

## **A six month extension to look for property; ruling confirms opportunity to buy from related party**

September 25, 2008 - Front Section

Exchanges between related parties have been a major source of confusion. The absence of Regulations and the IRS' mixing-up of different related party exchange rules contribute to the confusion. In Private Letter Ruling 200440002, the IRS had both the rule and the rationale correct. This ruling completes a critical piece of the puzzle for exchanges involving related parties. Unfortunately, the guidance is a private letter ruling, rather than a revenue ruling which other taxpayers can rely on.

The general rule, stated in Rev. Rul. 2002-83, 2002-2 C.B. 927, is that, when a taxpayer does a deferred exchange through a qualified intermediary (QI) and acquires replacement property from a related party, the exchange will fail as a valid exchange under Â§1031(f)(4). The exceptions to this rule are ill-defined, and require analysis of the purpose of Â§1031(f). The exceptions arise when the acquisition of the replacement property in this manner does not result in cashing out on the sale of high basis property and deferring gain from the exchange of low basis property (basis shifting).

In this new ruling, the taxpayer was Partnership AB. AB sold Building 1 to an unrelated third party for cash through a QI, then used the proceeds to acquire Building 2 from Partnership CD, a related party, in a like-kind exchange. Partnership CD sold Building 2 to AB through a QI and acquired its replacement property from an unrelated third party in a like-kind exchange.

Citing the legislative history of 26 U.S.C. Â§1031(f), the IRS held that this transaction was not a transaction structured to avoid the related party rules and did not result in a failed exchange under Â§1031(f)(4). Since both AB and CD were doing a like-kind exchange, there was no cashing out and no basis shifting among AB and CD. Both AB and CD ended up with a carryover basis and reinvestment of equity in their respective replacement properties.

So what is the benefit of this ruling? Answer: It can lengthen the amount of time to find replacement property by 6 months. Here is how the strategy works...

First AB sells property to an unrelated party and starts an exchange. Then by the 45th day after closing AB identifies in writing properties X, Y and Z, Z being the related party's property. Lets assume that the acquisition of property X and Y falls through. AB can keep looking for suitable replacement property until day 180. Once a new replacement property (NewProp) is found (and hopefully put under contract) then AB buys property Z from the related party (CD) closing out AB's exchange. Now CD has started an exchange and can close out its exchange by acquiring NewProp.

It should be noted that this strategy is most effective when the related parties' interests are closely aligned. However, if they are, then finding replacement property may have become a bit easier.

Note:

\*Both AB and CD represented in the ruling they would hold their replacement property for two years.

\*If both AB and CD are prohibited from disposition their replacement property for two years, this prohibition seem to preclude not only a sale (which would be a cashing-out) but also an exchange (which would not be a cashing-out).

\*The two-year limitation precludes CD from repeating this strategy with yet another related party.

\*The ruling did not mention that AB identified other replacement property and the property acquired from CD was an alternative "back-up" identification.

\*A taxpayer undertaking this strategy should insure that BOTH the taxpayer and the related party not only start, but also complete their exchanges. If the second exchange is not completed then there will be two failed exchanges.

\*If the exchanges involved a party acquiring not only like-kind property, but also boot, a different result might be obtained, making this an "all or nothing" strategy.

Andrew Gelson is a managing director of Compass Exchange Advisors, Plymouth, Mass.

New England Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540