RETHINKING TAX-AVOIDANCE POLICY ON SALES BETWEEN RELATED PARTIES IN ESTATES: CLOSING COSTS ARE NOT PAPER LOSSES

by Drew A. Cummings[*]

I. INTRODUCTION

Martha Jones dies in 2011 without a will.[1] Her property, including her 1920s home, will be transferred intestate to her seven children. Only one of her children, Jenny, lives near the house and is the only child who wants it. An appraisal reveals that the house is worth $400,000 on the day of Martha's death. So how is the family to transfer the property to Jenny?[2] Under the current regime of § 267 of the Internal Revenue Code, any loss on the sale of

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1. Martha Jones is a hypothetical individual, but her story is not uncommon.

2. *See infra* Part IV.A (using the Internal Revenue Code's definition of "family" for the purposes of this article).

the property would be currently disallowed based on Jenny being a related party to the estate under subsection (b)(13).[3]

As highlighted by the above example, after the death of a surviving parent, the decedent's children may not necessarily live near each other or near their recently passed parent. These children may not wish to inherit property that is distant from their homes. Moreover, when one child lives near the parent, it is impractical for all of the other siblings to own a part of the property as tenants in common. Without a will to transfer the property to the proper sibling, the state laws of intestacy will control the disposal of property.[4] Generally, without a surviving spouse, property transfers to all of the children in equal shares.[5] Although transferring property to multiple children who live across the country as tenants in common is rarely practical, intestacy laws dictate that the property is to be divided along those lines.[6]

One possible solution to this problem is the sale of the property to a single child. Most probate codes in the country permit courts to grant the administrator of the estate the power to sell the property.[7] With this power, families sometimes prefer that the child who lives in the same town as their deceased parents purchase the property and divide the proceeds among the other children.[8] It is common practice for the price paid by the child to be less than the fair market value at death; especially once the closing costs are factored into the basis of the property (if the child purchased the property at a gain to the estate, the income would be taxable to the estate).[9] If Internal Revenue Code § 267 did not exist, the estate could take the entire deduction against current income for any loss when the sale resulted in a loss.[10] However, § 267 disallows a deduction for the sale between related parties.[11] Congress sought to avoid the ability of taxpayers to manufacture losses to offset against capital gains or to shift income from high earners to low earners.[12] Yet the result is that losses that are non-manufactured cannot be offset. Even funds that are transferred to parties that are non-related parties under § 267(b) may not

3. I.R.C. § 267(b)(13) (2010).

4. UNIF. PROBATE CODE § 2-101 (2006).

5. *Id.* at §§ 2-103, 2-106.

6. *See generally id.*

7. *See, e.g.*, KAN. STAT. ANN. § 59-2303 (2009).

8. *See generally* UNIF. PROBATE CODE Part II.

9. For estates of decedents dying in 2010, the exclusion of gain on the sale of a principal residence under I.R.C. § 121 applied to property sold by the estate of a decedent, any individual who acquired the property from the decedent (within the meaning of the I.R.C. § 1022 modified carryover basis rules), and a trust that, immediately before the death of the decedent, was a qualified revocable trust (QRT, as defined in I.R.C. § 645(b)(1) established by the decedent). I.R.C. § 121(d)(11) (2010). On December 17, 2010, Congress reinstated the Estate Tax and repealed subsection (d)(11). Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, Title III, § 301(a), 124 Stat. 3300.

10. *See* I.R.C. § 267 (2006).

11. *Id.*

12. *See generally* discussion *infra* Part IV.

qualify as a deduction, such as closing costs.[13] Closing costs that are from an independent real estate agent or attorney are not manufactured losses—those are not the type of loss that § 267 was intended to deny.[14] The intent of § 267 applies to funds paid to related parties, but not to non-related parties, such as real estate brokers; those amounts are only disallowed a deduction because of the mechanical implementation of capital expenditures and how it relates to § 267.[15]

An estate should be able to deduct independent costs paid out to non-related parties.[16] To support this argument, this article explores three issues.[17] Part II discusses how the tax code treats closing costs as capital expenditures.[18] Due to the capitalization of closing costs, these costs are not currently deductible but are added to the basis of the property.[19] Part III explores the issue of whether an estate can make a deduction based upon § 165, which disallows losses on the sale of personal items.[20] Part III concludes that, because an administrator with a duty to sell the property for a profit conducts the sale of a residence from an estate, a loss should be deductable.[21] Part IV explains the operation, history, and intent behind § 267—disallowing current losses for property sold between related parties.[22] Part IV concludes that § 267 should not apply to costs incurred from non-related parties and thus Congress should create an exception allowing such costs to be currently deductible in the context of an estate.[23]

II. CLOSING COSTS ARE ADDED TO THE BASIS

Consider again the scenario involving Martha Jones.[24] Martha's house was worth $400,000 at the date of her death.[25] What if the estate spent $22,800 in real estate commissions and $500 in title inspection fees to sell the property to her daughter Jenny?[26] How is that $23,300 treated for tax purposes?[27] Under current law, because it is a capital expenditure, it cannot currently

13. In this article, the use of the phrase "non-related parties" denotes a transfer between two parties who are not "related," as defined by I.R.C. § 267(b).

14. *See* I.R.C. § 267 (2006).

15. *Id.*

16. *See* discussion *infra* Parts II–IV.

17. *See* discussion *infra* Part II–IV.

18. *See* discussion *infra* Part II.

19. *See* discussion *infra* Part II.

20. *See* discussion *infra* Part III.

21. *See* discussion *infra* Part III.

22. *See* discussion *infra* Part IV.

23. *See* discussion *infra* Part IV.

24. *See* discussion *supra* Part I.

25. *See* discussion *supra* Part I.

26. The estate and beneficiary are not required to have a real estate agent; the property could be purchased through a private sale. *See*, *e.g.*, McCormick v. Comm'r, 26 B.T.A. 1172, 1174 (1932). But, many times these individuals feel more comfortable paying a real estate agent to complete the sale.

27. *See* discussion *supra* Part I.

qualify as a deduction; instead, it must be added to the estate's basis of the house, adjusting the basis to $423,300.[28]

The Internal Revenue Code generally permits the deduction of expenses from income as they are incurred, subject to several exceptions.[29] One of the key provisions disallowing current deductions is § 263, which denies deductions for capital expenditures.[30] Specifically, § 263 denies a deduction "for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."[31]

Distinguishing capital expenditures from currently deductible expenses is often difficult. As the Supreme Court stated in *INDOPCO, Inc. v. Commissioner*, "the 'decisive distinction' between current expenses and capital expenditures 'are those of degree and not of kind.'"[32] Courts tend to focus on the future benefit of the expenditure: "[A] taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization."[33]

Applying the reasoning of *INDOPCO*, the Supreme Court held in *Woodward v. Commissioner* that expenses incurred in acquiring stock of a corporation was a capital expenditure and could not be deducted currently.[34] The *Woodward* opinion explicitly stated that the disposition costs of property are to be treated as capital expenditures as well.[35] According to the Court, "[i]t has long been recognized, as a general matter, that costs incurred in the acquisition or disposition of a capital asset are to be treated as capital expenditures."[36] Instead of recognizing a loss immediately, "[s]uch expenditures are added to the basis of the capital asset with respect to which they are incurred, and are taken into account for tax purposes either through depreciation or by reducing the capital gain (or increasing the loss) when the asset is sold."[37]

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28. *See* discussion *supra* Part I.

29. I.R.C. § 161 (2006); *see also* I.R.C. § 261 (2006).

30. I.R.C. § 263 (2006).

31. *Id.*

32. INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 86 (1992) (*citing* Welch v. Helvering, 290 U.S. 111, 113 (1933)); Deputy v. Du Pont, 308 U.S. 488, 495 (1940); Kevin J. Coenen, *Capital Or Ordinary Expense? The Proper Tax Treatment of a Target Corporation's Expenditures in an Acquisitive Reorganization*, 58 OHIO ST. L.J. 583, 584 (1997) ("The Code and Regulations have not, however, produced a bright-line test upon which taxpayers can rely.").

33. *INDOPCO, Inc.*, 503 U.S. at 87.

34. Woodward v. Comm'r, 397 U.S. 572, 574 (1970).

35. *Id.*

36. *Id.* at 575 ("The most familiar example of such treatment is the capitalization of brokerage fees for the sale or purchase of securities, as explicitly provided by a longstanding Treasury regulation, Treas. Reg. on Income Tax s 1.263(a)-2(e), and as approved by this Court in Helvering v. Winmill, 305 U.S. 79 . . . (1938), and Sprecks v. Commissioner of Internal Revenue, 315 U.S. 626 . . . (1942).").

37. *Id.* at 574–75. However, if the asset in question is simply retired or discarded, the cost is ordinarily deductible. Rev. Rul. 2000-7 I.R.B. 2000–9 (2009); *see, e.g.*, Spangler v. Comm'r, 323 F.2d 913, 921 (9th Cir. 1963); United States v. St. Joe Paper Co., 284 F.2d 430, 432 (5th Cir. 1960).

The Treasury regulations endorse and mandate this conclusion. The Treasury regulations explain that "[c]ommissions and other transaction costs paid to facilitate the sale of property generally must be capitalized."[38] Generally, a taxpayer begins with a basis in property equal to its cost, which is defined as "the amount paid for such property in cash or other property."[39] This basis is then adjusted under § 1016.[40] These adjustments include fees incurred in the acquisition or disposition of a capital asset and are treated as capital expenditures, which are "added to the basis of the capital asset with respect to which they are incurred."[41]

The Internal Revenue Code, Treasury regulations, and case precedent confirm that the $23,300 the administrator spent to sell the property to Jenny must be capitalized and thus added to the basis. Thus far, the closing costs, even if independent, must be added to the basis. If the property is sold to Jenny for $400,000, this would result in a $23,300 loss. Before deciding whether the loss is or should be disallowed by the related party limitations in § 267, we must decide whether the realized loss represents a nondeductible personal loss.

III. ESTATE MAY DEDUCT LOSS ON SALE OF PRIMARY RESIDENCE OF DECEASED

After determining that closing costs are added to the basis, the taxpayer will be worried if he or she will be able to deduct any loss on a piece of real estate that was used as the personal residence of the deceased. Such a loss, conceivably, could be disallowed under § 165. Almost universally, however, case law and precedent hold that an estate is allowed a deduction for the sale of property, even if the property was the primary residence of the decedent.[42]

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38. Treas. Reg. § 1.263(a)-1T(d) (2011).

39. Treas. Reg. § 1.1012–1(a) (2011); *see* I.R.C. § 1012 (2006).

40. I.R.C. § 1011(a) (2006). Section 1011(a) defines "adjusted basis" as follows: "The adjusted basis for determining gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis [(cost)] . . . adjusted as provided in Section 1016." *Id.*

41. *Woodward*, 397 U.S. at 574–75. I.R.C. § 1016(a) provides that "[p]roper adjustment in respect to the property shall in all cases be made—(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account . . . ." *Id.*; *see also* Berry Petroleum Co. & Subs. v. Comm'r, 104 T.C. 584, 618 (1995), *aff'd without published opinion*, 142 F.3d 442 (9th Cir. 1998).

42. *See, e.g.*, Watkins v. Comm'r, 32 T.C.M. (CCH) 809, 811 (1973); Estate of Miller, 26 T.C.M. (CCH) 229, ¶ 10 (1967) (allowing a deduction for the sale of property by spouse after husband's death when spouse did not use property for personal use after husband's death and sold property immediately); Waterman's Estate v. Comm'r, 195 F.2d 244, 245 (2d Cir. 1952), *rev'd*, 16 T.C. 467 (1951). The Internal Revenue Service Publication, *Publication 559 Survivors, Executors & Administrators*, explains:

> If the estate is the legal owner of a decedent's residence and the personal representative sells it in the course of administration, the tax treatment of gain or loss depends on how the estate holds or uses the former residence. For example, if, as the personal representative, you intend to realize the value of the house through sale, the residence is a capital asset held for investment and gain or loss is capital gain or loss (which may be deductible). This is the case even though it was the decedent's personal residence and even if you did not rent it out. If, however, the house is not held for business or investment use (for example, if you intend to permit a beneficiary to live in the residence rent-free and then distribute it to the beneficiary to live in), and you later decide to sell

Under § 165 of the Internal Revenue Code:

> In the case of an individual, the deduction [for a loss] shall be limited to: (1) losses incurred in a trade or business; (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and (3) except as otherwise provided in subsection (h), losses on property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.[43]

Section 165(c) further provides that the only allowable loss deductions for personal property are losses arising from "fire, storm, shipwreck, or other casualty, or from theft" as long as those issues are not compensated through insurance.[44] It logically follows that losses on the sale of a residential property used as a personal residence are not deductible.[45] Therefore, from our example, if Martha sold the property to her daughter Jenny (or anyone else) for a loss while she was using the property as her personal residence during her lifetime, any loss would be disallowed. However, if that sale is postponed until her death, the outcome changes.[46]

An estate that holds the primary residence of the deceased will not be disallowed a deduction on any loss on the sale of that property because of § 165. If the estate holds the property for sale, any loss will be sustained in a transaction entered into for profit, even though the property was not ordinary investment property.[47] This is because an estate of a deceased is a separate and independent taxpayer.[48] For the loss to be deductible, the sale by the personal representative on behalf of the estate must be a "transaction entered into for profit" in the statutory sense.[49]

> the residence without first converting it to business or investment use, any gain is capital gain, but a loss is not deductible.

I.R.S. Pub. 559, 2009 WL 6047599, at *39 (I.R.S. 2009). *But cf.* I.R.S. SCA 198-012, at 3 (Apr. 7, 1988) ("Under common law and under the laws of many states, title to real property vests in the heirs or devisees immediately upon the death of a decedent. This is true, in most situations, in New Jersey and in New York.") (noting that while sometimes a loss is not allowed in these above-mentioned states, this rule generally applies only to specifically devised property, which does not cover our situation).

43. I.R.C. § 165(c) (2006).

44. § 165(c)(3); *see also* I.R.C. § 262(a) (2006) ("Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.").

45. § 165(c); 26 C.F.R. § 1.1.65-9 (2011); P. V. Smith, *Income Tax: Deduction of Loss On Sale or Demolition of Residential Property*, 139 A.L.R. 815, Right to Deduction ¶ 5 (1942).

46. If inherited property was used by the decedent for personal purposes (e.g., as a residence), then the courts treat the fact that the property was acquired by inheritance as a neutral circumstance and focus on the use to which it was put by the heir after acquiring it. *See* Marx v. Comm'r, 5 T.C. 173, 174 (1945) (allowing loss on an inherited yacht); Campbell v. Comm'r, 5 T.C. 272, 274 (1945) (allowing loss on an inherited residence).

47. Appeal of Williams, 1 B.T.A. 1101, 1105 (1925).

48. *See* I.R.C. § 641(a) (2006); Waterman's Estate v. Comm'r, 195 F.2d 244, 245 (1952), *rev'd*, 16 T.C.M. 467 (1951).

49. I.R.C. § 165(c)(2) (2006); *see* F. LADSON BOYLE & JONATHAN BLATTMACHR, BLATTMACHR ON INCOME TAXATION OF ESTATES AND TRUSTS § 3:2 (Practicing Law Institute, 2007).

As explained in *Waterman's Estate v. Commissioner*, based on the duty of the administrator under state probate laws, the possibility of the administrator holding any assets for any personal use is excluded.[50] *Waterman* requires the personal representative to dispose of the property "on the best terms possible and to account to the estate for whatever, if anything, he [or she] could legitimately get."[51] A personal representative "presumably always possesses a profit motive in dealing with the assets of a trust" or estate.[52] Even if the most the executor can get is less than the value of the asset when it was acquired, it is a transaction entered into for profit and a loss on the sale of the property is deductible.[53] Furthermore, a taxpayer may hold property for profit even though his predecessor did not have a profit motive.[54] Therefore, because the Administrator is not holding the property for personal use, but has a duty to sell it for as much as may be garnered, the estate is allowed a deduction.[55]

The IRS has adopted the analysis from *Waterman* and applied it to transactions between family members.[56] For example, in Technical Advice Memorandum 6810230510A, the IRS held that a loss was allowed when a taxpayer's will left the exclusive options to purchase portions of his capital stock in three corporations to his two daughters, his brother, and certain key employees.[57] The issue was whether or not a loss on the sale of these options would be deductible under § 165.[58] The IRS explained that this issue was controlled by the principles enunciated in *Waterman*.[59] The IRS accepted the logic that the personal representative had a duty to the estate. Therefore, in dealing with the estate's assets, the personal representative's actions on behalf of the estate were a "transaction entered into for profit."[60]

The tax court applied the same logic in a case involving a personal residence.[61] In *Watkins v. Commissioner*, the tax court allowed an estate to deduct a loss on the sale of a personal residence even though the taxpayer used the property for personal use after the deceased owner's death.[62] The taxpayer in *Watkins* inherited a house from his wife, which they used as their personal

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50. *Waterman's Estate*, 195 F.2d at 245.

51. *Id.*; *see also* Wilmington Trust Co. v. United States, No. 377–72, 1976 WL 23958, at *6 (Ct. Cl. June 18, 1976).

52. BNA TAX MANAGEMENT PORTFOLIOS, *Losses from Business or Transactions Entered Into for Profit*, Business or Profit Requirement, Individuals, Transactions Entered Into for Profit ¶ 3 (2012) (available on Westlaw at TMFEDPORT No. 527 s III).

53. *Waterman's Estate*, 195 F.2d at 245; *see also* Kress v. Stanton, 98 F. Supp. 470, 476 (1951).

54. The IRS allows loss deduction for an inherited residence that the taxpayer never used as a personal residence and placed the residence for rent or sale immediately after the inheritance. *See* Campbell v. Comm'r, 5 T.C. 272, 274 (1945); *see also* Worcester v. Comm'r, 21 T.C.M. (CCH) 1139 (1962).

55. *Waterman's Estate*, 195 F.2d at 245.

56. I.R.S. Tech. Adv. Mem. 6810230510A (Oct 23, 1968).

57. *Id.*

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.*

62. Watkins v. Comm'r, 32 T.C.M. (CCH) 809, 811 (1973).

residence before the wife's death.[63] The taxpayer/husband was allowed a loss deduction on the sale of the house after occupying the house for approximately four months after her death.[64] The court held that his residence in the house before her death did not make it property held for personal use, and the time taken to sell the residence was not unreasonably long considering its acquisition through a personal tragedy.[65] The court recognized that if the taxpayer had sold the residence, which had been used by the taxpayers as their personal residency prior to the wife's death, then the loss would not have been deductible.[66] The court noted that it was clear that property acquired by inheritance had a neutral status.[67] Thus, "the fact that the taxpayer utilized the residence as his personal residence prior to his acquisition of it by inheritance did not taint the purpose for which the residence was deemed to have been held subsequent to the time of inheritance."[68] The court allowed the taxpayer to deduct the loss on the sale of the property even though some of his children lived in the residence for four months after his wife's death; the taxpayer allowed some of his children to live rent free in the residence for two additional months after the taxpayer had moved out; the taxpayer did not offer the residence for rent; and the taxpayer did not offer the residence for sale until after he had remarried.[69]

While the court in *Watkins* allowed a deduction even after the residence was used for personal reasons for almost four months after the deceased death, it is recommended that the property not be used for any personal use until after the property is sold.[70] As shown, however, courts have allowed losses on such sales to be deductible if the property is being marketed for sale while resided in.[71]

Notwithstanding this favorable authority, the IRS will always be worried about family transactions.[72] While not necessary, it may be wise for the administrator to rent out the property before the sale to establish a clear profit motive.[73] If property purchased "by the taxpayer for use as his personal residence is, prior to its sale, rented or otherwise appropriated to income-producing purposes and is used for such purposes up to the time of its sale, a loss sustained on the sale of the property shall be allowed."[74] Thus, the Administrator of Martha Jones' Estate could rent out the property to a third party while a deal is worked out with Jenny to purchase the property.

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63. *Id.* at 809.
64. *Id.* at 811.
65. *Id.* at 810.
66. *Id.*
67. *Id.*
68. *Id.*
69. *Id.* at 810–11.
70. *See id.*
71. *See id.*
72. *See* I.R.C. §§ 267, 280A (2006).
73. *See* I.R.C. § 165 (2006); Treas. Reg. § 1.165–9(b) (as amended in 1964).
74. Treas. Reg. § 1.165-9(b)(1).

On the opposite extreme, § 165 would not apply to a situation where the deceased owned rental properties or other business properties.[75] Section 165 should grant an administrator who wishes to sell property that is not the personal residence of the decedent, but is held as rental or residential property, a loss.[76] In this instance, the family member purchaser and the estate should not worry about § 165 applying to the sale of the property.[77]

Even if an estate is allowed a loss, that loss may be limited in amount.[78] Section 165 goes on to state that "losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in §§ 1211 and 1212."[79] These code sections limit:

> losses from sales or exchanges of capital assets to the extent of the gains from such sales or exchanges, plus (if such losses exceed such gains) the lower of—(1) $3,000 ($1,500 in the case of a married individual filing a separate return), or (2) the excess of such losses over such gains.[80]

But many times estates have capital gains, so a full loss may very well be allowed, and if not, can be carried forward to the beneficiaries.[81]

Therefore, in our example, the estate would be allowed a deduction if the property was sold for a loss to a third party.[82] Section 165 would not prohibit the loss if the estate sold the property to Jenny.[83] However, as explained in Part IV, § 267, which disallows a current deduction if the sale is to a related party, would limit the loss.[84]

IV. SECTION 267 DISALLOWS CURRENT DEDUCTION ON SALES TO RELATED PARTIES

This part will first examine the operation of § 267. This part will note that taxpayers can currently carry forward nondeductible losses to offset future gains; however, in the unique situation of a child buying the family home from an estate, it would be preferable for the child to take the loss currently because the child may never sell the house. The child may very well leave the house in an estate plan to their children. Second, this part will describe the history of

75. *See* I.R.C. § 165(c) (2006).
76. *See* § 165(a), (b).
77. *See id.*
78. § 165(f); *see* I.R.C. § 469 (2006) (noting that even though sometimes a loss from rental property is disallowed, the limitation on the deduction of losses disappears when the taxpayer disposes of the entire interest in a passive activity in a fully taxable transaction. Even if the taxpayer sells at a loss, the code treats the loss as one that is not from a passive activity.).
79. § 165(f).
80. I.R.C. § 1211(b) (2006).
81. I.R.C. § 642(h) (2006).
82. *See supra* note 74.
83. *See* § 166(a)–(b).
84. I.R.C. § 267 (2006).

§ 267; specifically, how Congress enacted this section to prevent the creation of "paper" losses.[85] From the history of § 267, it is apparent that it applies to the sale of a residence from an estate to a child-beneficiary.[86] Third, this part will describe the intent behind § 267, which is to solve the difficulty the IRS has with classifying these transactions between related parties as fair or not.[87] Based on the difficulty of classifying these transactions, the IRS has enacted this per se rule for the sake of administration.[88] Fourth, this part will argue that based off the history and intent of § 267, Congress should enact an exception for any expenses paid out to non-related parties at the closing of real estate sales when the sale is between an estate and a beneficiary.

A. Operation of § 267

Section 267 disallows a current deduction for any loss on the sale or exchange of property between related parties.[89] Currently, it describes thirteen pairs of related parties:

> **(1)** Members of a family . . . ;
> **(2)** An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;
> **(3)** Two corporations which are members of the same controlled group . . . ;
> **(4)** A grantor and a fiduciary of any trust;
> **(5)** A fiduciary of a trust and a fiduciary of another trust, if the same person is a 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 a grantor of both trusts;
> **(8)** A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;
> **(9)** A person and an organization to which section 501 . . . applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;
> **(10)** A corporation and a partnership if the same persons own—**(A)** more than 50 percent in value of the outstanding stock of the corporation, and

85. Unionbancal Corp. v. Comm'r, 305 F.3d 976, 982–83, 985 (9th Cir. 2002).
86. § 267(b)(13).
87. Ronald Moran Cadillac, Inc. v. United States, 385 F.3d 1230, 1233 (9th Cir. 2004).
88. *Id.*
89. § 267 (a)(1) ("No deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b). The preceding sentence shall not apply to any loss of the distributing corporation (or the distributee) in the case of a distribution in complete liquidation.").

> **(B)** more than 50 percent 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 percent 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 percent in value of the outstanding stock of each corporation; or
> **(13)** Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.[90]

The IRS does not allow deductions for losses arising from direct or indirect sales or exchanges of property between persons who, on the date of the sale or exchange, are within any one of the relationships specified in § 267(b).[91] Section 267 is a per se rule: it applies even if the sale was a bona fide, arm's-length transaction.[92] Also, it does not matter that the sale was made indirectly through a middleman.[93]

The subsection that applies to our situation is subsection (13), which deals with a sale between a beneficiary and an estate.[94] If a sale occurs between these two related parties, the code currently disallows any loss.[95] The code requires the taxpayer to carry over this loss to a future sale of the property as described below.[96]

The code disallows the amount of the loss on the sale of property that would be the "excess of the adjusted basis provided in such section for determining loss over the amount realized."[97] The code defines the adjusted basis for determining loss from the sale as the basis adjusted as provided in § 1016.[98] The cost of acquisition usually determines the basis, but in regard to an estate, the basis is stepped-up at the death of the owner.[99] This basis is then modified and adjusted "for expenditures, receipts, losses, or other items, properly chargeable to capital account."[100] Any current loss, as determined from the paragraph above, is carried forward to a future sale of the property.[101] If the related person who has carried forward a loss to whom property was originally sold or exchanged sells or exchanges the same property at a gain, the

90. *Id.* at (b).
91. *Id.*; Treas. Reg. § 1.267(a)-1 (1960).
92. Treas. Reg. § 1.267(a)-1(c) ("Section 267(a) requires that deductions for losses or unpaid expenses or interest described therein be disallowed even though the transaction in which such losses, expenses, or interest were incurred was a bona fide transaction.").
93. Hassen v. Comm'r, 599 F.2d 305, 305 (9th Cir. 1979).
94. § 267(b)(13).
95. § 267(a)-1.
96. *Hassen*, 599 F.2d at 305.
97. I.R.C. § 1001(a) (2006).
98. I.R.C. § 1011 (2006).
99. *See* I.R.C. § 1012 (2006) (cost basis); I.R.C. § 1014 (2006) (stepped-up basis).
100. I.R.C. § 1016(a)(1) (2006); *see supra* Part III.
101. *See supra* Part III.

gain will be recognized only to the extent it exceeds the loss originally denied by reason of the related parties rules.[102]

A simple example demonstrates how this section applies. Assume that a father sells stock with a basis of $800 to his daughter for $500. Father and daughter are related parties so § 267 disallows the $300 loss to the father. Daughter later sells this stock for $1,000. Although daughter's realized gain is $500 ($1,000 minus $500—her basis), her recognized gain under § 267(d) is only $200, the excess of the realized gain of $500 over the loss of $300 (the carried forward loss) not allowable to her father.[103]

This reduction of gain applies to a sale or exchange of the property only if there is a gain to be reduced.[104] For example, taking the facts from above, assume that the daughter sold the property for $300 instead of $1000. Under § 267, the daughter still has $300 of disallowed loss that the statute carries forward from the original sale from her father. However, because the daughter subsequently sold the property for a loss, that $300 of disallowed loss has nothing to offset. Therefore, instead of receiving a $500 loss ($200 for the loss and $300 from the disallowed § 267 loss), the daughter is only entitled to a loss of $200.[105] The daughter cannot take a $300 loss from the original sale between her and her father.[106]

The general rule only benefits the original transferee; it does not apply to any original transferee (e.g., a donee) who uses any means other than purchase or exchange to acquire.[107] Assume the same facts from above except that the daughter transferred her stock as a gift to an unrelated taxpayer. For the purpose of determining gain, § 1015 states that the basis of the stock in the hands of the unrelated taxpayer is the same as the daughter's, $500.[108] If the unrelated taxpayer later sells the stock for $1,000, the IRS will tax the entire $500 gain to him or her.[109]

These examples demonstrate that there is no guarantee the IRS will ever allow an offset when property is later sold or exchanged. If the property is later sold for a loss or inherited by a new party, the original disallowed loss will

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102. Treas. Reg. § 1.267(d)-1(a)(2) (2012) ("The general rule is also applicable to a sale or other disposition of property by a taxpayer when the basis of such property in the taxpayer's hands is determined directly or indirectly by reference to other property acquired by the taxpayer from a transferor through a sale or exchange in which a loss sustained by the transferor was not allowable. Therefore, section 267(d) applies to a sale or other disposition of property after a series of transactions if the basis of the property acquired in each transaction is determined by reference to the basis of the property transferred, and if the original property was acquired in a transaction in which a loss to a transferor was not allowable by reason of section 267(a)-(1) (or by reason of section 24(b) of the Internal Revenue Code of 1939).").

103. Treas. Reg. § 1.267(d)-1(a)(4) Example 1 (2012).

104. *See id.*

105. *Id.* at Example 2.

106. *Id.* at Example 2.

107. *Id.* at (a)(3).

108. *See* I.R.C. § 1012 (2006).

109. Treas. Reg. § 1.267(d)-1(a)(4) Example 1 (2012).

never be allowed.[110] Even if the IRS later allows an offset on a subsequent sale of the property, a current deduction will almost always be better than an offset years later.[111] Because the carried forward loss is never guaranteed, especially in this unique situation of a child buying the family home from the estate, it would be preferable for the estate to take the loss currently.

B. History of § 267

Congress gradually enacted § 267 to respond to attempts to circumvent the tax code.[112] As Congress found more ways that taxpayers were circumventing the Code, it added more definitions of "related parties" to counter those tax evasion efforts.[113] However, § 267 has always been about denying deductions to funds that related parties retained control over so that taxpayers could not recognize "paper" losses.[114]

Before 1934, a taxpayer could transfer property to a related person and deduct any resulting losses.[115] Taxpayers took advantage of this tax loophole.[116] For example, in *Mitchell v. Commissioner*, Henry Mitchell sold 300 shares of stock to his wife at a loss and deducted the loss on his income tax return.[117] The IRS disallowed the loss, claiming that:

> [T]he sale and repurchase of the securities . . . does not constitute a loss . . . . While a theoretical or paper loss may have been sustained, there was no actual loss in the amount claimed. Actually you [the taxpayer] were not poorer . . . after the transactions had been completed. During the entire period the stocks were listed in your wife's name they were serving the same purpose they were before . . . .[118]

The court held that "a sale of shares of stock by a husband to his wife is not to be treated differently from a sale by a husband to any other person. If, on such a sale, a loss is sustained the amount thereof is deductible from gross income."[119] Therefore, because Mitchell completed the sale in good faith and was bona fide, the court allowed the deduction.[120]

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110. *Id.*
111. *Id.*
112. *See* I.R.C. § 267 (2006).
113. *See* Comm'r v. McWilliams, 158 F.2d 637, 638–40 (6th Cir. 1946).
114. *See* Comm'r v. P.G. Lake, Inc., 356 U.S. 260, 265 (1958).
115. *See Income Taxes-Joint Returns-Losses Sustained by Husband from Sale of Capital Assets Held Deductable in a Joint Return from Gains of Wife From Similar Sales*, 53 HARV. L. REV. 681, 681–82 (1940).
116. *See, e.g.*, Mitchell v. Comm'r, No. 80868, 1937 WL 6805, Findings of Fact no. 3–9, Opinion ¶¶ 2, 5–8 (B.T.A. Dec. 23, 1937).
117. *Id.* at Findings of Fact no. 3.
118. *Id.* at Opinion ¶ 2.
119. *Id.*
120. *Id.* "The only question involved in the case is whether a certain transfer of securities made by the plaintiff to his wife was made in good faith and was a bona fide sale." *Id.*

Based on the tax avoidance strategy employed in *Mitchell* and similar schemes, Congress enacted legislation to close that loophole.[121] In 1934, Congress enacted § 24(a), which disallowed deductions on sales or exchanges of property between related individuals.[122] The first statute that Congress enacted only applied to sales or exchanges between members of a family and between individuals and corporations when such individuals owned more than 50% of the value of the outstanding stock.[123]

Just three years later, in 1937, Congress amended § 24(a) of the 1934 Act.[124] It added what are the modern subsections of 267(b)(4)–(6), with the definition of "related parties" extending to a number of trust situations.[125] In 1954, § 24 was recodified as § 267.[126] The designated related party relationship expanded to those described in current sections (b)(1)–(9).[127] Subsection (d) was also added, making the disallowed loss a possible offset against the gain from future sales.[128]

In 1963, before subsection (b)(13) was added, the courts had to determine whether a transfer from an estate to a beneficiary could be properly classified as a transfer between related parties.[129] In *Estate of Hanna v. Commissioner*, Ruth Hanna died intestate on July 4, 1955.[130] Her gross estate included 2,500 shares of The Leader Building Company stock.[131] "Natalie Hanna Marvin, Charlotte Hanna Royce and Mary Hanna Ross were sisters of the decedent," and each owned approximately one-fourth of The Leader Building Company.[132] The decedent's sisters had options to purchase the stock but did not exercise their options.[133] Beginning in 1956, the company redeemed 1,153 shares of its stock from the estate.[134] The three sisters split 450 shares through intestacy, and "the remaining 897 shares were subsequently surrendered to the company upon its complete liquidation."[135] The estate claimed losses on its income tax return

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121. Jacob Stewart Seidman, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 317 (2003); *see also* I.R.C. § 24 (1934).

122. Revenue Act of 1934, H.R. 7835, 73d Cong., 2d Sess. 1934 (enacted).

123. I.R.C. § 24(a)(6) (1934) ("Loss from sales or exchanges of property, directly or indirectly, (A) between members of a family, or (B) except in the case of distributions in liquidation, between an individual and a corporation in which such individual owns, directly or indirectly, more than 50 per centum in value of the outstanding stock. For the purposes of this paragraph—(C) an individual shall be considered as owning the stock owner, directly or indirectly, by his family; and (D) the family of an individual shall include only his brothers and sisters (whether by whole or half blood), spouses, ancestors, and lineal descendants.").

124. *Id.*

125. Revenue Act of 1937, H.R. 8234, 75th Cong., 1st Sess. 1937 (enacted).

126. I.R.C. § 267 (1954).

127. *Id.*

128. *Id.*

129. *See, e.g.*, Estate of Hanna v. Comm'r, 320 F.2d 54, 56–57 (1963).

130. *Id.* at 55.

131. *Id.*

132. *Id.*

133. *Id.*

134. *Id.*

135. *Id.*

resulting from the redemption of the stock.[136] The Commissioner disallowed the loss claimed in 1958 because the "amounts deducted as losses arose from transactions between related parties, which were not deductible within the provisions of section 267."[137] The Commissioner argued that

> The disallowance of the loss . . . was under Section 267(b)(2) which disallows a loss resulting from a sale or exchange of property between an *individual* and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual. Although the sale or exchange was between an *estate* and a corporation, instead of between an *individual* and a corporation as specified in the statute, the Commissioner contends that under Section 267(c)(1) the stock owned by the estate is considered as being owned by the beneficiaries of the estate, and under Section 267(c)(2) and (4) an individual is considered as owning the stock owned by or for his family, which includes sisters. The net result of this reasoning is that the stock was sold by a sister, who was an individual rather than an estate, and that such sister, being considered as owning the stock of the other sisters, owned more than 50 percent of the outstanding stock of the redeeming corporation.[138]

"The Tax Court adopted this reasoning and" disallowed the loss deduction.[139] However, the decision was reversed on appeal.[140] The court reasoned that "under Section 267(a) and (b) losses resulting from sales or exchanges of property, otherwise deductible, are disallowed *only* if such sales or exchanges are between specified persons."[141] Because the sale was not between an individual and a corporation in which 50% of the value of outstanding stock was owned directly or indirectly by or for an individual and his family, the statute did not cover the sale by an estate that was clearly different from an individual.[142]

Even though the IRS lost this case in 1963, Congress did not amend § 267 until 1997 to remove the estate transfer loophole.[143] At that time, Congress added subsection (b)(13) to the definition of related parties: "No deduction shall be allowed . . . [e]xcept in the case of sale or exchange in satisfaction of a

136. *Id.*
137. *Id.* at 56.
138. *Id.* at 56–57.
139. *Id.* at 57.
140. *Id.*
141. *Id.*
142. *See id.* (citing Estate of Charles C. Ingalls v. Comm'r, 45 B.T.A. 787, 792 (1941)).
143. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1308(a).

pecuniary bequest, [between] an executor of an estate and a beneficiary of such estate."[144]

Appellate courts have rarely ruled on the application of (b)(13). However, the Tax Court has held that the sale of a residence between an estate and a child-beneficiary is a covered transaction.[145] In *Schneider v. Commissioner*, the Tax Court applied subsection (b)(13) dealing with transfers between estates and taxpayers.[146] In that case, the taxpayer was denied the first time homebuyer's credit under § 36 because of the application of § 267.[147] No first time homebuyer's credit is allowed if the purchase is between related persons.[148] The statute holds that a person shall be treated as related to another person if the relationship between such persons "would result in a disallowance of losses under [§ 267]."[149] In *Schneider*, a daughter purchased a residence from her mother's estate.[150] She took the credit on her tax return, and the Commission denied her deduction because it was between related persons as defined by § 267(b)(13).[151] From this case, it is apparent that § 267(b)(13) applies to the sale of a residence from an estate to a child-beneficiary.[152]

C. Intent Behind § 267

Congress passed the predecessor to § 267 in order to thwart the type of transaction described in *Mitchell*, where a husband sold his stock to his wife to claim a loss but continued exercising control over it.[153] This shifting of income to create paper losses was a major concern of Congress.[154] For example, while debating the early versions of this provision, Mr. Doughton of North Carolina discussed transactions between related taxpayers: "Many instances have been brought to light where transactions of this character have taken place for the sole purpose of avoiding payment of taxes, and it is believed that the suggested change will effectively close this loophole."[155]

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144. I.R.C. § 267(a)(1), (b)(13) (2006).
145. Schneider v. Comm'r, T.C. 2011-72, 2011 WL 2460960, at *2 (June 16, 2011).
146. *Id.* at *1.
147. *Id.* at *2–3.
148. *Id.*
149. *See* I.R.C. § 267(f)(4) (2006).
150. *Schnieder*, 2011 WL 2460960, at *1.
151. *Id.* at *1–2.
152. *See id.*
153. Mitchell v. Comm'r, No. 80868, 1937 WL 6805, at Findings of Fact no. 3–9 (1937).
154. H.R. Rep. No. 73-704, at 23 (1934) ("Experience shows that the practice of creating losses through transactions between members of a family and close corporations has been frequently utilized for avoiding the income tax. It is believed that the proposed change will operate to close this loophole of tax avoidance.").
155. SEIDMAN, *supra* note 121 (quoting Cong. Rec. Vol. 78 (1934)). Senator Harrison stated, "In several recent cases losses of this character have proved to be an important method of tax avoidance." *Id.* Rep. Samuel B. Hill noted, "[W]e have removed the temptation from tax dodgers who transfer securities or other property from one member of a family to another in order to deduct a capital loss against ordinary income." *Id.*

Along with the worry over paper losses, Congress was also concerned about how the IRS did not have the relevant information to determine if a transaction was a bona fide, arm's length transaction.[156] A 1934 Ways and Means Committee report illustrates the concern:

> This provision [§ 267] of existing law is not exclusive and the Government may still deny losses in the case of sales or exchanges not specifically covered thereby (for instance, between uncle and nephew) if such sales or exchanges are not bona fide. *However, because the evidence necessary to establish the fact that a sale of exchange was not made in good faith is almost wholly within the knowledge of the person claiming the deduction, the Government has encourage considerable difficulty in sustaining the disallowance of the deduction in a great many cases*. Moreover, the specific provisions of section 24(a)(6) of existing law have provided inadequate to meet many situations of this type. Accordingly, your committee proposes the amendment of this section to provide certain additional restrictions on deductions of this character. However, as in the case of the provisions of existing law, it is not intended by this amendment to imply any legislative sanction of claiming deductions for losses on sales or exchanges in cases not covered thereby, where the transaction lacks the elements of good faith or finality, generally characterizing sales and exchanges of property.[157]

The government was correct in worrying that too great a burden would be placed on the IRS and the courts to determine whether each transaction between related parties was bona fide or not. IRS agents could not possibly handle all of their other duties as agents, as well as determine whether certain transactions between private individuals who were familiar with each other and who had nearly all of the relevant information were an arm's length transaction. To solve this problem, the government made it a per se, non-refutable rule that any transaction between related taxpayers was disallowed a loss.[158] Congress denied deductions for losses on all sales or exchanges between related persons, regardless of such persons' subjective intent.[159] It was and still is immaterial whether the particular transaction involved is a bona fide, arm's-length transaction.[160] It seems to be a rule of convenience for the government. Courts have routinely cited this intent when deciding cases involving § 267 and have denied deductions in those cases.[161]

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156. *Id.*

157. *Id.* at 198–99 (quoting H.R. Rep. No. 7-1546 (1934)) (emphasis added).

158. *See* I.R.C. § 276(a)(1), (b) (2006).

159. *See* Treas. Reg. § 1.267(a)-1(c) (1960).

160. *Id.*

161. *See, e.g.*, Nationwide Corp. v. United States, No. 68-98, 1972 WL 409, at *2 (Apr. 5, 1972) ("The entire decisional and legislative history behind the present Section 267 manifests the Congressional purpose to avoid transfers between members of families motivated solely by a desire to establish deductible losses. The Code seeks to put an end to the right of taxpayers to choose by intrafamily and other devices the time for realizing tax losses on investments which for the most practical purposes are continued uninterrupted."); *see also* McWilliams v. Comm'r, 331 U.S. 694, 699 (1947). The absence of a tax avoidance motive, however,

D. A Unique Situation Calls for an Exception

Based on the mechanism for deducting closing costs, the history of § 267, and the intent of disallowing these related party transactions, a current deduction should be allowed for closing costs. This should be done if the estate sustains a loss on the sale or exchange of property to a beneficiary. A sale of property from an estate creates a unique opportunity for the IRS to quickly and efficiently verify the loss on the property. Because of the step-up in basis, the taxpayer does not have to document the years of modifications to the basis because it is reestablished at the fair market value on the date of death.[162] With this ease, and based on the intent of Congress, closing costs incurred against non-related parties should currently be deductible because those costs are more closely related to taxes (which are deductible), than to payments made to a related party (which are not deductible).[163] This is not to say that all of the loss should be deductible, rather only that part of the loss attributed to actual money paid to a non-related party.

Current funds transferred to non-related parties should be deductible. Whether a source is a non-related party should be determined based on the list of related parties under § 267(b).[164] For example, if the parties use a real estate broker that is not a related party under § 267(b) those closing costs should be deductible. However, if that same real estate broker is a related party as defined by § 267(b), then those expenses should not be deductible because of the intent of § 267 to disallow losses between related taxpayers. Suffice it to say, this exception to § 267 would not apply to the portion of any losses incurred as a result of a reduced price paid by a beneficiary to the estate.

1. Step-up in Basis

The main distinction of the sale of property from an estate to a beneficiary (as opposed to a sale from one related party to another during their lives) is that at the death of the individual who owns the property, the property receives a step-up in basis.[165] This means, most likely, the only modification to the basis of the estate will be the closing costs of selling the property to a beneficiary. Documentation of those expenses from the estate can be easily obtained and

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will not affect the operation of section 267. *See* Merritt v. Comm'r, 400 F.2d 417, 421 (5th Cir. 1968); Inv. Research Associates, Ltd. v. Comm'r, 78 T.C.M. (CCH) 951, 1125 (1999), *vacated and amended sub nom* by Ballord v. Comm'r, 429 F.3d 1026, 1032 (11th Cir. 2005) (vacated and amended based on the Tax Court's use of Tax Court Rule 183).

162. I.R.C. § 1014 (2006).

163. *See Closing Costs in a 1031 Exchange*, FIRST AMERICAN EXCHANGE COMPANY, http://firstexchange.com/closing-costs-in-an-exchange (last visited Mar. 30, 2012).

164. I.R.C. § 267(b) (2006).

165. I.R.C. § 1014(a) (2006) ("In general . . . [e]xcept as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be . . . (1) the fair market value of the property at the date of the decedent's death[.]").

easily verified by the IRS. This is especially true when compared with a piece of property that has had its basis modified under § 1016 many times over the years. Verifying that information could be difficult and time consuming for the IRS and the taxpayer.

Section 267 denies a deduction even if it is an arms-length transaction.[166] State probate laws require the administrator to conduct each deal as an arm's-length transaction or the administrator will be in violation of the law.[167] Based on the discussion in Part III, by its very definition, the transaction between administrator and beneficiary will be fair assuming the Administrator is not a related party. Describing a fair transaction is fact-specific, and the IRS does not have the resources to verify each of these related party transactions.[168] However, if the only required examination involves verifying the closing costs, then the IRS's job is not difficult or time-consuming. When the IRS audits these returns, it could do so by mailing a request to obtain the receipts and bills from any costs paid out to non-related parties. The taxpayer could submit those documents, if required, and the process of confirming that information should be easy and quick for the IRS.

2. More Similar to Taxes

Examining the treatment of closing costs against taxes when an estate sells property juxtaposes their unequal treatment. Closing costs, like real estate taxes, are transferred away from the store of family wealth.[169] However, while the real estate property taxes are currently deductible by an estate, the closing costs may not be if the property is sold to a related party.[170] When the estate sells the residence to a beneficiary, the taxes for the year may be apportioned between the two parties. Normally, the taxes are apportioned according to the number of days that each party held the property.[171] The taxes are then apportioned to the seller up to the date of sale and to the buyer beginning with the date of sale.[172] For example, if the property sells on July 1, each party will hold the property for 6 months and split the property taxes 50/50.[173] The estate would be responsible and would pay half of the property taxes.[174] A non-related party—the local county or town where the real estate is located—will receive the payment.[175]

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166. *See* I.R.C. § 267 (2006).

167. Waterman's Estate v. Comm'r, 195 F.2d 244 (1952), *rev'd*, 16 T.C.M. 467 (1951).

168. *See generally supra* Part IV.

169. I.R.C. § 691(b) (2006).

170. *Id.*

171. *See* Nancy Ann Connery, *The "How To" Manual for Closing a Residential Sale*, 43 PLI/NY 391, 466 (1999).

172. *Id.*

173. *Id.*

174. *See id.*

175. *See* Wenona Whitfield, *Survey of Property Law*, 23 S. ILL. U. L.J. 1221, 1240 (1999).

A taxpayer can deduct property taxes regardless of whether a related party purchases the property.[176] Section 267 only applies to deducting capitalized expenses.[177] Capitalized payments do not include payments made to cover current taxes; therefore, these expenses are taken during the year paid.[178] While a taxpayer can deduct the taxes immediately, closing costs incurred—even if made to a non-related party—are capitalized and thus are not currently deductible.[179]

Closing costs could include commissions paid to real estate agents, physical inspections of the property, escrow fees, and title inspections.[180] A taxpayer can make these payments to multiple non-related parties, which may include expenses necessary to sell the property, and the taxpayer can divert all funds from the family wealth.[181] Even if these expenses are paid to a non-related party, they are not deductible under § 267.[182] The legislature adopted § 267 to prevent taxpayers from shifting income between parties in order to garner tax advantages while still maintaining control over the transferred funds as in *Mitchell*.[183] In a situation where funds are being transferred away from the family, such as taxes and closing costs, then a deduction should be allowed because those funds are no longer part of the family wealth.

3. Example of Martha Jones

Returning to the original example involving Martha Jones illustrates the proposed deduction.[184] Recall that Martha Jones died intestate.[185] Her estate included her primary residence with a fair market value at death of $400,000, and her administrator wished to sell the residence to her daughter-beneficiary Jenny.[186] Assume that the net sales price is $380,000. A real estate broker, a non-related party, who will take a 6% commission on the sale, $22,800, represents the estate. The estate will also have to pay $2,000 of real estate taxes on the property. Jenny owns a title inspection company that will be paid $500 for its title inspection work on the property.

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176. *Cf.* I.R.C. § 267(b) (2006) (explaining what qualifies as a related party with respect to deductions under section 267).

177. Megibow v. Comm'r, 21 T.C. 197, 197 (1953) (stating that "real estate taxes . . . paid on property while it was being used and occupied regularly as a residence are deductible as paid and are not carrying charges to be capitalized as a part of the cost of the property").

178. *Id.* at 198.

179. *See supra* Part II.

180. *See generally Closing Costs Explained*, HOME CLOSING 101.ORG, http://www.homeclosing101.org/costs.cpm (last visited Feb. 12, 2012).

181. *See id.*

182. *See* I.R.C. § 267 (2006).

183. *See* Mitchell v. Comm'r, No. 80868, 1937 WL 6805, at Findings of Fact (Dec. 23, 1937).

184. *See* discussion *supra* Part I.

185. *See* discussion *supra* Part I.

186. *See* discussion *supra* Part I.

With our current tax code, the closing costs would be added to the fair market value at death basis of $400,000, to be adjusted to $423,300. The real estate taxes of $2,000 are currently deductible separate from the loss on the property. This begs the question—What about the loss of $43,300 ($423,300 - $380,000)? By applying § 267, the IRS disallows all of the loss on the property this year because the sale was between related parties: the estate and a beneficiary.[187] The basis in the property would be $380,000, with a carried forward loss of $43,300 that Jenny could take in the future if she sold the property for a gain. If Jenny made this real estate her new primary residence and then sold it two years after living there, or if she died and transferred it on her death, then she would never take the carried forward loss.[188] In this situation, a large loss to an individual would be disallowed because of the rigid mechanics of capital expenditures, even though the intent of § 267 does not apply to the entire loss.[189]

The calculation would be different with this article's proposed exception. The adjustments to the basis would be the same. The loss would equal $43,300, but a part of that loss would be currently deductible. Any amount that the estate transferred to a non-related party would be deductible in 2011.

In this example, the amount paid to the real estate broker was made to a non-related party: that is, a party not covered in § 267(b).[190] Those funds are no longer part of the family wealth and, thus, no longer covered by § 267's intent.[191] Congress was worried about dealing with the problem in *Mitchell* where the family would create a paper loss, but would keep real control over the property.[192] The family no longer has control over those funds, as demonstrated by the chart below. However, the costs paid to the title inspection company would be paid to a related party—a company owned by Jenny.[193] This means that the $22,800 (commission) would be currently deductible, but the $500 (title inspection) would still be carried-forward with the rest of the loss that was not attributed to the closing costs. In the end, the estate would deduct the $2,000 for taxes and the $22,800 for commissions. The basis in the property would be $380,000 and the carry-forward disallowed loss would be $20,500 ($43,300 - $22,800). The $20,500 represents $20,000 for a reduced price paid by the daughter-beneficiary below fair market value, and the $500 represents funds paid to the title inspection company, which are both transfers between related parties. The chart below demonstrates this result: monies paid

187. *See* § 267.

188. *See* I.R.C. § 121 (2006). If Jenny was married, section 121 allows $500,000 of gain to be unrecognized on the sale of the primary residence or $250,000 if she is not married. *Id.* If Jenny transfers the property on death, then the carried forward loss does not apply. *Id.*; *see also* § 267(d).

189. *See* § 267.

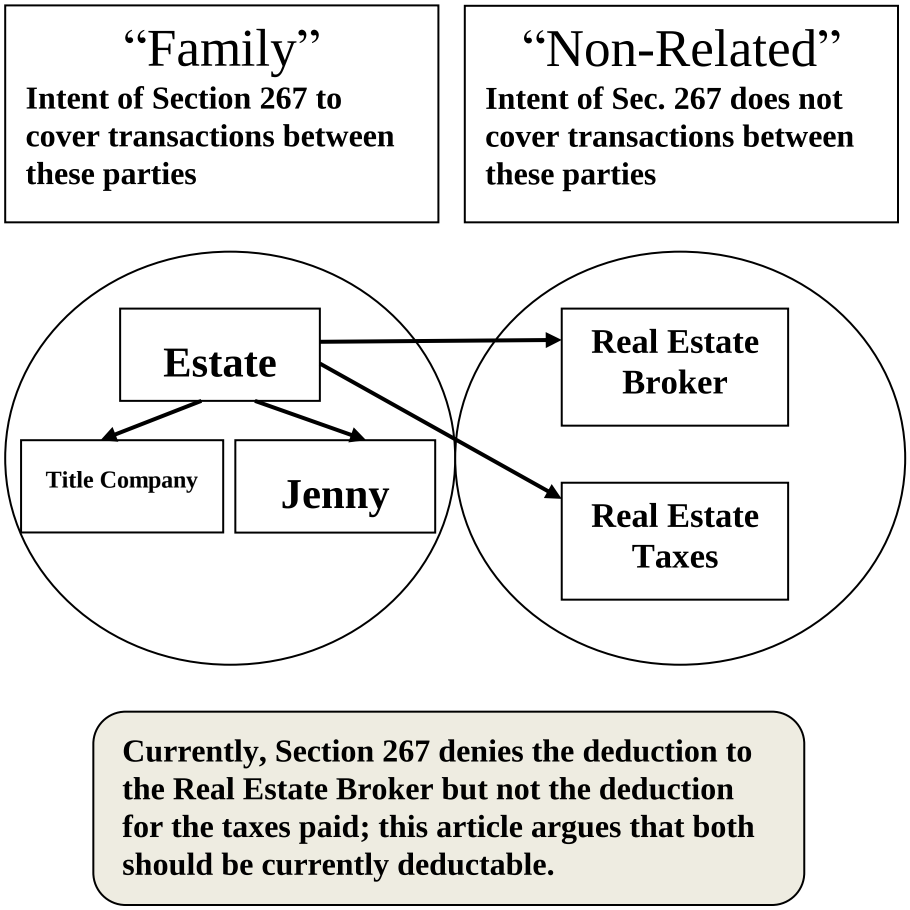
190. *See id.*

191. *See id.*

192. *See supra* notes 114–19.

193. § 267(b)(2) (disallowing deduction of the costs).

to related parties should not be deductible under § 267 and monies paid to non-related parties should be.



The true paper losses could be increased or decreased at the whim of the family, but that does not affect the analysis of this paper. For example, Jenny could pay the estate only $300,000 to purchase the property. This would create a much greater paper loss for the family. The commission would be reduced to $18,000, and the inspection would remain at $500. In this case, the family would be disallowed a much greater loss under § 267 (under either the current section or with this article's proposed exception), but the commission paid would still be removed from the family wealth and is not a paper loss.[194] This example demonstrates that the price the family member could pay may fluctuate, and that the paper loss could be large or small. But the funds

194. *See* § 267.

transferred to non-related parties should still be deductible, no matter the size of the paper loss.

In this case, the taxpayer receives a deduction for assets that are no longer in the family. Funds that remain within the family—the funds paid from beneficiary to estate and paid from estate to the title inspection company—are not deductible because the logic and policy of § 267 applies.[195] The intent of § 267 does not apply to funds that are paid to a non-related party; these amounts are only disallowed a deduction because of the mechanical implementation of capital expenditures and how it relates to § 267.[196] The exception to § 267 to allow this sort of loss matches with § 267's intent.[197]

V. CONCLUSION

Congress enacted § 267 to deal with taxpayers who created paper losses while keeping the transferred property within the family, as defined with reference to the definition of "related parties."[198] Only because of the strict mechanics of the capital expenditures rules are closing costs disallowed.[199] The intent of § 267 does not apply if money is being diverted away from the taxpayer and his family and to a third party via closing costs.[200] In those instances, and those instances alone, the taxpayer should be allowed a current deduction.[201] The intent of § 267 does not apply because closing costs are not a paper loss but are funds that are no longer available to the family.[202]

195. *See id.*; *see also* Part IV.C.
196. *See* § 267; *see also supra* Part IV.C.
197. *See* § 267; *see also supra* Part IV.C.
198. *See supra* Part IV.C.
199. *See supra* Part II.
200. *See supra* Part IV.D.
201. *See supra* Part IV.D.
202. *See supra* Part IV.D.