CHAPTER 9

Real Estate Dealer vs. Investor: Maximizing Capital Gains

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§ 9.07 Appendix A

§ 9.01 INTRODUCTION

[1] Tax Stakes: Capital Gain v. Ordinary Income

[a] Rate Differential

[i] Historic Rate Differential

Appendix A sets forth a table that compares the maximum federal income tax rates on ordinary income and capital gains since 1916.

[ii] Undeveloped Real Property

If a taxpayer sells undeveloped real property which has been held for more than one year, then the gain is subject to a maximum federal capital gain rate of 15% if the land constitutes a "capital asset" within the meaning of Section 1221. On the other hand, if the land constitutes "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" or otherwise constitutes property that is "properly included in inventory," so-called "dealer property," then the gain is subject to a maximum federal income tax rate of 35%.[1] Moreover, gain from dealer property is generally subject to self-employment taxes, whereas capital gain property generally is not.[2]

[iii] Depreciable Real Property

Gain on the sale of depreciable real property held for more than one year may be subject to three different tax rates: (i) depreciation recapture taxed as ordinary income at a maximum rate of 35%; (ii) unrecaptured Section 1250 gain taxed at a maximum rate of 25%; and (iii) long-term capital gain taxed at a maximum rate of 15%.[3] To illustrate, assume Taxpayer sells a building for $10 million that he purchased for $5 million in December 2005. During this time, Taxpayer has recognized $2 million in depreciation, $500,000 of which exceeded the amount allowed under the straight-line method (for example, because of "bonus depreciation" claimed and allowable under the Hurricane Katrina relief provisions in Section 1400N). Under these facts, Taxpayer recognizes a $7 million gain, taxed as follows: (i) additional depreciation of $500,000 is taxed as ordinary income, (ii) unrecaptured Section 1250 gain of $1.5 million is taxed at 25%, and (iii) the remaining $5 million is long-term capital gain taxed at 15%.

[b] Look-Through Capital Gain Rules

[i] Sale of Partnership Interest

Under Section 741, the gain or loss resulting from the sale or exchange of a

[1] Compare IRC § 1(a) with IRC § 1(h).

[2] See IRC § 1402(a)(3)(A).

[3] See IRC §§ 1(h)(1)(D), 1(h)(6), 1250.

partnership interest is generally capital in nature. Under the look-through capital gain rules, if the selling partner held his partnership interest for more than year, one of three long-term capital gains rates may apply: 15%, 25% (unrecaptured Section 1250 gain), or 28% (collectibles gain).[4]

[A] Unrecaptured Section 1250 Gain

If a partnership (or limited liability company classified as a partnership for federal income tax purposes) owns depreciable real property, the look-through capital gain rules allocate a proportionate share of the unrecaptured Section 1250 gain to the selling partner.[5] However, the regulations specifically provide that on a redemption of a partner's interest in a partnership, the redeemed partner will ***not*** pick up his proportionate share of the unrecaptured Section 1250 gain, and as such, the remaining partners will still be subject to all of the unrecaptured Section 1250 gain on a subsequent disposition of the property. Consequently, structuring a transaction as a sale of a partnership interest versus a redemption of a partnership interest can have significant tax effects with respect to the unrecaptured Section 1250 gain inherent in any of the partnership's property.

[B] Ordinary Income

Additionally, Section 751 (the collapsible partnership provision) may treat a portion of the gain attributable to inventory and unrealized receivables (so called "hot assets") as ordinary income.

[ii] Sale of S Corporation Shares

The capital gains look-through rule provides that when a taxpayer sells stock in an S corporation held for more than one year, the taxpayer may recognize ordinary income under Sections 304, 306, 341 and 1254; collectibles gain; and long-term capital gain.[6]

[A] No Unrecognized Section 1250 Gain Look-Through

Because the look-through capital gain rules applicable for S corporations do ***not*** include unrecaptured Section 1250 gain, no portion of the taxpayer's gain on the sale of the S corporation stock will treated as attributable to unrecaptured Section 1250 gain.

[4] See IRC § 1(h); Treas. Reg. § 1.1(h)-1(a).

[5] Treas. Reg. § 1.1(h)-1(b)(3)(ii).

[6] Treas. Reg. § 1.1(h)-1(a).

[B] Collapsible Corporation

The Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA"),[7] repealed, albeit temporarily, the collapsible corporation rules (Section 341) for tax years beginning after December 31, 2002. Under the current sunset provisions, these rules will again apply to tax years beginning after December 31, 2010 (extended from 2008, by reason of Section 102 of the Tax Increase Prevention and Reconciliation Act of 2005). Thus, for at least the near future, the prospect of treating the gain on the sale of S corporation stock as ordinary income is greatly diminished.

[c] Character of Gain Depends upon Classification of Seller

As will be discussed in more detail below, the character of the gain (or loss) resulting from the sale of real estate depends upon the classification of the seller as an investor or dealer. For investors, the gain (or loss) is capital; for dealers, the gain (or loss) is ordinary. The central issue with respect to the sale of real estate is whether the sale is in the "ordinary course of a trade or business." In defining the term "capital asset," Section 1221(a)(1) expressly excludes inventory and property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. This determination focuses on the intent of the seller and the purpose for which the seller purchased the property. Other requirements, such as that sales be made to customers and that the property be "held primarily for sale," are relevant, but not necessarily dispositive, in characterizing gain (or loss) on the sale of real property.[8]

[d] Miscellaneous Other Special Capital Gain-Related Provisions

[i] Collectibles

Gain from the sale or exchange of "collectibles" is taxable at a maximum federal income tax rate of 28%.[9] "Collectibles" include works of art, antiques, rugs, metals, gems, stamps, coins, and other items specified by regulation.[10]

[ii] Capital Loss Deduction Limits

Non-corporate taxpayers may deduct up to $3,000 of net capital losses against ordinary income for any taxable year and carry any excess over to succeeding taxable years.[11]

[iii] Partial Exclusion for Small Business Stock

Section 1202 provides for an exclusion of fifty percent of any gain from the sale or

[7] Pub. L. No. 108-27.

[8] See §§ 9.02[1] and [2] *infra*.

[9] IRC § 1(h)(4), -(h)(5).

[10] See IRC § 404(m).

[11] IRC §§ 1211(b), 1212(b).

exchange of "qualified small business stock."

[iv] 5-Year Dealer Taint on Distributed Inventory Items from Partnership

Section 735 provides that if a partnership distributes "inventory items" (such as dealer property) to a partner, the dealer taint attributable to dealer property remains with the property for five years even if the distributee partner is not a dealer.

[v] Dealer Property Not Eligible for 1031 Exchange Treatment

In general, dealer property is not eligible for like-kind exchange treatment.[12]

[vi] Charitable Deduction Limitations for Dealer Property

Generally, the amount of a charitable deduction for long-term capital gain property is the fair market value of the property contributed. In contrast, a taxpayer is generally permitted to claim as a charitable deduction only his basis in dealer property and capital gain property held for one year or less, even where the fair market value of the property is higher than the taxpayer's adjusted basis.[13]

[vii] Utilization of Section 1031 Exchange in Order to Obtain Long-Term Holding Period

Short-term capital gains are generally subject to a maximum federal rate of 35%. In order to obtain a longer-than-one-year holding period on short-term capital gain property being disposed of by the taxpayer, often it is advisable to undertake a like-kind exchange in order to obtain a "tacked" holding period in the replacement property.[14] Upon the later sale of the replacement property, long-term capital gain rates may be available. Utilization of a like-kind exchange can achieve a permanent elimination of the rate differential. It is important to confirm that the requirements of Section 1031 are satisfied.

[viii] Section 121 Exclusion for Gain from Sale of Principal Residence

Section 121 provides for the exclusion of up to $500,000 in the case of joint returns, and $250,000 in other cases, of gain from the sale of a taxpayer's principal residence if the property was the taxpayer's principal residence for at least two out of the preceding five years. If the property was acquired pursuant to a like-kind exchange, there is a five year waiting period before becoming eligible to claim the benefits of Section 121.[15]

[12] IRC § 1031(a)(2)(A).

[13] IRC § 170(e)(1).

[14] See IRC §§ 1031(a), 1223(1).

[15] IRC § 121(h)(10).

important is the frequency and substantiality of the taxpayer's sales. The court went on to state that "when dispositions of ***subdivided property*** extend over a long period of time and are especially numerous, the likelihood of capital gain is very slight indeed."

[d] Broader Application

Although the Fifth Circuit's framework is binding only for those courts within that Circuit and the Eleventh Circuit, *see Bonner v. City of Prichard*,[17] this framework is nevertheless instructive in analyzing capital gain/dealer property issues in other jurisdictions.

[2] Specific Factors

As discussed above, in analyzing the issue of whether a taxpayer is a "real estate dealer" or a "real estate investor," the courts have examined the factors listed in the *Winthrop* case, which will be discussed in detail below.

[a] Nature and Purpose of the Acquisition of the Property and the Duration of the Ownership

[i] Nature of Acquisition

The first question with respect to this factor is what was the taxpayer's motivation in holding the property prior to the sale.[18] The course of conduct over a period of time, and not a pinpointed moment in time, is relevant.[19] A taxpayer should contemporaneously document the motivation for acquisition and any subsequent change of purpose. Often, it is advisable to review the name (for example, does the name contain the term "development" or similar words) and "purpose clause" of the organizational documents for the entity acquiring the property. The IRS and the courts consider such language relevant.

[ii] Original Purpose

A taxpayer's purpose for acquiring property establishes the taxpayer's primary purpose for originally holding the asset. Unless controverted by evidence of a subsequent change in purpose, the original purpose controls.[20] The cases indicate that it is more likely that a change will occur from holding as an investment to holding for sale to customers in a business than the opposite. Indications of a changed purpose

[17] *Bonner v. City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981).

[18] See *Daugherty v. Commissioner*, 78 T.C. 623 (1982) and *Biedermann v. Commissioner*, 68 T.C. 1 (1977).

[19] See, e.g., *Heller Trust v. Commissioner*, 382 F.2d 675 (9th Cir. 1967), *rev'g* 25 T.C. Memo (CCH) 634 (1966) and *Municipal Bond Corp. v. Commissioner*, 341 F.2d 683 (8th Cir. 1965), *rev'g* 41 T.C. 20 (1963).

[20] *Tollis v. Commissioner*, 65 T.C. Memo (CCH) 1951 (1995).

include significant improvements to the property or solicitations or advertising evidencing a motivation to sell to customers.[21]

[A] Dual Purpose

A dual purpose, however, is to be distinguished from a changed purpose since the determination of the primary motivation is to be made at the time of the disposition.[22] For example, where a taxpayer holds land primarily for investment, but incidentally for sale, this is distinguishable from the case where a taxpayer holds land initially for investment then changes his plans to hold the land primarily for sale.[23] In the first instance, the asset would not be excluded from capital asset status under Section 1221(a)(1), while in the second instance, if the sale is made to customers in the ordinary course of the taxpayer's trade or business, the Section 1221(a)(1) exception applies and any gain or loss is ordinary.

[B] Changed Purpose

Generally, where evidence of a changed purpose exists, an original investment purpose will be overridden unless the taxpayer can show "unanticipated externally induced factors which make impossible the continued pre-existing use of the realty."[24] Examples of such events include those rendering property unfit for its intended use,[25] as well as "Acts of God, condemnation of part of one's property, new and unfavorable zoning regulations, or other events forcing alteration of [a] taxpayer's plans."[26]

Illness and threat of foreclosure may also be included in the changed purpose exception. In *Herndon v. Commissioner*,[27] the taxpayer, a real estate dealer, sold certain subdivided farm property following the illness of his wife. The Court considered this factor in holding that the sale was for the purpose of liquidating the taxpayer's investment, and therefore was a capital transaction. In *Erfurth v. Commissioner*,[28] the taxpayer converted apartment units into condominium units and was allowed to report capital gain on the sale of the condominium units to the extent the

[21] See, e.g., *Jersey Land & Development Co. v. United States*, 539 F.2d 311 (3d Cir. 1976); *Reithmeyer v. Commissioner*, 26 T. C. 804 (1956); *Herzog Bldg. Co. v. Commissioner*, 44 T.C. 694 (1965); and *Ferguson v. Commissioner*, 53 T.C. Memo (CCH) 864 (1987).

[22] See *Bynum v. Commissioner*, 46 T.C. 295 (1966).

[23] See, e.g., *Biedenharn Realty Co., Inc. v. United States*, 526 F.2d 409 (5th Cir. 1975); and *Bynum v. Commissioner*, 46 T.C. 295 (1966).

[24] *Biedenharn Realty Co., Inc. v. United States*, 526 F.2d 409 (5th Cir. 1975).

[25] *Estate of Barrios v. Commissioner*, 265 F.2d 517 (5th Cir. 1959).

[26] See Kaster, "When Will the Liquidation-of-Investment Theory Apply to a Sale of Condominium Units?," 70 J Tax'n 46 (1989).

[27] 27 T.C. Memo 662 (1968).

[28] 53 T.C. Memo 767 (1987).

sales were made to remove the property from the threat of foreclosure. Gain from property which was not threatened by foreclosure had to be reported as ordinary income.

[iii] Duration of Ownership

Not all courts have identified the holding period as a factor. However, the courts that have considered it have generally indicated that holding an asset for a long period of time evidences an investment purpose.

The Supreme Court alluded to this in stating that the distinction between capital and ordinary gains and losses lay between "profits and losses arising from the everyday operation of a business on the one hand and the realization of appreciation in value accrued over a substantial period of time on the other."[29]

In *Pritchett v. Commissioner*,[30] the Tax Court, in allowing capital gains treatment for the taxpayer, emphasized that "th[e] lengthy retention of the property is indicative of [the taxpayer's] intention to hold it for investment purposes."[31]

[b] Number, Extent, Continuity and Substantiality of the Sales

Although the *Winthrop* case singled out this factor as the "preeminent factor," there is no bright line test as to how many sales are too many. In *Biedenharn*, the taxpayer made 934 sales of real property over a 43-year period and, in the three taxable years at issue before the court, the taxpayer had 37 separate sales, most of which consisted of individual single-family lots. The taxpayer in *Biedenharn* had also subdivided and improved its properties, including adding streets, sewers and utilities. The court has no problem in finding that under such circumstances, the taxpayer was a dealer in real property

Another major case addressing the frequency and substantiality of sales is the decision of the Fifth Circuit in *Suburban Realty Co. v. United States*.[32] In *Suburban Realty*, the taxpayer made five separate sales of ***undeveloped*** real property during the period 1968 through 1971. However, the court noted that the taxpayer in *Suburban Realty* had been engaged in the real estate business for 33 years which included at least 244 sales of real properties, a portion of which had been subdivided, developed and sold by the taxpayer. The court emphasized the preeminence of the frequency and substantiality of sales factor in making this determination but, most significantly, did so in the context of the ***entire 33-year operating history of Suburban Realty Co.*** rather

[29] *Malat v. Riddell*, 383 U.S. 569 (1966).

[30] 63 T.C. 149 (1974).

[31] See also *Municipal Bond Corp. v. Commissioner*, 382 F.2d 184 (8th Cir. 1967); and *Schueber v. Commissioner*, 371 F.2d 996 (7th Cir. 1967).

[32] See Note 16, *supra*.

than just focusing upon the three years at issue. Moreover, the taxpayer consistently characterized itself on its tax returns as being involved in the business of "development and sales of real estate" and initially reported the gain from the transactions in question as ordinary income. (This was later changed to long-term capital gain in an amended return.) Moreover, although the court emphasized the preeminence of the frequency and substantiality of sales factor, it made the following observation:

> However, substantial and frequent sales activity, standing alone, has never been held to be automatically sufficient to trigger ordinary income treatment. In fact, we have continual reminders of the fact that 'specific factors, or combinations of them are not necessarily controlling, . . .

The court in *Suburban Realty* ultimately held that gain derived from the sales by the taxpayer of the undeveloped properties were ordinary income, but also went to great lengths to point out that the analysis was not confined to the taxable years at issue but spanned thé entire history of the taxpayer's operations.

Another decision of the Fifth Circuit, *Byram v. United States*,[33] involved an individual taxpayer who during the years 1971 through 1973 sold 22 parcels of undeveloped real property. In the only year at issue before the court, the taxpayer sold seven properties, six of which were held for periods ranging from six to nine months (six months was the minimum holding period to obtain long-term capital gain treatment under the law in effect in 1973). The seventh property was held for two and one-half years. Moreover, the IRS pointed out that on at least two, and possibly three, instances, the taxpayer had already ***entered into contracts to sell the property before he had even closed on the purchase of the property***. The court noted that none of the properties sold was platted or subdivided and that the taxpayer had devoted only minimal time and effort to sales of the properties. The court stated that this was a very close case based upon the frequency and substantiality of the sales, but ultimately affirmed the decision of the district court below in holding that the taxpayer held the properties ***primarily for investment*** purposes and was, therefore, entitled to long-term capital gain treatment.

In another case, the court held that the taxpayer had ordinary income where the taxpayer has an average of 15 lot sales per year during a 5-year period.[34] On the other hand, one court has upheld capital gain treatment where the taxpayer sold 63 properties over more than 20 years.[35]

Another factor that courts have analyzed is the relative ratio of income from real

[33] 705 F.2d 1418 (5th Cir 1983).

[34] *Sanders v. Unted States*, 740 F.2d 886 (11th Cir. 1984).

[35] *Matz v. Commissioner*, 76 T.C. 465 (1988).

[3] Installment Reporting

[a] Eligibility and Basic Rules

Under the installment reporting method, a portion of each payment must be reported as income as received. The portion to be recognized as income is determined by multiplying the amount of payment by a fraction, the numerator of which is the "gross profit," and the denominator is the "total contract price" (*i.e.*, the "gross profit percentage").[47]

"Gross profit" is the selling price less the? adjusted basis in the property.[48] "Total contract price" is the selling price less "qualifying indebtedness" assumed or taken subject to by the buyer to the extent that such qualifying indebtedness does not exceed the basis.[49] Qualifying indebtedness generally means debt encumbering the property, subject to certain limitations.[50]

Installment reporting is mandatory unless the seller "elects out" under Section 453(d) by filing IRS Form 6252 with a timely filed return (including extensions) for the taxable year in which the closing takes place.[51] The election, once made, may not be revoked without the consent of the IRS.[52]

If there is any Section 1245 recapture, the entire amount of the recapture income must be recognized in the taxable year in which the closing occurs, regardless of the amount of payments received in such year.[53]

If the interest rate provided in the purchase money note is less than the applicable federal rate, a portion of the payments due under the note will be treated as original issue discount ("OID"), and both the timing and the amount of income to be reported by reason thereof will be governed by Sections 1272 through 1275. Limited relief from the general rules of Section 1274 is afforded under Section 1274A if the "stated principal amount" of the purchase money note does not either exceed the $2,800,000 threshold for Section 1274A(b) and the $2,000,000 requirement of Section 1274A(c).

If qualifying debt assumed or taken subject to exceeds the seller's? basis, such excess will be treated as an additional payment at closing.[54] Where several parcels are being sold, a question arises as to whether the sales will be viewed as separate or aggregated for purposes of this rule. Although the law on this issue is not entirely clear, aggregation of the sale of several parcels into a single sale may be permitted where the parcels are contiguous, they were offered as a unit, the contract and all closing documents treat them as a single unit, and they are also similar real properties.[55]

[47] Temp. Reg. § 15A.453-1(b)(2)(i).

[48] Temp. Reg. § 15A.453-1(b)(2)(v).

[49] Temp. Reg. § 15A.453-1(b)(2)(iii).

[50] See, Temp. Reg. § 15A.453-1(b)(2)(iv).

[51] Temp. Reg. § 15A.453-1(d)(3)(i).

[52] IRC § 453(d).

[53] IRC § 453(i).

[54] Temp. Reg. § 15A.453-1(b)(3)(i).

[b] Interest Toll Charge Applicable to Installment Sales

Section 453A(a)(1) imposes a toll charge in the form of interest on certain installment obligations arising during the taxable year.

The interest charge imposed under Section 453A(a)(1) applies to an installment obligation ("ISO") arising from a sale of property, but only if the selling price of the property exceeds $150,000.[56]

ISOs from the sale by an individual taxpayer of personal use property (as defined in Section 1275(b)(3)) and ISOs of any taxpayer arising from the sale of property used or produced in the trade or business of farming (within the meaning of Section 2032A(e)(4) or (5)) are ***not*** subject to the interest toll charge provisions.[57]

In addition, even if an ISO arises from the sale of property with a selling price in excess of $150,000, the interest toll charge will not apply to any such ISOs which are received by the seller during the tax year unless the face amount of all such ISOs which first arose in such tax year and which are still outstanding as of the end of such tax year exceeds $5,000,000.[58]

Once an ISO becomes subject to the interest toll charge imposed by Section 453A(a)(1), the charge will apply every year until the ISO is either fully paid or is otherwise disposed of to a third party.[59]

The method for computing the interest charge is set forth in Section 453A(c). The interest computation can be expressed as a formula as follows:

$$\begin{gathered}\text{Applicable Percentage} \times \\ \text{Deferred Tax Liability} \times \\ \text{Section 6621(a)(2) Under Payment Rate} = \text{Interest}\end{gathered}$$

The "Applicable Percentage" for the ISO is determined as of the close of the year

[55] *Compare*, *Veenkant v. Commissioner*, 416 F.2d 93 (6th Cir. 1969); with *Charles A. Collins*, 48 T.C. 45 (1967), *acq.* 1967-2 C.B. 2; and *Richard H. Pritchett*, 63 T.C. 149 (1974), *acq.* 1975-2 C.B. 2; and Rev. Rul. 76-110, 1976-1 C.B. 126.

[56] IRC § 453A(b)(1).

[57] See, IRC § 453A(b)(3).

[58] IRC § 453A(b)(2).

[59] See, IRC § 453A(c)(1).

$150,000 or less by non-dealers.[72] Ordinarily, non-dealers only pay the interest charge if (1) the taxpayer has installment obligations arising from the disposition of property in which the sales price exceeds $150,000 ("Section 453A obligations"), and (2) the face amount of all such Section 453A obligations held by the taxpayer at the close of the taxable year exceeds $5 million.[73]

[5] Rolling Options

[a] Description of Rolling Options

Rolling options may be used as an alternative to installment sales.[74] Under this approach, a sale of a parcel or parcels of property is divided into separate parcels which are designated as "Option Parcels." For purposes of this discussion, it will be assumed that the purchaser of the properties will develop them into a residential subdivision. The balance of the property to be sold may be earmarked for development into things such as a golf course, tennis center, marina and park, entryway and the principal access roads that will service the entire subdivision (the "Amenities Properties").

The purchaser initially pays the seller an agreed upon amount as consideration for an option to purchase the first Option Parcel and the Amenities Properties for a specified total purchase price, which option will remain open for a stated period of time. The period of time during which the option remains open is designed to enable the purchaser to pursue and obtain all necessary permits and approvals from federal, state and local governmental agencies to develop the property. If the option is exercised, the option monies will be applied against the purchase price for the first Option Parcel and the Amenities Properties. If the option lapses, the monies will be forfeited. The purchase prices for the remaining Option Parcels will also be agreed upon in advance as well as the time and sequence in which such options will be exercisable. The prices will be negotiated and will take into account the fact that the seller must hold these properties off the market during the applicable option periods and that the properties will appreciate in value both because of inflation and due to development of the contiguous properties.

At the time of exercise of the first Option Parcel and subsequent Option Parcels, the purchaser will also be required to pay an additional amount to the seller as consideration for the remaining options, which monies will also apply against the purchase prices of such Option Parcels if exercised or will be forfeited if the options are allowed to lapse. Once an option is exercised, the purchase price for such option parcel will be payable in cash at closing.

[72] IRC § 453A(b)(4).

[73] IRC § 453A(b). See discussion at § 9.02[3][b] above.

[74] The authors would like to acknowledge contributions by Charles H. Egerton to this section.

The rolling option alternative provides the purchaser with down side protection since it has the ability to walk away from the project at any point in time before fully exercising all of its options and thereby limit its costs to the properties previously purchased plus any forfeitable option monies paid for future options. Any costs associated with future options (*i.e.*, options that have not yet been exercised) generally should not need to be reflected as debts on the purchaser's balance sheet since there is no obligation for the purchaser to pay these amounts until the options are exercised.

Although the seller is called upon to assume an additional degree of economic risk under this proposal,[75] there are several aspects of the offer which are favorable to the seller. First, the total purchase price for the properties will likely be significantly higher. The seller should also retain the right to approve all preliminary and final land plans as well as overall development plans since these plans will impact the value of the seller's remaining properties if one or more of the options are not exercised. Further, even if the purchaser allows one or more options to lapse, presumably the value of any property that the seller will be left with will be enhanced in value by reason of the development of the contiguous properties. Finally, there are some significant tax advantages to the seller inherent in this proposal which will be discussed below.

[b] Tax Consequences of Rolling Options

[i] Option Monies

Despite the fact that the seller will have unrestricted use of the option monies from the point in time that the seller receives them, the seller will not be taxed on these amounts until the options to which they relate are either exercised or lapse.[76] The rationale behind these cases is that the taxability of the payments cannot be determined until the options either lapse or are exercised.

If an option is exercised and the option monies are applied against the purchase price, the monies will be treated as having been received in a sale or exchange of the option properties.[77] Even if the option monies are not applied against the purchase price, the Tax Court in *Koch v. Commissioner*[78] held that the same rule applies.

[75] Perhaps part of this economic risk could be offset by giving the seller a non-simultaneous "put option" to sell the property to the purchaser. See, e.g., *Penn-Dixie Steel Corporation v. Commissioner*, 69 T.C. 837 (1978).

[76] *Virginia Iron, Coal & Coke Co. v. Commissioner*, 37 BTA 195 (1938), *aff'd.*, 99 F.2d 919 (4th Cir. 1938), *cert. denied*, 307 U.S. 630; *Kitchin v. Commissioner*, 340 F.2d 895 (4th Cir. 1965); *Koch v. Commissioner*, 67 T.C. 71 (1976); *Hicks v. Commissioner*, 37 T.C. Memo 1540 (1978) and *Old Harbor Native Corporation v. Commissioner*, 104 T.C. 191 (1995).

[77] IRC § 1234(a)(1); Treas. Reg. § 1.1234-1(a).

[78] *Koch v. Commissioner*, 67 T.C. 71 (1976).

If the option lapses, the option monies must be reported by the optionor (the seller) in its taxable year in which the lapse occurred. Prior to September 4, 1997 such amounts were treated as ordinary income.[79] However, Section 1234A, which was added to the Code by the Taxpayer Relief Act of 1997 ("TRA 97") now provides that any gain arising from a lapse or other termination of a "right" with respect to property which is a capital asset in the hands of the taxpayer will be treated as gain from the sale of a capital asset. An option will presumably be treated as a "right" with respect to property. A question now arises as to whether this change in character from ordinary to capital undermines the rationale of *Virginia Iron, Coal & Coke Co.*

[ii] Installment Reporting

If the rolling option transaction is properly structured and constitutes a true series of options, the installment sale provisions, including the interest toll charges and pledging rules of Section 453A, should not apply. Moreover, to the extent that any depreciation recapture may be inherent in the property under Section 1245, the acceleration of gain attributable to this depreciation recapture under Section 453(i) would also not apply.

[iii] Capital Gains

If the property has been held by the seller for investment purposes, all the gain from the sale of the property should be taxed as long term capital gains. The IRS, however, may argue that a portion of the option prices should be recharacterized as ordinary income on the grounds that disguised interest is built into these option prices.

The IRS has argued that option payments are tantamount to interest and should be taxed as such, but this position was rejected by the Tax Court in *Koch v. Commissioner*.[80]

The original issue discount rules of Sections 1271 through 1275 should not apply since a true option contract would not constitute a "debt instrument" as defined in Section 1275(a)(1).[81] In *Koch*, the Tax Court found that an option contract does not constitute a "debt"[82] and this rationale would also seem to negate the presence of a "debt instrument."

[iv] Estate Planning Opportunities

The rolling option approach also presents potential estate planning advantages to the seller in addition to the income tax advantages discussed above. For example, if the seller's properties were acquired by the purchaser in a straight sale (as opposed to a

[79] Treas. Reg. § 1.1234-1(b); Rev. Rul. 57-40, 1957-1 C.B. 266.

[80] See note 78 *supra*.

[81] See, IRC § 1274(a).

[82] 67 T.C. at 82, 83.

rolling option approach), the seller would receive an installment note for a portion of the purchase price. This installment note would be treated as income in respect of a decedent under Section 691 upon a subsequent death of the seller prior to the full collection of the note. Thus, the decedent's estate may be required to pay estate taxes on the value of the installment note and, most importantly, the decedent's heirs would also inherit the decedent's income tax liability with respect to the unpaid balance of the installment note.[83] However, structuring a transaction as a series of rolling options can eliminate the income tax problems that the seller's heirs would otherwise inherit. The properties that are subject to options that have not yet been exercised at the date of death will be included in the decedent's estate and the values will probably be tied, at least in part, to the option prices which may eliminate the necessity of obtaining expensive appraisals for estate tax purposes. The decedent's heirs would also be entitled to a new "stepped-up basis" under Section 1014 for the portions of the property subject to the unexercised options which will enable them to subsequently sell these properties if the options are exercised without the necessity of paying income taxes (because the sales prices will be exactly equal to their tax bases). Note that the repeal of the stepped-up basis rules in 2010, and the institution of new modified carryover basis rules under the Economic Growth and Tax Reconciliation Act of 2001, would undermine this planning for decedents who die in 2010.

§ 9.03 DEALERS HOLDING REAL PROPERTY FOR INVESTMENT

[1] Dual Role Dealers

It is well-established that a dealer in real property may occupy a dual role in that he holds some real property for sale to customers in the ordinary course of his trade or business and other property for investment purposes.[84]

[a] Parcel-by-Parcel Determination

Because the analysis of whether the disputed property is held primarily for sale to customers is undertaken on a property-by-property basis, "dealers" may still successfully assert that a particular parcel was primarily held for investment, and not for sale in the ordinary course of business, if they can sustain the difficult burden of proof which they bear. In *Wood v. Commissioner*,[85] the court noted without question that "a property owner may hold some [property] for sale to customers in the ordinary course of business and hold the remainder as capital assets"), and in *Maddux Construction v. Commissioner*,[86] the court held that the taxpayer could treat its gain on the sale of

[83] See, IRC § 1014(c).

[84] See, *Fabiani v. Commissioner*, T.C. Memo. 1973-203.

[85] *Wood v. Commissioner*, 276 F.2d 586 (5th Cir. 1960).

[86] *Maddux Construction v. Commissioner*, 54 T.C. 1278 (1970).

dealer taint for five years following such distribution.

Bramblett v. Commissioner[91] concluded that the dealer activities of a development corporation that purchased real estate from a related partnership were not attributable to the partnership when determining whether the partnership was in the business of selling land. In reaching this result, the Court rejected the IRS arguments that either the development corporation was an agent of the partnership or the dealer activities of the corporation should be imputed to the partnership on a substance over form theory. The court also noted that there was at least one major independent business reason to form the corporation and have it, rather than the partnership, develop and sell the land: to insulate the partnership and the partners from unlimited liability. Finally, the court observed that there was no evidence to suggest that the transaction was not at arms' length or that business and legal formalities were not observed.

§ 9.04 SECTION 1237—SAFE HARBOR FOR REAL PROPERTY SUBDIVIDED FOR SALE

[1] Principal Conditions of Qualification

[a] Three-Part Test

Section 1237(a) provides a limited statutory safe harbor for taxpayers other than C corporations through which the sale of a lot or parcel that is part of a tract of real property is not deemed to be held primarily for sale to customers in the ordinary course of a trade or business at the time of the sale solely because the taxpayer subdivided the land for subsequent sale or because of any activity incident to such subdivision or sale. Generally, the following conditions must be met in order to qualify for Section 1237 treatment:

- The taxpayer has not been a dealer in real estate with respect to the lot or parcel (or tract of which it is a part) in any year prior to sale and in the year of sale is not a dealer with respect to any other real property;
- The taxpayer has not made substantial improvements that substantially enhance the value of the lot or parcels sold; and
- The taxpayer has held the parcel for 5 years, except when acquired by inheritance or devise.

[b] Tract of Real Property Defined

Section 1237(c) defines the term "tract of real property" to mean either (i) a single piece of real property, or (ii) two or more pieces of real property if they were contiguous at any time while held by the taxpayer, or would have been contiguous but

[91] *Bramblett v. Commissioner*, 960 F.2d 526 (5th Cir. 1992).

for the interposition of a road, street, railroad, stream or similar property.

[2] Disqualification Arising from Holding Real Property Primarily for Sale

[a] General Rule

Although the "holds property primarily for sale to customers" analysis under Section 1221 discussed above applies here as well, the most significant factor for purposes of Section 1237 qualification may be the manifestation of the taxpayer's intent as evidenced by the extent of improvements. Because the statute and the Regulations promulgated thereunder clearly apprise the taxpayer of acceptable improvements, it is entirely within a taxpayer's province to memorialize his intention through the scope of the improvements, or lack thereof, to the tract.

[i] Subdividing and Selling Activities

The Regulations provide that such activities are disregarded for purposes of determining whether a taxpayer held real property primarily for sale to customers in the ordinary course of business if they are only evidence indicating that the taxpayer should be treated as a dealer with respect to the sold lots.[92] However, when other evidence tends to show that the taxpayer is dealer, the taxpayer's subdividing and selling activities will be taken into account.[93]

[ii] Factors that Do Not Alone Indicate Dealer Tendencies

The regulations provide that the following factors do not in and of themselves indicate dealer status:

- Holding a real estate license;
- Selling other real property clearly held for investment;
- Acting as a salesman for a real estate dealer, but without any financial interest in the business; or
- Mere ownership of other vacant real property without engaging in any selling activity whatsoever with respect to it.[94]

[b] Attribution Rules Apply

For purposes of determining whether the taxpayer holds any property as a dealer, property held jointly or as a member of a partnership is attributed to the taxpayer.[95] Generally, property owned by members of the taxpayer's family, an estate or trust or

[92] Treas. Reg. § 1.1237-1(a)(2).

[93] Treas. Reg. § 1.1237-1(a)(3).

[94] Treas. Reg. § 1.1237-1(a)(3).

[95] Treas. Reg. § 1.1237-1(b)(3).

a corporation will not be considered as being owned by the taxpayer.[96] The taxpayer, nevertheless, may be considered a dealer by virtue of his relationship to a predecessor-in-interest to the extent this indicates the purpose for which the taxpayer has held the lot or tract.[97]

[3] Disqualification Arising from Substantial Improvements

[a] Substantial Value Increase

Before a substantial improvement will preclude the availability of the Section 1237 safe harbor, the improvement must substantially enhance the value of the lot sold.

[i] More than 10% test

As for what increase in value is substantial, Treas. Reg. § 1.1237-1(c)(3)(ii) states that if improvements increase the value of lots by 10% or less, the increase will ***not*** be considered substantial; however, if such value is increased by more than 10%, then all relevant factors must be considered to determine whether, under the circumstances, the increase is substantial. Changes in the market value of the lots not attributable to the improvements are disregarded.

[ii] *Revell*

In *Revell v. United States*,[98] a 12.5% increase in the value of the property, combined with (1) the sale of 117 of 120 lots in three years, (2) the costs of improvement, including street improvements of $21,174 and a water system of $41,195, and (3) other improvements (such as surveys, platting, streets cut, surface drainage installation), was sufficient for the Court to find that the gain did not qualify for Section 1237 treatment.

[b] When an Improvement Is Substantial

Activities considered substantial include any permanent structures, or installation of hard surface roads or utilities such as sewers, water, gas, or electric lines.[99] In contrast, temporary structures used as a field office, surveying, filling, leveling or clearing land and the construction of minimum all-weather roads, including gravel roads where required by the climate, generally are not substantial improvements.[100]

[c] Improvements Deemed to Be Made by the Taxpayer

Improvements made by members of the taxpayer's family (as defined in Section 267(c)(4)), a corporation controlled by the taxpayer, an S corporation in which the

[96] Treas. Reg. § 1.1237-1(b)(3).

[97] Treas. Reg. § 1.1237-1(b)(3).

[98] *Revell v. United States*, 1972-1 USTC ¶ 9298 (D.S.C. 1972).

[99] Treas. Reg. § 1.1237-1(c)(4).

[100] Treas. Reg. § 1.1237-1(c)(4).

taxpayer is a shareholder, or a partnership which included him as a partner, are treated as being made by the taxpayer.[101]

Improvements made by a lessee if the improvement constitutes income to the taxpayer may also be treated as made by the taxpayer.[102]

Improvements made by a Federal, state or local government, or political subdivision thereof, will also be considered as being made by the taxpayer, but only if the improvement constitutes an addition to basis for the taxpayer. Payment of a special tax assessment would constitute such an addition.[103]

[d] Special Rule for Necessary Improvements

Section 1237(b)(3) provides that an improvement will ***not*** be considered substantial if the lot or parcel is held by the taxpayer for 10 years or more (not including any tacked period due to inheritance of the property) and the following conditions are met:

- Such improvement is the building or installation of water, sewer, drainage facilities (either surface, sub-surface or both), or roads, including hard surface roads, curbs and gutters;
- The IRS District Director agrees that, without such improvement, the lot or parcel sold would not be marketable at prevailing local prices for "similar building sites"; and
- The taxpayer elects not to make any adjustment to the basis of the lot or parcel (or any other property owned by the taxpayer) because of such improvement. Such election does not make any item deductible which would not otherwise be deductible.

[e] Manner of Making Election Required by Section 1237(b)(3)(C)

As a cautionary note, the tax return must contain adequate notice as to the reliance of the taxpayer on Section 1237 and the bases thereof. If these conditions are not met, the installation of these improvements would be deemed substantial and the taxpayer would be disqualified from using Section 1237. Treas. Reg. § 1.1237-1(c)(5)(iii) provides that the election required by Section 1237(b)(3)(C), which is filed with the

[101] IRC § 1237(a)(2)(A).

[102] Section 1237(a)(2)(B); Treas. Reg. § 1.109-1 (describing situations where a lessor has income by reason of a lessee making improvements to land); *see, e.g.*, PLR. 8038196 (June 30, 1980); PLR 8637012 (June 2, 1986); PLR 9123026 (March 8, 1991); PLR (May 20, 1996) (a series of related letter rulings where lessees had improved land by building condominiums and single-family housing, but taxpayers were nonetheless found to be entitled to the benefits of Section 1237—note the span of years between sales).

[103] IRC § 1237(a)(2)(C).

taxpayer's return for the taxable year in which the lots subject to the election are sold, must include the following:

(a) A plat showing the subdivision and all improvements attributable to the taxpayer.

(b) A list of all improvements to the tract, showing:

(1) The cost of such improvements;

(2) Which of the improvements, without regard to the election, the taxpayer considers "substantial" and which he considers not "substantial";

(3) Those improvements which are substantial to which the election is to apply, with a fair allocation of their cost to each lot they affect, and the amount by which they have increased the values of such lots; and

(4) The date on which each lot was acquired and the basis for determining gain or loss, exclusive of the cost of any improvements listed above.

(c) A statement confirming that the taxpayer will neither deduct as an expense nor add to the basis of any lot sold, or of any other property, any portion of the cost of any substantial improvement which substantially increased the value of any lots in the tract and which either the taxpayer or the District Director deems substantial.

[4] 5-Year Holding Period Requirement

[a] Section 1223 Tacking Rules Apply

Generally, the provisions of Section 1223 are applicable in determining the period during which the taxpayer held the property.[104] Thus, for example, the holding period tacks in carry-over basis transfers (e.g., gifts, liquidations, like-kind exchanges, etc.).

[b] Property Acquired Upon Death

There is no 5-year holding period requirement if the taxpayer inherited the property.[105] For purposes of Section 1237, neither the survivor's one-half of community property, nor property acquired by survivorship in a joint tenancy, qualifies as property acquired by devise or inheritance. The holding period for the surviving joint tenant begins on the date the property was originally acquired.[106]

104 Treas. Reg. § 1.1237-1(d)(1).

105 Treas. Reg. § 1.1237-1(d)(2).

106 Treas. Reg. § 1.1237-1(d)(2).

[5] Special Rule for Computing Taxable Gain

[a] Sale of Five or Fewer Lots in Same Tract

When the taxpayer has sold five or fewer lots or parcels from the same tract during a taxable year, the entire gain is capital. In computing the number of lots sold, two or more contiguous lots sold to the same buyer in a single sale are counted as only one lot.[107]

[b] Sale of Six or More Lots in Same Tract

If the taxpayer has sold a sixth lot from the same tract within the taxable year, the amount, if any, by which 5% of the selling price of each lot exceeds the expenses incurred in connection with its sale or exchange will be treated as ordinary income to the extent it represents gain on the sale.[108]

Example 1. Taxpayer sells 6 lots from the same tract in 2004. Assume the selling price of the sixth lot was $10,000 with a basis of $5,000 and selling expenses of $750. In this example, none of the taxpayer's recognized gain of $4,250 will be treated as ordinary income because the selling expenses ($750) exceed 5% of the sales price ($500).

Example 2. Assume the same facts as Example 1, except that the selling expenses are only $300. Under these facts, the taxpayer recognizes a gain of $4,700 of which $200 will be treated as ordinary income. The remaining $4,500 is capital gain.

[6] Relationship of Section 1237 and Section 1231

Any gain or loss realized on the sale of real property used in a trade or business for purposes of Section 1237 will be treated as a Section 1231 gain or loss if the only reason the property does not qualify as Section 1231 property is that the taxpayer subdivided the tract of which the lot sold was a part.[109]

§ 9.05 TRANSFER OF REAL PROPERTY TO A RELATED ENTITY

[1] Transfer to Controlled Corporation

Taxpayers, such as Nick and Urban in the introductory illustration, that may both invest in and develop real estate, understand that post-development profits may outweigh the pre-development appreciation of the real estate and thus are remiss to sell the property to an unrelated third party who will then reap all the post-development profit. To this end, such taxpayers often sell undeveloped real estate to a controlled

107 Treas. Reg. § 1.1237-1(e)(2).

108 IRC § 1237(b)(1), (2); Treas. Reg. § 1.1237-1(e)(3).

109 Treas. Reg. § 1.1237-1(f).

corporation (within the meaning of Section 368(c)) that will develop and sell the property to unrelated third parties in the ordinary course of business. Because very few developer corporations consider paying cash for undeveloped property, the seller almost always receives an installment note, which gives rise to the potential for recharacterization as an equity contribution. Outright cash sales funded through the dealer corporation's prior operations or an unrelated lender should be immune from such recharacterization.

[a] Recharacterization of Installment Sale Under Section 351

Although taxpayers have experienced a good degree of success in defending installment sales to related entities as true sales, the IRS has also been successful, albeit to a lesser degree, in recharacterizing the sale of land to the developer corporation as a nontaxable equity contribution. The proper treatment of each transaction is highly fact dependent and generally turns upon whether the installment note is respected as debt.

[b] Debt v. Equity Considerations

Through the years, the IRS and the courts have developed a number of factors to determine whether a purported debt should be treated as equity for tax purposes.[110] Specifically, the courts have identified the following broad factors, several of which were codified in Section 385(b):

- Intent of the parties:
  — The extent to which the creditor participates in management;
  — Whether the obligation to pay is contingent on the performance of the corporation;
  — The names given to the certificates evidencing the indebtedness; and
  — The identity of interest between creditor and shareholder.
- Formal characteristics of indebtedness:
  — Fixed rate of interest at or above AFR;
  — The presence or absence of a maturity date;
  — The right to enforce the payment of principal and interest;
  — Whether the note is subordinate to other creditors; and
  — The presence or absence of a redemption provision.

110 See, e.g., *Bauer v. Commissioner*, 748 F.2d 1365 (9th Cir. 1984); *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968); *J.S. Biritz Constr. Co. v. Commissioner*, 387 F.2d 451 (8th Cir. 1967); *Smith v. Commissioner*, 370 F.2d 178 (6th Cir. 1966); *Gilbert v. Commissioner*, 262 F.2d 512 (2d Cir. 1959).

- Economic realities of the transaction:
  — "Thin" or inadequate capitalization (i.e., debt-to-equity ratio);
  — The corporation's ability to obtain financing from outside lenders;
  — Source of the interest payments;
  — Risk assumed by the creditor; and
  — Voting power of the creditor.

[c] Pro-Taxpayer Cases

Cases in which various courts have respected the taxpayers' characterization of the transfer of real estate to a controlled corporation as a sale include the following.

The Fourth Circuit, in *Piedmont Corp. v. Commissioner*,[111] addressed whether the assignment to Piedmont Corporation of certain option rights held by its shareholders in exchange for $10,000 cash and $160,000 in unsecured promissory notes constituted a bona fide sale or a contribution of capital. Piedmont Corporation's two shareholders owned a renewable 10-year option to purchase an 11-acre parcel of land. This property was divided into four separate tracts, each with a fixed purchase price under the option. Piedmont acquired the option in three successive transactions, paying for the portion of the option acquired each time by its unsecured promissory notes, exercising the option and then selling lots from the land it acquired to outside purchasers. In reversing the Tax Court, the Fourth Circuit held that the transaction should be characterized as a sale because a fair price was paid for the successive transfers of a portion of the option and for the land and because Piedmont paid the principal and interest on the notes in a timely manner. The Court reached this holding notwithstanding the thin capitalization of Piedmont.

In *Bradshaw v. United States*,[112] the taxpayer was an individual who owned 200 acres of real estate in Dalton, Georgia. Realizing the potential value of this property, the taxpayer formed a wholly owned corporation to develop the land. He then transferred a 40-acre tract to his developer corporation in exchange for five promissory notes maturing in successive years. The Court held that the transfer was a sale, not an equity contribution under Section 351, because the price paid by the developer corporation for the subdivision reflected the fair market value and the formalities of sale were strictly observed.

Another case addressing the sale versus contribution issue is *Bramblett v. Commissioner*.[113] In addition to concluding that the post-sale dealer activities of a related

111 *Piedmont Corp. v. Commissioner*, 388 F.2d 886 (4th Cir. 1968).

112 *Bradshaw v. United States*, 683 F.2d 365 (Cl. Ct. 1982).

113 *Bramblett v. Commissioner*, 960 F.2d 526 (5th Cir. 1992).

corporation should not be imputed to the related investment partnership that sold the undeveloped property to the corporation, the Fifth Circuit noted that common ownership (in this case, identical common ownership) was not enough to establish an agency relationship. Notwithstanding this aspect of the Court's ruling, the identical ownership structure in *Bramblett* would have appeared ripe for an alter ego argument to disregard the transfer between the related parties.

[d] Pro-IRS Cases

Two of the more notable cases in which the courts have held in favor of the IRS on the issue of whether the transfer of land to a controlled corporation in exchange for an installment note constituted a deemed capital contribution are *Burr Oaks Corp. v. Commissioner*,[114] where the court held that the transfer of undeveloped land held jointly by three individuals to a corporation in return for two-year promissory notes represented capital contributions and not a sale, and *Aqualane Shores, Inc. v. Commissioner*,[115] where the court held that the transfer of real estate to a thinly capitalized controlled corporation was a capital contribution.

[2] Transfer to Related but Not Controlled Corporation

Taxpayers seeking greater certainty with respect to the treatment of a real estate transfer as a sale should consider transferring the property to a related (greater than 50% ownership) but ***not*** controlled (at least 80% ownership) corporation.

[a] Busted Section 351 Transaction

Section 351(a) provides for the general nonrecognition of gain or loss upon the transfer by one or more persons of property to a corporation solely in exchange for stock or securities in such corporation if, immediately after the exchange, such person or persons are in control of the corporation to which the property was transferred. To be in control of the transferee corporation, such person(s) must own at least 80% of the total combined voting power and at least 80% of the total number of shares.[116]

[i] Greater than 20% Ownership by Unrelated Third Party

The IRS cannot invoke Section 351 to recharacterize a real estate transfer as a nontaxable equity contribution if unrelated third parties own more than 20% of the transferee corporation, because the transferor lacks the required control over the transferee corporation immediately after the transfer.

[ii] Related Parties and Attribution

The related party and attribution rules apply for purposes of testing whether the

[114] *Burr Oaks Corp. v. Commissioner*, 365 F.2d 24 (7th Cir. 1966).

[115] *Aqualane Shores, Inc. v. Commissioner*, 269 F.2d 116 (5th Cir. 1959).

[116] IRC § 368(c).

transferor controls the transferee corporation. Under Section 267(b), the following persons are considered related for this purpose and thus do not count towards the greater than 20% unrelated owner threshold:

(1) Members of the transferor's family (i.e., brothers, sisters, spouse, ancestors and lineal descendants);

(2) A corporation of which more than 50% of the value of its outstanding stock is owned by the transferor;

(3) Certain trust relationships; and

(4) Corporations and partnerships if the same persons own more than 50% of the corporation's outstanding stock measured by value and more than 50% of the capital or profits interests in the partnership.

[b] Avoiding Recharacterization

Transferring property to a corporation not controlled by the transferee precludes the applicability of Section 351 and thus should minimize, if not eliminate, the risk that the IRS will recharacterize the transfer as a nontaxable equity contribution.

[3] Transfer to Controlled Partnership

[a] Section 707(b)(2) May Classify Recognized Gain as Ordinary Income

Pursuant to Section 707(b)(2), gain from the sale of property that is not a capital asset (within the meaning of Section 1221) in the hands of the buyer will be treated as ordinary income if the buyer is a partnership and if the seller owns, directly or indirectly, more than 50% of the capital or profits interests in such partnership.

[i] Section 1231 Gain

Generally, gain on the sale or exchange of a Section 1231 asset, which includes real property used in a trade or business and held for more than one year, is treated as capital. Section 707(b)(2), however, recharacterizes Section 1231 gain as ordinary income, because Section 1231 assets are not capital assets, as defined in Section 1221.

[ii] Indirect Ownership

Section 707(b)(3) invokes the constructive stock ownership rules of Section 267(c) (other than subparagraph (3) thereof) for purposes of determining whether a partnership is controlled. Accordingly, the following attribution rules apply under Section 707(b)(2):

(1) Capital or profits interests owned, directly or indirectly, by or for a corporation, partnership, estate or trust are considered as being owned by or for its shareholders, partners or beneficiaries; and

(2) An individual is considered to own the stock owned, directly or indirectly, by or for his "family", which Section 267(c) defines as the individual's brothers and

sisters (whether by whole or half blood), spouse, ancestors and lineal descendants.

[b] Planning Techniques to Avoid Section 707(b)(2) Recharacterization

[i] Sale to Non-Controlled Partnership

Because Section 707(b)(2) only applies if the transferee-partnership is controlled by the seller, selling the property to a non-controlled partnership (i.e., transferor partnership owns 50% or less of transferee partnership) removes the sale from the scope of this provision.

[ii] Sale to S Corporation

Subchapter S does not have a provision comparable to Section 707(b)(2). Assuming the seller prefers to retain as much control as possible over the real estate post-transfer, this technique is the better of the two because it allows the seller to transfer real estate to a related but not controlled S corporation. See 9.05[1] above for issues affecting transfers to controlled corporations (at least 80% ownership). Section 1239, which is discussed below, remains a concern for sales of depreciable real property to an S corporation.

[4] Section 1239: Sale of Depreciable Real Property to Related Person

Section 1239(a) characterizes any gain recognized on the sale or exchange of property between "related persons" as ordinary income if the property is depreciable in the hands of the related party transferee.

[a] Related Persons

Section 1239(b) defines "related persons" to mean:

- A person and all entities that are "controlled entities" with respect to that person (i.e., generally more than 50% ownership);
- A taxpayer and any trust in which the taxpayer (or his spouse) is a beneficiary, unless such beneficiary's interest in the trust is a remote contingent interest; and
- An executor of an estate and a beneficiary of such estate, except in the case of a sale or exchange in satisfaction of a pecuniary request.

[b] Available Planning Techniques

[i] Related/Unrelated

Under Section 1239(b)'s definition of "related persons", taxpayers that own appreciated real property that will be depreciable in the hands of the transferee may not only lock-in capital gains treatment on the appreciation realized to date, but also retain an interest in the property's upside potential so long as the transferee is not a related person. Thus, a taxpayer may sell such property to a new or existing entity in which

the taxpayer holds a non-controlling interest without triggering the recharacterization rule of Section 1239(a).

If the owner decides to form a new entity to acquire the property, the following considerations should be taken into account prior to formation:

(1) In most situations, in order to protect against potential liability from a myriad of possible problems, the use of a corporation or limited liability company will be preferable. However, due to state tax issues in some states, the better alternative may be to form a limited partnership with a corporation or limited liability company as the general partner. In light of the double taxation inherent in a C corporation, the S corporation will probably be preferable, as long as corporate formalities are followed and it is capitalized with sufficient equity to avoid the risk of a creditor "piercing the corporate veil."

(2) As noted above, to qualify as a genuine unrelated party, the entity must be at least 50% owned by unrelated parties. There are several persons who might desire to fill the role of the controlling owner, yet allow the current owner of the real estate to retain a significant, but non-controlling, interest in the newly formed entity that will purchase the real estate. This arrangement may appeal to a condominium converter or a sales or marketing agent because it allows them to share in the upside potential of the real estate, which may exceed their normal fee for their services.

[ii] Additional Planning Issues

The unrelated party should pay value for his percentage of ownership. Absent this, the value of the property must be sufficiently extracted on the sale into the corporation or partnership so that there is no concern that too much has been left on the table. Second, it is desirable to limit the unrelated co-owner's share of the profits. Thus, a cap on the share of profits, or an offset for any fees earned directly, or a buy-sell enabling the unrelated co-owner to be taken out of the corporation or partnership at a later time are all factors to consider, but with a great deal of caution.

Another important issue arises when the sale to the unrelated corporation is made on the installment method, which is often the case because the new entity probably has not obtained sufficient financing to enable it to pay the purchase price in full. When installment sales are at issue, there are a couple of considerations that deserve attention.

If the terms of the obligations are long enough that they are not considered debt, but rather a form of equity, the equity might be deemed a second class of stock. This would disqualify an S corporation if that was the vehicle used to buy the taxpayer's property. If the debt obligations are in the same proportion as the stock as to the face amount and ownership, the obligations are likely to be deemed equity.[117]

Furthermore, assuming the installment debt is treated as debt, if the duration is too long, then the interest on the debt will consume a substantial portion of the profits that might otherwise qualify as capital gains. This could also result in the installment notes not being paid in full on the eventual sell-out of the project, which, in turn, would result in the mismatch of a capital loss from a non-business bad debt to the taxpayer and ordinary income from the discharge of indebtedness at the entity level. Successful conversion requires that the participants have a clear grasp of the numbers and timing.

[5] Suggested Action Steps for Enhancing Capital Gain Position

The following are suggested action steps to be taken in order to produce a strong evidentiary position to support a capital gain position. This list is not intended to be exclusive:

- Review organizational documents of selling entity and purchasing entity to reflect appropriate investment or developer intent, as the case may be. The investors should form a new entity for each new project, rather than using the same entity for multiple transactions. This should minimize the tainting of a property by virtue of prior transactions undertaken by an entity.
- The sales price should be supported by a good appraisal. The terms of the sale should reflect the terms that would have been arrived at by arms' length bargaining by unrelated parties. If anything, the parties should err on the side of selling for too low a price (rather than too high a price). The purchaser/developer should have a realistic opportunity to realize a profit upon its sales of the property. On the other hand, a sale that is too low could potentially trigger federal gift tax concerns if the owners of the purchasing entity are comprised of children or other descendants or beneficiaries of the seller's (or its owners') estate.
- In the installment sale setting, the purchasing development entity should have a sufficient amount of the equity in its capitalization in order to establish that its "ability to pay the note is not otherwise in doubt."[118] Many commentators consider a net equity capitalization of

[117] See, e.g., *Gamman v. Commissioner*, 46 T.C. 1 (1966); *Lewis Building & Supplies, Inc. v. Commissioner*, 25 T.C. Memo 844 (1966); and *Raynor v. Commissioner*, 50 T.C. 762 (1968).

[118] PLR 9535026 (Sept. 1, 1995).

10% of the purchasing entity to be a reasonable amount of funding.[119] Such equity funding should be used as a down payment at the time of closing. The balance of the purchase price should be adequately secured (such as by a first mortgage on the property being sold).

- If the purchase price is contingent on the developer corporation's receipt of proceeds from its sales of lots, this will likely cause the seller to be recharacterized as a joint venturer with the purchaser, thereby subjecting the gain the seller realizes to ordinary income rates. Such a structure with respect to the payment of the note should be avoided.
- The payment schedule under the installment note can be tied to the developer corporation's receipt of proceeds from its sales of lots by virtue of release clauses. To qualify for the installment method of reporting, the note must provide that at least one payment is to be received after the close of the taxable year of the sale. The note should require the developer corporation to repay the note even if, for whatever reason, it cannot sell some or all of the lots.
- Proper formalities should be followed. Mortgages and UCCs should be recorded. The note should be in writing. Moreover, if a transaction constitutes a conflict of interest transaction, proper approvals of non-interested parties, if any, should be duly obtained after full disclosure of the facts.
- The purchaser should not undertake "pre-sale" activities prior to acquiring the property. Moreover, the purchaser should not make improvements or repairs to the property prior to at least having a binding purchase agreement in place. Preferably such activities should not occur until the purchaser has acquired title to the property.
- The purchaser should timely make all payments under the note. If there is a default, it is important that the seller pursue all remedies available to it under the note and security documents.
- The seller and purchaser should be treated as separate and distinct entities. As such, they should maintain separate books, records, bank accounts and similar items. In addition, it may be advisable to build into the relationship concepts that could support the position that, in some respects, the parties' interests are not aligned. For instance, the developing entity may try to compensate its development personnel

[119] *Cf.* PLR 9535026 (Sept. 1, 1995) (requiring grantor trust to have equity of at least 10% of the installment purchase price).

based upon the profitability of the development. The selling entity may elect to compensate its personnel based upon the net realization of the note.

- In addition to the sale terms, if the related parties have other relationships, those should also be monitored to ensure that those other relationships are conducted in an arms' length manner.
- The selling entity should refrain from constructing infrastructure and otherwise physically improving the property before conveying the property to the development entity. To the extent possible, the development entity should make all applications for approvals and should record any subdivision plat. It is not uncommon to provide in the purchase agreement that the purchasing entity has such authority.
- Ideally, the owners of the selling entity and the purchasing entity will not be identical. It may be advisable to consider selling or issuing interests in the development entity to key employees or other persons. Although there are cases that appear to permit identical ownership, varying the ownership of the entities to some degree may reduce the risk of the activities of purchaser being attributed to the seller.
- In the wake of the check-the-box regulations, it is not uncommon for the selling entity to have acquired title to the property through a single-member LLC. The selling entity may be able to sell the LLC interest to the developing entity, in order to minimize transfer or recording taxes incident to the sale because the sale of the LLC interests is characterized under federal income tax law as the sale of the property owned by the LLC. How states treat such transfers for recording tax purposes varies from state to state.

§ 9.06 INSTALLMENT SALES WITH RELATED ENTITIES

[1] Purchaser's Subsequent Disposition of Property

[a] General Rule

If, in an installment sale, the taxpayer sells property to a related person (the "first disposition"), and if before the person making the first disposition has received all payments with respect to that disposition, the related person disposes of the property (the "second disposition") less than 2 years after the first disposition, the amount realized with respect to the second disposition will be treated as received at the time of the second disposition by the person who made the first disposition.[120] The 2-year

[120] IRC § 453(e)(1).

limitation does not apply in the case of marketable securities.[121] The running of the 2-year period is tolled or suspended for any period during which the related person's risk of loss with respect to the property is substantially diminished by: (i) the holding of a put with respect to the property; (ii) the holding by another person of a right to acquire the property; or (iii) a short sale or any other transaction.[122]

[b] Limitation of Recognition to Amount Realized by Purchaser on Second Disposition

The amount treated as received by the person that made the first disposition cannot exceed the excess of (a) the lesser of the total amount realized with respect to any second disposition or the total contract price for the first disposition, over (b) the sum of the aggregate amount of payments received with respect to the first disposition, plus the aggregate amount treated as received with respect to the first disposition for prior taxable years.[123]

[c] Payments after Second Year

Payments received in taxable years subsequent to the two-year period by the person that made the first disposition will not be treated as the receipt of payments with respect to the first disposition to the extent that the aggregate of such payments does not exceed the amount treated as received under the general rule.[124]

[2] Sale of Depreciable Property to Controlled Entity in Installment Sale

[a] General Rule

The installment sale method is not available for an installment sale of depreciable property between related persons.[125] All payments to be received under the installment note are deemed received in the year of disposition. For purposes of Section 453(g), the term "related persons" has the same meaning as in Section 1239(b), except that such term also includes two or more partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interests of such partnerships.[126]

[b] Exception Where Tax Avoidance Is Not a Principal Purpose

If the taxpayer can establish to the satisfaction of the IRS that the installment sale

[121] IRC § 453(e)(2).

[122] IRC § 453(e)(2).

[123] IRC § 453(e)(3).

[124] IRC § 453(e)(5).

[125] IRC § 453(g)(1).

[126] IRC § 453(g)(3).

did not have as one of its principal purposes the avoidance of federal income tax, then Section 453(g)(1) will not apply.[127] However, this burden will be very difficult to satisfy. Moreover, the taxpayer will be required to disclose the transaction on its tax return in order to eligible for this exception.

[c] Contingent Payments

In the case of contingent payments that are contingent as to the amount but with respect to which the fair market value may not be reasonably ascertained, the basis may be recovered ratably.[128]

[d] Purchaser's Basis in Acquired Property

The purchaser may not increase the basis of any property acquired before the seller includes such amount in gross income.[129]

[3] Lease Transactions That Are Recharacterized as Disguised Purchases

Sometimes taxpayers attempt to reclassify an installment sale to a related party as a lease transaction in order to avoid some of the provisions noted above. A lease payment that is really consideration for the purchase of property is not deductible as rent.[130] In determining whether a transaction is in fact a sale or a lease, several factors must be examined at the initiation of the transaction (rather than retroactively).

[a] Rent Significantly Exceeds Fair Rental Value

When the rent under the lease significantly exceeds the fair rental value of the property, the lease may be recharacterized as a sale.[131] Courts have generally examined the overall reasonableness of the rent based on the fair market value of the property.

[b] Part of Lease Payment Designated as Interest

If any part of the lease payments is either designated as interest or easily seen as such, recharacterization of the lease as a sale is likely.

[127] IRC § 453(g)(2).

[128] IRC § 453(g)(1)(B)(ii).

[129] IRC § 453(g)(1)(C).

[130] Section 162(a)(3) provides that a taxpayer may deduct as a trade or business expense "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity"; see also *Oesterreich v. Commissioner*,[130] *Minneapolis Security Bldg. Corp. v. Commissioner*,[130] *Home News Pub. Co. v. Commissioner* [130] and PLR 9026033 (Mar. 28, 1990).

[131] *See, e.g., Haggard v. Commissioner*, 241 F.2d 288 (7th Cir. 1956).

For example, in *Judson Mills v. Commissioner*,[132] the Court held that the monthly amounts paid were not deductible as rent because the taxpayer thereby acquired an equity interest in the machinery. The Court also held that a portion of the monthly payments equal to the factor designated as interest in the letters explaining the terms of the agreement was deductible as interest. The taxpayer, a textile producer, acquired new mill machinery through lease payments to the machinery manufacturers and could then acquire title to the machinery by payment of a relatively small additional amount. As set forth in the correspondence, the amounts payable in monthly installments were computed to include 5% or 6% interest on the principal; interest tables were attached to the manufacturer's explanatory letters.

[c] Option to Purchase the Property During the Lease

If the lease contains an option to purchase, and such option permits credits against the purchase price for some or all of the rents previously paid, the transaction may be characterized as an installment sale for federal income tax purposes, rather than a lease. In *Bowen v. Commissioner*,[133] the court held that the transaction was a sale where title to the property would be transferred to the tenant when monthly rental payments equaled the stated value plus one percent, or, if payments had not equaled the stated value plus one percent at the time of expiration of the lease, the tenant would nonetheless have the option to purchase the property at that time. On the other hand, in *Smith v. Commissioner*,[134] the court held that the fact that there was an option to purchase would not, in and of itself, be considered as conclusively indicating a sale. It is clear, however, that no rent deduction will be allowed if, without further act or consideration, the tenant acquires title to the property after a certain number of lease payments.[135]

By the same token, it is possible that purchase transactions involving certain purported option arrangements may be reclassified as leases depending upon the facts. In general, the key issue is the level of control over and right of access to the "optioned" property which is granted to the purported optionee prior to the exercise of the option.[136]

[d] Significant Tenant Improvements

A sale rather than a lease will likely be found where the tenant makes significant

[132] *Judson Mills v. Commissioner*, 11 T.C. 25 (1948).

[133] *Bowen v. Commissioner*, 12 T.C. 446 (1949).

[134] *Smith v. Commissioner*, 51 T.C. 429 (1968).

[135] See *Chicago Stoker Corp. v. Commissioner*, 14 T.C. 441 (1950) and *St. John v. Commissioner*, 29 T.C. Memo 621 (1970).

[136] See *Howlett v. Commissioner*, 56 T.C. 951 (1971) and PLR 9129002 (Mar. 26, 1991) (citing *Virginia Iron Coal & Coke Co. v. Commissioner*, 99 F.2d 919 (4th Cir. 1938)).

improvements to the property that either are not recoverable through depreciation or amortization deductions (such as land improvements) or can only be protected through the exercise of an option.[137]

§ 9.07 APPENDIX A

Top Federal Income Tax Rates on Regular Income and Capital Gains since 1916

Year	Top Rate on Regular Income	Top Rate Applies to Married Taxable Income Over:	Top Rate on Capital Gains	Notes on Capital Gains Treatment
1916	15%	$2,000,000	15%	Capital gains taxed the same as regular income
1917	67%	2,000,000	67%	"
1918	77%	1,000,000	77%	"
1919-21	73%	1,000,000	73%	"
1922	58%	200,000	12.5%	Max rate of 12.5%
1923	43.5%	200,000	12.5%	"
1924	46%	500,000	12.5%	"
1925-28	25%	100,000	12.5%	"
1929	24%	100,000	12.5%	"
1930-31	25%	100,000	12.5%	"
1932-33	63%	1,000,000	12.5%	"
1934-35	63%	1,000,000	31.5%	Sliding exclusion of 70% > 10 yrs; 0% < 1 yr.
1936-37	78%	2,000,000	39%	"
1938-40	78%	2,000,000	30%	Excl. 50% > 2 yrs; 67% 18–24 mo; 0% < 18 mo; 30% Max
1941	80%	2,000,000	30%	Excl. 50% > 2 yrs; 67% 18–24 mo; 0% < 18 mo; 30% Max
1942-43	88%	200,000	25%	Exclusion 50% > 6 months; 25% maximum
1944-45	94%	200,000	25%	Exclusion 50% > 6 months; 25% maximum

[137] See, e.g., *M&W Gear Co. v. Commissioner*, 446 F.2d 841 (7th Cir. 1971) and *Oesterreich v. Commissioner*, 226 F.2d 798 (9th Cir. 1955).

Year	Top Rate on Regular Income	Top Rate Applies to Married Taxable Income Over:	Top Rate on Capital Gains	Notes on Capital Gains Treatment
1946-47	86.5%	200,000	25%	Exclusion 50% > 6 months; 25% maximum
1948-49	82.1%	200,000	25%	Exclusion 50% > 6 months; 25% maximum
1950	84.4%	200,000	25%	Exclusion 50% > 6 months; 25% maximum
1951-64	91%	200,000	25%	Exclusion 50% > 6 months; 25% maximum
1965-67	70%	200,000	25%	Exclusion 50% > 6 months; 25% maximum
1968	75.3%	200,000	26.9%	Vietnam War 10% surtax for part of year
1969	77%	200,000	27.5%	Vietnam War 10% surtax
1970	73.5%	200,000	32.3%	Transition on CG, Vietnam War 5% surtax; minimum tax effects
1971	70%/60%	200,000	34.3%	Transition on CG & 50% top rate on earnings; minimum tax effects
1972-75	70%/50%	200,000	36.5%	50% exclusion, minimum tax effects
1976-77	70%/50%	203,200	39.9%	50% exclusion, minimum tax effects
1978	70%/50%	203,200	39%	50% exclusion, minimum tax effects; late year reduction
1979-80	70%/50%	215,400	28%	60% exclusion
1981	70%/50%	215,400	23.7%	50% or 60% exclusion, etc., transition
1982-86	50%	215,400	20%	60% exclusion
1987	38.5%	192,930	28%	28% maximum rate
1988-90	28%/33%	*see below	28%/ 33%	Realized gains taxed same as other income
1991-92**	31% (31.9%)	84,300	28% (28.9%)	28% (28.9%) maximum rate
1993-96**	39.6% (40.8%)	255,100	28% (29.2%)	28% (29.2%) maximum rate

Year	Top Rate on Regular Income	Top Rate Applies to Married Taxable Income Over:	Top Rate on Capital Gains	Notes on Capital Gains Treatment
1997-2000**	39.6% (40.8%)	280,300	20% (21.2%)	20% (21.2% maximum rate)
2001**	39.1% (40.3%)	297,350	20% (21.2%)	"
2002**	38:6% (39.8%)	307,050	20% (21.2%)	"
2003-05**	35% (36.1%)	319,100	15% (16.1%)	Capital gains rate also applies to dividends
2006-07**	35% (35.7%)	338,525	15% (15.7%)	"
2008**	35% (35.4%)	351,250	15% (15.4%)	"
2009**	35% (35.4%)	360,050	20% (20.4%)	Dividends return to regular tax rates
2010	35%	369,050	20%	Note: All Bush tax cuts expire after 2010
2011 on	39.6% (40.8%)	378,250	20% (21.2%)	20% (21.2% maximum rate)
*1988-90 detail	28%	31,050	28%	
	33%	75,050	33%	
	28%	155,780	28%	

**Rates in parentheses include an additional tax on Adjusted Gross Income (phased out starting in 2006; repealed in 2010).

Notes: The definition of taxable income varied very substantially over the years. Taxable income is much less than actual income. Starting points for the top rate (indexed) are averages when multiple years are shown after 1987.

Further Note: 1970-81 rates reflect a lower top rate on earned income (second figure listed).