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Recommended Citation
Available at: http://lib.dr.iastate.edu/aglawdigest/vol13/iss18/1

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PARTITION AND THE RELATED PARTY RULE
— by Neil E. Harl

The settlement of an estate and distribution of property to the heirs or devisees after the deaths of the parents often involve an exchange of interests between or among the individuals involved unless the parties sell or exchange the entire property interest, agree to maintain their undivided interests for some time or shift the asset or assets involved to a separate entity.¹ One concern is whether the exchange invokes the related party rules under the like-kind exchange provision.²

Related party rules

Under the related party rule applicable to like-kind exchanges, 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, the gain is recognized.³ A primary objective in enactment of the related party rules was to deny non-recognition treatment for transactions in which related parties exchange high basis property for low basis property in anticipation of sale of the low basis property.⁴ Thus, if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, “cashed out” of the investment and the original exchange is not accorded nonrecognition treatment.⁵ The related parties, in such transactions, are treated as a single taxpayer and the subsequent disposition of exchange property by the related party is treated as a “cashing out” by the other related property.⁶

For this purpose, “related person” is defined in I.R.C. §§ 267(b) and 707(b)(1) of the Internal Revenue Code.⁷ That means the term includes members of the family (brothers and sisters, spouse, ancestors and lineal descendants),⁸ an individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual,⁹ two corporations which are members of the same controlled group,¹⁰ a grantor and a fiduciary of a trust,¹¹ a fiduciary of a trust and the fiduciary of another trust if the same person is a grantor of both trusts,¹² a fiduciary of a trust and the beneficiary of the same trust,¹³ a fiduciary of a trust and the beneficiary of another trust, if the same person is a grantor of both trusts,¹⁴ a fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person

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who is a grantor of the trust, a person and a tax-exempt organization which is controlled, directly or indirectly, by the person or by members of the person’s family, a corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of the capital or profits interest in the partnership, an S corporation and another S corporation if the same person or persons own more than 50 percent in value of the outstanding stock of each corporation, an S corporation and a C corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation or an executor of an estate and a beneficiary of the same estate (except for a sale or exchange in satisfaction of a pecuniary bequest). In addition, the term “related person” includes a partnership and a person owning, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership or two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital or profits interests.

IRS has ruled that routing the exchange through an unrelated party to avoid the related party rules does not avoid the denial of like-kind exchange treatment. In that type of exchange, the mere interposition of a qualified intermediary between the parties does not correct a transaction otherwise flawed under the related party rule. The same outcome occurs for a multi-party transaction involving related parties where there is “basis shifting” of the taxpayer’s low basis in its relinquished property to the replacement property which had been owned by the related party prior to the transactions that included the exchanges.

Exceptions to the related party rule

The like-kind exchange related party rule does not apply to—(1) dispositions involving the death of the taxpayer or a related person, (2) compulsory or involuntary conversions if the exchange occurred before the threat or imminence of conversion or (3) if IRS is convinced that neither the exchange nor the disposition had as one of its principal purposes the avoidance of federal income tax. The Senate Finance Committee report states that the third exception includes—(1) transactions involving an exchange of undivided interests in different properties that result in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of the properties; (2) dispositions of property in non-recognition transactions; and (3) transactions that do not involve the shifting of basis between properties. IRS has ruled that the exchange of an undivided interest for a whole interest is not a “disposition” of property subject to the waiting period for related party transactions. In the facts of that ruling, a like-kind exchange of timberland between spouses after a divorce of what had been tenancy in common property did not preclude cutting of the timber during the two year period; the transaction came within the exception where IRS did not believe it was a matter of tax avoidance.

In conclusion

An exchange of interests in the nature of a partition of property, where related taxpayers with undivided interests end up with whole interests in assets, does not come within the two-year redisposition rules.

FOOTNOTES

1 For a discussion of like-kind exchanges, see generally 4 Agricultural Law Manual § 27.03[8][a][ii] (2002); Harl, Agricultural Law Digest § 3.02[16] (2002).
2 I.R.C. § 1031(f).
3 I.R.C. § 1031(f).
5 Id.
6 Id.
7 I.R.C. § 1031(f)(3).
8 I.R.C. §§ 267(b)(1), 267(c)(4).
9 I.R.C. §§ 267(b)(1), 267(c)(4).
10 I.R.C. § 267(b)(2).
13 I.R.C. § 267(b)(5).
14 I.R.C. § 267(b)(6).
15 I.R.C. § 267(b)(7).
16 I.R.C. § 267(b)(8).
17 I.R.C. § 267(b)(9).
18 I.R.C. § 267(b)(10).
19 I.R.C. § 267(b)(11).
20 I.R.C. § 267(b)(12).
21 I.R.C. § 267(b)(13).
25 Id. See Ltr. Rul. 9931002, April 12, 1999 (parent-children transaction).
32 Id. See I.R.C. § 1031(f)(2)(C).
33 See notes 29 and 30 supra.

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