2014 REAL ESTATE TAX UPDATE
REAL PROPERTY SECTION
NORTH CAROLINA BAR ASSOCIATION

February 21, 2014

By:

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Introduction

This manuscript contains a survey of selected tax issues of interest to many real estate practitioners.

You will note that this manuscript is subdivided into five (5) parts.

Part One reviews the current tax rates in effect after the American Tax Relief Act of 2012.

Part Two reviews the age old issue of whether a taxpayer holds real property for investment as a capital asset or as inventory in its capacity as a dealer.

Part Three provides a brief overview of the new 3.8% surtax on "net investment income" under Section 1411 of the Internal Revenue Code. Part Four discusses income tax developments involving Section 1031 like-kind exchanges. And Part Five discusses tax deferral opportunities using installment sales and a potential new technique, called the "structured Sale" technique.

PART ONE
NEW TAX RATES AFTER THE AMERICAN TAX RELIEF OF 2012

I. Individual Tax Rate Increases

The following summary will review the current tax rate structure for individual taxpayers, which include shareholders of an S corporation or members of an LLC, after the American Tax Relief Act of 2012. Under the American Tax Relief Act of 2012, the top marginal individual income tax rate for 2013 has been increased from 35% to 39.6%. Also, there is an additional Medicare tax of .9% on wages and self-employment income as well as a new 3.8% net investment income tax on the lower of modified adjusted gross income or net investment income (discussed in Part Three below).

The new additional Medicare tax and the net investment income tax apply to single taxpayers earning more than $200,000 or $250,000 for married taxpayers, filing jointly.

Also, there is a new maximum capital gains tax rate and qualified dividend tax rate of 20% (up from 15% from prior years). The new maximum 20% capital gains tax rate and maximum 20% tax rate on qualified dividends applies for single individuals with taxable incomes over $400,000 and married filing jointly taxpayers with taxable incomes over $450,000. Please note that these same taxpayers could also be subject to the 3.8% net investment income tax on qualified dividends and capital gains which could increase the maximum tax rate to 23.8% on qualified dividends and capital gains.

The tax rate remains at 15% on capital gains and qualified dividends for single taxpayers with taxable incomes under $400.000 and for married filing jointly taxpayers with taxable incomes under $450,000. However, these taxpayers can also be subject to 3.8% net investment income surtax which could push the maximum tax rate for these taxpayers up to 18.8% on qualified dividends and capital gains.

Individual taxpayers will also pay tax at a maximum 25% tax rate on all "depreciation recapture" as defined under Section 1245 of the Internal Revenue Code. The capital gain above the deemed depreciation recapture is subject to the normal capital gains tax rate.

II. C Corporation Tax Rates.

The American Tax Relief Act of 2012 did not alter the tax rates for C corporations. Accordingly, the following schedule will show the tax rates for C corporations as follows:

Corporate Tax Rates

Taxable Income Over	Not Over	Marginal Tax Rate
$ 0	$ 50,000	15%
50,000	75,000	25%
75,000	100,000	34%
100,000	335,000	39%
335,000	10,000,000	34%
10,000,000	15,000,000	35%

Please note that for C corporation corporate taxpayers, any long-term capital gain will be taxed at the regular tax rates, including the 39% phase-out rate for corporations with income between $100,000 and $335,000.

PART TWO
ORDINARY INCOME OR CAPITAL GAIN ON THE SALE OF REAL PROPERTY?

I. Introduction

A. Background. When a taxpayer sells real estate, often the IRS and the taxpayers are at odds as to whether the sale should be treated as the sale of investment property or as the sale of ordinary income "inventory" property by a dealer. The tax differences can be significant for both the taxpayer and the IRS.

If the transaction is treated as a sale of **"investment"** real property, then any gain on the sale will be taxed at the **capital gain tax rates**. And the gain recognized by the investor will not be subject to self-employment taxes.

In addition to the capital gain tax and self-employment tax benefits available to the real estate investor, such investors also can benefit from:

(i) Section 1031 tax-free exchanges;

(ii) Section 1033(g) (relating to condemnation of real property held for productive use in a trade or business or for investment); and

(iii) Section 453 installment sale reporting.

These are tax benefits that are **not** available to ***dealers*** of real property.

On the other hand, real estate investors must be cognizant of (i) the passive activity loss limitations of Section 469 and (ii) the capital loss limitations applicable to investment property (since, if the sale generates a loss, then the taxpayer's loss will be limited by the capital loss limitation rules - that is, the capital loss can only offset other capital gains income and another $3,000 of ordinary income for the year).

If the sale is treated as a sale of **inventory** by a **developer**, then any gain will be treated as **ordinary income**, and thus will be subject to the ordinary income tax rates as well as subject to **self-employment tax**. On the other hand, if the sale of the deemed **inventory** generates a tax loss, then the tax loss will be **fully deductable** against other ordinary income as well as capital gains.

In this day and age, as compared with past years, we are much more inclined to argue that our clients are holding properties as inventory as opposed to for investment purposes. Since property values have diminished substantially over the last five years or so, many of our clients will seek to take the position that their loss property was held as inventory as opposed to property for investment purposes.

B. Past Case Law.

The issue of whether the sale of real property should be treated as the sale of investment property versus inventory property has generated much litigation in the past. Throughout various court cases analyzing these issues, most courts cite the "investor versus dealer tests" analyzed under Biedenharn Realty Company v. United States, 526 F.2d 409 (5th Cir. 1976); Suburban Realty Co. v. US, 615 F.2d 171 (5th Cir. 1980). Under these cases, the courts have focused on the question of whether the property is held primarily for sale to customers in the ordinary course of the taxpayer's business versus whether the taxpayer held the property purely for investment purposes.

Because gain or loss from the disposition of real property is capital if it was held as an investment and ordinary if it was held "***primarily"*** for sale to customers, the identification of a particular parcel of real property as investment property or as property held primarily for sale to customers is critical.

According to the court in Malat v. Riddell (383 U.S. 569 (1966)), the term “primarily” means of “first importance” or “principally,” so that the issue turns on the taxpayer’s intent with respect to holding of the property, which is obviously a factual issue.

Accordingly, a taxpayer's position, that an investment in real estate is merely being disposed of in the most economically profitable manner is a sustainable argument, despite the taxpayer's engagement in activities traditionally conducted by a real estate dealer, provided that the taxpayer otherwise manages his property holdings in a manner substantially similar to that of an investor. Further, the taxpayer must be careful not to reinvest in substantially similar property shortly after the liquidation of the investment if he seeks to avoid ordinary income characterization.

Unfortunately, no definitive trend has arisen that identifies which factors will guarantee investor treatment. As the court in Biedenharn Realty Co., Inc. v. U.S. (526 F.2d 409 (1976)) noted, resolving this question is often a "vexing and ofttimes elusive" task. Obviously, however, the greater the degree of development and sales activities undertaken by the taxpayer, the more likely the taxpayer will be unsuccessful in sustaining its argument that the property is investment property rather than inventory property.

Cases that have addressed the issue have emphasized various factors in different contexts, in a manner that makes it difficult to construct a pattern from which outcomes in other situations can be predicted with any degree of confidence.

For example, the court in Kirschenmann v. Comr. (24 T.C.M. 1759 (1965) held that frequent sales of lots undertaken by the taxpayer because the property was no longer suited for its intended purpose did not make the property investment property, while the court in Austin v. U.S. (116 F. Supp. 283 (1953) reached the opposite conclusion on similar facts. Similarly, capital gain treatment was allowed to the taxpayer in Brenneman v. Comr. (11 T.C.M. 628 (1952)), who sold his lots after an ordinance was enacted that barred the taxpayer's original plans, while the taxpayer in Shearer v. Smyth (116 F. Supp. 230 (1953)) was required to pay tax at ordinary rates under similar circumstances.

C. Factors Reviewed By The Courts. The Court in Ada Belle Winthrop, (CA-5) 24 AFTR 2d 69-5760, rev'g (DC) 20 AFTR 2d 5477 (October 22, 1969), established a set of criteria which have been cited frequently by the courts addressing these dealer vs. investor arguments. In the order of frequency cited in other cases, these seven factors, known as the "seven pillars of capital gain," are as follows:

1. Nature and purpose of the acquisition and duration of ownership.

2. Extent and nature of the efforts of the owner to sell the property.

3. Number, extent, continuity and substantiality of the sales.

4. Extent of subdividing, developing and advertising to increase sales.

5. Time and effort devoted to sales.

6. Character and degree of supervision over sales representatives.

7. Use of a business office to sell the property.

Other courts have applied a nine (9) factor test as follows:

1. The taxpayer's purpose in acquiring the property;

2. The purpose for which the property was subsequently held;

3. The taxpayer's everyday business and the relationship of the income from the property to the total income of the taxpayer;

4. The frequency, continuity, and substantiality of sales of property;

5. The extent of developing and improving the property to increase sales revenue;

6. The extent to which the taxpayer used advertising, promotion, or other activities to increase sales;

7. The use of a business office for sale of the property;

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

9. The time and effort the taxpayer habitually devoted to sales.

Moreover, the Court of Appeals for the 5th Circuit has noted that "frequency of sales" is especially important to review because "the presence of frequent sales ordinarily runs contrary to the taxpayer's position" for investment. Suburban Realty Company.

II. Sale of Lawsuit Rights by Real Estate Developer Generate Ordinary Income and Not Capital Gain; *Long v. Commissioner*, TC Memo 2013 – 233 (October 21, 2013).

Mr. Long was involved in several real estate development activities in Florida. In 2002, Mr. Long entered into a Contract (the "Contract") to purchase real estate located on Las Olas Boulevard (the "Property") from Las Olas Riverside Hotel ("LOR") in 2002.

When the Contract was executed, Mr. Long intended to build a condominium building on the Property and then sell off the condominium units.

The closing on the Property sale was scheduled to occur on December 31, 2004, but before the closing date, the president of LOR died and his heirs decided that they did not wish to go through with the Contract sale.

In March 2004, Mr. Long sued LOR for "specific performance" and for monetary damages.

By this time, Mr. Long had decided that he no longer wished to construct the condominium project on the Property, but instead decided to sell the Property, which was ready for construction, to another party. In November 2005, the State Court ordered that LOR perform its obligations under the Purchase Contract. During the appeal of that court case in September 2006, Mr. Louis Ferris offered to purchase Mr. Long's position in his lawsuit against LOR for a purchase price of $5.75 Million.

In his 2006 tax return, Mr. Long filed a Schedule C reporting that he was a "real estate developer".

In the Tax Court proceeding, Mr. Long argued that he should be entitled to capital gains tax treatment on the sale of his lawsuit claim to Mr. Ferris on the basis that, at the time of filing his original lawsuit, he had decided to forego development of the condominium project but instead had decided to sell the Property to one single purchaser.

The Tax Court noted that the proper analysis focuses on Mr. Long's intention at the time the property was disposed of in determining whether the Property was held for investment purposes or as inventory for sale in the ordinary course of the taxpayer's business. See, for example, *Rice v. Commissioner*, TC 2009 – 142; Raymond v. Commissioner, TC Memo 2001-96.

The Court noted that the purpose of Section 1221(a)(1) - which excludes inventory from the definition of a "capital asset" - is to "differentiate between gain arrived from the everyday operation of a business and gain derived from assets that have appreciated in value over a substantial period of time." *McManus vs. Commissioner*, 65 TC 197 (1975); and *Malat*, 383 U.S. 569 at 572 (9th Cir.). The Court noted that, in determining whether or not property is "a capital asset" or "stock in trade" under Section 1221(a), courts often apply the nine factor test set forth in *Biedenharn*, *Winthrop* and *Suburban Realty Co.*

So, according to the Court, the key analysis was whether, at the time that Mr. Long decided to sell the Property to another developer, was he intending to sell the Property to customers in the ordinary course of his business? Here, even though Mr. Long decided to sell the Property in one transaction, the Court nevertheless held that the Property was "inventory," and not a capital asset, based upon the following factors:

1. The intent of Mr. Long at the time he acquired the Property. At the time of the lawsuit, Mr. Long's intentions were to acquire the Property, design a condominium building, secure zoning approval, and then sell the undeveloped Property to another purchaser.

2. The Nature of the Taxpayer's Business. Mr. Long's fulltime business activity was developing real estate, and, at the time that he attempted to acquire the LOR Property, his fulltime activity was working on developing that Property for the condominium building.

3. Frequency, Continuity and Substantiality of Property Sales. Mr. Long had already received deposits from 20% of condominium purchasers and therefore the court ruled that, although Mr. Long had changed his plans and decided to sell the Property ready for construction, this did not alter the court's view that Mr. Long held the Property primary for sale to customers in the ordinary course of his business. The sale of the Property would have generated a large profit which would have been the result of Mr. Long's effort to develop the Property and not the result of the mere passage of time.

4. Extent to which the Taxpayer Developed and Approved the Property. Here, Mr. Long hired architects, obtained zoning permit and printed promotion materials and negotiated contracts with Unit customers.

5. The Extent to which the Taxpayer Used Advertising. Through Mr. Long's own sales efforts, he had already received deposits on 20% of the Units.

6. Use of A Business Office. Mr. Long used a business office to sell the condominium units.

7. Character and Degree of Supervision or Control Exercised by the Taxpayer over any Representatives on the Property. The court said that, if Mr. Long had not sold his rights under the lawsuit to Mr. Ferris, then he would have been primarily responsible for selling the Property.

8. Time and Effort the Taxpayer Devotes to Sales of Property. Here, Mr. Long was a professional real estate developer, and his full time business was developing and selling condominium properties.

Based upon the foregoing, the Court held that the gain from the sale of Mr. Long's rights under the Purchase Contract should be ordinary income, as he would have earned ordinary income on the sale of the Property.

III. Garrison vs. Commissioner, TC Memo 2010-261 (December 1, 2010); Sales of Real Property Produce Ordinary Income and Not Capital Gains, Since the Taxpayers Were Dealers and not Merely "Investors".

The Tax Court held that proceeds of sales of real property that a mortgage banker and his spouse bought and sold in a relatively short period of time to support and supplement their other income would be taxable as ordinary income and not capital gains. This court case involved the **1998 and 1999** tax years. During these years, the taxpayers regularly purchased and sold real estate within short periods of time.

Mr. Garrison earned less than $40,000 a year as a mortgage banker and the court found that their gains from their real estate transactions substantially contributed to their income.

Mr. and Mrs. Garrison regularly purchased property through foreclosure. In 1998, they purchased parcels of real property and sold all of these properties within two months of purchase. Mr. and Mrs. Garrison did not claim any expenses for repairs for any of these properties. In 1999 and 2000, Mr. and Mrs. Garrison sold four parcels of real estate each year. These properties were sold within ten (10) weeks of acquisition. During the 1998, 1999 and 2000 years, Mr. and Mrs. Garrison did not rent any of the properties before selling them.

During the tax court proceedings, Mr. Garrison testified that "I am in the business of buying material, fixing houses, and reselling them." Based upon all this evidence, the court quickly determined that the sales were sales of inventory and not sales of capital assets. The Court was most persuaded by the following facts:

1. The income from the sales substantially contributed to the Garrisons' income when considering his relatively low wages from his mortgage brokerage business;

2. The frequency and continuity of sales (including the fact that they had sold fifteen (15) properties over three years); and

3. Mr. Garrison's own testimony that he was in the business of buying, fixing and reselling properties.

IV. Day Trader Was Also a Property Dealer; Flood v. Commissioner, TC Memo 2012-243 (August 27, 2012).

In Flood v. Commissioner, TC Memo 2012-243 (August 27, 2012), during the 2004 and 2005 tax years, Mr. Flood was a "day trader" in the stock market. Mr. and Mrs. Flood also operated a real estate venture which involved the purchase and sale of vacant lots. Mr. and Mrs. Flood did not subdivide the lots nor did they construct houses on the lots they purchased. From 2001 to 2008, Mr. and Mrs. Flood purchased at least 250 lots. During 2004, they sold two lots, and during 2005 they sold forty (40) lots.

The issue before the Tax Court was whether or not Mr. and Mrs. Flood held the lots "primarily for sales to customers in the ordinary course of business." If so, all of the gain would be ordinary income rather than capital gain income.

The Tax Court held that the Floods held the lots for inventory, and not for investment purposes, based upon the following factors:

(1) The purpose of acquiring and holding the properties. Mr. Flood claimed that he only sold lots to pay real estate taxes, and noted that he only sold a small number of lots in 2004 and 2005 when compared to the larger number of lots that they still held for resale. The Court noted, however, that even though they only sold a few lots during the years at issue (42 lots total), the Floods earned an enormous gain of over $1 Million on their sales. The Court also noted that the remaining lots not sold in 2004 and 2005 had relatively low value compared to the lots sold in 2004 and 2005.

(2) **<u>The nature of the taxpayer's every day business</u>.** The Floods argued that their everyday business was not being in the sale of real estate since Mr. Flood was a day trader. The Court noted, however, that the income from Mr. Flood's day trading activity was modest compared to the gains from their real estate ventures.

(3) **<u>Frequency, continuity and substantiality of sales</u>.** Again, the Floods only sold two lots in 2004 and forty lots in 2005. However, the two lots that they sold in 2004 had just been purchased in 2003. Of the forty lots that they sold in 2005, eleven lots had been purchased in 2001, fifteen lots had been purchased in 2002 and twelve lots had been purchased in 2003.

(4) **<u>Development activities of the taxpayer</u>.** Even though the Floods did not develop or improve the lots and did not use a business office for their activities, they put considerable time, effort and resources into their real estate ventures.

Accordingly, the Tax Court concluded that the Floods' real estate transactions were conducted in the ordinary course of a trade or business.

> **<u>Note</u>**: However, the Tax Court did not uphold the assessment of accuracy-related penalties.

V. <u>Gardner vs. Commissioner; Contractor Treated As An Investor (And Not As A Dealer); Gardner, TC Memo 2011-137 (June 20, 2011).</u>

In the case of <u>Gardner</u>, TC Memo 2011-137 (June 20, 2011), Mr. Gardner purchased a parcel of real estate with a plan that he would build multi-family projects on the land to generate future rental income. When Mr. Gardner purchased the tract in 2004, the tract had been approved for subdivision into five (5) lots. However, as a result of financial issues, Mr. Gardner decided to sell three lots from the subdivided tract, at a short term capital gain of over $370,000.

The IRS contended that, by virtue of Mr. Gardner's past development activities, that Mr. Gardner should be treated as a "dealer" with respect to the three lots, and so the IRS assessed **self-employment taxes on the short term capital gain.**

Over a 26 year period, Mr. Gardner bought and sold 16 parcels of real estate. Sometimes, Mr. Gardner would purchase unimproved land, build multi-family housing on the land and would hold it for long term investment. In other cases, Mr. Gardner would buy unimproved land and then sell it later.

The IRS argued that Mr. Gardner's past history showed that he was a developer and also argued that, when Mr. Gardner purchased the 2004 tract, his intent was to sell off previously approved subdivided lots.

Mr. Gardner admitted that, in the past, he had been both the dealer and investor. Mr. Gardner pointed to the fact that his past practice of holding multi-family properties, for long terms, proved that he was an investor with respect to those types of properties. In addition, in the past when Mr. Gardner had sold multi-family properties, he usually had held them for at least several years before selling them.

At trial, the Tax Court agreed that Mr. Gardner had demonstrated a long term practice of holding multi-family investments for long term investment purposes.

> **Note:** This case seems to critically "hinge" on the fact that Mr. Gardner was a credible witness at trial in testifying as to his original purchase purpose in acquiring the 2004 tract - that is, to build multi-family properties and hold them for long term rental potential.

PART THREE

NEW SECTION 1411 "NET INVESTMENT INCOME TAX."

I. <u>Introduction</u>.

For tax years beginning in 2013, there is a new 3.8% tax on "net investment income." The new 3.8% net investment income tax was part of the Affordable Care Act. In late November 2013, the IRS finally issued final regulations outlining how the new net investment income tax would apply.

IRC Section 1411(a) imposes a tax on individuals equal to 3.8% times the **<u>lesser</u>** of:

(a) net investment income for the year; or

(b) the excess of: (i) modified adjusted gross income for such tax year over (ii) the "threshold amount."

In the case of estates or trusts, the tax is 3.8% times the **<u>lesser</u>** of:

(a) the undistributed net investment income of the estate or trust for such year; or

(b) the excess of (i) the adjusted gross income of the trust or estate for the year over (ii) the "threshold amount."

In the case of individuals, the "threshold amount" is $250,000 for joint return filers or $200,000 for an individual tax filer. Section 1411(b). For trusts or estates, the "threshold amount" is at the start of the highest trust tax bracket, which is basically around $12,000. These amounts are not indexed for inflation in future years.

II. <u>What is "Net Investment Income?"</u>

Next, Section 1411(c) defines "net investment income" as income earned from interest, dividend or annuities and capital gains. IRC Section 1411(c)(1)(A)(i).

In addition, "rents" that are not derived in the ordinary course of the taxpayer's business ("triple net leases") and "rents" that are deemed "passive income" to the taxpayer also are included within the definition of "net investment income." And "net investment income" also includes gains relating to disposition of investment property or passive activity property.

And, the term "net investment income" also includes pass-through income of an LLC or an S Corporation if the activities of the S Corporation or LLC are a "passive activity" of the taxpayer as defined under Section 469 of the Internal Revenue Code. Finally, sales of a taxpayer's interest in an S corporation or LLC will also be subject to the new 3.8% net investment income tax unless the taxpayer materially participated in the business activities of the S corporation or LLC.

So, for our clients who are heavily invested in real estate, these real estate clients will pay 3.8% net investment income tax on the following:

(1) pass-through income of an LLC or an S Corporation if the activities of the S Corporation or LLC are a "passive activity" of the taxpayer under Section 469 of the Internal Revenue Code;

(2) capital gains on the sale of real estate, unless the real estate is used in an active trade or business or unless the gain is statutorily excluded under Section 121 (sales of a principal residence), deferred under Sections 1031 or 1033, or similar tax planning opportunities; and

(3) rents received by the taxpayer during the year, unless (a) the taxpayer can prove that the rents were derived in the ordinary course of a trade or business of a Materially Participating Real Estate Professional or (b) in the limited instance in which the rents would be treated as "non-passive income" under certain limited provisions of Section 469 of the Code, and these limited instances in which rents will be treated as "non-passive income" under Section 469 of the Internal Revenue Code are where:

(i) The taxpayer rents the property to a business in which the taxpayer materially participates (self-rental); and

(ii) Certain other rental activities for which the taxpayer has made a "grouping" election to treat a rental activity and a trade or business activity as "one activity" for purposes of Section 469.

A Materially Participating Real Estate Professionals ("MPREPs") is someone whose rental activities constitute a trade or business. This is a facts and circumstances determination. Nevertheless, Treasury will assume that the rentals of the MPREP are a trade or business where:

(i) the MPREP participates in their rental real estate activities (not all activities, but rental ones) for more than 500 hours during the year, or

(ii) the MPREP has participated in these rental activities for more than 500 hours in any five of the ten prior years.

III. **<u>Planning Opportunities</u>**.

Unfortunately (or fortunately), there is only a very limited amount of tax planning that one can do to avoid the net investment income tax when it applies. However, here are some of the possible strategies you might want to employ after you consult with the client's CPA. Some tax planning opportunities would include:

1. Make sure a trust or estate distributes out all of its net investment income above the $12,000 total income threshold amount to its beneficiaries who may otherwise have modified adjusted gross income below the threshold amount.

2. Use the installment method (or other tax deferred techniques) to spread the taxable gain from disposition of property over several years, to perhaps keep income in all years under the threshold.

3. Convert a "triple net lease" to a "gross lease" for landlords who are in the real estate trade or business and who qualify as Materially Participating Real Estate Professionals.

4. Advise your client to file "grouping elections" with the IRS under Section 469 to group a rental activity with a trade or business activity. Note that grouping elections cannot be changed unless the original grouping "was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate." Regs. 1.469-4(e)(2). Nevertheless, the Final Regs under Section 1411 provide that a regrouping is allowed for **the first year after 2012 where the taxpayer is subject to this tax**. Thus, it is important that such a discussion happen in time for consideration in the filing of the **2013 tax return**, because the taxpayer may not have a window for such a planning opportunity in the future.

5. For rental arrangements that cannot otherwise be excluded from the Section 1411 definition of net investment income, consider opportunities to transfer ownership of the rental entity to the next generation. While the "kiddie tax" prevents an income tax benefit from transferring assets from parents to children, there is no such equivalent in the Section 1411 arena. Thus each small child, for example, has $200,000 of income threshold (the single threshold amount before imposition of the tax) from this Section 1411 tax.

PART FOUR
WHEN CAN "PERSONAL USE" PROPERTY QUALIFY AS SECTION 1031 LIKE-KIND EXCHANGE PROPERTY?

I. **Background.**

Under Section 1031 of the Internal Revenue Code, no gain or loss is recognized upon the disposition of property held for use in a trade or business or for investment in exchange for other property that likewise will be used in a trade or business or held for investment. Taxpayers can even structure Section 1031 exchanges where the buyer does not have property to convey back to the taxpayer. In those cases, the seller/taxpayer uses a "qualified intermediary" to facilitate the acquisition of qualifying replacement property in a "deferred exchange."

Of course, the key here is that both the relinquished property and the replacement property must both be held for productive use in a trade or business or for investment. Tax practitioners have long wondered whether it may be possible to engage in a Section 1031 Exchange for "dual use" property, such as vacation property at the beach or in the mountains, or even for property used as the taxpayer's primary residence.

Until recent years, we have had very little regulatory or case law guidance to consider.

Cautious and conservative tax advisors have warned that virtually any personal use of the relinquished or replacement property could disqualify the exchange for Section 1031 treatment. Clients, of course, plea their case that they have purchased the vacation property with a hope, and anticipation, that the vacation property would increase in value or would generate rental income, notwithstanding that they also would use the vacation property for personal enjoyment.

II. **Tax Court Affirms A Valid 1031 Exchange, Even Though Rental Property Was Soon Converted to a Primary Residence; *Reesink v. Commissioner, TC Memo 2012-118 (April 26, 2012).***

Mr. Reesink owned an apartment building with his brother. The building was sold in 2005, and Mr. Reesink structured his share of the sale as a Section 1031 tax-free exchange. Mr. Reesink used his share of the sales proceeds to purchase a residence on Laurel Hill Lane in a neighboring city using his share of the Section 1031 sales proceeds, as well as funds from a bank loan. On the bank loan application, Mr. Reesink stated that the property was being acquired "for investment purposes."

For the next seven months, Mr. Reesink unsuccessfully attempted to rent the property. Although they never advertised in any local newspapers, the Reesinks posted flyers throughout the town that the Laurel Hill Lane property was available for rent.

The Reesinks owned another primary residence and a trailer that was close to Mr. Reesink's job. Due to financial difficulties, the Reesinks sold their primary residence and moved into the Laurel Hill Lane property about seven months after the sale of the apartment building.

The IRS sought to disallow the Section 1031 exchange on the basis that the Reesink's primary purpose of acquiring the Laurel Hill Lane property was to use it as a primary residence.

Ultimately, Mr. Reesink was able to prevail at trial primarily based upon the testimony of his brother, who testified that the Reesinks had stated that they intended to move to the Laurel Hill Lane area once their children were out of his school. But at that time, Mr. Reesink's son was only fifteen years old and a long way from high school graduation. According to the Court, therefore, at the time the Reesinks acquired the replacement property, they intended to hold it for investment purposes.

III. <u>No Section 1031 Treatment Allowed Where A Married Couple Moves Into Replacement Property Only After Two Months of Attempts to Rent It Out. Goolsby, TC Memo 2010-64 (April 1, 2010).</u>

In <u>Goolsby</u>, TC Memo 2010-64 (April 1, 2010), the married taxpayers owned investment property which they sold and then purchased two (2) pieces of replacement property under a Section 1031 deferred like-kind exchange. Here are the facts:

Mr. Goolsby purchased investment property in 1990. In 2002, Mr. Goolsby signed a contract to purchase property in Pebble Beach, Georgia. However, the purchase agreement obligation was contingent on the Goolsbys' sale of their then current personal residence.

The Goolsbys sold the investment property through IPX, a qualified intermediary ("QI") and the QI used the sales proceeds to purchase both the Pebble Beach property as well as a second property – which was a four-unit apartment building. The Goolsbys then moved in with some relatives and placed advertisements in the local newspaper offering the Pebble Beach property for rent. Two months later, the Goolsbys moved into the Pebble Beach home after not finding any tenants for the Pebble Beach property.

According to the Tax Court, the Goolsbys could not prove that they purchased their Pebble Beach replacement property with any intent to use it for productive use in a business or for investment since they ultimately moved into it in such a short period of time after the purchase. Perhaps one of the most unfavorable facts here was that Mr. Goolsby had asked IPX, the QI, before the sale of the investment property, if he could move his family into the Pebble Beach property, and still qualify for Section 1031 treatment, if he was not able to rent out the Pebble Beach property to a tenant.

Note: The Court also upheld penalties against Mr. and Mrs. Goolsby.

IV. <u>Vacation Real Estate: Tax Court Case of Moore V. Commissioner And The "Primarily Held for Investment" Requirement</u>.

A. <u>Overview.</u> The case of <u>Barry Moore v. Commissioner</u>, TC Memo 2007-134 (May 30, 2007) revolved around whether or not the Moore family could claim Section 1031 treatment on their sale of certain lake front property for other lake front property where both properties were used by the Moores primarily for recreational purposes. As discussed further below, although Mr. Moore presented evidence at the Tax Court trial that he purchased the relinquished and replacement properties for investment purposes, the facts also demonstrated that the Moores used the relinquished and replacement property primarily for recreational purposes. Therefore, although Mr. Moore contended that he purchased the replacement and relinquished property in hopes that those properties would appreciate in value, this was not sufficient to bring the replacement and relinquished properties within the parameters of Section 1031.

Instead, the Tax Court held that, in order for the Section 1031 requirements to be met, the Moores would have to prove that the **primary** purpose of their purchase was to earn rental income or to recognize appreciation in value. Unfortunately, the facts bore out that the Moores purchased and used both properties **primarily** for recreational purposes rather than for investment purposes. Therefore, the 1031 relief was not available since neither the relinquished property nor the replacement property were held for "primarily" for investment purposes.

B. Facts of Moore v. Commissioner, TC Memo 2007-134 (May 30, 2007). In the Moore case, Mr. Moore wanted to exchange vacation property on Clark Hill Lake for other vacation property on Lake Lanier. Originally, the Moores purchased the Clark Hill Lake property in 1988. The Clark Hill Lake property consisted of two adjacent parcels of lake front real property along with a mobile home located on one of those parcels.

Previously, Mr. Moore had bad experiences with the stock market. Mr. Moore produced evidence at trial indicating that he purchased the Clark Hill lake property with the anticipation that it would appreciate in value. At that time, Mr. Moore's personal residence in Norcross, GA was a three hour drive from the Clark Hill property.

The Moores used the Clark Hill Lake property during the summer months on a regular basis. The mobile home located on the Clark Hill Lake property was a double wide mobile home. The Moores built a deck around the house and added a screened in porch and installed a satellite television receiver. They also replaced the roof and painted the home two or three times. They installed a new washer and dryer and replaced some of the furniture.

Until they decided to acquire the Lake Lanier property in late 1999, the Moores never advertised the Clark Hill property for sale although they had received purchase offers. Also, they never rented or attempted to rent the Clark Hill property to others.

On their 1996 through 1999 tax returns, the Moores listed deductions for "home mortgage interest". They did not list on those returns any deductions for **investment interests** nor did they deduct **any maintenance or other expenses** associated with the Clark Hill Lake property.

Later, the Moores moved to Marietta, GA and then the length of commute to the Clark Hill lake property was more like five or six hours. In December 1999, the Moores decided to sell the Clark Hill Lake property and they then entered into exchange agreement through a qualified intermediary and sought to purchase property on Lake Lanier as replacement property. Evidence at trial indicated that one of the primary purposes for moving to the Lake Lanier property was the fact that the Moores changed their primary residence from Norcross, GA to Marietta, GA.

Indeed, after the Moores changed their primary residence from Norcross to Marietta, GA, the length of the drive to the Clark Hill property made it inconvenient for the family to spend weekends at the Clark Hill property. As a result, they used that property less frequently.

So, in late 1997 or early 1998, the Moores began to investigate properties on Lake Lanier which is much closer to their Marietta, GA residence. Evidence at trial indicated that the Moores felt that a house on Lake Lanier would be much more use to them than the Clark Hill property. However, the Moores also believed that the property on Lake Lanier would appreciate more readily in value than the Clark Hill property, since Lake Lanier is much closer to Atlanta. So, the Moores purchased the Lake Lanier property in January 2000.

The Lake Lanier property was much more impressive than the Clark Hill property. The Lake Lanier property was a 1.2 acre tract of land and had the largest double slip boat dock allowable on that lake. The new house on Lake Lanier had five screened-in porches and five bedrooms and 4½ bathrooms. The new Lake Lanier property was also fully furnished. After they bought the Lake Lanier home, the Moores visited the home regularly, during each summer.

The Moores deducted substantially all of their home mortgage expense on Lake Lanier as home mortgage interest and a small amount as investment in interest. However, the Moores never took any maintenance or other deduction expenses associated with the Lake Lanier property on their tax returns. Also, the Moores never attempted to rent or sell the Lake Lanier property - until Mr. and Mrs. Moore got divorced and therefore needed to sell the Lake Lanier property to raise liquidity in connection with their divorce.

The IRS challenged the Moores' attempted Section 1031 tax-free exchange of the Clark Hill Lake property for the Lake Lanier property on the basis that the Moores used both properties for their personal use purposes rather than for investment purposes. The Moores, however, contended that they owned both properties with the expectation that both properties would appreciate in value.

In the Moore case, the Tax Court stated that "for investment" under Section 1031 has the same meaning as:

(i) "for profit" for purposes of taking a loss on the sale of property under Section 165(c); and

(ii) "for the production of income" for purposes of taking deductions under Section 212.

The Court then cited the cases under both Section 165(c) and 212 (or their predecessor sections) which held that properties must be held "**primarily** for profit" to take a Section 165(c) loss, or "**primarily** for the production of income" to take deductions under Section 212.

The Tax Court concluded that there was no convincing evidence that the Moores held either property for production of income but instead that there was convincing evidence that the Moores used both properties as vacation retreats. The Moores never attempted to rent either property. In addition, they never attempted to sell either property for a profit. In fact, they did not offer the Clark Hill Lake property for sale until they found the Lake Lanier property. They never attempted to sell the Lake Lanier property until Mr. Moore needed liquidity for his divorce. In fact, they did not offer the Clark Hill Lake property for sale until late 1999 when they decided to acquire the more accessible Lake Lanier property which was closer to their primary residence.

Also, although the Moores made substantial improvements and repairs to both properties, those improvements were more consistent with enjoying the properties as vacation homes. In fact, the improvements made to the Clark Hill Lake property (such as adding a screened-in porch, installing satellite television receiver and such) were more personal use related than designed to increase the value of the Clark Hill Lake property.

Also, with respect to the Lake Lanier property, it was true that the Lake Lanier property represented a substantial investment by the Moores. However, the Tax Court noted that the Moores did not attempt to recover any portion of that investment in the Lake Lanier property by renting the house out or attempting to sell. Also, on their tax return, the Moores treated all of their interest deductions on the Clark Hill Lake property and most of their deductions on the Lake Lanier property as home mortgage interest **rather than as investment interest**.

Thus, the evidence overwhelmingly demonstrated that the Moores' primary purpose in acquiring and owning both the Clark Hill Lake property and the Lake Lanier properties was to enjoy the use of those properties as vacation homes.

The final conclusion of the Tax Court was that "the mere hope or expectation that property may be sold at a gain cannot establish an investment intent if the taxpayer uses the property as a residence."

V. IRS Guidance Provides a "Safe Harbor" for Section 1031 Exchanges of Vacation Real Estate

In early 2008, the IRS issued Rev. Proc. 2008-16 (February 15, 2008) in response to the Barry Moore case and created a new "safe harbor" for like-kind exchanges of vacation homes and other rental property. The general thrust of the new Revenue Procedure 2008-16 is that the IRS will not challenge a vacation home as qualifying for purposes of Section 1031 (as property held for productive use in a trade or business or for investment) if the home is only occasionally used by the taxpayer for personal use and its predominant use is to generate rental income. The rental income must be bona fide and at fair rental value.

The new safe harbor under Rev. Proc. 2008-16 addresses both relinquished property and replacement property, and the following requirements must be met:

(1) Relinquished property. A dwelling unit that a taxpayer intends to be relinquished property in a §1031 exchange qualifies as property held for productive use in a trade or business or for investment if:

(a) The dwelling unit is owned by the taxpayer for at least 24 months immediately before the exchange (the "qualifying use period"); and

(b) Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange,

(i) The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and

(ii) The period of the taxpayer's personal use of the dwelling unit does not exceed the **greater** of (A) <u>14 days</u> **or** (B) <u>10 percent</u> of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

For this purpose, the first 12-month period immediately preceding the exchange ends on the day before the exchange takes place (and begins 12 months prior to that day) and the second 12-month period ends on the day before the first 12-month period begins (and begins 12 months prior to that day).

(2) <u>Replacement property</u>. A dwelling unit that a taxpayer intends to be replacement property in a §1031 exchange qualifies as property held for productive use in a trade or business or for investment if:

(a) The dwelling unit is owned by the taxpayer for at least 24 months immediately after the exchange (the "qualifying use period"); and

(b) Within the qualifying use period, in each of the two 12-month periods immediately after the exchange,

(i) The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and

(ii) The period of the taxpayer's personal use of the dwelling unit does not exceed the **greater** of (A) 14 days or (B) 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

For this purpose, the first 12-month period immediately after the exchange begins on the day after the exchange takes place and the second 12-month period begins on the day after the first 12-month period ends.

The new safe harbor provides valuable planning opportunities because now we have a "bright line" test for determining whether vacation homes qualify as investment property for Section 1031 purposes. Before the new ruling, clients would often ask:

- “When must I stop using my vacation home before I sell it in a 1031 exchange?"

- "How long do I have to rent the replacement property out before I can convert it to personal use purposes?"

Now we can answer that the safe answer would be “two years.”

PART FIVE

The Structured Sale Agreement
A Potential Tax-Planning Tool in a Recovering Economy

By

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Introduction

As the country emerges from the "Great Recession," taxpayers have a renewed interest in selling appreciated assets. As always, taxpayers will seek from their trusted advisors legitimate strategies to maximize the value of such transactions. Moreover, given the imposition of the new 20% maximum capital gains tax rate and the new 3.8% net investment income tax on taxpayers with adjusted gross incomes over $250,000 (for joint filers) or $200,000 (for non-married filers), it is even more likely that taxpayers will want to spread large payments of income over several years into the future to manage their yearly taxable income.

This paper discusses several mechanisms of deferral and focuses specifically on the use of a new and untested deferral strategy, called the "structured sale."

A. Section 1031 Exchange

One strategy, used by many taxpayers to defer gain recognition, is the well-known Section 1031 exchange. Under Section 1031, a taxpayer "exchanges" appreciated investment or business real estate for other real estate (called "like-kind" property) and therefore defers the capital gain on the initial asset sale, until the taxpayer ultimately sells the replacement property. Moreover, if the taxpayer dies while owning the replacement property, the tax basis of the replacement property is "stepped-up" to that asset's fair market value, which effectively allows the heirs to sell the replacement property for no taxable gain. As a result, the heirs' inheritance is maximized.

As many advisors are aware, however, this tax strategy is fraught with traps for the unwary, including the need to identify specific replacement properties and to purchase at least one of those replacement properties within strict time constraints. If the taxpayer does not obtain one of these parcels of replacement property, or if the taxpayer otherwise fails to meet other Section 1031 requirements (such as the requirement that the replacement property must be held for investment), then the taxpayer immediately recognizes gain on the sale of the relinquished property.

B. Deferring Tax Through a Sale for a Promissory Note

Of course, the Section 1031 exchange is not a simple transaction.

Moreover, some taxpayers simply do not wish to invest in real property any longer and would rather receive cash. Therefore, some taxpayers forego the Section 1031 exchange and opt to receive a promissory note in exchange for the sold real property. As described below, under Section 453, such a taxpayer will not recognize all of the capital gain on the sale of the real property at once; instead, the taxpayer will recognize income as he or she receives payments on the note from the buyer.

The use of a promissory note, however, is risky because the obligor can default on the note, i.e., there is a risk that the taxpayer-seller will not receive full payment for the sold property. Moreover, under the North Carolina General Statute Section 45-21.38, if a seller sells his or her real property to a buyer for a promissory note, secured by a purchase money deed of trust, and if the buyer defaults on payment of the purchase money note, then the seller's only recourse is to foreclose on the property upon the buyer's default; the seller cannot then sue the buyer for any deficiency between the value of the property (which may have dropped following the sale) and the amount owed by the buyer to the seller.

C. The New Structured Sale Technique

The concept of a "structured sale," which relies upon Section 453 concepts, evolved in the early 2000's as a possible technique for achieving installment sale treatment upon the exchange of real property for an annuity or a similar investment. Unfortunately, there is very little IRS guidance we can rely upon to determine if this structure works to defer tax.

1. Traditional Structured Sale

In a traditional "structured sale" transaction, a buyer issues a note to the seller of property and takes title to the sold asset. The buyer then assigns its purchase obligations under the note to a third party assignee[1] pays an amount to the third party assignee which is roughly equal to the discounted value of future payments the buyer is obligated to pay to the seller under the note. The third party assignee assumes the buyer's obligation and purchases an annuity from a life insurance company which is used to make note payments to the seller.

[1] Note that the IRS recognizes the transfer of an installment obligation to a third party under Section 453, as discussed in Revenue Ruling 82-122 and Revenue Ruling 75-457. In Revenue Ruling 82-122, the IRS explained, "Actions of the obligor that result in a change in the installment obligation, such as a transfer to a third party or a change in the form of the note, are not ordinarily treated as a disposition because the effect is merely to continue the seller's right to receive installment payments, without substantially changing the rights arising from the original transaction." Therefore, the IRS held that the substitution of the new obligor was not a satisfaction or disposition of the installment obligation within the meaning of Section 453B of the Code.

The seller benefits not only from deferral of income, but also benefits from a more financially sound source of payment.[2] While tax is not permanently deferred, as conceptually possible in a Section 1031 exchange where the seller dies owning the replacement property, the risk of default associated with an installment sale note decreases drastically. Moreover, the taxpayer-seller can benefit by investing the entire corpus of the proceeds into the annuity, as opposed to only being able to invest the after-tax dollars.

This "structured sale" concept is based on Section 453(a)(1), which allows a taxpayer to report gain arising from the disposition of certain types of property under the installment method. Note that only the timing, and not the character, of the gain is affected by Section 453 installment method. Accordingly, if the disposition of certain property would result in ordinary income, Section 453 may not be used to convert that income into capital gain. Reporting gains under the installment method simply suspends the reporting of gain until the actual receipt of the payments. For example, taxable gain on depreciation recapture cannot be deferred under Section 453 and must be recognized immediately.

Like Section 1031, this strategy is not a failsafe. In fact, we understand that this technique is unproven, as we have not located any Tax Court cases or IRS rulings addressing the use of a "structured sale" in the context of a deferred installment sale for real estate.

As such, we considered other cases that might give some guidance to support this approach. Based on our research, it seems that the "structured sale" technique relies upon the concept of deferred tax recognition in the context of personal injury plaintiff lawyers, who have agreed to accept a "structured sale annuity" in exchange for contingency fees received upon settlement of a personal injury lawsuit.

For example, in <u>Richard A. Childs, et al. v. Comm.</u>, 103 TC 634 (1994), a plaintiff's attorney sought to defer the contingency fee income he earned on a successful plaintiff's case by opting to have his fee paid to him by the defendants by way of an annuity. The Tax Court determined that the plaintiff's attorney was not required to currently recognize taxable income on the fair market value of future annuity payments arising from services already performed on behalf of the plaintiff; instead, the plaintiff's attorney could recognize income as he received annuity payments in the future. The Tax Court reasoned that because the promises to pay future amounts were neither <u>funded</u> nor <u>secured</u>, such promises did not constitute "property" under Section 83 and, as a result, the plaintiff's attorney did not have to recognize the future income stream as taxable income in the current year. The Tax Court determined that promises to pay are not <u>funded</u> if (1) the trust or policy at issue is subject to the general creditors of the owner of the policy (the third party who accepted assignment of the obligation to pay the taxpayer) or (2) if the taxpayer does not own the policy and the owner has the right to change the annuitant or beneficiary of the policy without the taxpayer's consent. Moreover, Tax Court held that the promises to pay were not <u>secure</u> even though they were guaranteed and even though the insurance companies were required to maintain adequate reserves.

[2] These steps are adapted from a discussion of the same in Robert W. Wood's "Structured Installment Sales as a Backup to Section 1031 Exchange," 48 Tax Mgmt. Memo. 06 (03/19/2007).

Similarly, in PLR 200836019, another case involving a plaintiff's attorney seeking to defer recognition of contingency fee wage income, the IRS determined that the attorney was not in actual or constructive receipt of periodic payments under Section 453 until she received the applicable cash payment. Several factors contributed to this determination. For example, under a settlement agreement and an assignment agreement, the attorney agreed that she could not change the timing or amount of the periodic payments and that she could neither assign nor transfer the payments. Further, under the assignment agreement, the attorney agreed that she had no rights against the assignee other than that of an unsecured general creditor, and that she would not be a third party beneficiary under any annuity purchased by the assignee. Also, the assignment stated that no assets were set aside to secure the payments.

Reading these cases in the context of a seller of real property attempting to defer taxable income on the sale of real property in exchange for a structured sale annuity, it is critical that the taxpayer-seller not own the annuity, be unable to affect how the annuity is invested and be unable to control the periodic payments. Otherwise, the seller-taxpayer may be in constructive receipt of the entirety of the proceeds at the time of the sale or while receiving one of the annuity payments.. Therefore, it is essential for the tax advisor to determine whether the taxpayer has actual control of the sales proceeds after completion of the sales transaction.

Note that while some private companies may offer this strategy in the context of the sale of an appreciated asset, we have not located any guidance from the Internal Revenue Service or the Tax Court specifically recognizing the "structured sale annuity" technique as a valid mechanism to defer recognition of taxable income on the sale of real property.

2. Limited Use of Structured Sale in Failed Section 1031 Exchanges

a. Background and Limited Application

Oftentimes, attempted Section 1031 exchanges fail because the replacement property is not "identified" or "acquired" in time, or because the seller is in constructive receipt of the sales proceeds before appropriate replacement property is obtained. As a result, taxpayers seeking to exchange assets are looking for alternatives to this deferral mechanism.

One suggestion growing within the marketplace is the concept of a structured installment sale that incorporates both the provisions of Section 1031 and Section 453, discussed above. Arguably, this structure has less tax risk from the concept of a property sale solely in exchange for an installment sale annuity as discussed above.

This concept arises from the intersection of Section 1031 and Section 453, specifically, the rules applicable to qualified intermediaries. Pursuant to Regulation Section 1.1031(k)-1(j)(2), in the case of a taxpayer's transfer of relinquished property to a qualified intermediary, the determination of whether the taxpayer has received a payment for purposes of Section 453 and Section 15a.453-1(b)(3)(k) is made as if the qualified intermediary is not an agent of the taxpayer. In other words, because the qualified intermediary is not the taxpayer's agent, the taxpayer is not deemed to have received assets received by the qualified intermediary; put simply, the taxpayer is not in constructive receipt of the proceeds of the sale of the appreciated assets. This special rule lasts until the earlier of (a) the taxpayer's ability to control the money or assets held by the qualified intermediary and (b) the end of the exchange period. See Reg. §§ 1.1031(k)-1(j)(2)(i) and (ii). This rule applies even if the qualified intermediary ultimately fails to obtain like-kind property, as long as the taxpayer had a "bona fide intent" to enter into a deferred exchange at the beginning of the exchange period.

Consider the following examples, provided by the regulations:

> **Example 1:** Jane Taxpayer enters into an exchange agreement with a qualified intermediary, who receives $100,000 from a buyer in exchange for Jane's appreciated real property during Year 1. On the date of the agreement, Jane had a bona fide intent to enter into a deferred exchange. Under the agreement, Jane has no rights to receive, pledge, borrow or otherwise obtain the benefits of the money held by the qualified intermediary ("QI") until the earlier the date the replacement property is delivered to Jane or the end of the exchange period. During Year 2, the QI acquires replacement property having a fair market value of $80,000 and delivers this property, along with the remaining $20,000 to Jane.
>
> Under Section 1031(b), Jane recognizes gain to the extent of the $20,000 cash that she receives in the exchange. Under Regulation Section 1.1031(k)-1(j)(2)(ii), any agency relationship between Jane and the QI is disregarded for purposes of Section 453 and Regulation Section 15a.453-1(b)(3)(i) in determining whether Jane is in receipt of payment. As a result, Jane is not treated as having received payment in Year 1 but is instead treated as receiving payment in Year 2, when she receives the $20,000 from the QI. Reg. Sec. 1.1031(k)-1 (j)(2)(vi), Example 2.
>
> **Example 2:** Joe Taxpayer enters into an exchange agreement with a qualified intermediary, who receives $80,000 and a 10-year installment obligation of $20,000 from a buyer in exchange for Joe's appreciated property. The exchange agreement provides that Joe has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money or other property held by the QI until the earlier of the date the replacement property is delivered to Joe or the end of the exchange period. Also, the buyer's obligation bears adequate stated interest and is not payable on demand or readily tradable. The QI acquires replacement property having a fair market value of $80,000 and delivers this replacement property, along with the buyer's installment obligation, to Joe.
>
> Under Section 1031(b), $20,000 of Joe's payment (i.e., the amount of the installment obligation Joe receives in the exchange) does not qualify for nonrecognition under section 1031(a). However, under Regulation Section 1.1031(k)-1(j)(2) (ii) and (iii), Joe's receipt of the buyer's obligation is treated as the receipt of an obligation of the person acquiring the property for purposes of Section 453 and Regulation Section 15a.453-1(b)(3)(i) in determining whether Joe is in receipt of payment. Accordingly, Joe's receipt of the obligation is not treated as a payment. Subject to the other requirements of Sections 453 and 453A, Joe may report the $20,000 gain under the installment method on receiving payments from the buyer on the obligation. Reg. Sec. 1.1031(k)-1 (j)(2)(vi), Example 4.

The argument that we have run across is that, since Section 1031 contemplates that a taxpayer may defer gain recognition under Section 453 upon a failed Section 1031 exchange, a taxpayer also should be able to use a long-term structured sale annuity within the same context of a failed Section 1031 exchange to accomplish the same outcome.

In his article, "How a Failed 1031 Exchange Can Become an Installment Sale," [3] Robert W. Wood explains that parties attempting a Section 1031 exchange may consider incorporating the possibility an installment sale in their exchange agreement through use of a structured sale annuity if the Section 1031 exchange fails. Specifically, Mr. Wood suggests that, as part of negotiating the exchange agreement between a seller and the QI prior to beginning the exchange transaction, these parties could agree that if the QI receives boot from the buyer or if the exchange transaction does not satisfy the requirements of Section 1031, then seller will have no right to receive the cash paid by the buyer; instead, the QI will issue a note to the seller within the replacement period in order for the seller to recognize income under the installment method. The exchange agreement would then provide that the QI would assign its obligations under the note to an assignment company and pay to the assignment company the discounted value of the future periodic payments. The QI would negotiate with the assignment company regarding the amount and timing of the future periodic payments. The assignment company would then make the periodic payments to the seller.

Presumably, the same factors considered in the plaintiff's attorney deferred income cases discussed above must also be considered here, i.e., the seller/attorney's lack of control over future payments and whether the future stream of income would be construed as "property" of the taxpayer.

Above all, however, the facts and circumstances must demonstrate that the seller had a "bona fide" intent to enter into a Section 1031 exchange. Otherwise, the seller could be construed as having constructive receipt of cash received by the QI, thereby preventing the deferral of gain recognition.

In past cases, courts have determined that a taxpayer has "bona fide" intent if it is reasonable to believe, based on all the facts and circumstances as of the beginning of the exchange period, that like-kind replacement property will be acquired before the end of the exchange period. In Smalley v. Commissioner, 116 T.C. 450 (2001), the Tax Court determined a taxpayer who had attempted to exchange timber in exchange for parcels of real property under Section 1031 had a bona fide intent at the commencement of the exchange period that he would satisfy the like-kind deferred exchange requirements. In addition to considering case law discussing whether timber and real property were "like-kind" in nature, the Tax Court also considered the following factors: (1) the agreement between the taxpayer and the buyer expressly conditioned the transaction on "reasonable cooperation and a tax free exchange qualifying under Section 1031," (2) the taxpayer's use of a qualified escrow account and proper escrow agent as required by Section 1.1031(k)-1(g)(3), (3) the taxpayer's timely identification and receipt of the replacement properties, (4) the taxpayer's credible testimony regarding his intent, and (5) the fact that the taxpayer had relied upon advice from a well-known timber taxation expert and his long-

[3] Wood, Robert W., 49 Tax Mgmt. Memo. 04 (02/18/08), attached hereto with permission from the author.

time accountant. Moreover, the IRS had not imposed any negligence or accuracy-related penalty in regards to the transaction.

Note that while some private companies may offer this strategy, we have not located any guidance from the Internal Revenue Service or the Tax Court specifically recognizing this strategy as a valid mechanism to defer taxable income in the context of a failed Section 1031 exchange.

b. More Aggressive Use of the Structured Sale Concept

Some participants in the structured sale market suggest that the taxpayer can not only defer taxes, but can also enjoy the use of the proceeds without triggering current gain recognition.

Though we have reviewed conceptual overviews of this approach and sought additional guidance from promoters, we have not received a comprehensive explanation of the steps of such an approach and how this approach is supported by existing tax law.

In this approach (as we understand it from our initial discussions with some promoters using this approach), a buyer assigns to a third party assignee its obligation to the seller and then takes title to the sold property. The assignee wires the cash received from the buyer to a custodial account held by another third party (the "Trust") instead of obtaining replacement property with the cash. A money manager invests the cash in a manner agreed upon by the taxpayer and the third party assignee. At the third party assignee's direction, the Trust wires periodic payments to the third party assignee, who wires the payments to the taxpayer, in such amounts and at such times as agreed upon with the taxpayer at the time the structured sale is established.

So far, this approach seems somewhat similar to the annuity-type approach discussed earlier. What follows, though, is very different.

As we understand it, some promoters suggest that, separate and apart from the foregoing process, the taxpayer can then borrow money from a separate third party ("Lender") under common control with the money manager, up to an amount that is a percentage of the cash managed by the money manager. The taxpayer would make interest payments on the loan using the periodic payments received from the third party assignee, and then deduct the interest payments. Similarly, when the loan is due in full, the taxpayer would pay the loan using the final payment from the third party assignee. Presumably, the additional income earned from the money manager's investment of pre-tax proceeds (through the Trust) would offset the interest expense associated with the loan. Though the taxpayer would then recognize the remaining income, entities marketing this approach suggest that the taxpayer can defer recognition of gain on the proceeds of the sale while still enjoying their use through the loan arrangement. In this manner, the taxpayer (a) defers income recognition, (b) presently benefits from most of the sales proceeds, and (c) earns greater income from having invested the entirety of the proceeds into the market (as opposed to only investing the after-tax proceeds).

As with the traditional structured sale discussed above, it would be critical that the note be issued prior to the end of the exchange period because the QI can only hold the cash until the earlier of (a) the time at which the taxpayer controls the cash and (b) the time in which the applicable exchange period ends, which is at the latest one hundred eighty days following an attempted exchange transaction, before the QI's possession of the cash is attributed to that of the seller-taxpayer. See Regulation Section 1.1031(k)-1(j)(2). Therefore, if this strategy were to have a chance of success in meeting its duplicate goals of deferral and access to cash, both the terms of the note and the terms of the loan would need to be structured prior to the commencement of the exchange period.

Some promoters using this approach seem to suggest that the taxpayer may actually negotiate on an ongoing basis the timing and amount of payments by the Trust with the money manager, which may be an entity related to, or under common control with, the Lender. However, if the taxpayer can control payments under the note, other than the initial negotiation of terms prior to the QI's receipt of the sales proceeds (to coincide, for example, with the payment terms associated with the accompanying loan), then the question arises whether the taxpayer controls the cash and is so in constructive receipt of the cash.

Finally, if there is no bona fide intent of the taxpayer receiving like-kind property in exchange for the appreciated asset, the taxpayer arguably should recognize gain on the transaction immediately.

While it is possible that this approach may be sound, we have not located any definitive guidance from the Internal Revenue Service or the Tax Court regarding whether it will be respected.

Moreover, though all of the involved third parties may be separate legal entities, it is possible that some of these third parties may be under common control. As a result, under the Substance over Form Doctrine, recently codified in Section 1409(a) of the Health Care and Education Reconciliation Act of 2010, it is possible that the IRS could treat two or more of these entities as one entity for purposes of determining whether the taxpayer is in constructive receipt of the proceeds. This question has not been addressed by the IRS.

Conclusion

So, questions to ask when presented with structured sale strategies include the following:

1. If not conducted in connection with a failed Section 1031 exchange, does the person receiving the cash purchase an annuity from a third party, the payments from which the taxpayer cannot and does not control?

2. If conducted in connection with a failed Section 1031 exchange, did the taxpayer have a bona fide intent to enter into a tax-deferred exchange of like-kind property at the beginning of the exchange period?

3. After the sale transaction is complete, and regardless of whether an annuity is purchased and what paperwork is signed, does the taxpayer have actual control on how the proceeds are invested and how payments are made?

4. In the case of a structured sale combined with a loan, are the assignee and the lending party under common control?

Assuming this structure is sound, other purely economic issues arise: Do fees associated with the transaction (investment management fees, financing charges, interest, etc.) exceed the potential tax savings of income deferral, investment with pre-tax dollars, and the potential avoidance of the alternative minimum tax or loss of phased out deductions? As always, each tax advisor should consider his or her individual client's specific facts, desires and needs before entering into this or any other transaction.

In conclusion, the recovering economy and the imposition of the higher capital gains tax rate and the new Net Investment Income tax will likely attract taxpayers who wish to sell appreciated assets and defer recognition of resulting gain over a period of time. While some deferral strategies are "tried and true," CPA's may be confronted with the possible growing use of structured sales as income tax deferral techniques. As a client's trusted advisor, a CPA should make sure to investigate any tax deferral strategies, but especially such untested strategies, to ensure that they actually provide the deferral sought by the taxpayer.

1042933-3 KAW