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Related Parties, Tax-Deferred Sales, and Cashing Out

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Before the 1989 addition of section 1031(f) to the code, tax practitioners could suggest that their clients use related-party transactions with section 1031 tax-deferred exchanges to liquidate an investment with minimal tax consequences. The House committee report on the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) explained one of the ways that was done:

> Because a like-kind exchange results in the substitution of the basis of the exchanged property for the property received, related parties have engaged in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale. Basis shifting also can be used to accelerate a loss on retained property. The committee believes 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.

A decade before, section 453 had already dealt with a similar problem involving installment sales to related parties and had adopted a two-year rule. So section 1031(f) decreed that for its purposes, a disposition of either the property transferred to the related person or the property received from the related person in less than two years would invalidate the original tax-deferral treatment. The date of the sale would, however, be the date of the "cashing-out" of the property, not the date of the exchange between the related parties.

Teruya Brothers

In Teruya Brothers Ltd. and Subsidiaries v. Commissioner, 124 T.C. No. 4 (2005), Doc 2005-2696, 2005 TNT 27-8, Teruya transferred real property to a qualified intermediary. The QI sold that property to unrelated parties and then used the sales proceeds plus boot to buy replacement properties from Times Super Market Ltd., a corporation in which it owned 62.5 percent of the common stock. The property sold by the QI had a low tax basis, whereas the property bought from Times had a high tax basis. One way to avoid section 1031(f) is to establish the absence of a tax-avoidance motive for the related-party transaction. When the IRS audited Teruya, however, the agent determined that if Teruya and Times were viewed as one taxpayer, that taxpayer had "cashed out" its investment in the property sold with minimal income tax consequences, and section 1031(f) applied to prevent the tax-deferred exchange from working. Teruya sought technical advice from the IRS. In TAM 200126007, Doc 2001-17897, 2001 TNT 127-33, the IRS sided with the revenue agent. The IRS then determined a $4,144,359 deficiency. Teruya petitioned the Tax Court.

"This case presents an issue of first impression regarding the application of section 1031(f)," admitted Tax Court Judge Michael B. Thornton. Teruya had used a qualified intermediary to handle its transaction. Thus, there was no actual direct exchange of property between Teruya and Times, the related parties. Teruya argued that, as a result, the requirement of section 1031(f)(1) was not met. Therefore, it concluded, the rule of section 1031(f) did not apply.

The IRS did not waste much effort contesting Teruya's contention that section 1031(f)(1) was bypassed by use of the QI. Even if that was so, explained IRS, it was irrelevant. A transaction that avoids section 1031(f)(1) may still be struck down as violative of section 1031(f)(4), which provides: "This section shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection." That is, if related-party transactions

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are used to take advantage of the tax deferral of section 1031 and are structured to avoid the ambit of section 1031(f)(1), they may still be ineligible for tax deferral under section 1031(f)(4) if they run afoul of the purpose of the section 1031(f) related-party rules.

The Purpose of Section 1031(f)

Of course, a statement of the purpose of section 1031(f) would have made clearer the meaning of section 1031(f)(4), but Congress did not deign to put anything like that in the statute. Judge Thornton was forced back into the legislative history of section 1031(f) to discern the "purpose" of section 1031(f). The IRS argued that an example there was on point:

> Nonrecognition will not be accorded to any exchange which is part of a transaction or series of transactions structured to avoid the purposes of the related party rules. For example, if a taxpayer, pursuant to a prearranged 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. [H.R. Rep. No. 101-247, at 1341 (1989).]

A qualified intermediary, argued the IRS, was exactly the type of unrelated party to which the example referred. Thus, "a deferred exchange between related parties, involving a qualified intermediary, should be recast as a direct exchange between the related parties." Therefore, "if section 1031(f)(1) would preclude nonrecognition treatment for the recast transaction, then the deferred exchange should be deemed to have been structured to avoid the purposes of section 1031(f)." That, concluded the IRS, should end the inquiry under section 1031(f)(4).

Judge Thornton was not willing to let the question be that easily settled:

> Although respondent's argument has superficial appeal, it is only loosely grounded in the above-quoted, highly elliptical example in the legislative history. Cf. Mandarino, "Reconciling Rulings on Related Party Like-Kind Exchanges", 30 Real Estate Tax'n 174, 175 (Third Quarter 2003) ("Because of the way this example is drafted, it appears not to make the point for which it is offered."). Moreover, respondent's analysis fails to consider the non-tax-avoidance exception of section 1031(f)(2)(C). Because this exception is subsumed within the purposes of section 1031(f), any inquiry into whether a transaction is structured to avoid the purposes of section 1031(f) should also take this exception into consideration.

Avoidance of Federal Income Taxes as a Principal Purpose

Having said that, however, Judge Thornton then pointed out that the transactions were the economic equivalent of direct exchanges between Teruya and Times, followed by Times's sales of the properties to unrelated parties. He observed that "the record discloses no reason (other than seeking to avoid the section 1031(f) rules) for Teruya's using a qualified intermediary to accomplish the transactions." From that he concluded that the purpose of the multiparty structure had to be to avoid the income tax consequences of a direct exchange while still achieving the same economic effect.

Teruya argued that it had no tax avoidance motive. It pointed to the fact that it had retained the properties it received from Times and

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thus it met the "continued investment" requirement in section 1031. That argument did not impress Judge Thornton:

> Section 1031(f) presupposes that an exchange to which it applies otherwise meets the requirements of section 1031(a)(1). See sec. 1031(f)(1)(b). Even if Teruya never intended to make a direct sale of the relinquished properties, this does not mean that section 1031(f) is not implicated or that the deferred sale was not structured so as to avoid Federal income taxes. The economic substance of the transactions remains that the investments . . . were cashed out immediately and Times, a related person, ended up with the cash proceeds.

Other Transactions

What about the fairly common situation in which an adult child owns suitable replacement property with a relatively high tax basis? The parent wants to sell his own low-basis property but still wants to avoid any tax on the transaction. How does section 1031(f) apply in that situation if the parent transfers the property to be sold to a qualified intermediary, who then sells it and uses the proceeds to acquire the replacement property from the child?

That was the situation in Rev. Rul. 2002-83, 2002-2 C.B. 927, Doc 2002-26223, 2002 TNT 228-14. The ruling cited the committee report example we quoted above:

> If a taxpayer, pursuant to a prearranged 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.

The ruling concluded that the taxpayer "is using the QI to circumvent the purposes of section 1031(f) in the same way that the unrelated party was used to circumvent the purposes of section 1031(f) in the legislative history example." If the QI were eliminated from the transaction, in other words, the taxpayer and the related party would have swapped properties, followed by the related party selling the property it received from the taxpayer. "The non-recognition provisions of section 1031(a) do not apply to that exchange," reasoned the ruling, because the related party sold the replacement property within two years of the exchange.

Change the facts slightly. The child's property is also low-basis property and the amount of the child's gain on the sale of the replacement property to the QI will approximate the amount of gain the parent would have realized through selling his property outright without any attempt at tax deferral. If the child has an unused capital loss carryover, so that the amount of tax that will actually be paid will be far less than the tax if the parent had to recognize the gain, it would appear that section 1031(f) would apply to treat the sale within two years as that of the parent.

However, if all that is happening is that taxation is being shifted from the parent, a resident of a high-tax state, to the child, a resident of a state without an income tax, it appears that the parent should have a good argument under section 1031(f)(2)(C) that what has occurred did not have "as one of its principal purposes the avoidance of Federal income tax." It may have been intended to avoid state income tax, but that is a legitimate business purpose under federal income tax law.

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Form vs. Substance

In Barker v. Commissioner, 74 T.C. 555, 561 (1980), the Tax Court commented about section 1031 that:

> The "exchange" requirement poses an analytical problem because it runs headlong into the familiar tax law maxim that the substance of a transaction controls over form. In a sense, the substance of a transaction in which the taxpayer sells property and immediately reinvests the process in like-kind property is not much different from the substance of a transaction in which two parcels are exchanged without cash. Bell Lines, Inc. v. United States, 480 F.2d 710, 711 (4th Cir. 1973). Yet, if the exchange requirement is to have any significance at all, the perhaps formalistic difference between the two types of transactions must, at least on occasion, engender different results. Accord, Starker v. United States, 602 F.2d 1341, 1352 (9th Cir. 1979).

Into that formalistic approach to property exchanges, with its specific statutory rules and regulatory embellishments (enacted in the wake of Starker) governing deferred exchanges, section 1031(f) introduced two subjective rules regarding related-party transactions: the rule of section 1031(f)(2)(C) that related-party transactions were acceptable if avoidance of federal income tax was not one of their principal purposes and the rule of section 1031(f)(4) that said that they were verboten if structured to avoid section 1031(f).

Thus, if Parent and Child exchange property and treat the transaction on both sides as section 1031 exchanges, and Child later decides not to retain the property received from Parent, both may still have valid section 1031 exchanges if they can establish that federal income tax avoidance was not a principal purpose of the exchange. But what if Child decides, within two years of the exchange, to enter into another tax-free exchange with an unrelated party, using the property acquired from Parent to acquire a different piece of property. Section 1031(f)(1(C) voids the section 1031 treatment if "the related person disposes of such property" within the two-year period. However, what is the meaning of "disposed"? Is a further section 1031 exchange with an unrelated party a disposition?

We do not think so. It is true that section 1031(f)(2) does not treat any disposition after the death of either the taxpayer or the related person, or in certain compulsory or involuntary conversions, as a disposition that triggers section 1031(f). In compulsory or involuntary conversion situations, the section 1031 exchange must have occurred before the threat or imminence of the conversion. From that, one could deduce an intent -- by not mentioning those transactions -- to treat a further section 1031 exchange as a disposition. But even if the second section 1031 exchange is technically a disposition, it would appear to be excludable from the voiding effect of section 1031(f) because of section 1031(f)(2)(C), because avoidance of federal income tax would seem unlikely. That avoidance would normally be unlikely because Parent could have engaged in the second tax-free exchange without tax consequences even without the first exchange having occurred. Death and involuntary conversions are situations that can be objectively identified as being beyond the control of the taxpayer and thus not situations involving tax avoidance in either the exchange of properties or their disposition. So, too, it should be possible to argue successfully that tax avoidance is hardly the motivation if the disposition can be demonstrated to be something not contemplated at the time of the original exchange that occurred because of developments beyond the control of the taxpayer. It normally should also be possible to demonstrate the lack of tax avoidance motive when the transaction

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could have been structured to be tax-free under section 1031 without the related-party exchange.

Related Persons

The related parties to whom section 1031(f)(4) applies are not -- contrary to what one logically might expect from our earlier reference to the similar two-year rule in section 453(e) -- the identical related parties specified in section 453(f)(1), but they are nearly so. Section 453 related persons are determined under either section 267(b) or section 318(a). Section 267(b) also applies for section 1031(f) purposes, but section 707(b)(1) partnership attribution replaces section 318(a)'s stock attribution. The difference is due to the greater emphasis on corporate stock in the installment sale area and on partnerships when dealing with section 1031 exchanges, dominated as that area is by real estate transactions.

Section 267(b) lists 13 categories of relationships, including members of a family, corporations in which an individual owns more than 50 percent in value of the outstanding stock, grantors and fiduciaries of trusts, and fiduciaries and beneficiaries of trusts. Notably absent from section 267(b) is the partner-partnership relationship. That is dealt with by the reference in the section 1031(f)(3) definition to "any person bearing a relationship to the taxpayer described in . . . section 707(b)(1)," which embraces both "a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest in such partnership, or two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profit interests."

Conclusion

Section 1031 exchanges between related parties are permitted, but the tax practitioner needs to think through the details to avoid unexpected consequences. The lesson of the Teruya opinion is that if the effect of what happened in a multiparty exchange is the same as if an exchange had occurred between related parties, the mere fact that unrelated parties were involved, especially when involved as qualified intermediaries, will not change the outcome. If either related party to the exchange disposes of the property received within two years, there is a probability that the IRS will take the position that the original exchange is thereby rendered taxable as of the date of that disposition. The taxpayer can still keep the original tax-free treatment if it can be established that avoidance of federal income taxes was not a principal purpose of both the original exchange and the subsequent disposition of the property. The tax practitioner involved with that related-party transaction therefore needs to focus on documenting the absence of federal income tax avoidance motives. In turn, taxpayers need to be cautioned of the tax danger of either property being disposed of within the two-year period. Form 8824, the like-kind exchange reporting form, is useful in that regard. Part I asks whether a related-party exchange occurred and Part II asks for additional information covering current related-party exchanges and those of the prior two years.

The tax practitioner also needs to be sensitive to the possibility that a related-party exchange may have occurred indirectly -- such as through the use of a qualified intermediary -- and focus when analyzing the transaction on not only the nature of the property being acquired as replacement property but also on the identity of the person from whom it is being acquired. Section 1031(f)(1) does not say "directly or indirectly" when describing taxpayer exchanges with a related person, but Judge Thornton has so interpreted section 1031(f)(4) in his Teruya opinion as to impart "directly or indirectly" into those transactions covered by section 1031(f) by virtue of being structured to avoid that

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subsection. The Form 8824 questions ask about direct or indirect related-party transactions.

In any event, the valuation of properties involved in related-party exchanges needs to be better documented than often occurs. Related-party exchanges without subsequent dispositions often provide an avenue for the transfer of values from one party to another, such as in an exchange by Parent of Blackacre, with an actual fair market value of $2 million, for Child's Whiteacre, which has an actual fair market value of only $1.2 million even though its agreed value in the transaction is also treated as $2 million. In addition to improper valuations, of course, creation and exchange of fractional interests can also affect valuations, but legitimately. For example, Husband and Wife, owning real estate as separate property, can reduce the total value of that property by exchanging fractional interests between themselves and their children. If Husband dies owning 25 percent undivided interests in four equally valuable parcels of real estate, the estate tax valuation of his interests in real estate may be 25 percent to 40 percent less than if he had died owning 100 percent of one piece. Neither attribution nor aggregation rules generally apply when it comes to gift or estate tax valuation. See Estate of Bright v. United States, 658 F2d 999 (5th Cir. 1981).

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