

# Related Party Issues

## Caution Needed In These Transactions

1031

Knowledge



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 1031 exchange in which the taxpayer cannot 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 to 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.

Although it is important to consult with tax and/or legal advisors before attempting any 1031 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 capital gain taxes will need to be recognized.

### Delayed Exchange – Selling to a Related Party

In several Private Letter Rulings, the IRS has clarified that an exchange in which a taxpayer sells to a related party and buys from an unrelated third-party seller will likely be respected, even if the related party disposes of the property during the two years following the exchange.

### Delayed Exchange – Purchasing from a Related Party

A taxpayer should not purchase a replacement property from a related party where the related party receives exchange proceeds and the taxpayer receives the property previously owned by the related party. In Technical Advice Memorandum 9748006, the IRS disallowed tax deferral to a taxpayer who purchased his mother’s property as replacement property in a 1031 exchange. Revenue Ruling 2002-83 also denies tax deferral treatment to a taxpayer using a qualified intermediary to ultimately purchase 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 may be disallowed.”* Any exchange with a related party must be reported to the IRS on IRS Form 8824, Like-Kind Exchanges.

### Compliments of:



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