Tax Action Memo®

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Using "Developer Entity Strategy" to Lock in Favorable Capital Gain Treatment for Land Appreciation

Type of Clients: Individuals who own appreciated land that's about to be subdivided, developed, and sold off. **Situation:** It sure would be nice if long-term capital gain treatment could be claimed for the predevelopment land appreciation. **Deadline:** Before development activities commence.	**Tax Action Required:** Client should consider selling the appreciated land to a controlled S corporation that will then conduct the subdividing and development activities.

Background

In many parts of the country, real estate has been hot for quite a while—especially single family homes. Therefore, some individuals who have been holding raw land for investment may now be ready to cash in by subdividing their acreage into parcels, developing them, and selling them off at huge profits.

When the client takes this course of action, he is generally deemed by the tax law to be acting as a dealer in real property who is simply selling off inventory. [See IRC Sec. 1221(a)(1) and *Winthrop*.] When dealer status applies, the client's entire profit (including the part attributable to predevelopment appreciation in the value of the land) is considered ordinary income. It is therefore taxed at the client's regular federal rate of up to 35%. Rats! With the new 15% maximum federal rate on long-term capital gains, clients may view that 35% rate with disdain.

Of course, if your client is lucky, his situation will be such that he can take advantage of the special IRC Section 1237 exception. In very limited circumstances, it allows long-term capital gain treatment when land held for investment is subdivided into lots. (For the scoop on how the Section 1237 rules work, see PPC TAM-933[1] dated 1/21/03.) Unfortunately, many clients won't qualify for the Section 1237 break. Rats again!

Thankfully, you may still be able to help your client structure a deal that allows him to claim long-term capital gain treatment for the predevelopment land appreciation, assuming the land really and truly was held for investment (i.e., the client is not a dealer with respect to the property). However, profits attributable to the later subdividing, development, and marketing activities will still be considered ordinary income collected by a dealer in real property. Oh well. Since predevelopment appreciation is often the biggest part of the total profit, your client should be overjoyed if you can set him up to pay only 15% on that piece. The remainder of this release outlines a way to achieve this tax-saving goal.

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[1] A copy of this article has been placed on PPC's website for the benefit of those who were not subscribers when it was originally published. To retrieve or view the article, print subscribers should go to **www.ppcnet.com** and click on the "*Practitioners Tax Action Bulletins* print subscribers" line in the right hand column. (Check the top of the first page of the most recent *Tax Action Memo* you've received for the current PTAB user name and password.) And finally, at the PTAB Online Resource Center, click on "Articles Mentioned in Previous Issues."

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Form an S Corporation to Function as Developer Entity

Say your client forms a new S corporation. He sells the appreciated raw land to the corporation for its pre-development fair market value (FMV). If necessary, the sale can be for a bit of cash and a lot of installment notes owed by the corporation to the client. Provided the client has held the land for investment (rather than for sale in the ordinary course of business) and has held it for more than one year, this sale will qualify for capital gain treatment. So, your client will lose only 15% of his whopping big long-term capital gain to the tax collector. Sweet!

However, let's not get totally carried away here! For several reasons, the client shouldn't count too much on collecting additional tax benefits under the installment sale rules.

- First, deferring gain by using installment reporting wouldn't turn out to be very smart if our beloved Congress raises the maximum long-term gain rate before the client collects all of his notes from the S corporation. That could happen, folks. The political winds are unpredictable. For this reason, the client may actually be well-advised to elect out of installment reporting to lock in the current ultra-low 15% rate.

- Even if the client chooses to use installment reporting, the so-called second disposition rule will trigger deferred gains attributable to land sold by the S corporation within two years after buying it from the client [IRC Sec. 453(e)].

- Finally, if the client uses installment reporting, he might fall under the dreaded installment sale interest charge rule of IRC Sec. 453A(a)(1). If so, he must pay interest on at least part of the deferred federal income tax bill. That takes the fun out of using the installment method!

All things considered, it might be best to elect out of installment reporting and simply pay the 15% tax on the front end. If necessary, borrowing enough money to do so and incurring the resulting interest expense could be worth it. Of course, that's for the client to decide.

In any case, let's get back to our developer entity strategy. After buying the land from the client, the S corporation proceeds to subdivide and develop the property, market it, and sell it off. The profits from these activities will be ordinary income passed through to the client. However, this is still a great tax-saving deal when the land is highly appreciated to start with.

To sum up so far, the developer entity strategy allows the client to lock in the favorable long-term gain rate for all the predevelopment appreciation while paying higher ordinary income rates on the additional profits from development and related activities. This bifurcated tax outcome actually reflects economic reality and is therefore fair and just (although the IRS may not see it that way).

So What's the Catch?

By now, you're probably thinking this all sounds way too good to be true. Is there something wrong here? Actually, the developer entity strategy should work just fine as long as you make the developer entity an S corporation rather than a controlled partnership (or multimember LLC treated as a partnership for tax purposes). Why? Because IRC Sec. 707(b)(2) mandates ordinary income treatment for gain from a sale to a controlled partnership (or LLC treated as such) when the asset in question is not a capital asset in the hands of the partnership (LLC). Since the land in our situation would not be a capital asset in the hands of the developer entity, any gain from selling the land to a developer entity that is a controlled partnership (LLC) would be ordinary income. Of course, that would defeat the whole purpose. So, use an S corporation as the developer entity. Don't use a controlled partnership (or LLC treated as such).

Also, be aware of potential IRS arguments against the developer entity strategy and plan accordingly. For instance, the IRS may argue that what actually happened here was a capital contribution of appreciated land to the S corporation developer entity followed by development and sales activities. If successful, this

argument would result in the entire profit being recognized as ordinary income belonging to the S corporation (as opposed to the bifurcated treatment we want).

The good news: in *Bradshaw*, the taxpayer beat the IRS on this very issue. Even so, the moral of the story is to carefully document and execute the sale between the client and the S corporation developer entity. If installment notes are involved, be sure the interest and principal get paid according to the terms of the notes. Do all of the other things that indicate a sale rather than a capital contribution. Make sure the formation and capitalization of the S corporation and the sale of the land to the S corporation are completely separate and distinct events. Get the land appraised before the sale to the S corporation and charge an arm's length price. Don't let the S corporation issue any stock to the client at the same time the land sale is made. Yada, yada, yada. You get the idea.

Alternatively, the IRS could argue that the S corporation developer entity is actually the client's agent. If this argument is successful, the purported sale of the land to the S corporation would be completely disregarded for tax purposes. The client would fall into dealer status, and all profits would be ordinary income. However, in *Bramblett*, the Fifth Circuit rejected this agency argument, even though there were some "bad facts" in that case. Still, the moral of this second story is to keep the affairs of the client and the S corporation developer entity completely separate and distinct. That will defeat any agency argument.

Conclusions

With the new ultra-low 15% federal tax rate on long-term capital gains, the whole concept of converting ordinary income into capital gains is sure to heat up again. In the right circumstances, the developer entity strategy outlined in this release can make you look really smart. Executed properly, the strategy should be above reproach. Enjoy, but be careful out there!

References:

IRC Secs. 453(e), 453A(a)(1), 1221(a)(1), and 1237.
Bradshaw, Jolana S. v. U.S., 50 AFTR 2d 82-5238, 683 F2d 365, 82-2 USTC 9454 (Ct Cl, 1982).
Bramblett, Richard H. v. Comm., 69 AFTR 2d 92-1344, 960 F2d 526, 92-1 USTC 50,252 (5th Cir, 1992).
Winthrop v. U.S., 24 AFTR 2d 69-5760, 417 F2d 905, 69-2 USTC 9686 (5th Cir, 1969).

Subscriber Note: This *Tax Action Memo* was written by Tax Action Panel member William R. Bischoff, CPA of Colorado Springs, Colorado.

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