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Tax Planning for Real Estate Developers

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TAX PLANNING FOR REAL ESTATE DEVELOPERS

By

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I. Factual Background

A. Description of property and introduction of characters. Donald Trumpet and his wife, Nervanna, are highly successful real estate investors in the Central Florida area. As early as 1985 Donald and Nervanna anticipated major population growth west of Orlando. During the past decade the Trumpets have quietly assembled 3,000 acres of contiguous land known as the Taj Mahal Grove, which is located close to a major roadway between Orlando and Walt Disney World. The Trumpets’ foresight was further rewarded by a recent announcement that the proposed beltway to be constructed around Orlando will pass close to their property and a major interchange is planned within a quarter-mile of a portion of their property. The property consists of approximately 1,000 acres of orange grove with the balance comprised largely of undeveloped pasture land. The Trumpets operated the grove at a modest profit until December 1989 when the trees were all destroyed by a major freeze. The Trumpets determined not to replant the grove and have ceased all activities with respect to the care and maintenance of the trees.

The property is situated around three large spring fed lakes that have historically provided irrigation for the groves. The pasture land is leased out to ranchers who pay the Trumpets a small sum for the right to graze their cattle on the property. Approximately 10% of the Taj Mahal Grove is comprised of wetlands which are environmentally protected and may not be developed.

Several properties in the vicinity of the Taj Mahal Grove have recently been acquired by a prominent local developer who has announced plans for the development of both a major residential community and an office park. The Trumpets are constantly besieged by inquiries from both developers and land speculators who have recognized the significant potential of the Taj Mahal Grove property for a major development, but the Trumpets have thus far refused to discuss disposition or development of the property with anyone.

The long awaited announcement of the route for the western beltway caused the Trumpets’ property to escalate substantially in value and they recently concluded that the time may be ripe to either dispose of the Taj Mahal Grove or, alternatively, participate in some manner in the ultimate development and sale of the property. Although the Trumpets are knowledgeable real estate
investors, they have never engaged in the development of any of their properties, preferring instead to sell or exchange their properties and roll their investment into new properties with significant upside potential. However, the Trumpets have studied the Central Florida real estate market carefully and have concluded that the location and natural amenities of the Taj Mahal Grove, together with the westward expansion of the Greater Orlando urban sprawl, all point to the conclusion that a well planned mixed use development on their property could be immensely profitable. They have, therefore, decided to examine all of their options with respect to the Taj Mahal Grove.

The Trumpets recently commenced discussion with Trammel Crowbar, whose corporation, Crowbar Development Co. (Developer), is one of the nation's largest developers of both residential and commercial properties. The Trumpets believe that Developer is an ideal candidate to either acquire the Taj Mahal Grove or to enter into a joint venture to develop the property. Crowbar became aware of the Trumpets' property after receiving a mailing from the Trumpets' trusted secretary, Sugar Maples. After investigation of the property, Developer has concluded that it will be a premiere site for an upscale mixed use development project. Mr. Crowbar informed the Trumpets that he is willing to discuss an outright purchase of the Taj Mahal Grove, a like kind exchange, a joint venture arrangement or any other approach that will meet the Trumpets' reasonable tax and business objectives.

B. Financial and tax data. The Trumpets acquired the Taj Mahal Grove in three separate transactions. The first parcel, consisting of 1,000 acres (First Parcel) was acquired in 1985 for $1,000 per acre or a total purchase price of $1,000,000. The Trumpets acquired the First Parcel with funds inherited from Donald's uncle. The second purchase was made in 1986 and consisted of 1,500 acres (Second Parcel) which the Trumpets purchased for $4,000 per acre or a total purchase price of $6,000,000. The total purchase price of $6,000,000 was properly allocated $1,000,000 to the citrus trees located on the property with the balance ($5,000,000) allocable to the land. The Second Parcel was financed equally with equity capital of the Trumpets and purchase money financing. However, in order to raise cash needed for another investment the Trumpets refinanced the Second Parcel in early 2000 which resulted in a new mortgage (replacing the prior purchase money mortgage) of $6,000,000 bearing interest at 8% which now encumbers only the Second Parcel. The final purchase was a smaller 500 acre tract (Third Parcel) acquired in the latter part of 1996 in order to gain more road and lake frontage and to otherwise square off the Trumpets' property and make the overall tract more marketable. This property was acquired at $8,000 per acre and was

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financed by $1,000,000 of the Trumpets' own funds plus a purchase money mortgage in the amount of $3,000,000 which also bears interest at 8%, all of which remains outstanding.

The citrus trees, which are located on the Second Parcel, have been fully written off for federal income tax purposes through a combination of depreciation and casualty loss (from the 1989 freeze) deductions. Thus, the adjusted tax basis of Second Parcel has been reduced to $5,000,000. The current fair market values, tax bases, and mortgage balances of the three parcels are as follows:

<table>
<thead>
<tr>
<th>Parcel</th>
<th>Fair Market</th>
<th>Adjusted Tax Basis</th>
<th>Mortgage Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Parcel</td>
<td>$10,000,000</td>
<td>$1,000,000</td>
<td>$0</td>
</tr>
<tr>
<td>Second Parcel</td>
<td>$15,000,000</td>
<td>$5,000,000</td>
<td>$6,000,000</td>
</tr>
<tr>
<td>Third Parcel</td>
<td>$5,000,000</td>
<td>$4,000,000</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$30,000,000</td>
<td>$10,000,000</td>
<td>$9,000,000</td>
</tr>
</tbody>
</table>

The Trumpets are cash basis taxpayers who operate on a calendar year for federal income tax purposes. Florida does not impose an income tax on individuals and state income taxes will, therefore, be ignored.

C. Plans for development. Developers' engineers and land planners have proposed a preliminary development plan for the Taj Mahal Grove which calls for a multi-use project to be developed and sold in phases with a projected sell-out over a period of eight to ten years. The plan includes an office park, a shopping center, a residential community consisting of half-acre and one-acre residential lots together with clusters of townhomes. The planned amenities include two championship golf courses, a tennis center, a park and a marina located on the largest lake which will be designed for sailboats and houseboats.

II. Sale of Property -- Alternative Proposals. Crowbar has received and reviewed all of the preliminary reports from Developer's planners, including pro forma projections on various alternatives for development of the Taj Mahal Grove. He has also consulted Developer's tax attorneys and CPAs to assist in structuring several alternative proposals for the purchase of the property that will meet both Developer's cash flow requirements and the tax and economic objectives of the Trumpets as well. Each of Developer's proposals will be described and analyzed below.

A. Installment sale with assumption of existing mortgages.

1. Description of proposal. The first proposal contemplates a purchase of the entire Taj Mahal Grove by Developer from the Trumpets for $30,000,000, payable as follows:
<table>
<thead>
<tr>
<th>Amount</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>$5,000,000</td>
<td>Down payment at closing (includes $1,000,000 deposit)</td>
</tr>
<tr>
<td>9,000,000</td>
<td>Assumption of existing mortgages</td>
</tr>
<tr>
<td>16,000,000</td>
<td>Purchase money note and mortgage</td>
</tr>
<tr>
<td>30,000,000</td>
<td></td>
</tr>
</tbody>
</table>

The purchase money note calls for payments of interest only at 10% per annum, payable annually for two years. Thereafter, principal will be paid in annual installments of $1,000,000 per year plus interest accrued on the outstanding principal balance for a period of five years, and with a balloon payment due on the 8th anniversary of the closing. In addition, the mortgage will contain provisions for the release of commercial lots, residential lots, and townhome sites at set prices determined by the size and location of each lot, and such prices are to be revised annually after the third anniversary of the closing date for increases in the Consumer Price Index. Developer intends to seek a modification of the existing mortgages to also accommodate releases and subordination, but if it is unsuccessful in obtaining such a modification, Developer has the right to refinance both mortgages in which case the Trumpets will be required to subordinate their purchase money note and mortgage to such refinanced debt. Lands earmarked in Developer’s development plans (the Land Plan) for the entryway, streets, medians and amenities (golf courses, tennis courts, parks, etc.) may be released from the mortgage upon payment of $1,000 per acre and upon Developer’s posting of a payment and performance bond assuring construction of these improvements in accordance with the Land Plan. The Land Plan is subject to the Trumpets’ prior approval. The purchase money note and mortgage also require the Trumpets to subordinate to a development loan, the proceeds of which will be utilized to develop the Taj Mahal Grove in accordance with the Land Plan.

2. Character of income. Gains from sales or exchanges by non-corporate taxpayers such as the Trumpets of capital assets held for more than one year as well as certain net §1231 gains are now taxed at a maximum rate of 20% (a maximum rate of 10% will apply for taxpayers in the 15% tax bracket, §1(h)). However, gains from the sale of depreciable real property will be taxed at a maximum rate of 25% to the extent of unrecaptured §1250 gains. By contrast, the maximum rate imposed on the ordinary income of a non-corporate taxpayer is 39.6%. In the case of individuals, the effective rate applicable to ordinary income can be increased by an
additional 1.188% under §68 by limiting the use of itemized deductions and by an additional 0.67% under §151(d)(3) by phasing out the personal and dependent exemptions. When these are combined, the maximum effective rate on ordinary income for individual taxpayers can be as high as 41.458%. Thus, there is a potential deferral of as high as 21.458% between the maximum long term capital gain rates and the ordinary rates of individual taxpayers.

a. The portion of the Trumpets' property that has been operated as an orange grove may be classified as a §1231 asset pursuant to §1231(b), but the abandonment of all grove operations in December 1989, and the subsequent decision of the Trumpets to hold the property for future appreciation will probably be deemed to have converted the property from a trade or business property to a capital asset held as a long term investment. See, §1221.

b. The balance of the property will qualify as a capital asset under §1221 because the Trumpets have held the property as a long term investment, have never developed it and have not otherwise engaged in any dealer activities with respect to the land.

(1) The passive ground lease of the remainder of the property to ranchers as pasture will probably not be sufficient to characterize this portion of the property as §1231 property under §1231(b).

c. It is possible that a small portion of the Trumpets' gain will be converted from long term capital gains to ordinary income. Citrus trees are §1245 properties as defined in Reg. §1.1245-3(b)(1). The lesser of the recomputed basis of the trees or the gain attributable to the trees will be recharacterized as ordinary income under §1245(a). However, since the trees were all either killed or severely damaged by the freeze, and since Developer intends to remove all of them in the course of developing the property, the parties may properly allocate zero or minimal value to the trees which will eliminate (or virtually eliminate) any §1245 recapture. Note: the allocation rules of §1060 will not apply to this sale because there has been no sale of assets which constitute a trade or business. See, §§1060(a) and (c).
Caveat also possible application of §1231(c) which provides for the recapture of certain prior §1231 loss deductions taken during the five most recent preceding taxable years upon disposition of a §1231 asset.

d. Classification of the Trumpets as investors rather than dealers with respect to the Taj Mahal Grove is also very important in an installment sale. Gains from the sale of most dealer properties are no longer eligible for installment reporting. See, §§453(b)(2)(A) and 453(1).

3. Installment reporting -- Eligibility and Basic Computations. The Trumpets will be eligible to report their gains from the sale of their property under Developer's first proposed alternative on the installment basis.

a. Under the installment reporting method, a portion of each payment received by the Trumpets must be reported as income. The portion to be recognized as income is determined by multiplying the amount of payment by a fraction, the numerator of which is the gross profit, and the denominator is the total contract price (i.e., the gross profit percentage). Temp. Reg. §15A.453-1(b)(2)(1).

(1) **Gross profit** is the selling price less the Trumpets' adjusted basis in the property. Temp. Reg. §15A.453-1(b)(2)(v).

(2) **Total contract price** is the selling price less qualifying indebtedness assumed or taken subject to by the buyer to the extent that such qualifying indebtedness does not exceed the Trumpets' basis. Temp. Reg. §15A.453-1(b)(2)(iii). Qualifying indebtedness generally means debt encumbering the property, subject to certain limitations. See, Temp. Reg. §15A.453-1(b)(2)(iv).

b. Installment reporting is mandatory unless the Trumpets elect out under §453(d) by filing I.R.S. Form 6252 with a timely filed return (including extensions) for the taxable year in which the closing takes place. Temp. Reg. §15A.453-1(d)(3)(i). The election, once made, may not be revoked without the consent of the I.R.S. §453(d).
c. If the Trumpets have any §1245 recapture, the entire amount of the recapture income must be recognized in the taxable year in which the closing occurs, regardless of the amount of payments received in such year. §453(i).

d. If the 10% interest rate provided in the purchase money note is less than the applicable federal rate, a portion of the payments due under the note will be treated as original issue discount (OID), and both the timing and the amount of income to be reported by reason thereof will be governed by §§1272 through 1275.

(1) The limited relief from the general rules of §1274 which is afforded under §1274A would not be available (if needed) to the Trumpets because the stated principal amount of the purchase money note exceeds both the $2,800,000 threshold for §1274A(b) and the $2,000,000 requirement of §1274A(c).

e. The computation of the amount of gain to be recognized by the Trumpets in the year of sale under §453 (assuming no §1245 recapture, no OID and ignoring selling expenses) is as follows:

<table>
<thead>
<tr>
<th>Gross Profit</th>
<th>Selling Price</th>
<th>Adjusted Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>$30,000,000</td>
<td>$20,000,000</td>
<td></td>
</tr>
</tbody>
</table>

Total Contract Price:

<table>
<thead>
<tr>
<th>Selling Price</th>
<th>Qualified Debt Assumed</th>
</tr>
</thead>
<tbody>
<tr>
<td>$30,000,000</td>
<td>$21,000,000</td>
</tr>
</tbody>
</table>

Gross Profit Percentage:

\[
\frac{\$20,000,000}{\$21,000,000} = 95.24\%
\]

Gain to be Recognized in Year of Closing:

\[
\$5,000,000 \times 95.24\% = \$4,762,000
\]

f. If qualifying debt assumed or taken subject to exceeds the Trumpets' basis, such excess will be treated as an additional payment to the Trumpets at closing. Temp. Reg. §15A.453-1(b)(3)(i). If the sales of the First, Second, and Third Parcels are aggregated
and deemed to constitute the sale of a single property, the mortgage balance ($9,000,000) will not exceed the Trumpets' basis ($10,000,000). On the other hand, if each parcel is viewed as a separate sale, the mortgage balance on the Second Parcel ($6,000,000) exceeds the adjusted basis of such parcel ($5,000,000) which could result in an additional payment of $1,000,000 in the year of sale. Although the law on this issue is not crystal clear, it appears likely that the Trumpets will be able to aggregate the parcels into a single sale because the parcels are contiguous, they were offered as a unit, the contract and all closing documents treat them as a single unit, and they are also similar real properties. Compare, Veenkant v. Commissioner, 416 F.2d 93 (6th Cir. 1969); with Charles A. Collins, 48 T.C. 45 (1967), acq. 1967-2 C.B. 2; Richard H. Prichettt, 63 T.C. 149 (1974), acq. 1975-2 C.B. 2; and Rev. Rul. 76-110, 1976-1 C.B. 126.

4. Toll charge for privilege of using installment method. Section 453A(a)(1) imposes a toll charge in the form of interest on certain installment obligations arising during the taxable year.

a. The interest charge imposed under §453A(a)(1) applies to an installment obligation (ISO) arising from a sale of property, but only if the selling price of the property exceeds $150,000. §453A(b)(1). Since the sale of the Trumpets' property under this first proposed alternative is $30,000,000, this condition is met.

(1) ISOs from the sale by an individual taxpayer of personal use property (as defined in §1275(b)(3)) and ISOs of any taxpayer arising from the sale of property used or produced in the trade or business of farming (within the meaning of §2032A(e)(4) or (5)) are not subject to the interest toll charge provisions. See, §453A(b)(3). Although the Second Parcel would previously have qualified as property used in the business of farming, the abandonment of all grove activity at the end of 1989 would preclude the Trumpets from benefiting from this exception. Moreover, the passive ground lease of the balance of the land to farmers for a nominal price will likewise not qualify.
b. In addition, even if an ISO arises from the sale of property with a selling price in excess of $150,000, the interest toll charge will not apply to any such ISOs which are received by the Trumpets during 2001 (the taxable year in which the closing on the Taj Mahal Grove would take place) unless the face amount of all such ISOs which first arose in 2001 and which are still outstanding on December 31, 2001, exceeds $5,000,000. §453A(b)(2). Even if the ISO from the sale of the Taj Mahal Grove is the only ISO of the Trumpets which arose in 2001, this second test will also be met because the ISO will have a face amount of $16,000,000 (i.e., well in excess of the $5,000,000 threshold).

c. If an ISO once becomes subject to the interest toll charge imposed by §453A(a)(1), the charge will apply every year until the ISO is either fully paid or is otherwise disposed of. See, §453A(c)(1). Thus, the Trumpets must pay interest on the Taj Mahal Grove ISO in 2001 and in every year thereafter until it is paid off or disposed of.

d. The method for computing the interest charge with regard to the Taj Mahal ISO is set forth in §453A(c). The interest computation can be expressed as a formula as follows:

\[
\text{Applicable Percentage} \times \text{Deferred Tax Liability} \times \text{§6621(a) (2) Underpayment Rate} = \text{Interest}
\]

(1) The \text{Applicable Percentage} for the Taj Mahal ISO will be determined as of December 31, 2001 (the year in which the ISO arose) and will remain constant throughout the entire period that it is held by the Trumpets. The Applicable Percentage is determined by dividing the excess of the aggregate face amount of all ISOs which arose during 2001 and which are subject to §453A(b)(2) over $5,000,000, by the aggregate face amount of all such ISOs. §453A(c)(4). Thus, the \text{Applicable Percentage} for the Taj Mahal ISO would be computed as follows:

\[
\frac{($16,000,000 - $5,000,000)}{16,000,000} = 68.75\%
\]

(2) The \text{Deferred Tax Liability} with respect to the Taj Mahal ISO at the end of any taxable year will be
equal to the amount of gain inherent in the ISO which has not yet been recognized as of the last day of such taxable year, multiplied by the maximum rate of tax applicable to individual taxpayers for such taxable year.

§453A(c)(3). Note that, if the gain is treated as long term capital gains, the maximum rate will be the maximum rate under §1(h) (currently 20%). The Deferred Tax Liability of the Trumpets with respect to the Taj Mahal ISO as of December 31, 2001 (assuming no rate changes between now and such date) will be computed as follows:

\[
\begin{align*}
\text{Unrecognized Gain as of 12/31/01 in Taj Mahal ISO} & \times 0.20 \\
\text{Deferred Tax Liability as of 12/31/01} & = \$3,047,600
\end{align*}
\]

The amount of unrecognized gain in the Taj Mahal ISO is computed by multiplying the outstanding unpaid balance of the ISO ($16,000,000) by the gross profit percentage (95.24%).

Since the amount of the unrecognized gain with respect to the Taj Mahal ISO will change each time a payment of principal is made, and individual tax rates are also subject to change at the whim of Congress, the Deferred Tax Liability is subject to change every year (in contrast to the Applicable Percentage which is always a constant).

(3) The underpayment rate under §6621(a)(2) will be determined as of the last month of each taxable year in which the interest calculation is made. It will be assumed for purposes of this outline that the underpayment rate is 10%.

(4) In summary, if the Trumpets sold the Taj Mahal Grove to Developer under this first alternative, the interest toll charge computed under §453A(c) with respect to the Taj Mahal ISO for 2001 would be as follows:

\[
68.75\% \text{ (Applicable Percentage)} \times \frac{\$3,047,600}{\text{Deferred Tax Liability}}
\]
(a) It should also be noted that a full year's interest will be charged for each and every year to which the interest toll charge applies. Thus, if the Trumpets closed on the sale of the Taj Mahal Grove on December 1, 2001, they would still be required to pay a full year's interest for 2001 even though the deferred gain will have only been outstanding for a period of one month during that year. Consequently, the Trumpets should attempt to defer the closing until January if at all possible and avoid this substantial interest charge for 2001.

(5) Section 453A(c)(1) provides that if the toll charge under §453A(a)(1) applies, the tax imposed by this chapter for such taxable year shall be increased by the amount of interest computed under §453A(c). Although this raises a question as to the nature of the charge (i.e. whether it is a tax or interest), §453A(c)(5), which was added by the Revenue Reconciliation Act of 1989 (the '89 Act), now clearly provides that such amount will be treated as interest for purposes of testing for deductibility under §163. Congress presumably referred to the interest charge as an increase to the seller's tax in order to enable the IRS to assess and collect the interest in the same manner as a tax deficiency. Thus, the interest toll charge imposed upon the Trumpets for 2001 will be nondeductible personal interest under §163(h). Reg. §1.163-9T(b)(2); Miller v. United States, 65 F3d 687 (8th Cir.1995); and J.E. Redlark v. Commissioner, 98-1 USTC 450,322 (9th Cir. 1998), reversing the Tax Court.

5. Application of pledge rules. Section 453A, which was first enacted as part of the Omnibus Budget Reconciliation Act of 1987 (OBRA) not only imposed an interest toll charge, but also subjected any ISOs arising from sales with a selling price in excess of $150,000 to the new pledge rules found in §453A(d). Thus, if the Trumpets pledge the
Taj Mahal ISO to secure indebtedness of any kind, the net proceeds from such secured indebtedness will be treated as a payment received on the ISO as of the later of (i) the time at which the indebtedness first becomes secured, or (ii) the time the proceeds of such secured indebtedness are first received by the Trumpets. §453A(d)(1). However, the amount treated as received under the pledging rules by reason of any secured indebtedness cannot exceed the excess (if any) of the total contract price under the ISO over any portion of the total contract price previously received under the contract before the secured indebtedness was incurred (including amounts previously treated as received under the pledge rules). §453A(d)(2).

B. Installment sale with wraparound mortgage.

1. Description of proposal. Developer's second proposal to acquire the property is identical to the first except that, in lieu of assuming the existing $9,000,000 of mortgages securing the property and giving a purchase money note and mortgage for $16,000,000, Developer will give the Trumpets a single purchase money mortgage in the amount of $25,000,000, bearing interest at 10% per annum which will wrap around the two original mortgages encumbering the second and third parcels (the Original Mortgages). The mortgage is called a wraparound mortgage because the Trumpets will continue to be responsible for the Original Mortgages, including the payment of all principal and interest due thereunder. The wraparound mortgage will contain the same terms and conditions (except with respect to the principal amount and the interest rate) as the purchase money note and mortgage described in the first proposal but, as a condition to this proposal, the Trumpets must obtain a modification of the Original Mortgages to include release provisions that will work in tandem with the release provisions of the wraparound mortgage. Note that the Trumpets should (if possible) negotiate release prices under the Original Mortgages lower than the release prices under the wraparound mortgage to insure that they will receive sufficient cash to both secure the release of the applicable portion of the property from the Original Mortgages and to have enough cash left to cover their tax liability on the payment received by them under the wraparound mortgage.

2. General considerations.

a. From a nontax perspective, the wraparound purchase money mortgage provides the Trumpets the opportunity to continue to benefit from the favorable
terms of the Original Mortgages including the 8% interest rate (thereby
enjoying the benefit of the spread between the 10% interest rate paid by
Developer under the wraparound mortgage versus the 8% rate the Trumpets must pay
on the Original Mortgages).

b. The principal tax issue is whether Developer will be deemed to have
acquired the property subject to the $9,000,000 balance of the Original
Mortgages. The consequences stemming from the resolution of this issue are
significant to the Trumpets.

(1) If the property is determined to have been conveyed subject to the
Original Mortgages, the Trumpets may be deemed to have received an
additional payment in the year of sale equal to the excess of the
$6,000,000 principal balance on the Original Mortgage encumbering the
Second Parcel over the adjusted basis in the Second Parcel of
$5,000,000, or $1,000,000. See Temp. Reg. §15A.453-1(b)(3)(i); see also, discussion of the issue
of whether the First, Second and Third Parcels can be aggregated and
handled as a sale of a single property under Part II.A.3.(f), supra. In addition, the gross
profit percentage the Trumpets must apply to the payments received in
the year of sale will be increased.

§15A.453-1(b)(3)(ii) provided that
any conveyance of property which is
encumbered by a prior liability
that is purportedly wrapped around
by a new purchase money
mortgage, will be deemed to have
been conveyed subject to the
existing debt.

requires the computation of a gross
profit percentage which is to be
applied to payments in the year of
sale (computed in the normal
fashion) and a separate gross
profit percentage for the
wraparound note and mortgage. The
calculations called for under the
Regulations are as follows
(assuming that there will be no
additional payment in the year of
sale because of a mortgage in
excess of basis and assuming no
prepayments for releases):

- 13 -
Selling Price $30,000,000

Contract Price

\[
\begin{align*}
\text{Selling Price} & \quad 30,000,000 \\
\text{Contract Price} & \quad 30,000,000 \\
\text{Gross Profit} & \quad 10,000,000 \\
\text{Gross Profit Percentage} & \quad 20,000,000 \quad = \quad 95.24% \\
\end{align*}
\]

Taxable Gain in Year of Sale

\[
\begin{align*}
\text{Payment} & \quad 5,000,000 \\
\text{Gross Profit Percentage} & \quad x \quad 0.9524 \\
\text{Calculations with respect to the wraparound note and mortgage are as follows:} \\
\text{Basis in Wrap Note:} & \quad 10,000,000 \\
\text{Gross Profit in Wrap Note} & \quad 25,000,000 \\
\text{Gross Profit Percentage for Wrap Note} & \quad 15,238,000 \quad = \quad 60.95% \\
\end{align*}
\]

The Trumpets' contention is that the Original Mortgages were neither assumed nor taken subject to. Under this approach the computations would be as follows (with the same assumptions as noted above):

\[
\begin{align*}
\text{Selling Price} & \quad 30,000,000 \\
\text{Contract Price} & \quad 30,000,000 \quad \text{(no reduction for Original Mortgages)} \\
\text{Gross Profit} & \quad 10,000,000 \\
\text{Gross Profit Percentage} & \quad 20,000,000 \quad = \quad 66.67% \\
\text{Taxable Gain in Year of Sale} & \quad 5,000,000 \\
\end{align*}
\]
Comparison of timing of recognition of gain:

<table>
<thead>
<tr>
<th>Year</th>
<th>IRS Approach</th>
<th>Taxpayer's Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$4,762,000</td>
<td>$3,333,500</td>
</tr>
<tr>
<td>2</td>
<td>-0-</td>
<td>666,700</td>
</tr>
<tr>
<td>3</td>
<td>609,500</td>
<td>666,700</td>
</tr>
<tr>
<td>4</td>
<td>609,500</td>
<td>666,700</td>
</tr>
<tr>
<td>5</td>
<td>609,500</td>
<td>666,700</td>
</tr>
<tr>
<td>6</td>
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<td>666,700</td>
</tr>
<tr>
<td>7</td>
<td>609,500</td>
<td>666,700</td>
</tr>
<tr>
<td>8</td>
<td>12,190,500</td>
<td>13,333,000</td>
</tr>
</tbody>
</table>

$20,000,000 $20,000,000

The interest toll charge levied under §453A(a)(1) (see, discussion under Part II.A.4., supra) will also apply to the wraparound note. As previously noted, the interest toll charge is applied to the deferred tax liability (the amount of unrecognized gain inherent in the note as of the end of a particular taxable year). If the wraparound mortgage is respected for federal tax purposes, the amount of deferred tax liability will be greater (especially in the early years) than in the case of a conventional purchase money note coupled with an assumption of the Original Mortgages. This will always be true because the use of a wraparound mortgage defers recognition of gain longer than in the case of a conventional assumption. Thus, §453A dilutes the tax benefits associated with deferral that are otherwise available when a wraparound mortgage is used.

3. Status of the law with respect to wraparound mortgages. The tax treatment of wraparound mortgages has, until recently, been an unsettled issue.


b. Later cases involving purported wraparound mortgages held for IRS, but in each instance the Court dodged the
principal issue and held that, on the facts before it, the purchaser had actually assumed or taken subject to the pre-existing mortgage. See, Voight v. Commissioner, 68 T.C. 99 (1977), aff'd per curiam, 614 F.2d 94 (5th Cir. 1980); Waldrep v. Commissioner, 52 T.C. 640 (1969), aff'd per curiam, 428 F.2d 1216 (5th Cir. 1970); and Goodman v. Commissioner, 74 T.C. 684 (1980).

c. After passage of the Installment Sales Revision Act of 1980 (the Installment Sales Act), a substantial portion of the installment reporting rules was changed. The Service took advantage of this situation and included the anti-wraparound mortgage provision found in Temp. Reg. §15A.453-1 discussed supra. However, the Service's position in this regard is questionable since the installment sale provisions added by the Installment Sales Act did not alter the rules regarding the computation of gross profit percentage. The Service's proposed regulation, as it applies to wraparound mortgages, was criticized on several grounds including the following:

(1) It utilizes two separate gross profit percentages which seems to be taking great liberties with the language in the statute.

(2) There is an ambiguity in the Service's definition of qualifying indebtedness which may cause problems for real estate developers who refinance a construction loan with a permanent, take out loan.

(3) The definition of wrapped indebtedness in the regulation is not clear.

(4) In Hunt v. Commissioner, 80 T.C. 1126 (1983), the Tax Court for the first time dealt with a pure wraparound mortgage (which did not involve a de facto assumption or taking subject to as in Voight and Goodman) and held for the taxpayer. The court held that the Stonecrest line of cases, which involved conditional sales, also applies to wraparound mortgages. The facts of Hunt pre-date the Installment Sales Act and the court specifically reserved judgment on what impact, if any, the Service's Temporary Regulation would have on its decision if it were presented similar facts arising after 1980.
In *Professional Equities Corporation v. Commissioner*, 89 T.C. 165 (1987), the Tax Court held that Temp. Reg. §15A.453-1(b)(2)(ii) was invalid and was inconsistent with the Stonecrest line of cases. The Commissioner subsequently announced acquiescence in the *Professional Equities* decision. 1988-2 C.B. 1. However, it is important to note that the court was not required to specifically address the issue of mortgage in excess of basis. In dicta contained in footnote 17 of its opinion, the court stated that it seemed reasonable to treat mortgage in excess of basis as a payment in the year of sale. This comment appears inconsistent with the Stonecrest line of cases and this issue must be listed as unresolved until a later court is required to deal with it.


C. Installment sales with participation feature.

1. Description of proposal. A third alternative proposed by Developer provides for the purchase of the Taj Mahal Grove for $25,000,000 plus 10% of the sales price, net of sales commissions and other selling expenses, derived from all sales of lots or parcels from the property for a period of ten years after closing (referred to as an 'Equity Kicker'). However, the aggregate payments under the Equity Kicker feature are not to exceed $15,000,000. The $25,000,000 fixed portion of the sales price is payable as follows:

<table>
<thead>
<tr>
<th>Amount</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>$5,000,000</td>
<td>Down payment</td>
</tr>
<tr>
<td>9,000,000</td>
<td>Assumption of original mortgages</td>
</tr>
<tr>
<td>11,000,000</td>
<td>Purchase money note and mortgage</td>
</tr>
<tr>
<td>$25,000,000</td>
<td></td>
</tr>
</tbody>
</table>

The purchase money note and mortgage will contain the same terms and conditions as under the first proposal except that the terms of the Equity Kicker will also be incorporated into the note, and interest will be payable solely with respect to the $11,000,000 principal amount and not on the Equity Kicker.

2. Planning with regard to equity participation features. Property owners, such as the
Trumpets, who sell land to developers are frequently torn between the desire to engage in an outright sale of their property or to enter into a joint venture with the developer to develop and sell the property and obtain a greater return. In an attempt to obtain the best of both worlds, some sellers attempt to sell their properties for a fixed price coupled with a participation feature equal to a fixed or variable percentage of the proceeds derived by the developer from resale of the land. There are a number of variations of this approach. For example, the participation interest furnished to the Trumpets might have been payable from net profits (rather than from net sales proceeds); it might have been subject to a greater or lesser ceiling than $15,000,000 (or, alternatively, to no ceiling at all); and the participation might have phased out over a greater or lesser period of years than ten. The objective of the seller in each of these instances is to lock in a guaranteed minimum selling price for his land while at the same time participating in the upside potential from subsequent development of the property.

3. Tax issues. Equity participation sales give rise to a number of tax issues including the following:

a. Sale versus partnership (or, alternatively, part sale/part partnership).

b. If the transaction is recognized as a sale for tax purposes, will installment reporting be available for the contingent portion of the purchase price?

c. If installment reporting is available, how do the original issue discount (OID) rules of §§1272-1275 apply to the contingent payments (which, in our example, are non-interest bearing)?

d. If installment reporting is available, how does the interest toll charge of §453A(a)(1) apply to the contingent portion of the sales price?

4. Application of installment reporting rules to contingent price sales. If the sale by the Trumpets for $25,000,000 plus an Equity Kicker is recognized as a sale for federal income tax purposes, the application of the installment reporting rules of §453 to the contingent portion of the purchase price is governed by a special set of rules.

a. Prior to Installment Sales Act, if a purchase price was contingent,
installment sale reporting was not available but the seller was entitled to recover basis against the first proceeds received. Gralapp v. Commissioner, 458 F.2d 1158 (10th Cir. 1972); In Re Steen, 509 F.2d 1398 (9th Cir. 1975). The determination of whether the selling price was contingent was to be made as of the end of the taxable year in which the closing took place. See, Rev. Rul. 76-109, 1976-1 C.B. 125.

b. The Installment Sales Act added §453(j) to the Code which instructs the Treasury to issue new regulations which, among other things, shall include regulations providing for ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot be readily ascertained. §453(j)(2).

(1) This determination is to be made at the end of the taxable year of closing. Temp. Reg. §15A.453-1(c)(1).

(2) If the contract is deemed to have a maximum stated selling price, the selling price for purposes of §453 will be deemed to be the maximum price payable if all contingencies are met. If the price ultimately payable is less than this amount, the gross profit ratio will be recomputed. Temp. Reg. §15A.453-1(c)(2)(i)(A).

(3) If the selling price is not determinable at the end of the taxable year of closing (i.e., no maximum stated selling price) but the maximum period over which payments may be received is determinable, the seller's basis (inclusive of selling expenses) must be prorated evenly over the maximum pay-out period. Temp. Reg. §15A.453-1(c)(3)(i). If the payment in any taxable year is less than the basis allocable for that year (or if no payments are made in such year), no loss will be allowed unless such year is the final year of payment, and the basis allocable to such year will be carried forward to the next succeeding taxable year. Id.

(4) If there is neither a maximum stated selling price nor a fixed pay-out period, and if the transaction qualifies as a sale for
tax purposes, the seller's basis will be recovered in equal annual increments over a period of 15 years, commencing with the taxable year in which the closing takes place. Temp. Reg. §15A.453-1(c)(4). If no payment is received in a year, or if the payments received are less than the basis allocable to such year, no loss will be allowed (unless the remaining debt is determined to be worthless), but basis will be carried over to the next succeeding year.

(5) In each of these three instances provision is made for alternative treatment if the seller can establish to the satisfaction of the Commissioner that the general rules would substantially and inappropriately defer recovery of the seller's basis. See, Temp. Reg. §15A.453-1(c)(7).

5. Although interest is payable regularly at a rate which exceeds the applicable federal rate with respect to the $11,000,000 fixed principal amount of the purchase money note, the absence of an interest payment obligation applicable to the Equity Kicker will result in original issue discount (OID). See, generally, §§1272 through 1275. Since the purchase money note is issued for non-publicly traded property (i.e., the Taj Mahal Grove), the rules of Reg. §1.1275-4(c) will apply. Under these rules, the non-contingent payments (i.e., the obligation for payment of $11,000,000 of principal and interest thereon at 10% per annum, payable annually) will be separated from the contingent payments (i.e., the Equity Kicker) and the purchase money note will be treated as two separate debt instruments for purposes of applying the OID rules. Reg. §1.1275-4(c)(3).

a. The debt instrument representing the non-contingent portion of the payments will not be deemed to have OID because the stated redemption price at maturity ($11,000,000) does not exceed the issue price ($11,000,000 -- see, §1273(a).

b. The rules governing the contingent payments due under the note are found in Reg. §§1.1275-4(c)(3) and (4). Under this section, the portion of each payment due under the Equity Kicker that is treated as interest will be includible in the income of the Trumpets, and will be treated as a payment of interest by Developer, in
their respective taxable years when the amount of the payment becomes fixed. Reg. §1.1275-4(c)(4)(i).

(1) Each payment under the Equity Kicker will be treated as consisting of: (i) a payment of principal in an amount equal to the present value of the payment, determined by discounting such payment at the applicable federal rate (determined as of the issue date) from the date the payment becomes fixed to the issue date of the note, and (ii) the payment of interest in an amount equal to the excess of the total amount of such payment over the amount treated as principal under (i) above.

6. Section 453A(a)(1) will impose an interest toll charge upon the deferred tax liability inherent in the purchase money note and mortgage (see, discussion under Part II.A.4., supra). Will the toll charge be levied not only with respect to the deferred gain on the fixed price portion of the note but also the Equity Kicker? If so, will the Deferred Tax Liability be based upon the maximum stated sales price? Cf. Temp. Reg. §15A.453-1(c)(2)(i)(A). If the regulations ultimately take this approach, will the Trumpets be able to recoup part of the interest payable with respect to the Equity Kicker if they ultimately receive less than the maximum amount due under the Equity Kicker? Alternatively, will a cumulative toll charge be levied as payments under the Equity Kicker become fixed and determinable?

D. Rolling options.

1. Description of proposal. Developer's fourth alternative proposal is designed to enable Developer to acquire the Taj Mahal Grove in a series of four rolling options. Under this approach, most of the Taj Mahal Grove will be divided into four separate parcels which will be designated as Option Parcels 1 through 4. The balance of the property will be earmarked for development into the golf courses, tennis center, marina and park, entryway and the principal access roads that will service the entire property (the Amenities Properties).

Developer will initially pay the Trumpets $1,000,000 as consideration for an option to purchase Option Parcel 1 and the Amenities Properties for a total purchase price of $8,000,000, which option will remain open for a period of 18 months. The 18-month period is designed to enable Developer to pursue and obtain all necessary permits and approvals from federal, state and local governmental
agencies to develop the property. If the option is exercised, the $1,000,000 option monies will be applied against the purchase price for Option Parcel 1 and the Amenities Properties. If the option lapses, the monies will be forfeited. The purchase prices for Option Parcels 2 through 4 will also be agreed upon in advance as well as the time and sequence in which such options will be exercisable. The prices will be negotiated and will take into account the fact that the Trumpets must hold these properties off the market during the applicable option periods and that the properties will appreciate in value both because of inflation and due to development of the contiguous properties.

At the time of exercise of Option Parcels 1 through 3, Developer will also be required to pay an additional $1,000,000 to the Trumpets as consideration for their remaining options, which monies will also apply against the purchase prices of such parcels if exercised or will be forfeited if the options are allowed to lapse. Once an option is exercised, the purchase price for such option parcel will be payable in cash at closing.

This proposal provides Developer with downside protection since it has the ability to walk away from the project at any point in time before fully exercising all of its options and thereby limit its costs to the properties previously purchased plus any forfeitable option monies paid for future options. Developer has also been advised by its accountants that any costs associated with future options (i.e., options that have not yet been exercised) need not be reflected as debts on its balance sheet since there is no obligation for Developer to pay these amounts until the options are exercised.

Although the Trumpets are called upon to assume an additional degree of economic risk under this proposal, there are several aspects of the offer which appeal to them. First, the total purchase price for the Taj Mahal Grove (consisting of the aggregate prices for Option Parcels 1 through 4 together with the Amenities Properties) is significantly higher. Under the terms of Developer's offer, the Trumpets will be given the right to approve all preliminary and final land plans as well as overall development plans since these plans will impact the value of their remaining properties if one or more of the options are not exercised. Further, even if Developer allows one or more options to lapse, presumably the value of any property that the Trumpets will be left with will be enhanced in value by reason of the development of the contiguous properties. Finally, there are
some significant tax advantages to the Trumpets inherent in this proposal which will be discussed below.

2. Tax consequences of proposal.

a. Option monies. Despite the fact that the Trumpets will have unrestricted use of the $1,000,000 of option monies from the point in time that they receive them, they will not be taxed on these amounts until the options to which they relate are either exercised or lapse. See, Virginia Iron, Coal & Coke Co. v. Commissioner, 37 BTA 195 (1938), aff'd., 99 F.2d 919 (4th Cir. 1938), cert. denied, 307 U.S. 630; Kitchin v. Commissioner, 340 F.2d 895 (4th Cir. 1965); Koch v. Commissioner, 67 T.C. 71 (1976); Hicks v. Commissioner, 37 T.C.M. 1540 (1978); and Old Harbor Native Corporation v. Commissioner, 104 T.C. 191 (1995). The reason behind these rulings is that the taxability of the payments cannot be determined until the options either lapse or are exercised.

(1) If an option is exercised and the option monies are applied against the purchase price, the monies will be treated as having been received in a sale or exchange of the option properties. §1234(a)(1); Reg. §1.1234-1(a). Even if the option monies are not applied against the purchase price, the Tax Court in Koch v. Commissioner, 67 T.C. 71 (1976) held that the same rule applies.

(2) If the option lapses, the option monies must be reported by the optionor (the Trumpets) in its taxable year in which the lapse occurred. Prior to September 4, 1997 such amounts were treated as ordinary income. Reg. §1.1234-1(b); Rev. Rul. 57-40, 1957-1 C.B. 266. However, §1234A, which was added to the Code by the Taxpayer Relief Act of 1997 (TRA '97) now provides that any gain arising from a lapse or other termination of a right with respect to property which is a capital asset in the hands of the taxpayer will be treated as gain from the sale of a capital asset. An option will presumably be treated as a right with respect to property. Query: will this change in character from ordinary to capital undermine the rationale of Virginia Iron, Coal & Coke Co., supra?
b. Installment reporting. If the rolling option transaction is properly structured and constitutes a true series of options, the installment sale provisions, including the interest toll charges and pledging rules of §453A, should not apply. Moreover, to the extent that any depreciation recapture may be inherent in the property under §1245, the acceleration of gain attributable to this depreciation recapture under §453(i) would also not apply.

c. Capital gains. Since the Trumpets' property has been held by them for investment purposes, all the gain from the sale of the property should be taxed as long term capital gains. The Service, however, may argue that a portion of the option prices should be recharacterized as ordinary income on the grounds that disguised interest is built into these option prices.

(1) The Service has argued that option payments are tantamount to interest and should be taxed as such, but this position was rejected by the Tax Court in *Koch v. Commissioner*, supra.

(2) The original issue discount rules of §§1271 through 1275 should not apply since a true option contract would not constitute a debt instrument as defined in §1275(a)(1). See, §1274(a). In *Koch v. Commissioner*, supra, the Tax Court found that an option contract does not constitute a debt (67 T.C. at pp. 82,83), and this rationale would also seem to negate the presence of a debt instrument.

d. Estate planning opportunities. The rolling option approach of Developer also presents potential estate planning advantages to the Trumpets in addition to the income tax advantages discussed above. For example, if the Trumpets' properties were acquired by Developer in a straight sale (as opposed to a rolling option approach), the Trumpets would receive an installment note for a portion of the purchase price. This installment note would be treated as income in respect of a decedent under §691 upon a subsequent death of either of the Trumpets prior to the full collection of the note. Thus, the decedent's estate may be required to pay estate taxes on the value of the
installment note and, most importantly, the decedent's heirs would also inherit the decedent's income tax liability with respect to the unpaid balance of the installment note. See, §1014(c).

However, structuring a transaction as a series of rolling options can eliminate the income tax problems that the Trumpets' heirs would otherwise inherit. The properties that are subject to options that have not yet been exercised at the date of death will be included in the decedent's estate and the values will probably be tied, at least in part, to the option prices which may eliminate the necessity of obtaining expensive appraisals for estate tax purposes. The decedent's heirs would also be entitled to a new stepped-up basis under §1014 for the portions of the property subject to the unexercised options which will enable them to subsequently sell these properties if the options are exercised without the necessity of paying income taxes (because the sales prices will be exactly equal to their tax bases). Caveat: the repeal of the stepped-up basis in 2010, and the institution of new modified carryover basis rules under the Economic Growth and Tax Reconciliation Act of 2001 would undermine this planning for decedents who die in 2010.

III. Exchange of Properties. In their preliminary discussions with Developer, the Trumpets suggested that they might ask Developer to accommodate their tax planning objectives by structuring all or a portion of the acquisition of the Taj Mahal Grove as a like-kind exchange under §1031. An exchange is particularly appealing to the Trumpets because they will be able to roll all or a substantial portion of their $21,000,000 of equity in the Taj Mahal Grove into one or more replacement properties. By contrast, a sale of the property followed by a reinvestment of the after-tax proceeds in replacement property will reduce the Trumpets' equity in such property to approximately $15,400,000.

A. Developer's proposal. After consideration of all of the alternative proposals described in Part I above, the Trumpets have informed Developer that they are neither willing to defer receipt of their monies nor to accept the risks inherent in subordination to an acquisition and development loan. After considerable hand-wringing and discussions with its bankers, Developer has been able to raise sufficient financing to purchase the entire Taj Mahal Grove for cash. Accordingly, Developer has informed the Trumpets of its willingness to purchase the property for $30,000,000, payable by assuming (or refinancing) the existing $9,000,000 of mortgage indebtedness with the balance payable in cash at closing. The
contract will be subject to a 180-day investigation period in which Developer will be able to satisfy itself with regard to title, zoning, permits, environmental compliance, soil testing, etc. If, at the end of the 180-day period, Developer has not notified the Trumpets of its intent to terminate the contract (in which case it would have no further obligation to the Trumpets other than to provide them with the results of its investigation), it will be obligated to close on the property within 45 days thereafter. Developer has agreed to insert an exchange cooperation clause in the contract of sale setting forth its agreement to cooperate to a reasonable extent with the Trumpets in structuring the disposition of all or a portion of the Taj Mahal Grove as a §1031 exchange.

The Trumpets have been advised by their tax attorney and CPA that they may defer recognition of income on the disposition of the Taj Mahal Grove through a §1031 exchange. Under the plan proposed by the Trumpets' tax advisors, the Trumpets would enter into an exchange agreement with Great Clinton Trust and Fidelity Exchange Corporation which will serve as a qualified intermediary in connection with the transaction. The exchange agreement will require the Trumpets to assign all of their rights under the real estate sales agreement between Developer and the Trumpets to the Qualified Intermediary and Developer will be notified in writing of the assignment. On the closing date for the sale of the Taj Mahal Grove to Developer, Qualified Intermediary will complete the sale of the Taj Mahal Grove to Developer in accordance with the terms of the real estate sales agreement. However, in order to avoid possible liabilities from getting in the chain of title and in order to avoid transfer taxes, Qualified Intermediary will instruct the Trumpets (pursuant to the right to do so contained in the exchange agreement) to direct deed the Taj Mahal Grove property to the Developer at closing. Thus, even though the rights of the Trumpets under the real estate sales agreement will have been assigned to Qualified Intermediary and Qualified Intermediary will be reflected as the seller of the Taj Mahal Grove at closing, the Trumpets will execute a deed conveying the Taj Mahal Grove directly to Developer at closing. The net cash due the seller will be paid directly to Qualified Intermediary who will hold the funds in escrow under the terms of the exchange agreement.

The exchange agreement provides that the Trumpets will have 45 days after the date of closing on the conveyance of the Taj Mahal Grove to identify one or more replacement properties. If the Trumpets have not identified any replacement properties within such 45-day period, they will have a right to withdraw all monies out of the escrow in which the Qualified Intermediary was holding such funds. In such a case, the Trumpets understand that the
transaction will be treated as a fully taxable sale by them and no deferral under §1031 will be available. However, if any properties are identified within the 45-day period, the escrow monies will be used by the Qualified Intermediary to purchase replacement properties approved by the Trumpets and any unused funds can be claimed by the Trumpets only after the Trumpets have received all the replacement properties to which they are entitled or upon the expiration of the exchange period. The exchange period is defined in the exchange agreement to be a period which commences on the date of closing of the conveyance of the Taj Mahal Grove and which ends on the earlier of: (i) the 180th day after the closing date, or (ii) the due date (including any extensions actually obtained) for the Trumpets’ federal income tax return for the taxable year in which the closing on the transfer of the Taj Mahal Grove took place.

The exchange agreement will permit the Trumpets to locate suitable replacement properties which were identified within the initial 45-day period, contract for the purchase of such properties and assign such contracts to the Qualified Intermediary with appropriate written notice to the seller of each such replacement property. The Qualified Intermediary will then acquire each such replacement property identified by the Trumpets using the funds held by it in escrow and, once again, will instruct the seller of the replacement property to direct deed the property to the Trumpets.

The exchange agreement also requires the Qualified Intermediary to segregate all funds obtained by it from the sale of the Taj Mahal Grove in a separate bank account and to invest such funds in conservative, interest bearing investments which are readily convertible to cash on short notice.

B. Tax implications to Trumpets.

1. General rules of §1031. Section 1031(a)(1) permits a taxpayer to eliminate recognition of gain if property held by such taxpayer either for productive use in a trade or business or for investment is exchanged solely for replacement property of a like kind which will also be held by such taxpayer either for productive use in a trade or business or for investment. Since the Trumpets have held the Taj Mahal Grove (referred to in this section of the outline as the relinquished property) for investment purposes, the exchange of such property for like kind property which will be held by the Trumpets either for productive use in a trade or business or for investment will qualify for nonrecognition treatment under §1031(a)(1).

   a. If the Trumpets receive both like kind property and cash or other non-like kind
properties in exchange for the relinquished property, the transactions will not qualify for nonrecognition treatment under §1031(a)(1) because the relinquished property will not have been exchanged solely for like kind property. However, §1031(b) provides that if an exchange would otherwise be eligible for tax free exchange treatment but for the presence of cash or some other form of nonqualifying property (boot), any gain realized in the transaction will be recognized for tax purposes but only to the extent of the sum of the money and the fair market value of the other boot received.

(1) Relief from liabilities either through assumption of such liabilities by the other party to the exchange or by conveyance of property to the other party subject to an existing mortgage will be treated as a receipt of boot to the extent of the debt assumed or taken subject to. Reg. §1.1031(b)-1(c). Thus, the Trumpets will be deemed to have received at least $9,000,000 of boot attributable to Developer's assumption of existing mortgages encumbering their property.

(2) Under certain circumstances, boot received by the Trumpets in the form of mortgages assumed or taken subject to may be offset or netted against boot given in the exchange by the Trumpets in the form of cash paid or by the assumption of (or taking subject to) mortgages encumbering the replacement property received by the Trumpets in the exchange. For example, if the replacement properties received by the Trumpets from Developer are encumbered by mortgages totaling $9,000,000 or more, the Trumpets will not be deemed to have received any net boot in the exchange attributable to the $9,000,000 mortgage debt which they were relieved of upon transfer of the Taj Mahal Grove.

b. Section 1031(a)(1) requires that both the relinquished property and the replacement property be held by the Trumpets for productive use in a trade or business or for investment.

(1) The regulations under §1031 do not contain any guidance regarding use in a trade or business or for
However, for useful analogies see §§167 and 1231 regarding trade or business properties and §1221 for investment properties.

(a) Property held for productive use in a trade or business may be exchanged for property held for investment or vice versa. Reg. §1.1031(a)-1(a). For example, the Trumpets may exchange the relinquished property, which was held by them for investment, for other real property which will be held by them for productive use in a trade or business.

(2) The requirement that both the relinquished property and the replacement property be held for one of the requisite purposes raises some potential problems. For example, if the Trumpets receive qualifying like kind replacement property in exchange for the relinquished property but immediately thereafter sell the replacement property in a taxable transaction, the exchange probably will not be eligible for §1031 nonrecognition treatment because the replacement property will be deemed to be held for sale rather than for investment or for productive use in a trade or business. See, Black v. Commissioner, 35 T.C. 90 (1960).

(a) The Service has also taken the position that if property received in an exchange which would otherwise qualify under §1031 is promptly disposed of in a nontaxable exchange, the receipt of the replacement property will not be eligible for §1031 nonrecognition treatment because it was not held for the required purposes. See, e.g., Rev. Rul. 75-292, 1975-2 C.B. 333 (property received in a purported §1031 exchange immediately transferred to a controlled corporation under §351 ineligible for §1031 nonrecognition treatment). However, thus far the courts have not been very sympathetic to the Commissioner's position with regard to tax free dispositions or acquisitions of properties either preceding
or following a purported §1031 exchange. See, Magneson v. Commissioner, 81 T.C. 767 (1983), aff'd. 753 F.2d 1490 (9th Cir. 1985); Bolker v. Commissioner, 81 T.C. 782 (1983), aff'd. 85-1 U.S.T.C. §9400 (9th Cir. 1985); Mason v. Commissioner, 55 T.C.M. 1134 (1988); and Maloney v. Commissioner, 93 T.C. 89 (1989).

c. Another requirement for nonrecognition treatment under §1031(a)(1) is that the relinquished property and the replacement property must be of like kind. The regulations adopt a liberal construction of like kind for purposes of applying the nonrecognition rules:

The words 'like kind' have reference to the nature or character of the property and not to its grade or quality. . . . The fact that any real estate involved is improved or unimproved is not material, that fact relates only to the grade or quality of the property and not to its kind or class. Reg. §1.1031(a)-1(b).

Based upon this liberal definition of like kind, the Trumpets may (for example) exchange the Taj Mahal Grove for a commercial office building or an apartment complex. Since both the commercial office building and the apartment complex are real properties, they are deemed to be of like kind with the Taj Mahal Grove under the definitional test of the regulations.

(1) Note that, to the extent that the Trumpets may also receive tangible personal property in connection with the apartment complex or commercial office building in addition to the real property, the value of the tangible personal property will constitute boot and would not be regarded as like kind. It is not real property.

(2) Citrus trees are §1245 property. If any portion of the purchase price is allocated by the parties to the citrus trees and like kind real properties which also constitute §1245 properties and with a value at least equal to the value of the citrus trees are not included in the replacement properties received by the
Trumpets, §1245(b)(4) will override §1031(a) and force recognition of the §1245 recapture income.

d. Section 1031 is a deferral provision. Like most deferral provisions of the Code, it exacts a price for nonrecognition in the form of a reduction in basis in the replacement property received in a §1031 exchange. Under §1031(d), the Trumpets' tax basis in the replacement property will be equal to the basis of the relinquished property reduced by any cash received and any loss recognized (which would be attributable to the exchange of boot properties), and increased by any gain recognized. For this purpose, liabilities encumbering the relinquished property and the replacement property which are either assumed or taken subject to will be treated as cash received or cash paid (respectively) for purposes of the basis computation rules. §1031(d).

e. Tacking of holding periods is authorized under §1223(1) with respect to the replacement properties received by the Trumpets in the exchange if both the relinquished property and the replacement properties are either capital assets, as defined in §1221, or properties described in §1231. Thus, assuming that the Trumpets receive qualifying replacement property that will constitute either a capital asset or a §1231 asset in their hands, they will be eligible to tack on the holding period of the relinquished property to the replacement property under §1223(1).

2. Multi-party exchanges. The plan conceived by the Trumpet's tax advisors contemplates more than a simple barter exchange of properties between two people. Under this plan, the Trumpets must first locate, negotiate and probably contract for the acquisition of one or more replacement properties. Thereafter, any such contract for a replacement property will be assigned to Qualified Intermediary (with written notice to the seller of such property) which will then close on the purchase of the replacement property using funds from the qualified escrow and instruct the seller to direct deed the replacement property to the Trumpets. This scenario is but a short step removed from the payment of cash by Developer to the Trumpets (or to an agent of the Trumpets) followed by reinvestment of the cash in replacement properties.
a. Not surprisingly, the latter view was adopted by the Service when first confronted with multi-party exchanges. Fortunately for taxpayers, the early decisions in this area adopted a liberal construction of §1031 as it applied to multi-party exchange situations and established a pro-taxpayer trend that, with some judicial deviations, has been liberalized to an even greater extent in recent years. See, e.g., Mercantile Trust Co. of Baltimore v. Commissioner, 32 B.T.A. 82 (1935); J. H. Baird Publishing Co. v. Commissioner, 39 T.C. 608 (1962); Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963); Coastal Terminals, Inc. v. United States, 320 F.2d 333 (4th Cir. 1963) (the preceding cases represent the early line of cases applying an expansive application of §1031 to multi-party exchanges); Biggs v. Commissioner, 632 F.2d 1171 (5th Cir. 1981); Starker v. United States, 602 F.2d 1341 (9th Cir. 1979); Barker v. Commissioner, 74 T.C. 555 (1980); Brauer v. Commissioner, 74 T.C. 1134 (1980); Hayden v. United States, 82-2 U.S.T.C. ¶9604 (D. Wyo. 1981) and Garcia v. Commissioner, 80 T.C. 491 (1983) (the second group of cases represent the more recent and, if anything, more liberal decisions involving multi-party exchanges).

3. Deferred exchange. The exchange plan proposed by the Trumpets' tax advisors contemplates that all of the replacement property may be identified and/or acquired and transferred to the Trumpets after the closing (i.e., after the transfer of the relinquished property by the Trumpets to Developer through the Qualified Intermediary). This is referred to as a deferred exchange. Deferred exchanges present several unique tax issues which have generated a great deal of controversy between taxpayers and the Service.

a. The Tax Reform Act of 1984 (TRA '84) added §1031(a)(3) to the Code which provides that any property received in a deferred exchange will be treated as boot unless:

1. The replacement property must be identified on or before the 45th day after the taxpayer transfers the relinquished property, and

2. The replacement property must be actually received by the taxpayer on or before the earlier of: (i) 180 days after the relinquished property is transferred, or (ii)
the due date (determined with extensions) of the transferor's return for the taxable year in which the transfer of the relinquished property occurs.

The addition of §1031(a)(3) to the Code by TRA '84 was designed to prevent potential abuses which both the Service and Congress believed could occur if no time constraints were imposed on closing out deferred exchanges. However, this section effectively sanctions the use of deferred exchanges that otherwise qualify for like kind exchange treatment under §1031 and meet the identification and receipt requirements of §1031(a)(3).

b. On May 1, 1991, final regulations were issued by Treasury governing deferred exchanges which apply to transfers of property made on or after June 10, 1991 (subject to certain rules applicable to transfers made on or after May 16, 1990). Reg. §1.1031(k)-1(o). These regulations define deferred exchanges, establish operating rules for the identification and receipt requirements of §1031(a)(3), create four safe harbors from the constructive receipt rules that will be unique to deferred exchanges and, finally, provide additional guidance for the computation of gain or loss to be recognized as well as basis computations in deferred exchanges.

c. Assuming that all or a substantial portion of the replacement properties are not received by the Trumpets prior to closing, what impact will the deferred exchange regulations have upon the transactions contemplated by Developer's proposal to the Trumpets?

(1) First, the Trumpets must identify one or more like kind replacement properties before the expiration of the identification period.

(a) The identification period begins on the date the Trumpets transfer the relinquished property to Developer (through the Qualified Intermediary) and ends 45 days thereafter. Reg. §1.1031(k)-1(b)(2). For purposes of determining the date on which the identification period ends, §7503 (relating to the time for performance of acts where the last day falls on a Saturday, Sunday or legal
(b) In order to identify replacement property, the Trumpets must either (i) designate the replacement property in a written document signed by them and hand-delivered, mailed, telecopied or otherwise sent before the expiration of the identification period to Qualified Intermediary or (ii) execute a written agreement with Qualified Intermediary which meets all of the above-described identification requirements and which is signed by all parties to the transaction. Reg. §1.1031(k)-1(c)(2). Notwithstanding the foregoing, any replacement property actually received by the Trumpets before the expiration of the identification period will in all events be treated as if it had been identified. Reg. §1.1031(k)-1(c)(1).

(c) The Trumpets must unambiguously describe the replacement property in the written document or agreement. Reg. §1.1031(k)-1(c)(3). Since the replacement property will be a real estate parcel, it must be described either by utilizing its full legal description or a street address. Id.

(d) In view of the size and value of the Taj Mahal Grove, it is unlikely that the Trumpets will be able to find a single replacement property for Qualified Intermediary to acquire and transfer to them. The proposed regulations will enable the Trumpets to designate alternative and/or multiple properties within the identification period. Reg. §1.1031(k)-1(c)(4). The proposed regulations provide
that the maximum number of replacement properties that the Trumpets may identify is either (i) three properties without regard to the fair market values of such properties (the 3-property rule) or (ii) any number of properties provided that the aggregate fair market value at the end of the identification period of all such properties does not exceed 200% of the fair market value of the relinquished property determined as of the date the relinquished property is transferred by the Trumpets (the 200% rule). A warning is contained in Reg. §1.1031(k)-1(c)(4)(ii) that if at the end of the identification period the Trumpets have identified more property than is permitted under the alternative rules described above, they will be treated as if they had failed to identify any property under such rules (subject to two limited savings provisions).

i) The Trumpets are given the opportunity to steer clear of the rather harsh penalties for failing to meet either the 3-property rule or the 200% rule through the use of the revocation rules contained in Reg. §1.1031(k)-1(c)(6). This provision enables the Trumpets to terminate the designation of any particular replacement property prior to the end of the identification period in the same manner as such property was originally identified. It should be noted that an oral revocation will not be effective. Reg. §1.1031(k)-1(c)(6) and (7), Ex.7.

(2) Secondly, §1031(a)(3)(B) provides that the replacement property which has been properly identified in accordance with the requirements set forth above must also be received by the Trumpets within the exchange period. The receipt
requirements are explained and amplified in Reg. §§1.1031(k)-1(b) and (d). Reg. §1.1031(k)-1(b)(1) states that any property which is not received within the exchange period will be treated as boot.

(a) The exchange period is defined in Reg. §1.1031(k)-1(b)(2) as a period beginning on the first date the Trumpets transfer the relinquished property and ending on the earlier of 180 days thereafter or the due date (including extensions) for their tax return for 2001 (i.e., the year in which the transfer of the relinquished property took place). The rules for determining the commencement date of the exchange period as well as of the date of expiration are identical to those applicable to the identification period.

(b) The Trumpets will only be deemed to have received replacement property within the exchange period if (i) they receive the replacement property before the end of the exchange period, and (ii) the replacement property is substantially the same property as identified. Reg. §1.1031(k)-1(d). The use of the term substantially the same incorporates a degree of tolerance for a minor change in circumstances. See, e.g., Reg. §1.1031(k)-1(d)(2) Exs. 3 and 4.

(3) One of the principal problems confronting taxpayers such as the Trumpets who enter into deferred exchange transactions is how to secure performance by the other party under its obligation to acquire and transfer replacement properties in accordance with the agreement. The plan proposed by the Trumpets' tax advisors deals with this issue by placing any monies that were not expended to acquire replacement property at the time of closing in an escrow fund with Qualified Intermediary. The placement of cash in an escrow has caused many practitioners to worry that the taxpayer would be deemed to have constructively received the
cash. [In addition, Qualified Intermediary may be deemed to be merely an agent of the Trumpets. This issue will be discussed below.] In the installment sale area, the Service has successfully asserted that securing an installment obligation with cash resulted in constructive receipt. See, Oden v. Commissioner, 56 T.C. 569 (1971); Pozzi v. Commissioner, 49 T.C. 119 (1967); and Rev. Rul. 79-91, 1979-1 C.B. 179. Moreover, the temporary regulations under §453 reinforce this concept. See, Temp. Reg. §15A.453-1(b)(3)(i).

However, in Garcia v. Commissioner, 80 T.C. 491 (1983), funds placed in escrow to secure a deferred exchange and which were subject to substantial restrictions which prevented the taxpayer from gaining access to the funds except in the event of a default resulted in a ruling in favor of the taxpayer on the issue of constructive receipt. However, see, Maxwell v. United States, 88-2 U.S.T.C. ¶9560 (S.D. Fla. 1988) which resulted in a holding in favor of the Service because the taxpayer had failed to provide a bulletproof escrow.

(a) The deferred exchange regulations establish a safe harbor from the constructive receipt rules if the obligation of Qualified Intermediary to purchase and transfer replacement properties is secured by cash or a cash equivalent held in a qualified escrow account. Reg. §1.1031(k)-1(g)(3). A qualified escrow account is one in which the escrow holder is neither the taxpayer nor a disqualified person (as defined in Reg. §1.1031(k)-1(k)) and in which the taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of the cash or cash equivalent held in escrow are limited to the following circumstances:

i) The taxpayer may withdraw the cash if he has not identified replacement property within the identification period but such withdrawal may only take place after the
expiration of the identification period.

ii) The taxpayer may withdraw any remaining cash held in escrow after he has received all of the identified replacement property to which he is entitled.

iii) If the taxpayer has identified qualified replacement property but has conditioned the receipt of such property upon a material and substantial contingency that relates to the deferred exchange, that is provided for in writing and that is beyond the control of both the taxpayer and any related party, and if such material contingency is not satisfied, then the taxpayer may receive cash from the escrow (but not prior to the end of the identification period).

iv) The taxpayer may receive any cash remaining in escrow after the end of the exchange period.

Reg. §1.1031(k)-1(g)(6).

Thus, if the Trumpets wish to take advantage of the safe harbor, they must be certain that the terms of the escrow comply with the conditions outlined above.

(b) It is important to note (and frequently overlooked) that the qualified escrow is intended as a passive vehicle to secure the buyer's performance of its obligations to acquire and convey replacement property to the taxpayer. If the escrow agent assumes a more active role, such as contracting to purchase replacement property and convey it to the taxpayer, the escrow agent must also qualify as a qualified intermediary as described in (4) infra.

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(c) The Trumpets will be transferring the relinquished property when it is encumbered by mortgages totaling $9,000,000 which will be assumed by Developer. As noted in the discussion above, the assumption of indebtedness encumbering the relinquished property constitutes boot to the Trumpets unless it is netted against either cash paid by the Trumpets or mortgages on replacement properties that are assumed or taken subject to by them. Suppose that the transfer of the relinquished property by the Trumpets takes place in 2001 but the receipt of replacement properties does not occur until 2002. Can the determination of whether the relief from $9,000,000 of liabilities constitutes boot be postponed until the replacement properties are received (at which time it could be determined whether the Trumpets are entitled to net any liabilities assumed or taken subject to or whether they will be required to pay cash)? This question is not answered directly in the proposed regulations but Reg. §1.1031(k)-1(j) Ex.5 contemplates that deferred netting of mortgages will be allowed.

(d) The proposed plan to accomplish a §1031 exchange of the Taj Mahal Grove contemplates that Qualified Intermediary need not acquire title to replacement property in its name. Qualified Intermediary may refuse to appear in the chain of title for fear that it might incur potential liability for environmental cleanup problems. It is now clear that both the relinquished property and any replacement properties may be direct deeded for bona fide non-tax reasons such as enabling the purchaser or intermediary to avoid being in the chain of title. See, Reg. §§1.1031(k)-1(g)(4)(iv)(B) and 1.1031(k)-1(g)(4)(v) in which direct
deeding using the qualified intermediary safe harbor is specifically sanctioned. See, also, Rev. Rul. 90-34, I.R.B. 1990-16 (4/16/90); W. D. Haden Co. v. Commissioner, 165 F.2d 588 (5th Cir. 1948); Biggs v. Commissioner, 632 F.2d 1171 (5th Cir. 1981); Brauer v. Commissioner, 74 T.C. 1134 (1980); and Rutland v. Commissioner, 36 T.C.M. 40 (1977).

(4) More often than not a prospective buyer will refuse to be an active participant in accomplishing a tax-free exchange for the taxpayer. In other words, the purchaser generally has little if any interest in becoming involved in acquiring replacement property on behalf of the taxpayer. In such cases, taxpayers are frequently tempted to use an intermediary to accomplish the sale of the relinquished property while at the same time facilitating a deferred exchange under §1031. The intermediary will typically enter into an exchange agreement with the taxpayer pursuant to which the taxpayer will convey its property to the intermediary (or will direct deeding to the ultimate purchaser when the intermediary closes on the sale of the relinquished property) in exchange for the intermediary's agreement to acquire and convey replacement property to the taxpayer. The principal tax risk associated with this technique was that the intermediary would be found to be the taxpayer's agent and that, as a consequence, the receipt of money or other non-like kind property by an intermediary would be treated as having been received by the taxpayer.

The deferred exchange regulations now offer a very generous safe harbor for the use of a qualified intermediary to facilitate an exchange with the promise that, if complied with, the intermediary will not be treated as the taxpayer's agent for tax purposes and the taxpayer will not be treated as being in actual or constructive receipt of money or other non-like kind property held by the intermediary. Reg. §1.1031(k)-1(g)(4)(i).
Trumpets' tax advisors have relied upon this safe harbor in structuring their proposed plan to accomplish a §1031 exchange.

(a) A qualified intermediary is defined in Reg. §1.1031(k)-1(g)(4)(iii) as "a person who (A) is not a taxpayer or a disqualified person [as defined in Reg. §1.1031(k)-1(K)], and (B) enters into a written agreement with the taxpayer (the exchange agreement) and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer."

(b) The exchange agreement that is required to be entered into by the taxpayer and the intermediary must include the following:

(i) The agreement must require that the intermediary acquire the relinquished property from the taxpayer, transfer the relinquished property, acquire the replacement property and transfer the replacement property to the taxpayer. Reg. §1.1031(k)-1(g)(4)(iii)(B); and

(ii) Restrict the taxpayer's right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the intermediary to the extent required in Reg. §1.1031(k)-1(g)(6). Reg. §1.1031(k)-1(g)(4)(ii).

(c) Direct deeding is specifically sanctioned in the final regulations in connection with the qualified intermediary safe harbor. Although the qualified intermediary is required to both acquire and convey the relinquished property, Reg. §1.1031(k)-
1(g)(4)(iv)(B) provides that an intermediary will be treated as acquiring and transferring the relinquished property if the intermediary enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is transferred to that person (i.e., direct deeded from the taxpayer to the ultimate purchaser). It should be noted that direct deeding is sanctioned only if the intermediary first establishes contractual privity with the purchaser of the relinquished property. However, Reg. §1.1031(k)-1(g)(4)(v) also authorizes the taxpayer to enter into a contract for the conveyance of the property and specifically assign that contract to the intermediary (which presumably may be coupled with the direct deeding) provided that all parties to the agreement are notified in writing of the assignment on or before the date of the relevant transfer of property. Similar rules are also provided with respect to direct deeding in connection with the acquisition of the replacement property by the qualified intermediary and ultimate conveyance by it to the taxpayer. See, Reg. §1.1031(k)-1(g)(4)(iv)(C).

Direct deeding is almost essential because of concerns regarding compliance with environmental laws and the possible exposure that the intermediary might face if it were included in the chain of title.

(d) The proposed §1031 exchange plan developed by the Trumpets' advisors contemplates the use of the qualified intermediary safe harbor in conjunction with a qualified escrow in order to better secure performance by the intermediary and protect, to the extent possible, the
monies and other properties held by or for the intermediary from the claims of the intermediary's creditors, including the bankruptcy trustee. This tandem use of these safe harbors is specifically sanctioned in Reg. §1.1031(k)-1(g)(1) provided that all of the terms and conditions of each safe harbor are separately satisfied.

(5) The exchange agreement that the Trumpets' tax advisors have proposed contemplates that any monies held by the Qualified Intermediary pending acquisition of replacement properties will be placed in interest bearing investments. Consequently, any such interest will be added to the amount held by the Qualified Intermediary until the replacement properties are acquired. Reg. §1.1031(k)-1(g)(5) provides that the right of a taxpayer to receive interest or a growth factor with respect to a deferred exchange will not, in and of itself, cause the taxpayer to be deemed to have actually or constructively received boot. Prior to the conclusion of this safe harbor in the regulations, a number of practitioners questioned whether the taxpayer could receive interest earned on funds held by an intermediary and generally suggested that all such funds should belong to, and be retained by, the intermediary in order to avoid having the intermediary treated as the taxpayer's agent.

Just as in the case of the other safe harbors provided in the deferred exchange regulations, the interest or growth factor safe harbor will not apply unless the taxpayer's right to receive the interest or growth factor is limited to circumstances described in Reg. §1.1031(k)-1(g)(6).

(i) Any interest earned while the funds are held by the Qualified Intermediary will be treated as interest, regardless of whether the Trumpets ultimately receive this interest in the form of
like-kind property or in cash. Reg. §1.1031(k)-1(h)(2).

(ii) The deferred exchange regulations do not address who is to be taxed on the income held in the qualified escrow or with a qualified intermediary. Section 468(B)(g) provides that nothing in any provision of the law will be construed as providing that an escrow account, settlement fund or similar fund is not subject to current income taxation. The Treasury has deferred promulgating rules on the taxation of earnings within a qualified escrow until regulations under §468(B)(g) are published. See, preamble to T.D. 8346. Thus, there is still some question as whose taxpayer identification number should be used when an escrow agent invests funds held in a qualified escrow or qualified trust.

IV. Partnership Proposal.

A. Description of proposal. Developer's third alternative proposal to the Trumpets contemplates the formation of a limited partnership to develop and market the Taj Mahal Grove. The general partners in this partnership will consist of Developer and a new limited liability company to be formed by the Trumpets. The limited partner will be the world renowned professional golfer, Tiger Nicklaus. Although Nicklaus has built his reputation by dominating the professional tour for the past decade, he has also recently developed a reputation as an outstanding golf course architect. Nicklaus has agreed to design both of the championship golf courses for the project in exchange for his normal fees for design services. However, he has also agreed to promote the project and be its chief spokesman throughout the United States and the world for a period of ten years in exchange for a limited partnership interest which will provide him with a special interest in partnership profits described below.

1. Trumpets' partnership interest. Developer's plan calls for the Trumpets to first contribute the Taj Mahal Grove subject to the Original Mortgages to a newly formed limited liability company (TLLC) in exchange for membership interests in TLLC. TLLC will then contribute the property to a newly formed limited partnership consisting of TLLC and Developer as general partners and Tiger
Nicklaus as the limited partner. The partnership will assume the Original Mortgages. TLLC will be given credit for a capital contribution in the amount of $21,000,000 representing the $30,000,000 gross fair market value of the Taj Mahal Grove reduced by the $9,000,000 outstanding balance of the Original Mortgages. TLLC will be responsible for 50% of all partnership indebtedness including the Original Mortgages. Although TLLC will not be the managing general partner of the partnership, Developer would like to utilize Donald and Nervanna Trumpets' contacts in the Orlando community, where the Trumpets have been very active in local political and community affairs. In addition, although the Trumpets have not been involved in any real estate development projects, Developer has been impressed with their knowledge of real estate in general and wishes to utilize them from time to time as consultants in the development and marketing of the project. Finally, as a general partner in the partnership, all major policy decisions must be approved by both Developer and TLLC as well as all development and marketing plans.

2. Developer's partnership interest. Developer will contribute $4,000,000 in cash to the limited partnership in exchange for its partnership interest and will also assume responsibility for 50% of all partnership indebtedness. As managing general partner of the partnership, Developer will be initially responsible for obtaining all financing necessary to develop the property, for the preparation of a development plan, for obtaining all requisite zoning permits necessary for the development of the Taj Mahal Grove in accordance with the development plan and, finally, for the management and marketing of the property after development. Developer will be entitled to a reasonable management fee for its services commencing upon completion of the first phase of development together with a sales fee equal to 6% of all proceeds from the sale of lots, townhomes, and industrial sites, and a rental fee of 6% of all rents collected from the lease of space in the shopping center.

3. Tiger Nicklaus' partnership interest. Tiger Nicklaus will not be required to make a capital contribution in exchange for his limited partnership interest. The consideration for his partnership interest will be the rendering of future services over a ten-year period which services are set forth in a separate promotional agreement entered into with the limited partnership. Nicklaus' right to this profits interest will at times during the initial ten-year period
of the partnership be contingent upon the fulfillment of his contractual obligations to promote the project.

4. Capital accounts, profits, losses and cash flow. Since the partnership agreement will contain numerous special allocations of profits and losses which will not be in accordance with the capital interests of the partners, the partnership’s tax attorneys and CPAs have insisted that the partnership agreement be structured to comply with the Treasury regulations promulgated under §704(b). The first step in this process is the maintenance of capital accounts in accordance with Reg. §1.704-1(b)(2)(iv). The maintenance of capital accounts in accordance with this regulation will effectively require the partnership to maintain two sets of books -- one for book purposes which reflects the Taj Mahal Grove at a book basis of $30,000,000, and a second set of books which will be maintained for tax purposes and which will reflect the Taj Mahal Grove at its tax basis of $10,000,000.

Subject to the special tax allocations described in the following paragraph, profits from operations will be allocated equally to Developer and TLLC until the partnership has generated net profits for book purposes of $2,500,000 per annum, determined on a cumulative basis since the inception of the partnership. Any operating profits in excess of this amount will be allocated 45% to Developer, 45% to TLLC and 10% to Tiger Nicklaus. Profits derived from major capital events (i.e., profits derived from a sale of all or a portion of the partnership’s real properties other than the ordinary course of business or in liquidation of the partnership or upon a condemnation of more than a minor amount of the partnership’s real properties) will be allocated first to partners with negative capital accounts until such capital accounts have been restored to zero; secondly to the partners in proportion to their unrecovered capital contributions until the capital accounts have been restored to the level of their unrecovered capital contributions; thirdly, to Developer and TLLC until they have received allocations of net profits from all sources equal to their preferential $2,500,000 per year cumulative return; and, finally, any remaining net profits will be allocated 45% to Developer, 45% to TLLC and 10% to Tiger Nicklaus. Losses from any source will be allocated 50% to TLLC and 50% to Developer. Under no circumstances are any losses to be allocated to Tiger Nicklaus.

The Taj Mahal Grove contributed to the partnership by TLLC will have a built-in gain.
of $20,000,000 ($30,000,000 fair market value less $10,000,000 tax basis). The partnership agreement requires that this excess be accounted for in accordance with the requirements of §704(c) of the Code. Thus, for example, if the entire property was sold on December 31, 2001, for $35,000,000, and the partnership's tax basis in the property had not changed, the first $20,000,000 of taxable gain must be allocated solely to TLLC. The remaining $5,000,000 of taxable gain would be allocated among all of the partners in accordance with the allocations applicable to major capital events described above.

All positive cash flow generated from general operations by the partnership will be distributed solely to Developer and TLLC until they have received total distributions aggregating $2,500,000 per year, determined on a cumulative but not compounded basis. Thereafter, any excess net cash flow will be distributed 90% to Developer and TLLC and 10% to Tiger Nicklaus. Distributions of net cash flow to Developer and TLLC will be divided between them on the basis of 70% to TLLC and 30% to Developer until their capital accounts have been equalized and thereafter net cash flow distributed to them will be on an equal basis.

Upon liquidation of the limited partnership or upon liquidation of any partner's interest in the partnership any distributions are required in all cases to be made in accordance with positive capital account balances of the partners subject to the rules of Reg. §1.704-1(b)(2)(i)(b)(2). If any partner (other than Nicklaus) has a deficit balance in its capital account following the liquidation of such interest, that partner is unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of the taxable year of liquidation (or, if later, within 90 days after the date of such liquidation) in accordance with Reg. §1.704-1(b)(2)(ii)(b)(3).

5. Financing commitment. Developer has informed the Trumpets that it has received a binding commitment to provide full development financing for the entire project and to refinance the Original Mortgages. The terms of the development loan include interest at two points over prime; interest only for a period of two years and thereafter principal and interest to be amortized on the basis of a 25-year mortgage with a balloon at the end of ten years; reasonable release prices for single family lots, townhome lots and industrial sites based upon projected resale values; and other usual and customary
development loan provisions. The loan will be full recourse to the partnership but the Trumpets will not be required to personally guarantee the loan. Tiger Nicklaus, as a limited partner in the partnership with no deficit capital account restoration obligations, will also not be required to guarantee the loan.

6. Economic advantages and disadvantages to the Trumpets. The Trumpets will be attracted to this proposal if they believe that 50% of the profits in the partnership (45% above the preferential level) will generate a substantially greater return than an outright sale of the property. On the negative side, the income generated from this proposal will be ordinary income. Furthermore, while the Trumpets may enjoy greater opportunities for profits under the partnership proposal, they will also bear a greater risk that the project may fail or may generate less profits than expected.

7. Economic advantages and disadvantages to the Developer. There are also pluses and minuses associated with the partnership proposal from Developer's viewpoint. The obvious advantage of this proposal as contrasted with the other alternatives is that Developer will not be required to make any investment in the initial acquisition of the land. Thus, it can both acquire and develop the property with capital supplied by TLLC and the development lender. The drawback to this proposal from Developer's perspective is that it must now deal with a partner (rather than have complete control of the project) and it must also relinquish 50% (55% above the preferential level) of the potential profits derived from the venture.

B. Tax consequences to the Trumpets and TLLC.

1. Choice of entity. The Trumpets were advised by their attorney that TLLC should be formed to participate in the development activities in order to limit their liabilities. Their attorney noted that they are already risking $21,000,000 of equity in the project and they certainly would not want to risk anything more. In addition, since the development partnership will clearly be engaged in dealer activities, the Trumpets' attorney indicated that the use of a separate entity such as a limited liability company should also protect the Trumpets from the taint of being engaged (in their individual capacities) in such activities.

The Trumpets have also been advised by their accountant that TLLC will be treated for tax purposes as a partnership (unless the Trumpets elect to have it taxed as a
corporation, which they will not do). Reg. §301.7701-3. He explained that, as a partnership, all of the corporation's income and losses will pass through to the Trumpets as its sole members (subject to certain limitations set forth in Subchapter K of the Code). Since the Trumpets have no interest in retaining the profits from this venture in TLLC, the use of a limited liability company which is taxed as a partnership will facilitate the distribution of their share of the profits without incurring a double tax. In addition, the accountant noted that Developer's projections reflected small start-up losses for the first two years of operations. Fifty percent of these losses will pass through to the Trumpets as the sole members of TLLC and (subject to certain limitations noted below) may be used by them against their income from other sources.

2. Limitations on utilization of losses. One of the inducements to the Trumpets to utilize a limited liability company which is treated as a partnership for tax purposes is the ability to utilize losses from TLLC on their personal Form 1040. However, their tax advisors have cautioned them that these losses are subject to three primary limitations.

a. First, the source of any losses that may ultimately flow through to the Trumpets is the partnership. Although most expenditures incurred in the conduct of a development business must be capitalized into the costs of lots and improvements, it is still possible to generate taxable losses. Losses incurred by a partnership will pass through to its partners in accordance with their respective distributive shares. §702(a). However, §704(d) provides that a partner's distributive share of losses for a taxable year will be allowed only to the extent of such partner's adjusted basis in its partnership interest determined as of the end of such taxable year. A partner's basis in its partnership interest initially consists of the amount of money plus the adjusted basis of any property contributed by it to the partnership (§722), and is thereafter adjusted upward for its distributive share of partnership profits plus additional contributions, and decreased for its distributive share of the partnership's losses and for any distributions made by the partnership to such partner. §§705 and 721. Most importantly, a partner's basis in its partnership interest is also increased for its share of the liabilities of the partnership and for any partnership
liabilities assumed by it. §752(a). Conversely, any reduction in such partner's share of liabilities will correspondingly reduce such partner's basis in its partnership interest. §752(b). Losses in excess of a partner's tax basis in its interest will be carried forward to future taxable years until the partner's basis has increased sufficiently to facilitate the pass through of the loss. §704(d).

b. Secondly, TLLC's distributive share of the partnership's losses will flow through to the Trumpets in accordance with their distributive shares of losses of TLLC. Since TLLC will be treated as a partnership for federal income tax purposes, the same rules and limitations discussed in IV.B.2.a, supra will apply. Moreover, due to a recent change in Florida law, TLLC will also be treated as a partnership for Florida tax purposes and will, thus, not be subject to Florida income taxes.

c. Finally, any losses which escape the first two layers of limitations will be subjected to a third level of limitations applicable to passive activity losses under §469. [Note: the loss limitation rules of §§704(d) are applied before the passive activity loss limitations of §469. See, Reg. §1.469-2T(d)(6).]

(1) The first step in testing losses flowing from TLLC to the Trumpets under §469 is to identify the activity or activities which generated these losses. Since the shopping center will constitute a material undertaking (assuming that the gross income from the shopping center will exceed 20% of the gross income of the entire project so it will not be deemed to be an incidental operation -- see, Reg. §1.469-4(d)(1), the shopping center must be segregated and treated as an activity separate and apart from the development and sales operations which will also be treated as a single separate activity. Reg. §1.469-4(c). (It is assumed that the operation of the tennis facilities, golf courses, and marina will likely be treated as incidental to, and a part of, the development and sale activity.)

(2) Any losses attributable to the shopping center activity, which is
a rental activity, will automatically be classified as passive activity losses, regardless of the amount of time the Trumpets participate in the activity. §469(c)(2) and (4). [It should be noted, however, that if the Trumpets can satisfy the requirements of §469(c)(7), which would require the Trumpets to demonstrate a high degree of personal involvement (involving the performance of personal services) in the real estate business, the shopping center activity could be tested under §469 as a regular trade or business (i.e., requiring a demonstration of material participation). However, it will be assumed here that the rigorous requirements of §469(c)(7) cannot be met by the Trumpets.] Thus, any such losses may only be deducted by the Trumpets against their passive income (if any), with any losses in excess of passive income to be suspended and carried forward to future years. §§469(a)(1), (b), and (d)(1).

(3) Losses attributable to the development and sales activity will be deemed to be attributable to a trade or business activity. If the Trumpets materially participate in such activity in the taxable year in question, such losses will be treated as active losses and will not be subject to the limitations of §469(a). See, §469(c)(1). Material participation means involvement by a taxpayer in the activity which is regular, continuous and substantial. §469(h)(1). The regulations under §469 interpret this section to require satisfaction of any one of several alternative criteria. See, Reg. §1.469-5T(a). The principal test applicable to the Trumpets requires them to participate in the development and sales activity to the extent of 500 hours during the taxable year. Reg. §1.469-5T(a)(1). For this purpose, the hours of participation of Donald and Nervanna Trumpet will be aggregated. §469(h)(5). If the 500-hour threshold is met, the losses attributable to such trade or business activity may be claimed by the Trumpets without limitation under §469.
3. **Tax consequences to Trumpets and TLLC attendant to formation of TLLC.** No gain will be recognized by the Trumpets or TLLC upon conveyance of the Taj Mahal Grove to TLLC. §721(a).

   a. The assumption of the $9,000,000 mortgage by TLLC upon contribution of the Taj Mahal Grove by the Trumpets will not generate taxable income to the Trumpets. See discussion under IV.B.4.a.(1), infra.

   The basis of property received by TLLC is the same as it was in the hands of the Trumpets. §723. The basis of the membership interests received by the Trumpets will be the same as the basis of the property transferred ($10,000,000), reduced by the $9,000,000 mortgage balance assumed by the corporation or a net basis of $1,000,000. §722.

4. **Tax consequences to TLLC on formation of partnership.**

   a. No gain will be recognized by TLLC upon conveyance of the Taj Mahal Grove to the partnership. §721(a).

   (1) The assumption of $9,000,000 of existing mortgage debt will not result in a taxable gain to TLLC. The contribution of property to a partnership which is subject to indebtedness which the partnership either assumes or takes subject to will yield the following results to the contributing partner:

   a) The contributing partner will increase the basis in its partnership interest by an amount equal to the adjusted basis of the property. §722.

   b) The contributing partner will also increase the basis in its partnership interest for its share of the partnership's debt. §§752(a) and 722.

   c) Finally, the contributing partner will decrease its basis by the entire amount of the debt. §752(b).

   The increase in basis under §752(a) above is treated as a contribution of cash by the contributing partner to the partnership. §752(a). Conversely, the decrease in basis attributable to the relief from liability referred to above will be treated as a distribution of cash by the partnership to the partner. §752(b). Distributions of cash by a
partnership to a partner (including constructive distributions under §752(b)) will not result in any recognized gain to a recipient partner except to the extent that they exceed the basis in its partnership interest. §731(a)(1). The recipient's basis in its partnership interest will be decreased (but not below zero) by such distribution. §§705(a)(2) and 733(1). If the money distributed and/or deemed to be distributed exceeds basis, such excess will be deemed to have been received in connection with the sale of the recipient partner's partnership interest. §731(a).

(2) TLLC's share of the existing mortgages assumed by the partnership will be determined in accordance with Reg. §§1.752-1 and 2. Since the debt consists of recourse liabilities as defined in Reg. §1.752-1(a)(1), each partner's share of such liability will be equal to the portion thereof for which such partner bears the economic risk of loss as determined under Reg. §1.752-2(a).

(a) As a general rule, a partner will be deemed to bear the economic risk of loss for a recourse debt to the extent that such partner would be obligated to make a payment to the creditor or a contribution to the partnership with respect to such debt (and would not be entitled to be reimbursed for such payment or such contribution) if all of the partnership's liabilities were due and payable in full, all of the partnership's assets (including money) were worthless, the partnership disposed of all of its assets in a fully taxable transaction for no consideration other than the relief of liabilities, and the partnership allocated all items of income, gain, loss, deduction and credit among the partners and liquidated the partners' interests in the partnership. Reg. §1.752-2(b)(1).

(b) Applying this test to the facts at hand, TLLC's share of the existing mortgage indebtedness will be 50%.

i) It is possible the Service might argue that, by virtue of the creation of TLLC by the Trumpets to participate in the partnership in order to shield them from liabilities.
associated with the operation of the partnership's business, TLLC's responsibility for 50% of the debt is nominal and not real. However, the Trumpets capitalized TLLC with substantial assets ($21,000,000 in equity) and the application of this position to the facts at hand seems unwarranted.

(3) The application of the steps described above to TLLC's contribution of the Taj Mahal Grove to the partnership in exchange for its partnership interest will be as follows:

\[
\begin{align*}
&\$10,000,000 \quad \text{Adjusted basis in property (§722)} \\
+&\ 4,500,000 \quad \text{50% share of partnership debt (§§752(a) and 722)} \\
-&\ 9,000,000 \quad \text{Assumption of existing mortgage debt by partnership (§§752(b) and 733)} \\
&\ 5,500,000 \quad \text{Basis of TLLC in its partnership interest}
\end{align*}
\]

TLLC will recognize no gain or loss by reason of the contribution. §721(a).

(4) The Service might take the position that §707(a)(2)(B) should apply to a portion of the $6,000,000 mortgage encumbering the Second Parcel which was assumed by the partnership. The Service's argument would be predicated upon the fact that the Trumpets refinanced the $3,000,000 purchase money mortgage on the Second Parcel in early 2000 and increased the debt to $6,000,000. The additional $3,000,000 was used by the Trumpets to finance the purchase of an unrelated piece of property. The question to be addressed under §707(a)(2)(B) is whether the borrowing of the additional $3,000,000 and the assumption of the debt in late 2001 by the partnership were related and should be treated as a disguised sale. Any debt which is assumed by the partnership and which was incurred less than two years prior to the date of contribution, will be treated as consideration received in a sale under §707(a)(2)(B) unless the Trumpets can demonstrate that such debt was not incurred in anticipation of the transfer of the partnership. Reg. §§1.707-5(a)(1), 6(i)(B) and (7).

However, since the Trumpets had not seriously considered forming a partnership with anyone when the refinancing took place and almost two years have elapsed since the refinancing, TLLC and the Trumpets
should be able to assert a strong case that §707(a)(2)(B) should not apply. However, the Trumpets must disclose that they are treating the liability as a qualified liability for purposes of §707(a)(2)(B). Reg. §1.707-5(a)(7)(ii).

b. TLLC will be entitled to tack its holding period for the property onto its partnership interest. Under §1223(1) tacking of holding periods is permitted if the partnership interest is received in exchange for a capital asset or property used in a trade or business which is described in §1231(b).

c. TLLC's contribution of property with a value of $30,000,000 and a basis of $10,000,000 to the partnership means that the partnership has inherited an unrealized gain of $20,000,000. (The partnership's basis in the property received from TLLC is $10,000,000 under §723.) Under §704(c)(1)(A), as amended by the Revenue Reconciliation Act of 1989, all of this latent gain must be allocated to TLLC for tax purposes when recognized by the partnership. Thus, the disparity between the book value of the Taj Mahal Grove contributed by TLLC to the partnership and its tax basis (see, discussion of difference between book value and tax basis in Part IV.A.4 infra) will ultimately be eliminated when the property is disposed of in a taxable transaction. (Note that if the property had been depreciable, the book tax disparity would have been eliminated on a more rapid basis through special allocations of depreciation.)

d. The economic arrangement agreed to among TLLC, Developer and Nicklaus provides for allocations of profits, losses and cash flow in a manner which differs from, and is disproportionate to, the agreed values of the capital contributions made by the parties. These allocations will be respected by the Service if they meet any one of the following criteria:

(i) the allocations have substantial economic effect as determined under Reg. §1.704-1(b)(2);

(ii) the allocations are in accordance with the partners' interests in the partnership, determined by taking into account all facts and circumstances as determined under Reg. §1.704-1(b)(3); or
(iii) the allocations are deemed to be in accordance with the partners' interests in the partnership under one of the special rules set forth in Reg. §1.704-1(b)(4). See, Reg. §1.704-1(b)(1)(i).

Since the second and third alternatives are dependent upon facts and circumstances and are inherently subjective, the safest method to insure that the partners' allocations will be accepted by the Service is to comply with the substantial economic effect safe harbor established under Reg. §1.704-1(b)(2). In order to avail themselves of this safe harbor, the partners' allocations must both have economic effect and must be substantial. Reg. §1.704-1(b)(2)(i).

(1) In order to have economic effect, the partnership agreement must provide for the following throughout the full term of the partnership:

(a) for the determination and maintenance of the partners' capital accounts in accordance with Reg. §1.704-1(b)(2)(iv);

(b) upon the liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners and such distributions are to be made within the time period referred to in the regulations; and

(c) if a partner has a deficit balance in his capital account following the liquidation of his interest in the partnership (taking into account certain adjustments), such partner must be unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of the taxable year in which the liquidation takes place (or, if later, within 90 days after the date of such liquidation).

If the partnership agreement provides for the maintenance of capital accounts and for
distributions upon liquidation in accordance with positive balances in capital accounts, but fails to meet the deficit restoration obligations set forth above, the regulations establish an alternate economic effect test which will enable a partner who is not obligated to restore a negative capital account balance to avail itself of the safe harbor if the partnership agreement contains a qualified income offset. Reg. §1.704-1(b)(2)(ii)(d).

(2) The economic effect of an allocation will be substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. The rules for determining substantiality are set forth in Reg. §1.704-1(b)(2)(iii).

The allocations described in Part IV.A.4., supra, comply with the requirements set forth above and such allocations will, therefore, be respected for tax purposes.

e. A partnership is a flexible form of entity that is ideally suited for this venture. It is a passthrough entity which means that the income of the entity will not be subject to tax at the entity level but instead will pass through to its partners. Likewise, losses will flow through to the partners subject to the basis limitation rules of §704(d). However, these favorable tax benefits will only be available to TLLC and the other partners if the partnership will be treated as a partnership for federal income tax purposes. Since a limited partnership has many of the same features as a corporation, the issue is whether the entity will be treated for tax purposes as a partnership or a corporation.

The determination of whether an entity will be recognized as a partnership (rather than a corporation) for tax purposes is now governed by Reg. §§301.7701-1 and 2, the so-called check-the-box regulations. Under the check-the-box regulations, a partnership (including a limited partnership) that is formed under the law of the
State of Florida or any other state which will be recognized as a partnership for federal income tax purposes unless the partnership as an association, taxable as a corporation. Reg. §301.7701-3(a) and (b). The check-the-box regulations became effective as of January 1, 1997. These regulations are in marked contrast to the four factor tests of old Reg. §301.7701-2. Thus, the new limited partnership formed by TLLC, Developer and Tiger Nicklaus will automatically be classified as a partnership for tax purposes unless the partners file IRS Form 8832 with the Service affirmatively electing to be classified as a corporation (which the parties will not file because all of them desire to have the limited partnership treated as a partnership for tax purposes).

C. Tax consequences to Tiger Nicklaus.

1. Profits interest for future services. The limited partnership interest to be issued to Tiger Nicklaus does not require Nicklaus to make a capital contribution to the partnership. Nicklaus will receive a secondary profits interest which will enable him to share in profits of the partnership in excess of $2,500,000 per year. In consideration for such interest, Nicklaus is required to promote the partnership's development project throughout the United States and the world for a period of five years. If Nicklaus ceases to render such services at any time prior to the expiration of such 5-year period, his interest in the partnership will be terminated and he will only be entitled to any partnership profits previously accrued on his behalf and which remain undistributed at such time (i.e. the positive balance in his capital account).

a. In many cases a service partner is not given an interest in partnership capital but receives instead an interest in future profits of the partnership for his services. Reg. §1.721-1(b)(1) deals with the tax treatment of such event in a rather circuitous fashion as evidenced by the following:

... To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished
profits) in favor of another partner as compensation for services. Section 721 does not apply.
[Emphasis supplied]

The underscored parenthetical appears to exempt the receipt of an interest in partnership profits for services from taxation and this interpretation of the regulations was accepted by most tax practitioners prior to 1971. See, e.g., Willis, Willis on Partnership Taxation (1st Ed.) §9.07 (McGraw-Hill 1971).

(1) This position was supported by a footnote to the Tax Court's opinion in Hale v. Commissioner, 24 T.C.M. 1497 (1965) which provided that under the regulations, the mere receipt of a partnership interest in future profits does not create any tax liability. 24 T.C.M. at 1502, n.3.


b. In 1971 the Tax Court, in a unanimous reviewed decision in Diamond v. Commissioner, 56 T.C. 530 (1971), aff'd. 492 F. 2d 286 (7th Cir. 1974), held that the receipt of an interest in the profits of a partnership in consideration for services previously rendered constituted taxable income to the recipient. The Tax Court in Diamond commented that the meaning of the parenthetical reference to a profits interest in Reg. §1.721-1(b)(1) was obscure and went on to hold that, since neither §721 nor the regulations thereunder specifically exempted a compensatory transfer of a partnership profits interest from taxation, the transfer of the profits interest to the taxpayer in Diamond should be governed by the general statutory provisions of §61. 56 T.C. 530, 546.

(1) The Tax Court's opinion in Diamond appears to distinguish between the receipt of an interest in the profits of a partnership for past services and the receipt of such an interest for future services, with the implication that the latter case might not be taxable.

(2) The Seventh Circuit, in affirming the Tax Court's decision in Diamond, did not make a similar
distinction between a profits interest received for past or future services, but indicated that the determination of whether a profits interest will result in taxable income to the service partner will be determined by whether the interest has an ascertainable value. The Seventh Circuit's opinion implies that this will be more the exception than the rule.

(3) The Seventh Circuit's opinion in Diamond also addresses the fact that taxation of the service partner on the present value of a profits interest may result in double taxation because he will be taxed initially on the value of such interest and then again on these future profits when they are realized. The Court's suggested solution to the problem is to allow a taxpayer to amortize the value of his interest and the Court urged the Commissioner to promulgate regulations establishing a method of doing so.

c. Approximately five years after the Seventh Circuit handed down its opinion in Diamond, the Service issued General Counsel Memorandum 36346 (7/25/77) which announced that the Service would not follow the Diamond decision with respect to a compensatory transfer of a profits interest in a partnership in exchange for services. The GCM defines a profits interest as one which gives the holder no rights to existing assets upon liquidation. The primary concern of the GCM is that a purported partnership profits interest might instead constitute a disguised interest in partnership capital. Thus, for example, if the assets of the partnership are under-valued such that a sale of the partnership's assets at fair market value immediately after the receipt of the partnership interest by the service partner, followed by a liquidation and distribution of proceeds would result in the service partner receiving any proceeds, then the service partner would be deemed to have received an interest in partnership capital (which is clearly taxable under Reg. §1.721-1(b)(1)) rather than an interest purely in partnership profits.

d. Subsequent to the issuance of GCM 36346 and prior to 1990, there were only three cases decided involving the receipt of a
partnership profits interest for services. In each of these cases the court adopted the Diamond approach by holding that the receipt of a partnership profits interest for services is a taxable event under §61 and is subject also to §83 (governing the receipt of property for services). However, in each case the court adopted the liquidation method of valuing the profits interest described in GCM 36346 which resulted in nominal value for the interest. See, St. Johns v. United States, 84-1 U.S.T.C. ¶9158 (C.D. Ill. 1983); Kenroy, Inc. v. Commissioner, 47 T.C.M. 1749 (1984); and National Oil Co. v. Commissioner, 52 T.C.M. 1223 (1986).

e. On March 27, 1990, the Tax Court handed down its decision in William C. Campbell v. Commissioner, 59 T.C.M. 236 (1990). The Tax Court's opinion in Campbell held that the receipt of a partnership profits interest in exchange for services rendered prior to the formation of the partnership is a taxable event and that the value of the partnership interest is taxable to the recipient under §61, subject to the timing and characterization rules of §83. However, unlike St. John, Kenroy, Inc., and National Oil Co., which went through a hypothetical liquidation by the partnership of all of its assets and a distribution of the proceeds thereof to the partners in order to value the interest of the service partner, the Tax Court in Campbell resorted to a prolonged analysis of future income stream and future tax benefits, all of which were quantified and discounted back to present value in order to value the profits interest received by the service partner. It appears from the opinion that, if the Court had employed a liquidation approach to value the interests, the interests would have had a speculative or zero value in each instance. The Tax Court thus refused to acknowledge the limitations placed on its holding in Diamond by the Seventh Circuit. Moreover, the Court demonstrated an apparent willingness to grapple with the task of valuing almost any profits interest, no matter how speculative the value might be.

f. It was for this reason that the Eighth Circuit reversed Campbell and held in favor of the taxpayer on the grounds that the profits interest had speculative value. Using the rationale of the Seventh Circuit in Diamond, the Eighth Circuit reasoned that the
taxpayer had received no quantifiable taxable income. Thus, the reversal in Campbell was achieved on the basis of the value, or lack thereof, of the profits interest. See, also, Pacheco, 912 F.2d 297 (9th Cir. 1990) in which the Ninth Circuit unequivocally stated that Diamond stood for the limited proposition that if a profits interest has a determinable marketable value at the moment of creation, the interest is taxable under Section 721 but that such a case was distinguishable from the typical situations where the profits interest will have only a speculative value, if any.

g. On June 19, 1993, the Service issued Rev. Proc. 93-27, 1993-2 C.B. 343 in which the Service announced that a transfer of a partnership profits interest to a service partner in consideration for services rendered to or for the benefit of the partnership will generally not be a taxable event. Rev. Proc. 93-27 also fills a void in both the existing and proposed regulations under Section 721 by providing definitions of both a capital interest and a profits interest.

(1) Section 2.01 of Rev. Proc. 93-27 states that a capital interest is an interest that would give a holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This definition, which is designed to prevent a capital interest from being masqueraded as a profits interest by under-valuing partnership properties, is virtually identical to the definition in GCM 36,346. A profits interest is described in Section 2.2 as simply a partnership interest other than a capital interest.

(2) The safe harbor for compensatory transfers of partnership interests will not be available under any of the following circumstances (which are set forth in Section 4.02 of Rev. Proc. 93-27):

(a) The profits interest relates to the substantially certain and predictable stream of income from partnership assets, such as income from
high-quality debt securities or a high-quality net lease.

(b) The partner disposes of the profits interest within two years of its receipt.

(c) The profits interest is a limited partnership interest in a publicly traded partnership as defined in §7704(b) of the Code.

h. If the receipt of a special interest by Tiger Nicklaus is examined in light of Rev. Proc. 93-27, the following analysis should apply:

(1) The first issue to be resolved is whether Nicklaus has received a profits interest or a capital interest. In testing for the existence of a capital interest, Section 2.01 of Rev. Proc. 93-27 creates a hypothetical sale of all of the partnership's assets at their fair market values, followed by a distribution of the proceeds of such sale in complete liquidation of the partnership. If the service partner would have received any portion of the liquidating distribution with respect to the partnership interest received in exchange for services, the interest will be a capital interest. Assume for this purpose that the interest received by Tiger Nicklaus would not be treated as a capital interest under this test.

(a) In the case of the partnership interest received by Tiger Nicklaus, another very important issue to be resolved is when the interest is to be tested to determine if it is a capital interest or a profits interest. The interest to be received by Nicklaus will be forfeited if Tiger Nicklaus ceases rendering services at any time during the initial 5-year period. The partnership agreement also provides that the interest is non-transferable during this period. Based upon these facts, the property (i.e., the partnership interest) to be received by Nicklaus will be treated as a non-vested interest under §83. See, Reg. §1.83-3(c). Under the general

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rules of §83(a), income will be recognized at such time as the interest first becomes vested and the measure of the income will be the value of the partnership interest at that time over the amount (if any) paid by the service partner for his partnership interest. If, as noted above, the partnership interest to be received by Tiger Nicklaus is tested at the time the interest is initially granted to Nicklaus, it will qualify as a profits interest. However, if the vesting requirements under §83(a) are deemed to suspend the time for testing the interest, the interest may very well be converted from a profits interest to a capital interest because the interest may build up value over the 5-year vesting period. However, the Service has recently issued guidance in Rev. Proc. 2001-43, 2001-34 IRB 191 indicating that a service provider who receives an unvested profits interest which meets the requirements of the Procedure will not recognize income either at the time the interest is received or at the time it vests.

(2) Two other requirements of Rev. Proc. 93-27 are that the services rendered by Tiger Nicklaus must be to or for the benefit of the partnership and must be rendered in Nicklaus' capacity as a partner in the partnership. Both of these requirements would appear to be met in the case of Tiger Nicklaus.

i. The regulations under §83 also pose some additional potentially troublesome problems to Tiger Nicklaus and to the partnership.

(1) Reg. §1.83-1(a)(1) provides that the transferor of property to a service provider will be deemed to still be the owner of the property for tax purposes until such time as income is recognized by the service provider (i.e., when the interest becomes vested or an election under §83(b) is made). The regulation also provides that any income received from such property
during the interim period will constitute additional compensation in the recipient's taxable year of receipt. If applied literally to the profits interest received by Tiger Nicklaus and if Nicklaus failed to file a §83(b) election, Nicklaus would presumably not be recognized as a partner for tax purposes until the restrictions lapse. Thus, Nicklaus' allocable share of profits might be required to be reallocated to the other partners, even though the economic benefit associated with such profits inures to the benefit of Nicklaus. In addition, all cash distributions from the partnership to Nicklaus would, if this regulation were applied, be taxed to him as ordinary income rather than being received as a tax-free (to the extent of basis) distribution under §731.

(2) Reg. §1.83-6(b) requires that the transferor of property in a §83 compensatory transfer recognize gain or loss equal to the difference between (i) the amount paid (if any) by the transferee of the property plus the amount of the deduction (or capital expenditure) to the transferor under §83(h), and (ii) the transferor's basis in the property. The Service has not issued any guidance as to how this Regulation would apply in the case of the transfer of a partnership profits interest or capital interest for services.

D. Tax consequences to Developer.

1. Possible Diamond gain. It is possible that Developer's 50% interest in profits will be deemed to have been received in part in exchange for future services (i.e., Developer will contribute 16% of the total capital of the partnership, but will have a 50% interest in profits and losses). If so, the discussion under Part IV.C., supra, will be applicable.

2. Basis. Developer's initial basis in its partnership interest will be $4,000,000 (attributable to money contributed) plus $4,500,000 (deemed contribution by virtue of allocation of one-half of partnership debt to Developer) §§722 and 752(a); Reg. §1.752-1(b). If Developer is forced to recognize income under Diamond, its basis will also be increased by the amount of such income. §1012.
3. **Holding period.** No tacking of holding period with respect to Developer since Developer contributed only money (or money plus services) to the partnership in exchange for its interest. Reg. §1.1223-1(a).

4. **Treatment of fees.** Management, sales and rental fees will be treated as guaranteed payments to Developer because they are determined without regard to partnership income. §707(c).

**E. Tax consequences to partnership.**

1. **No gain or loss recognized from contributions.** The partnership will recognize no gain or loss upon the receipt of property and money in exchange for partnership interests. §721.

2. **Basis in contributed property.** The partnership's basis in the **Taj Mahal Grove** will be a carryover basis. §723.

3. **Holding periods.** The partnership will be entitled to tack the holding period with respect to the **Taj Mahal Grove.** §1223(2).

4. **Amortization of organizational expenses.** A 60-month amortization of organization expenses is available under §709 if properly elected.

5. **Partnership's corollary to Diamond gains.** If either Developer or Nicklaus is deemed to have received compensation income as a result of the receipt of a partnership interest for services, the partnership may have a deduction in an equal amount under §162 or, alternatively, may be deemed to have made a capital expenditure under §263. §83(h) and Reg. §1.83-6(a). In addition, the partnership may be deemed to have recognized income under Reg. §1.83-6(b) if it is determined that the profits interest distributed to the service partner constitutes appreciated property. See, discussion under Part IV.C.1.i.(2), supra.

6. **Guaranteed payments.** Guaranteed payments to Developer for management, sales and rental fees will either be treated as deductible trade or business expenses under §162 or as a capital expenditures under §263, depending upon the circumstances giving rise to the payment. §707(c); Cagle v. Commissioner, 63 T.C. 86, affd. 539 F.2d 409 (5th Cir. 1976); and Gaines v. Commissioner, 45 T.C.M. 363 (1982).