



## Related Party 1031 Exchanges Rules for Real Estate Investors

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1031 tax deferred exchange transactions can be powerful tax-deferral strategies for real estate investors and property owners. However, when a sale or purchase of real property involves a related party, the 1031 exchange becomes significantly more complex and is subject to special Internal Revenue Service (IRS) requirements.

Like kind exchange transactions involving related parties are permitted only under certain limited circumstances and they must be structured very carefully to ensure compliance. The Internal Revenue Service (IRS) applies these special rules to prevent real estate investors from using related party structures or strategies to shift their tax basis, reduce or eliminate their taxable gain, or avoid their federal income tax altogether (i.e., tax evasion) on the sale of investment real property in a way that is inconsistent with Section 1031 of the Internal Revenue Code.

This article explains what a related party tax deferred exchange is, who are [related parties](#) pursuant to the tax code and regulations, and the key rules real estate investors should understand before selling to, buying from, or exchanging with a related party.

### What Is a Related Party 1031 Exchange?

A related party exchange generally occurs when a taxpayer either:

- Sells relinquished property to a related party;
- Buys replacement property from a related party; or
- Swaps properties directly or indirectly with a related party or parties.

These transactions can involve individuals, business entities, trusts, partnerships, corporations, or other legal ownership structures. Because of the relationship between the parties, the IRS looks closely at whether the like-kind exchange is being used for legitimate investment purposes or whether it is being structured to avoid or evade paying capital gain and depreciation recapture taxes.

The related party rules are found primarily in Section 1031(f) of the Internal Revenue Code (IRC), with the definition of related parties drawn from Sections 267(b) and 707(b) of the IRC.

### Why the IRS Applies Special Scrutiny

The IRS created the [related party rules](#) and guidelines to prevent tax basis shifting and tax avoidance, and in some cases tax evasion.

In a standard 1031 exchange, the taxpayer defers their taxable gain by selling real property that has been held for rental, investment, or use in a trade or business and subsequently acquiring like-kind replacement real property that is also held for rental, investment or business use. The taxpayer's basis generally carries over into the replacement property.

In a related party exchange, however, related taxpayers may be able to shift a low tax basis from one property to another or arrange the transaction so that one related party "cashes out" while the other claims tax deferral.



### **Example of Basis Swapping**

Assume a parent owns a property worth \$1,000,000 with a very low tax basis of \$100,000. If the parent sells that property outright, the parent may recognize a substantial taxable gain.

Now assume the parent's child owns a property worth \$1,000,000 with a much higher tax basis. If the parent sells his or her property for \$1,000,000 and completes a 1031 exchange by acquiring their child's high adjusted cost basis property, the parent defers the payment of his or her taxes and the child recognizes very little to no taxable gain upon the sale to the parent. The child as the related party was able to "cash out" and pay virtually no capital gain taxes or depreciation recapture taxes due to the related party swap.

The related party rules are designed to prevent this type of basis shifting when the transaction is structured primarily to avoid federal income tax.

### **Who Is Considered a Related Party?**

The definition of a related party is one of the most important issues in any related party 1031 exchange. Related party status is not limited to family members. It can also apply to corporations, partnerships, limited liability companies, trusts, and other entities. Therefore, related parties generally include certain family members, related business entities, and other relationships involving common ownership or control.

#### **Definition of Related Parties Pursuant to Sections 267(b) and 707(b)(1)**

The term "related person," "related party," or "related parties" means any person or party, including any legal entities, that has a relationship to the taxpayer described in Section 267(b) or Section 707(b)(1) of the Internal Revenue Code, including:

- Members of the same family unit such as siblings, spouse, ancestors (e.g., parents, grandparents, great grandparents), and lineal descendants (e.g., children, grandchildren, great grandchildren);
- A corporation where more than 50% of the value of the stock is owned directly or indirectly by or for one particular individual that is related to the taxpayer;
- Two (2) corporations that are in the same controlled group (as defined in Section 1031, subsection (f));
- A grantor and a fiduciary of any trust;
- A fiduciary of one trust and the fiduciary and/or beneficiary of another trust where the same person is the grantor for both trusts;
- A fiduciary of a trust and a beneficiary of the same trust;
- A corporation where more than 50% of the value of the stock is owned directly or indirectly by or for one particular trust or by or for the grantor or fiduciary of the trust;
- An organization qualified under Section 501 of the Internal Revenue Code (relating to certain educational or charitable non-profit organizations) which is controlled directly or indirectly by a specific person or (if such person is an individual) by members of the family of such individual;
- A corporation and a partnership if the same person or people own:
  - more than 50% in value of the outstanding stock of the corporation, and
  - more than 50% of the capital interest, or the profits interest, in the partnership;
- An S corporation and another S corporation or a C corporation if the same person or persons own more than 50% in value of the outstanding stock of each corporation;
- A partnership and a person owning, directly or indirectly, more than a 50% capital interest or a 50% profits interest, in such partnership;
- Two partnerships in which the same person or persons own, directly or indirectly, more than a 50% capital interest or a 50% profits interest, in both partnerships;
- An executor of an estate and the beneficiaries of the estate; or
- Other relationships described under Internal Revenue Code Sections 267(b) and 707(b).

One trust created and formed by a husband and one trust created and formed by a wife are not related persons because the two (2) trusts have different grantors. Investors may be able to eliminate related party transaction issues by changing the ownership of the related party such as transferring or disposing of interests in a partnership



or shares of stock in a corporation to an unrelated third-party in order to get the related party's ownership interest below the 50% level.

### **Constructive Ownership and Attribution Rules**

It appears that the constructive ownership rules, aggregation of ownership or attribution rules under Section 267(c) of the Internal Revenue Code apply in determining the ownership of stock, capital interest, or profits interest. Because these indirect ownership and attribution rules may apply, the analysis can be more complicated than it first appears. Investors should not assume that separate legal entities are unrelated simply because they have different names or different ownership structures.

### **Relationships That May Not Always Be Treated the Same Way**

Some relationships that people commonly assume are related parties may not necessarily be treated as related parties in the same way under the applicable tax code provisions and corresponding Treasury Regulations. Depending on the facts, this may include certain relationships such as:

- In-laws;
- Aunts and uncles;
- Nieces and nephews;
- Cousins;
- Stepparents or stepchildren;
- Former spouses; and
- More distant family relationships.

However, these relationships should still be reviewed carefully. The tax code rules are technical, and ownership interests, entity structures, trust arrangements, or indirect relationships can change the analysis. A relationship that appears unrelated at first may still create related party concerns under the applicable rules.

### **Main Related Party 1031 Exchange Scenarios**

Related party exchange issues generally arise in three main transaction structures:

- Exchanging or swapping properties with one or more related parties;
- Selling relinquished property to a related party while buying replacement property from an unrelated party; and
- Buying replacement property from a related party while selling relinquished property to an unrelated party.

Each related party structure carries different risks and requirements.

#### **Swapping Properties With a Related Party**

A direct or indirect swap with a related party occurs when the taxpayer transfers relinquished property to a related party and receives replacement property from that same related party. This exchange may also involve multiple related parties, relinquished properties and/or replacement properties.

This type of exchange or swap may qualify for tax deferral if the transaction is properly structured and both parties satisfy the related party holding requirements.

The most important requirement is the two-year holding rule.

#### **The Two-Year Holding Rule**

In a related party exchange, both the taxpayer and the related party generally must hold the properties received in the exchange for at least two (2) years. The two-year holding period generally begins on the date of the last transfer that is part of the 1031 exchange.



If either party disposes of the property received in the tax-deferred exchange before the end of the two-year holding period, the exchange may be disqualified. If that happens, the deferred gain may become taxable. This rule is designed to ensure that the transaction is a true continuation of investment, not a short-term pre-planned arrangement to avoid tax.

#### **Selling to a Related Party and Buying from an Unrelated Party**

A taxpayer may sell relinquished property to a related party and acquire replacement property from an unrelated seller through a properly structured 1031 exchange. This structure is often less problematic than buying from a related party because the taxpayer remains invested in like-kind real estate, and the replacement property is not coming from the related party. However, this does not mean the transaction is risk-free. The IRS may still review the transaction to determine whether it was structured to avoid federal income tax or to circumvent the related party rules. Investors should pay close attention to:

- Whether the related buyer will hold the property;
- Whether the transaction is at fair market value;
- Whether the sale is commercially reasonable;
- Whether the exchange has a legitimate business or investment purpose; and
- Whether the transaction is properly disclosed on IRS Form 8824.

#### **Buying Replacement Property from a Related Party**

Buying replacement property from a related party is often the most problematic related party 1031 exchange structure and often will not qualify for tax-deferred exchange treatment. In this scenario, the taxpayer sells relinquished property to an unrelated buyer and uses like-kind exchange proceeds to acquire replacement property from a related party (seller). The concern is that the related party seller may receive cash and effectively “cash out” by paying very little to no income taxes on the sale, while the taxpayer attempts to defer gain through the 1031 exchange.

The IRS has taken the position that using a qualified intermediary does not solve this issue. If the overall transaction has the same effect as a related party exchange followed by a quick cash sale, the IRS may deny tax-deferred treatment. A purchase from a related party may be more likely to qualify when:

- The related party seller is also completing its own 1031 exchange;
- The related party remains invested in like-kind real property;
- There is no material cashing out by the related party;
- The transaction is not structured to avoid federal income tax; and
- The taxpayer can demonstrate a legitimate non-tax business or investment purpose.

Because these transactions are heavily scrutinized, investors should obtain qualified tax and legal advice before buying replacement property from a related party.

#### **Exceptions to the Two-Year Holding Rule**

There are limited exceptions to the two-year holding requirement. A disposition during the two-year period may not automatically disqualify the exchange if one of the recognized exceptions applies. The principal exceptions include:

##### **Death of the Taxpayer or Related Party**

If the taxpayer or the related party dies during the two-year holding period, a later disposition may fall within an exception to the related party holding rule.

##### **Involuntary Conversion**



A disposition may also be excepted if it occurs because of an involuntary conversion under Internal Revenue Code Section 1033, such as certain condemnations, casualties, eminent domain (public taking) or other qualifying forced transfers.

### **No Tax-Avoidance Purpose**

The exchange may not be disqualified if the taxpayer can establish that neither the exchange nor the later disposition had as one of its principal purposes the avoidance of federal income tax. This exception is fact specific. The taxpayer must be able to support the business or investment purpose of the transaction and show that the structure was not designed to avoid the related party rules.

### **The Anti-Abuse Rule**

Internal Revenue Code Section 1031(f) includes an important anti-abuse rule. The tax-deferral benefits of Section 1031 of the IRC do not apply to any exchange that is part of a transaction, or series of transactions, structured to avoid the purposes of the related party rules. This means the IRS may look beyond the form of the transaction and evaluate the overall result.

For example, adding a qualified intermediary or using multiple steps will not necessarily protect the exchange if the end result is that a related party cashes out or the parties shift basis to reduce tax. The IRS will generally focus on substance over form. If the transaction produces the type of tax avoidance the related party rules were designed to prevent, the exchange may be challenged.

### **IRS Form 8824 Disclosure Requirement**

Related party 1031 exchanges must be reported on IRS Form 8824, Like-Kind Exchanges.

When a related party is involved, the taxpayer must provide additional information, which may include:

- The name of the related party;
- The related party's address;
- The related party's taxpayer identification number;
- The relationship between the parties; and
- Details about the exchange transaction.

Accurate reporting is essential. Failure to disclose related party information properly can create tax reporting issues and may increase IRS scrutiny.

### **Practical Planning Considerations**

Related party exchanges require careful planning before any purchase agreement is signed or any property is transferred. Investors should consider the following practical steps:

- Identify all related parties early in the transaction;
- Review family, entity, trust, and ownership relationships;
- Confirm whether more than 50% common ownership or control exists;
- Determine whether the related party is selling, buying, or swapping property;
- Evaluate whether the related party will receive cash or remain invested in real estate;
- Confirm whether the two-year holding rule applies;
- Document the business and investment purpose of the transaction;
- Use an experienced qualified intermediary such as [Exeter 1031 Exchange Services, LLC](#); and
- Consult tax and legal advisors before proceeding.

The structure of the exchange should be reviewed before closing. Once the relinquished property has been sold or exchange funds have been transferred, it may be too late to correct a related party issue.



## **Proceed With Care Before Exchanging with a Related Party**

Related party 1031 exchanges can be valid, but they are subject to special rules, strict holding requirements, and close IRS review. The most important issues are identifying who qualifies as a related party, understanding whether the transaction could result in basis shifting or tax avoidance (or tax evasion), and complying with the two-year holding rule and reporting requirements.

Before selling to, buying from, or swapping property with a related party, investors should consult with qualified tax and legal advisors. Careful planning can help protect the intended tax deferral and reduce the risk of an unexpected taxable event.

## **1031 Exchange Related Party Frequently Asked Questions (FAQs)**

### **What is a related party in a 1031 exchange?**

A related party is generally a person or entity that has a close family, ownership, or control relationship with the taxpayer. For 1031 exchange purposes, related parties are identified by reference to Internal Revenue Code Sections 267(b) and 707(b), and the rules can apply to both individuals and business entities.

### **Which family members are generally considered related parties?**

Related parties generally include a taxpayer's spouse, brothers, sisters, ancestors, and lineal descendants. Ancestors include parents and grandparents, while lineal descendants include children and grandchildren. Other family relationships may require closer review because the tax rules are specific and fact dependent.

### **Can business entities be related parties in a 1031 exchange?**

Yes. Corporations, partnerships, limited liability companies, trusts, and other entities may be related parties when ownership or control thresholds are met. A common example is an entity in which the taxpayer owns more than 50.0% of the stock, capital interest, profits interest, or similar ownership interest.

### **Can I sell my relinquished property to a related party?**

In many cases, a taxpayer may sell relinquished property to a related party and acquire replacement property from an unrelated seller. However, the transaction should be carefully structured, commercially reasonable, and properly reported. The IRS may still review whether the exchange was designed to avoid federal income tax.

### **Can I buy replacement property from a related party?**

Buying replacement property from a related party is possible in limited circumstances, but it is often more difficult. These transactions receive close IRS scrutiny, especially if the related party seller receives cash and does not complete its own 1031 exchange or remain invested in like-kind real estate.

### **Why is buying from a related party more difficult?**

Buying from a related party is more difficult because it can create the appearance of tax basis shifting (tax avoidance or tax evasion) or "cashing out." The IRS may view the transaction as if the taxpayer exchanged with the related party and the related party immediately sold for cash without paying any taxes, which can defeat the purpose of the related party rules.

### **What is the two-year holding rule for related party exchanges?**

The two-year holding rule generally requires both the taxpayer and the related party to hold the properties received in the exchange for at least two years. The holding period usually begins on the date of the last transfer in the exchange. Early disposition may cause the deferred gain to become taxable.

### **Are there exceptions to the two-year holding rule?**

Yes. Limited exceptions may apply if the disposition occurs because of the death of the taxpayer or related party, an involuntary conversion, or if the taxpayer can establish that neither the exchange nor the later disposition had tax avoidance as a principal purpose. These exceptions require careful tax review.

### **Does using a Qualified Intermediary remove related party concerns?**



No. A [qualified intermediary](#) is essential for delayed 1031 exchanges but using one does not eliminate related party concerns. The IRS may look at the entire transaction, not just its form, to determine whether the exchange was structured to avoid the related party rules.

**Why does Form 8824 disclosure matter in a related party exchange?**

Form 8824 is used to report like-kind exchanges to the IRS, and related party exchanges require additional disclosure. Taxpayers may need to provide the related party's name, address, taxpayer identification number, and relationship. Accurate reporting helps document compliance and should be reviewed with a qualified tax advisor.