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Dealer Status and Condo Conversion

Recourse Liabilities and Disregarded Entities

'Traditional' Allocations for Contributed Property

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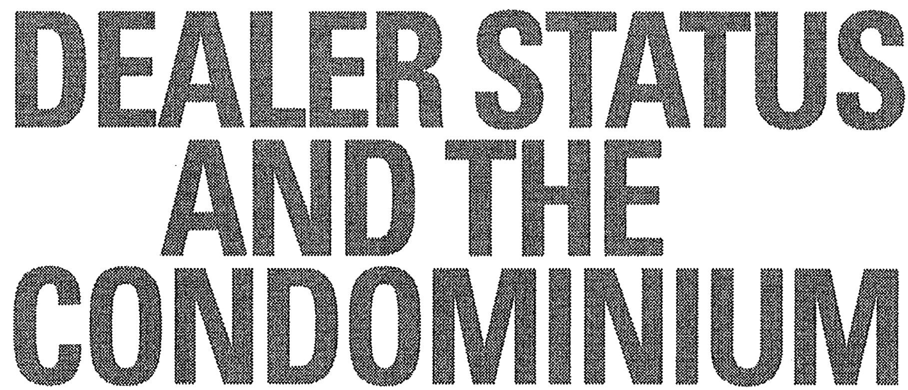

DEALER STATUS AND THE CONDOMINIUM CONVERSION

Three potential strategies can help to stay on the right side of the "indistinct line of demarcation between investment and dealership."

MICHAEL K. HAUSER, J.D., CPA

A previous article by the author on the dealer vs. investor issue discussed the statutes, cases, and other legal precedents that apply to whether or not a given sale of real estate meets the standards for capital gain/loss treatment.[1] The classic example covered by that article is the sale of raw land, but much of the reaction that the author received dealt with the application of the rules to the conversion of an apartment building into condominium units held for individual sale. Condominium conversions involve additional rules, however. Besides additional statutes, cases, and rulings that must be considered, there are additional issues. They allow three alternative strategies for possibly attaining capital gain treatment in condominium conversion situations—pre-conversion sale to a 50%-owned entity, pre-conversion sale to a majority-owned entity, and "orderly liquidation." Since C corporations do not benefit from capital gains tax rates, the following discussion is principally of relevance to rental properties owned by individuals, directly or through flow-through business entities or trusts.

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Dealer status in general

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.[2] A sale generally will produce capital gain or loss if the property is held as an "investment" with the expectation of speculative appreciation in its market value. A sale will produce ordinary income or loss if the property is held by a "dealer" in "the everyday operation of a business"[3] that involves activities such as developing, improving, marketing, and/or selling land. This is an inherently factual determination that depends on the "totality of circumstances" in each case.[4] "Dealer" in this context is actually a borrowed term that comes from Section 453, the installment sale provision, but it is widely used to denote one who holds real property for sale rather than for investment.

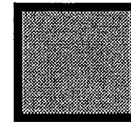
Real property will not be deemed a capital asset if it is "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" under Section 1221(a)(1). Courts will look to whether the taxpayer (1) is engaged in the trade or business of selling real property, (2) holds the specific property at issue primarily for sale in that business, and (3) made the specific sale at issue in the ordinary course of that business. Rental properties are generally deemed to be held either for "investment" or for "use in a trade or business" rather than

"for sale," and thus will be taxed as either capital assets or Section 1231 assets, not ordinary income assets. The Supreme Court in *Malat v. Riddell*[5] held that if land is developed and held for the "dual purpose" of either renting it or selling it, with neither intent primary over the other, the property will be a capital asset.

Some factors frequently considered in determining whether land is dealer property include:[6]

- 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.[7]



THE FREQUENCY AND SUBSTANTIALITY OF SALES IS THE MOST IMPORTANT FACTOR.

Dealer status is generally determined on a property-by-property basis,[8] and also on an entity-by-entity basis.[9] Thus, someone may be deemed to hold one property for investment and another property primarily for sale if the activities and intent differ with respect to each of the properties, especially if the properties are held by different taxable entities.[10] Dealer status is preferred if a property will produce losses, but is otherwise usually unfavorable since it will prevent capital gain treatment, disallow installment sale treatment, potentially cause self-employment tax, and also bar the use of a Section 1031 exchange to defer gain.[11]

The concept of entity-level characterization has enabled many land developers to bifurcate their gain into capital and ordinary components. The strategy used to accomplish this begins with the purchase of land in an LLC or partnership that holds the land for over a year in its raw form (no development). During this time, the property appreciates due to changes in market conditions, zoning changes, or otherwise. The property is then sold to a related corporation (with similar or even identical ownership) for its fair market value as raw land, and capital gain is claimed on the sale. The corporation will develop and sell the property and recognize ordinary income on the profits therefrom.[12]Case law has upheld this and similar approaches, provided that the taxpayer can establish that there was an independent business purpose for the sale, such as limiting potential exposure to contingent liabilities.[13] The activities of the investment entity and the development entity should be segregated as much as possible, and thus all negotiations with, and correspondence to, government agencies, utility companies, local associations, and builders regarding development should be carried out by (and in the name of) the development corporation.[14]

An IRS information letter released on this topic does 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.[15] The IRS, however, "typically argues that an agency relationship exists between the seller entity and the related purchaser entity," meaning that the purchaser

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[1] Hauser, "Avoiding 'Dealer' Status to Obtain Capital Gains," 32 Real Estate Tax'n 115 (Second Quarter, 2005).

[2] Buono, 74 TC 187 (1973).

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

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

[5] 383 US 569,17 AFTR2d 604 (1966).

[6] Bramblett, 960 F.2d 526, 69 AFTR2d 92-1344 (CA-5, 1992); Phelan, TCM 2004-206 (citing inter alia Suburban Realty Co., 615 F.2d 171, 45 AFTR2d 80-1263 (CA-5, 1980)). See also Hancock, TCM 1999-336.

[7] Phelan, *supra* note 6, Bynum, 46 TC 295 (1966).

[8] Tibbals v. U.S., 176 Ct. Cl. 196, 17 AFTR2d 1213 (1966) ("purpose or intention must be determined with respect to each tract").

[9] *See e.g.* Bramblett, *supra* note 6 (entity-level characterization upheld for flow-through entity), but note that a single-member LLC that has not elected corporate status is disregarded as an entity.

[10] See Scheuber, 371 F.2d 996, 19 AFTR2d 639 (CA-7, 1967); Tucker, *Tax Aspects of Real Estate Transactions* ([Thomson West, 2003]), ¶ 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].

[11] The test under Section 1031 is slightly stricter than the capital asset test. See Neil T. Baker Enterprises, TCM 1998-302.

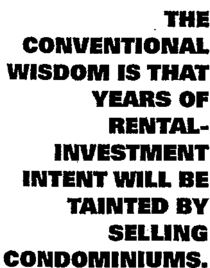
[12] The purchasing entity must be a corporation, rather than a partnership, due to Section 707(b)(2)(B).

[13] Bramblett, *supra* note 6; Phelan, *supra* note 6.

[14] 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.

[15] IRS Information Letter 2002-0013.

entity's activities should be imputed to the seller entity in determining whether the seller entity held the land as an investment. The letter also focused on "the magnitude of the seller entity's pre- and post-transfer activity with 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.[16] 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. These factors are similarly relevant in the pre-conversion sale of a building to be made into condominiums.



THE CONVENTIONAL WISDOM IS THAT YEARS OF RENTAL-INVESTMENT INTENT WILL BE TAINTED BY SELLING CONDOMINIUMS.

Tainting the rental intent by converting

The conventional wisdom is that, if an apartment building owner converts the building to condominiums, the many years of rental-investment intent will be tainted by selling condominiums as inventory in the ordinary course of (this new) business.[17] This notion was advanced by the IRS in Ltr. Rul. 8338114, which stated that the "conversion of an existing building into condominiums *usually* changes the tax status of the building from property used in a trade or business [e.g. rental] or held for investment to property held primarily for sale. As a result, the income from the sale of the individual condominiums is *usually* ordinary income rather than capital gain." (Emphasis added). Similarly, a congressional committee report from 1984 states that "the entire gain on the conversion of property into condominiums and the individual sale of those condominiums *generally* is treated as ordinary income to the seller." (Emphasis added).[18] In 1984, the House considered a bill that would make condominium sales partially capital gain and partially ordinary income, but the bill did not pass.[19]

Thus, the $64,000 question is whether this result can be avoided. The question takes on special importance because the basis of apartment buildings will often be low due to depreciation, even if the property has not significantly appreciated. If such a property qualifies for capital gain treatment, to the extent there has previously been unrecaptured Section 1250 gain, the gain would be taxed at 25%, with the remainder at the 15% long-term capital gain rate,[20] but all this would revert to a maximum 35% rate if the entire gain becomes ordinary income.

Pre-conversion sale—the 50% method

Appreciated raw land that has been held for a year can be sold to a related development corporation to bifurcate capital gain and ordinary income. Why, then, can one not simply employ the same theory here? Just sell the apartment building to a related corporation which will do the conversion? The answer, at least at first blush, is that the entire gain would automatically be converted into ordinary income because Section 1239(a)(1) provides that the sale of depreciable property between related taxpayers will result in ordinary income (this stance is challenged in the next section).

Thus, the easiest method to allow capital gain on the conversion of a building into condominiums involves selling the entire building to a 50%-owned entity before any conversion activities have taken place, since 50% is below the threshold of being a related taxpayer. Ideally, the building's current owner will hold the building exclusively for rental up until the date of the sale, without evidencing any intent to conduct a conversion. The sale should be for the building's fair market value, determined on an arm's-length basis as if it was being sold to a third party, and ideally supported by an independent appraisal. The purchasing entity should conduct all conversion activities, including preparation

[16] 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, TCM 1996-419.

[17] The term "conversion" is used throughout this discussion because a state law conversion of a property into a condominium generally coincides with a decision to sell the individual units. In some circumstances, however, a building may be legally organized as a condominium all along, but with the units nevertheless held for rental. In those cases, the "conversion" for tax purposes would likely be measured as of the time when steps are taken to sell the units individually instead of holding them all for rental.

[18] H. Rep't No. 98-861, 99th Cong., 2d Sess. 1270 (1984) (Conference Report). See also H. Rep't No. 98-432, 98th Cong., 2d Sess. 1080 (1984) (Conference Report). The terms "usually" and "generally" imply there are exceptions, as discussed in the "liquidation" section below.

[19] *Id.*

[20] These rates do not apply to C corporations. This discussion presumes that individuals or flow-through entities (beneficially owned by individuals) hold title to the rental properties discussed.

and filing of all condominium legal documents, communication with all government entities regarding the conversion, and retaining an architect and builder to construct renovations (if any). By using this method, all of the pre-conversion economic appreciation in the building, plus all straight-line depreciation previously taken, will be taxable as capital gain (and/or unrecaptured Section 1250 gain).

The 50% maximum for common ownership is set forth in Sections 1239(b), (c), and (d), which reference certain of the related party provisions of Sections 267 and 318, including constructive ownership provisions. In a nutshell, the 50% limitation cannot be avoided by having controlled entities (owned by the same people or their close family members) own the other 50% of the new entity, so a truly independent party should own the other 50%. That said, the Section 1239 related-party rules, though complicated and a trap for the unwary, do have some flexibility in terms of which family members are counted in the 50% (as individuals or beneficiaries of trusts[21]). Still, if a new 50% owner is an entity owned by relatives outside the scope of Section 1239 (such as a stepmother, a cousin, or a son-in-law), the IRS could question whether the sale was a bona fide transaction, or whether the new owner was the proverbial "straw man."

Thus, the new owner should share proportionately in post-conversion profits and should make a capital contribution (and should bear some risk with respect to it). The sale itself should have all of the formalities of any other property transfer, and a down payment of a respectable size should be made (if the sale will be seller-financed). The IRS can always argue that the purchasing entity acted as the agent of the selling entity, especially if any future options or contracts to sell units to third parties were in place at the time of the sale, but if all formalities are followed and the new 50%-owner bears the proportionate benefits and burdens of ownership, there will not ordinarily be undue risk.

Some more aggressive sellers could attempt to bail out additional conversion profits by taking a high-interest note back from the purchasing entity. For example, instead of having the purchasing entity obtain a bank loan or assume the selling entity's loan, it could agree to pay above-market interest to the seller entity (perhaps through a wrap loan arrangement[22]). The 50% line could get tested, and possibly crossed, if the seller's high-interest loan is considered a disguised form of equity. The selling entity could alternatively use a standard interest rate on its loan, but provide for some form of contingent interest "kicker" or participation right in the purchaser's later proceeds of sale.[23] This would push the 50% line to the limit, and possibly cross it, but the taxpayer could still retain as a back-up argument the following over-50% approach.

Pre-conversion sale—the over-50% method

An alternative to the 50% strategy, which has not yet been tested in the courts or ruled on by

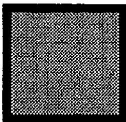
[21] The sale of the entire property to a trust for the benefit of a taxpayer's children does not appear to come under the 50% maximum of Section 1239. The reason is that such a trust does not fit within any of the categories of related parties under Section 1239, which are limited to (1) 50%-owned corporations and partnerships, (2) trusts in which the taxpayer or his/her spouse is a beneficiary, (3) executors of estates with estate beneficiaries, and (4) certain employers and benefit funds. If, however, such a trust is not the direct purchaser but instead is an owner of a partnership or corporation that purchases the property, the attribution rules would cause the taxpayer to be deemed the owner of the trust's interest.

[22] For the use of a wrap mortgage in the context of installment sale treatment, see Webb, TCM 1987-451.

[23] See Tucker, *supra* note 10 at § § 26:02-05 for a discussion of possible types of "kickers" and the debt vs. equity issues that accompany them.

the IRS,[24] involves selling the rental building to a corporation[25] with greater than 50% common ownership, perhaps even identical ownership. Although such a sale would seem to invoke Section 1239(a), the theory is that when the corporate purchaser converts the building into condominiums held for sale, the property is nondepreciable inventory in the hands of the purchaser, avoiding the literal language of Section 1239(a), which provides that "[i]n the case of a sale or exchange of property, directly or indirectly, between related persons, any gain recognized to the transferor shall be treated as ordinary income if such property is, *in the hands of the transferee*, of a character which is subject to the allowance for depreciation provided in section 167." (Emphasis added).

Assuming this theory were upheld, Section 1239(a) would not convert capital gain into ordinary income. Here, it is paramount to not only prevent the selling partnership from being a "dealer" but also to concurrently ensure that the purchasing corporation is in fact a "dealer." Thus, the purchasing corporation would need to have the intent to convert the rental apartments into an inventory of condominiums held for sale as soon as reasonably possible. Potential problems with this are apparent—contract issues (the apartments are likely to be tied up in leases), legal issues (legal actions and government approvals needed to effect the conversion may take time). and business issues (the owners will want to continue renting the units unless and until buyers show up to gradually buy them, over a period of months or years depending on the circumstances). Notwithstanding these limitations, the taxpayer could still try to demonstrate that the building conversion and sale of individual units was conducted as quickly as commercially reasonable under the circumstances.



THE EASIEST METHOD INVOLVES SELLING THE ENTIRE BUILDING TO A 50%-OWNED ENTITY BEFORE CONVERSION ACTIVITY TAKES PLACE.

As a threshold matter, the apartments would need to be converted into "inventories" for tax purposes. Depreciation is not allowed on "inventories or stock in trade."[26] The IRS position is that "inventory" is any property held "primarily for sale to customers in the ordinary course of [a] business."[27] In Ltr. Rul. 8338114, the IRS held that the conversion of an apartment building into condominiums "usually" changes the tax status of a building to "property held primarily for sale" which, upon sale, gives rise to ordinary income. As support, the ruling cited an earlier revenue ruling stating that the "purchase of an apartment building for sale as condominiums is analogous to the purchase of a large tract of real estate for subdivision."[28]

Assuming that the purchasing corporation holds the building units as inventory, the common ownership between the selling and purchasing entities can exceed 50%, but how high can the common ownership go? Section 351(a) provides that a transfer to a corporation in exchange for stock will be a non-taxable capital contribution if the transferor(s) receive at least 80% of the corporation's stock.[29] Because Section 351 is mandatory, the IRS has sometimes been successful in recasting purported sales of real estate to 80%-plus owned corporations as capital contributions if, in fact, the corporation is undercapitalized and/or the transaction does not reflect a bona fide sale on arm's-length terms.[30] In theory, the 80%-common ownership concern of Section 351 can be addressed by simply following all formalities of a sale, making sure that the corporation is adequately capitalized and makes a sizable down payment, and otherwise being able to justify the transaction as an arm's-length sale (e.g., appraisal to back up the sales price). Another way to help guard against Section 351 is to avoid the 80% test merely by holding stock indirectly through pass-through entities or having close family members own it, since the stock attribution rules do not apply under Section 351.[31]

Still, having 80%-plus common ownership is just one more potential concern with audit risk—first because of Section 351 and secondly (even if Section 351 is avoided) because the

[24] The idea has, however, been bandied about by commentators. See e.g. Hamill and White, "Choice of Entities for Real Estate Development," 1 Business Entities 34 (Sep/Oct, 1999).

[25] If common ownership will exceed 50%, Section 707(b)(2)(B) comes into effect. Thus, if the selling entity is taxed as a partnership, the purchasing entity must be a corporation (either C or S).

[26] Reg. 1.167(a)-2.

[27] IRS Publication 946, "How To Depreciate Property."

[28] Rev. Rul. 79-276, 1979-2 CB 200. This ruling, however, addressed basis allocation issues and not gain characterization.

[29] There is no attribution of stock ownership under Section 351.

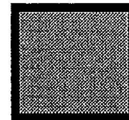
[30] See Burr Oaks Corp., 365 F.2d 24, 18 AFTR2d 5018 (CA-7, 1966) and Aqualane Shores, Inc., 269 F.2d 116, 4 AFTR2d 5346 (CA-5, 1959) (both cases involving seller-financed sales of land to undercapitalized corporations for more than fair market value). See also Robinson, *Federal Taxation of Real Estate* (Warren, Gorham & Lamont, 2007), ¶ 14.03[1][a][ii]; Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (Warren, Gorham & Lamont, 2007) ¶ 3.14[1].

[31] Yamamoto, TCM 1986-316 (citing Section 318, Section 351, and Section 368); see also Bittker and Eustice, *supra* note 30, ¶ 3.07[1].

transaction may be held to lack a business purpose. In the closely analogous case of the sale of land by a partnership to an identically owned development corporation, courts have held that the transaction will be respected if all formalities are followed, the terms are at arm's length, and the transaction can be justified by the existence of an independent business purpose. *Bramblett*[32] and *Phelan*[33] demonstrate business purposes in the land sale situation. In *Bramblett*, where a general partnership sold land to an identically owned corporation, the business purpose of the sale was to transfer the land to an entity with limited liability. In *Phelan*, where an LLC sold part of a larger tract to an identically owned corporation, the business purpose of the sale was to divide a tract in two, thereby segregating the liabilities of each entity's parcel. The IRS may also employ a "business purpose" argument in the Section 351 context.[34]

If there is a significant difference in ownership of the apartment-renting entity and condominium conversion entity, the business purpose could be that it was necessary to start a new entity to attract a new investor (or service provider) who would be willing to make a significant contribution of cash and/or services, the reason being that the new co-owner would not want to be tainted by the first entity's contingent liabilities (the proverbial tenant who fell down the stairs, etc.).[35] Similarly, the condominium conversion costs (for remodeling, etc.) may be financed by a new bank loan (replacing or supplementing the original loan), and the bank may have a general policy against lending to a "recycled" entity (and instead could require, or prefer, that a "fresh" entity serve as the borrower).

If less than the entire property will immediately be held for sale as condominiums, there may be a business purpose in splitting out the "inventory" units into a separate entity because that way the liabilities of the new sales entity[36] will be segregated from the liabilities of the entity that retains a portion of the property.[37] This scenario could occur if one floor will be retained for rental to commercial tenants. It could also occur if the parking structure will be retained by the original owner and then leased to the condominium association (which in turn will provide parking spots to the unit owners), or if there is an undeveloped portion of the parcel that could be kept for a future development or for potential future donation to a municipality for use as a park. Another business purpose could be obtaining limited liability for all owners (if the property is now held by an individual, a general partnership, or a limited partnership with an individual serving as the general partner).[38] The transfer itself arguably could be considered a business purpose because the corporation could advertise that the building is "under new ownership." This might have a beneficial effect from a marketing or community relations standpoint, or it could help transform the relationship with the tenants (for example, long-term tenants unhappy with the conversion may feel there is no point in complaining to a new owner).



AN ALTERNATIVE INVOLVES SELLING THE RENTAL BUILDING TO A CORPORATION WITH GREATER THAN 50% COMMON OWNERSHIP.

If the pre-conversion sale method is used, it may be appropriate to capitalize certain expenses of the corporation incurred in connection with and during the conversion as costs apportioned to the "inventory" under Section 263A, instead of deducting them when incurred.[39] If, for example, real estate taxes and insurance payments for the building get deducted currently as an offset to rental income, this would evidence that the corporation still has a rental intent. On the other hand, if these charges are capitalized, the corporation is demonstrating that its conversion activities are akin to those of a developer that purchases, subdivides, and sells lots, and only incidentally is receiving rental income pursuant to pre-existing leases for the remainder of their terms.

To summarize key planning points, if this method will be employed:

[32] 960 F.2d 526, 69 AFTR2d 92-1344 (CA-5, 1992).

[33] TCM 2004-206 .

[34] See Bittker and Eustice, *supra* note 30 at ¶ 3.17[6].

[35] Although one could argue that the transfer of the property could have been done just as easily by a non-taxable contribution as opposed to a taxable sale, it has long been established that "one may so arrange his affairs that his taxes shall be as low as possible," Helvering v. Gregory, 69 F.2d 809, 13 AFTR 806 (CA-2, 1934), *aff'd* 293 U.S. 465, 14 AFTR 1191 (1935). Thus, "when a taxpayer chooses to conduct his business in a certain form, 'the tax collector may not deprive him of the incidental tax benefits flowing therefrom, unless it first be found to be but a fiction or a sham.'" W. Braun Co., 396 F.2d 264, 21 AFTR2d 1438 (CA-2, 1968) (citing Polak's Frutal Works, Inc., 21 TC 953 (1954)).

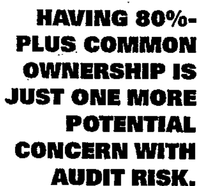
[36] The condominium conversion entity could become subject to liabilities such as a loan for remodeling costs, or lawsuits for either faulty work on the remodeling or for sales misrepresentations to condominium purchasers.

[37] A similar business purpose was held to be valid in Phelan, *supra* note 6.

[38] See Bramblett, *supra* note 6.

[39] See Section 263A and the regulations thereunder. See also Tucker, supra note 10 at § § 14:07-14:10, for a discussion of specific expenses such as interest and legal fees. The author also thanks Dean Rocheleau, Esq. for a helpful discussion of these issues.

1. Do not take depreciation on the tax return of the purchaser-corporation.
2. Do not have the partnership engage in any condominium-related activities, including the legal conversion filings and the selling efforts in particular, as all such activities must be carried out in the name of the corporation, and preferably should be done primarily after the sale.
3. The corporation should demonstrate an intent to immediately convert the building into condominiums held for sale as soon as is practicable (granted, there may be a delay due to existing leases,[40] government regulation, etc.).
4. Although this method could work with 100% common ownership, keeping direct common ownership below 80% would be preferable in light of Section 351.
5. The sale price should be set on arm's-length terms, preferably backed up by an appraisal of the property as a rental building.
6. If the sale is reported under the installment method, make sure there is a significant down payment.
7. Certain expenses of the purchasing corporation should be capitalized.
8. There should be an independent business purpose motivating the arrangement, other than (and in addition to) the objective of bifurcating the taxable income into a capital gain component and an ordinary income component. (There should be a likelihood that the purchasing corporation will indeed have profits that will be taxable as ordinary income).



HAVING 80%-PLUS COMMON OWNERSHIP IS JUST ONE MORE POTENTIAL CONCERN WITH AUDIT RISK.

If installment sale treatment is invoked in this context, special issues arise. First, because it is a related-party sale, the seller may not continue to defer gain on the sale to the extent that the related-party purchaser resells a portion of the property within two years.[41] Second, the audit risk is somewhat enhanced by Section 453(g), which provides that installment sale treatment may not be used on a sale of depreciable property to a related party. This provision need not prevent the use of the installment method, because the test of whether the property is depreciable is measured in the hands of the transferee.[42] However, if this method fails on audit because the property is deemed to be depreciable in the hands of the transferee under Section 1239(a), the installment method will be retroactively invalidated under Section 453(g).

Third, as mentioned above, it is advisable that the conversion corporation be capitalized with some amount of shareholder capital, a part of which would be used to make a down payment on the installment note even though some tax would need to be paid currently. In this manner, the corporation will not appear to be a thinly capitalized nominee for the seller.[43] Any installment note must also be interest-bearing.[44]

The orderly liquidation

Though the conventional wisdom may be that converting an apartment building into condominiums held for sale will bar capital gain, actual cases on the subject are mixed (consistent with the implication in the sources cited above that there are exceptions to the general rule).[45] There are cases, most notably *Gangi*,[46] holding that if the conversion of an apartment building into condominiums can be classified as the orderly liquidation of an investment, falling short of the "trade or business" of selling condominiums, capital gain treatment will apply.

In the condominium conversion context, a crucial question in determining whether property is held primarily for sale to customers in the ordinary course of a trade or business under Section 1221(a)(1) is when to measure the "primary" intent for holding property. Although the original intent upon acquisition is one factor, courts have ruled that the initial intent is not usually controlling. The Fifth Circuit stated in *Biedenharn Realty Co.*[47] that "[w]e do not hereby condemn to ordinary income a taxpayer merely because, as is usually true, his principal intent at the exact moment of disposition is sales. Rather, we refuse capital gains treatment in those instances where over time there

[40] The corporation could afford all tenants the unilateral right to immediately terminate their leases. Although this would help show an intent other than rental, building owners will not usually want to do it unless the units will surely sell quickly.

[41] Section 453(e).

[42] Section 453(f)(7).

[43] See Robinson, *supra* note 30 at ¶ 14.03[1][a][ii].

[44] See Section 483.

[45] The IRS has ruled that one particular capital gain provision, Section 1237, does not apply to the sale of condominium units. Rev. Rul. 80-216, 1980-2 CB 216. The IRS later ruled privately, however, that the sale of condominium units may qualify as capital gain under some other Code provision besides Section 1237. Ltr. Rul. 8204031.

[46] TCM 1987-561.

[47] Biedenharn Realty Co., Inc. v. U.S., 526 F.2d 409, 37 AFTR2d 76-679 (CA-5, 1976).

has been such a thoroughgoing change of purpose ... as to make untenable a claim either of twin intent or continued primacy of investment purpose."

The *Biedenharn* analysis regarding timing was expanded on and clarified in *Cousins Properties*,[48] an unpublished opinion of the Court of Claims. That court stated: "When the court must determine whether the primary purpose of holding the property in question was for some purpose *other* than sale, the *dominant* purpose during the period immediately *prior* to the ultimate decision to sell is controlling.... If the evidence indicates that at this prior period the taxpayer would not have made the sale in question but for the occurrence of a changed condition or a sudden and unexpected opportunity, it will be presumed that he was not holding the property 'primarily' for sale."[49] [Emphasis in original.] This language, though helpful, was stated in the context of a sale of several entire apartment buildings, rather than the sale of individual units.

Gangi and other favorable cases

In *Gangi*, two individuals who were residential builders formed a partnership and built a 36-unit apartment building for about $600,000, intending to keep it as a retirement investment. This building was the partnership's only asset. They rented the property for eight years, spending minimal time on management. The business relationship deteriorated and the partners decided to sell the building. They determined that the building did not produce enough rental income to justify selling it intact, and that the most profitable course would be to sell off units as condominiums. The partnership spent about $30,000 on legal and engineering work, and about $100,000 on minor repairs (which would have been incurred even had the building been kept as apartments). The units were listed for exclusive sale by a firm that was half-owned by the taxpayer's brother, but the partnership considered other realty firms as well. This conversion was the only time that either partner had engaged in condominium activity. Twenty-six of the units were sold within one year. The IRS argued that the conversion shifted the partnership's intent from investment and rental to sale in the ordinary course of business. The court ruled, however, that the partners decided to "liquidate their investment and terminate the business, a business decision necessitated by the ... real estate market and a desire by [the partners] to go their separate ways ... [and] a business judgment was made to convert the building to condominiums." The court ruled that the original investment intent should be viewed as the dominant factor, since the selling activity did not rise "to the level of holding property 'primarily' for sale to customers."

Very few sources since have cited *Gangi*. In Ltr. Rul. 8938004, the IRS favorably cited *Gangi* for the notion that courts consider the original intent of a party in determining whether it held property for rent or for sale. The ruling cited the court's characterization of *Gangi* as the liquidation of an investment. It also noted that if a taxpayer liquidates its assets, the sales are necessarily substantial and extensive, and this factor therefore is not weighed as heavily (against capital gain). One case that cited *Gangi* was *Tollis*.[50] The taxpayer in that case was an individual who had built and sold about 400 condominium units (individually and through his corporation). At issue was the characterization of gain from the sale of eight condominiums that, the taxpayer claimed, he had held for four to eight years

[48] 40 AFTR2d 77-5262 (Ct Cl. 1977).

[49] *Id.*, citing Biedenharn, *supra* note 47, and Tibbals, supra note 8. Tibbals held that "it is the dominant purpose of his holding during the period prior to the sale which is critical."

[50] TCM 1993-63.

as part of a separate management business, and not as part of his condominium sales business. He had rented out most of these units, which he had retained to make it easier for him to manage the various properties and adjoining ones. When he decided to retire, he gradually sold these eight units without significant advertising. The court cited *Gangi* for the principle that the increased sales activity related to the liquidation of the management business, and did not indicate a change in holding purposes. Capital gain treatment was allowed.

INITIAL INTENT IS NOT USUALLY CONTROLLING.

Gangi relied heavily on *Heller Trust.*[51] There, two partners (who had previously built and sold 500 single-family homes) built 194 duplexes to be held for rental. Occupancy was only about 75% and the partners differed on how to improve that. After a partnership division, the family of one partner, Edward Smotkin, and his wife received the duplexes and the stock of a related management corporation. The duplexes, which had been previously advertised only for rent, were now extensively advertised for sale in newspapers and on the radio. The sales and advertising was all done by the management corporation, which operated a model unit, employed salesmen, and printed brochures. One hundred sixty-nine duplexes were sold over a three-year period. The taxpayer took capital gain treatment, arguing that the duplexes were sold because of Smotkin's deteriorating health and because the duplex rental operation was a business failure. The court ruled that, since the taxpayer's primary purpose was "rental" up until shortly before the first sales, the facts indicated that the series of sales were made with a liquidation intent and therefore capital gain treatment applied.

An old but helpful case is *Goldberg.*[52] At issue was whether 90 houses sold by a corporation were "then held primarily for sale to customers in the ordinary course of trade or business." The houses were built for residential rental to defense workers during World War II. From 1943 to 1946, the corporation reported a loss from rental activities. In 1946, after the war, the houses were put up for sale, but there were no salesmen, no commissions, no advertising, and no for-sale signs. Rather, because of a heavy demand for housing, "word of mouth" sufficed and 90 houses were sold in 1946. The sales were made by one of the owners, who was also a real estate agent. The court examined whether the purpose of the sales was primarily to carry out the business of home selling, or instead to liquidate a rental business, noting that "courts do not deny capital gain benefits simply because a large number of sales are made in a short period." The court allowed capital gain treatment, stating that "the only evidence that the corporation was engaged in the business of selling real estate was the frequency and continuity of sales, and this for a comparatively short time." This "comparatively short time" period factor from *Goldberg* was cited in Ltr. Rul. 8938004 as a positive factor favoring "capital" treatment.

Erfurth[53] was a condominium conversion case that resulted in a mixed ruling. The taxpayers had been in the business of building and renting properties, but the immediate and unanticipated threat of foreclosure forced them to convert to condominiums. The taxpayers had built and sold entire apartment projects, but had not previously done any condominium conversions. A bank loan had financed a 76-unit apartment project, but the bank became insolvent and the FDIC demanded immediate payment. The building was not fully rented, and a new loan could not be obtained; thus, the apartments were converted to condominiums, and about 20 units were sold per year over the next three years (entirely through independent brokerage agencies). The court noted that there were few cases on point because "normally such a conversion from rental operation to sales of condominium units would generate ordinary income." The court found that sales forced by the FDIC foreclosure gave rise to capital gain because they were not in the ordinary course of a business. After the FDIC was paid off, however, the court held that all later sales were in the ordinary course of a business and were thus taxable as ordinary income.

Other favorable cases include the following:

- In *Cottle,*[54] a taxpayer bought three "four-plex" units in a 21-unit complex, intending to improve them and hold them for rent, but then sold them due to changed circumstances and properly claimed capital gain treatment.
- In *Ross,*[55] an attorney who developed land into rental properties as a side business

[51] 382 F.2d 675, 20 AFTR2d 5370 (CA-9, 1967).
[52] 223 F.2d 709, 47 AFTR 1314 (CA-5, 1955).
[53] TCM 1987-232.
[54] 89 TC 467 (1987). The change of circumstances related to the fact that the other four-plex owners had unexpectedly sold their units so control over the complex was lost.
[55] 227 F.2d 265, 48 AFTR 389 (CA-5, 1955).

properly claimed capital gain on 40 sales (totaling over 200 lots). His plan to build rental houses for minority members in the city outskirts was scuttled when discriminatory zoning ordinances in the city were held invalid, and the market for the proposed rental units never materialized.

- In *Porsio,*[56] a taxpayer was allowed capital gain on the sale of 21 apartment units over a ten-year period (typically after the units had been rented for about one to two years).
- In *Smith v. Dunn,*[57] the sale of 51 subdivided lots over two years produced capital gain where the taxpayer was not in the real estate business and instead used a broker to carry out all selling efforts (at the broker's own expense).

Unfavorable cases on liquidation

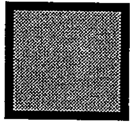
The seminal case against capital gain on conversions arguably is *Home Co.*[58] There, a real estate company engaged in development, construction, and brokerage built two projects consisting of single-family dwellings for rental purposes. The units were designed for military personnel, and were subject to government restrictions. Due to war-related issues, the rental operations were unprofitable from 1943 to 1945. At the end of 1945, the taxpayer decided to sell the units individually (after the Army removed war-related sales restrictions). The taxpayer commenced a very active sales and marketing campaign, and listed the units with real estate firms. Most of the 60 units were sold during 1946. The court stated that a capital asset can be liquidated in the most advantageous manner, producing capital gain, but not if the taxpayer "enters the real estate business and carries on the sale in the manner in which such a business is ordinarily conducted." The *Home Co.* court found that the sales were in the ordinary course of a real estate business because the taxpayer "carried on an active sales campaign, did extensive advertising, employed real estate agents, paid commissions, made sales through its own agents, actively solicited purchasers for the property, in fact, did everything one ordinarily does in carrying on such a business."

In *Ferguson,*[59] a partnership acquired an apartment building with the stated intent of converting it into condominiums and selling the units within two to five years. The taxpayer-owner claimed that he abandoned his original intent and held the apartments for rental. After the rental business was unsuccessful, and after he tried to sell the project as a whole, he again changed his intent and converted the project into condominiums. At this time, he also bought out his roughly 14 investor-partners. The taxpayer-owner was also the president and owner of Professional Condominiums of America, Inc.

[56] TCM 1961-65.
[57] 224 F.2d 353, 47 AFTR 1418 (CA-5, 1955).
[58] 212 F.2d 637, 45 AFTR 1480 (CA-10, 1954).
[59] TCM 1987-257.

and he was actively involved in the conversion of 38 apartment buildings into condominiums. The court looked to the taxpayer's "primary" intent at the time of sale, which amounted to the ordinary conduct of a business of selling condominiums (there were significant renovations, public advertising, and selling efforts that resulted in the sale of 71 units).[60]

In *Parkside, Inc.*,[61] the roles were reversed. The taxpayer wanted to avoid classification as a "personal holding company" and thus tried to convince the court that his sale of 47 individual duplexes (which previously had been held for rental for many years) was in the ordinary course of business. The IRS argued the duplexes were capital assets. The facts were similar to *Gangi* except that selling efforts, and sales and advertising expenses, were greater. The overall case arguably presented just as strong a case for "capital" status, but the court allowed the taxpayer to have "ordinary" asset treatment.[62] Arguably, in the author's view, the fact that the IRS took a diametrically opposite view to its standard position (because it suited the government's interest to do so) pulls the rug out at least from the notion that a taxpayer should be assessed with a negligence or understatement penalty for availing of the "liquidation" theory.[63]



THERE IS A WIDE 'GRAY AREA' THAT GIVES VITALITY TO THE LIQUIDATION METHOD.

In *Vidican*,[64] a taxpayer had an ongoing business of building ten-unit apartment complexes, renting the units until the buildings were fully occupied, then selling the entire building and starting a new one. The taxpayer had done this about ten times. At issue in the case was the sale of 33 condominiums from the last three projects. He had not been able to fully rent these buildings and sell them as a whole, and thus he argued that he was merely "liquidating" his investment. He advertised the units and sold them himself as well as through an agency. The court ruled that the taxpayer was in the business of building and selling apartment properties, which was clearly shown by his similar activities in the past, and questioned the taxpayer's allegations regarding intent.

In Ltr. Rul. 8415002, a taxpayer acquired eight condominium units as part of an investment syndicate managed by outside parties. The taxpayer's stated intent was to buy the units, upgrade them, and sell them at a profit. The units were temporarily rented, but that was a secondary purpose. Significant renovations were done in the first year and selling began at the end of the second. The IRS characterized all gain as ordinary income. Although the taxpayer himself was basically passive, the IRS attributed the activities of the sales broker and others to him in determining that the units were sold in a "business-like manner," and noted that he closely monitored the broker's activities, firing the first one and then retaining another. The IRS did state that "the cases differ on when it is proper to attribute another's activities [to a taxpayer]."[65] Notably, the IRS cited *Cousins Properties* favorably for the principle that sales may produce capital gain when the sales are "not the normal source of business income."

Summary of liquidation strategy

Due to the uncertainty inherent in the *Gangi* liquidation approach, the method is generally frowned upon (if not ruled out) by many practitioners. A close examination of the cases and rulings described above, however, indicates that there is a wide "gray area" on this point, and thus the author believes that there is more vitality in the liquidation method than is often recognized. At a minimum, the method will at least be relevant in a few situations. First, for some taxpayers, the pre-conversion sale either will not be feasible or just will not be worth the trouble. Second, by the time they consider tax planning, some taxpayers will be too far along into the conversion process to benefit from the pre-conversion sale method. Third, some fact patterns will much more strongly resemble the liquidation cases in which capital gain was in fact allowed, making the risk less of a concern.

If the liquidation strategy is employed, the following are among the factors that may convince the IRS and the courts to accept it:

- Investment or syndication materials for the entity showing a rental intent.
- Evidence that a conversion had not been contemplated.

[60] The court noted that the taxpayer's testimony was filled with inconsistencies regarding such issues as the model unit, amount of advertising, etc.

[61] 571 F.2d 1092, 45 AFTR 1480 (CA-9, 1977).

[62] Although the case involved the personal holding company provisions, the capital vs. ordinary test was decided under the same Section 1221(a)(1) that covers the "dealer" issue.

[63] *See* Section 6664(c), which provides an exception to the negligence and substantial understatement penalties if a taxpayer's position, taken in good faith, was based on "reasonable cause."

[64] TCM 1969-207.

[65] "A so-called 'passive' owner can engage in the real estate business and act through agents." Scheuber, TCM 1961-43.

- Absence of other condominium sales by the same taxpayer.[66]
- Minimal amount of renovation work and other expenditures for the conversion.
- Sales activities being conducted and paid for by an independent company that receives sales commissions in exchange for paying the costs of marketing, advertising, operating a model unit, etc.
- Non-identical ownership between the sales company and the property-owning entity.
- Compelling business reasons motivating the conversion (e.g. an unexpected boom in the condominium market or other changed circumstances, either in the market or in the personal circumstances of one or more taxpayers).
- Rapid condominium sales in a short period.[67]
- A relatively small number of units being in the project.
- A long period of exclusive rental prior to the conversion.

Due to the factual nature of these issues, the IRS ordinarily will not issue a ruling on whether capital gain treatment will be allowed.[68]

Conclusion

Careful and thorough advance planning can avoid the heavy tax burden of recognizing all ordinary income on the sale of a depreciated apartment building as condominiums. Practitioners will need to closely analyze the fact patterns and work with the clients on developing the best plan for their circumstances. The pre-conversion sale is generally the preferred method, with 50%-common ownership generally considered safe and above-50% common ownership considered more aggressive. If planning is not done in advance it may be too late, but the liquidation theory at least holds out enough hope to be worthy of close analysis when the tax return is prepared. Further, in some cases the liquidation theory may be adequately supported by the factual scenario, even if the taxpayer still has time to employ the pre-conversion sale technique. ■

[66] Although the primary question is whether the property-owning entity itself has had such activity, courts and the IRS will also look to whether the owners of the entity have been engaged in the condominium sales business.

[67] Ironically, the converse may also work. For example, if a building is converted to condominiums under state law so the primary intent is still rental, then so long as the selling efforts are rather minimal (e.g. informing the tenants of an option to purchase their units), this type of gradual liquidation could also qualify for capital gain treatment.

[68] Rev. Proc. 2007-3, 2007-1 IRB 108, § 4.02(5).