

## Section 1031.—Exchange of Property Held for Productive Use or Investment

26 CFR 1.1031(k)-1: Treatment of deferred exchanges.

**Related party like-kind exchanges.** Under the facts described, a taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party is not entitled to nonrecognition treatment under section 1031(a) of the Code if, as part of the transaction, the related party receives cash or other non-like-kind property for the replacement property.

### Rev. Rul. 2002-83

#### ISSUE

Under the facts described below, is a taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party entitled to nonrecognition treatment under § 1031(a) of the Internal Rev-

enue Code if, as part of the transaction, the related party receives cash or other non-like-kind property for the replacement property?

#### FACTS

Individual A owns real property (Property 1) with a fair market value of \$150x and an adjusted basis of \$50x. Individual B owns real property (Property 2) with a fair market value of \$150x and an adjusted basis of \$150x. Both Property 1 and Property 2 are held for investment within the meaning of § 1031(a). A and B are related persons within the meaning of § 267(b).

C, an individual unrelated to A and B, wishes to acquire Property 1 from A. A enters into an agreement for the transfers of Property 1 and Property 2 with B, C, and a qualified intermediary (QI). QI is unrelated to A and B.

Pursuant to their agreement, on January 6, 2003, A transfers Property 1 to QI and QI transfers Property 1 to C for \$150x. On January 13, 2003, QI acquires Property 2 from B, pays B the \$150x sale proceeds from QI's sale of Property 1, and transfers Property 2 to A.

#### LAW AND ANALYSIS

Section 1031(a)(1) 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 the property is exchanged solely for property of a like kind that is to be held either for productive use in a trade or business or for investment. Under § 1031(d), the basis of property acquired in a § 1031 exchange is the same as the basis of the property exchanged, decreased by any money the taxpayer receives and increased by any gain the taxpayer recognizes.

Section 1031 and the regulations thereunder allow for deferred exchanges of property. Under § 1031(a)(3) and § 1.1031(k)-1(b) of the Income Tax Regulations, however, the property to be received by a taxpayer in the exchange (replacement property) must be: (i) identified within 45 days of the transfer of the property relinquished in the exchange (relinquished property) and (ii) received by the earlier of 180 days after the transfer of the relinquished property or the due date (including extensions)

of the transferor's tax return for the taxable year in which the relinquished property is transferred.

Section 1.1031(k)-1(g)(4) allows taxpayers to use a qualified intermediary to facilitate a like-kind exchange. In the case of a transfer of relinquished property involving a qualified intermediary, the taxpayer's transfer of relinquished property to a qualified intermediary and subsequent receipt of like-kind replacement property from the qualified intermediary is treated as an exchange with the qualified intermediary.

Section 1031(f) provides special rules for property exchanges between related parties. Under § 1031(f)(1), a taxpayer exchanging like-kind property with a related person cannot use the nonrecognition provisions of § 1031 if, within 2 years of the date of the last transfer, either the related person disposes of the relinquished property or the taxpayer disposes of the replacement property. The taxpayer takes any gain or loss into account in the taxable year in which the disposition occurs. For purposes of § 1031(f), the term "related person" means any person bearing a relationship to the taxpayer described in § 267(b) or 707(b)(1).

Section 1031(f) is intended to deny nonrecognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property. The legislative history underlying § 1031(f) states that "if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, 'cashed out' of the investment, and the original exchange should not be accorded nonrecognition treatment." H.R. Rep. No. 247, 101<sup>st</sup> Cong. 1<sup>st</sup> Sess. 1340 (1989).

To prevent related parties from circumventing the rules of § 1031(f)(1), § 1031(f)(4) provides that the nonrecognition provisions of § 1031 do not apply to any exchange that is part of a transaction (or a series of transactions) structured to avoid the purposes of § 1031(f)(1). The legislative history underlying § 1031(f)(4) provides:

If a taxpayer, pursuant to a pre-arranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying un-

der section 1031, the related party will not be entitled to nonrecognition treatment under section 1031. *Id.* at 1341.

Accordingly, under § 1031(f)(4), if an unrelated third party is used to circumvent the purposes of the related party rule in § 1031(f), the nonrecognition provisions of § 1031 do not apply to the transaction.

In the present case, A is using QI to circumvent the purposes of § 1031(f) in the same way that the unrelated party was used to circumvent the purposes of § 1031(f) in the legislative history example. Absent § 1031(f)(1), A could have engaged in a like-kind exchange of Property 1 for Property 2 with B, and B could have sold Property 1 to C. Under § 1031(f)(1), however, the non-recognition provisions of § 1031(a) do not apply to that exchange because A and B are related parties and B sells the replacement property within 2 years of the exchange.

Accordingly, to avoid the application of § 1031(f)(1), A transfers low-basis Property 1 to QI who sells it to C for cash. QI acquires the high-basis replacement property from B and pays B the cash received from C. Thus, A engages in a like-kind exchange with QI, an unrelated third party, instead of B. However, the end result of the transaction is the same as if A had exchanged property with B followed by a sale from B to C. This series of transactions allows A to effectively cash out of the investment in Property 1 without the recognition of gain.

A's exchange of property with QI, therefore, is part of a transaction structured to avoid the purposes of § 1031(f) and, under § 1031(f)(4), the non-recognition provisions of § 1031 do not apply to the exchange between A and QI. A's exchange of Property 1 for Property 2 is treated as a taxable transaction. Under § 1001(a), A has gain of \$100x, the difference between A's amount realized on the exchange (\$150x, the fair market value of Property 2) and A's adjusted basis in the property exchanged (\$50x).

## HOLDING

Under the facts described above, a taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party is not entitled to nonrecognition treatment under § 1031(a) of the Internal Revenue Code if, as part of the

transaction, the related party receives cash or other non-like-kind property for the replacement property.

## DRAFTING INFORMATION

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