section 1031 exchange. Therefore, the Court determined that MBL had a tax avoidance purpose in violation of Section 1031(f)(4) and disallowed the exchange.

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