Tax Tip

Sales of Real Estate Between Related Entities—Planning to Avoid Unpleasant Surprises

By Charles H. Egerton and Edward A. Waters

A and B are equal partners in a tax partnership known as AB LLC that has owned undeveloped real property ("Blackacre") for in excess of five years. AB LLC has a tax basis in Blackacre of $500,000, but Blackacre has appreciated significantly during the past five years and was recently appraised for $2 million. A and B are both sophisticated real estate investors and are aware that Blackacre is ripe for development. After consulting with several local developers, they believe that the best use for Blackacre is for development into a multi-phase, single-family residential project that would require expenditures of an additional $1.5 million for planning, platting, engineering, permitting and approvals as well as construction of improvements and infrastructure. Upon completion of the development process, it is anticipated that the sellout would generate approximately $10 million of sales revenues over a five-year period. If the projected development and sales of single-family lots is completed by AB LLC, it would yield $8 million of ordinary income.

Assume that A and B have consulted their tax advisor who has advised them to form a new S corporation, Development Corp., to purchase Blackacre from AB LLC for its current appraised value of $2 million. A and B will each own 50 percent of the stock of Development Corp. The objective of such a sale is to lock in the current unrealized gain of $1.5 million ($2 million current fair market value less $500,000 tax basis) at long-term capital gain rates. Development Corp., would thereafter undertake the development of Blackacre into the single-family residential project and, if the projections are correct, would enjoy $6.5 million of gain ($10 million sales revenues less $2 million initial cost of Blackacre and less $1.5 million capitalized development costs) over a five-year period, all of which would be taxed as ordinary income because it would be engaged in developing and selling single-family lots to customers in the ordinary course of its business.

Taxpayers, such as AB LLC, frequently attempt to sell undeveloped property to a controlled corporation in order to lock in the pre-sale appreciation at long-term capital gains rates. Generally, such sales are made to the corporation on an installment basis with the expectation that gains would be deferred until the installment payments are received under Code Sec. 453. If the sale is respected for federal income tax purposes, the corporation will take a new tax basis under Code Sec. 1012 equal to the cost of acquiring the property ($2 million in this example).

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If A and B had owned Blackacre as tenants-in-common, rather than through AB LLC, the IRS might challenge the validity of a sale of Blackacre by them to Development Corp., on the basis that the installment notes should be viewed as disguised equity rather than debt and that the transaction, therefore, should be recast as a transfer of Blackacre to Development Corp., in exchange for stock (*i.e.*, treating the installment notes as equity or stock) that would fall within the nonrecognition provisions of Code Sec. 351(a) because A and B are in "control," as defined in Code Sec. 368(c), of Development Corp. "Control" is defined in Code Sec. 368(c) as ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote *and*at least 80 percent of the total number of shares of all other classes of stock. The IRS has been successful on a number of occasions in making its Code Sec. 351 argument, especially when one or more of the following factors have been found by the courts to be present:

- inadequate or "thin" capitalization;
- identity of interest between those who own stock and those who hold the installment notes;
- intention not to enforce the installment notes, such as failing to insist upon payment of interest and principal payments when due;
- installment notes subordinated to general creditors;
- inflated price; and
- no overriding business purpose.[1]

If the IRS prevails in its effort to recast the purported sale of Blackacre to Development Corp., in exchange for installment notes as a Code Sec. 351 nonrecognition exchange, Development Corp., will take a $500,000 carryover basis in Blackacre under Code Sec. 362(a) (rather than the $2 million cost basis under Code Sec. 1012 that would have been available if the intended sale treatment had been upheld), thereby effectively denying A's and B's objective of ultimately paying tax on the built-in $1.5 million appreciation in Blackacre at long-term capital gains rates. Adding insult to injury, the IRS may also assert that the "equity" (in the form of the installment notes) received constitutes a second class of stock with the result that Development Corp.'s S election is terminated.[2]

There are a number of steps that A and B could take to minimize or eliminate the risk that the IRS will prevail in its attempt to recast the purported sale as Code Sec. 351 exchange. An examination of the numerous cases cited in endnote 1 of this column will reveal that the courts faced with this issue have applied the six factors noted above to varying degrees in their analysis. Although the courts may vary in articulating their versions of the tests to determine whether a sale should be respected for tax purposes, the ultimate question that they are asking is whether it is reasonable to expect that A and B would have sold Blackacre to an unrelated party that was capitalized in the same manner as Development Corp., and at the price and upon the terms that make up the purported sale. With this in mind, we offer the following recommendations to shore up A's and B's chances of having the sale respected for tax purposes.

1. Obtain a contemporaneous appraisal prepared by a qualified real estate appraiser to establish that the sale price is reasonable and represents the fair market value of Blackacre.
2. Adequately capitalize Development Corp., with (for example) $750,000 of cash ($500,000 of which could be used as a down payment, and the balance could be held in reserve to cover interest payments on the installment notes). This capitalization should be undertaken to avoid the "thin-capitalization" argument that the IRS frequently makes in these cases.
3. Secure the installment notes with a first mortgage on Blackacre (or with subordination solely to a development lender, but not to general creditors), and structure the payment terms under the installment notes in such a manner that A and B are relatively confident that Development Corp., will be able to meet each and every payment of principal and interest under the notes as and when due.
4. If at all possible, bring in another investor who holds more than 20 percent of the stock of Development Corp., and who will (hopefully) be able to add additional capital to Development Corp. This will effectively create a "busted Code Sec. 351 exchange" because, if the third-party investor holds more than 20 percent of the stock of Development Corp., A and B will no longer have "control" as defined in Code Sec. 368(c).

The facts set forth in the first example described above do not, however, involve a sale by A and B, but rather posit a sale by AB LLC, a tax partnership. AB LLC does not own any stock in Development Corp., and thus does not *directly* have control of Development Corp., as required under Code Secs. 351(a) and 368(c). Unlike most other Code provisions that test for "control" or for "related parties," no attribution rules are incorporated into, or are otherwise applicable to, the determination of whether "control" exists for purposes of Code Sec. 368(c).[3] Thus, the IRS is unlikely to succeed in recasting the purported sale of Blackacre between AB LLC and Development Corp., as a Code Sec. 351 exchange. This does not mean, however, that the IRS does not have other weapons to attack the validity of the purported sale.

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The IRS has, on occasion, argued that if a sale to a related development corporation is made and is followed shortly thereafter by the development and sale of the property in such a manner that the development corporation will be treated as a "dealer" in real estate, the dealer activities of the related development corporation should be attributed back to the selling taxpayer with the result that any gains would be taxed as ordinary income.[4] However, in a 1992 decision by the Fifth Circuit Court of Appeals, the IRS's attempt to attribute dealer activities of the related corporate purchaser to the selling taxpayer was squarely rejected. In *R.H. Bramblett*,[5] the selling party was a partnership equally owned by four individuals. Shortly after the partnership was formed and real property was acquired, the same four individuals created a development corporation that was also owned equally by the same four individuals. The partnership ultimately sold almost all of its land to the development corporation, which subsequently developed and sold it to third parties in the ordinary course of its business. In the only sizable sale of real property by the partnership to the development corporation, the partnership reported its gain as long-term capital gain. The IRS argued that the profits should be taxed as ordinary income on several grounds, the first of which was that the partnership and the development corporation were jointly engaged in the development and sale of real estate in the ordinary course of a trade or business. Although the Tax Court had initially held in favor of the IRS,[6] the Fifth Circuit examined each of the arguments made by the IRS and accepted by the Tax Court in favor of ordinary-income treatment. It began its analysis by reviewing the activities of the selling partnership against the standards for testing whether a taxpayer should be regarded as having sold real property to customers in the ordinary course of its trade or business (*i.e.*, engaged in "dealer activities") established by the Fifth Circuit in *A.B. Winthrop*,[7] *Biedenharn Realty Co.*,[8] *Suburban Realty Co.*[9] and *J.D. Byram*,[10] and held that any determination by the Tax Court that the selling partnership was *directly* engaged in dealer activities was clearly erroneous, relying principally on the lack of any frequent sales or any direct engagement in development activities. The Fifth Circuit then turned to the second IRS argument that the related development corporation was the "agent" of the selling partnership. The Fifth Circuit relied upon two cases decided by the U.S. Supreme Court, *National Carbide*[11] and *M.G. Bolinger*,[12] and noted that the mere existence of common control is not sufficient to establish an agency relationship. Finally, the Fifth Circuit refused to apply the "substance-over-form" doctrine to attribute the development corporation's dealer activities to the partnership.

Although many tax commentators seem to take the view that *Bramblett* has once and for all settled the issue that an "investment entity" may sell undeveloped real estate to a related development corporation without fear of IRS challenge, this view may be overly optimistic. First and foremost, *Bramblett* is governing law only in the Fifth Circuit, and other circuits are still free to take a different view. Second, the IRS might argue that the purported debt, in the form of the installment obligation received by the selling entity, does not qualify as *bona fide* debt for federal income tax purposes with the result that the obligation should be viewed as stock (equity). Code Sec. 351(a) would not be applicable to the transaction (because the transferring entity does not have "control" of the related development corporation), and this will be treated as a fully taxable transaction under Code Sec. 1001, with the selling entity treated as having received sale proceeds equal to the fair market value of the equity received. Although this will enable the development corporation to receive a stepped-up cost basis under Code Sec. 1012, the gain to the selling entity would be fully taxable in the tax year in which the sale took place (*i.e.*, installment reporting would not be available). The IRS would rely upon some or all of the same six factors cited at the outset of this column to support its position that the installment obligation should be viewed as disguised equity.[13] In addition, if the development corporation is an S corporation, the IRS may also argue the "disguised equity" constitutes a second class of stock, thereby terminating its S status.[14] Consequently, it is still prudent for tax advisors to encourage their clients to structure sales between related entities to comply with the four recommendations set forth earlier in this column. Finally, it should be noted that if both the selling entity and the commonly controlled purchasing entity are tax partnerships, even if the sale is respected for tax purposes, all of the selling entity's taxable gain will most likely be taxed as ordinary income under Code Sec. 707(b)(2)(B) because the purchased real property will not be a capital asset in the hands of the development entity.

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If the sale of Blackacre by AB LLC to Development Corp., meets all of the standards referenced above and is to be respected for federal income tax purposes, and assuming that AB LLC has not engaged in any dealer-type activities with respect to its ownership of Blackacre, AB LLC would be entitled to report its gain from the sale on the installment basis under Code Sec. 453(a).[15] Nevertheless, if AB LLC and Development Corp., are deemed to be "related persons," as defined in Code Sec. 453(f)(1), any amount received by Development Corp. upon a subsequent disposition of any portion of Blackacre within two years of the date of the original sale will result in an acceleration of a corresponding portion of the income under Code Sec. 453(e). "Related persons" are defined in Code Sec. 453(f)(1) using the attribution rules of *both* Code Sec. 267(b) and Code Sec. 318. In order to avoid the mismatching of gain recognition and the receipt of sufficient cash payments to cover the tax on the income recognized, most mortgages securing these installment obligations will include "release provisions" requiring Development Corp., to prepay principal in order to obtain a release of a lot developed on Blackacre from AB LLC's mortgage.

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Assume now that the property held by AB LLC consists of Blackacre as well as depreciable improvements. Under Code Sec. 1239, the gain resulting from the sale or exchange of property between related persons is treated as ordinary income if the transferred property qualifies for depreciation in the hands of the transferee. Related persons are defined under Code Sec. 1239(b) to include a person and all entities which are controlled entities with respect to such person. Controlled entities are subsequently defined under Code Sec. 1239(c) and include many of the relationships specified under Code Sec. 267(b). Among these relationships are a corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of the capital interest or the profits interest in the partnership.[16] Under the facts above, the ownership of AB LLC and Development Corp., is identical, thereby qualifying them as controlled entities. As a result, the sale of the property by AB LLC to Development Corp., will fall within Code Sec. 1239, causing the gain *attributable to the depreciable improvements* (but not the land because it is not depreciable) to be characterized as ordinary income.[17]

Alternatively, assume that the buyer is a tax partnership rather than a corporation and is owned 50 percent by A and 50 percent by B. This sale will result in even harsher tax consequences than the sale between AB LLC and Development Corp., as Code Sec. 707(b)(2)(B) will apply. Under Code Sec. 707(b)(2)(B), gain recognized on the sale of property other than a capital asset between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests is characterized as ordinary income. Because AB LLC and Development Corp. are both partnerships and share identical ownership structures, and because Blackacre will not be a capital asset in Development Corp.'s hands, Code Sec. 707(b)(2)(B) will apply. The application of Code Sec. 707(b)(2)(B) is more severe than Code Sec. 1239, as Code Sec. 707(b)(2)(B) characterizes gain from both Blackacre and the depreciable improvements as ordinary income, since neither asset is a capital asset under Code Sec. 1221. In the sale between AB LLC and Development Corp., Code Sec. 1239 characterized only the gain from the depreciable property as ordinary income, while the gain from Blackacre remained capital. Thus, the tax consequences of the sale between AB LLC and Development Corp. are even less desirable than the consequences stemming from the sale between AB LLC and Development Corp.

Conclusion

In summary, sales of real property between related entities or related parties can be successfully accomplished to lock in the unrealized appreciation in value at long-term capital gains rates or for other *bona fide* reasons, but a great deal of care and attention should be devoted in structuring the transactions to avoid the many obstacles described in this column.

ENDNOTES

1 The IRS has been successful in recasting a purported sale as a Code Sec. 351 transaction and treating the installment notes as disguised equity (stock) in each of the following cases: *Gooding Amusement Co.*, 23 TC 408, CCH Dec. 20,681 (1954), *aff'd*, CA-6, 56-2 USTC ¶9808, 236 F2d 159, *cert. denied*, SCt, 352 US 1031, 77 SCt 595 (sale of business); *Aqualane Shores,* 30 TC 519, CCH Dec. 23,013 (1958), *aff'd*, CA-5,

59-2 USTC ¶9632, 269 F2d 116 (sale of land); *Truck Terminals,* 33 TC 876, CCH Dec. 24,044 (1960), *acq.*, 1960-2 CB 7, *aff'd*, CA-9, 63-1 USTC ¶9317, 314 F2d 449 (sale of equipment to subsidiary); *Burr Oaks Corp.*, 43 TC 635, CCH Dec. 27,240 (1965), *aff'd*, CA-7, 66-2 USTC ¶9506, 365 F2d 24, *cert. denied*, SCt, 385 US 1007, 87 SCt 713 (1967) (sale of land); *Slappey Drive Ind. Park*, CA-5, 77-2 USTC ¶9696, 561 F2d 572 (sale of land); *Western Hills, Inc.*, DC-IN, 71-1USTC ¶9410 (successive sales of land); and *Marsan Realty Corp.*, 22 TCM 1513, CCH Dec. 26,379(M), TC Memo. 1963-297 (sale of land). By contrast, the following cases upheld the validity of the sales and treated the installments as *bona fide* debt: *Sun Properties*, CA-5, 55-1 USTC ¶9261, 220 F2d 171 (income from transferred warehouse property sufficient to pay expenses and notes); *Piedmont Corp.*, CA-4, 68-1 USTC ¶9189, 388 F2d 886 ($10,000 cash and $160,000 purchase money notes equal to value of option right to purchase land, and there was a reasonable probability that the notes would be repaid; "thin capitalization" not sufficient to negate sale); *Gyro Engineering Corp.*, CA-9, 69-2 USTC ¶9678, 417 F2d 437 (income from transferred apartment house was sufficient to pay expenses and notes; "thin capitalization" doctrine held not applicable); *J.S. Bradshaw*, CtCls, 82-2 USTC ¶9454, 683 F2d 365 (taxpayer transferred 40-acre tract of land to his wholly owned corporation in exchange for five promissory notes; held that sale was valid because price was reasonable and formal terms of installment notes were strictly adhered to); *Hollywood, Inc.*, 10 TC 175, CCH Dec. 16,230 (1948), *acq.*, 1948-1 CB 2 (sale of land to corporation which did not develop but, instead, resold it in the same condition as acquired); *Evwalt Development Corp.*, 22 TCM 220, CCH Dec. 25,980(M), TC Memo. 1963-56 (sale of land to corporation having "not neglible" capital, 14 months after it was formed; installment notes given for prior sales were paid promptly); *C.E. Curry*, 43 TC 667, CCH Dec. 27,251 (1965), *non acq.*, 1968-2 CB 3 (sale of income-producing office building); *A.M. Rosenthal*, 24 TCM 1373, CCH Dec. 27,565(M), TC Memo. 1965-254; *A. Perrault*, 25 TC 439, CCH Dec. 21,370 (1955), *acq.*, 1956-1 CB 5, *aff'd*, CA-10, 57-1 USTC ¶9632, 244 F2d 408; *S. Tauber*, 24 TC 179, CCH Dec. 21,002 (1955), *acq.*, 1955-2 CB 9; and *W.H. Brown*, 27 TC 27, CCH Dec. 21,972 (1956), *acq.*, 1957-2 CB 4 (each involving sale of business and ascribing goodwill as an asset which augmented capital).

[2] *See* Code Secs. 1361(b)(1)(D) and 1362(d)(2).

[3] *See S.H. Brams*, CA-6, 84-1 USTC ¶9495, 734 F2d 290 and Rev. Rul. 56-613, 1956-2 CB 212.

[4] *See*, *e.g.*, *Burgher v. Campbell*, CA-5, 57-2 USTC ¶9740, 244 F2d 863; *R.W. Brown*, CA-10, 71-2 USTC ¶9634, 448 F2d 514; and *T. Tibbals*, CtCls, 66-1 USTC ¶9462, 362 F2d 266.

[5] *R.H. Bramblett,* CA-5, 92-1 USTC ¶50,252, 960 F2d 526.

[6] *R.H. Bramblett,* 59 TCM 876, Dec. 46,651(M), TC Memo. 1990-296.

[7] *A.B. Winthrop,* CA-5, 69-2 USTC ¶9686, 417 F2d 905.

[8] *Biedenharn Realty Co.,* CA-5, 76-1 USTC ¶9194, 526 F2d 404.

[9] *Suburban Realty Co.,* CA-5, 80-1 USTC ¶9351, 615 F2d 171.

[10] *J.D. Byram*, CA-5, 83-1 USTC ¶9381, 705 F2d 1418.

[11] *National Carbide,* 49-1 USTC ¶9223, 336 US 422, 69 SCt 726 , 1949-1 CB 165.

[12] *M.G. Bolinger*, SCt, 45 US 340 (1988).

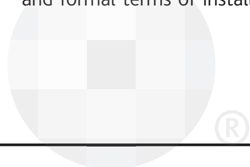
[13] *See* cases applying these six factors set forth *supra* note 1.

[14] *See supra* note 2.

[15] Installment reporting will not be applicable if AB LLC has elected out of installment reporting under Code Sec. 453(d).

[16] *See* Code Secs. 1239(b)(1), 1239(c)(1)(C) and 267(b)(10).

[17] If the depreciable improvements consist of a rental apartment complex and Development Corp., acquired the property to convert the apartments into condominiums and sell the units to customers, Code Sec. 1239 may not apply because Code Sec. 1239(a) states that the conversion to ordinary income will only occur if the improvements are depreciable "*in the hands of the transferee*." If none of the units are occupied by renters at the time of the sale and Development Corp., proceeds with the conversion and sale of units immediately following the sale, Code Sec. 1239 should not apply because the units would be inventory and not depreciable property. If, on the other hand, a number of the units were still occupied by renters at the time of the sale and Development Corp., deferred the conversion until all leases expired, it would be a much closer question.



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