

TAX LETTER

Related Party Transactions OK'd for Section 1031 Exchange

Dear Clients and Friends,

Good news, contrary to common belief, IRS in a Letter Ruling (200730002) determined that an exchange of partial interests in two parcels of property between related persons, followed by the sale of one of the parcels to an unrelated party within two years, did not violate Section 1031. Therefore, these transactions will not be considered as a series of transactions triggering IRC 1031(f) gain recognition.

Facts and Circumstances: In year 1 when their mother died, three adult children, namely the Taxpayer (X), his Brother (Y) and a Deceased Brother (D), together inherited two parcels of land, Parcels A and B (together referred to as the "property"). In the same year, the Deceased Brother transferred his interest in the property to a revocable Grantor Trust. Since it was a grantor trust, he remained as part owner of the property for Federal income tax purposes.

In year 2, D died. Pursuant to the trust instrument, his interest in the property was to be distributed outright to the sole beneficiary of the trust, his daughter (N). X had been the trustee of the trust for many years. According to the trust document, on X's death or resignation, N would become the successor trustee. This way, when the property was sold or exchange, X would have no fiduciary relationship or Section 267(b) relationship to either the trust or N. Therefore, N was treated as a one-third owner of the property. (Note: she inherited from her father, D).

X solicited potential buyers for the property, and the city in which the property was located indicated an interest in acquiring both Parcels or just Parcel B. Finally, the city presented a letter of intent to purchase Parcel B for \$6 and willing to cooperate with the sellers to structure the transaction such that it fell within the parameters of Section 1031.

The Fair Market Value (FMV) of Parcel B was \$6. The FMV of Parcel A was \$3. All three of them (X, Y and N) agreed that X would exchange his one-third interest in Parcel B worth \$2 (\$6 divided by 3) for Y's and N's combined two-thirds interest in Parcel A (which was also worth \$2). After this, Y and N would each own one-half of Parcel B, with each half worth \$3. The two (Y and N) would sell Parcel B to the city for \$6 and split the proceeds. X retained 100% ownership of Parcel A with FMV = \$3.

IRS reasoning. There are exceptions to the general non recognition rule under Section 1031(f). For example, non recognition of gain or loss is permitted if all three elements are met: (1) A taxpayer exchanges property with a related person; (2) Gain or loss would generally **not** be recognized on such exchange under Section 1031; and (3) Within two

years after the last transfer that was part of such exchange the related person did not dispose of the property and the taxpayer did not dispose of the like-kind property received in the exchange from the related person.

IRS clarified that Section 1031(f)(2)(C) provides that, for purposes of the third element described above, there will not be taken into consideration any disposition with respect to which the taxpayer establishes that neither the exchange nor such disposition had as one of its principal purposes the avoidance of federal income tax. The relevant committee report further clarified this issue, explaining that the **non-tax-avoidance exception** generally would apply to a transaction involving an exchange of undivided interests in different properties that resulted in each taxpayer holding either an entire interest in a single property or a larger undivided interest in any such properties.

IRS recognized that certain dispositions are not taken into account in determining the applicability of the special rules. In other words, there are exceptions to the exceptions. For example, Section 1031(f)(2)(C) provides that non recognition of gain is not denied where the initial exchange or the subsequent sales had no tax avoidance as its principal purposes. Here, before the sale of Parcel B to the city, there was an exchange of undivided interests in which the exchanging parties received either a whole interest in property or a larger undivided interest in property. The Service acknowledged that this situation was analogous to the one described in the legislative history. Thus, the IRS concluded that the parties did not have and were not deemed to have the intent to avoid federal income taxes by participating in the described transactions.

In summary, IRS ruled that X's exchange of his one-third interest in Parcel B for Y's and N's two-thirds interest in Parcel A (within 2 years) was not done principally to avoid federal income tax. The IRS further stated that the transactions in question were not structured to avoid applicable rules or regulations regarding related-party transactions under Section 1031(f). This Ruling demonstrated that the IRS is willing to examine the particular sets of facts and circumstances of a case, and willing to recognize the difference between planning for a legitimate income tax deferral **vs** planning for the purposes of avoiding income taxes.