

Tax Implications for Related Parties

Controlled Groups of Corporations

A controlled group of corporations involves two or more related corporations. Many tax benefits must be aggregated and shared by members of a controlled group, including the following:

- Graduated tax rate structure
- Election to expense depreciable assets §179 deduction
- AMT exemption
- \$25,000 general business credit

Controlled Groups are of two kinds. The **Parent-Subsidiary** controlled group involves one corporation owning at least an 80% interest in stock or assets of another corporation. The **Brother-Sister** controlled group involves a group of five or fewer shareholders having collectively at least an 80% interest of two or more corporations. A brother-sister group will then exist if the common ownership among them for both corporations is at least 50%.

Gains and Losses on Property Sales

In general a loss cannot be recognized on the sale of property to a related party. This disallowance applies to a group of companies with certain levels of common ownership, as well as to certain family members.

If there is a gain on the sale of property from one related party to another and the purchased property is depreciable by the purchaser, *all of the gain must be recognized as ordinary income rather than capital gain by the seller.*

Fringe Benefit Rules

Employees of all businesses, which are under common control, whether incorporated or not, must be aggregated to determine non-discrimination rules for employee benefit plans. For example, if three professionals form individual corporations, which in turn own another corporation for which their shared employees work, the professionals and the employees must be aggregated for application of the non-discriminatory rules.

Losses on Small Business Stock

Losses on the sale of stock are usually treated as capital losses. Capital losses are subject to significant limitations, individuals can only use \$3,000 of capital losses annually to offset ordinary income.

IRC Sec. 1244 allows ordinary loss treatment on the sale or worthlessness of certain small business stock. The maximum amount deductible as an ordinary loss in any year is \$50,000 (\$100,000 for a joint return). The loss is even considered a business deduction for NOL purposes. The 1244 ordinary loss is available only to individuals. Trusts and estates do not qualify.

To qualify as 1244 stock:

1. The issuing corporation must have been a small business when the stock was issued. A corporation is a “small business corporation” while its contributed capital and paid-in surplus does not exceed \$1,000,000. The corporation can issue more than \$1,000,000 in capital, but Section 1244 treatment only applies to the first \$1,000,000 of stock/contribution of capital received by a corporation.
2. The stock must have been issued for money or other property (except stock or securities)
3. The corporation’s gross receipts from investment property were not more than 50% of its aggregate gross receipts for its most recent 5 tax years that ended before the shareholder’s loss.

A critical requirement to benefit from Sec. 1244 is that the investor must be the original holder of stock. The stock must have been purchased directly from the corporation. Any subsequent transfer, even a gift/transfer between spouses, disqualifies stock.

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Editor’s Note --- Bob is a Manager in the firm’s Meadville Office. The article is derived from portions of a course that he taught as a component of tax seminars presented to other professionals and sponsored by the Land Grant University Tax Education Foundation, Inc.