

The Partnership: Preserving Capital Gains on Real Estate Investments

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Abstract

This paper considers the use of partnerships as an effective tool for preserving capital gains on real estate investments. For tax purposes, the Internal Revenue Service generally treats a limited liability company as a partnership. This form of organization is widely used for real estate investments, and by taking a few simple precautions an LLC may ensure that any gain on its investments in undeveloped real property will be treated as capital gains. Such treatment may reduce the LLC's tax costs substantially.

The Fifth Circuit developed a framework that has proven invaluable for analyzing the activity of the LLC to determine whether it will be afforded capital gains status. This paper spends a considerable amount of time analyzing that framework as well as exploring examples of how the courts have applied this framework. Additionally, this paper discusses choice of entity concerns for investors and briefly analyzes the life cycle of a typical real estate investment partnership.

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I. Introduction to the Real Estate Investment Partnership

For many years, real estate investors who opt to pool their assets have chosen to organize as partnerships. There are a number of advantages to pooled investments; principal among them are the reduction of risk and the ability to obtain financial leverage. There are, of course, disadvantages to this form of investment as well. After all, it is not an easy task to find partners whom one can trust with one's financial well-being, can bear to work with, and have the technical know-how to partake in such an investment.

This is perhaps one reason why the use of real estate investment partnerships is often limited to professionals such as real estate brokers, developers, and professional investors. Such professionals all bear some risk that the I.R.S. will consider them to be in the trade or business of selling or developing real estate. This is where the partnership entity may prove useful. The partnership allows the professional some ability to step away from the transaction and separate his real estate investments from property held as inventory, or held for sale in the ordinary course of business.

While neither the I.R.S. nor the courts are so kind as to provide any bright-line test for differentiating between property held for investment and property held in the ordinary course of business, the Fifth Circuit has set forth a framework that is useful for constructing partnerships that the I.R.S. will respect. This framework will be discussed later in this paper, as will other important issues such as the financing and liquidation of these partnerships, but first one must consider why it is best to organize as a partnership.

II. Choice of Entity Concerns

At its base, the choice of entity is a simple question – what legal form should one use for an investment in realty? In reality, choice of entity represents a complex web of decisions related to tax, liability, ownership and control issues. The wrong choice can cost investors dearly, and given that the law is not an exact science, clients often leave the balancing of relative costs and benefits to their attorney. Thus, the choice of entity is one of the first questions considered in real estate investment, and so this section begins analyzing the investor’s options by starting with the simplest of entities, the individual.

A. The Individual

Individual ownership of an investment in real estate is, of course, the simplest option: the start-up expenses are minimal, there is a single set of books, a single tax, and no arguments arise over control or when and whether to sell. This freedom does, however, come at a cost. First, this form of ownership is not feasible for a dealer in real estate who wishes to maintain the capital nature of his investment in the property.¹ Second, the individual’s aversion to liability is an important factor. When the issue of liability arises the first thing that comes to mind is the potential for loss related to tortious

¹ It is difficult for an individual to segregate real estate held for investment purposes from that held for sale. In some instances, the IRS will seek to attack one’s status as a dealer or independent investor where the individual has substantial dealings in real estate. *See Adam v. Comm’r*, 60 T.C. 996 (1973) (holding that an accountant who purchased 11, and sold 9, parcels of undeveloped land in 4 years was not a dealer); *Cary v. Comm’r*, 32 TCM 913 (1973) (participation of a real estate dealer in a land venture does not, in itself, vitiate the investment purpose of an undertaking – an individual may occupy a dual role, but careful planning is necessary to segregate investments).

conduct. While this is important, the individual owner must also consider the possibility that he will be personally liable for the mortgage.²

In many respects, individual ownership of investment property is closely related to common law forms of joint ownership such as tenants in common and joint tenancy.³ Generally, when investors own property as tenants in common, they each hold an undivided fractional interest in the property. Since this interest is undivided, each tenant has an equal right to use of the whole property. Clearly, this can give rise to dispute when the parties have differing opinions as to the best use of the property.⁴

This form of ownership is complicated further by the fact that a tenant in common may deduct only that portion of the expenses attributable to his interest in the property, even though he may pay more than his share.⁵ Other unfavorable aspects of the joint tenancy form of ownership include its lack of protection against personal liability and its potential for unexpected treatment as a partnership.⁶ Treatment as a partnership, when unexpected, may dramatically change the tax treatment of certain transactions. For

² A non-recourse mortgage may limit this risk, but these are often difficult for an individual to obtain unless they can guarantee substantial equity in the property; cash down payments of 25-30% are not uncommon.

³ Note that this discussion does not consider tenants by the entirety as a form of investment ownership since it only applies to a husband and wife in the majority of jurisdictions. Furthermore, while the forms of ownership in this section might more closely resemble a partnership than individual ownership, I have chosen to address them here since the partnership section will contemplate other entities such as the LLC.

⁴ See *Spiller v. Mackereth*, 334 So. 2d 859 (Ala. 1976) (holding that tenants in common each have an equal right to occupy; and unless the one in actual possession denies to the other the right to enter, or agrees to pay rent, nothing can be claimed for such occupation).

⁵ *Boyd's Estate v. Comm'r*, 28 T.C.M. 564 (1957) (holding that owner of a 50% interest in income producing realty could only deduct his share of expenses since he is entitled to reimbursement from the co-owner of the property for any payments in excess of his share).

⁶ See *Powell v. Comm'r*, 26 T.C.M. 161 (1967) (holding that co-owners did not constitute a partnership). I.R.C. § 761 provides the statutory definition of a "partnership" and also allows the partners to elect to avoid the application of Subchapter K if certain conditions are met. The resultant entity is very similar to one where individuals own property as joint tenants. The § 761 election is considered in more detail later in this paper.

example, in *Demirjian v. Commissioner*⁷ the parties were, or at least should have been, aware that they were engaged in business as a partnership when they attempted to replace condemned property in accordance with § 1033. This section provides an election whereby the taxpayer may opt to replace property subject to involuntary condemnation proceedings with similar property. When read together with § 703 however, § 1033 “requires that election for nonrecognition of gain on involuntary conversion of partnership property...be made by [the] partnership; replacement by individual partners of property owned by partnership does not qualify for nonrecognition.”⁸

This is just one of the many pitfalls that await the unwary user of a tenancy in common for real estate investments. Generally, the risks and benefits of using joint tenancy for real estate investment parallel those of the tenants in common.⁹ The principal difference between the two forms of ownership is that if a joint tenant pays expenses associated with the property, those expenses are properly deductible only by the tenant who pays them.¹⁰

⁷ 457 F.2d 1 (1972). It is also interesting that the husband and wife trading and Kin-Bro Real Estate Company were treated as a partnership despite their arguments to the contrary and their failure to execute a formal partnership agreement. This fact underlies an important aspect of partnership law; namely, that a partnership may exist when “tenants in common...actively carry on a trade, business, financial operation, or venture and divide the profits thereof.” *Id.* at 4-5.

⁸ 26 U.S.C.S. § 1033, Note 23. *Demirjian*, 457 F.2d at 5-6. *But see* Priv. Ltr. Rul. 8041061 (Jul. 17, 1980) (permitting a partnership to terminate and distribute land to the partners as tenants in common so that the individual partners could take the § 1033 election).

⁹ An interest held by joint tenancy is freely alienable, just as an interest held by a tenant in common, but when the joint tenant disposes of his interest the tenancy is broken and the purchaser of the interest becomes a tenant in common with the other tenants. A joint tenant, like a tenant in common, must also report his respective share of income and loss associated with the property. *See Haynes v. Comm’r*, 7 B.T.A. 465 (1927).

¹⁰ *See* Rev. Rul. 71-179, 1971-1 C.B. 58 (1971).

B. The Corporation

The use of a C-Corporation for real estate investment presents a host of tax related problems that are difficult to escape. That is exactly why the C-Corp is seldom used for such investments, and after a short discussion of the C-Corp, this section will concentrate primarily on the potential benefits and disadvantages of the S-Corporation. The paramount problem associated with the C-Corp is double taxation. When the corporation has income, it pays taxes on this income at rates as high as 35%,¹¹ and when the corporation distributes this income to shareholders those shareholders again pay tax on the dividend distributions.¹² Other significant problems include the potential for an accumulated earnings tax¹³ and classification as a personal holding company.¹⁴

For these reasons, and others, investors are more likely to choose to organize as an S-Corp than a C-Corp. The S-Corp combines prominent features of both the C-Corp and the common partnership. Most importantly, the S-Corp provides the limited liability benefits of a corporation while permitting pass-through treatment of income, just like a partnership.¹⁵ Notwithstanding these benefits, there are down sides to the S-Corp, so it is not necessarily the best option for real estate investment activity.

¹¹ Corporate income tax rates are strategically scaled from 15% to 39% such that corporations in the highest tax bracket, those earning over \$18,333,333 per year, pay an average, and marginal, rate of 35%. *See* I.R.C. § 11(a).

¹² Depending on the circumstances, the dividend income may be taxed at either ordinary income rates (up to 35%) or at special rates for qualified dividend income. *See* I.R.C. § 1(h)(11)(B).

¹³ *See* I.R.C. §§ 531-535. The accumulated earnings tax is a tax equal to 15% per year on the accumulated taxable income retained by a corporation.

¹⁴ Personal holding company income is taxed at 15%. The rules for classification as a PHC are set forth in § 541 et seq.

¹⁵ S-Corp pass-through treatment of income and loss is not identical to that of a partnership, but is very similar. *See* I.R.C. § 1366 et seq.

First, there are numerous restrictions on the size of an S-Corp and the members who compose it. The corporation must be a domestic corporation,¹⁶ it is limited to 100 shareholders,¹⁷ and these shareholders must be individuals or estates who are not nonresident aliens.¹⁸ Ownership of S-Corp shares by a trust or estate is also severely limited by § 1361(c)(2).

Second, the S-Corp is limited to only one class of stock.¹⁹ This may not sound like a tremendous problem, but it can cause difficulties when there is some benefit to separating the ownership, financing, and control functions of shareholders. There are some qualifications to this ‘one class of stock’ rule though. The I.R.S. will not treat an S-Corp as having more than one “class of stock solely because there are differences in voting rights among the shares of common stock.”²⁰ What then, is the point of this rule if two shares of stock can have different voting rights yet not be termed different classes of stock? Evidence seems to suggest that the I.R.S. added this unnecessary ambiguity for the dual purpose of avoiding the special allocation mess inherent in partnership taxation, and to prevent otherwise ineligible shareholders from obtaining convertible debt (stock in disguise) while avoiding disqualification of the S-Corp.²¹

Finally, an S-Corp may lose its Subchapter S election in a variety of ways, and some of these ways are particularly relevant to real estate investments. The passive investment income test, for example, applies when an S-Corp has “accumulated earnings and profits” at year end, and “gross receipts more than 25 percent of which are passive

¹⁶ I.R.C. § 1361(b)(1).

¹⁷ I.R.C. § 1361(b)(1)(A).

¹⁸ I.R.C. § 1361(b)(1)(B)-(C).

¹⁹ I.R.C. § 1361(b)(1)(D).

²⁰ I.R.C. § 1361(c)(4).

²¹ Martin D. Ginsburg & J.S. Levin, *The Subchapter S One-Class-of-Stock Regulation*, Fried Frank, Jan. 3, 2005, available at: <http://www.ffhsj.com/reprints/oneclass.htm>.

investment income.”²² If the S-Corp meets this test, then its passive income will be taxed at ordinary corporate rates prescribed by § 11(b), currently as high as 35%, which would negate the pass-through tax advantages of the S-Corp.²³ Further, the corporation’s Subchapter S status may be revoked if it ceases to be a small business corporation,²⁴ or if it meets other conditions under § 1362(d) relating to Subchapter C earnings and passive investment income.²⁵

C. The Partnership

In very general terms, a partnership is a business venture entered into between two or more people. The most common reasons for entering into a partnership relate to the tax advantages of this entity. For Federal income tax purposes, the partnership is not a taxable entity, and all income flows through to the individuals,²⁶ thus avoiding the double taxation to which corporate profits are subject. Several different entities fall within the general classification of “partnerships.” Most common among these is the general partnership, but there are also limited partnerships, and limited liability companies, which, for tax purposes, are a partnership.²⁷ Each entity has its benefits, and so this paper will consider each in turn.

²² I.R.C. § 1375(a). Passive investment income “is defined generally as gross receipts from royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of stock or securities.” 118 A.L.R.5th 597; *citing* I.R.C. § 1362(d)(3)(C)(i). It is noteworthy that rents are not considered passive income if significant services are rendered. *See* Reg. § 1.1362-2(c)(5)(ii)(B)(2); PLR 8926039; 1989 PLR LEXIS 1072.

²³ I.R.C. § 1375(a).

²⁴ *See* I.R.C. § 1362(d)(2)(A).

²⁵ *See* I.R.C. § 1362(d)(3)(A)(i)(I)-(II).

²⁶ I.R.C. § 701.

²⁷ The IRS treats an LLC as a partnership unless the members elect treatment as a corporation, in which case they must file Form 8832. A single-member LLC is a disregarded entity for tax purposes, and is treated as a sole proprietorship.

A general partnership is exceedingly simple to create. There is generally no requirement that there be a written partnership agreement,²⁸ and any joint venture by means of which any business is carried on, may constitute a partnership.²⁹ Notwithstanding this very general definition of a partnership, neither the mere co-ownership of property, nor a joint undertaking to share expenses, is sufficient to create a partnership.³⁰

Once two or more people create a partnership their legal rights change, and their accounting becomes more complex. First, the partners must begin to track both their “inside basis” and “outside basis” in the partnership. This essentially means that the partners must keep one set of books to track their basis in the partnership, and another set of books to track the partnership’s basis in its assets. Second, in making business decisions, the partners must consider what they can do as individuals, and what decisions must be made by the partnership as a whole. As previously discussed, this becomes especially troublesome with § 1033 elections.³¹ Finally, there is the issue of liability. A general partner is personally liable for the debts of a partnership,³² and so this exposure to liability may be yet another reason for choosing a different entity for one’s real estate investments, especially where rental property is involved.

In order to avoid unlimited liability, some investors have chosen to organize as a limited liability partnership. There are numerous tax and non-tax advantages to

²⁸ Podell v. Comm’r, 55 T.C. 429, 431 (1970) (the factors in determining whether a “joint venture” is present include (1) whether there is an express or implied agreement, (2) for joint control of a business, (3) a contribution of money/property/services, and (4) a sharing of profits, but not necessarily losses). *See also* Allison v. Comm’r, 35 T.C.M. 1069 (1976); Luna v. Comm’r, 42 T.C. 1067 (1964).

²⁹ McDougal v. Comm’r, 62 T.C. 720 (1974). *See* I.R.C. § 7701(a)(2).

³⁰ *See* Reg. § 301.7701-1(a)(2).

³¹ U.S.C.S., *supra* note 8 and accompanying text.

³² *See* Sloan v. Thornton, 249 Va. 492 (1995) (primarily considering the liability of a general partner in a limited partnership).

organizing as a limited partnership (“LP”) or limited liability partnership (“LLP”).³³ One major advantage, at least in Virginia, is that an interest in the partnership is considered personal property, and so the transfer of an interest in an LP or LLP that holds real estate is the transfer of personal property, and not of real property.³⁴ Thus, by transferring an interest in the partnership, the partner can avoid payment of state and local real property transfer taxes in some jurisdictions.³⁵ These fees, though a small percentage of the purchase price, may be high enough to justify evasive planning methods in large real estate deals.³⁶

Many of the other tax and non-tax benefits of an LLP are similar to those associated with the general partnership. The disadvantages associated with this form of ownership are few, but include the personal liability of general partners, and in some instances limited partners where they are not cautious in exercising management and control functions.³⁷ There are, however, ample opportunities to plan around this potential liability,³⁸ and so the limited partnership remains a popular choice of entity for real estate investment purposes.

³³ See Va. Code § 50-73.1 et seq. for the statutory requirements of this entity.

³⁴ Va. Code § 50-73.44. *Forward v. Beucler*, 702 F. Supp. 582 (E.D. Va. 1988) (“A partnership interest -- regardless of the nature of the partnership's assets -- is personalty, not realty.”). See also Uniform Ltd. P'ship Act (2001) § 701.

³⁵ This is still the case in Virginia, but some jurisdictions (D.C. for instance) have modified their real property transfer tax statutes so that they apply to real property or any interest in that property.

³⁶ In Arlington and Fairfax counties, this tax equals 0.433% of the purchase price of the property (0.25% state transfer tax, 0.0833% county transfer tax, and 0.1% grantor's tax), that works out to \$4,333 per million in land value. The transfer taxes in Virginia are actually relatively low; in Prince George's County, MD, for instance, the transfer tax is a whopping 2.34%, or \$23,400 per million.

³⁷ Va. Code § 50-73.24; *C.F. Trust, Inc. v. First Flight Ltd. P'Ship*, 306 F.3d 126 (4th Cir. 2002) (A “limited partner may be liable for the obligations of the partnership if the limited partner is also a general partner or if he participates in the control of the business, but even then only to creditors that reasonably believe, based on the limited partner's conduct, that the limited partner is a general partner.”).

³⁸ Commonly employed tactics include exculpatory clauses in permanent mortgages, care in dealing with third parties (being sure that they know you are not a general partner), outside guarantors, and adequate insurance coverage.

Even more popular than the limited partnership is the limited liability company (“LLC”). The LLC is yet another statutory form of business which typically limits the personal liability of its owners to the amount of their investment.³⁹ Though the LLC has many features of a corporation, it is treated as a partnership for tax purposes.⁴⁰

The LLC is a highly flexible entity. In general, an LLC must have two or more members⁴¹ and must register in accordance with state statutory requirements, but once registered its membership (both in terms of composition and number) is virtually unlimited.⁴² There are, however, some minor disadvantages that accompany the flexibility of the LLC. First, a member of an LLC generally cannot transfer his entire interest absent the unanimous written consent of all other members.⁴³ Second, depending on the jurisdiction where the LLC is registered, the LLC may dissolve upon the happening of one of four events: 1) the expiration of the specified term of the LLC, 2) the unanimous written consent of the members, 3) the entry of a decree of judicial dissolution, or 4) automatic cancellation of the registration certificate.⁴⁴ The LLC may contract around many of these provisions by modifying the articles of organization. Such

³⁹ Va. Code § 13.1-1000 et seq.

⁴⁰ Rev. Rul. 88-76, 1988-2 C.B. 360; *codified at* Treas. Reg. § 301.7701-2.

⁴¹ A single member LLC is generally a disregarded entity, but it may elect treatment as a corporation for Federal income tax purposes. *See* Treas. Reg. § 301.7701-2.

⁴² Unlike the S-Corp, LLC members may include individuals, partnerships, corporations, or any other business association. Additionally, LLC’s are not subject to the 100 shareholder cap placed on S-Corps.

⁴³ This is the general rule, but Va. Code § 13.1-1039 provides that unless the articles of organization state otherwise, a member may transfer all or part of his interest in an LLC to another. Such assignment does not dissolve the LLC, nor does it entitle the assignee to participate in the management or control of the entity; rather, the assignee only has a right to receive “any share of profits and losses and distributions to which the assignor would be entitled.” The assignee is not entitled to become a member absent a majority vote of current members. Va. Code § 13.1-1040.

⁴⁴ These factors are set forth in Va. Code § 13.1-1046. It is notable that these factors are not the same in every state. Many jurisdictions provide that the LLC shall terminate upon the death, retirement, resignation, bankruptcy, etc., of one of the members, but Virginia modifies this common law rule by statute. *See* Va. Code § 13.1-1040.2.

flexibility is one reason the LLC has become a popular choice for risky ventures such as real estate investing.⁴⁵

III. The Fifth Circuit Framework

Often, a real estate developer, realtor, or home builder will find it difficult to segregate real property held for investment purposes from that held as inventory in the ordinary course of business. Thus, the IRS may seek to classify gains on the sale of property as ordinary rather than capital. Such reclassification would result in substantially higher taxation as rates rise from 15% for long-term capital gains to 35% for ordinary income.⁴⁶ There are however, planning techniques and statutory safe harbors available that serve to preserve capital gains treatment on the sale or transfer of undeveloped real estate.

The Fifth Circuit has a great deal of experience addressing issues surrounding real estate development partnerships, and so the framework developed in that circuit is presently employed in many jurisdictions.⁴⁷ In order to determine whether an individual or partnership is selling a capital asset or property held for sale in the ordinary course of business, the Fifth Circuit begins by answering three principal questions:⁴⁸

- 1) Was taxpayer engaged in a trade or business, and, if so, what business?
- 2) Was taxpayer holding the property primarily for sale in that business?

⁴⁵ Susan Pace Hamill, *The Limited Liability Company: A Possible Choice for Doing Business*, 41 U. FL. L. REV. 721, 749 (1989).

⁴⁶ I.R.C. §§ 1(a)-(i).

⁴⁷ The Fifth Circuit (encompassing Texas, Louisiana, and Mississippi) cases cited herein are only binding precedent in the Fifth and Eleventh circuits (prior to October 1, 1981). THE BLUEBOOK: A UNIFORM SYSTEM OF CITATION R. 10.8.2, at 96 (Columbia Law Review Ass'n et al. eds., 18th ed. 2005).

⁴⁸ *Suburban Realty Co. v. United States*, 615 F.2d 171, 178 (5th Cir. 1980). The court continues by stating that in cases with different factual patterns, other questions may include “whether the contemplated purchasers were customers of the taxpayers, or whether business activity is to be imputed to taxpayer so as to be considered taxpayer's business.” *Id.*

3) Were the sales contemplated by taxpayer ordinary in the course of that business?

The court considers a number of factors in answering these questions.⁴⁹

The first factor considered is the “nature and purpose of the acquisition and the duration of ownership,”⁵⁰ and the central purpose of this question is to determine the taxpayer’s motivation in holding the property at the time of sale.⁵¹ Recognizing that the taxpayer’s motive may change, courts have held that it is the course of conduct over a period of time, and not a pinpointed moment in time, that is relevant.⁵² In analyzing the taxpayer’s intent, courts often begin by looking to the taxpayer’s original purpose for acquiring the property.⁵³ This “original purpose” analysis coincides with the court’s interpretation of § 1221(a)(1). Courts look to the original purpose of the taxpayer to differentiate between assets held “*primarily* for sale to customers in the ordinary course” of business and those held for investment purposes.⁵⁴

As used in § 1221, “‘primarily’ means ‘of first importance’ or ‘principally.’”⁵⁵

Often, one’s original purpose is synonymous with one’s primary purpose, but on occasion

⁴⁹ These factors range from five to nine in number, depending on the particular case. The courts enunciating more factors simply tend to divide a single factor into several elements. *See Pritchett v. Comm’r*, 63 T.C. 149, 162-63 (1974).

⁵⁰ *Daugherty v. Comm’r*, 78 T.C. 623, 629 (1982); *citing* *United States v. Winthrop*, 417 F.2d 905, 909-10 (5th Cir. 1969); *Smith v. Dunn*, 224 F.2d 353, 356 (5th Cir. 1955) (providing the first comprehensive analysis of the modern Fifth Circuit factors and listing “in chronological order, a dozen of our cases in which we have used language from which the tests listed are distilled”).

⁵¹ The Court states that while “it is the purpose for which property is held at the time of sale that determines tax treatment,” the “Court can and does look at earlier events to decide precisely what that purpose was when the sale was consummated.” *Id.*; *citing* *Biedermann v. Comm’r*, 68 T.C. 1, 11 (1977); *Maddux Constr. Co. v. Comm’r*, 54 T.C. 1278, 1284 (1970).

⁵² *Heller Trust v. Comm’r*, 382 F.2d 675, 680 (9th Cir. 1967) (“Where the facts clearly demonstrate that a taxpayer held certain property as an investment, and further show that this purpose continued until shortly before the time of a sale, and that the sale is prompted by a liquidation intent, the taxpayer should not lose the benefits provided for by the capital gain provisions.”).

⁵³ *See Tollis v. Comm’r*, T.C. Memo 1993-63, 65 T.C.M. (CCH) 1951.

⁵⁴ *Heller Trust*, 382 F.2d at 679.

⁵⁵ *Id.*

there is a dual purpose or changed purpose that skews this analysis.⁵⁶ In differentiating between a dual purpose and a changed purpose the Tax Court has reasoned that:

Where the acquisition and holding of property was for a dual purpose (either to develop for rental, or to sell) that a ‘substantial’ purpose is not necessarily the ‘primary’ purpose, but that the statutory word ‘primarily’ means ‘of first importance’ or ‘principally’ and that “the purpose of the statutory provision with which we deal is to differentiate between the ‘profits and losses arising from the everyday operation of a business’ on the one hand (internal citation omitted) and ‘the realization of appreciation in value accrued over a substantial period of time’ on the other.”⁵⁷

In *Bynum v. Commissioner*, the Tax Court held that though the taxpayers purchased a farm as an investment, their primary purpose for holding the farm changed when they subdivided the property, and at the time of sale they were “undoubtedly engaged in the vocation of selling lots” in the ordinary course of a trade or business.⁵⁸ This analysis highlights the distinction between land held for a dual purpose, and that held for a changed purpose. The former taxpayer may retain capital gains treatment if the investment purpose is his “primary purpose,”⁵⁹ but the later taxpayer will be subject to ordinary income treatment though he purchased the property for investment purposes.⁶⁰

⁵⁶ *Id.* at 679-80. The Ninth Circuit reasoned that though the taxpayer’s original purpose for building duplexes was to hold them for sale to customers, his intent changed over time (he began an investment in rental property) and the “Tax Court was clearly erroneous in determining that the duplex operation was a continuance of taxpayer’s business.”

⁵⁷ *Bynum v. Comm’r*, 46 T.C. 295, 298-99 (1966); *citing* *Malat v. Riddell*, 383 U.S. 569 (1966); *Corn Prods. Co. v. Comm’r*, 350 U.S. 46 (1955).

⁵⁸ *Bynum*, 46 T.C. at 299; *citing* *Mauldin v. Comm’r*, 195 F. 2d 714, 717 (1952).

⁵⁹ *Malat v. Riddell*, 383 U.S. 569 (1966) (vacating and remanding 347 F.2d 23). On remand, the court found that the property was held for investment purposes and granted capital gains treatment. 275 F. Supp. 358 (Ca. 1966).

⁶⁰ *Bynum*, 46 T.C. at 299. When there is evidence of a changed purpose (i.e. from investment to held-for-sale) the IRS and courts will ordinarily ignore the prior purpose unless the change “results from unanticipated, externally induced factors which make impossible the continued pre-existing use of the realty.” *Biedenharn Realty Co., Inc. v. United States*, 526 F.2d 409, 421 (5th Cir. 1975) (examples of such “externally induced factors” include: 1) Acts of God, 2) condemnation, or 3) new and unfavorable zoning regulations, among others).

As stated previously, the duration of ownership is yet another element courts consider in examining the intent of the taxpayer.⁶¹ Congress, and seemingly the Supreme Court, have long recognized that “capital gains...accruing over long periods of time” should not be taxed at the same rate as ordinary income.⁶² The logic behind this theory is that since capital gains accrue over a long period of time it would be inequitable to recognize the full amount of gain in one year, thereby pushing the taxpayer into a higher marginal tax bracket and charging him with a great burden in the year of sale.⁶³

Accordingly, the Tax Court has, on numerous occasions, considered the taxpayer’s retention of the property for a lengthy period of time indicative of an investment purpose.⁶⁴ In *Pritchett v. Commissioner*, for example, the Tax Court held that land sold by a licensed realtor after an 11 year holding period was capital in nature despite the taxpayer’s status as a dealer.⁶⁵ The Court reasoned that the taxpayer’s “lengthy retention of the property is indicative of petitioner's intention to hold it for

⁶¹ Daugherty, 78 T.C. at 629; *see supra* note 50 and accompanying text.

⁶² *Burnet v. Harmel*, 287 U.S. 103, 106 (1932); *see Comm’r v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 134 (1960) (“This Court has long held that the term ‘capital asset’ is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year.”); *Malat*, 383 U.S. at 572 (differentiating ordinary income from “the realization of appreciation in value accrued over a substantial period of time”).

⁶³ *Id.* “Before the Act of 1921, gains realized from the sale of property were taxed at the same rates as other income, with the result that capital gains, often accruing over long periods of time, were taxed in the year of realization at the high rates resulting from their inclusion in the higher surtax brackets. The provisions of the 1921 revenue act for taxing capital gains at a lower rate, reenacted in 1924 without material change, were adopted to relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.” *Id.*; *citing* House Report No. 350, Ways and Means Committee, 67th Cong., 1st Session on the Rev. Bill of 1921, p. 10; *see also Alexander v. King*, 46 F.2d 235 (10th Cir. Okla. 1931).

⁶⁴ *See Pritchett v. Comm’r*, 63 T.C. 149, 166-67 (1974); *Municipal Bond Corp. v. Comm’r*, 382 F.2d 184, 189 (8th Cir. 1967) (considering time a major factor in ruling that property was held for investment); *Schueber v. Comm’r*, 371 F.2d 996, 999 (7th Cir. 1967) (property “held for realization of appreciation in value to be accrued over a substantial period of time” (9 years) was an investment).

⁶⁵ 63 T.C. at 166-67.

investment purposes.”⁶⁶ Unfortunately, neither *Pritchett* nor its predecessors provide a bright-line test for how long is long enough when it comes to the holding period; but conveniently, this single factor is not dispositive of the question of whether property is held for investment purposes.⁶⁷

The second factor of the Fifth Circuit’s analysis is the extent and nature of the taxpayer’s efforts to sell the property.⁶⁸ Some courts have hinted that the correct question is not whether the seller engaged others to assist him in efforts to sell the property, but whether he engaged in any such efforts at all.⁶⁹ These selling efforts suggest that the taxpayer is pursuing customers and is no longer willing to hold the land; and when the taxpayer engages in these efforts himself, courts often consider this further evidence that he is engaged in the business of selling real estate.⁷⁰

The comparison of two cases turning on this point serves as an excellent example of the logic surrounding this factor. In *Thompson v. Commissioner*, the taxpayer engaged in “regular and ordinary” sales of lots while not employing a broker; nor did he advertise,

⁶⁶ *Id.* The court also thought it important that over this eleven year period the “petitioner never improved or subdivided this land, offered it for sale, posted ‘for sale’ signs on it, or advertised it.” *Id.* at 167.

⁶⁷ *Id.* at 162-63; citing *Thrift v. Comm’r*, 15 T.C. 366, 369 (1950) (no single factor “can be regarded as determinative, but the question must be viewed in the light of all pertinent factors and particularly the facts of the individual case”).

⁶⁸ *Daugherty v. Comm’r*, 78 T.C. 623, 629 (1982); see *supra* note 50.

⁶⁹ See *Sanders v. United States*, 740 F.2d 886, 889 (11th Cir. 1984) (“Merely because the appellant himself did not actively advertise or sell directly to the home buyers does not mean he was not engaged in the real estate business.”).

⁷⁰ *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 418-19 (5th Cir. 1975). The court rejected Biedenharn’s argument “that one who is not already in the trade or business of selling real estate does not enter such business when he employs a broker who acts as an independent contractor.” The court reasoned that when the landowner retains substantial control over the sales function (in this instance he set prices and established credit policies) the “brokers did not so completely take charge of the whole of the...sales as to permit [Biedenharn Realty] to wall itself off legally from [the broker’s] activities.” *Id.* But see *Estate of Barrios v. Comm’r*, 265 F.2d 517 (5th Cir. 1959). In *Estate of Barrios* the court ruled that land was held for investment purposes where taxpayer “never engaged in any form of advertising, or employed a real estate agent, or solicited a prospective purchaser.” *Id.* at 520. Clearly, the employment of a real estate agent, in itself, is not determinative of this issue.

post signs, conduct an organized sales program, or haggle over prices.⁷¹ Nonetheless, the court reasoned that his sales were taxable as ordinary income because he engaged in “extensive” sales activities related to a large number of lots (though not in the tax years at issue) in the same subdivision.⁷² In *Pritchett v. Commissioner* however, the court declined to classify the sale of several properties held by a real estate broker as ordinary income.⁷³ The court looked to the fact that Pritchett “made no effort to sell or improve” these properties, nor did he advertise it or solicit buyers, and each buyer approached Pritchett about the purchase of the properties concerned.⁷⁴ Thus, the court reasoned that Pritchett maintained his investment motive because he “simply held [the land] passively, allowing it to appreciate.”⁷⁵

The third factor of the Fifth Circuit’s analysis is the “frequency, number, and continuity of sales.”⁷⁶ Although there is no bright-line test with respect to this element, the courts have held that “the frequency and substantiality of sales are highly probative on the issue of holding purpose because the presence of frequent sales ordinarily belies the contention that property is being held ‘for investment’ rather than ‘for sale.’ And the frequency of sales may often be a key factor in determining the ‘ordinariness’ question.”⁷⁷ Though there appear to be no cases where this factor alone is

⁷¹ 322 F.2d 122, 126-28 (5th Cir. 1963).

⁷² *Id.* at 124. *Citing* *Thompson v. United States*, 136 Ct.Cl. 671, 145 F. Supp. 534 (1956) (prior suit against same taxpayer, but covering different tax years). Taxpayer made the mistake of admitting that his sales activity did not change substantially over the years (even after the tax years covered by 145 F. Supp. 534, where the court found “extensive” sales activities) and that “after the subdividing of any of the property, naturally it was available for sale...” *Id.* at 127.

⁷³ 63 T.C. 149 (1974).

⁷⁴ *Pritchett*, 63 T.C. at 165-66.

⁷⁵ *Id.* at 165.

⁷⁶ *Id.* at 162-63. This is actually the fourth factor in the *Pritchett* analysis, but that court arranges the factors differently. The *Suburban Realty* court asserts that this is the most important factor in determining whether the taxpayer is engaged in the real estate business. 615 F.2d at 178.

⁷⁷ *Suburban Realty Co.*, 615 F.2d at 178. Each case listed in footnotes 78-83 supports this proposition, and some, such as *Matz*, explicitly state their concurrence.

determinative,⁷⁸ courts have held that: 376 lots over 15 years constitutes a trade,⁷⁹ 244 sales over 33 years constitutes a trade,⁸⁰ sales of 15 lots per year over 5 years is a trade or business,⁸¹ sale of 38 lots over 3 years is a trade or business,⁸² and the sale of 63 properties over more than 20 years was not a trade or business.⁸³

The courts have not stipulated any particular number of sales that pushes an investor over the threshold into the realm of business activity;⁸⁴ rather, courts evaluate all of the factors together, and one consideration closely related to the number of sales is the substantiality of income derived from those sales.⁸⁵ In *Adam v. Commissioner* the Tax Court held that the taxpayers, husband and wife, were not engaged in the real estate business though they purchased and sold approximately twelve coastal Maine properties over a three year period. Among the factors considered by the Court was “the relative amounts of income from the taxpayer’s regular business and from the property transactions” at issue.⁸⁶ The Court reasoned that “the significant difference in income generated by the two activities tends to show that Mr. Adam’s real estate dealings were investment activities.”⁸⁷

⁷⁸ See *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 416 (5th Cir. 1975) (Reasoning that “although frequency and substantiality of sales are not usually conclusive, they occupy the preeminent ground in our analysis.”).

⁷⁹ *Thompson*, 322 F.2d at 124-25.

⁸⁰ *Id.* at 174.

⁸¹ *Sanders v. United States*, 740 F.2d 886 (11th Cir. 1984).

⁸² *Biedenharn Realty Co.*, 526 F.2d at 416.

⁸³ *Matz v. Comm’r*, T.C. Memo 1998-334, 76 T.C.M. (CCH) 465, 16-18 (1998).

⁸⁴ In *Sanders*, for instance, the taxpayer sold an average of only 3 lots per year, but the court held that he was engaged in a trade or business. Yet, in *Matz*, the taxpayer sold an average of 3.15 lots per year, and in *Gartrell* the taxpayers sold an average of 5.11 lots per year, and the court held that they were not engaged in a trade or business. *Gartrell v. United States*, 619 F.2d 1150 (6th Cir. 1980). As a general rule of thumb, three sales per year seems to be near the upper end of a permissible number of sales, at least so long as the other 5th Circuit factors favor the investor.

⁸⁵ See *Adam v. Comm’r*, 60 T.C. 996, 999-1000 (1973).

⁸⁶ *Adam*, 60 T.C. at 999; *citing* *Real Estate Corp. v. Comm’r*, 35 T.C. 610 (1961), *aff’d*, 301 F. 2d 423 (C.A. 10 1962), *cert. denied*, 371 U.S. 822 (1962), *reh’g denied*, 371 U.S. 917 (1962).

⁸⁷ *Adam*, 60 T.C. at 1000. Mr. Adam was a CPA and partner at a large accounting firm in Maine, and “the net gain from his real estate activities was approximately 5 percent of his total income in 1967, 16

The fourth factor of the Fifth Circuit’s analysis is the extent of subdividing, developing and advertising engaged in to increase sales.⁸⁸ In numerous cases courts have held that extensive development activity is evidence of a business,⁸⁹ and not the mere liquidation of an investment.⁹⁰ This extensive activity often includes subdivision into residential lots, the grading and surfacing of streets, the installation of drainage facilities and utilities, and other similar improvements.⁹¹

It is important to note however, that when the taxpayer undertakes “purely legal steps to make [the property] more marketable” those actions will ordinarily not weigh against the taxpayer.⁹² In *Buono v. Commissioner* the court held that the taxpayers were entitled to capital gains treatment despite their “improvement” of an undeveloped tract of land.⁹³ The evidence showed that the taxpayers formed an S-Corp for the purpose of purchasing an undeveloped tract of land, and that they intended to sell the entire tract as soon as they could obtain appropriate subdivision approvals from the local

percent in 1968, and 30 percent in 1969.” *Id.* For further cases considering the substantiality of income, see *Estate of Webb v. Comm’r*, 30 T.C. 1202 (1958), and *Hoover v. Comm’r*, 32 T.C. 618 (1959).

⁸⁸ *Adam*, 60 T.C. at 1000 (“Mr. Adam did not plot or subdivide any of his waterfront properties. He did not add any structures or facilities to them. They were sold in the same physical condition in which they were purchased. Mr. Adam made some surveys, obtained some rights-of-way, and extinguished an easement over at least one of the properties, but such activities were not significant.”); *Biedenharn Realty Co. v. United States*, 526 F.2d 409 (5th Cir. 1975) (Court held that extensive development and improvement raised activity to the level of a business).

⁸⁹ See Rev. Rul. 59-91, 1959-1 C.B. 15; *Sanders v. United States*, 740 F.2d 886 (11th Cir. 1984); *Gault v. Comm’r*, 332 F.2d 94 (2nd Cir. 1964).

⁹⁰ *Biedenharn Realty Co.*, 526 F.2d at 418. The Court engages in an interesting analysis of the “liquidation plus integrally related improvements theory” under which the taxpayer may be able to escape ordinary income treatment if engaged in a liquidation of the investment. *Id.* at 417-18, 420-21. There is also a valuable statutory safe harbor in § 1237(a). Though this safe harbor is seldom used because it requires a 5-year holding period, it prevents the reclassification of subdivided property so long as the taxpayer is not a dealer in real estate and the taxpayer has not made “substantial improvements” to the parcel. There are numerous special rules that apply to this section. See I.R.C. §§ 1237(a)(2)(A)-(C), 1237(b) and (c).

⁹¹ Rev. Rul. 59-91, 1959-1 C.B. 15.

⁹² *Buono v. Comm’r*, 74 T.C. 187, 201 (1980).

⁹³ *Id.* at 187.

municipality.⁹⁴ The taxpayers ultimately sold the tract five years later and the court reasoned that though the subdivision of the property took the taxpayers “in the direction of the indistinct line of demarcation between investment and dealership,” their “purely legal steps” were insufficient to cross the line since they intended to sell the property as a single tract.⁹⁵

The final three factors often considered in the Fifth Circuit’s analysis are the taxpayer’s use of a business office for the sale of property, the character and degree of supervision or control exercised by the taxpayer over any representative selling the property, and the time and effort the taxpayer habitually devoted to the sales.⁹⁶ Courts do not typically discuss these three factors in great detail, and so they receive commensurate treatment here. Essentially, the taxpayer’s goal should be to minimize or eliminate the court’s consideration of each of these factors.

IV. Substance over Form

As is typical in tax matters, the substance of a transaction is more important than its form. In building on the Fifth Circuit’s framework discussed in the previous section, this section explores various real estate investment partnership transactions that have, and have not, been upheld by the courts. For an introductory example, assume that partners A and B form partnership P, an LLC formed under Virginia law.⁹⁷ In 2000, P purchased a

⁹⁴ *Id.*

⁹⁵ *Id.* at 201. The Court also notes that many decisions have followed similar lines of reasoning, and the Court, in following the 5th Circuit’s decision in *Winthrop*, rejects the Commissioner’s overly broad reading of the “taxpayer efforts” rule. *Id.* at 204; *citing* United States v. Winthrop, 417 F.2d at 909.

⁹⁶ *Biedenharn Realty Co.*, 526 F.2d at 415. The *Graves* court provides these tests as applied by the Fourth Circuit; the listing is not substantially different, but the Fourth Circuit does not emphasize the last three factors. *Graves v. Commissioner*, 867 F.2d 199, 202 (4th Cir. 1989).

⁹⁷ The next section will explore the technical details of partnership tax law and examine how the Code influences the life cycle of a typical real estate investment partnership.

parcel of undeveloped land for \$1 million in cash. Six years later, A and B want to sell this property and maximize the amount of money in their pockets, what should they do?⁹⁸

A. A Simple Sale of Undeveloped Property

The first option is for A and B to take the easy route. If P sells the undeveloped land to Z LLC, an unrelated developer, for \$2 million, P could recognize a long term capital gain of \$1 million. A and B would each take \$500,000 in gain and pay \$75,000 in taxes; that would put \$425,000 in cash in their pockets, but why would they do this when they can make more? What would happen, for instance, if A and B instead sold the property to Y LLC, a development company wholly owned by A and B? Could they then charge a higher price for the property to increase their capital gain and decrease the ordinary income recognized on the development activity of Y LLC?⁹⁹

Unfortunately, this activity is not quite kosher in the eyes of the I.R.S. Section 707(b)(2) serves to convert P's capital gain into ordinary income because Y is a related party, and thus the parcel is not a capital asset in the hands of Y. For the purposes of § 707(b)(2)¹⁰⁰ a related party transaction includes those between (i) a "partnership and a person owning, directly or indirectly, more than 50 percent of the...interest...in such partnership, or (ii) between two partnerships in which the same persons own, directly or

⁹⁸ For the sake of simplicity, this example ignores the details of how the partners started up and funded the partnership, and it also assumes that A and B are equal partners and that both are in the highest tax bracket. More detailed transactions will be considered later.

⁹⁹ A scheme of this sort might be organized as such: P sells property (FMV of \$2 million) to Y for \$4 million. Y subdivides the property into 100 lots and makes improvements thereon. Y sells all lots to R, a realtor who happens to be a friend of A and B, for \$4.5 million (\$45,000 each). A and B, as partners of P, recognize a combined long term capital gain of \$3 million, and recognize ordinary income of \$500,000 on the development activities of Y. Again, this is where substance over form comes into play.

¹⁰⁰ A "related party" is also defined by I.R.C. § 453(g)(2), § 1239(b), and § 707(b)(1)(B). Note that sections may define the term slightly differently.

indirectly, more than 50 percent...” In any such related party transaction the “gain recognized shall be considered as ordinary income.”¹⁰¹

In this example, if the gain is properly reclassified as ordinary income, P would ultimately recognize a \$3.5 million gain, with A and B each paying approximately \$612,500 in taxes and taking home \$1,137,500.¹⁰² The tax implications of this transaction are very similar to what would result if A and B simply developed the land themselves and sold it to numerous buyers in the ordinary course of business.

B. The Sale of Undeveloped Property to a Related Corporation

The previous example demonstrates how the sale of undeveloped property to a related partnership can create a trap for the unwary, but what if P instead sells the property to a related corporation? Assume, for example, that P sells the property to X Corp., a real estate development corporation owned equally by A and B, for \$4 million. In this example, § 707(b)(2) does not apply to reclassify the gain as ordinary income.¹⁰³ Furthermore, no other section applies to reclassify this transaction because the property is not “subject to the allowance for depreciation.”¹⁰⁴ Were this property subject to depreciation, the gain would be reclassified under § 1239(a), but since X Corp. holds the land as inventory the \$3 million gain retains its classification as a capital gain.¹⁰⁵ Accordingly, A and B would recognize a capital gain of \$3 million on the sale from P to

¹⁰¹ I.R.C. § 707(b)(2)(B).

¹⁰² If these amounts were not reclassified as ordinary income under § 707 partners A and B would pay taxes of only \$312,500 each, and would take home \$1,437,500.

¹⁰³ I.R.C. § 707(b)(2) only applies to transactions between a partnership and an owner of that partnership, or between two or more partnerships; it does not apply to sales between a partnership and a corporation.

¹⁰⁴ I.R.C. § 1239(a)-(b). Remember, this example contemplates the sale of a parcel of raw land.

¹⁰⁵ I.R.C. § 167(a). Treas. Reg. § 1.167(a)-2 provides that an allowance for depreciation “does not apply to inventories or stock in trade, or to land apart from the improvements or physical development added to it.”

X Corp., and pay taxes of \$225,000 each. Then, assuming X Corp. sold these lots for a gain of \$500,000, A and B would each take home \$111,069 of this gain,¹⁰⁶ for a total gain on the deal of \$1,386,069.

While this transaction appears to easily foil the Commission's reclassification as ordinary income it is very important to note that these transactions can be tricky, and the Commission may argue that an agency relationship exists between the purchaser and seller, or that the parties were not dealing at arm's length.¹⁰⁷ If there is an agency relationship between the parties, the activities of the purchaser are relevant to determine whether the seller intended to hold the land as an investment or in the ordinary course of business.¹⁰⁸ Among the factors considered by the Commission in determining whether an agency relationship exists between the parties are:

- 1) The magnitude of the seller's activity with respect to the property.¹⁰⁹
- 2) The length of time between the seller's purchase and sale of the land.¹¹⁰
- 3) Seller's purchase and sale of other properties and general experience and involvement in real estate.¹¹¹

¹⁰⁶ In order to calculate this figure X Corp. must have exactly \$500,000 (at a marginal rate of 34%) in income and A and B must pay individual income taxes at a marginal rate of 35%. Corporate income taxes would equal \$158,250, and individual income taxes would equal \$119,613, for a total of \$277,863 in taxes (a composite rate of 55.57%). See I.R.C. § 11(b).

¹⁰⁷ I.R.S. Information Release 2002-0013 (3/29/02). If an "agency relationship exists between the seller entity and the related purchaser entity...the purchaser entity's activities are relevant to the determination of whether the seller entity intended to hold the land as an investment." *Id.* at 2.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* This is the most important factor according to the IRS. The activity of the taxpayer in *Brown* is particularly indicative of an agency relationship. In that case the seller "contacted an engineering company to find out where streets and utilities would be located and had the land platted and approved by his local planning commission prior to selling the land to his corporation. With respect to another tract of land, the seller had his attorney initiate the formation of a local public works authority for the purpose of having the city construct a sewer system on the tract before selling the land to his corporation." *Brown v. Comm'r*, 448 F.2d 514, 517 (10th Cir. 1971).

¹¹⁰ Release, *supra* note 107 at 3-4. A short holding period is indicative of an agency relationship and/or an intent to sell to customers. See *Brown*, 448 F.2d 514 (10th Cir. 1971) (holding periods of 7 to 8 months); *Tibbals v. United States*, 362 F.2d 266, 270 (Ct. Cl. 1966) (a few days after purchasing property taxpayer "petitioned the county for water, sewer and street improvements, which were begun in autumn 1951," and he sold some lots to his corporation as early as April 1951, and sold the remaining 100 lots by June 1952); *Boyer v. Comm'r*, 58 T.C. 316 (1972) ("Sellers entered into a contract to purchase land on April 4, 1966 and closed on May 25, 1966," but by May 12, 1966 they "entered into a contract to sell their land to their corporation...for twice what they paid for it.").

4) Seller's purpose with respect to the land.¹¹²

In light of these factors, it is important that a partnership that desires to sell investment property to a related corporation be very careful in how they structure the deal and be cautious of issues that might give the Commission any opportunity to challenge the transaction.

C. Sale to a Related Corporation – *Phelan v. Commissioner*

As evidenced above, a sale of undeveloped land to a related corporation may be structured so as to preserve capital gains, and *Phelan v. Commissioner* is just one such success story.¹¹³ This section provides a brief analysis of what the taxpayers did correctly, and what could be improved to ensure that such a transaction goes more smoothly for other investors. In *Phelan*, partners A, B, and C owned 40%, 40%, and 20% of the partnership and corporation, respectively.¹¹⁴

In 1994 the petitions and two other men organized the Jackson Creek Land Co. (JCLC), and soon thereafter they purchased a 1050 acre tract of land in Colorado for \$2.9 million.¹¹⁵ Two years later the same group of investors formed Vision Development Corp. (Vision) for the purpose of developing a 46.5 acre parcel of the Jackson Creek tract

¹¹¹ Release, *supra* note 107 at 4. See *Brown*, 448 F.2d 514 (seller's purchase and development of multiple tracts of land during the same period of time evidenced his involvement in the real estate business and his lack of investment intent); *H-H Ranch, Inc. v. Comm'r*, 357 F.2d 885, 886-87 (7th Cir. 1966) ("Selling corporation lacked investment intent based on a ultimate finding that...the selling corporation was in the business of subdividing real property into improved lots and selling such lots to customers. The H-H Ranch court also cited the fact that the shareholder of the selling corporation had been in the building business since 1914.").

¹¹² Release, *supra* note 107 at 4-5. Where the previous three factors fail to clearly establish the seller's intent the court will look to the seller's stated investment purpose, if any. *Id.* In *Bramblett*, the court considered "the selling partnership's stated purpose of acquiring property for investment purposes." 960 F.2d at 531.

¹¹³ T.C. Memo 2004-206, 88 T.C.M. (CCH) 223.

¹¹⁴ *Id.* at 7.

¹¹⁵ *Id.* at 1-5. The Court also found that JCLC's intent at the time of purchasing the land was to hold it for investment purposes, and so they did not advertise the Jackson Creek property for sale. *Id.* at 5.

for resale to a homebuilder.¹¹⁶ In 1996 JCLC conveyed this parcel to Vision for \$1,571,145 and the members of JCLC claimed a long term capital gain of \$47,319 with respect to this transaction.¹¹⁷ This fact pattern thus presented the court with “the purely factual question of whether gain from the sale of real property resulted in ordinary or capital gain income.”¹¹⁸

The I.R.S., of course, contended that the development activity on the Jackson Creek property was done at the behest of JCLC¹¹⁹ or, alternatively, that the sale of Jackson Creek from JCLC to Vision “was done solely for tax avoidance and had no independent business purpose.”¹²⁰ The Tax Court, however, analogized this case to *Bramblett*,¹²¹ where the Fifth Circuit analyzed a similar fact pattern and concluded that “the business activities of the corporation were not attributable to the partnership.”¹²² Both the *Phelan* and *Bramblett* courts relied on the Supreme Court’s holding “that where the form chosen by the taxpayer is compelled or encouraged by business or regulatory realities, is imputed with tax-independent considerations, and is not shaped solely by tax-avoidance features, the form should be honored by the Government.”¹²³ Likewise, in this

¹¹⁶ *Id.* at 7-8.

¹¹⁷ *Id.* at 7.

¹¹⁸ *Id.* at 11. The Tax Court Memo goes into significantly greater detail about the business relationships surrounding this transaction and other ventures in which the partners were involved, but those facts are not necessary for the purpose of this analysis.

¹¹⁹ See Release, *supra* note 107 and accompanying text. Essentially, the IRS argues that due to the common ownership of JCLC and Vision, they are affiliated entities and the acts of one should be imputed to the other. T.C. Memo 2004-206, at 17.

¹²⁰ T.C. Memo 2004-206, at 21. Again, the IRS complains that the acts of Vision should be imputed to JCLC.

¹²¹ *Bramblett v. Comm’r*, 960 F.2d 526, 528 (5th Cir. 1992).

¹²² T.C. Memo 2004-206, at 21-22.

¹²³ *Id.* at 22; *citing* *Frank Lyon Co. v. United States*, 435 U.S. 561, 583 (1978). See also, *Bramblett*, 960 F.2d at 533.

instance, there were legitimate business reasons to organize Vision, and so the Tax Court concluded that Vision’s development activity was not attributable to JCLC.¹²⁴

So, notwithstanding the fact that this transaction was challenged by the I.R.S., JCLC must have done something right to win this case. By examining what they did correctly (and how their efforts may be improved) we can create a relatively reliable model for future transactions. First, and perhaps most importantly, JCLC and Vision observed all corporate formalities.¹²⁵ The Tax Court considers important the fact that they observed all such formalities and created Vision for a legitimate business purpose. Second, JCLC purchased the land and held it for approximately four years before selling a single parcel.¹²⁶ The Court reasoned that the “frequency and substantiality of sales is the most important factor to be considered,”¹²⁷ and the two sales by JCLC in four years “were of insufficient frequency to support the conclusion that JCLC’s sales were in the ordinary course of business.”¹²⁸

Third, while the Court did not spend a substantial amount of time discussing these factors, they did mention that the partners did not hold real estate licenses,¹²⁹ they did not advertise the property for sale or hire agents to sell the property,¹³⁰ and all sales were unsolicited.¹³¹ Finally, the Court noted that JCLC was responsible for only limited improvements to the property and “did not have employees or engage in any business

¹²⁴ T.C. Memo 2004-206, at 23. The Petitioner (Phelan) conceded that, unlike in *Bramblett*, there was no need to protect the partnership from unlimited liability, but he argued (and the Court agreed) that there was a legitimate business purpose for the organization of Vision; namely, to protect JCLC’s sole asset, the remaining tract of land. *Id.*

¹²⁵ *Id.*

¹²⁶ *Id.* at 24.

¹²⁷ *Id.* at 23; *citing* *Suburban Realty Co. v. United States*, 615 F.2d 171, 176 (5th Cir. 1980).

¹²⁸ T.C. Memo 2004-206, at 24-25.

¹²⁹ *Id.* at 2.

¹³⁰ *Id.* at 5, 17.

¹³¹ *Id.* at 17.

outside of holding and selling a limited number of parcels...”¹³² From this case, and others analyzed herein, there are a number of factors that the real estate investment partnership should be conscious of when engaging in such transactions: 1) the terms of the sale should always be established on an arm’s-length basis,¹³³ 2) all formalities of the sale should be respected by the parties,¹³⁴ 3) all corporate formalities should be respected in all activities,¹³⁵ 4) the purchase price should not be contingent on the sales efforts of the developer,¹³⁶ 5) the developer corporation should not pre-sell any property or engage in development activity before settling with the partnership,¹³⁷ 6) the development activity of the partnership should be strictly limited to legal improvements only,¹³⁸ 7) the ownership structure of the entities should be varied,¹³⁹ and 8) the investors should limit the number of transactions engaged in by any single real estate investment partnership.¹⁴⁰

¹³² *Id.* at 18. The limited improvements made to the property were primarily legal in nature and included the preliminary and final site plan approvals and a Preliminary Geotechnical Investigation (soil test). The Court reasoned that these improvements fell well short of those permitted in other cases and did not serve to establish an “ordinary course of business.” *Id.* at 25-26.

¹³³ Release, *supra* note 107 and accompanying text. *See also* Bramblett v. Comm’r, 960 F.2d 526 (5th Cir. 1992).

¹³⁴ If formalities are not observed the parties may bear the risk that loans/debt will be deemed a capital contribution. *See* Burr Oaks Corp. v. Comm’r, 365 F.2d 24 (7th Cir. 1966) (holding that the transfer of land in exchange for promissory notes constituted a capital contribution and not a sale); Aqualane Shores, Inc. v. Comm’r, 269 F.2d 116 (5th Cir. 1959) (holding that the transfer of property to a thinly capitalized corporation constituted a contribution of “risk capital”); Bradshaw v. United States, 683 F.2d 365 (Cl. Ct. 1982) (upholding transaction because price reflected fair market value and the formalities of sale were strictly observed).

¹³⁵ Phelan v. Comm’r, T.C. Memo 2004-206, 88 T.C.M. (CCH) 223.

¹³⁶ Release, *supra* note 107 and accompanying text.

¹³⁷ Boyer, *supra* note 110 and accompanying text.

¹³⁸ *See supra* note 132. *See also* Buono, *supra* note 92 and accompanying text.

¹³⁹ Though this is not a strict requirement, courts are somewhat suspect of arrangements where the two entities have identical common ownership. *See* Bramblett v. Comm’r, 960 F.2d 526 (5th Cir. 1992).

¹⁴⁰ *See supra* note 127 and accompanying text. Since the “frequency and substantiality” of sales is one of the most important factors in determining whether the court will afford capital gains treatment it is best to present the court with a partnership that has engaged in very few transactions when possible. *Id.*

V. The Life Cycle of a Real Estate Investment Partnership

Thus far, this paper has concentrated on the legal precedent that supports a viable real estate investment partnership. Though this precedent establishes the foundation of partnerships and transactions that the courts will sustain, in many respects it neglects the underlying details of how the Internal Revenue Code works to shape the operation of the partnership. This section focuses on the continuous interplay between the Code and a typical real estate investment partnership from formation to dissolution.

A. Formation

While it is possible for a partnership to arise unintentionally,¹⁴¹ is not typical for the vast majority of real estate investment partnerships. Rather, a well-planned real estate investment partnership will organize as an LLC and register under the laws of the state where it plans to conduct business.¹⁴² Further, there are a number of elections that the partnership must make upon formation.¹⁴³ The first of these elections is whether the LLC wants to be treated, for tax purposes, as a corporation or a partnership.¹⁴⁴ Ordinarily, the answer to this question is rather straightforward – partnerships pay less in taxes because they are not subject to double taxation, and so a real estate investment partnership will almost always elect treatment as a partnership.

¹⁴¹ See *supra* note 7 and accompanying text.

¹⁴² See Va. Code § 13.1-1000 et seq.; § 13.1-1007 makes it unlawful (a Class 1 misdemeanor) to transact business as an LLC in Virginia unless authorized to do so.

¹⁴³ Most of these elections may not actually be made until the first tax return is filed by the partnership, but they are addressed early in this section for the sake of simplicity.

¹⁴⁴ Treasury Form 8832; see also Reg. § 301-7701 et seq. for details on this election. Also note that a single-member LLC is typically treated as a disregarded entity for tax purposes. See *supra* note 27.

Second, the partnership must determine whether it will qualify as an electing large partnership (“ELP”).¹⁴⁵ While this election will not apply to the vast majority of real estate investment partnerships it is worth noting because it may offer substantial savings related to accounting expenses when available.¹⁴⁶ In order to qualify as an ELP the partners must not perform substantial services,¹⁴⁷ the partnership must have 100 or more partners,¹⁴⁸ and the partnership must elect classification as an ELP.¹⁴⁹

The third common election is a § 754 election. When an incoming partner purchases the partnership interest of another, he ordinarily assumes the seller’s pro rata share of the partnership’s adjusted basis in its property.¹⁵⁰ In many instances this does not cause a problem, but if the partnership assets have appreciated significantly the “difference between the new partner’s inside and outside basis can be substantial.”¹⁵¹ The result is that the new partner may be deprived of depreciation deductions and his gain from subsequent property dispositions may be artificially inflated.¹⁵² Section 754 was created to remedy this problem by equalizing a new partner’s inside and outside

¹⁴⁵ See I.R.C. §§ 771-77.

¹⁴⁶ The 100+ member requirement will disqualify most real estate investment partnerships. I.R.C. § 775(a)(1)(A). Reduced accounting expenses ordinarily result from the simplified flow-through structure of an ELP and the simplified K-1.

¹⁴⁷ I.R.C. § 775(b)(1)-(2). The partnership is excluded from making an ELP election if “substantially all the partners...are individuals performing substantial services in connection with the activities of such partnership or are personal service corporations,” or are retired partners who performed substantial services, or spouses of partners who are performing, or previously performed, such services. *Id.*

¹⁴⁸ I.R.C. § 775(a)(1)(A).

¹⁴⁹ I.R.C. § 775(a)(1)(B). This election applies to the taxable year for which made and all subsequent years unless revoked or there are fewer than 100 partners. § 775(a)(1)-(2).

¹⁵⁰ Paul J. Streer & Caroline D. Strobel, *Tax Effects on Partnership and Limited Liability Company Interests: Using Section 754 Elections to Enhance Value and Marketability*, THE CPA JOURNAL, Feb. 2005, at 1.

¹⁵¹ *Id.*

¹⁵² *Id.*

basis.¹⁵³ This section works in conjunction with §§ 743(b) and 734(b),¹⁵⁴ and once the election is made it is very difficult to revoke.¹⁵⁵

The § 754 election is generally beneficial, but in some instances a partnership may determine that it either does not want to make the initial election or it wants to revoke the election. The two principal reasons for avoiding the election are that it increases paperwork and accounting expenses, and it may be detrimental where an incoming partner's inside basis exceeds his outside basis.¹⁵⁶ Further, there is a "safety-valve provision" that may, in limited circumstances, work to protect a new partner even when the partnership does not have a § 754 election in place.¹⁵⁷ This provision does not, however, have exactly the same effect as § 754 and is limited to property that is distributed within two years after the partnership interest is transferred.¹⁵⁸ Further, the provision has no effect until a distribution is made and, in some situations, the I.R.S. may force the application of this provision outside the two year timeframe when the fair market value of property distributed exceeds 110% of its adjusted basis to the partnership at the time of acquisition by the new partner.¹⁵⁹

¹⁵³ See I.R.C. § 743(b)(1).

¹⁵⁴ I.R.C. § 743(b) requires the partnership to allocate any basis adjustment to its assets and "separately compute the incoming partner's annual share of depreciation and gain or loss from the sale of its property." Streer, *supra* note 150 at 2. I.R.C. § 734(b) results in an adjustment to the partnership's basis for its remaining property following a distribution of cash or property to the partners. *Id.*

¹⁵⁵ The I.R.S. must consent to any revocation of the § 754 election and valid reasons for the revocation are generally limited to: a change in the nature of the partnership business, a substantial increase in the number of assets in the partnership, a change in the character of partnership assets, or an increased frequency of retirements or ownership shifts. Streer, *supra* note 150 at 3; *citing* Reg. § 1.754-1(c).

¹⁵⁶ This scenario could result in a negative basis adjustment which would require the partner to report more gain, or less loss, on the disposition of partnership property. The I.R.S. will not grant a revocation of the § 754 election if this problem arises. Streer, *supra* note 150 at 5.

¹⁵⁷ *Id.* at 4-5; see I.R.C. § 732(d).

¹⁵⁸ I.R.C. § 732(d).

¹⁵⁹ *Id.*; see also Streer, *supra* note 150 at 4-5.

Finally, in limited circumstances, the partnership may elect treatment under I.R.C. § 761.¹⁶⁰ This election, when made, permits the partnership to avoid the application of Subchapter K.¹⁶¹ However, this election is limited to partnerships that operate for investment purposes only and do not provide services, and where the partners own the property as co-owners.¹⁶² The requirement that partners own the property as co-owners and reserve the right to separately dispose of their interest typically disqualifies the use of this section for real estate investment purposes.¹⁶³

Beyond the matter of elections taken, the partnership must be certain to capitalize and deduct organizational expenses as appropriate. Section 709 provides the rules controlling the deduction of organizational and syndication fees.¹⁶⁴ Under this section the partnership may deduct certain expenses immediately, while capitalizing others and amortizing them over a 180-month period.¹⁶⁵ Generally, organizational expenses are those which are incident to the creation of the partnership,¹⁶⁶ chargeable to capital account, and are of a character which, if expended incident to the creation of a

¹⁶⁰ See *supra* note 6 and accompanying text.

¹⁶¹ I.R.C. § 761(a).

¹⁶² I.R.C. § 761(a)(1)-(2); Treas. Reg. § 1.761-2(a)(2).

¹⁶³ Treas. Reg. § 1.761-2(a)(2)(i)-(ii). Where the partners own the property as co-owners the dissent of even one partner may thwart attempts of the others to sell or refinance the property. Further, where a § 761 election is in effect, any loss upon the sale of property is generally a capital loss. See *Yarbro v. Comm’r*, 737 F.2d 479 (5th Cir. 1984).

¹⁶⁴ I.R.C. § 709(a); Treas. Reg. § 1.709-1. Technically § 709(b) provides for an election, but that election is simply made by attaching a statement to the partnership’s return for the tax year in which the partnership begins business. This statement must set forth each organizational expense incurred, the amount of that expense, the date incurred, and the month in which the partnership began business. Treas. Reg. § 1.709-1(c).

¹⁶⁵ I.R.C. § 709(b)(1). It is important to remember that the amortization period defined in § 709(b)(1)(B) recently changed from 60 months to 180 months; this was modified by the American Jobs Creation Act of 2004. An alternative election under § 709(b)(1)(A) may also permit the partnership to deduct up to \$5,000 of these expenses in the first year of operations.

¹⁶⁶ Generally, an expense is “incident to the creation of the partnership” if “incurred during the period beginning at a point which is a reasonable time before the date prescribed by law (without regard for extensions) for filing the partnership return for the year in which the partnership begins business. Further, these expenses must be for the creation of the partnership, not for its operation, and are expenses of a nature normally expected to benefit the partnership throughout its entire life. Treas. Reg. § 1.709-2(a).

partnership having an ascertainable life would be amortized over that time.¹⁶⁷ Such organizational expenses commonly include legal fees, accounting fees, and filing fees incurred before the partnership begins business.¹⁶⁸ The issue of when a partnership “begins business” is more contentious than one might initially expect, but is too weighty of a topic for substantial discussion at this point.¹⁶⁹

B. Financing and Land Acquisition

Once the real estate investment partnership is organized it must tackle the formidable task of financing operations and searching for assets that will yield an acceptable rate of return. In the perfect world, all of the partners would contribute large amounts of cash and nothing else. While this may be somewhat common for real estate investment partnerships, there is also a strong likelihood that one partner will enter with a large parcel of land and rely on the expertise of the other partners to help him make the most of his investment. Alternatively, all of the partners may come in with a small amount of equity and rely on other sources to finance their investment.

Generally, when a partner contributes property (i.e. a large tract of undeveloped land) to the partnership in exchange for an interest in the partnership there is no

¹⁶⁷ I.R.C. § 709(b)(3).

¹⁶⁸ All of these expenses must be “incident to the organization of the partnership” and do not include such expenses as those connected with the acquisition of partnership assets, the transfer of assets to the partnership, expenses connected with the admission or removal of partners (outside of the initial partnership organization), and expenses associated with the ongoing operations of the partnership. *See* Treas. Reg. § 1.709-2(a).

¹⁶⁹ The I.R.S. has stated that the determination of when a partnership begins business is “a question of fact that must be determined in each case in light of all the circumstances of the particular case.” But generally, a partnership begins business when it starts operations for the purpose for which it was organized, and the “mere signing of a partnership agreement is not alone sufficient to show the beginning of business.” Treas. Reg. § 1.709-2(c). Obviously, were the signing of the agreement sufficient, the partnership would sign this agreement as soon as possible to accelerate the deduction of expenses and minimize those expenses that must be capitalized under this section.

recognition of gain or loss.¹⁷⁰ Further, the elementary principals of partnership taxation dictate that the partner's basis in the property, as well as his holding period, are transferred to the partnership and result in an increase in the partner's basis.¹⁷¹ Likewise, if the partner contributes encumbered property to the partnership, he must decrease his outside basis in the partnership by the amount of any debt assumed by the partnership.¹⁷²

While a real estate investment partnership may not encounter many of the partnership tax problems associated with professional service partnership, there are situations that are more likely arise with this type of partnership. First, a real estate investment partnership may borrow against contributed property and thus encounter a situation where it has nonrecourse liabilities in excess of its basis in the asset. In that situation, sections 752 and 704 would operate together to allocate a portion of the liability to the contributing partner, and then allocate the remainder to the partners in accordance with their share of partnership profits.¹⁷³

The second problem that the partnership may encounter is one where it gives an individual a partnership interest in exchange for services rendered. Generally, a partnership should avoid this type of transaction since it results in income for the service provider and a resulting "tax cost" basis in the partnership.¹⁷⁴ An easy way around this

¹⁷⁰ See I.R.C. § 721(a). The partnership must pay particular attention to special allocations of gain, loss, etc, from the contributed property. In every instance these special allocations must have substantial economic effect under § 704(b). See generally Treas. Reg. § 1.704-1(b)(2); *Orrisch v. Comm'r*, 55 T.C. 395 (1970).

¹⁷¹ See I.R.C. §§ 723 and 1223(2). § 704(c) operates to prevent the pre-contribution gain or loss from shifting to other partners.

¹⁷² I.R.C. § 752(b). Under § 752(a) the noncontributing partners would record an increase in their outside basis in the partnership to the extent that they assume liability for debts contributed by another partner.

¹⁷³ See Treas. Reg. § 1.752-3(a)(3).

¹⁷⁴ I.R.C. § 1012. Additionally, this expense may not be immediately deductible; the partnership must consider the nature of the service rendered and may have to capitalize the expense. See Treas. Reg. § 1.83-6(a)(4). See generally, *McDougal v. Comm'r*, 62 T.C. 720 (1974).

problem is to have a valuable service provider buy into the partnership and then pay them for services rendered or provide them a guaranteed payment.¹⁷⁵

Yet another problem that may commonly arise for real estate investment partnerships is the question of how to account for fees related to the acquisition of real estate and financial commitments to acquire property. Generally, fees incurred in the acquisition of real property must be capitalized to the cost of that asset.¹⁷⁶ Of particular importance for a real estate investment partnership is the requirement that expenses related to purchase documents, brokerage fees, and title review must be capitalized;¹⁷⁷ expenses incurred to defend title must be capitalized,¹⁷⁸ and the cost of surveys must be capitalized,¹⁷⁹ but real property taxes are generally deductible when paid or incurred.¹⁸⁰

Also important to the real estate investment partnership is the potential deduction associated with searching for and evaluating potential investments. If a transaction is “entered into for profit” the partnership may be permitted an ordinary loss deduction

¹⁷⁵ An even simpler solution would be to maintain the employer/employee relationship, but that option is not always feasible. For more on guaranteed payments or payments for services rendered by partners see I.R.C. §§ 707(a)(1) and 707(c).

¹⁷⁶ I.R.C. § 263; *see also* *Surloff v. Comm’r*, 81 T.C. 210 (1983) (requiring capitalization of legal fees incurred to acquire a partnership interest under § 709(b)).

¹⁷⁷ *Millinery Center Bldg. Corp. v. Comm’r*, 21 T.C. 817 (1954); and *Thompson v. Comm’r*, 9 B.T.A. 1342, 1928 B.T.A. LEXIS 4254 (1928).

¹⁷⁸ *Boagni v. Comm’r*, 59 T.C. 708 (1973). Of particular interest is *Godfrey*, where the court required capitalization of legal fees incurred in an unsuccessful zoning challenge. *Godfrey v. Comm’r*, T.C. Memo 1963-1, 22 T.C.M. (CCH) 1, at *21-22 (1963) (I.R.C. § 212 does not apply to capital expenditures).

¹⁷⁹ *Wacker v. Comm’r*, T.C. Memo 1980-324, 40 T.C.M. (CCH) 1009, at *51-54 (holding that survey costs constitute a capital expenditure within the meaning of § 263).

¹⁸⁰ I.R.C. § 164(a)(1). Though contrary to logic, this section does seem to apply to real property held for investment purposes, and even extends a deduction to real estate transfer taxes to “dealers or investors in real estate.” *Treas. Reg. § 1.164-1*; *but c.f.* *Priv. Ltr. Rul. 199932056* (May 20, 1999). Notwithstanding this provision, real estate taxes paid or incurred on real property during the construction of improvements are capitalized to the cost of the improvement. *See* I.R.C. § 266. Though only tangentially related to the present issue, it is interesting that real estate taxes paid by the winning bidder in a foreclosure sale for delinquent real estate taxes are not presently deductible under § 164; rather, they are capitalized to the asset. *See* *Treas. Reg. § 1.164-6(b)(2)*.

under § 165.¹⁸¹ Further, the I.R.S. has permitted a loss deduction under § 165(c)(2) for evaluation expenses incurred by a business that ultimately decided not to purchase a particular property.¹⁸²

Finally, once the partnership has acquired land (or has at least found a viable opportunity) it is often concerned with issues such as loan costs, commitment fees, and interest expenses.¹⁸³ Ordinarily, the costs of obtaining a loan are not deductible by the partnership; rather, they must be amortized over the term of the loan.¹⁸⁴ If any portion of these expenses remain unamortized at the time the partnership sells the investment property they are deductible immediately.¹⁸⁵ More immediate deductions, however, may be available where the partnership pays interest expenses on loans obtained for investment purposes.¹⁸⁶

C. Sale of the Investment and Dissolution of the Partnership

At this point every partnership hopes to find itself in a position whereby it is tempted to sell the investment property for a substantial gain. There are many ways in which this may be accomplished, and not all of them involve a traditional sale. In addressing the simplest and most common scenario first, consider the consequences to a

¹⁸¹ I.R.C. § 165(c)(2); *see* Rev. Rul. 79-346, 1979-2 C.B. 84 (Though “expenses incurred in a general search for, or preliminary investigation of, a business or investment are personal and not deductible...if a taxpayer has gone beyond this point and has focused on a specific acquisition, expenses incurred therefore would be capital in nature. However, if the attempted acquisition fails, the amount that had been capitalized would become deductible.”).

¹⁸² Rev. Rul. 74-104, 1974-1 C.B. 70.

¹⁸³ As previously mentioned, the partnership and lender should take care that the loan is not reclassified as an equity investment since this could have harmful and unanticipated consequences.

¹⁸⁴ Treas. Reg. § 1.263(a)-2(a); Rev. Rul. 70-360, 1970-2 C.B. 103.

¹⁸⁵ *See* S&L Bldg. Corp. v. Comm’r, 19 B.T.A. 788, 1930 B.T.A. LEXIS 2322 (1930) (subsequently overruled); Priv. Ltr. Rul. 8637058 (Jun. 12, 1986).

¹⁸⁶ *See* I.R.C. § 163(d). Investment interest deductions are limited to “the net investment income of the taxpayer for the taxable year,” but if not used immediately the taxpayer may carry the deductions forward to future years. I.R.C. § 163(d)(1)-(2).

real estate investment partnership that sells investment property to an unrelated third-party developer. There are two ways the partnership may arrange this transaction; it could sell the property and then distribute the cash to the partners, or the partners could sell their interest in the partnership to the developer.¹⁸⁷

If the partnership chooses to sell the property and then distribute cash to the partners in a pro rata liquidation of the partnership, this transaction will fall under sections 731, 732 and 735.¹⁸⁸ However, if the partners choose to sell their interests in the partnership, sections 741-743 apply to the transaction.¹⁸⁹ Under § 741 the gain or loss on any such sale is capital in nature except to the extent that it accrues from unrealized receivables and inventory.¹⁹⁰ Thus, this option may present the partnership with a simple and attractive alternative to the outright sale of property in jurisdictions where real property transfer taxes are exceptionally high.¹⁹¹

A second option for disposal of the real property involves a like-kind property exchange.¹⁹² Section 1031 provides for the non-recognition of gain or loss from property exchanges when the exchanged property is of a “like kind.”¹⁹³ Though the election for

¹⁸⁷ By transferring the partnership interest instead of the real property the partnership may be able to avoid substantial real estate transfer taxes. See *supra* notes 34-36 and accompanying text.

¹⁸⁸ STEPHEN A. LIND, ET AL, FUNDAMENTALS OF PARTNERSHIP TAXATION 350 (7th Ed. Foundation Press 2005). Since the existence of § 751 property, namely unrealized receivables, is unlikely for a real estate investment partnership, this transaction involves a rather straightforward distribution of cash to partners.

¹⁸⁹ *Id.* at 249-50.

¹⁹⁰ I.R.C. § 741. As previously discussed, the existence of § 751 property is not likely in a real estate investment partnership, and so this section does not discuss the conversion of capital gain into ordinary gain or loss. See *Glazer v. Comm’r*, 44 T.C. 541 (1965) (holding that uncompleted homes constituted unrealized receivables and were subject to classification as ordinary income under § 751) for a case that is particularly relevant to this analysis.

¹⁹¹ See *supra* notes 34-36 and accompanying text. The partnership must be certain to have a § 754 election in place if it intends to take this route; otherwise the purchaser of the partnership interests may be stuck with an unadjusted inside basis in the property. See Lind, *supra* note 188, at 273-75.

¹⁹² See I.R.C. § 1031; Treas. Reg. § 1.1031(a)-1 et seq.

¹⁹³ “Like kind” property does not include any interest in a partnership. I.R.C. § 1031(a)(2)(D). Nor does it include any exchange of real property located in the United States for property located outside of the U.S. I.R.C. § 1031(h)(1). Interestingly, “like-kind” property may include a transfer of real property in exchange for a leasehold of 30 years or more by a non-dealer. Treas. Reg. § 1.1031(a)-1(c)(2).

treatment under this section must be made at the entity level,¹⁹⁴ this election provides the partnership an opportunity to exchange substantially appreciated investment property for other property with appreciation potential while forestalling the recognition of gain and thus temporarily avoiding the tax on that gain.¹⁹⁵

Other options available to the partnership include installment sales and sale-leaseback transactions. These options are certainly not beneficial to every real estate investment partnership and so they are not discussed in great detail here, but a brief overview of these transactions may be helpful. Installment sales, though once commonplace, have fallen out of favor to some extent but are still used when a partnership sells property to a related entity.¹⁹⁶ However, if a partnership engages in such a transaction with a related developer it must be careful to avoid recharacterization of the installment note as an equity contribution.¹⁹⁷ The Code enumerates several factors used to determine whether the I.R.S. will classify the installment note as debt or equity; these factors include:¹⁹⁸ 1) the formality of the indebtedness,¹⁹⁹ 2) the economic realities of the transaction,²⁰⁰ and 3) the intent of the parties.²⁰¹

¹⁹⁴ I.R.C. § 703(b); *Demirjian v. Comm’r*, 457 F.2d 1 (1972).

¹⁹⁵ This results because the purchaser takes a basis in the new property equal to the basis in the property exchanged. I.R.C. § 1031(d). The purchaser should be cognizant of special rules related to the identification and transfer of property which are detailed in § 1031(a)(3).

¹⁹⁶ The developer entity can generally obtain more beneficial financing terms from the related party than it could from another lender, but this occasionally leads to reclassification problems. *See* I.R.C. § 351.

¹⁹⁷ *Id.*; *see also* § 385(b).

¹⁹⁸ The 9th Circuit goes beyond this analysis and enumerates eleven factors. *Bauer v. Comm’r*, 748 F.2d 1365, 1368 (9th Cir. 1984) (this decision has been cited with approval in nearly every circuit).

¹⁹⁹ I.R.C. § 385(b)(1)-(2). The I.R.S. looks at whether there is a written unconditional promise to pay a determinable sum on demand, or on a specified date. The note should also include a reasonable rate of interest and should not be subordinate to other indebtedness to any significant extent.

²⁰⁰ I.R.C. § 385(b)(3)-(4). The I.R.S. considers whether the debtor has inadequate capital, the debtor’s ability to obtain outside financing, and whether the debt is convertible.

²⁰¹ I.R.C. § 385(b)(5). The I.R.S. considers the relationship between the parties and whether the obligation to pay is contingent.

A sale-leaseback transaction may be beneficial when the partnership finds it advantageous to liquidate the investment and then lease the property back so that they may develop it or lease it to a third party.²⁰² Again, these transactions may be reclassified if suspect. Generally, the court will choose to classify the transaction either as an actual sale,²⁰³ a financing transaction,²⁰⁴ or an exchange.²⁰⁵ The ultimate decision is dependent upon a large number of factors.

VI. Conclusion

Real estate investment partnerships, typically organized as an LLC, offer tremendous tax benefits by preserving capital gains. Though numerous pitfalls await the unwary investor, the Fifth Circuit's framework provides attorneys with an excellent guide for structuring these transactions to preserve capital gains. Fortunately, application of the Fifth Circuit's framework is not limited to that jurisdiction,²⁰⁶ and the elements of that framework are broad enough to afford investors the freedom to structure these transactions in many ways. The partnership itself, as a flow-through entity, provides the flexibility required to make these investments. Furthermore, the ease of organization, though perhaps not the ease of record keeping, makes the partnership and LLC a natural choice for real estate investments.

²⁰² This transaction may be used to obtain cash in exchange for the property and will generally yield more cash than a bank would be willing to loan against the property. Thus, the question arises as to whether this transaction should be classified as a sale or a loan. Further, this transaction may secure capital gains status for one year when the partnership's subsequent activity would likely convert the gain to ordinary income.

²⁰³ See generally *Leslie Co. v. Comm'r*, 64 T.C. 247 (1975), *aff'd* 539 F.2d 943 (3rd Cir. 1976), *nonacq.* at 1978-2 C.B. 3 (I.R.S. 1978).

²⁰⁴ *Ill. Power Co. v. Comm'r*, 87 T.C. 1417 (1986), *acq.* 1990-2 C.B. 1.

²⁰⁵ See *supra* note 193; Rev. Rul. 60-43, 1960-1 C.B. 687.

²⁰⁶ Though the framework is binding precedent only in the 5th Circuit, it has been applied in one form or another in nearly every U.S. jurisdiction.