Optimizing Capital Gains Tax Rates in Sales Transactions

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I. WHAT ARE THE STAKES?

A. Rate Differentials and How and to Whom They Apply

The rate spread between long term capital gains and ordinary income for non-corporate taxpayers, although non-existent as recently as 1986, has widened to the point that significant incentives now exist for preserving the capital asset or Section 1231 asset status of appreciated real properties and other assets that are to be disposed of.

1. Non-Corporate Taxpayers.

a. The maximum marginal rate applicable to individuals, estates and trusts on ordinary income is 39.6%. §1, Internal Revenue Code of 1986, as amended (hereinafter, all references to sections shall be deemed to refer to sections of the Internal Revenue Code of 1986, as amended). However, the effective rate can be increased for individuals by 1.188% under §68(b) by limiting itemized deductions, and by an additional .67% under §151(d)(3) by phasing out personal and dependent deductions. In addition, if the ordinary income constitutes net investment income derived from the conduct of a trade or business in which the taxpayer did not materially participate, it may be subject to an additional 3.8% tax under §1411. Thus, the maximum effective federal income tax marginal rate applicable to the ordinary income of individuals can reach 45.258%.

b. Long term capital gains derived by non-corporate taxpayers from sales or (taxable) exchanges of capital assets or of §1231 assets that are included within net §1231 gains for the taxable year will be taxed at the following rates: (i) 28% on gains from the sale of collectibles (§1(h)(1)(F)); (ii) 25% on unrecaptured §1250 gain (i.e., recapture of straight line depreciation on real estate improvements) (§1(h)(1)(E); and (iii) either 15% or 20% on all other long term capital gains (§1(h)(1)(C). In addition, if the capital gain constitutes net investment income, it will be subject to an additional 3.8% tax under §1411(a).

c. Net long term capital losses of non-corporate taxpayers may be deducted against other income in an amount not to exceed $3,000 per year, with any excess carried over to succeeding taxable years. §§1211(b) and 1212(b).

d. If a taxpayer has net short term capital gain for a taxable year, the gain will be taxed at ordinary rates.

2. Corporate Taxpayers. The maximum marginal rate applicable to both ordinary income and long term capital gains of a corporate taxpayer is 35%. §§11 and 1201.

Capital losses of a C corporation may be applied against capital gains, but may not otherwise be deducted against other income. §1211(a). Excess capital losses may be carried back three years (except in the case of a REIT--§1212(a)(4)(b)) and forward five years pursuant to §1212.

If a REIT sells "dealer property" (i.e., property held primarily for sale to customers in the ordinary course of a trade or business as described in §1221(a)(1)) other than foreclosure property and has a recognized gain from the sale, this will be treated as income from a prohibited transaction and will be subject to a 100% tax under § 857(b)(6) unless the sale transaction falls within one of the two safe harbors set forth in §§ 857(b)(6)(C) and (D).

3. Recharacterization of Income Under Recapture Rules. Congress has enacted a variety of recapture rules over the years which are designed to recapture as ordinary income the benefit of prior depreciation deductions and certain other ordinary losses that have been claimed by taxpayers in prior years to offset ordinary income. The recapture provisions most commonly encountered in the sales or exchanges of real property and other assets are discussed below.

a. Recapture Under Sections 1245 and 1250. Section 1245 operates to reclassify as ordinary income what would otherwise be § 1231 gain of the taxpayer, taxable at long term capital gain rates if such gain was included in the taxpayer's net § 1231 gains for such year, with respect to a sale or taxable exchange of depreciable tangible personal property and certain other specified properties. § 1245(a)(1). By contrast, Section 1250(a)(1), which applies to depreciable real property placed in service prior to 1986, recaptures only the accelerated portion of depreciation deductions allowable for such real property. Caveat: certain assets such as citrus trees, although generally treated as real property under state law, are classified as § 1245 property (subject to full depreciation recapture) for federal income tax purposes.

b. Section 1231(c) Recapture. Section 1231(c) contains an often overlooked recapture provision that may apply to recognized gain from the sale or exchange of a taxpayer's §1231 assets. Although the recognized net §1231 gains derived from the sale or exchange of a taxpayer's §1231 assets during the taxable year will generally be eligible for long term capital gain treatment under §1231(a)(1), a portion or all of such recognized gain may be recharacterized as ordinary income under §1231(c) to the extent that the taxpayer had net §1231 losses in any of such taxpayer's 5 preceding taxable years which have not previously been recaptured during such 5 year period.

c. Unrecaptured Section 1250 Gains. Section 1(h)(1)(E) provides that unrecaptured §1250 gain will not be eligible for the 15%-20% rates generally applicable to long term capital gains but rather will be subjected to a special 25% rate. Unrecaptured §1250 gain, as defined in §1(h)(6), includes the amount of gain that would have been recaptured under §1250 (which applies to depreciable real property used in a trade or business or held for investment) based on the assumption that §1250(b)(1) applies to all depreciation (rather than just accelerated depreciation) and the further assumption that the applicable percentage under such section is 100% . In other words, it operates as a full depreciation recapture provision but subjects the recaptured income to a special 25% rate.

Under Reg. §1.1(h)-1(b)(3)(ii), when an interest in a partnership held for more

than one year is sold or exchanged in a fully taxable transaction, the selling partner must take into account in computing his unrecaptured §1250 gain for the taxable year in which the sale occurred the amount of §1250 gain that would have been allocated to him, with respect to the portion of his partnership interest that was sold, if the partnership had disposed of all of its §1250 property in a fully taxable transaction for cash in an amount equal to the fair market value of such property. These rules only apply to the sale of a partnership interest and are not applicable to the liquidation of a partnership interest (i.e., a redemption of a partnership interest which is governed by §736). Reg. §1.1(h)-1(b)(3)(ii)(last sentence).

The look through rules applicable to unrecaptured §1250 gain that apply to the sale of a partnership interest are not applicable to the sale of stock of an S corporation.

If a C corporation, or an S corporation that was a C corporation at any time during its 3 preceding taxable years, sells real property with unrecaptured §1250 gain it is required to recapture 20% of the depreciation on such property, but not to exceed the recognized gain on such transaction, as ordinary income under §291(a)(1).

d. Collapsible Provisions. The collapsible partnership provisions of §751 override the general rule of §741 that the sale of a partnership interest will be treated as a sale of a capital asset. If the partnership in which the selling partner had an interest held either inventory or unrealized receivables, as such terms are defined in §§751(c) and (d), the portion of the sale proceeds received by the selling partner attributable to his interest in such assets will be treated as having been received in exchange for property other than a capital asset. Thus, a portion or all of such selling partner's gain from the sale may be treated as ordinary income.

Section 341, frequently referred to as the "collapsible corporation provision", was the counterpart to § 751 in Subchapter C governing the taxation of C corporations. Section 341 was originally repealed on a temporary basis by the Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA"), Section 302(e)(4). The repeal was subject to JGTRRA's sunset provision (Section 303) which provided in part that the repeal of this provision would expire at the end of 2010. However, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 TRA"), Section 102, amended the JGTRRA sunset provision to postpone expiration until December 31, 2012. Finally, the American Taxpayer Relief Act of 2012 ("2012 ATRA"), Section 102(a), removes the JGTRRA sunset provision applicable to § 341, thereby making the repeal of the collapsible corporation provisions permanent.

e. Character Freezing Provisions. There are several provisions in the Code and regulations that operate to freeze the character of an asset in the hands of a taxpayer who holds such asset as dealer property when that asset is subsequently transferred by such taxpayer to an entity in a non-recognition transaction.

Section 724 provides that if property that is dealer property in the hands of a partner is contributed by such partner to the partnership in a § 721 non-recognition transaction and the partnership has a recognized gain or loss from the sale of such property within 5 years after it was contributed, such gain or loss will be ordinary. It should be noted that the amount of ordinary gain or loss recognized by the partnership under § 724 will not be limited to the amount of built-in gain or loss at the date of contribution.

Section 735 is the flip side of § 724 and freezes the character of certain assets held by a partnership when they are distributed out to one or more partners. If a partnership distributes an asset that constitutes an "unrealized receivable," as defined in § 751(c), to a partner, any gain or loss recognized by such distributee partner from a taxable sale of such asset will be ordinary in nature, regardless of when the sale takes place (*i.e.,* there is no 5 year time limitation). § 735(a)(1). Section 735(a)(2) also provides that if an asset that constitutes an inventory item under § 751(d) in the hands of the partnership (subject to a special rule relating to § 1231 assets) is distributed to a partner and such partner recognizes a gain or loss from the sale of such asset within 5 years from the date it was distributed to him, such gain or loss will be ordinary.

Character freezing rules also apply in the S corporation area. Under § 1366(b) and Reg. § 1.1366-1(b)(1), if the sale of an asset by an S corporation results in long term capital gain, each shareholder's allocable share of such gain will retain its character as such even though such shareholder may otherwise be deemed to be a dealer in such assets.

Reg. § 1.1366-1(b)(2) contains an anti-abuse rule intended to prevent one or more shareholders who hold dealer property from contributing such property to an S corporation in a § 351 non-recognition transaction and thereafter cause the S corporation to sell the contributed property and report the gain as long term capital gain. This regulation requires that such gain be treated as ordinary income. Unlike § 724 in the partnership area, this regulation has no 5 year time limitation.

5. Holding Period. The favorable rates applicable to recognized gains from the sale or exchange of a capital asset discussed in part I. A.1., *supra*, are only available for long term capital gains. Long term capital gains are recognized gains derived from the sale or exchange of capital assets held for more than 1 year. §1222(3). The favorable rates applicable to long term capital gains also apply to the taxpayer's net §1231 gains for the taxable year. In the case of a sale or exchange, the assets sold that resulted in the net §1231 gain must consist of property used in the taxpayer's trade or business of a character which is subject to the allowance for depreciation under §167 and which is held for more than 1 year, as well as real property (including land, which is non-depreciable) used in the taxpayer's trade or business and which is held for more than 1 year. §1231(b)(1). Thus, to qualify for these favorable rates the selling taxpayer must have a holding period with respect to such capital assets and §1231 assets that exceeds 1 year.

a. General Rules For Determining Holding Period. If a taxpayer purchases an asset, his holding period generally commences on the date of purchase and terminates on the date he disposes of it. In some instances, however, the taxpayer's holding period may relate back to a prior transaction that gave rise to a "tacking" of holding periods, such as under the circumstances described in §1223. Thus, for example, if a taxpayer contributes a capital asset that had been held by him for 2 years at the time of contribution to Corporation X in exchange for stock in a transaction described in §351in which no gain or loss is recognized, the stock received by him in the transaction will have a holding period in his hands of 2 years. §1223(1).

b. Special Rules Applicable To Determining The Holding Period Of

Partnership Interests. If a taxpayer contributes $100 cash to a partnership in exchange for a partnership interest, her holding period with respect to the partnership interest received commences on the date of issuance. Suppose that, instead of contributing cash, the taxpayer contributed a capital asset which she had held for two years immediately prior to the contribution and which had a fair market value of $100 to the partnership in exchange for a partnership interest. No gain or loss will be recognized by the taxpayer under §721, the tax basis that she will take in the partnership interest will be the same as the tax basis that she had in the contributed asset under §722, and her holding period for the partnership interest received will include the two year holding period for the contributed capital asset pursuant to §1223(1).

(1) Simultaneous Contributions of Two or More Assets. If the taxpayer contributed both $100 cash and a capital asset worth $100 in which she had a two year holding period to the partnership in exchange for a partnership interest worth $200, what holding period will she have in her partnership interest? Reg. § 1.1223-3(a) provides that, as a general rule, a taxpayer will not have a divided holding period for a partnership interest unless (1) the partner acquired portions of the partnership interest at different times, or (2) the partner acquired portions of the partnership interest in exchange for property transferred at the same time but resulting in different holding periods (citing, for example, a tacking of holding periods under circumstances described in § 1223). Under the facts posed above, Reg. § 1.1223-3(b)(1) instructs that the portion of a partnership interest to which a holding period relates is to be determined by reference to a fraction, the numerator of which is the fair market value of the portion of the partnership interest received in exchange for a contributed property that establishes a holding period for such portion of the partnership interest, and the denominator of which is the fair market value of the entire partnership interest received in the transaction. Thus, based on the facts of our example and focusing first on her $100 cash contribution, the numerator of the fraction will be $100 representing the $100 fair market value of the portion of her partnership interest received by the taxpayer in exchange for her $100 cash contribution, and the denominator will be $200 which is the fair market value of the entire partnership interest received by the taxpayer in the transaction. The result of this calculation indicates that 50% of the partnership interest received by her will be attributable to her $100 cash contribution and will have a holding period commencing on January 1, 2016, the date of its issuance. The remaining 50% of the partnership interest will be deemed to have been received by the taxpayer in exchange for her contribution of the $100 capital asset in which she had a 2 year holding period on the date of contribution and will have a holding period in the taxpayer's hands of 2 years (determined in the same manner by applying the fraction rule described in the Regulation) under §1223(1) on the date of issuance (1/1/16).

(2) Impact Upon Holding Period When Taxpayer Makes Additional Cash Capital Contributions. Assume that the transactions described in i. above took place on January 1, 2016. Assume further that on January 1, 2017, when the fair market value of the taxpayer's partnership interest had risen to $400, the taxpayer made an additional capital contribution of $100 in cash to the partnership and that she also received a cash distribution of $50 from the partnership on March 1, 2017. On June 30, 2017, the taxpayer sold her entire partnership interest for $600 at a time when the partnership had no § 751 assets and no unrecaptured § 1250 gain. The sale resulted in a $400 capital gain under § 741.

How do we determine how much of this $400 gain is long term or short term? In

order to make this determination, we must first determine what impact the additional cash contribution made by the taxpayer on January 1, 2017, as well as the cash distribution received by the taxpayer on March 1, 2017, may have on the holding period in her partnership interest. We know from the example in i. above that on January 1, 2016, 50% of her partnership interest had a holding period commencing on January 1, 2016 (attributable to her initial $100 cash contribution to the partnership in exchange for a portion of her partnership interest), and the remaining 50% of her interest had a 2 year holding period on January 1, 2016 (attributable to her contribution of the $100 capital asset which enabled her to "tack" her 2 year holding period in the capital asset to 50% of her partnership interest). Under Reg. §§ 1.1223-3(b)(1) and (2) and Reg. § 1.1223-3(f), *Example (3)*, we discover that a cash contribution, even though it may have been paid on a pro rata basis by all of the partners, is deemed to result in the acquisition of an additional portion of the taxpayer's partnership for purposes of determining the holding period of the taxpayer's partnership interest and results in a further bifurcation of the taxpayer's holding period in her partnership interest. However, Reg. § 1.1223-3(b)(2) contains a taxpayer-friendly rule that allows a partner to net all cash distributions received within the 1-year period ending on the date of sale of the partnership interest against all cash contributions made by such partner within such 1-year period (on a last-in, first-out basis), with only the excess (if any) of cash capital contributions over cash distributions being treated as a cash contribution to the partnership. By applying this rule, the taxpayer will be treated as having made an additional cash contribution of a net $50 on January 1, 2017. Based upon the facts assumed above, the partnership interest had a fair market value of $400 on January 1, 2017, when the taxpayer was treated as having made a $50 net cash contribution to the partnership. Applying the formula set forth in Reg. § 1.1223-3(b)(1), $50/$450 equals one-ninth. Thus, one-ninth of taxpayer's partnership interest will be treated as having a holding period commencing January 1, 2017. When the sale of the taxpayer's entire partnership interest took place on June 30, 2017, eight-ninths of her partnership will have a holding period in excess of 1 year and, therefore, eight-ninths of her $400 gain will be long term. The remaining one-ninth of her $400 gain will be short term. See, Reg. § 1.1223-3(f), *Example (3)*.

B. <u>Availability of Installment Reporting</u>

When a taxpayer sells real property which is dealer property any gain realized from such sale will not be eligible for reporting on the installment method.

1. Dealer Dispositions. Section 453(b)(2)(A) provides that an installment sale does not include a "dealer disposition". Thus, any gains derived from a dealer disposition may not be deferred under §453. Section 453(*l*)(1)(B) defines a dealer disposition to include any disposition of real property which is dealer property in the hands of the taxpayer.

a. An exception to the loss of installment reporting is provided under §§453(*l*)(2)(B) and (3) for certain sales of time share interests and residential lots if the taxpayer agrees to pay an interest toll charge for the privilege of deferring income on the installment method.

C. <u>Section 1031 Exchanges</u>

Real property which is dealer property in the hands of the taxpayer will <u>not</u>

qualify for non-recognition treatment under §1031 if it is exchanged for other real property under § 1031(a)(2)(A) because it will be deemed to be "stock in trade or other property held primarily for sale."

II. DEALER VS. INVESTOR: FATHOMING THE "GOSSAMER LIKE DISTINCTIONS"

A. Statutory Requirements for Long-Term Capital Gain Treatment

Section 1222(3) defines "long-term capital gain" as gain from the sale or exchange of a capital asset held for more than one year (provided that such gain is taken into account in computing gross income). Thus, assuming that any such gain will be recognized for federal income tax purposes, there are three elements which must be present in order to qualify for long-term capital gain treatment:

1. Sale of Exchange. The gain must be derived from a "sale or exchange" in order to be accorded long-term capital gain treatment.

a. That the term "sale" is not defined in the Code, but has been interpreted by the courts to have its plain and ordinary meaning. A sale is generally defined as a transfer of property in exchange for cash and/or a promise to pay money. *Rogers v. Commissioner*, 103 F.2d 790 (9th Cir. 1939), *cert. denied*, 308 U.S. 580 (1939); *Guardian Industries Corp. v. Commissioner*, 97 T.C. 308 (1991). Likewise, an "exchange" has been defined simply as a transfer of property for other property. *Commissioner v. Brown*, 380 U.S. 563 (1965).

b. Congress has from time-to-time added provisions to the Code that create a deemed sale or exchange where one would not otherwise exist in order to characterize gains or losses from specific types of transactions as capital gains or capital losses. One such provision is §1234A which provides that "Gain or loss attributable to the cancellation, lapse, expiration or other termination of (1) a right or obligation…with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer…shall be treated as gain or loss from the sale of a capital asset."

CRI-Leslie, LLC v Commissioner¸ 147 T.C. No. 8(9/7/16) presented a case of first impression with regard to the interpretation of §1234A. The taxpayer in *CRI-Leslie* was an LLC that was treated as a tax partnership. The LLC purchased the Radisson Bay Harbor Hotel in Tampa, Florida, in February, 2005 for $13.8 million and thereafter operated a hotel and restaurant business on the property, using an independent third party as the hotel manager. In July, 2006, the LLC entered into a contract to sell the entire hotel property and business to RPS, LLC for $39 million. The contract for sale was amended a number of times over the ensuing two years including an increase of the purchase price and extensions of the closing date. The contract finally terminated in 2008 when the purchaser failed to close and the $9.7 million deposit paid by the purchaser was forfeited to the LLC. The LLC reported the entire $9.7 million gain as a long-term capital gain on its 2008 federal income tax return. In November, 2013, the Service issued a final partnership administrative adjustment to the tax matters partner of the LLC which recharacterized the entire $9.7 million gain from long-term capital gain to

ordinary income.

The case was submitted to the Tax Court on a fully stipulated basis, with the ultimate outcome dependent upon whether §1234A applied to the transaction. Included in the stipulation was an acknowledgment by both the LLC and the Service that the entire hotel property, improvements and related business assets constituted §1231 property. Section 1234A, which is quoted in relevant part above, creates a sale or exchange upon an expiration or termination of "a right or obligation which is (or on acquisition would be) *a capital asset* in the hands of the taxpayer". (Emphasis supplied). The Service argued that the definition of a capital asset, as set forth in §1221(a), specifically excludes from its ambit §1231 assets. §1221(a)(2). It further argued that the plain and unambiguous language of §1234A limits its application solely to assets which are capital assets in the hands of the taxpayer.

The LLC attempted to counter this argument by the Service by noting that, had the LLC completed the sale of the hotel property to RPS, LLC, its gain would have been treated as long-term capital gain under the provisions of §1231. The LLC argued that §1234A was enacted by Congress to ensure that taxpayers receive the same tax treatment whether a contract is closed or is terminated, and that the narrow reading of §1234A advocated by the Service would lead to the illogical result of treating a gain upon receipt of termination payments on a contract to sell §1231 assets as ordinary income while treating gain from a sale of the same property as long-term capital gains.

The Tax Court agreed with the Service that the plain and unambiguous language of §1234A specifically limits its application to capital assets, thus rejecting the LLC's argument that the Tax Court should look into the Congressional intent underlying the enactment of §1234A which the Tax Court noted would only be appropriate to resolve ambiguities in the statutory language. Finding no such ambiguities, the Tax Court refused to extend §1234A to §1231 assets.

2. Capital Asset. Section 1221 provides in pertinent part that a "capital asset" is "property held by the taxpayer," but does not include "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." §1221(1). Property used by the taxpayer in his trade or business and which is subject to the allowance for depreciation provided in §167, as well as any real property used by the taxpayer in his trade or business (regardless of whether or not such property is depreciable), is also excluded from the definition of "capital asset." However, gains from sales or exchanges of any such trade or business property held for over 1 year will be treated as long term capital gains (except to the extent that any recapture provisions apply) provided that the gains from all taxable dispositions of such properties by the taxpayer in the taxable year at issue exceed the losses from the disposition of such assets within such taxable year. §§1231(a) and (b). *See*, discussion under II. B., *infra*.

3. Holding Period. A capital asset that is sold must be held (or deemed to have been held if tacking of holding periods is appropriate under §1223) for more than one year in order for the gain to qualify as "long term." Similarly, a trade or business asset must be held in excess of 1 year at the time of its sale to be treated as a §1231 asset. §1231(b).

B. Dealer Property

As noted in II.A.2., *supra*, "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" is specifically excluded from the definition of a "capital asset." Such property is commonly referred to as "dealer property." The characterization of real property as either a capital asset (or a §1231 asset) or dealer property is one of the most frequently litigated issues in the tax law. More often than not, the distinction between investment property and dealer property is difficult to discern, leading one appellate judge to refer to the issue as an "old, familiar, recurring, vexing and ofttimes elusive" problem. *Thompson v. Commissioner*, 322 F.2d 122 (5th Cir. 1963). The Fifth Circuit Court of Appeals, which has decided more dealer vs. investor cases than any other circuit, is prone to express its exasperation over the difficulty of deciding these cases through the use of flowery metaphors. For example, consider the following:

> "Finding ourselves engulfed in a fog of decisions with gossamer like distinctions, and a quagmire of unworkable, unreliable, and often irrelevant tests, we take the route of an ad hoc exploration to find ordinary income." *United States v. Winthrop*. 417 F.2d 905, 906 (5th Cir. 1969).
>
> "In analyzing a case of this sort no rubrics of decision or rubbings from the philosopher's stone separate the sellers garlanded with capital gains from those beflowered in the garden of ordinary income." *Id*. at 911.

1. Primarily for Sale. A taxpayer can, and usually does, have more than one purpose for holding a parcel of real property. In order to be excluded from the definition of a "capital asset" under §1221(1), the property must be held **primarily** for sale to customers in the ordinary course of a trade or business. The Supreme Court, in *Malat v. Riddell*, 383 U.S. 569 (1966), has held that the word "primarily" in §1221(1) means "principally," and "of first importance." Thus, for example, if a taxpayer holds property for rental purposes and also for sale (and if such selling activities would rise to the level of a "trade or business"), the sale intent must be predominant over the rental intent.

2. Early Confusion Over Whether Profits from Sales of Realty Are Derived from External Factors vs. Taxpayer Efforts. In *United States v. Winthrop*, 417 F.2d 905 (5th Cir. 1969), the Service argued for a "taxpayer efforts rule" asserting that the taxpayer was not entitled to capital gains treatment because the appreciation in value of property was attributable primarily to the efforts of the taxpayer (e.g., obtaining entitlements, subdivision of land or construction of improvements to make the land more saleable). The following quote from *Winthrop* sets forth the Service's argument in this regard:

> "In other words, the government argues that where the appreciation is due to the taxpayer's efforts, all profit should be reported as ordinary income. In statutory terms the government argues that the subdivided land ceased to be a 'capital asset' when the taxpayer improved the land through his own efforts by platting the lots, paving streets, and installing utilities. Although recognizing that the subdivided land is not expressly removed from the 'capital asset' category by the exclusionary provisions of I.R.C. §1221 unless such land is held primarily for sale

to customers in the ordinary course of business, the government, nevertheless, maintains that its taxpayer efforts rule has, in effect, been read into the statute by the courts." *Id*. at 908.

The Fifth Circuit, noting that numerous prior cases had allowed capital gains treatment even where the taxpayer's efforts have contributed to value, expressly rejected the Service's proposed rule of construction that taxpayer improved properties must automatically be excluded from the definition of capital assets.

3. Sales to Customers in the Ordinary Course of a Trade or Business. The statutory exclusion of real property from the capital asset category under §1221(1) requires not only that the property be held "primarily for sale" (it is axiomatic that every property is held "primarily for sale" at the point in time that it is sold), but the holding for sale must also be to "customers in the ordinary course of his trade or business." As the Supreme Court observed in its opinion in *Malat v. Riddell*, §1221(1) is designed to differentiate between "profits and losses arising from the everyday operation of a business" and "the realization of appreciation in value over a substantial period of time." 383 U.S. at 572. As virtually every court that has tackled this issue has come to realize, this standard is far easier to articulate than to apply. Ascertaining the principal purpose for which a taxpayer held real property is necessarily a factual issue and requires a complete judicial review of all of the surrounding facts and circumstances. In order to bring some degree of order to this process, the courts have developed a number of key factors to be applied in this analysis. The following list of factors from *United States v. Winthrop*. 417 F.2d 905 (5th Cir. 1969) is representative and is frequently cited:

a. The nature and purpose of the acquisition of the property and the duration of the ownership.

b. The extent and nature of the taxpayer's efforts to sell the property.

c. The number, extent, continuity and substantiality of the sales.

d. The extent of subdividing, developing and advertising to increase sales.

e. The use of a business office for the sale of the property.

f. The character and degree of supervision or control exercised by the taxpayer over any representative selling the property.

g. The time and effort that the taxpayer habitually devoted to the sales.

417 F.2d at 910.

Although the factors set forth above are often cited, the courts have made it clear that no single factor controls. However, in *Biedenharn Realty Co., v. United States*, 526 F.2d 409 (5th Cir. 1976), *cert. denied*, 429 U.S. 819 (1976), the court noted that the most important of these factors appear to be the substantiality and frequency of sales, the degree of improvements

made by the taxpayer, and the solicitation and advertising efforts including broker activities. *Id*. at 415.

4. Examination of the Factors.

a. Nature and Purpose of Acquisition, and Duration of Ownership. Although §1221(1) focuses on the purpose for which real property is held, a number of courts have found it relevant to inquire why the property was originally acquired. If the taxpayer can demonstrate from the evidence that the property was clearly acquired for investment purposes, it will certainly be helpful to the taxpayer although the courts have almost uniformly recognized that, even though property may have been originally acquired for investment purposes, that purpose may change over time. *See*, e.g., *Suburban Realty Co. v. United States*, 615 F.2d 171 (5th Cir. 1980), cert. denied, 449 U.S. 920 (1980); *Biedenharn Realty Co., Inc. v. United States*. 526 F.2d 409 (5th Cir. 1976), cert. denied, 429 U.S. 819 (1976), and *Commissioner v. Tri-S Corp*., 400 F.2d 862 (10th Cir. 1968). In *Boree v Commissioner*, 837 F.3d 1093 (11th Cir. 2016), the taxpayers who had developed real property as a single family residential subdivision and sold a significant number of lots to customers over several years, attempted to claim a change of purpose when it bulk-sold the remaining portion of their property in a subsequent year. The taxpayers were faced with unexpected new restrictions imposed by the county commission on the sale of single family lots from subdivisions such as theirs' which would have required them to incur substantial additional expenses to comply with these new restrictions. The taxpayers opted instead to bulk-sell the remainder of their property to another developer. The taxpayers reported their gain from the sale as long-term capital gain. The Eleventh Circuit affirmed the prior decision of the Tax Court that held the taxpayers' gain was ordinary income, finding that the taxpayers had always intended to develop and sell their property in the ordinary course of their real estate sales business and that the final bulk sale was merely a continuation of this business activity.

Perhaps the most helpful factor of all is when the taxpayer acquires property by gift or inheritance (see discussion at II.B.5., *infra*), but even this factor is not enough to overcome facts which indicate a clear change in direction. *See, e.g., Winthrop,* 417 F.2d at 911-912.

b. Extent and Nature of Taxpayer's Efforts to Sell the Property. Although this factor is cited in most of the decided cases involving the dealer vs. investor issue, there is a wide degree of variance in how the courts have applied this factor to a particular set of facts. With the possible exception of a fortunate investor who receives an unsolicited offer for his property, most taxpayers who hold property for investment ultimately resort to some degree of sales activities to sell the property such as placing a "for sale" sign on the property, listing the property with a broker, etc. On the other end of the spectrum, a taxpayer who is actively engaged in the business of subdividing and selling real estate may have a very active sales force which promotes the sale of lots or improved properties in a variety of ways. The higher the degree of sales activity, the greater the risk that a court will find that §1221(1) applies. *Biedenharn Realty Co., Inc. v. United States, supra; Sanders v. United States*, 740 F.2d 886 (11th Cir. 1984); *Ferguson v. Commissioner*, 53 T.C.M. 864 (1987). In some cases when the market is "hot" and taxpayers have been able to sell lots with virtually no sales activities (including the absence of any brokers), the courts have still found that the property is dealer

property based upon a combination of other factors. *Thompson v. Commissioner*, 322 F.2d 122 (5th Cir. 1963); and *United States v. Winthrop, supra*. The following quote from the opinion in *Winthrop* is instructional:

> "The taxpayer has made much over the fact that no office was used, no brokers were employed, no time was spent promoting sales, and no advertising was used. . . . Here it is evident that the taxpayer was quite successful in selling the lots without the assistance of these usual props. It is not necessary that customers be actively and fervently and frenetically sought. *Winthrop* had lots to sell and not mousetraps, so they beat a way to his door to buy his lots." 417 F. 2d at 912.

c. Number, Extent, Continuity and Substantiality of Sales. This factor, together with the development activities undertaken by the taxpayer, consistently carry the most weight in the courts' analysis. In *Biedenharn Realty Co., Inc. v. United States, supra*, the court cited this factor as the most important of all.

> "Although frequency and substantiality of sales are not usually conclusive, they occupy the preeminent ground in our analysis. The recent trend of Fifth Circuit decisions indicates that when dispositions of subdivided property extend over a long period of time and are especially numerous, the likelihood of capital gains is very slight indeed. . . . Conversely, when sales are few and isolated, the taxpayer's claim to capital gain is accorded deference." 526 F.2d at 416.

Despite the emphasis accorded this factor by the courts, there does not seem to be any magic number of sales that will separate a dealer from an investor. Compare, *Suburban Realty Co. v. United States*, 615 F.2d 171 (5th Cir. 1980), *cert. denied*, 449 U.S. 920 (1980) (244 lot sales over a 32-year period); *Biedenharn Realty Co., Inc. v. United States, supra* (208 lot sales together with 12 additional parcels sold within a 31-year period, coupled with 477 lots sold from properties other than those at issue) *and Sanders v. United States*, 740 F.2d 886 (11th Cir. 1984) (an average of 15 lot sales per year over a five-year period) which found dealer status, with *Byram v. United States*, 705 F.2d 1418 (5th Cir. 1983) (22 parcels of real estate sold over a three-year period for over $9,000,000) which found investor status. It is clear from review of the cases that the more frequent and substantial the sales of real property by the taxpayer, the heavier the burden imposed upon him to obtain capital gains status. It should be noted that some courts have even held that a single sale can result in ordinary income if the taxpayer engaged in substantial development activity. *See, e.g., Patterson v. Belcher*, 302 F. 2d 289 (5th Cir, 1962); *Guardian Indus. Corp. v. Commissioner*, 97 T.C. 308 (1991), *aff'd in unpublished opinion*, 21 F. 3d 427 (6th Cir, 1994); and *S&H, Inc. v. Commissioner*, 78 T.C. 234 (1982).

The courts have also emphasized the substantiality of sales, comparing the amount of income derived from real estate activities with income from other activities of the taxpayer. *See, e.g., Guardian Industries Corp. v. Commissioner*, 97 T.C. 308 (1991). However, it should be noted that a taxpayer who holds property for long term appreciation may have a very large amount of income derived from the sale of that property in a particular year which may dwarf his other sources of income. This factor by itself should certainly not be determinative because it can also be an indication that the property has appreciated significantly over a long period of time, the hallmark of an investor.

d. Development Activities. Any development activity by the taxpayer (directly or through agents) which is designed to make the property more marketable to potential buyers makes the taxpayer look more like he is in the business of selling real estate in the eyes of the courts. Thus, platting properties (for a subdivision) coupled with clearing, grading, construction of entryways, streets, sewers, etc. are considered by the courts to be indicia of dealer activity. *See, e.g., Bush v. Commissioner*, 610 F.2d 426 (6th Cir. 1979); *Jersey Land & Development Co. v. United States*, 539 F.2d 311 (3rd Cir. 1976); *United States v. Winthrop*, 417 F.2d 905 (5th Cir. 1969); and *Bynum v. Commissioner*, 46 T.C. 295 (1966). However, if the improvements are not too extensive and the taxpayer can prove that they added very little to the gain which was ultimately realized by the taxpayer on the disposition, the taxpayer may still obtain capital gains status. *See, Huey v. United States*, 504 F.2d 1388 (Ct.Cl. 1974); *Barrios Estate v. Commissioner*, 265 F.2d 517 (5th Cir. 1959) and *Brodnax v. Commissioner*, 29 T.C.M. 733 (1970).

In *Gartrell v. United States*, 619 F.2d 1150 (6th Cir. 1980), the taxpayer was employed full time in a non-real estate position. The taxpayer purchased real property, subdivided it and added gravel roads and then sold the lots over a 20-year period. The court determined that the sales generated capital gains. In *Buono v. Commissioner*, 74 T.C. 187 (1980), *acq*., 1981-1 C.B. 1, an S corporation purchased a tract of land with a view to obtaining residential zoning approval on the tract and then selling it in bulk to a developer. It was anticipated that the property would be held for only 1-1/2 years. After a protracted and expensive process that lasted over 5 years, zoning approval was finally obtained and the property was sold in three transactions. The Tax Court noted that even though the property had always been held for sale to customers, the taxpayer had never engaged in a trade or business because of the infrequency of the sales of property by the taxpayer.

At least three Circuit Courts of Appeals have stated that significant development activity coupled with frequent and regular sales will almost always result in dealer classification. *Biedenharn Realty Co., Inc. v. United States*, 526 F.2d 409 (5th Cir. 1976), cert. denied, 429 U.S. 819 (1976); *Gault v. Commissioner*, 332 F.2d 94 (2d Cir. 1964); and *Achong v. Commissioner*, 246 F.2d 445 (9th Cir. 1957).

e. Use of a Business Office for Sale of Property. The use of a business office to conduct and coordinate sales activities for real estate together with obtaining the necessary licenses and permits to conduct the sales activities are considered indicia of dealer status. See, *Segel Est. v. Commissioner*, 370 F.2d 107 (2d Cir. 1966).

f. Supervision or Control Exercised by Taxpayer Over Selling Efforts. The devotion of a significant amount of time by the taxpayer with regard to the sale of properties, together with hands-on supervision and control of any agents who are involved in such efforts, were found by the courts to support dealer status. *See, e.g., Biedenharn Realty Co., Inc. v. United States, supra*. However, in *Fahs v. Crawford*, 161 F.2d 315 (5th Cir. 1947) and *Smith v. Dunn*, 224 F.2d 353 (5th Cir. 1955), the taxpayer turned the entire property over to brokers who were granted total responsibility with respect to the sale of properties including decisions regarding the setting of sales prices. The court in both *Fahs* and *Smith* found that the taxpayer was an investor rather than a dealer. Under normal circumstances, however, any activities undertaken by a broker will be attributed to the taxpayer because the broker will be

regarded as the taxpayer's agent. *Biedenharn, supra*.

g. Time and Effort Devoted by Taxpayer to Sales Activities. The devotion of a significant amount of time by the taxpayer to the types of activities that imbue the property with dealer characteristics will increase the likelihood that the taxpayer will be deemed to be a dealer with respect to the property in question.

5. Special Treatment for Property Acquired by Gift or Inheritance. Property which is received by a taxpayer through inheritance or through a lifetime gift is generally viewed in a more favorable light by the courts (this relates to the first factor in *Winthrop* — the nature and purpose of the acquisition of the property). The courts have even exhibited a willingness to permit a taxpayer to engage in a certain amount of development and sales activities in order to dispose of inherited or gifted property. For example, in *Yunker v. Commissioner*, 256 F.2d 130 (6th Cir. 1958), the taxpayer inherited farm land. The taxpayer was unable to sell the inherited property as a whole. However, with the aid of a real estate broker, the taxpayer improved the land by building roads and providing utilities. The taxpayer then sold the land and subdivided lots over a two-year period. The court allowed capital gains treatment for the income from the sale of the property, and stated "Where a taxpayer liquidates his real estate holdings in an orderly and businesslike manner, he is not by that circumstance held to have entered into the conduct of a business." *Id*. at 134. *See, also, Reidel v. Commissioner*, 261 F.2d 371 (5th Cir. 1958), and *Fahs v. Taylor*, 239 F.2d 224 (5th Cir. 1956), *cert. denied*, 355 U.S. 936 (1957).

On the other hand, if the liquidation process extends over a considerable period of time and is coupled with development and sales activities, the courts may not hesitate to classify the property as dealer property. Thus, in *Winthrop, supra*, inherited land was subdivided and sold during the period commencing in 1932 and ending in 1960. The taxpayer engaged in platting, clearing and creating the property; he introduced utilities, provided an entryway and roads and ran sewer lines in through the property. The taxpayer also participated in building five houses on the lots which were held for sale. During this period of time over 456 lots were sold. Despite the fact that the property had been inherited by Mr. Winthrop, the court determined that he had developed a clear intent to sell off the property in the regular course of his trade or business. Thus, it is fair to say that, while the courts are more tolerant with respect to development and sales activities in the case of property that is either received by gift or inheritance, there is a limit to this tolerance. Particularly if the development and sales activities are extended over more than a few short years.

6. Liquidation of Investment. There are several cases which permit a taxpayer with a large tract of land and who can demonstrate that it is very difficult or impractical to bulk sell the property at a fair price, to engage in a certain amount of development and sales activities in order to "liquidate his investment." For example, in *Heller Trust v. Commissioner*, 382 F.2d 675 (9th Cir. 1967), a partnership built duplexes which were held for rent. The partnership ultimately experienced problems in keeping the duplexes rented and was only able to do so at a very low rental rate. A disagreement among the partners ensued with respect to whether it would be prudent to make further improvements to increase tenant occupancy. The partners could not resolve their dispute and it was ultimately decided that the duplexes would be liquidated. They were advertised for sale using extensive newspaper and radio advertising; a sales office was opened; one of the duplexes was utilized as a model and a staff of salesmen was

employed to sell them. The duplexes were also completely reconditioned and redecorated in order to make them salable. The duplexes were ultimately sold off during a four-year period. The Ninth Circuit Court of Appeals found that the property was originally held for investment purposes and was ultimately sold off on a unit-by-unit basis simply because this was the most efficient and expedient manner of liquidating the partnership's investment. Thus, the court found that the partnership was entitled to capital gain treatment on the sales.

The Tax Court reached a similar conclusion in *Charles R. Gangi*, 54 TCM 1048 (1987), in which the taxpayer converted a 36-unit rental apartment building into condominiums and proceeded to sell the condominiums as a means of liquidating his investment. The Tax Court found that the taxpayers were entitled to treat the gains as long term capital gains.

On the other hand, even if a taxpayer has clearly held property for investment purposes for an extended period of time, if he engages in subdivision activities, undertakes significant sales activities, and continues this process over an extended period of time, the previous investment intent will not be sufficient to warrant capital gain treatment. Thus, in *Biedenharn Realty Co., Inc. v. United States*, 526 F.2d 409 (5th Cir. 1976), *cert. denied*, 429 U.S. 819 (1976), the Fifth Circuit Court of Appeals upheld the Service's treatment of sales by the taxpayer as ordinary income despite the fact that the taxpayer had operated the property in question as farm land for a period of over five years. The taxpayer later improved the land, adding streets, drainage and water lines, sewers and electricity. The cost of the improvements was substantial. Although the subdivided lots were sold primarily by word of mouth, literally hundreds of lots were sold over a period of approximately 30 years. In holding for the Service, the court made the following observation which is pertinent to the issue at hand.

> "Undoubtedly, in most subdivided-improvement situations, an investment purpose of antecedent origin will not survive into a present era of intense retail selling. The antiquated purpose, when overborne by later, but substantial and frequent selling activity, will not prevent ordinary income from being visited upon the taxpayer... Generally investment purpose has no built-in perpetuity nor a guaranty of capital gains forever more." *Id*. at 421.

The court went on to offer the following observation which may be helpful in determining when the liquidation theory may prove useful to a taxpayer:

> "There will be instances where an initial investment purpose endures in controlling fashion notwithstanding continuing sales activity. We doubt that this aperture, where an active subdivider and improver receive capital gains, is very wide; yet we believe it exists. We would most generally find such an opening where the change from investment holding to sales activity results from unanticipated, externally induced factors which make impossible the continuing pre-existing use of the realty."

7. Suggested Techniques and Planning to Use the Special Exceptions for Inherited or Gifted Properties and the Limited "Liquidation" Exception. If a taxpayer has received property by gift or inheritance or if a taxpayer has property that has clearly been held for investment purposes and has determined that it is not feasible to sell the property in bulk but

must resort instead to the subdivision and/or sale of the property in multiple parcels, consider the use of some or all of the following:

a. If the property is held by an entity, such as a corporation, limited liability company or partnership, include clear statements of intent in the articles of incorporation, minutes, partnership agreements, etc. which clearly set forth that the principal objective of the entity is to liquidate the properties and distribute the proceeds thereof in an expedient fashion. The "plan of liquidation" should be clear, concise and accurate. The language can be appropriately embellished to track the history of the property; the desire of the owners to dispose of the property and to divide the proceeds; and the use of the entity as a vehicle to liquidate its remaining real estate investments. In this regard, it may also be useful to select an appropriate name for the entity such as the "XYZ Liquidating Partnership, Ltd." (Of course, the actions taken by the entity must be consistent with these statements of intent or they will be regarded as meaningless, self-serving declarations.)

b. Segregate clear investment parcels from development parcels. If certain portions of the property will be sold in bulk and others are to be subdivided and sold in a piecemeal fashion, it would probably be prudent, as a hedge against possible classification of the entire property as dealer property, for the entity to adopt a written plan which designates a portion of its properties that are to be segregated from the balance of the property and sold in bulk. The remaining properties would be placed in a second category as properties which will be "developed if necessary in order to liquidate." It would also be helpful if the segregation of the properties be accomplished in conjunction with placing the bulk sale properties in a subsidiary entity and the remaining "develop if necessary" properties be placed in another subsidiary entity, both of which can be disregarded entities for tax purposes. Since it is possible even for a dealer to obtain capital gains treatment on certain properties that are held for investment (*see* discussion in II.B.8 below), the division of properties in this manner may serve as a hedge to at least protect the bulk sale properties from dealer status if it is later determined that the developed property is dealer property.

c. A liquidation plan generally means that once properties are sold the proceeds will be distributed to the owners as quickly as possible. Although it may be necessary to retain a portion of the proceeds to cover the cost of holding the remaining properties, the balance of the sales proceeds should be distributed as promptly as possible. Any reinvestment of proceeds in additional real property would clearly be inconsistent with the liquidation purpose.

d. Although stating the obvious, the taxpayer should carefully review the seven *Winthrop* factors and make every effort to minimize those activities which the court equates to dealer activities. This might include some or all of the following:

(1) If it is necessary to put streets, sewers and utilities into a specific piece of property, and if the taxpayer is dealing with one or more builders who will buy all or a substantial number of the lots in the new subdivision, consider working a deal with the builders to have them install these improvements in exchange for a reduced cost of the lots.

(2) If a builder is going to acquire substantially all of the lots in a particular phase or subdivision, consider granting the builder an <u>option</u> to acquire the property and allow him to interface with governmental authorities to obtain permits and approvals, as well as to perform improvements as described above. This will remove the taxpayer from this process.

(3) Bulk sell as many properties as possible, consistent with obtaining a reasonable after-tax return thereon.

e. Any dealings with the local press with regard to the development should be minimized but, to the extent required, should emphasize that the purpose of the entity is to liquidate the taxpayer's real estate holdings. You should keep in mind that anything that is said to the press can and will be found and used against the taxpayer by an IRS agent if it supports the Service's case.

8. Can a Taxpayer, Who Has Become a "Dealer" with Respect to Certain Properties, Hold Other Properties for Investment? There are a number of cases which hold that a taxpayer can be a dealer in real estate as to some properties and an investor as to other properties. *See, e.g., Fraley v. Commissioner*, 66 T.C.M. 100 (1993); *Maddux Construction Co. v. Commissioner*, 54 T.C. 1278 (1970); and *Planned Communities, Inc. v. Commissioner*, 41 T.C.M. 552 (1980). However, although a taxpayer may be able to establish certain parcels are held primarily for investment while at the same time holding others for a clear dealer purpose, there is a heavy burden on him to establish the segregation of the parcels. *Graves v. Commissioner*, 867 F.2d 199 (4th Cir. 1989); *Slappey Drive Ind. Park v. United States*, 561 F.2d 572 (5th Cir. 1977).

a. If a taxpayer/dealer seeks to avail himself of this limited opportunity, he should go out of his way to demonstrate that the purported investment properties have been segregated and are both treated and accounted for separately.

9. Section 1237. Section 1237 provides limited statutory relief for certain non-corporate taxpayers that engage in limited development activities with respect to real property.

a. The general requirements for eligibility under §1237 are as follows:

(1) The lots, unless acquired by inheritance, must have been held by the taxpayer for five years or more.

(2) There are no substantial improvements which enhance value. Decisions finding substantial improvements and increased value are: *Pointer v. Commissioner*, 419 F.2d 213 (9th Cir. 1969); *Kelly v. Commissioner*, 281 F.2d 527 (9th Cir. 1960). Section 1237(b)(3) extends assurance that specified improvements will not be "substantial" if stated requirements are met. Rev. Rul. 77-338, 1977-2 C.B. 312 permitted capital gain treatment under §1237 where land was leased on a long term basis to developers who improved and subdivided the land, constructed houses on the land and sold the houses subject to the lease. A testamentary trust created under the will of the lessor subsequently sold

the land to tenant/homeowners. The Service held that, since the taxpayer had not improved the land (developers, who are unrelated to the lessor, made all improvements), the sales qualified under §1237.

(3) The taxpayer may not be a dealer in real estate with respect to the lot or parcel in any year prior to the sale and in the year of the sale is not a dealer with respect to any other real property.

b. Effect of §1237:

(1) All of the gains from the first five lot sales within a particular parcel will be treated as long term capital gains.

(2) For the sixth and all subsequent lot sales from the parcel, a portion of the gain equal to the excess of 5% of the selling price of each lot over the sales expenses associated with such lot will be treated as ordinary income under §1237(b)(1) and the balance will be treated as long term capital gain.

III. SALES OF REAL PROPERTY TO RELATED PARTIES

A. Factual Setting

Assume that a taxpayer has raw land with a tax basis of $500,000 that he has held for 3 years. The taxpayer expects to incur expenditures of an additional $1,500,000 for planning, platting, engineering, permitting and approvals as well as construction of improvements and infrastructure. Thus, the total tax basis of the fully developed parcel will be $2,000,000. Assume that the property will be developed into a multi-phase single-family residential project with a total projected sell-out netting $10,000,000. This will yield $8,000,000 of ordinary income.

1. Sale of Property to Related Entity. If the property has an appraised value before any development work is commenced of $2,500,000, a sale of the property for its current fair market value to a controlled entity will, if respected for tax purposes, convert $2,000,000 (i.e., the excess of the $2,500,000 fair market value over the $500,000 initial tax basis) of the potential $8,000,000 of gains from ordinary income into long term capital gains. *See, Bramblett v. Commissioner*, 960 F. 2d 526 (5th Cir. 1992), which is the most often cited example of the successful employment of this type of strategy. The *Bramblett* case is discussed in more detail in part III. B. 5., *infra*.

B. Sale to Related Corporation

Taxpayers 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 the sale is made to the corporation on an installment basis. If the sale is respected, the corporation will take a new tax basis under §1012 equal to the cost of acquiring the property.

1. Debt vs. Equity. The Service may argue that the installment notes received by the taxpayer from the sale should be treated as equity and the equivalent of stock

received in a §351 exchange with the following results:

a. The taxpayer's lower cost basis carries over to the corporation.

b. The corporation will receive additional taxable income as a result of the lower tax basis and, after corporate taxes, will have additional E&P to support dividend distributions.

c. The taxpayer's receipt of interest and principal payments will be taxed as dividends.

2. Cases Upholding the Service's Treatment of "Debt" as "Equity." Cases which have addressed the "debt vs. equity" and "sale vs. contribution to capital" issues and held for the government are as follows: *Gooding Amusement Co. v. Commissioner*, 23 T.C. 408 (1954), *aff'd.*, 236 F.2d 159 (6th Cir. 1956), *cert. denied*, 352 U.S. 1031 (1957) (sale of business); *Aqualane Shores, Inc. v. Commissioner*, 30 T.C. 519 (1958), *aff'd.*, 269 F.2d 116 (5th Cir. 1959) (sale of land); *Truck Terminals, Inc. v. Commissioner*, 33 T.C. 876 (1960), *acq.*, 1960-2 C.B. 7, *aff'd.*, 314 F.2d 449 (9th Cir. 1963) (sale of equipment to subsidiary); *Burr Oaks Corp. v. Commissioner*, 43 T.C. 635 (1965), *aff'd.*, 365 F. 2d 24 (7th Cir. 1966), cert. denied, 385 U.S. 1007 (1967) (sale of land); *Slappey Drive Ind. Park v. United States*, 561 F.2d 572 (5th Cir. 1977) (sale of land); *Western Hills, Inc. v. United States*, 71-1 U.S.T.C. ¶9410 (S.D. Ind. 1971) (successive sales of land); and *Marsan Realty Corp.*, 22 T.C.M. 1513 (1963) (sale of land). All of the above-cited cases resulted in adverse decisions to the taxpayer.

3. Adverse Factors. Factors which led to the adverse decisions noted in 2 above include:

a. Inadequate or "thin" capitalization.

b. Identity of interest between those who own stock and notes.

c. Intention not to enforce the notes, such as failing to insist upon payment of interest and principal payments when due.

d. Notes subordinated to general creditors.

e. Inflated price.

f. No overriding business purpose.

4. Installment Sales to Controlled Corporations That Have Been Respected by the Courts. An installment sale of real property to a controlled corporation may be respected if there is a demonstrated likelihood of early repayment. *Sun Properties v. United States*, 220 F.2d 171 (5th Cir. 1955) (income from transferred warehouse sufficient to pay expenses and notes); *Piedmont Corp. v. Commissioner*, 388 F.2d 886 (4th Cir. 1968) ($10,000 cash and $160,000 purchase money notes equal value of option right to purchase land, and there was a reasonable probability that notes would be repaid; "thin capitalization" not alone sufficient to negate sale); *Gyro Engineering Corp. v. United States*, 417 F.2d 437 (9th Cir. 1969) (income

from transferred apartment house was sufficient to pay expenses and notes; "thin capitalization" doctrine held not applicable); *Hollywood, Inc. v. Commissioner*, 10 T.C. 175 (1948), *acq.*, 1948-1 C.B. 2 (sale of land to corporation which did not develop but, instead, resold it in the same condition as when acquired); *Evwalt Development Corp. v. Commissioner*, 22 T.C.M. 220 (1963) (sale of land to corporation having "not negligible" capital, 14 months after it was formed; and notes given for prior sales were paid promptly); *Charles E. Curry v. Commissioner*, 43 T.C. 667 (1965), *nonacq.*, 1968-2 C.B. 3 (sale of income producing office building); *Arthur M. Rosenthal v. Commissioner*, 24 T.C.M. 1373 (1965); *Ainslie Perrault v. Commissioner*, 25 T.C. 439 (1955), acq.,1956-1 C.B. 5, *aff'd.*, 244 F.2d 408 (10th Cir. 1957); *Sheldon Tauber v. Commissioner*, 24 T.C. 179 (1955), *acq.*, 1955-2 C.B. 9; *Warren H. Brown*, 27 T.C. 27 (1956), *acq.*, 1957-2 C.B. 4 (each involving sale of business, and ascribing goodwill as an asset which augmented capital).

a. The decision in *Warren H. Brown* provides helpful guidelines on this issue:

> ". . . the apparent intention of the parties, the form of contract here in question, the reservation of title in the transferors until the full purchase price is paid, the obvious business considerations motivating the partners to cast the transaction in the adopted form, the substantial investment by the transferors in stock of the corporation, the superior position of the transferors' claims to the claims of the other corporate creditors, the fact that the contract price was equal to the stipulated fair market value of the assets transferred thereunder, the contract provision calling for fixed payments to the partners without regard to the corporate earnings, the provision requiring the payment of interest to the transferors at a reasonable rate, the absence of an agreement not to enforce collection, and the subsequent payment of all installments which became due under the contract during the years in issue. . ." 27 T.C. at 35, 36.

5. Corporation/Purchaser's Dealer Activities May Adversely Affect Taxpayer's Ability to Claim Capital Gains on Sales. If the corporate purchaser immediately subdivides and sells the land purchased from the taxpayer in a manner in which stamps it as a dealer, some cases have applied various theories to find that these dealer activities will cause a taxpayer to have ordinary income on his sale to the controlled corporation. *See, e.g., Burgher v. Campbell*, 244 F.2d 863 (5th Cir. 1957); *Tibbals v. United States*, 362 F.2d 266 (Ct.Cl. 1966); and *Brown v. Commissioner*, 448 F.2d 514 (10th Cir. 1971).

In a frequently cited decision by the Fifth Circuit Court of Appeals, however, the Service's attempt to attribute dealer activities of the corporate purchaser to the selling taxpayer was squarely rejected. In *Bramblett v. Commissioner*, 960 F.2d 526 (5th Cir. 1992), the "taxpayer" was a partner in a partnership which acquired several parcels of land for the stated purpose of investment. The partnership was comprised of four individuals. Shortly after the partnership was formed, the same four individuals who were partners in the partnership formed a new corporation which was owned by them in the same proportions as they held their partnership interests. The partnership then sold almost all of its land to the corporation which subsequently developed and sold it to third parties in the ordinary course of its business. The partnership reported its income from the sale of land to the corporation as long term capital gains. The Service argued that the profits should be taxed as ordinary income because the partnership, in

conjunction with the corporation which was owned by the same persons and in the same proportions as the partnership, were jointly engaged in the development and sale of real estate in the ordinary course of a business. The Fifth Circuit, reversing the Tax Court, held that the partnership was entitled to long term capital gains treatment. It began its analysis by reviewing the seven *Winthrop* factors and found that, based solely upon a review of the partnership's activities, the property was certainly not "dealer property" in the hands of the partnership. The court went on to hold that the corporation was a separate taxable entity and that, under the Supreme Court's decisions in *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949) and *Commissioner v. Bollinger*, 485 U.S. 340 (1988), the corporation cannot be said to have been functioning as an "agent" for the partnership. The court also refused to apply the "substance over form" doctrine to attribute the corporation's dealer activities to the partnership. *See, also, Timothy J. Phelan*, 88 TCM 223 (2004) which upheld long term capital gain treatment on similar facts.

6. Constructing A Defensible *Bramblett* Transaction. Tax practitioners should not be lulled into a false sense of security in employing a Bramblett strategy of acquiring land in an investment entity and reselling it to a commonly controlled development corporation in order to lock in appreciation in value at long term capital gains rates. If, for example, the investment entity is allowed to become involved in some or all of the development activities with respect to the property and/or is involved in the marketing of developed lots to third party buyers, it may be found to have engaged in the sale of properties to customers in the ordinary course of its trade or business and thus be found to be a "dealer" in its own right. If this occurs, the Service would not even need to argue for the imputation of the activities of the development entity to the investment entity as it unsuccessfully attempted to do in *Bramblett* and *Phelan*. For a textbook example of what can happen when this occurs, *see, Cordell D. Pool*, 107 TCM 1011 (2014) where the taxpayer did almost everything wrong and the investment entity was taxed on its gains from the sale of its land to the development corporation at ordinary income rates.

In order to minimize the risks of this type of challenge by the Service, consider the following suggestions:

a. The investment entity (which will almost always be a partnership or an LLC, treated as a partnership for tax purposes) should clearly set forth in the purpose clause of its partnership agreement that it its primary purpose is to acquire, hold, and, at the appropriate time, sell or exchange real property for investment purposes. The investment entity's tax returns and SS-4 form should be consistent with this purpose (and should not state that it is a developer of real estate) and all governmental filings should also be consistent with this description.

b. There should be a good business purpose, apart from intended tax savings, for the use of the investment entity to acquire and hold the undeveloped land and the use of a separate corporation to purchase, develop and market the developed parcels, such as the need to protect the remaining land (if all of the land is not sold in a single transaction to the development corporation) from the risks inherent in the development and sale of developed land and/or to protect the sales proceeds received by the investment entity from the sale(s) from such risks.

c. The sales price for each part of the land sold by the investment entity to the development corporation should be substantiated by an appraisal prepared by a qualified appraiser contemporaneous with the sale, and the terms of sale should be entirely arm's length.

d. Adhere as closely as possible to the guidelines for respecting a sale for tax purposes set forth by the Tax Court in its decision in *Warren H. Brown, supra*, as quoted in part III. B. 4. a., *supra*.

e. Minimize or, to the extent possible, avoid having the investment entity participate in pre-development activities such as applying for entitlements necessary for the intended development of the property, especially to the extent that they may identify the investment entity as the "developer" of the property. In addition, and most importantly, the investment entity should not engage in any physical development such as clearing, grading, constructing infrastructure improvements, etc., and should not engage in any marketing efforts with respect to the sale of developed properties to customers.

f. Minimize the number of sales by the investment entity to the development entity (and to third parties) to the extent possible.

g. Although both the investment entity and the development corporation in *Bramblett* were owned by the same persons in the same proportions, the bona fides of the transaction will be enhanced if the identity of the owners and/or the ownership percentages in these two entities differ in some material respects.

7. Installment Sale Rules.

a. Gains from the sale of investment property by a taxpayer to a "related party," as defined in §453(f)(1), are eligible for installment reporting, but any amounts received by the transferee upon a subsequent disposition of the property within two years of the date of the original sale will result in acceleration of income. Under §453(e), any amounts received by the transferee upon a subsequent disposition will be treated as a payment received by the taxpayer unless an exception applies.

(1) "Related parties" are defined in §453(f)(1) using the attribution rules of <u>both</u> §267(b) and §318.

b. If <u>depreciable property</u> is sold to a "related party," which, for purposes of this provision, will be limited to parties described in either §1239(b) or §707(b)(1)(B), the seller will not be eligible to report on the installment method. Exception to this disallowance is available, however, if the taxpayer can demonstrate to the Service that he did not have as one of his principal purposes the avoidance of federal income taxes. §453(g)(2).

c. Any recapture income resulting from the sale of real property to a controlled entity under §1245 and/or §1250 must be reported in the year of sale (*i.e.*, deferral under the installment method is not available). §453(i).

d. As a general rule, "dealers" who are holding property for sale to

customers in the ordinary course of a trade or business will no longer be eligible for installment reporting. §§453(b)(2)(A) and 453(l). However, certain dealers in timeshare properties and residential lots may elect to utilize the installment method if they agree to pay an interest toll charge for the privilege of doing so. *See*, §453(l).

C. Sale to Related Partnership.

1. Section 707(b)(2). Under §707(b)(2), a sale of property between a person and a partnership which, in the hands of the transferee is property that is not classified as a capital asset (as defined in §1221), the gain will be ordinary if the person owns, directly or indirectly, more than 50% of the capital interests or profits interests in the partnership.

a. Under §707(b)(3), "ownership" of a capital or profits interest in a partnership is to be determined in accordance with the rules of constructive ownership of stock provided in §267(c) (other than paragraph 3 of such section). Under §267(c) the following rules apply:

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

(2) An individual is considered to own partnership capital or profits interests owned, directly or indirectly, by or for members of his family. "Family" includes brothers and sisters, spouse, ancestors, and lineal descendants.

Note that §707(b)(2) would recharacterize the nature of income on the sale of any property that is not a capital asset. Thus, a sale of a §1231 asset (even if not depreciable) would be caught in this section.

A key to avoiding §707(b)(2) is to sell to a partnership or LLC (that is treated as a partnership) which the selling party does not directly or indirectly control.

b. Contrast Tax Treatment with Sale to Controlled S Corporation. There is no counterpart to §707(b)(2) in the S corporation area. The only section that has to be dealt with for recharacterization purposes in an S corporation setting is §1239.

2. Section 1239. Section 1239 would recharacterize capital gain into ordinary income upon sales of assets between a person and a partnership in which the selling person owns more than 50% of the capital or profits, directly or indirectly, and if the property, in the hands of the transferee partnership, is depreciable property. The §267(c) attribution rules also apply in the case of §1239.

a. Note that there is obvious overlap between §707(b)(2) and §1239 in connection with the sale of depreciable property to a controlled partnership. However, §707(b)(2) would also apply to non-depreciable property such as inventory or raw land that constitutes

D. Sale of Equity Interests in Development Entity

If a taxpayer is successful in navigating the tests applicable to sales of real property to a related entity described in III.B. and C., supra, the ultimate success in conversion of ordinary income into capital gains would be to then sell all of the stock of the development corporation (or all of the partnership interests in the development partnership) to a third party. Although gains from the sale of stock of a corporation held for more than 1 year generally qualify for long term capital gain treatment, in years prior to 2003 the corporation might have been deemed to be a "collapsible corporation," as defined in § 341(b)(1), with the result that all of the gain derived from the sale of stock would have been converted from capital gain to ordinary income. However, as noted in part I.A.3.d., infra, § 341 was permanently repealed in 2012, retroactive to 2003.

The counterpart to §341 in the partnership area is §751. Under §751, any proceeds from the sale of a partnership interest which, under the rules of §751 is deemed to be attributable to the value of "inventory properties" (including real property held for sale to customers in the ordinary course of a trade or business) of the partnership, will be treated as ordinary income rather than long term capital gains.

IV. WILL THE SALE OF CONTRACT RIGHTS TO ACQUIRE REAL PROPERTY OPEN NEW OPPORTUNITIES TO CONVERT ORDINARY INCOME INTO CAPITAL GAIN?

A. Background Facts

D, who is a long time dealer in real property, locates 50 acres of undeveloped land in a prime location for development as a residential condominium project. D is simultaneously developing another condominium project in another part of town that is close to completion with a large number of pre-sale contracts in hand and he is optimistic that this new location will be even more successful. D enters into a contract to purchase the new location $8,000,000 on July 1, 2016, with a delayed closing date of December 30, 2017, in order to enable D to line up his financing, obtain architectural drawings and engineering studies and apply for the entitlements necessary to develop the project.

Subsequent to entering into the contract to purchase the property D devotes his full time and attention to completing all of the preliminary steps for the development including hiring an architect and obtaining the necessary architectural plans, obtaining the necessary entitlements and preparation of marketing materials for the new project. D also opens a sales office and begins soliciting pre-development contracts. By October, 2017, D has pre-development contracts with 10% deposits for better than 20% of the condo units. Then the bombshell hits. D receives a notice from the seller of the property that it is cancelling the contract and will not go through with the sale. D consults his attorneys and immediately thereafter files suit in state court seeking specific performance of the contract plus damages. The trial is held in 2018 and results in a judgment in favor of D, requiring the defendant-seller to close under the contract, but granting the seller just short of one year to effectuate the closing.

The litigation has taken a toll on D and the delays have broken the momentum for his condominium project. Early in the litigation process D determines to abandon the development of his project and resolves that, if he is successful in the litigation and acquires the

land, he will flip it to another developer. He is relatively confident that the land will be highly saleable because it is well located and has benefitted from all of his pre-development work.

The defendant-seller appeals the adverse decision to a state appellate court. While the appeal is still pending, D is approached by a third party who offers D $5,750,000 in exchange for a complete assignment of his court judgment and all of his rights as a buyer under the contract to purchase the land. D accepts the offer and makes the assignment. D has a gain from the sale of approximately $4,000,000.

Query: what are the tax consequences to D from the sale of his judgment and contract rights?

B. **The *Philip D. Long* Case in the Tax Court**

Based upon facts essentially identical to those set forth in IV. A, *supra*, the Tax Court held in *Philip D. Long*, 106 TCM 409 (2013), that the taxpayer (D, in our Background Facts) had ordinary income. The Tax Court based its holding on the fact that the taxpayer intended to acquire the land to develop it into a condominium project and to sell the individual condo units to customers in the ordinary course of a trade or business. The Tax Court also noted that the taxpayer had undertaken a number of steps toward the intended development of his condominium project even before closing on the property. Although the Tax Court accepted the fact that the taxpayer had changed his mind during the litigation process and decided to sell the property if he was successful in the litigation, it nevertheless concluded that even if he had done so, he had moved far enough down the development path that such a sale of the land would still produce ordinary income. Thus, based upon the Tax Court's analysis of the character of the gain that the taxpayer would have had if he had actually acquired the property, it determined that the gain from the sale of his rights under the lawsuit and contract resulted in ordinary income.

C. **The *Philip Long* Case in the Eleventh Circuit Court of Appeals**

In *Philip Long v. Commissioner*, 772 F. 3d 670 (11th Cir. 2014), the Eleventh Circuit began its review of the Tax Court's finding that the taxpayer had ordinary income from the sale by noting that the Tax Court had focused on the wrong "property" that gave rise to the gain.

"The Tax Court erred by misconstruing the 'property' subject to capital gains analysis under § 1221…The dispositive inquiry is not 'whether Long intended to sell the land to customers in the ordinary course of his business,' but whether Long held the exclusive right to purchase the property 'primarily for sale to customers in the ordinary course of his trade or business.'" 772 F. 3d 670, 676.

The Service asserted two alternative arguments in favor of affirming the Tax Court's decision. First, the Service argued that the taxpayer's gain from the sale was short term, noting that the sale of his rights had occurred less than 1 year after the entry of final judgement. The Eleventh Circuit dismissed this argument noting that the taxpayer had initiated the litigation more than 1 year prior to the sale and also pointed out that it was the taxpayer's contract right to purchase the property that was the focus of the litigation and this contract had been in existence several years before the sale closed. Based on this analysis, the Appeals Court held that the gain

was long term.

The second argument advanced by the Service was that the $5,750,000 sale proceeds constituted a lump sum substitute for his future ordinary income and must, therefore, be treated as ordinary income under the substitute for ordinary income doctrine. The Eleventh Circuit also dismissed this argument by noting that the substitution for ordinary income doctrine only applies to an assignment of a fixed amount of future earned income that would be taxed as ordinary income, citing *Hort v. Commissioner*, 313 U.S. 28 (1941) (landlord's receipt of a lump sum payment in exchange for cancelling a lease); and *Womack v. Commissioner*, 510 F. 3d 1295 (11th Cir 2007) (lottery winner's receipt of a lump sum payment in lieu of future periodical payments). 772 F. 3d 670, 677. The Court then made the following statement:

"We have already held that selling a right to earn future undetermined income, as opposed to selling a right to earned income, is a critical feature of a capital asset. *United States v. Dresser Indus. Inc.*, 324 F. 2d 56, 59 (5th Cir. 1963). The fact that the income earned from developing the project would otherwise be considered ordinary income is immaterial." 772 F. 3d 670, 677.

The Appeals Court went on to hold that the gain from the sale of the taxpayer's rights to purchase the land was more appropriately characterized as capital gain.

D. Did the Eleventh Circuit Get It Right In Its *Long* Decision?

The Tax Court in *Long* determined that the taxpayer's sole purpose for entering into the contract to purchase the land was to accomplish his goal of constructing a condominium project and marketing individual condo units to customers in the ordinary course of his real estate trade or business. The Tax Court also found that the taxpayer had initiated a number of actions even prior to purchase of the land to accomplish this goal. It intuitively determined that this purpose flavored all of his rights and interests in the property, including his contractual right to purchase the property and his rights under the pending litigation.

The Eleventh Circuit correctly determined that the Tax Court had focused solely on the land and the taxpayer's intended use of such property, but failed to pay adequate attention to the fact that what was sold was not the land but rather the taxpayer's rights to acquire the land—an asset that was separate and distinct from the land itself. The Eleventh Circuit went on to conclude that, because the taxpayer did not hold his contract rights to acquire the land primarily for sale to customers in the course of his trade or business, what he sold was a capital asset. But was the Eleventh Circuit correct in completely severing the taxpayer's clear intentions from the outset to develop a residential condominium complex on the property, his significant actions to carry this objective out prior to closing and his historical track record as a dealer in real property, from the determination of the nature of the contract rights that he sold?

It could be argued that gain from the sale of a right with respect to property that would clearly be inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business should be characterized as ordinary income under the Supreme Court's decision in *Corn Products Ref., Co. v. Commissioner*, 350 U.S. 46 (1955), as refined by the Court's subsequent decision in *Arkansas Best Corp. v. Commissioner*,

485 U.S. 212 (1988). This argument was apparently not raised by the parties in the Long case and was not discussed in either the opinion of either the Tax Court or the Eleventh Circuit. The argument might be further advanced by analogy to § 1234 which provides in part that gain from the sale of an option to buy property will have the same character for tax purposes as gain from the sale of the property to which it relates would have had in the hands of the taxpayer. The contract rights involved in Long were not equivalent to an option and would not be subject to § 1234, but Congress clearly evidenced its intent, at least in connection with option rights, to characterize gains from the sale of an option contract by reference to the character the underlying property would have if directly owned by the taxpayer. This result seems intuitively correct but is admittedly subject to debate and will have to await future litigation or legislative action to be resolved. For a more in depth discussion of the *Long* case and this issue, *see* "Reexamining Capital Gains for Real Estate," by Jasper L. Cummings, Jr., Tax Notes Today (March 19, 2015).

E. Does the *Long* Case Open New Planning Opportunities?

Based upon the Eleventh Circuit's reasoning in the *Long* case, a similarly situated taxpayer who holds a contract (that is not an option that would be subject to § 1234) to acquire real property that is intended for development in a clear dealer activity, and who has held the contract for over 1 year, may reasonably claim long term capital gain treatment if he is able to sell all of his contract rights at a gain. It may seem too good to be true, but there is now a reasonable basis to claim long term capital gain treatment, especially if the taxpayer resides in the Eleventh Circuit.

OPTIMIZING CAPITAL GAINS TAX RATES IN SALES TRANSACTIONS

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