

# Mastering Tax Reporting and Planning in Real Estate Partnerships

Navigating "Dealer vs. Investor," Installment Sale Issues for Real Estate, and More

TUESDAY, APRIL 26, 2016, 1:00-2:50 pm Eastern

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April 26, 2016

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# Tax Reporting and Planning in Real Estate Partnerships

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# Dealer vs. Investor Issues

# Dealer vs. Investor Issues

- Dealer Property—Tax Consequences:
  - 1. Gain from sale is ordinary income
  - 2. Gain cannot be reported under installment method
  - 3. Section 1031 not available to defer gain

# Dealer vs. Investor Issues

- Recent cases
  - *Evans v. Commissioner*, T.C. Memo. 2016-7
  - *Fargo v. Commissioner*, T.C. Memo. 2015-96
  - *Allen v. United States*, 2014-1 USTC Para. 50,300 (N.D. Ca.)
  - *SI Boo, LLC v. Commissioner*, T.C. Memo. 2015-19
  - *Pool v. Commissioner*, T.C. Memo. 2014-3

# Dealer vs. Investor Issues

- What is “dealer property”?
- Different definitions depending on context
  - For purposes of whether gain from sale is capital or ordinary:
    - “Property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.” IRC § 1221(a)(1); 1231(b)(1)(B).
  - For purposes of whether sale is a “dealer disposition” of real property:
    - “Real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer’s trade or business.” IRC § 453(l)(1)(B).
  - For purposes of whether IRC section 1031 applies:
    - Property “held primarily for sale.” IRC § 1031(a)(2)(A)
    - IRC section 1031 definition is broader

# Dealer Status

- The issue in the case of real estate is whether the property sold is held by the taxpayer “primarily for sale to customers in the ordinary course of his trade or business.” That is, real estate generally will not constitute inventory or stock in trade.
- There are a great number of cases that address the Dealer Property question.
- The following slides identify certain of the significant cases cited by courts and commentators, and then apply the authority to various common scenarios.

# Selected Dealer Property Cases

*Malat v. Riddell* [383 US 569 (1966)].

- Partnership purchased unimproved property, subdivided a portion into lots and constructed subdivision improvements on such portion. Lots distributed to partners. Following unsuccessful attempts to develop balance of property, after 8-9 month hold, remaining property was sold in two sales.
- Court concluded that “primarily” meant “principally” or “of first importance.” Accordingly, it should not be enough that a substantial purpose of the taxpayer is the sale of the property.
- A question to address: Does profit arise from everyday operation of business or long-term appreciation?

# Selected Dealer Property Cases

*Biedenharn Realty Co. v. US* [526 F.2d 409 (5<sup>th</sup> Cir. 1976) ], cert. den. 429 US 819 (1976)]

- Land that had been held for investment was subdivided, improved and sold in numerous lot sales. Court concludes not a mere liquidation of investment but a change of purpose to dealer status.
  - Frequency and substantiality of sales is the most important factor in determining holding purpose, existence of trade or business and “ordinariness” of sales.
  - There is no exception for liquidating a prior investment – same analysis applies, particularly where decision to sell is not compelled but events outside TP’s control.
  - Solicitation activities and development can suggest dealer status but absence of such activities are not necessarily determinative.

# Dealer Factors

Certain courts have identified factors to consider, including:

- (1) Acquisition purpose
- (2) Purpose during course of ownership
- (3) Purpose at time of sale
- (4) Extent of improvements
- (5) Frequency, number and continuity of sales
- (6) Nature and substantiality of transactions
- (7) Dealings in similar property
- (8) Advertising, listing with brokers and other sales efforts
- (9) Duration of ownership
- (10) Ordinary business of TP

*See, e.g., Maddux Contr. Co. v. Commissioner* [54 TC 1278 (1970)], *Case v. US* [633 F.2d 1240 (1980)]; *Winthrop v. US* [417 F.2d 910 (5<sup>th</sup> Cir. 1969)].

# Dealer Factors

- “Over the past 40 years, this case by case approach with its concentration on the facts of each suit has resulted in a collection of decisions not always reconcilable.... [S]pecific factors, or combinations of them are not necessarily controlling....’[The factors are not] the equivalent of the philosopher’s stone, separating ‘sellers garlanded with capital gains from those beflowered in the garden of ordinary income.’ ” [citations omitted].

*Biedenharn Realty Co. v. U.S.* [526 F.2d at 414-415].

# When To Determine If Property Is Held For Sale

- While purpose for acquiring and purpose during course of ownership are relevant, the Tax Court has noted that the purpose can change and purpose at time of sale is most relevant.
- Compare how this test is applied in *Maddux Constr. Co. v. Commissioner* [54 TC at 1278] (noting that original purpose to develop and sell raw land changed two years prior to sale) with *Fargo v. Commissioner* [TC Memo 2015-96] (noting that despite lengthy holding of property for rental, original purpose to develop property for sale never changed.) See also *Cottle v. Commissioner* [89 TC 467 (1989)] (Tax Court stated that the purpose for holding property may change and the purpose at the time of sale generally determines tax treatment.)
- The court in *Suburban Realty Co. v. US* [615 F.2d 171 (5<sup>th</sup> Cir. 1980)], stated that the focus should be on the holding purpose over the entire course of ownership not the moment of sale, but acknowledged that the holding purpose can change.

# Entity v. Aggregate Issues

- Where a partnership/LLC sells property, the analysis of whether the property is held for sale should not be dependent on the businesses separately engaged in by partners. *See, e.g., Phelan v. Commissioner*, TC Memo 2004-206.
- Character of gain determined at the partnership level. IRC § 702(b).
  - Note: If property is contributed to the partnership by a partner in whose hands the property was an “inventory item,” gain on sale is ordinary for 5-year period after contribution. IRC § 724(b).
- Similarly, for S corporations, character of gain determined at the entity level. IRC § 1366(b); Treas. Reg. § 1.1366-1(b)(1).
- Similarly, partners generally should not be tainted by dealer activities of partnerships of which they are partners.

## “One Off” Sales

More than one court has stated that the frequency and substantiality of sales is the most important factor to be considered. *See, e.g., Biedenharn Realty v. US*, 526 F.2d at 409; *Buono v. Commissioner* [74 TC 187 (1980), acq., 1981-2 CB 1]; *Phelan v. Commissioner* [TC Memo 2004-206].

However, compare results in the following cases:

*Buono v. Commissioner*. TP purchased undeveloped land with intent to subdivide and then, about 18 months later, sell to one purchaser. Later, a portion of property was subdivided into residential lots and was sold to single buyer (about 5 years after purchase due to subdivision issues) following an unsolicited offer. No sales activity or improvements and only sale during the year. Held, not a dealer. Although planned to sell, not in the business of selling property. Court acknowledges that intent at all times was to sell the single tract. Focus is on lack of sales.

# “One Off” Sales

- *S&H, Inc. v. Commissioner*, 78 TC 234 (1982). TP held several properties for investment. Following acquisition of undeveloped land, it sold small portions in 3 unrelated sales following receipt of unsolicited offers. TP engaged in a transaction in which it agreed to construct and lease facility to third party coupled with purchase option. Held, transaction was a sale and TP was a dealer and sale was part of new business of constructing and selling real estate. Court stated that *Buono* did not create a one sale safe harbor – there is no “one bite rule.”

## “One Off” Sales

- *Fargo v. Commissioner* [TC Memo 2015-96]. Partnership acquired leasehold of building (which was leased to tenants) and surrounding land in 1988 with plans to develop townhouse/retail complex. (Presumably, it was intended that the townhouses would be developed for sale.) Plans later suspended but in order to facilitate obtaining financing, p’ship acquired fee in 1997. Soft development costs incurred in 1999-2001, and received unsolicited offer in 2001, which it accepted (its only sale). Notwithstanding single sale resulting from unsolicited offer and generation of rental income throughout holding period, p’ship held to be a dealer in that it never abandoned its development objective. (Court doesn’t seek to distinguish *Buono* but might argue that in *Buono* there was never an intent to engage in more than one sale.)

# Can One TP Hold Different Properties For Different Purposes?

- Yes. A single taxpayer may be treated as holding certain properties for investment while holding other properties for sale to customers in the ordinary course of his business. *See, e.g., Rouse v. Commissioner* [39 TC 70 (1962)]; *Cottle v. Commissioner* [89 TC at 467]; *Gardner v. Commissioner* [TC Memo 2011-37].

# Liquidation Exception?

*Heller Trust v. Commissioner* [382 F.2d 675 (9<sup>th</sup> Cir. 1967)]

Corporations created to develop rental housing (duplexes). Duplexes later distributed to shareholders. Related party engaged to undertake significant sales activity, selling 169 units individual units over multiple years. TP a dealer with respect to other property. Held, not a dealer. This was a separate rental business that continued until shortly before sale. [Court does not appear to distinguish corporate holding purpose from TP's purpose.]

*Parkside v. Commissioner*, [571 F.2d 1092 (9<sup>th</sup> Cir. 1977)].

Corporation developed rental housing and four years later began to undertake sales activity to sell individual units. Issue was application of personal holding company tax. Held, dealer. Liquidation of investment does not compel a result. Here, improvements to properties, significant sales activity and a large number of sales were determinative.

# Liquidation Exception?

*Gangi v. Commissioner* [TC Memo 1987-561]

Relying on *Heller Trust* (case was appealable to 9<sup>th</sup> Cir.), court held that partnership was not a dealer where it held 36-unit apartment bldg. for rental for 8 years but then converted units to condos and sold individual units over 2 years. Court focused on the fact that this was a liquidation of an investment due to various factors. Court distinguished *Parkside* on basis that Parkside engaged to a greater extent in sales activities.

*Cottle v. Commissioner* [89 TC at 467].

Changed circumstances and no negative factors point to liquidation of investment.

# Out Parcels

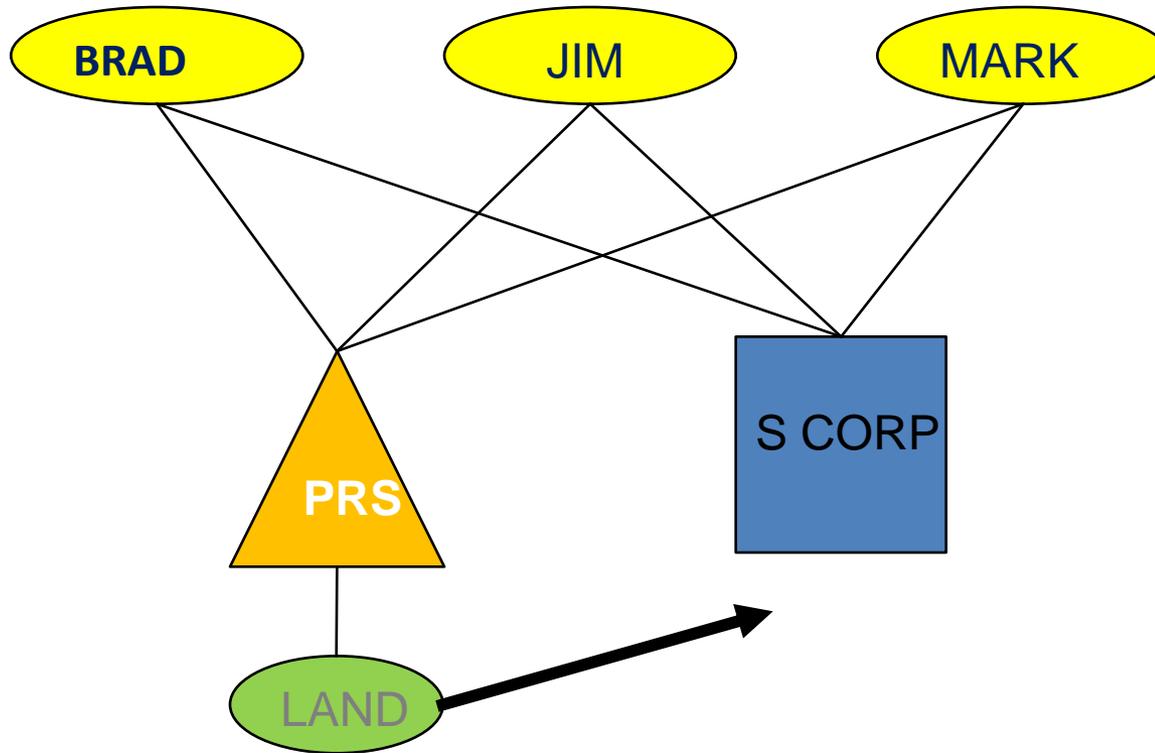
Sale of “out parcels” shortly following acquisition?

*Ayling v. Commissioner* [32 TC 704 (1959)]; *M.S. Doss v. U.S.* [54-1 USTC ¶ 9413 (D.C. Texas)]; *Toll v. Commissioner* [TC Memo 1961-301]; *Metz v. Commissioner* [TC Memo 1955-303].  
Compare *Wibbelsman v. Commissioner* [12 TC 1022 (1949)]; *DeMars v. US*, [71-1 USTC ¶9288 (DC S.D. Ind.) (1968)]; *Klarkowski v. Commissioner* [385 F.2d 398 (7<sup>th</sup> Cir. 1967)].

# Planning

- LLC/PRS agreement, tax returns and financial statements should all indicate that business is holding for investment (assuming that's the case).
- Consider ability to minimize advertising and other sales-related activity.
- Hold investment assets in different entity.
  
- Divide separate assets into separate entities to limit “frequent sales” argument

# Bradshaw/Bramblett/Phelan



1. Can Land be sold pre-development to related corp?
2. What if property is apt bldg. to be converted to condos?

## Bradshaw/Bramblett/Phelan

- Gain from the sale of land not held for sale to a related partnership that will hold the property for sale to customers is treated as ordinary income. IRC § 707(b)(2). However, can a taxpayer sell to a related C or S corporation?
- *Bradshaw v. US*, 683 F.2d 365 (Ct.Cl. 1982), TP sold property to his wholly-owned S corporation in exchange for notes. S Corp intended to subdivide, develop and sell property. Held, transaction respected as a sale. No attempt to treat TP as a dealer.

## *Bradshaw/Bramblett/Phelan*

- *Bramblett v. Commissioner*, 960 F.2d 526 (5<sup>th</sup> Cir. 1992). Partnership sold land to commonly-owned S corporation, which held land as a dealer and resold in 8 transactions. Corp tendered notes. Held, p'ship not in the business of selling land and corp is not the p'ship's agent. Court noted that 5 sales over 3 years by p'ship did not rise to the level of frequency to cause p'ship to be a dealer.
- Property was held for 3 years without development activity or sales-related activity. Intent of partnership was to hold for investment.
- Under *National Carbide* and *Bollinger* standards, the Corp was not the P'ship's agent. (Did not use P'ship's employees or assets; did not have authority to bind P'ship; did not engage in normal agency activities, etc.)
- Court noted that separate business purpose of Corp was to protect P'ship from unlimited liability.

## Bradshaw/Bramblett/Phelan

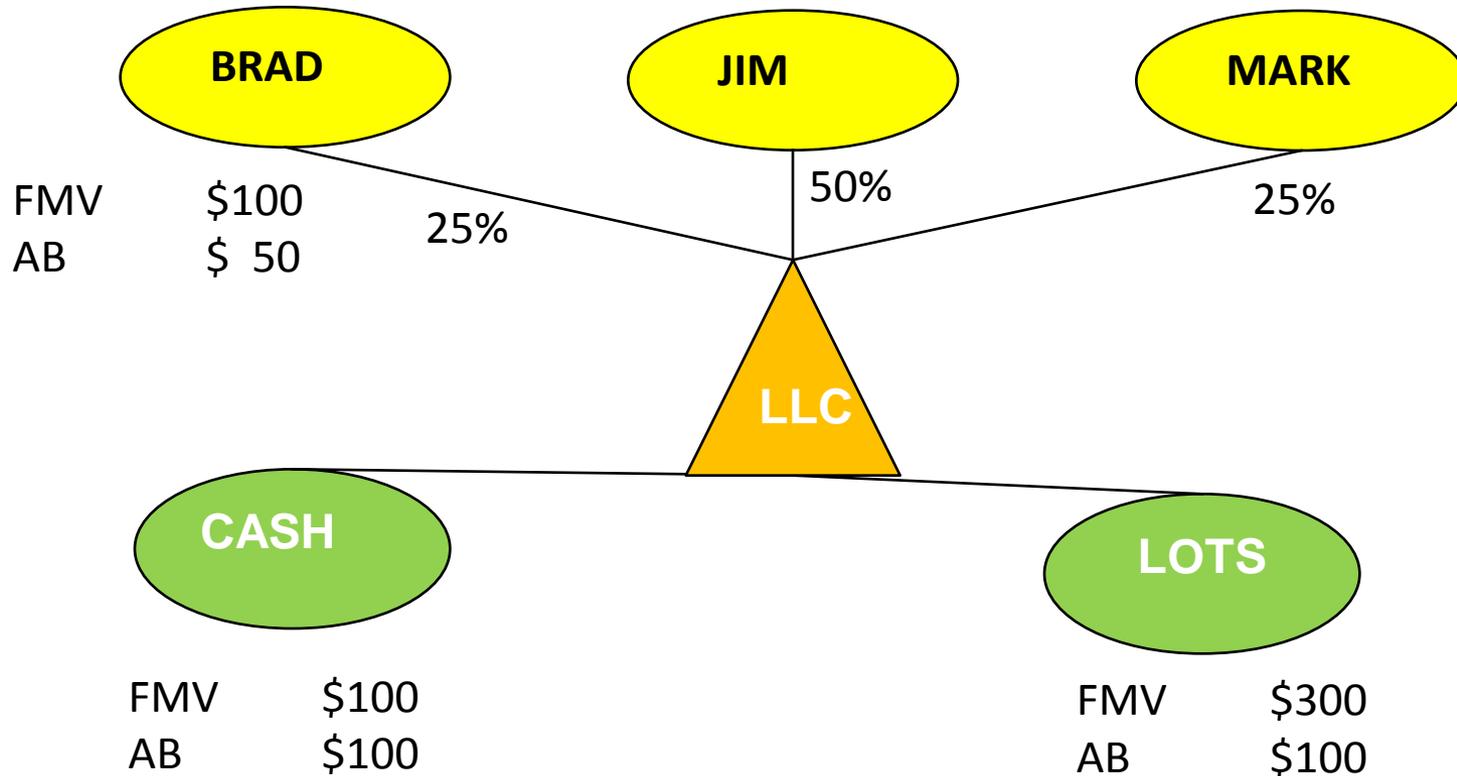
- *Phelan v. Commissioner* [TC Memo 2004-206]. Similar to *Bramblett*. Regarding business purpose, court noted that no unlimited liability concern for transferring LLC but limiting liability (but having related corporation make sales) did protect LLC's retained asset
- Various issues to consider
  - Is transfer to corp a § 351 transaction or contribution to a JV? Will installment debt be recognized as such?
    - See *Burr Oaks Corp. v. Commissioner*, 365 F2d 24 (7<sup>th</sup> Cir. 1966); *Aqualane Shores, Inc. v. Commissioner*, 269 F2d 116 (5<sup>th</sup> Cir. 1959).
    - Debt must be adequately secured, bear interest, and have limited term.
  - Is there a business purpose for the transfer?
  - Application of various § 453 & § 453A provisions.
  - Calculation of sales price. Is it FMV? Avoid participations in resales?
  - Liabilities in excess of basis?

# *Bradshaw/Bramblett/Phelan*

## Condo conversion

- Strategy won't work due to § 1239 if property is still in service at time of sale (sale to related party of property that is (temporarily) depreciable by buyer)
- Similarly, installment method not applicable if property is depreciable in the hands of the S corporation purchaser. IRC § 453(g).
  - Consider whether purchaser can take the position that it is holding property for sale beginning on date of acquisition.
- Can objective be accomplished by selling [90+]% of partnership interests to the corporation?

# Withdrawal From Dealer Partnership



Brad wants to cash out of homebuilding LLC.

Any planning opportunities?

# Withdrawal From Dealer Partnership

- If Brad receives liquidating distribution of \$100, it appears that § 751(b) would apply, causing him to recognize \$50 of ordinary income. Similar consequence under § 751(a) if he sells interest.
- Can LLC use cash to purchase rental property and within one year distribute property to Brad?
  - Prior to one year, rental property is neither capital asset nor 1231 Property; should be treated as “hot asset” under IRC § 751(d) and Treas. Reg. § 1.751-1(d)(2)(ii) (i.e., a “substantially appreciated inventory item” by virtue of the fact that all inventory items in the aggregate are substantially appreciated). Thus, distribution does not result in a 751(b) exchange.
  - Brad takes substituted basis in property (i.e., step down to \$50) and LLC gets a corresponding step up in basis of lots if § 754 election is in effect.

# Withdrawal From Dealer Partnership

- Consider substance of purchase of rental property followed by distribution. See *Countryside L.P. v. Commissioner* [TC Memo 2008-3]; ILM 200650014.
- Consider impact of proposed § 751(b) regulations