College of William & Mary Law School
William & Mary Law School Scholarship Repository

William & Mary Annual Tax Conference | Conferences, Events, and Lectures

2008

Capturing Capital Gain While Staying in the Deal

Thomas P. Rohman

Todd D. Golub

Repository Citation
Rohman, Thomas P. and Golub, Todd D., "Capturing Capital Gain While Staying in the Deal" (2008). *William & Mary Annual Tax Conference*. 45.
https://scholarship.law.wm.edu/tax/45

Copyright c 2008 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.
https://scholarship.law.wm.edu/tax

CAPTURING CAPITAL GAIN WHILE STAYING IN THE DEAL

November 13, 2008

Thomas P. Rohman
trohman@mcguirewoods.com
McGuireWoods LLP
901 E. Cary Street
Richmond, VA 23219
(804) 775-1032

Todd D. Golub
todd.d.golub@bakernet.com
Baker & McKenzie LLP
130 E. Randolph Drive
One Prudential Plaza
Chicago, IL 60601
(312) 861-6595

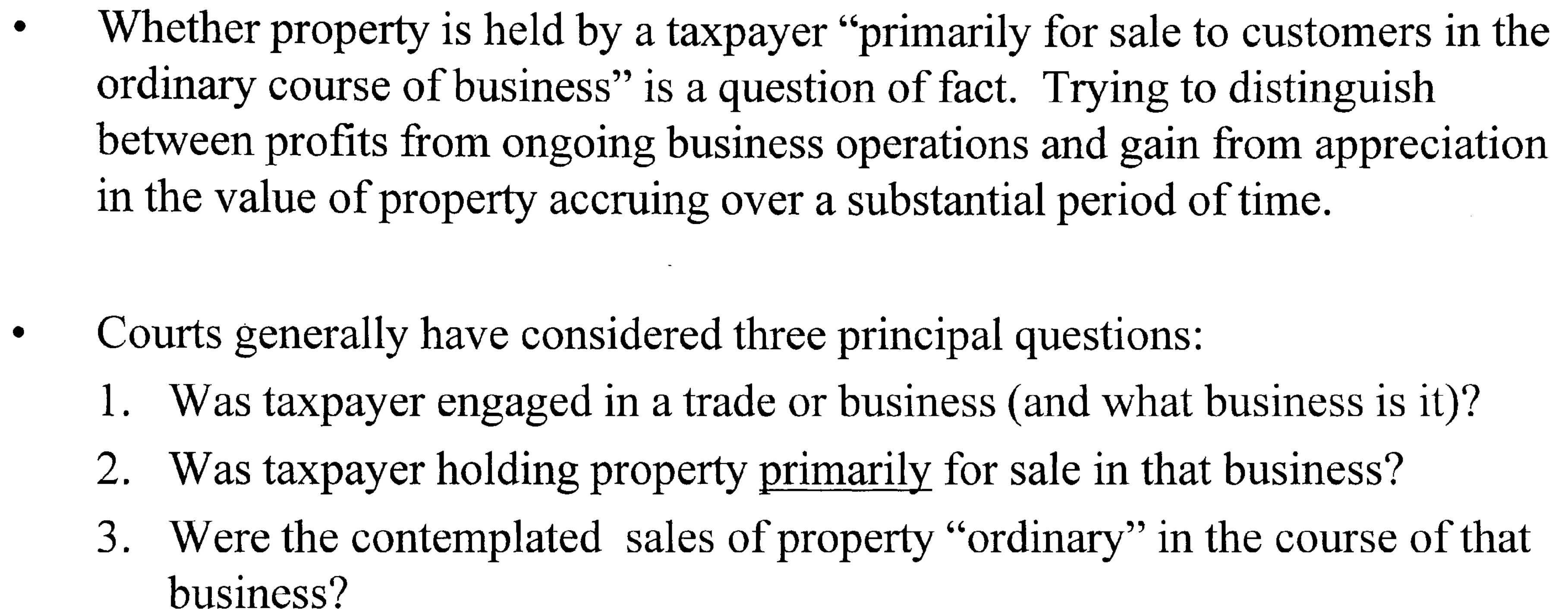
THIS PAGE INTENTIONALLY LEFT BLANK

Federal Income Tax Rates For Individuals

- Tax Reform Act of 1986 eliminated the income tax rate differential between capital gain and ordinary income. Both capital gain and ordinary income were subject to top rate of 28 percent.
- Since then the top individual tax rate on ordinary income has climbed as high as 39.6 percent and the top individual tax rate on long-term capital gain has dropped as low as 15 percent.
- The Jobs and Growth Tax Relief Reconciliation Act of 2003 set the maximum individual income tax rate on ordinary income at 35 percent and the maximum individual income tax rate on long-term capital gain at 15 percent (i.e. a 20 percent point differential).
- The 20 percentage point differential creates incentive for individual taxpayers to convert potential ordinary income into long-term capital gain (as well as incentive for the IRS to characterize income or gain as ordinary).

Real Estate: Is it Dealer Property or Capital Gain Property?

- To qualify for long-term capital gain treatment (and the exalted 15 percent individual income tax rate) the taxpayer must satisfy certain requirements. There must be:
  - A. Gain
  - B. From the sale or exchange
  - C. Of a capital asset
  - D. Capital asset must be held for more than one year
  - E. No statute, regulation, or case law that would convert capital gain to ordinary income (e.g., related party sale).
- Capital asset means property held by the taxpayer (whether or not connected with taxpayer's trade or business), but does not include:
  - A. Property held by the taxpayer primarily for sale to customers in the ordinary course of taxpayer's trade or business ("Dealer Property")
  - B. Real property used in trade or business

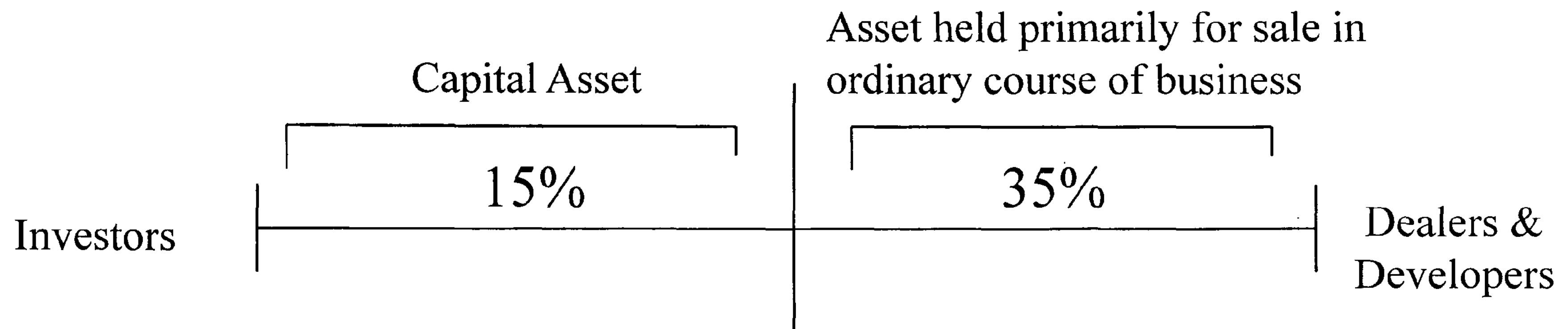


- Whether property is held by a taxpayer "primarily for sale to customers in the ordinary course of business" is a question of fact. Trying to distinguish between profits from ongoing business operations and gain from appreciation in the value of property accruing over a substantial period of time.

- Courts generally have considered three principal questions:
  1. Was taxpayer engaged in a trade or business (and what business is it)?
  2. Was taxpayer holding property <u>primarily</u> for sale in that business?
  3. Were the contemplated sales of property "ordinary" in the course of that business?

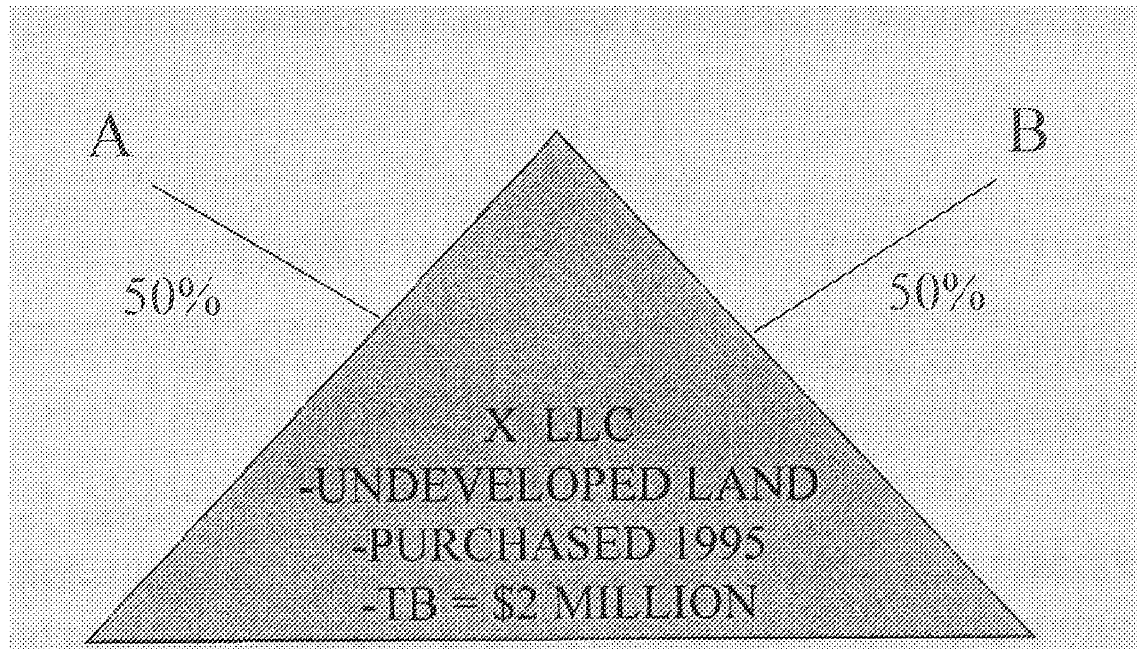
- The analysis is imprecise at best because taxpayers generally hold property for more than one purpose. In *Malat v. Riddell* (383 U.S. 569 (1966)), the U.S. Supreme Court held that where business and investment motives coexist, the principal motivation controls. In determining the principal motivation in holding property, the IRS and the courts have considered the following factors:
  - The nature and purpose of the acquisition of the property
  - The duration of the ownership of the property
  - The nature and extent of the taxpayer's efforts to sell the property
  - The number, extent, continuity, and substantiality of the sales
  - The extent of the subdividing, developing, and advertising to increase sales
  - The use of a business office for the sale of the property
  - The character and degree of supervision or control exercised by the taxpayer over any representative selling the property
  - The time and effort habitually devoted to the sale
  - Substantiality of income derived from sales, including the proportion of sales income to taxpayer's total income

- Resolution of these factors moves a taxpayer along the continuum between absolute investors on one extreme to absolute dealers/developers on the opposite extreme.



- Bottom line: list of factors is not exhaustive; very, very difficult to discern any "bright lines" or absolute rules from the hundreds of decided cases.
- "Taxpayers should not attempt to use any case or precedent or distinguish any case based on its individual circumstances. The unique particulars must be developed independently so as to present the strongest case for capital asset status using the factors listed above." Tax Plg. Real Est. Trans §25:03 (Thomson-West).

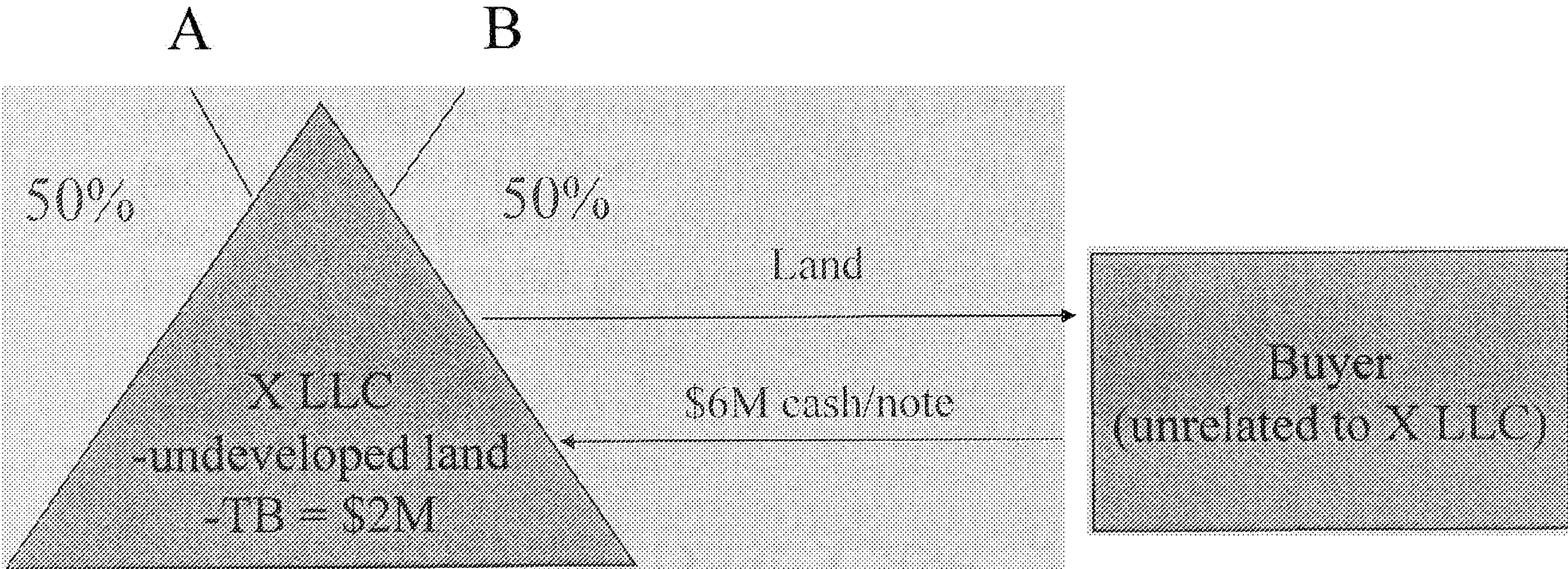
Base Case



Base Case

- Assumptions:
  - X LLC acquired the property solely for investment in 1995. Since 1995, X LLC has not engaged in any activity that would suggest that its original purpose for acquiring the property has changed (i.e., no efforts to sell the property by, for example, solicitation or engaging sales personnel or brokers; no use of a business office; no sale of any parcels; no improvements or development activity to increase value of property.) In 2008 the undeveloped parcel has a value of $6M in its undeveloped state.
  - The parcel is developable. X LLC has been advised that it could subdivide the parcel into 100 residential lots.
  - The cost of developing the parcels (including roads, utilities, subdividing; engineering; legal) would be $6M.
  - Construction costs would be $10M.
  - The 100 developed and improved lots including would sell for $300,000 each ($30M total).
- What options are available to X LLC?

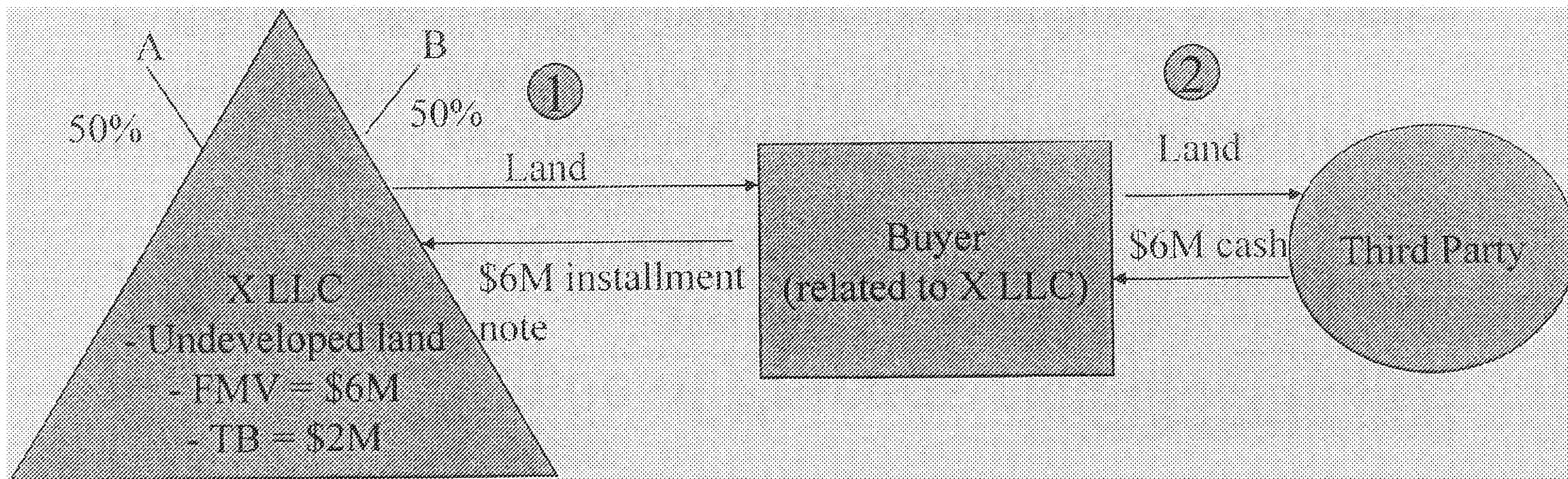
Option One: Sale of Property (Undeveloped)



Option One: Sale of Property (Undeveloped)

- Undeveloped land is a capital asset in hands of X LLC and its holding period exceeds 12 months.
- X LLC's $4M recognized gain is long-term capital gain; $600,000 federal income tax (15%) for A & B collectively.
- If X LLC takes back $6M installment note from Buyer, X LLC entitled to report its $4M gain on installment method (IRC §453).
- Consider IRC §453A (interest charge payable to IRS on the tax on the gain from the portion of the installment note in excess of $5M ($5M threshold apparently applied at partner level)).

Variation of Option One: Installment Sale of Property (Undeveloped) to "Related Party"



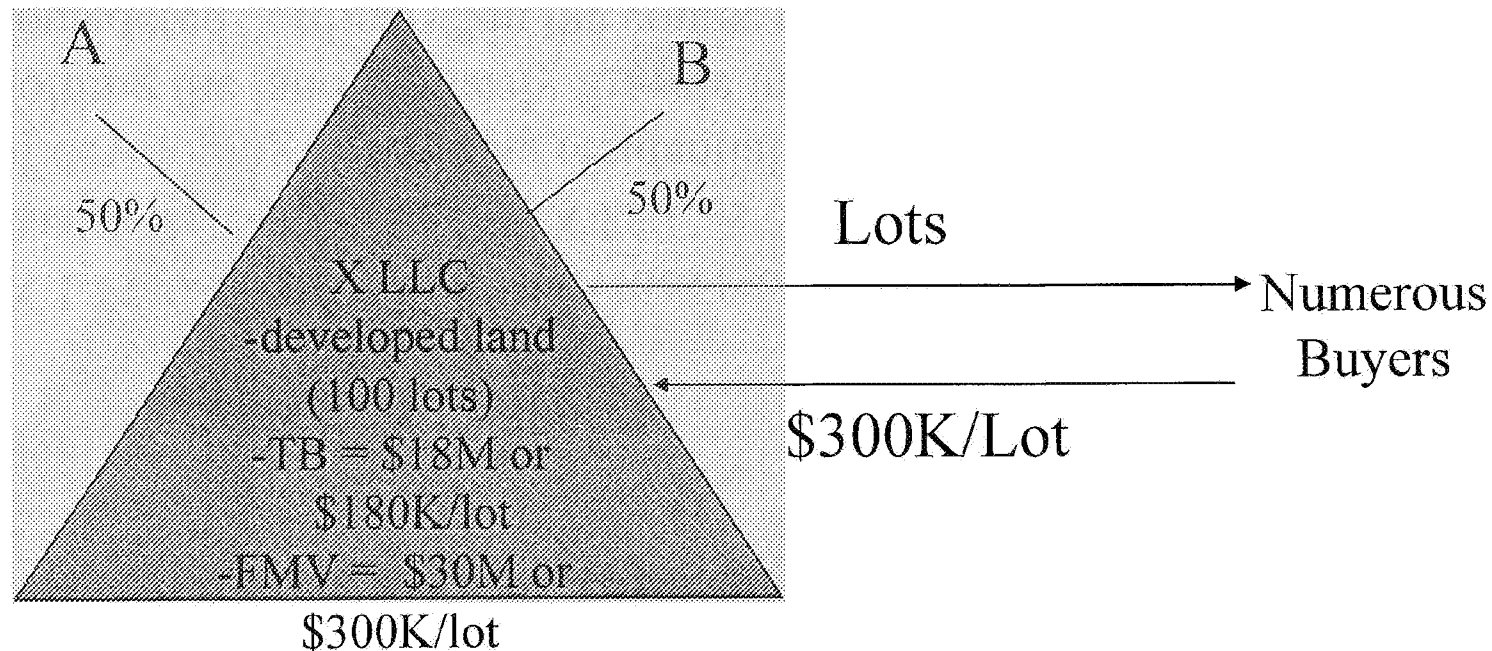
Installment Sale of Property (Undeveloped) to "Related Party"

- On sale ① X LLC entitled to report its $4M LTCG on installment method even though Buyer is "related" to X LLC. IRC §453 permits installment reporting of gain on the sale of nondepreciable real property to a related party if the real property sold is a capital asset. (IRC § 453(a), (b)(2), (e)). If real property is instead depreciable, the sale to a "related party" is generally not eligible for installment reporting (IRC § 453(g) (1)(A)) unless tax avoidance is not a principal purpose (IRC § 453(g)(2)). Related parties defined in IRC § 453(g)(3) (IRC§§1239(b) and 707(b)(1)(B)).

Installment Sale of Property (Undeveloped) to "Related Party"

- If sale ② occurs within two years of sale ①, however, and X LLC has not yet received all of the principal payments under the $6M note from Buyer, X LLC's deferred $4M LTCG would be accelerated and recognized by X LLC in the year of sale ② (IRC §453(e)) unless tax avoidance is not a principal purpose (IRC §453(e)(7)).

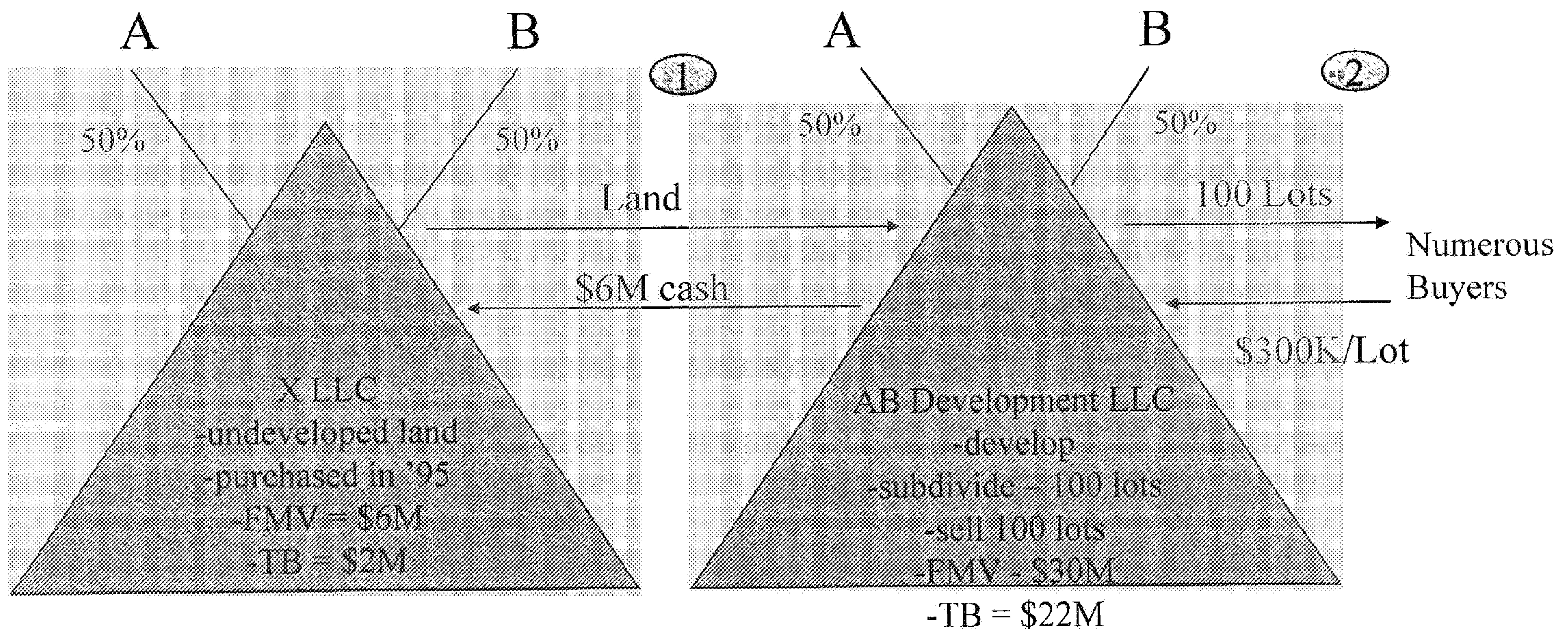
Option Two: Develop Property and Sell ($800K Tax Cost)



Option Two: Develop Property and Sell ($800K Tax Cost)

- X LLC's development activities (subdivision, etc.) and sales of the lots causes the following: (i) X LLC is considered to be in the trade or business of developing and selling residential lots; (ii) X LLC is now considered to be holding the land primarily for sale in that business; and (iii) the lot sales are considered "ordinary" in the course of that business. Accordingly, none of the developed land is considered a "capital asset" and X LLC's recognized gain of $12M (which includes the $4M of appreciation in the land that existed before commencement of development activities) is characterized as ordinary income and subject to a 35 percent top federal income tax rate.
- By converting the land from a capital asset to a non-capital asset, X LLC has an additional tax cost on the $4M of pre-development appreciation of $800,000 (20% (35% less 15%) of $4M).

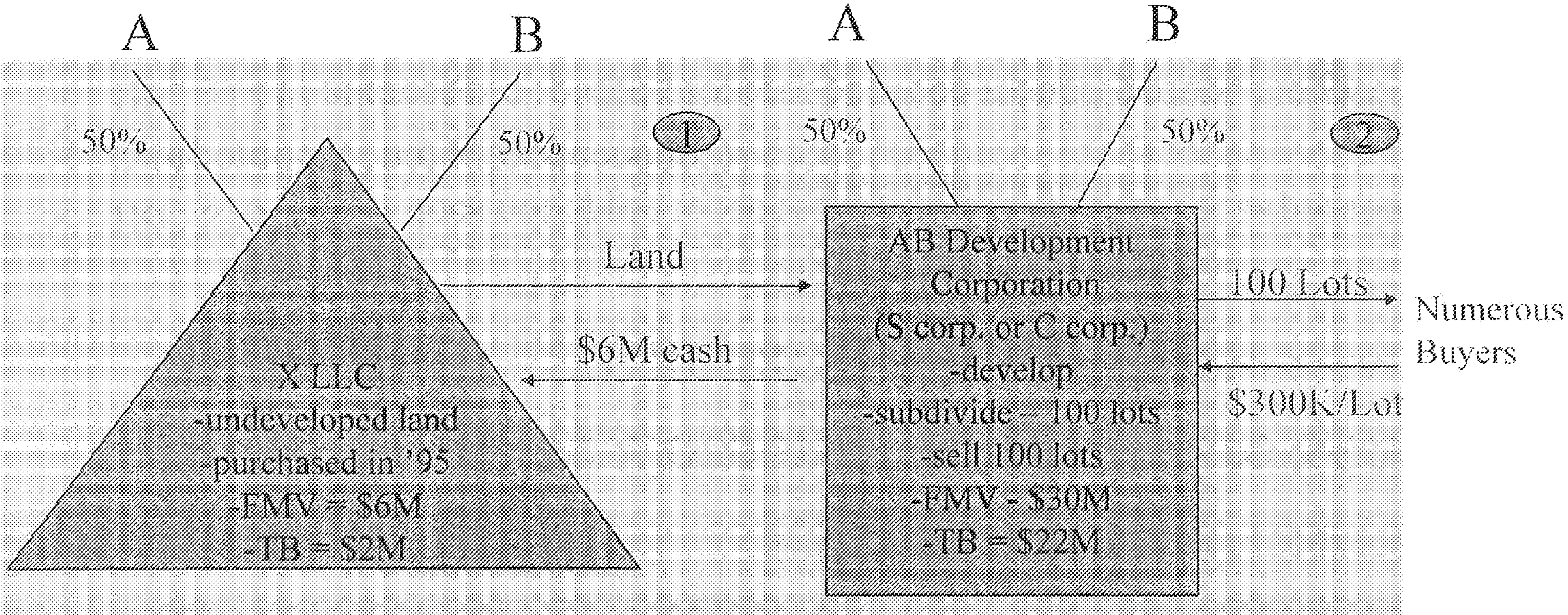
Option Three: Sale to Related Partnership to Capture $4M Capital Gain?



Sale to Related Partnership to Capture $4M Capital Gain?

- X LLC recognizes $4M of gain on sale to AB Development. Is X LLC's gain characterized as "long-term capital gain"? (the undeveloped land is a capital asset in the hands of X LLC (X LLC is not holding the property primarily for sale to customers in the ordinary course of business)).
- Notwithstanding that X LLC has gain from the sale of a capital asset (held for more than one year), IRC §707(b)(2) converts X LLC's capital gain into ordinary income because (i) AB Development LLC is a related party as to X LLC; and (ii) the property sold is not a capital asset in the hands of AB Development LLC.
- Related parties include (i) two partnerships, in which the same persons own, directly or indirectly, more than 50% of the capital interests or profits interests; and (ii) a partnership and a person owning, directly or indirectly, more than 50% of the capital interests, or profits interests, in such partnership. IRC §707(b)(3).

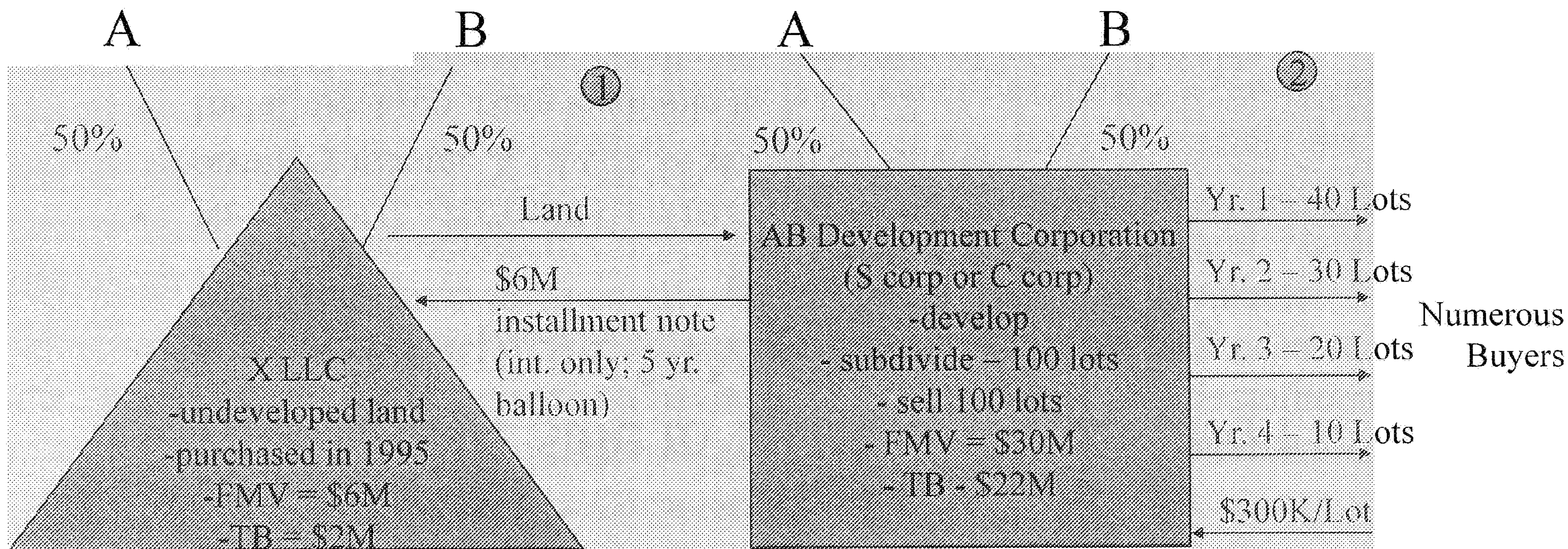
Option Four: Sale to Related Corporation to Capture $4M Capital Gain?



Sale to Related Corporation to Capture $4M Capital Gain?

- IRC §707(b)(2) does not apply to sale (1) (AB Development Corporation is a "corporation," not a "partnership").
- IRC §1239 addresses a sale of property between related parties, but IRC §1239 is limited to property which is depreciable in the hands of the transferee. (IRC §1239(a)). Because the lots would be considered inventory in the hands of AB Development Corporation and therefore not depreciable (Treas. Reg. section 1.167(a)-2), IRC §1239 would not apply to sale (1) and would not recharacterize the $4M gain as ordinary income to X LLC. (IRC §167(a)).

Variation of Option Four: Installment Sale to Related Corporation to Capture $4M Capital Gain?



Installment Sale to Related Corporation to Capture $4M Capital Gain?

- Neither IRC §707(b)(2) nor IRC §1239(b) applies to recharacterize as ordinary income X LLC's $4M gain on sale ① .
- Installment reporting available to X LLC?
  - IRC §453 permits installment reporting of gain on the sale of nondepreciable real property to a related party if the real property sold is a capital asset (IRC §453(a), (b)(2), (l)).
- What effect on X LLC of AB Development Corporation's sales of 100 individual lots in sales ② ?
  - Not entirely clear.
  - Because X LLC and AB Development Corporation are related parties (IRC §453(f)(1)), the sales ② that occur in year 1 (40 lots) and year 2 (30 lots) trigger IRC §453(e).

Installment Sale to Related Corporation to Capture $4M Capital Gain?

- When AB Development Corporation resells the property it acquired from X LLC within two years of acquiring it (and before X LLC has received all of its deferred purchase price under the $6M installment note), the lesser of (i) the sales price realized by AB Development Corporation on the sales in years 1 and 2 and (ii) the contract price on sale ① (reduced by the total payments received by X LLC through the year in which sales ② occurred) would be treated as a payment to X LLC (on its $6M installment note), thereby accelerating gain to X LLC on its installment sale to AB Development Corporation.

- Legislative history indicates that AB Development Corporation's proceeds from its sales in years 1 and 2 would <u>not</u> be treated as realized by X LLC to the extent those proceeds are attributable to any improvements to the property made by AB Development Corporation (S. Rep. No. 1000, 96th Cong., 2d Sess. 14-15 (1980)).

IRS Views of Related Party Sales to Capture Capital Gain

Information Release 2002-0013 (3/29/02)

- Whether the first business entity will realize capital gain on the transaction turns on whether the first business entity is considered to have held the land primarily for sale to customers in the ordinary of its trade or business.
- Intent of the seller entity is determinative.
- IRS typically argues that an agency relationship exists between the seller entity and the related purchaser entity and, therefore, the purchaser entity's activities are relevant to the determination of whether the seller entity intended to hold the land as an investment.
- Important factors in determining whether an agency relationship existed and the seller entity held the land primarily for sale to customers in the ordinary course of its trade or business are:

IRS Views of Related Party Sales to Capture Capital Gain

- Factor One: magnitude of the seller entity's pre- and post- transfer activity with respect to the property. In each of these cases, the magnitude of the seller's pre- and post- transfer activity supported the conclusion that an agency relationship existed between the seller entity and the related corporation:

  (a) Seller contacted engineering company to determine location of streets and utilities before selling the land to his corporation; seller also initiated the formation of a local public works authority for the purpose of having the city construct a sewer system on the tract before selling the land to his corporation (*Brown v. Comm'r*, 448 F.2d 514 (10th Cir. 1971));

IRS Views of Related Party Sales to Capture Capital Gain

(b) Seller sponsored petitions for county construction of water, sewer and street improvements on the land before selling it to his corporations (*Tibbals v. U.S.*, 362 F.2d 266 (Ct. Cl. 1966));

(c) Sellers (not in their individual capacities) participated in the development of the land by surveying and platting land, installing streets, sewers and other improvements, and having it rezoned. (*Boyer v. Comm'r.*, 58 T.C. 316 (1972)).

IRS Views of Related Party Sales to Capture Capital Gain

- Factor Two: length of time between the seller entity's purchase of the land and its sale of the land to related purchaser entity. In each of these cases, the short period between the seller's purchase of the land, his commencing development, and the sale of the land to a related entity supported the conclusion that the seller held the land primarily for sale to customers in the ordinary course of its trade or business:

  (a) Seller purchased land in June 1958, platted it and had it approved by the planning commission in January 1959. Seller then sold the land to his related corporation in January 1959. Seller purchased a second tract in December 1958 and initiated the formation of a local public works authority to construct a sewer system on the tract in March 1959. Seller then sold the tract in September 1959 (*Brown v. Comm'r*, 448 F.2d 514 (10th Cir. 1971);

IRS Views of Related Party Sales to Capture Capital Gain

(b) Seller purchased land in February 1950. Several days later seller petitioned the county for water, sewer, and street improvements. Such improvements were begun in Fall 1951 and were completed in early 1953. During that time (in April 1951 and June 1952) seller sold some of the land to his related corporation (*Tibbals v. U.S.*, 362 F.2d 266 (Ct. Cl. 1966));

(c) Seller purchased land on May 25, 1966. Before closing on the purchase, however, seller entered into a contract on May 12, 1966 to sell the land to its related corporation for double the price seller paid for the land (*Boyer v. Comm'r.*, 58 T.C. 316 (1972)).

IRS Views of Related Party Sales to Capture Capital Gain

- Factor Three: the seller entity's purchase and sale of other real property and general experience and involvement in the real estate business :

  (a) Seller had purchased and developed other tracts of land during the same period that the seller sold land to his related corporation (which evidenced seller's involvement in the real estate business, and, therefore, seller's lack of investment intent) (*Brown v. Comm'r*, 448 F.2d 514 (10th Cir. 1971));

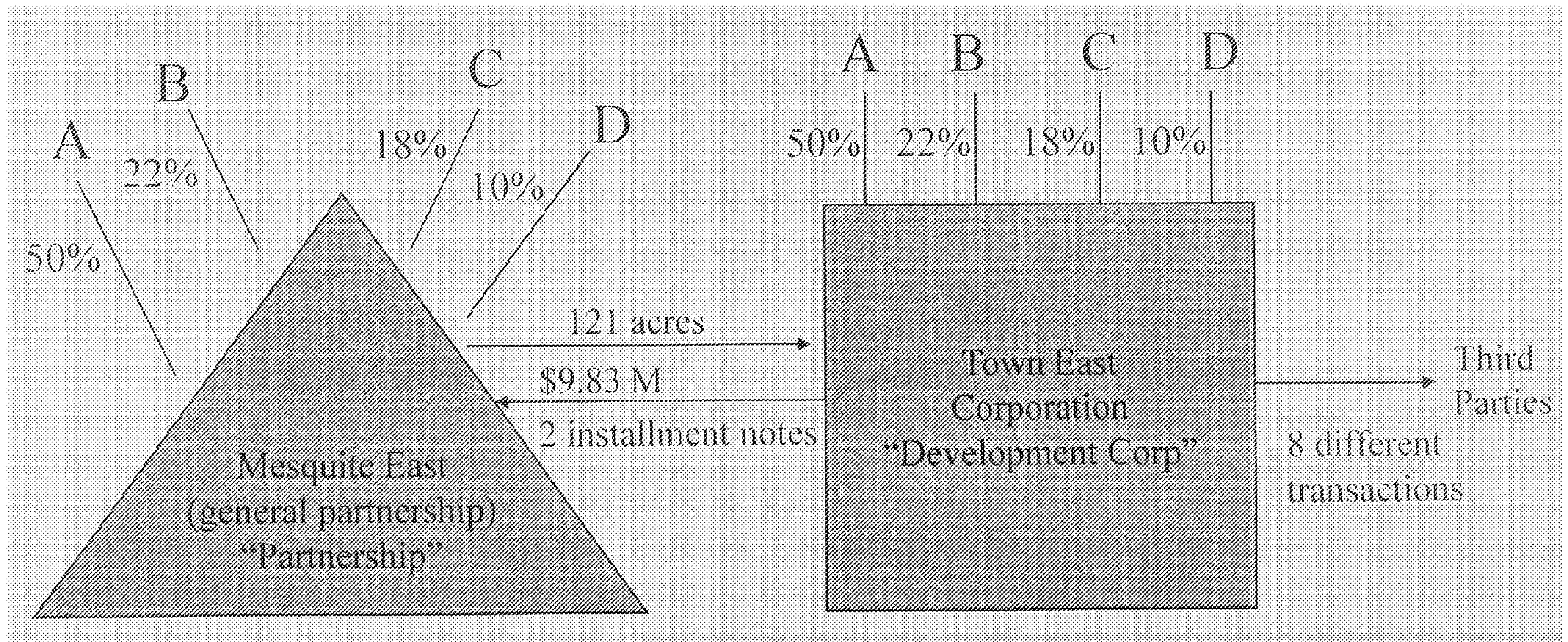
  (b) Seller was in the business of subdividing real property into improved lots and selling lots to customers and therefore lacked investment intent (*H-H Ranch, Inc. v. Comm'r*, 357 F.2d 885 (7th Cir. 1966)).

IRS Views of Related Party Sales to Capture Capital Gain

- Factor Four: seller's purpose with respect to the land (i.e. investment purpose or purpose to sell land to customers in the ordinary course of a trade or business):

  (a) Statement in an earnest money agreement between seller and the original owners of the land provided that sellers intended to subdivide and sell the land. This statement evidenced seller's intent to sell the land to customers in the ordinary course of its trade or business (*Boyer v. Comm'r*, 58 T.C. 316 (1972)).

Bramblett v. Commissioner
960 F.2d 526 (5th Cir. 1992)



Bramblett v. Commissioner 960 F.2d 526 (5th Cir. 1992)

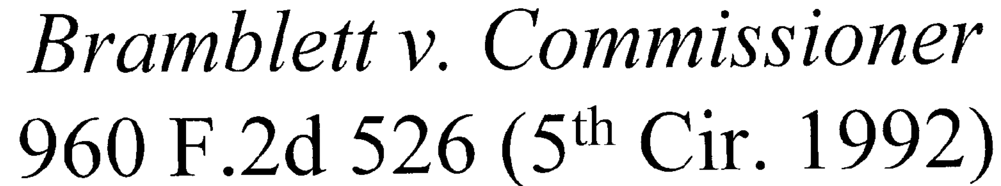
- Background
  - On May 16, 1979, A, B, C, and D formed Partnership. On June 4, 1979 they formed Development Corp. for the stated purpose of developing and selling real estate.
  - In late 1979 and early 1980 Partnership bought several parcels of vacant land for the stated purpose of investment.
  - In 1981, Partnership sold various parcels of property to Development Corp. on three separate occasions and reported this gain as ordinary income. Also, in 1981, Partnership sold one parcel of property to a third party and reported the gain as ordinary income.

Bramblett v. Commissioner 960 F.2d 526 (5th Cir. 1992)

- In December 1982, Partnership sold 121 acres to Development Corp. in exchange for two promissory notes totaling $9.83M (as determined by an appraiser to be its fair market value). The notes required annual principal payments of $1.5M and interest at 12 percent. Partnership reported its gain ($7M+) as capital gain.
- Development Corp. developed the property and sold most of it to unrelated third parties in eight different transactions.
- Development Corp. made no note payments until after it had sold the property. Although Development Corp. paid all of the note principal by the end of 1984, it did not make all required interest payments.

Bramblett v. Commissioner 960 F.2d 526 (5th Cir. 1992)

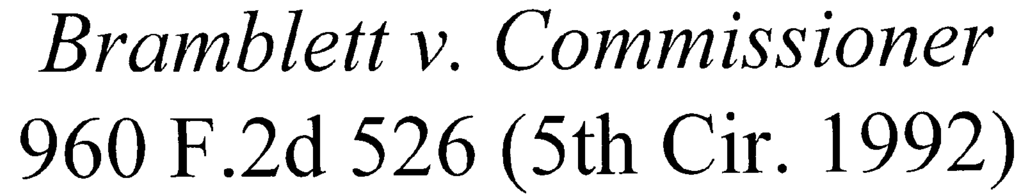
- Tax Court:
  - Concluded that Partnership was in the business of selling land and characterized Partnership's $7M+ gain as ordinary income.
  - Conclusions:
    - Partnership and Development Corp. were owned by same owners in the same proportions.
    - Development Corp. was formed less than one month after Partnership.
    - Development Corp. routinely entered into contracts of sale to third parties before buying the property from Partnership.



- Development Corp. made no note payments to Partnership until Development Corp. received proceeds from its sales to third parties.
- Development Corp. did not make required interest payments on its notes to Partnership.
- Development Corp. only developed land that it bought from Partnership.

Bramblett v. Commissioner 960 F.2d 526 (5th Cir. 1992)

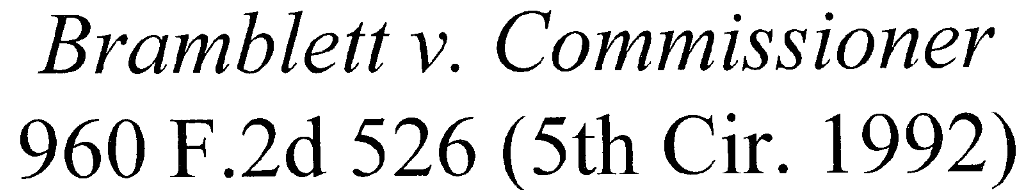
- Fifth Circuit:
  - Reversed the Tax Court's decision as clearly erroneous. Partnership's recognized gain on sale to Development Corp. was properly characterized as capital gain.
- Findings of Fifth Circuit:
  - Partnership was not directly in the business of selling land
    - It did not sell land frequently (only five sales over a three-year period).
    - Even if considered frequent, substantial and frequent sales activity, standing alone, has never been held to trigger automatically ordinary income treatment.



- Stated purpose of Partnership was to acquire the property for investment purposes
- Partnership sought advice as to how to structure the transaction to preserve its investment purpose
- Partnership held the property for over three years
- Partnership did not advertise or hire brokers
- Partnership did not develop the property
- Partnership did not maintain an office
- Partners of Partnership did not spend more than a minimal amount of time on Partnership's activities

Bramblett v. Commissioner
960 F.2d 526 (5th Cir. 1992)

- Partnership was not indirectly in the business of selling land. Specifically, Development Corp. was not an agent of Partnership (Agency Theory), and Development Corp.'s activities were not attributed to Partnership on a substance over form principle (Substance over Form Theory)
  - Agency Theory: Fifth Circuit relied on principles outlined in *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949) and *Commission v. Bollinger*, 485 U.S. 340 (1988)
    - No evidence that Development Corporation ever acted in the name of or for the account of Partnership

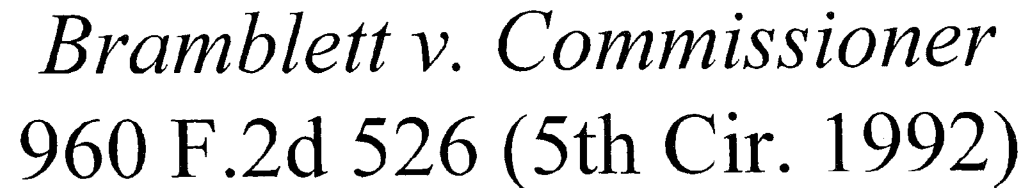


- Development Corp. did not have authority to bind Partnership
- The amount of money that Development Corp. transferred to Partnership equaled the agreed upon fair market value of the property at the time of sale
- Development Corp. realized a profit from its development that was much larger than a typical agency fee
- The receipt of income by Development Corp. was <u>not</u> attributable to the services of employees of Partnership or assets belonging to Partnership

Bramblett v. Commissioner 960 F.2d 526 (5th Cir. 1992)

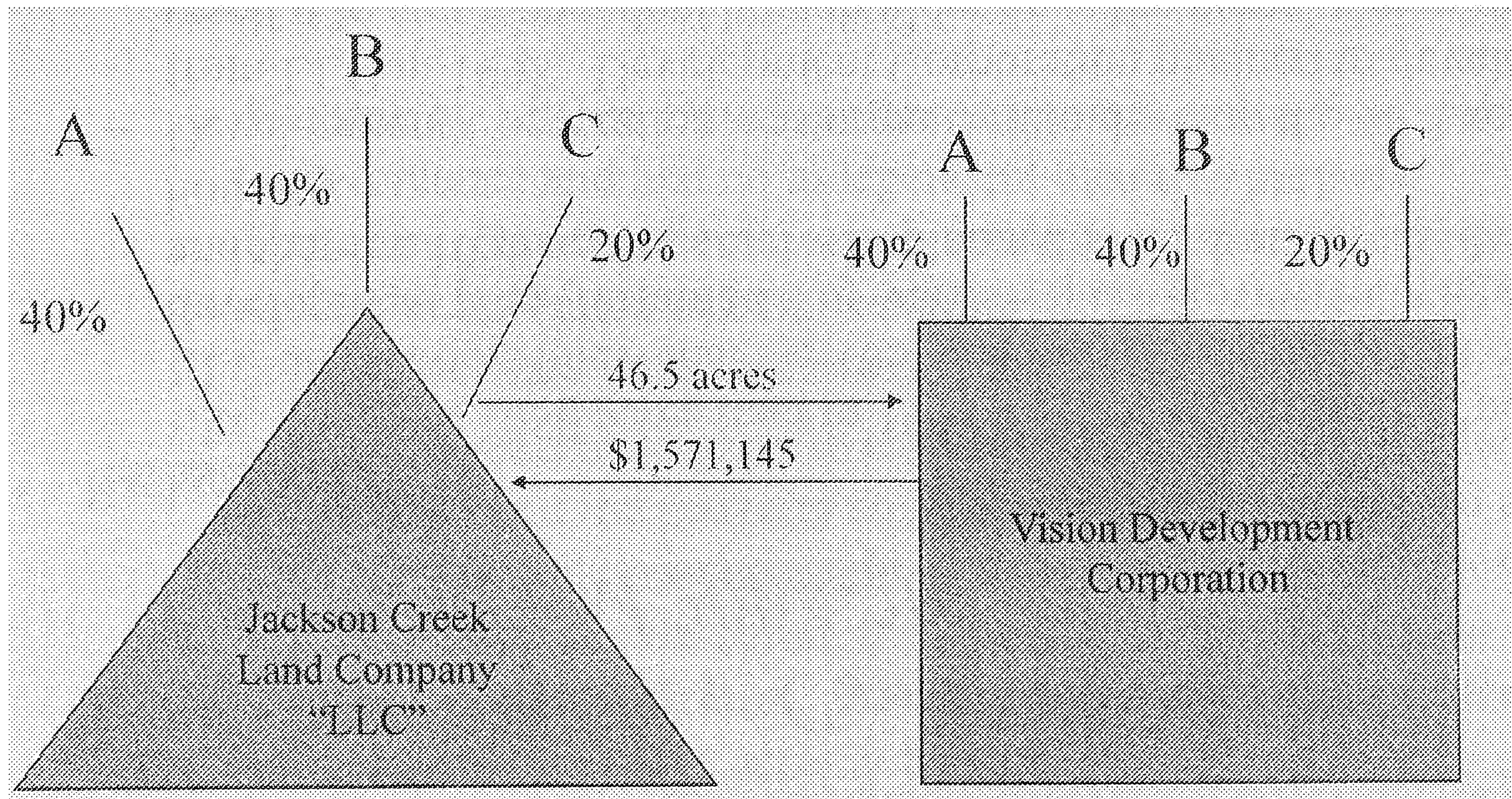
- Common ownership of both activities is <u>not</u> enough to prove an agency relationship
- Development Corp. was not carrying on the normal duties of an agent; it was not selling or developing the property on behalf of Partnership because Development Corp. retained all of the profit from the development activity

- Substance over Form Theory: Fifth Circuit concluded that the principle of substance over form did not support the attribution of Development Corp.'s activities to Partnership
  - Both Partnership and Development Corp. were separate taxable entities



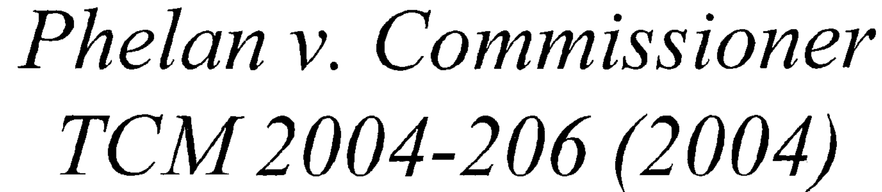
- At least one major independent business reason to organize Development Corp. to develop and sell the property which was to insulate Partnership and its partners from unlimited liability from the development activity
- No substantial evidence that transaction between Partnership and Development Corp. was not an arm's-length transaction or that business and legal formalities were not observed
- Partnership bought the real estate as an investment and bore the risk that real estate would not appreciate

Phelan v. Commissioner TCM 2004-206 (2004)



- organized in 1994
- acquired 1050 acre tract in 1994
- sold 46.5 acre parcel in 1998

- organized in 1996
- develop and resell to third-party homebuilder



Phelan v. Commissioner
TCM 2004-206 (2004)

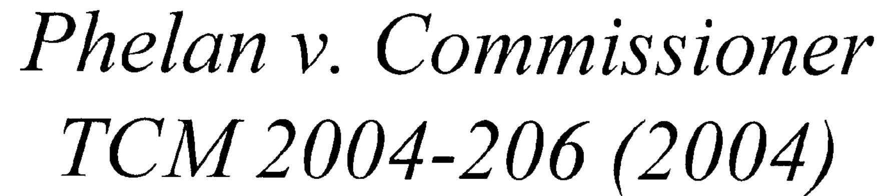
- Background:
  - LLC acquired 1050 acres tract in 1994 for $2.9M. At time of purchase, LLC and owners knew that the 1050 acres tract was part of an overall development plan (formulated by various quasi-government agencies) and that the 1050 acres parcel was planned to be used for residential housing.
  - Development Corporation was organized to develop the 46.5 acre parcel from LLC in 1998. Development Corporation planned to develop it and resell it to an independent homebuilder once the parcel was suitable for residential homebuilding.
- IRS Contention:
  - LLC was directing the development activities of the Development Corporation and entities affiliated with LLC (based on the fact that there was common ownership of LLC, Development Corporation and the affiliated entities).

Phelan v. Commissioner
TCM 2004-206 (2004)

- The sale by LLC to Development Corporation was done solely for tax avoidance and had no independent business purpose. Therefore, Development Corporation's development activities should be attributed to LLC (resulting in LLC's holding the property for sale in the ordinary course of business).
- LLC engaged a third party to evaluate soil conditions for the development of the property sold. In addition, the amended and final plans for the property sold to Development Corporation were approved by the town before the sale transaction by LLC to Development Corporation. IRS contended that these two facts indicated development activity by LLC.

Phelan v. Commissioner *TCM 2004-206 (2004)*

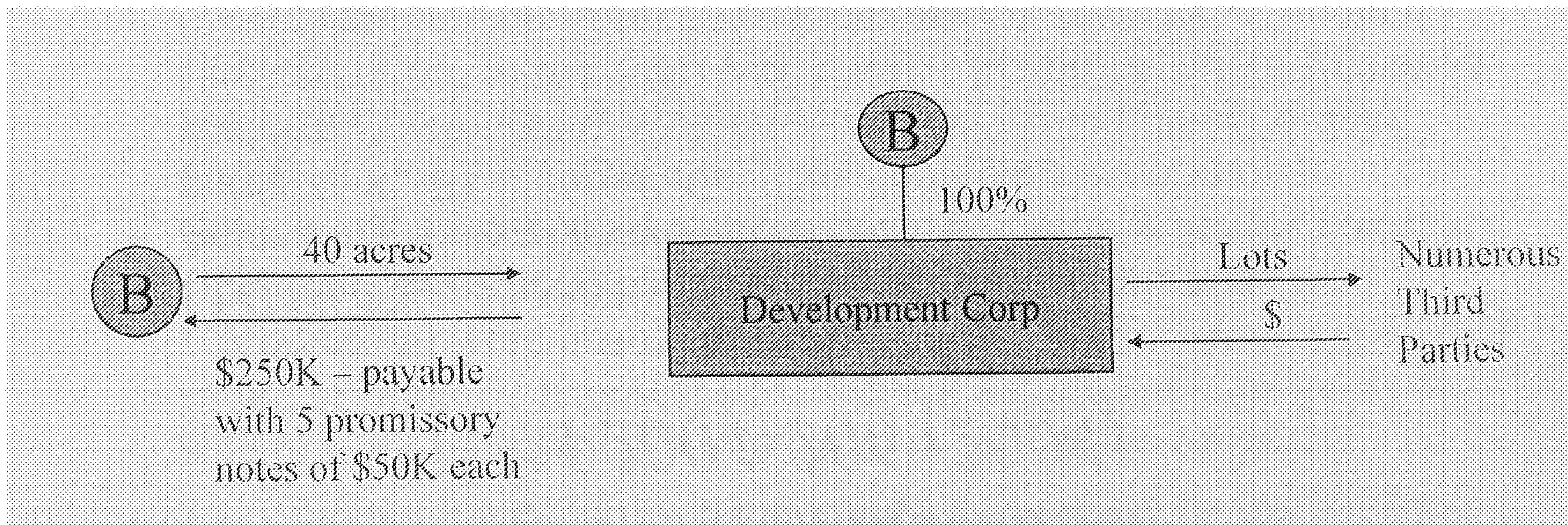
- Court Findings:
  - LLC was organized with the intent and for the purpose of purchasing the property and holding it for investment and appreciation (even though LLC knew that the property would eventually be developed into residential housing).
  - Sales by LLC of limited number of parcels from its 1050 acre tract (including the 46.5 acre parcel to Vision Development Corporation) were unsolicited; the owners of LLC did not hold real estate or broker's licenses; LLC did not advertise the property for sale or have representatives to assist in selling the property.
  - LLC did not have employees nor did LLC engage in any business activities outside of holding and selling a limited number of parcels of property from the 1050 acre tract.



- LLC (and its owners) had a legitimate business purpose for organizing Vision Development Corp. and selling the 46.5 acre parcel to it. By incorporating Development Corporation to perform development work on a relatively small parcel of land (46.5 acres out of the 1050 acre tract), LLC protected its sole asset, the remaining land, from obligations arising from Development Corporation's development activities. All corporate formalities were followed.

- <u>Conclusion</u>:
  - gain recognized by LLC to Development Corporation was characterized as capital.

Capital Contribution Theory
Bradshaw v. U.S., 683 F.2d 365 (Ct. Cl. 1982)



Capital Contribution Theory
Bradshaw v. U.S., 683 F.2d 365 (Ct. Cl. 1982)

- Background
  - B, an individual, acquired a 200 acre tract in 1961. In 1968 B sold 40 acres to Development Corp. for $250,000, which was payable in the form of five promissory notes (each in the principal amount of $50,000) bearing interest at four percent. Maturity dates on the notes ranged from 2 ½ - 6 ½ years. The notes were not secured with collateral. B reported his gain on the sale to Development Corp. as capital gain. In 1968 B organized Development Corp. and was its sole shareholder. B contributed an automobile (valued at $4500) and $3200 cash to its capital. Development Corp. improved the property, subdivided it, and sold the lots to numerous third parties in 1971, 1972 and 1973.

Capital Contribution Theory
Bradshaw v. U.S., 683 F.2d 365 (Ct. Cl. 1982)

- IRS arguments:
  - The transfer of the 40 acres by B to Development Corp. was NOT a sale; instead it was a transfer in exchange for stock or securities within the meaning of IRC § 351. Accordingly, Development Corp.'s tax basis on the property was not $250K (the purchase price), but rather equal to B's tax basis ($8K) which carried over to Development Corp. under IRC § 362
  - Alternatively (if not an exchange under IRC § 351), the transfer by B was in substance a capital contribution to Development Corp. (with the same carry over basis result under IRC § 362)

Capital Contribution Theory
Bradshaw v. U.S., 683 F.2d 365 (Ct. Cl. 1982)

- Court Findings:
  - Concluded that evidence supports a sale and not a contribution to capital
    - Price paid by Development Corp. ($250K) reflected its actual fair market value. It did not constitute an inflated value for the property, and, therefore did not represent an attempt to transfer to B any subsequent appreciation in the property's value or any gain from development
    - The fact that the transaction was between a corporation and its sole shareholder does not by itself support the characterization of the transaction between B and Development Corp. as a contribution to capital

Capital Contribution Theory
Bradshaw v. U.S., 683 F.2d 365 (Ct. Cl. 1982)

- Formalities of a sale were strictly observed (the promissory notes were negotiable instruments and contained unqualified obligations to pay principal with fixed maturity dates; the notes bore a reasonable rate of interest; the notes were not subordinated to general creditors)
- Principal and interest on the notes were always paid as due
- Although Development Corp. was thinly capitalized, it had access to other sources of financing and capital and the land it acquired from B was marketable at its development; repayment of the $250K of notes was not subject to the fortunes of Development Corp.'s business; therefore, the $250K of notes were debt and not equity.

Bradshaw v. U.S., 683 F.2d 365 (Ct. Cl. 1982)

- Concluded that the $250K of notes were not "securities" under IRC § 351 and therefore § 351 was not applicable.

Other Cases

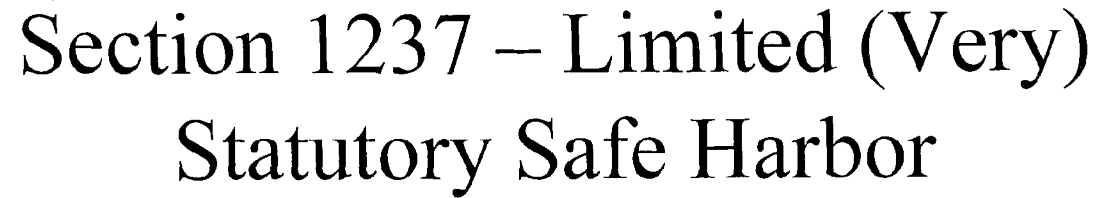
- <u>Capital Gain Captured</u>

1. *Gordy v. Commissioner*, 36 T.C. 855 (1961)
   - gains from transactions were capital gains because they were not within the ordinary course of taxpayer's business; rather, it was the business of his company
2. *Davis v. Commissioner*, 28 T.C.M. 1167 (1969)
   - taxpayer, although an officer and shareholder of the development company, was not individually engaged in the business; he made no personal efforts to sell property to others or develop it for sale as a subdivision
3. *Cary v. Commissioner,* 32 T.C.M. 913 (1973)
   - sale prices of land reflected fair market value, agreed upon during arm's length negotiations
4. *Ronhovde v. Commissioner*, 26 T.C.M. 1251 (1967)
   - not taxpayer's ordinary course of trade or business; taxpayer's partnership engaged in only one isolated transaction and did not engage in any actual solicitation of the land, even though taxpayer did promote a corporation to which to sell the land
5. *Tibbals v. Commissioner*, 17 T.C.M. 228 (1958)
   - property not held by taxpayers in ordinary course of trade or business; taxpayers made no improvements to land and made no efforts to promote sales of lots

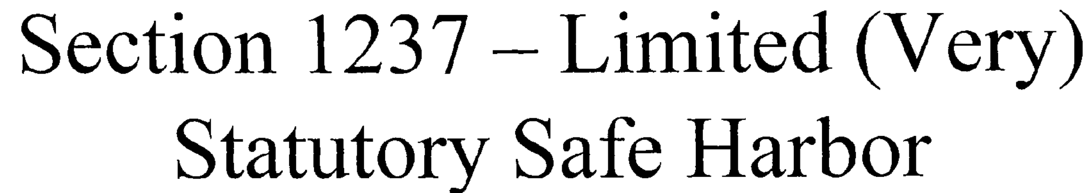
Other Cases

- Capital Gain Not Captured

1. *Tibbals v. U.S.*, 362 F.2d 266 (Ct. Cl. 1966)
   - taxpayer's closely-held corporation was his agent; taxpayer conducted substantial personal developmental activities and engaged in use of and sale to a controlled corporation which continued the development
2. *Browne v. U.S.*, 356 F.2d 546 (Ct. Cl. 1966)(per curiam)
   - activities conducted by the taxpayer were equivalent to the platting, subdividing, installation of streets, and making of utility arrangements
3. *Boyer v. Commissioner*, 58 T.C. 316 (1972)
   - agency theory; taxpayers set price on the sale to development corporation, which actually lost money on the development and sale of the land because of the artificially inflated price
4. *Cappuccilli v. Commissioner*, 40 T.C.M. 1084 (1980) aff'd, 668 F.2d 138 (2d Cir. 1981)
   - land sales were structured so that no interest was actually charged, repayment scheduled over several years as the land was expected to be developed and resold, and delivery of the deed contingent upon zoning approval
5. *Slappey Drive Industrial Park v. United States*, 561 F.2d 572 (5th Cir. 1977)
   - transactions were capital contributions because individuals failed to insist on timely repayment or payment of interest
6. *Burr Oaks Corp. v. Commissioner*, 43 T.C. 635 (1965)
   - transaction was a capital contribution, not a sale, because corporation had no significant capitalization, payment for land was solely dependent on success of an untried corporation with uncertain prospects, transferors of land completely dominated and controlled development corporation, and price of land was highly inflated



- Special rule for land that has been held for at least five years (unless inherited)
- If applicable, section 1237 enables a taxpayer to obtain capital gain treatment on the sale of land. If section 1237 is not applicable, the standard dealer rules apply.
- If a taxpayer (other than a C corporation) has held a tract of land for investment for at least five years, and the taxpayer sells any lot or parcel within that tract, the land will not be considered dealer property solely because the taxpayer subdivided the tract for purposes of sale or because of advertising, promotion, selling activities or the use of seller agents in connection with the sale of lots.



- The tract must never have been held for sale; in the year of sale, the taxpayer must not have held any other real property for sale.
- After taxpayer has sold five lots or parcels from the tract, gain recognized from further sales will be ordinary income to the extent of five percent of the sale price of each lot.
- Additional requirement of section 1237 (applied on a lot-by-lot basis) is that no substantial improvement that substantially enhances the value of the lot or parcel sold can have been made by the taxpayer, a related party, or certain lessees or government entities, if the improvements cause an increase in value of the lot of more than ten percent.

- Substantial improvements include buildings, hard-surface roads, and utility lines (sewer, water, gas or electric). However, if the tract has been held by taxpayer for at least ten years, building or installation of water, sewer, or drainage facilities or roads will not be considered substantial improvements provided that taxpayer can demonstrate that such improvements were needed to make the lots marketable
- Non-substantial improvements including building a temporary field office, surveying, filling, draining, leveling and clearing operations, and the construction of minimum all weather access roads

Planning Tips and Suggestions for Capturing Capital Gain While Staying in the Deal

- The sale transaction between the related parties should be "arm's length"
  - Purchase price should be based on an appraisal (or two)
  - Financing terms should be "arms-length"
  - Installment notes should be secured by deed of trust on real estate acquired; cash down payment recommended; installment note should bear reasonable interest rate
  - If possible, installment note should not be subordinate to Development Corp's development financing or construction loan financing
  - Observe all formalities of sale (as parties would if they were not related) (e.g. record deeds and deeds of trust, etc.)
  - Purchase price should not be contingent on success of development entity's activity

Planning Tips and Suggestions for Capturing Capital Gain While Staying in the Deal

- Establish an independent business purpose
- Purchaser-development corporation should make all interest and principal payments on the note on a timely basis. Therefore, purchaser-development corporation should have sufficient capital (or access to sufficient capital) to stay current on its installment note obligation.
- Seller-partnership should not engage in any activity (improvements to property, subdivision activity, etc.) that might support the conclusion that it is holding the property for sale in the ordinary course of its business.

Planning Tips and Suggestions for Capturing Capital Gain While Staying in the Deal

- Purchase-development corporation should avoid entering into contracts to sell property before it has acquired the property from the related party. Such activities help support the IRS contention that the development entity and the related party-seller are in the business together of selling property in the ordinary course or that the development entity's activities should be attributed to the related party-seller.
- If possible, the owners of the seller (e.g. partners of the seller-partnership) should be different than the owners of the development entity (e.g. shareholders of purchaser - S corporation).

THE END