

## IRS Rules Related Party Exchange Followed By Sale Does Not Trigger Gain Under §1031(f)

In PLR 200706001 taxpayer exchanged a 25% undivided fractional interest in timberlands for a 100% fee interest in like-kind timberlands with a related trust. Within two years of the exchange the trust sold the interest previously held by the taxpayer to an unrelated third party.

The IRS held that because the tax basis of the relinquished and replacement property were equivalent, that the exchange and subsequent sale was not a transaction whose principle purpose was the avoidance of tax under IRC §1031(f)(2)(C). Accordingly, taxpayer was not required to recognize gain under IRC §1031(f)(1)(C)(i), despite the disposition by the trust within two years of the exchange.

This ruling may indicate a willingness on the part of the IRS to allow exchanges between related parties, followed by a subsequent sale where no basis shift has occurred. Taxpayers should be cautious when structuring related party exchanges. It is fairly clear from prior rulings, particularly the tax court decision in Teruya Brothers, 124 TC 45(2005), that the IRS and courts are unwilling to allow a related party exchange followed by a sale within two years, even where the Exchangor would not have paid additional tax, where a basis shift had occurred.

### Recent Private Letter Rulings

#### Private Letter Ruling 200709036:

A taxpayer’s sale of the relinquished property to a related party, followed by sale by the related party does not trigger gain to the taxpayer under 1031(f).

#### Private Letter Ruling 200701008:

The IRS ruled that the disposition of property in this instance was not a prohibited REIT transaction.

#### Private Letter Ruling 200651030:

The IRS ruled that future development restrictions conveyed by a taxpayer under a state conservation program would qualify as being like-kind to a fee interest in real estate. This transaction was unusual because the easement was converted into credits, then into cash, and finally, into real estate, all accomplished through a qualified intermediary.

#### Private Letter Ruling 200616005:

PLR 200616005 reaffirms the ruling of PLR 20040002 that a taxpayer could acquire replacement property from a related party if the related party is also doing an exchange.

## Upcoming Events

We will be conducting the following seminars on §1031 exchanges:

#### Basic Section 1031 “Starker” Tax-Deferred Exchange Seminars

May 2, 2007 – Effingham, IL  
June 6, 2007 – Chicago, IL

#### A Short Course in Drafting Estate Planning Instruments

April 25, 2007 – Oak Lawn, IL  
May 16, 2007 – Northbrook, IL  
May 17, 2007 – Fairview Heights, IL

#### ATG Trust Member Luncheons

May 9, 2007 – Oakbrook, IL  
May 17, 2007 – Fairview Heights, IL  
June 6, 2007 – Chicago, IL

#### Wisconsin Member Dinner

May 10, 2007 – Milwaukee, WI

CONTACT US AT 312.752.1031 FOR MORE INFORMATION.

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## Seven Requirements for a §1031 Exchange

There are seven basic requirements necessary to complete a deferred exchange under Internal Revenue Code Section 1031.

What are the seven requirements?

- Exchange – Not Sale
- Like Kind Property
- Proper Use Of Property
- 45 day Identification Period
- 180 day Replacement Period
- Qualified Intermediary
- Same Taxpayer

**Exchange – Not Sale** – There must be an exchange of the old property for a new property. The transaction cannot be a sale followed by the purchase of the new property.

**Like Kind Property** – Replacement property must be “like-kind” to the relinquished property. All real property in the United States is like kind. State law determines what is real property. The qualifications for personal property are more restrictive and must be like kind or like class.

**Proper Use Of Property** – Both the old property and the new property must be held for productive use in a trade or business or for investment.

**45 Day Identification Period** – The taxpayer has 45 days to identify the new property. Exchangors need to pay particular attention to the details of this requirement as the IRS does not allow ANY deviation from this rule.

**180 Day Replacement Period** – The taxpayer has 180 days to take title to the new property. Exchangors need to pay particular attention to the details of this requirement as the IRS does not allow ANY deviation from this rule.

**Qualified Intermediary** – The taxpayer cannot have actual or constructive receipt of the property (proceeds from the sale of the old property) during the exchange period. Most Exchangors satisfy this requirement by utilizing the services of a qualified intermediary. ATG Trust Company acts as a qualified intermediary for §1031 exchanges.

**Same Taxpayer** – The same taxpayer who disposed of the old property must take title to the new property. Give special attention to situations involving partnerships, LLCs and corporations.

Keep in mind that there are a number of other rules and requirements. Be sure to consult our website for additional information. You can always call us at 312-752-1031 with your §1031 exchange questions.

Interest Rate Credited  
On Exchange Funds  
Average For March 2007

4.68%

## Attend a §1031 Exchange CLE at Your Desk

We are pleased to announce that as part of ATG Legal Education, ATG Trust Company will be offering CLE seminars by webcast beginning in May. The subject of the sessions will be §1031 exchange basics and advanced topics in addition to a wide range of estate planning and trust topics.

These CLE seminars are delivered over the internet and you can literally sit at your desk and attend the seminar. You even have the ability to ask questions by typing a question on your computer screen; (only the presenters can see your question) and then we’ll answer the question – live.

Programs are typically 1.5 hours in length and will qualify for 1.5 hours of Illinois Continuing Legal Education credit. Visit the ATG Trust website ([www.atgtrust.com](http://www.atgtrust.com)) or the Attorneys’ Title Guaranty Fund website ([www.atgf.com](http://www.atgf.com)) for details and a current schedule.

## Tax-Free Or Tax-Deferred?

By: Brian Michaels, Vice President

Recently a qualified intermediary published an article with a chastising tone for those who refer to exchanges under Internal Revenue Code Section 1031 as “tax-free” and not as “tax-deferred.” Another article published on a real estate related website states that if someone uses the words tax-free to describe a §1031 exchange they are not well informed and you should be wary of any other advice they give you. Even the Federation of Exchange Accommodators, the qualified intermediary trade association, states on its website under frequently asked questions that an exchange is tax-deferred and not tax-free because tax must be paid on the gain when the asset is eventually sold.

I have given this a great deal of thought and disagree. Why my disagreement?

Internal Revenue Code Section 1031 provides that:

“No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.”

And, in fact, Treasury Regulation Section 1.1031(b)-1 is titled “Receipt of other property or money in tax-free exchange.” Additionally, Treasury Regulation Section 1.1031(d)-1 is titled “Property acquired upon a tax-free exchange.”

Treasury Regulation Section 1.1031(d)-1 provides the rules for determining the basis of the property exchanged for, i.e., the replacement property. That is the theory of exchanging under

Section 1031, that the taxpayer has the same investment, just in a different form and therefore no tax should be recognized. That makes the exchange tax-free.

Sure, tax may have to eventually be paid on that gain. But then, in some situations, tax may never be paid on that gain. Whether tax is eventually paid is not dependent upon the exchange transaction, but rather, some later transaction.

I have heard it said “but the taxpayer will have to pay taxes on that gain when he or she dies.” Wrong. Their estate may have to pay estate taxes on the value of the property if they have a taxable estate, but there are many estate tax advisors who advise daily on how to prevent that from happening. However, under current tax law the capital gain is wiped out by the “step up in basis” that occurs on death. Uncle Sam values everything you have as of the date of death and that value becomes the new tax basis for the heirs of the estate. Remember too, that the taxpayer could be a corporation, chartered in perpetuity, who never sells the asset. No sale equals no gain equals no tax. Or what if the taxpayer donated the property to a 501(C)(3) charitable organization? No tax paid – plus – probably a tax deduction.

Many people have used Code Section 1031 as a wealth building strategy over the years. By exchanging, and the prudent use of debt, a tax payment can (and is) eliminated.

My conclusion is that if someone wants to refer to a §1031 exchange as tax-deferred that is OK with me. On the other hand, if they want to refer to an exchange as tax-free that is OK with me too – and probably more technically correct.

## Debt And The §1031 Exchange

What is the rule for an exchange to be currently tax free? The rule is that the Exchangor must trade even or up in equity and value. Note that gain is not a criteria, only what the Exchangor is avoiding. Historically, this rule has created many question, particularly related to debt. Questions revolve around those situations in which an investor has debt on their relinquished, or old property. The question is often asked, how much debt must be placed on the replacement, or new property?

A quick review of the general example above, i.e., equal or up in equity and value, gives us the answer. The Exchangor must exchange into a new property that is worth at least as much as the old property AND must put as much, or more equity, into that new property as was in the old property.

Equity equals the value of the property less any debt (mortgage) on the property. Here is an example. Exchangor owns a property valued at \$500,000. The property has a \$300,000 mortgage against it. The equity in this example is \$200,000. If the taxpayer wishes to accomplish a §1031 exchange that is currently tax-free, then a new property must be acquired with a value of at least \$500,000 and equity of at least \$200,000.

Notice we haven’t discussed what the potential gain on the sale of the property would be. That illustrates a very important point. The potential gain does not matter when evaluating HOW to not currently pay tax on whatever that gain may be. What is important is the value of the property and the equity associated with the property.

Here’s a shorthand of the rule: generally, the Exchangor must reinvest all the proceeds from the sale of the old property in the new property. To the extent the taxpayer takes any cash out of the exchange, i.e., does not reinvest, it will generally be taxable and taxable to the extent it represents gain.

## The Real Related Party Rules (in a §1031 Exchange)

This is one of those areas of §1031 exchanges that seem to generate confusion and quite a few questions. It is understandable, as the rules can be a bit murky and confusing. Let’s try to make the rules more clear.

Internal Revenue Code Section 1031 states that a taxpayer can exchange property with a related party and the exchange will qualify as tax free. However, if either party disposes of a property acquired in that exchange within two years of that exchange then the exchange is disallowed. When the exchange is disallowed, any tax not paid because of the exchange will become currently due and payable. So, even if only ONE party to a related party exchange disposes of a property within two years of the exchange, BOTH parties will have to recognize any gain from that transaction. Again, that is because by exchanging, the taxpayers did not currently pay any tax owed on the disposition of their relinquished property. When the exchange is disallowed, the disposition of the relinquished property becomes a sale and any tax due becomes currently payable. It is evident how this could become a problem: it is possible the triggering of the payment of tax occurs because of the actions of someone other than you.

Another problem occurs when a taxpayer wants to purchase a replacement property from a related party. That is allowable if that related party is also doing an exchange. However, if that related party is not doing an exchange then it is not allowed, the exchange would fail, and the gain would be taxable. Contrast that with the situation where a related party wishes to purchase an Exchangor’s relinquished property. That is allowable whether or not the related party is also exchanging under §1031.

## WHO IS A RELATED PARTY

1. Members of the same family (including spouses, ancestors, & lineal descendants);
2. Corporations, if part of a controlled group, i.e., ownership of stock possessing at least 50% of the total combined voting power of all classes of the voting stock;
3. An individual and a corporation, if the individual owns more than 50% of the corporation;
4. A corporation and a partnership, if Taxpayer owns more than 50% of each;
5. A Grantor and fiduciary of the same trust;
6. A fiduciary and the fiduciary of another trust, if both trusts have common grantors;
7. A fiduciary and beneficiary of the same trust;
8. A partnership and a person owning directly or indirectly more than 50% of the capital interest or profit interest of the partnership;
9. A fiduciary of a trust and a corporation, where more than 50% of the stock is owned directly or indirectly, by or for the trust, or by or for a person who is a grantor of the trust;
10. Two partnerships, if one person owns more than 50% of each;
11. A person and a §501 organization, if the person or their family control the organization;
12. Two sub S corporations that are controlled by one person, directly or indirectly; or
13. Two corporations where one is a sub S and the other is a C corporation.