

RELATED PARTY EXCHANGES

"CAUTION NEEDED IN THESE TRANSACTIONS"



Compliments of

INTENT OF THE RELATED PARTY RULES

The related party rules were enacted to prevent related parties from "cashing out" of an investment and avoiding tax if either party's property is disposed of within two years of the exchange. In addition, Section 1031(f) states that the Internal Revenue Service reserves the right to invalidate any exchange in which the taxpayer can't prove that the "exchange" did not have a principal purpose of avoiding taxes that would otherwise be due or avoiding the purposes of the related party rules.

WHO IS A RELATED PARTY?

A related party is any person or entity bearing a relationship with the taxpayer. Although not an exhaustive definition, this includes:

- Family members such as brothers, sisters, spouses, ancestors and lineal descendants. (Stepparents, uncles, in-laws, cousins, nephews and ex-spouses are not considered related.)
- A corporation or partnership in which more than 50% of the stock or more than 50% of the capital interest is owned by the taxpayer.

LET'S LOOK AT SEVERAL SCENARIOS

Although it is important to consult with tax or legal advisors before attempting any exchange with a related party, some guidelines exist which are useful in analyzing related party exchanges.

Simultaneous Exchange

When related parties directly swap with each other, both parties must hold the property acquired for two years following the exchange. If either party disposes of their property within the two year holding period, then the capital gain tax will need to be recognized.

Delayed – Selling to a Related Party

A taxpayer can sell to a related party, but the related party must hold the property for a minimum of two years or the exchange will be invalidated.

Delayed – Purchasing from a Related Party

In Private Revenue Ruling 9748006, the IRS disallowed tax deferral to an Exchanger who purchased his mother's property. Revenue Ruling 2002-83 also denied tax deferred treatment to an Exchanger using a Qualified Intermediary to ultimately purchase a replacement property from a related party. A conservative guideline to observe is: *"If the buyer and seller are related, and one of the parties ends up with the property and the other ends up with the cash, the exchange will probably be disallowed."*



ASSET PRESERVATION
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