RELATED PARTY ISSUES

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Learning Objectives

After completing this session, participants will be able to perform the following job-related tasks:

- ✔ Match expense deductions for payments to related parties to the same tax year that the payee reports the corresponding income
- ✔ Identify when gain must be recognized in a like-kind exchange between related parties
- ✔ Apply the I.R.C. § 179 limit on expensing property acquired from a related party
- ✔ Report the sale of property at a loss to a related party
- ✔ Explain installment sales to a related party and what happens upon a subsequent disposition of the property
- ✔ Recognize when the gain on a sale or exchange of depreciable property between related parties is treated as ordinary income
- ✔ Explain the related party loan exclusion from the determination of a taxpayer's amount at-risk

- ✔ Apply the related party rules for passive activity loss deduction limitations
- ✔ Apply the I.R.C. § 280A limits on rental of a residence and the impact of related party rentals on personal use days
- ✔ Explain the rules for travel expenses and qualified educational assistance programs for related parties
- ✔ Explain the taxation of a property transfer between spouses

Introduction

Related party rules frequently affect the timing or character of income or deductions and sometimes disallow a loss or deduction entirely. This chapter provides a summary of various Internal Revenue Code provisions that define related parties, and it explains the rules applicable to several types of related party transactions.

ISSUE 1: DEFINITIONS OF RELATED PARTIES A number of Internal Revenue Code provisions define *related parties.*

I.R.C. § 267(a) limits losses, expenses, and interest deductions for transactions between related parties. I.R.C. § 267(b) defines a *related party*, and I.R.C. § 267(c) explains the *constructive ownership of stock* rules for purposes of determining a related party under I.R.C. § 267(a). I.R.C. § 318 lists the related party relationships that apply for various corporate transactions, I.R.C. § 707(b)(1) and I.R.C. § 707(b)(2) address related party transactions between partners and partnerships, I.R.C. § 1239 defines related persons for purposes of treating gain from the sale of depreciable property as ordinary income, and I.R.C. § 1563(d) and (e) provides rules for determining stock ownership within a controlled group of corporations.

I.R.C. § 267(b) Relationships

I.R.C. § 267(b) defines a *related party* to include the following:

1. Members of a family, including brothers, sisters, half-brothers, half-sisters, spouse, ancestors (parents, grandparents, ancestors beyond grandparents) and lineal descendants (children, grandchildren, lineal descendants beyond grandchildren)–but not nieces, nephews, aunts, uncles, cousins, in-laws, and step-relatives
2. An individual and a corporation in which the individual owns, directly or indirectly, more than 50% of the value of the outstanding stock
3. Two corporations that are members of the same controlled group within the meaning of I.R.C. § 1563(a), substituting "more than 50%" for "at least 80%" and without regard to insurance companies or stock owned by any I.R.C. § 401(a) employees' trust
4. A grantor and a fiduciary of any trust
5. A fiduciary of a trust and fiduciary of another trust if the same person is the grantor of both trusts
6. A fiduciary of a trust and a beneficiary of such trust
7. A fiduciary of a trust and a beneficiary of another trust if the same person is the grantor of both trusts
8. A fiduciary of a trust and a corporation in which the trust or the grantor of the trust owns, directly or indirectly, more than 50% of the value of the outstanding stock
9. A person and an I.R.C. § 501 tax-exempt organization that is controlled directly or indirectly by the person, or if the person is an individual, by members of the individual's family
10. A corporation and a partnership if the same persons own (a) more than 50% of the value of the outstanding stock of the corporation

and (b) more than 50% of the capital interest or the profits interest in the partnership

11. An S corporation and another S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation
12. An S corporation and a C corporation if the same persons own more than 50% in value of the outstanding stock of each corporation
13. An executor of an estate and a beneficiary of such estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest

Observation Partner and Partnership

Partners in a partnership and the partnership are not considered related parties for I.R.C. § 267 purposes. Transactions between partners and partnerships are covered by I.R.C. § 707 and Treas. Reg. § 1.707-1.

Practitioner Note Personal Service Corporation

For purposes of matching deductions and gross income inclusion under I.R.C. § 267(a)(2), a personal service corporation and its employee-owner are related parties.

The family attribution rules in I.R.C. § 267 apply even when there is hostility between family members [*Miller v. Commissioner*, 75 T.C. 182 (1980)].

I.R.C. § 267(c) Constructive Ownership of Stock

I.R.C. § 267(c) takes into account both direct and indirect ownership of stock in defining related persons. The I.R.C. § 267(c) *constructive ownership of stock* rules include the following:

1. Stock owned by a corporation, partnership, estate, or trust, directly or indirectly, is deemed owned proportionately by the entity's shareholders, partners, or beneficiaries.
2. Stock owned by an individual's family, directly or indirectly, is deemed owned by the individual.
3. Stock owned by an individual's partner, directly or indirectly, is deemed owned by the individual if the individual otherwise owns any stock in the corporation (without regard to family attribution).
4. An individual's family includes only his or her brothers, sisters, half-brothers, half-sisters, spouse, ancestors, and lineal descendants.
5. Stock constructively owned by a person by reason of item 1 is deemed owned by that person for the purpose of applying items 1, 2, or 3, but stock constructively owned by an individual by reason of items 2 or 3 is not deemed owned by the individual to make another person the constructive owner of the same stock.

I.R.C. § 318 Constructive Ownership of Stock

I.R.C. § 318 lists the related party relationships that apply for various corporate transactions, including stock redemptions (I.R.C. §§ 302 and 304), disposition of I.R.C. § 306 stock, certain stock purchases treated as asset acquisitions (I.R.C. § 338), net operating loss (NOL) carryovers (I.R.C. § 382), real estate investment trust (REIT) real property rents (I.R.C. § 856), and foreign corporations (I.R.C. §§ 958 and 6038). Constructive ownership of stock occurs in 10 ways:

1. Stock owned, directly or indirectly, by an individual's spouse, children (including adopted children), grandchildren, and parents is deemed owned by the individual. (This does not include a spouse who is legally separated from the individual under a decree of divorce or separate maintenance.)

Practitioner Note Siblings

Unlike I.R.C. § 267, family attribution for constructive ownership of stock does not include siblings. Family attribution also does not include nieces, nephews, aunts, uncles, or cousins.

Example 2.1 Family Attribution

Howard Henderson; his wife, Wanda Henderson; his son, Samuel Henderson; and his grandson (Samuel's son), Gerald Henderson, each own 25 shares of stock in a corporation. Howard, Wanda, and Samuel each are deemed to own 100 shares (25 directly and 75 constructively). Gerald is deemed to own 50 shares (25 directly and 25 constructively from his father) [Treas. Reg. § 1.318-2(b), Example 1]. **Figure 2.1** shows the constructive ownership of stock according to I.R.C. § 318(a)(1).

FIGURE 2.1 Illustration of Family Attribution

	Actual and Constructive Ownership				
Shareholder	**Howard**	**Wanda**	**Samuel**	**Gerald**	**Total**
Howard (husband)	25	25	25	25	100
Wanda (Howard's spouse)	25	25	25	25	100
Samuel (Howard and Wanda's son)	25	25	25	25	100
Gerald (Howard and Wanda's grandson)	0	0	25	25	50

2. Stock owned, directly or indirectly, by a partnership, S corporation, or estate is deemed owned proportionately by its partners, shareholders, or beneficiaries.
3. Stock owned by a trust (other than an I.R.C. § 401 employees' trust) is deemed owned by its beneficiaries in proportion to their actuarial interests in the trust.

Example 2.2 Attribution to a Trust

A testamentary trust owns 25 of the outstanding 100 shares of stock of a corporation. Aaron Alexander, an individual, holds a vested remainder interest in the trust that has an actuarial value of 4% of the trust property. Aaron owns the remaining 75 shares. Since Aaron's interest in the trust is a vested interest rather than a contingent interest (whether remote or not), the trust is deemed to own 100 shares. Aaron is deemed to own 76 shares [75 shares that Aaron actually owns plus 1 share (4% of the 25 shares owned by the trust)] [Treas. Reg. § 1.318-2(c), Example 2].

4. Stock owned by a trust in which a person is considered the owner (grantors and other substantial owners) is deemed owned by that person.
5. Stock owned by a C corporation is deemed owned proportionately by any shareholders who own, directly or indirectly, at least 50% in value of the corporation's stock.

Example 2.3 Attribution to a C Corporation

Amanda Andrews, an individual, has a 50% interest in a partnership. The partnership owns 50 of the 100 outstanding shares of stock of a corporation, and Amanda owns the remaining 50 shares. The partnership is deemed to own 100 shares of the corporation. Amanda is deemed to own 75 shares [Treas. Reg. § 1.318-2(c), Example 1].

6. Stock owned by a partner, an S corporation shareholder, or a beneficiary of an estate is deemed owned by the partnership, S corporation, or estate.
7. Stock owned by a beneficiary of a trust (other than an I.R.C. § 401 employees' trust) is deemed owned by the trust, unless the beneficiary's interest is a *remote contingent interest* (actuarially 5% or less of the value of the trust property).
8. Stock owned by a person who is considered the owner (grantors and other substantial owners) of the trust is deemed owned by the trust.

9. Stock owned by a person owning 50% or more in value in a corporation is deemed owned by the corporation.
10. Stock options owned by a person are treated as stock owned by the person.

Stock constructively owned by an individual by reason of item 1 is not deemed owned by the individual for applying item 1 again to attribute constructive ownership to another family member. Similarly, stock constructively owned by a partnership, estate, trust, or corporation by reason of items 6, 7, 8, or 9 is not deemed owned by it for purposes of applying items 2, 3, 4, or 5. Otherwise, stock constructively owned by a person under one provision of I.R.C. § 318 is deemed actually owned by the person for applying other provisions of I.R.C. § 318. If stock may be deemed owned by an individual under both items 1 and 10, it is deemed owned under item 10.

Practitioner Note Indirect Ownership of Partnership

The constructive ownership principles of I.R.C. § 267(c) apply to attribute indirect ownership of a capital or profits interest in a partnership, except that an individual's interest is not attributed to the other partners, and a C corporation's interest in the partnership is attributed only to shareholders who own, directly or indirectly, more than 5% in value of the corporation's stock.

Cross-Reference Affordable Care Act

Related party rules also impact the determination of applicable large employer (ALE) status for the Affordable Care Act, Pub. L. No. 111-148. See the "Affordable Care Act" chapter in this book.

I.R.C. § 707(b)(1) Loss Disallowance

I.R.C. § 707(b)(1) denies recognition of losses resulting from sales and exchanges between

1. a partnership and a person owning, directly or indirectly, more than 50% of the capital or profits interest in such partnership; or
2. two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interest.

I.R.C. § 707(b)(2) Gains Treated as Ordinary Income

I.R.C. § 707(b)(2) requires ordinary income treatment of gains from sales and exchanges of property other than a capital asset between

1. a partnership and a person owning, directly or indirectly, more than 50% of the capital or profits interest in such partnership; or
2. two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interest.

I.R.C. § 1239 Gain from the Sale of Depreciable Property

Under I.R.C. § 1239, any gain recognized by a seller on the sale of property must be treated as ordinary income if the property is, in the hands of the buyer, depreciable under I.R.C. § 167. I.R.C. § 1239 defines related persons for this purpose as the following:

1. A person and all entities controlled by that person. A *controlled entity* for this purpose means
   a. a corporation in which a person owns, directly or indirectly, more than 50% of the value of the outstanding stock;
   b. a partnership in which a person owns, directly or indirectly, more than 50% of the capital interest or profits interest; and

c. any entity that is a related person under items 3, 10, 11, or 12 of I.R.C. § 267(b), listed earlier in this section

2. A taxpayer and any trust in which the taxpayer (or spouse) is a beneficiary, unless the beneficiary's interest is a remote contingent interest, as defined in I.R.C. § 318
3. An executor and beneficiary of an estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest
4. An employer (and any person related to the employer) and a welfare benefit fund controlled by the employer or a person related to the employer

Example 2.4 Sale of Commercial Rental Property to a Related Party

Sam and his son George each have a 50% interest in SG Realty, LLC (taxed as a partnership). George wants to sell one of his commercial rental buildings (I.R.C. § 1250 property) to SG Realty. The sale price is $450,000, and George's adjusted tax basis is $150,000 ($350,000 original cost – $200,000 accumulated depreciation). George recognizes $300,000 of *ordinary* income under I.R.C. § 1239 ($450,000 – $150,000). Under I.R.C. § 267, George must attribute his father's 50% interest in SG Realty to himself. Then, as he has over a 50% interest in the LLC, George must recognize ordinary income because the building is depreciable in the hands of SG Realty. In contrast, if George sold the building to an unrelated party, the gain would be unrecaptured I.R.C. § 1250 gain to the extent of the $200,000 of accumulated depreciation (taxed at a maximum 25% tax rate) and I.R.C. § 1231 gain to the extent of the remaining $100,000 gain.

I.R.C. § 1563(d) Controlled Corporation Rules for Determining Stock Ownership

I.R.C. § 1563(d) provides rules for determining stock ownership in a parent-subsidiary controlled group and a brother-sister controlled group.

1. *Parent-subsidiary controlled group*: Stock owned by a corporation includes the stock it directly owns and stock it owns under the constructive ownership rules relating to stock options, partnerships, estates, and trusts in I.R.C. § 1563(e). These are items 1, 2, and 3 in the next section.
2. *Brother-sister controlled group*: Stock owned by an individual, trust, or estate includes directly owned stock and stock owned under all of the constructive ownership rules of I.R.C. § 1563(e).

I.R.C. § 1563(e) Constructive Ownership in Controlled Corporations

I.R.C. § 1563(e) provides the following constructive ownership rules for determining whether corporations are members of a controlled group:

1. Stock options owned by a person are treated as stock owned by such person.
2. Stock owned directly or indirectly by a partnership is deemed owned by any partner having a 5% or more capital or profits interest in the partnership. The constructive ownership is proportionate to the greater of the capital or profits interest.
3. Stock owned directly or indirectly by an estate or trust [other than an I.R.C. § 401(a) employees' trust] is deemed owned by any beneficiary who has a 5% or more actuarial interest.
4. Stock owned directly or indirectly by a trust in which a person is considered the owner (grantors and other substantial owners) is deemed owned by such owner.
5. Stock owned directly or indirectly by a corporation is deemed proportionately owned by any shareholder who owns 5% or more in value of its stock.
6. Stock owned directly or indirectly by a spouse (other than a spouse who is legally separated from the individual under a decree of divorce or decree of separate maintenance) is deemed owned by the individual, unless all of the following criteria are met:

a. The individual does not own directly any stock in the corporation during the year.

b. The individual is not a director or employee and does not participate in the management of the corporation during the year.
c. Not more than 50% of the corporation's gross income for the tax year is derived from royalties, rents, dividends, interest, and annuities.
d. The stock is not subject to conditions that limit the spouse's right to dispose of the stock and run in favor of the individual or the individual's children who have not attained age 21.

7. Stock owned directly or indirectly by an individual's children under the age of 21 is deemed owned by the individual.
8. Stock owned directly or indirectly by an individual is deemed owned by the individual's children under the age of 21.
9. An individual who owns more than 50% of the total combined voting power or total value of a corporation's stock is deemed to own the stock held directly or indirectly by his or her parents, grandparents, grandchildren, and minor children under the age of 21.

Cross-Reference Controlled Corporations

See pages 207–212 of the *2015 National Income Tax Workbook* for more detailed coverage of the I.R.C. § 1563 provisions and related examples.

ISSUE 2: MATCHING EXPENSE DEDUCTIONS

This section discusses the matching requirement for reporting payee income and expense deductions arising from related party transactions.

I.R.C. § 267(a)(2) requires matching expense deductions for payments to related parties to the same tax year that the payee reports the corresponding income. If the payer is an accrual basis taxpayer and the payee is a cash basis taxpayer, the allowable deduction generally is limited to the amount includable in the payee's gross income for the same tax year. Deductions disallowed by virtue of I.R.C. § 267(a)(2) are deferred until the year the amounts are includable in the payee's gross income. This frequently affects the timing of deductions for rental expenses and depreciation, as well as for interest payments.

Practitioner Note Outdated Regulations

Treas. Reg. § 1.267(a)-1 has not been updated to reflect the changes made by the Deficit Reduction Act of 1984, Pub. L. No. 98-369. For transactions before 1984, a deduction was permanently denied if the related party did not recognize income from the transaction during the tax year or within 2½ months of the end of the tax year. The regulations reflect that rule rather than the new rule for transactions after 1983, which merely postpones the deduction until the related party recognizes the income.

Example 2.5 Related Party Accrued Interest

Xavier, an individual taxpayer, holds an interest-bearing note of XD Corporation (a calendar-year taxpayer). Xavier owns all the stock in XD Corporation. XD Corporation uses the accrual method of accounting, and Xavier uses the cash basis method. XD Corporation does not pay any interest on the note to Xavier in 2016 but properly accrues $8,300 interest on its books.

Xavier and XD Corporation are related because Xavier owns more than 50% of the stock. XD cannot deduct the accrued interest in computing its taxable income for 2016.

However, if the interest is actually paid to or constructively received by Xavier in 2017, XD Corporation can deduct the $8,300 interest in computing its 2017 taxable income.

Practitioner Note Deferred Deduction When Relationship Ceases

If an otherwise deductible amount is deferred by I.R.C. § 267(a)(2) and, prior to the time it is includable in the payee's gross income, the related party relationship ceases to exist, the deduction remains suspended until the amount is includable in the payee's gross income [Treas. Reg. § 1.267(a)-2T(b); *Ronald Moran Cadillac, Inc. v. U.S.*, 385 F.3d 1230 (9th Cir. 2004)].

ISSUE 3: SALE OF PROPERTY AT A LOSS

This section explains the loss disallowance rule for property sales between related parties.

Except for distributions in a corporate liquidation, no deduction is allowed for losses resulting from the direct or indirect sale or exchange of property between related parties [I.R.C. § 267(a)(1)]. This loss disallowance rule also applies to the sale or exchange of property (other than a partnership interest) between related persons and partnerships as defined in I.R.C. § 707(b)(1). The loss disallowance is not affected by the fact that the related party transaction is bona fide and the sale is made at fair market value (FMV).

Example 2.6 Sale of Property to Related Party

Darla Dearing sells land to her daughter, Carol, for its $95,000 FMV. Darla's adjusted basis in the land is $100,000. The $5,000 loss ($95,000 FMV – $100,000 adjusted basis) is disallowed because Carol is a related party under I.R.C. § 267(b). Carol's cost basis in the land is $95,000.

Subsequent Sale of Property

If the acquiring related taxpayer subsequently sells or disposes of the property to an unrelated taxpayer, any gain realized is recognized only to the extent it exceeds the previously disallowed loss [I.R.C. § 267(d)], unless the subsequent disposition is a wash sale under I.R.C. § 1091.

Example 2.7 Subsequent Sale of Property with Previously Disallowed Loss

Two years later, Carol from Example 2.6 sells the land to Eddie, an unrelated taxpayer, for $101,000. Carol's realized gain is $6,000 ($101,000 sale price – her $95,000 adjusted basis), but her recognized gain is only $1,000, the excess of the $6,000 realized gain over the $5,000 loss disallowed to Darla.

If Carol sells the land for $93,000, her realized and recognized loss is $2,000 ($93,000 selling price – $95,000 adjusted basis). Darla's previously disallowed loss is never recovered. The use of the previously disallowed loss applies only to the recognition of gain. It does not affect the basis of the property, and it does not allow Carol to add Darla's loss to her own loss.

Basis of Disallowed-Loss Property

The basis of property for depreciation is the owner's basis for determining gain [I.R.C. § 167(c)(1)]. The potential allowance of a previously disallowed loss upon disposition of the property does not affect the purchaser's adjusted basis for depreciation [Treas. Reg. § 1.267(d)-1(c)(1)]. Therefore, the related party purchaser uses the purchase price to calculate depreciation.

If the gain on a subsequent sale is subject to the depreciation recapture rules, it is not reduced by the related party's disallowed loss [I.R.C. §§ 1245(a)(1) and 1250(a)(1)].

Example 2.8 Depreciable Basis and Subsequent Sale

In January 2015, Roger Rickel purchased equipment from his father, Charles, for its $45,000 FMV. The equipment has a $50,000 adjusted basis to Charles. His $5,000 loss ($45,000 FMV – $50,000 adjusted basis) is disallowed because Roger is related to Charles.

Roger uses the equipment (7-year MACRS property) in his business and then sells the equipment to an unrelated party in March 2016 for $46,000. Roger's $12,941 realized gain [$46,000 sale price – ($45,000 basis – $11,941 accumulated depreciation)] is reduced by $1,000 of the previously disallowed loss, as shown in **Figure 2.2**. The remaining $4,000 loss ($5,000 – 1,000) disallowed to Charles is not recovered.

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FIGURE 2.2 Subsequent Sale of Disallowed Loss on Depreciable Property

Sales proceeds		$ 46,000
Cost basis	$45,000	
2015 depreciation: $45,000 × 0.1429	(6,431)	
2016 depreciation: $45,000 × 0.2449 × ½	(5,510)	
Adjusted basis		(33,059)
Realized gain		$ 12,941
Previously disallowed loss (limited to appreciation)		(1,000)
Recognized gain—I.R.C. § 1245 recapture		$ 11,941

Observation Gift of Assets

The basis rules for a gift of property to another taxpayer, whether or not related to the donor, have the same effect of not allowing the donee to claim a loss that occurred while the donor owned the property. However, because the basis for depreciating the property after the gift is the donor's basis for determining gain [I.R.C. § 167(c)(1)], the donee uses the donor's carryover basis for depreciation rather than the FMV of the property [I.R.C. § 1015(a)].

Example 2.9 Gift of Asset Depreciable Basis

If Charles from Example 2.8 gives the equipment to Roger instead of selling it to him, Roger's unadjusted basis for computing a loss on a subsequent sale is $45,000, and his unadjusted basis for computing a gain is $50,000. Therefore, his depreciable basis is the $50,000 carryover basis from Charles.

ISSUE 4: LIKE-KIND EXCHANGES

This section provides an overview of the like-kind exchange provisions and explains an exception to the nonrecognition of gain or loss after an exchange between related parties.

I.R.C. § 1031(a) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like-kind that is to be held for productive use in a trade or business or for investment. If a like-kind exchange occurs between related persons and either the taxpayer or the related person disposes of the property within 2 years after the exchange date, both parties must recognize any gain or loss that was previously deferred.

General Like-Kind Exchange Rules

Like-kind nonrecognition treatment does not apply to inventory, securities (including stocks, bonds, and notes), partnership interests, certificates of trust or beneficial interests, and certain intangible property rights (such as potential claims).

Most real estate is considered like-kind, whether it is improved or unimproved. But real property located in the United States and real property located outside the United States are not like-kind. Similarly, personal property used primarily in the United States and personal property used primarily outside the United States do not qualify as like-kind property [I.R.C. § 1031(h)].

For personal property, *like-kind* is defined more narrowly. However, Treas. Reg. § 1.1031(a)-2(b) provides two different safe harbors for treating personal property as like-kind. The first safe harbor applies if the property is in a specified general asset class defined in Rev. Proc. 87-56, 1987-2 C.B. 674. If the relinquished and replacement properties are in the same class, they are like-kind. The second safe harbor is product classes in specified sectors of the North American Industry Classification System (NAICS). If the properties are in the same six-digit class in those sectors, they are like-kind. If the relinquished and replacement properties are not in either of the safe harbors, they are like-kind if they meet the definition of like-kind property.

Whether intangible personal property is like-kind to other intangible personal property generally depends on the nature or character of the rights involved (e.g., patent or a copyright) and on the nature or character of the underlying property to which the rights relate.

If the exchange includes the receipt of cash or its equivalent (such as liabilities assumed by the transferee) or of unlike property, a taxpayer realizes and recognizes gain to the extent of the money or unlike property received [I.R.C. § 1031(b)]. The taxpayer recognizes a loss if the taxpayer transfers unlike property with an adjusted basis that exceeds its FMV. The basis of the acquired like-kind property is the carryover basis of the property exchanged, less boot received, increased by any gain recognized, and decreased by any loss recognized [I.R.C. § 1031(d)].

An exchange does not have to be simultaneous to qualify for the nonrecognition rules. In a deferred exchange, the replacement property must be (1) identified within 45 days after the taxpayer relinquishes the exchanged property and (2) received by the earlier of 180 days after the date the taxpayer relinquishes the exchanged property or the due date of the taxpayer's return for the tax year in which the relinquishment occurs [I.R.C. § 1031(a)(3)].

A deferred exchange requires the use of a qualified intermediary. A qualified intermediary is a person who enters into a written agreement with the taxpayer to (1) acquire and transfer the relinquished property from the taxpayer and (2) acquire and transfer the replacement property to the taxpayer. The qualified intermediary is not considered an agent of the taxpayer for purposes of the constructive receipt rules, and the transfer of properties through the intermediary is treated as an exchange [Treas. Reg. § 1.1031(k)-1(g)(4)].

Related Party Exchanges

An exception to the nonrecognition rule of I.R.C. § 1031 applies if a like-kind exchange occurs between related persons and either the taxpayer or the related person disposes of the property within 2 years after the exchange date. When there is an early disposition by either party, both parties must recognize any gain or loss that was previously deferred [I.R.C. § 1031(f)(1)]. The gain or loss is recognized as of the date of the early disposition. For purposes of this exception, a related person is defined in I.R.C. § 267(b) or I.R.C. § 707(b)(1).

Example 2.10 Disposition of Like-Kind Property Exchanged between Related Taxpayers

In July 2015, Emily and Arthur Larson, mother and son, exchanged land held for investment. Before the exchange, Emily's parcel A had a $100,000 FMV and a $60,000 adjusted basis, and Arthur's parcel B had a $100,000 FMV and an $80,000 adjusted basis. The exchange qualified for gain deferral under I.R.C. § 1031.

In April 2016, Arthur sold parcel A to an unrelated person for $102,000. Arthur must recognize a gain on the sale of $22,000 ($102,000 sale price – $80,000 basis of exchanged property). Arthur's early disposition also requires Emily to recognize the $40,000 ($100,000 FMV – $60,000 basis of exchanged property) deferred gain on parcel A on her 2016 tax return. Emily increases her basis in parcel B to $100,000 ($60,000 adjusted basis + her $40,000 deferred gain now recognized).

Dispositions Not Triggering Gain or Loss Recognition

Related party dispositions specifically excluded from this exception to the nonrecognition rule include

1. dispositions due to the death of the taxpayer or the related person,
2. involuntary conversions within the meaning of I.R.C. § 1033, and
3. dispositions when the taxpayer convinces the IRS that both the exchange and the disposition lacked a tax avoidance motive [I.R.C. § 1031(f)(2)].

Practitioner Note Accepted Reasons for Early Dispositions

The taxpayer reports both the original exchange and the early disposition on Form 8824, Like-Kind Exchanges. The IRS generally will accept a position that tax avoidance was not a principal purpose in either the exchange or the disposition if: the disposition was a nonrecognition transaction, the related parties derived no tax advantage from shifting basis between the exchanged properties, or an exchange of undivided interests in different properties resulted in each related party holding either the entire interest in a single property or a larger undivided interest in any of the properties.

Example 2.11 Death of Taxpayer before Expiration of the 2-Year Period

Assume in Example 2.10 that Arthur died before parcel A was sold in April 2016. Upon his death, the land passed to his spouse, who chose to sell it. Emily does not have to recognize the $40,000 gain on parcel A that was deferred in the like-kind exchange, because a disposition after the death of one party and before the 2-year period has passed is specifically excluded from triggering gain or loss recognition.

Subsequent Like-Kind Exchange within 2 Years

Gain generally will not be triggered to the other party when property received in a related party like-kind exchange is transferred within 2 years if the second transfer is also a qualified like-kind exchange [Ltr. Rul. 2004-40-002 (October 1, 2004)].

Example 2.12 Subsequent Like-Kind Exchange

Ken and Tommy Thomas are father and son. Tommy owned farmland A that the local hospital wanted to acquire. Ken owned farmland B that Tommy wanted to purchase. Ken exchanged farmland B ($200,000 FMV and $80,000 adjusted basis) for farmland A ($200,000 FMV and

$120,000 adjusted basis), and then immediately sold farmland A to the hospital.

Because Ken and Tommy are related parties within the meaning of I.R.C. § 267(b) and Ken disposed of the like-kind property before the 2-year period following the exchange, Tommy is required to recognize his $80,000 gain ($200,000 – $120,000) from the exchange of farmland A. Tommy's basis in farmland B is increased to $200,000 ($120,000 basis in farmland A + $80,000 gain recognized).

To avoid triggering gain recognition for Tommy, Ken could have exchanged farmland A for like-kind property, either in a direct exchange with the hospital or by entering into an agreement with a qualified intermediary to buy replacement property with the proceeds from the sale of farmland A to the hospital. After 2 years, Ken could sell the replacement property without causing Tommy to recognize the gain he realized on his exchange of farmland A.

Practitioner Note Multiparty Transactions Involving Related Parties

A transfer of property to a qualified intermediary in exchange for replacement property formerly owned by a related party does not qualify for nonrecognition of gain or loss [Rev. Rul. 2002-83, 2002-2 C.B. 927]. Therefore, Tommy could not use an intermediary to sell farmland A to the hospital and purchase farmland B from Ken. Ken must receive replacement property and hold it until the 2-year period for the initial exchange has elapsed.

ISSUE 5: I.R.C. § 179

This section discusses the exclusion from the I.R.C. § 179 expense election for property acquired from a related party.

I.R.C. § 179 allows a taxpayer to expense all or a portion of the cost (up to $500,000 in 2016) of qualifying I.R.C. § 1245 property for the tax year in which the property is placed in service. The maximum allowable deduction is reduced by each dollar that the total qualifying property placed in service exceeds a threshold amount ($2,010,000 for 2016). Therefore, for 2016, a taxpayer who places $2,510,000 of qualifying property in service is not eligible for an I.R.C. § 179 election.

Property qualifying for the I.R.C. § 179 deduction does not include property acquired from a related person as defined in I.R.C. § 267 or 707(b), and it does not include property acquired by one component member of a controlled corporate group from another component member of the same controlled group within the meaning of I.R.C. § 1563(a), replacing "at least 80%" with "more than 50%." However, the attribution rules do not apply to siblings for purposes of I.R.C. § 179.

In applying the constructive ownership of stock rules of I.R.C. § 267(c)(4), family members include only the individual's spouse, ancestors, and lineal descendants. This definition excludes brothers and sisters.

Example 2.13 I.R.C. § 179 Election Disallowed on Related Party Purchase

Paul and Jeremy Jones are father and son, and each owns 50% of PJ Corporation. PJ Corporation sold equipment to Paul for $50,000 to be used in another trade or business. Applying the stock attribution rules, Paul is deemed to own 100% of PJ Corporation and therefore is a related person within the meaning of I.R.C. § 267(c)(4). The purchased equipment thus is not qualifying property for purposes of the I.R.C. § 179 election.

If Paul and Jeremy were brothers, Jeremy's stock would not be attributed to Paul, and the equipment would be qualifying I.R.C. § 179 property.

ISSUE 6: INSTALLMENT SALES This section explains limitations on use of the installment sale method for sales between related taxpayers.

I.R.C. § 453(b) defines an installment sale as a disposition of property where the seller receives at least one payment after the close of the tax year in which the disposition occurs. The term *installment sale* does not include dealer dispositions, or the disposition of personal property or nonfarm inventories. The installment sale method does not apply to any sale of stock or securities traded on an established securities market.

Under the installment method, the seller recognizes income as the seller receives payments, based on the gross profit as a percentage of the total contract price. The seller must recognize any I.R.C. § 1245 and I.R.C. § 1250 depreciation recapture in the year of the disposition [I.R.C. § 453(i)].

Use of the installment sale method is required for eligible sales unless the taxpayer elects out by the due date of the taxpayer's return for the tax year of the sale. However, some sales between related parties do not qualify. Related persons may use the installment sale method only for sales of nondepreciable property (unless they can establish that tax avoidance is not a principal purpose of the sale of depreciable property to a related party).

Sale to Related Party—Nondepreciable Property

Related persons may use the installment method for sales of nondepreciable property. The term *related person* includes a related person as defined in I.R.C. § 267(b) or a person who qualifies as a related person as a result of the I.R.C. § 318(a) attribution rules, excluding the rule for stock options [I.R.C. § 453(f)]. Reacquisition of stock by the issuing corporation is not treated as a first disposition, and an involuntary conversion (when the threat occurred after the first disposition) or a disposition after death is not treated as a second disposition [I.R.C. § 453(e)(6)].

The original seller's gain will generally be accelerated if a second disposition occurs

1. before all payments are made for the first sale, and
2. within 2 years after the date of the first disposition.

A disposition by the related party purchaser within the applicable period requires the original seller to recognize all or part of the deferred gain in the year the related person makes the second disposition. The original seller is treated as receiving the amount realized on the second disposition.

The acceleration of gain does not apply if the taxpayer can prove to the IRS that neither the first nor the second disposition was for the primary purpose of tax avoidance [I.R.C. § 453(e)(7)]. Generally, the IRS will accept a non-tax-avoidance explanation if the second disposition was forced (e.g., a creditor of the related party purchaser foreclosed on the property or the related party purchaser declared bankruptcy), or if the second disposition was also an installment sale, with terms of payment substantially equal to or longer than those of the first sale. The resale terms must not permit significant deferral of recognition of gain from the first sale (e.g., if amounts from the resale are being collected sooner).

Example 2.14 Second Disposition by Related Person—Proceeds Exceed Original Sale Price

In April 2015, Sally Donovan sold land to her daughter Jackie for $240,000, receiving $60,000 down with the remaining $180,000 due in three annual installments of $60,000, plus an adequate stated rate of interest on the balance due. The land was not subject to any mortgages. Sally's basis in the land was $144,000, resulting in a gross profit percentage of 40% and $24,000 of installment sale income for 2015, as shown in **Figure 2.3**.

FIGURE 2.3 Gross Profit Percentage and 2015 Installment Sale Income

Contract price	$ 240,000
Adjusted basis	(144,000)
Gross profit	$ 96,000
Gross profit percentage ($96,000 ÷ $240,000)	40%
Down payment received in 2015	$ 60,000
Gross profit percentage	× 40%
Installment sale taxable income for 2015	$ 24,000

FIGURE 2.4 2016 Installment Sale Income—Proceeds Greater Than Original Sale Price

Lesser of (1) amount realized on second disposition or (2) first-disposition contract price	$ 240,000
Payments from 2015 and 2016	(120,000)
Amount treated as received because of second disposition	$ 120,000
Payment received in 2016	60,000
Total payments received and treated as received in 2016	$ 180,000
Gross profit percentage	× 40%
Sally's installment sale income for 2016	$ 72,000

In 2016, Jackie sold the land to an unrelated person for $250,000 after making the $60,000 payment due for 2016. Sally calculates her installment sale income for 2016 as shown in **Figure 2.4** and will report this income on Form 6252, Installment Sale Income (**Figure 2.5**).

FIGURE 2.5 Form 6252 for Sally Donovan

Form **6252**
Department of the Treasury
Internal Revenue Service

Installment Sale Income
▶ **Attach to your tax return.**
▶ **Use a separate form for each sale or other disposition of property on the installment method.**
▶ **Information about Form 6252 and its instructions is at *www.irs.gov/form6252*.**

OMB No. 1545-0228
2016
Attachment Sequence No. **79**

Name(s) shown on return: **SALLY DONOVAN**
Identifying number: **123-45-6789**

1 Description of property ▶
2a Date acquired (mm/dd/yyyy) ▶ **11/18/1996** **b** Date sold (mm/dd/yyyy) ▶ **4/11/2015**
3 Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4 . . . . ☑ Yes ☐ No
4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale . . . . ☐ Yes ☑ No

Part I **Gross Profit and Contract Price.** Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. **Don't** include interest, whether stated or unstated			5	
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6			
7	Subtract line 6 from line 5	7			
8	Cost or other basis of property sold	8			
9	Depreciation allowed or allowable	9			
10	Adjusted basis. Subtract line 9 from line 8	10			
11	Commissions and other expenses of sale	11			
12	Income recapture from Form 4797, Part III (see instructions)	12			
13	Add lines 10, 11, and 12			13	
14	Subtract line 13 from line 5. If zero or less, **don't** complete the rest of this form (see instructions)			14	
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-			15	
16	**Gross profit.** Subtract line 15 from line 14			16	
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	
18	**Contract price.** Add line 7 and line 17			18	

FIGURE 2.5 Form 6252 for Sally Donovan (Continued)

Part II **Installment Sale Income.** Complete this part for the year of sale **and** any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage (expressed as a decimal amount). Divide line 16 by line 18. For years after the year of sale, see instructions	19	0.4000
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-	20	0
21	Payments received during year (see instructions). **Don't** include interest, whether stated or unstated	21	60,000
22	Add lines 20 and 21	22	60,000
23	Payments received in prior years (see instructions). **Don't** include interest, whether stated or unstated — 23: 60,000		
24	**Installment sale income.** Multiply line 22 by line 19	24	24,000
25	Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)	25	
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)	26	24,000

Part III **Related Party Installment Sale Income. Don't** complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party 555-44-6666
JACKIE DONOVAN, 6785 COUNTY ROAD 4, CANANDAIGUA, NY 14424

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? ☑ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

- a ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (mm/dd/yyyy) ▶
- b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.
- c ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.
- d ☐ The second disposition occurred after the death of the original seller or buyer.
- e ☐ It can be established to the satisfaction of the IRS that tax avoidance wasn't a principal purpose for either of the dispositions. If this box is checked, attach an explanation (see instructions).

30	Selling price of property sold by related party (see instructions)	30	250,000
31	Enter contract price from line 18 for year of first sale	31	240,000
32	Enter the **smaller** of line 30 or line 31	32	240,000
33	Total payments received by the end of your 2016 tax year (see instructions)	33	120,000
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	120,000
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	48,000
36	Enter the part of line 35 that is ordinary income under the recapture rules (see instructions)	36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797 (see instructions)	37	48,000

For Paperwork Reduction Act Notice, see page 4. Cat. No. 13601R Form **6252** (2016)

Sally will not include any of the installment obligation principal payments she receives in 2017 or 2018 in her income because she reported her total $96,000 gain in 2015 and 2016.

Example 2.15 Second Disposition by Related Person—Proceeds Less Than Original Sale Price

The facts are the same as in Example 2.14, except that Jackie sold the property to an unrelated person in 2016 for $210,000, after making the $60,000 payment due for 2016. This is $30,000 less than the original sale price by Sally. Sally calculates her installment sale income for 2016 as shown in **Figure 2.6**.

FIGURE 2.6 2016 Installment Sale Income—Proceeds Less Than Original Sales Price

Lesser of (1) amount realized on second disposition or (2) first-disposition contract price	$ 210,000
Payments from 2015 and 2016	(120,000)
Amount treated as received because of second disposition	$ 90,000
Payment received in 2016	60,000
Total payments received and treated as received in 2016	150,000
Gross profit percentage	× 40%
Sally's installment sale taxable income for 2016	$ 60,000

Sally will not include any of the installment obligation principal payment she receives for 2017 in her income because she has already reported more gain than originally scheduled on the sale [(3 years × $24,000 per year = $72,000) compared to ($24,000 in 2015 + $60,000 in 2016

= $84,000)]. In 2018, Sally receives the final $60,000 payment and calculates her remaining installment sale income as shown in **Figure 2.7**.

FIGURE 2.7 2018 Installment Sale Income—Proceeds Less Than Original Sales Price

Total payments from the first disposition	$ 240,000
Payments from 2015 and 2016	(120,000)
Amount treated as received in 2016	(90,000)
Payment received in 2018 on which gain is recognized	$ 30,000
Gross profit percentage	× 40%
Installment sale income for 2018	$ 12,000

Sale to Related Party—Depreciable Property

The installment sale method may not be used for a sale of depreciable property between related persons unless it is established that tax avoidance is not a principal purpose. For purposes of a sale of depreciable property, the term *related persons* is defined in I.R.C. § 1239(b), and also includes two or more partnerships described in I.R.C. § 707(b). An individual's family members are not related persons under this definition. The IRS will accept an explanation that tax avoidance was not a motive if no significant tax-deferral benefits will result from the sale.

ISSUE 7: GAIN FROM SALE OR EXCHANGE OF DEPRECIABLE PROPERTY

This section reviews the ordinary income treatment of gain on the sale or exchange of depreciable property between related persons.

Under I.R.C. § 1239, any gain recognized on a sale or exchange of property, directly or indirectly, between related persons is treated as ordinary income if the property is depreciable in the hands of the transferee. I.R.C. § 1239 ordinary income treatment also applies to the gains recognized by the transferor under the provisions of I.R.C. § 351(b) and I.R.C. § 357(c) when depreciable property is transferred as part of a qualifying I.R.C. § 351 exchange. The definition of related persons for purposes of I.R.C. § 1239 is explained in the first section of this chapter. Patent applications are treated as depreciable property under I.R.C. § 1239(e).

I.R.C. § 1239 Sale of Depreciable Property

Gain recognized on a sale or exchange of property between related persons is treated as ordinary income if the property is depreciable in the hands of the transferee.

Practitioner Note Goodwill

Because personal goodwill is not depreciable, its sale results in capital gain, even when the sale is to a related party. In *Est. of Walter A. Krafft*, T.C. Memo. 1961-305 (1961), the taxpayer sold her business to a related corporation and allocated a substantial portion of the consideration paid to personal goodwill. The IRS challenged the allocation, and the Tax Court held that if the business had any personal goodwill, its value was no more than nominal. Thus, the entire gain was derived from the sale of the leasehold improvements and depreciable assets. Because the taxpayer and the corporation were related within the meaning of I.R.C. § 1239, the gain was taxed as ordinary income.

Example 2.16 Ordinary Income on Sale of Equipment to Related Party

Noelle purchased equipment in February 2015 for $250,000. She elected out of the bonus depreciation and did not make the I.R.C. § 179 election. In April 2016 she sold the equipment for

$255,000 to a corporation that is wholly owned by her parents. Because Noelle is considered to own the stock owned by her parents, her $71,338 gain on the sale is ordinary income, as shown in **Figure 2.8**.

FIGURE 2.8 Character of Gain on Sale of Depreciable Property

Sales proceeds		$ 255,000
Cost basis	$250,000	
2015 depreciation: $250,000 × 0.1429	(35,725)	
2016 depreciation: $250,000 × 0.2449 × ½	(30,613)	
Adjusted basis		(183,662)
Realized and recognized gain		$ 71,338
I.R.C. § 1245 depreciation recapture—ordinary income ($35,725 + $30,613)		$ 66,338
I.R.C. § 1239 ordinary income ($255,000 – $250,000)		5,000
Total recognized gain		$ 71,338

I.R.C. § 351 Transfer of Depreciable Property

I.R.C. § 351(a) provides that no gain or loss is recognized if property is transferred to a corporation solely in exchange for stock, and if immediately after the exchange the transferors control (own 80% or more of the stock) the corporation. I.R.C. § 351(b) requires the recognition of gain if the transferors receive money or property in addition to the stock, but only to the extent of the money or property received. Additionally, I.R.C. § 357(c) provides that if liabilities assumed by the controlled corporation exceed the adjusted basis of the property transferred, the excess amount is considered a gain from the sale or exchange of the transferred property.

Rev. Rul. 60-302, 1960-2 C.B. 223, applies I.R.C. § 1239 ordinary income treatment to the gains recognized by the transferor under the provisions of I.R.C. § 351(b) and I.R.C. § 357(c) when depreciable property is transferred as part of a qualifying I.R.C. § 351 exchange.

Example 2.17 Ordinary Income Treatment Applied to I.R.C. § 351 Transaction

In a qualifying I.R.C. § 351 transfer, Wiley transferred a factory building with a $500,000 adjusted basis and an $800,000 FMV to Acme Corporation in exchange for $220,000 of stock and a $50,000 note. The building is encumbered by a $530,000 mortgage that was assumed by the corporation. Wiley must recognize a $50,000 gain for the note amount received [I.R.C. § 351(b)] and a $30,000 gain ($530,000 – $500,000) for the liability in excess of the basis [I.R.C. § 357(c)]. Both of these gains are treated as ordinary income on the exchange of depreciable property to a related party. The remaining $220,000 realized gain is deferred under the provisions of I.R.C. § 351(a), as shown in **Figure 2.9**.

FIGURE 2.9 Realized and Recognized Gain

FMV of Acme Corp. stock	$ 220,000
Liability assumed by Acme Corp.	530,000
Note received by Wiley from Acme Corp.	50,000
Total proceeds	$ 800,000
Adjusted basis of factory building	(500,000)
Realized gain on transfer	$ 300,000
I.R.C. § 351(b) amount (note received) recognized as ordinary income under I.R.C. § 1239	$ 50,000
I.R.C. § 357(c) amount ($530,000 mortgage – $500,000 adjusted basis) recognized as ordinary income under I.R.C. § 1239	30,000
Total recognized gain	$ 80,000
Gain deferred under I.R.C. § 351(a)	$220,000

ISSUE 8: PARTNERSHIP INTEREST BUYOUT EXAMPLE

This section illustrates the impact of related party rules on the buyout of a partnership interest.

The following example shows how the related party provisions come into play in a two-step buyout of a partner's partnership interest.

Facts

Frank Finley, his son Steven Finley, and his nephew Nicholas Finley each own one-third of a partnership. After attribution of Frank's interest, his son Steven constructively owns a two-thirds interest in the partnership, and Steven and the partnership are related parties.

Steven lost interest in the partnership business, and the partnership bought out his one-third interest in accordance with a buy-sell agreement that required the partnership and Steven to carry out a two-step process. The first step is a distribution of a one-third interest in all partnership assets to Steven. The second step is a purchase of that one-third interest in the assets by the partnership.

Relevant Related Party Provisions

The following Internal Revenue Code provisions impact these transactions between related parties:

1. I.R.C. § 707(b)(1) disallows loss recognition on sales and exchanges of property other than an interest in the partnership between a partnership and a person who owns, directly or indirectly, more than a 50% capital or profits interest in the partnership.
2. I.R.C. § 707(b)(2) requires a seller that is a partnership or a related party person to treat gain recognized on the sale or exchange of property to a person or partnership that is a related party as ordinary income, unless the property is an I.R.C. § 1221 capital asset.
3. I.R.C. § 179(d)(2)(A) disallows an I.R.C. § 179 deduction on otherwise qualifying purchases from related parties.

Two-Step Buyout of Partnership Interest

The first step in the buyout process is a distribution of one-third of all partnership assets to Steven in complete liquidation of his partnership interest. There is no technical termination of the partnership due to the liquidation of Steven's interest [I.R.C. § 708]. The distribution does not result in gain or loss to the partnership [I.R.C. § 731(b)]. Proportionate distributions that consist only of property other than cash or marketable securities do not result in immediate gain or loss to Steven [I.R.C. § 731(b)]. Distributions of cash (including liability relief) and marketable securities are taxable to Steven only to the extent (if any) that they exceed his basis in the partnership.

After that distribution, Frank and Nicholas are each 50% partners in the partnership. Steven is deemed to own Frank's 50% partnership interest under the attribution rules. But because this constructive ownership is not more than 50%, Steven and the partnership are not related parties within the meaning of I.R.C. § 707(b).

The second step in the buyout process is an installment purchase of the distributed assets by the partnership. Because Steven and the partnership are no longer related parties, Steven is not prohibited by I.R.C. § 707 from recognizing a loss, if he has one. He will not be required to treat any gain on the sale of the assets to the partnership as ordinary income due to the related party rules, but other provisions of the Internal Revenue Code (such as depreciation recapture) may characterize part of the gain as ordinary income. The parties may be able to negotiate the allocation of the purchase price among the assets to minimize this.

Because the partnership and Steven are no longer related parties, the partnership is also not precluded from electing the I.R.C. § 179 deduction on any qualifying property it purchases from Steven.

ISSUE 9: AT-RISK LIMITATIONS

This section explains the related party debt exclusion from the determination of a taxpayer's amount at-risk.

The at-risk rules limit deductible losses to the taxpayer's amount at risk in the activity. Excess losses are suspended until the taxpayer's at-risk amount is increased. The rules affect individuals (including partners and S corporation shareholders), estates, trusts, and some closely held C corporations. The at-risk limits apply before the passive activity loss limitation rules that are explained in the following "Sale of a Passive Activity" section.

Taxpayers are generally at-risk in any activity for

1. the money and adjusted basis of property the taxpayer contributed to the activity, and
2. amounts the taxpayer borrowed for use in the activity if the taxpayer is personally liable for the repayment, or the taxpayer pledges property (other than property used in the activity) as security for the loan.

Cross-Reference At-Risk Loss Limitations

See pages 169–171 of the *2008 National Income Tax Workbook* for more detailed coverage of the at-risk rules.

In applying the at-risk rules to an activity, taxpayers may not include amounts borrowed from another person who has an interest in the activity, or from any person related to any person who has an interest in the activity. The scope of this restriction was expanded in Treas. Reg. § 1.465-8 for loans taken out after May 3, 2004.

The definition of related persons includes the relationships in I.R.C. §§ 267(b) and 707(b)(1), but the ownership requirement is reduced to "more than 10%" rather than the "more than 50%" floor used in those sections [I.R.C. § 465(b)(3)(C)]. Persons with interests in businesses under common control (as defined in I.R.C. § 52) are also related parties for the at-risk loss limitations.

However, the related party debt restriction does not apply to the following:

1. Shareholder loans to a corporation if the lender's only interest in the activity is as a shareholder of the corporation
2. Loans from a person whose interest in the activity is as a creditor
3. Loans that are secured by real property used in an activity of holding real property (other than mineral property) that would be qualified nonrecourse financing if they were nonrecourse loans
4. Loans taken out before May 4, 2004, for an activity other than farming; leasing I.R.C. § 1245 property; exploring for or exploiting oil, gas, or geothermal deposits; or holding, producing, or distributing motion picture films or videotapes

Exception 1 applies only when a corporation is the borrower. Amounts one shareholder borrows from another shareholder to contribute to the corporation cannot be included in the borrower's amount at risk. In *Van Wyk v. Commissioner*, the taxpayer was a 50% shareholder in an S corporation engaged in the business of farming. He borrowed money from the other shareholder (his brother-in-law) and then transferred the borrowed money to the S corporation (1) to pay off debt owed to the S corporation and (2) to create a new loan to the S corporation. The wives of both shareholders also were parties to the note. The Tax Court held that Van Wyk was not at risk with respect to this loan to the S corporation because the money was borrowed from a person with an equity interest in the activity [*Van Wyk v. Commissioner*, 113 T.C. 440 (1999)].

ISSUE 10: SALE OF A PASSIVE ACTIVITY

This section provides an overview of related party rules for passive activity loss deduction limitations and the treatment of suspended losses upon disposition of the passive activity.

A taxpayer who disposes of his or her entire interest in a passive activity in a fully taxable transaction can typically deduct all current and suspended losses from the activity. However, if the taxpayer sells that interest to a related person in an otherwise fully taxable transaction, the taxpayer may not deduct the suspended losses until (1) the related party disposes of the activity to an unrelated person in a fully taxable transaction or (2) the taxpayer has other passive income to offset the loss.

General Rule for Loss Deduction

A passive activity either is a trade or business activity in which the taxpayer does not materially participate or is any rental activity. Material participation, as defined in I.R.C. § 469(h), requires involvement on a regular, continuous, and substantial basis and generally excludes limited partners. A taxpayer may materially participate in a trade or business by meeting any one of seven tests in Temp. Treas. Reg. § 1.469-5T. Rental real estate activities are passive regardless of the taxpayer's level of participation, unless the taxpayer is a real estate professional who meets a material participation test for the activity.

I.R.C. § 469(a) disallows a current deduction for passive activity losses that exceed passive activity income. Disallowed passive activity losses are carried forward to the next tax year [I.R.C. § 469(b)]. An individual taxpayer with modified adjusted gross income (MAGI) of $100,000 or less who actively participates in rental real estate activities may deduct up to $25,000 of excess rental real estate passive activity losses against other income. A phaseout of this deduction begins when a taxpayer's MAGI exceeds $100,000; the deduction is fully disallowed when the taxpayer's MAGI reaches $150,000. The dollar limits are halved for an eligible married person who files a separate return, but the deduction is not allowed on a married filing separately return if the couple lived together at any time during the year.

Example 2.18 Carryover of Disallowed Passive Activity Losses

George Griffith reports his income and losses for 2016 as shown in **Figure 2.10**.

FIGURE 2.10 George's 2016 Income and Losses

Salary	$100,000
Nonrental passive activity A income	$ 20,000
Nonrental passive activity B loss	$ (35,000)

George may use $20,000 of his loss from passive activity B to offset passive activity A income. He is not allowed to deduct the additional loss against his active (salary) income. The excess $15,000 loss ($20,000 – $35,000) is carried over to the next tax year as a suspended passive activity B loss. If the passive activity B loss was instead a rental real estate passive loss, George could deduct the $15,000 excess loss from his salary income.

Sale of Passive Activity to Unrelated Person

A taxpayer who disposes of his or her entire interest in a passive activity (or former passive activity) to an unrelated person in a fully taxable transaction can deduct all current and suspended losses from the activity. The taxpayer calculates the deduction using any gain or loss recognized on the disposition, as well as the prior- and current-period suspended losses [I.R.C. § 469(g)(1)].

Example 2.19 Sale of Passive Activity to an Unrelated Person

In 2016, Raymond Roth had $6,000 taxable income from passive activity Y and a $10,000 loss from passive activity Z. He also had $22,000 of suspended passive activity Z losses from previous years. Before the end of 2016, Raymond sold passive activity Z to Bob Brooks (an unrelated person) in a fully taxable transaction for an $18,000 gain. Raymond may deduct all of his losses from passive activity Z, reducing his nonpassive income by $8,000, as calculated in **Figure 2.11**.

FIGURE 2.11 Release of Passive Activity Suspended Losses

Gain from the sale of passive activity Z	$18,000	
Current-year passive activity Z loss	(10,000)	
Suspended losses from passive activity Z	(22,000)	
Overall loss from passive activity Z		$ (14,000)
Current-year passive activity Y income		6,000
Current-year deduction against other income		$ (8,000)

Sale of Passive Activity to Related Person

If the taxpayer sells his or her interest to a related person in an otherwise fully taxable transaction, applying the rules in I.R.C. §§ 267(b) and 707(b)(1), the taxpayer may not deduct the suspended losses until (1) the related party disposes of the activity to an unrelated person in a fully taxable transaction or (2) the taxpayer has other passive income to offset the loss.

Example 2.20 Sale of Passive Activity to a Related Person

Assume that in Example 2.19, Bob is Raymond's son. Raymond cannot deduct all of his suspended losses in the current year. He can use $18,000 of losses to offset the $18,000 gain on disposition, and he can deduct $6,000 of the losses against the $6,000 passive activity Y income. He is left with $8,000 of suspended losses.

Raymond carries forward these suspended losses to deduct against his own future passive income. When Bob disposes of passive activity Z to an unrelated person in a fully taxable transaction, Raymond may deduct any remaining passive activity Z suspended losses.

Practitioner Note Other Transactions Precluding Suspended Loss Deduction

Even if the transferee is not a related party, dispositions that are not fully taxable prevent the taxpayer from deducting the activity's suspended passive losses from nonpassive income. Examples of nonrecognition transactions include exchanges governed by I.R.C. § 351 (transfers to a controlled corporation by a transferor), I.R.C. § 721 (contribution of property to a partnership), and I.R.C. § 1031 (like-kind exchanges). The taxpayer can deduct suspended losses against any gain recognized in the transaction and against income from property received in the transaction if the income is derived from the same passive activity as the original losses. Therefore, the taxpayer must show that the activity remains the same and only the form of ownership has changed. This rule does not apply to the activity's portfolio income. Any remaining suspended losses are allowed when the taxpayer disposes of his or her entire interest in the property received in the exchange.

Gift of Passive Activity Interest

A gift of a taxpayer's interest in a passive activity does not release suspended losses. If the taxpayer gives his or her entire interest away, any suspended losses are added to the basis of the property immediately before the gift. If the taxpayer gifts only a portion of his or her interest, an allocable portion of any suspended losses are added to the donee's basis. The remaining losses continue to be suspended in the hands of the donor. No special related party exceptions disallow this basis adjustment.

Example 2.21 Gift of Passive Activity Interest

Martha had $12,000 of suspended losses from a residential rental activity when she gave the house to her son, John. The FMV of the house at the time of the gift was $120,000, and Martha's adjusted basis was $45,000. The $12,000 of suspended losses is added to the $45,000 adjusted basis, giving John a $57,000 adjusted basis in the house.

Cross-Reference Passive Activity Rules

See pages 171–187 of the *2008 National Income Tax Workbook* for more detailed coverage of the passive activity rules.

ISSUE 11: RENTAL OF A HOME

This section explains the I.R.C. § 280A limits on rental of a residence and the impact of related party rentals on personal use days.

I.R.C. § 280A limits the deduction of certain business and rental expenses when the taxpayer uses a dwelling as a residence. The taxpayer must calculate the number of personal use days to determine whether the dwelling is used as a residence. For purposes of this calculation, rental to a family member is included in personal use, unless the family member uses the dwelling as his or her main residence and pays fair rental value.

General Rule

I.R.C. § 280A was enacted as part of the Tax Reform Act of 1976, Pub. L. No. 94-455, to disallow a deduction for business and rental expenses related to a dwelling unit that is used by the taxpayer as a residence. The limitation does not apply to deductions otherwise allowable to homeowners, such as qualifying home mortgage interest, property taxes, and casualty losses.

A de minimis rule excludes from gross income the rents received by a taxpayer who uses a dwelling unit as a residence during the year and rents it to others for fewer than 15 days. Coupled with the exclusion is a provision barring the deduction of any expenses as rental expenses [I.R.C. § 280A(g)].

A dwelling unit is used as a residence during a tax year if the taxpayer uses it for personal purposes for more than the greater of

1. 14 days, or
2. 10% of the total days it is rented to others at a fair rental price [I.R.C. § 280A(d)].

A fair rental price is generally the amount of rent that an unrelated person would be willing to pay, taking into consideration comparable rentals in the area.

Personal Use Days

The taxpayer is deemed to use a dwelling unit for personal use on any day (or part of a day) the unit is used by any of the following persons:

1. The taxpayer or any other person who has an interest in the unit (except in the case of a shared equity financing arrangement, discussed later in this section)
2. A family member, as defined in I.R.C. § 267(c)(4), of any owner, *except when it used as a main home and a fair rental price is paid*
3. Any individual in a house-swap (home exchange) arrangement with the taxpayer, even if rents are paid
4. Anyone who does not pay a fair rental price, except for an employee whose use is excluded from gross income under I.R.C. § 119

A day that the taxpayer spends working, substantially full-time, to repair and maintain the dwelling unit is not counted as a personal use day even if family members use the property for recreational purposes on the same day. A day of personal use is not counted as a day of rental at fair rental value.

Rental to a Family Member

Renting a dwelling unit for use as a main home to a family member is not treated as personal use by the taxpayer if the family member actually pays a fair rental price. The taxpayer cannot avoid the personal use limits by deeming rent to have been paid.

In *Jackson v. Commissioner*, T.C. Memo. 1999-226 (1999), the taxpayers (husband and wife) rented a house to the wife's parents. They reported rent received on their tax returns at an amount equal to the fair rental value to satisfy the fair rental requirement of I.R.C. § 280A. The actual rent paid, based on bank records and statements from the wife's parents, was less than the amount reported. The Tax Court determined that the residence was not rented at a fair rental value during the tax years in question and disallowed the related expenses, other than interest and taxes allowable on Schedule A (Form1040), Itemized Deductions.

Practitioner Note Rental Income Taxable Despite Disallowance of Expenses

When rental expense deductions are disallowed under the personal use rules, the taxpayer is still required to report the rental income if the dwelling unit was rented more than 14 days during the tax year.

Example 2.22 Rental of Home to a Family Member at Fair Rental Price

Alice Arnold owns a second home that she rented to her brother, Norm, for the entire year of 2016. Norm used it as his main home and paid $900 rent per month, which represented the fair rental price for comparable rentals in the area. Alice is not deemed to have used the property for personal use during 2016, and she is allowed to deduct all of her ordinary and necessary expenses related to the property, as shown in **Figure 2.12**, even though they result in a loss.

FIGURE 2.12 Rental to Family Member at Fair Rental Price

Rental income ($900 × 12 months)		$ 10,800
Interest and taxes	$ 8,600	
Other expenses	2,800	
Depreciation	6,300	
Total expenses		(17,700)
Rental property loss (subject to I.R.C. § 469 limitations)		$ (6,900)

Example 2.23 Personal Use Days for a Vacation Home—Fair Rental Price Days Not Personal Use

Marc Mathison owns a condominium in Gulf Shores, Alabama. In 2016, he used it for his family vacation for 16 days and also rented the condominium at a fair rental price to his brother Jim for 170 days. Jim used the condo as his main home while he was rebuilding his own home after a casualty loss. Marc is not subject to the I.R.C. § 280A limitations, because he used the condo for personal purposes for only 16 days, which is less than the greater of 14 days or 10% of the 170 days it was rented (17 days) at a fair rental price. If instead Jim used the condominium as a vacation home (not his main home), Jim's use is included in Marc's calculation of his personal use days, and Marc is subject to the I.R.C. § 280A limitations.

Example 2.24 Personal Use Days for a Vacation Home—Rent-Free Days Are Personal Use

The facts are the same as in Example 2.23 except that Marc received a fair rental price for only 150 of the 170 days. He let his sister Amy use the condominium rent-free for the other 20 days. Marc is deemed to have used the condominium for personal purposes for 36 days (16 family vacation days + 20 rent-free days), which is more than the greater of 14 days or 10% of the 150 days it was rented at a fair rental price (15 days).

Observation Same Result for Unrelated Parties

The result in Example 2.24 would be the same if Marc was not related to Jim or Amy.

Example 2.25 Personal Use Days for a Vacation Home—Arrangement to Use Another Home

The facts are the same as in Example 2.24, except that Marc also rents Jim's vacation home in Gatlinburg, Tennessee, for 30 days, paying a fair rental price. Marc is deemed to have used his condominium for personal purposes for 30 of the 170 days it is used by Jim because of the arrangement that allowed him to use Jim's home. Marc has now used the condominium for personal purposes for 46 days (16 family vacation days + 30 deemed personal use days), which is more than the greater of 14 days or 10% of the 140 days it was rented at a fair rental price (14 days).

Observation Same Result for Unrelated Parties

The result in Example 2.25 would be the same if Marc and Jim were not related.

Shared Equity Financing Arrangement

A shared equity financing arrangement exists when two or more persons acquire qualified ownership interests in a dwelling unit, and one or more of the owners are entitled to use the dwelling unit as a principal residence, paying rent to the nonoccupant co-owners. This rental is not considered personal use of the dwelling unit by the non-occupant co-owners [I.R.C. § 280A(d)(3)]. A qualified ownership interest must be undivided, include an interest in land, and be for a period of more than 50 years if it is a term interest.

Example 2.26 Shared Equity Financing Arrangement

Carolyn and Sarah are co-owners of a home that is rented to Sarah for the entire year as her principal residence at a fair rental price under a shared equity financing agreement. The fair rental price that Sarah pays to Carolyn is half of the total fair rental value, because Carolyn is a 50% owner [Prop. Reg. § 1.280A-1(g)]. Carolyn is not considered to have used the home for personal purposes by reason of the rental agreement. However, Sarah is considered to be using the home for personal purposes for the period she occupies the residence.

Reporting Expenses Subject to I.R.C. § 280A

When a rental activity is subject to the I.R.C. § 280A limitations, the taxpayer reports rental income on Schedule E (Form 1040), Supplemental Income and Loss. The taxpayer prorates deductions based on the number of days of rental at fair value divided by the total days of use. If the allocable deductions exceed the rental income, the taxpayer carries over excess operating expenses, casualty and theft losses, and depreciation to the next year. Expenses allocable to personal use days are either nondeductible (operating expenses and depreciation) or potentially deductible only as itemized deductions (mortgage interest, property taxes, and casualty and theft losses).

Example 2.27 Rental of Second Home to a Family Member at Less Than Fair Rental Price

The facts are the same as in Example 2.22, except Norm became unemployed in late June. He paid the fair rental price for only 6 months (182 days), and Alice allowed him to live in the home rent-free for the remainder of the year. Alice's personal use days include the 184 rent-free days, and her rental expense deductions on Schedule E (Form 1040) are limited to her income from the property, as shown in **Figure 2.13**. She can deduct the $4,323 of interest and taxes allocable to the personal use days ($8,600 – $4,277) on Schedule A (Form 1040) if she treats the property as her second home for the mortgage interest deduction. Alice carries forward the $3,402 of excess expenses ($8,802 – $5,400) allocable to the fair rental period.

FIGURE 2.13 Rental to Family Member at Less Than Fair Rental Price

Rental income: $900 × 6 months		$ 5,400
Interest and taxes: $8,600 × (182 ÷366)	$ 4,277	
Other expenses: $2,800 × (182 ÷ 366)	1,392	
Depreciation: $6,300 × (182 ÷ 366)	3,133	
Total expenses ($8,802) limited to rental income		(5,400)
Rental property income		$ 0

Practitioner Note Not-for-Profit Rental to Unrelated Party

The not-for-profit activity rules of I.R.C. § 183 may limit deductions if I.R.C. § 280A does not apply. This occurs when the taxpayer charges less than a fair value rent and does not meet the personal use test (e.g., the owner uses the dwelling unit for only 7 days and rents it to an unrelated person during the rest of the year). When I.R.C. § 183 applies, the taxpayer reports rent on line 21 ("Other income") of Form 1040, U.S. Individual Income Tax Return, and any allowable expenses (limited to the rental income) are deductible only on Schedule A (Form 1040).

ISSUE 12: SUBSTANTIATION OF TRAVEL EXPENSES

This section discusses the additional substantiation rules for travel expenses when the business and the worker are related parties.

Related parties cannot substantiate lodging expenses using the federal per diem rate or the high-low method, and they must keep records to substantiate actual lodging expenses.

Accountable Plans

Reimbursements for business expenses made under an accountable plan are not included in the worker's gross income. To qualify as an accountable plan, the reimbursement or allowance arrangement must include all three of the following constraints:

1. The expenses must have a business connection (an employee's expenses must have been incurred while performing services as an employee of the employer).
2. An adequate accounting for the expenses must be made to the business within a reasonable period of time (generally 60 days after the travel).
3. Any excess reimbursement or allowance must be returned to the business within a reasonable period of time (generally 120 days after the travel).

General Substantiation Rules

Temp. Treas. Reg. § 1.274-5T(b) requires the taxpayer to substantiate the following elements for travel away from home:

1. The amount of the expense
2. The dates of departure and return
3. The place of travel
4. The business purpose of the expense

Employees who give their travel expense records and documentation to their employers, who are reimbursed for these expenses, and who do not take a deduction on their personal income tax returns generally are not required by the IRS to keep copies of this information.

Per Diem or Allowance Arrangement

Rev. Proc. 2011-47, 2011-42 I.R.B. 520, provides general rules for the use of a per diem allowance to substantiate business expenses for meals and incidental expenses and lodging. Each year, the IRS issues a notice to update the rules. Notice 2015-63, 2015-40 I.R.B. 461, is effective for expenses incurred on or after October 1, 2015.

Practitioner Note IRS Per Diem Notice Effective Date

Notice 2015-63 is effective for expenses incurred before October 1, 2016. The GSA has issued a new notice for expenses incurred on or after October 1, 2016 [GSA Per Diem Bulletin FTR 17-01, (August 12, 2016)].

Use of a per diem allowance eliminates the requirement to record expense amounts, but the taxpayer still must maintain records reflecting the dates, place, and business purpose of the travel.

If an employer provides a per diem allowance, the amount that is deemed substantiated is equal to the lesser of the employer's per diem allowance or the federal employee per diem rate for the locality of travel. The locality of travel is defined as the place where the employee stops for sleep or rest. The high-low substantiation method may be substituted for the federal per diem rate method.

Per Diem Method

The federal per diem rate is the highest amount that the federal government will reimburse its employees for lodging, meals, and incidental expenses (or meals and incidental expenses only) while they are traveling away from home in a particular area. The rates vary by city and are published annually by the General Services Agency (GSA). Rates for the continental United States (CONUS) can be found on the GSA website at `www.gsa.gov/perdiem`. The GSA website includes links to the Department of Defense and State Department websites for the per diem rates outside the continental United States (OCONUS).

High-Low Method

The high-low method can be used for travel within the continental United States. It eliminates the need to keep a current list of the per diem rate for each city. Notice 2015-63 lists the localities eligible for the high-cost per diem amount for the 2015–2016 fiscal year. The low-cost-per-diem amount is applied to all other localities.

Related Persons Exception

Related parties may be reimbursed for meals and incidental expenses using a federal per diem rate, but they are specifically excluded from satisfying the substantiation requirement for lodging expense by using either the federal per diem rate or the high-low method. Related persons include those defined in I.R.C. § 267(b), but the ownership percentage is reduced from 50% to 10%. Therefore, an employee who is considered related to his or her employer must keep records to substantiate actual lodging expenses.

A nontaxable reimbursement under an accountable plan is limited to the actual lodging expense. If the related employee meets the broader documentation requirements for reimbursement of related party expenses under an accountable plan, the reimbursements are excluded from income in the same manner as for an unrelated employee. If the employer does not have an accountable plan, the employee (related or unrelated) must keep adequate records to support his or her deduction of employee expenses on Form 2106, Employee Business Expenses.

Example 2.28 Substantiation by Related Employee

Tina and David, employees of Frazier Corporation, traveled to Chicago for a 3-day business trip in June 2016. The federal per diem rate for lodging, meals, and incidental expenses for Chicago is $274 per day, which includes $200 for lodging. As required by Frazier Corporation's accountable plan, Tina and David accounted for the dates, place, and business purpose of the trip. Frazier Corporation reimbursed each employee $822 ($274 × 3 days). Neither Tina's nor David's living expenses in Chicago exceeded $274 per day.

Tina is a 5% shareholder in Frazier Corporation and is not a related party for purposes of the travel expense substantiation requirement. Frazier Corporation excludes the reimbursement from her Form W-2, Wage and Tax Statement, and Tina does not deduct any of the expenses on her tax return.

David is a 25% shareholder in Frazier Corporation and is a related party for purposes of the travel expense substantiation requirement. Unless the reimbursement plan requires David to account to the employer for lodging costs, and he does substantiate lodging expenses of at least $200 a day, Frazier Corporation must include the $822 as a wage payment to David. David can claim an employee expense deduction on Form 2106 for his travel expenses, including the actual lodging expense. He may use either his actual expenses for meals and incidentals, which must be substantiated, or the $74 federal per diem allowance for meals and incidental expenses.

Practitioner Note Incidental Expenses Definition

The term *incidental expenses* is defined in the Federal Travel Regulations, 41 C.F.R. 300-3.1. This definition was revised on October 22, 2012, to include only fees and tips given to porters, baggage carriers, hotel staff, and staff on ships. Transportation between places of lodging or business and places where meals are taken, as well as the mailing cost associated with filing travel vouchers and payment of employer-sponsored charge card billings, is no longer included in incidental expenses. The federal per diem rates include a $5 amount for incidental expenses [Notice 2015-63, 2015-40 I.R.B. 461].

ISSUE 13: EDUCATIONAL ASSISTANCE PROGRAMS

This section provides the general rules for an I.R.C. § 127 qualified educational assistance program and the related party limitations.

An employee does not have to include in income amounts paid under a qualified educational assistance program. For certain related employers and employees, the plan is not qualified, and the employee must include educational assistance payments in his or her income.

General Rule

I.R.C. § 127 excludes from an employee's gross income up to $5,250 of employer-provided educational assistance during a calendar year.

Education is defined in Treas. Reg. § 1.127-2(c)(4) as any form of instruction or training that improves or develops the capabilities of an individual. It is not limited to courses that are job-related or part of a degree program.

An employer's plan may pay for educational expenses incurred by or on behalf of the employee at a third-party educational institution, or the employer may provide the course of instruction directly. The following expenses are not eligible for the exclusion:

1. Tools or supplies (other than textbooks) that the employee may retain after completing the course of instruction
2. Meals, lodging, or transportation
3. Education involving sports, games, or hobbies, unless the education involves the business of the employer or is required as part of a degree program

A qualifying program cannot allow employees to choose taxable benefits in lieu of the available educational benefits.

A qualified employer educational assistance program must be a separate written plan that benefits employees who satisfy eligibility criteria established by the employer. The classification of eligible employees must not discriminate in favor of officers, shareholders, self-employed individuals, highly compensated employees, or their dependents.

Related Party Benefit Limitation

Even when the written plan is not discriminatory, the program is not qualified in any year that more than 5% of the amounts paid or incurred for education assistance benefits were spent for

1. shareholders who, on any day of the program year, own more than 5% of the total number of shares of outstanding stock of the employer;

2. owners of an unincorporated trade or business who, on any day of the program year, own more than 5% of the capital or profits interest in the employer; and
3. spouses or dependents of shareholders or owners.

The attribution rules of I.R.C. § 1563 are applied to determine stock ownership in a corporation. The interest of an employee in an unincorporated trade or business (including partnerships and proprietorships) is determined using the common control provisions of I.R.C. § 414(c). These use principles similar to those in I.R.C. § 1563.

Example 2.29 Educational Assistance Program

The PGR Partnership has three equal partners: Phil, Guido, and Robert. Phil's spouse, Arlene, is an employee of the partnership. The partnership has a written plan to provide educational assistance to all employees. In 2016, PGR Partnership reimbursed Arlene $2,500 for tuition, fees, and books to attend the University of Wisconsin. She was the only employee who received educational assistance during the year.

Because Arlene is the spouse of a more-than-5% owner in the partnership, and more than 5% of the amounts paid for educational assistance benefits went to her, the educational assistance plan is not a qualified program for the year. Arlene's $2,500 reimbursement must be included in her wages on Form W-2. Because this amount is not excluded from income, she may be eligible to benefit from the lifetime learning credit, the tuition and fees deduction (on line 34 of Form 1040), or the employee business expense deduction (if the education otherwise qualifies as an itemized deduction on Schedule A of Form 1040).

ISSUE 14: S CORPORATION 100-SHAREHOLDER LIMIT

This section explains the *family shareholder* provision for counting the number of S corporation shareholders.

The American Jobs Creation Act of 2004 (Jobs Act of 2004), Pub. L. No. 108-357, increased the S corporation shareholder limit from 75 to 100 and added a provision allowing all members of a family to be counted as one shareholder, effective for tax years beginning after December 31, 2004. The changes to I.R.C. § 1361 are intended to "eliminate undue restrictions on S corporations" so that "more corporations and their shareholders will be able to enjoy the benefits of subchapter S status" [House Committee Report No. 108-548, for Pub. L. No. 108-357].

Members of a family include a common ancestor, lineal descendants of the common ancestor (including adopted children and foster children), and the spouses (or former spouses) of the lineal descendants of the common ancestor. The common ancestor cannot be more than six generations removed from the youngest generation.

Practitioner Note Election No Longer Required

Prior to 2005, the taxpayer had to make an election to count all members of the family as one shareholder. The Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, eliminated the need for an election.

Example 2.30 Family Shareholders Counted as One Shareholder

In 2016, 110 individuals held stock in the newly created Pelican Corporation. Fifteen of the individuals are family members as defined in I.R.C. § 1361. The remaining 95 individuals are unrelated.

The 15 related shareholders are treated as 1 shareholder, and Pelican Corporation is treated as having only 96 shareholders, thus satisfying the limit on the number of shareholders for the S corporation election.

ISSUE 15: PROPERTY TRANSFERS BETWEEN SPOUSES

Special rules apply to the transfer of property between spouses.

No gain or loss is recognized on property transfers between spouses. If the transfer is incident to a divorce, the rule also applies to former spouses [I.R.C. § 1041(a)]. Property transfers incident to divorce include transfers occurring within 1 year after the marriage ceases or transfers related to the cessation of the marriage. The transferee treats the property as acquired by gift, and the transferee's basis in the property is a carryover basis from the transferor [I.R.C. § 1041(b)].

Example 2.31 Property Transfer Incident to Divorce

Joyce and Raymond Jamison divorced in 2016. Joyce was the sole owner of a parcel of land, and in accordance with the divorce decree, she transferred the land to Raymond. The land had a $200,000 FMV and an $80,000 adjusted basis. Joyce recognized no gain on the transfer, and Raymond assumed an $80,000 basis in the land.

I.R.C. § 1041 applies to any transfer of property between spouses even if the transfer was in exchange for cash, the assumption of liabilities, or other consideration.

Example 2.32 Buyout of Property from Spouse

The facts are the same as in Example 2.31, except that Joyce and Raymond owned the land as joint tenants and the land was encumbered by a $50,000 mortgage. As part of the divorce decree, Raymond purchased Joyce's one-half interest in the land for $100,000 and assumed the entire $50,000 liability. Joyce recognizes no gain on the sale of the land or the liability relief, and Raymond assumes the $80,000 basis in the land. Raymond cannot increase his basis by either the amount paid to Joyce or his assumption of the full liability.

Practitioner Note — **Exception for Property Transfers between Spouses**

The gain or loss nonrecognition rule does not apply to property transfers if the spouse or former spouse of the transferor is a nonresident alien [I.R.C. § 1041(d)]. Additionally, the nonrecognition rule does not apply to the transfer of property in a trust to the extent that the sum of the liabilities assumed, plus the liabilities to which the property is subject, exceeds the property's adjusted basis [I.R.C. § 1041(e)].