THOMSON REUTERS
CHECKPOINT™

Real Estate Taxation

4th Quarter 2014
Volume 42, Number 1

HOW TO PRESERVE PREDEVELOPMENT APPRECIATION OF REAL ESTATE

BLAISE M. SONNIER, J.D., DBA, CPA

The U.S. real estate market continues to struggle toward a recovery from the Great Recession of 2007-2009, with the number of new home starts showing a gradual increase since it hit bottom in 2009. Since the onset of the Great Recession, builders have focused primarily on building homes that cater to higher-income buyers. A recent *Wall Street Journal* article reported that home-building experts are predicting a shift in new construction in the next 12 to 18 months to homes at lower prices for low- and moderate-income buyers.[1] One challenge that builders seeking to fill the demand for moderately priced housing will encounter is a shortage of residential lots that can be priced for this market.[2] The lack of supply of such lots will provide an opportunity for individuals who have been holding property waiting for a recovery in the real estate market to develop that property for sale as residential lots. Individuals who purchased property at the right price prior to 2000, or during the downturn of the Great Recession, and choose to develop and sell that property may soon face what comes with large profits absent proper planning—unnecessarily large tax bills.

BLAISE M. SONNIER is the Wilcox Endowed Professor of Accounting and an associate professor of tax accounting at the University of Colorado Colorado Springs College of Business Administration.

The recovery of the residential housing market coincides with the increase in the highest marginal tax rate on individuals' ordinary income from 35% to 39.6% in 2013. For high-income individuals who itemize their deductions, the highest marginal tax rate on ordinary income is even greater when the phase-out of itemized deductions and personal and dependency exemptions is taken into consideration. In comparison, gain on the sale of a capital asset held for more than 12 months by an individual, partnership, or S corporation is generally subject to either the 15% or 20% federal long-term capital gains rate, depending on the individual's taxable income.[3] Therefore, taxpayers subject to the highest marginal tax rate on ordinary income who are able to obtain long-term capital treatment on the sale of real estate can reduce their marginal tax rate on the gain by up to 49%.

In a time of increasing real estate prices, a property owner may undertake the development and division of its property into lots to maximize its profits. On the other hand, a risk-averse property owner may sell the property in its entirety to a real estate investor or developer. In turn, the real estate investor or developer may hold the property for some time prior to its development, division, and resale to maximize

As confusing as the tax law may be in this area, the difference between an asset being classified as a 'capital asset' or 'held primarily for sale to customers' can have a substantial impact on the amount of tax due.

its profit on the venture. In both situations, the taxpayer seeking to develop and subdivide the property will benefit substantially if all or part of its gain on the appreciation of the value of the real estate can be classified as a long-term capital gain instead of ordinary income.

Taxation of property transactions

To qualify for favorable long-term capital gain treatment under the Code, a gain must arise from the sale or exchange of a "capital asset" that the taxpayer has held for more than one year.[4] A gain on "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" is not entitled to favorable capital gain treatment because, by definition, such an asset is not a capital asset.[5] One federal judge described determining whether an asset held by a taxpayer was a "capital asset" or "held primarily for sale to customers in the ordinary course of business" as an "old, familiar, recurring, vexing, and ofttimes elusive problem."[6] In describing the jurisprudence in this area, another judge observed being "engulfed in a fog of decisions with gossamer-like distinctions, and a quagmire of unworkable, unreliable, and often irrelevant tests."[7] As confusing as the tax law may be in this area, the difference between an asset being classified as a "capital asset" or one "held primarily for sale to customers" can have a substantial impact on the amount of tax due by a taxpayer.

One judge observed being 'engulfed in a fog of decisions with gossamer like distinctions, and a quagmire of unworkable, unreliable, and often irrelevant tests.'

Whether real estate held by a taxpayer is a capital asset turns on whether it is held *primarily* for sale to customers. In *Malat v. Ridell*,[8] the U.S. Supreme Court construed *primarily* to mean "of first importance" or "principally." When there is both a business and investment motive for holding a particular parcel of real estate, *Malat* says that the taxpayer's principal motivation for holding the property will determine whether it is a "capital asset" or held "primarily for sale to customers." In *Winthrop*, the Fifth Circuit listed seven factors that should be considered in making the determination:

1. Nature and purpose of the acquisition of the property and duration of the ownership.
2. Extent and nature of taxpayer's efforts to sell the property.
3. Number, extent, continuity, and substantiality of the sales.
4. Extent of subdividing, developing, and improving the property that was done to increase sales.
5. Use of a business office and advertising for sale of the property.
6. Character and degree of supervision and control that taxpayer exercised over any representative selling the property.
7. Time and effort that taxpayer actually devotes to the sale of the property.[9]

Whether a taxpayer held property primarily for sale to customers in the ordinary course of business is a question of fact.[10] In discussing its seven-factor test, the court in *Winthrop* said that the "seven pillars of capital gain treatment in and of themselves ... have no independent significance, but only form part of a situation which in the individual case must be considered in its entirety to determine whether or not the property involved was held primarily for sale in the ordinary course of business."[11] In *Biedenharn Realty Co.*,[12] the Fifth Circuit said that each case must be decided based on its particular facts, with the "individual factors having varying weights and magnitudes, depending on the facts of the case." However, the court then said that the frequency and substantiality of

1 "Experts: Builders' Shift to More Construction Might Take 1-2 Years," Wall St. J., 6/12/14.

2 *Id*.

3 Long-term capital gains will generally be taxed at 15% until a taxpayer's marginal tax rate reaches 39.6%. At that point, long-term capital gains are taxed at 20%. In 2014, the marginal tax rate of taxpayers becomes 39.6% for taxable income beginning at $406,750 for single taxpayers and $457,600 for married taxpayers filing jointly.

4 Section 1222.

5 Section 1221(a)(1).

6 *Thompson,* 322 F.2d 122, 12 AFTR2d 5451 (CA-5, 1963).

7 *Winthrop*, 417 F.2d 905, 24 AFTR2d 69-5760 (CA-5, 1969).

8 383 U.S. 569, 17 AFTR2d 604 (1966).

9 *Winthrop, supra* note 7 at 417 F.2d 909.

10 *Friend,* 198 F.2d 285, 42 AFTR 489 (CA-10, 1952); *Austin,* 263 F.2d 460, 3 AFTR2d 647 (CA-9, 1959); *Byram,* 705 F.2d 1418, 52 AFTR2d 83-5142 (CA-5, 1983); *Pool,* TCM 2014-3; *Allen,* 2014 U.S. Dist. LEXIS 73367 (N.D. Cal., 2014)

11 *Winthrop, supra* note 7, at 417 F.2d 910, citing *Cole v. Usry*, 294 F.2d 426, 427, 8 AFTR2d 5411 (CA-5, 1961).

12 526 F.2d 409, 415, 37 AFTR2d 76-679 (CA-5, 1976).

13 615 F.2d 171, 177 45 AFTR2d 80-1263 (CA-5, 1980).

14 *Rollingwood Corp.,* 190 F.2d 263, 40 AFTR 1006 (CA-9, 1951); *Pool,* 251 F.2d 233, 1 AFTR 428 (CA-9, 1957), *cert. den.*

15 Reg. 1.1402(a)-4(a); *Austin, supra* note 10.

16 350 U.S. 46, 47 AFTR 1789 (1955).

17 *Gillette Motor Transport, Inc.,* 364 U.S. 130, 134, 5 AFTR2d 1770 (1960).

18 The term "capital gains bailout" was first used in Wells and Caplan, "Tax Law: Achieving Capital Gains Treatment on Redevelopment Real Property Appreciation," 80 Fla. Bar J. 36 (April 2006).

19 960 F.2d 526, 69 AFTR2d 92-1344 (CA-5, 1992).

20 TCM 2004-206.

sales is the most significant or preeminent factor in the analysis.

The Fifth Circuit's opinion in *Suburban Realty Co.* served as a reminder that the ultimate question to be decided in determining whether one is entitled to favorable capital gain treatment is whether the property was "held by the taxpayer primarily for sale to customers in the ordinary course of business."[13] The seven-factor test in *Winthrop* provides guidance in answering that question. To bring into focus the purpose of *Winthrop's* seven-factor test, the Fifth Circuit in *Suburban Realty Co.* said that the principal inquiries that the Code demands are:

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 that the taxpayer contemplated "ordinary" in the course of that business?

In theory, the distinguishing factor between capital gain treatment and ordinary income treatment is the purpose for which the taxpayer is holding the property.[14] An individual who holds a parcel of real estate primarily for sale to customers in the course of his or her trade or business is taxed on any gains at ordinary income tax rates.[15] An individual who holds a parcel of real estate for speculation or investment does not hold the property "primarily for sale to customers" and so is entitled to capital gain treatment on the sale of the property. The U.S. Supreme Court in *Corn Products Refining Co.* said that it had always construed the definition of a capital assets narrowly.[16] In a later decision, the Court said that courts should construe capital assets narrowly, "to afford capital gain treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time."[17]

Taxpayers with a large gain on the sale of real estate often find themselves trying to piece together a case after the fact to establish that the property sold was held for investment rather than "primarily for sale to customers." Instead of being in that position, a taxpayer who expects to seek favorable capital gain treatment on the sale of a property should approach the real estate investment with the assumption that he or she will have the burden of establishing that the property was held for investment or speculation. This is particularly important for taxpayers who own multiple properties because the IRS may argue that one or more are held primarily for sale to customers. A review of the cases establishes that the earlier that a taxpayer documents that a parcel of property is being held for investment, and the more consistent the treatment of the property as investment property over a long period, the greater the likelihood that the taxpayer will prevail in obtaining capital gain treatment. Taxpayers who engage in deliberate planning (beginning with acquisition of the property) to structure their affairs to obtain capital gain treatment are much more likely to succeed.

The longer the time between acquisition and transfer to the development company, the greater the likelihood of capital gain treatment

Capital gain bailout strategy

The determination of whether property is held as a capital asset or "primarily for sale to customers" is made property by property even if the taxpayer is engaged full-time as a real estate dealer. In other words, a real estate professional can acquire one or more properties and hold them for long-term appreciation or speculation as an investor. A real estate professional who is uncertain regarding the future development of one or more of his or her real estate holdings may use a capital gain bailout strategy to allow any appreciation that has accrued prior to the property becoming held "primarily for sale to customers" to be taxed at favorable capital gains rates.[18] This technique provides for separate ownership of property being held for investment ("investment company") and property being held "primarily for sale to customers" ("development company"). Prior to the commencement of development activities that would result in the investment property being converted into property held "primarily for sale to customers," the investment company sells the property to the development company at fair market value. Since the sale occurs prior to the commencement of significant development activities, any gain on the sale reflects the appreciation in value over the period that the investment company held the asset—the type of appreciation meant to be taxed at capital gains rates. Taxpayers used this technique successfully in *Bramblett*[19] and *Phelan.*[20]

Bramblett. The taxpayer in *Bramblett* was a partner in Mesquite East, a joint venture taxed as a partnership for federal income tax purposes. Mesquite East was formed in May 1979 and had four partners. Shortly after forming Mesquite East, the four partners formed Town East Development Company to develop and sell real estate. The shareholders' percentage interest in Town East mirrored their percentage interest in Mesquite East. In late 1979 and early 1980, Mesquite purchased 265 acres of property in

Texas. In December 1982, Mesquite East sold a portion of the property to Town East for $9,830,000, which an appraiser determined to be the fair market value of the property, in exchange for two promissory notes that bore interest at 12% per year and required annual principal payments of $1.5 million. Town East proceeded to develop the property and sold most of it to unrelated third parties in eight different transactions. Town East made no payments on the notes until after the property had been sold to third parties. While it paid the entire principal amount due on the notes, it did not make any interest payments.The partners reported their respective portion of the gain on the sale of the property by Mesquite, the investment company, to Town East, the development company, as capital gain.

The investment company should avoid all references to holding the property for development, subdivision, or sale or marketing to third parties.

IRS argument. The IRS sought to tax the gain as ordinary income on the ground that the development activities of Town East should be attributed to Mesquite East under the substance-over-form doctrine. Because the same individuals owned Town East and Mesquite East, the IRS was attempting to attribute Mesquite East's business activities as a real estate professional or dealer to Town East. It also argued that Town East was simply acting as Mesquite East's agent in developing and selling the real estate to third parties.

The decision. The Fifth Circuit held that the gain on the sale between Mesquite East (the investment company) and Town East (the development company) was a capital gain. First and foremost, the court rejected any attempt to attribute the development, marketing, and sales activities of Town East to Mesquite East. The court said that mere common ownership was not sufficient to prove an agency relationship between the development company and the investment company. Town East never acted in the name of or for the account of Mesquite East, was not selling or developing property on behalf of Mesquite East, and retained all of the profit from the development activities. Further, Mesquite East sold the property to Town East for fair market value at the time of the sale based on a third-party appraisal.

The court also rejected the Service's argument that the separate existence of the investment and development companies should be disregarded for lacking a business purpose. The court concluded that there was a legitimate business reason to form the development corporation—to insulate the partnership and the partners from unlimited liability from a multitude of sources related to the development activity. Therefore, the court said that the only issue was whether Mesquite East held the property sold to Town East as investment property or as an asset held "primarily for sale to customers."

In evaluating the activities of Mesquite East, the court concluded that it was proper to accord favorable capital gain treatment to the gain on its sale of real estate to Town East. The court made the following observations in reaching this conclusion:

- Mesquite's stated purpose was to acquire the property for investment purposes.
- Mesquite sought advice as to how to structure the transaction to preserve its investment purpose.
- Mesquite held the property for over three years prior to the sale to Town East.
- Mesquite did not advertise the property for sale, hire brokers, develop the property, or maintain a sales office.
- The partners did not spend more than a minimal amount of time on activities of Mesquite East.
- Mesquite made only one substantial sale (the one at issue in *Bramblett)* and four insubstantial sales over a three-year period.

Based on this record, the Fifth Circuit held that the gain on the sale of the land by the investment company to the development company was entitled to capital gain treatment.

Phelan. The capital gain bailout strategy using separate investment and development companies with the same equity owners to achieve favorable capital gain treatment was affirmed in *Phelan.* There, the members of Jackson Creek Land Co. (JCLC), a limited liability company (LLC) taxed as a partnership, and the shareholders of Vision Development Corporation, held identical percentage interests in the two entities. JCLC (the investment company) was formed in 1994 and Vision (the development company) was formed in 1996. In 1994, JCLC purchased a 1,050-acre tract in Colorado intending to hold it as a long-term investment. JCLC purchased the property knowing that the land would eventually be developed into residential housing. Prior to JCLC's acquisition of the parcel, the master plan to develop the property had been approved by the appropriate governmental authorities, and local governmental entities had entered into agreements with the landowner to improve the land and prepare it for further development by constructing infrastructure. In its acquisition of the property in 1994, JCLC was conveyed all rights of the prior owner of the parcel to enforce the obligations of the governmental entities to install the infrastructure. In 1996, Jackson conducted a preliminary geological investigation to evaluate subsurface conditions for the development of the property as residential lots. Shortly thereafter, it obtained an amended and final development plan for the property, which enabled the commencement of construction.

In 1997, JCLC was approached by Elite Properties of America Corporation ("Elite"), a residential property developer and builder, about purchasing a portion of the property. The parties entered into a purchase agreement that included a provision requiring JCLC to cause the relevant governmental entities to install and maintain infrastructure improvements pursuant to governmental agreements. The sale to Elite closed in 1998 and JCLC reported a $607,344 long-term capital gain on the sale.

In 1998, JCLC also sold a 47-acre parcel of land to Vision Development. Keller Homes had approached JCLC about purchasing the tract provided that JCLC developed the property for residential home building. Because JCLC was not interested in developing the property, its owners formed Vision Development Company. Vision purchased the property from JCLC and made the improvements. JCLC reported a $47,319 long-term capital gain on the sale to Vision. Vision sold the property to Keller Homes after the improvements were completed.

The decision. The Tax Court began its analysis by observing that the character of the gain must be determined at the partnership (entity) level rather than at the partner level.[21] As in *Bramblett,* the IRS argued that the sale by the investment company (JCLC) to the development company (Vision) was done solely for tax avoidance and had no independent business purpose, and so should be disregarded. As a result, the IRS asserted that the development activities performed by Vision should be attributed to JCLC, resulting in JCLC holding the property for sale in the ordinary course of business. Citing *Bramblett*, the court dismissed the Service's argument. The Tax Court recognized that Vision was incorporated to perform development work on a relatively small parcel of land to protect JCLC's sole asset, the remaining land, from obligations arising from development activities. Having concluded that Vision was organized for a legitimate business purpose and all corporate formalities were followed, the court held that Vision's development activities would not be attributed to JCLC.

Next, the court evaluated the activities of JCLC to determine whether it held the property at issue "primarily for sale to customers." In finding that JCLC held the property as a capital asset, the court cited the following factors:

- The sales of JCLC's unimproved realty were unsolicited.
- JCLC did not advertise the property for sale or hire representatives to assist it in selling the property.
- JCLC did not have employees or engage in any business activities outside of holding and selling a limited number of parcels of property.
- Improvements to the property sold to Elite were made pursuant to the preexisting contractual obligations of governmental entities rather than by JCLC.
- JCLC held the property for approximately four years before selling it to Elite and Vision.
- Two sales of property in four years was insufficient in frequency to support a finding that the sales were in the ordinary course of JCLC's business.
- The preliminary geotechnical investigation and modifications of the development plan by JCLC were not substantial in relation to other costs to complete development of the property.

Pool. The Tax court's decision in *Pool*[22] contributes to the discussion regarding the capital gain bailout strategy by providing an example of poor planning and execution that resulted in a bad tax outcome for the taxpayer. In June 2000, Concinnity, an LLC taxed as a partnership, purchased a 300-acre tract of undeveloped property ("Elk Grove PUD") outside Bozeman, Montana, for $1.4 million. Prior to the acquisition, it had been divided into four phases for development. On the purchase date, Concinnity obtained three mortgage loans for nearly $3.5 million secured by the property.

In August 2000, the members of Concinnity incorporated Elk Grove Development Company in Montana. Concinnity then entered into an agreement giving Elk Grove the exclusive right to purchase Phases 1-3 (300 lots) of the Elk Grove PUD. Under the agreement, Elk Grove was required to complete all infrastructure improvements necessary to obtain the final plat of each phase of the Elk Grove PUD. At about the same time, Concinnity entered into an agreement with the county government agreeing that "it, as subdivider, shall, at its own

Some variation in ownership structure of development and investment companies would strengthen the taxpayer's position that they are stand-alone entities.

[21] See *Cannon,* 949 F.2d 345, 68 AFTR2d 91-5845 (CA-10, 1991); *Brannen,* 78 TC 471 (1982); *Podell,* 55 TC 429 (1970).

[22] Note 10, *supra.*

cost and expense, pay for the improvements" to the land in Phase 1 of the Elk Grove PUD. Then in June 2011, Concinnity filed an affidavit pursuant to a county subdivision regulation wherein Concinnity bonded 150% of the total improvement costs of the Elk Grove PUD. In the affidavit, Concinnity stated that (1) it was the developer of the proposed subdivision, and (2) it had entered into buy-sell agreements for 81 lots within Phase 1. At issue in *Pool* was whether gains reported from sales of property by Concinnity from 2003 to 2005 were properly reported as capital gains.

Pool provides an example of how important it is for a taxpayer's records to be consistent with the position taken on its return. Executing documents contemporaneously with a transaction that conflict with its tax return position is obviously not good for the taxpayer and can be the perfect "smoking gun" for the IRS. Although Concinnity argued in *Pool* that it acquired the Elk Grove property solely for investment, its position was doomed by the documents that it executed. Strike 1: On its tax return for 2000, the year that Concinnity acquired Elk Grove PUD, Concinnity described its principal business activity as "development" and its principal product as "real estate." Strike 2: Concinnity filed an affidavit with the county government stating that it was the developer of the proposed subdivision of the Elk Grove PUD. Strike 3: The affidavit filed with the county government said that Concinnity had entered into buy-sell agreements for the sale of 81 lots within Phase 1.

If the development company is interested in developing a large parcel of real estate owned by the investment company, it should purchase the entire property in one transaction.

Concinnity admitted in an affidavit that it is a real estate developer and that it directly entered into buy-sell agreements for 81 individual lots with purchasers. Despite Concinnity's argument that it was a mere investment company, and that Elk Grove purchased the entirety of Phase 1 and developed the property for ultimate sale to customers, it failed to produce evidence that contradicted the June 2001 affidavit filed with the county government. The record was unclear as to whether Concinnity sought out 81 individual purchasers, purchasers sought out Concinnity, or Concinnity sold only to Elk Grove Development Company. Based on the record before it, the court was compelled to rule in favor of the IRS that Concinnity's gain was ordinary income.

The lessons are clear. The taxpayer has the burden of establishing its entitlement to favorable capital gain treatment, which burden should not be taken lightly. Also, documents created in the ordinary course of business (e.g., to obtain approval of a development plan) can and will be used by the IRS to the detriment of the taxpayer when possible. This case highlights that the IRS can use even what appear to be innocuous, run-of-the mill documents or statements against the taxpayer.

Planning tips for a successful capital gain bailout

Bramblett, Phelan, and *Pool* provide guidance on achieving capital gain treatment on appreciation that occurs prior to the commencement of development activities using a capital gain bailout strategy. There is usually a lapse of time between acquiring a parcel of property and commencing development activities, either because of preliminary matters that need to be resolved prior to breaking ground or because the potential developer simply is tied up on other projects. Alternatively, one may acquire a parcel of real estate with a long-term prospect for development based on the growth of a region or area. Situations where there will be a significant lapse of time between acquisition of the property and its development are especially suitable for the capital gain bailout strategy.[23] In *Bramblett* and *Phelan,* there was a lapse of three and four years, respectively, between acquisition of the property and transfer to the development company. The longer the time between acquisition and transfer to the development company, the greater the likelihood of capital gain treatment.[24]

Successful use of the capital gain bailout strategy is based on the premise that the investment company is acquiring the property primarily as an investment for future appreciation in value. A taxpayer seeking favorable capital gain treatment has the burden of establishing that it held the property for investment or speculation and not "primarily for sale to customers in the ordinary course of its trade or business."[25] A good starting point in meeting this burden is for the organizational documents of the investment company to indicate that it was organized for this purpose.[26] The taxpayer should be consistent in referring to itself as an investment company in all tax filings, agreements, contracts, statements, or other documents. The IRS will use references to the company as a real estate developer, real estate dealer, real estate professional, or similar language to argue that the taxpayer held the property "primarily for sale to customers." *Pool* is a prime example of a taxpayer denied capital gain treatment after referring to itself as engaged in the business of "real estate development" on its federal tax return and as the "developer of the proposed subdivision" in documents filed with the county government. The investment company should avoid all references (even in documents for internal use only) to the company holding the property for development, subdivision, or sale or marketing to third parties. Any such statements will jeopardize the position that the property is being held for investment.

During the period that the investment company owns the property, it must refrain from engaging in any activity that is an indication of its intention to develop the property. This can be an extremely gray area. In *Phelan*, the court held that conducting a preliminary geotechnical investigation at a cost of $2,200 to evaluate soil conditions for development and obtaining approval by the local government of final development plans prior to the sale at issue did not establish that the taxpayer held the property primarily for sale to customers in the ordinary course of business. Likewise, in *Buono*,[27] merely obtaining approval of the subdivision plat by the local planning board did not result in ordinary income treatment. Improvements to the property itself, however, increase the risk that a court may find that the investment company held the property "primarily for sale to customers" or changed the purpose for holding the property from investment to "primarily for sale to customers." Any indicia that the taxpayer's intention was to engage in development activities may jeopardize favorable capital gain treatment. For example, the taxpayer in *Pool* purchased the property for $1.4 million but, on the sale date, took out mortgages on the property totaling $3,475,000. Although the court never raised the issue, one must question why the taxpayer borrowed $2 million above the purchase price on the purchase date if, at the time of the acquisition, it did not intend to develop the property.

Business purpose. The IRS attacked the capital gain bailout transactions in *Bramblett, Phelan*, and *Pool* on the ground that there was no independent business purpose (other than tax avoidance) for separate investment and development companies and that the sale between the related parties in each case was solely for tax-avoidance purposes. The IRS argued that, absent a legitimate business purpose for the separate entities, the activities of the development company should be attributed to the investment company resulting in the latter holding the property for sale in the ordinary course of business. The court in each case rejected outright the argument that identical ownership of the investment and development companies doomed capital gain treatment. Each court recognized that protecting the assets of the investment company from the risks and liabilities associated with developing the property for sale to customers was a legitimate business purpose.

Arm's-length terms. For the capital gain bailout transaction to be respected for tax purposes, it must be on an arm's-length basis.[28] This begins with a purchase price at fair market value supported by an appraisal.[29] Taxpayers may be tempted to inflate the price at which the investment company sells the property to the development company to convert all or part of the post-development ordinary income (of the development company) into income taxed as a capital gain (to the investment company).[30] The court in *Pool* explicitly cited the lack of evidence in the record indicating that the sale of the property to the development company was at fair market value. This was of great concern to the court given that two days after purchasing the entire property for $1.4 million, the investment company granted an option to the development company to purchase a portion (three of four phases) of the property for $7.6 million. The court said that "these circumstances strongly suggest that petitioners chose the price to convert a large portion of the project's final profits to capital gain."[31] The court concluded that the sale at an inflated price indicated the investment company's involvement in the development activities, resulting in the entire gain being taxed as ordinary income.[32]

In addition to a price being at fair market value (with an appraisal to support that fact), the other terms of the sale must also be at arm's length. This would include proration of prop-

If the taxpayer limits its business activities to real estate investments held for long-term appreciation or rental, the likelihood of capital gain treatment is much increased.

[23] *Gillette Motor Transport, Inc., supra* note 17; *Winthrop, supra* note 7.
[24] *Winthrop, supra* note 7.
[25] Section 122(1).
[26] *Bramblett, supra* note 19.
[27] *Buono,* 74 TC 187 (1980).
[28] *Bramblett, supra* note 19; *Pool, supra* note 14; *Bradshaw,* 683 F.2d 365, 50 AFTR2d 82-5238 (Cls. Ct., 1982).
[29] *Bramblett, supra* note 19.
[30] *Bradshaw, supra* note 28.
[31] *Pool, supra* note 10 at 22.
[32] *Pool, supra* note 10. The taxpayer's effort to set the purchase price exorbitantly high further supports the axiom that "pigs get fat, hogs get slaughtered."

erty taxes, allocation of the cost of closing between the buyer and seller in accordance with the custom and practice where the property is located, and payment of costs for recording the deed and mortgage in accordance with local practice. If the investment company provides owner financing to the development company, the terms of the loan should be the same that would be extended to the development company by a third-party lender. This would include a reasonable down payment at closing, interest at the going rate for a similar type of property, periodic payments of interest and principal by the borrower, and a first mortgage to secure the loan in favor of the investment company.[33]

The taxpayer should document in board minutes, documents with its banker, and any other appropriate documents that property is being acquired for investment.

Agency. In challenging the capital gain bailout transaction in *Bramblett*, the IRS argued that the development company was merely acting as an agent of the investment company. Accordingly, the Service's position was that the investment company was simply selling land through its related brother-sister development company, so the entire gain should be taxed as ordinary income.[34] While the taxpayer in *Bramblett* prevailed, parties using a capital gain bailout strategy must proceed with caution to avoid the creation of an agency relationship between the investment and development companies. First, the entities should adhere strictly to formalities establishing their separate existence by maintaining separate books and records, separate bank accounts, and minutes of management meetings (whether of a board of directors, members, or partners). Each entity also should act and enter into agreements solely on its own behalf, separately and independently of the other, showing complete respect for their separate existence.

Second, transactions between the investment and management companies should be kept to a minimum to strengthen the position that they are separate, independent entities. If there are any transactions between the companies, such as cost-sharing of office space and employees or intercompany loans, they must be on an arm's-length basis with the taxpayer able to establish that with admissible evidence. Third, while the courts have upheld capital gain bailout transactions when the development and investment companies' ownership structures were identical, some variation in their ownership structure would strengthen the taxpayer's position that they are separate, standalone entities.[35]

Avoiding Section 707(b)(2). In structuring the capital gain bailout transaction, consideration must be given to Section 707(b)(2), which requires that any gain on a sale or exchange between a partnership and a related party be treated as ordinary income if the property in the hands of the purchaser or transferee is not a capital asset. In a capital gain bailout transaction, the property will be held by the purchaser primarily for sale to customers. For purposes of Section707(b)(2), a related party of a partnership includes:

- A person owning, directly or indirectly, more than 50% of the capital interests or profits interests in the partnership.
- Another partnership in which the same persons own, directly or indirectly, more than 50% of the capital interests or profits interests of the partnership.

Avoidance of Section 707(b)(2) is critical to achieving the desired outcome of the capital gain bailout transaction. Therefore, taxpayers and their advisors must proceed with caution if a partnership is involved in a capital gain bailout transaction and more than 50% of the capital or profits interests of the partnership (applying the attribution rules of Section 267(c)) is owned by one partner. In *Bramblett, Phelan*, and *Pool,* the development company was a corporation. Section 707(b)(2) does not apply to corporations, and flow-through taxation can be achieved simply by making an S election.

No appearance of sale to customers. For the investment company to receive the benefit of the favorable capital gains rates, the property being sold obviously must be a capital asset in its hands. Therefore, the investment company must avoid

33 *Bradshaw, supra* note 28 at 683 F.2d 373. Although capital gains treatment was extended in *Bramblett* with the investment company providing an unsecured loan for the entire purchase price to the development company, a loan at arm's length will provide stronger support for the capital gain bailout strategy.

34 *Bramblett, supra* note 19.

35 See Wells and Caplan, *supra* note 18.

36 For a comprehensive discussion of factors taken into consideration in determining whether a promissory note is debt or equity, see Bittker & Eustice, *Federal Income Taxation of Corporations & Shareholders* (Thomson Reuters/WG&L, 2006), ch. 4; Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 Tax L. Rev. 369 (1971). Many cases discuss the issue, including *Slappey Drive Industrial Park,* 561 F.2d 572, 40 AFTR2d 77-5940 (CA-5, 1977) and *Litton Bus. Systems, Inc.,* 61 TC 367 (1973).

any activities that may give the appearance that it acquired and is holding the property primarily for sale to customers. The seven factors in *Winthrop,* discussed above, provide guidance on the type of activities that the investment company should avoid. A good starting point is for the investment company to minimize the number of transactions in which it sells real estate. If the development company is interested in developing a large parcel of real estate owned by the investment company, it should purchase the entire property, in one transaction if possible. The investment company should also avoid any development or marketing activities relating to the real estate. All such activities should be undertaken by the development company.

Debt vs. equity. If the development company is a corporation and promissory notes were used to pay the purchase price, the IRS may argue that the notes are equity instead of debt. The result would be that the transaction would be cast as a capital contribution to the development company (corporation) and as additional stock being received by the investment company. As a result, the basis of the property in the hands of the development company would be equal to its basis in the hands of the investment company, with all gains on an ultimate sale being taxed as ordinary income to the development company. While a detailed discussion of the "debt vs. equity" issue is beyond the scope of this article, it is certainly an important issue that should not be overlooked.[36]

Long-term strategy. The investment company should evaluate whether capital gain treatment is in fact in its long-term interest. If projections indicate that losses are possible in the long term, consideration should be given to the limitation on the deductibility of capital losses and whether

The taxpayer's original purpose for acquiring property generally will be deemed to have continued unless the taxpayer can provide evidence of a subsequent change in purpose.

Services and Information
REAL ESTATE TAXATION

TO ORDER

Subscription Department....1-800-431-9025
FAX....1-800-782-8242
E-mail....rg.customerservice@thomsonreuters.com
Internet....http://ria.thomsonreuters.com/journals
Or mail to:
Thomson Reuters
117 East Stevens Avenue
Valhalla, NY 10595

CUSTOMER SERVICE

Billing Inquiries, Back Issues,
and Change of Address....1-800-431-9025
Internet....http://support.rg.thomsonreuters.com

Or send correspondence to the above address.

TO PLACE AN AD

Display or
Classified Advertising....800-322-3192
FAX....651-687-7374

EDITORIAL INQUIRIES

Address to: Real Estate Taxation
Thomson Reuters
195 Broadway, 8th Floor
New York, NY 10007
Phone....212-807-2826
E-mail....robert.murdich@thomsonreuters.com

PERMISSION TO PHOTOCOPY

Contact: Copyright Clearance Center....978-750-8400
FAX....978-646-8700
Or mail to:
222 Rosewood Drive
Danvers, MA 01923

REAL ESTATE TAXATION is now available on CHECKPOINT from RIA and on WESTLAW (WGL-TXACCT).

current favorable treatment of capital gains may be detrimental to being able to deduct losses in the future against ordinary income. An individual taxpayer may deduct only up to $3,000 of net capital losses per year and is permitted to carry over any excess capital losses to future years.[37] If future capital losses are possible, that possibility needs to be factored into the cash-flow projections for the project.

Achieving capital gain treatment on holdback property

It is not unusual for a landowner to sell only a portion of an undeveloped tract of land to a development company while retaining the balance. The landowner might decide to develop a portion itself while retaining the remainder as an investment in raw land, or it might hold the entire parcel as raw land.

Sales that 'empty the shelves' are no less a sale in the ordinary course of business than the sale of the first lots of developed property.

Also, a developer may decide to hold selected lots in its development as rental property or for long-term appreciation in value as the area becomes established. In each of these situations, it is incumbent on the property owner to engage in proper planning if it wants capital gain treatment should the retained property be sold in the future. Of course, the tax treatment at the time of sale will depend on whether the taxpayer held the property prior to sale as a capital asset or "primarily for sale to customers."

In a situation involving undeveloped land, if the taxpayer has always held the property for investment and sold a portion of it to a development company in a capital gain bailout transaction, making the case for capital gain treatment should be relatively straightforward. The taxpayer need only prove that it acquired the property for investment, never engaged in any development activities, continued to hold the property since its acquisition for investment, and engaged in limited sales of other portions of the parcel without marketing the property or soliciting sales. If the property is held by a taxpayer or in an entity that limits its business activities to real estate investments held for long-term appreciation or rental, the likelihood of achieving capital gain treatment is much increased. The taxpayer should document—in minutes of its board or other management meetings, business plan, communications or documents with its banker or other lenders, and any other documents where appropriate—that the property is being acquired for investment. It should also minimize the number of sales of portions of the tract, given that frequency and substantiality of sales is viewed as the most important of the seven *Winthrop* factors.

A taxpayer that has acquired a parcel of property for development and then decides to retain all or a portion of the undeveloped property as an investment, or that has developed the property and then decides to retain one or more of the developed lots for investment purposes, has a greater challenge to achieve capital gain treatment on a later sale of the retained property or lots. It is well settled that a person can hold real estate both as an investor and a dealer.[38] The determination of capital asset status must be made with respect to each tract, and the purpose for holding real estate (i.e. as a capital asset or primarily for sale to customer) may vary with respect to different tracts.[39] As a general rule, the taxpayer's original purpose for acquiring property will be deemed to have continued unless the taxpayer can provide evidence of a subsequent change in purpose.[40] Where a taxpayer has gone from holding the property for sale to holding it for investment, it has the "burden of proving the negative by a preponderance of the evidence, i.e. that the property was not held primarily for sale."[41] As any attorney can attest, meeting the burden of proof to prove a negative is usually very difficult.

The central inquiry in determining whether a taxpayer is entitled to capital gain treatment remains the dominant purpose for holding the property during the period prior to the sale.[42] The taxpayer's intended purpose for using or holding the property at the time that it was acquired, as well as the purpose or use for which it was held during the holding period, are rele-

---

37 Sections 1211(b), 1212(b).

38 *Herndon*, TCM 1968-135.

39 *Municipal Bond Corp*., 341 F.2d 683, 15 AFTR2d 408 (CA-8, 1965); *Margolis*, 337 F.2d 1001, 14 AFTR2d 5667 (CA-9, 1964); *Wood*, 276 F.2d 586, 5 AFTR2d 1232 (CA-5, 1960); *Tibbals*, 362 F.2d 266, 17 AFTR2d 1213 (Ct. Cl., 1966).

40 *Biedenharn Realty Company, supra* note 12; *Sanders*, 740 F.2d 886, 54 AFTR2d 84-5847 (CA-11, 1984).

41 *Cousins Properties, Inc.*, 40 AFTR2d 77-5262, 77-5265 (Ct. Cl., 1977).

42 *Malat v. Ridell, supra* note 8.

43 *Cousins Properties, Inc.*, 40 AFTR2d 77-5262.

44 *Id*.

45 *Margolis, supra* note 39.

46 *Thompson,* 322 F.2d 122, 12 AFTR2d 5451 (CA-5, 1963).

47 *Cousins Properties, Inc., supra* note 41.

48 *Margolis, supra* note 39.

49 *Id*.

vant.[43] The focus is on the taxpayer's purpose in holding the property at or shortly before the transaction or transactions leading to the sale.[44] The courts have been reluctant to grant a taxpayer capital gain treatment on lots or property that it has developed based on a mere statement of intention that it plans on hold the property for a substantial period before sale to realize the appreciation in value over time.[45] Just because a substantial period lapses between completion of development and sale of the last residential lots in a subdivision does not justify capital gain treatment. Sales that "empty the shelves" are no less a sale in the ordinary course of business than the sale of the first lots of developed property.[46]

To achieve capital gain treatment for developed lots, the taxpayer must produce clear evidence that it converted the property for a use other than selling to customers. Meeting the burden of proof that there has been a change in purpose for holding the property generally will require some objective evidence of the change in purpose—a mere self-serving declaration of a change in purpose will not be sufficient.[47] Actually converting the property into income-producing property has been required by at least one court.[48] Obviously, the longer the property has been income-producing property prior to sale the better.[49] Evidence of a change in the purpose for holding the property due to an unexpected event or change in life circumstance can also be used to support a taxpayer's position for capital gain treatment. For example, an illness that prohibits an individual from further engagement in real estate development and sales activities can be used to support a change in purpose for holding the property.

Conclusion

As the market for new home construction begins to recover from the Great Recession, opportunities should develop for prudent investors and real estate developers to realize large gains on property transactions. Whether a particular parcel of property is treated as a capital asset or as one held "primarily for sale to customers" makes a tremendous difference in the amount of federal income tax due on the gain realized from a property transaction. As demonstrated in *Bramblett* and *Phelan*, taxpayers can reduce their tax burden on property transactions by using a capital gain bailout strategy with proper planning and implementation of the plan. However, *Pool* is a reminder that a taxpayer seeking favorable capital gain treatment has the burden of proving that the property that was sold was a capital asset in the hands of the seller and that lack of proper implementation of a capital gain bailout transaction can be painful. ■