Mary Foster discusses the practical application of Code Sec. 1031(f), specifically addressing recent private letter rulings, some of which contain important planning techniques, and examines who is and who is not a related party under Code Sec. 1031(f).

Introduction

Transactions between related parties always receive higher scrutiny under the Internal Revenue Code (the “Code”) due to the “greater potential for complicity between related parties in arranging their affairs in a manner devoid of legitimate motivations.”1 Prior to 1989, Code Sec. 1031 had no restriction on related-party exchanges. Related parties were free to “basis shift” through an exchange and thereby move the highest tax basis to the property that was being sold in a taxable sale, thus reducing the overall tax to the related-party group. In 1989, Congress amended Code Sec. 1031 by adding subsection (f), which limits basis shifting between related parties. This article discusses the practical application of Code Sec. 1031(f), and specifically addresses recent private letter rulings, some of which contain important planning techniques. Finally, the article examines who is and who is not a related party under Code Sec. 1031(f).

It is important to note at the outset of this discussion that Code Sec. 1031 is inapplicable to any intercompany transactions for those taxpayers filing consolidated returns.2 Instead, Code Sec. 1502 and Reg. §1.1502-13 apply to the treatment of intercompany exchanges of property. However, if property received in an intercompany transaction is later transferred outside the consolidated group, the gain on the transfer can be deferred under Code Sec. 1031.3

Code Sec. 1031(f) and Related-Party Transactions

A related party may acquire or dispose of property as part of the taxpayer’s exchange in three different scenarios: (1) the taxpayer and the related party may be directly swapping properties, with no unrelated parties involved in the transaction; (2) the taxpayer may be acquiring the replacement property from a related party with the relinquished property being transferred to an unrelated party; or (3) the taxpayer may be transferring the relinquished property to a related party and acquiring the replacement property from an unrelated party. Each of these transactions leads to different results with respect to Code Sec. 1031(f). These results are analyzed below.

#1. The Direct Swap between Related Parties: The Two-Year Rule

The “Related Party Swap” is perhaps the least common of the three scenarios outlined above. The taxpayer and the related party are actually swapping properties with each other. While the Related Party Swap is relatively unusual today, it is still important to understand the applicable rules because they provide the basis for the applicable rules for the more common second and third scenarios.

The Related Party Swap rules are found in Code Sec. 1031(f)(1). If a taxpayer swaps property with a related party and defers the recognition of gain under Code Sec. 1031, no gain is recognized if each related party holds its replacement property for two years (the “Two-Year Rule”). The Two-Year Rule applies...
only when the exchange is a Related Party Swap with no third-party buyer of the relinquished property or third-party seller of the replacement property.

Gain from a Related Party Swap will be recognized if the taxpayer disposes of the replacement property or the related party disposes of the taxpayer’s relinquished property within two years after the date of the last transfer that is part of the swap transaction. Note that a subsequent disposition within the two-year period not only includes direct transfers of either property but also indirect dispositions of a property, such as by means of the disposition of the stock of a corporation or interest in a partnership that owns the property.

Example: Assume that A and B are related parties. A is an individual and B is his wholly owned S corporation. A owns Lot 1 with an FMV of $150,000 and a basis of $50,000. B owns Lot 2 with an FMV of $150,000 and a basis of $150,000. A would like to sell Lot 1 at some point in the next few years and hold on to Lot 2 for long-term appreciation and possible development. Therefore, A would like to shift B’s high basis into Lot 1 to reduce or avoid the gain on the future sale, while shifting A’s low basis into Lot 2. A and B exchange their lots in a tax deferred exchange with the result that B now owns Lot 1 with an adjusted basis of $150,000 and A owns Lot 2 with a basis of $50,000. If B waits two years and sells Lot 1 to a third-party buyer, B will only have taxable gain on any appreciation above $150,000.

As the example shows, basis-shifting swaps between related parties are valid provided the Two-Year Rule is satisfied. There is no requirement that the taxpayer have a non-tax avoidance motive in doing a Related Party Swap if the taxpayer is patient and bides his or her time for two years.

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Exceptions to the Two-Year Rule

Some post-exchange dispositions are excepted from the Two-Year Rule. No gain is recognized if the subsequent disposition is due to the death of the taxpayer or the related party, or if the disposition is due to the compulsory or involuntary conversion of one of the properties that was not imminent or threatened at the time of the initial exchange.

Under Code Sec. 1031(f)(2)(C), the disposition is also excepted if the taxpayer can establish that neither the exchange nor the later disposition was principally designed to avoid federal income tax. The legislative history provides that this non-tax avoidance exception applies to (1) transactions involving an exchange of undivided interests in different properties that result in each taxpayer holding either the entire interest in a single property or a larger interest in any of those properties; (2) dispositions of property in nonrecognition transactions; and (3) transactions that do not involve the shifting of basis between properties.
Possible nonrecognition transactions might include a post-swap contribution of the property to a partnership or LLC under Code Sec. 721, or to a corporation under Code Sec. 351, a charitable donation or gift of the property, or a transfer incident to divorce under Code Sec. 1041. The IRS has privately ruled that a taxpayer’s transfer of the replacement property to a grantor trust within two years of a Related Party Swap is not a “disposition” under Code Sec. 1031(f) and, therefore, would not trigger recognition of gain. The IRS did caution that a transfer by the trust to a third party or a termination of grantor trust status might trigger recognition depending on the circumstances. A post-swap exchange by one of the parties under Code Sec. 1031 would also not trigger gain because it is a nonrecognition transaction.

The Family Partition
Most Related Party Swaps seem to occur when families are dividing their holdings. Typically, the family members have inherited the property together as tenants in common. After a period of co-ownership, they no longer get along or have divergent goals. Thus, they want to split the properties up between themselves through a partition or some other split of the properties. If the parties inherited the property together, they each will have the same relative tax basis. The exchange is not a basis-shifting plan, but instead is a way to settle the parties’ differences. The family members will want to know if the Two-Year Rule will apply to them after the partition. If it does, then they will need to enter into an agreement that holds a party liable if the gain is triggered on the other party’s exchange due to a disposition that violates the Two-Year Rule.

If the co-owned property is one contiguous parcel, then the IRS has ruled a partition into separate parcels is not an exchange. Instead, it is merely a severance of joint ownership and not a disposition under Code Sec. 1001. Thus, neither Code Sec. 1031 nor the Two-Year Rule would apply.

If co-owned property is more than one parcel, however, then the partition is an exchange. Therefore, the family members must be advised on the applicability of the Two-Year Rule to the partition. The family members may have been gifted or inherited the properties at the same time and thus have equivalent tax bases in their share of the properties. In such a situation, the IRS recently ruled in LTR 200706001 that there is no basis shifting and neither the partition nor the subsequent disposition of a property by one of the related parties would cause gain recognition.

What if the family members do not have equivalent tax bases in the properties, but the party cashing out has a relatively higher tax basis? Perhaps this party inherited the property at a later date than the other family members. The legislative history suggests that the partition should fall within the non-tax avoidance exception of Code Sec. 1031(f)(2)(C) as “transactions involving an exchange of undivided interests in different properties that result in each taxpayer holding the entire interest in a single property or larger interest in any of those properties.” LTR 200706001 did not address this legislative history language, but instead relied on the no basis-shifting rationale. In LTR 20073002, involving a family partition, however, the IRS did rule that the non-tax avoidance exception applied to the initial exchange involving the partition of jointly owned properties between related parties and, therefore, the Two-Year Rule did not apply after the partition. This was a change from prior private letter rulings involving partitions between related parties, in which the IRS cautioned the taxpayer that the Two-Year Rule might apply.

#2. Acquiring Replacement Property from a Related Party when Relinquished Property is Transferred to Unrelated Party
Direct Related Party Swaps are relatively unusual. More commonly, a taxpayer transfers the relinquished property to an unrelated party in a deferred exchange using a QI, and the taxpayer then wants the QI to acquire the replacement property from a related party. For example, a real estate entity might want to acquire a new project constructed by a related developer entity. The related developer entity has a high tax basis in the new project and would recognize little or no gain on the transfer to the taxpayer through the QI. Many taxpayers and their advisors believed that these transactions were not disallowed by Code Sec. 1031(f) so long as the taxpayer held the replacement property acquired from the related party for at least two years after the acquisition. This misconception still exists today, although recent rulings have made it clear that this is not the rule, and simply holding the replacement property for two years after its acquisition from the related party will not remedy an otherwise basis-shifting transaction.

As discussed, Code Sec. 1031(f) was enacted to prevent taxpayers from using Code Sec. 1031 to shift tax bases between properties owned by related par-
ties shortly before or during an exchange to minimize overall taxable gain to the related-party group. This can be easily understood in the Related Party Swap, where the related parties directly swap tax bases to put the highest tax basis in the property that is being subsequently sold. This same result can be reached by restructuring the Related Party Swap into a sale of the relinquished property to an unrelated party in an exchange using a QI, followed by an acquisition of the replacement property from the related party. Therefore, Code Sec. 1031(f)(4) provides that nonrecognition treatment does not apply to an exchange “which is part of a transaction or series of transactions structured to avoid the purposes of” the related-party rules.

Rev. Rul. 2002-83

In Rev. Rul. 2002-83, the IRS illustrated the meaning of the language in Code Sec. 1031(f)(4). This ruling holds that the taxpayer may not transfer relinquished property to an unrelated party in an exchange (using a qualified intermediary) and acquire replacement property from a related party, if the related party has a high tax basis in the replacement property and the related party is cashing out on the sale or receiving non-like-kind property.

Example: Individual A owns Property 1 with a tax basis of $50,000 and FMV of $150,000. Individual B owns Property 2 with a tax basis of $150,000 and FMV of $150,000. A and B are related parties for the purposes of Code Sec. 1031(f). A transfers Property 1 to C, an unrelated individual, using a qualified intermediary (QI). QI then uses the exchange funds to pay B for Property 2, and A acquires Property 2 as A’s replacement property.

The ruling finds that A’s exchange does not qualify under Code Sec. 1031 because A is using the QI to circumvent the purposes of Code Sec. 1031(f). If A had exchanged Property 1 for Property 2 with B, and B then sold Property 1 to C, the exchange would have taxable under Code Sec. 1031(f)(1) because B would have violated the Two-Year Rule. In Rev. Rul. 2002-83, A attempts to avoid the application of Code Sec. 1031(f)(1) by transferring low-basis Property 1 to the QI who sells it to C for cash. The QI then acquires the high-basis replacement property from B and pays B the cash received from C. Thus, A exchanges with the QI, an unrelated third party, instead of B. However, the end result of the transaction is the same as if A had exchanged property with B followed by a sale from B to C. This series of transactions allows A effectively to cash out of the investment in Property 1 without the recognition of gain to the related-party group. A’s exchange of property with the QI, therefore, is part of a transaction structured to avoid the purposes of Code Sec. 1031(f). Under Code Sec. 1031(f)(4), the exchange is taxable. This will be referred to as an “(f)(4) Transaction” in this article.

While the ruling is limited to its facts, the holding most likely will apply any time the related party has a high tax basis in its property and is cashing out by transferring the property to the taxpayer as replacement property in an exchange. This ruling has clarified the meaning of Code Sec. 1031(f)(4) and ruined the plans of many taxpayers who thought they had the perfect replacement property for their exchange.

Teruya Brothers

A subsequent Tax Court opinion confirmed the IRS’s interpretation of Code Sec. 1031(f)(4). In Teruya Brothers Ltd., in a series of planned transactions, the taxpayer transferred real properties to a QI, who then sold them to unrelated third parties. The QI used the sale proceeds to purchase replacement properties from a corporation related to the taxpayer. The Tax Court held that the exchanges were taxable under Code Sec. 1031(f)(4) because they were structured to avoid the purposes of Code Sec. 1031(f). Importantly, the Tax Court did hold that the non-tax avoidance exception of Code Sec. 1031(f)(2), which only refers to Related Party Swaps, also applies to (f)(4) Transactions. The taxpayer argued that the non-tax avoidance exception should apply because the related party recognized more gain on the sale of the replacement property to the taxpayer than the taxpayer was deferring in the exchange. The Tax Court rejected this argument noting that the related party incurred no additional tax because it had a large NOL (net operating loss) that totally offset its gain from the sale to the taxpayer. Thus, the related party’s only tax consequences were reductions in its NOL for the year of the sale and its NOL carryovers for subsequent taxable years. This case has been appealed to the Ninth Circuit, which has had a reputation of favoring the taxpayer on Code Sec. 1031 issues. That court might be more sympathetic to the fact that the related party used up its NOL to offset the gain, thus potentially paying additional taxes in future years.
The taxpayer in *Teruya Brothers* was not assessed penalties, but the exchange occurred in 1995, well before the issuance of Rev. Rul. 2002-83. Furthermore, the related party did recognize substantial gain in the exchange, even though it did not pay actual taxes because of the NOL offset. For many years following the 1989 enactment of Code Sec. 1031(f), taxpayers did (f)(4) Transactions under the common misconception that they only needed to hold the replacement property for two years following the exchange. Today, however, a taxpayer that attempts to acquire replacement property from a related party in circumstances similar to Rev. Rul. 2002-83 will lack substantial authority for the position, and will perhaps even be in negligent or disregard of rules and could be assessed a penalty under Code Sec. 6662. The instructions to IRS Form 8824, the reporting form for Like-Kind Exchanges, direct the taxpayer to Rev. Rul. 2002-83 and put the taxpayer on notice. In short, (f)(4) Transactions should not be undertaken without a non-tax avoidance exception.

### When do the Non-Tax Avoidance Exceptions Apply to (f)(4) Transactions?

As the Tax Court stated in *Teruya Brothers*, the non-tax avoidance exceptions of Code Sec. 1031(f)(2)(C) apply to (f)(4) Transactions as well as to Related Party Swaps. Thus, the taxpayer can acquire replacement property from a related party (when transferring the relinquished property to an unrelated party through a QI in an exchange) if the taxpayer convinces the IRS that the avoidance of federal income tax was not one of the principal purposes of either the exchange or the disposition to the unrelated party. The Conference Committee Report indicated that the non-tax avoidance exception is intended generally to apply to (1) partitions, discussed above in the Related Party Swap; (2) dispositions of property in nonrecognition transactions; and (3) transactions that do not involve the shifting of basis of properties. Exceptions (2) and (3) could apply in an (f)(4) Transaction.

#### Exception (2): Dispositions of property in nonrecognition transactions. Code Sec. 1031(f) limits the swapping of tax bases between the taxpayer and the related party, with the subsequent cashing out by the related party at reduced tax cost. What if the related party is not cashing out, but is also doing an exchange?

**Example:** Assume the facts of Rev. Rul. 2002-83. B, instead of selling Property 2 for cash, exchanges out of Property 2 into Property 3, owned by an unrelated party. B does not end up with cash, but ends up with like-kind property.

In two private letter rulings, the IRS has ruled that this transaction satisfies the non-tax avoidance exception. In both rulings, the taxpayer and the related party each represented that they would hold their respective replacement property for 2 years from the date of the receipt of the replacement property. These rulings distinguish their facts from those in Rev. Rul. 2002-83 because the related party in the rulings is not cashing out, but instead is acquiring replacement property. The transaction thus satisfies the “non-tax avoidance” exception in Code Sec. 1031(f)(2)(C) because both the taxpayer and the related party have engaged in nonrecognition transactions.

Both rulings also state that nonrecognition treatment does not apply to the extent of any boot received by the taxpayer or the related party in the exchanges at issue. In the later ruling, the taxpayer represented that it was trying to obtain additional replacement property from an unrelated seller, and the taxpayer would pay tax on the cash received if the taxpayer were unable to find additional replacement property. The ruling stated that the receipt of such cash will cause the taxpayer to recognize gain on the taxpayer’s exchange, but not in excess of the cash distributed to the taxpayer from the QI.

What if the related party also receives some cash boot in its exchange? The same analysis should apply to the related party. The related party will recognize gain in the amount of the boot and the tax will be paid by the related party on the gain. Although the rulings do not address this issue, to avoid any basis-shifting argument by the IRS, the related party should not receive boot in excess of the related party’s realized gain.

**Example:** Assume the same facts as the above example, except that B’s tax basis is $125,000 in-
stead of $150,000. Related Party B exchanges out of Property 2 valued at $150,000, and acquires Property 3, owned by an unrelated party, valued at $110,000 and receives $40,000 of cash boot. Only $25,000 of the cash boot is taxable, so the taxpayer and the related party have accomplished a shifting of basis to the extent of $15,000.

**Exception (3): Transactions that do not involve the shifting of basis between properties.** The nonbasis shifting exception was discussed under the Related Party Swap and was the subject of LTR 200706001. It should apply in an (f)(4) Transaction if the related party is paying as much or more tax than the taxpayer is deferring in the exchange.

**Example:** Assume the facts of Rev. Rul. 2002-83, but B’s basis in Property 2 is $50,000 rather than $150,000. B has taxable gain of $100,000 and there is no apparent basis shifting occurring in the transaction. Teruya Brothers suggests that this might be an exception if there is no offsetting NOL and B is actually paying the tax.

Most related parties are looking to pay little or no tax on the sale of the replacement property to the taxpayer, and will fall into the basis-shifting category. However, sometimes the related party just wants to sell the property for business or personal reasons that are not tax-motivated and is willing to pay a significant amount of tax. For example, the related party may be an elderly relative that wants to get out of the property management business.

What if the related party is selling his or her principal residence to the taxpayer (which will be held for investment)? The related party may recognize significant gain in the transaction, but is able to exclude the gain under Code Sec. 121 and avoid paying any taxes. Teruya Brothers suggests that the gain recognition is not enough to fall under the nonbasis-shifting exception. The related party must actually pay the taxes on the gain. Therefore, the taxpayer should assume that this transaction would be taxable as an (f)(4) Transaction.

**Other Possible Exceptions to Code Sec. 1031(f)(4).** Code Sec. 1031(f)(4) applies when the taxpayer undertakes steps “structured to avoid the purposes of” the related-party rules. Suppose the taxpayer sells the relinquished property in an exchange with the intent to acquire replacement property from an unrelated party. The taxpayer endeavors in good faith to find a suitable property during the 45-day identification period. On day 45, along with two highly contingent properties, the taxpayer also identifies his mother’s rental house. When the other two properties fall through in the following months, the taxpayer acquires the rental house from his mother near the end of his exchange period. His father had died recently, and his mother has a fair market basis in the rental house and recognizes no gain on the sale. Arguably, this taxpayer did not structure the exchange with the intent to avoid the related-party rules. The taxpayer only acquired his mother’s property as a last ditch alternative in a deferred exchange and, thus, the exchange does not fall within the literal language of Code Sec. 1031(f)(4). The taxpayer would have to prove that he had no intent at the start of the exchange to acquire his mother’s property, and made a good faith effort to acquire other properties. Presumably, this transaction would have to be disclosed on the Form 8824, and an explanation attached.

What if the related party is a dealer with respect to the replacement property and is selling it to the taxpayer on the same terms as it sells the same type of property to unrelated parties? For example, the related party may be a home builder or an equipment seller, and will recognize ordinary income on the profit from the sale and the sale price is the same as offered to other parties. While this does not seem like an abusive transaction, the IRS has yet to rule on it yet and the taxpayer should proceed with caution.

**New Construction by Related Party**

Suppose that the taxpayer wants to exchange into new improvements that will take longer than 180 days to construct. Thus, the taxpayer would be outside the 180-day safe harbor of Rev. Proc. 2000-37 (the IRS’s safe harbor for reverse like-kind exchanges). Therefore, a related party acquires property solely for the taxpayer’s exchange, and constructs improvements for the taxpayer. When the taxpayer later sells the relinquished property, the taxpayer acquires the land and improvements from the related party. Arguably, this should not be an (f)(4) Transaction because the related party acquired the property solely for the taxpayer’s exchange. The taxpayer is not attempting to shift basis into replacement property owned by the related party prior to the idea of the exchange. However, the IRS has never ruled on this issue, and has said informally that this would fall within the related-party prohibitions. Therefore, the taxpayer should use an unrelated party to acquire replace-
The taxpayer may transfer the relinquished property in an exchange to a related party and obtain the replacement property from an unrelated party.

#3 Transfer of Relinquished Property to Related Party when Replacement Property is Acquired from Unrelated Party.

The taxpayer may transfer the relinquished property in an exchange to a related party and obtain the replacement property from an unrelated party. There had been some question as to whether the related party must then hold the relinquished property for two years after the acquisition. The IRS has recently issued private letter rulings that conclude that the transaction is not covered by Code. Sec. 1031(f) and, therefore, the Two-Year Rule does not apply.

In the first ruling, the taxpayer was an affiliate operating partnership of a publicly held real estate investment trust (“REIT”). The taxpayer wanted to transfer the relinquished property in the exchange to its taxable REIT subsidiary (“TRS”), and the taxpayer would then acquire the replacement property from an unrelated party. TRS would pay cash for the relinquished property at a fair market value purchase price. The TRS would then sell the relinquished property within two years from the date of its acquisition. The ruling concludes that Code. Sec. 1031(f) does not apply. First, the ruling holds that this is not a Related Party Swap because the taxpayer is exchanging property with a QI and the QI is not a related person. Further, this is not an (f)(4) Transaction because the taxpayer and TRS are not exchanging properties either directly or through the QI. The related-party TRS did not own, prior to the exchange, any property that taxpayer will acquire in the exchange. The ruling further holds that because this is not a Related Party Swap or an (f)(4) Transaction, the Two-Year Rule does not apply to any disposition of the relinquished property or the replacement property within two years of acquisition.

This ruling potentially presents many planning possibilities, although it is just a private letter ruling and can only be relied upon by the taxpayer obtaining it. For example, if a taxpayer wants to sell off appreciated property in a manner that might give rise to dealer status, the taxpayer can transfer the property to a related party in an exchange. The related party can then perform the dealer activities and pay ordinary income tax on the gain from the sale. The related party will start with a fair market value tax basis, so the subsequent gain only should be attributable to the dealer activities and not the pre-exchange appreciation. The taxpayer can acquire replacement property in the exchange and defer the gain on the transfer to the related party.

According to the facts in the later private letter ruling, the related party wished to acquire the relinquished property apartment building from taxpayer
but did not own like-kind assets that taxpayer wished to acquire.\textsuperscript{31} The taxpayer entered into an agreement with an unrelated third party that required the closing of the acquisition of replacement property to occur before the taxpayer transferred the relinquished property to the related party. The taxpayer therefore structured the transaction as a “reverse” like-kind exchange under the provisions of Rev. Proc. 2000-37. The taxpayer entered into a qualified exchange accommodation arrangement with an EAT. Subsequently, the taxpayer entered into an agreement with the related party to transfer the relinquished property to the related party’s wholly owned subsidiary. The related party intended to dispose relinquished property within two years of its receipt.

This ruling presents the same issues as the earlier ruling, but in a reverse exchange context. The exchange in this later ruling was also approved by the IRS because it was not a Related Party Swap. Further, it was not an (f)(4) Transaction because: (1) the related parties did not exchange high-basis property for low-basis property in anticipation of the sale of the low-basis property; (2) only the taxpayer held property before the reverse like-kind exchange and continued to hold like-kind property after the exchange, while the related party did not hold property before the exchange; and (3) the related party’s disposal of the relinquished property within two years of the acquisition did not result in a “cashing out” of an investment or shifting of basis between the taxpayer and the related party.

Relying on the analysis in this ruling, a taxpayer can avoid a reverse exchange by transferring the relinquished property to a related party at the same time the taxpayer acquires the replacement property. The related party can then market the relinquished property for sale and is not limited to the 180-day restriction of Rev. Proc. 2000-37. Alternatively, the taxpayer can use the structure in the private letter ruling by starting a reverse exchange with an EAT acquiring the replacement property while the taxpayer attempts to find a buyer for the relinquished property. If such a buyer cannot be found within 180 days, then the taxpayer can transfer the relinquished property to a related party. Note that it is permissible under the safe harbor of Rev. Proc. 2000-37 for the taxpayer to transfer the relinquished property to a related party if the EAT is holding title to the replacement property. The safe harbor, however, does not allow the EAT to hold title to the relinquished property and later transfer it to the related party.\textsuperscript{32}

Neither ruling states why the related party wanted the relinquished property, or why the related party would dispose of the relinquished property within two years of acquisition. There is no representation of business purpose in either ruling. Nevertheless, the transaction must pass muster under general tax principles even if it is not covered by Code Sec. 1031(f). Importantly, the related party should be a real party in interest and not just a shell entity set up to do this transaction with the entity disappearing after the relinquished property is sold. Note that the related party in the first ruling was a TRS, which is an entity that is actively involved in businesses that the REIT itself does not perform. The related party should bear the benefits and burdens of the ownership of relinquished property, and should not be acting as the taxpayer’s agent.\textsuperscript{33} Further, the purchase price of the relinquished property should be fair market value. The purchase price was paid in cash in the two rulings. However, outside the Code Sec. 1031 area, the courts have respected sales of appreciated property by a taxpayer to a wholly owned corporation even though part of the consideration was a promissory note from the related party.\textsuperscript{34}

Note that the transactions described in these letter rulings will not apply to members of a consolidated group because Code Sec. 1031 does not apply to transfers between them, as discussed at the beginning of this article. Thus, the relinquished property would have to be transferred to a related party outside of the consolidated group, such as a partnership.\textsuperscript{35}

### Potential Ordinary Income on Transfer to Related Party

A few other Code sections should be considered when structuring an exchange involving related parties. Code Sec. 1239(a) provides that gain recognized on the sale or exchange of depreciable property to certain related entities (as defined in Code Sec. 1239(b)) will be treated as ordinary income rather than capital gain. This provision is limited to “any gain recognized” so it will not trigger ordinary income in an otherwise tax-deferred exchange.\textsuperscript{36} The IRS’s position is that the ordinary income element is carried forward, however, and recognized on the subsequent taxable disposition of the replacement property by the taxpayer, although there are some tax professionals who question whether this position is correct.\textsuperscript{37} Code Sec. 707(b)(2) further provides that any recognized gain on a sale or exchange between a partnership
and a related person or a related partnership will be ordinary income if the asset is not a capital asset under Code Sec. 1221 in the hands of the transferee. While the ordinary income from these provisions is limited to the gain recognized, a taxpayer considering a sale of the relinquished property to a related party in an exchange should also consider the potential of ordinary income due to taxable boot in the exchange, as well as the carry forward of the ordinary income element to the replacement property.

Who Are (And Are Not) Related Parties Under Code Sec. 1031(F)?

Related parties for the purposes of Code Sec. 1031(f) are defined by Code Secs. 267(b) or 707(b), and include:

**Family members.** Family members are related parties. The definition of family members is limited to siblings, spouses, ancestors and lineal descendants. Thus, it does not include aunts and uncles, or nephews and nieces. It also does not include in-laws or stepparents. Therefore, a mother would not be a related party to her son-in-law or stepson. Importantly, family members also do not include domestic partners.

**Entities.** Related parties include: (1) an individual and corporation, where more than 50 percent in value of the stock is owned directly or indirectly by or for such individual; (2) two corporations part of the same control group (but remember that Code Sec. 1031 is inapplicable to corporations filing consolidated returns); (3) a corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of capital interest or profits interest in the partnership; (4) an S corporation and another S corporation or a C corporation if the same persons own more than 50 percent of the value of the outstanding stock of each corporation; (5) a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or profits interest, in such partnership; (6) two partnerships in which the same persons own, directly or indirectly, more than 50 percent capital interests or profits interests; and (7) a person and a Code Sec. 501 organization, if the organization is controlled by that person or that person’s family. The constructive ownership rules, discussed below, apply in defining ownership in an entity.

Note that tenants in common are not related parties if the individual tenants in common are otherwise unrelated. Therefore, a taxpayer can acquire the interest of an unrelated co-tenant as replacement property.

**Trusts and Estates.** Related parties in this category include: (1) a grantor and a fiduciary of the same trust (i.e., a grantor and any trust that he or she created); (2) a fiduciary and a beneficiary of the same trust; (3) a fiduciary of a trust and the fiduciary or beneficiary of another trust where the same person is the grantor of both trusts (i.e., two trusts with the same grantor, or a trust fiduciary and the beneficiary of another trust created by the same grantor); (4) a fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for the grantor of the trust; and (5) an executor of an estate and the beneficiaries of the estate.

A remote or contingent beneficiary is a related party to a trust for his or her benefit. A beneficiary is a related party not only to the trust but also to the person acting as the fiduciary of the trust. Thus, a niece is related to her uncle in his individual capacity because he is acting as trustee of a trust for her benefit, even though she would not be related to him if he was not the trustee. He will cease to be a related party to his niece if he resigns as trustee. The IRS has ruled that two trusts, one a testamentary trust created by the husband and the other an inter vivos generation-skipping trust created by the wife, are not related persons because the trusts did not have the same grantor. The ruling points out that Code Sec. 267 is a carefully drafted statute that imposes an irrebuttable presumption of a lack of bona fides on taxpayers and should be narrowly construed.

**Constructive Ownership Rules.** The constructive ownership rules of Code Sec. 267(c) apply when there are multiple related-party owners. Under Code Sec. 267(c)(1), stock owned, directly or indirectly, by or for a corporation, partnership, estate or trust is treated as owned proportionately by or for its shareholders, partners or beneficiaries. Importantly, this proportion-
ate ownership under (c)(1) is considered “actual” ownership and is thus subject to further attribution to other related parties. Under Code Sec. 267(c)(2), an individual is considered to constructively own the stock owned, directly or indirectly, by or for his family [his brothers and sisters (whether by the whole or half blood), spouse, ancestors and lineal descendants]. Thus, in a typical family limited partnership, in which the parents and children are the only partners, each partner would be deemed to own 100 percent of the partnership. Likewise, parents are related parties to entities owned by their children because of the constructive ownership rules of Code Sec. 267(c)(2). An individual need not own stock or interests directly in the corporation or partnership to be considered as constructively owning the stock of a corporation or partnership interests that are owned, directly or indirectly, by or for members of the individual’s family.

Unlike the Code Sec. 267(c)(1) rules, the family attribution in Code Sec. 267(c)(2) is not deemed to be “actual” ownership and there is no additional attribution from the constructive owner. Therefore, while the taxpayer’s spouse is deemed to own the taxpayer’s interests in a family LLC, the spouse would not be deemed to own the taxpayer’s parents interests in the family LLC.

Under Code Sec. 267(c)(3), an individual treated as actually owning any stock in a corporation shall be considered as constructively owning the stock owned, directly or indirectly, by or for a person that is his partner in a partnership. The partner attribution rules result in constructive and not actual ownership of stock and there is no further attribution from the constructive owner. Fortunately, there are no similar attribution rules for ownership interests in a partnership. Thus, partners are not deemed to own the partnership interests of their partners in other partnerships.

Creating an unrelated party. The taxpayer may be able to avoid the application of Code Sec. 1031(f) by changing the ownership of the related-party entity. For example, if the related party is a partnership owned 51 percent by a family member, the family member could transfer one percent of his or her interests in the partnership to a partner that is unrelated to the taxpayer, such as the family member’s spouse, to bring the related-party percentage of ownership down to 50 percent. An unrelated party also can be created by forming a partnership with no more than 50 percent related-party ownership. For example, if the taxpayer’s mother and stepfather own marital property in their individual names, they can contribute their property to an LLC (and file a Form 1065) to create an unrelated party to the taxpayer as to 100 percent of the property. If a mother desires to acquire property from her son, her son could transfer his interest to his wife as his wife’s separate property because in-laws are not related parties. In all of these circumstances, however, the unrelated party would have to hold the interest indefinitely and not immediately transfer it back to the related party, so as to avoid a step transaction or sham transaction problem.

Conclusion

Three basic related-party transactions were discussed in this article. The first transaction, the Related Party Swap, is a valid exchange if the related parties are patient and comply with the Two-Year Rule. Many taxpayers desire to accomplish the second transaction, an (f)(4) Transaction, by transferring the relinquished property to an unrelated party and then acquiring the replacement property from a related party. However, this transaction is only valid in limited circumstances, such as when the related party is also doing an exchange or the related party is paying tax on as much gain as the taxpayer is deferring in the exchange. The third transaction, in which the taxpayer transfers the relinquished property to the related party and acquires the replacement property from an unrelated party, has been the subject of recent private letter rulings. These rulings allow the related party to perform dealer activities on the relinquished property and sell it within the two-year period following the related party’s acquisition. The rulings also appear to allow the taxpayer to avoid the 180-day limitation of Rev. Proc. 2000-37 in a reverse exchange by transferring the relinquished property in the exchange to the related party who can then sell it at any time to an unrelated party.

Endnotes

1 J.P. Kornfeld, CA-10, 98-1 USTC ¶50,241, 137 F3d 1231. Cert. denied, 119 SCt 171.
2 Reg. §1.1502-80(f).
3 Reg. §1.1502-13(c)(7), Example 1(h).
4 Code Sec. 1031(f)(1).
6 Note that Code Sec. 1239(a) is inapplicable because the properties are not subject to depreciation. See discussion infra re the application of Code Sec. 1239(a) to Related Party Swaps.
7 FSA 200137003 (May 10, 2001).
8 Code Sec. 1031(f)(1).
9 Code Sec. 1031(g).
**ENDNOTES**

10 Code Secs. 1031(f)(2)(A) and (B).
13 LTR 200444002 (June 14, 2004) and LTR 200616005 (Dec. 22, 2005).
14 LTR 200411022 (Dec. 10, 2003) and LTR 200328034 (Oct. 1, 2002).
16 LTR 200706001 (Oct. 31, 2006).
18 LTR 200730002 (Apr. 26, 2007).
19 See also LTR 199926045 (Apr. 2, 1999).
22 LTR 200444002 (June 14, 2004) and LTR 200616005 (Dec. 22, 2005).
24 LTR 200251008 (Sept. 11, 2002) and LTR 200329021 (Apr. 7, 2003).
29 LTR 200709036 (Nov. 28, 2006).
31 LTR 200712013 (Nov. 20, 2006).
34 See Bramblett, supra note 30.
35 LTR 9645015 (Aug. 9, 1996).
36 LTR 8038099 (June 26, 1980).
38 C.J. Wyly, Sr., Est., CA-5, 80-1 USTC ¶13,332, 610 F2d 1282.
40 LTR 9224008 (Mar. 6, 1992).
42 Code Sec. 267(c)(5); Reg. §1.267(c)-1a(3).
43 Reg. §1.267(c)-1(a)(2); Reg. §1.707-1b(3).
44 Code Sec. 267(c)(5); Reg. §1.267(c)-1a(3).
45 Id.
46 Reg. §1.707-1b(3), which does not apply to Code Sec. 267(c)(3).