Related Party Sales

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RELATED PARTY SALES

— by Neil E. Harl

Disposition of property by sale is commonplace in farm and ranch operations with a substantial part of those sales involving closely related parties. Care is needed in setting up related-party transactions to avoid unintended tax consequences.

Depreciable property

For depreciable property sales between related parties, any deferred payments are deemed to be received in the taxable year of sale. Thus, installment sales of depreciable property are ineffective to defer recognition of gain beyond the year of sale. This rule is of major importance for sales of machinery, equipment, and breeding stock. The provision does not, however, apply to nondepreciable assets such as land.

An exception is provided if income tax avoidance is not a principal purpose of the transaction.

Other property

For property that is not depreciable, gain may be deferred in related-party sales so long as the buyer does not transfer the property within two years of the related party transaction. If transfer occurs within the two year period, acceleration of recognition of gain from the first sale generally results to the extent additional cash or other property flows into the related group as a result of the second disposition of the property. For a second disposition which is not a sale or exchange, the fair market value of the property disposed of is treated as the amount realized on the disposition.

This rule was enacted in 1980 largely in response to the then emerging practice of using sales to closely related parties (followed by resale to a developer or other buyer) as a substitute for escrow arrangements. Escrow and escrow-like arrangements had not fared well in delaying receipt of the proceeds of sale because of constructive receipt of income. Thus, placing certificates of deposit in escrow had not succeeded, payment of amounts to a trust for the seller’s benefit had failed and even court-ordered escrow arrangements had not been successful in delaying recognition of gain. To survive a constructive receipt challenge, the escrow must impose a substantial restriction serving a bona fide purpose of the purchaser. Escrow arrangements had been upheld if entered into prior to the existence of the seller’s unrestricted right to the sales proceeds.

Although some related party sales were unsuccessful in deferring the recognition of gain, some sales to related parties followed by resale by the buyer were successful in protecting the initial seller from recognition of gain. The 1980 two-year retransfer rule was enacted to combat attempts by taxpayers to use related party sales as a type of escrow arrangement.

The 1980 legislation identified four exceptions to the rule triggering recognition of gain to the original seller if retransfer occurred within two years.

• Involuntary conversions.
• Transfers after the death of the initial seller or purchaser.
• Where it is established to the satisfaction of the Internal Revenue Service that none of the dispositions had as one of its principal purposes income tax avoidance.
• Sales or exchanges of stock to the issuing corporation.

For purposes of the related party rules, a definition of related party is adopted that includes the spouse, children, grandchildren, parents, brothers and sisters. In the case of a corporation, it is considered related to another taxpayer if so related under the I.R.C. § 318 attribution rules. Similarly, attribution rules apply to partnerships, trusts and estates.

FOOTNOTES

2 I.R.C. §§ 453(g), 1239.
3 See I.R.C. § 453.
4 I.R.C. § 453(g).
5 See Ltr. Rul. 9001013, Oct. 5, 1989 (sale of land to buyer related to corporate shareholders not subject to rule as non depreciable property).
6 I.R.C. § 453(g)(2).

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EXEMPTIONS

COWS. The debtor had granted a non-possessory, non-purchase money security interest in five Hereford cows and five calves. The debtor claimed the ten animals as exempt milk cows under Okla. Stat. tit. 31, § 1(A)(10). The debtor testified that the cows were raised as beef cattle and that the cows were milked only for the purposes of feeding new calves. The court held that the cows were not eligible for the exemption because the cattle were not held or bred for the production of milk and were not held for use by the debtor’s family. In re Luckinbill, 163 B.R. 856 (W.D. Okla. 1994).

HOMESTEAD. The debtor had lived with the debtor’s former spouse in a rural homestead until 1981 when the couple divorced. The debtor moved to an apartment in the building which also housed the debtor’s used car business. In 1984 the debtor obtained a mortgage loan from a bank. The mortgage contained a pre-printed clause stating that the debtor did not claim any residential or business homestead in the used car building. In 1987, the debtor had filed written statements in regard to other loans, stating that the debtor claimed the rural home as the homestead property. In re Julian, 163 B.R. 478 (Bankr. N.D. Tex. 1994).

The debtors’ homestead was sold at a tax foreclosure sale by the county in violation of the automatic stay. However, the sale was allowed with the proceeds in excess of the taxes transferred to the bankruptcy estate. The debtors claimed their homestead exemption in the proceeds and the trustee objected, arguing that the sale eliminated all encumbrances against the property, including the homestead exemption. The court held that the trustee’s objection was ineffective because it was not timely filed. In addition, the court held that the debtors’ homestead exemption rights continued as to the proceeds of a tax foreclosure sale. In re Cunningham, 163 B.R. 593 (Bankr. W.D. Wash. 1994).

PERSONAL PROPERTY. The debtor was a widow who had farmed with the decedent spouse. At the time of the bankruptcy filing, the debtor lived alone on the farm and the children lived elsewhere independent of the debtor. The debtor claimed the $60,000 personal property exemption for a family under Tex. Prop. Code § 42.001. A creditor argued that because the debtor lived alone and had no dependents, the debtor was eligible for only the single adult exemption of $30,000. The court held that the debtor’s eligibility for the “family” exemption arose while the debtor’s spouse was alive and would continue as to their property after the spouse died. In re Coffman, 163 B.R. 766 (N.D. Tex. 1994).

FEDERAL TAXATION-ALM § 13.03[7].