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TAX

Related Party Sales

By Louis Vlahos

In the context of a family business, we are sometimes presented with situations in which the business wishes to sell property to, or acquire property from, a family member or an affiliated business in which he is involved. The transferors are often surprised by the tax consequences of these transactions.

Assume that Taxpayer owns land and buildings that he leases to various businesses. Taxpayer has depreciated the buildings over several years, and the value of the properties has appreciated. If Taxpayer were to sell the property to an unrelated Purchaser, in an arm's length transaction, in exchange for cash and an installment note, Taxpayer would realize gain equal to the excess of the amount realized (the sum of the cash and the note) over the adjusted basis in the property. In general, such gain would be long-term capital gain, which, in the case of an individual, would be subject to federal income tax, in part at the 20 percent capital gain rate and in part at a 25 percent rate. (A 3.8 percent surtax may also apply.) Part of the gain would be recognized in the year of the sale, and the balance would be recognized, under the installment method, as payments are received on the note.

These results change significantly if Purchaser is related to Taxpayer. The definition for "related person" varies slightly depending on the context of the particular transaction, but it generally includes a person and any entity in which such person owns, directly or indirectly, a greater than 50 percent equity interest. It also generally includes business entities that are under common control. When Taxpayer sells to a related person, there are several risks of which he should be aware.

Risk #1: loss of capital gain treatment

The Internal Revenue Code provides that in a sale of property between "related persons," any gain recognized to the transferor shall be treated as ordinary income (taxable, in the case of an individual, at a maximum rate of 39.6 percent) if such property is depreciable in the hands of the transferee.


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Similarly, in the case of a sale of property (whether or not depreciable) between a partnership and a person owning more than 50 percent of the capital or profit interests in the partnership, or between two commonly controlled partnerships, any gain recognized shall be considered ordinary income if the property is other than a capital asset.

If Taxpayer, above, were to sell the property to a Purchaser "related" to Taxpayer, the portion of the gain attributable to the depreciable buildings may be taxed as ordinary income. If the sale was between related partnerships, the entire gain may be taxed as ordinary income, because neither real property (land) used in a trade or business nor depreciable property (buildings) used in a trade or business is a "capital asset."

Risk #2: loss of installment reporting

Moreover, if Taxpayer's sale is to a related Purchaser, the Taxpayer may not be entitled to report under the installment method the gain realized on the sale that is attributable to depreciable property (the buildings); in that case, all payments to be received under the note will be treated as received, and included in Taxpayer's income, for the year of the sale, unless the Taxpayer can establish that the sale did not have tax avoidance as one of its principal purposes. The gain attributable to the land (which is not depreciable) may still be reported on the installment method, subject to one exception.

If a taxpayer (the original seller) sells property to a related person and, before the taxpayer receives all the installment payments with respect to such sale, the related purchaser disposes of the property, then the amount realized at the time of the second sale will generally be treated as received at that time by the taxpayer, provided the second sale is not more than two years after the first sale.

Risk #3: scrutiny of "bargain" transfers

In other situations, the Taxpayer may want to transfer property to a related entity for an amount of consideration that is less than the property's fair market value. From the Taxpayer's perspective, there may be reasonably good business reasons for doing so; however, the IRS will closely scrutinize any such transfer. On examination of a "bargain" transfer, the IRS may conclude that the transfer was not a bona fide business transfer, and that the transferor Taxpayer intended to make a gift to the transferee or, where the transferee is an entity, to the owners thereof (who are related to the transferor).

Similar considerations apply where the sale is between commonly controlled or related business entities, and the purchase price reflects a premium or discount. In that case, the IRS will inquire as to the reasons why one entity paid too much, or too little, for the property sold. Was income being shifted to an owner in a lower tax bracket? Did one of the entities have tax characteristics (such as losses) that the "other than arm's length" sale sought to utilize? In these situations, the IRS may reallocate the gain or income between the related parties so as to prevent the avoidance of tax.

Risk #4: disallowed losses

Where the sale of property between related parties results in the realization of a loss, the seller's deduction in the year of the sale in respect of the loss will be disallowed. However, if the related party purchaser subsequently sells the property at a gain, such gain will be recognized only to the extent it exceeds the previously disallowed loss.

Risk #5: loss of a tax-free like-kind exchange

Even an otherwise tax-free exchange may be adversely impacted where the parties to the transaction are related. For example, if a Taxpayer exchanges property with a related person in a tax-free like-kind exchange, the Taxpayer may nevertheless be forced into recognizing gain if the related person disposes of the property exchanged within two years of the original transaction. Even where the Taxpayer's transaction is part of a deferred exchange with an unrelated purchaser, if the qualified intermediary acquires the replacement property from a person that is related to the Taxpayer, the transaction will result in an immediately taxable event.

You may not choose your related parties, but you can plan

The foregoing describes only some of the pitfalls of which a seller of property must be aware when dealing with a related party buyer. Any sale that may involve a related party should be examined closely to take these and other tax consequences into account. Once the tax issues and the business factors have been identified, the taxpayer can plan accordingly.

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