

Related Parties for Federal Income Tax Purposes*

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Introduction

“Relationships! We all got ‘em, we all want ‘em. What do we do with ‘em?” – Jimmy Buffett

The lyrics of the song “Fruitcakes,” sung by Jimmy Buffett, ask what to do with relationships. Taxpayers need to be aware of potential income tax consequences when dealing with related parties in business transactions. Specifically, the taxpayer must identify the potentially related party and the tax issue that may apply relative to both the taxpayer and the potentially related party. To further muddy the waters regarding this issue, related parties may be defined differently for different income tax transactions. Five common tax issues, with defined related parties, are listed below.

Loss Transactions: Sale or Exchange

No loss deduction is allowed to a taxpayer when the transactions involve a related party [Code Section 267(a)]. Without such a provision, related parties could create fictitious tax losses that lack economic substance since the related parties continue to enjoy the benefits of the property subject to the loss sale. Generally, and for this purpose (disallowance of a loss), the IRS defines related parties to be [Code Section 267(b)]:

- The seller’s immediate family: brothers or sisters (whole or half-blood), spouses, ancestors, and lineal descendants. In-laws are not considered members of the seller’s family.
- Controlled corporations: Control is defined by the IRS in this case to be more than 50% direct or indirect ownership. A corporation controlled by a trust for the benefit of the taxpayer is also treated as related.
- Controlled group member: If a corporation is a member of a controlled group of corporations and a transaction occurs between members, the loss is deferred.

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- A corporation and a partnership are related if the same persons own more than 50% of the outstanding stock and more than 50% of the capital interests or profit interest in the partnership.
- One Sub-S corporation and another Sub-S corporation with the same persons owning a greater than 50% interest in outstanding stock value of both corporations.
- Similarly, a Sub-S corporation and a C corporation having the same persons owning a greater than 50% interest in outstanding stock value of both corporations.
- An estate and a beneficiary of that estate.
- Trustees, grantors, and beneficiaries of trusts.
- An exempt organization and a person controlling the exempt organization directly or indirectly.

Note. See *IRS Publication 544: Sales and Other Disposition of Assets*.

Sale of Depreciable Property to a Related Person on an Installment Sale

Many rules apply for transactions that have income tax consequences; however, there are also exemptions to the rules. If you sell depreciable property to certain related persons, you generally cannot report the sale using the installment method. Instead, all payments to be received are considered received in the year of sale. However, there is an exception.

You can use the installment method to report a sale of depreciable property to a related person if no significant tax deferral benefit will be derived from the sale. You must show to the satisfaction of the IRS that avoidance of federal income tax was not one of the principal purposes of the sale. If you sell property to a related person and the related person disposes of the property before you receive all payments with respect to the sale, you may have to treat the amount realized by the related person as received by you when the related person disposes of the property. Related parties for these provisions are as defined above for loss transactions.

Note. See *IRS Publication 537, Installment Sales*.

Like-Kind Exchange under Code Section 1031

The IRS uses the same definition of related parties under the like-kind exchange rules as found above regarding loss transactions. The purpose, in this case, is to say that related-party exchanges are subject to special reporting rules if a disposition of the exchanged property occurs within two years of the original exchange. The circumstance of recognition is either recognizing the deferred gain or loss of the earlier transaction. Indirect transfers are treated as a disposition and trigger this recognition requirement by the taxpayer.

Note. See *Chapter 2 of IRS Publication 544, Sales and Other Dispositions of Assets*.

Section 179 Expensing

The IRS has a slightly different definition of related party for the purposes of allowing a taxpayer to elect to expense qualifying depreciable property. In this case, related parties are defined to be the same as discussed above, taken from IRC § 267(b) and (c); however, the definition of taxpayer's family is changed. Brothers, sisters, and cousins are **not** considered to be family in this case. Therefore, a taxpayer could buy a tractor from a brother and be allowed to expense that tractor. However, if the taxpayer bought a tractor from his father, the taxpayer would be prohibited from expensing the tractor.

Note. See *IRS Publication 946, How to Depreciate Property, Chapter 2, Electing the Section 179 Deduction.*

Dependency Exemption

The IRS uses the relationship test as one way of determining whether a taxpayer may claim a dependency exemption for an individual. In recent years the related parties (family) definition has been refined. Generally, ancestors of the taxpayer meet the relationship test: parents, grandparents, great-grandparents, etc. Likewise, descendants of the taxpayer meet the relationship test: children, grandchildren, step-children, adopted children, foster children, etc. Siblings, step-siblings, half-siblings, or a descendent of these persons meet the relationship test relative to the taxpayer. In-laws can also qualify as being "related" for the purposes of the dependency exemption. Cousins are not related for dependency as a relative. However, they may meet the "member-of-household" test as applied under the new rules by residing in the taxpayer's home for the entire year.

Taxpayers should study the rules as to who may be treated as "related" and any special conditions that must be met, such as living the entire year in the taxpayer's home as opposed to more than six months of the year.

Note. See *IRS Publication 17, Your Federal Income Tax, Chapter 1, The Income Tax Return.*

Caution. Transactions, which occur throughout the year, may have related-party issues that the taxpayer needs to address for the correct and complete filing of his or her income tax return. As briefly discussed above, the definition of related party is often dependent upon the nature of the transaction or deduction. Taxpayers and their tax advisers are cautioned to research the nature of the relationship between parties of a transaction to ensure compliance for proper filing of income tax returns.

IRS Publications

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Additional Topics

This fact sheet was written as part of Rural Tax Education, a national effort including Cooperative Extension programs at participating land-grant universities to provide income tax education materials to farmers, ranchers, and other agricultural producers. For a list of universities involved, other fact sheets, and additional information related to agricultural income tax, please see RuralTax.org.

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