Related Party Issues

Teruya Brothers V. Comm. and PLR 2004-40002

1031 Knowledge

TERUYA BROTHERS V. COMM. (2005)

The U.S. Tax Court held that a taxpayer who was a company could not defer gain in a 1031 exchange through the use of a qualified intermediary (QI) who sold and then later bought replacement properties from a party related to the taxpayer because the company could not demonstrate that tax avoidance was not a principal purpose of the transaction.

Section 1031 rules state that if someone exchanges with a related party and the related party sells the property within two years, the transaction is disqualified from the tax deferral benefits of a 1031 exchange.

WHERE TERUYA BROTHERS STUMBLED

When the taxpayer, the Teruya Brothers, sold the Royal Towers Apartments and the Ocean Vista Condominiums in 1996 they did so through a 1031 exchange with a qualified intermediary. The qualified intermediary acquired the replacement property from Times Super Market, a Hawaii grocery chain. The qualified intermediary then transferred the replacement property to Teruya Brothers, all in compliance with the 45-day and 180-day limits.

However, there was a problem. Teruya Brothers owned 62.5% of Times Super Market. Unfortunately, for Teruya Brothers, the IRS has taken the position that this fact pattern is taxed as a 1031exchange of relinquished and replacement properties between the Teruya Brothers and Times Super Market, followed by a sale to the third-party by Times Super Market.

The tax court indicated that an exchange involving a qualified intermediary and a related party which did not involve tax avoidance might be valid in certain cases. However, in the Teruya Brothers case, the tax court found that tax avoidance was a principal purpose and disallowed the 1031 exchange.

PLR 2004-40002

This private letter ruling is important in that it validated a situation where related parties exchanged with each other, both performed a 1031 exchange and never cashed out of their investment.

Partnership A owned Building 1 and Partnership B owned Building 2. Partnership A and Partnership B are considered related persons under IRC §1031(f)(3). Partnership A had entered into a purchase and sale agreement to sell Building 1 to an unrelated third party and then purchase Building 2 from Partnership B in a 1031 exchange. Partnership B is also interested in a 1031 exchange on the sale of Building B as its relinquished property. Partnership B's replacement property is owned by a completely unrelated seller. Partnerships A and B hire the same qualified intermediary to prepare all needed exchange documents. Partnerships A and B both represent they will not sell Building 2 or Partnership B's replacement property within two years from their acquisition in a 1031 exchange.

The IRS ruled that neither IRC §1031(f)(1) nor §1031(f)(4) with the tax avoidance structuring exception apply since neither of the related persons are cashing out of their investment and both partnerships are seeking to acquire like-kind replacement properties under §1031.

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