TAX PLANNING OPPORTUNITIES FOR REAL ESTATE CLIENTS

NORTH CAROLINA REAL PROPERTY SECTION
2008 ANNUAL MEETING

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PART ONE

WHEN CAN VACATION PROPERTY QUALIFY AS SECTION 1031 LIKE-KIND EXCHANGE PROPERTY?

I. Background.

Tax practitioners have long wondered whether it may be possible to engage in a Section 1031 Exchange for "dual use" vacation property, such as beach property, mountain property, etc. Previously, before the Barry Moore case and IRS Revenue Procedure 2008-16, we had no regulatory or case law guidance to consider.

Cautious and conservative tax advisors have warned that virtually any personal use of the

vacation property could disqualify the exchange for Section 1031 treatment. Clients, of course, plea their case that they 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 would use the vacation property for personal enjoyment. This truth has been borne out in the last five years by virtue of the escalating value of some vacation real estate.

II. <u>The New Tax Court Case of Moore V. Commissioner Provides a New "Primarily Held for Investment" Requirement with Respect to Exchanges of Vacation Real Estate</u>.

A. <u>Overview.</u> The case of <u>Barry Moore v. Commissioner</u>, TC Memo 2007-134 (May 30, 2007) resolved around whether or not the Moore family could claim Section 1031treatment 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** <u>nor</u> 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 a 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."

III. New 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 14 days or 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 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) Replacement property. 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 14 days or 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 TWO

TAX CONSEQUENCES TO COMMERCIAL DEBTORS FROM DISCHARGE OF INDEBTEDNESS, BANKRUPTCY AND FORECLOSURE

I. **General Rules.**

A debtor's release from the obligation to repay a loan will generally constitute taxable income to the debtor. U.S. vs. Kirby Lumber 284 U.S. 1 (1931). Indeed, IRC Section 61(a)(12) provides that the taxpayer will be required to recognize ordinary income as a result of "discharge of indebtedness" income ("COD Income"). This is because the taxpayer will realize an increase in wealth due to the discharged debt.

This discharge from indebtedness income will arise as a result of formal action taken by the creditor (such as a formal discharge or a loan compromise) or by operation of law (such as a discharge in bankruptcy or the expiration of the statute of limitations for enforcing a loan).

II. **Character of Taxable Income and Calculating the Amount of the Debt Discharge Income.**

The taxable income recognized by the debtor may be a capital gain, ordinary income or non-taxable income, depending upon the specific fact situations of the debtor. When property is foreclosed upon, the taxpayer will be concerned as to whether the foreclosure will generate income from discharge of indebtedness or gain from the sale of that property. This will be very important to the taxpayer if capital gains tax rates are lower than ordinary income rates, or if income from the discharge of indebtedness may be eligible for exclusion from gross income under Section 108.

Different rules apply depending upon whether the property is subject to non-recourse debt or recourse debt.

A. <u>Non-recourse Debt</u>. In general, debt-discharge income does **<u>not</u>** arise on a transfer of property where non-recourse debt exceeds the fair market value of the property transferred. Instead, the taxpayer must recognize **gain from the sale or exchange** of the property to the extent that the non-recourse indebtedness exceeds the taxpayer's tax basis in the property. Reg. Section 1.1001-2(a)(2). As a result, the taxpayer cannot utilize the exclusions contained in Section 108(a) to avoid income inclusion on account of the transfer of property in satisfaction of a non-recourse

debt. See Commissioner v. Tufts, 461 US 300 (1983) and Gershowitz v. Commissioner, 88 TC 984 (1987). So, in the case of a foreclosure of property subject to a non-recourse debt, the entire gain is treated as a gain from the sale or exchange.

B. **Recourse Debt.** Different rules apply in the case of recourse debt. In the case of recourse debt, where property subject to a recourse debt is disposed of in satisfaction of the debt, and if the amount of the debt exceeds the property's fair market value, then the IRS regulations bifurcate the transaction and provide that:

(1) gain from the sale or exchange of property arises to the extent that fair market value of the property exceeds his tax basis in the property; and

(2) debt discharge income arises to the extent of the excess of the debt over the fair market value of the property.

Regs. 1.1001-2(c); Gehl v. Commissioner, 102 TC 784 (1994), affirmed, 75 A.F.T.R. 2d 95,667

(8th Circuit 1995); Frazier v. Commissioner, 111 TC 243 (1998).

This will be a bad result for many taxpayers who dispose of property subject to a recourse mortgage in excess of the fair market value of the property who otherwise would be eligible for relief provisions under Section 108, since they would prefer to have discharge of indebtedness income rather than gain from the sale or exchange of the property.

> **Example**: In 2002, F transfers to a creditor an asset with a fair market value of $6,000 and a tax basis of $5,000 in satisfaction of a $7,500 recourse debt for which F is personally liable. The amount realized on the disposition of the asset is its fair market value of $6,000, so F realizes a taxable gain on the sale of $1,000. In addition, F also realizes income from discharge of indebtedness of $1,500 ($7,500 - $6,000). Regs. 1.1001-2(c), Example 8.

Also, under these regulations, debt-discharge income results whether the property is disposed of at a gain or a loss. Thus, in the above example, if F's tax basis in the property is $7,000

rather than $5,000, F realizes a loss of $1,000 on the disposition of the property to the creditor, but still realizes discharge of indebtedness income of $1,500.

III. <u>Exclusions from COD Income Where the Debtor Is Insolvent or Is In Bankruptcy</u>.

A. <u>General Overview</u>. The general rule is that a debtor recognizes ordinary income equal to the amount of the debt discharged over the amount of cash and the fair market of any property paid to the creditor. However, there is an important exception to this rule where the debtor is bankrupt or insolvent.

Under Section 108(a)(1), if the debtor is in **bankruptcy**, no debt discharge income is realized. If the debtor **is insolvent**, income **<u>must</u>** be recognized to the extent that the cancelled debt exceeds the amount by which the debtor was insolvent before the discharge. Section 108(a)(3).

<u>EXAMPLE</u>: Bob has assets worth $1 Million and debts of $1.3 Million. So, Bob is

"insolvent" to the extent of $300,000. If Bob's creditors forgive $400,000 of debt, then Bob must recognize $100,000 of COD income. However, if Bob was in bankruptcy at the time of the debt forgiveness, Bob would not have any taxable COD income.

The taxpayer must be insolvent at the time of the foreclosure, or the foreclosure must occur during bankruptcy to qualify for the exclusions. Thus, if the bankruptcy is filed too late or if the taxpayer has retirement funds or other assets available to satisfy the foreclosure, there can still be enormous and unexpected tax liability arising from the foreclosure.

If a taxpayer does not realize COD income by virtue of the bankruptcy or insolvency exclusion, the taxpayer must reduce certain tax attributes (such as loss carryforwards and asset basis). Section 108(b); Regs. 1.108-4(a).

B. Corporations, Partnerships and LLCs: Who Must Be Insolvent or in Bankruptcy? Different rules apply depending upon whether the taxpayer is a partnership (including an LLC) or a corporation. If the debtor is a corporation, the cancellation of

indebtedness income issue is determined based upon whether the corporation is solvent or insolvent, and the solvency or insolvency or bankruptcy status of the corporation's shareholders is irrelevant. Section 108(d)(7). In that case, the corporation must reduce its basis in its assets by the amount of the cancelled debt. Section 108(d)(7)(A). Or, in the case of S corporations, the S corporation shareholders may be required to reduce any suspended losses in excess of their tax basis in their S corporation stock. Section 108(d)(7)(B).

A different rule applies where the taxpayer is a partnership or an LLC. Where the taxpayer-debtor is a partnership or LLC, the cancellation of indebtedness income is passed through to the partners and LLC members and the availability of the bankruptcy or insolvency exception is determined at the partner or member level. Section 108(d)(6).

Let's look at some examples:

1. **S Corporations.** Let's assume Allen and Barry form an S Corporation as a 50/50 S Corporation. The S Corporation files bankruptcy and has COD income. Here, the

indebtedness discharged is determined by the corporate bankruptcy at the corporate bankruptcy level. This means that, under IRC §108(d)(7), Allen and Barry do not have any COD income to recognize since their S corporation was insolvent or bankrupt. However, Allen and Barry must reduce their tax attributes by the excluded COD income, such as reducing their basis in S corporation assets or by reducing any suspended loss carryovers to the extent that they have loss carryovers in excess of their available tax basis in their S corporation stock or their loans to the S Corporation.

2. **A Bankrupt Disregarded Entity.** Let's now assume that Steve is the sole owner of an LLC which is a disregarded entity for federal income tax purposes under Section 301.7701-2(a). Here, the single-member LLC is bankrupt, but Steve is solvent or has not declared bankruptcy himself. Under PLR 200652017, the IRS takes the position that Steve must recognize COD income since he is not bankrupt or insolvent.

3. **General Partnership Example.** Let's assume that Tom and Bob create an equal 50/50 partnership which files a bankruptcy petition and obtains a discharge of partnership liability. Let's also assume that Tom is bankrupt or insolvent, but that Bob is solvent. In this case,

under Section 108(d)(6), qualification for the exclusion of COD income is determined at the partner and not partnership level. Therefore, Tom's COD income is not taxable since he is bankrupt, but Bob's share of taxable income must be recognized as ordinary income unless he can avail himself of another Section 108 exclusion, such as the exclusion for discharge of qualified real property business debt under Section 108(a)(1)(D).

C. <u>Can the Partners Change the Tax Consequences by Allocating COD Income to the Insolvent Partner</u>? Generally, tax allocations in a Partnership Agreement or an amendment (executed before April 15 of the next tax year) will be respected as long as the tax allocations have "substantial economic effect." So, you may wonder if you can amend a partnership or LLC agreement so as to allocate COD income to the insolvent partner for tax purposes. Unfortunately, the case of <u>Gershowitz vs. Commissioner</u> (88 TC 984 (1987)) and Revenue Ruling 99-43 (1999-2 C.B. 506) provide that special allocations of COD income to an insolvent partner lacks "substantial economic effect" unless the insolvent partner will also be allocated an increase in his right to capital account distributions by the amount of the COD income.

D. When Is An Individual Insolvent? As indicated above, for individual taxpayers and for partnerships or LLC's, the insolvency exception only applies where the individual is insolvent. Again, the COD income test is applied at the partner or member level for a general partnership or LLC. Therefore, if that partner or member is not bankrupt, we need to determine whether he or she is insolvent for purposes of applying the insolvency exception.

This can be a very tricky analysis. In TAM 199935002, the IRS Chief Counsel stated that exempt assets for bankruptcy purposes should be included as "assets" for insolvency calculation. Therefore, it is quite likely that the IRS will argue that certain assets of the taxpayer which are exempt from creditor claims (such as IRAs, tenants by the entirety real property and 401(k) plan balances) must be included as countable assets for purposes of determining the insolvency exception.

Likewise, in Merkel v. Commissioner, 109 TC 463 (1997), the Tax Court concluded that the contingent liabilities of the taxpayer corporation (under the guaranteed debt and sales taxes)

should not be taken into consideration in calculating the taxpayers' insolvency, unless the taxpayers could prove that it was **more likely than not** that the taxpayers would indeed be held liable for the contingent liabilities.

IV. Making the Election to Reduce a Taxpayer's Basis in Property Instead of Recognizing Debt Discharge Income.

A. General Overview. Under the tax rules, a taxpayer, other than a C corporation, may elect to exclude the discharge of indebtedness income from gross income to the extent that the discharged debt is "qualified real property business indebtedness." Section 108(c)(3). Qualified real property business indebtedness (QRPBI) is indebtedness which:

(a) was incurred or assumed by the taxpayer in connection with real property used in a trade or business and which debt is secured by such real property;

(b) was incurred or assumed before January 1, 1993, or if incurred or assumed on or

after January 1, 1993, is “qualified acquisition indebtedness”; and

(c) with respect to which the taxpayer files the required election with the IRS.

Section 108(c)(3).

“Qualified acquisition indebtedness” means indebtedness incurred or assumed to acquire, construct, re-construct or substantially improve the property securing the debt. IRC §108(c)(4). The amount of QRPBI debt that can be excluded from gross income is limited to the excess of the outstanding principal amount of all QRPBI debt secured by the property (immediately before the discharge) over the fair market value of the property immediately before the discharge. Section 108(c)(2)(A); Regs. 1.108-6(b).

B. <u>Reducing Tax Attributes</u>. In those cases, where the taxpayer makes an election to exclude the discharged QRPBI from gross income, the taxpayer must reduce its basis in depreciable real property which can include reducing the portion of the taxpayer's basis in his

partnership interest attributable to the partnership's depreciable real property and making a corresponding reduction in his share of the partnership's basis in a depreciable real property. Section 1017(b)(3); Regs. 1.1017-1(a) and (g).

The reduction in basis is treated as additional depreciation for purposes of Section 1250. IRC §1017(b). This means that the excluded discharge of indebtedness will be offset by some combination of (1) foregone depreciation deductions, (2) ordinary income on the sale or disposition, and (3) reduced Section 1231 loss treatment on a sale. **Of course, if a taxpayer dies while holding the qualified real property, his heirs will receive an income tax basis step-up on death under Section 1014.**

C. Partnership Treatment. Unlike the case with individuals or S corporations, in the case of a partnership, the determination as to whether the discharged indebtedness is QRPBI (and the amount by which the principal amount of the QRPBI exceeded the fair market value of the property) would have to be determined at the partnership level. However, the election to exclude QRPBI debt is made by an individual partner. IRC §108(d)(6).

D. **Making the Election to Reduce Basis.** In order to make an election to reduce basis, the taxpayer must file with the IRS a completed Form 982 which must be made on a timely-filed income tax return for the taxable year in which the taxpayer has discharge of indebtedness income that is excludable under Section 108(a), including extensions. If the taxpayer fails to make the election on that return, the taxpayer must request the Commissioner's consent to file late election under Reg. §301.9100-1 through -3; Reg. §1.108-5.

PART THREE

NEW TAX RELIEF FOR RESIDENTIAL FORECLOSURES

I. Introduction.

In recent years, with the escalating value of homes, many people have bought more

"house" than they could afford and others have sought to refinance their homes in order to "pull out" attractive equity.

On December 20, 2007, the Mortgage Forgiveness Debt Relief Act of 2007 became law. Before this new law, cancellation of debt from foreclosure of homes or from short sales of homes (sale of a home for less than the amount of the debt owed) generally resulted in additional tax liability equal to the difference between what the home was sold for and the amount of the total debt. Short sales have been particularly troublesome to taxpayers. With a short sale, the homeowner makes arrangements to sell the house for less than the actual mortgage amount.

In these cases, the taxpayer has a terrible credit rating problem and, in addition, the taxpayer is left with a tax bill arising from the COD income by virtue of the short sale or foreclosure.

Under the new Mortgage Forgiveness Debt Relief Act of 2007 (PL 110-142), up to $2 Million ($1 Million for married individuals filing separately) of cancellation of indebtedness

income is not taxed if the indebtedness is "qualified principal residence" that is discharged in 2007, 2008 or 2009. Section 108(a)(1)(E), added by PL 110-142. This is great news for many homeowners caught in the sub-prime market trap.

The new rules provide that relief from debt stemming from foreclosure of a personal residence, to the extent that the debt was incurred to buy or improve a home, will now be excluded from taxable income if the foreclosure occurs between January 1, 2007 and December 31, 2009.

II. <u>Exceptions to New IRC Section 108(a)(1)(E) Rules</u>.

However, there are many exceptions to the new laws.

A. <u>Exclusion Limit</u>. First of all, the limits are $2 Million for joint taxpayers and $1 Million for married taxpayers filing separately.

B. <u>Only Debt to Purchase or Improve a Home Will Qualify For Exclusion</u>.

Second, the new law only provides relief for debt incurred to buy or improve a property or to refinance debt that previously was used to buy or improve a home. So, home equity loans will not be protected from the new relief rules. So, when calculating the amount of forgiven debt that is covered by the new exclusion rules, any debt not used to buy or improve the principal residence will continue to be considered as income to the foreclosed homeowner. This means that forgiven equity lines and many second mortgages will still be subject to the taxable income rules.

C. Second Homes, Vacation Homes and Business and Investment Property Are Not Eligible for the Exclusion. Finally, second homes, vacation homes and business and investment property are not included in the forgiveness rules. Instead, the new rules only apply to debts secured against the **qualified principal residence** of the taxpayer. If a taxpayer has two homes, only the home that is used the majority of the time will qualify for the new forgiveness debt rules.

D. Bankruptcy and Insolvency Exception Still May Be Available. Of course, the bankruptcy and insolvency exceptions to the COD income rules are still available. However, the

taxpayer must be insolvent at the time of the foreclosure, or the foreclosure must occur after or during bankruptcy to qualify for the exclusions. Thus, if the bankruptcy is filed too late or if the taxpayer has retirement funds or other assets available to satisfy the foreclosure, there can still be enormous and unexpected tax liability arising from the foreclosure.

III. Creditor and Debtor Reporting Requirements.

The creditor will send the homeowner and the IRS a Form 1099-C, Cancellation of Debt Form, to report the amount of the forgiven debt. In order to exclude the COD income from taxable income, the taxpayer-homeowner must file a **Form 982**, Reduction of Tax Attributes Due to Discharge of Indebtedness, with the IRS to claim the exclusion of forgiveness of debt income.

IV. Reduction of Tax Attributes.

If debt is discharged under new Section 108(a)(1)(E) and the taxpayer keeps his home, the taxpayer must reduce his tax basis in the home by the amount of the released debt.

PART FOUR

THE "SHOVEL IN THE GROUND PROBLEM":

PLANNING FOR REAL ESTATE DEVELOPMENT ACTIVITIES

I. Introduction

The uncertainty surrounding the "real estate dealer versus investor" issue has generated a substantial degree of caselaw over the years. Much of this uncertainty stems from what has been coined as the "shovel in the ground problem" – i.e, when do the taxpayer's value-enhancing activities, such as landscaping or installing sewer systems, convert investment property into dealer property, such that ordinary income tax consequences will result. This part of this paper will explore some of the issues associated with the dealer versus investor challenge and will suggest

possible tax planning strategies to achieve a favorable tax result for your client. However, as most tax practitioners who have tackled this issue can attest to, there is no definitive answer to this issue.

II. Significance of Characterization

Gain and loss recognized from the disposition of real property must be characterized as either ordinary or capital in order to determine the appropriate tax treatment of the gain or loss.

A. Tax Rates. For non-corporate taxpayers, the capital gains tax rate cannot exceed 5%, 15% or 25%, depending on the type of capital gain (Sec. 1(h)), whereas the nominal marginal tax rate applicable to ordinary gains can be as high 35% (Sec. 1(i)). With respect to C corporations, the tax rates applicable to capital gains portion of taxable income cannot exceed 35% (Sec. 1201), which is the highest marginal rate applicable to corporate taxable income. In addition, non-corporate taxpayers can deduct capital losses only to the extent of capital gains increased by the lesser of (i) $3,000 or (ii) the excess of capital losses over capital gains (Sec. 1211(b)). C corporation taxpayers can only deduct capital losses to the extent of capital gains.

B. Other Benefits of Capital Asset Treatment. Investors also benefit from Section 1031 nontaxable exchanges, Section 1033(g) (relating to condemnation of real property held for productive use in a trade or business or for investment) and Section 453 installment sale reporting; these are benefits that are not available to ***dealers*** of real property. Also, individual real property dealers may have to pay self-employment tax on sales of dealer property.

On the other hand, investors in rental real estate must be cognizant of the passive activity loss limitations of Section 469 and the capital loss limitations applicable to investment property.

C. Capital Gain Defined. To obtain capital gain treatment, there must be (i) a sale or exchange (or deemed sale or exchange), (ii) a one-year holding period if long-term treatment is desired, and (iii) a capital asset (Sec. 1221) or an asset held for productive use in a trade or business (Sec. 1231). Under §1221 of the Code, a capital asset is defined as any property held by a taxpayer, whether or not connected with a trade or business, subject to eight exceptions, three of which are germane in the context of real estate business activity. The three significant exceptions to the definition of a capital asset are:

(1) Stock in trade or other property of a kind which would be included in inventory if on hand at the close of the taxable year and property held primarily for sale to customers in the ordinary course of business (Sec. 1221(a)(1));

(2) Depreciable property and real property used in a trade or business (Sec. 1221(a)(2)); and

(3) Accounts and notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of stock in trade, inventory, and property held primarily for sale to customers (Sec. 1221(a)(4)).

D. **The Sale or Exchange Requirement.** In order to obtain long-term capital gain, the taxpayer must demonstrate that a sale or exchange of a capital asset held for more than one year occurred and the gain was taken into account in computing gross income (Sec. 1222(3)). Under the broad definition of Treasury Regulation 1.1002-1(d), a "sale" is transfer for property for an amount of money or a money equivalent that is fixed and determinable. Similarly, an "exchange" is a transfer of property for property other than money or a money equivalent.

Generally, capital gains and losses result from the sale or exchange of a capital asset, though certain transactions not involving the sale or exchange of a capital asset are deemed to constitute the sale or exchange of a capital asset (e.g., §§ 1231(a)(1), 1233, 1234, 1234A, 1235). In other situations, property may be characterized as a capital asset even though it might not otherwise be so characterized under certain other circumstances (e.g., §§ 731, 741, 1237, 1256). Other transactions that would normally be characterized as sales or exchanges of capital assets are treated as ordinary income transactions (e.g., §§ 707(b)(2), 751, 1231, 1236, 1239, 1242, 1243, 1244, 1245, 1248, 1249, 1250, 1252, 1253, 1254, 1255, 1257, 1258, 1287). Finally, in other situations, the Code deems a sale or exchange to exist even though such characterization might not be deemed to exist in other situations (e.g., §§ 1241, 1271).

E. Quasi-Capital Assets: Section 1231. The primary purpose of Section 1231 is to provide special, favorable tax treatment to the sale or exchange of real or depreciable property used in the taxpayer's trade of business. Such property is excluded from the definition of "capital asset" under Section 1221(a)(2). So, in the absence of Section 1231, any gain or loss recognized on the disposition of such property would necessarily be ordinary gain or loss.

Under Section 1231(b), however, **net gain** in excess of losses from the sale of Sec. 1231(b) property is characterized as a **capital gain**, while **net losses** on the sale of 1231(b) property results in an **ordinary loss** (hence the term "quasi-capital assets"). Thus, in dealing with Section 1231 property, the taxpayer has the benefit of capital gain rates and the avoidance of the capital loss limitations. However, the Code mandates that the taxpayer recapture, as ordinary income, the lesser of (i) the aggregate amount of the unrecaptured ordinary losses deducted under Section 1231 in the preceding five years, or (ii) the Sec. 1231 gain for the current year. When analyzed with the recapture provisions of Section 1245 and Section 1250, this recapture provision may make it more difficult for the taxpayer to obtain capital gain treatment on the sale of business assets.

F. The Holding Period Requirement. In order for a taxpayer to achieve the more favorable long-term capital gain rate (15%), the property sold or exchanged must have a holding period longer than 12 months.

The holding period commences on the day after the acquisition date and is computed through the day of disposition of the property. Under Section 1223(1), the holding period may be *tacked on* in a situation where the basis of property acquired is determined in whole or in part by reference to the basis of property transferred, such as in nontaxable exchanges, involuntary conversions, foreclosures and certain other situations.

Interestingly, Section 1223 does not reference a holding period for assets held for resale in the ordinary course of business (i.e., inventory). Since an asset held as inventory does not appear to generate a holding period under the Code, the holding period would only seem to run during the period of time the asset is held as a capital asset or asset held for productive use in a trade or business.

G. Deemed Depreciation Recapture. With respect to the tax treatment of depreciable real property, the maximum tax rate is modified for the *deemed depreciation recapture.* Accordingly, any depreciable real property sold after May 7, 1997 must be treated, for maximum tax rate purposes only, as if it were Section 1245 property. To the extent that

depreciation on the property would be recaptured as ordinary income under Sec. 1245, the deemed depreciation recapture would be taxed at a rate not to exceed 25%. The capital gain above the deemed depreciation recapture is subject to the normal capital gains rate.

> **Example:** Bob purchased a shopping center that is Section 1245 (because it was placed in service in 1985 and thus subject to Accelerated Cost Recovery System depreciation) for $9,500,000, and depreciated it under an accelerated method, claiming $5,000,000 in depreciation deductions. Bob sells the apartments to Sue for $12,000,000, creating a gain on the sale of $7,500,000 ($12,000,000 sales price less adjusted basis of $4,500,000 ($9,500,000 - $5,000,000)). Since the property is characterized as Section 1245 property, the $5,000,000 in depreciation will be taxed ordinary income. Therefore, the gain equal to the deemed depreciation recapture of $5,000,000 would be subject to a maximum 25% tax rate. The remainder of the gain - $2,500,000 - would be subject to the capital gains maximum rate.

While the deemed depreciation recapture is referred to as "*unrecaptured section 1250 gain,*" this amount is not actually Section 1250 recapture for any purpose other than the maximum tax rate calculation. Accordingly, the unrecaptured section 1250 gain is not subject to the rules that relate to depreciation recapture, e.g. required recognition in the year of an installment sale of the property, etc. (discussed below).

III. Taxation of Dealer Income and Expenses

The classification of a real estate owner as a dealer or investor as significant tax implications aide from the character of gain the taxpayer will recognize upon disposition. We will now address some of these issues.

A. Denial of Installment Sales. Perhaps most significantly, dealers in real property are not entitled to take advantage of the tax deferral benefits allowed by use of the installment sale method under Section 453 for reporting gain on sales.

B. Self-Employment Tax Issues. In 2007, self-employment income not in excess of $97,500 is subject to self-employment tax at a rate of 12.4%, plus an additional 2.9% medicare tax on all net earnings from self-employment. However, the self-employed taxpayer is allowed to

deduct one-half of the self-employment tax paid. Section 1402(a) defines "net earnings from self-employment" as *gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle, which are attributable to such trade or business.* The section provides that rental income from real estate and from personal property leased with the real estate is not self-employment income unless the rental income is received in the course of a trade or business as a real estate dealer. Rental income from real estate and from personal property leased with such real estate will constitute self-employment income only if received by real estate dealers (not investors) in the ordinary course of business.

C. Business Expense Deductions. Under Code Section 162, the real estate dealer is permitted to deduct all the ordinary and necessary business expenses incurred in the conduct of business activities. The dealer-taxpayer ordinarily reports these business expenses on Schedule C as a reduction in self-employment income.

On the other hand, under Section 212, a real estate investor is only allowed to deduct all ordinary and necessary business expenses incurred for the production or collection of income or

for the management, conservation, or maintenance of property held for the production of income. These itemized deductions (ordinarily listed on Schedule A) primarily consist of 163(d) interest expenses, Section 164 real estate taxes, or miscellaneous Section 67 itemized deductions to the extent they exceed 2% of the taxpayer's adjusted gross income.

D. Other Tax Implications. Section 1031 provides for tax deferral on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment. Accordingly, a dealer holding property for sale to customers in the ordinary course of business is not entitled to use this special tax provision that is available to real estate investors. In addition, Section 1231 benefits are not available to dealers, while Section 1033 involuntary conversion benefits aren't either. Accordingly, the classification of a taxpayer as an investor or dealer has significant tax implications beyond capital gain treatment throughout the Internal Revenue Code.

IV. The Real Estate "Dealer" Versus "Investor"

A. Identifying the Real Estate Investor. While the capital gain benefits once available to the real estate investor have been diminished by recent amendments to the tax laws, such investors can still benefit from Section 1031 nontaxable exchanges, Section 1033(g) (relating to condemnation of real property held for productive use in a trade or business or for investment) and Section 453 installment sale reporting, benefits that are not available to *dealers* of real property. On the other hand, investors in rental real estate must be cognizant of the passive activity loss limitations of Section 469 and the capital loss limitations applicable to investment property.

Often a taxpayer acts under the assumption that his real estate undertakings are investment activities qualifying for capital gain treatment, when in actuality, the facts and circumstances surrounding the taxpayer result in dealer status. 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 investor rather than dealer 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.

B. The Taxpayer Argument for Real Estate Dealer Status. Historically, the

taxpayer - in disputes regarding real estate dealer versus investor status -has advocated investor classification, while the IRS has argued for dealer status. However, there have been a numerous cases where the opposite has been true, primarily because the taxpayer is seeking to deduct substantial amounts of interest without being subject to the investment interest limitations of Section 163(d). See, for example, Harris M. Miller, 70 TC 448, Edward H. Boseker, TC Memo 1986-353 and E. Dean Morley, 87 TC 1206 where the taxpayers were successful in establishing that they were dealers as opposed to investors in real estate.

The facts and holding in Morley indicate that an individual can be a dealer in what essentially amounts to a single transaction trade or business. The taxpayer in Morley purchased a single parcel of land with the intent of immediately reselling it to a pre-arranged purchaser. However, due to changes in the economic conditions in the area, the pre-arranged purchaser chose not to acquire the property and the taxpayer was left holding the property for several years, during which time he paid significant interest on his mortgage payments. This single tract was the only such property purchased by the taxpayer, was obviously acquired with the intent to resell, was held for sale for the entire period of ownership, experienced no improvements or modifications during

the time of the taxpayer's ownership, and produced no current income to the taxpayer.

In light of the holding in Morley, there is a greater potential for the taxpayer to establish dealer status, if the taxpayer objective is to avoid the passive activity loss or investment interest limitation rules. On the negative side, however, the case creates a greater trap for unwary taxpayers to accidentally fall into dealer status. Taxpayers and their advisors should exercise great care in structuring activities so that the potential benefits of avoiding the passive activity loss or investment interest limitation rules (i.e., dealer status) are weighed against the tax rate benefit of capital gains treatment (i.e., investor status). The tax rate differential between capital gains and ordinary income can provide an important tax benefit to the taxpayer in higher marginal tax brackets.

In Margaret Hancock, TC Memo 1999-336, the IRS argued that any losses the taxpayer realized on lots she and her late husband had subdivided and developed should be characterized as capital losses rather than ordinary because she was an investor. The IRS's position was predicated on three points:

1. The nature of the real properties changed at the time of the late husband's death.

2. The taxpayer's pattern of selling more lots in years when market conditions were more favorable was an indication that she was an investor, as opposed to a dealer.

3. The lack of development activities subsequent to her husband's death suggested investor rather than dealer status.

In considering the facts, the Tax Court noted that community property basis adjustment that occurred on her husband's death facilitated the losses. The economics of the real property transactions indicated that the Hancocks actually made money on the sales if compared to their original costs absent the tax adjustments. The properties declined in value after the death of the taxpayer's husband.

Further, over the ten year period following her husband's demise, the taxpayer sold 47 of the 48 lots she received on her husband's death. The Tax Court held that the **frequency and substantiality** of sales over the 10 year period was the most important factor in concluding that the property was held for sale by the taxpayer in the ordinary course of business.

Finally, the Court noted that it is possible for a taxpayer to be in the business of *selling lots,* even if the business activities did not rise to the level of *developing lots.*

C. Indicia of Dealer Status

1. The Purpose for the Purchaser. The taxpayer's intent with respect to the disposition of the property at the time of the acquisition is a significant factor considered by the courts. Accordingly, platting or rezoning of the property by the taxpayer for eventual subdivision may indicate dealer intent, while more passive-type activities by the taxpayer at the time of acquisition of the property suggest an investor intent. The aforementioned activities can result in dealer status even if the taxpayer-seller plats and/or subdivides for the benefit of a developer-purchaser. In these circumstances, the taxpayer-seller must demonstrate that he is acting strictly as an agent for the developer-purchaser under the terms of the contract. However, see George V. Buono, 74 TC 187, where the Tax Court allowed the taxpayer capital gain treatment on a one-time sale where preliminary subdivision work had been undertaken. See also Planned Communities, Inc., TC Memo 1980-555.

2. <u>Change in Purpose During the Taxpayer's Holding Period – "Significant Economic Event"</u>

(i) In General.

While the intent of the taxpayer at the time of acquisition can be that of a dealer, often the facts and circumstances surrounding the property change such that the use of the property during the holding period converts to investment use. This is especially prevalent in situations where factors that arise subsequent to the acquisition of the property create an impediment for the taxpayer in realizing his original intent of the ownership of the property (e.g., government regulations, change in market conditions, failure to obtain adequate zoning, etc.). The changed in circumstances is often referred to as a *significant economic event*.

Either the taxpayer or the IRS may argue that the original purpose has changed in order to achieve the results each desires. Some Circuit Courts appear to be less ready that the Tax Court to find a change in original purpose where the property was acquired for

investment. Thus, the Ninth Circuit has held that investment property doesn't cease to be a capital asset merely because the taxpayer decides to liquidate his investment after it is found to be unprofitable if until shortly before the first sale the taxpayer held the property primarily for investment. See Heller, TC Memo 1965-302.

(ii) Disposal of Costly Investment.

The Ninth Circuit also held that the taxpayer's investment purpose had not changed to a sale purpose where, shortly after the taxpayer acquired the property, it made extensive efforts to sell the property. The property was listed, sales brochures were prepared, potential buyers were contacted, advertisers were employed, and a feasibility study was made to determine the best use of the property. The Tax Court and the Ninth Circuit concluded that while those actions might have been taken by an owner in the real estate business, they were also consistent with the taxpayer's announced purpose of seeking to dispose of a costly capital investment that threatened its regular business (Redwood Empire Savings & Loan Assoc. V. Comr., 68 T.C. 960 (1977), affd. (1980, CA9)).

The Eleventh Circuit affirmed the Tax Court in holding that property held by the taxpayer for various alternative purposes, but separated from the taxpayer's ordinary development activity, was held in the ordinary course of a trade or business at the time of sale (Major Realty Corporation (CA-11) 55 AFTR2d 85-608). Under these facts, the property was listed in the taxpayer's records as property held for development, distinguished from other property being held for sale. Sales of the property had been stagnant for over seven years and the taxpayer was keeping his options open in holding the property thereby him to sell it rather than develop and hold it if circumstances presented themselves such that greater profit could be made from sale. This latter factor appears to be the controlling issue.

(iii) Loss of Regulatory Approval for Development.

In Harry Olstein, TC Memo 1999-290, the taxpayer closed its model homes after the taxpayer's company lost its regulatory approval for further development. Thereafter, it

ceased further development and offered the remaining lots for sale. Subsequently, an unrelated developer-purchaser defaulted on the lots purchased, and a successor entity owned by the taxpayer received settlement proceeds on the sale of the lots as a result. The taxpayer treated the proceeds as capital gain. The Court found for the taxpayer in holding that, the earlier litigation against the taxpayer's development company and the foreclosure against the developer-purchaser constituted a significant economic event, which converted the real property from property held in the ordinary course of business to investment property.

(iv) Protecting/Enhancing the Taxpayer's Investment.

Some activities, which may under certain circumstances be seen as selling activities, are considered activities to protect and enhance the taxpayer's investment. Thus, a partnership was upheld in its position that its original purpose to hold a 319 acre tract of farm land for investment remained unchanged six years later when a 133 acre portion of the tract was sold even though the taxpayer had the land rezoned and made additional

purchases. These activities, said the court, are those of prudent businessmen designed to protect and enhance their investment rather than an indication of an intent to hold property for sale to customers in the ordinary course of business. At no time did the partnership, or any of its partners, solicit or advertise any portion of the property for sale, nor was a "For Sale" sign ever placed on the property. Moreover, since its acquisition, the unsold portion of the property was continuously used for farming operations. William B. Dean, (1974) T.C. Memo 1974-236.

(v) Change in Circumstances.

The original purpose of holding investment property continues where a change in circumstances forces a sale. There was no change from original purpose where a surveyor-engineer who had purchased land to farm later sold it as lots when the land proved too dry to farm and became valuable as residential property. The court held that he didn't lose his investor status merely because he disposed of the land in the most advantageous manner. Barker v. U.S., (1965, DC CA) 16 AFTR 2d. 6035.

Where bankrupt medical specimen company had never been in the business of selling real property, any loss created by the sale of its property by its Chapter 7 trustee resulted in capital loss. The taxpayer argued that the realty was acquired after the bankruptcy petition was filed when the taxpayer had ceased its pre-petition business and was engaged through the trustee only in the business of liquidating assets. But the court said, absent a court order permitting the continuance or expansion of the taxpayer's business, the taxpayer and the trustee couldn't unilaterally change the nature of the business. Working with the trustee to liquidate assets didn't constitute a new business for the taxpayer. Diane Reed v. U.S., (2006, DC TX) 97 AFTR 2d 2006-2348.

The Fifth Circuit held that even if a taxpayer was no longer in the business of selling real property when a particular sale was made, it will realize ordinary income from the sale if it had been in the trade or business of selling real estate, had held the real estate for sale in that business, and the sales contemplated by it were ordinary in the course of that business. Suburban Realty Co. v. U.S., (1980, CA5) 45 AFTR 2d. 80-1263.

In the following case, the original business purpose did not change into an investment purpose. The taxpayer purchased a 140 acre parcel of unimproved land, platted the entire parcel into residential and commercial lots, and gradually but regularly improved the parcel section by section and sold them to builders. The final ten acres were on rough terrain and the taxpayer decided not to improve these lots and sold them unimproved. The decision not to improve the final section did not change its character from property "held for sale" to investment property. In the context of the overall factual situation, the sale took place in the ordinary course of the taxpayer's business. Robert Haynsworth v. U.S., (1981, Ct. Cl.) 229 Ct. Cl. 602.

Similarly, in Tollis, (1993) TC Memo 1993-63, the court held that the original business purpose did not change into an investment purpose where a real estate developer, who acquired land for the purpose of improving it and selling it to customers in the ordinary course of business, sold portions of the land without developing them. He had intended to continue to develop these portions of the land if the sales had not materialized, and he continued to develop other parcels when plans to sell them unimproved fell through.

Caveat. The taxpayer would be well advised to allow the one year holding period to run after the significant economic event in order to establish investor status.

3. The Continuity, Number and Frequency of Sales.

As a general rule, the frequency and continuity of sales efforts generally indicate that the property is held for sale, while the absence of sales efforts ordinarily speaks in favor of investment. Investors are more inclined than dealers to hold property for a substantial period of time in hopes of realizing appreciation in property value and sell the bulk of their property in a single transaction. However, as indicated by some of the cases discussed above, pure sales numbers are not dispositive. For instance, the taxpayer in George J. Wibbelsman , 12 TC 1022, was held to be a real estate dealer with only seven sales, while the taxpayer in J.T.G. Crawford, (CA-5) 161 F.2d 315, sold 95 subdivided lots over two years and was held not to be a dealer.

In determining the frequency and substantiality of sales, the Fifth Circuit said it was necessary to look not only at sales in the tax years in issue from a particular part of a tract but at sales made from the entire tract since its acquisition (Houston Endowment Inc. v.

U.S., (1979, CA-5) 44 AFTR 2d. 79-6074). The Fifth Circuit emphasized that frequent and substantial sales were more important factors than development activities or solicitation and advertising efforts in Suburban Realty Co v. U.S.. Also, one court held that the absence of selling and advertising activity won't support a claim that property is held for investment where the type of property involved doesn't require selling and advertising activity. Klarkowski, (1965) TC Memo 1965-328. In one case, however, even though promotional activity wasn't required, the taxpayer's lack of any marketing activity whatsoever showed that he was holding the real estate involved as an investment. D.J. Williams, (1983, DC TX) 53 AFTR 2d. 84-884.

The intensity of sales activities and promotion through advertisements, "for sale" signs, maintaining a sales office, hiring sales personnel, etc., can be of great importance. Thus, the proceeds from the sales of the unneeded portions of two factory sites were taxed as ordinary income on one sale and as capital gain on the other. The difference in tax treatment resulted from active selling activity in one case and the lack of any promotion or advertising in the other. Hutchinson.

4. <u>The Sales Activity of the Owner</u>.

The more involved the owner becomes in attempting to dispose of the property and the more time and money that is spent in advertising and attempting to dispose of the property, the more likely it is that a taxpayer will be a dealer. Despite the taxpayer having hired a real estate broker to orchestrate the sale, the acts of the broker, **as agent for the owner**, are taken into consideration in determining if the owner is a dealer. In these circumstances, the seller should attempt to establish that he was reluctant to sell the property. In other words, the purchaser bought the property… the taxpayer did not sell it.

(i) <u>Awaiting Appreciation in Value</u>

A sale of property held for appreciation doesn't result in ordinary income since the sale of such property isn't in the ordinary course of business. Property isn't held primarily for sale to customers if the taxpayer's principal purpose is to hold the property until its price goes up and then sell at a profit (<u>Municipal Bond Corp. v. Comr.</u>, 20 AFTR 2d. 5393). Buying non-income producing realty with the expectation of profiting only

from a rise in value may qualify as a form of investment entitling the taxpayer to capital gain treatment on the sale of the realty for profit (Ronhovde, (1967) TC Memo 1967-243).

Finally, a limited liability company was determined to have bought and held land for appreciation in value that showed an investment purpose even though at least some of the appreciation was to be derived from the infrastructure work to be done by entities other than the LLC under agreements already in place when the LLC acquired the land. Phelan, (2004) TC Memo 2004-26.

(ii) Seeking Approval to Subdivide

In Buono (cited above), capital gain treatment on the sale of unimproved land was permitted where most of the land was sold in a single sale, after the taxpayers obtained the municipality's permission to subdivide. The intent was to hold the property for about a year and a half and to apply for permission to subdivide which would

enhance the value of the property. Permission to subdivide was granted four years later as part of a settlement of the taxpayers' suit against the town which had refused permission to subdivide. While the intent was always to sell the property, obtaining permission to subdivide wasn't, by itself, sales activity in the ordinary course of business in the absence of substantial and frequent sales. Subdivision is evidence of dealership but here taxpayers merely enhanced the value of the property by taking a purely legal step to make it more marketable. The taxpayers had intended to sell the property as a single tract, and made no improvements or individual lot sales.

In Newman, (1982) TC Memo 1982-61, the taxpayer, who had never previously sold real estate, purchased three single pieces of land and sold them over a three year period. The IRS asserted that each of these sales were pursuant to an overall scheme whereby the taxpayer would acquire property which was ripe for development, perform the engineering work needed in preparing development plans, obtain the necessary rezoning for such properties, and finally, sell such properties to a waiting developer, all the result of the extension of his occupations as a politician and an engineer. However,

the taxpayer engaged in no sales activity whatsoever either on his own or through brokers. Profits that were the direct result of rezoning, and therefore a direct result of his efforts, weren't enough to put the taxpayer in the trade or business of developing and selling real estate. Also, there was no evidence that his real estate activities were part of his occupation (politician) or business (engineering)

5. Subdivision or Developmental Undertakings.

The presence of substantial subdivision and development activities almost always indicates dealer activities have been initiated. In Aram P. Jarrett, TC Memo 1993-516, the taxpayer bought land with the intention of subdividing and reselling but held the property until he received city approval for subdivision some $11^{1}/2$ years later. The Court nevertheless held that the gain on sale was ordinary income. It is still possible, however, that the weight of other circumstances and factors may mitigate the dealer taint in some situations.

6. Other Sources of Income.

The taxpayer may have an easier time establishing investor status where the

taxpayer has substantial income exclusive of investment activities in real estate. A taxpayer may seek to recognize real estate investment income in years where other non-investment income is higher than anticipated.

7. **<u>The Taxpayer's Status as a Dealer</u>.**

It becomes more difficult for the taxpayer who is a real estate dealer with respect to certain property, to claim investor status for other property that he or she owns, holds and sells. The courts will look at numerous factors in conducting this analysis including the taxpayer's own representations, whether the taxpayer is licensed as a real estate broker/agent, indicated occupation on the tax return, etc. Property owned by a partnership in which one or more partners are real estate dealers is particularly susceptible to the dealer taint. However, the existence of dealer partners is but one factor in the analysis as the dealer status of the property is determined at the partnership level.

It is critical that the dealer segregate investor activities in terms of (i) type of

property and (ii) separate accounting. The most effective method of separating the investor from the dealer property is to transfer investor property into a limited liability company (or similar entity) that is distinct from the entity in which dealer property is held. This segregation has been respected even where the taxpayer is the sole owner of both entities, or if one or both of the entities is a disregarded entity for tax purposes.

8. <u>The Taxpayer's Purchase of Other Property at Time of Sale</u>.

An investor who transfers property and proximately thereafter purchases additional property may resemble a dealer who is essentially restocking inventory for sale in the ordinary course of business. This is particularly true if this occurs frequently in a given time frame. Dealers are more inclined to sell and subsequently purchase new realty inventory, while investors tend to exchange properties and hold them for long periods.

9. <u>Liquidation-of-Investment Theory</u>.

The liquidation of investment theory, i.e., the disposition of property in order to achieve greater economic returns, eliminate the potential for continued economic losses or to mitigate other factors which make the continued investment use of the property

undesirable, has been successfully argued by many taxpayers seeking investors status. Biedenharn Realty Co., (CA-5) 37 AFTR 2d 76-679. The argument is undermined, however, where the investor acquires similar property shortly thereafter, or where the taxpayer fails to liquidate all of his or her investments of that type.

In Charles R. Gangi, TC Memo 1987-561, the Tax Court expanded on the "liquidation of investment" theory espoused in Biedenharn by permitting the use of the liquidation-of-investment theory in a situation where the deadlock of a partnership business relationship among the partners was sufficient to constitute the "significant economic event" needed to sustain continued investor treatment. The partners were not required to demonstrate that a bulk sale of the property (a 36-unit apartment house) was impractical in arguing that disposition by condominiumization was a continuation of their investor intent.

See also Zane R. Tollis, TC Memo 1993-63, where the Court determined that the taxpayer's liquidating sale of his properties following the taxpayer's retirement from the real estate development business did not automatically convert the assets to investment

property.

D. Summary of Factors: The Winthrop Pillars of Capital Gain

The Court in Ada Belle Winthrop, (CA-5) 24 AFTR2d 69-5760, rev'g (DC) 20 AFTR2d 5477, 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.

E. Suburban Realty Co. Criteria

The Fifth Circuit's decision in Suburban Realty Co. has played a significant role in dealer/investor cases. The Fifth Circuit focused on three questions in deciding the case. The court in D.J. Williams posed two additional questions to arrive at what is now referred to as the expanded Suburban criteria:

1. Was taxpayer engaged in a trade or business, and, if so, what business?
2. Was taxpayer holding the property primarily for sale in the business?
3. Were the sales contemplated by taxpayer *ordinary* in the course of that business?
4. Were the contemplated purchasers, *customers* of the taxpayer?
5. Should the business activity of others be imputed to taxpayer so as to be considered the *taxpayer's business?*

The *Suburban* criteria have been addressed and analyzed in other jurisdictions as well. (See

Kenneth R. Dunwoody, TC Memo 1992-721). In Kenneth R. Terry, TC Memo 1984-442, the taxpayer was required by the Tax Court to recognize a capital loss on the foreclosure of unimproved land because the property, while held primarily for sale to customers, was not held within a trade or business. This holding seems to lend credence to the trade or business requirement discussed in Suburban, though other courts have found otherwise.

In Loren F. Paullus, TC Memo 1996-419, the Tax Court performed an extensive analysis of the expanded Suburban criteria in holding that certain properties held by the taxpayer and related corporations were actually investment properties for purposes of qualifying for Section 1031 tax deferred exchange treatment. However, the Court in Neal T. Baker Enterprises, Inc., TC Memo 1998-302, distinguished Paullus based on the taxpayer's segregation of development and investment properties into separate entities, holding that the taxpayer in this case was actually a dealer for 1031 purposes. The facts of both Paullus and Baker are quite similar except that the taxpayer in Baker did not sufficiently separate the dealer and investor properties, and the Tax Court was seemingly not inclined to do so for him.

IV. Subdivision Opportunities Under Section 1237

Section 1237 allows a taxpayer holding unimproved property, **other than through a C corporation**, to maintain some investor status despite subdividing the property and selling off parcels incrementally. Under Section 1237, any lot or parcel which is part of a tract of real property is not deemed to be held primarily for sale to customers in the ordinary course of trade or business at the time of sale solely because the taxpayer subdivided the tract for sale purposes or engaged in any activity incident to the subdivision or sale if that tract is a qualified tract. The Section 1237 safe harbor does not apply to C corporations, nor does it apply to the conversion of apartment units to condominium units.

A. Section 1237 Requirements

To qualify under Section 1237, three conditions must be met:

1. The property must never have been dealer property in the taxpayer's hands

and the taxpayer may **not** own any other dealer property in the same taxable year;

2. The taxpayer must **not** have made any substantial improvements to the property; and

3. As of the sale date, there must be a **five-year holding** period (including tacking) of the property by the taxpayer, although only a holding period in excess of one year is required in the case of property acquired by inheritance or devise.

However, Section 1237 does not apply to property which, under the specific facts and circumstances, is clearly either dealer property or Section 1221 property, Ralph E. Gordy, 36 TC 855, *acq.* Note that the Section 1237 provision is a safe harbor, and does not prevent the taxpayer from demonstrating that the lots are investment property in any event.

B. <u>What Constitutes "Substantial Improvements"?</u>

If the taxpayer makes substantial improvements on the property, the safe harbor under Section 1237 will not preserve capital gain treatment for the taxpayer unless the improvements are *necessary* improvements under the *ten-year rule* discussed below. Improvements made by members of the taxpayer's family will be attributed to the taxpayer under Section 267(c)(4), (including brothers, sisters, spouse, ancestors and lineal descendants); as will improvements made by lessees of the taxpayer, but only to the extent that the improvements are included in the income of the taxpayer; improvements made by governmental agencies, but only to the extent that the property improvements increase the taxpayer's basis in the property; and improvements made by an S corporation or controlled by the taxpayer or a partnership in which the taxpayer is a partner.

Under Reg. 1.1237-1(c)(3), substantial improvements have not occurred unless there is a substantial enhancement in the value of the property. The Regulations provide that a substantial improvement has not been made unless the property value is increased by <u>more than 10%</u> as a

result of the undertakings. However, even then, a facts and circumstances analysis must be made to determine if enhancement in value has occurred.

What constitutes substantial improvements is based totally on facts and circumstances. However, Reg. 1.1237-1(c)(4) specifies, *(A)mong the improvements considered substantial are shopping centers, other commercial or residential buildings, and the installation of hard surface roads or utilities such as sewers, water, gas or electric lines. On the other hand, a temporary structure used as a field office, surveying, filling, draining, leveling and clearing operations and the construction of minimum all-weather access roads, including gravel roads where required by the climate, are not substantial improvements.*

C. <u>The Five Lot Rule</u>

Section 1237 provides the taxpayer a method for achieving capital gains when the taxpayer engages in subdivision of the property. Gains from the sale of the **first five (5) lots** are fully capital gain. However, starting with the taxable year in which the sixth lot is sold, gains from all lots in

that taxable year and each subsequent taxable year will be taxed as ordinary income to the extent of 5% of the sales price. Accordingly, if Lots 1 -5 are sold in Year 1, and Lots 6-10 are sold in Year 2, the gain from Lots 1 - 5 would be entirely capital gain and 5% of the sales price for Lots 6- 10 would be ordinary income. The balance of the gain realized in Year 2 would be capital gain. However, if the sale of Lot 6 also takes place in Year 1, **all** of the lots sold in Year 1 would be subject to the 5% ordinary income treatment. Similarly, if three lots are sold in Year 1 and three in Year 2, the three lots sold during the second year will be subject to the 5% rule.

The Regulations allow the taxpayer to deduct (against the 5% ordinary income to the extent of such income) expenditures incurred in connection with the sale or exchange of any lot or parcel. Any excess expenditure is allowed as a cost of sale for purposes of determining the gain on the capital portion of the sale. Since the traditional sales commission paid to a broker on the sale of unimproved land is generally higher than five percent of the sales price, it is unlikely that any significant ordinary income will actually result under this provision.

Note: Substantial improvements to any one lot or parcel in the tract disqualifies the

tract, and thus precludes the Section 1237 safe harbor from applying to the sales of other lots or parcels from the same tract, even if those lots or parcels are not improved (Finder Est. v. Comr., 37 T.C. 411 (1961)).

D. Necessary Improvements - Ten-Year Rule

A *necessary* improvement is not treated as a substantial improvement if four conditions are satisfied. A necessary improvement is defined in Sec. 1237(b)(3):

- The taxpayer must have held the parcel or lot for at least 10 years, regardless of the method of acquisition.

- The improvement must be the building or installation of water, sewer or drainage facilities or roads, if the improvement would constitute a substantial improvement but for this exception.

- The taxpayer must demonstrate, to the satisfaction of the Commissioner, that the lot or

parcel which is being improved could not have been sold at the prevailing local price for similar building sites had the improvements not been made.

- The taxpayer must elect to make no adjustment to the basis of the lot or parcel sold, or of any other property owned by the taxpayer, for the cost of such improvements.

The taxpayer will have to do a cost-benefit analysis to determine if it is more advantageous to recognize all ordinary income after a deduction for the cost of making necessary improvements, or comply with the Section 1237 safe harbor and recognize the gain as long term capital gain without an increase in basis for the cost of the improvements.

E. Definition of Tract

A tract of real property is a single piece of real property, except that two or more pieces of real property are treated as a tract if at any time they were contiguous in the hands of the taxpayer or if they would be contiguous but for the interposition of a road, street, stream, or similar property

(Section 1237(c)). If after the sale or exchange of a lot or parcel from the tract, no other sales of any other lots or parcels from the remainder of the tract are made for a period of five years, the remaining property, even if no longer contiguous, is treated as a tract (Reg. 1.1237-1(g)(2)).

V. Sale Of Raw Land To A Controlled Corporation Prior To Development

A. In General

Real estate developers often hold their property in some corporate form (either in a corporation or a limited liability company) in order to take advantage of the liability protection afforded to these entities. By transferring development land into a controlled entity, the taxpayer seeks to limit his or her liability to the value of the entity's assets (thereby protecting against personal liability), while also achieving capital gain treatment on the sale of the land to the controlled entity, allowing such entity to undertake the development (i.e., dealer) activities). The taxpayer often seeks to defer tax by selling the property to the controlled entity for installment notes.

If the corporate form is utilized, the purchasing corporation will receive a step-up in basis upon the purchase of the property. Consequently, ordinary income recognition is effectively limited to the appreciation resulting from the development of the land in the hands of the

corporation. Further, the taxpayer can avoid the double tax treatment imposed on C corporations by selling the property to a controlled S corporation (i.e., a corporation that has made the proper S election). **Note: the taxpayer should not attempt to sell the property to a controlled partnership because Section 707 provides that any gain from such sale will be ordinary if the seller owns more than 50% of the partnership, unless the partnership holds the property for at least one year.**

B. Consequences of Section 1239 On Sales of Depreciable Property to a "Controlled Corporation"

In structuring a sale of land to a controlled corporation, the taxpayer must be weary of several other tax traps that may preclude capital gain treatment. For instance, Section 1239 provides that the sale of **depreciable** property by a shareholder to a more than 50% owned corporation will result in ordinary tax on the gain.

Note Section 1239 does not apply to the sale of **raw land**, so the taxpayer can still achieve capital gain treatment if he sells the raw land to the controlled corporation prior to developing depreciable property. Under Section 1239, any gain recognized from the sale or

exchange of property, directly or indirectly, between related persons is treated as ordinary income if in the transferee's hands the property is depreciable or would be depreciable but for the fact that it is amortizable.

Persons are related if they bear any of the following relationships to each other:

- A person and any corporation of which 50% or more of the value of its outstanding stock is owned, directly or indirectly, by or for that person (§1239(c)(1)(A));
- A person and any partnership in which more than 50% of the capital interest or profits interest is owner, directly or indirectly, by that person (§1239(c)(1)(B));
- Two corporations that are members of the same controlled group (§1239(c)(1)(C));
- An S corporation and another S corporation if the same person owns more than 50% in value of the outstanding stock of each corporation;
- An S corporation and a C corporation if the same person owns more than 50% in value of the outstanding stock of each corporation;
- A taxpayer and any trust in which the taxpayer or the taxpayer's spouse is a

beneficiary, unless the beneficiary’s interest in the trust is a remote contingent interest.

C. Example: Real Property Developers, That Held Investment Property in an LLC, Were Eligible for Capital Gain Tax Treatment on the Sale of LLC Property To A Related Corporation.

In Phelan v. Commissioner, TC Memo 2004-206 (September 2004), Mr. Phelan and his brother formed an LLC during 1994 to acquire a 1,050 acre parcel of land for investment purposes (the "Property"). Mr. Phelan owned 40% of the LLC, his brother owned 40% and an unrelated third party owned the remaining 20%. At the time the LLC purchased the Property, a third party was obligated to construct improvements on the Property.

Testimony indicated that the LLC’s purpose of purchasing the Property was for a long term investment. The LLC did not advertise the Property for sale or hire sales agents to market the Property. Mr. Phelan, his brother and the other member did not own real estate licenses.

Two years later, the LLC sold a portion of the Property and Mr. Phelan reported his share of the gain as capital gain on his personal tax return. Under the purchase contract, the LLC was obligated to pay for grading, utility installation or roadway improvements as may be required by the local town in connection with development of the Property.

In 1998, Mr. Phelan, his brother and a third party formed a corporation which purchased the remaining portion of the Property for a large purchase price generating substantial capital gain to the LLC. Once again, Mr. Phelan reported his share of the gain as capital gain on his 1998 tax return.

During the 1998 tax year, Mr. Phelan, his brother and a third party member all were heavily involved in general commercial real estate development. Therefore, the IRS contended that Mr. Phelan's gain from the sale of the property should be ordinary income rather than capital gain.

According to the Tax Court, in determining whether gains realized by the LLC from the

1998 sales of the Property were capital gain or ordinary income derived from the sale of Property in the ordinary course of business, three (3) factual inquiries had to be made:

1. Was the LLC engaged in a trade or business and, if so, what business?

2. Was the LLC holding the Property primarily for sale in that business?

3. Was the sale contemplated by the LLC in the ordinary course of its business?

In determining that the gains for 1998 were capital and not ordinary, the Tax Court addressed the following:

1. **Purpose of Acquisition of the Property:** Testimony indicated that the LLC purchased the Property for long term investment purposes.

2. **Activities of the Taxpayer Such as Improvements or Advertising the Property**

For Sale. With respect to this factor, the sales of the Property were unsolicited. However, Mr. Phelan and his LLC made substantial improvements to the Property to prepare it for sale. Moreover, the related corporation, which purchased the remaining Property from the LLC, also improved the Property. However, the Tax Court found that the development activities performed by the corporation should not be attributed to the LLC, since the LLC was formed for the (sole) business purpose of insulating the property owners from potential tort liabilities associated with the Property. See Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1992).

3. **The Continuity and Frequency of Sales As Distinguished from Isolated Transactions.** Frequent and substantial sales of real property more likely indicate sales in the ordinary course of business, whereas infrequent sales for significant profits are more indicative of real property held as an investment. In determining whether property is held for sale in the ordinary course of business, the frequency and substantiality of sales is the most important factor to be considered. Suburban Realty v. US, 615 F.2d 171 (5th Cir. 1980); Medlin v. Commissioner, TC Memo 2003-224; and

Hancock v. Commissioner, TC Memo 1999-336.

The Tax Court noted that the LLC purchased the Property in 1994 and held it for approximately four years before selling the parcels to the third party and a related corporation in 1998. And, during this period of time, the Property appreciated in value. The Tax Court found that the LLC began selling the Property at a time when it was believed that the LLC's investment and appreciation goals had been achieved.

Therefore, notwithstanding the fact that the LLC made some improvements to the property, the Tax Court held that, in viewing the other factors set forth in 1 and 2 above, the minimal development improvements to the property did not indicate that the property was held as inventory rather than as a capital gain asset.

D. The Section 351 Trap

In addition to the related party transaction traps of which a taxpayer must be cognizant, the

taxpayer should also be aware that the IRS will characterize the sale to an 80% or more controlled corporation as a tax-free contribution to capital under Section 351 in which no capital gain nor basis step-up would result. Section 351 can also defeat the installment sale transaction sought by the taxpayer. When the controlled corporation issues a debt instrument in exchange for the property (in order to achieve installment sale benefits), the taxpayer would be well-advised to ensure that the note is structured in an arms-length manner, with appropriate interest applied, includes a security interest in the transferred property, and that the repayment of the note is not contingent upon the success of the business. Otherwise, he IRS will likely argue that, in substance, the debt instrument is merely a form of equity investment in the corporation.

E. “Substance Over Form” Argument

There is always a risk that any transaction that is undertaken due, in significant part, to tax planning and tax considerations may be attacked under the general principles of the "substance over form" doctrine. The IRS attacked the transaction in Bramblett on these grounds, but the Fifth Circuit Court of Appeals rejected the argument. The Court of Appeals, relying on Frank Lion Co.

vs. United States, 435 U.S. 561 (1978), found that the form of a transaction chosen by a taxpayer will be respected as having genuine economic substance as long as it "is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax avoidance features."

Also, in *Bramblett* the Fifth Circuit found that the sales corporation was not a sham corporation, that the transaction was at arms length, that the business and legal formalities were observed, and that the original partnership had acquired the property with a bona fide intent to hold it for investment.

F. True Debt vs. Disguised Equity

It is recommended that any promissory note between the taxpayer and the controlled corporation require regular monthly payments of principal and interest on commercially reasonable terms, and that the development corporation make sure these payments are actually made. The note should be secured by a deed of trust on the land, although this deed of trust may be

subordinated to the primary construction loan. Payoffs of portions of the note can also be made as each lot is sold to induce the shareholder to release its security interest in the land for each lot. If there are no regular payments of principal and interest, if those payments are not actually made, or if the loan is not secured, it is much more likely that a court will find that the transaction should be disregarded under the substance over form doctrine.

There is a long history of case law involving IRS challenges to promissory notes between related parties on the grounds that they are not bona fide debt, but are in fact merely "disguised equity." There are several factors relevant to this issue, as identified in the case of Warren H. Brown, 27 T.C. 27 (1956). Some of the factors involved are (1) the apparent intentions of the parties, (2) the reservation of title or security interest in the land by the shareholder until full purchase price is paid, (3) business considerations causing the adoption of the form of the transaction, (4) the capitalization of the development corporation by its shareholders, (5) whether the price is at fair market value, (6) whether fixed payments are required under the promissory note without regard to the success or failure of the development corporation, (7) reasonable interest rates, (8) actual payment of installments, and (9) whether there is an agreement not to enforce

collection.

Also, in Jolana S. Bradshaw, et al., 50 AFTR 2d. 82-5238, the Court of Claims determined that undeveloped property transferred to a newly formed, wholly-owned corporation of the taxpayer was a sale and not a Section 351 contribution (despite the fact that the corporation appeared to be under-capitalized). The corporation issued the taxpayer five $50,000 promissory notes that matured over 2.5 to 6.5 years in exchange for the raw land. The court held that the transaction constituted a sale because: (1) the price paid was fair market value, (2) formalities evidencing the sale were observed, (3) the notes contained an unqualified obligation to pay a principal amount at fixed maturity dates, (4) the notes were not subordinated to general creditors, and (5) the principal and interest was always paid when due.

Failure to adhere to these formalities may result in the obligation being characterized as a form of equity in which Section 351 may apply. In addition, the IRS may argue that the corporation is acting as a mere agent of the taxpayer. See Royce W. Brown, (CA-10) 28 AFTR

71-5611.

VI. Sale to an Independent Developer

Obviously, the safest method for achieving capital gains would involved the real estate owner selling the real property to an independent party who would then assume all development activities. The taxpayer must be prepared to establish the actual independence of the developer (in rebuke to an IRS agency argument) and that the taxpayer and the developer have not joined together in a joint venture profit seeking enterprise.

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