

REVENUE RULING 2002-83: RELATED PARTY EXCHANGES

Background: In 1989, Section 1031(f) was added to the Code to impose a two-year holding period on exchanges between related parties. Any disposition of the property received in the exchange prior to 2 years after the date of the last transfer that was part of the exchange would disqualify the transaction.

IRC Section 1031(f)(2) provides a general exception for transfers that are made as a result of death, involuntary conversion, or situations where it is established, to the satisfaction of the Secretary that neither the exchange nor the subsequent disposition had, as its primary motive, avoidance of Federal income tax.

[Note: arguably every exchange under IRC Section 1031 has tax avoidance as its primary motive. The Service has expressed in several recent private rulings that the language in 1031(f)(2) was intended to address basis shifting transactions between related parties that are effected purely for tax avoidance purposes.]

IRC Section 1031(f)(3) defines "related person" for purposes of the Section as any person bearing a relationship described in Section 267(b) or 707(b)(1). Relationships under Section 267(b) include family and trust relationships: spouses, ancestors and lineal descendants and corporations. Relationships under Section 707(b)(1) include relationships between controlled partnerships: partnership and a person owning more than 50% of the controlling interest or two partnerships in which the same party owns more than 50% of the controlling interests of both entities.

IRC Section 267(b): Relationships

1. Members of a family, as defined in subsection (c)(4);
2. An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;
3. Two corporations which are members of the same controlled group (as defined in subsection (f));
4. A grantor and a fiduciary of any trust;
5. A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trust;
6. A fiduciary of a trust and a beneficiary of such trust;
7. A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
8. 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 a person who is a grantor of the trust;

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Recent Rulings: Prior to the issuance of Rev. Proc. 2002-83, a number of TAMs and PLRs were issued where related party exchanges were disallowed based on a re-characterization of the transaction. The classic example is as follows: Taxpayer owns relinquished property A that it sells to Unrelated Third Party Purchaser. Taxpayer acquires replacement property B from Taxpayer's mother. Taxpayer never intended to acquire any replacement property other than the property owned by Taxpayer's mother. In TAM 9748006 the Service concluded that this type of transaction should be re-characterized and viewed as a direct exchange between the related parties followed by a subsequent disposition of the relinquished property by the related party in violation of the two year holding period. For purposes of this transaction Taxpayer and his mother are considered to be a single economic unit that has "cashed out" (this characterization mirrors the provisions of Section 453(e)).

In PLR 200126007 Taxpayer asserted that the provisions of 1031(f)(4) should be interpreted as if they only applied to direct related party exchanges followed by a disposition – a transaction that was not feasible or possible in Taxpayer's situation. The Service ruled against Taxpayer and held, in part, that "by its terms, 1031(f)(4) denies 1031 nonrecognition treatment to any exchange which is part of a transaction structured to avoid the purposes of section 1031(f); **the exchange need not be a direct related party exchange**"[emphasis added] and further, that if 1031(f)(4) were intended to apply only to direct related party exchanges followed by a disposition that would "unwarrantedly restrict the application of section 1031(f)(4) on the basis of circumstances that have little, if any, relationship to the purposes of that Section".

The Full Text of Revenue Ruling 2002-83, issued November 25, 2002 follows:

Related party like-kind exchanges. Under the facts described, a Taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party is not entitled to nonrecognition treatment under section 1031(a) of the Code if, as part of the transaction, the related party receives cash or other non-like-kind property for the replacement property.

ISSUE: Under the facts described below, is a Taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party entitled to non-recognition treatment under section 1031(a) of the Internal Revenue Code if, as part of the transaction, the related party receives cash or other non-like-kind property for the replacement property?

FACTS: Individual A owns real property (Property 1) with a fair market value of \$150x and an adjusted basis of \$50x. Individual B owns real property (Property 2) with a fair market value of \$150x and an adjusted basis of \$150x. Both Property 1 and Property 2 are held for investment within the meaning of section 1031(a). A and B are related persons within the meaning of section 267(b).

C, an individual unrelated to A and B, wishes to acquire Property 1 from A. A enters into an agreement for the transfers of Property 1 and Property 2 with B, C, and a qualified intermediary (QI). QI is unrelated to A and B.

Pursuant to their agreement, on January 6, 2003, A transfers Property 1 to QI and QI transfers Property 1 to C for \$150x. On January 13, 2003, QI acquires Property 2 from B, pays B the \$150x sale proceeds from QI's sale of Property 1, and transfers Property 2 to A.

LAW AND ANALYSIS: Section 1031(a)(1) provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of a like kind that is to be held either for productive use in a trade or business or for investment. Under section 1031(d), the basis of property acquired in a section 1031 exchange is the same as the basis of the property exchanged, decreased by any money the Taxpayer receives and increased by any gain the Taxpayer recognizes.

Section 1031 and the regulations thereunder allow for deferred exchanges of property. Under section 1031(a)(3) and section 1.1031(k)-1(b) of the Income Tax Regulations, however, the property to be received by a Taxpayer in the exchange (replacement property) must be: (i) identified within 45 days of the transfer of the property relinquished in the exchange (relinquished property) and (ii) received by the earlier of 180 days after the transfer of the relinquished property or the due date (including extensions) of the transferor's tax return for the taxable year in which the relinquished property is transferred.

Section 1.1031(k)-1(g)(4) allows Taxpayers to use a qualified intermediary to facilitate a like-kind exchange. In the case of a transfer of relinquished property involving a qualified intermediary, the Taxpayer's transfer of relinquished property to a qualified intermediary and subsequent receipt of like-kind replacement property from the qualified intermediary is treated as an exchange with the qualified intermediary.

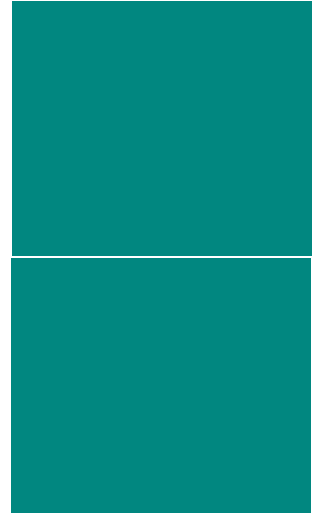
Section 1031(f) provides special rules for property exchanges between related parties. Under section 1031(f)(1), a Taxpayer exchanging like-kind property with a related person cannot use the nonrecognition provisions of section 1031 if, within 2 years of the date of the last transfer, either the related person disposes of the relinquished property or the Taxpayer disposes of the replacement property. The Taxpayer takes any gain or loss into account in the taxable year in which the disposition occurs. For purposes of section 1031(f), the term "related person" means any person bearing a relationship to the Taxpayer described in section 267(b) or 707(b)(1).

Section 1031(f) is intended to deny non-recognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property. The legislative history underlying section 1031(f) states that "if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, 'cashed out' of the investment, and the original exchange should not be accorded nonrecognition treatment." H.R. Rep. No. 247, 101st Cong. 1st Sess. 1340 (1989).

To prevent related parties from circumventing the rules of section 1031(f)(1), section 1031(f)(4) provides that the nonrecognition provisions of section 1031 do not apply to any exchange that is part of a transaction (or a series of transactions) structured to avoid the purposes of section 1031(f)(1). The legislative history underlying section 1031(f)(4) provides:

If a Taxpayer, pursuant to a pre-arranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the Taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031. *Id.* at 1341.

Editor's Note: *The Internal Revenue Service issued proposed Regulations under Section 168 (IA-18-95) on April 20, 1995 relating to property that is leased to a tax-exempt entity or a foreign entity where there is an exchange between related parties. While the proposed Regulations will have no impact on the qualification under Section 1031, it will require that the Taxpayer be bound by the same restrictive depreciation methods to which the related party tax-exempt property lessor was initially subject (i.e., Alternative Depreciation Schedule). The proposed Regulations are quite generous in that they do not disqualify Section 1031 application where the sole purpose of the exchange between the related parties is to achieve a non-Section 1031 tax benefit (i.e., shifting depreciation methods).*



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