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INNOVATIVE BY INSTINCT

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The Exchange

About the Author

Anna Gregory Wagoner grew up in Salisbury, North Carolina. She graduated from Wake Forest University in 1994 with a Bachelor of Arts in Psychology. Anna Gregory continued her education at Wake Forest, receiving her Juris Doctor from the School of Law in 1999. Prior to joining Investors Title, Anna Gregory worked as a real estate associate with Isaacson, Isaacson, & Sheridan, LLP for four years. She has also worked on real estate issues for a large corporation and has experience as a title attorney. Anna Gregory is a member of the North Carolina Bar Association. She is also a member of the Raleigh Jaycees. Anna Gregory joined ITEC in February, 2006.

Certified Exchange Specialist on Staff

Related Party Issues In 1031 Like-Kind Exchanges

By Anna Gregory Wagoner, Esq.

In 2007 the IRS issued several Private Letter Rulings regarding either selling to or buying from related parties in a Section 1031 exchange. These rulings provided specific taxpayers with guidance in certain related-party issues. In order to understand these rulings, we must first review the background and understand how related party issues became a potential problem in § 1031 exchanges.

Exchanges with related parties were not differentiated for Section 1031 treatment until Congress added section § 1031(f) to the Tax Code in 1989. Section 1031 (f)(1) states that related parties who exchange property with one another must each hold the property they acquired in the exchange for two years following the date of acquisition. This provision was added to the tax code to prevent related parties from exchanging a high-basis property for a low-basis property in anticipation of the sale of the low-basis property. This pre-sale exchange is known as basis shifting. Basis shifting is permissible in a direct swap by related parties, but the imposed two year holding period minimizes abusive basis shifting.

In an attempt to circumvent the two-year holding period, some taxpayers believed they could sell their relinquished property to an unrelated third-party buyer, via a qualified intermediary, and acquire their replacement property from a related party. However, Section 1031 (f)(4), a broad catch-all provision, states that non-recognition treatment does not apply to an exchange that is part of a transaction or series of transactions structured to avoid the two year holding restriction of Section 1031 (f)(1). A negative Technical Advice Memorandum, TAM 9748066, was issued in 1997. The taxpayer had sold his relinquished property to an unrelated party, and acquired his replacement property from his mother, using a qualified intermediary. The Service reasoned that this violated §1031 (f)(4). If the taxpayer had exchanged directly with his mother, she would have had to wait two years to sell the relinquished property to the third-party buyer. By structuring the exchange through the QI, the related parties, as a group, were able to cash out of one of their properties within a two year time frame.

In furtherance of the policies underlying Section 1031 (f)(4), the IRS issued Revenue Ruling 2002-83. Its holding states that in a like-kind exchange, a taxpayer cannot buy replacement property from a related party if, as part of the transaction, the related party receives cash or other non-like-kind property. The Service ruled that doing so was an attempt to avoid the two-year holding period requirement of Section 1031 (f)(1).

One exception to the two-year holding period applies if the taxpayer can show that the purpose of the transfer was not to avoid Federal income tax. This exception has led to some recent favorable rulings for taxpayers. In 2007 the IRS issued PLR 200730002, wherein the taxpayer exchanged properties with a related party and the related party then sold the properties it received in the exchange to an unrelated third-party in violation of the two-year holding period. The facts showed that the related party's basis in the property was lower than the taxpayer's basis in the property, so the related party recognized more gain (and paid more tax) than the taxpayer deferred in his exchange. The IRS ruled that the exchange was not structured to avoid Federal income tax or to avoid the restrictions set forth in Section 1031 (f)(4). (continued on back)

121 North Columbia Street
Chapel Hill, NC 27514

Email:
exchanges@invtitle.com

Phone: (800) 724-8791
Fax: (800) 653-9811

www.1031itec.com

Kelly Browne, CES
Exchange Coordinator

Brenda Wright
Exchange Coordinator

Caroline Vogel, CES
Senior Exchange Coordinator

Anna Gregory Wagoner, Esq.
Exchange Counsel

Jane Turner, CES
Vice President ITEC/ITAC

Carol Hayden, Esq.
Executive Vice President
ITEC/ITAC

Ann Cottrell
Business Dev. Manager
Mid Atlantic Region
3126 W. Cary Street, #232
Richmond, VA 23221
Email: acottrell@invtitle.com
Phone: (804) 560-1920
Fax: (804) 560-1921

ITEC, founded in 1988, is a leading qualified intermediary in like-kind exchange transactions, facilitating as many as 200 exchanges per month involving properties throughout the United States.

Is Your Qualified Intermediary "Qualified"?

The IRS requires those engaging in a 1031 Tax Deferred Exchange to retain the services of a qualified intermediary to hold the proceeds from the sale of one property and facilitate the purchase of a like-kind property. The responsibility of the qualified intermediary is to act as a neutral third party and hold the proceeds of the sale of an investment property until another property has been found. Obviously, choosing the right qualified intermediary is an important factor in conducting a 1031 Exchange. Remember, the qualified intermediary you choose to handle your 1031 Exchange will be entrusted with a great deal of money.

ITEC is a member of the Federation of Exchange Accommodators. The FEA was formed as a self-regulating professional association to maintain industry standards.

ITEC has two Attorneys and two Certified Exchange Specialists on staff. ITEC is covered by Fidelity Bonding, follows strict internal controls and is independently audited which ensures the safety of your funds.

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ITEC coordinates with your tax advisor and can provide information on court cases, revenue rulings, and private letter rulings.

ITEC has been in the qualified intermediary exchange business since 1988.

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Related Party Issues (continued)

The facts were similar in PLR 200706001, except that both properties had an equally low basis. The IRS ruled that the exchange would qualify under the non-tax avoidance exception. The purpose of the two-year holding period is to prevent abusive basis shifting, so if no abusive basis shift occurred, the taxpayers in these rulings prevailed on their "No Tax Avoidance" argument.

The taxpayer did not fare as well in a Tax Court case decided not long after Revenue Ruling 2002-83 was issued. In Teruya Bros. v. C.I.R., 124 T.C. 45 (2005), the taxpayer transferred relinquished property to a qualified intermediary, who then sold the property to an unrelated third-party, and used the proceeds from the sale to purchase replacement property from a related party. The taxpayer argued in this case that the related party recognized more gain when it sold the replacement property than the taxpayer was deferring in the exchange. The Court held that the non-tax avoidance exception did not apply because the related party's gain was offset by its net operating losses, so the only disadvantage to the related party when it sold the replacement property was a reduction in its net operating losses.

A taxpayer may purchase replacement property from a related party if the related party is also doing an exchange, as discussed in Private Letter Ruling 200440002. In this case both parties are attempting to defer their gain using a 1031 exchange. There is no cash-out of either property. In PLR 200616005, the taxpayer received cash boot in addition to the like-kind property, and the IRS held that the exchange still qualified for non-recognition treatment. It is important to note, however, that under this exception each party must hold the property it received in the exchange for a period of two years.

Another exception to the two-year holding period occurs in situations where the taxpayer, through a qualified intermediary, is selling relinquished property to a related party and buying replacement property from an unrelated third-party. In PLR 200709036, the IRS allowed such a transaction stating that the sale to a related party and purchase from an unrelated party did not constitute an exchange between the taxpayer and the related party, so the two-year holding period did not apply. The IRS also ruled that there was no tax avoidance purpose as there was no basis-shifting between the taxpayer and the related party. The same scenario was analyzed in Private Letter Ruling 200712013, except that the transfer was accomplished using an EAT in a reverse exchange, with the same result. Private Letter Ruling 200728008, issued in April, 2007, served to further reinforce the Service's position on the issue.

As discussed above, many taxpayers have the misconception that they can sell relinquished property to an unrelated third party and purchase replacement property from a related party as long as they hold that replacement property for at least two years from the date of acquisition. Related party issues can be very confusing. A prudent taxpayer who is contemplating such an exchange should consult with his or her tax advisor to avoid mishaps under the related party rules.

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