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

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When encountering the term “related party” or “related person” in a statute, it is always important to check the definition. For example, the definitions for the two provisions designed to combat abuse in the installment sales area—the so-called two-year disposition rule and the sale of depreciable property rule between related persons—have vastly different “related person” rules 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 ruling 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 2009 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. In 1989, the like-kind exchange rules were amended 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. 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. The question became, in the letter ruling, whether the related party rule would be invoked in the proposed transaction.
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. That includes the taxpayer’s brothers and sisters (whether by the whole or half blood), spouse, ancestors and lineal descendants. 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. This part of the related person rule did not apply to the facts of the letter ruling.

As for the other related party rule, that pertaining to members of the family, 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.

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. 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.” 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.

ENDNOTES

1 See, e.g., I.R.C. § 267(b), 707(b).


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).


6 I.R.C. § 1031.


8 I.R.C. § 1031(a)(1).


12 I.R.C. § 267(c)(4).

13 Id.

14 I.R.C. § 707(b)(1)(A), (B).


16 I.R.C. § 267(c)(4).


