THE “SHOVEL IN THE GROUND PROBLEM”:

PLANNING FOR REAL ESTATE DEVELOPMENT ACTIVITIES

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INTRODUCTION

The uncertainty surrounding the “real estate dealer versus investor” issue has generated a substantial degree of caselaw over the years. Much of this uncertainty stems from what has been coined as the “shovel in the ground problem” – i.e., when do the taxpayer’s value-enhancing activities, such as landscaping or installing sewer systems, convert investment property into dealer property, such that ordinary income tax consequences will result. This paper will explore some of the issues associated with the dealer versus investor challenge and will suggest possible tax planning strategies to achieve a favorable tax result for your client. However, as most tax practitioners who have tackled this issue can attest to, there is no definitive answer to this issue.

Significance of Characterization

Gain and loss recognized from the disposition of real property must be characterized as either ordinary or capital in order to determine the appropriate tax treatment of the gain or loss. For non-corporate taxpayers, the capital gains tax rate cannot exceed 5%, 15% or 25%, depending on the type of capital gain (Sec. 1(h)), whereas the nominal marginal tax rate applicable to ordinary gains can be as high 35% (Sec. 1(i)). With respect to corporations, the tax rates applicable to capital gains portion of taxable income cannot exceed 35% (Sec. 1201), which is the highest marginal rate applicable to corporate taxable income. In addition, non-corporate taxpayers can deduct capital losses only to the extent of capital gains increased by the lesser of (i) $3,000 or (ii) the excess of capital losses over capital gains (Sec. 1211(b)). Corporate taxpayers can only deduct capital losses to the extent of capital gains.

Capital Gain Defined

To obtain capital gain treatment, there must be (i) a sale or exchange (or deemed sale or exchange), (ii) a one-year holding period if long-term treatment is desired, and (iii) a capital asset (Sec. 1221) or an asset held for productive use in a trade or business (Sec. 1231). Under §1221 of the Code, a capital asset is defined as any property held by a taxpayer, whether or not
connected with a trade or business, subject to eight exceptions, three of which are germane in the context of real estate business activity. The three significant exceptions are:

1. Stock in trade or other property of a kind which would be included in inventory if on hand at the close of the taxable year and property held primarily for sale to customers in the ordinary course of business (Sec. 1221(a)(1));

2. Depreciable property and real property used in a trade or business (Sec. 1221(a)(2)); and

3. Accounts and notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of stock in trade, inventory, and property held primarily for sale to customers (Sec. 1221(a)(4)).

**Sale or Exchange**

In order to obtain long-term capital gain, the taxpayer must demonstrate that a sale or exchange of a capital asset held for more than one year occurred and the gain was taken into account in computing gross income (Sec. 1222(3)). Under the broad definition of Treasury Regulation 1.1002-1(d), a “sale” is a transfer for property for an amount of money or a money equivalent that is fixed and determinable. Similarly, an “exchange” is a transfer of property for property other than money or a money equivalent.

Generally, capital gains and losses result from the sale or exchange of a capital asset, though certain transactions not involving the sale or exchange of a capital asset are deemed to constitute the sale or exchange of a capital asset (e.g., §§ 1231(a)(1), 1233, 1234, 1234A, 1235). In other situations, property may be characterized as a capital asset even though it might not otherwise be so characterized under certain other circumstances (e.g., §§ 731, 741, 1237, 1256). Other transactions that would normally be characterized as sales or exchanges of capital assets are treated as ordinary income transactions (e.g., §§ 707(b)(2), 751, 1231, 1236, 1239, 1242, 1243, 1244, 1245, 1248, 1249, 1250, 1252, 1253, 1254, 1255, 1257, 1258, 1287). Finally, in other situations, the Code deems a sale or exchange to exist even though such characterization might not be deemed to exist in other situations (e.g., §§ 1241, 1271).

Other sections in the Code deal exclusively with the recognition of gain or loss and on the ascertainment of whether a specific transaction constitutes a sale or exchange. These provisions include, but are not limited to:

- Sec. 1001 - determination of amount of and recognition of gain or loss.
- Sec. 331 - distributions in liquidation of a corporation.
- Sec. 1031 - exchange of property held for productive use or investment.
Sec. 1033 - involuntary conversions.

A few of the special characterization rules referenced above that affect the disposition of real property or assets used in a real estate business will be discussed in this paper.

Under Section 1231(b), net gain in excess of losses from the sale of Sec. 1231(b) property is characterized as a capital gain, while net losses on the sale of 1231(b) property results in an ordinary loss. Thus, in dealing with Section 1231 property, the taxpayer has the benefit of capital gain rates and the avoidance of the capital loss limitations. However, the Code mandates that the taxpayer recapture, as ordinary income, the lesser of (i) the aggregate amount of the unrecaptured ordinary losses deducted under Section 1231 in the preceding five years, or (ii) the Sec. 1231 gain for the current year. When analyzed with the recapture provisions of Section 1245 and Section 1250, this recapture provision may make it more difficult for the taxpayer to obtain capital gain treatment on the sale of business assets.

Holding Period

In order for a taxpayer to achieve the more favorable long-term capital gain rate (15%), the property sold or exchanged must have a holding period longer than 12 months.

The holding period commences on the day after the acquisition date and is computed through the day of disposition of the property. Under Section 1223(1), the holding period may be tacked on in a situation where the basis of property acquired is determined in whole or in part by reference to the basis of property transferred, such as in nontaxable exchanges, involuntary conversions, foreclosures and certain other situations.

Interestingly, Section 1223 does not reference a holding period for assets held for resale in the ordinary course of business (i.e., inventory). Since an asset held as inventory does not appear to generate a holding period under the Code, the holding period would only seem to run during the period of time the asset is held as a capital asset or asset held for productive use in a trade or business.

Capital Gain Treatment

With respect to the tax treatment of depreciable real property, the maximum tax rate is modified for the deemed depreciation recapture. Accordingly, any depreciable real property sold after May 7, 1997 must be treated, for maximum tax rate purposes only, as if it were Section 1245 property. To the extent that depreciation on the property would be recaptured as ordinary income under Sec. 1245, the deemed depreciation recapture would be taxed at a rate not to exceed 25%. The capital gain above the deemed depreciation recapture is subject to the normal capital gains rate.
Example 1.
Bob purchased a shopping center that is Section 1245 (because it was placed in service in 1985 and thus subject to Accelerated Cost Recovery System depreciation) for $9,500,000, and depreciated it under an accelerated method, claiming $5,000,000 in depreciation deductions. Bob sells the apartments to Sue for $12,000,000, creating a gain on the sale of $7,500,000 ($12,000,000 sales price less adjusted basis of $4,000,000 ($9,500,000 - $5,000,000)). Since the property is characterized as Section 1245 property, the $5,000,000 in depreciation will be taxed ordinary income. Therefore, the gain equal to the deemed depreciation recapture of $5,000,000 would be subject to a maximum 25% tax rate. The remainder of the gain - $2,500,000 - would be subject to the capital gains maximum rate.

While the deemed depreciation recapture is referred to as “unrecaptured section 1250 gain,” this amount is not actually Section 1250 recapture for any purpose other than the maximum tax rate calculation. Accordingly, the unrecaptured section 1250 gain is not subject to the rules that relate to depreciation recapture, e.g. required recognition in the year of an installment sale of the property, etc. (discussed below).

Identifying the Real Estate Investor

While the capital gain benefits once available to the real estate investor have been diminished by recent amendments to the tax laws, such investors can still benefit from Section 1031 nontaxable exchanges, Section 1033(g) (relating to condemnation of real property held for productive use in a trade or business or for investment) and Section 453 installment sale reporting, benefits that are not available to dealers of real property. On the other hand, investors in rental real estate must be cognizant of the passive activity loss limitations of Section 469 and the capital loss limitations applicable to investment property.

Often a taxpayer acts under the assumption that his real estate undertakings are investment activities qualifying for capital gain treatment, when in actuality, the facts and circumstances surrounding the taxpayer result in dealer status. Because gain or loss from the disposition of real property is capital if it was held as an investment and ordinary if it was held primarily for sale to customers, the identification of a particular parcel of real property as investment property or as property held primarily for sale to customers is critical. According to the court in Malat v. Riddell (383 U.S. 569 (1966)), the term “primarily” means of “first importance” or “principally” so that the issue turns on the taxpayer’s intent with respect to holding of the property, which is obviously a factual issue.

Accordingly, a taxpayer’s position that an investment in real estate is merely being disposed of in the most economically profitable manner is a sustainable argument, despite the taxpayer’s engagement in activities traditionally conducted by a real estate dealer, provided that the taxpayer otherwise manages his property holdings in a manner substantially similar to that of an investor. Further, the taxpayer must be careful not to reinvest in substantially similar property shortly after the liquidation of the investment if he seeks to avoid ordinary income
characterization.

Unfortunately no definitive trend has arisen that identifies which factors will guarantee investor treatment. As the court in Biedenharn Realty Co., Inc. v. U.S. (526 F.2d 409 (1976)) noted, resolving this question is often a “vexing and oftentimes elusive” task. Obviously, however, the greater the degree of development and sales activities undertaken by the taxpayer, the more likely the taxpayer will be unsuccessful in sustaining its argument that the property is investor rather than dealer property.

Cases that have addressed the issue have emphasized various factors in different contexts, in a manner that makes it difficult to construct a pattern from which outcomes in other situations can be predicted with any degree of confidence. For example, the court in Kirschenmann v. Comr. (24 T.C.M. 1759 (1965) held that frequent sales of lots undertaken by the taxpayer because the property was no longer suited for its intended purpose did not make the property investment property, while the court in Austin v. U.S. (116 F. Supp. 283 (1953) reached the opposite conclusion on similar facts. Similarly, capital gain treatment was allowed to the taxpayer in Brenneman v. Comr. (11 T.C.M. 628 (1952)), who sold his lots after an ordinance was enacted that barred the taxpayer’s original plans, while the taxpayer in Shearer v. Smyth (116 F. Supp. 230 (1953)) was required to pay tax at ordinary rates under similar circumstances.

The Real Estate Dealer

Historically, the taxpayer in disputes regarding real estate dealer versus investor status has advocated investor classification, while the Service has argued for dealer status. However, there have been a numerous cases where the opposite has been true, primarily because the taxpayer is seeking to deduct substantial amounts of interest without being subject to the investment interest limitations of Section 163(d). See, for example, Harris M. Miller, 70 TC 448, Edward H. Boseker, TC Memo 1986-353 and E. Dean Morley, 87 TC 1206 where the taxpayers were successful in establishing that they were dealers as opposed to investors in real estate.

The facts and holding in Morley indicate that an individual can be a dealer in what essentially amounts to a single transaction trade or business. The taxpayer in Morley purchased a single parcel of land with the intent of immediately reselling it to a pre-arranged purchaser. However, due to changes in the economic conditions in the area, the pre-arranged purchaser chose not to acquire the property and the taxpayer was left holding the property for several years, during which time he paid significant interest on his mortgage payments. This single tract was the only such property purchased by the taxpayer, was obviously acquired with the intent to resell, was held for sale for the entire period of ownership, experienced no improvements or modifications during the time of the taxpayer’s ownership, and produced no current income to the taxpayer.

In light of the holding in Morley, there is a greater potential for the taxpayer to establish dealer status, if the taxpayer objective is to avoid the passive activity loss or investment interest limitation rules. On the negative side, however, the case creates a greater trap for unwary taxpayers to accidentally fall into dealer status. Taxpayers and their advisors should exercise
great care in structuring activities so that the potential benefits of avoiding the passive activity loss or investment interest limitation rules (i.e., dealer status) are weighed against the tax rate benefit of capital gains treatment (i.e., investor status). The tax rate differential between capital gains and ordinary income can provide an important tax benefit to the taxpayer in higher marginal tax brackets.

In Margaret Hancock, TC Memo 1999-336, the IRS argued that any losses the taxpayer realized on lots she and her late husband had subdivided and developed should be characterized as capital losses rather than ordinary because she was an investor. The IRS’s position was predicated on three points:

1. The nature of the real properties changed at the time of the late husband’s death.
2. The taxpayer’s pattern of selling more lots in years when market conditions were more favorable was an indication that she was an investor, as opposed to a dealer.
3. The lack of development activities subsequent to her husband’s death suggested investor rather than dealer status.

In considering the facts, the Tax Court noted that community property basis adjustment that occurred on her husband's death facilitated the losses. The economics of the real property transactions indicated that the Hancocks actually made money on the sales if compared to their original costs absent the tax adjustments. The properties declined in value after the death of the taxpayer’s husband.

Further, over the ten year period following her husband’s demise, the taxpayer sold 47 of the 48 lots she received on her husband's death. The Tax Court held that the frequency and substantiality of sales over the 10 year period was the most important factor in concluding that the property was held for sale by the taxpayer in the ordinary course of business.

Finally, the Court noted that it is possible for a taxpayer to be in the business of selling lots, even if the business activities did not rise to the level of developing lots.

**Indicia of Dealer Status**

Courts have looked at the following criteria in making the dealer or investor determination:

- **The purpose for the purchase.** The taxpayer's intent with respect to the disposition of the property at the time of the acquisition is a significant factor considered by the courts. Accordingly, platting or rezoning of the property by the taxpayer for eventual subdivision may indicate dealer intent, while more passive-type activities by the taxpayer at the time of acquisition of the property suggest an investor intent. The aforementioned activities can result in dealer status even if the taxpayer-seller plats and/or subdivides for the benefit of a developer-purchaser. In these circumstances, the taxpayer-seller must demonstrate that he is acting strictly as an agent for the developer-purchaser under the terms of the contract. However, see George V. Buono, 74 TC 187, where the Tax Court allowed the taxpayer capital gain treatment on a one-time sale where preliminary subdivision work had been undertaken. See also Planned Communities, Inc., TC Memo 1980-555.
Change in Purpose During the Taxpayer's Holding Period. While the intent of the taxpayer at the time of acquisition can be that of a dealer, often the facts and circumstances surrounding the property change such that the use of the property during the holding period converts to investment use. This is especially prevalent in situations where factors that arise subsequent to the acquisition of the property create an impediment for the taxpayer in realizing his original intent of the ownership of the property (e.g., government regulations, change in market conditions, failure to obtain adequate zoning, etc.). The changed in circumstances is often referred to as a significant economic event.

Either the taxpayer or the IRS may argue that the original purpose has changed in order to achieve the results each desires. Some Circuit Courts appear to be less ready that the Tax Court to find a change in original purpose where the property was acquired for investment. Thus, the Ninth Circuit has held that investment property doesn’t cease to be a capital asset merely because the taxpayer decides to liquidate his investment after it is found to be unprofitable if until shortly before the first sale the taxpayer held the property primarily for investment. See Heller, TC Memo 1965-302.

The Ninth Circuit also held that the taxpayer’s investment purpose had not changed to a sale purpose where, shortly after the taxpayer acquired the property, it made extensive efforts to sell the property. The property was listed, sales brochures were prepared, potential buyers were contacted, advertisers were employed, and a feasibility study was made to determine the best use of the property. The Tax Court and the Ninth Circuit concluded that while those actions might have been taken by an owner in the real estate business, they were also consistent with the taxpayer’s announced purpose of seeking to dispose of a costly capital investment that threatened its regular business (Redwood Empire Savings & Loan Assoc. V. Comr., 68 T.C. 960 (1977), affd. (1980, CA9)).

The Eleventh Circuit affirmed the Tax Court in holding that property held by the taxpayer for various alternative purposes, but separated from the taxpayer's ordinary development activity, was held in the ordinary course of a trade or business at the time of sale (Major Realty Corporation (CA-11) 55 AFTR2d 85-608). Under these facts, the property was listed in the taxpayer’s records as property held for development, distinguished from other property being held for sale. Sales of the property had been stagnant for over seven years and the taxpayer was keeping his options open in holding the property thereby him to sell it rather than develop and hold it if circumstances presented themselves such that greater profit could be made from sale. This latter factor appears to be the controlling issue.

In Harry Olstein, TC Memo 1999-290, the taxpayer closed its model homes after the taxpayer’s company lost its regulatory approval for further development. Thereafter, it ceased further development and offered the remaining lots for sale. Subsequently, an unrelated developer-purchaser defaulted on the lots purchased, and a successor entity owned by the taxpayer received settlement proceeds on the sale of the lots as a result. The taxpayer treated the proceeds as capital gain. The Court found for the taxpayer in holding that, the earlier litigation against the taxpayer's development company and the foreclosure against the developer-purchaser constituted a significant economic event, which converted the real
property from property held in the ordinary course of business to investment property.

Some activities, which may under certain circumstances be seen as selling activities, are considered activities to protect and enhance the taxpayer’s investment. Thus, a partnership was upheld in its position that its original purpose to hold a 319 acre tract of farm land for investment remained unchanged six years later when a 133 acre portion of the tract was sold even though the taxpayer had the land rezoned and made additional purchases. These activities, said the court, are those of prudent businessmen designed to protect and enhance their investment rather than an indication of an intent to hold property for sale to customers in the ordinary course of business. At no time did the partnership, or any of its partners, solicit or advertise any portion of the property for sale, nor was a “For Sale” sign ever placed on the property. Moreover, since its acquisition, the unsold portion of the property was continuously used for farming operations. William B. Dean, (1974) T.C. Memo 1974-236.

The original purpose of holding investment property continues where a change in circumstances forces a sale. There was no change from original purpose where a surveyor-engineer who had purchased land to farm later sold it as lots when the land proved too dry to farm and became valuable as residential property. The court held that he didn’t lose his investor status merely because he disposed of the land in the most advantageous manner. Barker v. U.S., (1965, DC CA) 16 AFTR 2d. 6035.

Where bankrupt medical specimen company had never been in the business of selling real property, any loss created by the sale of its property by its Chapter 7 trustee resulted in capital loss. The taxpayer argued that the realty was acquired after the bankruptcy petition was filed when the taxpayer had ceased its pre-petition business and was engaged through the trustee only in the business of liquidating assets. But the court said, absent a court order permitting the continuance or expansion of the taxpayer’s business, the taxpayer and the trustee couldn’t unilaterally change the nature of the business. Working with the trustee to liquidate assets didn’t constitute a new business for the taxpayer. Diane Reed v. U.S., (2006, DC TX) 97 AFTR 2d 2006-2348.

The Fifth Circuit held that even if a taxpayer was no longer in the business of selling real property when a particular sale was made, it will realize ordinary income from the sale if it had been in the trade or business of selling real estate, had held the real estate for sale in that business, and the sales contemplated by it were ordinary in the course of that business. Suburban Realty Co. v. U.S., (1980, CA5) 45 AFTR 2d. 80-1263.

In the following case, the original business purpose did not change into an investment purpose. The taxpayer purchased a 140 acre parcel of unimproved land, platted the entire parcel into residential and commercial lots, and gradually but regularly improved the parcel section by section and sold them to builders. The final ten acres were on rough terrain and the taxpayer decided not to improve these lots and sold them unimproved. The decision not to improve the final section did not change its character from property “held for sale” to investment property. In the context of the overall factual situation, the sale took place in the

Similarly, in Tollis, (1993) TC Memo 1993-63, the court held that the original business purpose did not change into an investment purpose where a real estate developer, who acquired land for the purpose of improving it and selling it to customers in the ordinary course of business, sold portions of the land without developing them. He had intended to continue to develop these portions of the land if the sales had not materialized, and he continued to develop other parcels when plans to sell them unimproved fell through.

The taxpayer would be well advised to allow the one year holding period after the significant economic event in order to establish investor status.

The continuity, number and frequency of sales. As a general rule, the frequency and continuity of sales efforts generally indicate that the property is held for sale, while the absence of sales efforts ordinarily speaks in favor of investment. Investors are more inclined than dealers to hold property for a substantial period of time in hopes of realizing appreciation in property value and sell the bulk of their property in a single transaction. However, as indicated by some of the cases discussed above, pure sales numbers are not dispositive. For instance, the taxpayer in George J. Wibbelsman, 12 TC 1022, was held to be a real estate dealer with only seven sales, while the taxpayer in J.T.G. Crawford, (CA-5) 161 F.2d 315, sold 95 subdivided lots over two years and was held not to be a dealer.

In determining the frequency and substantiality of sales, the Fifth Circuit said it was necessary to look not only at sales in the tax years in issue from a particular part of a tract but at sales made from the entire tract since its acquisition (Houston Endowment Inc. v. U.S., (1979, CA-5) 44 AFTR 2d. 79-6074). The Fifth Circuit emphasized that frequent and substantial sales were more important factors than development activities or solicitation and advertising efforts in Suburban Realty Co v. U.S. Also, one court held that the absence of selling and advertising activity won’t support a claim that property is held for investment where the type of property involved doesn’t require selling and advertising activity. Klarkowski, (1965) TC Memo 1965-328. In one case, however, even though promotional activity wasn’t required, the taxpayer’s lack of any marketing activity whatsoever showed that he was holding the real estate involved as an investment. D.J. Williams, (1983, DC TX) 53 AFTR 2d. 84-884.

The intensity of sales activities and promotion through advertisements, “for sale” signs, maintaining a sales office, hiring sales personnel, etc., can be of great importance. Thus, the proceeds from the sales of the unneeded portions of two factory sites were taxed as ordinary income on one sale and as capital gain on the other. The difference in tax treatment resulted from active selling activity in one case and the lack of any promotion or advertising in the other. Hutchinson.

The sales activity of the owner. The more involved the owner becomes in attempting to dispose of the property and the more time and money that is spent in advertising and attempting to dispose of the property, the more likely it is that a taxpayer will be a dealer. Despite the taxpayer having hired a real estate broker to orchestrate the sale, the acts of the
broker, as agent for the owner, are taken into consideration in determining if the owner is a dealer. In these circumstances, the seller should attempt to establish that he was reluctant to sell the property. In other words, the purchaser bought the property… the taxpayer did not sell it.

A sale of property held for appreciation doesn’t result in ordinary income since the sale of such property isn’t in the ordinary course of business. Property isn’t held primarily for sale to customers if the taxpayer’s principal purpose is to hold the property until its price goes up and then sell at a profit (Municipal Bond Corp. v. Comr., 20 AFTR 2d. 5393). Buying non-income producing realty with the expectation of profiting only from a rise in value may qualify as a form of investment entitling the taxpayer to capital gain treatment on the sale of the realty for profit (Ronhovde, (1967) TC Memo 1967-243).

In Buono (cited above), capital gain treatment on the sale of unimproved land was permitted where most of the land was sold in a single sale, after the taxpayers obtained the municipality’s permission to subdivide. The intent was to hold the property for about a year and a half and to apply for permission to subdivide which would enhance the value of the property. Permission to subdivide was granted four years later as part of a settlement of the taxpayers’ suit against the town which had refused permission to subdivide. While the intent was always to sell the property, obtaining permission to subdivide wasn’t, by itself, sales activity in the ordinary course of business in the absence of substantial and frequent sales. Subdivision is evidence of dealership but here taxpayers merely enhanced the value of the property by taking a purely legal step to make it more marketable. The taxpayers had intended to sell the property as a single tract, and made no improvements or individual lot sales.

In Newman, (1982) TC Memo 1982-61, the taxpayer, who had never previously sold real estate, purchased three single pieces of land and sold them over a three year period. The IRS asserted that each of these sales were pursuant to an overall scheme whereby the taxpayer would acquire property which was ripe for development, perform the engineering work needed in preparing development plans, obtain the necessary rezoning for such properties, and finally, sell such properties to a waiting developer, all the result of the extension of his occupations as a politician and an engineer. However, the taxpayer engaged in no sales activity whatsoever either on his own or through brokers. Profits that were the direct result of rezoning, and therefore a direct result of his efforts, weren’t enough to put the taxpayer in the trade or business of developing and selling real estate. Also, there was no evidence that his real estate activities were part of his occupation (politician) or business (engineering).

Finally, a limited liability company was determined to have bought and held land for appreciation in value that showed an investment purpose even though at least some of the appreciation was to be derived from the infrastructure work to be done by entities other than the LLC under agreements already in place when the LLC acquired the land. Phelan, (2004) TC Memo 2004-26.

Subdivision or developmental undertakings. The presence of substantial subdivision and development activities almost always indicates dealer activities have been initiated. In
Aram P. Jarrett, TC Memo 1993-516, the taxpayer bought land with the intention of subdividing and reselling but held the property until he received city approval for subdivision some 11 1/2 years later. The Court nevertheless held that the gain on sale was ordinary income. It is still possible, however, that the weight of other circumstances and factors may mitigate the dealer taint in some situations.

Other sources of income. The taxpayer may have an easier time establishing investor status where the taxpayer has substantial income exclusive of investment activities in real estate. A taxpayer may seek to recognize real estate investment income in years where other non-investment income is higher than anticipated.

The Taxpayer’s Status as a Dealer. It becomes more difficult for the taxpayer who is a real estate dealer with respect to certain property, to claim investor status for other property that he or she owns, holds and sells. The courts will look at numerous factors in conducting this analysis including the taxpayer's own representations, whether the taxpayer is licensed as a real estate broker/agent, indicated occupation on the tax return, etc. Property owned by a partnership in which one or more partners are real estate dealers is particularly susceptible to the dealer taint. However, the existence of dealer partners is but one factor in the analysis as the dealer status of the property is determined at the partnership level.

It is critical that the dealer segregate investor activities in terms of (i) type of property and (ii) separate accounting. The most effective method of separating the investor from the dealer property is to transfer investor property into a limited liability company (or similar entity) that is distinct from the entity in which dealer property is held. This segregation has been respected even where the taxpayer is the sole owner of both entities, or if one or both of the entities is a disregarded entity for tax purposes.

The Taxpayer’s Purchase of Other Property at Time of Sale. An investor who transfers property and proximately thereafter purchases additional property may resemble a dealer who is essentially restocking inventory for sale in the ordinary course of business. This is particularly true if this occurs frequently in a given time frame. Dealers are more inclined to sell and subsequently purchase new realty inventory, while investors tend to exchange properties and hold them for long periods.

Liquidation-of-Investment Theory. The liquidation of investment theory, i.e., the disposition of property in order to achieve greater economic returns, eliminate the potential for continued economic losses or to mitigate other factors which make the continued investment use of the property undesirable, has been successfully argued by many taxpayers seeking investors status. Biedenharn Realty Co., (CA-5) 37 AFTR 2d 76-679. The argument is undermined, however, where the investor acquires similar property shortly thereafter, or where the taxpayer fails to liquidate all of his or her investments of that type.

In Charles R. Gangi, TC Memo 1987-561, the Tax Court expanded on the “liquidation of investment” theory espoused in Biedenharn by permitting the use of the liquidation-of-investment theory in a situation where the deadlock of a partnership business relationship among the partners was sufficient to constitute the “significant economic event” needed to sustain continued investor treatment. The partners were not required to demonstrate that a bulk sale of the property (a 36-unit apartment house) was impractical in arguing that disposition by
condominiumization was a continuation of their investor intent.

See also Zane R. Tollis, TC Memo 1993-63, where the Court determined that the taxpayer’s liquidating sale of his properties following the taxpayer’s retirement from the real estate development business did not automatically convert the assets to investment property.

**Summary of Factors: The Winthrop Pillars of Capital Gain**

The Court in Ada Belle Winthrop, (CA-5) 24 AFTR2d 69-5760, rev'g (DC) 20 AFTR2d 5477, established a set of criteria which have been cited frequently by the courts addressing these dealer vs. investor arguments. In the order of frequency cited in other cases, these seven factors, known as the “seven pillars of capital gain,” are as follows:

1. Nature and purpose of the acquisition and duration of ownership.
2. Extent and nature of the efforts of the owner to sell the property.
3. Number, extent, continuity and substantiality of the sales.
4. Extent of subdividing, developing and advertising to increase sales.
5. Time and effort devoted to sales.
6. Character and degree of supervision over sales representatives.
7. Use of a business office to sell the property.

**Suburban Realty Co. Criteria**

The Fifth Circuit’s decision in Suburban Realty Co. has played a significant role in dealer/investor cases. The Fifth Circuit focused on three questions in deciding the case. The court in D.J. Williams posed two additional questions to arrive at what is now referred to as the expanded Suburban criteria:

1. Was taxpayer engaged in a trade or business, and, if so, what business?
2. Was taxpayer holding the property primarily for sale in the business?
3. Were the sales contemplated by taxpayer *ordinary* in the course of that business?
4. Were the contemplated purchasers, *customers* of the taxpayer?
5. Should the business activity of others be imputed to taxpayer so as to be considered the *taxpayer's business*?

The Suburban criteria have been addressed and analyzed in other jurisdictions as well.
(See Kenneth R. Dunwoody, TC Memo 1992-721). In Kenneth R. Terry, TC Memo 1984-442, the taxpayer was required by the Tax Court to recognize a capital loss on the foreclosure of unimproved land because the property, while held primarily for sale to customers, was not held within a trade or business. This holding seems to lend credence to the trade or business requirement discussed in Suburban, though other courts have found otherwise.

In Loren F. Paullus, TC Memo 1996-419, the Tax Court performed an extensive analysis of the expanded Suburban criteria in holding that certain properties held by the taxpayer and related corporations were actually investment properties for purposes of qualifying for Section 1031 tax deferred exchange treatment. However, the Court in Neal T. Baker Enterprises, Inc., TC Memo 1998-302, distinguished Paullus based on the taxpayer’s segregation of development and investment properties into separate entities, holding that the taxpayer in this case was actually a dealer for 1031 purposes. The facts of both Paullus and Baker are quite similar except that the taxpayer in Baker did not sufficiently separate the dealer and investor properties, and the Tax Court was seemingly not inclined to do so for him.

**Subdivision Opportunities Under Sec. 1237**

Section 1237 allows a taxpayer holding unimproved property, other than through a C corporation, to maintain some investor status despite subdividing the property and selling off parcels incrementally. Under Section 1237, any lot or parcel which is part of a tract of real property is not deemed to be held primarily for sale to customers in the ordinary course of trade or business at the time of sale solely because the taxpayer subdivided the tract for sale purposes or engaged in any activity incident to the subdivision or sale if that tract is a qualified tract. The Section 1237 safe harbor does not apply to C corporations. Nor does it apply to the conversion of apartment units to condominium units.

To qualify under Sec. 1237, three conditions must be met:

1. The property must never have been dealer property in the taxpayer’s hands and the taxpayer may not own any other dealer property in the same taxable year;

2. The taxpayer must not have made any substantial improvements to the property; and

3. As of the sale date, there must be a five-year holding period (including tacking) of the property by the taxpayer, although only a holding period in excess of one year is required in the case of property acquired by inheritance or devise.

However, Section 1237 does not apply to property which, under the specific facts and circumstances, is clearly either dealer property or Section 1221 property, Ralph E. Gordy, 36 TC 855, acq. Note that the Section 1237 provision is a safe harbor, and does not prevent the taxpayer from demonstrating that the lots are investment property in any event.

**What Constitutes “Substantial Improvements”?**

If the taxpayer makes substantial improvements on the property, the safe harbor under Section 1237 will not preserve capital gain treatment for the taxpayer unless the improvements are necessary improvements under the ten-year rule discussed below. Improvements made by
members of the taxpayer’s family will be attributed to the taxpayer under Section 267(c)(4), (including brothers, sisters, spouse, ancestors and lineal descendants); as will improvements made by lessees of the taxpayer, but only to the extent that the improvements are included in the income of the taxpayer; improvements made by governmental agencies, but only to the extent that the property improvements increase the taxpayer’s basis in the property; and improvements made by an S corporation or controlled by the taxpayer or a partnership in which the taxpayer is a partner.

Under Reg. 1.1237-1(c)(3), substantial improvements have not occurred unless there is a substantial enhancement in the value of the property. The Regulations provide that a substantial improvement has not been made unless the property value is increased by more than 10% as a result of the undertakings. However, even then, a facts and circumstances analysis must be made to determine if enhancement in value has occurred.

What constitutes substantial improvements is based totally on facts and circumstances. However, Reg. 1.1237-1(c)(4) specifies, (A)mong the improvements considered substantial are shopping centers, other commercial or residential buildings, and the installation of hard surface roads or utilities such as sewers, water, gas or electric lines. On the other hand, a temporary structure used as a field office, 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.

The Five Lot Rule

Section 1237 provides the taxpayer a method for achieving capital gains when the taxpayer engages in subdivision of the property. Gains from the sale of the first five lots are fully capital gain. However, starting with the taxable year in which the sixth lot is sold, gains from all lots in that taxable year and each subsequent taxable year will be taxed as ordinary income to the extent of 5% of the sales price. Accordingly, if Lots 1 -5 are sold in Year 1, and Lots 6-10 are sold in Year 2, the gain from Lots 1 - 5 would be entirely capital gain and 5% of the sales price for Lots 6-10 would be ordinary income. The balance of the gain realized in Year 2 would be capital gain. However, if the sale of Lot 6 also takes place in Year 1, all of the lots sold in Year 1 would be subject to the 5% ordinary income treatment. Similarly, if three lots are sold in Year 1 and three in Year 2, the three lots sold during the second year will be subject to the 5% rule.

The Regulations allow the taxpayer to deduct (against the 5% ordinary income to the extent of such income) expenditures incurred in connection with the sale or exchange of any lot or parcel. Any excess expenditure is allowed as a cost of sale for purposes of determining the gain on the capital portion of the sale. Since the traditional sales commission paid to a broker on the sale of unimproved land is generally higher than five percent of the sales price, it is unlikely that any significant ordinary income will actually result under this provision.

Note: substantial improvements to any one lot or parcel in the tract disqualifies the tract, and thus precludes the Section 1237 safe harbor from applying to the sales of other lots or parcels from the same tract, even if those lots or parcels are not improved (Finder Est. v. Comr., 37 T.C. 411 (1961)).
Necessary Improvements - Ten-Year Rule

A necessary improvement is not treated as a substantial improvement if four conditions are satisfied. A necessary improvement is defined in Sec. 1237(b)(3):

- The taxpayer must have held the parcel or lot for at least 10 years, regardless of the method of acquisition.
- The improvement must be the building or installation of water, sewer or drainage facilities or roads, if the improvement would constitute a substantial improvement but for this exception.
- The taxpayer must demonstrate, to the satisfaction of the Commissioner, that the lot or parcel which is being improved could not have been sold at the prevailing local price for similar building sites had the improvements not been made.
- The taxpayer must elect to make no adjustment to the basis of the lot or parcel sold, or of any other property owned by the taxpayer, for the cost of such improvements.

The taxpayer will have to do a cost-benefit analysis to determine if it is more advantageous to recognize all ordinary income after a deduction for the cost of making necessary improvements, or comply with the Section 1237 safe harbor and recognize the gain as long term capital gain without an increase in basis for the cost of the improvements.

Definition of Tract

A tract of real property is a single piece of real property, except that two or more pieces of real property are treated as a tract if at any time they were contiguous in the hands of the taxpayer or if they would be contiguous but for the interposition of a road, street, stream, or similar property (Section 1237(c)). If after the sale or exchange of a lot or parcel from the tract, no other sales of any other lots or parcels from the remainder of the tract are made for a period of five years, the remaining property, even if no longer contiguous, is treated as a tract (Reg. 1.1237-1(g)(2)).

Taxation of Dealer Income and Expenses

The classification of a real estate owner as a dealer or investor as significant tax implications aide from the character of gain the taxpayer will recognize upon disposition. We will now address some of these issues.

Denial of Installment Sales

Perhaps most significantly, dealers in real property are not entitled to take advantage of the tax deferral benefits allowed by use of the installment sale method under Section 453 for reporting gain on sales.

Self-Employment Tax Issues

In 2007, self-employment income not in excess of $97,500 is subject to self-employment tax at a rate of 12.4%, plus an additional 2.9% medicare tax on all net earnings from self-
employment. However, the self-employed taxpayer is allowed to deduct one-half of the self-
employment tax paid. Section 1402(a) defines “net earnings from self-employment” as *gross
income derived by an individual from any trade or business carried on by such individual, less
the deductions allowed by this subtitle, which are attributable to such trade or business.* The
section provides that rental income from real estate and from personal property leased with the
real estate is not self-employment income unless the rental income is received in the course of a
trade or business as a real estate dealer. Rental income from real estate and from personal
property leased with such real estate will constitute self-employment income only if received by
real estate dealers (not investors) in the ordinary course of business.

**Business Expense Deductions**

Under Code Section 162, the real estate dealer is permitted to deduct all the ordinary and
necessary business expenses incurred in the conduct of business activities. The dealer-taxpayer
ordinarily reports these business expenses on Schedule C as a reduction in self-employment
income.

On the other hand, under Section 212, a real estate investor is only allowed to deduct all
ordinary and necessary business expenses incurred for the production or collection of income or
for the management, conservation, or maintenance of property held for the production of income.
These itemized deductions (ordinarily listed on Schedule A) primarily consist of 163(d) interest
expenses, Section 164 real estate taxes, or miscellaneous Section 67 itemized deductions to the
extent they exceed 2% of the taxpayer’s adjusted gross income.

**Other Tax Implications**

Section 1031 provides for tax deferral on the exchange of property held for productive
use in a trade or business or for investment if such property is exchanged solely for property of
like kind which is to be held either for productive use in a trade or business or for investment.
Accordingly, a dealer holding property for sale to customers in the ordinary course of business is
not entitled to use this special tax provision that is available to real estate investors. In addition,
Section 1231 benefits are not available to dealers, while Section 1033 involuntary conversion
benefits aren’t either. Accordingly, the classification of a taxpayer as an investor or dealer has
significant tax implications beyond capital gain treatment throughout the Internal Revenue Code.

**Accounting for Subdivision Completion Costs**

Often times the development and subdivision activities undertaken by a taxpayer as part
of a development project totally completed in the same tax year. The taxpayer often seeks to
include in the basis of property sold in the current year, the costs of improvements that will
benefit such property but will not be completed until a subsequent tax year (e.g., installation of
roads, curbs, gutters, sidewalks, sewers, etc.). Accordingly, the taxpayer must devise some
method for allocating future costs that benefit all lots in the subdivision to the basis of lots sold
in the current tax year. Similarly, the developer must account for costs incurred in one year that
benefit properties that will not be sold until future tax years. In William C. Dahling, TC Memo
1988-430, the Tax Court mandated that the taxpayer must allocate costs to all property benefited
by common improvements.
Estimating Costs Under the Alternative Cost Method

Under Revenue Procedure 92-29, 1992-1 Cum. Bull. 748, a real estate developer is permitted to allocate to lots sold an allocable share of the estimated costs of common improvements, without regard to whether those costs have been actually incurred at the time the lots are sold. The amount of such costs that qualify for this allocation in any one year is limited to the total cumulative amount of actual construction costs for common improvements that, as of the end of such year, the developer has incurred in the entire development. Moreover, under Revenue Procedure 92-29, (1) the developer must be contractually obligated or required by law to provide the common improvements, and (2) the cost of common improvements must not be properly recoverable by the developer through depreciation deductions. Note that, under Bryce’s Mountain Resort, Inc., T.C. Memo 1985-293, an oral obligation will not suffice as a contractual obligation under (1) above.

The taxpayer must file a request with the IRS to use the alternative cost method for each development project undertaken. In addition, Revenue Procedure 92-29 requires that the taxpayer consent to an extension of the statute of limitations for the assessment of income tax when using the alternative cost method (an authorization many taxpayers may not be too keen to provide). Other administrative requirements under the revenue procedure include filing annual statements detailing the costs incurred for each project, and supplemental requests whenever the taxpayer realizes that completion of the project will take longer than ten years (the automatic ten taxable year time horizon) or the time period for completion as originally estimated by the taxpayer.

With respect to the consent for extension of the statute of limitations, the Tax Court in Robert F. Haynsworth, 68 TC 703, provided that the equitable apportionment and deduction of estimated development costs is not limited to situations in which waivers of the statute of limitations are filed. However, note that the Haynsworth decision came out prior to the publication of Revenue Procedure 92-29, so the tax practitioner may be well advised to follow the Revenue Procedure (assuming they can convince their clients to extend the SOL and incur the costs associated with assembling all the documentation required to be filed under the procedure). Revenue Procedure 92-29 indicates that Form 921 or 921-A should be filed to extend the period for tax assessment for one year after the return is filed for the taxable year in which the project is expected to be completed (as specified by the taxpayer).

“Common improvements” are defined in the Revenue Procedure as any real property or improvements to real property that benefit two or more properties that are separately held for sale by the developer. Examples of common improvements outlined in the revenue procedure include: streets, sidewalks, sewer lines, playgrounds, clubhouses, tennis courts and swimming pools that the developer is contractually obligated or required by law to provide and the costs of which are not properly recoverable through depreciation by the developer.

Estimated Costs of Common Improvements

Under the alternative cost method, the taxpayer estimates the costs of common improvements of a project as of the end of a taxable year by adding the costs of common improvements incurred under Section 461(h) (dealing with concepts of “economic
performance”) for that year to the 461(h) costs reasonably anticipated to be incurred by the taxpayer for the next ten succeeding taxable years.

The estimated costs of common improvements are prone to change from year to year due to changing materials prices, unexpected costs, etc. However, once a return has been filed, a developer may not go back and adjust the estimated cost of common improvements for a prior year when events after filing resulted in an overstatement or understatement of the original estimate. Accordingly, it would behoove the taxpayer to recalculate estimated costs each year so he or she doesn’t wind up with cancellation of debt income at the end of the project due to an overestimation of common improvement costs.

**Alternative Cost Method**

As noted above, real estate developers are permitted to allocate to the basis of lots sold an allocable share of the estimated costs of common improvements, without regard to whether those costs have been actually incurred under Section 461(h) at the time the lots are sold. Any reasonable allocation method consistently applied from year-to-year may be used to determined allocable share (i.e., the taxpayer may not change allocation methods from year to year). Therefore, available methods include: (1) a pro rata allocation based upon the number of lots sold, (2) the relative square footage of the lots, (3) the sales price per lot, or (4) the discounted present value of all lots (note: this method decreases the relative sales price of the last lots in the phase sold).

However, in allocating costs to the basis of properties sold, the taxpayer is limited to the costs of the common improvements actually incurred under Section 461(h). Therefore, the developer is prevented from taking the entire allocable share of the estimated costs into the basis of property sold, the taxpayer is permitted to take the costs not included into account in subsequent years when additional costs are incurred under Sec. 461(h).

**Example.** Bob undertakes a development project pursuant to which he subdivides a 40 acre parcel into 20 residential lots. Assume the cost of the land was $200,000 and that Bob estimated the costs of the common area improvements to be $800,000. In actuality, Bob has incurred $25,000 in development costs and has sold one lot for $200,000 as of the end of the current tax year. Bob files Form 921 in order to use the alternative cost system. It would appear that Bob would recognize $140,000 of gain ($200,000 (Sales Price) - $20,000 (Allocable Share of Basis) - $40,000 (Allocable Share of Estimated Costs)). However, under Revenue Procedure 92-29, Bob may only deduct total costs that have been actually incurred under Section 461(h) ($25,000). Thus, the allocable share of estimated common improvement costs is limited to $45,000 ($20,000 + $25,000), such that Bob’s recognized gain is actually $155,000. The additional $15,000 in costs allocable to that lot may be deducted in the first year in which Bob has incurred an additional $15,000 in costs under Section 461(h).

**Procedure for Securing IRS Consent**

In order to be permitted to use the alternative cost method, Revenue Procedure 92-29 requires that the developer file a request with the District Director on or before the extended due date for the federal tax return for the first year in which property is sold. In addition, the
taxpayer must attach a copy of the request to the taxpayer's timely filed original return for the taxable year. The revenue procedure requires that a developer who desires to ascertain the estimated costs without regard to the ten-year time horizon must obtain a private letter ruling in accordance with the guidelines contained in Revenue Procedure 92-29.

Section 6.04 of Revenue Procedure 92-29 provides the suggested form and required contents that should be included in the request:

1. The top of the first page should have the legend *Request to Use the Alternative Cost Method as Provided by Rev. Proc. 92-29.*

2. The developer's name, address, telephone number and Taxpayer Identification Number.

3. The Service Center where the developer's federal income tax returns is filed.

4. A description of the project covered by the request, including a description of the tract or tracts of land where the project is situated, city and state of location, plat map number and lot numbers, if applicable.

5. A schedule of the following information:
   
   a. The cost of the entire tract or tracts of land included in the project and a statement of how the cost was determined.
   
   b. A listing of lots by subdivision.
   
   c. A summary of the costs allocable to each lot and a description of the manner in which the costs were allocated.
   
   d. To the extent the request does not involve lots, the allocable costs and method of allocation for each property.

6. A schedule of the following information:
   
   a. A description of each common improvement that the developer is contractually obligated or required by law to provide.
   
   b. The persons to whom the developer is obligated to provide the common improvements.
   
   c. A description of the document containing the contractual obligation or law requirement.
   
   d. The estimated cost of each common improvement and the method of estimating the cost.
   
   e. The portion of the estimated cost of the common improvements allocable to each
lot (or other property) and the method for such allocation.

f. The estimated date production will commence and finish on each common improvement.

7. A signed statement under penalty of perjury regarding the validity of the facts presented in the request.

In addition, the developer must file an annual statement with his or her tax return summarizing the progress of the development project. The Revenue Procedure also contains provisions for filing supplemental requests for filing extensions.

If the taxpayer fails to comply with the provisions of Revenue Procedure 92-29, the alternative costs method can not be used, which means the taxpayer will effectively be precluded from including the allocable share of common improvement costs to the benefited property sold.

Example. If, in the example above, Bob had not elected the alternative cost system of Revenue Procedure 92-29, his deductible basis in the first lot sold would be limited to the land of $20,000 plus 10% of the costs actually incurred as of the end of the year of sale or $2,500. Gain of $177,500 would thus be recognized in that tax year.

Cost and Benefit Analysis of Subdivision of Property

Owners of a parcel of investment property often seek to maximize gains from the sale of the property by subdividing the land and selling individual lots to separate purchasers, as opposed to selling off the entire tract to a single buyer. In terms of sheer (pre-tax) gross profit sales, the sum of gross profits from the sale of individual lots is ordinarily greater than the (pre-tax) gross profit realized from the sale of the entire parcel of land.

While this “sum of the parts is greater than the whole” theory seems fairly accurate on a pre-tax basis, the real estate investor must consider the tax implications of subdividing the property, especially if significant improvements are necessitated by the local building codes and regulatory requirements. As discussed ad nauseam above, the sale of a single tract of land by an investor who has held the tract for a sufficient period of time may qualify for capital gain treatment under Sections 1221 or 1231(b). However, if the taxpayer undertakes development (e.g., subdivision) activities, it is quite probable that the IRS will argue the taxpayer’s intent for holding the property has changed to that of a dealer (i.e., intent to hold the property for sale to customers in the ordinary course of business). At that point, any extra profits that may have justified subdividing the property will likely be offset by the ordinary income tax attached to the sale of the individual lots.

Theories for Realizing Capital Gain on Subdivision

Depending on their risk aversion, individual clients may seek to assume the tax risks of subdivision while still attempting to achieve capital gains on the sale transactions. One possible theories taxpayers have advanced in supporting this position is a “liquidation-of-investment” theory.” Although this is a facts and circumstances analysis, taxpayers have been relatively successful in arguing that subdivision was required to most precipitously liquidate their
investment in the land (i.e., it was more marketable to subdivide and sell than offer the entire tract of land for sale). Again, this is a highly factual analysis, so it is likely the taxpayer will find himself in court when asserting this theory.

For a case in which the taxpayer has been successful in advancing the “liquidation of investment” theory to achieve capital gains see Charles R. Gangi, T.C. Memo 197-561. The taxpayer in Gangi owned a multi-family project for almost ten years and then converted the project to condos and sold out because of the deterioration of the owners’ business relationship. The owners advertised, although only to a limited extent, and maintained a sales office. The court took some comfort in the fact that the owners had not made any structural improvements on the property and had incurred minimal brokerage expenses. Perhaps the practitioners should ponder whether it is feasible to advance this deterioration of business relationship argument when their own clients are challenged on the ‘held for’ issue. See also Donald R. Cottle, 89 T.C. 467. But see Howard E. Furguson, T.C. Memo 1987-864, in which the taxpayer was denied capital gain treatment under similar facts.

**Capital Gain Treatment Under Sec. 1237**

As noted above, Section 1237 allows real estate owners to preserve capital gain treatment even after subdividing their land, provided certain requirements are met. The general consensus among practitioners who have encountered this issue seems to be that the tax code and regulations intend for the capital gain treatment to apply only to subdivided land (and not condominiumization of an apartment building). However, an aggressive client may seek to achieve capital gain treatment under Section 1237 upon condominiumization of an apartment building by arguing that a condominium unit is lot or parcel which is a part of a tract of real estate. Assuming the taxpayer makes doesn’t make substantial improvements as prohibited under Section 1237(b)(1) and (2), the condominium converter may have a viable argument for capital gain treatment. However, note that in Revenue Ruling 80-216, the IRS has taken the position that Section 1237 applies only to land. Therefore, reliance upon Section 1237 in seeking capital gain treatment upon condominiumization is likely a risky proposition.

**Sale to a Controlled Entity**

Real estate developers often hold their property in some corporate form (either in a corporation or a limited liability company) in order to take advantage of the liability protection afforded to these entities. By transferring development land into a controlled entity, the taxpayer seeks to limit his or her liability to the value of the entity’s assets (thereby protecting against personal liability), while also achieving capital gain treatment on the sale of the land to the controlled entity, allowing such entity to undertake the development (i.e., dealer) activities. The taxpayer often seeks to defer tax by selling the property to the controlled entity for installment notes.

If the corporate form is utilized, the purchasing corporation will receive a step-up in basis upon the purchase of the property. Consequently, ordinary income recognition is effectively limited to the appreciation resulting from the development of the land in the hands of the corporation. Further, the taxpayer can avoid the double tax treatment imposed on C corporations

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by selling the property to a controlled S corporation (i.e., a corporation that has made the proper S election). **Note: the taxpayer should not attempt to sell the property to a controlled partnership because Section 707 provides that any gain from such sale will be ordinary if the seller owns more than 50% of the partnership, unless the partnership holds the property for at least one year.**

In structuring a sale of land to a controlled corporation, the taxpayer must be weary of several other tax traps that may preclude capital gain treatment. For instance, Section 1239 provides that the sale of *depreciable* property by a shareholder to a more than 50% owned corporation will result in ordinary tax on the gain. Note Section 1239 does not apply to the sell of raw land, so the taxpayer can still achieve capital gain treatment if he sells the land to the controlled corporation prior to developing depreciable property. Under Section 1239, any gain recognized from the sale or exchange of property, directly or indirectly, between related persons is treated as ordinary income if in the transferee’s hands the property is depreciable or would be depreciable but for the fact that it is amortizable.

Persons are related if they bear any of the following relationships to each other:

- A person and any corporation of which 50% or more of the value of its outstanding stock is owned, directly or indirectly, by or for that person (§1239(c)(1)(A));
- A person and any partnership in which more than 50% of the capital interest or profits interest is owner, directly or indirectly, by that person (§1239(c)(1)(B));
- Two corporations that are members of the same controlled group (§1239(c)(1)(C));
- An S corporation and another S corporation if the same person owns more than 50% in value of the outstanding stock of each corporation;
- An S corporation and a C corporation if the same person owns more than 50% in value of the outstanding stock of each corporation;
- A taxpayer and any trust in which the taxpayer or the taxpayer’s spouse is a beneficiary, unless the beneficiary’s interest in the trust is a remote contingent interest.

In addition to the related party transaction traps of which a taxpayer must be cognizant, the taxpayer should also be aware that the IRS will characterize the sale to an 80% or more controlled corporation as a tax-free contribution to capital under Section 351 in which no capital gain nor basis step-up would result. Section 351 can also defeat the installment sale transaction sought by the taxpayer. When the controlled corporation issues a debt instrument in exchange for the property (in order to achieve installment sale benefits), the taxpayer would be well-advised to ensure that the note is structured in an arms-length manner, with appropriate interest applied, includes a security interest in the transferred property, and that the repayment of the note is not contingent upon the success of the business. Otherwise, the IRS will likely argue that, in substance, the debt instrument is merely a form of equity investment in the corporation.

There is always a risk that any transaction that is undertaken due, in significant part, to
tax planning and tax considerations may be attacked under the general principles of the "substance over form" doctrine. The IRS attacked the transaction in Bramblett on these grounds, but the Fifth Circuit Court of Appeals rejected the argument. The Court of Appeals, relying on Frank Lion Co. vs. United States, 435 U.S. 561 (1978), found that the form of a transaction chosen by a taxpayer will be respected as having genuine economic substance as long as it "is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax avoidance features."

Also, in Bramblett the Fifth Circuit found that the sales corporation was not a sham corporation, that the transaction was at arms length, that the business and legal formalities were observed, and that the original partnership had acquired the property with a bona fide intent to hold it for investment.

It is therefore recommended that any promissory note between the taxpayer and the controlled corporation require regular monthly payments of principal and interest on commercially reasonable terms, and that the development corporation make sure these payments are actually made. The note should be secured by a deed of trust on the land, although this deed of trust may be subordinated to the primary construction loan. Payoffs of portions of the note can also be made as each lot is sold to induce the shareholder to release its security interest in the land for each lot. If there are no regular payments of principal and interest, if those payments are not actually made, or if the loan is not secured, it is much more likely that a court will find that the transaction should be disregarded under the substance over form doctrine.

There is a long history of case law involving IRS challenges to promissory notes between related parties on the grounds that they are not bona fide debt, but are in fact merely "disguised equity." There are several factors relevant to this issue, as identified in the case of Warren H. Brown, 27 T.C. 27 (1956). Some of the factors involved are (1) the apparent intentions of the parties, (2) the reservation of title or security interest in the land by the shareholder until full purchase price is paid, (3) business considerations causing the adoption of the form of the transaction, (4) the capitalization of the development corporation by its shareholders, (5) whether the price is at fair market value, (6) whether fixed payments are required under the promissory note without regard to the success or failure of the development corporation, (7) reasonable interest rates, (8) actual payment of installments, and (9) whether there is an agreement not to enforce collection.

Also, in Jolana S. Bradshaw, et al., 50 AFTR 2d. 82-5238, the Court of Claims determined that undeveloped property transferred to a newly formed, wholly-owned corporation of the taxpayer was a sale and not a Section 351 contribution (despite the fact that the corporation appeared to be under-capitalized). The corporation issued the taxpayer five $50,000 promissory notes that matured over 2.5 to 6.5 years in exchange for the raw land. The court held that the transaction constituted a sale because: (1) the price paid was fair market value, (2) formalities evidencing the sale were observed, (3) the notes contained an unqualified obligation to pay a principal amount at fixed maturity dates, (4) the notes were not subordinated to general creditors, and (5) the principal and interest was always paid when due.

Failure to adhere to these formalities may result in the obligation being characterized as a
form of equity in which Section 351 may apply. In addition, the IRS may argue that the corporation is acting as a mere agent of the taxpayer. See Royce W. Brown, (CA-10) 28 AFTR 71-5611.

**Sale to an Independent Developer**

Obviously, the safest method for achieving capital gains would involved the real estate owner selling the real property to an independent party who would then assume all development activities. The taxpayer must be prepared to establish the actual independence of the developer (in rebuke to an IRS agency argument) and that the taxpayer and the developer have not joined together in a joint venture profit seeking enterprise.

**TIMING ISSUES – USE OF INSTALLMENT SALES**

Within their tax deferral arsenal, tax planners have available (i) the open transaction reporting method, (ii) the deferred payment method, or the (iii) installment method, as vehicles for deferring the recognition of gain on the sale of property. This section will focus on the use of the installment method to achieve tax deferral benefits upon the disposition of real property.

No matter what the taxpayer’s usual method of accounting, gain recognized from an installment sale is taken into account under the installment method of Section 453 (prior to the promulgation of the Installment Tax Correction Act of 2000, accrual method taxpayers were prohibited from using the installment method following the enactment of previous legislation). A taxpayer can elect not to use the installment method with respect to a particular installment sale by so electing under Section 453(d). However, the installment sale does not apply to sales in revolving credit plans.

**Qualifying for Installment Sale Reporting**

Section 453(a)(1) allows for reporting gain arising from the disposition of certain types of property under the installment method. However, the installment method is only permitted for reporting gains and is not allowed for deferring and recognizing losses. Note that only the timing, and not the character, of the gain is affected by Section 453 installment method. Accordingly, if the disposition of certain property would result in ordinary income, Section 453 may not be used to convert that income into capital gain. Reporting gains under the installment method simply suspends the reporting of gain until the actual receipt of the payments.

An installment sale is a disposition of property where at least one payment is to be received after the close of the taxable year in which disposition occurs (§453(b)(1)). Installment sales do not include dealer dispositions and dispositions of personal property required to be included in inventory (§453(b)(1)). Section 453(f)(6)(C) indicates that receipt of Section 1031 like-kind property will qualify as a payment for this purpose despite the fact that such property is
not classified as a payment for gain recognition purposes.

**Requirement of the Purchaser's Obligation**

In order for a sale to qualify for installment sale reporting, there must be an obligation or evidence of indebtedness from the purchaser. Treasury Regulation 1.453-4(c) indicates that receipt of evidence of indebtedness of the purchaser is not deemed to be a payment in the year of sale, even if the obligation is subsequently disposed of by the seller.

The obligation must not be that of anyone other than the purchaser of the property (i.e., Section 453 does not permit a transfer of a note payable by someone other than the purchaser of the property). For example, in the Section 1031 context, a purchaser of a property contemplated to be used as replacement property may not transfer the note they received in connection with the sale of the relinquished property because it would not be considered as a purchaser obligation.

Significantly, instruments which are payable on demand, issued by a corporation, government or political subdivision, and which are readily tradable will not qualify as an evidence of indebtedness of the purchaser (§453(f)(4)). Instead, it will be characterized as the receipt of a payment in the year of sale. Also, payments of principal on the purchaser obligation during the year of sale will also constitute payments in the year of sale.

**Computation of Amount Included in Gross Income**

The installment method is a method under which he income from a disposition included in gross income for a particular taxable year is the total payment received in that year multiplied by the gross profit ratio. The gross profit ratio is the gross profit divided by the total contract price (§453(c)).

**Example:** Tom owns land with a fair market value if $150,000. Tom’s adjusted basis in the land is $60,000. Tom sells the land to Mark. Mark agrees to pay Tom $10,000 each year for 15 years plus interest at the applicable federal rate. Ignoring selling expenses and other adjustments, Tom’s contract price is $150,000 and Tom’s gross profit is $90,000 ($150,000 minus $60,000). Tom’s gross profit ratio is 60%. In each year that Tom receives $10,000 from Mark, Tom includes $6,000 ($10,000 x 60%) in gross income.

**Contingent Sales Price**

Under Section 453(j)(2), the IRS is authorized to prescribe regulations providing for ratable basis recovery in transactions where there are contingencies in the sales terms (i.e., the gross profit, total contract price, or both cannot be readily ascertained at the time of sale). The circumstances most often addressed by the Section 15A.453-1(c)(2) include recovery of cost situations where there is a maximum stated sales price, but no fixed period over which payments are received; where there is a fixed period over which the payments are to be made, but with no maximum sales price indicated; or where no maximum sales price or fixed...
stated period are indicated.

A contingent payment sale will be deemed to have a stated maximum selling price if the terms of the sales agreement are such that the maximum amount of sales proceeds that may be received by the taxpayer can be ascertained as of the end of the sale/disposition year (Temp Reg. 15A.453-1(c)(2)). Under the Regulations, one must assume all the contingencies contemplated by the sales agreement have occurred so as to maximize the selling price and accelerate payments to the earliest date allowed under the agreement. Accordingly, the stated maximum selling price will be characterized as the selling price when computing the gross profit, such that the taxpayer’s basis will be ratably allocated among payments that will be received under the stated maximum selling agreement pursuant to that characterization.

In transactions in which the maximum selling price can not be ascertained by the close of the taxable year in which the sales occurs, but there is a fixed maximum payment period under the contingent sales price contract, Treas. Reg. 15A.453-1(c)(3) provides that the taxpayer’s basis should be allocated equally to the years in which payments are to be received. The Treasury Regulations do, however, permit the basis to be allocated in non-equal annual increments pursuant to the terms of the sales agreement if it is likely that payments will actually be made in accordance with those terms. The Section 453 Temporary Regulations do not allow a loss to be recognized in those years (other than the final year) in which the allocated basis exceeds the payments received. Instead, such nondeductible losses will be carried forward to succeeding taxable years.

The IRS will closely examine agreements in which there is no stated maximum selling price or payment period to ensure the arrangement is actually a sale and not a rental or licensing arrangements (Temp. Reg. 15A.453-1(c)(4)). Assuming a sales truly exists, the taxpayer’s basis will be allocated in equal annual installments over a 15 year period beginning on the sale date. Again, the temporary regulations do not allow a loss to be deducted in years in which the payments received are less than the allocated basis, but instead require the nondeductible loss to be allocated quall over the remaining 15 year period. Any unrecovered basis at the end of the 15 year payment term will be carried forward to succeeding years until all basis has been recovered or the debt obligation becomes worthless.

The temporary regulations allow the taxpayer to apply an alternative basis recovery method if the taxpayer shows (prior to the extended due date of the return) that a substantial and inappropriate deferral of income would result under the normal basis recovery rules (Temp. Reg. 15A.453-1(c)(7)). However, the taxpayer must demonstrate that application of the alternative method will be reasonable and that basis will be recovered in at least half the time that the basis would otherwise be recovered under the normal basis recovery method. The taxpayer must submit a private letter ruling and receive approval from the IRS in order to use the alternative method. In Private Letter Ruling 8844063, the IRS approved a recovery method predicated upon expected total sales price as opposed to maximum potential sales price, thereby allowing the taxpayer to recover basis at a rate more than twice as fast as would have otherwise applied.

On the other hand, the IRS may require use of an alternative recovery method where application of the normal basis recovery rules would substantially and inappropriately accelerate the recovery of basis, unless the taxpayer can show it is unreasonable to assume that the normal basis recovery rules will result double the recovery rate as compared to the IRS proposed alternative
method.

**Payments Received in Year of Sale**

Liabilities attached to the property sold, whether assumed or taken subject to, and most kinds of
debt instruments of the purchaser do not constitute payments in the year of sale. However, obligations
created subsequent to the purchase of the property, and incurred or assumed by the taxpayer in
contemplation of the property’s disposition is not considered qualifying indebtedness if the arrangement
results in acceleration of basis recovery (Temp. Reg. 15A.453-(1)(b)(2)(iv)). Accordingly, it
appears any funds received from refinancing the property close to its sale that exceed the
existing mortgage will be characterized as an additional payment in the year of sale by the IRS.

In Robert C. Sallies, 83 T.C. 44, the Tax Court determined that the voluntary payoff of debt
attached to the property at the time of sale which is assumed by the purchaser did not constitute payment
in the year of sale. However, where a taxpayer assumes the indebtedness and pays it off over time in the
ordinary course, it less likely it will be treated as a payment in the year of sale. See James H. Marshall,
17 AFTR 2d. 696.

The following items constitute payment in the year of sale:

- All payments, down payments, etc. received in the year of sale;
- Boot and other property with a market value;
- Cash equivalents;
- Mortgages assumed or take subject to by the purchaser to the extent such debt is in
  excess of the adjusted basis of the property at the time of sale (Reg. 1.453-4(c));
- The payment of seller obligations by the buyer to seller’s obliges arising out of or
  prior to the sale (see Wagegro Corp., 38 BTA 1225);
- Cancellation of the seller’s debt by the purchaser as a component of the
  consideration (see Robert B. Riss, 18 AFTR 2d. 6021);
- A land contract that is marketable and has an ascertainable fair market value under
  the cash equivalency theory (see Warren Jones Co., 36 AFTR 2d. 75-5954);
- Payment of the mortgage liability of the seller in the year of sale without
  assumption of the liability, even if the parties implement an escrow arrangement to
  pay off the existing debts (see David C. Maddox).
The Implications of Depreciation Recapture

Section 453(i) requires that all depreciation recapture resulting from the sale of property be recognized as ordinary income irrespective of actual payments in installment sales. Accordingly, recapture gain cannot be reported using the installment method. However, the adjusted basis of the property is increased to the extent of recapture gain recognized in the year of sale.

Accordingly, tax planners must be wary of the recapture gain provisions and advise clients of the effect on installment sales when recapture property is sold under Section 1245 or 1250. In addition, the tax practitioner would be wise to allocate the sales price between recapture and non-recapture items such that sufficient cash is received in the year of sale in order to pay the resulting tax. Further, any cash down payment should be allocated assets with recapture gain, while the installment payments should be allocated to assets that are not subject to recapture gain recognition.

Unrecaptured Section 1250 gain, taxed at a rate of 25%, is the amount of recapture that would have been recognized on the sale of real property if the property had been characterized as Section 1245 personal depreciable property instead of Section 1231 property. Accordingly, any recapture taken after the date of acquisition that is in excess of the Section 1250 recapture is taxed at the 25% rate. Pursuant to Reg. 1.453-12, gain recognized upon the receipt the receipt of principal payments is first allocated to unrecaptured Section 1250 gain, with the remaining gain taxed at capital gain rates. Accordingly, unrecaptured 1250 gain is not recognized in the year of sale (unlike recapture gain), but is characterized as the first dollars of gain realized when the installment payments are received.

Section 453(d) Election Out of Installment Reporting

Unless a taxpayer elects out of the installment method by reporting all gain on Form 4797 or Schedule D, the transaction will be treated as an installment sale if the agreement provides for the receipt of payments in tax years subsequent to the year of sale. However, the election is irrevocable such that once it is made with respect to a transaction, it is irrevocable unless there is “good cause” (e.g., election results from a miscommunication or mistake by the taxpayer’s tax advisors). The election applies to both fixed and contingent sales agreements.

Section 453 Definitions

Selling Price. Includes gross cash sales price plus mortgages assumed or taken subject to, but does not include interest whether stated or unstated.

Gross Profit. Equals the sales price minus the adjusted basis (inclusive of selling expenses).

Contract Price. The amount the seller will actually receive from the disposition. Accordingly, the contract price is decreased by mortgages assumed or taken subject to that are not in excess of the seller’s basis in the property. This figure serves as the denominator in the formula to determine the percentage of gain to be recognized with each payment (the gross profit is the numerator).
**Example 2.** On July 1, 2005, Bob sold to XYZ, Inc., a parcel of land with a commercial building under the following terms:

<table>
<thead>
<tr>
<th>Charge Credit</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price</td>
<td>$400,000</td>
<td></td>
</tr>
<tr>
<td>Deed of Trust payable to Bob (10% 20 years)</td>
<td>$340,000</td>
<td></td>
</tr>
<tr>
<td>Interest on note to August 1, 2005</td>
<td></td>
<td>2.200</td>
</tr>
<tr>
<td>Title insurance</td>
<td>640</td>
<td></td>
</tr>
<tr>
<td>Recording protective covenants</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>Broker's commission</td>
<td>27,000</td>
<td></td>
</tr>
<tr>
<td>Real estate taxes to 7/1/2005</td>
<td>1,500</td>
<td></td>
</tr>
<tr>
<td></td>
<td>369,170</td>
<td>$402,200</td>
</tr>
<tr>
<td></td>
<td>33,030</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$402,200</td>
<td>$402,200</td>
</tr>
</tbody>
</table>

The property was acquired new four years ago. The depreciation schedule at 7/1/2005 is as follows:

<table>
<thead>
<tr>
<th>Property</th>
<th>Acquired</th>
<th>Life/Method</th>
<th>Cost</th>
<th>Accumulated Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>1-02-01</td>
<td>-----</td>
<td>$40,000</td>
<td>$</td>
</tr>
<tr>
<td>Building</td>
<td>1-02-01</td>
<td>39/150DB</td>
<td>140,000</td>
<td>22,249</td>
</tr>
<tr>
<td>Landscaping</td>
<td>6-30-01</td>
<td>10/SL</td>
<td>4,000</td>
<td>1,600</td>
</tr>
<tr>
<td>Sprinkler system</td>
<td>6-30-01</td>
<td>15/SL</td>
<td>4,500</td>
<td>1,200</td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td></td>
<td>$188,500</td>
<td>$25,049</td>
</tr>
</tbody>
</table>

Of the depreciation claimed on the building, $6,275 is the excess of accelerated over straight-line depreciation.

Bob started receiving monthly payments of $3,700 on August 1, 2005 and received 5 such payments prior to year end. The amortization schedule for the note shows that the 5 payments total $14,225 interest and $4,275 principal.

**INSTALLMENT SALES COMPUTATION**

29
<table>
<thead>
<tr>
<th></th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Gross sales price</td>
<td>$400,000</td>
</tr>
<tr>
<td>2</td>
<td>Original cost</td>
<td>$180,000</td>
</tr>
<tr>
<td>3</td>
<td>Cost of improvements</td>
<td>7,000</td>
</tr>
<tr>
<td>4</td>
<td>Expense of sale</td>
<td>27,670</td>
</tr>
<tr>
<td>5</td>
<td>Total cost</td>
<td>214,670</td>
</tr>
<tr>
<td>6</td>
<td>Less allowable/allowed depreciation</td>
<td>(22,428)</td>
</tr>
<tr>
<td>7</td>
<td>Adjusted cost</td>
<td>192,242</td>
</tr>
<tr>
<td>8</td>
<td>Depreciation recapture</td>
<td>6,275</td>
</tr>
<tr>
<td>9</td>
<td>Adjusted installment basis (line 7 + line 8)</td>
<td>198,517</td>
</tr>
</tbody>
</table>
Example 3. Now assume that there is an existing mortgage on the property assumed by the purchaser in the amount of $130,000 on the date of sale; that the note payable to Bob is $220,000 instead of $340,000; and principal payments on the $220,000 note are $1,500 for 2005.

INSTALLMENT SALES COMPUTATION

1. Gross sale Price $400,000
2. Original cost $180,000
3. Cost of Improvements 7,000
4. Expense of sale 27,670
5. Total cost $214,670
6. Less allowable/allowed depreciation (22,428)
7. Adjusted cost 192,242
8. Depreciation recapture 6,275
9. Adjusted installment basis (line 7 + line 8) 198,517
10. Net installment gain $201,483
11. Ratio of profit in sales price (from line 19 below) 79.15%
12. Amount received this year:
   (a) Down payment on note 60,000
   (b) Principal payment on sale 4,275
   (c) Fair market value of other property 0
   (d) Debt assumed in excess of basis 0
13. Total $64,275
14. Profit in payment (item 13 x item 11) $32,376
   Recapture income to be recognized $6,275
   TOTAL GAIN RECOGNIZED IN YEAR OF SALE $38,651
12. Amount Received this year:
   (a) Down Payment on Note $60,000
   (b) Principal Payment of Note $1,500
   13. Total $61,500
14. Profit in payment (item 13 x item 11) 48,677
    Recapture income to be recognized 6,275
   15. TOTAL GAIN RECOGNIZED IN YEAR OF SALE 54,952

If contract assumed:
15. Gross sales price (same as item 1) $400,000
16. Less: Mortgage assumed by purchase (130,000)
17. Plus: Debt assumed in excess of basis 0
18. Contract price $270,000
19. Ratio of profit to contract price (Lines 10 / 18) 79.15%

**Debt Overhang**

Debt overhang is the amount of the excess of the mortgages assumed, or taken subject to, over the seller’s adjusted basis in the property. Only the debt overhang amount is factored into the determination of the total contract price. Debt overhang can cause the gain recognized in the year of sale to increase significantly since it is used in determining payments in the year of sale and the contract price, and accordingly, should not find its way into the sale if possible. Accordingly, the tax planner may wish to combine several property sales to one purchaser into a single sales agreement in order to attempt to offset any debt overhang that may exist on one property against the additional basis in the other properties.

**Selling Expenses included in Basis**

Temp. Reg. 15A.453-1(b)(2)(ii) also specifically characterizes selling expenses as an increase in basis as opposed to a reduction of the sales price.

**Example 4.** Using the facts in Example 2, assume that the existing mortgage assumed by XYZ, Inc. is $240,000 and the resulting note to Bob is $98,000 with 2005 principal payments of $640.
# INSTALLMENT SALES COMPUTATION

1. Gross sales price $400,000
2. Original cost $180,000
3. Cost of improvements 7,000
4. Expense of sale 27,670
5. Total cost 214,670
6. Less allowable/allowed depreciation (22,428)
7. Adjusted cost 192,242
8. Depreciation recapture 6,275
9. Adjusted installment basis (line 7 + line 8) 198,517
10. Net installment gain $201,483
11. Ratio of profit in sales price (from line 19 below) 100.000%
12. Amount received this year:
   - (a) Down payment on note 60,000
   - (b) Principal payment on sale 640
   - (c) Fair market value of other property
   - (d) Debt assumed in excess of basis 41,483
13. Total 102,123
14. Profit in payment (item 13 x item 11) $102,123
   Recapture income to be recognized 6,275
   TOTAL GAIN RECOGNIZED IN YEAR OF SALE $108,398

**If contract assumed:**

15. Gross sales price (same as item 1) $400,000
16. Less: Mortgage assumed by purchaser (240,000)
17. Plus: Debt assumed in excess of basis 41,483
18. Contract price $201,483
19. Ratio of profit to contract price (10 / 18) 100.000%
WRAPAROUND MORTGAGES

Taxpayers have used the wraparound mortgage as a vehicle to finance property while avoiding taxes, such as those resulting from debt overhang. The term is defined in Temp. Reg. 15A.453-1(b)(3)(ii) as:

an arrangement in which the buyer initially does not assume and purportedly does not take subject to part or all of the mortgage or other indebtedness encumbering the property ("wrapped indebtedness") and instead, the buyer issues to the seller an installment obligation the principal amount of which reflects: such wrapped indebtedness.
In a wraparound mortgage situation, the seller will generally remain directly liable mortgage indebtedness, though legal title usually (but not always) passes to the buyer at the time of sale. Generally, the interest rate under the wrap mortgage is equal to or greater than existing senior mortgage. Often the payments under the wrap are also higher in order to provide a potential source of funds for payment of the existing mortgage. The term is generally longer as well.

Benefits Associated with Wrap Mortgages

Usually, the seller will receive greater income from the wraparound mortgage than he or she is obligated to pay under the existing mortgage. Further, it may be less complicated to account for installment reporting of the gain on the sale by using a wraparound than by selling the property for cash with the buyer's assumption of the first mortgage. The purchasers benefit by not having to pay as high a down payment as are customarily required with traditional mortgages, and the periodic payments are often lower than if there is an assumption of the first mortgage with a new second mortgage for the balance.

However, the IRS will often scrutinize these arrangements, especially if there is debt overhang involved. For instance, in Frank Hutchison, T.C. Memo 1981-513, the Tax Court determined that the purchaser acquired the property subject to the wrap when the wraparound mortgage was renegotiated as a result of a delayed foreclosure. The factors the Court considered in reaching this conclusion included:

- In light of a settlement in lieu of foreclosure, the purchaser essentially paid the seller his redemption interest in the property.
- The purchaser indicated that his debt to the mortgagee could be satisfied from the value of the property.
- Payments were made by the buyer directly to the mortgagee.
- After the settlement, the mortgagee's loan records were changed to reflect the name of the purchaser.
- The seller used the term assumption in various correspondences.
- The seller refrained from continuing to deduct interest on the debt to the mortgagee since he did not make the payments on the debt.
- There was very little contact between the seller and the mortgagee after the settlement.

That determination resulted in the taxpayer paying approximately $280,000 as payment in the year of settlement due to the debt overhang.

In Floyd J. Voight, 68 TC 99, (CA-5) 45 AFTR2d 80-1645, the Court concluded that there was an assumption of the mortgage where payments were made by the purchaser directly to the holder of the first mortgage and where the purchaser guaranteed such payments. The Court stated that the transaction was squarely within Reg. 1.453-4(c) dealing with the taxation of sales proceeds not directly received by the seller.
Surprisingly, the Tax Court actually upheld a definite wraparound mortgage on a property which had debt overhang. In D.A. Hunt, 80 TC 1126, the Court stated that taking a property subject to an existing indebtedness for tax purposes is not necessarily the same as taking a property subject to an indebtedness for state law purposes. Hunt reflects the sale of property for $2,701,000 made up of a cash down payment of $160,000 and an all-inclusive deed of trust (wraparound mortgage) for $2,541,000. The all-inclusive mortgage wrapped existing mortgages totaling $1,963,222 on a property which had a basis in the hand of the sellers of $1,576,410. The language in the all-inclusive deed of trust provided that the property was being taken subject to the underlying indebtedness. However, the Court found that this did not qualify as an assumption of the liabilities sufficient to trigger recognition of the debt overhang existing in the transaction. The Court considered several factors in reaching its conclusion that an assumption had not occurred:

- The selling price was not reduced by the underlying debts.
- There was an expectation between the parties that the sellers would continue to pay and satisfy the underlying debts. The entire selling price was paid directly to the sellers and not the mortgagees.
- The purchasers neither paid, nor did they intend to pay, the underlying debt to the mortgagee directly or through a conduit.
- There was no control element between the purchaser and seller or any other relationship with the purchaser for that matter.
- The purchaser's payments to the seller were made directly to the seller and not to the mortgagee on the underlying indebtedness.
- The purchaser obligation, and the payments required thereunder, were in no way based upon the underlying indebtedness.

The Tax Court is only one of a few courts which wraparound mortgages seem to have been explored in the last 40 years. In Professional Equities Inc., 89 TC 165, acq., the Tax Court again sanctioned a properly structured wraparound mortgage arrangement.

Professional Equities involved the purchase of tracts of land for resale, in which the purchaser assumed the existing mortgage on either the purchased property or other seller-financed property. On resale, the Company kept the underlying mortgages in place, exacting a 10% down payment and a wraparound mortgage for the 90% balance. The sales contracts provided that title did not transfer to the purchaser until the entire wraparound mortgage was paid.

In all of the sales contracts, the wraparound mortgage bore a higher interest rate at a rate than that on the underlying wrapped indebtedness. However, none of the sales executed by the Company included debt overhang.

The Tax Court considered similar factors to those addressed in Hunt in deciding that the Company had a qualified installment sale using the wraparound mortgage:
• The seller remained liable for, and made the payments on, the wrapped indebtedness.

• Purchaser was made payments on the wraparound purchase money obligation and was liable for the same.

• The obligation to the Company’s creditor was did not depend upon receipt by the Company of payments from its purchaser on the wraparound indebtedness.

• There was no collection agency, trustee, escrow or other arrangement which would have provided the purchaser with assurance of the Company's payment on the underlying indebtedness.

• There was no adjustment to the sales price of the property and the purchase money indebtedness to reflect the underlying wrapped indebtedness.

• Under the terms of the sales contracts, the Company was not required to make payments on the underlying wrapped indebtedness from payments received from the purchaser on the wraparound obligation. Such payments could have been made from other independent funds of the Company.

It is important to realize the Tax Court in these decisions emphasized that the wrapped indebtedness were not assumed by the purchaser because the purchaser did not incur any direct liability to the third party creditor. Also, the wrapped indebtedness was not taken subject to by the purchaser because the purchase price was not adjusted by the amount of the underlying wrapped indebtedness. The seller's right to receive the uninhibited use of the purchaser's payments is crucial to the validity of the installment sale model.

Note that if collection agents, escrows or direct payments from the purchaser to the creditor on the wrapped indebtedness are used, the property will likely be treated as taken subject to the underlying indebtedness by the purchaser. Under Sec. 453, this is essentially an assumption by the purchaser. See Robert E. Kline, TC Memo 1989-317, where the use of an escrow nullified the effectiveness of the arrangement despite the existence of the factors discussed above.

Use of Escrow Arrangements

Often, parties turn to escrow agreements in order to release the property from the seller so that the purchaser may obtain a new mortgage or so that it can undertake subdivision/selling activities. At one time, taxpayers could feel relatively safe the substitution of an escrow deposit in place of a deed of trust in a year after the year of sale would not be deemed to be payment of the unpaid balance (See Rev. Rul 68-246, 1968-1 CB 198, prior to its revocation). However, subsequent rulings and Tax Court cases introduced a significant degree of doubt as to whether taxpayers could continue to use installment reporting once an escrow arrangement had been implemented.

These more recent cases and rulings have indicated that the escrow arrangement will not vitiate
installment sale reporting where the escrow deposit merely served as security for the deal. See J. Earl Oden, 56 TC 569; Everett Pozzi, 49 TC 119; Rev. Rul 73-451,1973-2 CB 158. However, if the facts and circumstances suggested that the escrow arrangement was viewed by the seller as payment for all of the buyer’s obligations under the sales agreement, such that the payment obligations seemed complete, then the seller would recognize income as he or she would be deemed to be in constructive receipt of the payments. Accordingly, it is incumbent upon the planners and preparers of the escrow agreements to structure the agreements so that they will truly be viewed as security arrangements.

The IRS issued Revenue Ruling 77-294 in which an escrow agreement was not deemed to trigger income recognition under constructive receipt principles where an irrevocable escrow deposit in the amount of the remaining payment balance was substituted for the deed of trust. The Service emphasized that the independent escrow agent would make all future note payments from the escrow account, the purchaser was not released from his obligations under the note, and that other substantial restrictions were placed on the escrow arrangement. While the Ruling did suggest that income recognition could be triggered where collateral was merely substituted for existing security, PLR 8848054 provided that swapping other real property as collateral for the installment note will not be considered a disposition terminating the installment reporting under Section 453B.

The service amplified Revenue Ruling 77-294 with the issuance of Revenue Ruling 79-91, in which the seller released his security interest in the property upon buyer’s placement of collateral funds into escrow. The escrow agreement did not grant the seller a security interest in the funds until default on the installment note by the purchaser. Since the ultimate disposition of the funds was conditioned only upon the mere passage of time without substantial restrictions, the IRS determined that there was a deemed payment triggering income recognition. See also Temp. Reg. 15A.453-1(b)(3)(i) which provides that “(R)ecipient of an evidence of indebtedness which is secured directly or indirectly by cash or a cash equivalent, such as a bank certificate of deposit or a treasury note, will be treated as the receipt of a payment.”

The taxpayer may seek to rely on C.J. Porterfield, 73 T.C. 91, which contradicted the holding in Revenue Ruling 79-91, but which was issued before the temporary regulations were published. Under facts similar to those in the ruling, the Tax Court held that the intent of the parties should control.

Because the validity of the escrow agreement in conjunction with installment reporting is still in doubt, tax practitioners should exercise care in entering into these agreements.

Other Security Arrangements

Third party guarantees and standby letters of credit have been specifically endorsed by Congress as a permissible method of providing security in an installment sale.

Temp. Reg. 15A.453-1(b)(3)(iii) defines a standby letter of credit as “a nonnegotiable, non-transferable (except together with the evidence of indebtedness which it secures) letter of credit, issued by a bank or other financial institution, which serves as a guarantee of the evidence of indebtedness which is secured by the letter of credit.” However, arrangements in which the seller may draw upon the credit in the absence of default of payment on the installment note will not constitute a qualifying security. Accordingly, tax planners can feel fairly safe in using a third party guarantee or standby letter of credit arrangement to secure payments in an
installment sale in place of an escrow arrangement.

**Sales Between Related Parties**

Section 453(e) restricts taxpayers in those situations in which an installment sale is made to the related party, and the related party subsequently sells the underlying property prior to recognition of all installment reporting under the first sale. If Section 453(e) is triggered, the initial seller must recognize gain at the time of the sale by the related party to the extent of the lesser of:

(i) The gain measured by the total amount realized on a second disposition less payments already reported.

(ii) The uncollected contract price on the first disposition.

The seller will be required to recognize gain at the end of each taxable year until all installment gain has been reported.

There has been some question as to what constitutes the second sale for purposes of triggering Section 453(e). The Tax Court addressed this issue in James M. Shelton, 105 T.C. 114, where the stock in a closely held corporation was transferred to a related corporation owned by related party trusts. The acquiring corporation sold the assets of its related corporation within two years and distributed the assets in liquidation. Because the acquiring corporation’s risk of loss was substantially diminished as a result of the sale and subsequent liquidation, the Tax Court held that a disposition had occurred requiring acceleration of gain recognition.

**Exceptions to Income Acceleration**

Section 453(e) only applies during the two-year period after the date of the first disposition. However, the two year-period is suspended during times in which the buyer’s risk of loss is substantially diminished (e.g., purchase of a put on the property, purchase of a call to acquire other property at price different than fair market value at the exercise date, etc.).

In addition, disposition which occur after the death of the purchase or seller are excluded, as are non-liquidating installment sale of stock to the issuing corporation. Finally, Section 453(e) will not accelerate income recognition where the taxpayer can demonstrate that no tax avoidance intent existed.

**Sale of Depreciable Property to Related Parties**

Special rules apply to installment sales of depreciable property to related persons (§453(g)(1)). First, the installment method does not apply (§453(g)(1)(A)). Second, all payments to be received are treated as received in the year of disposition, except that payments that are contingent in amount and lack ascertainable fair market value are recovered ratably (§453(g)(1)(B)(ii)). Third, the purchaser may not increase basis in the property by any amount before that amount is included in the seller's gross income (§453(g)(1)(C)). These special rules do not apply if it is established to the satisfaction of the IRS that the disposition did not have as one of its principal purposes the avoidance of federal income tax (§453(g)(2)).

A related person is any person who satisfies one of two conditions. The first condition is
satisfied if the person is related for purposes of the §1239 recharacterization provisions to the person who made the disposition (§453(g)(3)). The second condition is satisfied if the disposition occurs between two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interests (§453(g)(3)).

**Modifications to the Obligation**

There is still some debate as to whether changes to one or more of the terms of an installment obligation will trigger income recognition. In *James Boccardo*, 82 AFTR 2d. 98-5424, the taxpayer’s extension of a note after its payment date resulted in income recognition to the seller under constructive receipt principles. Accordingly, it appears that any changes to the installment obligation should be done in writing and before the note becomes due and payable.

**Dealer Dispositions**

An installment sale is a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. Installment sales do not include dealer dispositions and disposions of personal property required to be included in inventory (§453(b)(2)).

In the context of real estate businesses and activities, a dealer disposition is a disposition of real property held for sale to customers in the ordinary course of the taxpayer's trade or business (§453(l)(1)(B)). Dealer dispositions do not include the disposition of property used in the trade or business of farming (§453(l)(2)(A)). Dealer dispositions also do not apply to qualified residential property dispositions if the taxpayer elects to pay interest on the resulting deferred tax liability (§453(l)(2)(B)(i)).

**Qualified Residential Property Dispositions**

A qualified residential property disposition is a disposition of a qualified residential property to an individual in the ordinary course of the taxpayer's trade or business (§453(l)(2)(B)(ii)). A disposition is not eligible to be a qualified residential property disposition if the resulting installment obligation is guaranteed by any person other than an individual (§453(l)(2)(B)(i)).

There are three types of qualified residential property:

- Timeshare rights to use, and timeshare ownership interests in residential real property for not more than six weeks per year (§453(l)(2)(B)(ii)(I)).
- Rights to use specified campgrounds for recreational purposes (§453(l)(2)(B)(ii)(II)).
- Residential lots, provided that improvements with respect to the lot will not be made by seller or any related person (§453(l)(2)(B)(ii)(II)).
For purposes of determining whether property is within either of the first two types, the taxpayer is treated as holding any timeshare right to use, or a timeshare ownership interest in, property that is held by the taxpayer's spouse, children, grandchildren, or parents.

**Payment of Interest on Deferred Tax Liability**

A taxpayer who holds installment obligations arising from a qualified residential property disposition must pay interest for any taxable year during which payment is received on one or more of those obligations (§453(l)(3)(A)). No interest must be paid with respect to payments received in the taxable year in which the disposition occurred (§453(l)(3)(B)(iii)).

Three special rules apply in computing the interest (§453(l)(3)(B)(i)). First, the interest is determined on the amount of tax for the taxable year which is attributable to the payments received during the year with respect to qualified residential property dispositions (§453(l)(3)(B)(i)(I)). For this purpose, the portion of tax attributable to the receipt of an installment payment is determined without regard to any interest that must be paid (§453(l)(3)(B)(ii)). Second, the interest is determined for the period beginning on the date of the disposition and ending on the date the payment is received (§453(l)(3)(B)(i)(II)). Third, the interest is determined by using the applicable federal rate in effect under §1274 at the time of the sale, compounded semiannually, and disregarding the lowest three-month rate rule (§453(l)(3)(B)(i)(III)).

**Interest Payable on Deferral Benefit**

Under certain circumstances, taxpayers using the installment method must pay interest on the deferred tax liability arising from the use of the installment method (§453A(a)). Interest is payable with respect to installment sales of property with sales prices exceeding $150,000, but only if there is an installment obligation outstanding as of the close of the taxable year and the face amount of all of the taxpayer's installment obligations as of the close of the taxable year exceeds $5,000,000 (§453A(b)). Installment obligations arising from qualified residential property dispositions are omitted from these determinations (§453A(b)(4)).