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Issue Contents

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Installment Sales Between Related Parties

-by Neil E. Harl*

For transactions involving farm and ranch property, installment sales are common[1] and installment sales between related persons are almost as common.[2] A 2009 private letter ruling[3] has cast light on both of the related person rules for installment sales[4] and on the recapture consequences of such transactions.[5] The two provisions governing related person transactions with respect to installment transactions are quite different and require careful planning if adverse income tax consequences are to be avoided.

Related Person Rule I

Because of the confusion over the two related person rules for installment reporting, the first of those provisions (limiting installment sale reporting where a second disposition occurs within two years) we have referred to as *Related Person Rule I*.[6] That rule was added to the Internal Revenue Code by the Installment Sales Revision Act of 1980[7] in response to complaints that some taxpayers were using installment sales between related parties to obtain highly favorable income tax results.

> **Example:** F, wishing to sell 80 acres of farmland to a local developer, H, for $500,000, was advised by her attorney that the income tax consequences would be severe and that an ordinary escrow arrangement would likely not prevent constructive receipt of the amount to F.[8]
>
> Rather than sell to H, F instead sold the 80 acres to her daughter, J, for $500,000 under a 25-year installment contract and gave J a deed for the property. J immediately resold the property to H for $500,000 in cash and gave H a deed to the 80 acres. J had no gain on the sale because of the $500,000 income tax basis obtained in the purchase from F. J invested the $500,000 cash payment from H in money market certificates.

In effect, intra-family sales before 1980 were coming to be viewed as a type of escrow arrangement.

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Initial versions of the bill (H.R. 6883) which ultimately became the Installment Sales Revision Act of 1980[9] would have barred installment reporting of gain from sales between related persons but, as finally enacted, the legislation permits installment reporting between related persons but imposes income tax liability on the original seller, with several exceptions, if the installment sale property is disposed of within two years by the obligor.[10] The gain is based upon the original seller's gross profit ratio to the extent the amount realized from the second disposition exceeds the actual payments made under the installment sale.[11] Thus, acceleration of gain from the first sale generally results only to the extent additional cash and other property flow into the related group as a result of the second disposition of the property.

If the original seller does not notify IRS of the second disposition, the original seller's income tax return for the year of the second disposition remains open indefinitely.[12] That is because the statute of limitations for deficiency assessments as to a first disposition does not expire until two years after IRS is notified of the second disposition by the person making the first disposition.[13] Thus, continued contact with the first transferee is essential.

The 1980 amendments contain several exceptions – (1) dispositions by involuntary conversion, if the first sale occurred before the threat or imminence of the conversion;[14] (2) transfers after the death of the installment seller or purchaser;[15] (3) sale or exchange of stock to the issuing corporation;[16] and (4) where it is established to the satisfaction of the Internal Revenue Service that none of the dispositions had as one of its principal purposes the avoidance of federal income tax.[17]

For purposes of the resale rules, the definition of "related person" includes spouses, children, grandchildren and parents.[18] The definition also includes related parties under the attribution rules of I.R.C. § 318(a) (except for paragraph 4) where attribution of ownership would apply to the person first disposing of the property or a person who bears a relationship described in Section 267(b) to the person first disposing of the property, for partnerships, trusts and corporations.[19] The 2009 letter ruling, which interpreted these related person rules,[20] noted that the regulations specify that for an individual to be considered as owning an interest, either actually or constructively, the individual must actually own or constructively own the property and that was not the case in the letter ruling.[21]

Related Person Rule II

The other related person rule, referred to as Related Person Rule II, refers more narrowly to *depreciable* property sales between related persons.[22] Under that rule, the deferred payments are deemed received in the taxable year of sale.[23] For this purpose, "related person" means ". . . a person and all entities which are controlled entities with respect to such person."[24] Family members are not included in the definition of "related person."[25]

The only exception to Related Person Rule II is if income tax avoidance is a principal purpose.[26]

The 2009 letter ruling[27] held, under the facts of that ruling, that the parties involved were not related persons under the statute.

Recapture of depreciation

The installment sale rules specify that, for installment sales, recapture income under I.R.C. §§ 1245 and 1250 is to be recognized in the year of the disposition.[28] But what about "unrecaptured section 1250 gain?"[29] That is the gain which essentially represents the gain attributable to depreciation previously claimed on depreciable real property except for gain recaptured as ordinary income.[30] The "unrecaptured section 1250 gain" is not subject to the rule requiring recaptured depreciation to be reported in the year of sale in the case of installment transactions.[31]

The 2009 letter ruling states that the unrecaptured Section 1250 gain must be reported over the term of the installment obligation with the unrecaptured Section 1250 gain taken into account before the adjusted net capital gain.[32] The ruling also notes that the unrecaptured Section 1250 gain, for Section 1231 assets, is limited, however, to the net Section 1231 gain for the taxable year.[33]

ENDNOTES

1 I.R.C. § 453(a).

2 I.R.C. § 453(e), (f)(1). See generally Harl, *Agricultural Law* § 48.03[10][a]. [b] (Matthew Bender 2009); Harl, *Agricultural Law Manual* § 6.03[1][e], [b][iv] (Agricultural Law Press 2009); Harl, *Farm Income Tax Manual* § 2.03 (Matthew Bender 2009 ed.). See also Harl, "Related Persons: Always Check the Definition—A Lesson From Like-Kind Exchanges," 20 *Agric. L. Dig*. 81 (2009).

3 Ltr. Rul. 200937007, March 10, 2009.

4 I.R.C. § 453(e)(1), (3) (two-year redisposition); I.R.C. §§ 453(g), 1239 (sales of depreciable property between related persons).

5 I.R.C. §§ 1245, 1250.

6 See, e.g., Harl, *Farm Income Tax: Annotated Materials* Ch. 5 (2009).

7 Pub. L. No. 96-471, § 6. 94 Stat. 2247, 2256 (1980).

8 E.g., Harris v. Comm'r, 477 F.2d 812 (4th Cir. 1973) (court-ordered escrow arrangement was not successful to defer income).

[9] See note 7 *supra*.

[10] I.R.C. § 453(e).

[11] I.R.C. § 453(e)(1), (3).

[12] I.R.C. Sec. 453(e)(8).

[13] *Id*.

[14] I.R.C. § 453(e)(6)(B).

[15] I.R.C. § 453(e)(6)(C).

[16] I.R.C. § 453(e)(6)(A).

[17] I.R.C. § 453(e)(7).

[18] I.R.C. § 453(f)(1)(B).

[19] I.R.C. §§ 453(f)(1)(A), 318(a).

[20] Ltr. Rul. 200937007, March 10, 2009.

[21] *Id*.

[22] I.R.C. §§ 453(g), 1239.

[23] *Id*.

[24] I.R.C. § 1239((b)(1).

[25] See Ltr. Rul. 8829002, March 18, 1988 (father and son are not related persons).

[26] I.R.C. § 453(g)(2).

[27] Ltr. Rul. 200937007, March 10, 2009.

[28] I.R.C. § 453(i)(1).

[29] I.R.C. § 1(h)(6).

[30] *Id*.

[31] Treas. Reg. §§ 1.1245-6(d)(1), 1.1250-1(c)(6).

[32] Ltr. Rul. 200937007, March 10, 2009. See Treas. Reg. § 1.453-12.

[33] Ltr. Rul. 200937007, March 10, 2009.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

ADVERSE POSSESSION

FENCES. The defendants constructed a barbed wire fence on the boundary between the defendants' and plaintiffs' properties. The new fence was located on the plaintiffs' side of the surveyed boundary line but in line generally with some old fence posts which no longer created a fence. The defendants counterclaimed title through adverse possession of the land based on the existence of the old fence. The trial court denied the claim for adverse possession and ruled that the fence had to be moved back to within six inches of the surveyed boundary line wherever the fence encroached on the plaintiffs' land more than six inches. The court also ordered both parties to pay one-half of the cost of the moving of the fence. The defendant appealed but the appellate court upheld the trial court's orders under Tenn. Code Ann. §§ 44-8-201, 44-8-202, governing partition fences. **Polos v. Shields, 2009 Tenn. App. LEXIS 625 (Tenn. Ct. App. 2009)**.

BANKRUPTCY

No items.

FEDERAL FARM PROGRAMS

No items.

FEDERAL ESTATE AND GIFT TAXATION

CLAIMS. The IRS has adopted as final regulations governing the use of post-death events to determine the amount deductible for claims against an estate. See discussion of the proposed regulation which still applies to the final regulations: Harl, "Proposed Regulations Issued on Effects of Post-Death Events on Deductibility From the Gross Estate," 18 Agric. L. Dig. 73 (2007) (footnotes omitted): ". . . The proposed regulations clarify that events occurring after a decedent's death are to be considered in determining the amount deductible under all provisions of the federal estate tax law allowing deductions for expenses, indebtedness and taxes. Thus, deductions are limited to amounts actually paid by the estate in satisfaction of deductible expenses and claims. Final court decisions as to the amount and enforceability of the claim or expense are accepted in determining the deductible amount. Settlements are acceptable if reached in bona fide negotiations between adverse parties with