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PROFESSIONAL SERVICES

IRS tightens related-party rules

A recent Internal Revenue Service ruling will now reduce taxpayer flexibility when they complete a 1031 exchange by buying property for a relative.

To be clear, there are two types of exchange involving relatives. In the *simultaneous* type, you trade deeds. Section 1031 allows you to swap properties tax-free with a relative provided both of you then hold the property your receive for at least two years.

In the *deferred* type of exchange, you sell your property to a third party and use the money to buy your relative's property section 1031 (f) prohibits such a purchase unless you can prove to the IRS that you had no motive to avoid tax. The new ruling pertains to this deferred type involving a relative.

Prior to this ruling, many exchange professionals assumed that the "no tax avoidance" exception meant that if a related seller of the replacement (let's call it the "new") property pays tax, or is able to sell the property without tax, then you could buy from them if they are related.

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For example, if your brother is selling you a house that he owns, and would have no tax liability because he is selling it at a loss, it was felt that your purchase of the property would be allowed because there is no tax avoidance. This is also true if it was his personal residence and the gain is excluded or if your brother merely declares the gain and pays the tax.

The new ruling makes it clear that the IRS sees the purchase of the new property from a related party in a deferred exchange as a violation of the prohibition against deferred related party dealings.

In the *Technical Advice Memorandum* issued as Private Revenue Ruling 9748006, a son sold an undivided interest in bare land and immediately purchased a residence from his mother. The mother had purchased the residence just prior to its acquisition by the son and had no

taxable gain on the sale. The son used a number of arguments making his case that the exchange should stand, the most prominent of which was that there was no tax avoidance in the transaction because the mother had no gain. The IRS disagreed and ruled that the purchase violated Section 1031(f) because the family unit (e.g., the mother and son) ended up with both the house and the cash in completion of the exchange.

One of the son's other arguments was that because he had used a qualified intermediary to handle his exchange, he had purchased the new property from the qualified intermediary, who was not related, rather than from his mother. Since the acquisition of the house from the mother happened simultaneously with the sale of the land, it seems that the only use of the qualified intermediary was to insert an unrelated party between the son and the mother. The IRS stated that the use of a qualified intermediary would not correct an otherwise flawed transaction.

This is the first ruling the

IRS has issued concerning deferred related part replacements in a 1031 exchange. It makes it clear that the IRS intends to narrowly apply the tax avoidance exemption allowed by 1031(f) in all cases except a direct swap of property. And it imposes a new rule of thumb that might simply be stated as follows:

"If the buyer and the seller are related, and one of the parties ends up with the property and the other ends up with the cash, the exchange will be disallowed."

As with many IRS ruling, it raises more questions than it answers. Most obvious is the question of "what situation would give rise to a 'no tax avoidance' situation." Nor is the ruling clear about what the son intended to do with property. The implication is that the son intended to rent the property to the mother. The IRS did not address that issue. And most interesting was the fact that this transaction was in effect a reverse exchange since the new property was acquired for the taxpayer before the taxpayer had closed the sale of the old property. ▲