Pitfalls in Transactions Between Related Parties

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PITFALLS IN TRANSACTIONS BETWEEN RELATED PARTIES

By John Lee and William J. Irvin

I. INTRODUCTION

The purpose of this paper is to sensitize the reader to the elements frequently recurring in related party transactions. The major focal points are: (1) the "economic unit" and (2) the "abuse transactions." Reilly, An Approach to the Simplification and Standardization of the Concepts "The Family," "Related Parties," "Control," and "Attribution of Ownership," 15 Tax L. Rev. 253 (1960)

A. Economic Unit

1. Family.

The range is from "spouse" alone to spouse, parents, grandparents, children, lineal descendants and brothers and sisters. Standard "incorporated" definitions are from Sections 267 or 318.

2. Controlled Entity.

Most common controlled entity is corporation; other controlled entities are partnership and more rarely trusts or estates or foundations. Usually with corporations and partnerships a benchmark is specified, e.g., 5%, 10%, 20%, 25%, 50% or 80%, with the latter two percents being the most common. Occasionally, "control" is not so defined by percentage ownership. Instead, "actual control," "practical control," or the "opportunity to control" is the focus.

3. Attribution.

In determining ownership most of the provisions surveyed contained attribution provisions, generally adopted from Sections 267 or 318. The three common patterns of attribution are: (1) attribution between members of a family, (2) attribution from an entity to a beneficiary (3) attribution from a beneficiary to an entity. Other more rare forms of attribution are attribution to or from stock option holders and from partner to partner. In some provisions, detailed operating rules as to reattribution are provided.

B. Abuse Transactions.

Transactions are categorized below by type of transaction — sale, lease, loan, or services — rather than by code section alone.

Trust, qualified plan and exempt organization related party transactions are not considered in this paper.
II. Related Party Transactions.

A. **Sales.**

The Service has a number of alternative approaches here. Section 482 in essence permits the Service to "change" the amount of the consideration. The constructive dividend rules fragment a sale transaction into part sale and part dividend. A third approach is to recharacterize a sale as something else, e.g., a contribution to capital.

1. Section 482.

   a If one member ("Seller") of a group of "controlled entities" sells or otherwise disposes of tangible property to another member ("Buyer") of such group at other than arm's length price, the IRS may make appropriate allocations between the Seller's and Buyer's incomes to reflect an arm's length price for such disposition. Treas. Reg. §1.482-2(e)(i)(i).

   b Appropriate allocations include an increase or decrease in (a) gross income, (b) deductions or (c) basis of assets, or any other "appropriate adjustment." Treas. Reg. §1.482-1(d)(1).

   (1) Where above "primary" adjustment is made, IRS must also make "correlative adjustments to the income of other member(s) of the group involved in the allocation. Treas. Reg. §1.482-1(d)(2).

   c Treas. Reg. §1.482-2(e)(2), (3), and (4) prescribes three methods of determining an arm's length price and the standards for applying each method: (a) "comparable uncontrolled price method," (b) "resale price method," and (c) "cost-plus method." In addition there is a special rule for determining an arm's length price for ore or mineral.

   d Unlike some other related party transaction provisions, neither Section 482 nor its accompanying regulations explicitly define the target controlled entities. Section 482 applies to "two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests." I.R.C. §482.

   (1) Reality of control is decisive, not form or mode of its exercise. Treas. Reg. §1.482-1(a)(3).

   (2) Based upon statutory reference to indirect ownership and control, courts have applied attribution principles. See Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders (4th Ed. 1979) at ¶ 15.06.

   (3) Ownership or control does not have to be held by same interests. Comm'r v. B. Forman Co., 453 F.2d 1144 (2d Cir.), cert. denied, 407 U.S. 934 (1972); see generally Nauheim, B. Forman & Co., Inc. — A Crucial Test of the Future of Section 482, 26 Tax Lawyer 107 (1973).

Section 482 by its emphasis on controlled businesses does not extend to intra-family transactions if the members of the family do not each constitute a business.

2. **Constructive Dividends From Inadequate Consideration and Excessive Consideration.**

   (a) Amount of Dividend.

   (1) A sale of property by a corporation to a non-corporate shareholder for less than its fair market value ("FMV"), i.e.,
inadequate consideration, is treated in part as a (dividend) distribution under Section 301. Treas. Reg. §1.301-1(j).

(2) A similar sale by a corporation to a corporate shareholder results in a Section 301 distribution equal to the excess of the adjusted basis over the amount paid for the property where the FMV equals or exceeds such basis. Where the fair market value of the property is less than its adjusted basis, the amount of the distribution is the excess of the fair market value over the amount paid for the property.

(b) Sales to a corporation by a shareholder of property for excessive amounts also constitute constructive dividends. See e.g., Goldstein v. Comm'r, 298 F.2d 652 (9th Cir. 1962).

(c) A bargain sale to a relative of a shareholder constitutes a constructive sale to the shareholder where he exercises substantial influence over the transaction. See Green v. United States, 460 F.2d 412 (5th Cir. 1972).

(d) The above rules apply to a distribution to any shareholder, whether or not he “controls” the corporation. As a practical matter, however, such bargain dispositions to or excessive cost acquisitions from shareholders are most likely where the shareholder has practical control over the corporation.

(e) A bargain sale between “controlled” corporations A and B may be treated by the Service as a constructive dividend by corporation A of the bargain element to the common shareholder followed by a contribution to the capital of B by such shareholder of such bargain element. See Bittker & Eustice, supra at ¶7.05, pages 7-29-30. See Sammons v. Comm’r, 472 F.2d 449 (5th Cir 1972) (test whether the distribution by corporation A was made primarily for the benefit of the common shareholder, rather than for any valid business purpose); But see Gray v. Comm’r, 56 T.C. 1032, 1065 N. 13 (1971), rev’d on other grounds, 561 F.2d 753 (9th Cir. 1977) (contrasting Rushing v. Comm’r, 52 T.C. 888, 894 (1969), aff’d. 44 F.2d 539 (5th Cir. 1971) with Sammons, and supporting the proposition that even if a disparity in consideration received in brother-sisiter sale of property existed, no constructive dividend to common shareholder). See generally Laure v. Comm’r 70 T.C. 1087, 1108 (1978) (noted that in Rushing payor-corporation had significant interest in payee-corporation’s successful development).

(f) Where a corporation sells property to a shareholder at a price in excess of the fair market value, the excess of the purchase price is treated by the Service as a contribution to capital by the shareholder. Cf. Treas. Reg. §1.385-3 (a) (1).

Recharacterization of Sale.

a. Sale or Equity Contribution.

(1) If a transfer by taxpayer of property to a corporation controlled by him (or by him and other transferors) within the meaning of Section 368(c) in exchange for an installment obligation constitutes a sale, the tax consequences are that the transferor generally will recognize income equal to the difference between his adjusted basis in the property and the amount realized by him. I.R.C. §1001. The transferee corporation’s basis in the property will be its cost under I.R.C. §1012. On the other hand, if the
transfer of the property for the installment obligation is treated as an exchange under Section 351, the transferor will recognize property received under Section 351(b) and the transferee corporation’s basis in the property will be the transferor’s carryover basis, increased by any gain recognized by the transferor on exchange. I.R.C. §362.

Under this approach if the installment note is treated as a “security”, the transferor will recognize no gain as to the receipt of the note. If the note is not a “security”, it will be taxed as “boot” resulting in a step up in basis as to the corporation. I.R.C. §362(b)

(a) If the installment note is treated under the Section 385 regulations as preferred stock issued for property (because held “proportionately” and “excessive debt” or not a “reasonable rate of interest”), the question of non-security debt or security debt does not arise. Treas. Reg. §1.385-6(d)(4) Ex. (3); Prop. Treas. Reg. §1.385-6(e)(4) Ex. (3). Under this approach the transfer would be treated as either (i) a Section 351 transfer, or (ii) a taxable exchange of property for stock (if the transferor is not in control of the corporation).

Frequently the issue of characterization as a sale or equity contribution arises where the transferor transfers low basis appreciated property to a controlled corporation in a transaction cast in the form of an installment sale. After the transfer the corporation develops the property, usually real estate, and it holds the developed property for sale to customers in the ordinary course of its business. The ideal goal is for the transferor to recognize a capital gain, reported on the installment basis as to the appreciation at the time of the transfer, with the corporation recognizing ordinary income only as to the spread between the fair market value at the time of transferee and the sales to unrelated third parties (Note: even assuming a sale, resales by the controlled corporation can cause problems under the new installment sales provisions discussed below at II.A.6.(C)).

(2) In determining under the Section 385 regulations whether a “proportionately-held” instrument issued for property is treated as preferred stock or debt, one of the determinative factors is whether the corporation has “excessive debt.” Treas. Reg. §1.385-6(f); Prop. Treas. Reg. §1.385-6(g)(1). A safe harbor is provided:

A corporation’s debt is not excessive if--

(1) the corporation’s “outside” debt-equity ratio does not exceed 10:1 and (ii) the corporation’s “inside” debt-equity ratio does not exceed 3:1. Treas. Reg. §1.385-6(f)(3); Prop. Treas. Reg. §1.385-6(g)(3). The “equity” component is the excess of the adjusted basis (not fair market value) of the corporation’s assets over its liabilities. Treas. Reg. §1.385-6(g)(2); Prop. Treas. Reg. §§1.385-6(h)(2)(i) and 6(h)(6)(i)(use straight-line depreciation as a under §312(k). The corporation’s basis in its assets will vary, however, accordingly to whether the transfer of property for the note is treated as a sale—property for debt—or an equity contribution—property for preferred stock.

(3) There are two possible approaches to the above “circular” adjusted basis question: (i) apply the pre-Section 385 authorities, without regard to Section 385, to determine the corporation’s hypothetical adjusted basis in the transferred property, and then apply the Section 385
regulations (and thereafter determine the corporation's actual basis), or (ii) apply the Section 385 regulations treating the T.C. 203, 210 (1968) acq. 1964-2 C.B. xxv; and a more or less traditional debt-equity analysis, see, e.g., Burr Oaks Corp. v. Comm'r, 365 F.2d 24, 27 (7th Cir. 1966), Kolkey v. Comm'r, 27 T.C. 37, 59 (1956), aff'd, 254 F.2d 51 (7th Cir. 1958). It may be noted that the authorities in this area cannot be easily reconciled. Rothman, Transfers to Controlled Corporations, Related Problems, 348 Tax Management Portfolio A-9 (1979).

Even when the step transaction approach was used, the determination of whether the instrument is a security or a non-debt security turns on factors substantially similar to the case law debt-equity factors. See Camp Wolters Enterprises, Inc. v. Comm'r, 22 T.C. 737, 751(1954), aff'd, 230 F.2d 555(5th Cir.), cert. denied, 352 U.S. 826 (1956) (although time period of note is important factor, "the controlling consideration is an over-all evaluation of the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to a cash payment, the purpose of that advance, etc."). As the Tax Court stated in D'Angelo Associates, Inc. v. Comm'r, supra at 130:

Whether a transaction constitutes a sale or exchange, the characterization of an obligation as stock or security, and the determination of control under sec. 351 are often discussed as separate factors. Given the complexity of many cases arising under sec. 351, and the varying importance and novelty of each factor in a particular case, this may simplify presentation. Nevertheless, the factors are usually interrelated and overlap. Even in those cases that decide a prior finding of a sale dispenses with a necessity of characterizing obligations as notes or securities, the criteria that would have already been carefully evaluated in deciding the transaction was a sale. 70 T.C. 130 n. 5.

Accordingly, since an equity contribution analysis and a step-transaction-security analysis ultimately turn on a case law debt-equity (flavored) analysis, it is not sound tax policy to have to turn to the pre-Section 385 debt-equity imbroglio to apply the Section 385 regulations.

(2) The determination for the purposes of debt-equity ratio of the adjusted basis of a corporation's assets is to be made "[w]ithout regard to the treatment of any interest as stock or indebtedness by reason of section 385, etc." Treas. Reg. §1.385-6(g)(3)(ii); Prop. Treas. Reg. §1.385-6(h)(3)(ii).

(3) The primary justification for the adjusted basis approach in determining debt-equity ratios was that the purpose of the safe harbor rules for the excessive debt determination (and for the reasonable rate of interest determination), was to promote certainty by providing an objective standard. Preamble, 45 Fed. Reg. 86443 (December 31, 1980). The drafters of the regulations reasoned that if a corporation were able to use the more subjective standard of fair market value rather than the objective standard of adjusted basis in computing a corporation's debt-to-equity ratio, the safe harbor would not provide an easy-to-apply objective standard. In the case, however, of a purposed sale of property to a corpo-
ration, the fair market value of the instrument land implicity of the property transferred had to be determined in any event under the bifurcation rules in order to determine whether the shareholders "paid" the fair market value for the instrument. See Treas. Reg. §1.385-33(a). Consequently, the fair market value of the asset, the property, had to be determined in any event. This may no longer be necessary under the proposed regulations. See Prop. Treas. Reg. §1.385-6(c)(1) and (2).

b. Section 304 Redemption.

(1) If one of two commonly "controlled" brother-sister corporations ("A") acquires stock in the other corporation ("B") from the controlling person(s) in exchange for property, (a) the property is treated as a distribution to such person(s) in redemption of the stock of A, and (b) the stock in B is treated as being contributed by the controlling person(s) to the capital of A. I.R.C. §304(a). Similarly, if a "controlled" subsidiary ("S") acquires stock in its parent ("P") from a shareholder of D in exchange for property, the property is treated as a distribution in redemption of the stock of P.

(2) "Control" is at least 50% of the voting power of voting stock or at least 50% of the total value of all classes of stock. I.R.C. §304(c)(1). If a person so controls one corporation ("P"), which in turn so controls another corporation ("S"), such person is treated as controlling S as well.

(3) The attribution rules of Section 318 apply, except that the 50% ownership floor for attribution to and from a corporation is eliminated. I.R.C. §304(c)(2).


a. Section 1239.

(1) Section 1239 provides that the gain recognized by the transferor in 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.

The purpose of Section 1239 was to put an end to the practice of selling depreciable assets to controlled corporations in order to establish a higher depreciation basis at the expense of the capital gains provisions. See H. Rep. No. 586, 82d Cong., 1st Sess. 26 (1951); S. Rep. No. 781, 82d Cong., 1st Sess. 69-70 (1951).

(2) The term "related persons" is defined as (a) the taxpayer and the taxpayer's spouse, (b) the taxpayer and an 80% owned entity, and (c) two 80-percent owned entities.

Entity here means a corporation or a partnership; in the former case 80% or more in value of the outstanding stock must be owned by the taxpayer and in the latter case 80% or more of the capital interest or profit interest must be owned by the taxpayer. I.R.C. §1239(c)(1). For this purpose the attribution principles of Section 318 apply, except that (a) members of an individual's family consist only of such individual and such individual's spouse and (b) the attribution to and from corporation rules are applied without regard to the usual limitation of no attribution unless the person owns 50% or more in value of the stock of the corporation. I.R.C. §§1239(c)(2) and 318(a)(2)(C) and (3)(C).
A major problem area under Section 1239 (c)(1) is the meaning of 80% or more in value of the outstanding stock. *See United States v. Parker*, 376 F.2d 402 (5th Cir. 1967) ("in value" is a broader phrase than merely the number of shares and voting power; calls for the familiar, though difficult, process of fair market valuation, including premium for control; *accord*, Rev. Rul. 69-339, 1969-1 C.B. 203. *But see Trotz v. Comm'r*, 26 T.C.M. 632 (1967) (no premium on control—79%—of a closely held corporation unless the existence of a "going concern" value could be clearly proved).

b. Section 707 (b)(2).

(1) Section 707 (b)(2) may be viewed in large part as a back-up provision to Section 1239. Section 1239 originally applied only to transactions between a taxpayer and his spouse and a taxpayer and his 80% owned corporation. Section 707 (b)(2) deals with transactions between a partner and a partnership in which he owns, directly or indirectly, more than 80% of the capital interest or profits interest, and to transactions between two partnerships in which the same persons own, directly or indirectly, more than 80% of the capital interests or profits interest.

(2) First it should be noted that Section 707 (b)(2) has always contained the direct or indirect ownership requirement, only recently added to Section 1239. Secondly, the transactions between two controlled partnerships under Section 707 (b)(2) applies if the same persons own more than 80% of the capital interest or profits interest, whereas a transaction between two 80% owned partnerships is covered by Section 1239 only where 80% or more of the capital interests or profits interests in the two partnerships are owned directly or indirectly, by the same person.

(3) The attribution rules under Section 707 are not the Section 318 attribution rules, now applicable to Section 1239, but rather the Section 267 attribution rules discussed below at, II. A. 5. (a)(3). §707(b)(3).

(4) There is a slight difference in the assets to which Sections 1239 and 707(b)(2) apply. Section 1239 applies to property which is depreciable in the hands of the transferee, whereas Section 707(b)(2) applies to property which is not a capital asset in the hands of the transferee. The latter is a broader definition which includes depreciable property used in a trade or business since such assets are excludable from Section 1221 under I.R.C. §1221(2). However, the term "property other than capital asset" includes also, but is not limited to, trade or accounts receivable, inventory, and stock in trade as well as real property which is not depreciable used in the taxpayer's trade or business. *See* Treas. Reg. §1.707-1(b)(2).

c. Section 1235.

A transfer of all substantial rights to a parent by any holder is considered the sale or exchange of a long-term capital asset. I.R.C. §1235(a). This provision was designed to obviate problems as to the sale or exchange requirement (Section 1235 applies regardless of whether the payments are periodic or contingent on productivity, use or disposition of the patent) and problems as to dealer status. *See generally* S. Rep. No. 1622, 83rd Cong. 2d Sess. 438(1954). Section 1235 is not exclusive, and gain on patent transfers may qualify for capital gain treatment under the general code provisions and cases. *See* Rev. Rull. 69-42, 1969-2 C.B. 164.
(1) Section 1235 does not apply to transfers of a patent by a holder to certain related persons described in Section 267(b), with certain modifications. I.R.C. §1235(b).

(2) Related persons in this context includes members of the holder’s family and a controlled corporation: Members of the holder’s family consist of spouse, and ancestors, and lineal descendants. I.R.C. §§367(c)(4), as modified by I.R.C. §1235(d)(2). In short, brothers and sisters are included in the general Section 267(c) definition of family, but are excluded for purposes of Section 1235(d). A controlled corporation is defined as one in which the holder owns, directly or indirectly, 25% or more in value of the outstanding stock. I.R.C. §§267(b)(2) and (3) and §1235(d)(1). Here the 50% benchmark normally used in Section 267 was lowered in 1958 to 25%. The other fiduciary, beneficiary and controlled tax-exempt Section 501 educational and charitable organization rules of §267 are followed.

Furthermore the attribution rules of I.R.C. §267 are used, with the above modifications of narrowing the definition of family and lowering the 50% controlled corporation benchmark to 25%.

(3) The consequence of Section 1235 not applying, is that the transaction must be tested under the general provisions governing disposition of a capital asset. However, a patent is a depreciable asset, if used in a trade or business or held for the production of income. Treas. Reg. §1.167(a)-6(a). Therefore, where the transfer of a patent is to an 80% owned entity or to a spouse, and the transferee uses the patent in his trade or business or for the production of income, then Section 1239 will apply.

There is no provision in Section 1235 or 267 which treats a partner and his partnership, or commonly controlled partnerships as related persons. However, Section 707(b)(2) denies capital gain treatment on the sale of asset to a partnership by an 80% partner or by 80% commonly controlled partnership where the asset in the hands of a transferee is not a capital asset. If the patent issued in the transferee’s trade or business it is therefore excluded from the definition of capital asset by I.R.C. §1221(2). See Soffron v. Comm’r, 35 T.C. 787 (1961); accord, Emory v. Comm’r, 47 T.C. 710 (1967).

5. Special Treatment of Losses.

Section 267(a)(1) disallows losses from the sales or exchanges of property, directly or indirectly, between certain related persons, including primarily members of a family; and individual and his 50% controlled corporation; and grantors, fiduciaries and beneficiaries of trusts. Section 267 does not apply to transactions between partners and partnerships, but Section 707(b)(1) correspondingly disallows loss deductions upon sales or exchanges of property, directly or indirectly, between a more than 50% partner and his partnership or between two partnerships which are more than 50% commonly owned.

a. Section 267.

(1) Section 267(a)(1) disallows losses (under Section 165) from sales or exchanges of property, directly or indirectly, between the specified related persons. Unlike the normal nonrecognition provisions, which provide for a carryover basis as a concomitant to nonrecognition, the transferee takes as his basis in the property his cost for purposes of (i) depreciation, (ii) losses realized on sale of the property and (iii) casualty losses. Treas. Reg. §1.267(d)-1(c)(i). See generally Harley, Dealings Between Closely-Held Corporations
and Their Shareholders, 25 Tax L. Rev. 403, 404 (1970). Note that if the
transferee sells the property at a gain where the transferor's loss was previously
disallowed under Section 267, gain realized by the transferee on a subsequent
sale or exchange of the property is recognized only to the extent it exceeds
the disallowed loss. I.R.C. §267(d).
There is no netting of Section 267 losses against gains realized in sales between
the same related parties, even if part of the same transaction. Johnson's Estate
v. Comm'r, 355 F.2d 931 (6th Cir. 1966).
Section 267(a)(1) by its own terms does not apply to a loss in a case of a
The rational for the §267(a)(1) disallowance of losses is that since members
of a family, a shareholder controlled corporation and certain trust arrangements
may well be considered a single economic unit, there is a basis for a unit
approach to financial affairs involving members of the same family or unit,
especially when the transaction results in a decrease of the tax liability of the
unit. Jetter & Reich, Related Taxpayers — Losses, Expenses, Interest A-1
(2) The Section 267 tainted relationships are as follows:
(a) Members of a family, which is limited to brothers and sisters, whether
by the whole or half-blood; spouse; ancestors; and lineal descendants. I.R.C.
§§267(b)(1) and §267(c)(4). No exclusion is provided for a spouse who is legally
separated under a decree of divorce or separate maintenance as is the case
under I.R.C. §318(a)(1)(A)(i). Furthermore, it may be noted that ancestors
and lineal descendants is a far broader category than that of children, grand-
(b) The "controlled corporation" standard here is that the individual owns,
directly or indirectly, more than 50% in value of outstanding stock of the
 corporation, I.R.C. §267(b)(2). A brother-sister standard (more than 50% in
value of the outstanding stock of two corporation is owned, directly or in-
directly, by or for the same individual) exists, but only if either one of the
corporations was for the taxable year of the corporation preceding the year
in which the sale or exchange a personal holding company or a foreign holding
company. I.R.C. §267(b)(3). The value here, as in §1239, can be affected by
voting control. See King Quirk & Co. v. Comm'r. 20 T.C.M. 1429 (1961).
(c) Sections 267(b)(4) through (8) bring within the related person standard
transactions between a grantor and fiduciary of any trust, a fiduciary and a
beneficiary of the same trust or of another trust with the same grantor, fi-
duciaries of trusts where the same person is grantor of both trusts, and a
fiduciary of a trust and a corporation more than 50% in value of the outstanding
stock of which is owned, directly or indirectly, by or for the trust or by or for
its grantor. And, Section 267(b)(9) brings within the related person def-
inition a person and a 501 tax-exempt organization which is controlled directly
or indirectly by the person or by members of his family.
(3) Section 267(c) provides extensive rules for "constructive ownership of
stock."
(a) Entity to beneficiary attribution. Stock owned, directly or indirectly, by
or for a corporation, partnership, estate or trust is treated as being owned
proportionately by or for its shareholders, partners or beneficiaries. I.R.C.
§267(c)(1). Contrast Section 318, where the attribution from a corporation to
a shareholder is limited to a 50% or more shareholder. Stock constructively
owned under this provision by a shareholder, partner, or beneficiary is treated as actually owned by him for purposes of applying the other attribution rules discussed below. I.R.C. §267(c)(5). Consequently, such constructive ownership by a shareholder, etc. will be attributed to members of his family to his partner, but in the case of attribution of stock owned by a corporation, a shareholder's construction proportionate interest will be attributed to his partner only if the partner already owns stock actually or constructively, other than stock attributed to him through ownership by members of his family. I.R.C. §267(c)(3); Treas. Reg. §§1.267(c)(1)(a)(2) and 1.267(c)-1(b), Example (3).

Section 267(c) does not provide how proportionate attribution from an estate or trust is to be determined, unlike §318(a)(2)(B) which provides in the case of a trust for actuarial values. Moreover, the Tax Court held that actuarial values are not to be used under Section 267 in determining attribution from a trust to beneficiaries. See Hickman v. Comm'r, 31 T.C.M. 1030 (1972); see generally Jetter & Reich, supra at A-9.

(b) Family attribution. An individual is considered as owning the stock owned, directly or indirectly, by or for his family. I.R.C. §267(c). As discussed above, family includes brothers and sisters (whether by whole or half blood, spouse, ancestors and lineal descendants). Distinctions between §267 family attribution and family attribution under §318 is discussed above. Stock constructively owned by an individual through entity to beneficiary attribution is considered as directly owned by him for his family. I.R.C. §267(c)(5). Conversely, stock ownership attributed to an individual through his family or through his partner may not be re-attributed to him from a member of his family or to his partners. I.R.C. §267(c)(5); Treas. Reg. §1.267(c)-1(a)(3).

A further distinction, and hence a potential trap for the unwary, between attribution under §267(c) and under §318, particularly as applied in other provisions, is that of redemptions. Under I.R.C. §302(c)(2) in the event of a complete termination of a shareholder's interest and his meeting certain other requirements, including the ten year look forward and ten year look back rules, family attribution is waived. Thus if a taxpayer has stock redeemed and touches all of the proper bases, stock of family members will not be attributed to him and a distribution can be treated as a sale or exchange rather than the equivalent of a dividend. Thus any gain could result in a capital gain rather than a dividend. But if the redemption involves a loss so that 267 may be called into play, there is no waiver of the family attribution. Hence in McCarthy v. Conley, 341 F.2d 948 (2d Cir. 1965), where all of the taxpayer's stock in the corporation was redeemed, leaving his brother and sister as the remaining shareholders, the distribution was deemed to be a distribution and redemption rather than an equivalent of a dividend, but since under Section 267 family attribution the stock of the brother and sister were attributed to the taxpayer, his loss on the redemption was disallowed.

(4) Section 267 reaches direct, or indirect, sales or exchanges of property at a loss between "related persons." An indirect sale encompasses sales to a third person which serves as a connecting link between the seller and the ultimate buyer, a related person. See, e.g., Boehm v. Comm'r. 28 T.C. 407 (1957, aff'd per curiam, 255 F.2d 684 (2d Cir. 1958) (sole shareholder of corporation sold stock at loss to father-in-law who sold same stock at same
price to corporation); *Nordling v. Comm'r.* 166 F.2d 703 (9th Cir.) cert. denied, 335 U.S. 817 (1948) (sale by taxpayer to son-in-law nominee for taxpayer's brother).

But there is no necessity of a third person serving as the connecting link: matching sales and purchases of stock, consummated simultaneously by pre-arrangement, through the medium of a stock exchange constituted indirect sale between the related parties who sold and purchased the shares of stock. *McWilliams v. Comm'r,* 331 U.S. 694 (1947); accord, *Shelthar v. Comm'r,* 28 T.C. 1222 (1957) (sales consummated in the over-the-counter market). Where there has been a significant time lapse between a sale of stock on a stock exchange by a son and a purchase of the same number of shares but at a different price by the mother, the Fifth Circuit held that there was no sale between them in the context of a pre-arrangement. *United States v. Norton,* 250 F.2d 902 (5th Cir. 1958) (28 day time lapse).

(5) In the case of a transfer of loss property between an individual and a controlled corporation (more than 50% in value of the stock is owned directly or indirectly by such individual), the requisite control is present where an individual has contracted to purchase more than 50% of a corporation's stock from the time the stock is placed in escrow by the seller to be released upon payment of the purchase price. *Moore v. Comm'r,* 17 T.C. 1030 (1951), aff'd 202 F.2d 45 (5th Cir. 1953). Conceptual symmetry is not obtained, however, since the same result obtains where a shareholder has contacted to dispose of control of a corporation and participates in a loss sale prior to the disposition. See *Federal Cement Tile Co. v. Comm'r,* 40 T.C. 1028 (1963), aff'd, 338 F.2d 691 (7th Cir. 1964) (after contract to sell but prior to closing, selling shareholders purchased assets from corporation; claimed corporate deductions of the losses arising from the sale disallowed). Moreover, a corporation has been disallowed a loss as to assets exchanged in redemption of a shareholder's stock where the redemption reduces the redeemed shareholder's stock ownership below 50% in value. *W.A. Drake, Inc. v. Comm'r,* 145 F.2d 345 (10th Cir. 1944).

b. Section 707.

Just as Section 707(b)(2) may be viewed as the partnership backup to Section 1239, although there are substantial differences, Section 707(b)(1) may be viewed as the partnership back-up to Section 267 (a)(1). Section 707(b)(1) disallows any deductions for losses from sales or exchanges of property, directly or indirectly, between a partnership and a more than 50% partner or between two partnerships in which the same person owns, directly or indirectly, more than 50%. The more than 50% test of ownership is of capital interest or profits interests and is discussed above. In the case of a subsequent sale or exchange by a transferee, the rule of Section 267(d) is applied, i.e., if the transferee sells the property at a gain, the gain realized is recognized only to the extent in excess of the disallowed loss.

Just as Section 267(a)(1) does not apply to a loss in the case of a distribution in the case of a distribution in a corporate liquidation, Section 707(b)(1) does not apply to a loss arising from an exchange by the partnership for the partners interest in the partnership — a liquidation or partial liquidation under Sections 731 or 736(b).
As discussed above, the Section 267 attribution rules are applied with certain modifications under Section 707(b).


A number of special tax credits or benefits, ranging from investment tax credit and special depreciation provisions to installment reporting, are denied to certain sales or exchanges between related parties. There is again no uniformity in the components making up the related party basic unit, i.e., the degree of control between entity and beneficial owner, the familiar relationship, or the attribution rules.

a. Investment Tax Credit.

Section 38 allows a tax credit the amount of which is determined under Section 46 for qualified investments — in effect Section 38 property. Section 48 in turn defines Section 38 property. This investment tax credit is limited under Section 48(c) to certain dollar limitations in the case of used Section 38 property. However, this investment tax credit for used Section 38 property is denied in the case of acquisitions from certain related persons.

(1) Section 48(c)(1) denies use of Section 38 property status, and hence and investment tax credit, as to property which after its acquisition by the taxpayer is used by a person who used the property before the acquisition or by person who is related to a person who used the property before the acquisition. I.R.C. §48(c)(1)

(2) Section 48(c)(1) defines related party by incorporating reference Section 179(d)(2)(A) or (B). That provision in turn utilizes the Section 267 (or Section 707) definition of related party and a controlled group under the Section 1563 definition of related party.

(a) The incorporation of the Section 267 (or Section 707(d)) standard is broad, including both the definition of economic units and the attribution rules, because the reference is to a person whose relationship to the person acquiring the property would result in the disallowance of losses under Section 267 or 707(b). The only limitation in applying these rules is that the family of an individual includes only his spouse, ancestors and lineal descendants and, hence, excludes the standard Section 267(c) inclusion in the definition of family of brothers and sisters, of the whole or the half blood.

(b) The Section 1563 controlled group definition is modified by using a more than 50% benchmark where Section 1563 uses an 80% benchmark I.R.C. 179(d)(7). Section 1563(e) contains its own complicated constructive ownership rules.

b. ACRS.

(1) The Accelerated Cost Recovery System (ACRS) allows recovery of cost of depreciable assets over periods generally shorter than their useful lives. I.R.C. §168(b).

(2) ACRS is not available as to property (a) owned or used by the taxpayer, or a "related person" at any time during 1980, (b) leased by the taxpayer to a person, or a person related to such party, who used it any time during 1980, or (c) acquired in a non-recognition exchange under I.R.C. §§1031, 1033, 1038 or 1039, to the extent of substituted basis representing the adjusted basis of other property owned by the taxpayer or a related person during 1980. I.R.C. §§168(e)(4) and (B).

(3) Related person status arises if (a) the related person bears a relationship
to the person specified in Section 267(b) or Section 707(b)(1) (reducing the
50% benchmark of Sections 267(b) and 707(b)(1) to 10%), or (b) the related
person and such person are engaged in businesses under common control
within the meaning of Section 52.

c. Installment Sales of Depreciable Property.
Section 453 provides for ratable recovery of basis and profit as payments are
received from a distribution of property where at least one payment is received
after the close of the taxable year in which the disposition occurs. I.R.C.
§§453(a), (b)(1) and (c). Section 453(h) provides that in a Section 331 liquidation
to which Section 337 applies, the distribution of an installment obligation
(acquired from a sale by the corporation during the 12-month period commen-
cing on the date of the adoption of the liquidation) is not treated as payment
for the stock in the liquidation, but instead payments received under the
installment obligation itself shall be treated by the shareholder as payment
for his stock.

The above two provisions are inapplicable to certain sales to related parties.
The rationale was derived from that of Section 1239. It will be recalled that
Section 1239 was designed to prevent a step-up in basis for depreciable
property sold to a related party who would then take ordinary deductions, at
a capital gains cost only to the transferor. Even after this abuse was closed by
Sections 1239 and 707, tax saving could still be obtained by deferring the
ordinary income bite to the transferor over a long period of time utilizing
installment reporting, while the transferee could immediately commence de-
preciation on the new step-up basis. See generally Ginsburg, Taxing the Sale
for Future Payment, 30 Tax L. Rev. 469 (1975). The related party exceptions,
therefore, deny the deferral as to transferors where the property is depreciable.

(a) I.R.C. §453(g)(1) provides that in the case of an installment sale of
property depreciable in the hands of the transferee, I.R.C. §453(f)(7), between
“related persons” installment method reporting is not available and all pay-
ments to be received under the installment obligations are deemed received
in the year of the disposition of the property.

This denial of installment reporting for sales of depreciable property between
related persons does not apply if the taxpayer can establish to the satisfaction
of the I.R.S. that the disposition did not have as one of its principal purposes
the avoidance of federal income tax. I.R.C. §453(g)(2).

(b) Section 453(h)(1)(C) provides that if the obligor of any installment and
the shareholder are “related persons” then the installment obligation distrib-
uted pursuant to a §331 liquidation to which §337 applies shall not obtain the
deferral of §453(h)(1)(A) and instead all payments to be received by the share-
holder under the installment obligations shall be deemed received in the year
that the shareholder receives the obligation. Note that this changes the result
somewhat of prior law. Under prior law, the shareholder would have been
taxed on the fair market value of the installment obligations in the year of
the distribution to him by the liquidating corporation, whereas under this
provision he is taxed on the face amount of all payments to be received.

(c) The term “related persons” for purposes of both I.R.C. §§453(g)(1) and
453(H) incorporated the definition of related persons of Section 1239(b). That
definition, as discussed above, means: (a) the taxpayer and taxpayer’s spouse,
(b) the taxpayer and an 80-percent owned entity, and (c) two 80-percent
owned entities. This entity definition as provided in I.R.C. §1239(c)(1) includes both corporations and partnerships. And with slight modifications the attribution rules of Section 318 apply.

7. Denial of Special Relief Provision.

In several instances exceptions are provided to penalty provisions and then such exceptions are denied where property is transferred between related persons.

a. Section 306.

(1) Section 306 generally provides that if a shareholder sells or otherwise disposes of “Section 306 stock,” the amount realized is treated either as ordinary income or as a distribution of property to which §301 applies, dependent upon whether the disposition is a redemption or otherwise. I.R.C. §306(a). This ordinary income result does not apply to a disposition (other than in a redemption) which terminates the shareholder’s entire stock interest in the corporation. I.R.C. §306(b)(1).

(2) The above exception for termination of a shareholder’s interest does not apply if the disposition is made, directly or indirectly, to a person the ownership of whose stock would be attributable to the shareholder under Section 318(a). As discussed above, under §318(a) there is family attribution, entity to beneficiary attribution, attribution to entity from beneficiary, and option attribution as well. These various attribution rules are discussed above.

b. Section 334(b)(2).

(1) Section 334(b)(2) provides that upon the liquidation of certain subsidiaries, the basis of the property received by the parent corporation is the adjusted basis of its stock in the liquidated subsidiary. Among other requirements, the parent must have acquired at least 80% of the voting stock and at least 80% of the total number of shares of all other classes of stock (except preferred) by “purchase” during a 12-month period beginning with the date of the first acquisition by purchase of the stock. I.R.C. §334(b)(2)(B).

(2) The term “purchase” for this purpose does not include stock acquired from a person the ownership of whose stock would be attributed to the person acquiring the stock under Section 318(a).

c. Section 341(e).

(1) Section 341(a) provides for ordinary income treatment on the gain from (a) the sale or exchange of stock of a collapsible corporation (b) a distribution in partial or complete liquidation of a collapsible corporation, and (c) a Section 301 distribution made by a collapsible corporation to the extent it exceeds the basis of stock and accumulated earnings and profits. Section 341(e) provides for certain exceptions to the application of §341 in the case of certain sales or exchanges of stock. I.R.C. §341(e)(1). Also Section 337 generally does not apply to sales made by a collapsible corporation, but §341(e)(4) provides that for purposes of §337 a corporation is not considered to be a collapsible corporation if certain requirements are met.

(2) These Section 341(e) exceptions are not available as to a more than 20% shareholder if the stock is sold to or exchanged with a “related person.” In the case of the Section 337 special rule, the exception does not apply if the corporation sells or exchanges property to any “person related” to the 20% plus shareholder.

(3) The term “related person” is defined for purposes of Sections 341(e)(1)
and (4) by Sections 341(e)(8) as follows: if the shareholder is an individual, his spouse, ancestors, and lineal descendants, and a corporation which is controlled by such shareholder. I.R.C. §341(e)(a)(A). Control for this purpose means ownership of stock possessing 50% of the total combined voting power of all classes of voting stock or at least 50% of the total value of shares of all classes of stock.

If the shareholder is a corporation, then related persons include a corporation which controls or is controlled by the shareholder, using the above definition of control, and if more than 50% of value of the outstanding stock of th shareholder is owned by any person, a corporation more than 50% in value of the outstanding stock of which is owned by the same person, i.e., a 50% commonly owned corporation.

(4) For purposes of determining ownership, I.R.C. §341(e)(8) incorporates the §267(c) attribution rules, except that the family of an individual includes only his spouse, ancestors, and lineal descendants, i.e., excluding the standard 267(c) inclusion in family of brothers and sisters of the whole or half blood.

B. Leases.

1. Section 482.

a. Control and general approach of Section 482 are discussed above at II A. a.

b. Treas. Reg. §1.482-2(c)(2) prescribes three alternate methods of determining an arm’s length charge for use of tangible property: (i) true arm’s length charge, (ii) sublease rental, and (iii) deemed arm’s length rental, See Schmidt & Levenson, Allocations (Sec. 482) — Specific Transactions (T.M. Portfolio #230 - 2d 1976).

(1) True arm’s length rental.
Amount of rental charged, or which would have been charged for the use of the same or similar property in independent transactions with unrelated parties, considering period and location of use, owner’s investment (or the rent paid for the property in case of sublease), expenses of maintaining the property, its condition and all relevant facts. Treas. Reg.§1.482-2(c)(2)(i)
Either the lessor or lessee must be engaged in the trade or business of leasing property, defined by the regulatons as renting to unrelated parties (other than solely casual or infrequent rentals of property predominantly used in the taxpayer’s trade or business), in which case this method is mandatory.Id.

(2) Sublease Rental.
Equal to the deductions claimed by sublessor as to subleased property, for rent and maintenance and repair, utilities, management, similar expenses. Treas. Reg. §1.482-2(c) (iii). If tangible property leased to the “owner” is subleased by him to the user, and neither are engaged in the leasing business, this method of mandatory, unless the taxpayer can show a more appropriate charge.

(3) Deemed arm’s length rental.
Sum of
(a) depreciable basis divided by useful life;
(b) 3% of the depreciable basis;
(c) total direct and indirect expenses paid during year by the owner., e.g.,
taxes, maintenance and repair, utilities, management fees, etc., but not interest; and
(d) total direct or indirect costs, including costs of rendering services and amortization of capital expenditures. Treas. Reg. §1.482-2(c)(ii).
If neither the lessor nor the lessee is engaged in the leasing business and the lessor is not subleasing the property to the lessee, this method is mandatory unless the taxpayer establishes a more appropriate charge. Id.

2. Constructive Dividends (and Disallowed Deductions) from Inadequate Rentals, Excessive Rentals.
a. Amount of Dividend.
A bargain lease to a shareholder of corporate property (or a lease by the shareholder of his property to the corporation at an excessive rental) constitutes a constructive dividend to the extent of the spread between the property’s fair rental value and the amount paid by the shareholder (or the corporation). See Rev. Rul. 58-1, 1958-1 C.B. 173 (rental of apartment units to shareholders at lower rental than charged general public). A bargain lease to dominant shareholder’s son constitutes a dividend to father. International Artists, Ltd. v. Comm’r, 55 T.C. 1225 (1971).
Rather than determine a hypothetical arm’s length rental, courts and the IRS often treat the corporation’s depreciation charges and maintenance expenses as constructive dividends (to extent not in excess of economic benefit). 3 Bittker, Federal Taxation of Income, Estates and Gifts 92-17 (1981).
b. A bargain lease or excessive rentals between commonly controlled corporations results in a constructive dividend to the common shareholder. Sparks Nugget, Inc. v. Comm’r, 458 f.2d 631f (9th Cir. 1972).

3. Shareholder Rents as Personal Holding Company Income.
A “personal holding company”, I.R.C. §543.1 is taxed on undistributed personal holding company income. I.R.C. §541. One category of personal holding company income is amounts received as compensation for the use of tangible corporate property where 25% or more of the corporation (at any time during the year) is owned, directly or indirectly, by or for an individual entitled to use the property. I.R.C. §543(a)(6).

a. Some jurisdictions integrate the conveyance (to a related party) and the lease-back requiring a business purpose for both components and finding none where the taxpayer occupied the property prior to the conveyance. Mathews v. Comm’r, 520 f.2d 323 (5th Cir. 1975), cert. denied, 424 U.S. 1967 (1967); Perry v. United States, 520 f.2d 235 (4th Cir. 1975), cert. denied, 425 U.S. 1052 (1976); White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951), cert. denied, 343 U.S. 928 (1952); Penn v. Comm’r, 51 T.C. 144, 149 (1968).
b. Other authorities analyze the conveyance and leaseback separately, requiring a business purpose only for the lease-back and find that the obligation to pay rent supports a deduction. Brown v. Comm’r, 180 F.2d 926 (3rd Cir. 1950); Skemp v. Comm’r, 168 F.2d 598 (7th Cir. 1948).

5. Amortization of Leasehold Improvements.
a. A lessee must include renewal periods in the periods over which he may write off the cost of leasehold improvements made by the lessee, unless he meets a fixed percentage test for the unexpired length of the lease period
(without regard to options to renew) or establishes that it is more than it will.
I.R.C. §178(a).
b. If the lessee and the lessor are "related persons" at any time during the
taxable year, the lease is treated as being for a period at least as long as the
remaining useful life of the improvement, regardless of whether the percentage
test is met. I.R.C. §178(b)(1).
c. A lessor and lessee are "related persons" if (i) they are members or an
"affiliated group" under Section 1504, or (ii) they are related under Section
267(b), except that the more than 50% benchmark is raised to 80% or more.
Also in applying the Section 267 attribution rules, "family" is limited to
6. Personal Use of Residence by Related Party.
a. Section 280A limits the deductibility of "business expenses" attributable
to rental use of a dwelling unit when the taxpayer uses it as a "residence"
during the taxable year. I.R.C. §§280A(5) and 1280(a)(d)(1). Personal use
during a taxable year for the greater of (i) 14 days or (ii) 10% of the number
days rented at a fair rental causes a dwelling unit to have "Residence
status".
b. Personal use includes use (even if rent is paid) by any member of the
taxpayer's family as defined in Section 267(c)(4).
C. Loans.
1. Section 482.
a. Control and the general approach of Section 482 are discussed above at
II.A.1.
b. Treas. Reg. §1.482-2(a)(2) provides three alternative methods of deter-
mining an arm's length interest: (i) true arm's length interest, (ii) loan of
borrowed funds, and (iii) deemed arm's length interest.
(1) True arm's length interest.
The rate of interest charged, or which would have been charged at the time
the indebtedness arose in independent transactions with unrelated parties under
similar circumstances. All relevant factors are considered, including the amount
and duration of the loan, the security involved, credit standing of the borrower,
and the interest rate prevailing for comparable loans. Treas. Reg. §1.482-
2(a)(2)(i).
If the loan in question does not represent the proceeds of a loan obtained by
the lender at the situs of the borrower, and if the creditor is not generally
engaged in the business of making the loans or advances of the same general
type to unrelated parties, then the actual arm's length interest rate described
above must be followed.
(2) If the loan advanced represents the proceeds of a loan obtained by the
lender at the situs of the borrower, then the arm's length rate in the taxable
year is equal to the rate actually paid by the lender, increased by an amount
which reflects the cost or deductions incurred by the lender in borrowing
these amounts and making such loans, unless the taxpayer establishes a more
appropriate arm's length interest rate.
(3) Deemed arm's length interest rate is 12% simple interest.
A safe haven is provided if the rate of interest actually charged is at least
11% but not in excess of 13% per annum simple interest. If the rate charged
is not between 11% and 13%, the facts must support the rate or an allocation reflecting the 12% rate may be made. This deemed arm’s length rate is mandatory where the creditor is not regularly engaged in the business of making loans and advances of the same general type, unless the taxpayer shows that the rate actually charged will be deemed a more appropriate rate under the arm’s length standard. Treas. Reg. §1.482-2(a)(2)(iii)(B).

(3) Treas. Reg. §1.482-1(d)(4) provides that a reallocation may be made under Section 482 for members of the group of controlled taxpayers engaged in transactions with each other even though the ultimate income may not be anticipated from the series of transactions may not be realized during the taxable year. An example given is one member of a group lending money to a second member in a taxable year with the possibility that the appropriate allocation reflects an arm’s length interest charge even if the second member does not realize income during the year. The Tax Court now follows these regulations. See Latham Park Manor, Inc. v. Comm'r, 69 T.C. 199 (1977), aff'd in unpublished opinion (4th Cir. 1980); see Kahler Corp. v. Comm'r, 486 F.2d 1 (8th Cir. 1973); Kerry Investment Co. v. Comm'r, 500 F.2d 108 (9th Cir. 1974).

(c) Where a taxpayer is subject to both Sections 482 and to 385 as to a loan, then the sections are applied in the following order:

(1) First, Section 385 and 1232, including the bifurcation rule discussed below are applied to determine:
(a) whether the loan is treated as stock or indebtedness; (B) whether capital contribution or distribution under Section 301 imputed; and (a) whether there is a discount or a premium.

(2) Second, Section 482 is applied. Section 482 is applied. Treas. Reg. §1.482-2(a)(5).

2. Interest-Free Loans.

Other than where Section 482 applies, the case law is well established that an interest-free loan does not give rise to income to the borrower, see Greenspun v. Comm'r, 72 T.C. 931, 947-49 (1979); Dean v. Comm'r, 35 T.C. 1083 (1961).

Furthermore there is no “gift” of the uncharged interest on an interest-free demand loan. Crown v. Comm'r, 585 F.2d 234 (7th Cir. 1978).

Where the lender has to borrow the money to make an interest-free loan, however, the lender has often been treated as a conduit with the ultimate borrower being treated as having borrowed the money from the original source of the loan. Query: The effect of the assignment of income doctrine as to the lender of an interest-free loan with respect to profits earned on the loan by the borrower, particularly if the lender can be said to control the borrower, e.g., a father-minor son loan.

3. Corporation to Shareholder Loans.

Where a corporation makes a loan to a shareholder, the determinative inquiry whether such transaction constitutes a loan or constructive dividend is whether the parties to the transaction intended at the time of the withdrawal that it would be repaid. Chism's Estate v. Comm'r, 322 F.2d 956, 960 (9th Cir. 1963).
Factors which are often significant in answering this inquiry are as follows:

1. Ability of shareholder to repay,
2. Giving of collateral.
3. Complete control of corporation by taxpayer or his family,
4. Treatment of withdrawal on corporate records,
5. Dividend policy of the corporation,
6. Ratio of advances to earnings and profits of the corporation,
7. Payment of interest,
8. Repayment of principal,
9. Purpose for which loan was used,
10. Ratio of disbursements to stockholdings,
11. Issuance of notes, and
12. Where the loan was ultra vires or unlawful.


One of the more significant factors is whether the withdrawal was in fact repaid. See generally Lee, Shareholder Withdrawal — Loan or Dividend: Repayments, Estoppel, and Other Anomalies, 12 William & Mary L. Rev. 512 (1971).

While it may be possible to have an interest-free loan, if Section 482 does not apply, between a corporation and a shareholder, the failure to charge interest may be taken by the courts as a factor indicating that the withdrawal actually constituted a constructive dividend. Again, there is no specification of control in this area, but as a practical matter, generally shareholder loans are to controlling shareholders. Furthermore, proportionality of withdrawals, which indicates control, is a very negative factor.

4. Shareholder Advances To Corporation.

a. Section 385 authorizes regulations to determine whether an interest in a corporation is to be treated as stock or indebtedness. While technically the regulation does not turn upon whether the holder of the instrument and the corporation are related, in fact in the area of non-demand written instruments, the factor of "control" is a determinative one. It is expressed in the context of the 385 regulations as "proportionality." If a written instrument is not held proportionately to stock ownership, then it automatically is treated as a debt. Treas. Reg. §1.385-6.

Proportionality apparently was determined under the final regulations basically by taking the percentage of common ownership by shareholders of stock and of a class of debt — the total overlap factor. If the common ownership did not exceed 50%, the instruments and the stock were not proportionately held (absent non-arm's length offsetting transactions). If the common ownership was 80% or more, then clearly under the final regulations instruments was held proportionately. Between 50 and 80 percent was uncharted area prior to the 1982 proposed regulations. See generally Levin & Bowen, The Section 385 Regulations Regarding Debt Versus Equity: Is the Cure Worse than the Malady?, 35 Tax Lawyer 1,9 (1981). The 1982 proposed regulations provide that holdings of stock and a class of instruments will be considered substantially proportionate if the total "overlap" of ownership of stock and the class of instruments exceeds 50%. Prop. Treas. Reg. §1.385-6(a)(2).
Furthermore, under the proposed regulations an instrument is treated as if held proportionately if (i) held by a 25% or more shareholder, and (ii) the debt-equity ratio exceeds 10:1. Prop. Treas. Reg. §1.385-6(a)(2)(vi).

For purposes of determining proportionality there is attribution among members of a family and between related entities. Treas. Reg. §1.385-6(a)(2) (incorporating §318(a) attribution rules into test for proportionality); Prop. Treas. Reg. §1.385-6(a)(2)(ii).

b. When dealing with a written instrument issued for cash (written instruments issued for property are discussed above in II.A.2), the determinative factor is whether the corporation has excessive debt (also discussed above in the same section), and under a second look doctrine whether interest called for under the instrument has been paid.

c. Independently of the debt-equity issue, under the final regulations (but not the 1982 proposals), if fair market value is not paid by the acquirer of an instrument, then the transaction is bifurcated into an acquisition of the instrument and a constructive dividend if the amount paid is less than fair market value and a contribution to capital if the amount paid is more than fair market value. Treas. Reg. §1.385-3(a). This question is to be distinguished from that of original issue discount and premium which turn on whether the face of the instrument is more than fair market value or less than fair market value, respectively.

5. Loans to Related Parties and Accumulated Earnings Tax.

a. Section 531 imposes an accumulated earnings tax on accumulated taxable income in excess of the accumulated earnings credit. I.R.C. §535 and §535(c).

In order for the accumulated earnings tax to apply, however, the corporation must have been formed or availed of for the purpose of avoiding income tax as to its shareholders by permitting earnings and profits to accumulate instead of being divided or distributed. I.R.C. §532(a).

(1) "Dealings between the corporation and its shareholders, such as withdrawals by the shareholders as personal loans or the expenditure of funds by the corporation for the personal benefit of the shareholders . . . ."

c. The accumulated earnings credit for a corporation other than a mere holding or investment company consists of an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business with certain adjustments. I.R.C. §535(c)(1).

Section 1.537-2(c) of the Treasury Regulations provides that accumulations of earnings and profits for the following reasons may indicate the the earnings and profits of a corporation are being accumulated beyond reasonable needs of business:

(1) "Loans to, or expenditures of corporate funds for the personal benefit of, shareholders;
(2) Loans having no reasonable relation to the conduct of business made to relatives or friends of shareholders or to other persons."


a. Section 531 imposes a personal holding company tax on undistributed personal holding company income of every personal holding company.

b. Adjusted income from rents does not constitute personal holding company income if such adjusted income constitutes 50% or more of the adjusted ordinary gross income and if any other category of personal holding company
income exceeds 10% of ordinary gross income, a dividend is paid equal to such excess. Hence, non-rent personal holding company income in excess of 10% of ordinary gross income is to be highly avoided. A frequent historical pattern in the rental real estate business was to have brother-sister corporations own various apartment projects (largely engendered, one suspects, by requests for multiple surtax exemptions). An equally prevalent pattern in a brothersister real estate group is for the cash rich companies to make loans to affiliates needing funds for development. Interest may or may not be charged on such loans. However, if interest is not charged, more than likely §482 will apply. The result is that the Service can allocate an arm's length interest charge to the creditor corporations. Such allocated interest or actual interest paid may well be the trigger causing the rents to become personal holding company income.

While the above problem is not limited to related party loans or controlled brother-sister corporations, the pattern is most prevalent where there is control.

7. **Borrowings From a Related Party and the At-Risk Provisions.**
   a. Section 465(a) limits the losses from specified activities by specified taxpayers to the amount that the taxpayer is “at risk” for such activity at the close of the taxable year. I.R.C. §465(a)(1).
   b. A taxpayer is considered at risk for an activity as to amounts borrowed with respect to the activity. I.R.C. §465(b)(1)(B). Borrowed amounts, however, do not include amounts borrowed from any person who has a relationship to the taxpayer specified under §267(b).

8. **Accrual of Interest as to Loans Between Related Taxpayers.**
   a. Section 267(a)(2) disallows expenses (otherwise deductible under §§162 or 212) or deductible interest if such interest is not paid during the taxpayer’s taxable year or 2-1/2 months thereafter, if such interest is accrued by the taxpayer and is not included in the gross income of the person to whom the payment is to be made, and the taxpayer and such payee are “related persons.”
   b. The definition of “related persons” and the attribution rules of §267 are discussed above.
   c. If the accrued item is later paid to the payee, it still does not become deductible then under the rationale that it was either deductible when accruable or not at all. Treas. Reg. §1.267(a)-1 (b)(2); accord, Aptitude Associates, Inc. v. Comm’r, 21 T.C.M. 1485 (1962), aff’d per curiam, 324 F.2d 499 (4th Cir. 1963). See generally, Hamovit Disallowance of Losses and Deductions and Characterization of Gains between Related Persons, 15 Western Reserve L. Rev. 270, 277 (1964).
   d. Section 267 does not apply to partnership accruals of interest as to loans from partners or partnership accruals as to loans between controlled partnerships.
Section 707 does not have an express provision analogous to Section 267 in this context, unlike the loss sale provision of §707(b)(1). However, the regulations under §707 achieve much the same result.

D. Services.

1. Section 482.
   a. Control and general approach of §482 are discussed above at II A. 1.
   b. Treas. Reg. §1.482-2(b)(3) in effect provides generally two alternative methods of determining an arm’s length charge for services: (i) True arm’s length charge and (ii) A deemed arm’s length charge.
      (i) True Arm’s Length Charge.
      Amount which was charged or which would have been charged, for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts. Treas. Reg. §1.482-2(b)(3).
      Whenever the services in question are an integral part of the business activities of either the member rendering the services or the member receiving the benefit of the services, a true arm’s length charge must be made. Services are such an integral part whenever they are important or significant to the profit-making activities of either of them in either a quantitative or qualitative sense. Treas. Reg. §1.482-2(b)(7).
      (2) Deemed Arm’s Length Charge.
      Treas. Reg. §1.482-2(b)(4) provides that the deemed arm’s length charge is equal to certain direct and indirect costs or deductions; and §1.482-2(b)(5) provides that certain costs and deductions are not to be taken into account. This deemed charge equal to the cost or deductions is mandatory, unless the taxpayer establishes a more appropriate charge, wherever services are not an integral part of the business activity of either member. Since some taxpayers may seek deemed arm’s length charge as a safe haven, the regulations provide that services will not constitute an integral part of the business activity if the cost of services of the renderer attributable to the rendition of services for the taxable year to related parties do not exceed 25% of the total costs or deductions of the renderer for the taxable year. Treas. Reg. §1.482-2(b)(7)(ii)(b).

2. Constructive Dividends.
   Where the corporation pays too much for an employee’s services or where the amount it pays is in excess of reasonable compensation, no deduction is allowed to the corporation under §162(a)(1). While in theory such excess might constitute compensation to the employee, in practical effect it is treated as a constructive dividend in most, if not all, instances. Where the corporation provides services to the employee for which it is not adequately compensated, this benefit too can constitute a constructive dividend. The more common occurrence, however, has been the unreasonable compensation issue whether at the corporate or shareholder level.
   a. The primary factors in determining reasonable compensation are as follows: (i) services performed; (ii) comparison with other employees; (iii) employer’s earnings; (iv) ownership; (v) economic conditions; (vi) employer’s dividend policy, and (vii) contingent compensation. These factors are evaluated and elaborated upon in 1 Bittker Federal Taxation of Income, Estates and Gifts, ¶ 22.2.2 (1981).
b. While technically the question of reasonable compensation could arise where the employer and the employee are unrelated, virtually all reasonable-compensation cases involve family corporations or other closely held enterprises. Bittker, supra. Not surprisingly, compensation in proportion to stockholding inevitably suggests that part of the compensation may be a disguised dividend. Id.

A problem of some standing has been the tendency of the Internal Revenue Service to argue that the income of a service corporation is taxed directly under common law doctrine such as the assignment of income doctrine, or §61 (or even §482) to the individual shareholder-service provider. Such non-§482 approaches would defeat the purpose of professional corporations since all income would be taxed directly to the individual and hence he would not be permitted to have compensatory fringe benefits from the corporation such as a qualified retirement plan or medical reimbursement plan. While undoubtedly qualified plans were the primary reason for incorporation of most professional practices, on occasion service providers have used their controlled corporations as a vehicle for sheltering income at the lower corporate tax bracket. It now appears that the Tax Court has fallen in line with the Circuit Courts and in the context of non-sham corporations and related shareholder-employee, will use only §482 to determine the appropriate arm’s length charge for the service renderer’s services. Under this approach, the professional’s income is first earned by the corporation and then paid to him as compensation or in the form of a qualified plan contribution or retained at the corporate level. Clearly, in the case of amounts paid out as direct compensation and the fringe benefit programs §482 does not serve to defeat this, rather such payments are almost by definition at least part of the arm’s length charge for the professional’s services. The Tax Court compares the fact that the professional or service provider earned all of the income prior to incorporation and therefore if all is paid after incorporation in direct compensation and plans, this is the arm’s length charge (and hence arguably, also reasonable compensation by definition). See Keller v. Comm’r, 77 T.C. No. 70 (Oct. 29, 1981), See generally Foglesong v. Comm’r, 621 F.2d 865 (7th Cir. 1980), reversing and remanding, T.C. Memo. 1976-294; Ruben v. Comm’r, 429 F.2d 620 (2d Cir. 1970). Where, however, the individual taxpayer does not draw out all of the income for his professional services from the corporation through direct compensation or through contributions to qualified plans, the courts are apt to allocate to the individual the funds left in the corporate treasury: “the touchstone for determining whether the financial relations between the petitioner and the corporation reflected those of unrelated parties dealing at arm’s length is the extent to which the total remuneration to the petitioner from the corporation for the services he performed (including salary, pension, and other benefits) was essentially equivalent to that which he would have received absent the corporation.” Foglesong v. Comm’r, 77 T.C. No. 74 (Nov. 16, 1981).

4. Personal Service Income as Personal Holding Company Income.
   a. Amounts received under a “personal service contract” constitute personal holding company income if (i) the performer of services is designated by name or by description in the contract or can be so designated by some person
other than the corporation; and (ii) the designated service performer owns (directly or indirectly including through attribution) 25% or more by value of the corporation's stock at some time during the taxable year. IRC §543(a)(7). The attributions rules of §544 are incorporated under Treas. Reg. §1.543-10(a). These attribution rules and family unit rules are broader than most of the attribution rules.

5. Substantial Improvements by a Related Party and Section 1237.
   a. Section 1237 provides that under certain conditions any lot or parcel which is part of a tract of real estate in the hands of a non-corporate taxpayer shall not be deemed to have been held primarily for sale to customers in the ordinary course of his business solely because the taxpayer subdivided the tract. There are a number of conditions that the taxpayer must meet, but §1237 is denied if a substantial improvement that substantially enhances the value of the lot or parcel was made by the taxpayer on the tract while he held it (or was made pursuant to a contract of sale entered into between the taxpayer and the buyer). IRC §1237(a). An improvement shall be deemed to have been made by the taxpayer under this provision if it was made by the taxpayer or members of his family as defined in §267(c)(4) or by a corporation controlled by the taxpayer or by a partnership which includes the taxpayer. IRC §1237(a)(3)(A).

6. Guaranteed Payments for Services by General Partner.
   Many tax shelter partnerships provide for management fees to be paid or sometimes accrued to general partners. The Fifth Circuit in Pratt v. Comm'r, 550 F.2d 1023 (5th Cir. 1977), refused to treat an accrual for management services performed by a general partner as a guaranteed payment. Its rationale was that where a general partner was performing those services which he was obligated to perform as a general partner he was not dealing with the partnership in a capacity other than a partner and hence no payments to him could be considered guaranteed payments under IRC §707.