Beware of Real Estate Exchanges Involving Related Parties

BY DAVID M. FOGEL, EA, CPA

A recent Tax Court case (Teruya Brothers v. Commissioner) reinforces the concept that whenever possible, taxpayers should avoid exchanging properties with a related party, even if a qualified intermediary is involved. The possible dangers of such an exchange can outweigh the potential tax benefits.

Section 1031 and the Related Party Exchange Rules

Section 1031(a)(1) of the Code provides, generally, that no gain or loss is recognized if property held for investment or for use in a business is exchanged for property of a like kind held for investment or for use in a business.

Section 1031(f) provides that if a taxpayer exchanges property with a related person, and before 2 years have elapsed, either the related person or the taxpayer disposes of the property received in the exchange, then any gain or loss that was deferred because of Section 1031 will be recognized.

Section 1031(f)(4) provides that the like-kind exchange rules don’t apply to an exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of Section 1031(f). The Code does not describe such an avoidance transaction. However, the legislative history provides further guidance. First, because property acquired in a like-kind exchange generally takes the basis of the property given up (“basis shifting”), Congress was concerned about related parties engaging in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale. Second, Congress indicated that a taxpayer should be deprived of nonrecognition treatment where a related party exchange is followed shortly thereafter by a disposition of the property, thereby allowing the related parties to “cash out” of the investment.

Section 1031(f)(2) contains three exceptions to the related-party exchange rules. They will not apply (A) to dispositions occurring after the death of the taxpayer or the death of the related person, (B) to dispositions relating to an involuntary conversion within the meaning of Section 1033, or (C) where the taxpayer establishes that neither the exchange nor the disposition had as one of its principal purposes the avoidance of income tax.

Congress intended the non-tax avoidance exception to apply to (1) an exchange of undivided interests in different properties that results in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of such properties; (2) dispositions of property in nonrecognition transactions; and (3) transactions that do not involve the shifting of basis between properties.

Taxpayers frequently structure exchanges that interpose a qualified intermediary in the middle of the transaction to acquire property from the taxpayer, transfer the property to the ultimate buyer, acquire like-kind replacement property, and transfer it to the taxpayer.

The related party exchange rules apply only to direct exchanges between related parties. What happens when the exchange transaction involves a related party and an intermediary who is not treated as a related party?

Related Party Exchanges Involving Intermediaries

In an IRS letter ruling, a taxpayer and his mother owned one-third and two-thirds interests, respectively, in unimproved land which they held for investment purposes. The taxpayer, his mother and an unrelated third party entered into an exchange. The steps in the exchange were (1) the taxpayer transferred his one-third interest in the land to an intermediary, who sold it to the third party; (2) the mother sold her two-thirds interest in the land to the third party; and (3) the mother transferred a residence to the intermediary, who then transferred it to the taxpayer (see Figure 1 on the next page). The IRS viewed the transaction as the taxpayer’s exchange of his one-third interest in the land for his mother’s residence, followed by the mother’s sale of the one-third interest in the land to the third party.
party. Since the mother had disposed of the one-third interest in the land (the property she received in the exchange), the related party rules applied and the exchange was taxable.

An IRS revenue ruling involved an exchange that had a similar structure. In this ruling, a taxpayer and a related party owned Properties #1 and #2, respectively, both of which had the same fair market value. The taxpayer, the related party, and an unrelated third party entered into an exchange. The steps in the exchange were: (1) the taxpayer transferred Property #1 to the intermediary; (2) the intermediary sold Property #1 to the third party for cash; (3) the related party transferred Property #2 to the intermediary in exchange for the cash; and (4) the intermediary transferred Property #2 to the taxpayer (see Figure 2).

The IRS concluded that the transaction was structured to avoid the application of the related-party rules. Economically, the IRS viewed the transaction as if the taxpayer had exchanged his Property #1 for the related party’s Property #2, followed by the related party’s sale of Property #1 to the third party. Since the related party had disposed of Property #1 (the property received in the exchange), the related party rules applied and the exchange was taxable.

Teruya Brothers

Recently, the Tax Court ruled on two separate real estate exchange transactions that were basically the same in structure as the exchange transactions described above. Both exchange transactions involved the taxpayer (Teruya Bros.) and Times Super Market, Ltd. (Times), a corporation whose stock was owned 62.5% by Teruya Bros. It was undisputed that Times was related to Teruya Bros. Each exchange transaction also involved an unrelated third party. The court referred to the two exchange transactions as the “Ocean Vista” and “Royal Towers” transactions.

The steps in the Ocean Vista exchange were: (1) Teruya Bros. transferred the Ocean Vista (relinquished) property to an intermediary; (2) the intermediary sold the Ocean Vista property to the third party for cash; (3) Teruya Bros. paid additional cash to the intermediary to acquire the replacement property; (4) the intermediary purchased the Kupuohi II (replacement) property from Times (the related party) with cash from the sale of the Ocean Vista property and cash received from Teruya Bros.; and (5) the intermediary transferred the Kupuohi II property to Teruya Bros. (see Figure 3).

Similarly, the steps in the Royal Towers exchange were: (1) Teruya Bros. transferred the Royal Towers (relinquished) property to an intermediary; (2) the intermediary sold the Royal Towers property to the third party for cash; (3) Teruya Bros. paid additional cash to the intermediary to acquire the replacement properties; (4) the intermediary purchased the Kupuohi I and Kaahumanu (replacement) properties from Times (the related party) with cash from the sale of the Royal Towers property and cash received from Teruya Bros.; and (5) the intermediary transferred the Kupuohi I and Kaahumanu properties to Teruya Bros. (see Figure 4).

Because an intermediary was involved, the IRS did not argue that the related party exchange rules applied, acknowledging that such rules apply only in the case of a direct exchange between related persons. Nonetheless, the Tax Court concluded that each transaction was economically
equivalent to a direct exchange of property between Teruya Bros. and Times (the related party) followed by Times’ sale of the relinquished property to the unrelated third party. Ruling that the transactions were structured to avoid the related party exchange rules of Section 1031(f), the Court held that the economic substance of the transactions was that Teruya Bros.’ investments in the Ocean Vista and Royal Towers properties were “cashed out” leaving Times with the sales proceeds.

Teruya Bros. argued that the related party exchange rules did not apply because neither the exchange nor the disposition of the exchanged properties had the principal purpose of avoiding tax\textsuperscript{12}. The Court ruled that Teruya Bros. did indeed have a tax avoidance motive. Teruya Bros. reported taxable income of $2,060,806 while Times reported a net operating loss (NOL) of $1,043,829 and therefore could absorb a large gain without incurring as much of a tax liability than if Teruya Bros. had to report the gain. The Court concluded that Teruya Bros. had structured the exchange in order to shift the gain to its related party, Times, thereby saving a significant amount of tax, while at the same time shifting higher-basis property from Times to Teruya Bros.

Whether Teruya Bros. had a tax avoidance motive by virtue of comparing its taxable income to Times’ NOL is debatable. The fact that Times had an NOL that would absorb a large gain in the current year is too narrow an analysis. Most likely, Times carried the NOL to other tax years where it was used to reduce tax liability. A more complete analysis that includes the effect of the NOL on Times’ tax liabilities in the other years should have been conducted before reaching the conclusion that tax avoidance was a principal purpose of structuring the exchanges\textsuperscript{13}.

However, even if a more complete analysis of Teruya Bros. and Times’ tax liabilities had been made and it were found that there was no tax avoidance motive associated with Times’ NOL, this might not change the result in this case. The legislative history indicates that if the exchange results in the shifting of basis between properties to reduce or avoid the recognition of gain, the non-tax avoidance exception of Section 1031(f)(2)(C) won’t apply. Accordingly, it is necessary to look at the two exchange transactions in Teruya Bros. to see if there was any “basis shifting” between Teruya Bros. and Times.

With respect to the Ocean Vista exchange, I think that it could be argued that there was little or no shift in basis that reduced or avoided the recognition of gain on the subsequent sale. As shown in the following table, Teruya Bros. gave up property with a fair market value of $1,468,500 and a basis of $93,270, gave up $1,366,056 cash, and received property with a fair market value of $2,828,000 and a basis of $1,475,361.

<table>
<thead>
<tr>
<th>Property given up</th>
<th>FMV</th>
<th>Basis</th>
</tr>
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<tbody>
<tr>
<td>Ocean Vista</td>
<td>$1,468,500</td>
<td>$93,270</td>
</tr>
<tr>
<td>Cash given up</td>
<td>1,366,056</td>
<td>1,366,056</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$2,834,556</strong></td>
<td><strong>$1,459,326</strong></td>
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<table>
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<tr>
<th>Property received</th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kupuohi II</td>
<td>$2,828,000</td>
<td>$1,475,361</td>
</tr>
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The fair market value and basis of the property given up was roughly equivalent to the fair market value and basis
of the property received. Times gave up property with a fair market value of $2,828,000 and a basis of $1,475,361, and reported a $1,352,639 gain on the disposition. Teruya Bros. did not “cash out” its investment in the property given up, but rather, it continued its investment in like-kind property, and Times reported a gain on the sale of its own property.

However, with respect to the Royal Towers exchange, there was a large shift in basis from Times to Teruya Bros. As shown in the following table, Teruya Bros. gave up property with a fair market value of $11,932,000 and a basis of $670,506, gave up $724,554 cash, and received property with a fair market value of $12,630,000 and basis of $17,105,112.

<table>
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<tr>
<th>Property given up—Royal Towers</th>
<th>FMV</th>
<th>Basis</th>
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<tbody>
<tr>
<td>Property given up—Kupuohi I</td>
<td>$8,900,000</td>
<td>$15,602,152</td>
</tr>
<tr>
<td>Property given up—Kaahumanu</td>
<td>$3,730,000</td>
<td>$1,502,960</td>
</tr>
<tr>
<td>Total</td>
<td>$12,630,000</td>
<td>$17,105,112</td>
</tr>
</tbody>
</table>

Times gave up property with a fair market value of $12,630,000 and a basis of $17,105,112, and reported a net loss on the disposition. Although Teruya Bros. continued its investment in like-kind property, it received a much higher basis in the property acquired ($17,105,112) than the property given up ($1,395,060). Because of the large shift in basis, the Court was probably correct in holding that a tax avoidance motive existed and therefore, the transaction was structured to avoid the related party exchange rules. According to the legislative history, this type of “basis shifting” without the recognition of gain is exactly the type of situation that Congress wanted to eliminate by enacting the related party exchange rules.

Conclusion

The mistake that Teruya Bros. made was to enter into two exchanges that were exactly the same in structure as an IRS letter ruling and revenue ruling where the IRS had announced that such a structure would run afoul of the related party exchange rules. Better tax advice and planning before engaging in the exchange transactions could have avoided this problem. This case, which resulted in over $12 million in taxable gain, reinforces the concept that whenever possible, taxpayers should avoid entering into exchanges with related parties, even if an intermediary is involved.

2 Id.
3 S. Print No. 101-56, supra at 152
4 Treas. Reg. sec. 1.1031(k)-1(g)(4)(iii).
5 Treas. Reg. sec. 1.1031(k)-1(k).
10 Code sections 267(b)(3) and (f) provide that two corporations are related if one owns more than 50% of the stock of the other.
11 Teruya Brothers Ltd. & Subsidiaries v. Commissioner, supra, footnote 11.
12 This is one of the exceptions to the related party exchange rules. See Code section 1031(f)(2)(C).

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