by Thomas O. Wells and Franklin H. Caplan

Achieving Capital Gains Treatment on Predevelopment Real Property Appreciation

Considering the dramatic appreciation in real estate values and strong residential markets fueled by consumer demand and inexpensive financing, many property owners are undertaking their own development — often condominium or other multi-unit projects — rather than selling the underlying real estate to a third party developer. Unit sales result in ordinary income to the developer, and profitability can be affected substantially where, as is often the case, the underlying real estate has appreciated prior to development. With planning, appreciated land values may be subjected to the favorable capital gains tax rate instead of the higher ordinary income rates. Several common scenarios highlight this opportunity. For example, developers may wish to hold back some units from the initial sales and marketing effort for leasing and investment purposes and to obtain capital gains treatment upon ultimate sale. In addition, to avoid subjecting pre-development appreciation to ordinary income tax rates, some owners have implemented a "capital gains bailout" strategy, by selling the pre-development property (that is, before development entitlements are procured) to an entity controlled by the owner which in turn develops the property and sells the units.

This article reviews basic income taxation principles for real estate investors and developers, explains the mechanics of a "capital gains bailout" transaction for pre-development and post-development planning purposes, and highlights the income tax benefits derived from such a transaction.

General Property Tax Principles

The gain upon sale of a capital asset held for more than 12 months, other than by a "C" corporation, is subject to the 15 percent federal long-term capital gains tax rate. However, a "capital asset" in this context excludes property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.[1] In a typical real estate development scenario, developer-owned lots or units intended for sale to consumers would not be deemed capital assets, and the gain realized when they are sold, therefore, would be subject to the higher 35 percent ordinary income tax rates. Profit margins may be affected significantly by the material difference between the federal income tax rate of 35 percent and the federal long-term capital gains tax rate of 15 percent.

Dealer Versus Holder of Capital Asset

Whether developer-owned real estate may be considered a capital asset depends on a fact-oriented analysis of the taxpayer's purpose in holding the property. Courts have focused on a number of factors to distinguish a capital asset from property held for sale to customers. For example, in *U.S. v. Winthrop*, 417 F.2d 905 (5th Cir. 1969), the Fifth Circuit cited the following seven factors as critical to the analysis of whether real estate qualifies as a capital asset in the hands of a taxpayer:

(1) the nature and purpose of the acquisition of the property and the duration of ownership;
(2) the extent and nature of sales efforts;
(3) the number, extent, continuity and substantiality of sales;
(4) the extent of subdividing, developing and advertising to increase sales;
(5) the use of a business office for sales;
(6) the taxpayer's control over sales representatives; and
(7) the amount of time and effort habitually devoted to selling.

No one factor is determinative and there is no bright-line test.[2] The likelihood that a taxpayer would be deemed a dealer (as opposed to holder of a capital asset) increases as the number and regularity of the taxpayer's sales increase, and as the taxpayer intensifies sales and marketing efforts by such things as improving the property or soliciting buyers.[3]

Treasury Regulation §1.1402(a)-(4)(a) defines a real estate dealer (subject as such to ordinary income tax rates) as follows:

> In general, an individual who is engaged in the business of selling real estate to customers with a view to the gains and profits that may be derived from such sales is a real-estate dealer. On the other hand, an individual who merely holds real estate for investment or speculation and receives rentals therefrom is not considered a real-estate dealer.

Capital Assets Subject to Ordinary Income Treatment

Assuming a taxpayer has satisfied the "capital asset" test for capital gains treatment, certain provisions in the Internal Revenue Code nevertheless potentially convert capital gains into ordinary income, when the taxpayer sells a capital asset to a related party. However, these code sections apply to a limited universe of transactions. For example, IRC §707(b)(2) imposes ordinary income treatment on gain from a sale of a capital asset between commonly controlled partnerships (defined as partnerships in which the same per-

sons own, directly or indirectly, more than 50 percent of the profits or capital interests in both partnerships), when the asset is not a capital asset in the hands of the purchasing partnership. The same result occurs under the same code section on a sale by a more-than-50 percent partner (again, based on either profits or capital interest) to his or her partnership, where the transferred asset is not a capital asset in the hands of the transferee. Code §1239 similarly applies to related-party sales of depreciable property.

There are limitations to these code provisions and the resulting conversion of capital gains into ordinary income. For example, the conversion effect under Code §707(b)(2) can be avoided if the property is conveyed, prior to development, by the investment partnership/owner to a development Subchapter S corporation controlled by the investmeut partnership. Also, application of Code §1239 can be avoided when the real estate is not subject to depreciation during the investment period prior to pre-development activity.

Are Transferor's or Investor's Dealer Characteristics Attributable to Transferee Owner?

One question that often arises is whether the real estate dealer characteristics of an equity owuer in the taxpayer entity are attributed to the taxpayer. The general rule is that such individual characteristics are *not* attributed to the eutity taxpayer. However, the IRS has successfully imputed a joint venture between the development entity transferee and the original owner/trausferor entity that retains ownership in the development entity.[4] Further, the Tax Court has held that real property sold by an independent broker was not a capital asset of the taxpayer, despite the taxpayer's claim that the conveyed property was dissimilar to the type of property that he normally developed, and that he held the conveyed property for a long time without a comprehensive development plan.[5] The Tax Court found the followiug factors importaut in determining that the taxpayer's gain was ordinary income: 1) The taxpayer was in the trade or business of selling real estate; 2) the taxpayer listed the property in inventory; and 3) the taxpayer capitalized development costs associated with the property.

The so-called "bail-out" transactions described here may, with proper structure, allow an owner to dispose of appreciating property so as to effect a distinction between itself as holder of a capital asset, and a development affiliate as a "dealer," thereby affording capital gains treatment to the owner.

The Pre-development Capital Gains "Bailout" Transaction

The leading case allowing capital gains treatment on a related-party sale is *Bramblett v. Comr.*, 960 F.2d 526 (5th Cir. 1992), *rev'g,* 59 T.C.M. 876 (1990). Iu *Bramblett*, four individuals owned all of the interests in a partnership that held several parcels of land. To develop the land, the same four individuals formed a corporation in which they owned identical percentage interests. They then caused the partnership to sell the land, within several years of its acquisition, to the development corporation. The purchase price paid by the corporation/buyer was based upon a current appraisal of the land, and the partnership/seller provided 100 percent purchase money fiuancing. Although the purchase money uote reflected a market rate of interest, it appears that the corporation/buyer never paid interest. Ultimately, the corporation/buyer developed and sold the real estate to third parties. The corporation/buyer repaid its note to the partnership/seller hy application of proceeds of the third party sales.

The IRS took the position that the activities of the development corporation/buyer should be attributed to the real estate investment partnership/seller. The Tax Court agreed with the IRS, because: 1) The partnership and corporation were formed within months of each other and were owned by the same individuals in exactly the same percentages; 2) the corporation had a history of buying property from the partnership and, in fact, presold portious of the property before acquisitions from the partnership were completed; and 3) the sale to the corporation/buyer was 100 percent financed by the partnership/seller, and the corporation failed to make the required interest payments due under the uote, and in fact did not make any principal payments until it resold the land.

On appeal by the taxpayer, the Fifth Circuit reversed the Tax Court and held that the partnership/seller

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was entitled to report its gain on sales as capital gains because the corporation/buyer was not an agent of the partnership/seller. The Fifth Circuit held that, by itself, common ownership is not sufficient to make a development corporation the agent of an affiliated seller. Furthermore, the Fifth Circuit was unwilling to impute the corporation's "dealer" business activities to the partnership by applying the "substance over form" doctrine. In the course of its opinion, the Fifth Circuit also applied the "clearly erroneous" standard and reversed the Tax Court's factual finding that the partnership was engaged in a trade or business of selling land.

The critical factors to the Fifth Circuit in *Bramblett* were: 1) There was a boua fide sale between the partnership and the corporation in which basic legal formalities were respected; 2) the sales price for the property represented its fair market value at the time of the sale; and 3) there was an independent business purpose behind the formation and use of the corporation and the conveyance from the partnership to the corporation, in order to limit the liability of the seller's partners in connection with the development of the land.

The Tax Court followed the Fifth Circuit's *Bramblett* decision in *Phelan v. Comr.*, T.C. Memo 2004-206. In *Phelan*, the Tax Court held that an LLC realized a capital gain on its sale of a portion of its land to a related corporation, notwithstanding the fact that three individuals owned identical percentage interests in both the buying and selling entities. The Tax Court found that the owners of the LLC had a legitimate business purpose for organizing the corporation (*i.e.*, protecting the balance of the LLC's land from the development risks related to the parcel sold to the corporation), and that the owners adhered to all corporate formalities with respect to the purchaser. Citing *Bramblett*, the Tax Court concluded that the purchaser should be respected as a taxpayer separate from the seller, and that the purchaser's development activities (resulting in ordinary income tax treatment) could not be attributed to the seller.

Although the statement of facts in *Phelan* does not describe the terms of the related party sale in detail, it appears that the buying corporation may have paid all cash for the property. In drawing lessons from *Phelan* and *Bramblett,* payment of cash at closing, while not always feasible or desirable from the perspective of affiliated sellers and buyers, of course, would obviate the concern manifested in *Bramblett* over the affiliated seller's financing and the seller's failure to enforce payment.

Postdevelopment Capital Gains Bailout Transaction

The concepts discussed above relative to a pre-development capital gains bailout transaction also apply to a development entity's sale of improved property to a related leasing or investment entity after project completion. In this context, the IRS will argue that the "dealer" activities of the development entity should be attributable to the related-party investment entity, and that the investment entity is an alter ego of the development entity. However, *Bramblett* and *Phelan* support the proposition that a leasing or investment entity related to a developer, that acquires improved property from the developer, may obtain capital gains treatment for appreciation accruing after acquisition upon resale of the acquired property. In other words, the lesson in sum is that a developer may create a separate investment entity to purchase, lease, and/or invest in the improved property that otherwise would be offered for sale by the developer. In this way, post-acquisition appreciation will be subject to the capital gains tax rate instead of the ordinary income rate at the time of resale by the investment entity.

Structuring Bailout Transaction

Tax planning along the lines suggested by *Bramblett* and *Phelan* will enhance the possibility that gains on the sale of pre-development and post-development real estate will be subject to capital gains treatment. In either case, the organizational and operating documents of the acquiring entity should be reviewed with care. With respect to pre-development transfers, any references in the investment entity documents to developing, listing, marketing, or selling real property should be eliminated.[6] The investment entity should not undertake any marketing or development activities.[7] The investment entity should attempt to sell all or substantially all of its property in one transaction.[8] Care should be taken to avoid any arrangement or agreement affecting the investment entity that would indicate an intent on the part of the development entity to sell the property to a customer.[9] The investment entity should be organized well in advance of the formation of the development entity.

As to the sale and purchase transaction between the investment entity and the development entity, the sale terms (*e.g.,* the purchase price and any financing terms) should be strictly on an arm's-length basis, and the purchase price should be documented as being supported by an appraisal.[10] Although *Bramblett* provides judicial support for a developer providing 100 percent unsecured financing in favor of the investment entity, the more prudent course is to require the investment entity to make a cash payment at closing and to secure the purchase money debt with a mortgage on the purchased property. The parties should comply with customary formalities consistent with an arm's-length purchase and sale transaction (*e.g.*, cost prorations and payment of applicable documentary stamp taxes, and recordation of a deed and mortgage).

The purchasing entity should not pre-sell any portions of the real estate before its acquisition. There should be no contingent sales price based on resale proceeds, since such arrangements may be characterized as a joint venture between the development and investment entities. The purchasing entity should make every effort to pay the purchase money debt on a current basis. It should be capitalized and have a reasonable net worth in order to demonstrate a realistic prospect of repaying any ap-

plicable purchase money financing. The entities should be maintained separately, with proper observance of their independent formalities (*e.g.*, maintenance of separate books, records, and bank accounts). The owners of the selling entity should consider altering the ownership of the purchasing entity so that the ownership structures of the two entities are not identical. Finally, the purchasing entity should be an S corporation if the selling entity is a partnership to avoid the application of IRC §707(b)(2).

Summary

There are complexities as noted in planning and structuring a pre-development or post-development real estate "bail-out" transaction, and the case law is sparse and not well-settled. However, the potential benefit to a taxpayer deriving from capital gains rather than ordinary income treatment is significant. Based on the *Bramblett* and *Phelan* cases, taxpayers might well consider using a related-party grantee to facilitate such planning. ☐

[1] I.R.C. §1221(a)(1), as amended.

[2] In fact, this area of the law is quite inconclusive. *See Winthrop*, 417 F.2d at 906 (The law in this area is "engulfed in a fog of decisions with gossamer-like distinctions, and a quagmire of unworkable, unreliable, and often irrelevant tests.").

[3] In *Biedenharn Realty Co., Inc. v. U.S.*, 526 F.2d 409 (5th Cir. 1976), *cert. denied*, 429 U.S. 819 (1976), the Fifth Circuit announced that the frequency of sales was one of the two most important of the judicially created criteria (the other being the size of sales) suggesting that in extreme cases, this factor alone might suffice to exclude the property from capital asset status. In fact, the court reached just that result in a later decision. In *Suburban Realty Co. v. U.S.*, 615 F.2d 171 (5th Cir. 1980), *cert. denied*, 449 U.S. 920 (1980), the corporation received property from its shareholders who acquired the property in a foreclosure proceeding. The corporation made over 240 individual sales of real estate out of the acquired property over a 33-year period. In each of these years, at least one sale was consummated, and in most years, at least four sales were made. The corporation engaged in no development or subdivision activity with respect to approximately two-thirds of the property, engaged in no solicitation or advertising efforts, and had no brokerage activities. In determining the character of the gain on the individual sales of the properties, the court focused its inquiry on whether the taxpayer had engaged in a sufficient amount of activity to be considered to be in a trade or business. Since the activity was found to be substantial and continuous, the court denied capital gains treatment notwithstanding the absence of other indicia of a trade or business.

[4] *Van Sickle v. Comr.*, T.C. Memo 1988-115, *aff'd without published opin.*, 875 F.2d 319 (9th Cir. 1989) (Joint venture comprised of real estate dealer and entity holding land for the first time was judged according to the intent of the joint venture entity at the time the property was held for sale to customers in the ordinary course.) *See also Pointer v. Comr.*, 419 F.2d 213 (9th Cir. 1969) (activities of agent imputed to taxpayer); *Tibbals v. U.S.*, 362 F.2d 266 (Ct. Cl. 1966) (The court held that a shareholder with extensive real estate development experience and the development corporation that had purchased the property were in a constructive joint venture with the investment corporation disallowing capital gain treatment to the investment corporation on its sale to the development corporation.); *Boyer v. Comr.*, 58 T.C. 316 (1972) (The Tax Court held that the purchasing development corporation acted as an agent or alter ego of its shareholders when it subsequently subdivided and resold the property; the court was also troubled by the fact that the purported purchase price for the property was inflated in an attempt to overstate the taxpayer's capital gain and reduce the subsequent ordinary income that would be realized by the development corporation on the resales.); TAM 8415002 (the activities of brokers were imputed to the taxpayer who was an investor in a condominium conversion project even though the taxpayer was a passive investor in the project).

[5] In *Walsh v. Comr.*, T.C. Memo 1994-293, *aff'd in an unpublished opin.*, 95-2 USTC ¶50,398 (8th Cir. 1995).

[6] *See Hansche v. Comr.*, 457 F.2d 429 (7th Cir. 1972) (partnership agreement listed real estate business as one of its activities).

[7] If a taxpayer develops real property by subdividing, grading, rezoning, or installing roads and utilities, he or she may be deemed a dealer by reason of these activities. *See Bush v. Comr.*, 610 F.2d 426 (6th Cir. 1979); *Harder v. Comr.*, T.C. Memo 1990-371; *Gates v. Comr.*, 52 T.C. 898 (1969); *Bynum v. Comr.*, 46 T.C. 295 (1966). *See also Pointer v. Comr.*, 419 F.2d 213.

[8] Under the single sale or "one-bite" theory, a taxpayer is not deemed to be in a trade or business if he makes only one sale. *See Reese v. Comr.*, 615 F.2d 226, 230-31 (5th Cir. 1980) (While there may perhaps be extraordinary circumstances in which a taxpayer's devotion of time and resources to a nonrecurring venture constitutes a trade or business, a single transaction ordinarily will not constitute a trade or business when the taxpayer enters into the transaction with no expectation of continuing in the field of endeavor.) *See also Mitchell v. Comr.*, 47 T.C. 120 (1966), *nonacq. on another issue*, 1970-2 C.B. XXII (purchase and sale of a single piece of real estate); *Ronhorde v. Comr.*, T.C. Memo 1967-243 (purchase and sale of undeveloped farmland); *Winding River Ranch, Inc. v. Comr.*, T.C. Memo 1966-260 (portion of riding ranch and restaurant sold to developer).

[9] The single sale theory, however, has been eroded, at least in the case where a sale of the asset is legally or economically predestined to occur. In *S & H, Inc. v. Comr.*, 78 T.C. 234 (1982), a taxpayer who was in the business of acquiring improved real estate for lease or use in the taxpayer's own business agreed to construct a warehouse for a purchaser to the purchaser's specifications, pursuant to a binding purchase agreement. The Tax Court stated that a single venture involving a single sale may still constitute a trade or business if there is a pre-existing arrangement to sell the property. *S & H, Inc.*, found that the taxpayer built the property with the specific intent to transfer it to a specific party who was committed to acquire the property on its completion. Thus, the sale was the sale of real estate constituting an asset held for sale to a customer in the ordinary course of business. *See also Morley v. Comr.*, 87 T.C. 1206 (1986) (The taxpayer purchased a parcel of real estate with the intention of promptly reselling it; the taxpayer found a prospective buyer before he actually purchased the property, but because of a sudden decline in real estate values, negotiations broke off and the taxpayer could not find another buyer for the property; and the Tax Court held that the taxpayer's original intent to purchase for resale indicated that he was a "dealer," even though economic conditions frustrated that intent.); and *Nielsen v. U.S.*, 333 F.2d 615 (6th Cir. 1964) (ordinary income realized by taxpayers who sold a single piece of property to a single customer pursuant to a prearranged plan).

[10] *See Bradshaw v. U.S.*, 683 F.2d 365 (Ct. Cl. 1982).

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