

RELATED PARTY EXCHANGES

"TERUYA BROTHERS V. COMM. AND PLR 2004-40002"



Compliments of

TERUYA BROTHERS V. COMM. (2005)

The U.S. Tax Court held that a company could not defer gain under §1031 on its exchange of properties through a Qualified Intermediary that sold them and then later bought replacement properties from a party related to the exchanger because the company could not demonstrate that tax avoidance was not a principal purpose of the transaction.

The Section §1031 rules say 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 Section §1031.

WHERE TERUYA BROTHERS STUMBLER

When 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 Intermediary acquired the replacement property from Times Super Market, a Hawaii grocery chain, and then the Intermediary 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: 1) exchange of relinquished and replacement properties between the Teruya Brothers and Times Super Market, followed by 2) a sale to the third party by Times Super Market.

The court indicated that an exchange involving a Qualified Intermediary and a related party that did not involve tax avoidance might be valid in certain cases. In this case, the court found that tax avoidance was a principal purpose and disallowed the exchange.

PLR 2004-40002

This private letter ruling is important in that it validated a situation where related parties exchanged with each other where 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 Section §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 doing 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. Partnership A and Partnership 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 2 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 their investment and both partnerships are seeking to acquire like-kind replacement properties under IRC §1031.



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