Preserving Capital Gains in Real Estate Transactions

Todd D. Golub
Richard M. Lipton

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PRESERVING CAPITAL GAINS IN REAL ESTATE TRANSACTIONS

THE COLLEGE OF WILLIAM & MARY
2008 TAX CONFERENCE

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I. WHAT ARE THE STAKES?

A. Rates.

1. **Noncorporate Taxpayers.** The maximum nominal rate imposed on ordinary income of individuals, estates and trusts under Section 1\(^1\) is 39.6 percent. This nominal rate may be increased for individuals by an additional 1.188 percent under the itemized deductions limitation of Section 68 and by an additional .67 percent under the phaseout of personal and dependent exemptions of Section 151(d)(3). Thus, the maximum marginal tax rate imposed on the ordinary income of individual taxpayers is presently 41.458 percent and 39.6 percent for estates and trusts. Long-term capital gains derived from sales or (taxable) exchanges of real estate by non-corporate taxpayers after December 31, 1997, will be taxed at either 20% or 25% marginal rates. Section 1(h). The 25% marginal rate applies to unrecaptured Section 1250 gains (i.e., the recapture of “straight line appreciation” on real estate improvements). All other recognized gains derived from sales or exchanges of real estate that is a capital asset in the hands of the taxpayer (as well as gains from sales or exchanges of real estate which is a Section 1231 asset which is included in net Section 1231 gains) which was held for more than one (1) year at the time of disposition will be taxed at a maximum rate of 20%. Section 1(h).

2. **Corporations.** The maximum marginal rate imposed on ordinary income of corporations under Section 11 is 35 percent. Likewise, the maximum rate imposed on the net capital gains of corporations under Section 1201 is 35 percent.

B. Capital Loss Deduction Limits.

1. **Noncorporate Taxpayers.** Noncorporate taxpayers may deduct up to $3,000 of net capital losses for any taxable year and carry any excess over to succeeding taxable years under Sections 1211(b) and 1212(b), respectively.

2. **Corporations.** Corporations may not deduct capital losses in excess of capital gains for any taxable year. Section 1211(a). Any excess capital loss is carried back three years and forward five years. Section 1212(a). Consequently, the major incentive for corporations to generate capital rather than ordinary income is to offset net capital loss carryovers that might otherwise expire.

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\(^1\) References to Sections refer to sections of the Internal Revenue Code of 1986, as amended. References to the Code refer to the Internal Revenue Code of 1986, as amended.
C. **Net Capital Gain Defined.** Under Section 1222(1 1), a taxpayer’s net capital gain (the amount qualifying for the preferential rate) equals the excess of the taxpayer’s net long-term capital gain over the net short-term capital loss for any taxable year. Long-term capital gains (losses) and short-term capital gains (losses) are defined as gains (losses) derived from the sale of a capital asset held for more than 1 year and 1 year or less, respectively. Sections 1222(l) - (4).

D. **Capital Asset Defined.** A capital asset is defined in Section 1221 to include all property held by a taxpayer, other than:

1. Stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

2. Property, used in his trade or business, of a character which is subject to the allowance for depreciation provided for in Section 167, or real property used in his trade or business;

3. Self created copyrights, compositions, memoranda and similar property;

4. Accounts or notes receivable acquired in the ordinary course of a trade or business for services rendered or from the sale of property described in 1 above; and


6. Under Section 1231, depreciable real property subject to the allowance for depreciation (subject to the recapture thereof under Sections 1245 and 1250) that has been held for more than one year is afforded capital gain treatment. Thus, the major definitional issue in determining whether or not a particular parcel of real property is a capital asset is whether such property was held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

E. **Protection.** Given the large difference in tax rates applicable to ordinary income versus capital gains set forth above, some taxpayers have once again become interested in protecting the capital status of any appreciation inherent in capital assets they own. This outline will set forth the applicable rules and restrictions which may impede a taxpayer’s ability to protect the capital gain treatment for this appreciation prior to the development of the property. First, at Section II, the outline will discuss the law regarding the determination of whether or not a particular taxpayer holds a particular parcel of property as a capital asset or inventory.
II. DEALER VERSUS INVESTOR

One of the most often litigated, and difficult to predict, areas of the tax law is whether real property (generally raw land) is held for investment as a capital asset or whether the taxpayer is a dealer, i.e., whether taxpayer is holding the property primarily for sale to customers in the ordinary course of his trade or business. In Malat v. Riddle, 383 U.S. 569 (1966) the Supreme Court (in its only consideration of the phrase) held that where both the business and investment motive exist in the holding of a particular parcel of real estate, the taxpayer’s principal motivation controls in determining whether the property was held primarily for sale to customers.

A. Factors Considered. Because the inquiry into the taxpayer’s motivation for owning a particular piece of real property is a factual one, the courts have developed sets of factors to determine whether the asset was capital or not. The following list set forth in United States v. Winthrop, 417 F.2d 905 (5th Cir. 1969) is representative and often cited:

1. The nature and purpose of the acquisition of the property and the duration of the ownership;
2. The extent and nature of the taxpayer’s efforts to sell the property;
3. The number, extent, continuity and substantiality of the sales;
4. The extent of subdividing, developing and improving the property that was done to increase sales;
5. The use of a business office and advertising for the sale of the property;
6. The character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and
7. The time and effort the taxpayer actually devotes to the sale of the property.

B. Methodology For Analysis.

1. No One Factor Controls. The Fifth Circuit summed up the application of the factors to each situation in Biedenharn Realty Co. v. U.S., 526 F.2d 409 (5th Cir. 1976) as follows: “No one set of criteria is applicable to all economic structures. Moreover, within a collection of tests, individual factors have varying weights and magnitudes, depending on the facts of the case. The relationship among the factors and their mutual interaction is altered as each criteria increases or diminishes in strength, sometimes changing the controversy’s outcome.” However, the court noted (and other courts have agreed) that the single most important factor is the frequency and substantiality of the sales of real property.
2. **Suburban Realty Inquiry.** To avoid becoming mired in the analysis of the factors only, the 5th Circuit in *Suburban Realty Co. v. United States*, 615 F.2d 171 (5th Cir. 1980), cert. denied 449 U.S. 920 (1980), set forth the three relevant questions which must be answered under the statutory framework by the application of the factors. These inquiries are:

   a. Was the taxpayer engaged in a trade or business, and, if so, what business?

   b. Was the taxpayer holding the property primarily for sale in that business?

   c. Were the sales contemplated by the taxpayer “ordinary” in the course of that business?

C. **Trade or Business Inquiry.**

1. **Frequency and Substantiality of Sales.** The court in *Suburban Realty* stated that a taxpayer who engages in frequent and substantial sales of real property is almost inevitably engaged in the real estate business.

   a. Frequency. There is no bright line test with respect to frequency or continuity of sales. The taxpayer in *Suburban Realty* had engaged in at least 244 individual sales in prior years. In *Biedenham Realty*, the taxpayer (held to be a “dealer”) had engaged in at least 477 lots sales from the basic subdivision in question. In *Sanders v. United States*, 740 F.2d 886 (11th Cir. 1984), the taxpayer (held to be a “dealer”) had averaged 15 sales of lots per year during a five year period with the number of sales ranging from zero to 21 in each of the years.

   (1) However, in *Reese v. Commissioner*, 615 F.2d 226 (5th Cir. 1980), the Fifth Circuit upheld the Tax Court’s determination that an executive was not engaged in the trade or business of developing real property. The executive had purchased a tract of land and arranged for the construction of a new plant on the land. The completed building was leased to the corporation that the executive owned. Following foreclosure, the taxpayer attempted to claim an ordinary loss, arguing that he acted as the general contractor on the construction project and thereby had begun to engage in the trade or business of real estate development. The court rejected that argument, holding that the project was clearly an isolated, nonrecurring venture.
Compare Morely v. Commissioner, 87 T.C. 1206 (1986) with Reese. In Morely, the taxpayer, who was engaged in the trade or business of selling real estate for commission as a broker, purchased a large tract of land and immediately began attempting to resell the property. The court determined that the taxpayer in Morely was engaged in the trade or business of selling real estate and, consequently, was not subject to the investment interest limitations of Section 163(d). In contrast, in Fraley v. Commissioner, 66 T.C.M. (CCH) 100 (1993), the taxpayer built homes on finished lots that he purchased. In 1979, the taxpayer purchased the lot in question, in 1981 he removed the house on the lot and in 1987 he sold the lot. During this period, he did nothing to improve the property and his sole marketing effort was to place a sign thereon indicating his willingness to build to suit. The court held that the sale generated a capital gain notwithstanding the taxpayer’s long involvement in buying and selling real estate.

In Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1992), the taxpayer was a partner in a joint venture that purchased unimproved property. The partners of the venture also formed a corporation shortly thereafter to perform all development activities on the property. Prior to the sale in dispute, the joint venture had made four sales, three of which were to the corporation. The remainder of the property was sold to the corporation which developed the property. The Fifth Circuit held that the Tax Court’s determination that the selling joint venture was directly in the business of selling land was clearly erroneous because the joint venture did not sell land “frequently” and the only “substantial” sale was the one at issue. The Fifth Circuit also rejected the Internal Revenue Service arguments that the corporation was acting as an agent for the joint venture and that the corporation’s development activities should be attributed to the joint venture.

b. Substantiality. The courts are also influenced by the substantiality of the amount and percentage of income derived from the sale of real property by a taxpayer. For instance, in Suburban Realty, the court noted that 83 percent of the taxpayer’s gross cash proceeds from all sources were derived from real estate sales. The court in Biedenharn Realty was likewise impressed with the sheer dollars generated by the sale of real property even though the taxpayer in
question also had significant income from other sources, thus rejecting the taxpayer's contention that it was not engaged in the trade or business of real estate development separate and apart from its other trades and businesses.

c. The courts have also emphasized the substantiality of sales, comparing the amount of income derived from real estate activities with income from other activities of the taxpayer. See e.g., Guardian Industries Corp. v. Commissioner, 97 T.C. 308 (1991). However, it should be noted that a taxpayer who holds property for long term appreciation may have a very large amount of income derived from the sale of that property in a particular year which may dwarf his other sources of income. This factor by itself should certainly not be determinative because it can also be an indication that the property has appreciated significantly over a long period of time, the hallmark of an investor.

2. Activities. Typically, an investor will merely wait for the value of property to appreciate with time, as opposed to seeking to increase the value of the property through improvements. Consequently, improvements are usually made by taxpayers engaged in the trade or business of developing the property. In Biedenharn Realty, the extensive development and improvement activities convinced the Fifth Circuit that a real estate company was not merely liquidating a former investment in farming property, but was selling property in its active conduct of a real estate business. Similar results were reached in Gault v. Commissioner, 332 F.2d 94 (2nd Cir. 1964) and Sanders v. United States, 740 F.2d 886 (11th Cir. 1984). Minor improvements may not rise to the level of causing a taxpayer to be engaged in trade or business. In Gartrell v. United States, 619 F.2d 1150 (6th Cir. 1980), the taxpayer was employed full time in a non-real estate position. The taxpayer purchased real property, subdivided it and added gravel roads and then sold the lots over a twenty year period. The court determined that the sales generated capital gains. In Buono v. Commissioner, 74 T.C. 187 (1980), acq. 1981-2 C.B. 1, an S corporation purchased a tract of land with a view to obtaining residential zoning approval on the tract and then selling it in bulk to a developer. It was anticipated that the property would be held for only 1-1/2 years. After a protracted and expensive process, zoning approval was obtained and the property was sold in three transactions. The Tax Court noted that even though the property had always been held for sale to customers, the taxpayer had never engaged in a trade or business because of the infrequency of the sales of property by the taxpayer.

3. Platting properties (for a subdivision) coupled with clearing, grading, construction of entryways, streets, sewers, etc., are considered by the courts to be indicia of dealer activity. See, e.g., Bush v. Commissioner, 610 F.2d 4206 (6th Cir. 1979); Jersey Land & Development Co. v. United
States, 539 F.2d 311 (3rd Cir. 1976); United States v. Winthrop, supra; and Bynum v. Commissioner, 46 T.C. 295 (1966). However, the improvements are not too extensive and the taxpayer can prove that they added very little to the gain which was ultimately realized by the taxpayer on the disposition, the taxpayer may still obtain capital gains status. See Huey v. United States, 504 F.2d 1388 (Ct.Cl. 1974); Barrios Estate v. Commissioner, 265 F.2d 517 (5th Cir. 1959) and Brodnax v. Commissioner, 29 T.C.M. 733 (1970). In Gartrell v. United States, 619 F.2d 1150 (6th Cir. 1980), the taxpayer was employed full time in a non-real estate position. The taxpayer purchased real property, subdivided it and added gravel roads and then sold the lots over a 20-year period. The court determined that the sales generated capital gains.

a. Use of a Business Office For Sale of Property. The use of a business office to conduct and coordinate sales activities for real estate together with obtaining the necessary licenses and permits to conduct the sales activities are considered indicia of deal status. See Segal Est. v. Commissioner, 370 F.2d 107 (2nd Cir. 1966).

b. Supervision or Control Exercised by Taxpayer Over Selling Efforts. The devotion of a significant amount of time by the taxpayer with regard to the sale of properties, together with hands-on supervision and control of any agents who are involved in such efforts, were found by the courts to support dealer status. See, e.g., Biedenharn Realty Co., Inc. v. United States, supra. However, in Fahs v. Crawford, 161 F.2d 315 (5th Cir. 1947) and Smith v. Dunn, 224 F.2d 353 (5th Cir. 1955), the taxpayer turned the entire property over to brokers who were granted total responsibility with respect to the sale of properties including decisions regarding the setting of sales prices. The court in both Fahs and Smith found that the taxpayer was an investor rather than a dealer. Under normal circumstances, however, any activities undertaken by a broker will be attributed to the taxpayer because they will be regarded as the taxpayer’s agent. Biedenharn, Supra.

c. Time and Effort Devoted by Taxpayer to Sales Activities. The devotion of a significant amount of time by the taxpayer to the types of activities that imbue the property with dealer characteristics will increase the likelihood that the taxpayer will be deemed to be a dealer with respect to the property in question.

D. Holding Property Primarily for Sale. As stated above, the Supreme Court in Malat v. Ridell held that the word “primarily” as used in Section 1221(1) means of first importance or principally.
1. **Purpose of Investment and Holding.** The relevant inquiry is the taxpayer’s motivation in holding the property prior to sale, not immediately before the sale, because at that point obviously the taxpayer’s motivation is to sell the property. Generally, the taxpayer’s original purpose for acquiring the property will continue unless such purpose is altered by evidence of a subsequent change. For instance, in *Suburban Realty,* the court assumed that the property was originally acquired as an investment. However, subsequent development activity stemming from the construction of an interstate highway through the property, changed this original purpose to that of holding primarily for sale to customers. A subsequent withdrawal of all development plats was not enough of an action to change the purpose from holding the property primarily for sale to customers back to an investment holding purpose.

2. **Changed Purpose.** An original investment purpose is typically overridden with evidence of a changed purpose unless the taxpayer can show “unanticipated externally induced factors which make impossible the continued preexisting use of the realty.” *Biedenharn Realty.* Examples of such events include events which render the property unfit for their intended use, acts of God, illness and threat of foreclosure. See, for example, *Estate of Barrios v. Commissioner,* 265 F.2d 517 (5th Cir. 1959) (construction of a government canal rendered land infeasible for continued farming and the taxpayer commenced to liquidate her investment by selling subdivided lots over a 14-year period), *Herndon v. Commissioner,* 27 T.C.M. (CCH) 662 (1968) (a real estate dealer was allowed to report the sale of subdivided farm property as capital gain because he was merely liquidating an investment following the illness of his wife), and *Erfurth v. Commissioner,* 53 T.C.M. (CCH) 767 (1987) (gain from the taxpayer’s sale of converted apartment units into condominiums was allowed to be reported as capital gain to the extent the sales were made to remove the property from the threat of foreclosure because the sales were not in the ordinary course of business; additional sales were required to be reported as ordinary income). The courts have utilized the extensive sales activities as evidence of a change in the purpose for holding the property from that of an investment intent to that of being held primarily for sale to customers in the ordinary course of business. *Thompson v. Commissioner,* 322 F.2d 122 (5th Cir. 1963).

3. **Solicitation, Advertising and Brokerage Efforts.** Solicitation and advertising tend to indicate that the taxpayer is searching for customers and not holding the land for appreciation over time. The courts may infer inherent advertising. For instance, in *Biedenharn Realty,* the court inferred an advertising and solicitation intent by the fact that the taxpayer made physical improvements to the property that would be noticed by customers who would inquire as to its availability for sale.
E. **Sales in the Ordinary Course.** Under Suburban Really, the relevant inquiry of what is “ordinary” is whether the sale was usual as opposed to an abnormal or unexpected event. Consequently, if the taxpayer’s purpose in holding the property was primarily for sale to customers and the sale occurred without the occurrence of an event which rendered its original use changed, an ordinary course sale will most likely be implied.

1. **Special Treatment for Property Acquired by Gift or Inheritance.** Property which is received by a taxpayer through inheritance or through a lifetime gift is generally viewed in a more favorable light by the courts (this relates to the first factor in *Winthrop* - the nature and purpose of the acquisition of the property). The courts have even exhibited a willingness to permit a taxpayer to engage in a certain amount of development and sales activities in order to dispose of inherited or gifted property. For example, in *Yunker v. Commissioner*, 256 F.2d 130 (6th Cir. 1958), the taxpayer inherited farmland. The taxpayer was unable to sell the inherited property as a whole. However, with the aid of a real estate broker, the taxpayer improved the land by building roads and providing utilities. The taxpayer then sold the land and subdivided lots over a two-year period. The court allowed capital gains treatment for the income from the sale of the property, and stated “Where a taxpayer liquidates his real estate holdings in an orderly and businesslike manner, he is not by that circumstance held to have entered into the conduct of a business.” *Id.* at 134. See also *Reidel v. Commissioner*, 261 F.2d 371 (5th Cir. 1958), and *Fahs v. Taylor* 239 F.2d 224 (5th Cir. 1956), cert. Denied, 355 U.S. 936 (1957). On the other land, if the liquidation process extends over a considerable period of time and is coupled with development and sales activities, the courts may not hesitate to classify the property as a dealer property. Thus, in *Winthrop*, *supra*, inherited land was subdivided and sold during the period commencing 1932 and ending 1960. The taxpayer engaged in platting, clearing and creating the property; he introduced utilities, provided an entryway and roads and ran sewer lines in through the property. The taxpayer also participated in building five houses on the lots which were held for sale. During this period of time over 456 lots were sold. Despite the fact that the property had been inherited by Mr. Winthrop, the court determined that he had developed a clear intent to sell off the property in the regular course of his trade or business. Thus, it is fair to say that, while the courts are more tolerant with respect to development and sales activities in the case of property that is either received by gift or inheritance, there is a limit to this tolerance, particularly if the development and sales activities are extended over more than a few short years.

2. **Liquidation of Investment.** There are several cases which permit a taxpayer with a large tract of land and who can demonstrate that it is very difficult or impractical to bulk sell the property at a fair price, to engage in a certain amount of development and sales activities in order to "liquidate
his investment." For example, in *Heller Trust v. Commissioner*, 382 F.2d 675 (9th Cir. 1967), a partnership built duplexes which were held for rent. The partnership ultimately experienced problems in keeping the duplexes rented and was only able to do so at a very low rental rate. A disagreement among the partners ensued with respect to whether it would be prudent to make further improvements to increase tenant occupancy. The partners could not resolve their dispute and it was ultimately decided that the duplexes would be liquidated. They were advertised for sale using extensive newspaper and radio advertising; a sales office was opened; one of the duplexes was utilized as a model and a staff of salesmen was employed to sell them. The duplexes were also completely reconditioned and redecorated in order to make them salable. The duplexes were ultimately sold off during a four-year period. The Ninth Circuit Court of Appeals found that the property was originally held for investment purposes and was ultimately sold off on a unit-by-unit basis simply because this was the most efficient and expedient manner of liquidating the partnership's investment. Thus, the court found that the partnership was entitled to capital gain treatment on the sales. The Tax Court reached a similar conclusion in *Charles R. Gangi* in which the taxpayer converted a 36-unit rental apartment building into condominiums and proceeded to sell the condominiums as a means of liquidating his investment. The Tax Court found that the taxpayers were entitled to treat the gains as long term capital gains. On the other hand, even if a taxpayer has clearly held property for investment purposes for an extended period of time, he engages in subdivision activities, undertakes significant sales activities, and continues this process over an extended period of time, the previous investment intent will not be sufficient to warrant capital gain treatment. Thus, in *Biedenharn Realty Co., v. United States*, 526 F.2d 409 (5th Cir. 1976), cert. Denied 429 U.S. 819 (1976), the Fifth Circuit Court of Appeals upheld the Service's treatment of sales by the taxpayer as ordinary income despite the fact that the taxpayer had operated the property in question as farm land for a period of over five years. The taxpayer later improved the land, adding streets, drainage and water lines, sewers and electricity. The cost of the improvements was substantial. Although the subdivided lots were sold over a period of approximately 30 years. In holding for the Service, the court made the following observation which is pertinent to the issue at hand:

a. "Undoubtedly, in most subdivided-improvement situations, an investment purpose of antecedent origin will not survive into a present era of intense retail selling. The antiquated purpose, when overcome by later, but substantial and frequent selling activity, will not prevent ordinary income from being visited upon the taxpayer. Generally investment purpose has no built-in perpetuity nor a guaranty of capital gains forever more." *Id*, at 421.
b. The court went on to offer the following observation which may be useful in determining, when the liquidation theory may prove useful to a taxpayer.

c. "There will be instances where an initial investment purpose endures in controlling fashion notwithstanding continuing sales activity. We doubt that this aperture, where an active subdivider and improver receives capital gains, is very wide; yet we believe it exists. We would most generally find such an opening where the change from investment holding to sales activity results from unanticipated, externally induced factors which make impossible the continuing pre-existing use of the reality."

3. **Suggested Techniques and Planning to Use the Special Exceptions for Inherited or Gifted Properties and the Limited “Liquidation” Exception.** If a taxpayer has received property by gift or inheritance or if a taxpayer has property that has clearly been held for investment purposes and has determined that it is not feasible to sell the property in bulk but must resort instead to the subdivision and/or sale of the property in multiple parcels, consider the use of some or all of the following:

a. If the property is held by an entity, such as a corporation, limited liability company or partnership, include clear statements of intent in the articles of incorporation, minutes, partnership agreements, etc., which clearly set forth that the principal objective of the entity is to liquidate the properties and distribute the proceeds thereof in an expedient fashion. The language can be appropriately embellished to tract the history of the property; the desire of the owners to dispose of the property and to divide the proceeds; and the use of the entity as a vehicle to liquidate its remaining real estate investments. In this regard, it may also be useful to select an appropriate name for the entity such as the “XYZ Liquidating Partnership, Ltd.” (Of course, the actions taken by the entity must be consistent with these statements of intent or they will be regarded as meaningless, self-serving declarations).

b. Segregate clear investment parcels from development parcels. If certain portions of the property will be sold in bulk and others are to be subdivided and sold in a piecemeal fashion, it would probably be prudent, as a hedge against possible classification of the entire property as a dealer property, for the entity to adopt a written plan which designates a portion of its properties that are to be segregated from the balance of the property and sold in bulk. The remaining properties would be placed in a second category as properties which will be “developed if necessary in order to
liquidate.” Since it is possible even for a dealer to obtain capital gains treatment on certain properties that are held for investment, the division of properties in this manner from dealer status if it is later determined that the developed property is dealer property.

c. A liquidation plan generally means that once properties are sold the proceeds will be distributed to the owners as quickly as possible. Although it may be necessary to retain a portion of the proceeds to cover the cost of holding the remaining properties, the balance of the sales proceeds should be distributed as promptly as possible. Any reinvestment of proceeds in additional real property would clearly be inconsistent with the liquidation purposes.

d. Although stating the obvious, the taxpayer should carefully review the seven Winthrop factors and make every effort to minimize those activities which the court equates to dealer activities. This might include some or all of the following:

(1) If it is necessary to put streets, sewers, and utilities into a specific parcel of property, and if the taxpayer is dealing with one or more builders who will buy all or a substantial number of the lots in the new subdivision, consider working a deal with the builders to have them install these improvements in exchange for a reduced cost of the lots.

(2) If a builder is going to acquire substantially all of the lots in a particular phase or subdivision, consider granting the builder an option to acquire the property and allow him to interface with governmental authorities to obtain permits and approvals, as well as to perform improvements as described above. This will remove the taxpayer from this process.

(3) Bulk sell as many properties as possible, consistent with obtaining a reasonable after-tax return thereon.

e. Any dealings with the local press with regard to the development should be minimized but, to the extent required, should emphasize that the purpose of the entity is to liquidate the taxpayer’s real estate holdings. You should keep in mind that anything that is said to the press can and will be found and used against the taxpayer by an IRS agent if it supports the Service’s case.

F. Section 1237. Section 1237 may provide statutory relief to certain noncorporate taxpayers that engage in limited subdivision activities.
1. **Statutory Requirements.** Under Section 1237, a noncorporate taxpayer will not be treated as a dealer merely because of the subdivision of a tract of land and promotional sales activities relating to it so long as:

   a. the taxpayer was not a dealer in real estate with respect to the lot or parcel (or tract of which it is a part) in any year prior to sale and in the year of sale is not a dealer with respect to any other real property;

   b. the lot or parcel has been held by the taxpayer for five years, except where acquired by inheritance or devise; and

   c. the seller did not make substantial improvements which substantially enhanced the value of the lot or parcel sold.

2. **Dealer Status.** Basically, the inquiry as to whether or not the taxpayer is a dealer in real property is the same as the common law inquiry discussed above, except the inquiry will not take into account any subdivisions of the tract of land and promotional sales activity relating to it, so long as there is no substantial other evidence that the taxpayer is a dealer. Under the Regulations, the relevant inquiry seems to be the taxpayer's intent and the existence of substantial other evidence. Substantial evidence to the contrary does not exist if one of the following is true and may not exist if more than one of the following is true:

   a. holding a real estate dealer's license;

   b. selling other real property which was clearly investment property;

   c. acting as a salesman for a real estate dealer, but without any financial interest in the business; or

   d. mere ownership of other vacant property without engaging in any selling activity whatsoever with respect to it.

   e. Treas. Reg. § 1.1237-1(a)(3). For purposes of determining the taxpayer's dealer status, the taxpayer is considered as holding property which he owns individually, jointly, or as a member of a partnership. He is not generally considered as holding property owned by members of his family, an estate or trust, or a corporation. Treas. Reg. § 1.1237-1(b)(3).

3. **Substantial Improvements.** As stated above, a taxpayer will not be eligible for the special provisions of Section 1237 if the taxpayer or certain others make improvements on the tract which are substantial and which substantially increase the value of the lot or parcel of real property sold.
a. Improvements That Are Not Substantial. Temporary structures used as a field office in surveying, filling, draining, leveling and clearing operations, and the construction of minimum all-weather access roads, including gravel roads where required by the climate, are not substantial improvements. Treas. Reg. Section 1.1237-1(c)(4).

b. Improvements That Are Substantial. Shopping centers, other commercial or residential buildings, and the installation of hard surface roads or utilities such as sewers, water, gas or electric lines are considered substantial. Because these improvements entail minimal activity, further relief provisions to the substantial improvement rule exist. An improvement will not be considered a substantial improvement if the lot or parcel is held by the taxpayer for ten years or more (regardless of whether acquired by inheritance) and (i) the improvement consists of the building or installation of water, sewer, or drainage facilities or roads, including hard surface roads, curbs and gutters; (ii) the District Director with whom the taxpayer must file his return is satisfied that without such improvement, the lot sold would not have brought the prevailing local price for similar building sites, and (iii) the taxpayer elects not to adjust the basis of the lot sold or any other property held by him for any part of the cost of such improvement attributable to such lot and not to deduct any part of such cost as an expense. Decisions finding substantial improvements increase value are Pointer v. Commissioner, 419 F.2d 213 (9th Cir. 1969); and Kelly v. Commissioner, 281 F.2d 527 (9th Cir. 1968).

c. Improvements By Others. Improvements to the taxpayer’s property by others are imputed to the taxpayer for purposes of determining whether or not the improvements are substantial for purposes of Section 1237. Improvements by the following are imputed to the taxpayer:

1. the taxpayer’s whole or half brothers and sisters, spouse, ancestors and lineal descendants;

2. a corporation controlled by the taxpayer (50% or more direct or constructive ownership of the corporation’s voting stock);

3. a partnership of which the taxpayer was a member at the time the improvements were made;

4. a lessee if the improvement takes the place of a payment of rental income;
(5) a federal, state or local government or political subdivision thereof, if the improvement results in an increase in the taxpayer’s basis for the property, as it would, for example, from a special tax assessment for paving streets;

(6) any improvements made by the buyer pursuant to a contract of sale entered into between the taxpayer and the buyer.


(8) See Rev. Rul. 77-338, 1978-2 C.B. 312, which permitted capital gain treatment under Section 1237 where land was leased on a long term basis to developers who improved and subdivided the land, constructed houses on the land, and sold the houses subject to a lease. A testamentary trust created under the will of the lessor subsequently sold the land to tenant/homeowners. The Service held that, since the taxpayer had not improved the land (developers, who are unrelated to the lessor, made all improvements), the sales qualified under Section 1237.

4. **Substantial Increase in Value.** To remove the taxpayer from the benefits of Section 1237, a substantial improvement must substantially increase the value of the lot sold. If the improvements increase the value of a lot by ten percent or less, such increase will not be considered as substantial, but if the value of the lot is increased by more than ten percent; then all relevant factors must be considered to determine whether, under such circumstances, the increase is substantial. Additionally, the increase in value to be considered is only the increase attributable to the improvement or improvements. Changes in the market price of the lots not attributable to the improvements are to be disregarded. Treas. Reg. Section 1.1237-1(c)(4).

5. **Special Rule for Sales of More Than Five Lots.** A taxpayer selling less than six lots in any taxable year will treat the entire gain as capital. In later years, five percent of the selling price, to the extent of its gain, on the sixth and all further lots is recognized as ordinary income with the remainder as capital gain. Expenses of the sale reduce the ordinary income portion of the gain first. However, if the sixth lot is sold in the same taxable year as the first five lots, five percent of the selling price on all of the lots, including the first five lots, is ordinary income. Treas. Reg. Section 1.1237-1(e).
III. SALES OF REAL PROPERTY TO RELATED PARTIES.

A. Factual Setting. Assume that a taxpayer has real property with a tax basis of $500,000. The taxpayer expects to incur expenditures of an additional $1,500,000 for planning, platting, engineering, permitting and approvals as well as construction of improvements and infrastructure. Thus, the total tax basis of the fully developed parcel will be $2,000,000. Assume that the property will be developed into a multi-phase single-family residential project with a total projected sell-out netting $10,000,000. This will yield $8,000,000 of ordinary income.

1. Sale of Property to Related Entity. If the property has an appraised value before any development work is commenced of $2,500,000, a sale of the property for its current fair market value to a controlled entity will, if respected for tax purposes, convert $2,000,000 (i.e., the excess of the $2,500,000 fair market value over the $500,000 initial tax basis) of the potential $8,000,000 of gains from ordinary income into long term capital gains.

B. Sale to Related Corporation. Taxpayers frequently attempt to sell undeveloped property to a controlled corporation in order to lock in the pre-sale appreciation at long term capital gains rates. Generally, the sale is made to the corporation on an installment basis. If the sale is respected, the corporation will take a new tax basis under Section 1012 equal to the cost of acquiring the property.

1. Debt v. Equity. The Service may argue that the installment notes received by the taxpayer from the sale should be treated as equity and the equivalent of stock received in a Section 351 exchange with the following results:

a. The taxpayer’s lower cost basis carries over to the corporation.

b. The corporation will receive additional taxable income as a result of the lower tax basis and, after corporate taxes, will have additional E&P to support dividend distributions.

c. The taxpayer’s receipt of interest and principal payments will be taxed as dividends.

d. The factors most often considered by the courts are:

   (i) The intent of the parties;

   (ii) The identity between creditors and shareholders;

   (iii) The extent of participation in management by the holder of the instrument;
(iv) The ability of the borrower to obtain funds from third-party sources;
(v) "Thin" capitalization;
(vi) The risk involved (equity-like or debt-like);
(vii) The formality of the arrangement;
(viii) Subordination to other creditors;
(ix) The voting power of the holder of the instrument;
(x) Fixed rate of interest;
(xi) Whether obligation to pay is contingent;
(xii) The source of the interest payments;
(xiii) The existence of a fixed maturity date;
(xiv) A provision for redemption by the borrower;
(xv) A provision for redemption at the option of the holder of the instrument; and
(xvi) The timing of the advance relative to the origination of the borrower.

(xvii) Fin Hay Realty Co. v. United States 398 F.2d 694 (3rd Cir. 1968).

2. Cases Upholding the Service's Treatment of "Debt" as "Equity". Cases which have addressed the "debt v. equity" and "sale v. contribution to capital" issues and held for the government are as follows: Gooding Amusement Co. v. Commissioner, 23 T.C. 408 (1954), aff'd., 236 F.2d 159 (6th Cir. 1956), cert. denied, 352 U.S. 1031 (1957) (sale of business); Aqualane Shores, Inc. v. Commissioner, 30 T.C. 519 (1958), aff'd., 269 F.2d 116 (5th Cir. 1959) (sale of land); Truck Terminals, Inc. v. Commissioner, 33 T.C. 876 (1960), acq. 1960-2 C.B. 7, aff'd., 314 F.2d 449 (9th Cir. 1963) (sale of equipment to subsidiary); Burr Oaks Corp. v. Commissioner, 43 T.C. 635 (1965), aff'd., 365 F.2d 24 (7th Cir. 1966), cert. denied, 385 U.S. 1007 (1967) (sale of land); Slappey Drive Ind. Park v. United States, 561 F.2d 572 (5th Cir. 1977) (sale of land); Western Hills, Inc. v. United States, 71-1 U.S.T.C. §9410 (S.D. Ind. 1971) (successive sales of land); Marsan Realty Corp. v. Commissioner, 22 T.C.M. 1513 (1963) (sale of land). All of the above-cited cases resulted in adverse decisions to the taxpayer.
3. **Adverse Factors.** Factors which led to the adverse decisions noted in 2 above include:

   a. Inadequate or "thin" capitalization.
   
   b. Identity of interest between those who own stock and notes.
   
   c. Intention not to enforce the notes, such as failing to insist upon payment of interest and principal payments when due.
   
   d. Notes subordinated to general creditors.
   
   e. Inflated price.
   
   f. No overriding business purpose.

4. **Installment Sale to Controlled Corporations That Have Been Respected by the Courts.** An installment sale of real property to a controlled corporation may be respected if there is a demonstrated likelihood of early repayment. *Sun Properties v. United States,* 220 F.2d 171 (5th Cir. 1955) (income from transferred warehouse sufficient to pay expenses and notes); *Piedmont Corp. v. Commissioner,* 388 F.2d 886 (4th Cir. 1968) ($10,000 cash and $160,000 purchase money notes equal value of option right to purchase land, and there was a reasonable probability that notes would be repaid; "thin capitalization" not alone sufficient to negate sale); *Gyro Engineering Corp. v. United States,* 417 F.2d 437 (9th Cir. 1969) (income from transferred apartment house was sufficient to pay expenses and notes; "thin capitalization" doctrine held not applicable); *Hollywood, Inc. v. Commissioner,* 10 T.C. 175 (1948), *acq.,* 1948-1 C.B.2 (sale of land to corporation which did not develop but, instead, resold it in the same condition as when acquired); *Evwalt Development Corp. v. Commissioner,* 22 T.C.M. 220 (1963) (sale of land to corporation having "not negligible" capital, 14 months after it was formed; and notes given for prior sales were paid promptly); *Charles E. Curry v. Commissioner,* 43 T.C. 667 (1965), *nonacq.,* 1968-2 C.B.3 (sale of income producing office building); *Arthur M. Rosenthal v. Commissioner,* 24 T.C.M. 1373 (1965); *Ainslie Perrault v. Commissioner,* 25 T.C. 439 (1955), *acq.,* 1956-1 C.B. 5, aff'd., 244 F.2d 408 (10th Cir. 1957); *Sheldon Tauber v. Commissioner,* 24 T.C. 179 (1955), *acq.,* 1955-2 C.B. 9; *Warren H. Brown,* 27 T.C. 27 (1956), *acq.,* 1957-2 C.B. 4 (each involving sale of business, and ascribing goodwill as an asset which augmented capital).

   a. The decision in *Warren H. Brown* provides helpful guidelines on this issue:
   
   b. "...the apparent intention of the parties, the form of contract here in question, the reservation of title in the transferors until the full purchase price is paid, the obvious business considerations
motivating the partners to cast the transaction in the adopted form, the substantial investment by the transferor in stock of the corporation, the superior position of the transferors' claims to the claims of the other corporate creditors, the fact that the contract price was equal to the stipulated fair market value of the assets transferred thereunder, the contract provision calling for fixed payments to the partners without regard to the corporate earnings, the provision requiring the payment of interest to the transferors at a reasonable rate, the absence of an agreement not to enforce collection, and the subsequent payment of all installments which became due under the contract during the years in issue...” 27 T.C. at 35, 36.

5. Corporation/Purchaser’s Dealer Activities May Adversely Affect Taxpayer’s Ability to Claim Capital Gains on Sales. If the corporate purchaser immediately subdivides and sells the land purchased from the taxpayer in a manner which stamps it as a dealer, some cases have applied various theories to find that these dealer activities will cause a taxpayer to have ordinary income on his sale to the controlled corporation. See e.g., Burgher v. Campbell, 244 F.2d 863 (5th Cir. 1957), Tibbals v. United States, 362 F.2d 266 (Ct.Cl. 1966), and Brown v. Commissioner, 448 F.2d 514 (10th Cir. 1971). However, in a recent decision by the Fifth Circuit Court of Appeals, the Service’s attempt to attribute dealer activities of the corporate purchaser to the selling taxpayer was squarely rejected. In Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1992), the “taxpayer” was a partner in a partnership which acquired several parcels of land for the stated purpose of investment. The partnership was comprised of four individuals. Shortly after the partnership was formed, the same four individuals who were partners in the partnership formed a new corporation which was owned by them in the same proportions as they held their partnership interests. The partnership then sold almost all of its land to the corporation which subsequently developed and sold it to third parties in the ordinary course of its business. The partnership reported its income from the sale of land to the corporation as long term capital gains. The Service argued that the profits should be taxed as ordinary income because the partnership, in conjunction with the corporation which was owned by the same persons and in the same proportions as the partnership, were jointly engaged in the development and sale of real estate in the ordinary course of business. The Fifth Circuit, reversing the Tax Court, held that the partnership was entitled to long term capital gains treatment. It began its analysis by reviewing the seven Winthrop factors and found that, based solely upon a review of the partnership’s activities, the property was certainly not “dealer property” in the hands of the partnership. The court went on to hold that the corporation was a separate taxable entity and that, under the Supreme Court’s decisions in National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949) and Commissioner v. Bollinger, 485 U.S. 340 (1988), the corporation cannot be said to have been functioning
as an “agent” for the partnership. The court also refused to apply the “substance over form” doctrine to attribute the corporation’s dealer activities to the partnership.

6. **Installment Sale Rules.**

a. Gains from the sale of property by a taxpayer to a “related party,” as defined in Section 453(f)(1), are eligible for installment reporting, but any amounts received by the transferee upon a subsequent disposition of the property within two years of the date of the original sale will result in acceleration of income. Under Section 453(e), any amounts received by the transferee upon a subsequent disposition will be treated as a payment received by the taxpayer unless an exception applies.

(1) “Related parties” are defined in Section 453(f)(1) using the attribution rules of both Section 267(b) and Section 318.

b. If depreciable property is sold to a “related party,” which, for purposes of this provision, will be limited to parties described in either Section 1239(b) or Section 707(b)(1)(B), the seller will not be eligible to report on the installment method. Exception to this disallowance is available, however, if the taxpayer can demonstrate to the Service that he did not have as one of his principal purposes the avoidance of federal income taxes. Section 453(g)(2).

c. Any recapture income resulting from the sale of real property to a controlled entity under Section 1245 and/or Section 1250 must be reported in the year of sale (i.e., deferral under the installment method is not available). Section 453(i).

d. As a general rule, “dealers” who are selling property held for sale to customers in the ordinary course of a trade or business will no longer be eligible for installment reporting. Sections 453(b)(2)(A) and 453(l). However, certain dealers in timeshare properties and residential lots may elect to utilize the installment method if they agree to pay an interest toll charge for the privilege of doing so. See Section 453(l).

C. **Sale to Related Partnership.**

1. **Section 707(b)(2).** Under Section 707(b)(2), upon a sale of property between a person and a partnership which, in the hands of the transferee is property that is not classified as a capital asset (as defined in Section 1221), the gain will be ordinary if the person owns, directly or indirectly, more than 50% of the capital interests or profits interests in the partnership.

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a. Under Section 707(b)(3), “ownership” of a capital or profits interest in a partnership is to be determined in accordance with the rules of constructive ownership of stock provided in Section 267(c) (other than paragraph 3 of such section). Under Section 267(c) the following rules apply:

(1) Capital or profits interests owned directly or indirectly by or for a corporation, partnership, estate or trust are considered to be owned proportionately by or for its shareholders, partners or beneficiaries; and

(2) An individual is considered to own partnership capital or profits interests owned, directly or indirectly, by or for members of his family. “Family” includes brothers and sisters, spouse, ancestors, and lineal descendants.

(3) Note that Section 707(b)(2) would recharacterize the nature of income on the sale of any property that is not a capital asset. Thus, a sale of a Section 1231 asset (even if not depreciable) would be caught in this section.

(4) A key to avoiding Section 707(b)(2) is to sell to a partnership or LLC (that is treated as a partnership) which the selling party does not directly or indirectly control.

b. Contrast Tax Treatment with Sale to Controlled S Corporation. There is no counterpart to Section 707(b)(2) in the S corporation area. The only section that has to be dealt with for recharacterization purposes in an S corporation setting is Section 1239.

2. Section 1239. Section 1239 would recharacterize capital gain into ordinary income upon sales of assets between a person and a partnership in which the selling person owns more than 50% of the capital or profits, directly or indirectly, and if the property, in the hands of the transferee partnership, is depreciable property. The Section 267(c) attribution rules also apply in the case of Section 1239.

D. Sale of Equity Interests in Development Entity. If a taxpayer is successful in navigating the tests applicable to sales of real property to a related entity described in III.B. and C., supra, the ultimate success in conversion of ordinary income into capital gains would be to then sell all of the stock of the development corporation (or all of the partnership interests in the development partnership) to a third party. Although the sale of stock of a corporation generally qualifies for long term capital gain treatment, the corporation may be deemed to be a “collapsible corporation” as defined in Section 341(b)(1) with the result that all of
the gain derived from the sale of stock may be converted from capital gain to ordinary income. It should be noted that Section 341(b)(1)(A) was amended in 1984 to describe the "tainted view" as a sale or exchange of stock by the shareholders of a corporation before the realization by the corporation of 66-2/3% or more of the taxable income to be derived from the (in this case) development and sale of the property owned by the corporation.

The counterpart to Section 341 in the partnership area is Section 751. Under Section 751, any proceeds from the sale of a partnership interest which, under the rules of Section 751 is deemed to be attributable to the value of "inventory properties" (including real property held for sale to customers in the ordinary course of a trade or business) of the partnership, will be treated as ordinary income rather than long term capital gains.

IV. CONTRIBUTION TO A CONTROLLED ENTITY

A. Contribution to a Controlled Entity. The taxpayer may contribute the property to a controlled partnership or corporation prior to the commencement of development activities. However, the capital gain inherent in the property may not be protected.

1. Partnership. The contribution of the property to a controlled partnership may not achieve the goal of locking-in the capital gain inherent in the parcel of investment property.
   a. Carryover Basis. Under Section 723, the partnership takes a carryover basis in the property, increased by the gain, if any, recognized by the taxpayer upon such contribution.
   b. Holding Period. Because the property has the same basis in the hands of the partnership as the contributing partner, the partnership’s holding period for the property would include the period of time the property was held by the contributing partner. Section 1223(2); Treas. Reg. Section 1.723-1.
   c. Substitute Basis. The taxpayer’s basis in his partnership interest is, generally, equal to his basis in the transferred property. Section 722.
   d. Disguised Sale. If the property is contributed to the partnership subject to a liability, an analysis of the shifting of a "qualified" or non-qualified liability must be conducted to determine if a disguised sale under Section 707(a)(2)(B) and Treas. Reg. Section 1.707-5 has been generated inadvertently.
   e. Deemed Distributions. If the property is contributed to the partnership subject to a liability, and assuming the transaction was not a disguised sale, an analysis of the shift in the sharing of the
liability among the partners under Section 752 must be made to minimize any gain recognized by the contributing partner on a deemed distribution of cash resulting from a reduction in his share of the partnership’s liabilities. Sections 752(b); 731(a).

f. Section 704(c) Allocations. Under Section 704(c), the built-in gain inherent in the property on contribution must be allocated to the contributing partner under one of the three methods specified in Treas. Reg. §1.704-3. Query -- Assuming the Section 704(c) built-in gain was allocated to the contributing partner upon the sale of the property by the partnership and following development activity, would the character of the gain be ordinary or capital? Should the character of the built-in gain be determined by viewing the partner’s activity only as to the pre-contribution gain under Treas. Reg. §1.702-1(b)? Does the determination hinge upon the utilization of the entity or aggregate theory of partnerships?

g. Subsequent Distributions. The distribution of the contributed property to another partner or the distribution of other property to the contributing partner within five years of the original contribution to the partnership may trigger the recognition of all or part of the built-in gain inherent in the property by the contributing partner. Sections 704(c)(1)(13) and 737.

h. Subsequent Transactions. If the partnership develops the property, a subsequent sale will generate ordinary income (except, perhaps, with respect to the built-in gain on the property, see III.B.I.f above), which will be allocated to the partners taking into account Section 704(c). The sale of a partnership interest will generate capital gain except to the extent the consideration is attributable to unrealized receivables and inventory of the partnership. Sections 741 and 751.

2. Corporation. The contribution of the property to a controlled corporation may not achieve the goal of locking-in the capital gain inherent in the parcel of investment property.

a. Carryover Basis. The corporation would take a carryover basis in the property, increased by any gain recognized by the taxpayer upon the contribution Sections 1032 and 362(a).

b. Holding Period. If the property has the same basis in the hands of the corporation as the contributor, the corporation’s holding period for the property would include the period of time the property was held by the contributing shareholder. Section 1223(2).
c. 351 Transfers. For the transfer to be a nonrecognition event to the transferor taxpayer, the transfer must qualify under Section 351, i.e., the transfer must be solely in exchange for stock and the taxpayer must be in control (80% of vote and 80% of all shares) of the corporation immediately after the exchange.

d. Substituted Basis. If the exchange qualifies under Section 351, the taxpayer's basis in the stock is, generally, equal to his basis in the transferred property. (If gain or loss is recognized, the basis is adjusted). Section 358(a). If the exchange does not qualify under Section 351, the transfer would be taxable and the taxpayer's basis in the stock would be its fair market value on the date of receipt (i.e., its cost basis). Section 1012.

e. Excess Liabilities. If the property is transferred subject to liabilities that exceed the taxpayer's basis in the property, the taxpayer must recognize gain (treated as if from the sale or exchange of the transferred property) in an amount equal to such excess. Section 357(c).

f. Subsequent Transactions. If the corporation develops the property, a subsequent sale will generate ordinary income to it. The stock should remain a capital asset in the hands of the taxpayer except to the extent the corporation is a collapsible corporation under Section 341.