



TAX DEFERRED

RELATED PARTY TRANSACTIONS

BACKGROUND

In 1989, Section 1031 of the Internal Revenue Code was amended to prevent "basis shifting" between and among related parties. For example, assume two related corporations own real estate. Parcel 1, owned by "X" Corporation, has an adjusted basis of \$100,000; and Parcel 2, owned by "Y" Corporation, has an adjusted basis of \$800,000. An unrelated party wishes to purchase Parcel 1 for \$1,000,000. If "X" sells Parcel 1, it will have a gain of \$900,000 (\$1,000,000 less \$100,000). Instead, "X" and "Y" exchange Parcels 1 and 2 in a tax deferred exchange with the result that "Y" now owns Parcel 1 with an adjusted basis of \$800,000, and thus, on sale to the third party unrelated purchasers, will have a gain of only \$200,000 (\$1,000,000 less \$800,000).

RULES FOR RELATED PARTIES

In order to prevent basis shifting as illustrated above, Sections 1031(f) and (g) were added to the Internal Revenue Code. Section 1031 (f) provides that if a taxpayer exchanges property with a "related person", (i) there is a non-recognition gain or loss on the exchange to the taxpayer under Section 1031 and (ii) before the date which is two years after the date of the last transfer which was part of the

exchange, either the taxpayer or the related person disposes of the property received in the exchange, then the original exchange *no longer* qualifies for non-recognition treatment under Section 1031, and the gain or loss recognized will be taken into account in the year of the disqualifying disposition.

OTHER PRECLUSIONS FROM NON-RECOGNITION

Non-recognition under Section 1031 does not apply to an exchange if it is part of a transaction or series of transactions which is structured to avoid the related party exchange restrictions. See an example of this tricky move below:

The related party rules may not be avoided by merely using a non-related third party as an intermediary. For example, rather than "X" and "Y" first exchanging the Parcels 1 and 2 and selling Parcel 1 to buyer, buyer could purchase Parcel 2 from "Y" and then exchange Parcel 2 for Parcel 1 held by "X". While "X" and "Y", the related parties, have not exchanged, the parties are in the same position as if "X" and "Y" have exchanged and "Y" had then sold Parcel 1 to buyer. This exchange will not be valid.

WHO ARE RELATED PARTIES?

Any person bearing a relationship to the taxpayer described in Section 267(b) or 707(b) (1). These include (a) members of a family (which included brothers and sisters, spouse, ancestors, and lineal descendant(s); (b) two corporations which are members of the same controlled group; (c) an individual in a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual; (d) a corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the

capital interests or the profit interest in the partnership; (e) a grantor or a fiduciary of any trust; (f) a partnership and a person owing, directly or indirectly, more than 50% of the capital or profit interest in such partnership.

OTHER EXCEPTIONS TO THE NON-RECOGNITION RULES

Non-recognition of gain is allowed despite the post-acquisition disposition within the two year period if: (i) it occurs after the death of the taxpayer or the related person; (ii) it is a result of a Section 1033 compulsory or involuntarily conversion (if the exchange occurred before the threat or imminence of such conversion); or (iii) the taxpayer convinces the IRS that neither the exchange nor the disposition have the avoidance of federal income tax as one of its principal purposes. (The Conference Committee Report indicates that this exception is intended generally to apply to transaction that do not involve the shifting of basis between properties or to dispositions of property in non-recognition transactions).

THIS LITERATURE IS PRODUCED TO PROVIDE A GENERAL OVERVIEW OF THE TAX-DEFERRED EXCHANGE PROCESS. YOU SHOULD NOT DEPEND UPON THIS LITERATURE WHEN DETERMINING WHETHER OR NOT YOU MAY WANT TO COMPLETE A TAX-DEFERRED EXCHANGE. YOUR DECISION TO DO SO RESTS ENTIRELY WITH YOU, WITH THE ADVISE OF YOUR OWN ACCOUNTING AND LEGAL PROFESSIONAL, WHETHER THAT BE YOUR ACCOUNTANT, C.P.A. OR ATTORNEY. WE ARE QUALIFIED INTERMEDIARIES AND ARE BY I.R.S. REGULATION PRECLUDED FROM ACTING AS YOUR QUALIFIED INTERMEDIARY IF WE HAVE BEEN YOUR ATTORNEY OR ACCOUNTANT DURING THE TWO (2) YEAR PERIOD BEFORE YOUR EXCHANGE. AS YOU CAN SEE, OUR SERVICES AS FACILITATOR DO NOT REPLACE THE TRULY PROFESSIONAL SERVICES OF YOUR ATTORNEY OR ACCOUNTANT!