

BUILDER TWENTY

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Preserving Capital Gains

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- The profit on the sale of a homebuilder's inventory of homes, or a developer's inventory of developed lots, is usually treated as ordinary income for tax purposes and is thus subject to ordinary income tax rates.
- The highest ordinary income tax rate (35% federal) is much higher than the highest long-term capital gains rate (15% federal).
- Land held for investment is a capital asset, and if held for more than 1 year prior to sale, should qualify for the long-term capital gains rate.
- This discussion focuses on how real estate activities can be structured to maximize the amount of profits that may be properly reported as long-term capital gains.

How to Maximize Profits by Structuring Tax Efficient Real Estate Transactions

Investors may realize substantial tax savings upon sale of real estate if they can categorize their profits as capital gain as opposed to ordinary income. The tax rate for ordinary income is substantially higher than long-term capital gain rate. While land held for investment is a capital asset, a homebuilder's inventory of homes, or a developer's inventory of developed lots does not qualify as capital assets. Therefore, the profits resulting from their sale is subject to ordinary income tax rates.

Real estate investors may also take advantage of the very advantageous treatment of Section 1031 of the tax code if they exchange their property for another piece of real estate.

This discussion focuses on how real estate activities can be structured to maximize the amount of profits that may be properly reported as long-term capital gains, or defer taxation altogether under Section 1031.

Indirect Acquisition and Development of Real Estate

The tax code denies capital asset status to "property held by the taxpayer primarily for sale to customers in the ordinary course of [taxpayer's] trade or business." As applied to real estate, the most troublesome and extensively litigated problem is the proper classification of real estate that is being subdivided by a taxpayer who did not acquire it with this in mind. The courts usually consider a number of factors in determining whether to accord capital asset status to a particular piece of real estate. The most frequently mentioned are the following:

1. Purpose of the acquisition
2. Number and regularity of sales
3. Subdividing and Improvements
4. Sales Effort
5. Relation of Activity to Taxpayer's Primary Occupation
6. Purpose at Time of Sale

The following factors are also mentioned by the courts but are not as important as the abovementioned ones:

7. Use of sales proceeds to replace the property. Replenishing a stock of goods is characteristic of merchants.
8. Duration of ownership. The assumption is that short term ownership is more characteristic of merchants than investors.
9. The reason for the sale, especially if this demonstrates a change in the purpose for which the property was held.

10. Prepurchase investigation or other activity regarding a property's potential for development, which may evidence that it was acquired for resale in the ordinary course of business.

Having these factors in mind, a real estate investor who wishes to qualify for capital gains tax rate may proceed as follows:

To begin with, the investor forms Investment Company, LLC which acquires the land. (See Diagram 1)

Next, the investor and an unrelated party form the Development Corporation. In this example, the investor owns 80% of the shares of the Corporation and the unrelated investor owns the remaining 20%. (See Diagram 2)

Finally, Investment Company, LLC sells the land to Development Corporation. In order for Investment Corporation to realize long-term capital gain the land must have been held for more than one year. Alternatively, Development Corporation may lease the land with purchase option exercisable after 1 year. Development Corporation can sell the land to a 3rd party builder or to a builder affiliate of Investor. (See Diagram 3) This latter sale generates ordinary income because as mentioned above a developer's inventory of developed lots does not qualify as capital assets.

On the following page marked "Illustration" compare the first two scenarios. In the first scenario the profits from the sale of the land is taxed at the higher ordinary income rate. In the second scenario the sale by Investment LLC is taxed at the capital gains rate, while the sale by Development Corporation is taxed at the higher ordinary income rate. This results in overall higher tax savings.

If Investment Company, LLC decides to continue its investment activities by acquiring another piece of real estate instead of selling the land and receiving cash, it may qualify for favorable treatment under Section 1031 of the tax code. The requirements of Section 1031 are explained below.

Like Kind Exchanges (Section 1031)

Summary

Gains or losses realized on the sale or exchange of property must generally be recognized. Under Section 1031 of the tax code, however, no gain or loss is recognized when property held for productive use in a trade or business or for investment is exchanged solely for property of "like kind" to be held for productive use in a trade or business or for investment.

Requirements

A. Taxpayer's Intent Requirement

To begin with in order to qualify for Section 1031 treatment, the property must be held by taxpayer for “productive use in a trade or business or for investment”. Thus if the property is held “primarily for sale” the transaction does not qualify for 1031. (see the factors considered by courts and discussed above.)

B. The Like Kind Requirement

“Like kind” refers to the nature or character of property, not its grade or quality. As applied to real estate, “like kind” is defined very broadly. For example, whether real estate is improved or unimproved is immaterial for Section 1031 purposes. Other examples include the following exchanges: city real estate for a ranch or farm, 30-year leasehold in real estate for real estate, a leasehold in a building for a sublease in another part of the building and golf club property for property subject to 99-year condominium leases.

C. The Holding Requirement

Section 1031 requires that the property exchanged be property “held for productive use in a trade or business or for investment” and that the property acquired be property “to be held either for productive use in a trade or business or for investment.” Thus, the exchange of a rental house for a house to be used as the taxpayer’s personal residence does not satisfy the “to be held” requirement. However, the applicability of Section 1031 to one party to an exchange does not depend on its applicability to other parties. For example, if Smith exchanges a rental house for Jones’ personal residence, which Smith will hold as a rental house, Section 1031 is applicable to Smith even though it cannot apply to Jones.

Section 1031 imposes a two-year holding period on exchanges between related parties. Specific holding periods are not otherwise required. In addition, Section 1031 requires that the exchange either be simultaneous or the taxpayer identify replacement property within 45 days of the transfer of the relinquished property and to receive the replacement property no later than 180 days after the transfer or the due date of the taxpayer’s tax return for the year of the transfer, whichever is earlier.

D. “Solely” for Like Kind Property

Section 1031 would be of little utility if qualifying exchanges could consist only of like kind properties of equal value. The properties are almost invariably unequal in value and at least one of the parties will have to transfer cash or non-like kind property (“boot”) to even up the exchange. The party giving, but not receiving, cash or other nonqualifying property, remains within the language of Section 1031, since he receives solely like kind property for the property he gives up. The party receiving cash or other

nonqualifying property, on the other hand, is not receiving “solely” like kind property. The statute, however, does not disqualify this exchange, but requires recognition of gain on the like kind property to the extent of the boot received. Recognition of loss on like kind property, however, is prohibited.

Treatment of Liabilities

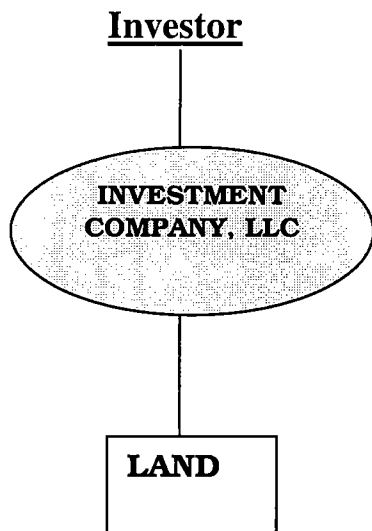
It is common for one or more of the properties in a like kind exchange to be transferred subject to a liability, or for one party to the exchange to assume a liability of another party. Such liability relief is treated under Section 1031 as money received by the taxpayer relieved of the liability. So if Taxpayer A transfers land worth \$50,000 but subject to a mortgage of \$10,000, to Taxpayer B in return for land worth \$40,000, Taxpayer A is treated as having received \$10,000 in cash. If both properties are encumbered only the net liability relief constitutes money received.

Three Way Exchanges

It is often the case that an exchange cannot be effected with just two parties. Consider the following example: Amy is interested in disposing of her ranch and acquiring a farm owned by Claire. Because there is considerable gain inherent in Amy’s property, she would prefer to exchange her ranch for Claire’s farm. Unfortunately, Claire is not interested in exchange but wants cash. Meanwhile, Brendan offers to purchase Amy’s ranch for cash. Instead of accepting Brendan’s offer, Amy proposes that Brendan purchase Claire’s farm and then exchange that farm for Amy’s ranch. This three-way exchange qualifies for Section 1031 treatment.

Another example of this three-way exchange is illustrated in Diagrams 5 & 6. Here Investor owns a piece of undeveloped land. Investor wants to develop the land and dispose of it without paying the taxes on the profits immediately. To begin with, Investor Affiliate and Bank Affiliate form Land Development Partnership “LDP”. Next, LDP and Investor sign a master ground lease with purchase option. LDP develops the property. Later, Investor transfers the property to Qualified Intermediary (QI). LDP decides to exercise its purchase option by acquiring the land from QI for cash. QI uses this cash to purchase the Replacement Property and later transfers the Replacement Property to Investor. Note that the identification and receipt of the Replacement Property must be accomplished within the time period specified by Section 1031.

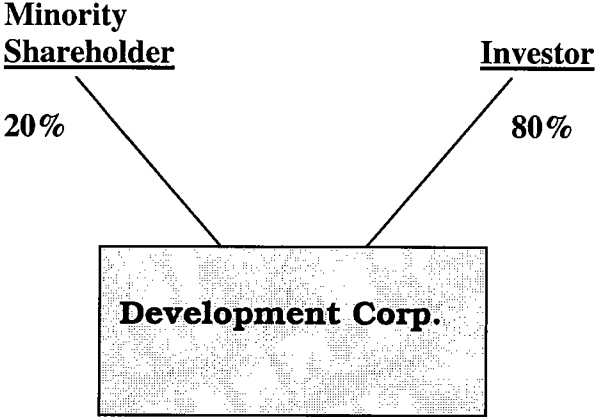
Purchase and Hold Land through an Investment Company



- Investor forms Investment Company, LLC. The LLC is a limited liability company for state law purposes, but is a partnership for federal income tax purposes.
- Investment Company, LLC acquires the Land.
- For ease of illustration, only one member is shown - there must be more than one member for the LLC to be taxed as a partnership for income tax purposes.

DIAGRAM 1

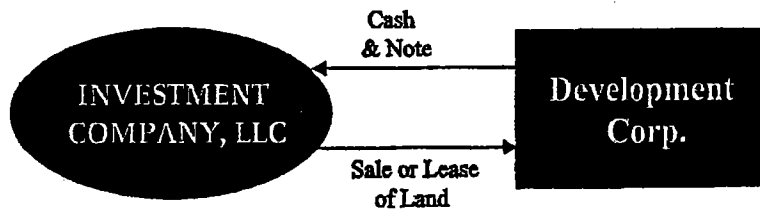
Form Separate Development Company



- Development Corp. is formed as a new, separate corporation.
- A corporation, rather than an LLC or partnership, is often used because of certain tax restrictions on transactions between related partnerships.
- Development Corp. is owned 80% by Investor and 20% by an unrelated party.

DIAGRAM 2

Sell/Lease Land to Development Corp.



- Before any "dirt work" begins, Investment Company, LLC sells the Land to Development Corp.
- If the Land has not been held for more than 1 year, the LLC might lease the Land to Development Corp. with a purchase option exercisable after 1 year.
- Development Corp. acquires the Land in exchange for cash, plus a note.
- Development Corp. can sell the developed Land to a third party builder or to a builder affiliate of investor.

DIAGRAM 3

Illustration

Assumptions:

200 Lots	
Initial Land Purchase Price/lot:	\$25,000
Development Costs/lot:	\$40,000
FMV Developed Land/lot in 12 months:	\$85,000
Purchase Price Negotiated	
With Investment Company, LLC:	\$40,000

SCENARIO 1	
<u>All Ordinary Income</u>	
Sale Proceeds:	\$17,000,000
Costs:	\$13,000,000
Profits:	\$4,000,000
Tax (35%):	(\$1,400,000)
Total After-Tax Profit:	\$2,600,000

SCENARIO 2		
<u>Some Capital Gain</u>		
	<u>INVESTMENT LLC</u>	<u>DEVELOP. CORP.</u>
Sale Proceeds:	\$8,000,000	\$17,000,000
Costs:	\$5,000,000	\$16,000,000 *
Profits:	\$3,000,000	\$1,000,000
Tax (15%/35%):	(\$450,000)	(\$350,000)
After-Tax Profit:	\$2,550,000	\$650,000
Total After-Tax Profit:	\$3,220,000	
*Costs include \$40,000/lot price paid to Investment LLC + \$40,000/lot development costs (total \$80K/lot)		

SCENARIO 3		
<u>Like Kind Exchange Tax Deferral</u>		
	<u>INVESTMENT LLC</u>	<u>DEVELOP. CORP.</u>
Sale Proceeds:	\$8,000,000	\$17,000,000
Costs:	\$5,000,000	\$16,000,000
Profits:	\$3,000,000	\$1,000,000
Tax (15%/35%):	(0)**	(\$350,000)
After-Tax Profit:	\$3,000,000	\$650,000
Total After-Tax Profit:	\$3,650,000	
** Zero current tax is attributable to the tax deferral from a like kind exchange.		

Leasehold Development Diagram

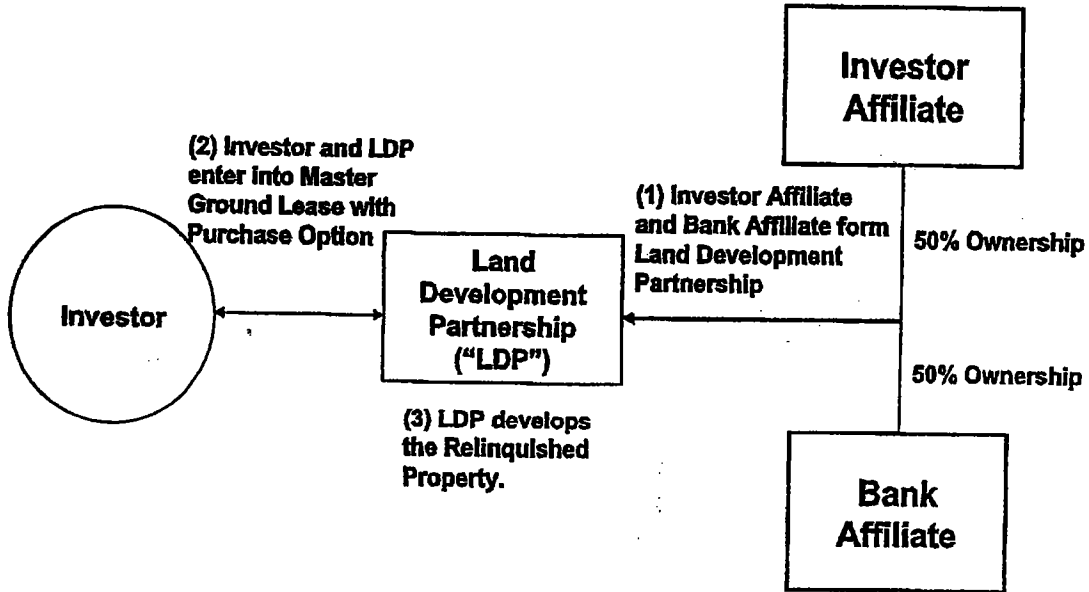


DIAGRAM 4

Leasehold Development Diagram

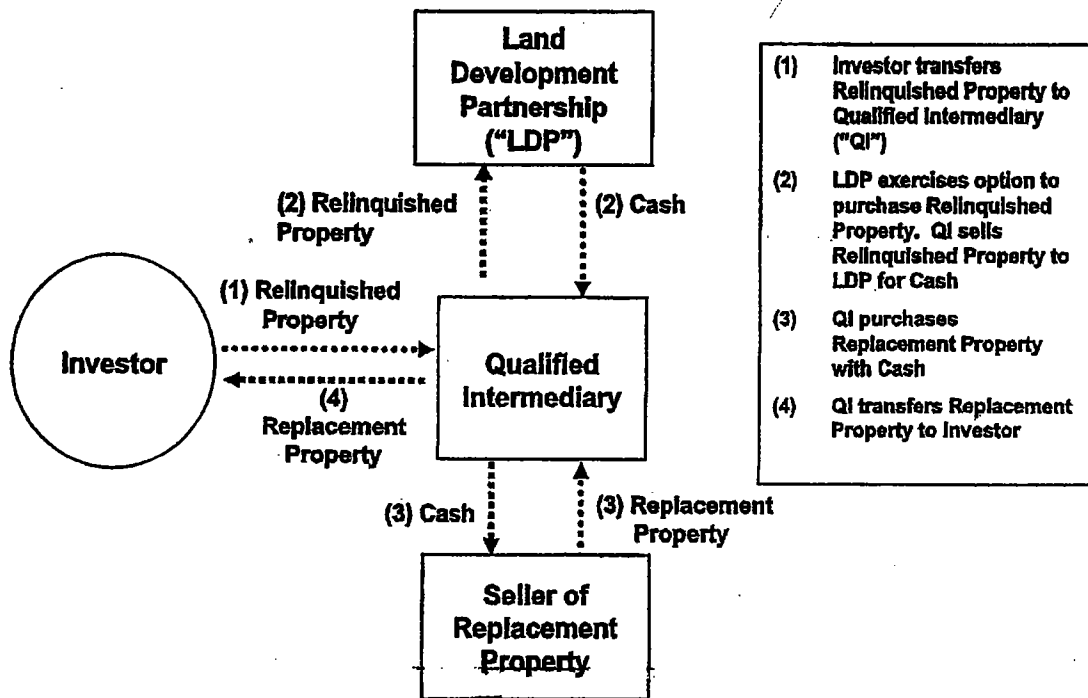


DIAGRAM 5



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