Document ID#: 547200610020

AMERICAN BAR ASSOCIATION -- SECTION OF TAXATION

2006 Joint Fall CLE Meeting

TITLE: Real Estate - Preserving Capital Gains, Dealer Issues

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PANEL: Preserving Capital Gains and Real Estate Developments

DATE: 10/21/06

COMMITTEE: Sales, Exchanges and Basis

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REAL ESTATE – PRESERVING CAPITAL GAINS, DEALER ISSUES

ABA SECTION OF TAXATION
COMMITTEE ON SALES, EXCHANGES & BASIS
PANEL PRESENTATION: OCTOBER 21, 2006

PREPARED: JULY 31, 2006

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I. INTRODUCTION

A. Capital Gain v. Ordinary Income

1. Rate Differential.

a. Undeveloped Land. Given the significant difference between the highest marginal tax rate for individuals (35%) and the maximum rate for long-term capital gains (15%) applicable to gains recognized on the sale or exchange of undeveloped real property held for more than one year, owners of such property generally prefer to treat their gain on the sale as a capital gain rather than ordinary income. See Section 1.

b. Depreciable Real Property. Gain on the sale of depreciable real property held for more than one year may be subject to three different tax rates—depreciation recapture taxed as ordinary income at a maximum rate of 35%, unrecaptured Section 1250 gain taxed at a maximum rate of 25% and long-term capital gain taxed at a maximum rate of 15%. See Sections 1(h)(1)(D), (h)(6).

To illustrate, assume Taxpayer sells a building for $10 million that he purchased for $5 million several years ago. During this time, Taxpayer has recognized $2 million in depreciation, $500,000 of which exceeded the amount allowed under the straight-line method. Under these facts, Taxpayer recognizes a $7 million gain, taxed as follows: (i) additional depreciation of $500,000 is taxed as ordinary income, (ii) unrecaptured Section 1250 gain of $1.5 million is taxed at 25%, and (iii) the remaining $5 million is long-term capital gain taxed at 15%.

2. Look-Through Capital Gain Rules.

a. Sale of Partnership Interest. Under Section 741, the gain or loss resulting from the sale or exchange of a partnership interest is generally capital in nature. Under the look-through capital gain rules, if the selling partner held his partnership interest for more than year, one of three long-term capital gains rates may apply—15%, 25% (unrecaptured Section 1250 gain), 28% (collectibles gain). See Section 1(h); Reg. § 1.1(h)-1(a).

(1) Unrecaptured Section 1250 Gain. If a partnership (or limited liability company classified as a partnership for Federal tax purposes) owns depreciable real property, the look-through capital gain rules allocate the unrecaptured Section 1250 gain to the selling partner. Reg. § 1.1(h)-1(b)(3)(ii).

(2) Ordinary Income. Section 751 (the collapsible partnership provision) may treat a portion of the gain attributable to inventory and unrealized receivables as ordinary income.

b. Sale of S Corporation Shares. The capital gains look-through rule provides that, when a taxpayer sells stock in an S corporation held for more than one year, the taxpayer may recognize ordinary income under Sections 304, 306, 341 and 1254; collectibles gain; and long-term capital gain. Reg. § 1.1(h)-1(a).

(1) No Unrecognized Section 1250 Gain Look-Through. Because the look-through capital gain rules applicable for S corporations do not include unrecaptured Section 1250 gain, no portion of the taxpayer's gain on the sale of the S corporation stock will treated as attributable to unrecaptured Section 1250 gain.

(2) Collapsible Corporation. The Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA"), Pub. L. No. 108-27, repealed, albeit temporarily, the collapsible corporation rules (Section 341) for tax years beginning after December 31, 2002. Under the current sunset provisions, these rules will again apply to tax years beginning after December 31, 2010 (extended from 2008, by reason of § 102 of the Tax Increase Prevention and Reconciliation Act of 2005. Thus, for at least the near future, the prospect of treating the gain on the sale of an S corporation interest as ordinary income is greatly diminished.

3. Character of Gain Depends upon Classification of Seller. The character of the gain (or loss) resulting from the sale of real estate depends upon the classification of the seller as an *investor* or *dealer*. For investors, the gain (or loss) is capital; for dealers, the gain (or loss) is ordinary.

a. The central issue with respect to the sale of real estate is whether the sale is in the "ordinary course of a trade or business." See Suburban Realty Co. v. United States, 615 F.2d 171 (5th Cir. 1980). In defining the term "capital asset", Section 1221(a)(1) expressly excludes inventory and property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. This determination focuses on the intent of the seller and the purpose for which the seller purchased the property.

b. Other requirements, such as that sales be made to customers and that the property be "held primarily for sale," are relevant but not necessarily dispositive in characterizing gain (or loss) on the sale of real property.

B. Illustrative Fact Pattern

A and B are residential real estate developers doing business together as AB Homes, LLC. For Federal tax purposes, AB Homes is treated as a partnership. AB Homes has identified an undeveloped tract of farmland for sale that would be ideal for a planned residential development. Based on their many years of experience in real estate, A and B believe this property will increase in value substantially if they are able to secure the necessary zoning and subdivision approvals for a planned development. Once they have the requisite approvals for development, they anticipate either selling the property to another developer or developing the property themselves. In either event, A and B prefer to structure the sale of this property in the most tax efficient manner.

C. Roadmap

This outline discusses planning techniques and statutory safe harbors available to developers, such as A and B, that allow them to preserve capital gain treatment on the sale or transfer of the undeveloped real estate to an other entity, related or not, for development. However, before addressing these issues, the outline begins with a foundational discussion regarding of the characteristics that courts have identified with respect to dealer property.

II. DEALER PROPERTY

A. Sales in the Ordinary Course of Trade or Business.

1. Fifth Circuit Framework. The Fifth Circuit has developed a framework for determining whether sales of land should be considered sales of a capital asset or sales of property primarily held for sale to customers in the ordinary course of a taxpayer's trade or business. See Suburban Realty Co. v. United States, 615 F.2d 171 (5th Cir. 1980); Biedenharn Realty Co. v. United States, 526 F.2d 409 (5th Cir. 1976); and United States v. Winthrop, 417 F.2d 905 (5th Cir. 1969). The framework adopted by the Fifth Circuit focuses on answering the following three principle questions:

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

b. Was the taxpayer holding the property primarily for sale in that business?

c. Were the sales contemplated by the taxpayer "ordinary" in the course of that business?

2. Broader Application. Although the Fifth Circuit's framework, as outline above, is precedential only for those courts within that Circuit and the Eleventh Circuit, it is nonetheless instructive for purposes of determining whether a taxpayer holds real property in the ordinary course of a trade or business or for investment purposes. Fifth Circuit decisions prior to October 1, 1981 are binding precedent on the Eleventh Circuit. See Bonner v. City of Prichard, 661 F.2d 1206,1209 (11th Cir.1981).

B. Relevant Factors. In attempting to define whether a taxpayer is engaged in a trade or business, courts consider the following factors to be relevant:

1. Nature and Purpose of the Acquisition of the Property and the Duration of the Ownership

a. Nature of Acquisition. The relevant inquiry here is what was the taxpayer's motivation in holding the property prior to the sale. See Daugherty v. Comm'r, 78 T.C. 623 (1982); and Biedermann v. Comm'r 68 T.C. 1 (1977). The course of conduct over a period of time, and not a pinpointed moment in time, is relevant. See, e.g., Heller Trust v. Comm'r, 382 F.2d 675 (9th Cir. 1967), rev'g 25 T.C.M. (CCH) 634 (1966); and Municipal Bond

Corp. v. Comm'r, 341 F.2d 683 (8th Cir. 1965), rev'g 41 T.C. 20 (1963). A taxpayer should contemporaneously document the motivation for acquisition and any subsequent change of purpose.

b. Original Purpose. A taxpayer's purpose for acquiring property establishes the taxpayer's primary purpose for originally holding the asset. Unless controverted by evidence of a subsequent change in purpose, the original purpose controls. Tollis v. Comm'r, 65 T.C.M. (CCH) 1951 (1995). Note that it is more likely that a change will occur from holding as an investment to holding for sale to customers in a business than the opposite. Indications of a changed purpose include significant improvements to the property or solicitations or advertising evidencing a motivation to sell to customers. See, e.g., Jersey Land & Development Co. v. United States, 539 F.2d 311 (3rd Cir. 1976); Reithmeyer v. Comm'r, 26 T. C. 804 (1956); Herzog Bldg. Co. v. Comm'r, 44 T.C. 694 (1965); and Ferguson v. Comm'r, 53 T.C.M. (CCH) 864 (1987).

(1) Dual Purpose. A dual purpose, however, is to be distinguished from a changed purpose since the determination of the primary motivation is to be made at the time of the disposition. See Bynum v. Comm'r, 46 T.C. 295 (1966). For example, where a taxpayer holds land primarily for investment but incidentally for sale is distinguishable under present law from the case where a taxpayer holds land initially for investment then changes her plans to hold the land primarily for sale. See, e.g., Biedenharn Realty Co., Inc. v. United States, 526 F.2d 409 (5th Cir. 1975); and Bynum v. Comm'r, 46 T.C. 295 (1966). In the first instance, the asset would not be excluded from capital asset status under Section 1221(a)(1), while in the second instance, if the sale is made to customers in the ordinary course of the taxpayer's trade or business, the Section 1221(a)(1) exception applies and any gain or loss is ordinary.

(2) Changed Purpose. Generally, where evidence of a changed purpose exists, an original investment purpose will be overridden unless the taxpayer can show "unanticipated externally induced factors which make impossible the continued pre-existing use of the realty." Biedenharn Realty Co., Inc. v. U.S., 526 F.2d 409 (CA5 1975).

(a) Examples of such events include those rendering property unfit for its intended use, see Estate of Barrios v. Comm'r, 265 F.2d 517 (CA5 1959), as well as "Acts of God, condemnation of part of one's property, new and unfavorable zoning regulations, or other events forcing alteration of [a] taxpayer's plans." See Kaster, When Will the Liquidation-of-Investment Theory Apply to a Sale of Condominium Units?, 70 J Tax'n 46 (1989).

(b) Illness and threat of foreclosure may also be included in the changed purpose exception. In Herndon v. Commissioner, 27 T.C.M. 662 (1968), the taxpayer, a real estate dealer, sold certain subdivided farm property following the illness of his wife. The Court considered this factor in holding that the sale was for the purpose of liquidating the taxpayer's investment, and therefore was a capital transaction. In Erfurth v. Commissioner, 53 T.C.M. 767 (1987), the taxpayer converted apartment units into condominium units and was allowed to report capital gain on the sale of the condominium units to the extent the sales were made to remove the property from the threat of foreclosure. Gain from property which was not threatened by foreclosure had to be reported as ordinary income.

c. Duration of Ownership. Not all courts have identified the holding period as a factor. However, the courts that have considered it have generally indicated that holding an asset for a long time evidences an investment purpose.

(1) The Supreme Court alluded to this in stating that the distinction between capital and ordinary gains and losses lay between "profits and losses arising from the everyday operation of a business on the one hand and the realization of appreciation in value accrued over a substantial period of time on the other." Malat v. Riddell, 383 U.S. 569 (1966).

(2) In Pritchett v. Commissioner, 63 T.C. 149 (1974), the Tax Court, in allowing capital gains treatment for the taxpayer, emphasized that "th[e] lengthy retention of the property is indicative of [the taxpayer's] intention to hold it for investment purposes." 63 T.C. at 167. See also Municipal Bond Corp. v. Comm'r, 382 F.2d 184 (8th Cir. 1967); and Schueber v. Comm'r, 371 F.2d 996 (7th Cir. 1967).

2. Extent and Nature of the Taxpayer's Efforts to Sell the Property

a. Solicitation and marketing efforts may controvert a taxpayer's statement that the purpose of holding property was for investment. See Ferguson v. Comm'r, 53 T.C.M. 864 (1987). The relevant question is whether any such efforts were engaged in, rather than whether the taxpayer engaged in such activities himself or hired others. See Sanders v. United States, 740 F.2d 886 (11th Cir. 1984). Solicitation and advertising suggest that the taxpayer is looking for customers and is no longer willing to hold the land for future appreciation. See Biedenharn Realty Co., Inc. v. United States, 526 F.2d 409 (5th Cir. 1975).

b. In Thompson v. Commissioner, 322 F.2d 122 (5th Cir. 1963), the Court held that gain from the sale of property was taxable as ordinary income because, although the taxpayer originally purchased the property for investment, he engaged in extensive sales activities in order to generate interest in the lots. Contrasting this is Pritchett v. Commissioner, 63 T.C. 149 (1974), in which the Court emphasized that the taxpayer, a real estate broker, by not engaging in sales efforts, had retained an investment motive with respect to the disputed sales because he maintained a disinclination to sell readily.

c. Whether property is sold directly by the taxpayer or through independent brokers may be relevant. In Estate of Barrios v. Commissioner, 265 F.2d 517 (5th Cir. 1959), the taxpayer's use of a broker was evidence, in the Court's view, that the taxpayer held the property for investment purposes. On the other hand, in Riley v. Commissioner, 328 F.2d 428 (5th Cir. 1964), the Court disallowed capital gains treatment to a taxpayer who sold certain properties only through an agent.

3. Number, Extent, Continuity and Substantiality of the Sales

a. Although there is no bright line with respect to frequency, number or continuity of sales, courts have held that 244 lot sales in a single year constituted a trade or business, Suburban Realty Co. v. United States, 615 F.2d 171 (5th Cir. 1980); that average lot

sales of 15 per year during a 5-year period was also a trade or business, Sanders v. United States, 740 F.2d 886 (11th Cir. 1984); but that the sale of 63 properties over more than 20 years was not a trade or business, Matz v. Commissioner, 76 T.C. 465 (1988).

b. Courts are also influenced by the substantiality of income derived from realty sales, as well as its proportion to the taxpayer's total income, in deciding whether or not a taxpayer is engaged in a real estate trade or business. See Adam v. Comm'r 60 T.C. 996 (1973).

4. Extent of Subdividing, Developing and Advertising to Increase Sales

a. Development activity is certainly relevant to determining whether a trade or business exists. Taxpayers with investment agendas may be willing to wait for the property to appreciate; they do not seek to increase the property's value through improvements. Accordingly, improvements usually are considered indicative of a trade or business.

b. In Biedenharn Realty Co. v. United States, 526 F.2d 409 (5th Cir. 1975), extensive development and improvement activities helped to convince the Fifth Circuit that a real estate company was not merely liquidating an investment, but was selling property in its real estate business. In Rev. Rul. 59-91, 1959-1 C.B. 15, the IRS denied capital gains treatment to a corporation for property it reportedly held as an investment, but which it sold after subdividing the property into residential lots, grading and surfacing the streets, and installing drainage facilities and utilities. See also Sanders v. United States, 740 F.2d 886 (11th Cir. 1984); and Gault v. Comm'r, 332 F.2d 94 (2d Cir. 1964).

c. Where the activities undertaken are not physical, these have not weighed against the taxpayer in determining capital asset status. In Buono v. Commissioner, 74 T.C. 187 (1980), for example, an S corporation obtained township approval for subdividing a tract of land it intended to sell, and in fact did sell, as one parcel. The Tax Court ruled that, although the taxpayer undertook steps to enhance the marketability of the property later sold, where those activities were "purely legal" and thus fell short of constituting a trade or business, the property was still a capital asset.

5. Additional Factors

a. Use of a business office for the sale of the property;

b. Character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and

c. Time and effort the taxpayer habitually devoted to the sales.

C. Installment Sales of Timeshares and Residential Lots

1. Limited Exception to General Denial of Installment Method for Dealers. Generally, any disposition of real property held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business is not eligible for the installment method. Section 453(b)(2). Dealers in timeshares and residential lots, however, may elect the installment

method if they agree to pay an interest toll charge on the deferred tax obligation. Section 453(l)(2).

2. Interest Toll Charge.

a. The period for which interest is computed begins on the date of the sale and ends on the date payment is received. Section 453(l)(3)(B)(i)(II). The rate to be used is the applicable Federal rate in effect at the time of the sale, compounded semiannually. Section 453(l)(3)(B)(i)(III). The tax attributable to the receipt of payments is determined without regard to any interest imposed under this provision. Section 453(l)(3)(B)(ii). No interest is due for payments received in the taxable year of the disposition from which the installment obligation arises. Section 453(l)(3)(B)(iii). Interest taken into account in computing the amount of any deduction allowable to the taxpayer for interest paid or accrued during the taxable year. Section 453(l)(3)(C).

b. The interest charge also applies to sales of timeshares and residential lots for $150,000 or less by nondealers. Section 453A(b)(4). Ordinarily, nondealers only pay the interest charge if (1) the taxpayer has installment obligations arising from the disposition of property in which the sales price exceeds $150,000 ("Section 453A obligations"), and (2) the face amount of all such Section 453A obligations held by the taxpayer at the close of the taxable year exceeds $5 million. Section 453A(b).

III. DEALERS HOLDING REAL PROPERTY FOR INVESTMENT

A. Dual Role Dealers. It is well-established that a dealer in real property may occupy a dual role in that he holds some real property for sale to customers in the ordinary course of his trade or business and other property for investment purposes. See Fabiani v. Comm'r, T.C. Memo. 1973-203.

1. Parcel-by-Parcel Determination. Because the analysis of whether the disputed property is held primarily for sale to customers is undertaken on a property-by-property basis, "dealers" may still successfully assert that a particular parcel was primarily held for investment, and not for sale in the ordinary course of business, if they can sustain the difficult burden of proof which they bear. See, e.g., Wood v. Comm'r, 276 F.2d 586 (5th Cir. 1960) (noting without question that "a property owner may hold some [property] for sale to customers in the ordinary course of business and hold the remainder as capital assets"); and Maddux Construction v. Comm'r, 54 T.C. 1278 (1970) (holding that the taxpayer may treat its gain on the sale of unimproved real property it held for a period of time and later sold in bulk for commercial development as capital because the sale was not in the ordinary course of the taxpayer's residential construction business).

2. Burden of Proof on Taxpayer. In Murray v. Commissioner, 370 F.2d 568 (4th Cir. 1967), the Fourth Circuit held that a real estate dealer was entitled to capital gain treatment where he proved that the properties sold were held for investment. Likewise, in Pritchett v. Commissioner, 63 T.C. 149 (1974), the Court allowed capital gains treatment on certain property sold even though the taxpayer was a real estate broker.

B. Clear Delineation between Dealer and Investment Activities. Developers, subdividers and other taxpayers who ordinarily deal in real estate should at all times be vigilant about the possibility of tainting all real estate transactions with their trade or business activities. The unfocused nature of the examination by the courts exposes many transactions to the risk of recharacterization. Unfortunately, because of the ad hoc nature of the analysis, it is impossible to present hard-and-fast rules or strategies to cope with the attendant uncertainty.

1. Hold Investment and Dealer Properties in Separate Legal Entities. To better substantiate the distinct purposes for which taxpayers may own real estate, taxpayers that are both investors and dealers in real estate should hold their properties in separate legal entities. Along these lines, some taxpayers form limited liability companies that they do not capitalize until they are ready to acquire the real estate in such entities.

a. Revisiting AB Homes LLC. This example presents the typical scenario in which a developer-dealer should contribute undeveloped real estate purchased for investment purposes to an existing or newly formed entity, preferably an LLC classified as a partnership for Federal tax purposes. If an existing entity is used, that entity should hold only investment property.

b. Ownership of Investment Property Entity. To avoid being classified as a disregarded entity for Federal tax purposes, the investment property entity should not be a single-member LLC wholly owned by the developer entity. Disregarded entity status would undermine the desired segregation for tax purposes. In most cases, the owner(s) of the dealer-developer entity and/or unrelated third-party investors own the investment entity. These issues are explored more fully in Part V below.

2. Cases Preserving Capital Gains. As a general proposition, however, legitimate containment of dealer activities can provide greater assurance that a taxpayer's nondealer purposes for holding property will be respected. See Suburban Realty v. United States, 615 F.2d 171 (5th Cir. 1980) (noting that a taxpayer may be able to preserve capital gain treatment on the sale of a clearly segregated tract of land). Such containment may span the spectrum from simply documenting nondealer purposes for holding particular properties, to establishing completely separate entities, to holding properties for clearly delineated purposes. Obviously, the effectiveness of such strategies will rest on the quality of planning and implementation involved, for numerous pitfalls imperil the uninformed. The degree to which the plan comports with economic reality is also critical inasmuch as the IRS and the courts are usually wary of window dressing.

a. Cary v. Commissioner, 32 T.C.M. 913 (1973), is an illustration of how careful planning and favorable facts enabled one taxpayer to separate corporate dealer activities from investment. Cary, a developer, was assigned the contractual rights to purchase two tracts of land by his wholly owned real estate development company. He contributed the contracts to two partnerships for a 50% interest in each. Unrelated third parties owned the other 50% interest in each. The partnerships did nothing to improve, develop or promote the land, and within one year they sold all of one tract and most of the other to the taxpayer's wholly owned corporation at a large profit. Accordingly, the potential for recharacterizing the transaction as part of a coordinated dealer transaction, which would render the partnerships' gains (or some

part of the gains) ordinary income, existed. The Court, however, held that the profits realized by the partnerships were not ordinary income but qualified as capital gains, because all the entities were separate and there was no evidence to suggest that the partnerships held the properties for anything but investment.

b. Graves v. Commissioner, 867 F.2d 199 (4th Cir. 1989), provides a contrasting example. In Graves, an individual taxpayer, who owned a construction company through which he had extensive development involvement, acquired three contiguous parcels in a joint venture with another individual. The joint ventures obtained development approvals for all three parcels, but declined to reserve sewer capacity requirements for one of the parcels. After development of the two parcels, each partner received a one-half interest in the remaining, undeveloped parcel. In the year after termination, Graves sold his one-half interest and reported a capital gain. The Tax Court denied capital gains treatment. On appeal, the Fourth Circuit affirmed because Graves failed to prove that the undeveloped parcel was held for any purpose other than development.

c. Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1992), concluded that the dealer activities of a development corporation that purchased real estate from a related partnership were not attributable to the partnership when determining whether the partnership was in the business of selling land. In reaching this result, the Court rejected the IRS arguments that either the development corporation was an agent of the partnership or the dealer activities of the corporation should be imputed to the partnership on a substance over form theory. The Court also noted that there was at least one major independent business reason to form the corporation and have it, rather than the partnership, develop and sell the land—insulate the partnership and the partners from unlimited liability. Finally, the Court observed that there was no evidence to suggest that the transaction was not at arms'-length or that business and legal formalities were not observed.

IV. SECTION 1237—SAFE HARBOR FOR REAL PROPERTY SUBDIVIDED FOR SALE

A. Principal Conditions of Qualification

1. Three-Part Test. Section 1237(a) provides a statutory safe harbor, albeit seldom used because of the 5-year holding period requirement, for taxpayers other than C corporations through which the sale of a lot or parcel that is part of a tract of real property is not deemed to be held primarily for sale to customers in the ordinary course of a trade or business at the time of the sale solely because the taxpayer subdivided the land for subsequent sale or because of any activity incident to such subdivision or sale if:

a. The taxpayer has not been a dealer in real estate with respect to the lot or parcel (or tract of which it is a part) in any year prior to sale and in the year of sale is not a dealer with respect to any other real property;

b. The taxpayer has not made substantial improvements that substantially enhance the value of the lot or parcels sold; and

c. The taxpayer has held the parcel for 5 years, except when acquired by inheritance or devise.

2. Tract of Real Property Defined. Section 1237(c) defines the term "tract of real property" to mean either (i) a single piece of real property, or (ii) two or more pieces of real property if they were contiguous at any time while held by the taxpayer, or would have been contiguous but for the interposition of a road, street, railroad, stream or similar property.

B. Disqualification Arising from Holding Real Property Primarily for Sale

1. General Rule. Although the "holds property primarily for sale to customers" analysis under Section 1221 discussed above applies here as well, the most significant factor for purposes of Section 1237 qualification may be the manifestation of the taxpayer's intent as evidenced by the extent of improvements. Because the statute and the Regulations promulgated thereunder clearly apprise the taxpayer of acceptable improvements, it is entirely within a taxpayer's province to memorialize his intention through the scope of the improvements, or lack thereof, to the tract.

a. Subdividing and Selling Activities. The Regulation provide that such activities are disregarded for purposes of determining whether a taxpayer held real property primarily for sale to customers in the ordinary course of business if they are only evidence indicating that the taxpayer should be treated as dealer with respect to the sold lots. Reg. § 1.1237-1(a)(2). However, when other evidence tends to show that the taxpayer is dealer, the taxpayer's subdividing and selling activities will be taken into account. Reg. § 1.1237-1(a)(3).

b. Factors that Do Not Alone Indicate Dealer Tendencies.

(1) Holding a real estate license;

(2) Selling other real property clearly held for investment;

(3) Acting as a salesman for a real estate dealer, but without any financial interest in the business; or

(4) Mere ownership of other vacant real property without engaging in any selling activity whatsoever with respect to it. Reg. § 1.1237-1(a)(3).

2. Attribution Rules Apply. For purposes of determining whether the taxpayer holds any property as a dealer, property held jointly or as a member of a partnership is attributed to the taxpayer. Reg. § 1.1237-1(b)(3). Generally, property owned by members of the taxpayer's family, an estate or trust or a corporation will not be considered as being owned by the taxpayer. Reg. § 1.1237-1(b)(3). The taxpayer, nevertheless, may be considered a dealer by virtue of his relationship to a predecessor-in-interest to the extent this indicates the purpose for which the taxpayer has held the lot or tract. Reg. § 1.1237-1(b)(3).

C. Disqualification Arising from Substantial Improvements

1. Substantial Value Increase. Before a substantial improvement will preclude the availability of the Section 1237 safe harbor, the improvement must substantially enhance the value of the lot sold.

a. More than 10% test. As for what increase in value is substantial, Reg. § 1.1237-1(c)(3)(ii) states that, if improvements increase the value of lots by 10% or less, the increase will not be considered substantial; however, if such value is increased by more than 10%, then all relevant factors must be considered to determine whether, under the circumstances, the increase is substantial. Changes in the market value of the lots not attributable to the improvements are disregarded.

b. In Revell v. United States, 1972-1 USTC ¶ 9298 (D SC 1972), a 12.5% increase in the value of the property, combined with (1) the sale of 117 of 120 lots in three years, (2) the costs of improvement, including street improvements of $21,174 and a water system of $41,195, and (3) other improvements (such as surveys, platting, streets cut, surface drainage installation), was sufficient for the Court to find that the gain did not qualify for Section 1237 treatment.

2. When an Improvement Is Substantial. Activities considered substantial include any permanent structures, or installation of hard surface roads or utilities such as sewers, water, gas, or electric lines. Reg. § 1.1237-1(c)(4). Whereas, a temporary structure used as a field office, surveying, filling, leveling or clearing land and the construction of minimum all-weather roads, including gravel roads where required by the climate, generally are not substantial improvements. Reg. § 1.1237-1(c)(4).

3. Improvements Deemed to Be Made by the Taxpayer.

a. Improvements made by members of the taxpayer's family (as defined in Section 267(c)(4)), a corporation controlled by the taxpayer, an S corporation in which the taxpayer was a shareholder, or a partnership which included him as a partner. Section 1237(a)(2)(A).

b. Improvements made by a lessee if the improvement constitutes income to the taxpayer. Section 1237(a)(2)(B); see Reg. § 1.109-1 (describing situations where a lessor has income by reason of a lessee making improvements to land). See, e.g., Priv. Ltr. Rul. 8038196 (June 30, 1980); Priv. Ltr. Rul. 8637012 (June 2, 1986); Priv. Ltr. Rul. 9123026 (March 8, 1991); Priv. Ltr. Rul. 9633029 (May 20, 1996) (a series of related letter rulings where lessees had improved land by building condominiums and single-family housing, but taxpayers were nonetheless found to be entitled to the benefits of Section 1237; note span of years between sales).

c. Improvements made by a Federal, state or local government, or political subdivision thereof, but only if the improvement constitutes an addition to basis for the taxpayer. Payment of a special tax assessment would be such an addition. Section 1237(a)(2)(C).

4. Special Rule for Necessary Improvements. Section 1237(b)(3) provides that an improvement will not be considered substantial if the lot or parcel is held by the taxpayer for 10 years or more (not including any tacked period due to inheritance of the property) and the following conditions are met:

a. Such improvement is the building or installation of water, sewer, drainage facilities (either surface, sub-surface or both), or roads, including hard surface roads, curbs and gutters;

b. The IRS District Director agrees that, without such improvement, the lot or parcel sold would not be marketable at prevailing local prices for "similar building sites"; and

c. The taxpayer elects not to make any adjustment to the basis of the lot or parcel (or any other property owned by the taxpayer) because of such improvement. Such election does not make any item deductible which would not otherwise be deductible.

5. Manner of Making Election Required by Section 1237(b)(3)(C). As a cautionary note, the tax return must contain adequate notice as to the reliance of the taxpayer on Section 1237 and the bases thereof. If these conditions are not met, the installation of these improvements would be deemed substantial and the taxpayer would be disqualified from using Section 1237. Reg. § 1.1237-1(c)(5)(iii) provides that election required by Section 1237(b)(3)(C), which is filed with the taxpayer's return for the taxable year in which the lots subject to the election are sold, must include the following:

a. A plat showing the subdivision and all improvements attributable to the taxpayer.

b. A list of all improvements to the tract, showing:

(1) The cost of such improvements;

(2) Which of the improvements, without regard to the election, the taxpayer considers "substantial" and which he considers not "substantial";

(3) Those improvements which are substantial to which the election is to apply, with a fair allocation of their cost to each lot they affect, and the amount by which they have increased the values of such lots; and

(4) The date on which each lot was acquired and the basis for determining gain or loss, exclusive of the cost of any improvements listed above.

c. A statement confirming that the taxpayer will neither deduct as an expense nor add to the basis of any lot sold, or of any other property, any portion of the cost of any substantial improvement which substantially increased the value of any lots in the tract and which either the taxpayer or the District Director deems substantial.

D. 5-Year Holding Period Requirement

1. Section 1223 Rules Apply. Generally, the provisions of Section 1223 are applicable in determining the period during which the taxpayer held the property. Reg. § 1.1237-1(d)(1). Thus, for example, the holding period tacks in carry-over basis transfers (e.g., gifts, liquidations, etc.).

2. Property Acquired upon Death. There is no 5-year holding period requirement if the taxpayer inherited the property. Reg. § 1.1237-1(d)(2). For purposes of Section 1237, neither the survivor's one-half of community property, nor property acquired by survivorship in a joint tenancy, qualifies as property acquired by devise or inheritance. The holding period for the surviving joint tenant begins on the date the property was originally acquired. Reg. § 1.1237-1(d)(2).

E. Special Rule for Computing Taxable Gain.

1. Sale of 5 or Fewer Lots in Same Tract. When the taxpayer has sold 5 or fewer lots or parcels from the same tract during a taxable year, the entire gain is capital. Reg. § 1.1237-1(e)(2). In computing the number of lots sold, two or more contiguous lots sold to the same buyer in a single sale are counted as only one lot. Reg. § 1.1237-1(e)(2).

2. Sale of 6 or More Lots in Same Tract. If the taxpayer has sold a sixth lot from the same tract within the taxable year, the amount, if any, by which 5% of the selling price of each lot exceeds the expenses incurred in connection with its sale or exchange will be treated as ordinary income to the extent it represents gain on the sale. Sections 1237(b)(1), (2); Reg. § 1.1237-1(e)(3).

a. Example 1. Taxpayer sells 6 lots from the same tract in 2004. Assume the selling price of the sixth lot was $10,000 with a basis of $5,000 and selling expenses of $750. In this example, none of the taxpayer's recognized gain of $4,250 will be treated as ordinary income because the selling expenses ($750) exceed 5% of the sales price ($500).

b. Example 2. Assume the same facts as Example 1, except that the selling expenses are only $300. Under these facts, the taxpayer recognizes a gain of $4,700 of which $200 will be treated as ordinary income. The remaining $4,500 is capital gain.

F. Relationship of Section 1237 and Section 1231. Any gain or loss realized on the sale of real property used in a trade or business for purposes of Section 1237 will be treated as a Section 1231 gain or loss if the only reason the property does not qualify as Section 1231 property is that the taxpayer subdivided the tract of which the lot sold was a part. Reg. § 1.1237-1(f).

V. TRANSFER OF REAL PROPERTY TO A RELATED ENTITY

A. Transfer to Controlled Corporation. Taxpayers, such as A and B in the introductory illustration, that both invest in and develop real estate understand that post-development profits may outweigh the pre-development appreciation of the real estate and thus

are remiss to sell the property to an unrelated third party who will then reap all the post-development profit. To this end, such taxpayers often sell undeveloped real estate to a controlled corporation (within the meaning of Section 368(c)) that will develop and sell the property to unrelated third parties in the ordinary course of business. Because very few developer corporations consider paying cash for undeveloped property, the seller almost always receives an installment note, which gives rise to the potential for recharacterization as an equity contribution. Outright cash sales funded through the dealer corporation's prior operations or an unrelated lender should be immune from such recharacterization.

1. Recharacterization of Installment Note under Section 351. Although taxpayers have experienced a good degree of success in defending installment sales to related entities as true sales, the IRS has also been successful, albeit to a lesser degree, in recharacterizing the sale of land to the developer corporation as an nontaxable equity contribution. The proper treatment of each transaction is highly fact dependent and generally turns upon whether the installment note is respected as debt.

2. Debt v. Equity Considerations. Through the years, the IRS and the courts have developed a number of factors to determine whether a purported debt should be treated as equity for tax purposes. See, e.g., Bauer v. Comm'r, 748 F.2d 1365 (9th Cir. 1984); Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968); J.S. Biritz Constr. Co. v. Comm'r, 387 F.2d 451 (8th Cir. 1967); Smith v. Comm'r, 370 F.2d 178 (6th Cir. 1966); and Gilbert v. Comm'r, 262 F.2d 512 (2d Cir. 1959). Specifically, the courts have identified the following broad factors, several of which were codified in Section 385(b):

a. Intent of the parties

(1) the extent to which the creditor participates in management;

(2) whether the obligation to pay is contingent on the performance of the corporation;

(3) the names given to the certificates evidencing the indebtedness; and

(4) the identity of interest between creditor and shareholder

b. Formal characteristics of indebtedness

(1) fixed rate of interest at or above AFR;

(2) the presence or absence of a maturity date;

(3) the right to enforce the payment of principal and interest;

(4) whether the note is subordinate to other creditors; and

(5) the presence or absence of a redemption provision.

c. Economic realities of the transaction

(1) "thin" or inadequate capitalization (i.e., debt-to-equity ratio);

(2) the corporation's ability to obtain financing from outside lenders;

(3) source of the interest payments;

(4) risk assumed by the creditor; and

(5) voting power of the creditor.

3. Pro-Taxpayer Cases. Cases in which various courts have respected the taxpayers' characterization of the transfer of real estate to a controlled corporation as a sale include the following.

a. The Fourth Circuit, in Piedmont Corp. v. Commissioner, 388 F.2d 886 (4th Cir. 1968), addressed whether the assignment to Piedmont Corporation of certain option rights held by its shareholders in exchange for $10,000 cash and $160,000 in unsecured promissory notes constituted a bona fide sale or a contribution of capital. Piedmont Corporation's two shareholders owned a renewable 10-year option to purchase an 11-acre parcel of land. This property was divided into four separate tracts, each with a fixed purchase price under the option. Piedmont acquired the option in three successive transactions, paying for the portion of the option acquired each time by its unsecured promissory notes, exercising the option and then selling lots from the land it acquired to outside purchasers. In reversing the Tax Court, the Fourth Circuit held that the transaction should be characterized as a sale because a fair price was paid for the successive transfers of a portion of the option and for the land and because Piedmont paid the principal and interest on the notes in a timely manner. The Court reached this holding notwithstanding the thin capitalization of Piedmont.

b. In Bradshaw v. United States, 683 F.2d 365 (Cl. Ct. 1982), the taxpayer was an individual who owned 200 acres of real estate in Dalton, Georgia. Realizing the potential value of this property, the taxpayer formed a wholly owned corporation to develop the land. He then transferred a 40-acre tract to his developer corporation in exchange for five promissory notes maturing in successive years. The Court held that the transfer was a sale rather than an equity contribution under Section 351 because the price paid by the developer corporation for the subdivision reflect the actual fair market value and the formalities of the sale were strictly observed.

c. Another case that is tangentially relevant on this issue is Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1992). In addition to concluding that the post-sale dealer activities of a related corporation should not be imputed to the related investment partnership that sold the undeveloped property to the corporation, the Fifth Circuit noted that common ownership (in this case, identical common ownership) was not enough to establish an agency relationship Notwithstanding this aspect of the Court's ruling, the identical ownership

structure in Bramblett would have appeared ripe for an alter ego argument to disregard the transfer between the related parties.

4. Pro-IRS Cases. Two of the more notable cases in which the courts have held in favor of the IRS on the issue of whether the transfer of land to a controlled corporation in exchange for an installment note constituted a deemed capital contribution are Burr Oaks Corp. v. Commissioner, 365 F.2d 24 (7th Cir. 1966) (holding that the transfer of undeveloped land held jointly by three individuals to a corporation in return for two-year promissory notes represented capital contributions and not a sale), and Aqualane Shores, Inc. v. Commissioner, 269 F.2d 116 (5th Cir. 1959) (holding that the transfer of real estate to a thinly capitalized controlled corporation was a capital contribution).

B. Transfer to Related but Not Controlled Corporation. Taxpayers seeking greater certainty with respect to the treatment of a real estate transfer as a sale should consider transferring the property to a related (greater than 50% ownership) but not controlled (at least 80% ownership) corporation.

1. Busted Section 351 Transaction. Section 351(a) provides for the general nonrecognition of gain or loss upon the transfer by one or more persons of property to a corporation solely in exchange for stock or securities in such corporation if, immediately after the exchange, such person or persons are in control of the corporation to which the property was transferred. To be in control of the transferee corporation, such person(s) must own at least 80% of the total combined voting power and at least 80% of the total number of shares. Section 368(c).

a. Greater than 20% Ownership by Unrelated Third Party. The IRS cannot invoke Section 351 to recharacterize a real estate transfer as a nontaxable equity contribution if unrelated third parties own more than 20% of the transferee corporation, because the transferor lacks the required control over the transferee corporation immediately after the transfer.

b. Related Parties and Attribution. The related party and attribution rules apply for purposes of testing whether the transferor controls the transferee corporation. Under Section 267(b), the following persons are considered related for this purpose and thus do not count towards the greater than 20% unrelated owner threshold:

(1) members of the transferor's family (i.e., brothers, sisters, spouse, ancestors and lineal descendants);

(2) a corporation of which more than 50% of the value of its outstanding stock is owned by the transferor;

(3) certain trust relationships; or

(4) corporations and partnerships if the same persons own more than 50% of the corporation's outstanding stock measured by value and more than 50% of the capital or profits interests in the partnership.

2. Avoid Recharacterization Issue. Transferring property to a corporation not controlled by the transferee precludes the applicability of Section 351 and thus should minimize, if not eliminate, the risk that the IRS will recharacterize the transfer as a nontaxable equity contribution.

C. Transfer to Controlled Partnership.

1. Section 707(b)(2) Treats Recognized Gain as Ordinary Income. Pursuant to Section 707(b)(2), gain from the sale of property that is not a capital asset (within the meaning of Section 1221) in the hands of the buyer will be treated as ordinary income if the buyer is a partnership and if the seller owns, directly or indirectly, more than 50% of the capital or profits interests in such partnership.

a. Section 1231 Gain. Generally, gain on the sale or exchange of a Section 1231 asset, which includes real property used in a trade or business and held for more than one year, is treated as capital. Section 707(b)(2), however, recharacterizes Section 1231 gain as ordinary income, because Section 1231 assets are not capital assets, as defined in Section 1221.

b. Indirect Ownership. Section 707(b)(3) invokes the constructive stock ownership rules of Section 267(c) (other than subparagraph (3) thereof) for purposes of determining whether a partnership is controlled. Accordingly, the following attribution rules apply under Section 707(b)(2):

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

(2) An individual is considered to own the stock owned, directly or indirectly, by or for his "family", which Section 267(c) defines as the individual's brothers and sisters (whether by whole or half blood), spouse, ancestors and lineal descendants.

2. Planning Techniques to Avoid Section 707(b)(2) Recharacterization.

a. Sale to Non-Controlled Partnership. Because Section 707(b)(2) only applies if the transferee-partnership is controlled by the seller, selling the property to a non-controlled partnership (i.e., transferor partnership owns 50% or less of transferee partnership) removes the sale from the scope of this provision.

b. Sale to S Corporation. Subchapter S does not have a provision comparable to Section 707(b)(2). Assuming the seller prefers to retain as much control as possible over the real estate post-transfer, this technique is the better of the two because it allows the seller to transfer real estate to a related but not controlled S corporation. See Part V.A above for issues affecting transfers to controlled corporations (at least 80% ownership). Section 1239, which is discussed below, remains a concern for sales of depreciable real property to an S corporation.

D. Section 1239—Sale of Depreciable Real Property. Section 1239(a) treats any gain recognized on the sale or exchange of property between related persons as ordinary income if the property is depreciable in the hands of the related party transferee.

1. Related Persons. Section 1239(b) defines "related persons" to mean:

a. a person and all entities that are "controlled entities" with respect to that person (i.e., generally more than 50% ownership);

b. a taxpayer and any trust in which the taxpayer (or his spouse) is a beneficiary, unless such beneficiary's interest in the trust is a remote contingent interest; and

c. an executor of an estate and a beneficiary of such estate, except in the case of a sale or exchange in satisfaction of a pecuniary request.

2. Available Planning Techniques. Under Section 1239(b)'s definition of "related persons", taxpayers that own appreciated real property that will be depreciable in the hands of the transferee may not only lock-in capital gains treatment on the appreciation realized to date but also retain an interest in the property's upside potential so long as the transferee is not a related person. Thus, a taxpayer may sell such property to a new or existing entity in which the taxpayer holds a non-controlling interest without triggering the recharacterization rule of Section 1239(a).

a. If the owner decides to form a new entity to acquire the property, the following considerations should be taken into account prior to formation:

(1) Choice of Entity – In most situations, in order to protect against potential liability from a myriad of possible problems, the use of a corporation or limited liability company will be preferable. However, due to state tax issues in some states, the better alternative may be to form a limited partnership with a corporation or limited liability company as the general partner. In light of the double taxation inherent in a C corporation, the S corporation will probably be preferable, as long as corporate formalities are followed and it is capitalized with sufficient equity to avoid the risk of a creditor "piercing the corporate veil".

(2) Identify Unrelated Co-Owner – As noted above, to qualify as a genuine unrelated party, the entity must be at least 50% owned by someone else. There are several persons who might desire to fill the role of the controlling owner, yet allow the current owner of the real estate to retain a significant, but non-controlling, interest in the newly formed entity that will purchase the real estate. This arrangement may appeal to a condominium converter or a sales or marketing agent because it allows them to share in the upside potential of the real estate, which may exceed their normal fee for their services.

b. Additional Planning Issues

(1) The unrelated party should pay value for his percentage of ownership. Absent this, the value of the property must be sufficiently extracted on the sale into the corporation or partnership so that there is no concern that too much has been left on the table. Second, it is desirable to limit the unrelated co-owner's share of the profits. Thus, a cap on the

share of profits, or an offset for any fees earned directly, or a buy-sell enabling the unrelated co-owner to be taken out of the corporation or partnership at a later time are all factors to consider, but with a great deal of caution.

(2) Another important issue arises when the sale to the unrelated corporation is made on the installment method, which is often the case because the new entity probably has not obtained sufficient financing to enable it to pay the purchase price in full. When installment sales are at issue, there are a couple of considerations that deserve attention.

(a) If the terms of the obligations are long enough that they are not considered debt, but rather a form of equity, the equity might be deemed a second class of stock. This would disqualify an S corporation if that was the vehicle used to buy the taxpayer's property. If the debt obligations are in the same proportion as the stock as to the face amount and ownership, the obligations are likely to be deemed equity. See, e.g., Gamman v. Comm'r, 46 T.C. 1 (1966); Lewis Building & Supplies, Inc. v. Comm'r, 25 T.C.M. 844 (1966); and Raynor v. Comm'r, 50 T.C. 762 (1968).

(b) Furthermore, assuming the installment debt is treated as debt, if the duration is too long, then the interest on the debt will consume a substantial portion of the profits that might otherwise qualify as capital gains. This could also result in the installment notes not being paid in full on the eventual sell-out of the project, which, in turn, would result in the mismatch of a capital loss from a non-business bad debt to the taxpayer and ordinary income from the discharge of indebtedness at the entity level. Successful conversion requires that the participants have a clear grasp of the numbers and timing.

E. Practice Tips for Preserving Capital Gain. To be in the best position to defend against a potential IRS challenge, the parties should adhere to the following guidelines as closely as possible:

1. Capitalize the developer corporation with more than just a *de minimis* amount of cash or other assets.

2. The terms of the sale (e.g., the purchase price and any financing terms) should be set on a strictly arms'-length basis and the purchase price should be documented with an appraisal.

3. The purchase price should not be contingent on the developer corporation's receipt of proceeds from its sales of lots.

4. The terms of the sale should be set such that the developer corporation has a realistic opportunity to realize a profit upon its sales of lots.

5. Although the courts have approved sales in which the sellers financed the full purchase price and accepted unsecured notes from the purchasing corporations, the more prudent course is to require the developer corporation to (a) make a cash down payment at closing and (b) provide adequate security for the purchase money debt.

6. The payment schedule under the installment note can be tied to the developer corporation's receipt of proceeds from its sales of lots by virtue of release clauses. (To qualify for the installment method of reporting, the note must provide that at least one payment is to be received after the close of the taxable year of the sale.) The note should require the developer corporation to repay the note even if, for whatever reason, it cannot sell some or all of the lots.

7. All formalities of the sale should be respected by the parties. For example, the parties should record a deed of trust, or file a UCC financing statement, to secure the purchase money debt.

8. The developer corporation should not pre-sell any of the property prior to its purchase of the undeveloped land from the investment partnership.

9. The developer corporation should consistently fulfill its payment obligations under the note; if it does not do so, the investment partnership should pursue legal remedies.

10. Notwithstanding any common ownership between the investment partnership and the development corporation, the separate entities should be respected in all of their activities (e.g., separate books and records and bank accounts should be maintained).

11. To the extent the related entities have any business dealings between themselves, in addition to the property transfer, they should conduct the transactions on arms'-length terms.

12. The investment partnership should refrain from constructing infrastructure and otherwise physically improving the property before conveying the transfer to the developer corporation. Along these lines, the developer corporation (rather than the investment partnership) should record the plat.

13. The owners of the investment partnership should alter the ownership of the developer corporation so that its ownership structure is not identical to that of the investment partnership. (For example, one or more new owners might be admitted into the investment partnership or the developer corporation.) Although several cases have approved a capital gain result on a sale between two mirror entities, litigating risks can be improved by introducing variations between the ownership of these related entities. See Part V.A.3 above discussing pro-taxpayer cases involving transfers to controlled corporations.

14. In certain situations, it may be preferable for the investment partnership to acquire the target investment property through a single-member LLC and sell interests in that entity to the developer corporation in order to avoid transfer and recordation taxes.

15. Finally, the investors should form a new LLC (or partnership) for each new development project, rather than using the same entity for multiple transactions.

VI. INSTALLMENT SALES WITH RELATED ENTITIES

A. Second Disposition by Related Person.

1. General Rule. If any person disposes of property to a related person (the "first disposition"), and if before the person making the first disposition has received all payments with respect to that disposition, the related person disposes of the property (the "second disposition") less than 2 years after the first disposition, the amount realized with respect to the second disposition will be treated as received at the time of the second disposition by the person who made the first disposition. Section 453(e)(1).

a. The 2-year cutoff does not apply in the case of marketable securities. Section 453(e)(2).

b. The running of the 2-year period is suspended for any period during which the related person's risk of loss with respect to the property is substantially diminished by (i) the holding of a put with respect to the property, (ii) the holding by another person of a right to acquire the property, or (iii) a short sale or any other transaction. Section 453(e)(2).

2. Amount Realized Limitation. The amount treated as received by the person that made the first disposition shall not exceed the excess of (a) the lesser of the total amount realized with respect to any second disposition or the total contract price for the first disposition, over (b) the sum of the aggregate amount of payments received with respect to the first disposition, plus the aggregate amount treated as received with respect to the first disposition for prior taxable years. Section 453(e)(3).

3. Later Payments. Section 453(e)(5) provides that payments received in taxable years subsequent to the two-year period by the person that made the first disposition will not be treated as the receipt of payments with respect to the first disposition to the extent that the aggregate of such payments does not exceed the amount treated as received under the general rule.

B. Sale of Depreciable Property to Controlled Entity.

1. General Rule. Section 453(g)(1) provides that the installment sale method is not available for an installment sale of depreciable property between related persons. Thus, all payments to be received under the installment note are deemed received in the year of disposition. For purposes of Section 453(g), the term "related persons" has the same meaning as in Section 1239(b), except that such term here also shall include 2 or more partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interests. Section 453(g)(3).

2. Contingent Payments. In the case of contingent payments that are contingent as to the amount but with respect to which the fair market value may not be reasonably ascertained, the basis may be recovered ratably. Section 453(g)(1)(B)(ii).

3. Purchaser's Basis in Acquired Property. The purchaser may not increase the basis of any property acquired before the seller includes such amount in gross income. Section 453(g)(1)(C).

C. Disguised Purchases. A lease payment that is really consideration for the purchase of property is not deductible. See Section 162(a)(3), which provides that a taxpayer may deduct as a trade or business expense "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity." See also Oesterreich v. Comm'r, 226 F.2d 798 (9th Cir. 1955); Minneapolis Security Bldg. Corp. v. Comm'r, 38 B.T.A. 1220 (1938); Home News Pub. Co. v. Comm'r, 38 T.C.M 834 (1969); and Priv. Ltr. Rul. 9026033 (Mar. 28, 1990). In determining whether a transaction is in fact a sale or a lease, several factors must be examined at the initiation of the transaction rather than retroactively.

1. Rent Significantly Exceeds Fair Rental Value. When the rent under the lease significantly exceeds the fair rental value of the property, the lease may be recharacterized as a sale. See, e.g., Haggard v. Comm'r, 241 F.2d 288 (7th Cir. 1956). Courts have generally examined the overall reasonableness of the rent based on the fair market value of the property.

2. Option to Purchase the Property During the Lease.

a. If there is an option to purchase the property at some time during the lease term with some part (or even all) of the lease payments, the transaction will more likely resemble an installment sale than a lease. For example, in Bowen v. Commissioner, 12 T.C. 446 (1949), the Court held the transaction was a sale where title to the property would be transferred to the tenant when monthly rental payments equaled the stated value plus one percent, or, if payments had not equaled the stated value plus one percent at the time of expiration of the lease, the tenant would nonetheless have the option to purchase the property at that time. But in Smith v. Commissioner, 51 T.C. 429 (1968), the Court ruled that the fact that there was an option to purchase would not, in and of itself, be considered as conclusively indicating a sale. It is clear, however, that no rent deduction will be allowed if, without further act or consideration, the tenant acquires title to the property after a certain number of lease payments. See Chicago Stoker Corp. v. Comm'r, 14 T.C. 441 (1950); and St. John v. Comm'r, 29 T.C.M. 621 (1970).

b. It should also be recognized that transactions involving certain purported option arrangements may be subject to recharacterization as lease arrangements. The determining factor in the cases addressing this issue is the level of control over and right of access to the "optioned" property which is granted to the purported optionee prior to the exercise of the option. See Howlett v. Comm'r, 56 T.C. 951 (1971); and Priv. Ltr. Rul. 9129002 (Mar. 26, 1991) (citing Virginia Iron Coal & Coke Co. v. Comm'r, 99 F.2d 919 (4th Cir. 1938)).

3. Part of Lease Payment Designated as Interest.

a. If any part of the lease payments is either designated as interest or easily seen as such, recharacterization of the lease as a sale is likely.

b. For example, in Judson Mills v. Commissioner, 11 T.C. 25 (1948), the Court held that the monthly amounts paid were not deductible as rent because the taxpayer thereby acquired an equity interest in the machinery. The Court also held that a portion of the monthly payments equal to the factor designated as interest in the letters explaining the terms of the agreement was deductible as interest. The taxpayer, a textile producer, acquired new mill machinery through lease payments to the machinery manufacturers and could then acquire title to the machinery by payment of a relatively small additional amount. As set forth in the correspondence, the amounts payable in monthly installments were computed to include 5% or 6% interest on the principal; interest tables were attached to the manufacturer's explanatory letters.

4. Significant Tenant Improvements. A sale rather than a lease will likely be found where the tenant makes significant improvements to the property that either are not recoverable through depreciation or amortization deductions (such as land improvements) or can only be protected through the exercise of an option. See, e.g., M&W Gear Co. v. Comm'r, 446 F.2d 841 (7th Cir. 1971); and Oesterreich v. Comm'r, 226 F.2d 798 (9th Cir. 1955).