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Understanding related party rules in 1031 exchanges: What real estate investors need to know - by Michele Fitzpatrick

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The Reality of Related Party Exchanges

Contrary to common belief, 1031 exchanges between related parties are permitted under the tax code - they simply come with additional considerations. Understanding these rules is essential for New England real estate investors seeking to maximize their investment strategies while remaining compliant.

Section 1031 of the Internal Revenue Code allows investors to defer capital gains taxes when exchanging like-kind properties held for business or investment purposes. When related parties enter the equation, additional safeguards apply to ensure transactions serve legitimate business purposes rather than tax avoidance.

Who Qualifies as a "Related Party"?

The definition extends beyond family relationships to include:

- Immediate family members (siblings, spouses, ancestors, and descendants);
- Business entities with more than 50% ownership by the exchanger;
- Fiduciary relationships (such as an exchanger and the fiduciary of a trust); and
- Affiliated businesses controlled directly or indirectly by the exchanger.

This comprehensive definition ensures transactions between closely connected parties receive appropriate scrutiny.

The Two-Year Holding Period Rule

The Tax Reform Act of 1984 introduced critical safeguards for direct exchanges between related parties. In a direct swap where properties are exchanged simultaneously, both parties must hold their newly acquired properties for at least two years. Early disposition triggers immediate taxation of the originally deferred gain.

Exceptions to this rule include:

- Death of either party during the holding period;
- Forced disposition through eminent domain or natural disaster; and
- IRS determination that the transaction wasn't structured to avoid taxes.

Different Scenarios, Different Rules

The application of related party rules varies based on transaction structure:

Selling Relinquished Property to a Related Party: This follows standard 1031 exchange rules without additional holding period requirements, provided all other exchange criteria are met.

Buying Replacement Property from a Related Party: This scenario triggers stricter requirements. The related party selling the replacement property must also be conducting their own 1031 exchange simultaneously. Otherwise, the transaction would be disqualified from 1031 treatment.

Why These Rules Matter

The related party provisions exist to prevent basis-shifting strategies that could undermine tax fairness. Before these regulations, related parties could potentially manipulate property values or shift tax liabilities improperly.

For example, without these safeguards, Party A (with a low-basis property) could exchange with Party B (holding a high-basis property), then Party B could sell the acquired property with minimal tax consequences - effectively circumventing proper taxation.

Best Practices for Related Party Exchanges

For real estate investors considering related party exchanges:

1. Consult with experts early. Identify potential compliance issues before they arise.
2. Document your business purpose. Maintain clear records demonstrating the legitimate investment or business reasons for the exchange.
3. Plan for holding periods. Structure your investment timeline to accommodate required holding periods where applicable.
4. Keep thorough records. Document all aspects of the transaction, including appraisals, contracts, and correspondence.

Navigating Complexity with the Right Partner

Related party 1031 exchanges can be valuable tools in your real estate investment strategy when approached with proper planning and expertise. While the rules may seem complex, working with experienced professionals can help ensure compliance while maximizing tax benefits.

At Northern Bank, we take a relationship-focused approach to helping investors navigate these complex transactions. Our team understands both the technical requirements and practical considerations of related party exchanges, providing collaborative solutions that align with your long-term investment goals while ensuring full compliance with current regulations.

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