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Thomas R. Frantz

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REAL ESTATE TAX SHELTERS—HISTORICAL STRUCTURES, REHABILITATED STRUCTURES, LOW-INCOME RENTAL HOUSING, CONDOMINIUM OR COOPERATIVE HOUSING CONVERSION TAX PROBLEMS AND ACRS ISSUES

THOMAS R. FRANTZ*

Introduction

As a result of recent attacks on tax shelters by Congress and the I.R.S. and the recent reduction in the ability to fund pension or profit sharing plans, high bracket taxpayers will be forced to increase their allocation of investment funds to real estate. It is important that such individuals and their advisers have a thorough understanding of the tax incentives available and the advantages and potential risks of leverage. Further, it is important that they consider the eventual disposition of real estate tax shelters in an effort to maximize their overall rate of return from a project. What they often find is that a condo conversion results in such maximization, notwithstanding the tax problems caused by exposure to dealer status with respect to the project. Because the more significant part of the overall rate of return with respect to a project is generated at the time of disposition and because practitioners generally have a fairly thorough understanding of the operational aspects of real estate ownership, the main thrust of this article is directed toward the conversion. In an effort to discuss the conversion subject as completely as possible, the article also covers the potential of capital gains for the taxpayer who purchases a project with a view to converting it to condos or constructing and selling condo units.

Compliance Provisions

Any discussion of tax shelters would not be complete without discussion of the related penalty and interest provisions, especially in view of the stiffening of these penalties and interest under TEFRA.¹ The Commissioner of the Internal Revenue Service has indicated that the penalties are only intended to cover abuse situations, but obviously there will be unanswered questions and "gray areas" and as a result, practitioners in this field should be well aware of the applicable penalties. The following discussion is not intended to be a comprehensive treatment of the applicable penalties, but rather a brief highlight.

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¹ The Tax Equity and Fiscal Responsibility Act of 1982 (H.R. 4961) (hereinafter cited as "TEFRA") was approved by Congress on August 19, 1982, and signed into law by President Reagan on September 3, 1982.

Section 6700 has been added to the Internal Revenue Code and imposes a penalty for promoting abusive tax shelters. Any person who organizes a partnership or other entity, any investment plan or arrangement, or who participates in the sale of any interest in an entity or plan or arrangement and makes or furnishes in connection with such organization or sale either (a) a statement with respect to the availability of a tax benefit from the investment, which the person knows or *has reason to know* is false or fraudulent as to any material matter or (b) a gross valuation overstatement (a statement of the value of property or services which exceeds 200% of the correct value) must pay a penalty equal to the greater of (i) \$1000, or (ii) 10% of the gross income derived or to be derived by such person from the activity. According to the conference report, the "reason to know" standard does not impose a duty of inquiry, but rather imputes knowledge to an individual consistent with his role in the transaction. The Secretary may waive all or a portion of the penalty with respect to any gross valuation overstatement on a showing that there was a reasonable basis for the valuation and that the valuation was made in good faith.² In addition, as a result of TEFRA, an action may now be brought to enjoin promoters of abusive tax shelters to prevent the recurrence of any conduct or activity subject to the § 6700 penalty.³

TEFRA also added § 6701 which imposes a civil penalty for aiding and abetting the understatement of tax liability. Any person who aids or assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim, or other document in connection with any matter arising under the Internal Revenue Laws, who knows that such portion will be used in connection with any material matter and who knows that such portion, if used, will result in an understatement of the liability for tax of another person, shall pay a penalty with respect to each document. The amount of the penalty is \$1,000 (\$10,000 if the item relates to the tax liability of a corporation). This penalty will not apply if a return preparer penalty is actually assessed with respect to a document.⁴

New § 6661 imposes a penalty equal to 10% of the amount of any understatement attributable to a substantial understatement of income tax for any taxable year. A substantial understatement is defined as any understatement for a taxable year which exceeds the greater of (a) 10% of the tax required to be shown on the return or (b) \$5,000 (\$10,000 in the case of a corporation). The amount of the understatement on which the penalty is imposed, shall be reduced by that por-

² Section 6700(b)(2), Internal Revenue Code of 1954, as amended (hereinafter cited only by Code section). The effective date of this Section is September 4, 1982.

³ § 7408 added by § 321(a) of TEFRA.

⁴ § 6701; the effective date of this provision is also September 4, 1982. See § 6701(b)(1) and (2), (c) and (f)(2). Under prior law, the only applicable civil penalty was § 6694(b) for return preparers. There was, however, an analogous criminal penalty under § 7206(2). Note: this criminal penalty is now \$100,000 (\$500,000 in the case of corporate tax liability).

tion attributable to the treatment of any item by a taxpayer if there is or was "substantial" authority for such treatment or attributable to any item with respect to which the relevant facts are adequately disclosed in the return or in a statement attached to the return. With respect to tax shelter items, however, in order to avoid the penalty a taxpayer must establish that in addition to having substantial authority for his position, he reasonably believed that the treatment claimed was "more likely than not" the proper treatment of the item. For purposes of this section, a tax shelter item is one arising from a partnership or other entity, plan or arrangement, the principal purpose of which is the avoidance or evasion of federal income tax. The statute authorizes the Secretary to waive the penalty if the taxpayer establishes that he had reasonable cause for the understatement and acted in good faith.

In addition to the above penalties, interest rates will be redetermined semi-annually, and interest accruing after December 31, 1982 will be compounded daily.⁵ The first adjustment under the new law is based on the average prime rate from April 1 to September 30, 1982. This adjustment reduces the interest rate to sixteen percent (16%) and is effective January 1, 1983.⁶ Because of the tougher penalties and the changes in the computation of interest, practitioners, especially in the tax shelter area, must act more judiciously than ever before.

Accelerated Cost Recovery System ("ACRS")

To compute depreciation before 1962, each taxpayer was required to prove the actual useful lives of its assets under the "facts and circumstances" test. To guide taxpayers, the Service published *Bulletin F Tables of Useful Lives of Depreciable Property*. *Bulletin F* contained the Service's reasonable normal periods of useful life which eventually contained 67 pages covering over 50 industries. In 1962, the Service issued Rev. Proc. 62-21 which set forth new guideline lives for buildings, machinery and equipment 30 to 40 percent shorter than those in *Bulletin F*.⁷

In 1971, The Treasury Department issued regulations which created asset depreciation ranges and periods ("ADR").⁸ For years 1971 through 1973, taxpayers could elect to exclude buildings from ADR if a shorter useful life was justified. After 1973, ADR no longer applied, and useful lives had to be determined by either Rev. Proc. 62-21 or the facts and circumstances test.⁹

ACRS deductions apply to all property (new or used) placed in service after December 31, 1980 and is mandatory for all taxpayers.¹⁰ "Placed in service" is not defined for purposes of § 168,

⁵ §§ 6621 and 6622.

⁶ Rev. Rul. 82-182, 1982-44 I.R.B.

⁷ 1962-2 C.B. 418.

⁸ Treas. Reg. § 1.167(a)-11.

⁹ Pub.L. No. 93-625 (S. Report No. 93-1357), 1975-1 C.B. 510 at 523.

¹⁰ § 168.

but the definition for purposes of ADR and investment credit will probably be adopted.¹¹

Real property which includes buildings and § 1250 class property that had an ADR class midpoint life of more than 12.5 years as of January 1, 1981 may be written off over fifteen years.¹² The fifteen-year depreciation table uses the 175 percent declining balance method, ignores salvage value, and switches to the straight-line method of computing depreciation. The recovery period begins on the first day of the month in which the property is placed in service.¹³ Low-income housing utilizes the double declining balance method. With certain exceptions, only straight-line cost recovery is allowed on fifteen-year real property, which is placed in service after December 31, 1982 and financed by industrial development bonds.¹⁴

Under ACRS, an election can be made to depreciate fifteen-year real property under the straight-line method using a 15, 35, or 45 year period.¹⁵ This election is made on a property-by-property basis.¹⁶ If the straight-line method is adopted, all gain is capital gain (i.e. no § 1250 ordinary income recapture) and no § 56 minimum tax liability results.¹⁷

For residential real property, there is no change in prior law in that § 1250 gain is treated as ordinary income to the extent that depreciation claimed exceeds depreciation computed under the straight-line method.¹⁸

With respect to nonresidential real property, *all* of the gain is ordinary income if accelerated cost recovery is used. This is true even though the ACRS percentages include a switch to the straight-line method. If, however, straight-line depreciation is claimed as provided in § 168(b)(3), all of the gain is capital gain.¹⁹

Under ACRS, component depreciation is no longer allowed. A transitional rule applies to a component added after 1980 to a pre-1981 building. Under this rule, an election can be made with respect

¹¹ According to ADR regulations, property is "first placed in service" when the property is "first placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business... or in a personal activity." Treas. Reg. § 1.167(a)-11(e)(1)(i).

¹² § 168(c)(2)(D).

¹³ § 168(b)(2)(A).

¹⁴ § 168(f)(12).

¹⁵ § 168(b)(3)(A).

¹⁶ § 168(b)(3)(B)(ii). Compare: The election for three, five and ten year property applies to *all* property in each class placed in service in the year of the election. § 168(b)(3)(B)(i).

¹⁷ §§ 1245(a)(5)(C) and 57(a)(12)(B).

¹⁸ §§ 1250(d)(11) and 1245(a)(5)(A). Note: Property is "residential" if eighty percent (80%) or more of gross rental income for a taxable year is from dwelling units within the building. Treas. Reg. § 1.167(j)-3(b). A dwelling unit is an apartment or a house as distinguished from a hotel or motel unit or a unit in any establishment in which more than half the units are used on a transient basis. "Transient basis" is defined as a dwelling unit used for more than one-half of the days in which the unit is occupied by a tenant or a series of tenants, each of whom occupy the unit for less than thirty days. Treas. Reg. § 1.167(k)-3(c)(2).

¹⁹ §§ 1245(a)(5)(C) and 1250(d)(11).

to the method and time to recover the component's cost, but once made the election is binding on all subsequent components added to the building. If no election is made, the component will be depreciated over the fifteen-year period under the Treasury table.²⁰ In addition, a substantial improvement will be treated as a separate building and eligible for a separate election.²¹

Under the anti-churning rules, ACRS will not apply to property acquired after 1980 if: (i) the taxpayer or a person related to the taxpayer owned the property during 1980; (ii) the property is leased back to a person that owned the property at any time during 1980 or to a person related to that person; or (iii) the property is acquired in certain like-kind exchanges, rollovers, etc. to the extent of the substituted basis of the property received.²² Also, ACRS will not apply if property is used in 1980 and transferred thereafter to a corporation or partnership with a carry-over basis. The transferee must use the same lives and methods as the transferor.²³

According to the Senate Finance Committee Report, gain or loss must be recognized on all dispositions under ACRS. Section 168(d)(2)(C) defines disposition to include retirements. Therefore, no distinction is made under ACRS between ordinary and extraordinary retirements; whereas, ADR depreciation deferred recognition of gain for ordinary retirements.²⁴ With respect to ACRS property, other than fifteen-year real property, there is no deduction for cost recovery in the year in which a taxpayer disposes of an asset. With respect to fifteen-year real property, the deduction for cost recovery is prorated based on the number of months the property is in service during the taxable year (including the year of disposition).²⁵

²⁰ § 168(f)(1)(B); § 168(b)(2) and (3).

²¹ § 168(f)(1)(C).

²² § 168(e)(4)(B). Note: In the case of personal property use of the property during 1980, without ownership, is sufficient to invoke the anti-churning rules § 168(e)(4)(A). Related persons for purposes of the anti-churning rules are siblings, spouses, ancestors, lineal descendants, a corporation and an individual owning more than ten percent (10%) of the value of the corporation's stock, etc. §§ 168(e)(4)(D), 267(b), and 707(b)(1).

²³ § 168(e)(4)(C).

²⁴ Section 168 does not deal with the tax treatment of asset retirements and other dispositions. Furthermore, although the Senate Report states that the gain or loss will be recognized on *all* dispositions under ACRS, the report is silent as to the tax treatment on dispositions such as the conversion of business property to personal use. Presumably, Rev. Rul. 69-487, 1969-2 C.B. 165, will continue to be the law, and the conversion of business property to personal use will not trigger ordinary income under § 1245.

²⁵ §§ 168(d)(2)(B) and § 168(b)(2)(B). See also, § 168(f)(7) which authorizes the Service to provide different rules for the disposal of assets in non-recognition transactions and § 168(d)(2)(A) and (B) which provides a special rule for the disposition of property, for which a mass asset election is made. A taxpayer may elect to include the disposition proceeds in income in lieu of recognizing gain or loss on the disposition of property included in mass asset accounts.

Credits And Qualified Rehabilitation Expenditures

Under prior law § 48(g) applied, which provided that the investment tax credit applied to rehabilitation expenditures for nonresidential buildings at least 20 years old if a major portion of the building was rehabilitated.²⁶ Under proposed regulations, the rehabilitation must be "substantial" based on all of the facts and circumstances.²⁷ In addition, prior law required that at least 75 percent of the existing walls be retained in place as external walls after the rehabilitation, the expenditures be made for property with a useful life of at least five years, and that at least twenty years elapse between qualifying rehabilitations.²⁸ If the above requirements were met, accelerated depreciation and the energy tax credit were allowed.

As a result of ERTA and TEFRA, the 10 percent investment tax credit, the energy credit, and the 60-month amortization provision for certified historic rehabilitation expenditures have been replaced for expenditures after December 31, 1981, by the following credits: (i) a fifteen percent credit for 30 year buildings, (ii) a twenty percent credit for 40 year buildings, and (iii) a twenty-five percent credit for certified historic structures.²⁹ The fifteen and twenty percent credits are limited to nonresidential buildings, while the twenty-five percent credit applies to residential as well as nonresidential buildings.³⁰

For rehabilitation credits after 1982 other than those for certified historic structures, the basis of the property must be reduced by the amount of the credit. Further, for recapture purposes under §§ 1245 and 1250, the reduction in basis is treated as a deduction allowed for depreciation, unless the taxpayer elects straight line depreciation with respect to the property. If the credit is recaptured, the resulting increase in tax is restored to the basis.³¹ As to certified historic structures, the basis is reduced by only fifty percent of the credit. This change was enacted in TEFRA § 205 which also provides that 50 percent of the tax will be added to the basis upon recapture. The rehabilitation of certified historic structures qualifies only if the taxpayer obtains a certificate from the Secretary of the Interior that the rehabilitation is consistent with the historic character of the property or the district in which such property is located.³² Furthermore, the property must be fifteen-year property, straight line depreciation must be used, the cost of acquiring a building cannot be included, and the energy credit will not be allowed.³³ In order for the expenditures to be qualifying,

²⁶ The classification of a building as non-residential is made based on the use of the building immediately after the rehabilitation. H. Report P.L. 95-600 11/6/78 p. 86; Cong. Rec.—Senate 10/7/78, p. 5-17552.

²⁷ Prop. Reg. § 1.48-11(b)(3).

²⁸ §§ 48(g)(1)(A)(i) and (iii) and § 48(g)(1)(B).

²⁹ The Economic Recovery Tax Act of 1981 ("ERTA") was enacted August 13, 1981. § 46(a)(2)(F)(i) and (ii).

³⁰ § 48(a)(3).

³¹ § 48(q).

³² § 48(g)(2)(C).

³³ §§ 48(g)(2)(A)(i), 48(g)(2)(B)(i) and (ii), and 46(a)(2)(F)(ii).

there must be a "substantial" rehabilitation of the building as defined in § 48(g)(1)(C) (as distinguished from the facts and circumstances analysis under prior law).

Expenditures by a lessee may be qualified rehabilitation expenditures only if the remaining term of the lease (without regard to renewal periods) is at least fifteen years.³⁴ In addition, the noncorporate lessor limitations under § 46(e)(3) do not apply to qualified rehabilitation expenditures.³⁵ The sixty-month amortization provisions for certified historic structures under § 191 and the accelerated depreciation rules under § 167(o) have been repealed.

Low-Income Housing

Under prior law, a taxpayer could elect to compute the depreciation deduction under § 167(a) by amortizing rehabilitation expenditures incurred with respect to low-income housing over sixty months on a straight-line basis with no salvage value.³⁶ Expenditures attributable to a dwelling unit did not qualify as rehabilitation expenditures unless following the completion of the rehabilitation, the dwelling unit was held for occupancy on a rental basis by low income tenants as defined in the regulations.³⁷ Expenditures to acquire or enlarge an existing building and expenditures attributable to commercial facilities were not qualified expenditures. Furthermore, the expenditure must have been in connection with the rehabilitation of an existing building (e.g. expenditures to pave a parking lot for use by tenants).³⁸ To qualify for the rapid amortization, the expenditures must have exceeded \$3,000 per unit over a period of two consecutive years and the maximum amount of rehabilitation expenditures paid or incurred by a taxpayer with respect to any dwelling unit was \$20,000.00.³⁹

ERTA amended § 167(k) by increasing the maximum amount of expenditures that may qualify for rapid amortization to \$40,000. The following requirements are now imposed: (i) the rehabilitation must be conducted pursuant to a program certified by the Secretary of Housing and Urban Development, or his delegate, or by the government of a State or political subdivision of the United States, (ii) development costs must be certified, (iii) the tenants must occupy units in the property as their principal residence, (iv) the program must provide for sale of units to tenants demonstrating home ownership responsibility, and (v) the amount of income derived from leasing plus the anticipated amount realized on the sale of a unit normally must not exceed the taxpayer's cost of the property, before deduction for

³⁴ § 48(g)(2)(B)(v).

³⁵ § 46(e)(3).

³⁶ § 167(k)(1). Rehabilitation expenditures were defined as expenditures incurred to rehabilitate an existing building for low-income housing and chargeable to the capital account of depreciable property with a useful life of five (5) years or more. § 167(k)(3)(A).

³⁷ § 167(k)(1) and § 167(k)(3)(B).

³⁸ § 167(k)(3)(A).

³⁹ § 167(k)(2).

depreciation, over the tax benefits realized by the taxpayer, less the tax incurred on any income from leasing.⁴⁰

Conversion Of Apartment Buildings To Condominiums Or Co-ops

There comes a time in the history of every building, often after the "tax shelter" has turned around on the owners, when the owners explore the feasibility of refinancing or disposing of the project. Serious consideration is often given to converting the project to a condominium or cooperative because of the potential profits. In the event the conversion route is elected, one must elect between condo and co-op.

There are many non-tax factors which determine the choice of ownership format. For example, there may be a certain buyer preference or resistance to a specific format of ownership. Many lenders in Virginia are not familiar with co-ops, but are very familiar (as is the general public) with condos, and therefore financing may be more readily available for a condominium. Because condominiums are real property, one must avoid undue restrictions on alienation. On the other hand, undesirables may be kept out of a co-op by voting on the sales.

If a co-op is chosen, however, a shareholder may potentially lose his pro-rata share of deductions. To allow pass-through deductions, a cooperative housing corporation must qualify under Section 216(b)(1) and eighty percent (80%) of cooperative housing corporation income must be from "tenant-stockholders" (individuals or a developer who sells the stock within three (3) years).⁴¹ Acts of one owner, however, will not affect deductions of other owners.

Section 55-79.46 of the Code of Virginia of 1950, as amended (Va. Code) requires that liens on a greater portion of the condominium than the condominium unit conveyed be released at the time of conveyance; whereas a preexisting lien, with favorable terms, may remain as a blanket lien assumed by a cooperative association. Retaining preexisting financing for a cooperative not only allows retention of favorable terms, but also allows the converter greater flexibility in providing the remaining financing necessary to sell the unit, making cooperative units more saleable.

Virginia's Condominium Act ("CA") exempts nonresidential units from registration (i.e. preparation and delivery of a Public Offering Statement ["POS"]). The Virginia Real Estate Cooperative Act ("RECA") also exempts residential cooperatives of less than three (3) units if not subject to any development rights.⁴² For units subject to registration under CA and RECA a ten (10) day "cooling off" period after the receipt of the POS; applies under both statutes. RECA,

⁴⁰ § 167(k)(2)(B). *Note:* Qualifying as a low-income government assisted project is unlikely because the amount realized includes the indebtedness assumed by the transferee.

⁴¹ § 216(b)(6)(A).

⁴² Virginia Condominium Act, Va. Code § 55-79.39, et seq. Virginia Real Estate Cooperative Act, Va. Code § 55-424, et. seq.

however, contains significant statutory penalties for failure to deliver the POS (ten percent (10%) of the sales price plus ten percent (10%) of the cooperative mortgages).⁴³ Both statutes require similar sixty (60) day periods after registration during which a tenant has the exclusive right to buy under the terms contained in the notice. Under RECA, however, the unit may not be sold under terms more favorable than those contained in the notice, for a period of 180 days after the end of the sixty (60) day period.⁴⁴ Both statutes authorize localities to enact ordinances requiring up to twenty percent (20%) of the building to be leased to existing disabled or elderly tenants and requiring reimbursement of certain expenses of any tenant in connection with a displacement resulting from a condominium or cooperative conversion.

Sale Of Apartment Building To Unrelated Third Party

A major issue in condominium conversions is whether the seller is a dealer who must report ordinary income on all of the sales, or an investor who is entitled to long-term capital gain. Section 1221 defines "capital assets" as property held by taxpayers whether or not connected with a trade or business, but not including: (i) stock in trade of the taxpayer or other property which would be inventory or property held by the taxpayer *primarily for sale to customers in the ordinary course of his trade or business* (emphasis supplied); and (ii) property used in a trade or business which is subject to allowance for depreciation, or real property used in trade or business.⁴⁵ Section 1231 provides in general that recognized gains on sales or exchanges of property used in a trade or business will be considered as gains from the sale or exchange of capital assets held for more than "one year." Included within this definition is property subject to depreciation and held for more than one year, which is not property included in inventory or property *held primarily for sale to customers in the ordinary course of a taxpayer's trade or business*. (emphasis supplied).

The courts and the Internal Revenue Service appear to be focusing their analysis under §§ 1221(1) and 1231(b)(1) on what activity gave rise to the income. In this regard, note that "primarily" means "of first importance" or "principally."⁴⁶ In their analysis, they try to determine whether the property was held for appreciation, for a business use or whether the income was derived wholly or in part from services rendered. To the extent that services rendered play a role in the income generated from the sale of property, the exceptions under §§ 1221(1) and 1231(b)(1) may come into play. "The purpose of the statutory provision with which we deal," the Supreme Court has said, "is to differentiate between the 'profits and losses arising from

⁴³ Va. Code §§ 55-79.88 and 55-483.

⁴⁴ Va. Code § 55-487(B).

⁴⁵ § 1221(1) and (2). See generally, Miller, *Can a Straight Condominium Conversion Produce a Capital Gain? An Analysis*, 54 J. Tax'n 8 (January, 1981).

⁴⁶ *Malat v. Riddell*, 383 U.S. 569, 572 (1966).

the everyday operation of a business,' on the one hand and 'the realization of appreciation in value accrued over a substantial period of time,' on the other."⁴⁷

The key requirement is that the subject property not be dealer property at the time of disposition.⁴⁸ Each element of the statutory language under § 1221(1) or § 1231(b)(1) must be present or property is not dealer property regardless of who owns it. Therefore, a dealer can hold property that does not constitute dealer property in his hands.⁴⁹ There is no provision for allocation of gain between the items that created the gain, notwithstanding Judge Tannenwald's oft-cited concurring opinion suggesting that legislation be adopted to permit such allocation.⁵⁰ Thus if a taxpayer, who acquired land and constructed an office building in 1970 at a cost of \$500,000, can now sell it to a condominium converter for \$2,500,000, elects instead to handle the conversion himself and sell off individual units for a total of \$3,000,000, he may well be required to recognize the entire \$2,500,000 gain as ordinary income.⁵¹ Dealer property may become investor property where the owner changes his plans and sells it in a manner other than in the ordinary course of his trade or business. It is, therefore, important to know how broadly a taxpayer's business is defined.⁵²

While there are many factors to which the courts look in determining the "dealer-investor" issue, in the past they frequently applied a "smell" test which has resulted in uncertainty in the area. Despite the presence of multiple sales, it would seem any gain on property held for a substantial period, derived without the presence of construction, renovation, supervision, financing or conversion services, sales activities, or similar services should give rise to capital gain. Unfortunately, while several factors have been repeatedly cited by the courts in deciding these cases, multiplicity of sales appears to be viewed by courts as the key factor. Other factors include the taxpayer's purpose for acquiring the property, the extent of property improvements, the extent of subdividing or conversion activities, sales and advertising efforts, the relation to the taxpayer's regular business,

⁴⁷ *Malat v. Riddell*, 383 U.S. at 572 (quoting *Corn Products Co.*, 350 U.S. 46 [1955] and *Gillette Motor Transport, Inc.*, 364 U.S. 130 [1960]).

⁴⁸ *Jersey Land and Development Corp.*, 539 F.2d 311 (3rd Cir. 1976); *Gamble*, 242 F.2d 586 (5th Cir. 1957); *Estate of Dean*, T.C. Memo 1975-137.

⁴⁹ See, e.g., *Schuber*, 371 F.2d 996 (7th Cir. 1967) and *Rouse*, 39 T.C. 70 (1962), acq., 1963-2 C.B. 5.

⁵⁰ *Bynum*, 46 T.C. 295, 302 (1966) (Tannenwald, J., concurring).

⁵¹ See, *Continental Can Co.*, 422 F.2d 405 (Ct. Cl.), cert. denied, 400 U.S. 819 (1970).

⁵² *Pontchartrain Park Homes, Inc.*, 349 F.2d 416 (5th Cir. 1965). Sale of developed, but unimproved, townhouse lots in bulk by company engaged in sale of individual lots improved with townhouses may in appropriate cases qualify for capital gain treatment. See, e.g., *Estate of Dean*, supra note 48 and *Silversmith*, 79-1 U.S.T.C. ¶ 9117 (D. Colo. 1978).

and the purpose for which the property was held at the time of the sale.⁵³

At first blush the sale of apartments to a cooperative corporation would not appear to involve the "dealer problems" encountered in a condominium conversion. To the extent that the building owner is instrumental in establishing the co-op and directly or indirectly involved in sales of its stock, however, problems may be encountered. If stock or securities of the co-op are taken back, the transfer may be regarded not as a sale but as an incorporation, governed by § 351.⁵⁴ If a taxpayer purchases a building for the purpose of converting it, and carries out significant activities in the conversion, the co-op may be viewed as a mere conduit through which units are retailed.⁵⁵ A taxpayer who transferred two apartment buildings to a co-op in exchange for its capital stock approximately one year after acquisition of the building, but after rental increases were denied, was taxed at ordinary income rates on the gains on the ground that the properties were held primarily for sale to customers in the ordinary course of business. Thirty percent (30%) of the shares were sold prior to, or as of the time, the properties were transferred to the co-op.⁵⁶ According to the Service, taxpayers who buy and sell or hold securities for investment or speculation; irrespective of whether such activities constitute the carrying on of a trade or business are not dealers of securities within the meaning of § 471.⁵⁷

If the property is not "dealer property", capital gains treatment is much more likely. Problems arise, however, when the owners wish to participate in the profits to be generated by the conversion. In this regard, the price might reflect a sales commission and discount from retail to reflect conversion costs and compensation for services. If the discount is too great, the third party may not be willing to take the risk of conversion. To compensate, the owner may require a nominal downpayment and accept a non-recourse note. In such a case, a court might decide that a sale had not taken place.⁵⁸ The tax difficulty with this technique is the more the third party's investment goes down,

⁵³ See, *Biedenharn Realty Company, Inc.*, 526 F.2d 409 (5th Cir. 1969), cert. denied, 429 U.S. 819 (1976); *Jersey Land and Development Corp.*, supra note 48; *George V. Buono*, 74 T.C. 187 (1980), acq., 1981-1 C.B. 1.

⁵⁴ See generally, Jacobs and Kuofist, "Cooperative Apartment Living and Loving: How I Converted My Apartment Building to Cooperative Ownership", 8 J. Real Estate Tax'n 27 (Fall 1980).

⁵⁵ See, *Combs v. U.S.* 655 F.2d 90 (6th Cir. 1981) and Boris, "Co-ops and Condominiums—Capital Gains on Conversion and Other Problems," 40 N.Y.U. Inst. on Fed. Tax 22 (1981).

⁵⁶ *Alexander L. Baris*, 24 T.C.M. 952 (1965).

⁵⁷ Treas. Reg. § 1.471-5; see also, *Francis C. Currie*, 53 T.C. 185 (1969), acq., 1970-2 C.B. xix.

At least two (2) authors believe the disposition of properties through sale of co-op shares, which will give the seller the greatest gain, should qualify for long-term gain treatment, if the sale to an unrelated party would so qualify. See, Boris, supra note 55 and Miller, supra note 45.

⁵⁸ *Estate of Charles T. Franklin*, 544 F.2d 1045 (9th Cir. 1976).

the more he looks like an agent for the Seller, and the more the transaction is subject to be collapsed as a sham and the gain of the owner subject to ordinary income rates.⁵⁹ Of course, any sales price that is tied to the developer's profit is particularly suspect.

The combination of multiple sales with conversion and merchandising efforts (services) make it almost impossible for an investor to convert his apartment project and obtain capital gains treatment on the sale.⁶⁰ Section 1237 was adopted to permit individuals who hold investment property to subdivide and sell it and obtain capital gains treatment on the sale.⁶¹ Generally, § 1237 only applies if the subdivided property has been held for at least five years, if the owner has made no substantial improvements, and if he is not otherwise a dealer. In addition to its limitations, § 1237 appears not to be applicable to a condominium (a condominium declaration is not a "subdivision"). Further, it is difficult to construe an apartment house as "a tract of real property". The Service has ruled that "the provisions of § 1237 do not apply to the subdivision and sale of improvements" and, accordingly, its benefits "do not apply to [a condominium conversion]".⁶²

If a taxpayer has held investment property for a long time, he may argue that he's merely liquidating his investment, even though he is selling the property off a little piece at a time. Despite some early taxpayer victories in this area, it now appears only remotely possible that a liquidation of investment theory in its broadest form will be successful.⁶³ Two offshoots of the liquidation of investment theory are the "only-economically feasible disposition" or "necessary to avoid a loss" theories. Neither of these theories should do any better if retailing activity, directly or through an agent, is involved. In the "necessary to avoid a loss" cases the owner is already off-setting capital losses with ordinary income. An unwilling seller who has no choice but to sell at retail may have a slightly better case, but such situations are extremely rare.⁶⁴

Sale To Related Entity

In any sale to a related party, it is critically important to sell at fair market value, to use recourse notes and to avoid indicia of agency and profit participation. In addition, § 1239 may convert gain realized on a sale to a related corporation from long-term capital gain to ordinary

⁵⁹ Robinson, *Federal Income Taxation of Real Estate*, Warren, Gorham and Lamont, Inc., 1979, ¶ 14.03 [2].

⁶⁰ See, Rev. Rul. 75-544, 1975-2 C.B. 343 (Multiple sales alone are not necessarily fatal) and *Buono*, *supra*, note 52; "subdivision of the tract into . . . building lots takes us in the direction of the indistinct line of demarcation between investment and dealership."

⁶¹ S. Rep't. No. 1622, 83rd. Cong., 2d Sess. 115 (1954).

⁶² Rev. Rul. 80-216 1980-2 C.B. 239.

⁶³ See, e.g., *Chandler*, 266 F.2d 403 (7th Cir. 1955) and *Heller Trust*, 382 F.2d 675 (9th Cir. 1967). See also, P.L.R. 7730021.

⁶⁴ See generally, *Miller*, *supra*, note 45.

income.⁶⁵ Under § 1239(a), any gain recognized on a sale or exchange of depreciable property is to be treated as ordinary income.

Section 707(b)(2)(A) provides in part that in the case of a sale or exchange, directly or indirectly, of property which, in the hands of a transferee, is property other than a capital asset as defined in § 1221, between a partnership and a partner owning, directly or indirectly, more than 80 percent of the capital interest or profits interest in such partnership, any gain recognized shall be considered ordinary income.⁶⁶

Section 453(e) can also be a trap for the unwary. Under its provisions, for example, recognition of the gain on an installment sale by a taxpayer may be accelerated upon a disposition of property purchased from such taxpayer by a related taxpayer, if the disposition occurs within two years of the purchase. Related taxpayers are generally lineal descendants and ascendants and over 50% owned entities. Under its provisions the amount realized with respect to the second disposition shall be treated as received by the original transferor at the time of the second disposition to the extent the amount realized from the second disposition exceeds the amount of payments (down payment and installment payments) previously received by the first transferor.

If § 351 is applicable to a "sale," the transaction may be reconstituted as a contribution to capital. Hence, gain will not, with a few exceptions, be recognized and the transferee corporation, partnership, or joint venture will carry-over the transferor's basis.⁶⁷ Section 351 will apply if property is transferred to a corporation by one or more persons solely in exchange for stock or securities of such corporation and immediately after such exchange, such person or persons are in control. "Control" is defined under § 368(c) to mean the ownership of at least 80 percent of the total combined voting power of all classes of voting stock and at least 80 percent of the total number of shares of all other classes of stock of such corporation.

Section 351 may be avoided if more than 20 percent of the stock of the corporation is distributed for services, as opposed to property. This may present a problem for services which are ancillary and sub-

⁶⁵ Under §§ 1239(b) and (c), a "related person" includes the seller and his spouse, the seller and an 80-percent owned entity, or two 80-percent owned entities. The rules of attribution under § 318 apply to an 80-percent owned corporation or partnership, except that in determining ownership attribution between a taxpayer and his or her spouse and a taxpayer and an 80-percent owned entity, members of a taxpayer's family include only the taxpayer and his or her spouse.

⁶⁶ Treas. Reg. § 1.707-1(b)(3) provides in part that in determining the extent of the ownership by a partner of a capital or profits interest in a partnership, the rules of constructive ownership of stock provided in § 267(c)(1), (2), (4) and (5) shall apply. Section 707(b)(1)(A) (and similarly § 707(b)(2)(A)) does not apply, however, to a constructive owner of a partnership interest since he is not a partner as defined in § 761(b).

⁶⁷ See *Oliver*, 13 T.C.M. 607 (1954), *aff'd* 55-1 U.S.T.C. ¶ 9175 (5th Cir. 1955) (sale to joint venture having no other capital-reconstituted as a contribution to capital).

sidiary to the transfer of property as they are in certain instances disregarded. Services relating to the promotion for sale of the subject property are ancillary and subsidiary.⁶⁸ Therefore, conveyance of twenty-one percent or more of the stock of the corporation to a real estate sales agency may be deemed ancillary and subsidiary.

To maximize chances of success from a tax standpoint, the sale should follow the incorporation and the conveyance of cash or property to the corporation in exchange for stock by as much time as possible. Most importantly, the sales transaction should appear in all respects to be a bona fide sale. Therefore, the sale price must be equal to the fair market value of the property; the note should be relatively short-term (no longer than five years) and its terms should be commercially reasonable; the note should require fixed payments of principal and interest without regard to corporate earnings and all payments should be made when due, even if additional contributions to capital or loans to the corporation are necessary; the interest rate should be a reasonable rate; there should be very strong default and foreclosure provisions; the note should not in any manner be subordinated to the rights of other general creditors of the corporation; as much should be paid for the stock of the corporation as possible; and there must be a reasonable anticipation that the conversion of the project will succeed and yield profits sufficient to pay the notes when due. A transferor will be taxed on "securities" upon receipt of payment under § 1232. Furthermore, a review must be made of the final § 385 Regulations for treating post-effective date corporate interests as debt or stock to be sure that the desired tax results are achieved.

"Boot" received by a taxpayer in a § 351 transaction may have the same effect as a taxable sale because the taxpayer is taxed on the "boot" to the extent of gain realized and the transferee corporation receives a stepped-up basis to such extent. "Boot" includes liabilities in excess of basis and short term notes which are not "securities".⁶⁹ One should keep in mind that a limited partnership interest transferred to a controlled corporation under a § 351 transaction is transferred subject to its share of partnership liabilities for purposes of §§ 357(c) and 358(d).⁷⁰

Use of "Collapsible Corporations"

Realization by the conversion corporation of at least one-third of the anticipated profit from the sale of units, followed by liquidation prior to entering into or negotiating contracts for sale of the remaining units, provides the shareholders with capital gain to the extent of the market value of unsold units and other assets as of the date of

⁶⁸ Rev. Rul. 64-56, 1964-1 C.B. (Part 1) 133.

⁶⁹ § 357(c); *Pinellas Ice and Cold Storage Co. v. Comm'r.*, 287 U.S. 462 (1933).

⁷⁰ Rev. Rul. 80-323, 1980-2 C.B. 124.

liquidation.⁷¹ Great care is required, therefore, in estimating anticipated profits (most advisors suggest at least forty percent realization prior to liquidation). Note that this requires prepayment of tax on anticipated appreciation, so the developer must have great confidence in the saleability of the remaining units, or a lot of cash. A properly timed liquidation (e.g. January) may result in the deferral of tax for an additional year (unless estimated tax provisions in the case of a particular taxpayer require otherwise). Query whether a Subchapter S corporation may be liquidated after one-third realization, i.e., is "realization" by a corporation sufficient if no corporate tax is paid.

In states such as Virginia, where a condominium on leased land is permitted, the owner should consider retaining the land and leasing it to the condominium association. If the condominium association has the option to buy the land, and the rents escalate periodically (perhaps through a cost-of-living adjustment) the unit owners' association may have an incentive to buy the land at some future date. Sale of the land at such future date may enable the converter to obtain capital gain treatment.⁷² The allocation of basis to land will, however, result in greater gains on unit sales. Furthermore, if maintenance or management contracts or recreational interests are granted by the developer to a shareholder, the value thereof may be a dividend.

Other Tax Planning Opportunities

Tax-free exchanges may be useful on occasion. In general, § 1031(a) provides, in part, that no gain or loss shall be recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment. If a taxpayer who is not a dealer in real estate, exchanges city real estate for a ranch, farm or improved land, no gain or loss is recognized.⁷³ If a taxpayer has been holding rental property for investment, then he can utilize a tax-free exchange by transferring the property to a condo converter (or use a multi-party exchange) for other property and thus avoid recognition of gain. Depending on the amount of mortgages assumed or taken subject to in the exchange transaction, the taxpayer can increase his basis and thereby achieve a higher depreciation base.⁷⁴ It is important to be aware that exchange transactions are possible with a related entity.⁷⁵

⁷¹ Rev. Rul. 72-48, 1972-1 C.B. 102; *Comm'r. v. Kelley*, 293 F.2d 904 (5th Cir. 1961).

⁷² *Gilbert Johnson*, T.C. Memo 1976-95. Caveat: If the economic compulsion of the association to buy is too great, capital gain treatment may not be available. *Comtel Corp. v. Comm'r.*, 376 F.2d 791 (2d Cir.), cert. denied, 389 U.S. 929 (1967).

⁷³ Treas. Reg. § 1.1031(a)-1(c)(2).

⁷⁴ Treas. Reg. § 1.1031(b)-1(c).

⁷⁵ See, Rev. Rul. 72-151, 1972-1 C.B. 225 and P.L.R. 8038099, 8041034, 8107099, and 811072.

Consideration should be given to the use of loss corporations to shelter the gains to be recognized in a conversion. Net operating losses may be carried back three years under § 172(b)(1), but losses incurred during years ending on or before December 31, 1975 may only be carried over for five years. As a result of amendments made by ERTA, net operating losses incurred in taxable years ending after 1975 may now be carried over up to fifteen years.⁷⁶ It may be possible to file consolidated returns and utilize a pre-consolidation loss of the parent corporation, and, therefore, acquisition of a loss corporation may be advisable.⁷⁷

⁷⁶ Sections 207(a)(1) and 209(c)(1)(A) of ERTA.

⁷⁷ Treas. Reg. § 1.1502-21. *See*, §§ 269, 381 and 382.