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# Transactions Between Related Taxpayers

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Many of the complexities of the present tax laws have arisen out of past attempts at tax avoidance. As alert taxpayers have sought and found loopholes that seemed to permit tax avoidance, Congress has been forced in turn to enact new rules to maintain the equity and integrity of the taxing system. In so doing it has gradually created a complex structure of law that may well trap the unwary or uninformed taxpayer, whether or not the intent underlying his transactions is solely one of obtaining tax reductions.

One of the areas in which this development has occurred has to do with transactions between related taxpayers. While many such transactions may be completely bona fide and may be made with no underlying tax saving motive, the possibility that closely related taxpayers might not deal at arms length and the accompanying opportunity for tax reductions could not be ignored. Leaving the question of good faith to be answered by the courts would not have provided an adequate safeguard; the intent of the parties to a transaction is often too elusive for factual determination, especially when they are related. This problem, together with the recognition that these transactions frequently do not represent a real change in economic interests, led Congress to enact a series of rules that prevent certain transactions between related taxpayers from receiving the treatment that would otherwise be available.

## LOSSES ON SALES OR EXCHANGES

Section 267 of the Internal Revenue Code disallows all losses on sales or exchanges between related taxpayers except for losses resulting from distributions in corporate liquidations. This is not merely a presumption subject to rebuttal; all such losses are disallowed regardless of whether the parties deal completely at arms length and in good faith.

The disallowance applies to indirect sales as well as to direct sales between related taxpayers. Thus a loss would not be recognized

on a sale made by a husband on a securities exchange to an unknown third party if at the same time his wife purchased a like item from another stranger. Even though the husband and wife do not deal with each other and do not sell and buy the same identical units, their group economic interest would remain the same and, except for the disallowance as an indirect sale, they would be in a position to choose the time for recognition of the loss without actually disposing of the property involved.[1]

A distinction should be drawn between a sale made between two related parties but in an indirect or circuitous manner, as in the preceding example, and one in which there is an attempt to attribute the purchase to a related person because that person is in turn indirectly related to the actual purchaser. If the effect is that two related persons have been dealing with each other, the form of the intervening transactions may well be disregarded. On the other hand, if the real purchaser and seller are unrelated, the loss will not be disallowed merely because a person related to the seller gives the purchaser the necessary funds, unless it can be shown that the purchaser is actually acting for the person who gives him the money.[2]

Even though there are related persons involved it may be that a transaction is not a sale or exchange and, therefore, there would be no disallowance of the loss. In one case it was held that an involuntary reversion of property from a son to his mother was not actually a sale and there should be no disallowance of the related loss.[3] On the other hand, in a case that arose prior to the enactment of the 1954 Code, when a taxpayer withdrew from a joint venture with other related persons and received cash instead of his pro-rata share of the assets, the Tax Court held that the result was an indirect sale rather than a distribution from the joint venture.[4]

It should be noted that the question of disallowance might be raised even though the sale in question is involuntary, as in a judicial sale, and even though it is clear that the related parties actually represent adverse interests. The Tax Court dealt with this problem in a case involving a sheriff's sale of a taxpayer's interest in farm land to his brothers and sisters as a result of foreclosure proceedings brought by them. It was decided, with three judges dissenting, that there was actually a sale between related persons even though the sale was made by the sheriff at the direction of a court.[5]

The eventual answer to this question is not clear, however, and the possible correctness of the dissent in this case is indicated by a later decision in another court on the same problem. A taxpayer's property was sold at a sheriff's sale to pay back taxes. It was purchased by a corporation that he controlled and the purchase was financed by him. The court held that the sale was made by the sheriff, a new chain of title was created, and the loss should not be disallowed.[6]

The potential danger of the disallowance rule to the uninformed taxpayer is well illustrated by the treatment of a package sale of several items resulting in a net gain. Since only losses are disallowed it might be thought that there would be no problem, even though separate sales of some of the items might have resulted in losses. Such a conclusion would be incorrect. If several items are sold to a related taxpayer, the gains and losses are treated separately and the losses are disallowed.[7] This is true even though there is only one sale. A transfer of a group of items in one sale at cost does not avoid disallowance of the actual losses. In a case involving the transfer of 172 different security issues at cost, the Tax Court held that cost and market value should be compared by issue, the apparent gains should be taxed, and the losses disallowed.[8] The same principle is applied to sales of real estate. However, if two properties which were acquired separately are actually welded into a single unit or so unified as to justify a consolidation of their bases, the result might be different and treatment as a single sale might be permitted.[9]

## EFFECT UPON GAIN FROM RESALE

The new Internal Revenue Code provides some relief where a loss has been disallowed because of the relationship of the parties to the transaction. Under the 1939 Code the basis to the purchaser was related to his purchase price and his gain or loss in a subsequent sale was measured by that basis. The loss previously disallowed could not be used to reduce a subsequent gain.

Under the new Code if the purchaser sells the property later at a gain, the gain will be taxed only to the extent that it exceeds the loss previously disallowed. This new rule is limited to the original purchaser in the transaction in which the loss was disallowed. If he gives or sells the property to a third person, that person does not acquire the right to avail himself of the loss in question. However, with respect to the original purchaser, the use of the loss does carry over to

other property if the basis of that property in his hands is determined directly or indirectly by reference to the property on which the loss was disallowed. Similarly, the use of the loss carries through a series of transactions if the basis of the property acquired in each is determined by reference to the basis of the property transferred.

This new rule does not affect anything other than the gain on a subsequent sale. It does not affect the basis of the property and, therefore, depreciation is computed on the amount actually paid. The holding period is not determined by reference to the time the property was held by the transferor, and if there is a loss from a subsequent sale, the loss cannot be increased by the amount of the loss previously disallowed.

The manner in which these rules operate can best be illustrated by an example. Let us assume that A owns a truck with a basis of $4000 and that he sells the truck to his brother, B, for $2000. The loss of $2000 will be disallowed. If B then sells the truck for $4000 no gain will be recognized because of the application of the $2000 loss previously disallowed to A. If B sells the truck for $1500, his loss will be only $500, despite the previous disallowance of A's loss. If the subsequent purchaser later sells the truck again, his gain or loss will not be affected by the amount originally disallowed to A. If B decides to keep the truck, his basis for depreciation will be his purchase price, $2000.

In the event that the property received by the purchaser is divisible or consists of several items, a problem may arise as to the determination of the basis for each item and the portion of the disallowed loss to be applied in reduction of any gain on subsequent, separate sales of the various items or parts. Following the rule that disallowed losses must be determined separately for each item in a package sale, the purchaser cannot use the entire disallowed loss to reduce a gain on a subsequent sale of any one item, but can use only the portion of the loss properly allocable to that item.

The purchaser's cost for each item is determined by allocating the aggregate cost among the various items on the basis of their fair market values at the time they are received. If one of the items is then sold at a gain, the amount of the previous loss that can be used to reduce the gain is determined by comparing the allocated cost of the purchaser in the original loss transaction with the adjusted basis of the seller in that transaction.

This assumes that the original seller had actually used a basis for the particular item in a tax computation in the past. If this cannot be established, the loss allocable to the particular item is the portion of the total loss disallowed to the original seller allocated on the basis of the values at the time of receipt of all of the property received in the original transaction. In other words, if the exact amount of the disallowed loss attributable to the particular item can be determined, that amount is recognized; but if it cannot be determined, it is assumed that the disallowed loss on all of the items was sustained in proportion to the value of each item.[10]

Despite all of the restrictions, the new rule permitting limited subsequent use of a disallowed loss represents a substantial improvement in the position of related taxpayers. However, it would be more equitable if the Code were further changed to permit the use of the disallowed loss in determining subsequent losses as well as subsequent gains.

## RELATED TAXPAYERS

The Code specifies nine different relationships that serve as the basis for disallowing losses. These relationships can be divided into four general groups: members of a family, controlled corporations, parties to trusts, and controlled exempt organizations.

### Members of a Family

Members of a family include brothers and sisters (whether by the whole or half blood), husband and wife, ancestors, and lineal descendants. As among the family members, no rule of constructive relationship can be applied even though there may be close relationships other than those specified.[11] A sale at a loss to relatives by marriage does not result in disallowance of the loss. Even if the sale is to a son-in-law and a daughter as tenants in common, the half of the loss applicable to the sale to the son-in-law should be allowed if there is no expressed intention of conveying the whole property to the survivor.[12]

Many of the cases that arise in this area seem to involve situations in which the problem could be avoided if all of the dangers were understood in advance. There is a good example in a recent case in which a father had to go to the Circuit Court before he established the right to deduct a loss on a sale to his son-in-law. The son-in-law paid for the property with funds from his joint bank account with his wife, the daughter of the taxpayer. Even though all of these funds were originally

supplied by the son-in-law, title to the property was taken by him and his wife in a tenancy by the entirety. Fortunately, the Court decided that the son-in-law was the actual purchaser, regardless of the form of the conveyance.[13]

The result is not affected by the fact that the purchaser is a member of the family of the wife of the seller and the loss is reported by the seller in a joint return with his wife.[14]

Controlled Corporations

No loss deduction is allowed upon a sale or exchange between an individual and a corporation that he controls, unless the loss results from a distribution in liquidation of the corporation. For this purpose, control is the ownership, either direct or indirect, of more than fifty percent of the value of the outstanding stock. Control need not exist both before and after the transaction in question. If the control exists at the time of the sale or exchange, the rule applies even though the sale or exchange may have been the means of obtaining control or may have resulted in the loss of control.[15]

Relating the control to value rather than to voting rights is consistent with the intent of the statute, which is that a loss should not be allowed when there is no substantial change in effective ownership. However, the determination of control on the basis of value may present difficult problems when several classes of stock are involved. Since there are many pertinent factors that may complicate the determination of relative values, it may be advisable not to rely on the absence of control unless the answer is clear.

A loss is also disallowed between two corporations if more than fifty percent of the value of the outstanding stock of each is owned directly or indirectly by the same individual, but only if one of the corporations was a personal holding company or a foreign personal holding company in the taxable year preceding the sale.

Constructive Ownership

The ownership of stock resulting in control may be either direct or indirect. The Code provides a number of rules under which stock not actually owned will be treated as being constructively owned for purposes of determining the existence of control.

Stock owned directly or indirectly by a corporation, partnership, estate, or trust is considered as being owned proportionately by its shareholders, partners, or beneficiaries. Stock constructively owned under this rule is considered as being actually owned for the purpose of

again applying this rule or the other rules of constructive ownership. For example, if A owns fifty percent of the stock of corporation P which owns sixty percent of the stock of corporation S, A is the constructive owner of thirty percent of the stock of S. A's wife is also the constructive owner of thirty percent of S because she is constructive owner of all stock owned by A.

An individual is considered as owning the stock owned by his family, and if he owns any stock in a corporation, he is also considered as owning any stock in that corporation which is owned by his partner. However, stock constructively owned under these rules is not considered as actually owned for the purpose of reapplying the rules in a determination of stock constructively owned by another person. This means that while a husband has constructive ownership of his wife's stock, the same stock would not also be owned constructively by the husband's brother.

These rules are not particularly difficult to understand but their application can be quite complicated. When they are to be applied to a series of interlocking business and family relationships, the only safe procedure is to make a careful analysis of each person's constructive stock ownership.

Parties to Trusts

The Code also disallows losses on sales or exchanges between certain parties to trusts. The prohibited trust relationships are:

A grantor and a fiduciary of a trust,

Fiduciaries of two different trusts if the same person is the grantor of both trusts,

A fiduciary and a beneficiary of a trust,

A fiduciary of one trust and a beneficiary of another trust if the same person is grantor of both trusts, and

A fiduciary and a corporation if more than fifty percent of the value of the corporation's stock is owned directly or indirectly by the trust or its grantor.

The last two items are new in the 1954 Code.

Controlled Exempt Organizations

Another new provision of the 1954 Code disallows losses on sales or exchanges between a person and an exempt organization[16] controlled directly or indirectly by that person, or by his family if the person is an individual. Since the word "person" also includes a trust, estate, partnership, or corporation, this new provision would apply to those

that control the many new charitable foundations that have been established in recent years.

Unfortunately the Code does not specify just what is intended to be control in this situation. The reports of the Congressional Committees are not particularly helpful either; they explain control in general terms that will be difficult to apply. The necessity for an exact definition has been included in the legislative recommendations recently made by the American Institute of Accountants.

## DEDUCTION OF ACCRUED EXPENSES AND INTEREST

In addition to losses on sales and exchanges, deductions for expenses and interest represent another area in which related taxpayers could obtain unwarranted tax savings if there were no restrictions. A common example would be an individual on the cash basis of accounting who controls a corporation that is on the accrual basis. The corporation might accrue and obtain a deduction for salary payable to the individual with no intention of eventual payment. The individual, being on the cash basis, would not have to include the salary in income.

Deductions resulting from arrangements of this type are limited by Section 267 of the Code. Interest and expenses otherwise deductible will be disallowed if:

1. They are not paid and are not includible in the gross income of the potential payee within two and one-half months after the close of the taxable year,
2. The method of accounting of the potential payee prevents the inclusion of the amount in his gross income for his taxable year in which or with which the taxable year of the taxpayer ends, and
3. At the close of the taxable year of the taxpayer or within two and one-half months thereafter, both the taxpayer and the potential payee are related persons.

The effect of these provisions is that if an accrual basis payer and a cash basis payee are related, deductions are not allowed for accrued expenses and interest unless they are actually or constructively paid within two and one-half months after the end of the payer's year.

Unless all three of the specified conditions exist the deduction is not subject to disallowance.[17] However, if the conditions do exist the Commissioner cannot allow the deduction even if there is no tax saving

motive involved in the failure to make timely payment.[18] Once disallowed, the deduction is lost for the future even though the payment is made eventually. Therefore, while the section is designed to prevent tax avoidance, it may be a dangerous trap for the uniformed.

The relationships involved are the same as those already described in connection with the disallowance of losses from sales and exchanges. The relationship is pertinent only if it exists at the end of the taxpayer's taxable year or at any time within two and one-half months thereafter. The fact that it existed at some prior time has no bearing on the disallowance.

Whether or not there is a timely payment of the item in question, it is not disallowed if, because of the payee's accounting method, it is includible in his income in the year in which or with which the year of the accrual basis payer ends. This means that the payee would have to be on the accrual basis of accounting. It does not mean that voluntary inclusion will suffice.[19] In the absence of payment or constructive receipt, the inclusion must stem from the accounting method of the payee.

## PAYMENT AND CONSTRUCTIVE RECEIPT

The deduction also is allowed if the amount is constructively received before the end of the two and one-half month period. Ordinarily there is constructive receipt if the amounts involved are credited to the payee, are payable on demand, and the payer is financially able to pay.[20] The amount of cash on hand is not the sole measure of ability to pay. If the credit position is good and the necessary funds could be borrowed, there is still ability to pay.[21] Actual credit to the account of the specific payee may not be necessary if the items in question are accrued and it is clear that the payee is aware of their availability.[22] If actual payment is prevented under these circumstances because of some contrary restriction, that fact does not relieve the taxpayer of the disallowance. The provisions of the statute are absolute and do not permit the consideration of extenuating circumstances, regardless of the hardship imposed.

In the absence of constructive receipt there must be an actual payment within the time specified. Payment is not limited for this purpose to the transfer of cash. The courts have been fairly consistent in treating the issuance of negotiable notes by a solvent taxpayer as payment. Either demand notes or time notes qualify.[23]

For some time the Treasury Department vigorously opposed the treatment of notes as payment. However, in a very recent ruling[24] this position was abandoned. If the taxpayer is solvent and the notes have a fair market value at the time of issuance equal to their face amount, they will be accepted as a form of payment. Nothing was said as to the treatment of notes that have some value but less than their face amount. This may still present a problem although it would seem proper to recognize them to the extent of their actual value.

Settlement in the form of a credit against other amounts receivable is also acceptable.[25] However, if an open account with the payee is involved and if there is a net liability to the payee resulting from the accumulation of a number of different items, the taxpayer must be careful in making current settlements to identify them specifically as being on account of the items for which he seeks a deduction. Otherwise the state law may be applied in determining which items have been settled, and it may be found that the settlements have to be applied to earlier balances or to some other items in the account.[26]

## GAINS AS ORDINARY INCOME

Another way in which related taxpayers might obtain a tax benefit without seriously disturbing their real economic interests is in the sale of depreciable property at a gain. If depreciable property with a low basis could be sold to a related taxpayer at a substantial gain that would be taxed at capital gain rates, there could be a net advantage arising out of the additional depreciation deduction allowed the purchaser on the resulting stepped-up basis.

The Code contains some limitations on the use of this tax saving device,[27] but they are much less severe than the restrictions on sales at a loss. If property that is subject to the allowance for depreciation in the hands of the transferee is sold or exchanged, directly or indirectly, between related taxpayers, the resulting gain is not permitted treatment as a capital gain.

There are only two classes of related taxpayers for this purpose: husbands and wives and an individual and a corporation if eighty percent of the value of the corporation's stock is owned by that individual, his spouse, and his minor children and grandchildren. Children and grandchildren include stepchildren and those legally adopted.[28] These relationships are much more restricted than those that must be con-

sidered in connection with disallowed losses and there are no rules of constructive ownership that apply. Furthermore, sales of depletable assets are not covered by the rule.

It is evident that a number of opportunities for tax saving are still available. For example, a father can sell depreciable property to his son or an individual can purchase from his corporation if he and his family own less than eighty percent of the value of its stock.

## OTHER SALES AND EXCHANGES

It should be recognized that even in a situation in which one of the statutory rules is not involved, there may still be problems if some degree of relationship or unity of interest is coupled with a lack of good faith, a primary motive of tax saving, or a selling price unrelated to actual market value. The Treasury Department will scrutinize these situations very carefully and probably will challenge the apparent results if it sees an advantage in doing so. The relationship may not in itself cause a transaction to be set aside, but it may be a contributing factor in leading the Treasury or the courts to conclude that a particular transaction is not in fact what it purports to be. That is, it may lead to the application of the rule that recognition should be given to the substance of a transaction rather than to its form.

If the parties to a transaction are related in some way and the only apparent motive is one of tax saving, the transaction may not be recognized even though the transfer is made at a price representing fair market value. Thus, in an early case that involved years before the introduction of the statutory rules of loss disallowance, the Supreme Court refused to recognize a loss on sales between a taxpayer and a corporation that he organized largely for the purpose of dealing with him. It regarded the corporation as a sham, because it was merely an extension of his self in another form.[29]

This does not necessarily mean that a tax avoidance motive will cause a transaction to be set aside. If the sale is a reality, control over the property not being retained by the seller, and if neither party to the transaction is a sham or a mere conduit, the transaction probably will be recognized.[30]

The test of good faith looks to the reality of the transaction itself. If it is not bona fide and is a mere subterfuge it will not be accepted. Again, the mere existence of a relationship between the parties to a transaction does not demonstrate that good faith is lacking, but it cer-

tainly causes a more careful examination than would be the case if there were no relationship. The question of good faith is a factual one that can be answered only after consideration of all of the circumstances. It has been the subject of a great deal of litigation and there is no simple rule to which we can look for an easy answer in a given case.

The relationship of the selling price to actual market value is just one of the factors that will be considered in answering the question of good faith. If a sale is not made at approximate market value and if the parties to the transaction are related, it is a good indication that the sale is not at arms length and that something else may have been intended. Thus what is ostensibly a sale may be treated as a gift or as a dividend after all of the facts have been examined.

No attempt will be made to summarize here the many decisions that deal with transactions that are not what they purport to be. They involve considerations other than taxpayer relationships, they are often conflicting, and they represent an area of tax law of sufficient importance to justify separate treatment at some future meeting of this Institute. The important points to related taxpayers are that the relationship itself may result in more than normal attention to a transaction and that mere avoidance of the provisions of the Code is not an absolute safeguard against attack.

## ASSIGNMENT OF INCOME

This analysis of transactions between related taxpayers would not be complete without some mention of the problems involved in attempts to assign income. These problems are not peculiar to related taxpayers in the sense that the term is used in the Code, but income assignments would be particularly advantageous to such taxpayers if they could be made without the transfer of the property from which the income is derived. If a father in the high tax brackets could assign income to his children without giving up his control of the related property, the tax savings could be substantial.

Most of the tax saving possibilities in this area have been removed by a series of Supreme Court decisions on the subject. It is well established that the assignment of the right to receive income will not insulate the assignor from the related tax liability. He remains taxable if he actually earns the income or is the source of the right to receive and enjoy it. He has this right if he retains control over the assigned property or over the receipt of the income.[31] Thus a taxpayer cannot

relieve himself of income tax liability by giving away present or future rights to receive interest or dividends if he retains ownership of the related securities.

In addition to outright gifts of the property itself, there are a few other ways still available in which advantages of this type can be obtained. One is in the gift of agricultural or manufactured products that have increased in value. For some time, the Treasury Department attempted to apply the assignment of income theory to gifts of farm products with a value in excess of their basis. However, after meeting with several reversals in the courts it abandoned that approach. In a recent ruling it conceded that gifts of this type will not result in income to the donor.[32] The donor will be required to adjust his inventory for the related costs and the basis to the donee will be the donor's basis or the fair market value at the time of gift, whichever is lower. It is not clear what reasoning lies behind the apparent intent to relate basis to fair market value if lower than the donor's basis; ordinarily that treatment would be applied only in the event of subsequent sale at a loss. The point probably is not too important, however, because market value usually will exceed the donor's basis.

Another possibility for the diversion of income lies in the creation of a reversionary trust. The owner of property can transfer it to a trust with a limited term if the reversion of his interest would not reasonably be expected to take effect within a period of ten years from the date of the transfer. The arrangement could be such that the beneficiaries would be taxed on the income while the property is held in trust. This assumes, of course, that the grantor will not be taxable because of some other reason arising out of the trust arrangement. The mere fact that the trust funds might revert in less than ten years because of the death of the income beneficiaries would not change the tax results suggested.[33]

Despite these examples, and some others that have not been mentioned, the rearrangement of income within a related economic group has been severely limited by the Code and by court decisions. The Internal Revenue Service is always alert to devices that seem to result in unwarranted advantages to related taxpayers. It is important, therefore, that extreme care be exercised in dealing with problems in this area in order to be sure that the effect of some completely bona fide transaction will not be upset because of a conflict with one of the many restrictive rules that must be observed.

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