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Tax Planning for the Real Estate Owner (Including Choice of Entity Considerations and Income Tax Issues in Acquiring Developing and Owning Real Estate)

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TAX PLANNING FOR THE REAL ESTATE OWNER
(INCLUDING CHOICE OF ENTITY CONSIDERATIONS
AND INCOME TAX ISSUES IN ACQUIRING,
DEVELOPING AND OWNING REAL ESTATE)

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I. THE CONCEPT OF GAIN OR LOSS

A. Generally.

1. For income tax purposes, gain or loss is neither realized nor recognized by the owner of property until the occurrence of a taxable event, such as a sale, exchange or other disposition. Secs. 1001(a) and 1001(c), I.R.C.

2. The concepts of "realization" of gain or loss and "recognition" of gain or loss are not synonymous. While there are no instances of gain or loss recognition without gain or loss realization, there are many examples of gain or loss realization without simultaneous recognition.

B. The Measure of Gain or Loss.

1. Gain or loss is measured, for Federal income tax purposes, as the difference between the aggregate amount realized and the adjusted basis for the property. Sec. 1001(a), I.R.C.

2. The amount realized is the sum of

a. any money received, plus

b. the fair market value of the property
(other than money) received. Sec. 1001(b), I.R.C.

c. Note that the amount realized does not include any reimbursement that the seller may receive from the purchaser for the payment of real property taxes imposed on the purchaser under Sec. 164(d), I.R.C. However, if the purchaser pays the amount of real property taxes imposed on the seller, that amount is taken into account for purposes of determining the amount realized under Sec. 1001(b), I.R.C. and in computing the cost of the property under Sec. 1012, I.R.C. Sec. 1001(b), I.R.C.; Regs. §§1.1001-1(b)(1) and (2).

3. As can readily be seen, in measuring gain or loss, the key considerations must include the following:

a. Was there a sale, exchange or other disposition, thereby triggering realization of gain or loss?

b. If there is an event resulting in gain or loss realization, is there recognition of such gain or loss, or is there a forgiveness or deferral of such recognition?

c. If gain or loss is to be recognized, in whole or in part, what is the adjusted basis of the property?

d. In determining the gain or loss recognized, does the amount realized exceed the adjusted basis of the property, or vice versa, and, in this connection, what is the fair market value of the property other than money received?

II. THE DETERMINATION OF BASIS

A. Basis: Impact of Means of Acquisition.

1. Property acquired by purchase --

a. Generally, the basis is the cost of the property. Sec. 1012, I.R.C.

(1) Recitals in a deed or contract are only evidence of cost; the actual cost will govern. Thus, if the cost is renegotiated at a later time, the renegotiated price applies. See also Freedom Newspapers, Inc. v. Comm'r, 36 TCM 1755 (1977), where a payment made by a third party to induce the taxpayer to purchase an asset was considered a reduction in basis of that asset, rather than income.

(2) If the property is acquired in a taxable exchange, and the fair market value of the property acquired cannot be ascertained, the cost is deemed to be the fair market value of the property transferred by the purchaser. See, e.g., Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954), and Williams v. Comm'r, 37 T.C. 1099 (1962).

b. "Cost" includes:

(1) Non-deductible acquisition expenses, such as, in the case of real estate, title charges, brokers' commissions, appraisal fees, surveys, attorney's fees, and payments to remove clouds on title. See, generally, Tucker and Leahy, The Deductibility of Costs Incurred by Real Estate Developers, 1 J.R.E. Tax. 408 (1974).

(2) Apportioned costs at settlement not deductible by purchaser, such as, in the case of real estate, certain real estate taxes and non-deductible assessments.

(3) Indebtedness assumed by the purchaser or incurred in the purchase of the property; but see Redford v. Comm'r, 28 T.C. 773 (1957), where the Court held that basis did not include the face amount of a nonnegotiable, noninterest bearing second mortgage note.

(4) Indebtedness to which the purchaser takes the property subject. See Crane v. Comm'r, 331 U.S. 1 (1947); Mayerson v. Comm'r, 47 T.C. 340 (1966); and Borinstein v. Comm'r, 31 TCM 743 (1972); but see Bixby v. Comm'r, 58 T.C. 757 (1972).

(5) The estimated cost of future improvements to property if such improvements are required by the terms of a binding sales contract. See Herzog Bldg.

Corp. v. Comm'r, 44 T.C. 694 (1965); and Bryce's Mountain Resort, Inc. v. Comm'r, 50 TCM 164 (1985). See also Rev. Proc. 92-29, 1992-1 C.B. 748.

c. "Cost" does not include:

(1) Deductible interest or, in the case of real estate, deductible real estate taxes on acquisition.

(2) If the property is subject to a mortgage or other liability in an amount greater than the value of the property at acquisition, cost may be limited to such value. See Mayerson v. Comm'r, 47 T.C. 340 (1966); Borinstein v. Comm'r, 31 TCM 743 (1972); Narver v. Comm'r, 75 T.C. 53 (1980), aff'd 670 F.2d 855 (CA9 1982); and Rev. Rul. 81-278, 1981-2 C.B. 159. See also Rev. Rul. 69-77, 1969-1 C.B. 59, accepting the Mayerson decision, but reaffirming the intention of the Service to litigate the issue where appropriate. As to partnerships, see Sec. 752(c), I.R.C. But see Waddell v. Comm'r, 86 T.C. 848 (1986), aff'd 841 F.2d 264 (CA9 1988). See, generally, Halpern, Liabilities and Cost Basis: Some Fundamental Considerations, 7 J.R.E. Tax. 334 (1980).

(3) If those liabilities assumed or taken subject to are highly speculative or contingent, they are not includible in basis until paid. See, e.g., Albany Car Wheel Co., Inc. v. Comm'r, 40 T.C. 831 (1963), aff'd 333 F.2d 653 (CA2 1964); and Long v. Comm'r, 71 T.C. 1 (1978). See also Rev. Rul. 55-675, 1955-2 C.B. 567, and Rev. Rul. 78-29, 1978-1 C.B. 62. Compare Brountas v. Comm'r, 73 T.C. 491 (1979), rev'd 692 F.2d 152 (CA1 1982), with Gibson Products Co.--Kell Blvd. v. United States, 637 F.2d 1041 (CA5 1981). See, generally, Landis, Liabilities and Purchase Price, 27 Tax Lawyer 67 (1973).

(a) See Pierce Estates v. Comm'r, 195 F.2d 475 (CA3 1975), holding that a liability is contingent if its payment is dependent upon the occurrence of a subsequent, indeterminant event, such as the earning of profits. Likewise, a liability will be deemed to be contingent if payment is dependent upon the presence of adequate net cash flow. See, e.g., Saviano v. Comm'r, 80 T.C. 955 (1983), aff'd 765 F.2d 643 (CA7 1985); Estate of Baron v. Comm'r, 83 T.C. 542 (1984), aff'd 798 F.2d 65 (CA2 1986); and Chamberlain v. Comm'r, 52 TCM 1348 (1987).

(b) In Rev. Rul. 80-235, 1980-2 C.B. 229, the Service found that a promissory note given by a partner to a partnership, though recourse, did not create basis because it was payable only from, and to the extent of, partnership distributions.

(4) If the purported liabilities are in fact shams, then they will not be includible in or utilizable as basis. See Milbrew v. Comm'r, 42 TCM 1467 (1981), aff'd 710 F.2d 1302 (CA7 1983).

(a) See, generally, Goldstein v. Comm'r, 364 F.2d 734 (CA2 1966), aff'g 44 T.C. 284 (1965), cert. denied 385 U.S. 1005 (1967); and Knetsch v. United States, 364 U.S. 361 (1960). See also Rev. Rul. 80-236, 1980-2 C.B. 240, where the Service

found sham debt in a Subchapter S situation, and then pointed out that "the holdings do not preclude the imposition of penalties under any provision of the Code."

(b) See Grodt & McKay Realty, Inc. v. Comm'r, 77 T.C. 1221 (1981), where the purchase price of units of cattle was \$30,000 per unit (consisting of 5 breeding cows per unit), with \$1,000 to \$1,500 down and the remainder represented by a nonrecourse note. The Court found the value per cow to be \$600. The Court concluded these were not bona fide sales. According to the Court, "when the various agreements are probed beneath their labels and are considered in the context of the surrounding facts and circumstances, it strains credulity and offends logic to find that a true sale, to be recognized for tax purposes, had taken place. We must conclude the contrary." Id. at 1243.

(c) See also Carnegie Productions, Inc. v. Comm'r, 59 T.C. 642 (1973), and Rev. Rul. 77-125, 1977-1 C.B. 130, both dealing with motion picture film transactions, where the maker of the note was found not to be liable thereon (and thus could not use the note as basis) because satisfaction of the note could come only from film earnings or from the guaranty of the owner of the film production rights. See also Brannen v. Comm'r, 78 T.C. 471 (1982), where a \$1,400,000 nonnegotiable note was found unreasonably to exceed the fair market value of a movie, so that the note could not be included in basis.

(5) Where the circumstances indicate that a "purchase" is in fact only an "option" to purchase, there will be no basis until such option is exercised. See, e.g., Estate of Franklin v. Comm'r, 64 T.C. 752 (1975), aff'd on other grounds 544 F.2d 1045 (CA9 1976), where a low "down payment", combined with the "seller" continuing to operate the motel (essentially for the "seller's" own profit or loss), and with a large "purchase money mortgage" due in the future, on a nonrecourse basis, convinced the Court that, if not a "sham" situation, the situation was, at best, an "option".

(6) See Rev. Rul. 78-411, 1978-2 C.B. 112, where purchases of animals for nonrecourse notes were held to be loans by the investors, rather than bona fide purchases, in situations where the seller agreed to buy any offspring at a specified price and guaranteed to purchase the animals at a specified price after 5 years. See also Villa v. Comm'r, 40 TCM 938 (1980), holding that, under the relevant documentation, the taxpayer had made a loan, rather than an investment, so that no depreciation or investment tax credit could be claimed. See, generally, Weidner, Realty Shelters: Non-Recourse Financing, Tax Reform, and Profit Purpose, 32 Southwestern L.J. 711 (1978).

2. Property acquired by gift --

a. Generally, such property has the same basis as in the hands of the donor. Sec. 1015(a), I.R.C.

b. There are three exceptions:

(1) The basis is increased (but not above the fair market value at the time of the gift) by the amount of Federal gift tax actually paid, but only to the extent such

gift tax is attributable to the appreciation in the value of the property. Sec. 1015(d), I.R.C. See Reg. §1.1015-5(a)(2), Examples (1) and (2), and Reg. §1.1015-5(b).

(2) If the property is later sold at a loss by the donee, the basis for computing loss is the lesser of (i) the basis in the hands of the donor, or (ii) the fair market value at the time of the gift. Sec. 1015(a), I.R.C.; Reg. §1.1015-1(a)(1). Thus, the donee does not recognize gain or loss in that situation where he sells the property at a price falling between the donor's basis and the fair market value at the date of the gift. See Reg. §1.1015-1(a)(2), Example.

(3) If neither the donee nor the District Director is able to determine the basis in the hands of the donor, the basis is considered to be the fair market value of the property as of the date or the approximate date at which, according to the best information available, the property was acquired by the donor. Reg. §1.1015-1(a)(3).

3. Property acquired by inheritance --

a. Generally, the basis of the property is its fair market value at the date of death or, if the alternate valuation date (up to six months after death) is used for Federal estate tax purposes, the value at such date used in the return becomes the basis. Sec. 1014(a), I.R.C.; Reg. §1.1014-1(a). Under the Tax Reform Act of 1984, however, the alternate valuation date may only be elected where the election will decrease the value of the gross estate and the estate's total federal estate tax liability. See Sec. 2032(c), I.R.C.

b. When special use valuation of the property is elected under Sec. 2032A, I.R.C., the basis of the property will be determined with reference to the special use valuation. Sec. 1014(a)(3), I.R.C. However, a valuation discount may not be used in conjunction with a special use valuation election. In Estate of Maddox v. Comm'r, 93 T.C. 228 (1989), the decedent held an interest in a family-owned farm. The executors of the decedent's estate elected to value the farm as special-use property under Sec. 2032A, I.R.C., and then claimed a minority interest discount as well. The Court observed that the election to value real property under Sec. 2032A, I.R.C. means that the actual fair market value of the stock is not being used for estate valuation purposes. Minority discounts are only relevant in computing fair market value of stock and thus may not be used to reduce the value of real property valued under Sec. 2032A, I.R.C.

c. Note that the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) amended Sec. 1014, I.R.C. which currently provides that the basis of property received from a decedent is the fair market value on the date of death. EGTRRA added Sec. 1014(f), I.R.C. which effectively terminates the step up or step down in basis rule for the estates of decedents dying after December 31, 2009 and before January 1, 2011. EGTRRA also amended Sec. 1022, I.R.C. to provide a modified carryover basis rule to determine a transferee's basis in property received from a decedent. Under Sec. 1022, I.R.C., a transferee's basis in property received from a decedent dying after December 31, 2009 is the lesser of (1) the fair market value as of the date of death, or (2) the adjusted basis of the decedent. A limitation applies so that the aggregate basis increase allowed is \$1.3 million, in general, and \$3 million for

property received by a spouse. Section 1022(g), I.R.C. was also added to clarify the treatment of liabilities that exceed the basis of property acquired from a decedent. The general rule is that, for income tax purposes, liabilities which exceed basis are disregarded in determining gain recognized at the time the estate or a beneficiary acquires such property from a decedent.

4. Property acquired in exchange --

a. If the exchange is wholly tax-free as a like-kind exchange under Sec. 1031, I.R.C., the basis of the property transferred becomes the basis of the property received, even though the fair market value of one property exceeds the other. Sec. 1031(d), I.R.C.

b. If the transaction is only partially tax free (because cash or other nonlike-kind property is received by the transferor), the basis of the property received will be the basis of the property transferred, reduced by the cash received (including mortgages assumed or taken subject to by transferee) and increased by (i) the amount of gain recognized and (ii) mortgages assumed or taken subject to by transferor. Secs. 1031(b) and 1031(d), I.R.C.

5. Property acquired in satisfaction of a debt --

a. Generally, property acquired (otherwise than through foreclosure or purchase in lieu of foreclosure) in payment of a debt or satisfaction of a claim has a basis equal to the fair market value of the property on the date of transfer. This is so even though the amount of the debt or claim is greater or less than such fair market value. See, e.g., Swaim v. Comm'r, 417 F.2d 358 (CA6 1969); and Vadner v. Comm'r, 14 TCM 866 (1955).

b. If the fair market value of the property is less than the debt, the creditor is entitled to a bad debt deduction, if not previously written off.

c. If the property has no ascertainable fair market value when the property is acquired, the creditor may utilize the amount of the debt as basis. See, e.g., Society Brand Clothes Inc. v. Comm'r, 18 T.C. 304 (1952); and Gould Securities Co. v. United States, 96 F.2d 780 (CA2 1938).

B. Allocation of Basis

1. Where a tract of land is purchased and subdivided, the entire cost must be "equitably apportioned" among all lots, so that gain or loss may be determined on each sale as the lots are sold. Reg. §1.61-6(a). See also Fairfield Plaza, Inc. v. Comm'r, 39 T.C. 706 (1963); and Rev. Rul. 70-7, 1970-1 C.B. 175. The costs of preparing property for subdivision and resale must be allocated among all parcels benefitting therefrom. See Dahling v. Comm'r, 56 TCM 131 (1988), where the taxpayer incurred development costs in a subdivision of six lots. Duplexes were built on only three of the lots, while the remaining three lots were left vacant and unsold. The taxpayer argued that all of the development costs should be allocated to the three lots sold because only those lots benefitted; however, the Court held that all six lots benefitted because the improvements were equally necessary to sell any of the lots.

2. Where the lots or tracts of land are acquired over a period of time, contrast (i) Searles Real Estate Trust v. Comm'r, 25 B.T.A. 1115 (1932), and Cleveland - Sandusky Brewing Corp. v. Comm'r, 30 T.C. 539 (1958), where it was held that each parcel had a separate basis, with (ii) Wilson v. United States, 322 F. Supp. 1166 (N.D. Ala. 1971), where it was held that a premium paid for the last parcel, as a result of bargaining by seller, was to be allocated over all parcels.

3. How is allocation substantiated?

a. Appraisals by qualified persons. See Hoven v. Comm'r, 56 T.C. 50 (1971), and Neese v. Comm'r, 12 TCM 1058 (1953).

b. Assessed values placed upon properties by local assessors. See, e.g., Cullinan v. Comm'r, 5 B.T.A. 996 (1927), and Graybeal v. Comm'r, 39 TCM 734 (1979).

c. Values set forth in sales contracts, where based on arms'-length negotiations. See, e.g., Comm'r v. Gazette Telegraph Co., 209 F.2d 926 (CA10 1954).

d. Offers received from willing buyers. See, e.g., Ayling v. Comm'r, 32 T.C. 704 (1959).

4. If there is no reasonable method of allocating a part of the original cost to that portion of the property sold, the sales proceeds are treated as a return of capital.

a. Compare Inaja Land Co., Ltd. v. Comm'r, 9 T.C. 727 (1947) (city diverted polluted water onto taxpayer's property and paid \$50,000 for release of liability for diversion and continued right to divert; court held payment to be partial return of basis because could not apportion basis to easement), with Rev. Rul. 68-291, 1968-1 C.B. 351 (payment for power line easement resulted in gain because easement affected specific portion of property and could apportion basis to that property).

b. In Rev. Rul. 81-152, 1981-1 C.B. 433, it was determined that amounts received from a condominium developer for damages to common areas arising from defects in the construction of the development were a reduction of the basis of each individual owner, not income.

5. Where an interest in property (such as a 20-year possessory interest or a "development right") is sold or otherwise disposed of, the calculation of basis, which must be made in order to determine any gain or loss, may be quite difficult. Contrast Rev. Rul. 77-413, 1977-2 C.B. 298, with Rev. Rul. 77-414, 1977-2 C.B. 299. See also Lomas Santa Fe, Inc. v. Comm'r, 693 F.2d 71 (CA9 1982), aff'g 74 T.C. 662 (1981), where the taxpayer attempted to create a write-off by severing the fee simple interest in land from an estate for years, and the Courts agreed with the Service that this could not be done.

C. Adjusted Basis

1. Generally, as set forth in Sec. 1016, I.R.C., adjusted basis equals basis as determined above, subject to the following principal adjustments:

a. Increased for expenditures properly chargeable to capital account (that is, the cost of nondeductible property improvements, or, in the case of real property, carrying charges as to which the appropriate election, discussed below, is made). Sec. 1016(a)(1), I.R.C.; Reg. §1.1016-2.

b. Reduced by receipts properly credited to capital account (see, e.g., Inaja Land Co., Ltd. v. Comm'r, 9 T.C. 727 (1947), and Rev. Rul. 81-152, 1981-1 C.B. 433), and by losses which directly affect capital account (such as loss due to fire or other casualty). Sec. 1016(a)(1), I.R.C.; Reg. §1.1016-2(a).

c. Reduced by depreciation, cost recovery, amortization and depletion allowed or allowable. Sec. 1016(a)(2), I.R.C.; Reg. §1.1016-3. See also Reg. §1.167(a)-1; Reg. §1.167(a)10(a); Kansas City Southern Ry. Co. v. Comm'r, 22 B.T.A. 949 (1931); and Comm'r v. Superior Yarn Mills, Inc., 228 F.2d 736 (CA4 1955).

2. Carrying charges may, in the case of real property, be capitalized and added to basis under the following circumstances:

a. Under Sec. 266, I.R.C., an election may be made in connection with unimproved and unproductive real property, and real property being developed or improved (including already improved property being improved again), to capitalize and add to basis certain items otherwise deductible when paid or accrued.

b. The election must be exercised by filing with the return a statement indicating the items so treated. Reg. §1.266-1(c)(3). However, the Service has ruled that a taxpayer who capitalizes carrying charges for two or more years without making a valid election will nonetheless have adopted a method of accounting with respect to such carrying charges. Rev. Rul. 90-38, 1990-1 C.B. 59.

(1) An election is generally only effective for the year for which it is made, and once made, the election is binding for that year. See Jackson v. Comm'r, 172 F.2d 605 (CA7 1949).

(2) If the election is made for real property undergoing development or improvement, the election is binding until the development or construction work has been completed. Reg. §1.266-1(c)(2)(ii)(a).

c. The election is available as to the following items:

(1) Interest; however, this is the case only as to interest paid on a purchase money obligation or on money borrowed in connection with the property; interest

paid on money borrowed for other purposes may not be capitalized (Queensboro Corp. v. Comm'r, 134 F.2d 942 (CA2 1943));

- (2) Expenses of care and maintenance;
- (3) Fire protection (see Warner Mountains Lumber Co. v. Comm'r, 9 T.C. 1171 (1947)); and
- (4) If and only if the property is being developed or improved:
 - (a) Social security and employment taxes paid to employees during the period of development;
 - (b) Sales and use taxes paid on materials used in construction (Reg. §1.266-1(b)); and
 - (c) Other "necessary expenditures" in connection with the property (Reg. §1.266-1(b)(ii)(d)).

d. The election is made on an item-by-item basis; however, if several items of the same type are incurred with respect to a single project, the election to capitalize, if made, must be exercised as to all items of that type. Reg. §1.266-1(b) and (c).

e. As to unimproved and unproductive property, the election as to each item (or class of items) may be exercised each year, regardless of how treated in any prior year. The election as to an item is effective only for the year for which it is made. Reg. §1.266-1(c)(2)(i). On the other hand, where the property is in the process of development, the election as to each item (or class of items) is binding until completion of the particular project. Reg. §1.266-1(c)(2)(ii)(a).

f. The election as to unimproved land terminates when such unimproved land is put to productive use or when development is complete. Reg. §1.266-1(c)(2)(ii).

g. As a result of the "uniform capitalization" rule enacted in the Tax Reform Act of 1986, the direct and indirect costs of producing property or of acquiring property for resale must be capitalized. Sec. 263A(a), I.R.C. Property subject to the rule includes (1) real or tangible personal property produced by the taxpayer, and (2) real or personal property which is stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of business. Sec. 263A(b)(1), I.R.C. See also Sec. 263A(c), I.R.C. for general exceptions. Two notable exceptions to the capitalization rules exist under Section 263A:

(1) Personal property acquired for resale is not subject to the capitalization requirement if the taxpayer's average annual gross receipts for the three taxable year period ending with the preceding taxable year do not exceed \$10 million. Sec. 263A(b)(2)(B), I.R.C.

(2) Property produced by the taxpayer for personal use is not subject to the capitalization rule. Sec. 263A(c)(1), I.R.C.

III. CHOICE OF OWNERSHIP VEHICLE

A. Individual Ownership vs. Corporation Ownership -- General Considerations.

1. Advantages of Individual Ownership. Among the advantages -- both tax and non-tax -- of the individual ownership of real or personal property, as compared to corporate ownership, are the following:

a. A single set of books, records and tax returns may be kept and filed by the individual; however, this is not true of the partnership or limited liability company.

b. There is a single tax imposed on income from the property. Furthermore, depreciation and other "tax shelter" items may be utilized to offset other personal income, thereby reducing taxes.

c. Generally, sale procedures are simpler. If the corporation were to sell real property or significant personal property, ordinarily the purchaser will require either a sale by the corporation (with potentially adverse tax consequences) or adequate warranties relating to the corporation and its status.

d. There are no corporate-type tax problems, such as personal holding company status, unreasonable accumulations of income, collapsibility and dividend distributions. (However, partnership ownership will, as noted below, entail some of such considerations.)

2. Disadvantages of Individual Ownership. Among the disadvantages -- both tax and non-tax -- of the individual ownership of real or personal property are the following:

a. Where the individual's income is high, the individual's tax rates could be greater than the corporate tax rates. Note, however, that this result may at some point be eliminated by the decrease in the individual income tax rates provided in the Economic Growth and Tax Relief Reconciliation Act of 2001.

b. The "dealer" in real estate will encounter difficulties in segregating investment real estate from real estate held for sale. See, e.g., Tibbals v. United States, 362 F.2d 266 (Ct. Cl. 1966), and Black v. Comm'r, 45 B.T.A. 204 (1941); but see Cary v. Comm'r, 32 TCM 913 (1973), Adam v. Comm'r, 60 T.C. 996 (1973), and Ridgewood Land Co. Inc. v. Comm'r, 31 TCM 39 (1972), aff'd 477 F.2d 135 (CA5 1973).

c. Where the individual owns real estate, personal liability on the mortgage is likely to present a significant risk, in the absence of explicit exculpatory clauses in mortgages or the very problematical use of straw or nominee corporations. See Bollinger v. Comm'r, 485 U.S. 340 (1988), for the successful use of an agency corporation.

3. Considering the Future. In deciding upon the form of real estate ownership, the taxpayer must consider the impact of the initial ownership upon future planning. For example,

a. Where the corporation initially takes title to the real estate, and the stockholder later decides that he would like to own the real estate personally, (i) liquidation may entail gain to the extent of any increase in value (Sec. 331, I.R.C.), which gain may be partially or wholly taxable as ordinary income (Secs. 1245 and 1250, I.R.C.), or double taxation upon sale (but see Sec. 337, I.R.C.); (ii) use of the property in redemption may entail, in addition to the foregoing considerations, the possibility of a tax imposed upon the corporation where the redemption is made with appreciated property (Sec. 311(b), I.R.C.), as well as ordinary income to the stockholder (Sec. 302, I.R.C.); and (iii) distribution of the property to the stockholder other than in liquidation or redemption may result in a taxable dividend (Sec. 301, I.R.C.).

b. Where property is owned by an individual or partnership, and it is desired to place the same into a corporation in order to enter a tax-free reorganization with another corporation or a real estate investment trust, this cannot be done as a step in a pre-arranged plan or reorganization, or taxability will result from the transfer to the corporation. Rev. Rul. 70-140, 1970-1 C.B. 73; see Rodman v. Comm'r, 57 T.C. 113 (1971), where the application of Rev. Rul. 70-140 was stipulated; see also Rev. Rul. 91-47, 1991-2 C.B. 16, where the debtor could not avoid cancellation of indebtedness income where an unrelated party formed a corporation to acquire the debt and then sold the corporation's stock to the debtor. However, where there is no prearranged plan, or prior commitment, to enter into the subsequent step, taxability will not result from the first transfer. See, e.g., Vest v. Comm'r, 57 T.C. 128 (1971), modified on other grounds 481 F.2d 238 (CA5 1973). See also Weikel v. Comm'r, 51 TCM 432 (1986).

B. Tenants in Common.

1. Generally, tenants in common own undivided fractional interests in property. Thus, a tenant in common may freely dispose of his interest in the property, and the transferee becomes a co-tenant with the other tenants in common.

2. Each tenant in common is required to report his share of income or losses produced by the property. On the theory that a tenant in common is liable personally only for his share of expenses, a tenant in common may deduct only that portion of the expenses attributable to his interest in the property, even though he may pay all of the expenses related to interests in the property. See Boyd's Estate v. Comm'r, 28 T.C. 564 (1957), and Webb's Estate v. Comm'r, 30 T.C. 1202 (1958). Gain or loss realized on the sale or other disposition of the property is divided among the tenants in common in proportion to their respective interests. See, generally, Fowler, Tax Aspects of Gifting Fractional Interests in Realty, 7 J.R.E. Tax. 5 (1980).

3. If there is activity involved, the Service may claim that in actuality a partnership exists. See Reg. §301.7701-3(a); Powell v. Comm'r, 26 TCM 161 (1967); and Ostrow v. Comm'r, 15 TCM 957 (1956); but see Rev. Rul. 75-374, 1975-2 C.B. 261, dealing

with a real estate investment trust. Note that in Levine's Estate v. Comm'r, 72 T.C. 780 (1979), aff'd 634 F.2d 12 (CA2 1980), where the taxpayer held properties as a tenant in common with another person, the court accepted the contention of the Service that, because such tenants in common "engaged in an active business, performed various services, and shared the gains and losses", they were "engaged in the operation of a partnership". [Among other things, this may require any reinvestment of condemnation proceeds under Sec. 1033, I.R.C. to be made at the entity level (see Demirjian v. Comm'r, 457 F.2d 1 (CA3 1972)), and may prevent different taxpayers from using different rates of depreciation for their respective interests in the property.] See Priv. Ltr. Rul. 8916034 (January 23, 1989), where individuals owning rental real estate were determined to be partners where proceeds from the sale of the property were deposited in the name of a partnership and a partnership tax return was filed in the year of sale.

C. Joint Tenants with Rights of Survivorship.

1. Generally, each joint tenant is a co-owner of property having an individual interest therein under a single deed; when one dies, his title passes immediately to the other joint tenants. However, a joint tenant may, in most jurisdictions, freely dispose of his interest, thereby breaking the joint tenancy, in which case the conveyee becomes a tenant in common with the other tenants. In most jurisdictions, a joint tenant does not have partition rights, but a tenant in common has such rights. [Note, however, that a tenant in common may generally effectively waive his partition rights. See, e.g., Prude v. Lewis, 78 N.M. 256, 430 P.2d 753 (1967); but see, Condrey v. Condrey, 92 So.2d 423 (Fla. 1957).]

2. Each joint tenant is required to report his share of any income or losses produced by the property. See Haynes v. Comm'r, 7 B.T.A. 465 (1927). However, the expenses incurred on or with respect to the property are deductible only by the joint tenant who pays them, on the theory that the joint tenant incurs joint liability for all expenses with respect to the property. See Tracy v. Comm'r, 25 B.T.A. 1055 (1932), and Powell v. Comm'r, 26 TCM 161 (1967). See also Rev. Rul. 71-179, 1971-1 C.B. 58.

D. Tenants by the Entirety.

1. In most jurisdictions, this applies only in the case of a husband and wife.

2. The tenancy by the entirety is similar to the joint tenancy in that the surviving spouse acquires title from the deceased spouse, and the ownership is co-equal. The tax impact is the same as that on the joint tenancy. See Rev. Rul. 71-268, 1971-1 C.B. 58; see also Rev. Rul. 75-347, 1975-2 C.B. 70, where married taxpayers filing separate returns were each required to deduct half the amount of a casualty loss resulting from damage to their residence which they owned as tenants by the entirety.

3. In many jurisdictions, the tenancy by the entirety provides much stronger protection against creditors than does the joint tenancy. While state laws vary, transferring title to real property from joint tenancy to tenancy by the entirety often will not trigger the imposition of transfer and recordation taxes.

E. S Corporations.

1. The Subchapter S Revision Act of 1982 enhanced the S corporation as an entity through which to operate real estate. S corporations may be even more desirable because of the projected decrease in individual income tax rates under the Economic Growth and Tax Relief Reconciliation Act of 2001.

2. Generally, where real or personal property is held for investment, in order to obtain leverage and depreciation, the S corporation is not a desirable form of ownership because of the inability of the shareholders to utilize the debts of the S corporation to increase their bases. Yet, the S corporation clearly may be useful under certain circumstances, such as:

a. Where the property acquired is already in a corporation which cannot be liquidated advantageously.

b. Where limited liability is desirable for all parties, so that the partnership would not serve the needs of the individuals, and losses are anticipated which the individuals either wish to deduct against their personal income or are willing to capitalize and offset against future income.

c. Where the corporation is primarily going to be engaged in active real estate operations, such as real estate sales, the mortgage or real estate brokerage business, hotel or motel operations, or the construction and sale of residences or residential units.

3. Simply stated, the tests for qualification as an S corporation are as follows:

a. The corporation must be a domestic corporation (includes the United States, any state or territory). Sec. 1361(b)(1), I.R.C.

b. The maximum number of shareholders is 100. Sec. 1361(b)(1)(A), I.R.C.

(1) For this purpose, a husband and wife (and their estates) are treated as one shareholder, regardless of how their stock is owned; however, each must satisfy the shareholder-level eligibility requirements separately. Sec. 1361(c)(1), I.R.C.

(2) Likewise, under the American Jobs Creation Act of 2004, up to seven (7) generations of family members may elect to be treated as one shareholder. Sec. 1361(c)(1), I.R.C.

c. The stockholders generally must be individuals or estates. Sec. 1361(b)(1)(B), I.R.C. (Under Sec. 1361(c)(3), I.R.C., the term "estate" includes an estate of an individual in bankruptcy.) Except as to certain trusts (as noted below), a trust generally is not a permissible shareholder. See Old Virginia Brick Co., Inc. v. Comm'r, 44 T.C. 724 (1965), in which an estate not closed for 18 years was held to be a de facto trust. See also Fulk & Needham, Inc. v. United States, 411 F.2d 1403 (CA4 1969); and W & W Fertilizer Corp. v.

United States, 527 F.2d 621 (Ct. Cl. 1975). Under Secs. 1361(c)(2)(A) and (B), I.R.C., the following domestic trusts are permitted as stockholders:

(1) Under Sec. 1361(c)(2)(A)(i), I.R.C., a trust with respect to which the grantor or another person is treated as the owner under Sec. 677 or 678, I.R.C. The grantor or such other person is considered the stockholder. Sec. 1361(c)(2)(B)(i), I.R.C.

(2) Under Sec. 1361(c)(2)(A)(ii), I.R.C., a trust as to which the grantor or another person was treated as the owner prior to such person's death and which continues in existence after such death. The estate of such person is treated as the stockholder. Sec. 1361(c)(2)(B)(ii), I.R.C.

(a) If the entire corpus of the trust is included in the gross estate of the deemed owner, then such trust may continue to be a stockholder for the two years beginning on the date of such death. Reg. §1.1361-1(h)(1)(ii).

(b) Otherwise, such trust may continue to be a stockholder only for the 60-day period beginning on the date of such death. Reg. §1.1361-1(h)(1)(ii).

(3) Under Sec. 1361(c)(2)(A)(iv), I.R.C., a voting trust. Each beneficiary is considered a stockholder. Sec. 1361(c)(2)(B)(iv), I.R.C.

(4) Under Sec. 1361(c)(2)(A)(iii), I.R.C., a trust under a will, but only for the two-year period beginning on the day on which the stock is transferred to it. The testator's estate is considered the stockholder. Sec. 1361(c)(2)(B)(iii), I.R.C.

(5) Under Sec. 1361(d), I.R.C., a "qualified Subchapter S trust" if the individual beneficiary of the trust (or his legal representative) irrevocably elects to be treated as the owner of the trust for purposes of Sec. 678, I.R.C. See Regs. §§1.1361-1(h)(1)(iii) and 1.1361-1(j).

(6) Under Secs. 1361(c)(2)(A)(v) and 1361(e), I.R.C., an "electing small business trust" if the trustee makes an election, no interest in the trust was acquired by purchase and the trust does not have a beneficiary other than an individual, an estate or a charitable organization with a contingent remainder interest.

d. Nonresident aliens cannot be stockholders. Sec. 1361(b)(1)(C), I.R.C.

e. The corporation cannot have more than one class of stock. Sec. 1361(b)(1)(D), I.R.C.

(1) A corporation is not treated as having more than one class of stock solely because there are differences in voting rights among the shares of common stock. Sec. 1361(c)(4), I.R.C.

(2) There is also a "safe harbor" for "straight debt" under Sec. 1361(c)(5), I.R.C.

(a) "Straight debt" is not treated as a second class of stock. Sec. 1361(c)(5)(A), I.R.C.

(b) "Straight debt" must meet the following conditions:

(i) a written unconditional promise
(Sec. 1361(c)(5)(B), I.R.C.);

(ii) to pay on demand or on a specified date
(Sec. 1361(c)(5)(B), I.R.C.);

(iii) a sum certain in money (Sec. 1361(c)(5)(B), I.R.C.);

(iv) if the interest rate and interest payment dates are not contingent on profits, the borrower's discretion or similar factors (Sec. 1361(c)(5)(B)(i), I.R.C.);

(v) there is no convertibility (directly or indirectly) into stock (Sec. 1361(c)(5)(B)(ii), I.R.C.); and

(vi) the creditor must be an individual (other than a nonresident alien), an estate, a trust permitted as a shareholder under Sec. 1361(c)(2), I.R.C., or a person which is actively and regularly engaged in the business of lending money. Sec. 1361(c)(5)(B)(iii), I.R.C.

4. The Subchapter S election may be lost in various ways. The most significant of these in the real estate area is the passive investment income test, which was substantially revised under the Subchapter S Revision Act. See, generally, Shaw and August, An Analysis of the Subchapter S Revision Act: Eligibility, Election, Termination, 58 J. Tax. 2 (1983).

a. The corporation may affirmatively revoke its election, with the consent of stockholders holding more than one-half of the shares of stock on the day on which the revocation is made. Sec. 1362(d)(1)(B), I.R.C.

(1) Such revocation may specify a prospective date for revocation on or after the date on which the revocation is made, in which case the revocation is effective on and after the date specified. Sec. 1362(d)(1)(D), I.R.C.

(2) Otherwise, a revocation made during the taxable year is effective as follows:

(a) If made on or before the 15th day of the third month, it is effective on the first day of the taxable year in which made. Sec. 1362(d)(1)(C)(i), I.R.C.

(b) If made after the 15th day of the third month, it is effective on the first day of the following taxable year. Sec. 1362(d)(1)(C)(ii), I.R.C.

b. The corporation will lose its Subchapter S status if it ceases to be a small business corporation; that is, it fails to meet one of the tests set forth above for qualification. Sec. 1362(d)(2)(A), I.R.C. Such termination is effective on and after the date of cessation. Sec. 1362(d)(2)(B), I.R.C.

c. The Subchapter S status of the corporation will be terminated when two conditions are both met:

(1) The corporation has Subchapter C earnings and profits at the close of each of three consecutive taxable years. Sec. 1362(d)(3)(A)(i)(I), I.R.C.

(a) "Subchapter C earnings and profits" are those from a taxable year of the corporation for which a Subchapter S election is not in effect. Reg. §1.1361-2(c)(3).

(b) A prior year is not taken into account unless it began after December 31, 1981 and the corporation was an S corporation for such taxable year. Sec. 1362(d)(3)(A)(iii), I.R.C.

(c) As to the concept of earnings and profits, see Sec. 312, I.R.C.

(2) The corporation has gross receipts for each of such three consecutive taxable years more than 25% of which are derived from "passive investment income" -- that is, rents, royalties, dividends, interest, annuities and sales or exchanges of stock or securities (but only to the extent of gains). Sec. 1362(d)(3)(A)(i)(II), I.R.C.

(a) Note that rents are not considered passive investment income if significant services are rendered. See Reg. §1.1372-2(c)(5)(ii)(B). See, e.g., Priv. Ltr. Rul. 8926039 (March 31, 1989).

(i) As to what constitutes rents, see, e.g., Rev. Rul. 64-232, 1964-2 C.B. 334 (personal property leased -- held significant services), and Rev. Rul. 65-40, 1965-1 C.B. 429 (cars leased on daily basis -- held significant services). See also Rev. Rul. 76-48, 1976-1 C.B. 265, where it was held that payments received for the use of tennis and handball courts by players who are provided with locker room and parking facilities, lesson fees with no additional charge made for the court and sales of sports items by a shop on the premises do not constitute passive investment income. Likewise, see Rev. Rul. 81-197,

1981-2 C.B. 166, distinguishing between "dry" leases of aircraft (that is, a rental rate for the plane alone, without pilot, fuel or oil), the payments for which are "rents" for Subchapter S purposes, and full-service chartering of aircraft (that is, the fee includes the pilot, fuel, catering, operating supplies, insurance, landing and parking fees), the payments for which are considered compensation for services rendered.

(ii) The Service has taken the position that activities of the corporation which are not required to maintain the rented real property in a condition suitable for occupancy will be treated as services rendered for the convenience of the tenant. See Comiter, Recent Private Rulings Hold Shopping Mall Rents Are Not Passive Investment Income, 6 J. Partnership Tax. 247 (1989). See also Priv. Ltr. Ruls. 8946043 (August 22, 1989) and 9045059 (August 16, 1990) (services to shopping center tenants); Priv. Ltr. Rul. 8931018 (May 3, 1989) (services in connection with rental of construction trailers and modular offices); and Priv. Ltr. Rul. 9045057 (August 16, 1990) (services to tenants of mobile home park).

(iii) Partnership income allocable to an S corporation partner is treated as income of the same character as in the hands of the partnership, even though the S corporation may be a limited partner. See, e.g., Priv. Ltr. Rul. 8931007 (April 28, 1989).

(3) Under Sec. 1362(f), I.R.C., it is recognized that an inadvertent termination may occur as to either the small business corporation qualification test (under Sec. 1362(d)(2), I.R.C.) or the passive investment income test (under Sec. 1362(d)(3), I.R.C.). If the I.R.S. determines that such termination was inadvertent, then, if certain conditions are met, the corporation may be treated as continuing to be an S corporation. See, e.g., Rev. Rul. 86-110, 1986-2 C.B. 150. Such conditions are:

(a) No later than a reasonable period of time after discovery of the event resulting in such termination, steps are taken so that the corporation is once more qualified under Subchapter S. Sec. 1362(f)(3), I.R.C.

(b) The corporation and each stockholder during the period specified by the I.R.S. agree to make such adjustments (consistent with the treatment of the corporation as an S corporation) as the I.R.S. requires. Sec. 1362(f)(4), I.R.C.

(4) If the Subchapter S election is terminated under Sec. 1362(d), and if Sec. 1362(f), I.R.C., does not apply, the corporation (and any successor corporation) cannot make a new Subchapter S election before its fifth taxable year which begins after the first taxable year for which such termination is effective, unless the I.R.S. consents. Sec. 1362(g), I.R.C.

(5) The Job Creation and Worker Assistance Act of 2002 amends Sec. 108(d)(7)(A), I.R.C. so that cancellation of indebtedness income which is excluded from the gross income of an S corporation shareholder shall not result in an adjustment to the stock basis of such shareholder. The amendment effectively precludes the result that the United

States Supreme Court reached in Gitlitz v. Comm'r, 531 U.S. 206 (2001), rev'g 182 F.3d 1143 (CA10 1999). The amended provision is effective for discharges of indebtedness which occur in taxable years ending after October 11, 2001. However, Sec. 108(d)(7)(A), I.R.C., as amended, does not apply to any discharge of indebtedness before March 1, 2002, which occurs pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001. Pub L No. 107-147, approved March 9, 2002.

F. General Partnerships.

1. The partnership is not a taxable entity for Federal income tax purposes, although it is a reporting entity. Sec. 701, I.R.C.

a. Prior to the Tax Reform Act of 1984, the exchange of partnership interests could qualify as a like-kind exchange under Sec. 1031, I.R.C., depending on the underlying property. Sec. 1031(a)(2)(D), I.R.C. now excludes exchanges of partnership interests.

b. Reg. §1.1031(a)-1(a)(1) provides that Sec. 1031(a)(1), I.R.C. does not apply to any exchange of interests in a partnership regardless of whether the interests exchanged are general or limited partnership interests or are interests in the same partnership or in different partnerships.

(1) With respect to the conversion of a general partnership into a limited partnership, or vice versa, see Rev. Rul. 84-52, 1984-1 C.B. 157, and Priv. Ltr. Rul. 8904061 (November 3, 1988).

(2) As to the conversion of a general partner interest into a limited partner interest, or vice versa, in the same partnership, see Priv. Ltr. Rul. 8912023 (December 22, 1988).

(3) The Regulation is applicable to transfers of property made on or after April 25, 1991.

c. In the Revenue Reconciliation Act of 1990, Sec. 1031(a)(2)(D), I.R.C. was further amended to provide that an interest in a partnership with a valid election in effect under Sec. 761(a), I.R.C. to be excluded from the application of Subchapter K is treated as an interest in each of the assets of the partnership, and not as an interest in the partnership.

(1) This amendment applies to all transfers after July 18, 1984.

(2) There is still a question as to whether the partnership interest can be exchanged for assets of like-kind to its assets, or whether the partnership's assets must first be distributed to the partners, who then complete the exchange. Generally, where a partnership has in effect a valid election under Sec. 761(a), I.R.C., the interest in the partnership is treated as an interest in each of the assets of the partnership and not as an interest in the partnership. Sec. 1031(a)(2), I.R.C. But see F.S.A. 199951004 (September 3, 1999), finding

that Sec. 1031, I.R.C. did not apply to a transaction where the taxpayer transferred a percentage interest in each of two buildings owned by a partnership which made an election under Sec. 761, I.R.C.

2. Certain elections, such as those under Secs. 754, 1033 and 1039, I.R.C., must be made at the partnership level, rather than by the individual partners. See, e.g., Demirjian v. Comm'r, 457 F.2d 1 (CA3 1972); but see Priv. Ltr. Rul. 8041061 (July 17, 1980), allowing a partnership to terminate and distribute its investment land to its partners as tenants in common "in anticipation of a condemnation", so that such persons could individually elect to use the provisions of Sec. 1033, I.R.C.

3. The term "partnership" is defined to include a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation or venture is carried on, and which is not a corporation or trust or estate within the meaning of the Code. Sec. 761(a), I.R.C. and Reg. §301.7701-1(a). See also McDougal v. Comm'r, 62 T.C. 720 (1974).

a. A joint undertaking merely to share expenses is not considered a partnership. See, e.g., Reg. §301.7701-1(a)(2), example of joint ditch to drain water.

b. The mere co-ownership of property maintained, kept in repair, and rented or leased does not constitute a partnership (see Reg. §301.7701-1(a)(2), example of farm leased to farmer for share of crops or cash rental); however, in contrast, tenants in common may be considered partners if they actively carry on a trade, business, financial operation or venture and divide the profits therefrom. See Reg. §301.7701-1(a)(2). But see Rev. Rul. 75-374, 1975-2 C.B. 261, holding a life insurance company and a REIT to be tenants in common in the ownership of an apartment building, which is managed by an unrelated management company, which furnishes (and receives the profits from) all services other than customary services.

c. All members of an unincorporated organization availed of for (i) investment purposes only and not the active conduct of a business or (ii) the joint production, extraction or use of property, but not the selling of services or the property produced or extracted, may elect to exclude the organization from the partnership provisions of the Code, if the income of such persons may be adequately determined without the computation of partnership taxable income. Sec. 761(a), I.R.C.

d. There is generally no requirement that there be a written partnership agreement. See, e.g., Buckley v. United States, 76-1 USTC 19473 (W.D. Tex. 1976). See also Luna v. Comm'r, 42 T.C. 1067 (1964), setting forth a number of factors (at pages 1077-1078) in determining whether a partnership exists, but not specifying any written agreement. However, where an agreement is entered requiring that certain conditions be met before the partnership is formed, then the partnership cannot be considered as formed unless and until those conditions are in fact met. Priv. Ltr. Rul. 8026001 (March 7, 1980).

4. The "joint venture" is, under most state laws, merely a general partnership. A joint venture is clearly treated as a partnership for Federal income tax purposes where the facts and circumstances so indicate. Priv. Ltr. Rul. 8105030 (October 29, 1980).

a. The traditional difference between the "joint venture" and the general partnership is that the "joint venture" is usually formed to hold one piece of real estate or one project, while the general partnership is ordinarily operational and used in the mercantile or similar areas. See Madison National Bank v. Newrath, 275 A.2d 495 (Ct. Appls. Md. 1971); 2 Rowley, Law of Partnership §52.1 et seq.; and Nichols, Joint Ventures, 36 Va. L. Rev. 425 (1950).

b. Although there are some technical differences under state law between the "joint venture" and the general partnership, perhaps the only significant difference is that the corporate laws of some states prohibit a corporation from becoming a "partner" but not from becoming a "venturer".

G. Limited Partnerships.

1. Non-Tax Advantages. Among the non-tax advantages of the limited partnership as the owning entity are the following:

a. Because it is required to file with the appropriate recording authorities a certificate of limited partnership (ULPA, Sec. 2), the limited partnership, for which any one or more of the general partners may be authorized to sign documents, may itself take legal title to partnership property.

b. An interest in the partnership is considered personal property, so that the transfer of an interest is the transfer of personal property. (ULPA, Sec. 18.) The sale of the project may be effectuated by selling the partnership interests, thereby avoiding payment of state or local real property transfer taxes. Certain jurisdictions have now eliminated this means of circumventing transfer taxes by enacting or re-drafting transfer tax statutes to apply to the transfer of real property or any interest in that property. These statutes generally define such an interest to include an interest in an entity which holds real property as its primary asset.

c. There is a lack of forms and formalities required to conform with ULPA, as compared with the bookkeeping, formalities and state and Federal filings required for the corporation.

2. Non-Tax Disadvantages. Among the non-tax disadvantages of the limited partnership as the owning entity are:

a. Generally, the general partners of the limited partnership [and the limited partners if they are not cautious in exercising management or control functions -- see ULPA, Sec. 7 (but contrast Revised Uniform Limited Partnership Act §402, imparting protection to investors if certain "investor democracy" rights -- particularly the right to remove the general partner -- are exercised); and see Feld, The "Control" Test for Limited Partnerships, 82 Harv.

L. Rev. 1471 (1969), and Note -- Partnership: Can Rights Required to Be Given Limited Partners Under New Tax Shelter Investment Regulations Be Reconciled with Section 7 of the Uniform Limited Partnership Act?, 26 Okla. L. Rev. 289 (1973)] have personal liability for all partnership debts and obligations. (ULPA, Sec. 9.)

b. However, there are alternatives, such as:

- (1) Exculpatory clauses in permanent mortgages.
- (2) Third parties which act as guarantors for a fee.
- (3) Adequate insurance protection.

3. Tax Advantages. Generally, but subject to further, more detailed discussion below, among the tax advantages of the limited partnership (as well as the general partnership) as the owning entity are:

a. Because the limited partnership is not considered a taxable entity, there is no double taxation imposed upon the partnership and its partners. Sec. 701, I.R.C.; Reg. §1.701-1. Rather, losses pass through the limited partnership to its partners and may be utilized to offset income from other sources; and partnership income is taxed at only one level -- that of the partners. Secs. 701 and 702, I.R.C.

b. Under the check-the-box entity classification regime, any domestic eligible entity with two or more members is classified as a partnership by default unless the entity elects otherwise. Formerly, the four corporate characteristics or "Kintner criteria" were evaluated to determine whether an entity should be classified as a corporation or a partnership for Federal income tax purposes. The check-the-box regulations do not consider whether the entity has any of such characteristics -- that is, continuity of life, centralized management, limited liability and free transferability of interests.

c. The rules of Sec. 751, I.R.C. (applying to "collapsible partnerships") are relatively limited in scope. But see Anderson and Bloom, Collapsible Partnerships: The Complexities of Section 751, 2 J.R.E. Tax. 425 (1975); and Applebaum, Collapsible-Partnership Danger Increases with Use of Partnerships as Tax Shelters, 42 J. Tax. 272 (1975). [Caveat: The term "unrealized receivables", as used in Sec. 751(c), I.R.C., will include Sec. 1245 and Sec. 1250 property, as well as farm recapture property (under Sec. 1251) and farm land (under Sec. 1252), to the extent of the amount that would have been treated as gain to which the relevant provision would have applied if such property had been sold by the partnership at its fair market value at the time.]

d. Distributions by the partnership to a partner will generally not, in and of themselves, cause recognition of gain or loss, so long as the partner retains a tax basis for his partnership interest. Sec. 731, I.R.C.; but see Secs. 736, 741 and 751, I.R.C. See, generally, Parker and Lee, Constructive Cash Distributions in a Partnership: How and When They Occur,

41 J. Tax. 88 (1974); Palmer, Breaking up Is Hard to Do: Redemptions of Partnership Interests under Section 736, 66 Taxes 914 (1988).

e. In connection with the treatment of transactions between partners and partnerships under Sec. 707(a)(2), I.R.C., Final Regulations on "disguised sales" of property between partners and partnerships were issued on September 30, 1992.

(1) Under Reg. §1.707-3(b)(1), a partner's transfer of property to a partnership and the partnership's transfer of money or other consideration to that partner are deemed a sale of the property by the partner to the partnership if

(a) the transfer of money or other consideration would not have been made by the partnership but for the partner's transfer of property, and

(b) either (1) the transfers are made simultaneously, or, if not, (2) the partnership's distribution is not dependent on the entrepreneurial risks of partnership operations. Reg. §1.707-3(b)(1).

(2) If, within a 2-year period, there are both a contribution by a partner to the partnership and a distribution by the partnership to that partner, these "interrelated" transfers are presumed to be a sale of the property to the partnership. Reg. §1.707-3(c)(1).

(a) If the contribution and distribution are more than two years apart, then these transfers are presumed not to be a sale of the contributed property, "unless the facts and circumstances clearly establish that the transfers constitute a sale." Reg. §1.707-3(d). See Reg. §1.707-3(f), Examples 5 through 7.

(b) Over and above the presumptions, 10 specific factors are set forth in Reg. §1.707-3(b)(2) that (although not exclusive) are considered evidence of the existence of a sale. Regs. §1.707-3(c) and (d).

(3) A "guaranteed payment for capital" (that is, a payment to a partner by a partnership determined without regard to partnership income and for the use of that partner's capital) is not treated as part of a sale of property (Reg. §1.707-4(a)(1)(i)) so long as:

(a) The payment is "reasonable" (Reg. §1.707-4(a)(1)(ii)); and

(b) The payment is characterized as a guaranteed payment. Reg. §1.707-4(a)(1)(ii).

(4) Contributions of encumbered property to a partnership may be treated as disguised sales to the extent of the debt deemed shifted to noncontributing partners, depending on whether the liability is a "qualified" or "non-qualified" liability, and whether it is recourse or nonrecourse (see Regs. §§1.752-1(a) and -2). Reg. §1.707-5.

(5) Under Reg. §1.707-9(a)(1), these Regulations apply to any transaction with respect to which all transfers that are part of a sale of an item of property occur after April 24, 1991. Transactions occurring in whole or in part before April 25, 1991 and, generally, after March 31, 1984 are determined on the basis of Sec. 707(a)(2), I.R.C. itself and the legislative history of the 1984 Tax Reform Act provision changing Sec. 707(a)(2), I.R.C.

f. There is a freedom of operation, both as to requisite income sources, and the lack of limitation upon the number of owners and the values of their respective holdings in a limited partnership, compared with the stringent rules as to the same governing the real estate investment trust.

g. There is an absence of personal holding company or unreasonable accumulation of income problems.

4. Basis for the Partnership Interest --

a. The contrast of the S corporation --

(1) The tax basis of the stockholder in an S corporation is limited to the sum of (i) the cost or other adjusted basis of his stock and (ii) the adjusted basis of any debt of the corporation directly to him. Secs. 1012 and 1367, I.R.C.

(2) Indebtedness of the corporation, whether recourse or nonrecourse, does not afford the stockholder any basis for deductibility. Nor do stockholder guarantees of corporate indebtedness. See, e.g., Rev. Rul. 69-125, 1969-1 C.B. 207; Rev. Rul. 70-50, 1970-1 C.B. 178, clarified by Rev. Rul. 71-288, 1971-2 C.B. 319; Perry v. Comm'r, 47 T.C. 159 (1966), aff'd 392 F.2d 458 (CA8 1968); and Williams v. Comm'r, 41 TCM 844 (1981). These are significant disadvantages of an S corporation because the amount of losses which a shareholder can recognize is limited to his basis. See, generally, Cantor and Brill, The S Corporation: An Alternative for Syndication, 61 Taxes 227 (1983); and Harns & Maiorano, Alternative Methods of Obtaining Basis in Leveraged S Corporation Assets, 64 Taxes 203 (1986);

(3) The technique of switching corporate loans guaranteed by stockholders to stockholder loans at the very end of the corporation's fiscal year, in order to create basis for the stockholder, was held to be ineffective in Underwood v. Comm'r, 63 T.C. 468 (1975), aff'd 535 F.2d 309 (CA5 1976). The Tax Court refused to elevate form over substance in order to create such basis, where "the only effect of these new notes was to shift the liabilities for the prior loans". But see Rev. Rul. 75-144, 1975-1 C.B. 277, and see Gilday v. Comm'r, 43 TCM 1295 (1982), in which Underwood was not even cited.

b. The Partnership.

(1) Under Sec. 722, I.R.C., a partner's basis in the partnership, for purposes of determining loss deductions, is equal to the adjusted basis of any property contributed by him to the partnership.

(2) Under Sec. 752(a), I.R.C., any increase in a partner's share of partnership liabilities, or any increase in his personal liabilities by reason of his assumption of any partnership liabilities, is considered as a contribution of money by such partner to the partnership, thereby increasing his basis. See Rev. Rul. 88-77, 1988-2 C.B. 129 (revoking Rev. Rul. 60-345, 1960-2 C.B. 211), which provides that, for partnership taxable years beginning September 19, 1988, accrued but unpaid expenses and payables will not be considered liabilities under Sec. 752, I.R.C. for purposes of computing adjusted basis of the interest of a cash-basis partner.

(3) Under Sec. 752(c), I.R.C., any liability to which the property is subject is, to the extent of the fair market value of the property, considered a liability of the property owner, thereby increasing his basis under and pursuant to Sec. 752(a), I.R.C. See Regs. §§1.752-1(b), 2(a), 2(d) and 2(e). See, in this context, Crane v. Comm'r, 331 U.S. 1 (1947), in the non-partnership situation. See, generally, Epstein, The Application of the Crane Doctrine to Limited Partnerships, 45 S.Cal. L. Rev. 100 (1972); and Halpern, Footnote 37 and the Crane Case: The Problem That Never Really Was, 6 J.R.E. Tax. 197 (1979).

(4) Notwithstanding Crane v. Comm'r, 331 U.S. 1 (1947), and Sec. 752(c), I.R.C., the limited partner in a limited partnership might be questioned, as the Service has from time to time sought to do, as to his basis, if any, in nonrecourse loans of the partnership.

(a) The two-tiered partnership situation was one area in which the Service raised some threats in the past. This question was put to rest by Secs. 751(f) and 706(d)(3), I.R.C., added by the TRA 1984, and specifically dealing with tiered partnerships. An upper-tier partnership's share of the liabilities of a lower-tier partnership (other than any liability of the lower-tier partnership that is owed to the upper-tier partnership) is treated as a liability of the upper-tier partnership for purposes of applying Sec. 752, I.R.C. to the partners of the upper-tier partnership. Reg. §1.752-4(a).

(b) Another issue is whether a person who acquires a partnership interest, but is not admitted to the partnership as a substituted limited partner, is entitled to his pro rata share of partnership losses.

(i) In Evans v. Comm'r, 54 T.C. 40 (1970), aff'd 447 F.2d 547 (CA7 1971), the taxpayer assigned his partnership interest to his wholly-owned corporation without his partner's knowledge or approval. The Service, relying on Burnet v. Leininger, 285 U.S. 136 (1932), contended that the assignment was ineffective. However, the Tax Court, referring to United States v. Atkins, 191 F.2d 146 (CA5 1951), found that the assignment was effective, so that the corporation owned a capital interest in the partnership, as required under Sec. 704(e), I.R.C., because capital was a material income-producing factor in the business.

(ii) In Rev. Rul. 77-137, 1977-1 C.B. 178, the Service effectively followed Evans, by ruling that, where an assignee acquired substantially all

of the dominion and control over a partnership interest, and where the partnership agreement provided the assignee would share in partnership profits and losses even without the requisite consent of the general partners where substitution of the assignee as a partner was not granted, then the assignee would be treated as a partner for Federal income tax purposes.

(5) As set forth in Reg. §1.752-3(a)(3), the partners generally share nonrecourse liabilities in accordance with their interests in the partnership. Reg. §1.752-3(a) provides that a partner's share of the nonrecourse liabilities of a partnership equals the sum of the following:

(a) The partner's share of partnership minimum gain, determined in accordance with the rules of Sec. 704(b), I.R.C. (see Reg. §1.752-3(c), Example 1);

(b) The amount of any taxable gain that would be allocated to the partner under Sec. 704(c), I.R.C. if the partnership, in a taxable transaction, disposed of all partnership property, subject to one or more nonrecourse liabilities of the partnership, in full satisfaction of the liabilities and for no other consideration; and

(c) The partner's proportionate share of excess nonrecourse liabilities (not allocated in (a) or (b) above) of the partnership, as determined in accordance with the partner's share of partnership profits. See Reg. §1.752-3(c), Example 2. [Note that Final Regulations effective October 31, 2000 provide that a partnership may allocate excess nonrecourse liabilities based on the excess Sec. 704 gain or the excess reverse Sec. 704 gain. See Reg. §1.752-3(b)(1).]

(6) If the general partner is personally liable on a partnership liability, the general partner, but not any limited partner, will include such liability in the basis for his partnership interest. Reg. §1.752-2(a).

(a) A partner's share of a recourse partnership liability equals the portion of the liability, if any, for which the partner or related person bears the economic risk of loss. Reg. §1.752-2(a).

(b) A partner is considered to bear the economic risk of loss for a partnership liability to the extent that the partner or a related person would be obligated to make either (i) a payment to any person or (ii) a contribution with respect to such liability, if in either case the partnership constructively liquidated at that time and there were no entitlements to any reimbursement from another partner or person related to another partner. Reg. §1.752-2(b).

(c) On a constructive liquidation of a partnership, the following events are deemed, under Reg. §1.752-2(b)(1), to occur simultaneously.

(i) All of the partnership liabilities become payable in full.

(ii) All of the assets of the partnership [excluding money or other separate property contributed by a partner for use by the partnership solely to secure the payment of a partnership liability] become worthless.

(iii) The partnership disposes of all of its property in a fully taxable exchange for no consideration (other than relief of liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership).

(iv) All items of income, gain, loss and deduction are allocated among the partners.

(v) The partnership liquidates.

(d) If the partnership assumes or takes subject to a liability so that the general partner becomes personally liable, only the general partner's basis for his interest in the partnership would be increased by the amount of such liability. See Regs. §§1.752-1(b), -2(a), -2(d) and -2(e).

(e) Where it is not the general partner, but his wholly-owned (or even 80%-controlled) corporation, which has guaranteed the loan, such guaranty will be considered a liability of the general partner. Reg. §1.752-1(a)(2) refers to a partnership liability being a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability under Reg. §1.752-2. A person is "related to" a partner if the person and the partner bear a relationship to each other that is specified in either Sec. 267(b), I.R.C. or Sec. 707(b)(1), I.R.C., except that (i) "80 percent or more" is substituted for "more than 50%"; (ii) Secs. 267(e)(1) and (f)(1)(A) are disregarded; and (iii) a person's family is determined by excluding brothers and sisters. Reg. §1.752-4(b).

(7) Where the general partner has guaranteed only the top portion of the permanent loan, and the "floor-loan" portion (or that portion which the lender agrees to fund without conditions, such as meeting a rent roll or occupancy requirements) carries no such guarantee, the floor-loan portion will provide basis to all partners in the limited partnership. Reg. §1.752-2(h). See Reg. §1.752-2(f), Example 5. See also Rev. Rul. 84-118, 1984-2 C.B. 120. However, an abundance of caution might call for two separate notes, secured by the same mortgage, with cross-default provisions if required by the lender.

(8) Under the prior Regulations, an agreement between the general partner and the limited partners whereby the limited partners agree to indemnify and hold harmless the general partner for any payments exceeding his pro rata share of the liabilities of the partnership would not afford additional basis to the limited partners to the extent of their pro rata share of such liabilities, for their agreement was with the general partner individually and created no obligation to the partnership. Rev. Rul. 69-223, 1969-1 C.B. 184.

(a) See also Danoff v. United States, 499 F. Supp. 20 (M.D. Pa. 1979), holding that, where a limited partner signed a mortgage assumption agreement

and delivered the same to the general partner, but not to the partnership creditors, such mortgage assumption agreement was only an indemnification agreement, which did not create basis for the limited partner. Furthermore, see Block v. Comm'r, 41 TCM 546 (1980), holding that a guarantee of a limited partner delivered to, and enforceable by, a creditor did not suffice to provide basis because that debt was not one which the limited partner was "obligated to make under the limited partnership agreement," under Reg. §1.752-1(e).

(b) Under the Regulations, however, all statutory and contractual obligations relating to the partnership liability are taken into account for purposes of determining a partner's share of recourse liabilities. Reg. §1.752-2(b)(3). Such obligations now specifically include contractual obligations outside the partnership agreement, such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors, to other partners, or to the partnership. Reg. §1.752-2(b)(3)(i)-(iii).

(9) The Regulations provide that a partner bears the economic risk of loss for a partnership liability to the extent that the partner, or a related person, makes (or acquires an interest in) a nonrecourse loan to the partnership and the economic risk of loss for the liability is not borne by another partner. Reg. §1.752-2(c)(1). (Contrast Sec. 465(b)(6), I.R.C.) See also Rev. Rul. 72-350, 1972-2 C.B. 394, where the Service ruled that a nonrecourse loan by a third party to the limited partnership, which was secured by a highly speculative and relatively low value property of the partnership, and which was convertible into a partnership interest, was not a bona fide loan, but rather an equity contribution to the partnership.

c. The "at-risk" limitation, as applicable prior to 1979:

(1) The TRA 1976 added Sec. 704(d) to the Code, providing "at risk" rules (i.e., a limitation on the allowance of losses) as to partnerships. See, generally, Weiler, The "At Risk" Rules: A New Consideration for Tax Shelter Investments and Partnerships, 36 N.Y.U. Inst. 1351 (1978), and O'Hara and Wiacek, Tax Shelters after 1977: Some Old Ones Remaining for Creation of New Ones, 48 J. Tax. 270 (1978).

(2) Under Sec. 704(d), I.R.C., nonrecourse partnership liabilities remained as basis for purposes of computing gain or loss on sale or other disposition of the property. However, such nonrecourse liabilities did not provide basis for taking losses; this basis was limited to the amount the partner has "at risk".

(3) While Sec. 704(d), I.R.C. was based on Sec. 465, I.R.C. (also added by the TRA 1976), it differed in two very material respects, as follows:

(a) Sec. 704(d), I.R.C. applied to any partner, whether general or limited, who had no personal liability. (Although Sec. 465, I.R.C. was not applicable to regular corporations, Sec. 704(d), I.R.C. covered all partners, even regular corporations.)

(b) Sec. 465, I.R.C. applied to certain specified activities, whereas Sec. 704(d), I.R.C. excluded those activities (but not partnerships engaging in those activities where such partnerships also engaged in activities not covered by Sec. 465,

I.R.C.) and did not apply to any partnership the principal activity of which was "investing in" real property (other than mineral property).

(i) The General Explanation of the TRA 1976 prepared by the Joint Committee on Taxation, and dated December 29, 1976, noted (at page 97, footnote 7), that: "Generally, the principal activities of a partnership would involve real property if substantially all of its activities involve the holding of real property for sale, for investment, or for deriving rental-type income."

(ii) While the two-tier partnership situation was apparently intended to be covered by footnote 7 on page 97 of the General Explanation, the language was not free from ambiguity. Such language is: "The holding of real property for sale, for investment, or for deriving rental-type income would include the investment in a partnership or joint venture where substantially all of the activities of the partnership or joint venture involve the holding of real property for sale, for investment, or for deriving rental-type income."

d. The 1978 Act revised the at risk rules in several respects, as follows:

(1) The 1978 Act expanded the specific at risk rule of Sec. 465, I.R.C., to cover all activities other than real estate, effective for taxable years beginning after December 31, 1978. Sec. 465(c)(3), I.R.C.

(a) Activities engaged in by the taxpayer in carrying on a trade or business or for the production of income were covered. Sec. 465(c)(3)(A)(i), I.R.C.

(b) Activities which constitute a trade or business will be treated as one activity, and thus aggregated, if the taxpayer actively participates in the management of such trade or business, or if such trade or business is carried on by a partnership or Subchapter S corporation and 65% or more of the losses for the taxable year are allocable to persons who actively participate in the management. Sec. 465(c)(3)(B), I.R.C. See also Priv. Ltr. Rul. 9035005 (May 30, 1990), where "trade or business" is defined through a circular reading of Sec. 446, I.R.C.

(c) On the other hand, the Service is given broad discretion to aggregate, or to treat as separate, any activities newly covered. Sec. 465(c)(3)(C), I.R.C. See, generally, Klein, Coping with the At-Risk Rules: Planning Opportunities Suggested by the 1978 Act, 51 J. Tax. 22 (1979).

(d) Moreover, under Sec. 465(c)(7), I.R.C., as added by the TRA 1984, active businesses (qualifying businesses") of regular corporations covered by the at-risk rules ("qualified C corporations") are treated as separate activities, so that Sec. 465(a), I.R.C. does not apply to losses from such businesses.

(2) Sec. 465(e), I.R.C., requires the recapture of previously allowed losses (that is, losses which were allowed and reduced the taxpayers at risk basis in the

activity involved for taxable years beginning after December 31, 1978) where the amount at risk is reduced below zero.

e. Impact of the Tax Reform Act of 1986:

(1) Pursuant to the Tax Reform Act of 1986, the at-risk rules were extended to all real estate activities, effective as to property placed in service after December 31, 1986, and as to interests in S corporations, partnerships or other pass-through entities acquired after December 31, 1986, irrespective of when the property was placed in service by such entity. See §503(c) of the TRA 1986, Pub. L. No. 99-514, 99th Cong., 2d Sess.

(2) In the case of an activity of holding real property, a taxpayer is considered at risk with respect to such taxpayer's share of any qualified nonrecourse financing secured by the real property used in such activity. See 465(b)(6)(A), I.R.C.

(3) "Qualified nonrecourse financing" means financing
(i) which is obtained by the taxpayer with respect to the activity of holding real property,
(ii) which is obtained from a "qualified person" or represents a loan from or is guaranteed by any federal, state or local government or instrumentality thereof, (iii) with respect to which no person is personally liable for repayment, except to the extent provided in the regulations, and
(iv) which is not convertible debt. Sec. 465(b)(6)(B), I.R.C.

(4) For purposes of Sec. 465(b)(6)(B)(ii), I.R.C., a "qualified person" is defined under Sec. 49(a)(1)(D)(iv), I.R.C., as any person which is actively and regularly engaged in the business of lending money and which is not (i) a related person with respect to the taxpayer, (ii) a person from which the taxpayer acquired the property, or (iii) a person who receives a fee with respect to the taxpayer's investment in the property. Sec. 465(b)(6)(D), I.R.C. The Senate Report for the Tax Reform Act of 1986 includes a bank, savings and loan association, credit union, or insurance company regulated by Federal, state or local law, or a pension trust as examples of qualified persons. S. Rep. No. 313, 99th Cong., 2d Sess. 749 (1986).

H. Limited Liability Companies.

1. Background.

a. The limited liability company ("LLC") is a statutory form of business which generally limits an owner's personal liability to his or her investment. First enacted in Wyoming in 1977, there was for a long time little interest either from business persons or other states because the Service had stated that such an organization would be taxed as a corporation. However, in 1988, the Service issued Revenue Ruling 88-76, 1988-2 C.B. 360, which classified a Wyoming limited liability company as a partnership.

2. Formation.

a. A limited liability company must have two or more members in order to be treated as a partnership for Federal tax purposes. A single member LLC may be either (1) disregarded as an entity separate from its owner (default status) or (2) treated as an association taxable as a corporation for Federal income tax purposes. The single member must make an affirmative election to be taxed as a corporation.

b. Members may be individuals, general partnerships, limited partnerships, other limited liability companies, corporations, trusts, business trusts, REITs, estates or any other type of association. This flexibility in membership is unlike an S corporation, which has an upward limit of 75 stockholders and is limited as to the type of entity which can own stock. Sec. 1361(b), I.R.C. Generally, an LLC may be formed for any lawful purpose.

3. Management.

a. Limited liability companies may be managed by the members of the LLC or by managers. The alternative chosen must be stated in the articles of organization.

b. If management is vested in all the members, this power is vested in proportion to their "adjusted" contributions to capital. [For this purpose, the term "adjusted" means that the proportion of management power takes into account withdrawals and additional contributions.]

4. Limited Liability.

a. Members and managers of a limited liability company generally may not be held liable for any judgment, decree or court order, or in any other manner for a debt or liability of the LLC.

b. A member will be liable to the LLC, though, for unpaid capital contributions or for property or money erroneously or wrongfully transferred to the member.

c. The jurisprudence of when this shield of liability might be pierced is unclear since an LLC is a new business form. Presumably, however, the analogy would be to corporate law and the fiduciary duties owed by corporate management.

5. Profits Allocations.

a. The members of an LLC are given complete freedom to divide the profits of the business on whatever basis is chosen in the operating agreement. Generally, distributions of those profits are made according to the operating agreement, but may only be made to the extent assets are in excess of liabilities.

6. Transferability of Interests.

a. A member generally cannot transfer his or her entire interest in an LLC without the unanimous written consent of all other members. An assignee is only entitled to the share of profits or other compensation which goes with that share.

b. Compare the treatment of a limited partnership where approval of the general partner (but not necessarily the limited partners) is required for transfer, and if such consent is not given, the beneficial interest is still assigned, but the assignee has no right to participate in the management of the company or become a member.

7. Continuity of Life.

a. An LLC continues in existence unless one of the following three dissolution events occurs:

(1) The expiration of the specified term of the LLC. A limited liability company generally has a limited duration. Though a duration must be chosen, there is no fixed requirement.

(2) The unanimous written agreement of all members.

(3) The death, retirement, resignation, expulsion, bankruptcy, dissolution of a member or occurrence of any other event which terminates the continued membership of an LLC member.

b. Notwithstanding such events of dissolution, the LLC may continue if the articles of organization of the LLC provide for the same on the unanimous consent of the remaining members, or if the articles of organization state that there is a right to continue, or a majority of the members agree to continue. The continuation standard that will be required depends on the applicable state statute.

c. Persons interested in forming an LLC will be frustrated by the uncertainty inherent in a new business form. Not only is there a lack of precedent, but the LLC's hybrid nature, combining both partnership and corporate characteristics, may create further apprehension in using such form of entity.

d. Despite this uncertainty, commentators are suggesting that high risk ventures dealing with natural resources or investments in real estate are logical candidates for such an entity. See Hamill, The Limited Liability Company: A Possible Choice for Doing Business, 41 U. Fla. L. Rev. 721 (1989).

8. Taxation.

a. Under the current check-the-box entity classification regime, an LLC with two or more members is treated as a partnership unless the entity elects to be classified

as an association taxable as a corporation. As noted above, unless the owner elects otherwise, a single member LLC is treated as a sole proprietorship for Federal tax purposes.

(1) An LLC which is treated as a partnership allows its members to avoid the double taxation and higher income tax rates of a corporation while, at the same time, retaining limited liability and other favorable attributes of a corporation.

b. Note that, even if an LLC is treated as a partnership for Federal income tax purposes, an LLC may also be treated as a corporation and subject to franchise taxes under state law. See D.C. Code § 47-1808.01 to .05 (unincorporated business franchise tax); Texas Tax Code §171.001(a) (corporate franchise tax imposed on LLCs).

I. Partnership Equity for Services.

1. Overview: On May 24, 2005, the Treasury issued Proposed Regulations addressing the treatment of a transfer of partnership equity in connection with the performance of services. Concurrently with the issuance of the Proposed Regulations, the IRS issued Notice 2005-43, 2005-24 I.R.B. 1221, announcing a proposed revenue procedure that provides a safe harbor election for determining the value of the transferred partnership interest.

2. New Rules: The Proposed Regulations introduce the following new rules:

a. The Proposed Regulations apply Section 83 to all partnership interests, without distinguishing between partnership capital interests and partnership profits interests. Hence, a partnership capital or profits interest is Section 83 property, and the transfer of a partnership interest in connection with the performance of services is subject to Section 83.

b. The partnership recognizes no gain or loss on the transfer of a partnership interest in exchange for the performance of services.

c. In the case of a transfer of a substantially non-vested partnership interest, if a Section 83(b) election is made, the transferee is treated as a partner for Federal income tax purposes. If no Section 83(b) election is made, then the holder of the partnership interest will not be treated as a partner until the partnership interest becomes substantially vested. These rules differ from Rev. Proc. 2001-43, 2001-2 C.B. 191, which provides that the holder of a partnership profits interest may be treated as a partner under certain circumstances, even if no Section 83(b) election is made.

d. The rules of Section 83(h) govern the timing and amount of any compensation deduction to the partnership.

e. The amount includible in income by the transferee and the amount deductible by the partnership generally is equal to the fair market value of the transferred partnership interest.

f. Upon receipt of the partnership interest, the service provider's capital account is increased by the amount taken into income plus any amounts paid for the transferred partnership interest.

g. In determining the value of the transferred partnership interest, the partnership and its partners can elect to treat the fair market value of the partnership interest as equal to its liquidation value pursuant to a safe harbor procedure provided in Notice 2005-43.

3. Effective Date: The Proposed Regulations would apply to transfers of property on or after the date Final Regulations are published in the Federal Register.

4. As noted above, Notice 2005-43, 2005-24 I.R.B. 1221, was issued simultaneously with the Proposed Regulations under Section 83 and Subchapter K. This Notice is in the form of a proposed revenue procedure that provides rules for the elective liquidation value safe harbor under Prop. Reg. §1.83-3(l) when a partnership transfers a partnership interest in connection with the performance of services. The safe harbor is intended to simplify the application of Section 83 to partnership interests and to coordinate the provisions of Section 83 with the principles of partnership taxation.

a. Liquidation Value. The proposed revenue procedure allows a safe harbor election by all parties—the partnership, its partners and the service provider—to use liquidation value in determining the value of the transferred partnership interest.

b. Safe Harbor Tax Consequences. In the case of the transfer of a partnership capital interest, the safe harbor election would result in income inclusion and deduction in the amount of the liquidation value of the partnership capital interest at the time of its grant. In the case of a transfer of a partnership profits interest, the safe harbor election would result in no income inclusion and no deduction at the time of its grant. Hence, the election to use liquidation value preserves the existing nonrecognition treatment of the transfer of a profits interest, but must be approved by all partners in a partnership.

c. Effective Date. It is expected that the Notice will be finalized and made effective in conjunction with the finalization of the related Proposed Regulations under Section 83 and the Proposed Regulations under Subchapter K.

d. Interim Treatment. The Notice, when finalized, will obsolete both Rev. Proc. 93-27, 1993-2 C.B. 343 (receipt of a partnership profits interest in connection with the performance of services not a taxable event under certain circumstances), and Rev. Proc. 2001-43, 2001-2 C.B. 191 (service provider treated as a partner upon receipt of substantially non-vested partnership profits interest under certain circumstances). However, until the proposed revenue procedure is finalized, taxpayers may not rely upon the safe harbor set forth in the proposed revenue procedure, but may continue to rely upon current law, including Rev. Proc. 93-27 and Rev. Proc. 2001-43.

IV. TAX PROBLEMS OF REAL ESTATE OWNERSHIP

A. Real Estate Acquisition -- Capitalization vs. Deductibility.

1. Organization of the Entity.

a. Partnership Organization.

(1) Until the 1976 TRA, the costs of organizing the partnership were not deductible or amortizable; rather, they had to be capitalized. Such costs became deductible when the partnership was terminated and dissolved.

(2) Sec. 709, I.R.C., added by the 1976 TRA, changed the rules, effective in the case of amounts paid or incurred in taxable years beginning after December 31, 1976.

(a) Under Sec. 709(a), I.R.C., the costs of promoting the sale, or of the sale, of interests in partnerships are not deductible or amortizable. Accordingly, such costs must be capitalized, as before.

(b) Under Sec. 709(b), I.R.C., the organizational expenses may be amortized over a 60-month period, beginning with the month in which the partnership "begins business."

(c) "Organizational expenses" are those which are: (i) incident to the creation of the partnership; (ii) chargeable to capital account; and (iii) of a character which, if expended incident to the creation of a partnership having an ascertainable life, would be amortized over such life.

(d) See Reg. §1.709-2(a), where the above concepts are explained as follows:

(i) Expenses are "incident to the creation of the partnership" if incurred during the period beginning within a reasonable time before the partnership begins business and ending with the due date of the return (without regard to extensions) for the taxable year in which the partnership begins business. In addition, the expenses must be for creation of the partnership and not for the operation or starting operation of the partnership trade or business.

(ii) As to the third statutory requirement, the expense must be for an item of a nature normally expected to benefit the partnership throughout the entire life of the partnership.

(A) Examples of organizational expenses under Sec. 709, I.R.C. are stated to be: legal fees for services incident to the organization of the partnership, such as negotiation and preparation of the partnership agreement;

accounting fees for services incident to the organization of the partnership; and filing fees. Reg. §1.709-2(a).

(B) Examples of non-organizational expenses under Sec. 709, I.R.C. are stated in Reg. §1.709-2(a) to be: expenses connected with acquiring assets for the partnership or transferring assets to the partnership; expenses connected with the admission or removal of partners other than at the time the partnership is first organized; expenses connected with a contract relating to the operation of the partnership trade or business (even where the contract is between the partnership and one of its members); and syndication expenses [which include, under Reg. §1.709-2(b), brokerage fees, registration fees, legal fees of the underwriter or placement agent or issuer (the general partner or the partnership) for securities advice and for advice pertaining to the adequacy of tax disclosures in the prospectus or placement memorandum for securities law purposes]. As to syndication expenses, see Marine Contractors and Supply, Inc. v. Comm'r, 43 TCM 305 (1982). See, generally, Larason, May Partnership Syndication Costs Be Written Off Over a Limited Partnership's Life?, 58 J. Tax. 336 (1983); and McGuire, Can the Syndication Costs of a Partnership Be Amortized? An Analysis of Authorities, 59 J. Tax. 208 (1983).

(e) The issue of when the partnership "begins business" remains difficult to ascertain.

(i) Under Reg. §1.709-2(c), it is stated that "[o]rdinarily, a partnership begins business when it starts the business operations for which it was organized. The mere signing of a partnership agreement is not alone sufficient to show the beginning of business."

(ii) However, as set forth in Reg. §1.709-2(c), "[i]f the activities of the partnership have advanced to the extent necessary to establish the nature of its business operations, it will be deemed to have begun business."

(f) The election, once made, is irrevocable; the period selected by the partnership in making its election may not be subsequently revoked. Reg. §1.709-1(b)(1).

b. Corporate Organization

(1) Under Sec. 248, I.R.C., the organizational expenditures of a corporation are amortizable over a 60month period, beginning with the month in which the corporation "begins business".

(a) The same definition of "organizational expenditures" applies to corporations. Sec. 248(b), I.R.C.

(b) As to what constitutes "beginning business", see Reg. §1.248-1(a)(3), which provides that "[t]he words 'begins business' . . . do not have the same meaning as 'in existence.' Ordinarily, a corporation begins business when it starts the business

operations for which it was organized; a corporation comes into existence on the date of its incorporation. Mere organizational activities, such as the obtaining of the corporate charter, are not alone sufficient to show the beginning of business. If the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations, however, it will be deemed to have begun business."

(2) Under Reg. §1.248-1(b)(3), the following expenditures are not considered "organizational expenditures":

(a) Expenditures connected with issuing or selling shares of stock or other securities, such as commissions, professional fees and printing costs. Reg. §1.248-1(b)(3)(i).

(i) This is so even where the particular issue of stock to which the expenditures relate is for a fixed term of years.

(ii) See Davis v. Comm'r, 151 F.2d 441 (CA8 1945), and United Carbon Corporation v. Comm'r, 32 B.T.A. 1000 (1935), supporting the position of the Regs. on such costs not constituting "organizational expenditures".

(b) Expenditures in connection with the transfer of assets to the corporation. Reg. §1.248-1(b)(3)(ii).

2. Acquisition of the Real Estate.

a. Legal Fees.

(1) Legal fees incurred in the acquisition of real property must be capitalized and added to the cost of the property. See also Surloff v. Comm'r, 81 T.C. 210 (1983), as to legal fees incurred in connection with the acquisition of a partnership interest.

(2) This includes fees related to the review of the purchase documents and the title. See Millinery Center Building Corp. v. Comm'r, 21 T.C. 817 (1954), rev'd on other issues 221 F.2d 322 (CA2 1955), aff'd 350 U.S. 456 (1956).

(3) This also includes payments incurred in the defense or protection of title to property. See, e.g., Boagni v. Comm'r, 59 T.C. 708 (1973); and Redwood Empire Savings Loan Assn. v. Comm'r, 68 T.C. 960 (1977), aff'd 682 F.2d 516 (CA9 1980).

b. Survey Costs.

(1) The costs of surveys of the land to be purchased, including boundary, topographical and use surveys, must be capitalized as part of the land cost. See, e.g., Johnson v. Comm'r, 14 TCM 981 (1955); and Wacker v. Comm'r, 40 TCM 1009 (1980).

(2) What if the taxpayer does not buy the land? Does he get a loss deduction? Does it make a difference whether the taxpayer is already in the trade or business of developing real estate? Can the transaction be considered as one from a "transaction entered into for profit", thereby giving rise to an ordinary loss deduction under Sec. 165(c)(2), I.R.C.? See Rev. Rul. 79-346, 1979-2 C.B. 84, holding that fees paid by an individual for expert geological advice and filing service rendered in connection with an unsuccessful attempt to acquire noncompetitive oil and gas leases were deductible under Sec. 165(c)(2), I.R.C., because the taxpayer had gone beyond a general search for a business or investment, and had focused on the acquisition of specific assets. See, generally, Wilberding, An Individual's Business Investigation Expenses: An Argument Supporting Deductibility, 26 Tax Lawyer 219 (1973). But see Rev. Rul. 83-137, 1983-2 C.B. 41, holding that a fee paid in 1982 to participate in a five-year program to acquire federal oil and gas leases was a capital expenditure includible in the basis of any leases acquired. No deduction was allowed for any part of the fee in the year it was paid. No deduction was allowed for the fee under Sec. 165(a), I.R.C. to the extent that no leases were acquired because the taxpayer had not sustained any uncompensated loss.

(3) See Rev. Rul. 74-102, 1974-1 C.B. 70, in which a corporation in the business of buying, renovating and selling residential property incurred evaluation expenses, and the Service allowed a loss deduction under Sec. 165, I.R.C., where the corporation decided, on the basis of such an evaluation, not to acquire the property. See also Rev. Rul. 77-254, 1977-2 C.B. 63; and Rev. Rul. 99-23, 1999-1 C.B. 998, where the Service held that expenses incurred in the course of a general search for, or investigation of, an active trade or business in order to determine whether to enter a new business qualify as investigatory costs that may be amortized as start-up expenses under Sec. 195, I.R.C. However, expenses incurred to acquire capital assets used in the search or investigation or in the attempt to acquire a specific business do not qualify as start-up expenses because they are acquisition costs subject to Sec. 263, I.R.C. See, generally, Priv. Ltr. Rul. 199901004 (September 28, 1998).

(4) As to "rejection fees" (that is, the portion of the broker's fee which represents payment for screening, evaluating and presenting properties that the investor ultimately does not purchase), an argument is made for their deductibility in Kanner, Rejection Fees as a Front-End Deduction, 7 R. Est. Law J. 169 (1978). See Haft and Fass, Tax Sheltered Investments Law Report, Vol. 1, No. 5 (November 1981). See also Dana v. United States, 174 F.3d 1344 (Fed. Cir. 1999), rev'g 38 Fed. Cl. 356 (1997), wherein retainer fees paid to a law firm were required to be capitalized and were applied against the costs incurred in acquiring a target.

c. Brokerage Commissions; Settlement Costs.

(1) Brokerage commissions are capitalized and added to the basis of the property acquired. See, e.g., Thompson v. Comm'r, 9 B.T.A. 1342 (1928).

(2) Title search, deed preparation, title company and miscellaneous settlement fees and charges must also be added to basis. See, e.g., Coupe v. Comm'r, 52 T.C. 594 (1969); Parkway Realty Corp. v. Comm'r, 18 TCM 235 (1959); and B. Cohen & Sons Co. v. Comm'r, 42 B.T.A. 1137 (1940).

d. Demolition Costs.

(1) Sec. 280B, I.R.C. requires that if land is purchased with structures thereon which are subsequently demolished, all demolition costs, as well as any loss sustained on account of the demolition, must be capitalized into the land. It is clear, however, that a demolition resulting from a casualty loss is not a situation where Sec. 280B, I.R.C. is applicable. Notice 90-21, 1990-1 C.B. 332. See Priv. Ltr. Rul. 9131005 (April 25, 1991).

(2) Where demolition is not expected to occur for some time after acquisition, the use of separate legal entities to own the land and structures, with a lease of the land to the entity owning the buildings, may operate to frustrate the operation of Sec. 280B, I.R.C. See Raby, When the Walls Come Tumbling Down: Demolition and the Tax Law, 52 Tax Notes 1292 (1991).

(3) Section 280B, I.R.C. will not apply to certain structural modifications to buildings which satisfy the safe harbor provisions of Rev. Proc. 95-27, 1995-1 C.B. 704. A modification of a building (other than a certified historic structure, as defined in Sec. 47(c)(3), I.R.C.) will not be treated as a demolition for purposes of Sec. 280B, I.R.C. if:

(a) 75 percent or more of the existing external walls of the building are retained in place as internal or external walls, and

(b) 75 percent or more of the existing internal structural framework of the building is retained in place.

(4) In De Cou v. Comm'r, 103 T.C. 80 (1994), the loss sustained from the abnormal retirement of a building caused by unexpected and extraordinary obsolescence prior to demolition was not disallowed under Sec. 280B, I.R.C. But see Gates v. United States, 98-1 USTC ¶ 50,353 (M.D. Pa. 1998), where the Court disallowed the taxpayer's demolition expenses under Sec. 280B, I.R.C., finding that the taxpayer failed to take affirmative steps to withdraw the building from use in the tax year at issue, and that the events which caused the building to lose its value occurred in taxable years prior to the year of the demolition. The Court distinguished De Cou, where the taxpayer took affirmative steps to withdraw their building from use and took the loss deduction in the same taxable year. For a cogent analysis exploring the scope of the Sec. 280B, I.R.C. demolition expense disallowance in the wake of De Cou and Gates, see Third Circuit Rebuffs Taxpayers' Attempt to Apply De Cou to Avoid §280B Disallowance of Loss in Connection with Demolished Building, 15 Tax Mgt. Real Est. J. 20 (1999).

e. Real Property Taxes.

(1) Generally, real property taxes are currently deductible, when paid or incurred. Sec. 164, I.R.C. [However, as to real property taxes during construction, see the discussion below.]

(2) Under Sec. 164(d), I.R.C., the deduction for the real property tax paid for the then-current real property tax year is, on the purchase of real property, apportioned between the buyer and seller in proportion to the part of the tax year elapsed before the date of sale and the part remaining thereafter.

(a) This proration is required whether the taxes become a lien before or after the date of sale. Reg. §1.164-6(b)(1).

(b) This apportionment is mandatory; it is immaterial whether, or how, the seller and buyer apportion the tax. Reg. §1.164-6(b)(1)(i).

(3) Notwithstanding the above, if the seller's portion of the real property taxes is paid by the buyer as part of the negotiations, the buyer capitalizes the same and adds it to his basis for the property, and the seller increases his sale proceeds. Reg. §1.1001-1(b)(2).

(4) Real estate taxes paid by the successful bidder of property foreclosed for delinquent real estate taxes during the redemption period of the owner (and before a tax deed is issued) are not deductible under Sec. 164, I.R.C.; they are considered part of the purchase price. Priv. Ltr. Rul. 8207036 (November 18, 1981).

B. Real Estate Construction -- Capitalization vs. Deductibility.

1. Capitalization of Construction Expenses

a. Under Sec. 263A, I.R.C., the costs of producing real property, either produced by or for the taxpayer, include the direct costs of the property and such property's allocable share of all indirect costs. Sec. 263A(a); Reg. §1.263A-1(e). All direct and indirect costs to produce -- that is, to construct, build, install, manufacture, develop, improve, create, raise or grow -- must be capitalized without regard to whether those costs are incurred before, during or after the production period. Regs. §§1.263A-2(a)(1) and -2(a)(3)(i). Thus a real estate developer must capitalize property taxes, insurance, and other costs incurred with respect to the property if, at the time the costs are incurred, it is reasonably expected that the property will be subsequently developed. Reg. §1.263A-2(a)(3)(ii). Producers are required to capitalize all indirect costs incurred after production that are properly allocable to the property produced. Reg. §1.263A-2(a)(3)(iii).

(1) Production costs incurred prior to the effective date of the final regulations must be capitalized. In Von-Lusk v. Comm'r, 104 T.C. 207 (1995), the taxpayer made no physical improvements or changes to the property during the years in question. Meeting with government officials, obtaining building permits and zoning variances, negotiating permit fees, performing engineering and feasibility studies and drafting architectural plans constituted production of the property for purposes of Sec. 263A, I.R.C.

(2) A developer's predevelopment carrying costs are required to be capitalized. Reg. §1.263A-2(a)(ii). See Reichel v. Comm'r, 112 T.C. 14 (1999). The

Court rejected the taxpayer's argument that Sec. 263A, I.R.C. did not apply because he had never begun development of the property. See also Hustead v. Comm'r, 68 TCM 342 (1994), where the Court required the capitalization under Sec. 263, I.R.C. of predevelopment costs incurred in challenging zoning restrictions on constitutional grounds.

(3) The costs of golf course and country club improvements should not be allocated to the bases of proximate residential lots purchased for resale and development. Charlevoix Country Club v. Comm'r, 105 F. Supp.2d 756 (W.D. Mich. 2000). See Kelley, Stradivarius at the Links: An Extension of the Depreciation of Classical Instrument Decisions to Golf Courses, 23 J. Real Est. Tax'n 313 (1996).

(4) The expenses of the construction of a restaurant were allocated to the individual bearing the burdens and risks associated with the property. Guaderrama v. Comm'r, 79 TCM 1752 (2000) (recharacterizing a purported sale and leaseback as a financing transaction).

2. Construction-Period Interest and Real Estate Taxes.

a. Treatment Prior to the Tax Reform Act of 1986.

(1) Prior to the 1986 Tax Reform Act, basis would be increased, pursuant to Sec. 1016(a)(1), I.R.C., by construction-period real estate taxes and interest and other carrying charges as to which the election under Sec. 266, I.R.C. was made by the taxpayer. If no such election was made under Sec. 266, I.R.C., then the mandatory rules of Sec. 189, I.R.C. (1954) would apply, pursuant to which (except in the case of low-income housing) construction-period real estate taxes and interest would not be added to basis, but rather would be capitalized and amortized over a 10-year amortization period. See Sec. 189(a), I.R.C., repealed by §803(b)(1) of TRA 1986.

(2) The first year of the amortization period was the taxable year in which such expenses were paid or accrued, and the second year was the latter of the following taxable year or the taxable year in which the real property was ready to be placed in service or to be held for sale. Sec. 189(c)(1), I.R.C. prior to repeal.

(3) The amortization period ultimately was a 10-year period, which became fully operative for construction-period interest and real estate taxes paid or accrued in taxable years beginning in 1982 in the case of nonresidential real property, and in taxable years beginning in 1984 in the case of residential real property (other than low-income housing). See, Sec. 189(b), I.R.C. (1954).

(4) Under Sec. 189(e)(2), the construction period was that period beginning on the date on which construction of the building or other improvement began, and ending on the date on which the item of property was ready to be placed in service or was ready to be held for sale. Preliminary work -- such as clearing a site, test drilling to determine soil conditions, or excavation to change the contour of the land (as opposed to excavation for footings) -- would not constitute the beginning of construction.

(5) Upon the sale or exchange of the property, under Sec. 189(c)(2)(B), the unamortized portion of such construction-period interest and taxes was added to basis for purposes of determining gain or loss. In the case of a nontaxable transfer or exchange of real property (such as a transfer to a partnership, a transfer to a "controlled" corporation, a like-kind exchange or a gift), the transferor, rather than the transferee, had to continue to take the deduction, because the deduction was considered to be personal to the transferor. This restriction on the transfer of the deduction was accomplished under Sec. 189(c)(2)(C) by deeming an exchange or transfer with a carryover (or transferred) basis, in whole or in part, as not being an exchange. This could result in the transferor triggering gain upon incorporation under Sec. 357(c), I.R.C. because of liabilities in excess of basis.

(6) The limitations of Section 189 initially applied only to individuals, S corporations and personal holding companies. As a result of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), such limitations became applicable to regular corporations with respect to construction-period interest and taxes paid or incurred in taxable years beginning after December 31, 1982, except for residential real property and certain transitional properties. As a result of TRA 1984, the limitations of Section 189 became applicable to residential real property constructed by regular corporations, effective as to taxable years beginning after March 1, 1984. Such limitations would not seem to have applied to partnerships as such; however, inasmuch as corporations became subject to Section 189 coverage, the partnership arguably could be covered by Section 189.

b. Treatment after Tax Reform Act of 1986.

(1) With respect to the treatment of construction-period real property taxes and interest paid or incurred after December 31, 1986, in taxable years ending after such date, Section 189 was repealed by the Tax Reform Act of 1986. The repeal had a retroactive impact because it applied even to those projects under construction at the time (with very narrow grandfathering relief provided).

(2) Under Sec. 263A, I.R.C., those costs that are either the direct costs of property or are that property's proper share of indirect costs (including taxes), part or all of which are allocable to such property, must be capitalized. This is the case as to both inventory and other property. See Sec. 263A(a)(1), I.R.C. While certain personal property acquired for resale by a taxpayer is excluded for a taxable year from the applicability of Sec. 263A, I.R.C. real property is included whether produced by the taxpayer or acquired for resale as dealer property. See Secs. 263A(b)(1) and 263A(b)(2)(A), I.R.C. Real property produced by the taxpayer for personal use -- that is, other than in a trade or business or an activity conducted for profit -- falls outside the rules of Sec. 263A, I.R.C. See Sec. 263A(c)(1), I.R.C.

(3) Under Sec. 263A, I.R.C., real estate taxes must be capitalized as an indirect production cost, to the extent attributable to labor, materials, supplies, equipment, land or facilities used in production activities. Reg. §1.263A-1(e)(3)(ii)(L).

(4) Final Regulations govern the capitalization of construction period interest costs paid or incurred in taxable years beginning on or after January 1, 1995. Interest costs are capitalized using the avoided cost method, which is based upon a theoretical "but for" proposition. Reg. §1.263A-8(a)(1). Interest should be capitalized that would theoretically have not been incurred if the expenditures made to produce the property had instead been used to pay down the debt. Reg. §1.263A-9(a)(1). The following types of "designated property" are required to capitalize interest:

- (a) real property;
- (b) tangible personal property with a class life of 20 years or more which is produced only for the taxpayer or a related party's use;
- (c) tangible personal property with an estimated production period greater than a year and an estimated cost of production greater than \$1 million; or
- (d) tangible personal property with an estimated production period exceeding two years.

(5) Property which would otherwise be designated property is excluded from the interest capitalization requirement under a de minimis rule if the production period does not exceed 90 days and the total production expenditures do not exceed \$1,000,000 divided by the number of days in the production period. Reg. §1.263A-8(b)(4).

(6) Real property is very broadly defined and includes land, unsevered natural products of land, buildings and inherently permanent structures, as well as an interest such as a leasehold or an option. Furthermore, any improvement to real property constitutes the production of property. Reg. §1.263A-8(c). However, incidental maintenance and repairs are not improvements.

(7) Interest is capitalized only during the production period, beginning on the first day that any "physical production activity" occurs. Regs. §§1.263A-12(c)(2) and 1.263A-12(e). Activities which do not constitute physical production activities include planning and design as well as incidental repairs. Reg. §1.263A-12(f). The end of the production period for property produced for self-use is the date the property is ready to be placed in service and all production activities reasonably expected to be undertaken by the taxpayer are completed. Reg. §1.263A-12(d)(1). The production period for property produced for resale ends when those production activities are also complete and the property is ready to be held for sale. The production period ends for property produced under a contract, however, when the property is ready to be placed in service by the customer, which is generally no earlier than the date the customer takes delivery. Reg. §1.263A-12(d)(1).

(8) The amount of interest to be capitalized is generally measured for the computation period and is the sum of the "traced debt amount" and the "excess expenditure amount". Reg. §1.263A-9(a)(2). The computation period is at least one period, no

longer than a full taxable year, but the taxpayer may choose more frequent shorter periods as long as they are of equal length and within the same taxable year. Reg. §1.263A-9(f)(1)(i). The number of computation periods is a method of accounting, and change after election requires the consent of the Commissioner. Reg. §1.263A-9(f)(1)(ii).

(9) Traced debt is eligible debt which is allocated to the accumulated production expenditures for a particular unit of property. All of the interest associated with this debt which would otherwise be deductible (i.e., economic performance has occurred) is capitalized. Reg. §1.263A-9(b).

(10) If there are accumulated production expenditures in excess of traced debt, an "excess expenditure amount" will be calculated, and interest incurred on nontraced debt, interest incurred on related party debt or any guaranteed payments for use of capital is capitalized to the extent of the "excess expenditure amount". Reg. §1.263A-9(c)(1). The "excess expenditure amount" is equal to the product of the weighted average interest rate for the computation period and average excess expenditures. Reg. §1.263A-9(c)(1).

(11) In the case of flow-through entities, the rules for allocation of interest apply first at the entity level and then, to the extent that the entity has insufficient debt to support the production or construction expenditures, at the partner, stockholder or beneficiary level. Sec. 263A(f)(2)(C), I.R.C. If the accumulated production expenditures of the flow-through entity exceed its traced and excess expenditure amounts, the deferred asset method or the substitute cost method are utilized to capitalize additional amounts. Notice 88-99, 1988-2 C.B. 422. See Rev. Proc. 95-19, 1995-1 C.B. 664, Procedure for Changing Methods of Accounting for Capitalized Interest Costs.

(a) See Reichel v. Comm'r, 112 T.C. 14 (1999), holding that a real estate developer was required to capitalize real estate taxes as indirect expenses of producing property even though development of the property had not begun due to adverse economic conditions. See also Von-Lusk v. Comm'r, 104 T.C. 207 (1995), holding that the taxpayer had begun development of land even though the land had not been physically altered, and so the taxpayer was required to capitalize related development costs.

(b) See Priv. Ltr. Rul. 199913030 (October 14, 1998), ruling that a public utility was required to include land acquisition costs in the accumulated production expenditures for a construction project even though the land was included in the taxpayer's rate base for ratemaking purposes prior to the production period.

3. Commitment Fees.

a. Background: Loan Costs.

(1) The costs of negotiating and obtaining a loan, such as appraisal and legal fees, title costs, brokerage commissions and surveys, are not added to the basis of the property acquired, but rather are amortizable over the term of the particular loan obtained. See Reg. §1.263(a)2(a); Rev. Rul. 70-360, 1970-2 C.B. 103; Klyce, Adm'r v. Comm'r,

41 B.T.A. 194 (1940); Anover Realty Corp. v. Comm'r, 33 T.C. 671 (1960); Enoch v. Comm'r, 57 T.C. 781 (1972); and Lovejoy v. Comm'r, 18 B.T.A. 1179 (1930). See, generally, Tucker and Leahy, The Deductibility of Costs Incurred By Real Estate Developers, 1 J.R.E. Tax. 408 (1974).

(2) If the property is sold or the loan paid off before full amortization of the loan costs, then the unamortized portion is deductible at the time of sale or payment. See S & L Bldg. Corp. v. Comm'r, 19 B.T.A. 788 (1930), and Buddy Schoellkopf Products, Inc. v. Comm'r, 65 T.C. 640 (1975). See also Priv. Ltr. Rul. 8637058 (June 12, 1986), where the Service ruled that prepaid interest being amortized over the life of a home mortgage loan became deductible in full when loan was paid in full. Such deduction is not affected by the fact that the cash used comes from a new mortgage loan. See Helvering v. California Oregon Power Co., 75 F.2d 644 (D.C. Cir. 1935).

b. Loan Commitment Fees.

(1) The commitment fees paid to the lender committing to provide financing -- whether construction or permanent -- for the project generally are not considered compensation for the use or forbearance of money, and so are not deductible as interest. Until 1981 such commitment fees were, generally, deductible as a business expense or investment activity expense under Sec. 162 or Sec. 212, I.R.C. See Rev. Rul. 56-136, 1956-1 C.B. 92. See also Priv. Ltr. Rul. 7924002 (February 23, 1979), which contains a discussion of the variety of fees designated as "commitment fees" from time to time. See, generally, Malloy and Hayes, Deductibility of "Commitment Fees": Are They for Services or for the Use of Money?, 51 J. Tax. 278 (1979).

(2) A group of cases, basically viewing commitment fees as interest (and usually because of a stipulation of the facts or because taxpayer's counsel sought such designation), deteriorated the strength of Rev. Rul. 56-136, without directly considering it. See Parks v. United States, 434 F. Supp. 206 (N.D. Tex. 1977); Trivett v. Comm'r, 36 TCM 675 (1977); Francis v. Comm'r, 36 TCM 704 (1977); and Lay v. Comm'r, 69 T.C. 421 (1977); but see Baird v. Comm'r, 68 T.C. 115 (1977), and Wilkerson v. Comm'r, 70 T.C. 240 (1978). See, generally, Note -- Lyndell E. Lay, 69 T.C. 421 (1977)--The Deductibility of Commitment Fees, Financing Fees and "Points", 31 Tax Lawyer 888 (1978).

(3) In Rev. Rul. 81-160, 1981-1 C.B. 312, the Service revoked Rev. Rul. 56-136; however, pursuant to the authority of Sec. 7805(b), I.R.C., the Rev. Rul. 56-136 revocation was not applied adversely to taxpayers who either (i) consummated transactions prior to the date of publication of Rev. Rul. 81-160 (June, 1981) or (ii) consummated transactions after that date pursuant to the terms of a binding written contract entered into before such date. See Priv. Ltr. Rul. 8143088 (July 30, 1981), permitting the deductibility of commitment fees incurred prior to the effective date of Rev. Rul. 81-160.

(a) As a result of Rev. Rul. 81-160, construction loan commitment fees are amortizable over the life of the construction loan, subject to the provisions of Sec. 195, I.R.C., which effectively defers the commencement of amortization until the month in which active trade or business begins.

(b) As a result of Rev. Rul. 81-161, 1981-1 C.B. 313, permanent loan commitment fees are amortizable over the life of the permanent loan. See also Duffy v. United States, 690 F.2d 889 (Ct. Cl. 1982).

(c) But see Johnsen v. Comm'r, 84 T.C. 344 (1985), holding that the taxpayer was entitled to deduct his distributive share of a construction loan commitment fee. The fees at issue were paid to the lender in return for the lender's present promise to make a loan of a stated amount at a stated interest rate over a stated period. The construction and permanent loan commitment fees were nonrefundable and due on acceptance of the commitment. See Neuman and Elfman, The Tax Treatment of Loan Commitment Fees after Rev. Ruls. 81-160 and 81-161, 60 Taxes 394, 395 (1982).

4. Pre-Opening Expenses.

a. Sec. 195, I.R.C. (effective as to amounts paid or incurred after July 29, 1980), as amended in toto by Section 94(a) of the TRA 1984 (applicable to tax years beginning after June 30, 1984), provides for 60-month amortization with regard to expenses paid or incurred in connection with creating, or investigating the creation or acquisition of, a trade or business entered by the taxpayer.

(1) "Start-up expenditures" include any amounts paid or incurred in connection with:

(a) investigating the creation or acquisition of an active trade or business, or

(b) creating an active trade or business, or

(c) any activity engaged in for profit or for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business. Sec. 195(c)(1)(A), I.R.C.

(2) The term "start-up expenditure" does not include any amount deductible under Sec. 163(a), 164 or 174, I.R.C., because separate capitalization rules apply to these provisions. In addition, costs amortizable under Sec. 195, I.R.C. must be costs that would otherwise be currently deductible if incurred in an already fully operating active trade or business. Sec. 195(c)(1)(B), I.R.C.

(3) An acquired trade or business is treated as beginning when the taxpayer acquires it. See Sec. 195(c)(2)(B), I.R.C.

(4) The 60-month period begins with the month in which the active trade or business begins. Sec. 195(b)(1), I.R.C. As to when "business begins," refer back to Secs. 248 and 709, I.R.C., and the Regulations or Proposed Regulations, respectively, thereunder. See H.R. Rep. No. 7956, 96th Cong., 2d Sess. (1980), at 14. The Service clearly

views an active trade or business as being started when there is enough activity to meet the Sec. 162(a), I.R.C. test of "carrying on a trade or business". See Priv. Ltr. Rul. 9027002 (May 16, 1990) and Priv. Ltr. Rul. 9047032 (August 27, 1990).

b. Start-up items eligible for amortization under Sec. 195, I.R.C., are advertising, salaries and wages being paid to employees being trained (as well as their instructors), travel and other expenses incurred in lining up prospective distributors, suppliers and customers, and salaries or fees paid for executives, consultants and similar professional services. See H.R. Rep. No. 7956, at 12. See, generally, Solomon and Weintraub, Business Start-Up Expenses and Section 195: Some Unresolved Problems, 7 Tax. Indivs. 123 (1983); and Bradley, Deductibility of a Partnership's Investigation and Start-Up Expenses, 2 J. Partnership Tax 233 (1985). Ground rent payments made with respect to a lease of land before improvements thereon are completed and active business begun may well fall within the start-up category. See Fishman v. Comm'r, 837 F.2d 309 (CA7 1988).

c. In the case of rental activities, there must be a significant furnishing of services incident to the rentals to constitute an active business. The operation of an apartment complex, office building or shopping center will generally be considered an active trade or business. See H.R. Rep. No. 7956, 96th Cong., 2d Sess. (1980), at 12. A triple net lease, on the other hand, would not qualify.

d. Since Sec. 195, I.R.C. requires the taxpayer to be pursuing the creation or acquisition of an active trade or business, there may remain some activities where Sec. 195, I.R.C. technically does not apply, although the expenditures are of a start-up nature. A number of cases have allowed current Sec. 162, I.R.C. deductions for preopening expenses on the theory of expansion of an existing business, rather than the establishment of a new business. See NCNB Corp. v. United States, 684 F.2d 285 (CA4 1982), rev'g en banc 651 F.2d 942 (CA4 1981); Briarcliff Candy Corp. v. Comm'r, 475 F.2d 775 (CA2 1973); First Nat. Bank of South Carolina v. United States, 413 F.Supp 1107 (D. S.C. 1976). But see Central Texas Savings & Loan Ass'n. v. United States, 731 F.2d 1181 (CA5 1984); and Seago, The Treatment of Start-Up Costs under Section 195, 66 J. Tax. 362 (1987).

5. Legal Fees.

a. Where the legal fees result from services incident to the construction of the building, they must be capitalized and added to the building cost.

(1) See W.P. Brown & Sons Lumber Co. v. Comm'r, 26 B.T.A. 1192 (1932), where the legal fees were for legal services of examining contracts with subcontractors, settling accident claims, reviewing loan documents and working on leases.

(2) The same applies to accounting fees. See Shainberg v. Comm'r, 33 T.C. 241 (1959), acq. 1960-2 C.B. 5, where the accounting fees were for reviewing a tax return and auditing a construction contract in connection with the construction of a shopping center.

b. Success or failure does not matter where the taxpayer owns the asset to which the legal services may be tied. See Godfrey v. Comm'r, 22 TCM 1 (1963), where fees incurred in an unsuccessful zoning fight nonetheless had to be capitalized as part of the land cost. See Galt v. Comm'r, 19 T.C. 892 (1953), where the Court rejected the taxpayer's argument that fees related to unsuccessful efforts to obtain a tenant should be currently deductible. See also Baylin v. United States, 94-1 USTC ¶ 50,029 (Ct. Cl. 1993), aff'd 95-1 USTC ¶ 50,023 (CA5 1995), where the Court held that legal fees incurred in defending a condemnation suit were capital expenditures and, as such, the taxpayer was not entitled to deduct the fees allocable to the interest component of the condemnation award. Similarly, in Jasko v. Comm'r, 107 T.C. 30 (1996), the Court held that the taxpayers could not claim a deduction under Sec. 212(1), I.R.C. for legal expenses incurred in challenging their insurance company's determination of the replacement value of their home.

c. Where the legal services relate to tax advice, and are clearly demarcated as such, they will be deductible. See Merians v. Comm'r, 60 T.C. 187 (1973). Generally, such expenses will be deductible under Sec. 212(3), I.R.C. See Kaufmann v. United States, 227 F. Supp. 807 (W.D. Mo. 1963). However, legal and accounting fees that qualify as pre-opening expenses are subject to the 60-month amortization rule under Sec. 195, I.R.C. Furthermore, legal fees for tax advice in connection with the sale or promotion of the sale of interests in a partnership are neither deductible nor amortizable. Sec. 709(a), I.R.C.; Reg. §1.709-2(b). See Rev. Rul. 88-4, 1988-1 C.B. 264. See also F.S.A. 199945004 (July 16, 1999), determining that attorneys' fees and accountants' fees incurred in the initial public offering of a real estate investment trust were subject to capitalization.

6. Insurance.

a. Generally, premiums paid for insurance in connection with the construction of improvements are considered a cost of construction. See The Columbia Theatre Co. v. Comm'r, 3 B.T.A. 622 (1926); and Rev. Rul. 66-373, 1966-2 C.B. 103. See also Lenington v. Comm'r, 25 TCM 1350 (1966).

b. This rule has been applied to public liability insurance, fire and extended coverage insurance, and workmen's compensation insurance. Compare Rev. Rul. 66-373, 1966-2 C.B. 103, with Lowrey v. Comm'r, 24 TCM 1078 (1965).

c. In contrast are those premiums connected with the financing of the construction.

(1) In Rev. Rul. 56-264, 1956-1 C.B. 153, mortgage insurance premiums were held deductible during the construction period. See also Rev. Rul. 70-360, 1970-2 C.B. 103, in which the current deduction of insurance premiums was not challenged.

(2) In Rev. Rul. 75-46, 1975-1 C.B. 55, premiums on an unrelated defaulting borrower's life insurance policy were held to be deductible when paid by a bank.

C. Real Estate Ownership -- Capitalization vs. Deductibility.

1. Interest Deductions.

a. Interest Deductions: Generally --

(1) A cash basis taxpayer may, as a general rule, deduct interest as an expense only in the taxable year in which paid. Sec. 461, I.R.C.; Reg. §1.461-1(a)(1). See, generally, Tucker, Tax Shelters: An Analysis of Recent IRS Moves to Limit Their Recognition and Their Benefits, 4 Tax. for Lawyers 138 (1975).

(a) The intention to pay will not itself permit the deduction to be taken. England v. Comm'r, 34 T.C. 617 (1960). Nor will the addition of the accrued interest to the principal amount of the note entitle the taxpayer to the interest deduction. Rev. Rul. 70-647, 1970-2 C.B. 38. See also Rubnitz v. Comm'r, 67 T.C. 621 (1978).

(b) Nor will payment be considered to have occurred where the taxpayer gives his own promissory note. Helvering v. Price, 309 U.S. 409 (1940). See also Battelstein v. Comm'r, 631 F.2d 1182 (CA5 1980), and Franklin v. Comm'r, 77 T.C. 173 (1981). This is so even if the note is secured by sufficient collateral to make payment certain. See Jenkins v. Bitgood, 101 F.2d 17 (CA2 1939), and Kuhn v. Comm'r, 34 B.T.A. 274 (1936).

(c) However, payment may be made by means of delivery of a note of another, where the note is negotiable and the maker solvent. See, e.g., Scharf Estate v. Comm'r, 316 F.2d 625 (CA7 1963); and Webb's Estate v. Comm'r, T.C. 1202 (1958).

(2) An accrual method taxpayer may deduct interest only in the taxable year in which all events have occurred which determine the fact of liability. Sec. 461, I.R.C.; Reg. §1.461-1(a)(2). See Cumberland Glass Mfg. Co. v. United States, 44 F.2d 455 (Ct. Cl. 1930). Under Reg. §1.461-1(a)(2)(i), the accrual method taxpayer must satisfy both the "all events test" and the "economic performance test" in order to meet the requirements for deducting a liability. However, if any Code provision requires deduction in a year later than the year in which the all events and economic performance tests are satisfied, such provision will overrule Sec. 461, I.R.C. Reg. §1.461-1(a)(2)(iii)(A).

(a) Because interest accrues ratably, it is deductible each taxable year of the taxpayer over the period of the loan (Chas. Schaefer & Son, Inc. v. Comm'r, 20 T.C. 558 (1953)), whether or not paid in advance, and whether or not actual payment is deferred beyond the taxable year. See, e.g., Warner Co. v. Comm'r, 11 T.C. 419 (1948), aff'd per curiam 181 F.2d 599 (CA3 1950).

(b) Where actual payment is deferred in a partnership situation, in order to achieve a deduction for the accrual method borrower-partnership, while permitting a cash basis lender-partner not to realize income, the Service could, nonetheless,

contend that the partner has income in the year in which the partnership takes the deduction. However, the Service does not need any such tool. Sec. 267(a), I.R.C., as amended, provides that a partnership (other than certain partnerships owning low income housing) can only accrue an expense payable to a related cash basis person in the taxable year of the partnership in which that expense is in fact paid. Under Sec. 267(e)(1)(B)(i), I.R.C., a related person, in the case of a partnership, is any person who owns (directly or indirectly) any capital interest or profits interest in such partnership.

b. Original Issue Discount.

(1) As an override to the other rules governing interest deductibility and income, the original issue discount rules, as broadened by the TRA 1984, must be taken into account.

(2) From the perspective of the lender or holder of the debt instrument having original issue discount, the rules are as follows:

(a) Generally, there is included in gross income an amount equal to the sums of the daily portions of the original issue discount for each day during the taxable year on which the holder held the debt instrument. Sec. 1272(a)(1), I.R.C.

(b) Certain debt instruments are not included within the original issue discount rules, such as United States savings bonds, obligations issued by natural persons before March 2, 1984, short-term (not more than one year) obligations, and loans between natural person which (i) do not exceed \$10,000, (ii) are not made in the course of a trade or business of the lender and (iii) are not for a principal purpose of tax avoidance. Sec. 1272(a)(2), I.R.C.

(3) From the perspective of the borrower or issuer of the debt instrument, the interest expense is deductible on an economic accrual approach, with a focus on the "issue price" of the debt instrument.

(a) If there is adequate stated interest, then the issue price is the stated principal amount. Sec. 1274(a)(1), I.R.C.

(i) Generally, the test rate of interest for a debt instrument issued in consideration for the sale or exchange of property is the applicable Federal short-term rate determined under Sec. 1274(d), I.R.C.

(b) If the stated interest is not adequate, then the issue price is the imputed principal amount, using the sum of the present value of all payments due under the debt instrument with a discount rate equal to the applicable Federal rate, compounded semiannually. Secs. 1274(a)(2) and (b)(2), I.R.C.

(4) The "original issue discount" is equal to the difference between the issue price of the debt instrument (as determined above) and its stated redemption price at maturity. Sec. 1273(a), I.R.C.

c. Prepaid Interest.

(1) Sec. 446(b), I.R.C., provides that if the method of accounting used by a taxpayer does not "clearly reflect income", the Service has the right to cause the computation of taxable income to be made under such a method as does clearly reflect income.

(2) Sec. 461(g), I.R.C., provides that a cash basis taxpayer must deduct any prepaid interest (including "points" which are in fact prepaid interest) over the specific period with respect to which the interest represents a charge for the use or forbearance of money. See Zidanic v. Comm'r, 79 T.C. 651 (1982), in which one year's interest was paid in October 1977 at the lender's insistence, and such interest was not under any circumstances refundable or reimbursable to the taxpayer; nonetheless, Sec. 461(g), I.R.C. was found to govern.

(a) This provision does not apply under Sec. 461(g)(2), I.R.C., to "points" charged on home mortgages if the charging of such points is an established business practice in the taxpayer's geographical area and the amount paid does not exceed the amount generally charged in such area.

(b) The Service has held that points paid in a mortgage refinancing, the proceeds of which are not used for improving the residence, are not deductible in the year paid because they are not incurred in the "purchase or improvement" of a principal residence. Rev. Rul. 87-22, 1987-1 C.B. 146. But see Huntsman v. Comm'r, 905 F.2d 1182 (CA8 1990), rev'g 91 TCM 917 (1988), where the Eighth Circuit approved the current deduction of points incurred in the refinancing of a short-term mortgage loan.

(c) Sec. 461(g), I.R.C., should not have any impact on those "points" which are not in fact prepaid interest. Accordingly, care should be taken so that the term "points" is not used as a catch-all for other fees. Carefully designating the fees will assist in dealing with the I.R.S. as to deduction or amortization. See Rev. Proc. 92-12, 1992-1 C.B. 663, setting forth the Service's position on what constitutes a point for taxable years beginning after 1990. See also Rev. Proc. 94-27, 1994-1 C.B. 613, superseding Rev. Proc. 92-12 and setting forth a change in the Service's position to allow buyers to deduct points paid by the seller.

d. The "Rule of 78s".

(1) The Rule of 78s is a technique by which interest deductions may be accelerated by creating larger deductions for interest in the earlier years of the loan. Interest is calculated under the Rule of 78s by (i) determining the total amount of interest due over the term of the loan, and (ii) amortizing that amount through the use of a fraction of which the denominator is the sum total of the number of periods under the terms of the loan and the

numerator in any period reflects the remaining number of periods. As an example, in the first year of a 12-year loan, the denominator is 78 (12 + 11 + 10 + 9 + 8 + 7 + 6 + 5 + 4 + 3 + 2 + 1), and the numerator is 12.

(2) Typically, the Rule of 78s is utilized by a lender making a short term (for example, 3 years), level payment loan in order to collect greater interest at the front end, particularly where the loan may be prepaid. See, e.g., Rev. Rul. 72-100, 1972-1 C.B. 122.

(3) In Rev. Rul. 83-84, 1983-1 C.B. 97, the Service stated that, irrespective of any formula to the contrary in a loan agreement, the same rate of interest must apply to each period of a loan. Accordingly, the amount of interest which economically accrues on a loan [which is the key measurement] during a period is determined by applying an "effective rate of interest" (that is, a cost of credit, stated as a constant yearly rate, which relates the amount and timing of values received to the amount and timing of payments made) on the loan to the unpaid balance of the loans for that period. For an examination of the scope of Rev. Rul. 83-84, see Kellar, Economic Accrual of Interest: Tax Court Restrains Administrative Overreach, 49 Tax Notes 1355 (1990).

(4) Rev. Proc. 99-49, 1999-2 C.B. 725, Appendix Sec. 5.04, provides the current authorized Rule of 78s method for the accrual of stated interest on short-term consumer loans. Rev. Proc. 99-49 continues to allow the Rule of 78s method for consumer loans only if the loans were issued prior to the first day of the taxpayer's first taxable year that begins on or after January 1, 1999.

e. The "Net Loan" Issue.

(1) Rev. Rul. 69-188, 1969-1 C.B. 54, and Rev. Rul. 69-582, 1969-2 C.B. 29, proved to be harbingers of things to come. In each, dealing with the deductibility of "points" as interest, the Service noted that the "taxpayer did not obtain the funds to pay the fee from the lender."

(2) In Rev. Rul. 70-647, 1970-2 C.B. 38, the Service emphasized that a cash basis taxpayer does not become entitled to an interest deduction merely because the lender gives the taxpayer a credit for interest paid. In Rev. Rul. 70-647, the interest was not considered to have been paid to the lender where the taxpayer executed a new note, which encompassed not only the unpaid balance of a prior note and an additional sum loaned, but also interest accrued and unpaid on the prior note.

(3) See Battelstein v. Comm'r, 613 F.2d 1182 (CA5 1980), and Blitzer v. United States, 684 F.2d 874 (Ct. Cl. 1982), where the "kiting" of checks enabled the Court to disallow the interest deduction to cash method taxpayers. In Noble v. Comm'r, 79 T.C. 751 (1982), the Court held, on the one hand, that commitment fees were not deductible where paid from loan proceeds simultaneously with the funding thereof, and, on the other hand, that interest was deductible where funds were commingled and the receipt of loan proceeds was not simultaneous with the interest payments. See, generally, Comment -- Battelstein v. Internal

Revenue Service: Deductibility of Interest Payments Financed by Additional Loans from the Same Lender, 35 Tax Lawyer 275 (1982).

(4) In Menz v. Comm'r, 80 T.C. 1174 (1983), the Court cited and analyzed the cases in this area dealing with loans from the same lender (where one loan is used to pay interest on a second), and decided that "deductibility turns on whether the taxpayer exercises unrestricted control over the money borrowed from the same lender". In this case, the Court noted, due to a variety of factors, that the partnership seeking deductibility for interest never had unrestricted control over the loan funds used to pay the interest.

f. Loans with Contingent Interest.

(1) In Rev. Rul. 83-51, 1983-1 C.B. 48, the Service tackled the shared appreciation mortgage problem. In the Ruling, the shared appreciation mortgage ("SAM") provided for fixed interest of 12 percent per year and contingent interest equal to 40 percent of the appreciation, as determined under the SAM, in the value of the residence over the term of the SAM, payable on termination of the SAM. The SAM terminated on the earliest of (i) prepayment of the entire outstanding balance, (ii) transfer of ownership or (iii) 10 years from the date of the SAM loan.

(a) Three different situations were discussed. In the first, the home was sold in three years; in the second, the mortgage was prepaid in full with funds obtained from a third party; and in the third, the home was refinanced with funds obtained from the same lender.

(b) Pointing out that "interest, in order to be deductible, need not be computed at a rigid stated rate; [but rather that all] that is required is that a sum definitely ascertainable be paid for the use of borrowed money, pursuant to the agreement of the lender and the borrower", in the first and second situations the Service found the contingent interest deductible under Sec. 163, I.R.C. In the third situation, the Service found that the homeowner, as a cash method taxpayer, had not repaid the loan when it refinanced with the same lender.

(c) The Service took care to state that the conclusions in Rev. Rul. 83-51 apply only to the fact situations therein set forth (that is, to an individual homeowner on the cash method). See Milner, Taxation of Residential and Commercial Shared Appreciation Mortgages after Rev. Rul. 83-51, 62 Taxes 631 (1984).

(d) The Service noted that, accordingly, the conclusions should not be considered to apply to SAMs where:

(i) The loan proceeds are used for commercial or business activities;

(ii) The lender acquires greater rights with respect to the borrower or mortgaged property than in the Ruling;

(iii) The parties evidence an intention to create a relationship other than that of debtor and creditor;

(iv) Other circumstances indicate that the SAM loan represents in substance an equity interest in the mortgaged property; or

(v) The borrower is a corporation.

(2) The Service did not break new ground in Rev. Rul. 83-51. There had been several cases over the years holding that a debtor-creditor relationship exists even though interest is contingent to an extent on the profits of the borrower. See, generally, Mooradian and Rosenblatt, Characterization of Contingent Payments on Shared Appreciation Mortgages, 57 J. Tax. 20 (1982).

(a) In Bedell v. Comm'r, 9 B.T.A. 270 (1927), aff'd 30 F.2d 622 (CA2 1929), the interest payable on the loan was wholly dependent on the profits of the borrower.

(b) In Kena Inc. v. Comm'r, 44 B.T.A. 217 (1944), the interest on the loan was 80 percent of the borrower's net profits, and a valid debt was found to exist. See also Rev. Rul. 74-187, 1974-1 C.B. 48.

(c) In Astoria Marine Construction Co. v. Comm'r, 4 TCM 278 (1943), a loan was found to exist even though the interest was 6 percent plus an amount contingent on the borrower's net profits.

(d) In Wynnefield Heights, Inc. v. Comm'r, 25 TCM 953 (1966), debt was held to be such even though there were payments contingent on lot sales.

(e) The Service itself, in Rev. Rul. 76-413, 1976-2 C.B. 213, held, in the REIT context, that contingent interest qualified as interest. The contingent interest was equal to the greater of a fixed percentage of gross receipts on sales of portions of acreage securing the mortgage or a fixed number of dollars per acre payable on sale.

(3) A Solomonic approach to the debt versus equity issue was taken in Farley Realty Corp. v. Comm'r, 279 F.2d 701 (CA2 1960), where an individual was asked to lend Farley \$70,000, but believed the loan to be risky and so asked for a high rate of interest, which the Farley stockholders did not want to pay. He then agreed to make the loan at straight interest (15 percent the first two years and 13 percent the remaining eight years of the loan), but only with a kicker, based on a put and call. The kicker was 70 percent of the first \$100,000 by which the selling price exceeded the mortgage balance and 50 percent of any excess. When a dispute arose as to the kicker, it was settled by Farley paying \$50,000 which it deducted as contingent interest.

(a) The Court held that the \$50,000 was attributable to the right to share in the appreciation of the corporate property, and that right was an equity interest.

(b) The position of the Court is consistent with its decision in Estate of Eisner v. Comm'r, 335 F.2d 209 (CA2 1964), reversing Lubin v. Comm'r, 22 TCM 1494 (1963), in which the Tax Court's holding (that the issuance of stock and sale of the same back to the issuer on a predetermined date was in fact a loan) was reversed.

2. Partnership Guaranteed Payments.

a. Under Sec. 707(c), I.R.C., as amended by the Tax Reform Act of 1976, "[t]o the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of Sec. 61(a), I.R.C. (relating to gross income) and, subject to Sec. 263, I.R.C. for purposes of Sec. 162(a), I.R.C. (relating to trade or business expenses)."

b. In Rev. Rul. 81-300, 1981-2 C.B. 143, the Service found that management fees paid to general partners of a limited partnership were deductible as guaranteed payments under Sec. 707(c), I.R.C., and in Rev. Rul. 81-301, 1981-2 C.B. 144, the Service found that an allocation of a percentage of the gross income to a general partner for advisory services was deductible under Sec. 707(a), I.R.C., as a payment for services performed in the capacity of a person who is not a partner.

c. The TRA 1976, in its amendment of Sec. 707(c), I.R.C., made it clear that Sec. 263, I.R.C., is at all times to be taken into account in determining whether a guaranteed payment is deductible under Sec. 707(c), I.R.C. See Martin v. Comm'r, 43 TCM 1216 (1982).

d. It should be remembered that, whether or not the guaranteed payment is deductible by the partnership under Sec. 707(c), I.R.C. or capitalized by the partnership, the guaranteed payment is nonetheless income to the recipient partner when received by a cash method partner or accrued by an accrual method partner. See Rev. Rul. 80-234, 1980-2 C.B. 203; Casel v. Comm'r, 79 T.C. 424 (1982); and Gaines v. Comm'r, 45 TCM 363 (1982).

e. Moreover, the impact of Sec. 267, I.R.C. and Sec. 461(h), I.R.C., must at all times be considered.

3. Operating Expenses.

a. Generally, the costs of operation of the rental project are deductible when paid or incurred. Regs. §§1.162-1 and 1.162-4.

b. In Rev. Rul. 78-195, 1978-1 C.B. 39, a corporation that was formed for the express purpose of investing in real property purchased a tract of unimproved, non-income producing real property, which it held for two years and sold without having made any substantial improvements. The corporation did not make any significant efforts to sell the property and did not engage in any other property transactions or other commercial activities. Expenses incurred for accounting fees and general office costs were held to be related to the investment property of the corporation and therefore deductible under Sec. 162, I.R.C.

c. As to management fees, care must be taken to ascertain their true character. Are they brokerage or finders fees, capital expenditures for the acquisition of an interest in property, start-up costs, or syndication costs?

(1) See O'Heron v. Comm'r, 42 TCM 1628 (1981), where management fees were held deductible even though measured by profits. The Court noted, at page 1631, that: "The fact that . . . compensation is measured by profits does not create suspicion on our part but rather appears as a very prudent motivational tool. The fact that the profits in question included profits on sale is similarly reasonable. A manager under such contingent agreement would be foolish to let the fruits of his efforts be sold out from under him. This management agreement is an arm's-length transaction between unrelated parties."

(2) In Rev. Rul. 81-150, 1981-1 C.B. 119, the Service held that management fees paid for supervising the construction and financing of an offshore drilling rig were start-up costs, subject to the 60-month amortization under Sec. 195, I.R.C., to the extent incurred after June 29, 1980.

(3) In Bonaire Development Co. v. Comm'r, 76 T.C. 789 (1981), aff'd 679 F.2d 159 (CA9 1982), it was held that advance management fees were not deductible when paid, but had to be amortized over the period to which attributable. The Court distinguished Zaninovich v. Comm'r, 616 F.2d 429 (CA9 1980), where advance rentals, for not more than 12 months beyond the taxable year in which paid, were held deductible in the taxable year in which paid, because, unlike the Zaninovich situation, the prepayment was voluntary, not required by any document.

d. In Blitzer v. United States, 684 F.2d 874 (Ct. Cl. 1982), a fee paid to the administrative general partner was broken down into different categories based on the services rendered, as follows:

(1) Organizational and syndication services (pre-Sec. 709, I.R.C.) -- amortizable over 50-year life of the partnership;

(2) Services in connection with the acquisition and construction of the partnership's capital assets -- capitalized and added to the bases of such assets;

(3) Services in connection with obtaining HUD approval of loans and insurance of the loans -- amortizable over the lives of the loans; and

(4) Services of a non-capital nature, such as bookkeeping -- deductible when paid or incurred.

e. See Priv. Ltr. Rul. 8211004 (November 27, 1981), in which fees paid to stockholders of a corporate borrower as compensation for their personal guaranties of corporate loans were found to be currently deductible. See also Tulia Feedlot, Inc. v. United States, 83-2 USTC ¶9516, 52 AFTR 2d 83-5702 (Cl.Ct. 1983), where guarantor fees paid by a close corporation to its shareholders, who guaranteed company loans, were held to be deductible business expenses. See, generally, Note -- Fee Payments for Shareholder Debt Guarantees in the Close Corporation Setting: Has the Internal Revenue Service Improperly Departed from Established Statutory and Judicial Doctrine?, 7 Va. Tax Rev. 157 (1987).

f. Caveat: under Sec. 461(h), I.R.C., the all events test, for accrual purposes, is generally not treated as met any earlier than when "economic performance" occurs with regard to an item.

(1) Economic performance generally occurs, under Sec. 461(h)(2), I.R.C., as a person provides services or provides property to the taxpayer or as the taxpayer uses property or provides property or services.

(2) There is an exception for recurring items, where economic performance occurs within a reasonable period after the close of the taxable year (but not more than 8½ months thereafter) and either the item is not material or its accrual in the year in which all events occur results in a more proper match against income than its accrual in the year in which economic performance occurs. Sec. 461(h)(3), I.R.C.

(3) In the case of cash basis "tax shelters" (as defined in Sec. 461(i)(3), I.R.C.), there is no deductibility for any item except when economic performance occurs (without the benefit of Sec. 461(h)(3), I.R.C.). Sec. 461(i)(1), I.R.C.

4. Environmental Remediation Expenses

a. Until the last quarter century, environmental hazards were not something which presented a problem to the real estate industry. However, with the enactment of legislation such as the Comprehensive Environmental Response, Compensation and Liability Act, the Resource Conservation and Recovery Act and the Toxic Substances Control Act, real estate owners have become responsible for remediating different types of hazardous waste. 42 U.S.C. §§9601-9575 (1986); 42 U.S.C. §§6901-6992k (1976); 15 U.S.C. §§2601-2671 (1976).

(1) The costs of asbestos removal are required to be capitalized and the costs of asbestos encapsulation are currently deductible. See Priv. Ltr. Ruls. 9240004 (June 29, 1992), 9315004 (December 17, 1992), and 9411002 (November 19, 1993). See also Plainfield-Union Water Co. v. Comm'r, 39 T.C. 333 (1962); and Midland Empire Packing Co. v. Comm'r, 14 T.C. 635 (1950), acq. 1950-2 C.B. 3.

(2) In Rev. Rul. 94-38, 1994-1 C.B. 35, the Service set forth a fact pattern where a taxpayer purchased land which was not contaminated. The taxpayer then buried hazardous waste resulting from its manufacturing operations which contaminated the land and groundwater. In order to comply with applicable Federal, state and local environmental requirements, the taxpayer remediated the land by excavating the contaminated soil, transporting it to a containment facility and filling the excavations with uncontaminated soil. A facility was built to extract, treat and monitor the groundwater. The Service held that the cost to build the groundwater treatment facility was a capital expense because the plant had a useful life substantially beyond the taxable year in which it was constructed. The Service held that the soil remediation expenditures and the ongoing groundwater monitoring were deductible costs because such costs did not produce permanent improvements or otherwise provide significant benefits. In determining whether the value of the property increased, the Service used the Plainfield-Union test, stating that the value of the property was not increased because the taxpayer restored its soil and groundwater to their approximate condition before they were contaminated. The Service noted that the expenditures did not prolong the useful life of the land, nor adapt it to a new and different use.

(3) In Priv. Ltr. Rul. 9627002 (January 17, 1996), the Service held that Rev. Rul. 94-38 will apply notwithstanding a break in ownership. The Service determined that, because the same taxpayer contaminated the property and incurred the costs (and whose liability for remediation was unchanged during the break in ownership), the interim break in ownership should not alone operate to disallow a deduction under Sec. 162, I.R.C. The cost of the environmental impact studies and the associated legal and consulting fees did not create or enhance an asset, nor did they produce a long-term benefit, and so they were deductible under Sec. 162, I.R.C.

(4) In Rev. Rul. 98-25, 1998-1 C.B. 998, the Service ruled regarding the treatment of expenditures in connection with the removal and replacement of underground storage tanks at retail gasoline stations. All costs incurred in connection with the removal, replacement and installation of USTs, in the same place as the old USTs, are deductible as ordinary and necessary business expenses under Sec. 162, I.R.C. This treatment is accorded because the USTs are filled with waste once, will not be emptied and reused, will be sealed indefinitely, have no remaining useful life to the company and no salvage value. The costs held to be deductible include the costs of removing, cleaning and disposing of the old USTs, the costs of acquiring, installing and filling the new USTs, the costs of monitoring the new USTs for leaks, and the costs incurred in cleaning up the soil and groundwater contamination by releases from such USTs. The Service noted that above ground storage tanks will receive similar treatment, and that no distinction is warranted between a taxpayer which is continuing in its line of business which creates such wastes and a taxpayer which has ceased such line of business. The ruling marks a significant departure from the Service's prior pro-capitalization policy for USTs. See also United Dairy Farmers Inc. v. United States, No. 00-3800, ___ F.3d ___ (CA6 2001), aff'g 107 F. Supp.2d 937 (S.D. Ohio 2000).

(5) In F.S.A. 199942025 (July 27, 1999), the Service advised that a corporation was entitled to a current deduction for environmental cleanup costs even though the costs were subject to indemnification under a stock purchase agreement. Corporation

A owned and operated a refining, marketing and transportation business. The stock of Corporation A was sold by Corporation B to Corporation X, pursuant to a stock purchase agreement. As part of this agreement, Corporation B and its parent, Corporation C, agreed to indemnify Corporation X for any subsequent environmental remediation costs incurred by Corporation A. Several years later, Corporation A began incurring environmental clean up costs on some of its properties. As the owner, operator and permit holder, Corporation A was legally responsible for all of these costs, whether or not such costs were subject to indemnification. Corporation A paid these clean up costs and claimed a current deduction for all of the costs. Corporation A was successfully able to have these costs indemnified, treating these payments as capital contributions and not taxable income, asserting that the payments related back to the stock purchase transaction and merely reduced the basis of the stock in Corporation A. The Service allowed the indemnified corporation to claim a current deduction for the indemnified costs connected with the transfer of stock. The Service concluded that the receipt of the indemnity payments constituted an adjustment to the sale price of the stock of the buyer and did not result in taxable income.

(6) In Priv. Ltr. Rul. 200108029 (November 24, 2000), the taxpayers purchased a parcel of property that had been contaminated with perchloroethylene (PCE) used in a dry cleaning machine. When the taxpayers purchased the property, it contained mobile home spaces, RV spaces with no utilities, a laundry facility and a dry cleaners. Subsequently, it was discovered that the property had both soil and groundwater contamination from PCE. The taxpayers incurred costs for consultants, testing, supplies, equipment, labor and legal fees related to the environmental remediation of the property. The taxpayers deducted such environmental clean up costs. The taxpayers received an insurance settlement under policies for defense, costs, expenses, supplemental payments and damages incurred from environmental claims arising in connection with the property. The Service concluded that the taxpayers were required to capitalize the costs to clean up their land and treat contaminated ground water. The Service treated the insurance proceeds received by the taxpayers as a reduction of basis and taxable only to the extent the basis of the land was reduced below zero. The expenditures for the remediation increased the value of the land by improving the land from a contaminated state to a remediated state. The taxpayers had acquired the property in a contaminated state, which was different from the situation in Rev. Rul. 94-38. In Rev. Rul. 94-38, the taxpayer was allowed to expense a portion of the environmental remediation costs because such costs did not increase the value of the land, but, rather, restored the land to the condition it was in before the taxpayer had contaminated it.

(7) In Rev. Rul. 2005-42, 2005-28 I.R.B. 67, the IRS extended its position in Rev. Rul. 2004-18, 2004-8 I.R.B. 509. In that Ruling, the Service concluded that environmental remediation costs incurred in cleaning land contaminated by the taxpayer corporation's manufacturing activity could not be deducted, and instead had to be capitalized as inventory costs under Sec. 263A, I.R.C. This Ruling altered the facts in five slightly different situations, and held that the remediation costs must be allocated to the inventory produced during the taxable year the costs were incurred.

In Situation 1, N was a corporation that owned and operated a stove manufacturing plant on its own land. The stoves, the only item N produced, were inventory in N's hands. These

manufacturing activities produced hazardous waste, which N had legally buried on its land in past years. Due to new environmental requirements, N incurred costs to remediate the contaminated soil and groundwater, which returned the land to its original condition. Production of stoves was ongoing throughout this process and continued afterwards.

In Situation 2, N manufactured clothes dryers instead of stoves. In Situation 3, N temporarily halted production of stoves during the cleaning process. In Situation 4, N stopped manufacturing stoves at the newly cleaned site and restarted at a new location. In situation 5, N dumped the waste at a remote dump on land it did not own, and ceased dumping at the remote location following the remediation.

The Service's conclusion for each situation was identical. In each situation, N incurred remediation costs caused by its production activities, as contemplated by Reg. §1.263A-1(e)(3)(i). The remediation costs were allocated to the inventory produced in the year the costs were incurred, pursuant to Regs. §§1.263A-1(c)(1) and 1.263A-1(c)(2), which call for this outcome, even though the cause for the necessary remediation dated back to previous years. Finally, the allocation of remediation costs to inventory would be done using an allocation method allowed under Reg. §1.263A-1(f).

V. CREATIVE FINANCING

A. Introduction.

1. The fixed rate mortgage cannot be found to any significant extent on a long-term basis. See Feder, "Either a Partner or a Lender Be": Emerging Tax Issues in Real Estate Finance, 36 Tax Lawyer 191 (1983). Most lenders seek to share the upside potential growth in value of the real estate itself, while shielding themselves from the downside risks.

2. Today, depending on whether one defines a 15-year fixed rate loan with a five- or ten-year call option as a long-term loan, one can once again find fixed rate long-term loans. In all events there is one certainty -- with continually-changing tax laws and continuous real estate acquisition, development, construction, sales and exchanges, there will always be a need for financing techniques which enable both the borrowers and lenders to attain sufficient rewards for the risks they take, and that need will continually challenge the tax counselor.

B. Issues Relating to Creative Financing.

1. There are many varieties of creative financing.

2. In each variation, from the perspective of the borrower, the following issues must be considered:

a. Will the lender be considered to be only a lender, or also an owner?

(1) If the owner/borrower is a partnership, will the lender be considered a member of the partnership? See, generally, Fisher, Real Estate Financing Techniques and Equity Aspects of Debt Arrangements, 61 Taxes 1040 (1982).

(a) If so, has the lender made a loan, so that the "other" members of the partnership retain basis?

(b) If so, how is that basis of the other members determined?

(2) If the owner/borrower is an S corporation, will the lender be considered a shareholder in the corporation?

(a) If so, will Subchapter S status be lost? If so, how can the lost status be cured?

(b) If the lender is not considered a shareholder, is it considered a partner with the S corporation? If so, the questions noted above are again to be considered.

b. What is "contingent" interest? Is it interest, or is it a share of profits? If not interest, is deductibility lost? Can a share of profits be considered, in the case of a partnership, as a guaranteed payment, thereby permitting deductibility?

c. What is the impact on depreciation? In turn, this issue returns one to the question of basis for depreciation? Coming full circle, if there is no loan, but an equity infusion, there is no basis, no depreciation attributable thereto and no interest deduction. See Pollack, Sale-Leaseback Transactions Adversely Affected by a Variety of Recent Developments, 64 J. Tax. 151 (1986). In connection with the issue of whether the lender should receive the depreciation, see Tufts v. Comm'r, 461 U.S. 300 (1983), where, at footnote 5, the Court stated:

The Commissioner might have adopted the theory, implicit in Crane's contentions, that a nonrecourse mortgage is not true debt, but, instead, is a form of joint investment by the mortgagor and the mortgagee. On this approach, nonrecourse debt would be considered a contingent liability, under which the mortgagor's payments on the debt gradually increase his interest in the property while decreasing that of the mortgagee.*** Because the taxpayer's investment in the property would not include the nonrecourse debt, the taxpayer would not be permitted to include that debt in basis.***

We express no view as to whether such an approach would be consistent with the statutory structure and, if so, and Crane were not on the books, whether that approach would be preferred over Crane's analysis. We note only that the Crane Court's resolution of the basis issue presumed that where property is purchased with proceeds from a nonrecourse mortgage the purchaser becomes the sole owner of the property. 331 U.S., at 6. Under the Crane approach, the mortgagee

is entitled to no portion of the basis. *Id.*, at 10, n. 28. The nonrecourse mortgage is part of the mortgagor's investment in the property, and does not constitute a coinvestment by the mortgagee. But see Note, 82 Colum. L. Rev. [1982], at 1513 (treating nonrecourse mortgage as coinvestment by mortgagee and critically concluding that Crane departed from traditional analysis that basis is taxpayer's investment in property).

3. Among the variations are the following:

a. Loan with an interest "kicker" -- The lender charges a fixed interest rate, but there is additional interest payable if certain pre-determined standards are met. Examples are (i) increase in gross rent roll over a "floor" amount, (ii) increase in "net cash flow" of the owning entity, and (iii) increase in "net income", with certain checkpoints on the ability of the borrower to exercise its imagination in reducing net income.

b. Loan with an "equity kicker" -- This variation is really a modification of that immediately above. The annual interest kicker is generally the same. In addition, on sale or refinancing, or at a date certain if earlier, the lender receives an amount over and above the unpaid principal amount of the loan. If there is a sale or refinancing, the amount is generally a percentage of the proceeds in excess of (i) the original principal amount of the loan, (ii) the unpaid principal amount of the loan (which is even more detrimental to the borrower), or (iii) the value of the property on which the original loan was based.

c. "Appraisal kicker" loan -- This variation builds on the two preceding types. Here, the lender makes a longer term loan, but at pre-determined dates (such as each five years) appraisals are made of the property, and the borrower pays a percentage of the increase in value over the prior appraisal date (or initial loan date) to the lender.

d. Convertible loan -- The lender has the right, under this technique, to convert a loan into an equity in the project. A foreign person, wishing the security of a loan, with guaranteed (or, at the least, priority) interest and a lien on the property, may make such a loan; the ability to convert into an equity interest in the property at a later point is required so that a sharing in the growth in value can be assured, while the risk of a downside turn is, through the loan feature, averted.

e. Loan with a put and call -- Here, the lender has the right to purchase the property ("put" the loan) at a multiple of net cash flow, which is most likely to be exercised if net cash flow is low. The borrower, in turn, has the ability to cause the lender to purchase the property ("call" the loan) at such multiple of net cash flow, which is most likely to be exercised if net cash flow is high.

f. Combination loan and investment -- The lender both participates as an equity investor (usually through the joint venture route) and makes a loan to the owning entity. If possible, the two roles would ideally be taken by two different entities.

g. Variable rate mortgage -- The interest rate is more the focus here, with annual or triennial adjustments. At each adjustment date, the borrower has the right to accept the new (but only new if higher, under most loan documents) rate, or pay off the loan and seek financing elsewhere.

C. Debt or Equity.

1. The Traditional Tests.

a. In the analysis of the tax impact of the financing format, there is, in the context of the corporation/ shareholder relationship, substantial authority which may be considered. While this authority might well, upon careful focus, appropriately be applicable only to the corporation/shareholder situation, it is clear that both the factors considered and the analysis utilized are broader in scope.

b. The tests of debt or equity may generally be gathered into three baskets, which are (i) the formal rights and remedies of the parties, (ii) thin capitalization and (iii) the intent of the parties. For a full discussion of the tests, see Plumb, The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and Proposal, 26 Tax L. Rev. 369 (1971). See, generally, O.H. Kruse Grain & Milling v. Comm'r, 279 F.2d 123 (CA9 1960); and Rowan v. United States, 219 F.2d 51 (CA5 1955).

c. The first test: The formal rights and remedies of the parties --

(1) While there is no absolute requirement that a promissory note or other evidence of indebtedness be issued (see Ortmayer v. Comm'r, 265 F.2d 848 (CA7 1959)), certainly the first factor to be considered is the presence of a note or other evidence of indebtedness. See, e.g., Nelson v. Comm'r, 19 T.C. 575 (1952); and Dodd v. Comm'r, 298 F.2d 570 (CA4 1962).

(2) The obligation to repay should have a fixed (or outside) maturity date. See, e.g., Utility Trailer Manufacturing Company v. United States, 212 F. Supp. 773 (S.D. Calif. 1962).

(3) Interest payments should be fixed or determinable based upon objective indices. Periodic payments which are contingent on earnings, or paid at the discretion of corporate directors, suggest that the contributions are equity rather than debt. See Fellinger v. United States, 363 F.2d 826 (CA6 1966). But see Monon R.R. v. Comm'r, 55 T.C. 345 (1970).

(4) Ordinarily, the obligation should not be subordinated in priority to those of general creditors. However, subordination will not necessarily be fatal where subordination is superimposed on the transaction by state law. See Jones v. United States, 659 F.2d 618 (CA5 1981).

d. The second test: Thin capitalization --

(1) As debt climbs in proportion to corporate equity, courts have concluded that the equity was too "thin" to support the debt structure. See, e.g., Dobkin v. Comm'r, 15 T.C. 31 (1950), aff'd per curiam 192 F.2d 392 (CA2 1951).

(2) Values have traditionally been computed using the market value of assets. See Kraft Foods Co. v. Comm'r, 232 F.2d 118 (CA2 1956).

(3) A debt-equity ratio of 3 to 1 has generally been considered to be safe. As one of many factors considered, much higher ratios have been sustained where the company's financial strength and cash flow would support full debt service. see Bradshaw v. United States, 683 F.2d 365 (Ct. Cl. 1982) (50 to 1 ratio held to be debt); and Baker Commodities, Inc. v. Comm'r, 48 T.C. 374 (1967) (700 to 1 was not fatal).

e. The third test: The intent of the parties --

(1) An earlier view expressed by the Tax Court held that a debtor-creditor relationship was not created where a dominant shareholder owned all of the notes issued by a corporation. It was the Court's conclusion that a stockholder so situated would not enforce the corporate debt. See Gooding Amusement Co., Inc. v. Comm'r, 23 T.C. 408 (1954), aff'd 236 F.2d 159 (CA6 1956), cert. denied 352 U.S. 1031 (1957).

(2) The courts have since looked to more objective criteria to determine whether the creation of a true creditor-debtor relationship was intended by the parties. In Gooding Amusement Co. v. Comm'r, 236 F.2d 159 (CA6 1956), cert. denied 352 U.S. 1031 (1957), the Court looked to:

(a) whether the shareholder-creditor conducted himself in a fashion consistent with that of a creditor;

(b) whether outside investors would have made such a loan on similar terms;

(c) use of the borrowed funds;

(d) the debt-equity ratio; and

(e) whether the debt was held pro rata.

(3) The establishment of a sinking fund to repay the corporate "debt" should indicate that the corporation intended to repay. In Portage Plastics Co., Inc. v. United States, 486 F.2d 632 (CA7 1973), the Court noted the absence of a sinking fund in holding for the government.

(4) Despite the fact that bona fide debt is created, it may later be transformed to equity if circumstances evolve which warrant the change. For example, in Tampa Gulf Coast R.R. Co. v. Comm'r, 56 T.C. 1393 (1971), aff'd per curiam 469 F.2d 263 (CA5 1972), the failure of the creditor to act as such transformed the debt to equity.

f. In Rev. Rul. 83-98, 1983-2 C.B. 40, the Service considered whether adjustable rate convertible notes (ARCNs) should be treated as debt or equity; such consideration, interestingly enough, was made without reference to Sec. 385, I.R.C. Under the facts of the ruling, X corporation was a publicly-traded corporation, with one class of common stock traded at about \$20 per share and a current dividend rate of 78¢ per share, or 3.9 percent, annually. X proposed to issue \$10 million of ARCNs, each at a price of \$1,000 cash or 50 shares of X common stock (worth \$1,000). The ARCNs would mature in 20 years; on maturity, the holder would receive, at its election, \$600 cash or 50 shares of X common stock; and until maturity each would be convertible into 50 shares of X common stock. Although there would be no call provision during the first two years, thereafter X could call any ARCN at a price of \$600 cash, with the holder then having the right to convert. While interest on a bond could not be less than \$60 nor more than \$175 per annum, the interest was tied to the dividends paid on the X common stock. Finally, the ARCNs were subordinated to all existing and future senior and general creditors of X.

(1) The Service found that, based on all the above factors, the ARCNs constituted an equity interest in X, treated as stock. The Service noted that the fixed interest and fixed minimum principal were insufficient factors to support their classification as debt. The Service emphasized that:

"Because of the very high probability that all of the ARCN's issued will be converted into stock, the ARCN's do not in reality represent a promise to pay a sum certain. Rather, the \$600 face value is a figure calculated primarily to ensure conversion into stock; its only function is to provide a floor for purposes of loss that will become material only if the price of X common stock declines by more than 40 percent from its price at the time the ARCN's are issued."

(2) The Service distinguished the subordinated debentures held to be debt in Rev. Rul. 68-54, 1968-1 C.B. 69, because (i) the instruments there were intended to and did create a fixed obligation to pay money on a given date; (ii) the interest rate, although to an extent dependent on earnings, was determinable according to a formula and did not float in tandem with discretionary common stock dividends; and (iii) the notes were not convertible into stock.

(3) In addition, the service distinguished the subordinated debt instruments in Rev. Rul. 73-122, 1973-1 C.B. 66, because (i) those instruments gave a right to be repaid a sum certain at some time within ten years; (ii) interest was to be paid at a fixed rate; and (iii) there was no conversion feature.

(4) One noticeable distinction between the 1983 ruling and the two earlier rulings is the absence of convertibility in the earlier rulings. Furthermore, it appears quite clear that the corporation in the 1983 ruling was looking from the beginning to compel conversion into its stock, so that the ARCNS could be said to have been essentially equivalent to the stock, from a tax point of view, from the very beginning. See also Rev. Rul. 85-119, 1985-2 C.B. 60, and Laidlaw Transportation, Inc. & Subs. v. Comm'r, 75 TCM 2598 (1998).

2. The Impact of Section 385.

a. In the 1969 Tax Reform Act, Congress added Sec. 385, I.R.C. to the Code in order to permit the Treasury Department to issue "legislative regulations" for purposes of distinguishing between debt and equity in the corporate context for all purposes under the Code. Such regulations were to set forth factors to be taken into account in determining the debt/ equity issue with respect to particular factual situations. Such factors could include, inter alia, the following (which will be recognized as some of the key factors in the traditional testing of debt versus equity):

- (1) A written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest (Sec. 385(b)(1), I.R.C.);
- (2) Subordination to or preference over any corporate debt (Sec. 385(b)(2), I.R.C.);
- (3) The debt-equity ratio of the corporation (Sec. 385(b)(3), I.R.C.);
- (4) Convertibility into corporate stock (Sec. 385(b)(4), I.R.C.); and
- (5) The relationship between stockholdings and holdings of the interest in question (Sec. 385(b)(5), I.R.C.).

b. On March 20, 1980, Proposed Regulations were issued under Sec. 385, I.R.C. These Proposed Regulations were revised extensively when the Proposed Regulations were supposedly finalized on December 29, 1980, to be effective as to interests created after April 30, 1981. The effective date for the finalization of the Proposed Regulations was postponed on April 27, 1981, so as to apply only to interests created after April 15, 1981, and again on December 30, 1981, so as to be effective only to interests created after June 30, 1982. Once again, the effective date was postponed, on June 29, 1982, to interests created after January 1, 1983. Finally, on July 1, 1982, the Internal Revenue Service announced that the Proposed Regulations would be withdrawn.

c. It is anyone's guess as to whether and when new Proposed Regulations will ever be promulgated, or whether the Treasury will at some point in fact seek to

have Congress remove Sec. 385 from the Code, so that the Service must again place its focus on the traditional tests of debt versus equity. Notwithstanding the long ago withdrawal of the proposed Regulations, a few key provisions of the proposed Regulations should be examined, with a view toward assessing their potential impact on the area of real estate financing.

d. In Prop. Reg. §1.385-0(b), it was noted that the initial inquiries of the Proposed Regulations were (i) whether there is an "instrument," as contrasted to an unwritten loan or one evidenced by a writing, for example, in the corporate books or a board of directors resolution, (ii) whether the instrument is straight debt or hybrid, with instruments convertible into stock or providing for contingent payment being considered hybrid instruments, and (iii) whether the instruments are held substantially in proportion to the corporate stock. Of these initial inquiries, neither the first nor the third should generally be a consideration so long as either the corporation is not a borrower or, even if the corporation is a borrower, the loan is made solely on the security of the real estate.

e. In Prop. Reg. §1.385-0(c)(2), it was pointed out that hybrid instruments "not issued proportionately are generally treated as indebtedness if the present value of straight debt payments with respect to the instrument is at least half of the fair market value of the instrument". Prop. Reg. §1.385-5 distinguished fixed payments from contingent payments in determining the present value of the straight debt payment.

(1) In Prop. Reg. §1.385-5(c)(1), "contingent payment" was defined to mean "any payment other than a fixed payment of principal or interest."

(2) In Prop. Reg. §1.385-5(c)(2), it was stated that an instrument provides for "fixed payments of interest" only if both of two conditions are met. First, interest at a definitely ascertainable rate is due on definitely ascertainable dates; and, second, with certain exceptions, the holder's right to receive interest when due (or within 90 days thereafter) cannot be impaired without the holder's consent.

(3) In Prop. Reg. §1.385-5(c)(3), it was stated that an instrument provides for "fixed payments of principal" only if both of two conditions are met: First, a definitely ascertainable principal sum is payable on demand or due on definitely ascertainable dates; and, second, with certain exceptions, the holder's right to receive principal when due cannot be impaired without the holder's consent, in this situation, one such exception is that the clarification of a payment as fixed is not affected by the fact that the obligation is nonrecourse, but only if the face amount would, if the obligation were issued in exchange for property, be included in the purchaser's adjusted basis for the property. Prop. Reg. §1.3855(c)(5)(iv). See also Prop. Reg. §1.385-5(f), Example (13).

(4) Under Prop. Reg. §1.385-5(c)(4), a rate of interest was "definitely ascertainable" if applied to a definitely ascertainable principal sum and either (i) invariable or (ii) variable, determined according to an external standard not subject to the borrower's control and not related to the success or failure of the borrower's business or activities.

(a) A principal sum is not variable simply because it is in the borrower's control to prepay all or a portion of the principal sum. Prop. Reg. §1.385-5(c)(4).

(b) An interest rate tied to the prime rate is considered to be a definitely ascertainable rate of interest. Prop. Reg. §1.385-5(f), Example (10).

(c) Where a fixed interest rate of 7 percent is combined with additional interest of 1 percent, contingent on the net profits of the borrower, and the obligations, which are subordinated, have a 10-year fixed maturity date, Prop. Reg. §1.385-5(f), Example (7), treats the obligation as indebtedness.

(d) In Prop. Reg. §1.385-5(f), Example (6), corporation W owns a tract of land and is building 350 houses thereon. W borrows \$300,000 from P on August 15, 1985, which is payable on demand at any time after December 31, 1990. In addition, W is to pay \$175,000 to P "in lieu of interest", with \$500 payable on the sale of each house. Based on an assumption as to the present value of the \$300,000 payment on August 15, 1985, the obligation to P is treated as debt.

(e) Where the maturity value of the obligation is determined according to the Consumers Price index, and the interest rate is paid on the fluctuating maturity value as a protection against inflation, then, under Prop. Reg. §1.385-5(f), Example (5), this is considered as straight debt, without any contingency.

D. The Sale-Leaseback.

1. Generally --

a. A sale-leaseback may take many forms. However, in real estate, generally the basic focus is on a two- step, two-party transaction, where one party ("X") sells the property to a second party ("Y") and then X leases the property back from Y.

b. The sale from X to Y may be financed by purchase money debt or may be financed by third party debt.

2. Reasons for use --

a. Historically, the use of the sale-leaseback technique started as a means of avoiding restrictive state usury laws.

b. The reason for use was then broadened to include the ability of borrowers to obtain higher loan-to-value ratios, because "purchasers" could pay full fair market value, whereas "lenders" could only lend some percentage of value. See, generally, Marcus, Real Estate Purchase-Leasebacks as Secured Loans, 2 R.E.L.J. 664 (1973), and Kaster, Purchase-Leaseback: Own or Loan?, 11 REIT Rev. 7 (1974).

c. Other reasons were offered, as follows:

(1) The "lender" would have better security in ownership and a leaseback, than under a mortgage, deed of trust or similar security instrument.

(2) The "borrower" would obtain working capital advantages through leasing, rather than borrowing. This was sometimes combined with the argument that, cosmetically, the "borrower's" balance sheet and profit and loss statement looked better with leases than with loans. However, FASB 13 has eliminated this supposed advantage in many circumstances. See Tucker, The Sale and Leaseback as a Financing Tool, 24 *Trusts & Estates* 27 (1985).

3. Caveat --

a. In analyzing the sale-leaseback transaction, and the alternative Federal income tax treatments thereof, one should always exercise caution. Most cases focus on the seller/lessee, as will be seen below. However, one must likewise focus on the purchaser/lessor. Does it have true ownership, or is it merely a financier? See, generally, Rosenberg and Weinstein, Applying the Tax Court's Nontax Benefit Test for Multiple-Party Sale-Leasebacks, 54 *J. Tax.* 366 (1981). See also Faber, Determining the Owner of an Asset for Tax Purposes, 61 *Taxes* 795 (1983).

b. In Frank Lyon Co. v. United States, 435 U.S. 561 (1978), the Supreme Court, finding the presence of a third-party lender to be the key factor, held that the taxpayer was the owner of the property (the headquarters building of a bank) that it had purchased and leased back to the bank.

(1) This was the case even though (i) the bank's lease payments essentially covered the mortgage payments, (ii) the lease was otherwise triple net, and (iii) the bank had the option to repurchase the building at a predetermined price, which would cover the unpaid balance of the mortgage, the taxpayer's out-of-pocket cash for the purchase of the building and a 6% return on the out-of-pocket cash.

(2) The Court noted, at pages 583-584, that:

"Where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes."

(3) See also Pacific Gamble Robinson & Affiliated Cos. v. Comm'r, 54 TCM 915 (1987); Sanderson v. Comm'r, 50 TCM 1033 (1985); West v. Comm'r, 48 TCM 796 (1984); and Dunlap v. Comm'r, 74 T.C. 1377 (1980), rev'd and rem'd on another issue 670 F.2d 285 (CA8 1982), in which the Court relied on Frank Lyon Co. in upholding a multi-party sale-leaseback of a supermarket.

c. In Hilton v. Comm'r, 74 T.C. 305 (1980), aff'd per curiam 671 F.2d 316 (CA9 1982), the Court found that the taxpayer was not a true property owner, because there was no real reason for the taxpayer's participation in the sale-leaseback transaction. Due to the nominal cash flow the purchaser/lessor would receive, the Court found that, from the point of view of economics, there was no detriment to abandonment of the property. [See also Rice's Toyota World, Inc. v. Comm'r, 81 T.C. 184 (1983), aff'd in relevant part 752 F.2d 89 (CA4 1985); and Narver v. Comm'r, 670 F.2d 855 (CA8 1982), aff'd 75 T.C. 53 (1980).] In addition, there were other factors that, in the view of the Court, served to distinguish Hilton from Frank Lyon Co., including the following:

(1) None of the funds of the investors in the purchaser/lessor partnership were paid to the seller/lessee.

(2) The rents were not based on a comparative fair rental value; moreover, after the initial lease term, the rents were minor, providing minimal economic return, even though several years in the future.

4. Alternatives: The Perspective of the Seller/Lessee --

a. The forms which a sale and leaseback may take, from the point of view of the seller/lessee, are as follows:

(1) A financing transaction --

(a) The determinative factors are as follows:

(i) An option to repurchase the property subject to the lease is the sine qua non. See Helvering v. F.& R. Lazarus Co., 308 U.S. 252 (1939). See also Illinois Power Co. v. Comm'r, 87 TCM 1417 (1986).

(A) While the existence of an option to repurchase does not assure a financing transaction (Desert Lawn Memorial Park, Inc. v. Comm'r, 19 TCM 32 (1960)), the absence of such an option negates a financing transaction.

(B) See Sun Oil Co. v. Comm'r, 35 TCM 173 (1976), rev'd 562 F.2d 258 (CA3 1977), where the Tax Court held that an option to repurchase did not make a sale-leaseback into a financing transaction where its purpose was to assure the taxpayer of a way to cancel a lease which had proven uneconomical to operate as a service station. The Tax Court did not make anything out of the rental being a 45/8% return overall after a return of the money invested. But see Belz Investment Co., Inc. v. Comm'r,

72 T.C. 1029 (1979), aff'd 661 F.2d 76 (CA6 1981), holding that a sale-leaseback with an option to repurchase was a true sale and leaseback, rather than a financing transaction; the Service has acquiesced in this decision.

(ii) The payment by the tenant of real estate taxes, insurance and all maintenance expenses. For a good discussion of this and the other factors listed, see Frenzel v. Comm'r, 22 TCM 1391 (1963).

(iii) The indemnification of the purchaser/landlord by the seller/tenant against claims for injury and damage and the maintenance by the seller/tenant of public liability insurance.

(iv) The lack of any duties or risks of ownership of the purchaser in connection with its ownership of the property. See, e.g., Schaefer v. Comm'r, 41 TCM 100, 105 (1980), where the Court noted that the "sale/leaseback left Schaefer in the same position vis a vis the hotel properties as he occupied prior to the agreement. The simultaneous leaseback of the hotel and the unbridled discretion vested in Schaefer to sublet the property permitted him to continue to operate the property in the same manner as before, namely, through lessees or managers."

(v) The only advantage to the seller/tenant in entering into the transaction being its immediate use of the cash paid to it as the purchase price.

(vi) Any unsuccessful effort made by the seller/tenant to get financing prior to the sale.

(vii) The payment by the seller of all settlement costs (including the payment of the purchaser's legal fees).

(viii) Evidence indicating that the seller/tenant intended to exercise its option to repurchase when it sold the property.

(ix) The provision in the lease for no abatement in rent for any damage to the property on account of casualty or act of God.

(x) The continuation in possession of the property by the seller/tenant.

(xi) A low or inadequate repurchase option price as measured by the present fair market value of the property; on the other hand, an option to repurchase at even fair market value will not necessarily negate a financing transaction. See, e.g., Shillito Corp. v. United States, 42-2 USTC ¶9712 (S.D. Ohio 1942); and Comtel Corp. v. Comm'r, 45 T.C. 294 (1965), aff'd 376 F.2d 791 (CA2 1967).

(b) The income tax consequences, generally speaking, of the financing transaction are:

(i) The seller/tenant has no gain or loss on sale, inasmuch as the sale is disregarded. In addition, the seller/tenant takes the usual income tax deductions and credits attributable to ownership of the property (such as ACRS under Sec. 168, I.R.C., depreciation under Sec. 167, I.R.C. and any investment tax credit); in turn, the seller/tenant obtains no rental payment deduction, but, instead, is deemed to pay interest and/or principal on the loan.

(ii) The purchaser/landlord has no ownership of the property, and so receives no depreciation or ACRS deductions and no investment tax credit. Rather, the purchaser/landlord receives interest income and/or principal repayments.

(iii) See, generally, Rev. Rul. 68-590, 1968-2 C.B. 66, amplified by Rev. Rul. 86-66, 1986-1 C.B. 9 and Rev. Rul. 73-134, 1973-1 C.B. 60; Rev. Rul. 72-543, 1972-2 C.B. 87, dealing with the sale-leasebacks of container ships, which set forth guidelines. On the characterization of equipment leases, see Rev. Rul. 55-540, 1955-2 C.B. 39; Rev. Proc. 75-21, 1975-1 C.B. 715; and Rev. Proc. 75-28, 1975-1 C.B. 758.

(2) A like kind exchange --

(a) Sec. 1031, I.R.C., provides for non-recognition of gain or loss if property held for productive use in a trade or business or for investment is exchanged for property of a "like kind."

(i) Reg. §1.1031(a)-1(c) treats a transfer of a fee in exchange for a leasehold of 30 or more years by a non-dealer as a like kind exchange. See Rev. Rul. 60-43, 1960-1 C.B. 687, and Rev. Rul. 76-301, 1976-2 C.B. 41. See also Priv. Ltr. Rul. 8304022 (October 22, 1982).

(ii) A lease for less than 30 years with an option to renew might, if the circumstances so warranted, be treated as equivalent to a fee under Sec. 1031, I.R.C.

(b) If there is a like kind exchange, and if there is boot [for example, fee with adjusted basis of \$1 million is exchanged for lease with a term of 40 years and \$1.5 million cash], a gain will be recognized, but loss will not be recognized. See, generally, Massey, Sale-Leaseback Transactions: Loss Realization--The Neglected Issue, 6 J.R.E. Tax. 308 (1979).

(c) Compare:

(i) City Investing Co. v. Comm'r, 38 T.C. 1 (1962), where a 21-year lease with a renewal option was considered a true sale/leaseback, so that the loss was recognized.

(ii) Century Electric Co. v. Comm'r, 192 F.2d 155 (CA8 1951), which held a lease of more than 30 years was a like kind exchange, so that loss was not recognized; but see Jordan Marsh Co. v. Comm'r, 269 F.2d 453 (CA2 1959) (non-acq., Rev. Rul. 60-43, 1960-1 C.B. 687), where loss was recognized (on the ground that both the sale and rental were at fair market value).

(iii) Leslie Co. v. Comm'r, 64 T.C. 247 (1975), aff'd 539 F.2d 943 (CA3 1976), in which the Court found a bona fide sale-leaseback, so that the taxpayer could recognize a loss on the sale. See also Crowley, Milner and Co. v. Comm'r, 76 T.C. 1030 (1981), aff'd 689 F.2d 635 (CA6 1982), finding that a sale-leaseback for 30 years was a bona fide sale, rather than a financing transaction. See, generally, Weinstein, Realizing a Loss through a Sale-Leaseback, 10 R.E.L.J. 247 (1982).

(d) If the transaction is considered a like kind exchange, then no gain or loss will be recognized (Sec. 1031(a), I.R.C.), except to the extent that boot (that is, cash or other property which is not within the tax-free category) is received. Sec. 1031(b), I.R.C. See, generally, Tucker, Don't Sell Your Real Estate -- Exchange It, 5 R.E. Rev. 94 (1976).

(e) The basis of the property received is the same as the adjusted basis of the property transferred, subject to adjustments. Sec. 1031(d), I.R.C. See Reg. §1.1031(d)-2; and Rev. Rul. 59-229, 1959-2 C.B. 180. See also Rev. Rul. 79-44, 1979-1 C.B. 265, and Priv. Ltr. Ruls. 8003004 (September 19, 1979) and 8248039 (August 27, 1982).

(3) A true sale and true leaseback --

(a) The seller/tenant recognizes gain or loss on the sale. See, e.g., Leslie Co. v. Comm'r, 64 T.C. 247 (1975), aff'd 539 F.2d 943 (CA3 1976). As a concomitant, the seller/tenant no longer takes deductions attributable to ownership of the property, such as depreciation or ACRS. The rent payments are generally recognized as such. See, generally, Kronovet, Characterization of Real Estate Leases: An Analysis and Proposal, 32 Tax Lawyer 757 (1979).

(b) The purchaser/landlord utilizes the purchase price as basis, subject to the limitations thereon hereinabove referred to. Likewise, the purchaser/landlord obtains the deductions attributable to ownership, subject to the multitude of limitations thereon, including particularly the investment interest deduction limitation under Sec. 163(d), I.R.C. for "net leases."

(c) Caveat: Where a "tax-exempt entity" is involved in the sale and leaseback, then, under Sec. 168(j), I.R.C., there are potentially significant adverse tax consequences.

E. The Purchase with a Wrinkle.

1. Purchase subject to a lease --

a. As a general rule, the purchaser of real property may claim depreciation from the date it takes title or possession, whichever is earlier. See Rev. Rul. 69-89, 1969-1 C.B. 59. See also Rev. Rul. 68-431, 1968-2 C.B. 99.

b. Where the property purchased is subject to a lease, and the purchase price is, at least in part, based on the lease, the courts are split (although the Tax Court itself is consistent) as to whether the purchaser can claim depreciation on the improvements prior to the time that the lease expires.

(1) In Wagner v. Comm'r, 518 F.2d 655 (CA10 1975), rev'g 33 TCM 201 (1974), the Circuit Court held that, where a buyer acquires property subject to an existing lease, the buyer need not have possession of the property in order to take depreciation. The Court relied on Wisconsin Electric Power Co. v. Comm'r, 18 T.C. 400 (1952), and Fribourg Navigation Co., Inc. v. Comm'r, 383 U.S. 272 (1966).

(2) However, in Geneva Drive-In Theatre, Inc. v. Comm'r, 67 T.C. 764 (1977), aff'd 622 F.2d 945 (CA9 1980), the Courts held that, where the taxpayer purchased property subject to a lease, paying \$200,000 more for the property than the raw land was worth, but the purchase price was partially based on the lease, the taxpayer could not take depreciation until the lease expired five years later.

(3) The lines of authority are reconcilable if one places focus on whether the lessor or the lessee constructed the improvements. On the one hand, in Wagner, the lessor that was the predecessor in interest of the purchaser erected the improvements; on the other hand, in Geneva Drive-In, the lessee of the land constructed the improvements. Thus, the holdings in the two cases leave only one party (that which either constructed the improvements or was the successor in interest thereto) depreciating the improvements at a time.

2. Purchase with a retained use --

a. As a general rule, rental payments, so long as they do not constitute a purchase of the equity in the property, will be deductible by the tenant (Sec. 162(a)(3), I.R.C.) and will constitute ordinary income to the landlord (Sec. 61(a)(5), I.R.C.).

b. If the rental to be paid by the seller/tenant is either very low in relation to the fair rental value of the property or is waived for a period of time, then, strange as it may seem, the purchaser may be deemed to have received prepaid rental income.

(1) See Alstores Realty Corp. v. Comm'r, 46 T.C. 363 (1966), and Steinway & Sons v. Comm'r, 46 T.C. 375 (1966), in which the Court decided cases involving both the seller and the purchaser in a sale-leaseback transaction.

(a) Steinway sold a warehouse to Alstores for \$750,000 in cash, taking back a lease of the premises for 2-1/2 years at no rental. This package was in lieu of Alstores' having paid the original offering price of \$1 million to Steinway for the property.

(b) The Court held that Steinway had in fact sold the property for \$1 million, receiving \$750,000 cash and a lease with a value of \$250,000. The Court found that, accordingly, Steinway had a selling price of \$1 million and a prepaid rental (amortizable over the 2-1/2 years) of approximately \$250,000. In contrast, Alstores was held to have paid \$1 million for the property, with a taxable rental income of approximately \$250,000.

(c) Alstores had argued that it paid only \$750,000, and that it hid no rental income, because Steinway retained a right to occupy the warehouse (which was a reserved term of years) so that Alstores bought only a future interest, taking possession after the 2-1/2 year term.

(d) The argument of Alstores was rejected by the Court because, in its view, Steinway did not, either in form or in substance, reserve an estate for years. The Court cited, but distinguished, Ashlock v. Comm'r, 18 T.C. 405 (1952), in which it had found that the purchaser had obtained only a future interest on its purchase, because the "seller had reserved an ownership interest in the property (an estate for years)". In this connection, in Ashlock, the seller in fact retained full control of the property for the term reserved, whereas in Steinway and Alstores the purchaser assumed both control and the risks of ownership.

(2) In Alstores, it was pointed out, at page 373, that "Possibly the result in the instant case would be different if the parties had in fact intended to carve out a reserved term for years in Steinway and had structured their transaction in that form. . . . The so-called space occupancy agreement placed the two parties' rights, obligations and risks as they would be allocated in a typical lease arrangement. Hence, the arrangement was a lease in substance as well as in form."

(3) See also Ellison v. Comm'r, 80 T.C. 378 (1983), citing Alstores with approval in its holding that rent reserved to the sellers (in a non-sale-leaseback transaction) was in fact income to the purchasers, inasmuch as it was, in substance, part of the consideration paid by the purchasers for the acquisition of the real property. The Court noted that:

"Certainly, if the buyers had simply collected the rent and then paid it over to the sellers as part of the purchase price, there would be no question that the rent was income to the buyers. This, in substance, is what happened, because the buyers owned, controlled, and managed (through agents) the apartments when they produced the rental income. In practical effect, they assigned to the sellers future rental income which was to be used to pay part of the purchase price. Taxation cannot be avoided by drawing up papers to deflect income to others even if the papers take the form

of a reservation of rents. Tax liability must be determined by the objective realities and substance of the transaction.*** Because, in substance, the buyer-partnerships used the "reserved" rents which they earned by application of their capital and labor to discharge a part of the consideration for the apartment complexes, the rents are taxable to petitioners as members of those partnerships."

3. Sale with reserved estate for years --

a. As a general rule, the cost of acquiring an estate for years is amortizable over the number of years of the Estate. See Reg. §1.162-11(a). See also Cooper Foundation v. O'Malley, 221 F.2d 279 (CA8 1955); and Bell v. Harrison, 212 F.2d 253 (CA7 1954). Where the tenant has an option to renew the lease, however, then, under Reg. §1.167(a)-4, the rules of Sec. 178, I.R.C. (dealing with lease renewals or the "reasonable certainty" thereof) must be considered.

b. Assume that a party owns land, which is a non-depreciable, non-amortizable asset under almost all circumstances. Assume further that the fee simple interest in the land is sold, with the seller retaining an estate for years. See, generally, Blum, Amortization of a Retained Terminable Interest after Transfer of a Remainder, 62 Taxes 211 (1984).

(1) In Lomas Santa Fe, Inc. v. Comm'r, 74 T.C. 662 (1980), aff'd 693 F.2d 71 (CA9 1982), the taxpayer built a golf course and a country club as the first step in the development of a luxury residential community. In order to solve title problems and insulate the taxpayer and its operations from the country club membership, the taxpayer formed a wholly-owned subsidiary and transferred the golf course and country club to that subsidiary, subject to a retained estate for 40 years in taxpayer.

(2) The Court found the subsidiary to a bona fide entity, separate from taxpayer, and refused to disregard the transfer of assets and existence of the estate for 40 years.

(3) However, the Court refused to allow the portion of the cost basis of the land attributable to the 40-year retained estate to be amortized by the taxpayer. Following the decision in United States v. Georgia Railroad & Banking Co., 348 F.2d 278 (CA5 1965), the Court found that:

"The land and landscaping of the golf course did not have limited useful lives when held by Lomas and, therefore, were non-depreciable assets. The separation of that property into two interests, namely, a retained estate for 40 years and a transferred remainder, does not transform either part of the whole into a depreciable asset. [The taxpayer] is not entitled to amortize its basis in the estate for 40 years because the estate for 40 years is not

an asset which is subject to an allowance for depreciation under section 167(a)."

VI. DEPRECIATION

A. Generally.

1. In the Economic Recovery Tax Act of 1981 (ERTA), Congress enacted the accelerated cost recovery system (ACRS) to replace the deduction for depreciation which was based on one of several methods to recover basis net of salvage value over the useful life of an asset. ACRS generally applies to property placed in service after December 31, 1980 and before January 1, 1987. The Tax Reform Act of 1986 enacted MACRS which extensively modified ACRS, generally effective for property placed in service after December 31, 1986. There are transitional rules that apply with respect to the ACRS and MACRS effective dates. The Technical and Miscellaneous Revenue Act of 1988 and the Omnibus Budget Reconciliation Act of 1989 further amended the MACRS rules. The Revenue Reconciliation Act of 1993 changed the recovery period for nonresidential real property from 31.5 to 39 years for property placed in service after May 12, 1993. Note that salvage value and useful life are only relevant under pre-ACRS depreciation for property placed in service before 1982, and do not affect the calculation of depreciation under ACRS and MACRS. Currently, MACRS depreciation is calculated by using the applicable depreciation method, the applicable recovery period and the applicable convention.

2. A building or other improvement acquired or constructed has a limited useful life. The taxpayer cannot treat an expenditure for a building or other improvement as a deduction in the year made; but he is permitted to take annual deductions for depreciation during the estimated useful life of the improvements.

3. "Depreciation" is defined as "a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property." Sec. 167(a), I.R.C.; Reg. §1.167(a)-9.

a. See United States v. Ludey, 274 U.S. 295, 300 (1927), where the Supreme Court said, in effect, that depreciation is that sum set aside each year in order that, at the end of the useful life of the property, the aggregate of the sums set aside will (with salvage value) suffice to provide an amount equal to the original cost. The theory was that "by using up the plant, a gradual sale is made of it"; the depreciation charged is the measure of the cost of the part sold.

b. Since the deduction for depreciation is taken for physical deterioration, exhaustion or normal obsolescence, mere shrinkage in market value as such may not be deducted as depreciation.

B. Who May Deduct Depreciation?

1. Generally, depreciation is deductible by the owner of real property. However, it is deductible, under Secs. 167(a)(1) and (2), I.R.C., and Reg. §1.167(a)-2, only if the property is used in a trade or business or held for the production of income.

a. No depreciation is allowed on a building used by the taxpayer as his personal residence. Reg. §1.167(a)-2.

b. No depreciation is allowed on inventory property (that is, real estate held for sale to customers). See, e.g., Cooper v. Comm'r, 31 T.C. 1155 (1959).

c. What is "property held for the production of income"?

(1) If property is not used in a trade or business, and there is no intention that it produce income at any time, then there is no depreciation. See, e.g., Yeager v. United States, 58-1 USTC ¶9174 (W.D. Ky. 1957); and International Trading Co. v. Comm'r, 275 F.2d 578 (CA7 1960).

(2) If property is held for the production of income, there is no necessity that it produce income, and it is even acceptable that it is simultaneously held for sale. See, e.g., Hormann v. Comm'r, 17 T.C. 903 (1951); Lorraine Corp. v. Comm'r, 17 TCM 719 (1958); and Mitchell v. Comm'r, 47 T.C. 120 (1966).

2. The mere ownership or possession of bare legal title does not in itself create the depreciation deduction. It must be shown that the claimant is the one who has the burdens and benefits of ownership and will suffer economic loss. See Royal St. Louis, Inc. v. United States, 76-2 USTC ¶9698 (E.D. La. 1976), aff'd 578 F.2d 1017 (CA5 1978), holding that where the landlord built a hotel and supplied furniture and fixtures, under a lease requiring the tenant to replace the furniture and fixtures in order to keep them in "first-class condition," no depreciation was allowable on the furniture and fixtures. For a subsequent history as to the same hotel, see Hibernia National Bank, Trustee v. United States, 569 F. Supp. 5 (E.D. La. 1983). See also Kindschi v. Comm'r, 39 TCM 638 (1979).

a. The purchaser may claim depreciation from the date it takes title or possession, whichever is earlier. See Rev. Rul. 69-89, 1969-1 C.B. 59. See also Rev. Rul. 68-431, 1968-2 C.B. 99.

b. A proprietary interest suffices even though there is only equitable ownership and not legal title.

(1) See Del E. Webb Development Co. v. Comm'r, 29 TCM 661 (1970), where it was held that a purchase and debt obligation, under a subdivision trust agreement providing for releases upon receipt of release payments, gave the taxpayer the requisite capital investment to be entitled to depreciation as of the date of the agreement.

(2) But see Lambert v. United States, 409 F. Supp. 1015 (W.D. Va. 1976), where it was noted that an option was not ownership.

c. The mortgagor is entitled to depreciation even after foreclosure, if he has the right to redeem, even though he does not at that time have legal title or possession. See Murray v. Comm'r, 21 T.C. 1049 (1954), aff'd on another issue 232 F.2d 742 (CA9 1956).

d. A life tenant is considered the owner for depreciation purposes. Thereafter, the remainder person is allowed any remaining depreciation deduction. Sec. 167(d), I.R.C.; Reg. §1.167(h)-1(a).

e. Where there is a trust, the deduction is apportioned between the income beneficiaries and the trustees, in accordance with the provisions of the trust instrument, or, in the absence of such provisions, on the basis of the trust income allocable to each. Sec. 167(d), I.R.C.; Reg. §1.167(h)-1(b).

f. Where there is an estate, the deduction is apportioned between the estate and the beneficiaries on the basis of the income of the estate allocable to each. Sec. 167(d), I.R.C.; Reg. §1.167(h)-1(c).

g. Where there is divided ownership (such as a joint tenancy, tenants in common or tenants by entirety), depreciation is allocated in proportion to the respective interests in the property. For an interesting discussion of the Federal estate tax and gift tax consequences of joint ownership prior to the TRA 1976, the 1978 Act and ERTA 1981, see Property Owned with Spouse: Joint Tenancy, by the Entireties and Community Property, 11 R.Prop.Prob.& Tr.J. 405 (1976).

h. As to leasehold interests, note, in general, that where the lessee makes improvements on property, he is entitled to tax deductions which recognize the loss in value over time.

C. What Property Is Depreciable?

1. Generally, the property must be of a type that is subject to wear or tear, decay or decline from natural causes, exhaustion or obsolescence. Reg. §1.167(a)-1(a); Prop. Reg. §1.168-3(a)(1)(ii).

2. Land is not depreciable. Reg. §1.167(a)-2.

a. But private streets, sidewalks, curbs, gutters and drains are not considered "land." Clinton Cotton Mills, Inc. v. Comm'r, 78 F.2d 292 (CA4 1935).

b. Building pads are not "land." Algernon Blair, Inc. v. Comm'r, 29 T.C. 1205 (1958).

c. The costs of clearing, grading, landscaping and planting grass and shrubs, except to the extent attributable to a building, have been held "inextricably associated" with the land and not depreciable. Algernon Blair, Inc., *supra*. On the other hand, in Trailmont Park, Inc. v. Comm'r, 30 TCM 871 (1971), the costs of clearing, grading, terracing and landscaping a mobile home park were held to be depreciable inasmuch as they were associated with the construction of the trailer pads and patios on the trailer lots. See also Rev. Rul. 74-265, 1974-1 C.B. 56, where the Service held that landscaping next to new apartment buildings were depreciable if the replacement of the buildings at the expiration of their useful lives would destroy the landscaping; other landscaping was held to be part of the land cost.

d. There is one situation where land is depreciable. In Browning-Ferris Industries, Inc. v. Comm'r, 53 TCM 397 (1987), the Court held that the taxpayer was entitled to depreciation on the land space exhausted in the operation of its landfills. See also Sexton v. Comm'r, 42 T.C. 1094 (1964); and Sanders v. Comm'r, 75 T.C. 157 (1980).

3. Improvements to land, such as buildings and other structures, are depreciable. Reg. §1.167(a)-2; Prop. Reg. §1.168-3(a)(1)(ii).

4. When property consists of both land and improvements thereon, the basis for depreciation of the improvements must be determined by an appropriate allocation of values. Reg. §1.167(a)-5; Camp Wolters Land Co. v. Comm'r, 160 F.2d 84 (CA5 1947). See also Universal Drilling Co., Inc. v. United States, 412 F. Supp. 1231 (E.D. La. 1976).

a. If the purchase price is not the fair market value, there must be an allocation on the basis of the fair market value.

b. Often assessments are used for values.

c. See Maloney v. Comm'r, 34 TCM 1237 (1975), where it was held that the allocation of the purchase price between land and buildings on the basis of the insurance maintained by the prior owner was incorrect.

D. When Does Depreciation Commence?

1. Prior to the Economic Recovery Tax Act of 1981, the deduction for depreciation generally commenced when the building was completed and ready for occupancy. See Mobile Light and RR Co. v. Comm'r, 23 B.T.A. 543 (1931); and Reg. §1.167(a)-10(b).

a. This was true even if minor work was done later. See Batman v. Comm'r, 9 TCM 210 (1950), *aff'd* on other issues 189 F.2d 107 (CA5 1951).

b. The taxpayer could not take any depreciation deduction with respect to a building under construction. Reg. §1.167(a)-10(b).

2. Under ACRS and MACRS, depreciation generally commences in the taxable year in which the real property is placed in service. ACRS applies to property placed in

service after December 31, 1980 and before January 1, 1987. MACRS applies to property placed in service after December 31, 1986. Note that if property is placed in service for personal use before 1987 and then converted after 1986 to use which justifies the taking of depreciation, the property is treated as placed in service at the time of the conversion. However, if property is placed in service for personal use before 1981 and converted after 1980 to use which justifies the taking of depreciation, the taxpayer cannot qualify for ACRS.

a. The half-year convention is used for all MACRS property except to the extent the mid-month convention or the mid-quarter convention applies. Sec. 168(d)(1), I.R.C. The half-year convention also applies for all ACRS property other than real property and low-income housing. Secs. 168(b)(1), (b)(3)(iii) and (f)(2)(E), I.R.C. (1954). If the half-year convention applies, the property is treated as placed in service on the mid-point of the taxable year. Sec. 168(d)(4)(A), I.R.C.

b. The mid-month convention is the applicable convention for MACRS residential rental property, MACRS nonresidential real property, ACRS 19-year real property and ACRS 18-year real property placed in service during the mid-month convention effective date period. Sec. 168(d)(2), I.R.C.; Sec. 168(b)(2), I.R.C. (1954). The mid-month convention effective date period generally applies for property placed in service after June 22, 1984. There is an exception for ACRS 18-year property which is placed in service after June 22, 1984, but before January 1, 1987, and the taxpayer meets one of two stated conditions. The first condition is satisfied if the taxpayer entered into a binding contract before June 23, 1984 to purchase or construct the property. The second condition is satisfied if construction was commenced before June 23, 1984. Property subject to the mid-month convention is treated as placed in service on the mid-point of the month. Sec. 168(d)(4)(B), I.R.C.

c. The full-month convention applies to ACRS 15-year real property, ACRS 18-year real property that is not placed in service during the mid-month convention effective date period, and ACRS low-income housing. If the full-month convention applies, the property is treated as placed in service on the first day of the month. Secs. 168(b)(2) and (b)(4)(B), I.R.C. (1954).

d. The mid-quarter convention is applicable if the aggregate bases of MACRS property placed in service during the last three months of the taxable year exceed 40 percent of the aggregate bases of MACRS property placed in service during the taxable year. Sec. 168(d)(3)(A), I.R.C.

E. What Amount Is Depreciable?

1. Depreciation is generally based on the cost or other basis, as adjusted (as to property acquired by purchase, under Secs. 1012 and 1016, I.R.C.), less (for non-ACRS property) salvage value. Regs. §§1.167(f)-1, 1.167(a)-1(a) and (c), and 1.167(g)-1. See, in this connection, Midler Court Realty, Inc. v. Comm'r, 521 F.2d 767 (CA3 1975), holding that the taxpayer could not take higher depreciation in the earlier years when higher rentals were paid.

2. Generally, non-ACRS assets cannot be depreciated below salvage value, so that salvage should be estimated at time of acquisition. Reg. §1.167(a)-1.

a. "Salvage value" is not scrap value, but the estimated proceeds (less costs of removal) which will be realized upon the sale or other disposition at the end of the asset's useful life. Reg. §1.167(a)-1(c)(1).

b. As to real estate, salvage technically must be considered under all methods of depreciation other than the declining balance method. However, as a practical matter, since the cost of razing a building may equal or exceed the estimated proceeds to be derived therefrom, salvage is not usually considered in determining depreciation on buildings. See Caruso v. Comm'r, 23 T.C. 836 (1955).

3. If there is no basis in the property, or basis cannot be established, then no depreciation may be taken. [See discussion of basis, supra.]

4. Where property is acquired by a corporation from a municipality as an inducement to the corporation to operate there, or from any other non-shareholder, such property is deemed a contribution to capital and not income to the corporation, but has zero basis, so no depreciation will be allowed. See Sec. 362(c), I.R.C.; and Reg. §1.362-2. For background, see Detroit Edison Co. v. Comm'r, 319 U.S. 98 (1943); and Brown Shoe Co., Inc. v. Comm'r, 339 U.S. 583 (1950).

5. Allowed or Allowable?

a. The key is not what was "allowed" (or taken), but what was "allowable."

b. If the taxpayer does not take what he could have taken, the amount foregone is lost forever; it cannot simply be deferred to a later year. The basis is reduced by the amount allowable. There is no argument that there was no tax benefit so that the taxpayer did not have to take depreciation. See Regs. §§1.167(a)-1 and 1.167(a)-10(a); and Kansas City Southern Rv. Co. v. Comm'r, 22 B.T.A. 949 (1930).

F. What Is the Depreciable Life?

1. Generally, the "useful life" of non-ACRS property is the period of time over which an asset can be depreciated. It represents the term during which the assets can reasonably be expected to be useful to the particular taxpayer, even though shorter than the estimated physical life of the assets. See Reg. §1.167(a)-1(b); and Massey Motors, Inc. v. United States, 364 U.S. 92 (1960).

2. Determinations of useful lives.

a. Before 1962, based on experience and Bulletin F (which was issued in 1941).

b. In 1962, the Service issued Rev. Proc. 62-21, 1962-2 C.B. 418.

(1) Set forth about 75 estimated useful lives.

(2) Permitted use of experience and the facts and circumstances.

(3) The application of Rev. Proc. 62-21 was not mandatory, so that the taxpayer could base his determination on the facts and circumstances in the particular situation, based on the experience of the taxpayer or in the community. See also Business Building Statistics: A Study of Physical and Economic Characteristics of the 1969 Stock of Non-Residential, Non-Farm Business Buildings and Depreciation Practices of Building Owners, 1971 (Office of Industrial Economics of the Department of Treasury 1975).

c. Rev. Proc. 62-21 was based upon "composite" depreciation. Thus, if the guideline lives were used, the structural shell and all integral parts of the building were included, as well as normal heating, plumbing, air-conditioning, fire prevention and power requirements, and equipment such as elevators or escalators. See Merchant's National Bank of Topeka v. Comm'r, 34 TCM 1030 (1975), aff'd 554 F.2d 412 (CA10 1977), for a listing of various components and their useful lives in a commercial office building; and Keller Street Development Co. v. Comm'r, 37 TCM 1451 (1978), dealing with a shopping center and showing the value of testimony of experienced persons.

d. Components and composite depreciation should be compared. Note that components usually resulted in shorter average useful life for a building.

G. The Accelerated Cost Recovery System.

1. Background.

a. The Reagan Administration believed that, in order to encourage significant increases in capital expenditures for tangible personal property, the old depreciation rules had to undergo substantial changes.

b. Accordingly, the conceptual approach adopted was to formulate a set of mandatory "audit proof" depreciation classes for all property, including both tangible personal property and real property.

2. Personal Property.

a. Cost recovery periods set forth in Sec. 168(e)(1), I.R.C. for the various classes of tangible personal property fall within six categories, as follows:

(1) 3-year property, where the property had a class life of 4 or less years;

- less than 10 years;
- (2) 5-year property, where the class life was more than 4 but less than 10 years;
- (3) 7-year property, where the class life was 10 or more but less than 16 years;
- (4) 10-year property, where the class life was 16 or more but less than 20 years;
- (5) 15-year property, where the class life was 20 or more but less than 25 years; and
- (6) 20-year property, where the class life was 25 or more years.

b. Of particular relevance are certain assigned classifications of tangible personal property. For example, 5-year property includes (i) semi-conductor manufacturing equipment; (ii) computer-based telephone central office switching equipment; (iii) property used in connection with research and experimentation; and (iv) any automobile or light, general purpose truck. Sec. 168(e)(3)(B), I.R.C.

c. Other specific examples are as follows: railroad track is 7-year property and single purpose agricultural or horticultural structures are included in 10-year property; municipal wastewater treatment plants are included within 15-year property, and 20-year property includes municipal sewers. See Sec. 168(e)(3), I.R.C.

d. Unless an alternative election is made, and (under Sec. 168(b)(2), I.R.C.) with exception of 15-year or 20-year property or property used in a farming business, the applicable depreciation method is the 200 percent declining balance method, switching to the straight-line method for the first taxable year for which using the straight-line method will yield a larger allowance. Sec. 168(b)(1), I.R.C.

e. A taxpayer may make an irrevocable election to utilize either the 150 percent declining balance method or the straight-line method pursuant to Sec. 168(b)(2) or (3), I.R.C. Such election may be made with respect to one or more classes of property for any taxable year and, once made with respect to any class, shall apply to all property in such class placed in service during the taxable year. Sec. 168(b)(5), I.R.C.

3. Cost Recovery Periods for Real Property.

a. ERTA 1981 assigned to all real property placed in service after December 31, 1980 a 15-year cost recovery period under ACRS. With the exception of low-income housing, which retained a 15-year recovery period, the recovery period was changed to 18 years by TRA 1984 as to real property placed in service after March 15, 1984 and prior to May 9, 1985, and then to 19 years as to real property placed in service after May 8, 1985 and prior to January 1, 1987.

b. Under TRA 1986, the cost recovery periods were again lengthened, as to property placed in service after December 31, 1986, subject to certain transitional exceptions. The current recovery periods are as follows:

(1) As to all residential rental property, the recovery period is 27.5 years, which must be taken on a straight-line basis. Secs. 168(c) and (b)(3)(B), I.R.C.

(2) With regard to all nonresidential real property, the recovery period is 39 years, which must be taken on a straight-line basis. Secs. 168(c) and (b)(3)(A), I.R.C.

4. Depreciation of Real Property.

a. With respect to real property placed in service after December 31, 1980, depreciation under Sec. 167, I.R.C., was superseded by ACRS (under Sec. 168, I.R.C.). Under ACRS, prior to TRA 1986, the taxpayer had several options:

(1) One option was to depreciate using an accelerated rate within the mandatory life period. Secs. 168(b)(2)(A) and (4)(A), I.R.C. (1954), permitted use of the 175% declining balance method (or 200% in the case of low-income housing) with a change to straight-line as prescribed by the Regulations.

(2) Another option was to elect to utilize the straight-line method over the mandatory life period or, if desired, over a longer period of 35 or 45 years. Sec. 168(b)(3)(A), I.R.C. (1954).

(3) If the property was tax-exempt use property under Sec. 168(h)(1), I.R.C. or property financed with tax-exempt bonds, a longer recovery period (the alternative depreciation period) of 40 years was imposed. Sec. 168(b)(3), I.R.C. (1954); see Prop. Reg. §1.168-2(c)(5).

b. Under TRA 1986, an alternative depreciation system continues to be imposed with regard to tax-exempt use property, which is either (i) that portion of any tangible property (other than nonresidential real property) leased to a tax-exempt entity or (ii) that portion of nonresidential real property leased to a tax-exempt entity in a disqualified lease (as defined in Sec. 168(h)(1)(B)(ii), I.R.C.). Sec. 168(h)(1), I.R.C.

(1) The alternative depreciation system uses a 40-year straight-line recovery period for residential rental property as well as nonresidential real property, except that, if the tax-exempt property is subject to a lease, the recovery period cannot be less than 125% of the lease term. Secs. 168(g)(2)(C) and (3)(A), I.R.C.

(2) A taxpayer may make an irrevocable election for any class of property. However, with the exception of nonresidential real property and residential rental

property, where the election may be made property-by-property, the election is binding on all property in such class placed in service in that taxable year. Sec. 168(g)(7)(A), I.R.C.

H. Depreciation of Real Property under MACRS

1. As referenced above, land is not subject to depreciation. Only improvements, physical developments and structures on land are eligible for depreciation. The straight-line method and the mid-month convention apply for MACRS depreciation of residential rental property and nonresidential real property. There is a separate table of percentages used to calculate MACRS depreciation for 27.5-year residential rental property, 31.5-year nonresidential real property and 39-year nonresidential real property.

a. Residential rental property has a recovery period of 27.5 years for purposes of MACRS depreciation. A building or a structure is "residential rental property" only if 80% or more of the gross rental income from such building or structure for the taxable year is rental income from dwelling units. Sec. 168(e)(2)(A)(i), I.R.C.

b. A "dwelling unit" is a house or apartment used to provide living accommodations in a building or structure. The definition of dwelling unit does not include a unit in a hotel, motel or other establishment if more than one-half of the units are used on a transient basis. The fair rental value of any portion of a building occupied by the taxpayer is included in gross rental income from the building. Sec. 168(e)(2)(A)(ii)(II), I.R.C.

2. Nonresidential real property has a recovery period of 39 years for purposes of MACRS depreciation. Sec. 168(e)(2)(B), I.R.C. Nonresidential real property is defined as Sec. 1250, I.R.C. property which is not residential real property or property with a class life of less than 27.5 years.

I. Bonus Depreciation for Qualified Business Capital Investments

1. The Job Creation and Worker Assistance Act of 2002 added Sec. 168(k), I.R.C., to allow an additional first-year depreciation deduction equal to 30% of the adjusted basis of qualified property. The deduction is allowed for both regular and alternative minimum tax purposes for the taxable year in which the property is placed in service.

2. The property eligible for the deduction must qualify as MACRS property (i.e., generally all tangible depreciable property placed in service after December 31, 1986) that (i) has an applicable recovery period of 20 years or less, (ii) is water utility property, (iii) is computer software as defined in Sec. 167(f)(1)(B), I.R.C., or (iv) is qualified leasehold improvement property.

3. The taxpayer's original use of the property must commence after September 10, 2001. The taxpayer must acquire the property after September 10, 2001 and before September 11, 2004. The property must be placed in service before January 1, 2005 or for certain property with longer production periods, before January 1, 2006.

4. “Qualified leasehold improvement property” is defined in Sec. 168(k)(3), I.R.C., as any improvement to an interior portion of a building which is nonresidential real property made under a lease by either the lessee or lessor. The portion of the property must be occupied exclusively by the lessee and the improvement must be placed in service more than three years after the date the building was first placed in service. Certain improvements, such as an enlargement of the building, escalator or elevator, are not eligible.

5. Note that a reciprocal provision is added under new Sec. 1400L(b), I.R.C., which allows a depreciation deduction equal to 30% of the adjusted basis for qualified New York Liberty Zone property. However, qualified property for purposes of Sec. 168, I.R.C. does not include qualified New York Liberty Zone leasehold improvement property as defined in Sec. 1400L(c)(2), I.R.C. (i.e., an improvement placed in service after September 10, 2001 and before January 1, 2007 in the New York Liberty Zone). Congress added Sec. 1400L(c), I.R.C. to provide that five-year property for purposes of depreciation under Sec 168, I.R.C. includes such property.

J. 15-Year Depreciation and Cost Recovery.

1. 15-Year Useful Life for Leasehold Improvements and Restaurant Property. The 15-year recovery period applies to any “qualified leasehold improvement property” or any “qualified restaurant property” placed in service after October 22, 2004 and before January 1, 2006. Sec. 168(e)(3)(E), I.R.C. Under prior law, the applicable recovery period for such property was 39 years.

a. Qualified Leasehold Improvement Property. In determining what is “qualified leasehold improvement property” for purposes of the reduced recovery period, the American Jobs Creation Act of 2004 added new Sec. 168(e)(6), I.R.C., which incorporated by reference the definition of “qualified leasehold improvement property” in Sec. 168(k)(3), I.R.C., with one modification. New Sec. 168(e)(6), I.R.C., expressly states that, if a lessor makes a leasehold improvement that qualifies for the 15-year recovery period, a subsequent owner of the leasehold improvement property may not depreciate the leasehold improvement over the reduced recovery period.

b. Qualified Restaurant Property. New Sec. 168(e)(7), I.R.C., defines “qualified restaurant property” as any Section 1250 improvement to a building if (i) the improvement is placed in service more than three years after the date the building was first placed in service and (ii) more than 50% of the building’s square footage is devoted to the preparation, seating and consumption of prepared meals.

2. 2-Year Extension of Increased Section 179 Expensing. The Jobs and Growth Tax Relief Reconciliation Act of 2003 increased the maximum amount deductible under Sec. 179, I.R.C., from \$25,000 to \$100,000. This increase was set to sunset in 2006. The American Jobs Creation Act of 2004 extended the availability of the increased Sec. 179, I.R.C., expense through 2008.

VII. INSTALLMENT SALES

A. Applicability.

1. The installment method applies broadly to dispositions of property which yield a gain, and which call for at least one payment after the close of the taxable year in which the disposition occurs. Secs. 453(a) and (b)(1), I.R.C., and Temp. Regs. §§15A.453-1(a) and 15A.453-1(b)(1). It does not apply to receipts of compensation, rents or lease payments. However, where a lease is treated as a sale for Federal income tax purposes, the installment method may be used.

2. Note that, in December 2000, Congress passed and the President signed the Installment Tax Correction Act of 2000, which repealed, on a fully retroactive basis, the modification of the installment method contained in the Taxpayer Relief Extension Act of 1999. TREA 1999 modified Sec. 453, I.R.C., in order to repeal installment sales reporting for accrual method taxpayers. The new Act generally provides that Sec. 453, I.R.C., shall be applied and administered as if the repeal (and concomitant modifications) of the installment method had never been enacted. Thus, the Act reinstates, nunc pro tunc, installment sales reporting for accrual method taxpayers. Pub. L. No. 106-573, approved Dec. 28, 2000.

B. Exceptions. Not all deferred payment dispositions qualify for the installment method.

1. Excepted Dispositions of Real Property. Dispositions of real property are covered unless they are dealer dispositions (dispositions of real property held for sale to customers in the ordinary course of the taxpayer's trade or business). Secs. 453(b)(2)(A) and (l)(1)(B), I.R.C.

2. Excepted Dispositions of Personal Property. Taxpayers engaging in (i) dealer dispositions or (ii) dispositions of inventories of personal property may not use the installment method. Sec. 453(b)(2), I.R.C. In addition, dispositions of publicly traded property, such as stock or securities, are excepted. Sec. 453(k)(2), I.R.C.

a. A dealer disposition is any disposition by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan. Sec. 453(l)(1)(A), I.R.C.

b. The inventory exception essentially excepts dispositions of personal property that may be held by a taxpayer whose sales activity may not rise to that of a dealer, but which is more than just casual.

c. A dealer disposition is also any disposition of real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business. Sec. 453(l)(1)(B), I.R.C.

C. Consequences of Not Using Installment Method. If a seller either does not qualify for the installment method or elects not to use it, that seller's regular method of tax accounting-- the cash or an accrual method -- applies.

1. Cash Method Taxpayer. Under the cash method of accounting, gross income, and consequently gain, is taxable when it is actually or constructively received. Reg. §1.451-1(a). A seller who uses the cash method must treat the fair market value of the installment obligation as the amount realized in the year of sale. Accordingly, cash basis sellers must generally recognize gain in full when they receive installment obligations, as long as those obligations have ascertainable fair market values. Property will be considered to have no fair market value only in "rare and extraordinary" cases. Neither the fact that the amount depends on material contingencies, nor that transferability is restricted, will render the obligation valueless. Temp. Reg. §15A.453-1(d)(2)(iii). In no event will the fair market value of an obligation be considered less than the fair market value of the property sold (less any other consideration received by the seller on the sale). Temp. Reg. §15A.453-1(d)(2)(iii).

2. Accrual Method Taxpayer. Under the accrual method, sellers must recognize gain when all the events have occurred which fix the right to receive income, and the amount thereof can be determined with reasonable accuracy. Reg. §1.451-1(a). Receiving an installment obligation at closing satisfies the receipt test and usually marks the point in time when the all-events test is met.

a. When the installment obligation is for a fixed amount, the amount realized by an accrual basis seller is the total amount payable on the obligation, not its fair market value. Temp. Reg. §15A.453-1(d)(2)(ii)(A).

b. Accrual basis sellers must recognize the fair market value of the obligation as the amount realized when the installment obligation is for a contingent amount. Temp. Reg. §15A.453-1(d)(2)(iii).

D. Election Out of the Installment Method. The installment method applies unless a taxpayer elects not to use it. Sec. 453(d)(1), I.R.C.

1. Timing. The election must be made no later than the due date of the return for the tax year in which the sale occurs, including extensions. Sec. 453(d)(2), I.R.C. and Temp. Reg. §15A.453-1(d)(3)(i). Exceptions are made only in rare circumstances where the taxpayer proves good cause for failing to make the election timely. Temp. Reg. §15A.453-1(d)(3)(ii).

2. Form of Election. An election out of the installment method must generally be made on Schedule D (Capital Gains and Losses) of the relevant income tax return form, or on Form 4797 (Sale of Business Property), depending on the nature of the property sold or exchanged. Temp. Reg. §15A.453-1(d)(3)(i). But see Priv. Ltr. Rul. 9214005 (Dec. 9, 1991). Taxpayers can also elect out by simply reporting as the amount realized the selling price (including the full face amount of any installment obligation received) on the tax return filed for the tax year in which the sale occurs. S. Rep. No. 1000, 96th Cong., 2d Sess. 12 (1980).

3. Revoking the Election. A valid election may be revoked only with the Service's consent. Revocation will not be permitted when one of its purposes is the avoidance of Federal income taxes, or when the tax year in which any payment was received has closed. Temp. Reg. §15A.453-1(d)(4).

a. It is clear that revocation will only be permitted in exceptional circumstances. Temp. Reg. §15A.453-1(d)(4).

b. It is unclear, however, under what circumstances revocation will be permitted, short of the tax-avoidance threshold. See Priv. Ltr. Rul. 9218012 (Feb. 3, 1992); Priv. Ltr. Rul. 9149044 (March 7, 1991); and Rev. Rul. 90-46, 1990-1 C.B. 107.

4. Strategy Regarding Electing Out. The consequences of electing out can be identified on two levels, direct and indirect.

a. The direct consequences of electing out of the installment method, whether by an accrual or cash basis taxpayer, are foregoing deferral of gain recognition and accelerating tax.

b. At the same time, indirect effects may overcome the direct disadvantages of electing out. Identifying and assessing these indirect consequences is the most challenging aspect of the analysis.

(1) For example, it may be desirable to elect out in order to utilize passive losses. Sec. 469, I.R.C.

(2) Moreover, decreasing examination exposure by electing out, reporting the sale in one year, and thereby limiting the statute of limitations period may be sufficient justification.

E. Computing Taxable Gain. Under the installment method, the seller recognizes gain over the term of the installment obligation as the payments are received. Temp. Reg. §15A.453-1(b)(2).

1. Each year the seller must report a portion of total payments received as taxable income. The taxable portion is the ratio that the seller's gross profit bears to the contract price, or the so-called "gross profit ratio".

a. Gross profit ratio is calculated:

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Contract Price}}$$

b. "Gross profit" is the excess of the selling price over the seller's adjusted basis in the property sold. Temp. Reg. §15A.453-1(b)(2)(v).

(1) Any brokers' commissions and other selling expenses paid by the seller are added to basis in order to arrive at gross profit. Temp. Reg. §15A.453-1(b)(2)(v).

(2) "Selling price" is the gross sales price without any reduction to reflect existing mortgages or other encumbrances on the property that the purchaser assumes or to which the purchaser takes subject. Reg. §1.453-4(c) and Temp. Reg. §15A.453-1(b)(2)(ii).

(3) Neither interest, stated or unstated, nor original issue discount should be included in the selling price. Temp. Reg. §15A.453-1(b)(2)(ii).

(4) "Adjusted basis" is the cost or other basis of property, adjusted for a variety of items enumerated in Sec. 1016, I.R.C. Sec. 1011(a), I.R.C.

c. The "contract price" is the selling price minus any indebtedness the purchaser assumes, or to which the purchaser takes the property subject. Generally, it is the amount that the buyer is obligated to pay directly to the seller. Temp. Reg. §15A.453-1(b)(2)(iii).

d. Qualifications.

(1) Assumption of nonqualifying indebtedness constitutes payment.

(a) Qualifying indebtedness is (1) a mortgage or other indebtedness encumbering the property and (2) indebtedness not secured by the property, but incurred or assumed by the purchaser incident to the purchaser's acquisition, holding or operation of the property in the ordinary course of business or investment. Temp. Reg. §15A.453-1(b)(2)(iv).

(b) Qualifying indebtedness does not include an obligation of the seller incurred incident to the sale, such as legal fees, or an obligation of the seller "functionally unrelated to the acquisition, holding, or operating of the property", such as the seller's medical bills. Temp. Reg. §15A.453-1(b)(2)(iv).

(2) Qualifying indebtedness may not be subtracted from the selling price to arrive at the contract price to the extent that the indebtedness assumed exceeds the seller's basis in the property sold. Temp. Reg. §15A.453-1(b)(2)(iii).

F. Depreciation Recapture. All depreciation recapture under Sec. 1245 or 1250, I.R.C. must be recognized in the year of sale, even if no payments are received in that year. Sec. 453(i)(1)(A), I.R.C. When a taxpayer using the installment method recognizes depreciation recapture, the taxpayer's adjusted basis is increased by the amount of the recapture income to determine the portions of each payment that comprise gain and basis recovery.

G. Definition of Payment. The Code takes an expansive view of "payment" and only makes the most obvious exception--the receipt of indebtedness of the person acquiring the property. Sec. 453(f)(3), I.R.C., and Temp. Reg. §15A.453-1(b)(3)(i).

1. Cash and Other Property.

- a. Obviously, a receipt of cash will constitute payment.
- b. Payment may also be received in other property, including foreign currency and marketable securities. Temp. Reg. §15A.453-1(b)(3)(i).
- c. Receiving evidence of indebtedness of a person other than the person acquiring the property constitutes payment. See First Nat'l Bank v. Comm'r, 921 F.2d 1081 (CA10 1990); Holmes v. Comm'r, 55 T.C. 53 (1970); Maddox v. Comm'r, 69 T.C. 854 (1978).

2. Purchaser Indebtedness Secured by Debt That Is Readily Tradable. Receipt of a purchaser's bond, note or other evidence of indebtedness that is payable on demand or that is readily tradable is payment. Sec. 453(f)(4), I.R.C., and Temp. Reg. §15A.453-1(e)(1)(i).

- a. An obligation is treated as "payable upon demand" if it is treated as such under applicable state or local law. Temp. Reg. §15A.453-1(e)(3).
- b. "Readily tradable" instruments are obligations issued by corporations or governmental agencies with interest coupons attached or in registered form, or in any other form designed to render such bond or other evidence of indebtedness readily tradable in an established securities market. Temp. Reg. §15A.453-1(e)(1)(i) and -1(e)(4).

3. Cash Escrow Deposits. Escrow deposits may constitute payment if there are no substantial restrictions on the seller's ability to receive deposited funds or if the seller can look directly to the escrow deposit for full payment in case the purchaser defaults. This is true even though the escrow funds are not immediately subject to seller's demand. See Rev. Rul. 73-451, 1973-2 C.B. 158, and Rev. Rul. 77-294, 1977-2 C.B. 173, amplified by Rev. Rul. 79-91, 1979-1 C.B. 179.

4. Assumption or Cancellation of Seller's Nonmortgage Obligations. A purchaser's assumption and payment of any obligations owed by a seller--such as brokerage commissions, interest expense or real estate taxes accrued prior to closing--are considered payments for installment method purposes. See Rev. Rul. 76-109, 1976-1 C.B. 125; Bostedt v. Comm'r, 70 T.C. 487 (1978); and Ehlert v. Comm'r, 50 TCM 1048 (1985).

5. Assumption of Mortgage for More Than Seller's Basis. Payment is inferred, to the extent the unpaid principal balance of the obligation exceeds the seller's adjusted basis in the property. Temp. Reg. §15A.453-1(b)(3)(i).

6. Pledges of Installment Obligations. If any indebtedness is secured by an installment obligation (which installment obligation arose out of a sale where the price exceeded \$150,000 and the property sold was not used for or produced by farming or personal use property), the net proceeds of the indebtedness constitute payment as of the later of (1) the time the indebtedness is secured by the obligation or (2) the time the taxpayer receives proceeds of the indebtedness. Sec. 453A(d)(1), I.R.C.

a. The amount treated as payment once pledging or receipt of the borrowings occurs, cannot exceed the contract price, reduced by any portion of the contract price received before the time the proceeds are treated as payment. Sec. 453A(d)(2), I.R.C.

b. Once payment is deemed made under Sec. 453A, I.R.C., actual payments later received for that obligation are not taken into account until the total of the subsequent payments exceeds the amount already deemed paid. Sec. 453A(d)(3), I.R.C.

H. Items Not Considered Payments.

1. Guarantees. No guarantee, not even that of a government agency, will render a purchaser's evidence of indebtedness "payment". Standby letters of credit are treated as third-party guarantees. Temp. Reg. §15A.453-1(b)(3)(i).

2. Assumptions of Ordinary-Course-of-Business Debt. Where a buyer purchases a business in an installment sale, including ordinary liabilities of a going business, and the buyer pays such liabilities, such payment is not considered payment to the seller under the installment method. Irwin v. Comm'r, 390 F.2d 91 (CA5 1968). However, if the total of all the liabilities assumed exceeds the basis of the property, such excess is included as payment in the year of sale. See Rev. Rul. 73-555, 1973-2 C.B. 159.

3. Interest. Interest payments, including original issue discount, are not payments that will trigger gain recognition under the installment method.

4. Wrap-Around Mortgages. Wrapped debt does not constitute payment. A wrap-around mortgage is an agreement in which the buyer neither assumes nor takes subject to part or all of the mortgage or other indebtedness encumbering the property purchased, but, instead, the buyer issues an installment obligation to the seller which incorporates the principal amount of the wrapped indebtedness and the seller, in turn, agrees to apply a part of the payments received to service the wrapped indebtedness. See Stonecrest Corp. v. Comm'r, 24 T.C. 659 (1955), and Professional Equities, Inc. v. Comm'r, 89 T.C. 165 (1987), acq. 1988-2 C.B. 1, invalidating Temp. Reg. § 15A.453-1(b)(3)(ii).

I. Installment Method for Contingent Payment Sales. Virtually all forms of contingent payment sales are categorized into three groups: (i) where a maximum selling price can be determined; (ii) where there is a fixed payment term and no maximum selling price can be determined, or (iii) where no maximum selling price can be determined and there is no fixed payment term.

1. Maximum Selling Price Determinable. Where a "stated maximum selling price" exists for a contingent payment sale, that price will be treated as the selling price for computing gain under the installment method. Temp. Reg. §15A.453-1(c)(2)(i).

a. A stated maximum selling price is determinable if the maximum amount of the sale proceeds that a taxpayer may receive can be determined under the terms of the sale agreement as of the end of the taxable year in which the sale occurs. Temp. Reg. §15A.453-1(c)(2)(i).

b. The stated maximum selling price is determined by assuming that all contingencies in the agreement are resolved at the earliest possible date and in a manner which will maximize the selling price. Temp. Reg. §15A.453-1(c)(2)(i).

c. In the event that the maximum amount is later reduced, the gross profit ratio will be recomputed for payments received in or after the tax year in which an event requiring a reduction occurs. Temp. Reg. §15A.453-1(c)(2)(i).

2. No Maximum Selling Price, but Payment Period Is Fixed. If there is no maximum selling price in a sale agreement, but the payment period is fixed, the taxpayer's basis is allocated ratably over the taxable years in which payments may be received in equal annual increments. Temp. Reg. §15A.453-1(c)(3)(i).

3. No Maximum Selling Price, and No Fixed Payment Period. When neither a maximum selling price nor a fixed period is specified in a sale agreement, the Regulations question whether a sale has occurred, or whether the payments received are more accurately rent or royalty income. If, after scrutinizing the pertinent facts (including the nature of the property), the arrangement is determined to be a sale, the taxpayer's basis, including selling expenses, will be recovered ratably over 15 years commencing with the date of sale. Temp. Reg. §15A.453-1(c)(4). Any basis not recovered at the end of the 15th year will be carried forward to the next succeeding tax year, and thereafter from year-to-year, until all the basis is recovered or the future payment obligation becomes worthless.

4. Alternative Methods of Basis Recovery. If a taxpayer demonstrates that application of the normal basis recovery rules set forth above substantially and inappropriately defer recovery of basis, the taxpayer may use an alternative method of basis recovery. To demonstrate that a deferral is inappropriate, the taxpayer must show that (1) the alternative method is reasonable, and (2) under the alternative method it is reasonable to conclude that, over time, the taxpayer is likely to recover basis at twice the rate at which basis would have been recovered under the otherwise applicable rules. Temp. Reg. §15A.453-1(c)(7).

J. Recognition Events for Installment Obligations. Any satisfaction at other than face value, and any distribution, transmission, sale or other disposition of an installment obligation will trigger the immediate recognition of gain or loss. Sec. 453B, I.R.C.

1. Sale or Exchange. The installment method terminates whenever an installment obligation is, in fact, sold or exchanged.

a. Satisfaction at other than face value is treated the same as a sale or exchange. A common example of this occurs when the buyer of property defaults on a deferred purchase money obligation, and the seller repossesses the property in satisfaction of that obligation. See Secs. 453B and 1038, I.R.C.

b. The amount recognized in a sale or exchange is the difference between the seller's basis in the obligation and the amount realized. Sec. 453B(a)(1), I.R.C.

(1) The seller's basis in the obligation is the unpaid balance of the obligation in excess of the amount of gain inherent in that unpaid balance. Sec. 453B(b), I.R.C.

(2) The character of gain or loss is determined by reference to the asset originally transferred. Sec. 453B(a), I.R.C.

2. Other Dispositions. Nonsale-or-exchange dispositions include transactions such as gifts, cancellations and distributions.

a. If disposition occurs other than by sale or exchange, the amount of gain or loss recognized is the difference between the seller's basis in the obligation and the fair market value of the obligation at the time of disposition. Sec. 453B(a)(2), I.R.C.

b. A common technique for making gifts is contributing installment obligations to a trust. In this way, a donor can give a partial interest, such as a term-for-years or a remainder interest, or otherwise condition a gift, especially if the beneficiary will be a minor. Whether contribution of an installment obligation to a trust is a disposition depends on whether the grantor is deemed to retain substantial ownership under Secs. 671 through 679, I.R.C.

c. Cancellations are similar to gifts, the distinguishing characteristic being the identity of the donee as the obligor of the indebtedness. See Frane v. Comm'r, 98 T.C. 341 (1992).

d. For nonindividual, noncorporate taxpayers such as partnerships and trusts, distributions of installment obligations to owners or beneficiaries may constitute nonsale-or-exchange distributions in certain circumstances. Most corporate distributions of installment obligations constitute nonsale-or-exchange dispositions for the corporation.

K. Nonrecognition Events for Installment Obligations. A number of events are not treated as dispositions. These include modifications of installment obligations, certain transfers to and from corporations or partnerships, and transfers incident to death or divorce.

1. Installment Obligation Modification. Modifying an installment obligation will not constitute a satisfaction or disposition unless the rights of the seller under the installment sale are substantially changed. See Rev. Rul. 82-122, 1982-1 C.B. 90.

2. Transfers to and from Corporations.

a. Transfers to corporations are excepted from gain or loss recognition under Sec. 453B, I.R.C. if the contribution is tax-free under the Code, such as Secs. 351 and 361, I.R.C. Reg. §1.453-9(c). This exception will not apply if the corporation receiving the installment obligation is the obligor. In such cases, the transfer will be deemed to be a disposition. See Rev. Rul. 73-423, 1973-1 C.B. 161.

b. Transfers from corporations are generally recognition events to shareholders except where (1) a corporate shareholder received installment obligations in a complete liquidation, (2) the shareholder received (in exchange for the shareholder's stock) an installment obligation acquired in a sale or exchange by the corporation during the 12-month period beginning on the date the plan of complete liquidation is adopted, and (3) the liquidation is completed during such 12-month period. Sec. 453(h)(1)(A), I.R.C.

(1) Notable limitations exist for this rule.

(2) The exception does not apply to sales of inventory or other property held primarily for sale to customers in the ordinary course of the corporation's trade or business, unless the sale is made in bulk. Sec. 453(h)(1)(B), I.R.C. The exception does not apply to the extent the obligation is attributable to the disposition of depreciable property, if the obligor and the shareholder are married to each other or are related persons. Sec. 453(h)(1)(C), I.R.C.

3. Transfers to and from Partnerships.

a. Contributions of property to a partnership in exchange for interests in the partnership do not trigger recognition of gain or loss. Sec. 721(a), I.R.C.

b. No gain or loss is generally recognized when distributions of installment obligations are made to partners. Sec. 731(a), I.R.C.

(1) When unrealized receivables or inventory are distributed to a partner, the Code construes a sale or exchange to the extent the distribution exceeds the partner's share in such property. A partner may be taxed as having sold or exchanged an installment obligation if the installment obligation constitutes "unrealized receivables". Sec. 751(b), I.R.C.

(2) When a partnership liquidates a retiring or deceased partner's interest, the partner must recognize gain or loss to the extent that the payment is deemed received in exchange for a share of the partnership's unrealized receivables. Therefore, liquidating distributions to retiring or deceased partners may also constitute sales or exchanges of installment obligations, where the obligations are unrealized receivables to the partnership. Sec. 736(a), I.R.C.

4. Transfers Incident to Death or Divorce.

a. Transmission at death is not a disposition. Therefore, no gain or loss is triggered merely on account of the decedent's death. Sec. 453B(c), I.R.C. This means the decedent's estate and heirs will not benefit from the tax-free step-up in basis to fair market value that normally accompanies death. The step-up in basis rule is terminated under Sec. 1014(f), I.R.C. for the estates of decedents dying after December 31, 2009. The unreported gain is "income in respect of the decedent" and remains taxable to whomever is entitled to receive it. Sec. 691(a)(1), I.R.C., and Reg. §1.691(a)-5(a).

b. A transfer of an installment obligation to which Sec. 1041 applies, and other than a transfer in trust, is not a disposition, and the same tax treatment applies to the transferee as would have applied to the transferor. Sec. 453B(g), I.R.C.

L. Dispositions to Related Persons. Taxpayers making installment sales to related persons may generally defer gain recognition under the installment method. However, there are certain anti-abuse provisions.

1. Sales of Depreciable Property. When a taxpayer sells depreciable property to a related person, the taxpayer may not use the installment method to report gain. Sec. 453(g)(1)(a), I.R.C.

a. "Related person" in this case means: (1) a person and all entities which are "controlled entities" with respect to that person; (2) 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 (see Sec. 318(a)(3)(B)(i), I.R.C.)]; and (3) two or more partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests. Sec. 453(g)(3), I.R.C.

b. This provision does not apply if the taxpayer establishes that the disposition did not have the avoidance of Federal income tax as one of its principal purposes. Sec. 453(g)(2), I.R.C.

2. Second Dispositions by Related Persons. If the installment method is used for a sale of property to a related person, and if the related person disposes of the property before making all payments and within 2 years of its purchase, the original seller will be treated as if it received all remaining payments at the time of the second disposition. Sec. 453(e)(1), I.R.C.

a. For this purpose, the term "related person" means: (1) a person whose stock would be attributed to the original seller under Sec. 318(a), I.R.C. ("Constructive Ownership of Stock, General Rule") [(other than paragraph (4) thereof, which addresses stock options)], or (2) a person who bears a relationship to the original seller described in Sec. 267(b), I.R.C. ("Losses, Expenses, and Interest with Respect to Transactions Between Related Taxpayers, Relationships"). Sec. 453(f)(1), I.R.C.

b. The running of the two-year period after the disposition to the related person is suspended for any period during which the related person's risk of loss with respect to the property is substantially diminished. Sec. 453(e)(2)(B), I.R.C.

c. Certain dispositions are excepted from this provision., as follows:

(1) Reacquisitions of stock by issuing corporations are not treated as first dispositions. Sec. 453(e)(6)(A), I.R.C.

(2) An involuntary conversion (within the meaning of Sec. 1033) and any transfer thereafter will not be treated as a second disposition if the first disposition occurred before the "threat or imminence" of the conversion. Sec. 453(e)(6)(B), I.R.C.

(3) Any transfer after the earlier of the death of the original seller or the related buyer, and any transfer thereafter, will not be treated as a second dispositions. Sec. 453(e)(6)(C), I.R.C.

M. Interest Charges on Deferred Taxes for Certain Dealers and Nondealers. The installment sale rules require dealers in timeshares and residential lots and nondealers with installment obligations with aggregate face amounts in excess of \$5 million to pay interest to the Service.

1. Dealers in Timeshares and Residential Lots. Dealers in timeshares and residential lots are permitted to utilize the benefits of Sec. 453, I.R.C., provided they pay interest on tax attributable to payments received during each taxable year. Sec. 453(l)(2), I.R.C.

2. Nondealers with Sec. 453A Obligations with an Aggregate Face Amount Over \$5 Million. If the conditions are satisfied, the taxpayer is required to pay interest on the "applicable percentage of the deferred tax liability" for each obligation. Sec. 453A(b)(2), I.R.C.

(a) The applicable percentage is determined by dividing (1) the amount by which the aggregate face amount of the obligations outstanding as of the close of the taxable year exceeds \$5 million, by (2) the aggregate face amount of these obligations. Sec. 453A(c)(4), I.R.C.

(b) This percentage will not change as payments are made (or deemed made under the pledge rule) in subsequent taxable years. H.R. Conf. Rep. 495, 100th Cong., 1st Sess. 929 (1987).

(c) The "deferred tax liability" for the obligation is the amount of gain which has not been recognized as of the close of the taxable year multiplied by the maximum tax rate in effect under Sec. 1 or 11, I.R.C., whichever is appropriate. Sec. 453A(c)(3), I.R.C.

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