

6-5-2009

Related Persons: Always Check the Definition - A Lesson from Like-Kind Exchanges

Neil E. Harl
Iowa State University

Follow this and additional works at: <http://lib.dr.iastate.edu/aglawdigest>

 Part of the [Agricultural and Resource Economics Commons](#), [Agricultural Economics Commons](#), [Agriculture Law Commons](#), and the [Public Economics Commons](#)

Recommended Citation

Harl, Neil E. (2009) "Related Persons: Always Check the Definition - A Lesson from Like-Kind Exchanges," *Agricultural Law Digest*: Vol. 20 : No. 11 , Article 1.

Available at: <http://lib.dr.iastate.edu/aglawdigest/vol20/iss11/1>

This Article is brought to you for free and open access by the Journals at Iowa State University Digital Repository. It has been accepted for inclusion in *Agricultural Law Digest* by an authorized editor of Iowa State University Digital Repository. For more information, please contact digirep@iastate.edu.



Agricultural Law Press

Publisher/Editor

Robert P. Achenbach, Jr.

Contributing Editor

Dr. Neil E. Harl, Esq.

* * * *

Issue Contents

Federal Estate and Gift Taxation

Does the estate tax adversely affect farmers? **83**

Gifts **83**

Marital deduction **83**

Transfers with retained interests **83**

Federal Income Taxation

Bad debt deduction **83**

C corporations

Controlled corporations **84**

Executive compensation **84**

Dependents **84**

Disabled access credit **84**

Disaster losses **84**

Discharge of indebtedness **84**

Education expenses **85**

Electricity production credit **85**

Health savings accounts **85**

Income **85**

IRA **85**

Innocent spouse **85**

Interest rate **85**

Like-kind exchange **85**

Meal expenses **86**

Partnerships

Administrative adjustments **86**

Penalties **86**

Pension plans **86**

Returns **86**

Safe harbor interest rates

June 2009 **87**

Sale of timber **87**

Self-employment income **87**

Travel expenses **87**

Work opportunity tax credit **87**

Right-to-Farm

Legislation **87**

Agricultural Law Digest

Volume 20, No. 11

June 5, 2009

ISSN 1051-2780

Related Persons: Always Check the Definition— A Lesson from Like-Kind Exchanges

-by Neil E. Harl*

When encountering the term “related party” or “related person” in a statute, it is always important to check the definition.¹ For example, the definitions for the two provisions designed to combat abuse in the installment sales area – the so-called two-year disposition rule² and the sale of depreciable property rule between related persons³ – have vastly different “related person” rules⁴ even though they are stabled in the same section of the Internal Revenue Code and deal with similar problems in the abuse area.

A recent letter ruling⁵ in the like-kind exchange area⁶ dramatizes, once again, how important it is to check the definition of “related party” or “related person.”

The 2009 letter ruling

A letter ruling issued in early 2009⁷ involved a fairly common fact situation. Farmland owned by the father was placed in two testamentary trusts at the father’s death with the income payable to the mother for life with the remainder interest held by the three children, A, B and C. Upon the death of the mother, the farmland was transferred to the three children in equal shares *as tenants in common*. The three children then transferred their interests in the farmland to three separate grantor trusts, Trust A, Trust B and Trust C. Child C later died with the farmland to Trust C to remain in trust for C’s surviving spouse for life, remainder to her children.

Trust C now wants to liquidate its ownership interest in the farmland. However, A and B wish to remain invested in the farmland through Trusts A and B. The trusts propose to exchange their respective undivided one-third interests for a 100 percent interest owned in fee simple to increase the marketability of the interest to be sold.

The ruling request characterized the proposed transaction as a like-kind exchange.⁸

In 1989, the like-kind exchange rules were amended⁹ to add a “related person” rule to deny non-recognition treatment for transactions in which related parties make exchanges of high basis property in anticipation of selling the low basis property.¹⁰ Under the related person rule, if within two years of a like-kind exchange with a related person, the related person disposes of the property or the taxpayer disposes of the property (either side of the transaction), the gain is recognized to both parties.¹¹ The question became, in the letter ruling, whether the related party rule would be invoked in the proposed transaction.

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

The ruling proceeds to examine whether the related person rule would be applicable to the proposed exchange. The statute defines “related person” as any person bearing the relationship to the taxpayer described in I.R.C. § 267(b) or I.R.C. § 707(b)(1). Under I.R.C. § 267(b), which refers to I.R.C. § 267(c)(4) for the definition, members of a family are considered related persons.¹² That includes the taxpayer’s brothers and sisters (whether by the whole or half blood), spouse, ancestors and lineal descendants.¹³ Under I.R.C. § 707(b)(1), the related party rule there includes a partnership and a person owning, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership and two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital or profits interest.¹⁴ This part of the related person rule did not apply to the facts of the letter ruling.¹⁵

As for the other related party rule, that pertaining to members of the family,¹⁶ the Internal Revenue Service ruled that the member of family rule did not apply either. As for Trusts A and B, neither of which anticipated sale of their resulting fee simple interests, the beneficiaries of neither Trust A nor Trust B are related persons to Trust C, the trustees of that trust or the beneficiaries of that trust. Children or spouse of a deceased brother or sister are not considered members of the family for this purpose. Therefore, the contemplated sale of property by Trust C within two years of the exchange would involve income tax liability for the selling taxpayers but *would not affect Trust A or Trust B*.¹⁷

Characterization as a partition?

Another approach, which should have produced the same result, would have been to characterize the transaction as a “partition” of the property.¹⁸ Rulings indicate that gain or loss in a partition is not recognized unless a debt security (such as a promissory note) or property is received that differs “materially . . . in kind or extent” from the partitioned property is received; otherwise, a mere partition should not be considered an “exchange.”¹⁹ Although not characterized as a partition, the fact situation in the ruling apparently did not involve a debt security or property that differed materially in kind or extent from the partitioned property.²⁰

ENDNOTES

¹ See, e.g., I.R.C. § 267(b), 707(b).

² I.R.C. § 453(e)(1), (3). See *Tecumseh Corrugated Box Co. v. Comm’r*, 94 T.C. 360 (1990), *aff’d*, 932 F.2d 526 (6th Cir. 1991) (transfer of property to trust which later assigned property to partnership formed by same parties followed by sale to U.S. Government; transaction represented second disposition by related party). See also 4 Harl, *Agricultural Law* § 27.04[11] (Matthew Bender 2009); Harl, *Agricultural Law Manual* § 4.02[16][i] (Agricultural Law Press 2009); Harl, *Farm Income Tax Manual* § 2.03 (Matthew Bender 2009).

³ I.R.C. §§ 453(g), 1239.

⁴ I.R.C. § 453(f)(1) (two-year disposition rule); I.R.C. § 453(g)(3) (depreciable property rule).

⁵ Ltr. Rul. 200919027, Feb. 3, 2009. A ruling with identical

facts and conclusions was issued three days later. Ltr. Rul. 200920032, Feb. 3, 2009.

⁶ I.R.C. § 1031.

⁷ Ltr. Rul. 200919027, Feb. 3, 2009.

⁸ I.R.C. § 1031(a)(1).

⁹ Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106 (1989), adding I.R.C. § 1031(f).

¹⁰ See H.R. Rep. No. 101-247, at III, reprinted in U.S. Code, Congressional, and Administrative News 1906 (1989).

¹¹ I.R.C. § 1031(f)(1).

¹² I.R.C. § 267(c)(4).

¹³ *Id.*

¹⁴ I.R.C. § 707(b)(1)(A), (B).

¹⁵ Ltr. Rul. 200919027, Feb. 3, 2009.

¹⁶ I.R.C. § 267(c)(4).

¹⁷ Ltr. Rul. 200919027, Feb. 3, 2009.

¹⁸ See Harl, “Like-Kind Exchanges: A Popular Option for Property Transfers,” 11 *Drake J. of Agric. L.* 25, 36 (2006).

¹⁹ Treas. Reg. § 1.1001-1(a). See Ltr. Rul. 200411022, Dec. 10, 2003 (no gain or loss on partition of tenancy in common property interest); Ltr. Rul. 200411023, Dec. 10, 2003 (same). See Rev. Rul. 79-44, 1979-1 C.B. 265 (gain recognized on partition of farmland only to extent one received note equal to one-half outstanding mortgage). See also Harl, “Is a Partition an ‘Exchange’?” 14 *Agric. L. Dig.* 41 (2003); Harl, “Partition and the Related Party Rule,” 13 *Agric. L. Dig.* (2002).

²⁰ Ltr. Rul. 200919027, Feb. 3, 2009.

**FARM INCOME TAX, ESTATE
AND
BUSINESS PLANNING SEMINARS**
by Neil E. Harl
January 4-8, 2010
Kailua-Kona, Big Island, Hawai‘i.

See page 88 below for more details.