re real estate taxation

2nd Quarter 2005

Payments by Guarantors and Joint Obligors

Section 467 Rental Agreements

Avoiding 'Dealer' Status

real estate taxation

2ND QUARTER 2005

VOLUME 32 NUMBER 3

ARTICLES

100
The Tax Aspects of Payments Made by Guarantors and Joint Obligors
Paul D. Carman and David C. Blum
The spectrum of differences and similarities suggests a series of tests.

110
Applying the Tax Accrual Method to Section 467 Rental Agreements
C. Todd Sinnett and Bridgett A. Earnhardt
You may have to stay late.

115
Avoiding 'Dealer' Status to Obtain Capital Gains
Michael K. Hauser
A 'business purpose' can do the trick.

128
Does an Exchange of Raw Land for Timber Qualify as a Section 1031 Exchange?
Ted. D. Englebrecht and Matthew C. Woodard
The transaction's qualification may depend on the property's location.

COLUMNS

137
RECENT DEVELOPMENTS
Robyn L. Dahlin and Andrew J. Alltizer
IRS Guidance 'Opens the Door' to Tax Deferral for Some Home Sellers

141
ALL IN THE FAMILY
James John Jurinski
Using Real Estate in an Individual Retirement Account

99
FROM THE EDITOR
John McHugh

WG&L
WARREN, GORHAM & LAMONT
OF RIA

AVOIDING 'DEALER' STATUS TO OBTAIN CAPITAL GAINS

The Tax Court's *Phelan* decision shows one more way in which it can be done.

MICHAEL K. HAUSER

The Tax Court has noted an "indistinct line of demarcation between investment and dealership" in the context of capital gain treatment on the sale of real property. Gain or loss on property held "for sale" by "dealers" generally is treated as ordinary income or loss for tax purposes, while that from sales of capital assets held for "investment" is treated as capital gain or loss. There is no defined legal standard that provides a safe harbor for avoiding dealer status, which is an inherently factual determination that depends on the "totality of circumstances" in each case.[1] The IRS has frequently litigated this issue with taxpayers.

The more factors that favor investment status in any given scenario, the more likely it is that a property will be eligible for capital asset treatment. Many of these factors can be taken into account by taxpayers in their tax planning. Although the IRS may always challenge the form of a transaction on "substance over form" grounds, the taxpayer still should choose the most advantageous form, because he or she generally is bound by the form chosen.[2]

Dealer property vs. investment property

The distinction between capital gain and ordinary income represents a recognition that gain due to appreciation in the market value of property differs from income due to "the everyday operation of a business,"[3] such as developing, improving, marketing, and selling land.[4] Real property will not be deemed a capital asset if it is "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" under Section 1221(a)(1) (hereinafter described as being "for sale"). Some courts have dissected this definition into a distinct three-pronged test.[5] Under this test, land is held for sale if the taxpayer:

1. Is engaged in the trade or business of selling real property.
2. Holds the specific property at issue primarily for sale in that business.
3. Made the specific sale at issue in the ordinary course of that business.

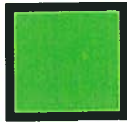
If real property is held for sale, gain or loss on its sale will be ordinary in character. If not, gain or loss will be capital in character or, in the case of a depreciable rental property, Section 1231 gain or loss.[6]

"Dealer" in this context is actually a borrowed term that comes from Section 453, the installment sales provision. Although Section 1221, the capital asset provision, makes no mention of dealers, the term is widely used to denote one who holds real property for sale rather than for investment, as the definition of "dealer" in Section 453 is analogous.[7]

It is notable that asset status is determined on a property-by-property basis. Thus, the same taxpayer has been deemed to hold one property for investment and another property primarily for sale where that taxpayer's activities and intent differed with respect to each of the properties.[8] The IRS has conceded that a tax-

MICHAEL K. HAUSER J.D., CPA, *is an attorney in the law firm of Maddin, Hauser, Wartell, Roth & Heller, P.C. in Southfield, MI.* *© Copyright 2005 Michael K. Hauser.*

payer's status as a dealer will not automatically disqualify the taxpayer from holding a property for investment, but has also said that "a heavier burden must be sustained by such a dealer in proving that fact."[9] Thus, it is preferable that every investment property should be held in an entity separate from every potentially ordinary income property.



THE TAX COURT HAS NOTED AN 'INDISTINCT LINE OF DEMARCATION BETWEEN INVESTMENT AND DEALERSHIP.'

The three-pronged test. In a 1998 case, the Tax Court held that the sale of 63 properties over about 25 years did not amount to the conduct of a trade or business.[10] Since the first prong of the dealer test was not met, the land was deemed a capital asset and the second and third prongs were not even considered.

The second prong of the test was discussed by the Supreme Court in *Malat v. Riddell.*[11] In that case, a partnership had sold land. The taxpayer claimed the land had been held for the purpose of developing and building a rental building to be owned and operated by the partnership, rather than being sold. The IRS argued that the land had been held for the "dual purpose" of developing a rental building or selling the land, whichever turned out to be more profitable. The IRS convinced the lower courts that the possibility of selling the land had been a "substantial" reason why the partnership had held the land, making this a primary reason for the partnership's having held the land. The Supreme Court reversed the lower courts on the grounds that an incorrect legal standard had been used—the term "primary" actually meant "of first importance" or "principally," and not merely one of two substantial reasons. Thus, the case was remanded for a trial court to decide whether the primary intent of the partnership was to hold the land for sale or to hold the land for rental. On remand, the trial court found that the land had been held primarily for rental before circumstances led to its sale.[12]

The taxpayer in one case based on *Malat* proved that he built improvements on land for the primary purpose of holding the improved property for rental, but then sold the property just after it was placed in service due to a changed circumstance.[13] The court granted capital gain treatment due to the taxpayer's "dominant" purpose of holding the property for rental, as judged at the time just prior to his decision to sell the property, even though some casual efforts had previously been made to sell the property prior to renting it. In another case based on *Malat,* a court granted capital gain treatment where a developer abandoned his intent to develop land, due to problems with zoning and financing, and then held the land for investment rather than "primarily for sale to its customers in the ordinary course of its business," at the time he sold the whole tract in bulk.[14]

As for the third, "ordinary course" prong, the Fifth Circuit stated that a taxpayer could be eligible for capital asset status if real property was sold out of the "ordinary course" due to "unanticipated, externally induced factors" such as "Acts of God, condemnation of part of one's property, new and unfavorable zoning regulations, or other events forcing alteration of taxpayer's plans" even where land had already been subdivided and improved.[15]

Factors considered. Some factors frequently considered in determining whether land is dealer property include:[16]

---

[1] Brown, 448 F.2d 514, 28 AFTR2d 71-5611 (CA-10, 1971).

[2] See Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders,* ¶ 1.05[2][B].

[3] Malat v. Riddell, 383 U.S. 569, 17 AFTR2d 604 (1966).

[4] Tucker, *Tax Planning for Real Estate* (Thomson West, 2003), ¶ 4.04.

[5] See Matz, TCM 1998-334 (1998).

[6] Section 1231 gain generally is equivalent to capital gain, although recapture of depreciation taken may be taxed at higher rates. Section 1231 treatment is favorable to capital asset treatment in the event of losses, since Section 1231 losses generally are ordinary losses, and are not subject to an annual limit as capital losses are. See Section 1211(b).

[7] Under Section 453(l)(1)(B), dealer dispositions, which are ineligible for installment sale deferral, include sales of real property that are "held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business."

[8] See Scheuber, 371 F.2d 996, 19 AFTR2d 639 (CA-7, 1967); Tucker, *supra* note 4 at ¶ 25:03, citing Estate of Freeland, 393 F.2d 573, 21 AFTR2d 903 (CA-9, 1968), and Murray, 370 F.2d 568, 19 AFTR2d 407 (CA-4, 1967); McKee et al., *Federal Taxation of Partnerships & Partners* (Warren, Gorham & Lamont, 2004) at ¶ 9.02[1][A].

[9] Scheuber, *supra* note 8,

[10] Matz, *supra* note 5.

[11] Note 3, *supra.*

[12] Malat v. Riddell, 275 F. Supp. 358, 18 AFTR2d 5015 (DC Cal. 1966).

[13] Cousins Properties, Inc, 40 AFTR2d 77-5262 (Ct. Cl. 1977) (unpublished decision).

[14] Hoagland, TCM 1971-310.

[15] Biedenharn Realty Co., 526 F.2d 409, 37 AFTR2d 76-679 (CA-5, 1976) (denying capital asset treatment on the facts of that case but citing Barrios Estate, 265 F.2d 517, 3 AFTR2d 1126 (CA-5, 1959) as a case where changed circumstances led to capital asset status).

[16] Bramblett, 960 F.2d 526, 69 AFTR2d 92-1344 (CA-5, 1992) (citing inter alia Suburban Realty Co., 615 F.2d 171, 45 AFTR2d 80-1263 (CA-5, 1980)). See also Hancock, TCM 1999-336.

- The nature and purpose of the acquisition of the property and the duration of the ownership.
- The extent and nature of the taxpayer's efforts to sell the property.
- The number, extent, continuity, and substantiality of the sales.
- The extent of subdividing, developing, and advertising to increase sales.
- The use of a business office for the sale of the property.
- The character and degree of supervision or control exercised by the taxpayer over any representative selling the property.
- The time and effort the taxpayer habitually devoted to the sales.

The frequency and substantiality of sales is the most important factor.

A taxpayer's intent with regard to property may change after acquisition. Thus, intent for holding property is also judged while the property is held and at the time that the property is sold.[17]

Preventing dealer status. Certain practical steps to attain investment status are simple but should not be overlooked.[18] A partnership, for example, should provide in its partnership agreement that it is being formed for investment purposes to acquire and hold property while seeking appreciation in value. Similar intent could be expressed in purchase contract recitals. The partnership's name should not include words like "development" or "developers," but could include words like "investments" or "investors." The tax return should list its business activity as investments and not development or sales. The balance sheet on the tax return and the financial statements should classify the property as a land investment and not as inventory or a business asset. To the extent feasible, different tracts of land should be owned in separate business entities and taxpayers should follow entity formalities, such as sending correspondence and doing business in the name of the proper entity. Taxpayers should document their time spent on each entity, as that may show that their effort relative to a specific land-holding entity was minimal.

In some situations, taxpayers may also be able to reduce, to some extent, their selling activities by not placing advertisements or retaining brokers to sell the property. The holding period for property could be lengthened in some situations by having a future purchaser tie up a property with an option[19] or a right of first refusal for some period, rather than initially purchasing the property outright. It may also be of some benefit, even after a purchase contract has been entered into for the sale of the land, to delay the closing for some period of time in light of contingencies. Lengthening the holding period in such a manner would more likely hurt rather than help, however, if development activities will be conducted during the additional time.

Case law. When a taxpayer holds only one property and sells it "in bulk," the general rule is that the property will be deemed held for investment, as the sale of one property will not ordinarily constitute the carrying on of a trade or business.[20] This "one-shot" rule is a positive factor for obtaining capital gain treatment but it is not decisive.[21] Thus, in *Paullus*,[22] land was not held for sale when it was sold as one tract to a developer, even though the seller had maintained a list of "97 people interested in purchasing lots" in the property. Similarly, the Tax Court in *Buono*[23] emphasized that the "crucial fact" in the case was that the taxpayer intended at all times to sell "unimproved property as a single tract." A related issue weighing in favor of investment status in a Seventh Circuit case was a high profit margin on the disposition of a single property. That court said that "extremely substantial gains ... were unrealistically high [returns] for items held for resale in day to day operation of a business."[24]

While physical activities to develop land may be overriding factors in favor of ordinary income status, activities conducted as part of

'DEALER' IN THIS CONTEXT IS ACTUALLY A BORROWED TERM.

[17] Phelan, TCM 2004-206 ; Bynum, 46 TC 295 (1966).

[18] See Bird, "Treatment of Capital Gain on Sale of Land to a Related Development Corporation," 22 Real Estate Tax'n 255 (1995), for a helpful discussion of this topic.

[19] Note, however, that courts may not distinguish between a developer's interest as the holder of an option to buy property and ownership of the property. See Brown, *supra* note 1.

[20] See Reese, 615 F.2d 226, 45 AFTR2d 80-1248 (CA-5, 1980) ("a single transaction ordinarily will not constitute a trade or business when the taxpayer enters into the transaction with no expectation of continuing in the field of endeavor.")

[21] See IRS Information Letter 2002-0013, citing Ronhovde, TCM 1967-243.

[22] TCM 1996-419.

[23] 74 TC 187 (1973).

[24] Scheuber, *supra* note 8. See also Paullus, *supra* note 22 ("infrequent sales resulting in large profits tend to show that property was held for investment.")

the process of obtaining governmental "entitlements" or of testing the soil will be less suggestive of ordinary income status. In *Buono*, the taxpayer had obtained subdivision approval from the local municipality and had subdivided the land into "half-acre building lots," but the court described these actions as the taxpayer's having "merely enhanced the property by taking *purely legal steps* to make it more marketable."[25] In *Phelan*,[26] a taxpayer received capital gain treatment on the sale of land after site plan approval had been obtained for a construction project and a soil investigation had been conducted.[27] Investment status has also been preserved notwithstanding pre-sale zoning changes.[28] The IRS has taken the position, however, that efforts to secure government entitlements are a significant factor indicating property was held for sale.[29]

CERTAIN PRACTICAL STEPS TO ATTAIN INVESTMENT STATUS ARE SIMPLE BUT SHOULD NOT BE OVERLOOKED.

There is no set rule about how many lots can be sold as investments without the activity rising to the dealer level. In *Byram*,[30] the Fifth Circuit found sales of land to be capital in nature even though the taxpayer had made 22 sales in a three-year period. Though the amount of sales was substantial, the sales had not been "sufficiently frequent or continuous to compel an inference of intent to hold the property for sale rather than investment." Importantly, the taxpayer did not "initiate the sales," did not maintain an office, did not develop the property, and did not "devote a great deal of time" to the sales. In contrast, the Tax Court found in *Hancock*[31] that a taxpayer who sold 48 unimproved lots over a nine-year period was "in the business of selling lots to customers," and her sales were deemed to be "frequent, regular, and substantial." Selling lots was her primary activity and she listed some of the lots for sale on the Multiple Listing Service. Though she neither used real estate agents nor maintained her own office, she actively tried to sell the lots by putting out "for sale" signs and by making the lots known to her contacts.

Advantages and disadvantages of capital asset treatment

If an individual's gain from the sale of property is capital gain, it generally is subject to a maximum tax rate of 15% rather than the usual rate for other income.[32] C corporations are not eligible for preferential tax rates for capital gains.[33]

The advantages of capital asset treatment go beyond favorable capital gains tax rates. One is the availability of installment sale treatment. By contrast, under Section 453(b)(2)(A), dealer sales of real property are taxable in full in the year of sale and ineligible for installment sale treatment, except for certain shares of residential lots. A second reason is that, under Section 1031(a)(2)(A), property that is held primarily for sale is not eligible for tax-free exchange treatment. This limitation is even stricter than that of Section 1221, because it can preclude Section 1031 treatment even if the property is not being held for sale "to customers in the ordinary course of [a] trade or business" (as is required under Section 1221(a)(1)).[34]

Capital asset treatment is a disadvantage, however, when a loss is incurred, because capital losses—apart from the first $3,000—may be deducted currently only to the extent that a taxpayer has capital gain in the same tax year, with any excess loss being carried forward indefinitely.[35] Capital losses also are less beneficial than ordinary losses in many situations, since capital losses offset capital gains (taxed at rates up to only 15% if long-term) rather than ordinary income. Thus, in some cases, the IRS has argued that a taxpayer who claimed an ordinary loss, on the grounds that he held property for sale, actually held the property as an investment.[36] Capital asset treatment may also be disadvantageous, to some extent, because interest paid on liabilities with respect to property held for investment will be deemed "investment interest" under Section 163(d). Such interest will be currently deductible only to the extent that a taxpayer (such as an owner of a partnership interest) has "investment income" such as dividends or interest, although disallowed interest may be carried forward.

---

[25] Note 23, *supra* (emphasis added).

[26] Note 17, *supra*.

[27] Note 17, *supra*.

[28] See Wray, TCM 1978-488; Klarkowski, TCM 1965-328.

[29] See IRS Information Letter 2002-0013.

[30] Byram, 705 F.2d 1418, 52 AFTR2d 83-5142 (CA-5, 1983).

[31] Note 16, *supra*.

[32] Section 1(h). This holds true regardless of whether a sale is made individually or by a pass-through entity, such as a partnership or S corporation.

[33] See Section 11.

[34] See Neal T. Baker Enterprises, Inc., TCM 1998-302.

[35] Sections 1211, 1212(b).

[36] See Matz, *supra* note 5.

Although sales of an interest in a partnership,[37] or of stock in a corporation, generally are entitled to capital gain treatment, a dealer who holds real property for sale generally cannot avoid ordinary income treatment by selling the corporation or partnership holding the property, rather than selling the property. Section 751(a) provides that the sale of a partnership interest will not be eligible for capital gain treatment to the extent that the partnership's assets include ordinary income items. Former Section 341, repealed in 2003, operated to recast the sale of corporate stock as the sale of a corporation's assets when a taxpayer used the sale of corporate stock as a device to attain capital gain treatment from the sale of an ordinary income asset. Although Section 341 has been repealed, it is possible that the IRS would make an equivalent argument based on case law if a taxpayer's use of a sale of corporate stock was an obvious way to avoid ordinary income classification on the sale of a property.[38]

Holding period. The favorable tax rate applicable to long-term capital gains is available only with respect to property that the taxpayer has held for over one year.[39] Thus, if a taxpayer does not plan to hold property for at least a year before selling it, the "dealer" issue will be of little importance.

The holding period of land can be lengthened by entering into purchasing agreements within a year but then delaying the closing until 12 months and one day after the property was first acquired, or by selling a purchase option to a presumed future purchaser. Unless the facts of the situation suggest that the benefits and burdens of ownership have substantially passed to the future purchaser, the sale will not be deemed to occur until the closing. In Rev. Rul. 69-93,[40] for example, the IRS ruled that a sale of real property was not final prior to the closing when a seller had entered into a binding purchase agreement and received a "nominal" down payment, but had retained all legal title, all right of possession, and all right to rents and profits.

In some circumstances, taxpayers possibly could get long-term capital gain treatment even for property held for less than 12 months by selling ownership of the business entity that holds the property rather than selling the property itself.[41] Assume, for example, that an LLC was formed by two members on 1/1/05 with the stated intent of acquiring land to hold for investment purposes. On 4/1/05, the LLC bought a parcel of land for $100,000. Ten months later, on 2/1/06, a developer offers to buy the land for $140,000. If the developer instead bought the membership interests in the LLC, not the underlying land, the members would be taxed on a sale of a membership interest held for 13 months rather than on a sale of land held for ten.[42] Although no statute or regulation provides the applicable holding period for a partnership interest in this context, the rule established from case law is that a "selling partner's holding period is based entirely on the period of time he has held the interest, without reference to the holding periods of the partnership's assets."[43] While a few old cases reject the "entity" theory of partnership tax and hold that the holding period for a partnership interest should be determined on an asset-by-asset basis,[44] the entity theory of partnership taxation has since taken much firmer root in case law and the Code.

For corporate stock, a taxpayer's argument for a long-term holding period, notwithstanding a short-term holding period of the corporation's assets, would appear to be at least as strong as the same argument in the partnership context.[45] However, the IRS could chal-

A PARTNERSHIP SHOULD PROVIDE IN ITS PARTNERSHIP AGREEMENT THAT IT IS BEING FORMED FOR INVESTMENT PURPOSES.

[37] Throughout this discussion, unless the context indicates otherwise, LLC's will be assumed to receive the same tax treatment same as partnerships, and the terms generally will be used interchangeably. See Reg. 301.7701-3(b).

[38] See Jacobs, 21 TC 165 (1953) (holding that sale of stock was a device to sell real property where property was transferred to a dormant corporation and then sold less than a week later to a pre-arranged purchaser); Margolis, 337 F.2d 1001, 14 AFTR2d 5667 (CA-9, 1964); see also Owens, 64 TC 1 (1975), *aff'd* 568 F.2d 1233, 41 AFTR2d 78-419 (CA-6, 1977) (addressing the sale of S corporation stock).

[39] Section 1222(3). For taxpayers with a net capital loss, a short-term capital gain is still preferable to ordinary income because the short-term capital gain can be netted against both short-term and long-term capital losses. See Sections 1211 and 1222.

[40] 1969-1 CB 139.

[41] In general, the sale of a partnership interest will result in capital gain or loss under Section 741, while the sale of stock in a corporation will result in capital gain under the default capital asset rule of Section 1221(a).

[42] Due to concerns about assuming liabilities or other factors, a developer may not be willing to buy an LLC owning land rather than directly buying the land itself.

[43] McKee et al., *supra* note 8 at ¶ 15.01[1], citing Lehman, 7 TC 1088 (1946), *aff'd* 165 F.2d 383, 36 AFTR 545 (CA-2 1948) (rejecting the IRS proposition that the holding period should be "computed separately for each firm asset held at the time of the sale of the partner's interest.") Citing Lehman in a 1987 case, the Tax Court ruled that a taxpayer's sale of 121 limited partnership interests in a hotel development partnership was partially short-term and partially long-term, where some of the interests had been held long-term and some had not. Aliber, TCM 1987-10. See also 7 ALR 2d 672 (Van Ingen, "Income Tax: Holding Period for Purposes of Computation of Gain or Loss on Sale of Partner's Interest in Firm").

lenge the use of the partnership or corporate form to lengthen holding periods, particularly if the maneuver was obviously calculated for tax reasons.[46] Still, if taxpayers form an entity to invest in land and fund it with reasonably significant capital contributions, then hold the land for nearly one year before selling the membership interests or stock, the taxpayers may be successful in arguing that they were entitled to long-term treatment, unless the facts showed that a holding period of less than 12 months was anticipated, or that the entity was neither the original purchaser of the land nor the original holder of an option to buy the land.

THE PARTNERSHIP'S NAME SHOULD NOT INCLUDE WORDS LIKE 'DEVELOPMENT' OR 'DEVELOPERS.'

Entity-level characterization of dealer status

Opportunities for avoiding dealer status are expanded by the use of business entities to hold real property because, where a taxpayer follows entity formalities, the entities generally will not be considered for tax purposes as mere alter egos of their owners or as shams. Thus, the activities of related entities generally will not be aggregated together for the purpose of characterizing whether items of gain represent capital gain or ordinary income.

The "frequency and substantiality" of real property sales is one of the important factors—perhaps the most important—in determining whether a taxpayer is a dealer or holds a specific property for sale rather than for investment.[47] Thus, where the separate existence of an entity is respected (as is usually the case), it is advantageous to hold each property in a separate entity to reduce the number of sales made by any one entity. Although the IRS could argue that sales by related entities should be aggregated, that argument has often been rejected and taxpayers might as well segregate their ownership of different properties into different entities if feasible.[48] Sales of properties by different entities would be least susceptible to potential aggregation if the ownership of the different entities is not identical and there are more than one or two parties in interest, but identical ownership between related entities will not ordinarily lead to aggregation.[49]

The strong weight of authority suggests that the characterization of gain is determined solely at the partnership level and not at the partner level.[50] The Supreme Court has held that, for purposes of "ascertain[ing] and report[ing]" a partnership's income, "the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners."[51] Thus, in a case involving the sale of residential real estate, the Tax Court stated that "the partnership is to be viewed as an entity and [gain and loss] items are to be characterized from the viewpoint of the partnership rather than from the viewpoint of the individual partner."[52] In *Blackburn v. Phinney*,[53] a partnership was held not to be a dealer in land when the partnership engaged in no selling activities with respect to the single property it owned, even though a 50% partner was considered a real estate dealer in his individual capacity.

It is of crucial importance in this context that a single-member LLC will not be recognized as a partnership for tax purposes and will be

CORRECTION

The name of an author was inadvertently misspelled in the Table of Contents in the First Quarter issue of *Real Estate Taxation*. Todd D. Golub—as correctly spelled—was an author of "The Intersection of DSTs and TICs on an Odd Day Indeed," along with Richard M. Lipton and Arnold Harrison. We apologize for the error.

---

[44] City Bank Farmers Trust Co. v. U.S., 47 F. Supp. 98, 30 AFTR 136 (Ct. Cl. 1942); City Bank Farmers Trust Co. v. U.S., 47 F. Supp. 105, 30 AFTR 143 (Ct. Cl. 1942).

[45] As noted below, Section 751 provides certain instances in which the sale of a partnership interest is treated in part as the sale of partnership assets. Similarly, Reg. 1.1(h)-1 provides a look-through rule for reporting capital gain from collectibles and Section 1250 property owned by a partnership upon the sale of a partnership interest. However, with the repeal of Section 341, as noted below, there is no provision for collapsing the sale of stock in a corporation into the sale of specific corporate assets.

[46] See e.g. Jacobs, *supra* note 38; Margolis, *supra* note 38. In Jacobs, the Tax Court disregarded taxpayer's attempt to avoid ordinary income treatment on the sale of land by transferring it to a "dormant" corporation and then selling the stock only five days later to a party who had wanted to buy the land itself. See also Van Heusden, 369 F2d 119, 18 AFTR2d 5970 (CA-5, 1966).

[47] Bramblett, *supra* note 16; Phelan, *supra* note 17.

[48] See Tucker, *supra* note 4 at ¶ 25.03 and cases cited therein.

[49] See e.g. Bramblett, *supra* note 16; Phelan, *supra* note 17.

[50] See sources cited in McKee et al., *supra* note 8 at ¶ 9.01[4][A].

[51] Basye, 410 U.S. 441, 31 AFTR2d 73-802 (1973).

[52] Podell, 55 TC 429 (1970).

[53] 8 AFTR2d 5220 (DC Tex., 1961).

disregarded as an entity unless the LLC elects to be taxed as a corporation.[54] The assets of such a disregarded entity are considered to be owned directly by the member, thus negating the opportunity to obtain distinct entity-level characterization.

For S corporations, the character of income is determined at the entity level, rather than at the shareholder level, under Section 1366(b).[55] Therefore, if an S corporation has a capital gain from the sale of land, as determined at the entity level, an individual shareholder will have pass-through capital gain even if he or she individually is a dealer in land.[56]

There are exceptions to the entity-level characterization for both partnerships and S corporations, but they apply only to situations in which the property owned by the entity was contributed to the entity by a partner or shareholder, rather than having been bought by the entity initially. Thus, under Section 724(b), if a partner contributes property that is an ordinary income asset in the hands of the partner, and the partnership sells the property within five years, any gain from the sale will automatically be ordinary income. An analogous provision applies to contributions of property by S corporation shareholders, turning gain from the S corporation's sale of such property into ordinary income if a primary purpose of the contribution was to obtain capital asset treatment.[57]

Case law. The Tax Court upheld entity-level characterization and granted capital gain treatment in *Cary*,[58] where a taxpayer's wholly owned real estate development corporation transferred two tracts of land (which it presumably held for sale) to two different partnerships and then re-purchased the tracts within one year. The court held that since the taxpayer, his wholly owned corporation, and the two partnerships (in which he owned 50% interests) were all "separate entities for tax purposes," the "[development] corporation's motives should not be imputed to the [taxpayers] or the [partnerships] unless it was serving as an agent for them."

A few key facts in *Cary* led the court to uphold capital gain treatment. First, since the taxpayer owned 100% of the development corporation and only 50% of the partnerships, the court concluded that (1) the other partners must have borne some risk and contributed some value in holding the tracts (through the partnerships) and (2) the corporation must have used "reasonable business judgment" in selling the land to the partnerships, because the taxpayer would not have been willing to give up 50% of the land sale profits gratuitously. Second, the amounts paid on both ends of the sale were legitimate "arm's-length" prices. Third, at the time of the corporation's land sales to the partnerships, there was no contract obligating the corporation to repurchase the land, only a right of first refusal that gave the corporation the right to repurchase the tracts on arm's-length terms. Thus, the taxpayer got an ideal result—the partnerships, each of which held one tract of land, were treated as engaging only in "isolated transactions" and "speculative investment activities." The court "look[ed] to the purpose for which the partnership held the property, rather than the intent of any specific partner, to determine the purpose for which the property was held at the time of the sales." No physical improvements were made while the partnerships held the tracts, but the municipalities involved were researching and then approving the infrastructure improvements needed for the land to be developed during that period.

THE 'ONE-SHOT' RULE IS A POSITIVE FACTOR FOR OBTAINING CAPITAL GAIN TREATMENT BUT IS NOT DECISIVE.

In contrast to the vast majority of cases decided in this area, legal entities were disregarded for the purpose of determining the character of gain from the sale of land in *Margolis*.[59] The taxpayer in that case used trusts, of which he was both trustor and beneficiary, as well as a corporation (owned by him and an associate) as vehicles to receive title to land. The Ninth Circuit disregarded the trusts as mere conduits

[54] Regs. 301.7701-2(a), -3(a), -3(b)(1)(ii). A single-member LLC, however, can be recognized as an entity and still obtain pass-through status by electing to be taxed as a corporation and then making a further election to be taxed as an S corporation.

[55] Two leading treatises have noted some ambiguity in the wording of Section 1366(b), but still conclude that the character of S corporation income is determined at the entity level. See Eustice and Kuntz, *Federal Income Taxation of S Corporations* (Warren Gorham & Lamont, 2004) at ¶7.04[2]; Christian and Grant, *Subchapter S Taxation* (Warren Gorham & Lamont, 2004), at ¶16.10.

[56] See Reg. 1.1366-1(b)(1) and Rev. Rul. 87-121, 1987-2 CB 217.

[57] Reg. 1.1366-1(b)(2).

[58] TCM 1973-197. At the time, the long-term holding period was six months.

[59] Note 38, *supra*. In a related case, non-dealer participants in the sales were afforded capital gain treatment. Riddell v. Scales, 406 F.2d 210, 23 AFTR2d 69-541 (CA-9, 1969). See also McKee et al, *supra* note 8 at ¶ 9.02[1][A] (discussing Ninth Circuit cases).

that the taxpayer controlled. The court also disregarded his attempt to use a "dormant" corporation to receive title to land and to then sell the stock about three months later for a purported long-term capital gain on the stock. The court did not address the holding period issue because it disregarded the use of the corporate form entirely as being a mere conduit for passing title. It did so because the taxpayer himself initially held title to the property but transferred it to the corporation with the pre-arranged intent of selling the stock to a particular purchaser. Further, the use of the corporation served no business purpose. The court held that corporations will be disregarded where a taxpayer transfers property to a corporation with the pre-arranged intent of selling the property to a third-party through the mechanism of selling the stock.

THERE IS NO SET RULE ABOUT HOW MANY LOTS CAN BE SOLD AS INVESTMENTS.

Sales to related-party developers

A strategy used by many land developers involves forming a partnership to buy and hold land for over a year. During that time preparations are made for developing the land, such as obtaining government approvals, but no physical development takes place. After the long-term holding period has been met and when development is ready to begin, the partnership sells the land to a commonly owned corporation. In this way, taxpayers attempt to obtain capital gain treatment on the land sale, followed by ordinary income treatment on the property development and sale to outside parties. A number of cases have litigated this precise issue and the results have been mixed.[60] As discussed below, the Tax Court in *Phelan* upheld capital gain treatment when this strategy was used, even though the land development corporation was owned by exactly the same individuals who owned the land investment partnership.

The activities of the investment entity and the development entity should be segregated as much as possible. All negotiations with, and correspondence to, government agencies, utility companies, local associations, and builders regarding development should be carried out in the name of the development corporation.[61]

One essential component of this strategy is to have a corporation, rather than a partnership, serve as the development entity. Section 707(b)(2)(B) provides that a gain on the sale of property between two commonly owned partnerships always will result in ordinary income if the property is ordinary income property in the hands of the purchasing partnership. In general, though, no such restriction exists on sales between a commonly owned partnership and corporation.[62] It is also notable that Section 1239 prohibits capital gain treatment on sales of depreciable property to related parties, but does not apply to non-depreciable property such as land.

IRS analysis. An IRS information letter released in 2002 analyzed the use of this related-party sale method.[63] The letter did not question the ability of a taxpayer, in proper circumstances, to obtain capital gain on the sale of land to an identically owned development corporation, stating that "the intent of the seller entity is determinative." It indicated, however, that the IRS "typically argues that an agency relationship exists between the seller entity and the related purchaser entity," meaning that the purchaser entity's activities should be imputed to the seller entity in determining whether the seller entity held the land as an investment. Thus, the taxpayer should be careful to document that neither entity operated in the name of, or for the account of, the other entity.

The letter stated that the "most important factor appears to be the magnitude of the seller entity's pre- and post-transfer activity with

[60] Brown, *supra* note 1; Bramblett, *supra* note 16; Phelan, *supra* note 17..

[61] See Bird, *supra* note 18.

[62] While corporations have typically been used as the development entity, Section 707(b)(2)(B) could be avoided if either the investment entity or the development entity is formed as a corporation, or as an LLC that elects to be taxed as a corporation and then makes an S election. Tax planners should also give careful attention to the effect of Section 707(b)(2)(A), which prevents capital gain treatment on sales by a partnership to a person who actually or constructively owns more than 50% of the partnership after taking Section 267(c) into account (without regard to Section 267(c)(3)). Generally, Section 707(b)(2)(A) can be avoided for the purposes discussed in this article because, under Section 267(c), an individual's ownership of a partnership interest will not be attributed to a corporation in which shares are held by that same individual (even though a corporation's ownership of a partnership interest would be attributed pro rata to the corporation's shareholders). This results from the fact that Section 707(b)(3) references Section 267(c) for its constructive ownership rules, while it is Section 267(b)(10) that deems there to be a relationship between a corporation and a partnership if more than 50% of the entities are commonly owned. In both Bramblett, supra note 16, and Phelan, supra note 17, the IRS apparently did not even argue that a sale from a partnership to an identically owned corporation could not produce capital gain.

respect to the property," in light of cases holding that development activities by seller entities—e.g., platting land, participating in efforts to promote governmental infrastructure improvement, and seeking zoning changes—were factors that led to the denial of capital gain treatment.[64] The letter also cited as important factors: (1) the length of time the property was held by the selling entity; (2) the existence of a contract to sell the land at the time the selling entity first acquired the property; (3) the seller entity's involvement in the real estate business generally; and (4) the seller entity's stated purpose with respect to the land on various documents.

Bramblett. The IRS document recognized the legitimacy of capital gains in a related-party sale, even where the entities have identical ownership, largely because of a 1992 Fifth Circuit case—*Bramblett*[65]—in which a land-selling "partnership" (a joint venture) and a land-purchasing corporation had exactly the same owners. The taxpayer was a partner in the partnership, which had made five sales over a three-year period, only one of which was "substantial," leading the court to conclude that the partnership "did not sell land frequently." The court noted that (1) the partnership's "stated purpose" was to acquire land for investment; (2) it had sought advice to deliberately obtain investment treatment; (3) it had held the land for three years prior to sale; (3) it had neither advertised nor hired brokers; (4) it had not developed the land; (4) it had not maintained an office; and (5) the partners spent only a "minimal amount of time" on partnership activities.

Although the IRS argued that the development corporation acted as an agent for the partnership, the court rejected this argument because the corporation never "acted in the name of or for the account of" the partnership and had no "authority to bind" the partnership into contracts. The court also held that "common ownership of both entities is not enough to prove an agency relationship." The transaction between the entities was on arm's-length terms and legal formalities were observed. Finally, the arrangement had "at least one major independent business reason," which was to insulate the partners from liabilities arising during the development process as the partnership was not a limited liability entity.

Phelan. *Bramblett* was tested and affirmed by the Tax Court last fall in *Phelan.*[66] The facts of the two cases are similar, but in *Phelan* the partnership was in fact a limited liability entity, leading the IRS to argue that the sale to a land development corporation lacked a business purpose.

The limited liability entity in question—an LLC—held a 1,050-acre parcel for three years, then sold 46.5 acres to an identically owned development corporation, which developed the land until it was suitable for residential homebuilding and then sold the land to an independent builder. During the LLC's three-year holding period, a quasi-governmental entity performed significant infrastructure development activities with help from financing provided by entities related to the LLC. The LLC itself engaged in certain activities that included obtaining preliminary and final site plan approval for development and retaining a soil-testing firm.[67]

Because the sale involved only one portion of the LLC's land, the court ruled that a valid business purpose existed in transferring that portion out of the LLC prior to development, to insulate the remaining land owned by the LLC from any liabilities that might arise during development of the portion sold, even though the LLC owners individually had protection from liability. The court also held that the infrastructure development performed by the quasi-governmental entity would not be imputed to the LLC because the LLC did not control that entity's activities, and because the financing help provided by entities related to the LLC was on fair market terms. The development activity conducted by the LLC itself was deemed too minor to override a finding that the land was held for investment, as the entity had no employees and engaged in no business activities other than holding a few parcels of land. Notably, the owners of the LLC were not principally engaged in residential land activity, but were instead engaged almost exclusively in the business of commercial general contracting.

ENTITIES GENERALLY WILL NOT BE CONSIDERED ALTER EGOS OF TAXPAYERS WHO FOLLOW THE FORMALITIES.

[63] IRS Information Letter 2002-0013. Information letters are advisory only and are not binding on the IRS.

[64] The Tax Court has held that "[a]lthough residential zoning is a necessary element for subdivision, it does not, per se, convert property to [ordinary income] status." *Paullus*, supra note 22.

[65] Note 16, *supra*.

[66] Note 17, *supra*.

[67] Notably, the site plan identified the development corporation, and not the land investment entity, as the property's developer, according to Petitioner's Reply Brief for Respondent, 2004 WL 23812066.

Other cases. In light of *Bramblett* and *Phelan*, the status of the law with respect to sales of land to related development corporations appears more favorable than it once did. In *Brown*,[68] the Tenth Circuit found that a related-party land sale led to ordinary income, and said:

> ... cases abound supporting the proposition that [a] taxpayer may not conduct his business through a closely controlled corporation, and secure capital gains treatment on the profits.... Gain realized from an interest in land transferred to a closely held corporation, which in turn disposes of that interest to the ultimate purchaser, has been held ordinary income by the United States courts.

In *Brown*, the taxpayer participated in and owned, together with his wife, substantially all of the land-selling entity and the related development corporation. Moreover, they also participated in and owned substantially all of two homebuilding corporations. The taxpayer had also, in his personal capacity, platted the land and interacted with governmental agencies and engineers concerning its development.

One important older case still cited frequently is *Ronhovde*.[69] That taxpayer recruited family members to buy a piece of land through a partnership, then publicly promoted a corporation (which had 30% common ownership with the partnership) to buy and develop the land. The taxpayer's activities with respect to platting and subdividing the land were all carried on in his capacity as promoter of the corporation, and thus were not imputed back to the partnership. The court ruled that capital gain treatment was allowed because, although the partnership had held the land for sale, the holding of a single tract of land did not amount to a trade or business.

A successful strategy, apparently not carried out for tax purposes, involved the ownership of land by an entity that was primarily engaged in a separate business. The primary activity of the entity in *Paullus*[70] was the development and operation of golf courses. It made seven land sales in a 12-year period to related development

[68] Brown, *supra* note 1.

[69] Note 21, *supra*, discussed in IRS Information Letter 2002-0013.

[70] Note 22, *supra*.

REPRINTS

NEW SERVICE FOR WG&L SUBSCRIBERS

The professional way to share today's best thinking on crucial topics with your colleagues and clients.

Now it's easy for you to obtain affordable, professionally bound copies of especially pertinent articles from this journal.

With ***WG&L Reprints***, you can:

- Communicate new ideas and techniques that have been developed by leading industry experts
- Keep up with new developments – and how they affect you and your company
- Enhance in-house training programs
- Promote your products or services by offering copies to clients
- And much more

For additional information about *WG&L Reprints* or to place an order for 100 copies or more, mail the coupon or call

1-973-942-5716 • REPRINTS

Please remember that articles appearing in this journal may not be reproduced without permission of the publisher. For orders of fewer than 100 reprints, call the Copyright Clearance Center at 978-750-8400.

▶ clip or photocopy and mail today ▶

Yes! I would like to order the *WG&L Reprints* listed below. Please contact me with pricing information.

Quantity of Reprints ____ No. of Pages ____

Publication (include Vol., No.) ____

Article Title ____

Author ____

Ship/Bill to: ____

Name ☐ Mr. ☐ Ms. ____ (please print)

Title ____

Firm ____

Address ____

City/State/Zip ____

Phone ( ) ____ ☐ Office ☐ Home

Mail to: Lont & Overkamp
Reprints
320 N. Sixth Street • Prospect Park, NJ 07508
or Fax: 973-942-8203.

and construction corporations, which built homes adjacent to the golf courses. The taxpayer's land sales were deemed to be incidental to the entity's primary business and thus did not amount to a separate trade or business.

Fair market value. One of the most important factors in determining whether a related-party sale arrangement will operate successfully is the existence of arm's-length terms in determining the sales price of land sold to a development entity.

In *Boyer,*[71] the sale of land to a related development corporation at an "artificially inflated price" caused the corporation to lose money on the development. In the absence of a fair profit allocation between the entities, the court found that the development entity was an agent of the sellers and did not truly conduct an "independent business venture." After attributing the development corporation's activities to the sellers, the gain on the sale to the corporation was deemed ordinary income.

In contrast, several courts have cited the existence of arm's-length terms in setting the property's value as a significant positive factor in upholding capital gain treatment in similar circumstances.[72] Notably, even if one related entity is not deemed to be an agent for the other entity, Section 482 enables the IRS to reallocate profits between related entities to clearly reflect the income of each. Therefore, it is very important that adequate documentation should exist to justify the sales price on a related-party land sale, and a certified appraisal is recommended.

Documenting a business purpose. In light of the Tax Court's "business purpose" decision in *Phelan,* care should be taken to go beyond the mere formalities of consummating a related-party sale and document that one or more business purposes motivated the related-party transaction.

First, although *Phelan* and *Bramblett* found that a business purpose existed in sales between identically owned entities, one way to show a business purpose would be to show a difference between the parties in interest in the two entities. A difference in ownership structure could be obtained by finding different outside investors to contribute to different stages of a project.

A riskier way to vary the ownership structure between entities would be to give an equity stake in one of the entities to a senior financier, doing so in a manner that gives the financier protections and investment returns similar to those of a conventional lender.[73] However, unless the financier would bear some degree of additional risk as a result of equity ownership, as compared to a straight debt position, the IRS might well recast the financier's equity as debt.

As demonstrated by *Phelan,* business purpose can be established where one larger tract is sold in smaller portions for different projects, giving the parties motivation to isolate different projects into separate entities in case a major, unanticipated liability arises during the development stage. Perhaps a land-selling entity could retain a portion of undeveloped land that ultimately will be used as a parking lot or as an outdoor park, while selling the land that will be developed to a development company. The retained land could later be ground-leased or sold to a separate development company. If feasible in the circumstances, this would enable a taxpayer to use the divided parcel liability-shielding argument that was used in *Phelan.* Because multiple sales of property will more likely lead to dealer status, however, dividing one sale into multiple parts would also have disadvantages.

A NUMBER OF CASES HAVE LITIGATED RELATED PARTY SALES AND THE RESULTS HAVE BEEN MIXED.

Related-party installment sales. While the sale of land at a gain after about one year of a multi-year project would require taxpayer to pay tax, the use of installment sale financing could delay that result.

Under Section 453, gain on the sale of non-dealer property to a related or unrelated party using seller financing will be recognized only as principal payments are made on the debt. This provision is limited for related-party sales in that the seller may not continue to defer gain on the sale if the related-party purchaser resells the property within two years,[74] but in that event the related party may well have sale proceeds to use for paying down the installment note. It is advisable that development corporations be capitalized with some amount of shareholder capital, a part of which would be used to make a down payment on the install-

[71] 58 TC 316 (1972).

[72] See Bramblett, *supra* note 16; Ronhovde, *supra* note 21; Cary, *supra* note 58.

[73] For example, a financier such as a REIT could be, for the land-selling entity, an LLC member that was entitled to a liquidation preference and a preferred return, but also to a return that was not strictly fixed at a certain percentage.

[74] Section 453(e).

ment note even though some tax would need to be paid currently. In this manner, the development corporation will not appear to be a thinly capitalized nominee corporation that should be disregarded.[75] Any installment note must be interest-bearing.[76]

Audit risk. Risk in such arrangements should be noted. If an audited taxpayer loses an attempt to sell land to a related corporation as a capital asset, Section 453 installment sale treatment will be deemed inapplicable and the seller entity will have to pay back taxes, plus interest and perhaps penalties, at ordinary income rates based on the land sale. For example, assume a related-party sale is made in 2005 for a $100,000 gain and is reported as an installment sale, with 10% of principal paid at closing. The taxpayer would pay only $1,500 in tax (15% of $10,000). If an audit in 2008 reveals that the taxpayer held the property for sale, 2005 tax liability will be redetermined at $35,000 (35% of $100,000), and the taxpayer will owe $33,500 in back taxes plus interest and possibly penalties.

ACTIVITIES OF THE INVESTMENT AND DEVELOPMENT ENTITIES SHOULD BE SEGREGATED AS MUCH AS POSSIBLE.

One possibly applicable penalty, the accuracy-related negligence penalty of Section 6662, applies to situations in which taxpayers have failed to make a reasonable attempt to comply with federal tax laws. In *Paullus*, cited herein as a successful "capital asset" case, the taxpayer conceded that he owed some back taxes due to other issues. On these issues, the taxpayer was assessed with a negligence penalty because, although he relied on the advice of his accountant, he failed to show evidence that such reliance was reasonable under the circumstances. This Tax Court holding suggests that the taxpayer could have better protected himself from the possibility of a negligence penalty by obtaining a more formal and documented tax opinion.[77]

Playing it safe. Taxpayers who seek further assurance about minimizing audit risk on an attempt to obtain capital gain treatment may file a request with the IRS for a private letter ruling on the issue.[78] The "dealer in land" issue is not on the Service's list of areas in which it will not issue rulings, yet it may decline to issue a ruling if the result would be highly dependent on the factual nature of the issue.[79]

Land held at least five years before sale

Section 1237 provides a special rule, which could loosely be termed a safe harbor, for land that has been owned for at least five years, enabling taxpayers in certain circumstances to obtain capital gain treatment on the sale of land. Whenever Section 1237 does not apply, the standard land dealer rules apply.[80]

Generally, if a taxpayer other than a C corporation has held a tract of land for investment for at least five years,[81] and sells any lot or parcel within that tract,[82] the land will not be considered dealer property "solely because of the taxpayer having subdivided such tract for purposes of sale" or because of "advertising, promotion, selling activities or the use of sales agents in connection with the sale of lots in such subdivision."[83] The tract must never have been held for sale and, in the year of the sale, that taxpayer must not have held any other real property for sale.[84] After five lots or parcels from the tract have been sold, gain from further sales will be ordinary income to the extent of 5% of the sales price.[85]

A special attribution rule makes Section 1237 unavailable to any taxpayer who owns an interest in a partnership that holds property for sale in the same year by deeming the taxpayer to be the owner of the partnership's property.[86] The legislative history suggests that the attribution rule treats S corporation stock like a partnership interest, but the attribution rule generally does not apply to property owned by a taxpayer's family or by a C corporation in which the taxpayer is a stockholder.[87]

Another requirement of Section 1237, applied on a lot-by-lot basis, is that "no substantial improvement that substantially enhances the value of the lot or parcel sold"

[75] See Robinson, *Federal Income Taxation of Real Estate* (Warren, Gorham & Lamont, 2004), at ¶ 14.03(1)(a)(ii).

[76] See Section 483.

[77] See Saltzman, IRS Practice and Procedure (Warren Gorham & Lamont, 2004), at ¶ 7B.03 (citing cases in which reliance on a tax return preparer or adviser was not reasonable due to "the complexity of the tax law.")

[78] IRS Information Letter 2002-0013, discussed above (*supra* note 21).

[79] Rev. Proc. 2004-1, 2004-1 CB 642, Section 6.02.

[80] Reg. 1.1237-1(a)(4).

[81] The five-year holding period is not necessary if the land was inherited. Section 1237(a)(3); Reg. 1.1237-1(a)(5).

[82] The term "tract" is defined as a "single piece of real property," including two or more pieces that are contiguous or would be contiguous but for an intervening road, railroad, or stream. Section 1237(c).

[83] Section 1237(a)(1); Reg. 1.1237-1(a)(2).

[84] Section 1237(a)(1).

[85] Sections 1237(b)(1), (2).

[86] Reg. 1.1237-1(b)(3).

[87] *Id.*; H. Rep't No. 104-737, 104th Cong., 2d Sess. 230 (1996) (Conference Report).

can have been made either by the taxpayer, a related party, or certain lessees or government entities, if the improvement caused an increase in value of more than 10%.[88] Examples of substantial improvements include buildings, hard-surface roads, and utility lines. Examples of insubstantial improvements include building a temporary field office, "surveying, filling, draining, leveling and clearing operations, and the construction of minimum all-weather access roads."[89] If the tract has been held for at least ten years, "water, sewer, or drainage facilities or roads" will not be considered substantial improvements, but only if the taxpayer can demonstrate that such improvements were necessary to make the lots marketable.[90] The ten-year rule will often be of little or no benefit, however, because taxpayers who use it must exclude the improvements from the property's cost basis, increasing the amount of taxable gain.[91]

Any fact that would suggest land is held for sale, other than subdividing and selling activities, could negate the applicability of Section 1237. If no substantial evidence exists to suggest that a taxpayer held land for sale, apart from subdividing and selling activities, those activities will be ignored in determining whether the land has been held for sale.[92] If the taxpayer (1) holds a real estate license, (2) has sold other real property, (3) has acted as a salesman for a dealer, or (4) has owned other vacant land without trying to sell it, the presence of one of these facts will not amount to substantial evidence that the taxpayer held property for sale. The presence of more than one of these facts will amount to such substantial evidence.[93]

Conclusion

Clear opportunities exist in certain situations to plan for capital gain treatment on land sales by avoiding dealer status. As the IRS has frequently contested capital gain treatment in sales of real property, taxpayers should be aware that claiming capital gain treatment may entail risk. On the other hand, since the IRS often objects to capital asset treatment in loss situations, a taxpayer who wants to be audit-proof would need to claim ordinary income treatment for all gains and capital loss treatment for all losses. Taxpayers who want seek capital gain treatment without as much risk can request a private ruling. ■

[88] Section 1237(a)(2); Regs. 1.1237-1(c)(3)(ii), (iii).
[89] Reg. 1.1237-1(c)(4).
[90] Section 1237(b)(3); Reg. 1.1237-1(c)(5).
[91] Section 1237(b)(3)(C); Reg. 1.1237-1(a)(5).
[92] Reg. 1.1237-1(a)(2).
[93] Reg. 1.1237-1(a)(3).