

Taxpayer Not Related To Sibling's Trust - Sale of Trust's Farmland Does Not Impact Tax-Deferred Exchange

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Overview

In recent years, “related party” transactions have been utilized to defer and/or avoid income tax. Sometimes, the transactions have risen to the level of being abusive tax transactions according to the IRS.¹ Related parties may also be involved in I.R.C. §1031 exchanges. As a result, the Congress has passed legislation and the Treasury has issued regulations designed to contain abuses of the tax-deferred exchange rules.² Much of the focus of the regulations has been on investors that attempt to shift income tax basis (called “basis swapping”) between properties that are owned by related parties so as to be able to reduce depreciation recapture and capital gain taxes that become due on sale of the property.

So, who are related parties for purposes of the tax-deferred exchange rules and, if the rules are triggered, what other restrictions apply? In two recent Private Letter Rulings,³ IRS ruled that the sale of farmland within two years after a like-kind exchange between family members would not cause the other parties to the exchange to recognize gain or loss. IRS said that the taxpayer and a trust created by a sibling of the taxpayer are not related persons under the tax-deferred exchange rules.

Related Party Rules

Under I.R.C. §1031(a)(1), no gain or loss is recognized on the exchange of property that is held for productive use in a trade or business or for investment if the 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.⁴ If the exchange occurs between “related parties,” a two-year rule applies.⁵ Under that rule, non-recognition treatment is lost if the related party with which like-kind property is exchanged disposes of the property within two years of the exchange.⁶

I.R.C. §1031(f)(3) defines “related party” by routing the answer through I.R.C. §§267(b) or 707(b)(1). Under those provisions, related persons to the taxpayer are:

- Brothers and sisters (whether whole or half-blood)
- The taxpayer’s spouse, ancestors, lineal descendants
- Certain types of entity relationships – a corporation, limited liability company or partnership and a person that owns (directly or indirectly) more than 50 percent of the stock, membership interests or partnership interests or more than 50 percent of the capital interests or profits interests, and two partnerships in which the same persons owns (directly or indirectly) more than 50 percent of the capital or profits interests
- Two entities in which the same individual owns directly or indirectly more than 50 percent of each entity
- An estate in which the taxpayer is either the executor or beneficiary of the estate
- A trust in which the taxpayer is the fiduciary and the related party is a beneficiary either of that trust or a related trust or a fiduciary of a related trust

Note: Related parties, however, do *not* include step-parents, uncles, aunts,

in-laws, cousins, nephews, nieces and ex-spouses.

Other related party scenarios. It is permissible to sell relinquished property to a related party and acquire like-kind replacement property from a non-related party without violating the 1031 exchange related party rules and guidelines.⁷ The related party must hold the acquired property for a minimum of two years, as must the replacement property. Likewise, a taxpayer may also defer income tax when purchasing property from a related party and the related party is also completing their own tax-deferred exchange transaction using the sales proceeds from the sale of the related party's property, or if it can be proven that the transaction did not result in an income tax basis swap.⁸

Exchanging interests in real estate. The exchange of interests in real estate among related parties can also qualify under the rules. In Rev. Rul. 73-476,⁹ IRS ruled that exchanges of undivided interests in multiple parcels of real estate for 100 percent ownership of one or more parcels of the same real estate qualify as valid like-kind exchanges. In addition, IRS has also ruled 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 and qualified for non-recognition of gain.¹⁰ Under the facts of the ruling, in the year that the taxpayer's mother died, three of her adult children, the taxpayer and two brothers, inherited two parcels of land, (referred to as the "property"). Later in the year, one brother transferred his interest in the property to a revocable trust. The property was owned equally by the trust and the other two brothers as tenants in common. Upon the death of the brother who had placed his property in the revocable trust, the property was distributed outright to his daughter. The taxpayer had been the trustee of the trust for many years, and proposed an exchange of interests which would allow the other remaining brother and the niece (the sole beneficiary of the trust) to combine their interests into one parcel which would then be sold to a city (as they desired), and thereby

allow the taxpayer to become the sole owner of a second parcel. According to the trust document, on the taxpayer's death or resignation, the niece would become the successor trustee. This way, when the property was sold or exchanged, the taxpayer would have no fiduciary relationship or disqualified relationship to either the trust or the niece. Therefore, the niece was treated as a one-third owner of the property. The taxpayer sought a ruling on the proposed deal – the taxpayer would exchange his interest in his parcel for the interest of his brother and niece in their parcel, followed by the brother and niece selling their respective 50 percent interests in their parcel to the city. IRS ruled that the transaction involved an exchange of undivided interests in which the parties received either a whole interest or a larger undivided interest in the property. 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, and the transaction qualified for deferral of gain.¹¹

Note: Before this ruling, IRS had issued guidance regarding the non-tax avoidance exception to the two-year related party rule. For example, in Priv. Ltr. Rul. 9116009 (Jan. 15, 1991), IRS ruled that a taxpayer's transfer of property acquired in a like-kind exchange with a related party to a grantor trust within two years of the exchange is not a disposition under I.R.C. §1031(f).

The Recent Rulings

In two recent Private Letter Rulings,¹² IRS ruled that the sale of property to a niece and nephew within two years after a like-kind exchange would not cause an acceleration of gain or loss. Under the facts of the rulings, a father owned farmland that he left under the terms of his will to his wife for life with the remainder passing in equal shares to his three children as tenants in common. The father died, and upon his widow's subsequent death each child created a revocable trust and placed their respective interest in the farmland into each trust. One of the children, who held the child's interest in the

farmland for a qualified use (i.e., for use in a trade or business or for investment) and was the trustee of the trust. One of the other children died, and the terms of that child's trust specified that the income of the trust be paid to the child's spouse for life with the remainder passing to the surviving spouse's children. But, for estate planning purposes, the owners of this child's trust wanted to liquidate their interest in the farmland. The other two children did not want to liquidate their interests, so all of the parties agreed to exchange each of their one-third undivided interest in the farmland held in the trusts for three 100 percent fee simple interests in the same farmland of equal value. No money or liabilities were involved in the exchange. But, because of the death of one of the children, the one-third interest in farmland contained in that child's trust had a higher income tax basis. After the exchange of the undivided interests for 100 percent-owned tracts, the trust containing the higher basis in the farmland planned to sell its parcel to a third party. The other two siblings planned to retain their tracts of farmland. IRS said the proposed transaction would qualify under I.R.C. §1031 because the taxpayer (one of the siblings that continued to hold their farmland interest for a qualified purpose) was not related to the trust that was selling its interest or to any of the trustees - the sibling's surviving spouse and his two children. So there was no exchange between related parties, and the two-year restriction did not come into play. However, a sale by either of the children of the decedent within two years of the exchange would have triggered gain under I.R.C. §1031(f), because children are related parties under I.R.C. §267.

Conclusion

The related party rules are important provisions in like-kind exchange transactions. With respect to real estate swaps, IRS rulings demonstrate that proper estate planning techniques can be utilized to achieve the desired results, so long as appropriate estate planning strategies don't yield to impermissible tax avoidance motivations.

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¹ See, e.g., IRS Notice 2003-47, 2003-2 C.B. 132 (concerning transfers of compensatory stock options to related persons).

² As part of the Omnibus Budget Reconciliation Act of 1989, the Congress enacted additional requirements for like-kind exchanges between related parties. See I.R.C. §1031(f). The primary focus of the rules is to eliminate the benefits that related parties could receive by exchanging low-basis property for high-basis property (known as "basis shifting") in anticipation of the profitable sale of the low-basis property. See H.R. Rep. No. 247, 101st Cong. 1st Sess. 1340 (1989).

³ Priv. Ltr. Ruls. 200920032 (Feb. 3, 2009) and 200919027 (Feb. 3, 2009). The rulings are nearly identical and are presumably directed at different parties to the same proposed transaction.

⁴ See e.g., Priv. Ltr. Rul. 200440002 (Jun. 14, 2004).

⁵ I.R.C. §1031(f)(1)(C). In addition IRS Form 8824 must be filed when an exchange involving like-kind property occurs. When related parties exchange property, additional information is required, including the name, address, identifying number and relationship of the related party. Also, Form 8824 must be filed for the year of the exchange and also for the two years following the exchange to provide the IRS with the information necessary to monitor the two-year holding requirement.

⁶ I.R.C. §1031(f)(1)(A)-(C). The two-year holding period starts running on the date of the transfer or conveyance of the last property involved in the exchange. There are exceptions to the two-year rule, however, for: (1) transfers that occur after the taxpayer's death or the related party's death; (2) transfers that occur due to an involuntary conversion, and; (3) transfers that do not involve tax avoidance as the purpose of the transfer. I.R.C. §1031(f)(2). There is also a "suspension" provision in I.R.C. §1031(g). Under that provision, the two-year holding period is suspended if either the taxpayer's or the related party's risk of loss is substantially decreased (due to an option, put, short sale or other transaction). Once the risk of loss ceases, the two-year period continues from the point where it stopped.

⁷ See, e.g., Priv. Ltr. Rul. 200712013 (Nov. 20, 2006).

⁸ See, e.g., Priv. Ltr. Rul. 200810016 (Dec. 6, 2007).

⁹ 1973-2, C.B. 300.

¹⁰ Priv. Ltr. Rul. 200730002 (April 26, 2007).

¹¹ The ruling demonstrates that the facts and circumstances of a particular situation are important,

and that IRS may be willing to examine a proposed transaction for the existence of legitimate income tax deferral planning as compared to tax avoidance planning. See also Priv. Ltr. Rul. 200706001 (Oct. 31, 2006)(no basis shifting involved).

¹² Priv. Ltr. Ruls. 200919027 (Feb. 3, 2009) and 200920032 (Feb. 3, 2009).