Legal Times
WEEK OF SEPTEMBER 11, 2006 • VOL. XXIX, NO. 37
ALM

Capital Gain, Plainly Explained

With planning, real estate sales don't have to be taxed as ordinary income.

By John P. Dedon

Those who invest in and develop real estate to sell properties at a profit strive to achieve capital gain rather than ordinary income. As an attorney advising clients engaged in real estate activities, either as part of their business or as an investment, I advise them that they can increase their net profit by structuring their operations to achieve capital gain. With proper planning and advice, the tax savings can be 20 percent or more than they would pay if they were counting the sales as ordinary income.

With some planning, investors can receive capital gain on the sale of property to a corporation or LLC and also share in gains derived from the development of the property. In other words, taxpayers can have the best of both worlds: They can minimize their tax liability through the use of capital gain and at the same time take advantage of the profits they'll make through the development of the property.

How does this happen? The first step in this process is to determine if the sale can be treated as a capital gain. The Internal Revenue Service allows taxpayers to use capital gain treatment on the sale of property only if that property is a "capital asset." Generally, the IRS code defines a capital asset as any property held by a taxpayer. There are exceptions to this, though, including "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

The purpose of this exception, in other words, is to differentiate between gain derived from the everyday operation of a business and gain derived from assets that have appreciated in value over a substantial period of time. A residential real estate developer must treat profit from lot sales as ordinary income. But if an individual who is trying to develop several acres does not understand this exception, he may inadvertently disqualify himself from the lower tax rates. In short, if too many development activities are mixed together and if there are continuous sales, the IRS would consider this as activities held in the ordinary course of business, and would tax it that way.

In determining if a property should be treated as a capital asset under the IRS code, the facts in each case must be considered. The courts have offered some guidelines to help taxpayers determine whether property can be treated as a capital asset. These guidelines generally focus on distinguishing between a long-term investment in a property that appreciates in value over time (a capital asset) and a property used for development activities. Here are some elements that must be considered:

- 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 sales.
- The extent of subdividing, developing, and advertising to increase sales.
- The use of the business office for the sale of the property.
- The character and degree of supervision or control exercised by the taxpayer over the representative selling the property.
- The taxpayer's time and effort habitually devoted to the sale.

The courts have generally held that the frequency and substantiality of sales are the most important factors in determining whether the sale of real estate constitutes a trade or business. But the courts have not applied these factors in a consistent manner. Nevertheless, attorneys advising clients can glean some advice from the case law.

Likely Outcomes

If a property owner does not engage in other property sales, and the entire piece of property is sold intact to a corporation or LLC, several things could happen:

- The property owner obtains rezoning for the land and sells it immediately to a corporation or other group. The likely result is a capital gain.
- Again, the owner obtains rezoning and sells the land, but this time he also subdivides the land. Although he may receive capital gain treatment, the IRS could challenge the transaction.
- This time, before selling the property, the owner obtains

© 2006 ALM Properties Inc. All rights reserved. This article is reprinted with permission from Legal Times (1-800-933-4317 • LTsubscribe@alm.com • www.legaltimes.com).

rezoning, subdivides the land, and makes improvements to it. It is likely that the IRS could successfully argue that this property owner is actually a real estate dealer and is therefore precluded from capital gain treatment.

In addition, if the property owner is engaged in multiple sales to other parties, the IRS may take the position that, at the individual level, he is a dealer in real estate. If so, he would be denied a capital gain on the sale to the entity. Finally, the IRS may attempt to attribute the sales activities of a related entity to this person. There are cases where the courts have held that a corporation was subject to ordinary income on the sale of property because of the number of sales conducted by related corporations during the same period.

Solution Time

But there are ways to solve these potential problems. Assuming that the property owner is an investor and not a dealer, he can form an entity to purchase the property. That entity can be either a "C" corporation, taxed as a separate entity, or an "S" corporation, not taxed as a separate entity, where income, losses, deductions, and credits are passed directly to the shareholders. Further, it could be a limited liability company, structured similarly to the S corporation but with more flexibility. In weighing the advantages and disadvantages of these entities, one should consider tax rates, dividend policy, the need for retained earnings, and spreading profits among several entities. The correct structure is different for every situation.

The following is one example of the way it could work. First, the owner forms a corporation as the purchasing entity. The property's selling price should be the fair-market value as determined by an independent appraisal. It's important to seek an appraisal with the highest fair-market value possible to maximize the capital gain while minimizing the ordinary income to the corporation on the corporation's future sales. The facts, however, must support the sale price. If not, the shareholder may be deemed to have received a dividend to the extent of the excess and the corporation's basis in the property may be reduced by that excess.

Here's the math on that deal. Assume that the property owner holds raw land with an adjusted basis of $200,000 and a fair-market value of $1 million. Next, assume that he sells the land to a controlled corporation for $1 million. Assume further that the land, after being rezoned, subdivided, and improved, is sold off in parcels by the corporation to various developers for a total purchase price of $5 million. This structure has ensured the property owner will receive capital gain treatment on the gain derived from the sale. He'll have $800,000 of capital gain, on which he will pay federal tax of $160,000. The corporation will have a gain of $4 million, on which it will pay federal tax, computed at the ordinary income rates, of $1.82 million. On the other hand, if the property owner subdivided, developed, and sold the property himself, he would have a gain of $4.8 million, on which he would pay tax at the ordinary income rates of $2.4 million.

This system works because of the definition of a valid business purpose. In addition to the rules for an individual taxpayer, the courts have held that partnerships or LLCs may also preserve capital gains by selling appreciated land to a controlled corporation. But there must be a valid business purpose for forming a controlled corporation; otherwise the corporate form may be ignored and the entire gain will be treated as ordinary income.

Two cases best illustrate this point. In *Bramblett v. Commissioner*, 960 F.2d 526, 534 (5th Cir. 1992), the four defendants purchased undeveloped land for investment under a general partnership. Then the defendants formed a controlled corporation and sold the land to the corporation to preserve the capital gain on the land. The IRS challenged the transaction, claiming that it had no valid business purpose. The court, however, held that forming a controlled corporation protected the partnership from unlimited liability arising from the corporation's development activities and that this was a valid business purpose. The court further noted that all corporate formalities were observed.

The *Phelan v. Commissioner*, T.C. Memo 2004-2006, case addressed the same type of transaction as in *Bramblett*, but the defendants in *Phelan* purchased property for investment under an LLC instead of a general partnership. The IRS argued that the transaction had no valid business purpose because an LLC provides the same protection from personal liability as a corporation. But the court held that forming a controlled corporation protected the LLC's assets from obligations arising from the corporation's development activities and that this was also a valid business purpose. Additionally, the *Phelan* court noted that all corporate formalities were observed.

Based on these rulings, it is likely that the courts will preserve the capital gain on a sale of undeveloped land by a partnership or LLC to a controlled corporation if a valid business purpose is established for the transaction and if corporate formalities are observed.

In the right situation, getting investors to think before they develop a property can save them a lot of money. Keep in mind the two common roadblocks in this situation. First, if the owner has already developed and improved the property and sold it off in parcels, he will likely be deemed to be in the real estate business and will be taxed on any gain as ordinary income. Second, if he sells the undeveloped land or apartment building in bulk to an unrelated purchaser, he will likely receive capital gain on the sale.

That transaction, however, will preclude him from receiving the post-sale profit derived from the property's ultimate development or conversion. If these common problems are addressed, this plan will provide investors with the best of both worlds: minimizing tax liability through capital gains and participating in gains derived from the development of the property.

John P. Dedon is a partner in the Fairfax, Va., firm of Odin, Feldman & Pittleman. He concentrates in estate planning, tax, and wealth preservation. He can be contacted at john.dedon@ofplaw.com.

© 2006 ALM Properties Inc. All rights reserved. This article is reprinted with permission from Legal Times
(1-800-933-4317 • LTsubscribe@alm.com • www.legaltimes.com).