TAX AND ASSET PROTECTION PLANNING FOR REAL ESTATE DEVELOPERS AND INVESTORS

THE NEW ENGLAND GRADUATE ACCOUNTING STUDIES CONFERENCE, INC.

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Moore works with individuals, businesses and their tax professionals to develop strategic plans that achieve maximum tax advantage. Moore’s extensive experience in capital gains planning, 1031 exchanges, tax planning for real estate developers, and estate tax minimization translates to substantial and significant savings for his clients. As an acknowledged expert in the practice of 1031 exchanges, Moore is a frequently requested speaker on the topic and has been retained as an expert witness on many occasions.

Moore is equally adept at developing effective asset protection plans. Moore works with individuals and businesses of all sizes to identify all current and potential risks, and then put into place the legal safeguard that matches the problem. This tailored approach ensures that an adequate level of protection is put into place and that all assets are effectively protected.

Moreover, he was honored by the Rhode Island Society of CPAs with the KPMG Peat Marwick award for the highest score on a composite of the Uniform CPA Examinations in Rhode Island. He has addressed the Boston Tax Institute on federal real estate tax issues, the Massachusetts Society of Public Accountants on the Massachusetts LLC Act and related tax law, and the Rhode Island Society of CPAs on the income, gift and estate tax issues surrounding business valuations, in addition to many seminars throughout the United States on 1031 exchanges.

Moore brings tremendous value to his clients by assisting them with the creation of self-directed IRAs to own investment real estate. In addition, Moore uses his influential connections to assist his clients in building wealth through life insurance products, including the sale of life insurance policies, as well as other wealth-building techniques.

Moore was also a longstanding member of the Federation of Exchange Accommodators (FEA), which is the national trade organization of section 1031 Qualified Intermediaries (QI). Moore was an active participant on the FEA Board of Directors, Executive Committee, and was elected by the FEA to serve as President, due to his dedicated leadership and extensive involvement, which is evidenced by the fact that he formed three committees within the FEA (the Small Business Resource Forum, the Affiliates Committee and the Strategic Alliances Committee)
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Introduction

A. Section 1031 provides an exception from the general rule requiring the current recognition of gain or loss realized upon the sale or exchange of property.

B. 1031 (a)(1) - no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

C. Like the other "nontaxable exchange provisions," §1031 provides an exception only from current recognition of gain realized. The realized gain is deferred until the "exchange property" is disposed of in a subsequent taxable transaction.

Statutory Requirements for Tax-Free Exchange

A. In general

1. Section 1031 provides that no gain or loss is recognized if certain qualifying property is exchanged solely for "like-kind" property. Property qualifying for nonrecognition is limited to "property held for productive use in a trade or business or for investment."

2. §1031 is not subject to election or waiver.

3. The transaction need not be tax free to both parties for §1031 to apply. An exchange may be taxable to one party and tax free to the other.

B. Relinquished Property must be held for productive use in a trade or business or for investment

1. In general

   a. Held for productive use in a trade or business

      (1) Neither the Code nor the regulations define "held for productive use in a trade or business."
(2) Qualifying property must be used in a trade or business in which the taxpayer is engaged.

b. Held for investment

(1) Neither the Code nor the regulations define "held for investment" for purposes of §1031.

(2) Unproductive real estate that is held by a nondealer for future use or future realization of the increment in value is held for investment.

(3) The test is applied at the time of the exchange without regard to the taxpayer's motive before the exchange.

2. Recent acquisitions

a. The words "held for" are a key element of the definition of property qualifying for exchange under §1031. Property acquired for an exchange is not "held for" the prescribed purpose and cannot be exchanged tax free.

b. How long one must "hold" property before an exchange is uncertain.

c. Neither section 1031 nor the regulations specify whether the original property owner's qualifying purpose flows through or is carried over to a donee or heir. The donee or heir is required to independently qualify the property before the donee or heir can exchange the property under section 1031.

C. The exchange requirement

1. In general

a. Ordinarily, a transaction constitutes an exchange if there is a reciprocal transfer of property, as distinguished from a transfer of property for money consideration only.

b. The mere intent to effectuate an exchange is not dispositive.

c. The receipt of property intended to compensate the taxpayer for his services or the use of his property will be so characterized.
2. Exchange of recently constructed property
   a. The transfer of property in exchange for property with improvements constructed according to the taxpayer's specifications may qualify as an exchange.

3. Receipt of improvements on taxpayer-owned land
   a. If improvements are constructed on property already owned by the taxpayer, the transaction is unlikely to be treated as a nontaxable exchange.

D. Relinquished Property and Replacement Property must be of like-kind

1. In general
   a. The words "like kind" refer to the nature or character of the property and not to its grade or quality. One kind or class of property may not be exchanged under §1031 for property of a different kind or class.

   b. Not all property transferred in an exchange must be like kind. Other property or money can also be transferred without taking the entire transaction outside of §1031. The receipt of money or other (non-like-kind) property causes the realized gain, if any, to be recognized to the extent of the sum of the money and the fair market value of the other property received. The transfer of both like-kind property and other property in exchange solely for like-kind property does not result in the recognition of gain to the transferor.

2. Personal property
   a. An exchange of business or investment personal property for other such personal property clearly comes within §1031.

3. Real estate
   a. The kind of real estate that can be exchanged within §1031 is extremely broad. The fact that any real estate is improved or unimproved is not material, for that fact relates only to the grade or quality and not to its kind or class.
b. Improved real estate can be exchanged for unimproved real estate. Thus, land with buildings thereon and unimproved land are like-kind property. Assets on land which are in the nature of real estate can also be exchanged for real estate.

c. Real property located in the United States and real property located outside the United States do not qualify as like-kind property. Foreign property can be exchanged for foreign property.

d. A tenants-in-common interest may be exchanged for a fee simple interest, and vice versa.

E. Replacement Property must be held for productive use in a trade or business or for investment

1. Nonrecognition under §1031 is premised on the receipt of like-kind property to be held for productive use in trade or business or for investment.

2. Holding requirement

a. An exchange of like-kind property will qualify provided the property received is "to be held for" productive use or investment, which reflects the continuity of ownership concept underlying nontaxable exchanges. How long the property received must be held by the taxpayer is uncertain.

b. Subsequent taxable sales or exchanges

(i) An immediate subsequent taxable disposition of property in a Section 1031 exchange is evidence that the property was not intended to represent a continuation of the taxpayer's investment still unliquidated.

(ii) The Code requires only that the property be acquired "to be held." The language is addressed to the taxpayer's motives at the time of the exchange. Subsequent events which alter the taxpayer's motivation should not operate to disqualify a prior completed transaction.

c. Subsequent nontaxable transactions

(i) A transaction may not qualify under §1031 if the property acquired is immediately disposed of in a subsequent nontaxable transaction, particularly if the disposition is prearranged.
(ii) The IRS will not necessarily view a transaction as outside of §1031 merely because it is prearranged or because the property received is disposed of shortly thereafter.

3. Replacement Property must be taken in the same name as held the relinquished property
   a. If the relinquished property is held in the name of one spouse, the replacement property cannot be taken in the name of both spouses. Title to the replacement property must be taken in the spouse’s name that owned the relinquished property.
   b. The IRS has ruled that title to the replacement property may be taken in the name of a single-member LLC, which is properly treated as a disregarded entity for federal tax purposes, even where title to the relinquished property was in the name of an individual taxpayer.

4. The use of the exchange proceeds to pay off existing debt on property already owned by the taxpayer does not qualify as replacement property.

F. Personal Use and Mixed Use Property

1. Property held as personal residence and for qualifying use
   a. An exchange may qualify under section 1031 where the taxpayer's property is partially a personal residence and partially qualifying property. Allocation of the value between the two types of property becomes important.
   b. That portion of the value allocation attributable to the personal residence may be eligible for gain exclusion under section 121.

2. Exchanges involving vacation homes
   a. Vacation homes may qualify as investment property if personal use in minimal or the home is also rented.
3. Converting personal residences to qualifying use
   a. A taxpayer may originally have acquired property for the purpose of constructing a principal residence. Such property may be treated as an investment property following a taxpayer's abandoning his or her original use purpose. A property previously occupied as a principal residence is converted to a qualifying use when the taxpayer abandons the personal use and thereafter holds it for rental income and appreciation in value.
   b. The residence may be exchanged after it has been rented for a sufficient period of time to establish abandonment of personal use and the holding for a qualified use. There is no bright line test for the length of time the residence must be rented out. The rental must be more than temporary.

4. Converting qualifying use to personal residence
   a. Similar issues arise when a taxpayer exchanges into land for investment or into a residence for rental income and appreciation, and subsequently converts the property to a personal residence. The subsequent conversion should not prevent the exchange from satisfying the qualifying use requirement provided the taxpayer did not have a concrete intention to convert the property to personal use at the time of the exchange.

III. Excluded Property
   A. In a §1031 exchange, realized gain is recognized to the extent of the sum of any money received and the fair market value of any "nonqualifying property."
   B. Stock in trade - property which would be included within the inventory of a dealer of that type of goods.
   C. Other property held primarily for sale
      1. Whether property is "held primarily for sale" is a question of fact.
      2. The term "primarily" has been construed to mean "principally" or "of first importance." The qualifying language of §1031 omits the phrase "to customers in the ordinary course of his trade or business" contained in both §§1221 and 1231. Thus, investment property which would entitle the taxpayer to long-term capital gains treatment upon sale may not qualify for a nontaxable exchange.
3. This exclusion from qualifying property applies to property transferred or received in an exchange. Thus, one cannot exchange or receive property held primarily for sale.

D. Stocks, bonds, notes

E. Choses in action

F. Certificates of trust or beneficial interest or other securities or evidences of indebtedness

G. Partnership interests

IV. Deferred Exchanges

A. Overview

1. The desirability of a delayed exchange (i.e., nonsimultaneous transfers) can result from several different considerations. For example, the exchangor may be unwilling, or unable, to wait until suitable exchange property can be located and acquired; the taxpayer, or the exchangor, may be unwilling, or unable, to wait until an improvement, to be financed by the exchangor, is completed on the exchange property.

2. Any property received by the taxpayer will not be treated as like-kind property if (1) "such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange," or (2) "such property is received after the earlier of (i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange," or (ii) "the due date (determined with regard to extensions) for the transferor's return . . . for the taxable year in which the transfer of the relinquished property occurs."

B. Identification and receipt requirements

1. Replacement property is treated as property which is not of a like kind to the relinquished property if the replacement property is not "identified" before the end of the "identification period," or if the identified replacement property is not received before the end of the "exchange period." The identification period and the exchange period both begin on the date the taxpayer transfers the relinquished property, but the identification period ends at midnight on the 45th day thereafter, whereas the exchange period ends at midnight on the earlier of the 180th day thereafter or the due date (including extensions) for the taxpayer's return.
for the taxable year in which the transfer of the relinquished property occurs. If the taxpayer transfers more than one relinquished property as part of the same deferred exchange and the relinquished properties are transferred on different dates, the identification period and the exchange period are determined by reference to the earliest date on which a transfer occurs.

a. The payment of earnest money deposit or other amounts with respect to the replacement property prior to the sale of the relinquished property does not cause the 45 day identification period or the 180 replacement period to begin.

2. Identification procedures

a. To properly identify replacement property, the property must be designated as replacement property in (i) a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to any person involved in the exchange other than the taxpayer or a "disqualified person" or (ii) a written agreement for the exchange of properties signed by all of the parties to the exchange before the end of the identification period. The person to whom the written identification may be sent includes the transferor of the replacement property (even if that person is a disqualified person) or any other person "involved" in the exchange (other than a disqualified person), such as an intermediary, an escrow agent, or the title company.

b. Any replacement property that is received by the taxpayer before the end of the identification period is treated as identified before the end of the identification period.

c. The replacement property must be "unambiguously described" in the written document or agreement. This requirement is generally satisfied, in the case of real property, with a legal description or street address or by a "distinguishable" name.

3. Identification of multiple properties

a. The maximum number of replacement properties that the taxpayer may identify is (a) three properties without regard to their fair market values, or (b) any number of properties as long as their aggregate fair market value as of the end of the identification period does not exceed 200% of the aggregate fair market value of all the relinquished properties as of the date the relinquished properties were transferred by the taxpayer.
b. With certain exceptions, if at the end of the identification period the taxpayer has identified more properties than permitted, the taxpayer is treated as if no replacement property had been identified. Exceptions are provided with respect to (i) replacement property received by the taxpayer before the end of the identification period, and (ii) replacement property identified before the end of the identification period and received before the end of the exchange period, but only if the taxpayer receives identified replacement property constituting at least 95% of the aggregate fair market value of all identified replacement properties. The fair market value of replacement property is determined as of the earlier of the date that the property is received by the taxpayer or the last day of the exchange period.

4. Revocation of identification

a. An identification of property as replacement property may be revoked at any time before the end of the identification period if certain formalities are followed.

5. Receipt of substantially the same property and constructed property

a. For replacement property to be treated as property that is of a like kind to the relinquished property, the taxpayer must receive the identified replacement property before the end of the exchange period, and the replacement property that is received must be substantially the same property as that which was identified as the replacement property.

C. Use of safe harbors

1. Four safe harbors are allowed which state that certain issues, such as agency and constructive receipt, will, in effect, be ignored for purposes of determining whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property.

2. Security or guarantee arrangements

3. Qualified escrow accounts and qualified trusts
4. Qualified intermediaries

a. The taxpayer's transferee may be the taxpayer's agent provided that
the transferee is a "qualified intermediary" and the taxpayer's rights
to receive money or other property from the qualified intermediary
are limited to the circumstances specified in the regulations. A
qualified intermediary is a person who is not the taxpayer or a
"disqualified person" and enters into an agreement ("exchange
agreement") with the taxpayer, and as required by the exchange
agreement, acquires the relinquished property from the taxpayer,
transfers the relinquished property, acquires the replacement
property, and transfers the replacement property to the taxpayer.

5. Growth factor

a. A taxpayer is permitted to receive interest or a growth factor with
respect to the deferred exchange, provided the taxpayer's rights to
receive such interest or growth factor are expressly limited to
certain circumstances specified in the regulations. A taxpayer is
treated as being entitled to receive interest or a growth factor if the
amount of money or property the taxpayer is entitled to receive
depends on the length of time elapsed between the transfer of the
relinquished property and receipt of the replacement property.

6. Additional restrictions

a. For purposes of the qualified intermediary safe harbor, a taxpayer
must not have the right to receive, pledge, borrow, or otherwise
obtain the benefits of money or property until:

(i) if the taxpayer has not identified replacement property
before the end of the identification period, after the end of
the identification period;

(ii) if the taxpayer identifies replacement property, after the
taxpayer has received all of the identified replacement
property to which the taxpayer is entitled;

(iii) if the taxpayer identifies replacement property, after the
later of the end of the identification period and the
occurrence of a material and substantial contingency that -

(A) relates to the deferred exchange
(B) is provided for in writing, and

(C) is beyond the control of the taxpayer or any disqualified person, or

(D) otherwise, after the end of the exchange period.

7. Disqualified person

a. The qualified intermediary must not be a "disqualified person." A person is a disqualified person if:

   (i) The person is the agent of the taxpayer at the time of the transaction

   (ii) The person and the taxpayer bear a relationship described in either §267(b) or §707(b) (determined by substituting in each section "10%" for "50%" each place it appears).

   (iii) The person and a person described above in (1) bear a relationship described in either §267(b) or §707(b) (determined by substituting in each section "10%" for "50%" each place it appears)

   (iv) Persons who acted as the taxpayer's employee, attorney, accountant or real estate agent or broker during the two-year period immediately preceding the taxpayer's transfer of the first relinquished property are treated as agents of the taxpayer at the time of the transaction. Performance of the following services for the taxpayer are not taken into account in determining whether a person is the taxpayer's agent: (1) services for the taxpayer with respect to exchanges intended to qualify under §1031; and (2) routine financial, title insurance, escrow or trust services performed for the taxpayer by a financial institution, title insurance company or escrow company.

D. Death of Taxpayer during exchange period

1. If a taxpayer dies during the exchange period, the taxpayer's estate or trustee may complete the exchange. The deceased taxpayer's estate defers the tax and also receives a stepped up basis in the replacement property. If the exchange is not completed with the acquisition of replacement
property by the personal representative or testamentary trust of the taxpayer, the disposition of the relinquished property would be taxable to either the taxpayer on his final income tax return, or to the estate or testamentary trust as income with respect to a decedent.

V. **Boot**

A. If an exchange would be within the provisions of §1031(a) but for the fact that the property received consists of qualifying property and other property or money, the gain, if any, to the recipient is recognized to the extent of the sum of the money and the fair market value of the other property received. This "money or other property" is commonly called "boot," and includes liabilities assumed or attaching to property received in an exchange. "Other property" is either property specifically excluded (stock or trade, stock, etc.) or property which is not of like-kind with property given in the exchange.

B. Giving boot

1. Giving "boot" or nonqualifying property along with qualifying property in an exchange will not take the transaction out of §1031.

C. Receiving boot

1. If the taxpayer receives nonqualifying property in addition to qualifying property, the gain, if any, is recognized to the extent of the sum of the money and the fair market value of the other property received.

2. The amount of any of the taxpayer's liabilities assumed in the exchange or the amount of any liabilities attaching to the property transferred by the taxpayer is treated as money received by the taxpayer in the exchange.

3. Netting boot and refinancing

   a. If each party to an exchange either assumes a liability of the other party or acquires property subject to a liability, then, in determining the amount of money received, consideration given in the form of an assumption of liabilities or a receipt of property subject to a liability is netted against consideration received in the form of an assumption of liabilities or a transfer subject to a liability.
b. Application of netting rules

(1) Consideration given in the form of cash or other property is netted against consideration received in the form of an assumption of a liability or a transfer of property subject to a liability. Consideration received in the form of cash or other property is not, however, netted against consideration given in the form of an assumption of liabilities or a receipt of property subject to a liability.

4. Summary of the boot offset rules

a. Liabilities assumed by the taxpayer in the exchange offset liability relief of the taxpayer in the exchange. This rule applies in a deferred exchange even though the liability relief occurs days or months before the new liability is incurred.

b. Cash paid by the taxpayer in the exchange offsets liability relief of the taxpayer in the exchange.

c. Cash paid by the taxpayer in some circumstances offsets cash received by the taxpayer. In a deferred exchange, the regulations take the position that cash received by the taxpayer during the exchange period may not be offset by cash subsequently paid by the taxpayer for the acquisition of the replacement property.

d. Cash received by the taxpayer does not offset debt incurred by the taxpayer. The taxpayer cannot take cash out of the exchange at the closing by incurring a liability on the replacement property greater than the liability on the relinquished property.

VI. Basis

A. The basis of property received in an exchange qualifying under §1031 is the basis of the property surrendered increased by any additional consideration given, decreased by the amount of any money received, and increased by any gain or decreased by any loss recognized on the exchange.

VII. Holding Periods

A. The holding period of property acquired in a §1031 exchange includes the holding period of the qualifying property transferred, provided that (i) the property transferred was either a capital asset or §1231 property and (ii) the basis of the property acquired is determined in whole or in part by the basis of the property exchanged. If the property acquired does not fall within these provisions, the holding period commences on the date of the exchange.
VIII. Related Party Exchanges

A. Taxpayers who directly or indirectly exchange property with a related party must hold the exchanged property for at least two years after the exchange in order for the exchange to qualify for nonrecognition treatment.

B. If either party to the exchange disposes of its replacement property in the two-year period, the gain or loss deferred on the original exchange will be taken into account on the date that the disqualifying disposition occurs. A disqualifying disposition does not include dispositions by reason of the death of either party, the compulsory or involuntary conversion of the exchanged property, or any disposition if neither the disposition nor the exchange had as one of its principal purposes the avoidance of federal income tax.

C. Related persons are defined by reference to IRC section 267(b) and 707(b)(1).

D. Further Restrictions on Exchanges Between Related Parties; Basis Shifting

1. Even where the general rules applicable to direct exchanges between related parties are satisfied, an indirect exchange of like-kind property between related parties may not qualify under §1031, especially where a shifting of basis occurs.

IX. Reverse Exchanges

A. A taxpayer occasionally must acquire a replacement property before the disposition of the relinquished property. The contingencies in the sale of the relinquished property may not be removed prior to the date of closing on the replacement property. Perhaps a buyer has not been found for the relinquished property. Perhaps the taxpayer must close on the replacement property or lose a substantial earnest money deposit. Perhaps the taxpayer’s financing commitment at favorable rates will expire if the replacement property fails to promptly close before the relinquished property closes. Sometimes the replacement property will require construction of improvements that will take more than 180 days to complete, so the replacement property must be acquired by an accommodator prior to the transfer of the relinquished property to, in effect, extend the 180-day replacement period.

B. If the taxpayer closes on the replacement property before closing on the disposition of the relinquished property, the transaction is a reverse exchange. A reverse exchange is not authorized by IRC § 1031(a)(3), nor the Regulations, but the IRS issued Revenue Procedure 2000-37 which provides the authority for reverse exchanges.
C. Rev. Proc. 2000-37 provides that a reverse exchange will not be challenged if the taxpayer, who will be the ultimate owner of the parked property, satisfies two requirements: (i) the taxpayer enters into a written Qualified Exchange Accommodation Arrangement ("QEAA"), and (ii) the taxpayer engages the services of an exchange accommodation titleholder ("EAT") which is typically a qualified intermediary.

X. Exchanges Involving Partnerships

A. Real estate is often held by co-owners in a partnership containing two or more partners or by co-owners as tenants in common or joint tenants.

1. Exchanges of partnership interests generally do not qualify for nonrecognition treatment under IRC § 1031. Therefore, when partners want to end their relationship, they cannot each exchange out of their partnership interests into another partnership interest or real property under IRC § 1031. Similarly, when an individual real property owner wishes to acquire property in a partnership form, he or she cannot exchange the real property interest for a partnership interest under IRC § 1031.

2. Such transactions can be structured as exchanges, however, by converting the partnership interest into a real property interest. Such structuring is not without tax risk.

XI. Exchanges Involving Undivided Fractional Interests in Real Property Under Revenue Procedure 2002-22

A. Rev. Proc. 2002-22 specifies the conditions under which the Internal Revenue Service will consider a request for a ruling that an undivided fractional interest in rental real property is not an interest in a business entity, within the meaning of Treas. Reg. § 301.7701-2(a).

XII. Financing Issues

A. If the taxpayer trades down in equity in an exchange by receiving cash at the closing of the acquisition of the replacement property, the cash will be taxable boot to the taxpayer. The cash received will be taxed even if the taxpayer offsets the trade down in equity with an increase in debt on the replacement property.

B. Placing Mortgages on Relinquished Property Prior to Exchange
1. In order to avoid the receipt of taxable boot, the taxpayer may consider taking equity out of the relinquished property by placing additional debt on the relinquished property prior to the closing of the exchange. Given the IRS’s position with respect to increasing debt prior to an exchange in order to receive tax-free cash, a cautious taxpayer will increase the debt on the relinquished property before listing the property for sale or entering into a contract to sell or exchange the property. The taxpayer can also support its tax position by having an independent business reason for the debt increase, such as some immediate need for the cash.

C. Refinancing Debt at Closing

1. Sometimes taxpayers wish to take advantage of the equity which they will have in the replacement property and, simultaneous with the closing, borrow against the equity and receive cash.

2. In order to avoid an assertion by the IRS that such additional borrowing is boot in the form of cash received as a result of the exchange, the closing documentation should reflect (i) that all of the cash from the exchange account was used to acquire the replacement property and (ii) any additional borrowings, in excess of the debt needed to acquire the replacement property, should be separately stated on a separate HUD-1 settlement sheet. Out of an abundance of precaution, the taxpayer may borrow just enough to acquire the replacement property and then subsequently borrow the additional amounts.

D. Placing Mortgages on Replacement Property After Exchange

1. Alternatively, the taxpayer could complete the exchange without increasing the debt or receiving any cash at closing, but could receive tax-free cash by placing additional debt on the replacement property after the closing of the exchange.

2. Increasing the debt on the replacement property after closing of the exchange appears less risky than doing so on the relinquished property before closing.
XIII. Improvement or Build to Suit Exchanges

A. Often, the taxpayer will want to make improvements to the replacement property and have the cost of the improvements included in the exchange value of the like-kind replacement property. The improvements may consist of repairs or remodeling of an existing building, or the construction of a new building on raw land. The construction period may be a matter of weeks for repairs, or months or years for a newly built building.

B. Improvements constructed after the taxpayer has acquired the replacement property do not qualify as like-kind replacement property.

C. If the exchange value of relinquished property is less than completed value of the replacement property, the replacement property may be conveyed to taxpayer when enough construction has occurred to cover the relinquished property exchange value. With real property, the improvements do not need to be completed for a valid exchange. The partially completed improvements are like kind to the relinquished property.
SECTION 1031 EXCHANGES: UPDATES

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A. PLR 201408019

The IRS considered an IRC Section 1031 Exchange in which the taxpayer sought to exchange a fee interest in improved real estate for a long-term land lease and improvements. The taxpayer transferred the relinquished property through an unrelated qualified intermediary (QI). The replacement property constituted improvements constructed by an EAT on land leased by the EAT from a party related to the taxpayer, as well as the lease itself. The lease term exceeded 30 years. Notwithstanding the related-party 1031 Exchange rules and the general prohibition against acquiring property the taxpayer already “owns” in a 1031 Exchange, the IRS ruled that the transaction qualified as a 1031 Exchange because (1) the taxpayer was exchanging property with the QI, who was not related to the taxpayer, (2) neither the taxpayer nor the related entity would be “cashing out,” and (3) the taxpayer did not own the replacement property prior to the exchange.

B. PLR 201416006

IRS ruled that the taxpayer successfully consummating the reverse like-kind exchange could defer tax under Code Sec. 1031, even though it and two related parties entered into separate qualified exchange accommodation arrangements for “parking” the same property held by an exchange accommodation titleholder (i.e., the same swap facilitator). The IRS ruled that the taxpayer's arrangement to acquire the property in whole or in part constitutes a QEAA, as defined in Rev. Proc. 2000-37, separate and distinct from the QEAs entered into by the related parties, with separate application of the identification rules of § 1.1031(k)-1(c)(4).

C. PLR 201332010

For purposes of qualifying for nonrecognition treatment under Code Sec. 1031, IRS ruled that an exchange accommodation titleholder (EAT) wasn't a disqualified person as a result of providing services for the exchanges related to State-provided incentives for trade-ins.

D. CCA 201325011

IRS concluded that a taxpayer's exchange qualified as a like-kind exchange under Code Sec. 1031, and that the taxpayer didn't have actual or constructive receipt of the relinquished property (RQ) sales proceeds under Reg. § 1.1031(k)-1. In the exchange, the RQ was security for lines of credit used to purchase the RQ and for general business
operations, and the taxpayer's qualified intermediary (QI) had to use the proceeds to pay down amounts that the taxpayer owed on the lines of credit.


The IRS added Section 1031(f) to its no-rule list in Rev. Proc. 2014-3. In particular, the IRS will not rule on whether an exchange described in Section 1031(f) involving related parties, or a subsequent disposition of property involved in the exchange, has as one of its principal purposes the avoidance of Federal income tax, or is part of a transaction (or series of transactions) structured to avoid the purposes of Section 1031(f). The ruling notes two exceptions: (i) a transaction involving an exchange of undivided interests in different properties that results in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of the properties or (ii) a disposition of property in a nonrecognition transaction.

F. Recent Legislative Proposals to Repeal or Limit Section 1031

President Obama’s 2015 budget proposes capping deferred gains for real estate under Section 1031 to $1 million per taxpayer per year (adjusted for inflation). In February, Republican House Ways & Means Committee Chairman Dave Camp of Michigan released a discussion draft of his Comprehensive Tax Reform Proposal, which proposes repealing Section 1031 in its entirety. These proposals are similar to the proposed repeal of Section 1031 by Democratic Senator Max Baucus last year.

G. North Central Rental & Leasing, LLC v. United States, 112 AFTR 2d 2013-7045 (DC ND), (September 3, 2013)

Magistrate judge determined that equipment leasing LLC/taxpayer wasn't entitled to Code Sec. 1031 nonrecognition treatment for gains on multiple exchanges involving qualified intermediary which sold properties to customers and used sales proceeds to purchase like-kind replacement properties from related party/taxpayer's parent co., which then had 6 months unfettered use of proceeds until it had to pay seller from whom it purchased properties: overall evidence showed that exchanges were part of series of transactions structured to circumvent Code Sec. 1031(f) restrictions and avoid tax. Notably, exchanges allowed taxpayer and related party to cash out of their investments in low-basis properties and immediately reap significant tax savings. Moreover, transactions' structure was unnecessarily complex and served no real non-tax purpose

H. Deseret Management Corp. v. United States, 112 AFTR 2d 2013-5530 (Ct Fed Cl) (August 22, 2013)

Holding corp.'s refund claim that, for Code Sec. 1031 computation purposes, agreed value of country radio station swapped in like-kind exchange didn't include any significant goodwill was upheld. While taxpayer was incorrect in arguing for bright line, per se rule that licensed radio station could never have goodwill, and although fact that station was underperforming wouldn't in itself necessarily mean lack of goodwill, record
ultimately showed that even though there was some goodwill, such was negligible, either because that was all station possessed or because nothing of value was exchanged for same. Gov't.'s contrary position, based on flawed valuation of license and corresponding goodwill computations, failed in face of fact that as adjusted, those computations resulted in goodwill value which collapsed to zero or below. While it wasn't govt.'s burden to prove goodwill's value, since it did embrace method of valuing same, it couldn't then “avoid results produced by that method when they turn[ed] negative.”

I. VIP's Industries Inc. & Subs., TC Memo 2013-157 (June 24, 2013)

Hotel/hospitality/real estate corp. was denied like-kind exchange treatment for exchange of leasehold interest in motel property, with term of 21 years and 4 months, for fee interest in 2 properties containing motel and office building: following earlier case law, and without deciding whether Reg § 1.1031(a)-1(c) mechanically excludes all exchanges of leaseholds with terms of less than 30 years for fee interests from receiving like-kind exchange treatment, Tax Court found that leasehold involved here was short-term property interest akin to other leasehold interests which had previously been found to be not equivalent to fee interests for Code Sec. 1031 purposes. Taxpayer's argument, that even if leasehold itself wasn't like-kind, motel improvements that had been made thereon were, was belied by lack of proof that improvements constituted majority of property's value and otherwise failed since taxpayer's interest therein would still be considered short-term and not equivalent to fee interests for Code Sec. 1031 purposes.
SELF-DIRECTED IRAS

June 18, 2014

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A History of Retirement Savings Programs

- Retirement Savings Programs
  - Prior to 1935 - Personal savings
  - Social Security created in 1935
    - Never intended as sole source of retirement income
  - Congress created Employee Retirement Income Security Act (ERISA) in 1974
    - Created IRAs to supplement Social Security

How Are Self-Directed IRAs “Born”? 

Self-Directed IRAs
- Traditional IRA
- Roth IRA
- SEP IRA
- Solo(k)

- 401(k)s
- 403(b)s
- 457 Plans
- Keogh Plans
- SEPs
- Profit Sharing Plans
- Traditional IRAs/Roths
- Defined Benefit Plans
Recent Changes Affecting IRAs

• See Attached Outline

What Can a Self-Directed IRA Invest In?

• The IRS via Publication 590 only specifies what an individual CANNOT invest in (which assets are excluded or prohibited)

• What An Individual Cannot Invest in:
  – Collectibles
  – Life Insurance
  – Stock of a Sub-chapter “S” corporation
A Word About IRA Custodians

- IRS Code 408-n defines who can offer IRA services, roles and responsibilities:
  - Banks
  - Insured credit union
  - Corporation supervised by Commissioner of Banking
  - Brokerage firm
  - Non-bank Trustees (meeting IRS requirements)

Analysis of the Market Place

Baby-Boomers – Rollovers and Transfers

- Devastation to savings over past 11 yrs.
  - 2001 – Enron, Arthur Anderson, 9-11
  - 2008 – Collapse of US Banking System & Capital Markets
- Living a longer life span
- Aggressive need and desire to recover from previous losses
National Media Has Discovered Self Directed IRAs

- Wall Street Journal
- Kiplinger
- Forbes
- Fortune Magazine
- Motley Fool
- Time Magazine
- Barron’s
- CNBC Power Lunch – TV Program

So Let’s Get Started

Section 1:

- Disqualified Persons

- Prohibited Transactions and

- Plan Asset Rules
Government Regulations

~ Be aware of IRS and Department of Labor regulations dealing with ~
- IRA: IRS Code 590
- Prohibited transactions: IRS Code 4975
- Disqualified persons: IRS Code 4975
- Linked transactions: IRS Code 4975
- Self dealing: IRS Code 4975
- UDFI/UBT: IRS Code 593
- Enabling: DOL 2000-10A
- Self-Dealing: DOL 2004-8
- Loans to IRA: DOL PTE 80-25
- Loans to Charities: DOL PLR 200741016

~ Tax Court Cases ~
- Swanson, 1997
- Rollins, 2004
- Rousey v. Jaconow, 2005
- Andris, 2002
- Woodard, 2009

~ Bankruptcy ~
- In re Chilton, 2010
- In re Willis, 2009

~ IRS News Release ~
- IR 2010-32

~ Private Letter Ruling ~
- 201015039

~ IRS Memorandum ~
- ROBS Memo, 2008

Disqualified Persons

- A member of the family including spouse, ancestor, lineal descendant and any spouse of a lineal descendant

Diagram:
- Grandparents
- Step Grandparents
- Aunts, Uncles, Cousins
- Parents
- Step Parents
- Siblings
- IRA Owner
- Spouse
- Spouse's Parents
- Children
- Spouse
- Grandchildren
- Spouse
Disqualified Persons

- A fiduciary
- A person providing services to the plan
- An employer any of whose employees are covered by the plan
- An employee organization any of whose members are covered by the plan
- An owner, direct or indirect of 50 percent or more of:
  - The combined voting power of all classes of stock entitled to vote or the total value of share of all classes of stock of a corporation
  - The capital interest or the profits interest of a partnership
  - The beneficial interest of a trust or unincorporated enterprise which is an employer or an employee organization
- An officer, director, 10% or more shareholder, or a highly compensated employee of a company with whom the IRA owner has a business relationship.

Prohibited Transactions

- Sale or exchange or leasing of any property between a plan and a disqualified person
- Lending of money or other extension of credit between a plan and a disqualified person
- Furnishing of goods, services or facilities between a plan and a disqualified person
- Transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan
- Act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interests or for his own account
- Receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan
Personal Use Examples (PROHIBITED)

- Buying a vacation home for your family
- Putting a new roof on yourself
- Hunting on your IRA land
- Lot on Private lake co-owned by an IRA

Self-Dealing

IRA owner cannot buy an asset from him or herself or any other disqualified person such as a person of ascending or descending lineage, including the husband or wife of a descendant.

For Example:
Individual cannot use IRA funds to pay off a personal mortgage. There should be no perceived direct or indirect personal benefit to the account owner.
Enabling Rules

You cannot perform a transaction with your IRA which is deemed necessary to enable a transaction that also involves yourself and/or other disqualified parties.

For Example:

If you CANNOT establish that you have sufficient net worth that can perform the investment without the use of the IRA, you could conflict with the co-investment rules. Co-invest in real estate with your IRA as Tenants in Common because it is a good investment and not because you need your IRA funds to complete the transaction.

(Code: DOL 2000-10A)

Using IRA as Collateral

You CANNOT use your IRA as collateral for a loan (e.g., you cannot guarantee a loan that is funded (collateralized) by a deposit from your IRA).

For Example:

Your IRA can leverage an investment by applying for a non-recourse loan.
Key Elements to a Prohibited Transaction

*Remember,*

A prohibited transaction requires three components:

1. Prohibited Person
2. Plan Asset
3. A Transaction between the two

Question

When is an asset an asset of “the plan” and why do we care?
Plan Asset Rules

• Department of Labor Regulations Section 2510.3-101
  – If 100% of an operating company is owned by “plan(s)” and the owner (and related parties) of the plan(s), then the entity is a “plan asset”, prohibiting transactions between the entity and the plan owner.

  – If 25% or more of an investment company is owned by “plan(s)” and the owner (and related parties) of the plan(s), then the entity is a “plan asset”, prohibiting transactions between the entity and the plan owner.

Operating Company Definition

• “[A]n entity that is primarily engaged, directly or through a majority owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital.”

• The term “operating company” includes “venture capital operating companies” and “real estate operating companies.”
Plan Assets – Options of Investing

• Direct Purchase
  
  Client instructs the custodian to purchase “X” investment within their IRA

• Investment made through Investment Vehicle
  
  Client instructs custodian to invest in private stock of LLC, LP, or a C-Corporation

  The newly-formed company then makes the desired investment

Operating Company Definition

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• The term “operating company” includes “venture capital operating companies” and “real estate operating companies.”
Investment Options: Consequences

• Direct purchase of asset by custodian on behalf of client IRA – is ALWAYS a Plan Asset

• Investing in an operating company will have different consequence, which requires greater analysis

50% RULE

If a disqualified person(s) own 50% or more collectively of an entity, then the IRAs of the disqualified persons cannot engage in transactions with the entity because the company is considered a disqualified person.

For Example:
If an you own 50% or more of an existing LLC that was a real estate operating company, you IRA would be prohibited from becoming a new member of the LLC. Your ownership must be less than 50%.
Prohibited Transaction Penalties

Loss of IRA status resulting from prohibited transaction:

- Loss of tax exempt status if not corrected within one year
- Distribution of IRA funds involved in Prohibited Transaction
  - 10% early distribution penalty if under age 59½
  - Income tax due on distributed amount
- Penalties and interest
  - 6% excise tax on amount of prohibited transaction
- Possible audit to determine extent of prohibited transactions

In Summary

- The rules and regulations are not necessarily black and white and are subject to interpretation
- Seeking tax and legal advice before making the IRA investment is always encouraged
- Tax court cases may set a precedent but are also subject to interpretation and cannot be considered as final judgment for all scenarios
- Impact of prohibited transaction can be costly
Just Remember...

- Objective of IRA investments in alternative assets
  
  GROW IRA WEALTH!

- There should be no direct or indirect personal benefit to the IRA account holder

Section 2:

Court Cases Affecting IRAs
Recent Cases Affecting IRAs

- Rollins v. Commissioner (Dkt. No. 598-03, Nov. 2004)
  - Plan asset rules
  - Simultaneous funding of an IRA investment
  - Abusive Roth transactions
- Rousey v. Jacoway (125 S. Ct. 1561 2005)
  - Bankruptcy Protection

Recent Cases Affecting IRAs

- In Re Chilton (Bankruptcy Court Texas 03/05/2010)
  - Inherited IRA
- In Re Willis (Bankruptcy Court Florida 08/06/2009)
  - Prohibited Transactions
- Ancira V. Commissioner, 119 TC 135 (2002)
  - Distribution from SD IRA
- PLR 201015039
  - Waiver of Rollover Requirement
Recent Cases Affecting IRAs

- Woodard, TC Sumary Opinion 2009-150
  - Accuracy-Related Penalties
- IRS News Release 2010-32
  - Tax Scams Involving SD IRAs
- IRS Memo (ROBS Memo), 2008
  - Rollovers as Business Start-Ups

Section 3:

Investment Structure Options
One IRA – All Cash

• One IRA buys one property, all cash

• IRA needs enough to cover purchase price, all closing costs, custodial fees, and ongoing property expenses

• Absolutely the simplest transaction

Multiple IRAs – All Cash T.I.C.

• IRAs may belong to anyone – even prohibited people (Swanson Case)

• All IRAs go on contract, and on title, as ‘tenants in common’. Unique ownership percentages must be identified and all costs and proceeds prorated correctly according to these percentages
Multiple Parties – IRAs & People
All Cash T.I.C.

• Same as multiple IRAs.
• As long as there is no loan (i.e. it is an ‘all-cash’ deal), it does not matter who the IRAs belong to, or who the people are.
• All names (IRAs and separate ‘human’ names) must be on contract, and title for unique percentages. Everything prorated accordingly.

T.I.C. Example

• Buyers:
  – ABC Trust Company, Custodian FBO John Taylor IRA, Acct. # TA321 for 28%
  – John Taylor for 32%
  – Bonnie Taylor (wife) for 30%
  – ABC Trust Company, Custodian FBO Kelly Taylor, Roth IRA, Acct. # TA322 (sister’s IRA) for 10%

(Note: Revenue & Expenses must be prorated according to ownership)
Closing Time

- Broker/title company prepare closing documents
- IRA owner initials for approval
- Originals sent to custodian for execution by the title company or broker
- Custodian signs, notarizes and returns overnight and wire balance of funds for closing
- Title company forwards recorded grant deed to Custodian

One IRA - Purchasing with Leverage

- IRA will need enough funds for:
  - 35 percent down payment (typically)
  - Mortgage payments
  - Other property expenses
When You Borrow With Your IRA

- You cannot guarantee the loan personally*
- You cannot co-invest with your IRA
- You pay a tax on any income or capital gains derived from leverage
- You can increase the returns and growth of your IRA two to three times!

* You must secure a “true non-recourse” loan

Simplicity of an all-cash IRA deal, but not enough funds?

- One Solution:
  Get the loan secured by some other property (your own home or other investment property)

For Example:
25 percent of purchase by IRA, 25 percent of personal funds and 50 percent from a personal loan (secured by other property)

Be Aware of: Enabling
Another Way to Invest in Real Estate Using an IRA

- IRA as the Lender:
- Facilitate a transaction for a buyer through a second mortgage loan from the buyer’s friend

For Example:
- San Francisco man wants to buy condo but couldn’t get loan due to FICO and down payment
- Friend’s IRA issues him a second mortgage and bank issues the first

Who wins???

Winners

- The Seller
- The realtor handling the condo
- The man buying the condo
- The bank
- The mortgage broker
- The friend’s IRA

None of the above possible without the IRA
Real Estate Purchases Funding Methods Summarized

- All cash by IRA
- All cash with IRA and personal funds
- All cash with your IRA and funds (including relatives) of others as co-tenants
- IRA as down payment (with non-recourse loan)
- Your IRA with non-prohibited parties and a non-recourse loan

The LLC

A Limited Liability Company (LLC) is often used to facilitate either:

- Transactions involving many investors
- Frequent Transactions

It, of course, also limits certain liabilities.

For Example:
- Several IRA owners use IRA funds to form an LLC
- The LLC purchases several multi-family homes
- The LLC hires a property manager to collect rent, pay bills and maintain the buildings
- Income & expenses flow in and out of the LLC
- IRA asset is shares of the LLC. LLC submits a K-1 for IRA asset valuation purposes
End Result: Some Unusual Real Estate Purchases!

- Boat slip (income and appreciation)
- Parking lot (income and appreciation)
- Storage unit (income and appreciation)
- Yacht (refurbished and sold for profit)
- Investment Property in Chile
- Roth IRA flipping in Punta Gorda, Florida

Entities An IRA Can Invest In

- As a member of an LLC
- As a stockholder in a C-Corp
- As a Limited Partner
When do entities make sense for self-directed investments?

- When there are large numbers of transactions
- When someone wishes to purchase tax liens or properties at auction
- When there is a large group of investors combining funds to make investments
- When there is a significant risk or liability associated with the investment(s)

Have a Client that Wants to Start or Run a Business?

- You can buy the corner store or own a pizza parlor on your block with your IRA
- There are an estimated 25 million small businesses in the U.S.
- 83 percent are funded with private funding from family and friends
- Self-Directed IRAs have funded thousands of new startups over the past 20 years
What Are Private Placements?

- Offerings of capital interests in entities that are not conducted through public stock exchanges
- There are federal and state securities regulations that need to be considered
  - There are rules on: How much can be raised
  - How one can solicit investors
  - What has to be disclosed

Examples

- Napa Valley B&B
- “Green” Manufacturing corporations
- Public radio station
- Biotech company (cancer drug research)
- Internet startups
- Broadway Plays
- Robotic device company
- And many more!
Examples

- Napa Valley B&B
- “Green” Manufacturing corporations
- Public radio station
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- And many more!

Submission Logistics

- Investment Sponsors Obtain copy of Private Investment Guidelines
  - Gather necessary documents
  - Complete Custodian’s Representation Letter
  - Send package to Custodian’s for review and acceptance (generally 48 hours)
  - Once investment has been accepted, your investors have less paperwork to provide
Document Vesting

What is the IRA’s name?

ABC Trust Company, Custodian FBO
‘IRA Owner’s Name’ IRA, Account # __________

What the IRA’s ‘Social Security Number’?

Custodian’s Tax ID: __________

Basic Rules of Engagement for Custodians

• Minimum cash balance at all times;
• Fee to do a wire; and
• Fee to send something FedEx.
Section 4: Investment Options: Real Estate & Leveraging

What Types Of Real Estate Can Be Put Into An IRA?

- Raw Land
- Residential
- Commercial
- Condominiums
Some Success Stories

- Client in 2007 buys real estate option contract for $10 and assigns for $175,000 profit!

- Clients wiped out in Florida by hurricane, receive 100 percent insurance payoff on the buildings, and still own land.

- Individuals place deposit on “spec” housing and flip property without buying at completion. (Pre-Construction)

The Loan Process

Non-recourse loan is made to IRA (non-person)

- IRA owner not personally liable for repayment
  - No recourse against IRA owner or owner’s other assets
- In event of default/foreclosure, property is sole source of repayment.
- Usually require 50 to 35% down, but may be higher and may require a reserve
- Loan processing timeframe usually around 45 days
- Usually a 3 to 5 year ARM
- Lender will have a list of ineligible properties
- Property typically needs to produce sufficient NOI
- Less than 5 non-recourse lenders have been identified
Refresher: When You Borrow With Your IRA

- You cannot guarantee the loan personally
- You cannot co-invest with your IRA
- You pay a tax on any income or capital gains derived from leverage
- You can increase the returns and growth of your IRA two to three times!

IRA Non-Recourse Loan Process

- Potential investment identified
- Math homework done
- Contact non-recourse lender, discuss specifics
- To proceed:
  - Open and fund self-directed IRA account
  - Continue to work with non-recourse lender
  - Offer and down payment must come from IRA funds
    - Vesting in name of custodian FBO
    - Custodian signs, on behalf of IRA, all closing documents (including loan)
Non-Recourse Lenders

- North American Savings
  Bank Lending institution since 1927
  - Issues non-recourse loans in the 50 states
    - [www.iralending.com](http://www.iralending.com)

- First Western Federal Bank
  Bank Lending institution since 1981
  - Issues non-recourse loans in 49 states
    - [www.myiralender.com](http://www.myiralender.com)

- Another Option: Seller Carry-Back

---

Leveraging an IRA Investment Within an Entity

- Example 1:
  - LLC established and funded 100% by single IRA, with an unrelated licensed professional reviewing all transactions to avoid prohibited transactions. Special Advisor Engagement & Representation Letter required.
  - LLC is asset of IRA due to 100% ownership
  - LLC (not IRA owner) seeks loan – can only be ‘non recourse’
  - IRA custodian actually executes loan document

- Example 2:
  - LLC established and funded with combination of IRA and non-IRA funds (IRA owner, disqualified persons and unrelated third parties)
  - LLC seeks ‘recourse’ loan
  - Non-IRA investor must sign and collateralize loan
You Should Know...

Whenever you use leverage on a IRA real estate investment, you are subject to Unrelated Business Income Tax (UBIT) based on Unrelated Debt Financed Income (UDFI).

Section 5: Self-Directed IRA Scenarios
• I am a mortgage broker and things are slow. I am thinking of starting a mortgage pool to take advantage of the opportunities. How can I raise capital from IRAs to fund my pool?

• I found a good deal on a local commercial property, but I don’t have enough in my own IRA to purchase it. Could I combine my IRA funds with my own personal funds and those of friends to make the purchase? Could I still get a conventional loan on the property?
• I need to execute a 1031 exchange in the next few weeks. Is it possible to use a self-directed IRA along with my 1031 exchange to afford the property I really want but cannot afford with my 1031 exchange alone?

• I want to invest more funds into my car wash business. A business broker friend of mine told me about self-directed IRAs. What do I need to know about making this work?
• My wife and I want to buy a possible retirement home in Florida. Can we purchase a condo through our IRAs together? What is the process for that?

• I am age 73, and have a Self-Directed Retirement Account that holds an apartment building. I am really nervous about my RMD this year, since my other accounts are down so much. What are my options with this investment to make the RMD?
Section 6: Wrap Up and Q&A

Thank you for joining me today
For more information, please visit us on the web at www.mclaughlinquinn.com or call (401) 421-5115.
Self-Directed IRAs: UBIT

Presented by:
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June 18, 2014

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Biography

F. Moore McLaughlin, IV, Esq., CPA

Founding Partner, McLaughlin & Quinn, LLC
Owner, All States 1031 Exchange Facilitator

- Admitted to Practice Law:
  - Rhode Island
  - Massachusetts

- CPA Licensed in Rhode Island

- Education:
  - Masters of Law in Taxation (LLM), New York University
  - JD, Pepperdine University
  - BS, cum laude, University of Texas, Dallas
You Should Know...

Whenever you use leverage on an IRA real estate investment, you are subject to Unrelated Business Income Tax (UBIT) based on Unrelated Debt Financed Income (UDFI).

The Unrelated Business Income Tax (UBIT)

- UBIT is a unique tax created by Congress to apply to tax-exempt entities; charities, churches, universities
- Prior to 1950, business income of exempt organizations was not subject to taxation
- Congress was concerned about active businesses being operated by exempt organizations and paying no tax
- Purpose of UBIT was to alleviate unfair competition by exempt organizations with taxable enterprises
Two Main Sources of UBIT... in the IRA World

Operating a Business; i.e., Fast food franchise, equipment leasing, bed and breakfast inn
(Note: Inserting a C-Corp into the investment structure solves this problem)

An IRA investing in “debt-financed” property; i.e., using leverage on a real estate purchase

UDFI – Simple Math

Income:
Rental Income $60,000

Expenses:
Depreciation $20,000
Interest $15,000
Taxes $6,000
Utilities $4,000
Misc. $5,000

Net Rental Income $10,000**

** Net Income from “Debt Financed Property” is the SAME as Regular Taxable Income if investment is outside of an IRA!!!
UDFI – Simple Math

Real Estate Cost = $500,000

Loan to IRA = $250,000

Average Acquisition Indebtedness

Average Adjusted Basis

\[ \frac{\text{Gross Income from Debt Financed Property}}{\text{Average Adjusted Basis}} \times \frac{\text{Loan to IRA}}{\text{Real Estate Cost}} \]

Unrelated Business Taxable Income = $5,000

Calculating UBIT

IRAs are Trust accounts and as such are taxed for UBIT at Trust tax rates

<table>
<thead>
<tr>
<th>2014 Trust Tax Rates</th>
<th>2014 Individual Tax Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 - $ 2,500 = 15%</td>
<td>$0 - $ 18,150 = 10%</td>
</tr>
<tr>
<td>$2,500 - $ 5,800 = 25%</td>
<td>$ 18,150 - $ 73,800 = 15%</td>
</tr>
<tr>
<td>$5,800 - $ 8,900 = 28%</td>
<td>$ 73,800 - $148,850 = 25%</td>
</tr>
<tr>
<td>$8,900 - $12,150 = 33%</td>
<td>$148,850 - $226,850 = 28%</td>
</tr>
<tr>
<td>$12,150 + = 39.6%</td>
<td>$226,850 - $405,100 = 33%</td>
</tr>
<tr>
<td></td>
<td>$405,100 - $457,600 = 35%</td>
</tr>
<tr>
<td></td>
<td>$457,600 + = 39.6%</td>
</tr>
</tbody>
</table>

* Married, Filing Jointly
Sales Analysis

Scenario:

- Hold property for 8 years
- Sell property for $550,000
- “Adj. Basis” = $350,000
- Current loan balance = $175,000
UBIT Capital Gain Calculation

**Step 1: Calc. Gain**
- Amount realized: $550,000
- Less: Adjusted basis: ($350,000)
- Gain realized: $200,000

**Step 2: UBIT on Cap. Gain**
- Average Acq. Indebtedness
- Average Adj. Basis
- Gain realized
- $175,000
- $200,000
- = $100,000 X 15% = $15,000

When is there no Capital Gains Tax?

- If on sale date, there was NO debt related to the property for last 12 months...
- No Capital Gain Tax due at all!
Let’s Compare

• Inside IRAs
  – Tax deferred growth on income and capital gains
  – No 1031 requirements on “like-kind” property and time restrictions
  – No annual tax reporting

• Outside IRA
  – Tax deferred cap gains (if 1031)
  – Tax on net income and capital gains
  – Annual reporting required

Example

This could be your IRA

– Purchase shares in a real estate LLC for $200,000 – representing 10% ownership

– LLC purchases an income property for $2,000,000 with $1,000,000 equity and $1,000,000 debt

– IRA shares bring $20,000 in net annual cash flow

– Property increases in value at 10% yearly

– LLC sells in 3 years for $2,662,000

– IRA’s gross payoff is $266,200
Time Of Sale

IRA’s Profit
$266,200 Gross Payoff
($200,000) Initial Investment
($18,634) Cost of Sale (7%)
$ 47,566 Gross profit

$47,566 Gross Profits
($ 1,000) Standard Deduction
$ 46,566 Taxable Income
$ 23,283 Subject to 15% Cap Gain (50% LTV)
$ 3,492 Capital Gains Tax
$ 44,074 Net After-Tax Profit

Cash Flow

Cash flow = $20,000 per Year

• $ 1,000 Free
• $19,000 Per year
• $ 9,500 Subject to UDFI
• $ 1,425 UDFI @ 2014 Trust Rate (15%)
• $18,575 Net After-Tax Profit
Inside vs. Outside

- Total NET PROFIT – Inside IRA
  - $44,074 From Sale
  - $55,725 From 3 Years’ Cash Flow
  - $99,799

- Total NET PROFIT – Outside IRA
  - $40,432 From Sale (15%)
  - $43,200 From Cash Flow (28%)
  - $83,632

The Bottom Line

- Outside IRA With Debt $83,632
- Inside IRA With Debt $99,799
Conclusions From Paying UBIT

- Paying some tax from an IRA usually results in less tax than paying tax from your 1040
- Make intelligent, informed, rational decisions
- Don’t let good investments pass just because your IRA might pay some UBIT

Wrap Up and Q&A
SELF-DIRECTED IRAS: UPDATES

F. MOORE McLAUGHLIN, IV, ESQ., CPA
JUNE 18, 2014

A. Ellis v. Comm'r., T.C. Memo 2013-245 (October 29, 2013)

Taxpayer/general manager of used car business/LLC, which was held 98% by IRA to which taxpayer had transferred Code Sec. 401(k) account balance, engaged in prohibited transaction under Code Sec. 4975 when he caused corp. to pay him compensation, resulting in deemed distribution and income inclusion under Code Sec. 408 and Code Sec. 72(a) of entire account balance in stated year. Argument that LLC was merely entity in which taxpayer's IRA invested and amounts LLC paid him represented its, not IRA's, income or assets was belied by facts that LLC was funded almost exclusively by IRA assets, which in turn consisted only of its ownership interest in LLC and relatively small amount of cash. In effect, LLC and IRA were substantially same entity. So, in causing LLC to pay him compensation, taxpayer, as IRA's fiduciary and beneficial shareholder of more than 50% of outstanding ownership interest in LLC, effectively engaged in transfer of plan income or assets for his own benefit in violation of Code Sec. 4975(c)(1)(D). Moreover, in authorizing and effecting such transfer, he dealt with IRA income or assets for his own account within meaning of Code Sec. 4975(c)(1)(E). However, prohibited transaction finding applied only to above and stated year and IRS's alternate determinations for subsequent year weren't upheld.

B. Lawrence F. Peek, et ux., et al., 140 T.C. 12 (May 9, 2013)

Taxpayers/attorney's and business colleague's personal guaranties of loan/note from their newly-formed corporation, stock of which was owned by taxpayers' self-directed IRAs, to a third party incident to asset purchase transaction were Code Sec. 4975 prohibited transactions where comprising indirect extensions of credit between taxpayers/disqualified persons and their IRAs. The fact that the loan guaranties didn't involve the IRAs directly was irrelevant since Code Sec. 4975 is broadly worded to include both direct and indirect loans or guaranties to IRAs, by way of the entity that the IRAs owned. Also, in light of the above finding, the IRAs ceased as of the prohibited transaction year and their assets (the corporate stock) were deemed to have been distributed to taxpayers personally, so gains on stock's subsequent sale were taxable to taxpayers individually. Although the sale occurred years after prohibited transactions and after stock had in interim been rolled over to ROTH or other IRAs, such fact was irrelevant because transactions were continuing prohibited transactions, and thus prevented subsequent accounts which held corporate stock in interim years from qualifying as IRAs.
TAX PLANNING FOR REAL ESTATE DEVELOPERS

June 18, 2014

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A. Introduction

1. Capital Gain v. Ordinary Income

   a. Rate Differential.

      i. Undeveloped Land. Given the significant difference between the highest
         marginal tax rate for individuals (39.6%) and the maximum rate for long-term
         capital gains (20%) applicable to gains recognized on the sale of exchange of
         undeveloped real property held for more than one year, owners of such
         property generally prefer to treat their gain on the sale as a capital gain rather
         than ordinary income. See Section 1.

      ii. Depreciable Real Property. Gain on the sale of depreciable real property held
          for more than one year may be subject to three different tax rates –
          depreciation recapture taxed as ordinary income at a maximum rate of 35%,
          unrecaptured Section 1250 gain taxed at a maximum rate of 25% and long-
          term capital gain taxed at a maximum rate of 15%. See Sections 1(h)(1)(D),
          (h)(6).

   b. Look-Through Capital Gain Rules.

      i. Sale of Partnership Interest. Under Section 741, the gain or loss resulting
         from the sale or exchange of a partnership interest is generally capital in
         nature. Under the look-through capital gain rules, if the selling partner held
         his partnership interest for more than a year, one of three long-term capital
         gains rates may apply – 15%, 25% (unrecaptured Section 1250 gain), 28%
         (collectables gain). See Section 1(h); Reg. § 1.1(h)-1(a).

         (a) Unrecaptured Section 1250 Gain. If a partnership (or limited liability
             company classified as a partnership for Federal tax purposes) owns
             depreciable real property, the look-through capital gain rules allocate the
             unrecaptured Section 1250 gain to the selling partner. Reg. § 1.1(h)-
             1(b)(3)(ii).

         (b) Ordinary Income. Section 751 (the collapsible partnership provision) may
             treat a portion of the gain attributable to inventory and unrealized
             receivables as ordinary income.
ii. 

**Sale of S Corporation Shares.** The capital gains look-through rule provides that, when a taxpayer sells stock in an S corporation held for more than one year, the taxpayer may recognize ordinary income under Sections 304, 306, 341 and 1254; collectibles gain; and long-term capital gain. Reg. § 1.1(h)-1(a).

(a) 

No Unrecognized Section 1250 Gain Look-Through. Because the look-through capital gain rules applicable for S corporations do not include unrecaptured Section 1250 gain, no portion of the taxpayer's gain on the sale of the S corporation stock will be treated as attributable to unrecaptured Section 1250 gain.

(b) 

Collapsible Corporation. The American Taxpayer Relief Act of 2012, which was signed into law on Jan. 2, 2013, repeals the collapsible corporation rules (which have been repealed on a temporary basis since 2003) via the repeal of The Jobs and Growth Tax Relief Reconciliation Act of 2003 (“JGTRRA”) sunset. (Former Code Sec. 341, as amended by Act Sec. 102(a))

c. 

**Character of Gain Depends upon Classification of Seller.** The character of the gain (or loss) resulting from the sale of real estate depends upon the classification of the seller as an *investor* or *dealer.* For investors, the gain (or loss) is capital; for dealers, the gain (or loss) is ordinary.

i. 

The central issue with respect to the sale of real estate is whether the sale is in the "ordinary course of a trade or business." See *Suburban Realty Co. v. United States,* 615 F.2d 171 (5th Cir. 1980). In defining the term "capital asset", Section 1221(a)(1) expressly excludes inventory and property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. This determination focuses on the intent of the seller and the purpose for which the seller purchased the property.

ii. 

Other requirements, such as the sales be made to customers and that the property be "held primarily for sale," are relevant but not necessarily dispositive in characterizing gain (or loss) on the sale of real property.

B. 

**Dealer Property**

1. 

**Sales in Ordinary Course of Trade or Business**

a. 

**Fifth Circuit Framework.** The Fifth Circuit has developed a framework for determining whether sales of land should be considered sales of a capital asset or
sales of property primarily held for sale to customers in the ordinary course of a taxpayer's trade or business. See Suburban Realty Co. v. United States, 615 F.2d 171 (5th Cir. 1980); Biedenharn Realty Co. v. United States, 526 F.2d 409 (5th Cir. 1976); and United States v. Winthrop, 417 F.2d 905 (5th Cir. 1969). The framework adopted by the Fifth Circuit focuses on answering the following three principle questions:

i. Was the taxpayer engaged in a trade or business, and if so, what business?
ii. Was the taxpayer holding the property primarily for sale in that business?
iii. Were the sales contemplated by the taxpayer "ordinary" in the course of that business?

b. Broader Application. Although the Fifth Circuit's framework, as outlined above, is precedential only for those courts within that Circuit and the Eleventh Circuit, it is nonetheless instructive for purposes of determining whether a taxpayer holds real property in the ordinary course of a trade or business or for investment purposes. Fifth Circuit decisions prior to October 1, 1981 are binding precedent on the Eleventh Circuit. See Bonner v. City of Prichard, 661 F.2d 1206, 1209 (11th Cir. 1981).

2. Relevant Factors

In attempting to define whether a taxpayer is engaged in a trade or business, courts consider the following factors to be relevant:

a. Nature and Purpose of the Acquisition of the Property and the Duration of the Ownership.

i. Nature of Acquisition. The relevant inquiry here is what was the taxpayer's motivation in holding the property prior to the sale. See Daugherty v. Comm'r, 78 T.C. 623 (1982); and Biedermann v. Comm'r 68 T.C. 1 (1977). The course of conduct over a period of time, and not a pinpointed moment in time, is relevant. See, e.g., Heller Trust v. Comm'r, 382 F.2d 675 (9th Cir. 1967), rev'd 25 T.C.M. (CCH) 634 (1966); and Municipal Bond Corp. v. Comm'r, 341 F.2d 683 (8th cir. 1965), rev'd 41 T.C. 20 (1963). A taxpayer should contemporaneously document the motivation for acquisition and any subsequent change of purpose.

ii. Original Purpose. A taxpayer's purpose for acquiring property establishes the taxpayer's primary purpose for originally holding the asset. Unless controverted by evidence of a subsequent change in purpose, the original purpose controls. Tollis v. Comm'r, 65 T.C.M. (CCH) 1951 (1995). Note that it is more likely that a change will occur from holding as an investment to holding for sale to customers in business than the opposite. Indications of a changed purpose include significant improvements to the property or solicitations or advertising evidencing a motivation to sell to customers. See, e.g., Jersey Land & Development Co. v. United States, 539 F.2d 311 (3rd Cir. 1976).
Dual Purpose. A dual purpose, however, is to be distinguished from a change purpose since the determination of the primary motivation is to be made at the time of the disposition. See *Bynum v. Comm'r*, 46 T.C. 295 (1966). For example, where a taxpayer holds land primarily for investment but incidentally for sale is distinguishable under present law from the case where a taxpayer holds land initially for investment then changes her plans to hold the land primarily for sale. See e.g., *Biedenharn Realty Co., Inc. v. United States*, 526 F.2d 409 (5th Cir. 1975); and *Bynum v. Comm'r*, 46 T.C. 295 (1966). In the first instance, the asset would not be excluded from capital asset status under Section 1221(a)(1), while in the second instance, if the sale is made to customers in the ordinary course of the taxpayer's trade or business, the Section 1221(a)(1) exception applies and any gain or loss is ordinary.

Changed Purpose. Generally, where evidence of a changed purpose exists, an original investment purpose will be overridden unless the taxpayer can show "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 (CA5 1975).

1. Examples of such events include those rendering property unfit for its intended use, *See Estate of Barrios v. Comm'r*, 265 F.2d 517 (CA5 1959), as well as "Acts of God, condemnation of part of one's property, new and unfavorable zoning regulations, or other events forcing alteration of [a] taxpayer's plans."

2. Illness and threat of foreclosure may also be included in the changed purpose exception. In *Herndon v. Commissioner*, 27 T.C.M. 662 (1968), the taxpayer, a real estate dealer, sold certain subdivided farm property following the illness of his wife. The Court considered this factor in holding that the sale was for the purpose of liquidating the taxpayer's investment, and therefore was a capital transaction. In *Erfurth v. Commissioner*, 53 T.C.M. 767 (1987), the taxpayer converted apartment units into condominium units and was allowed to report capital gain on the sale of the condominium units to the extent the sales were made to remove the property from the threat of foreclosure. Gain from property which was not threatened by foreclosure had to be reported as ordinary income.

3. Duration of Ownership. Not all courts have identified the holding period as a factor. However, the courts that have considered it have
generally indicated that holding an asset for a long time evidences an investment purpose.

(i) The Supreme Court alluded to this in stating that the distinction between capital and ordinary gains and losses lay between "profits and losses arising from the everyday operating of a business on the one hand and the realization of appreciation in value accrued over a substantial period of time on the other." Malat v. Riddell, 383 U.S. 569 (1966).

(ii) In Pritchett v. Commissioner, 63 T.C. 149 (1974), the Tax Court, in allowing capital gains treatment for the taxpayer, emphasized that "th[e] lengthy retention of the property is indicative of [taxpayer's] intention to hold it for investment purposes." 63 T.C. at 167. See also Municipal Bond Corp. v. Comm'r, 382 F.2d (8th Cir. 1967); and Schueber v. Comm'r, 371 F 2d 996 (7th Cir. 1967).

b. Extent and Nature of the Taxpayer's Efforts to Sell the Property.

i. Solicitation and marketing efforts may controvert a taxpayer's statement that the purpose of holding property was for investment. See Ferguson v. Comm'r, 53 T.C.M. 864 (1987). The relevant question is whether any such efforts were engaged in, rather than whether the taxpayer engaged in such activities himself or hired others. See Sanders v. United States, 740 F.2d 886 (11th Cir. 1984). Solicitation and advertising suggest that the taxpayer is looking for customers and is no longer willing to hold the land for future appreciation. See Biedenharn Realty Co., Inc. v. United States, 526 F.2d 409 (5th Cir. 1975).

ii. In Thompson v. Commissioner, 322 F.2d 122 (5th Cir. 1963), the Court held that gain from the sale of property was taxable as ordinary income because, although the taxpayer originally purchased the property for investment, he engaged in extensive sales activities in order to generate interest in the lots. Contrasting this is Pritchett v. Commissioner, 63 T.C. 149 (1974), in which the Court emphasized that the taxpayer, a real estate broker, by not engaging in sales efforts, had retained an investment motive with respect to the disputed sales because he maintained a disinclination to sell readily.

iii. Whether property is sold directly by the taxpayer or through independent brokers may be relevant. In Estate of Barrios v. Commissioner, 265 F.2d 517 (5th Cir. 1959), the taxpayer's use of a broker was evidence, in the Court's view, that the taxpayer held the property for investment purposes. On the other hand, in Riley v. Commissioner, 328 F.2d 428 (5th Cir. 1964), the Court disallowed capital gains treatment to a taxpayer who sold certain properties only through an agent.
c. **Number, Extent, Continuity and Substantiality of the Sales.**

i. Although there is no bright line with respect to frequency, number or continuity of sales, courts have held that 244 lot sales in a single year constituted a trade or business, *Suburban Realty Co. v. United States*, 615 F.2d 171 (5th Cir. 1980); that average lot sales of 15 per year during a 5-year period was also a trade or business, *Sanders v. United States*, 740 F.2d 886 (11th Cir. 1984); but that the sale of 63 properties over more than 20 years was not a trade or business, *Matz v. Commissioner*, 76 T.C. 465 (1988).

ii. Courts are also influenced by the substantiality of income derived from realty sales, as well as its proportion to the taxpayer's total income, in deciding whether or not a taxpayer is engaged in a real estate trade or business. See *Adam v. Comm'r*, 60 T.C. 966 (1973).

d. **Extent of Subdividing, Development and Advertising to Increase Sales.**

i. Development activity is certainly relevant to determining whether a trade or business exists. Taxpayers with investment agendas may be willing to wait for the property to appreciate; they do not seek to increase the property's value through improvements. Accordingly, improvements usually are considered indicative of a trade or business.

ii. In *Biedenharn Realty Co. v. United States*, 526 F.2d 409 (5th Cir. 1975), extensive development and improvement activities helped to convince the Fifth Circuit that a real estate company was not merely liquidating an investment, but was selling property in its real estate business. In Rev. Rul. 59-91, 1959-1 C.B. 15, the IRS denied capital gains treatment to a corporation for property it reportedly held as an investment, but which is sold after subdividing the property into residential lots, grading and surfacing the streets, and installing drainage facilities and utilities. See also *Sanders v. United States*, 740 F.2d 886 (11th Cir. 1984); and *Gault v. Comm'r*, 332 F.2d 94 (2d Cir. 1964).

iii. Where the activities undertaken are not physical, these have not weighed against the taxpayer in determining capital asset status. In *Buono v. Commissioner*, 74 T.C. 187 (1980), for example, an S corporation obtained township approval for subdividing a tract of land it intended to sell, and in fact did sell, as one parcel. The Tax Court ruled that, although the taxpayer undertook steps to enhance the marketability of the property later sold, where those activities were "purely legal" and this fell short of constituting a trade or business, the property was still a capital asset.

e. **Additional Factors.**

i. Use of a business office for the sale of the property;
ii. Character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and

iii. Time and effort the taxpayer habitually devoted to the sales.

3. **INSTALLMENT SALES**

   a. **Limited Exception to General Denial of Installment Method for Dealers.** Generally, any disposition of real property held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business is not eligible for the installment method. Section 453(b)(2).

   b. **Interest Toll Charge.**

      i. The period for which interest is computed begins on the date of the sale and ends on the date payment is received. Section 453(l)(3)(B)(i)(II). The rate to be used is the applicable Federal rate in effect at the time of the sale, compounded semiannually. Section 453(l)(3)(B)(i)(III). The tax attributable to the receipt of payments is determined without regard to any interest imposed under this provision. Section 435(l)(3)(B)(ii). No interest is due for payments received in the taxable year of the disposition from which the installment obligation arises. Section 453(l)(3)(B)(iii). Interest taken into account in computing the amount of any deduction allowable to the taxpayer for interest paid or accrued during the taxable year. Section 453(l)(3)(C).

      ii. The interest charge also applies to sales of timeshares and residential lots for $150,000 or less by nondealers. Section 453A(b)(4). Ordinarily, nondealer's disposition of property in which the sales price exceeds $150,000 ("Section 453A obligations"), and (2) the face amount of all such Section 453A obligations held by the taxpayer at the close of the taxable year exceeds $5 million. Section 453A(b).
C. DEALERS HOLDING REAL PROPERTY FOR INVESTMENT

1. DUAL ROLE DEALERS.

It is well-established that a dealer in real property may occupy a dual role in that he holds some real property for sale to customers in the ordinary course of his trade or business and other property for investment purposes. See Fabiani v. Comm'r, T.C. Memo. 1973-203:

a. Parcel-by-Parcel Determination. Because the analysis of whether the disputed property is held primarily for sale to customers is undertaken on the property-by-property basis, "dealers" may still successfully assert that a particular parcel was primarily held for investment and not for sale in the ordinary course of business, if they can sustain the difficult burden of proof which they bear. See, e.g., Wood v. Comm'r, 276 F.2d 586 (5th Cir. 1960) (noting without question that "a property owner may hold some [property] for sale to customers in the ordinary course of business and hold the remainder as capital assets"); and Maddux Construction v. Comm'r, 54 T.C. 1278 (1970) (holding that the taxpayer may treat its gain on the sale of unimproved real property it held for a period of time and later sold in bulk for commercial development as capital because the sale was not in the ordinary course of the taxpayer's residential construction business).

b. Burden of Proof on Taxpayer. In Murray v. Commissioner, 370 F.2d 568 (4th Cir. 1967), the Fourth Circuit held that a real estate dealer was entitled to capital gain treatment where he proved that the properties sold were held for investment. Likewise, in Pritchett v. Commissioner, 63 T.C. 149 (1974), the Court allowed capital gains treatment on certain property sold even though the taxpayer was a real estate broker.

2. CLEAR DELINEATION BETWEEN DEALER AND INVESTMENT ACTIVITIES.

Developers, subdividers and other taxpayers who ordinarily deal in real estate should at all times be vigilant about the possibility of tainting all real estate transactions with their trade or business activities. The unfocused nature of the examination by the courts exposes many transactions to the risk of recharacterization. Unfortunately, because of the ad hoc nature of the analysis, it is impossible to present hard-and-fast rules of strategies to cope with the attendant uncertainty.

a. Hold Investment and Dealer Properties in Separate Legal Entities. To better substantiate the distinct purposes for which taxpayers may own real estate, taxpayers that are both investors and dealers in real estate should hold their properties in separate legal entities. Along these lines, some taxpayers form limited liability companies that they do not capitalize until they are ready to acquire the real estate in such entities.
i. A typical scenario in which a developer-dealer should contribute undeveloped real estate purchased for investment purposes to an existing or newly formed entity, preferable an LLC classified as a partnership for Federal tax purposes. If an existing entity is used, that entity should hold only investment property.

ii. Ownership of Investment Property Entity. To avoid being classified as a disregarded entity for Federal tax purposes, the investment property entity should not be a single-member LLC wholly owned by the developer entity. Disregarded entity status would undermine the desired segregation for tax purposes. In most cases, the owner(s) of the dealer-developer entity and/or unrelated third-party investors own the investment entity.

b. Cases Preserving Capital Gains. As a general proposition, however, legitimate containment of dealer activities can provide greater assurance that a taxpayer's nondealer purposes for holding property will be respected. See Suburban Realty v. United States, 615 F.2d 171 (5th Cir. 1980) (noting that a taxpayer may be able to preserve capital gain treatment on the sale of a clearly segregated tract of land). Such containment may span the spectrum from simply documenting nondealer purposes for holding particular properties, to establishing completely separate entities, to holding properties for clearly delineated purposes. Obviously, the effectiveness of such strategies will rest on the quality of planning and implementation involved, for numerous pitfalls imperil the uninformed. The degree to which the plan comports with economic reality is also critical inasmuch as the IRS and the courts are usually wary of window dressing.

i. Cary v. Commissioner, 32 T.C.M. 913 (1973), is an illustration of how careful planning and favorable facts enabled the taxpayer to separate corporate dealer activities from investment. Cary, a developer, was assigned the contractual rights to purchase two tracts of land by his wholly owned real estate development company. He contributed the contracts to two partnerships for a 50% interest in each. Unrelated third parties owned the other 50% interest in each. The partnerships did nothing to improve, develop, or promote the land, and within one year they sold all of one tract and most of the other to the taxpayer's wholly owned corporation at a large profit. Accordingly, the potential for recharacterizing the transaction as part of a coordinated dealer transaction, which would render the partnerships' gains (or some part of the gains) ordinary income, existed. The Court, however, held that the profits realized by the partnerships were not ordinary income but qualified as capital gains, because all the entities were separate and there was no evidence to suggest that the partnerships held the properties for anything but investment.

ii. Graves v. Commissioner, 867 F.2d 199 (4th Cir. 1989), provides a contrasting example. In Graves, an individual taxpayer, who owned a construction company through which he had extensive development involvement, acquired three contiguous parcels in a joint venture with another individual. The joint ventures obtained development approvals for all three parcels, but declined to reserve
sewer capacity requirements for one of the parcels. After development of the two parcels, each partner received a one-half interest in the remaining, undeveloped parcel. In the year after termination, Graves sold his one-half interest and reported a capital gain. The Tax Court denied capital gains treatment. On appeal, the Fourth Circuit affirmed because Graves failed to prove that the undeveloped parcel was held for any purpose other than development.

iii. Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1992), concluded that the dealer activities of a development corporation that purchased real estate from a related partnership were not attributable to the partnership when determining whether the partnership was in the business of selling land. In reaching this result, the Court rejected the IRS arguments that either the development corporation was an agent of the partnership or the dealer activities of the corporation should be imputed to the partnership on a substance over form theory. The Court also noted that there was at least one major independent business reason to form the corporation and have it, rather than the partnership, develop and sell the land – insulate the partnership and the partners from unlimited liability. Finally, the Court observed that there was no evidence to suggest that the transaction was not at arms'-length or that business and legal formalities were not observed.

D. TRANSFER OF REAL PROPERTY TO A RELATED ENTITY

1. TRANSFER TO CONTROLLED CORPORATION.

Taxpayers, such as A and B in the introductory illustration, that both invest in and develop real estate understand that post-development profits may outweigh the pre-development appreciation of the real estate and thus are remiss to sell the property to an unrelated third party who will then reap all the post-development profit. To this end, such taxpayers often sell undeveloped real estate to a controlled corporation (within the meaning of Section 368(c)) that will develop and sell the property to unrelated third parties in the ordinary course of business. Because very few developer corporations consider paying cash for undeveloped property, the seller almost always receives an installment note, which gives rise to the potential for recharacterization as an equity contribution. Outright cash sales funded through the dealer corporation's prior operating or an unrelated lender should be immune from such recharacterization.

a. Recharacterization of Installment Note under Section 351. Although taxpayers have experienced a good degree of success in defending installment sales to related entities as true sales, the IRS has also been successful, albeit to a lesser degree, in recharacterizing the sale of land to the developer corporation as a nontaxable equity contribution. The proper treatment of each transaction is highly fact dependent and generally turns upon whether the installment note is respected as debt.
b. **Debt v. Equity Considerations.** Through the years, the IRS and the courts have developed a number of factors to determine whether a purported debt should be treated as equity for tax purposes. See, e.g., Bauer v. Comm'r, 748 F.2d 1365 (9th Cir. 1984); Fin Hay Realty Co. v. United States, 398 F.2d 694 (3rd Cir. 1968); J.S. Biritz Construction Co. v. Comm'r, 387 F.2d 451 (8th Cir. 1967); Smith v. Comm'r, 370 F.2d 178 (6th Cir. 1966); and Gilbert v. Comm'r, 262 F.2d 512 (2d Cir. 1959). Specifically, the courts have identified the following broad factors, several of which were codified in Section 385(b):

i. **Intent of the parties**

   (1) the extent to which the creditor participates in management;
   (2) whether the obligation to pay is contingent on the performance of the corporation;
   (3) the names given to the certificates evidencing the indebtedness; and
   (4) the identity of interest between creditor and shareholder

ii. **Formal characteristics of indebtedness**

   (1) fixed rate of interest at or above AFR;
   (2) the presence or absence of a maturity date;
   (3) the right to enforce the payment of principal and interest;
   (4) whether the note is subordinate to other creditors; and
   (5) the presence or absence of a redemption provision.

iii. **Economic realities of the transaction**

   (1) "thin" or inadequate capitalization (i.e., debt-to-equity ratio);
   (2) the corporation's ability to obtain financing from outside lenders;
   (3) source of the interest payments;
   (4) risk assumed by the creditor; and
   (5) voting power of the creditor.

2. **Transfer to Related but Not Controlled Corporation.**

Taxpayers seeking greater certainty with respect to the treatment of a real estate transfer as a sale should consider transferring the property to a related (greater than 50% ownership) but not controlled (at least 80% ownership) corporation.

a. **Busted Section 351 Transaction.** Section 351(a) provides for the general nonrecognition of gain or loss upon the transfer by one or more persons of property to a corporation solely in exchange for stock or securities in such corporation if, immediately after the exchange, such person or persons are in control of the corporation to which the property was transferred. To be in control of the transferee corporation,
such person(s) must own at least 80% of the total combined voting power and at least 80% of the total number of shares. Section 368(c).

i. **Greater than 20% Ownership by Unrelated Third Party.** The IRS cannot invoke Section 351 to recharacterize a real estate transfer as a nontaxable equity contribution if unrelated third parties own more than 20% of the transferee corporation, because the transferor lacks the required control over the transferee corporation immediately after the transfer.

ii. **Related Parties and Attribution.** The related party and attribution rules apply for purposes of testing whether the transferor controls the transferee corporation. Under Section 267(b), the following persons are considered related for this purpose and thus do not count towards the greater than 20% unrelated owner threshold:

1. members of the transferor's family (i.e. brothers, sisters, spouse, ancestors and lineal descendants);
2. a corporation of which more than 50% of the value of its outstanding stock is owned by the transferor;
3. certain trust relationship; or
4. corporations and partnership if the same persons own more than 50% of the corporation's outstanding stock measured by value and more than 50% of the capital or profits interest in the partnership.

b. **Avoid Recharacterization Issue.** Transferring property to a corporation not controlled by the transferee precludes the applicability of Section 351 and thus should minimize, if not eliminate, the risk that the IRS will recharacterize the transfer as nontaxable equity contribution.

3. **Transfer to Controlled Partnership.**

a. **Section 707(b)(2) Treats Recognized Gain as Ordinary Income.** Pursuant to Section 707(b)(2), gain from the sale of property that is not a capital asset (within the meaning of Section 1221) in the hands of the buyer will be treated as ordinary income if the buyer is a partnership and if the seller owns, directly or indirectly, more than 50% of the capital or profits interest in such partnership.

i. **Section 1231 Gain.** Generally, again on the sale or exchange of a Section 1231 asset, which includes real property used in a trade or business and held for more than one year, is treated as capital. Section 707(b)(2), however, recharacterizes Section 1231 gain as ordinary income, because Section 1231 assets are not capital assets, as defined in Section 1221.

ii. **Indirect Ownership.** Section 707(b)(3) invokes the constructive stock ownership rules of Section 267(c) (other than subparagraph (3) thereof) for purposes of
determining whether a partnership is controlled. Accordingly, the following attribution rules apply under Section 707(b)(2):

(1) Capital or profits interest owned, directly or indirectly, by or for a corporation, partnership, estate or trust are considered as being owned by or for its shareholders, partners or beneficiaries; and

(2) An individual is considered to own the stock owned, directly or indirectly, by or for his "family", which Section 267(c) defines as the individual's brothers and sisters (whether by whole or half blood), spouse, ancestors and lineal descendants.

b. **Planning Techniques to Avoid Section 707(b)(2) Recharacterization.**

i. **Sale to Non-Controlled Partnership.** Because Section 707(b)(2) only applies if the transferor-partnership is controlled by the seller, selling the property to a non-controlled partnership (i.e., transferor partnership owns 50% or less of transferee partnership) removes the sale from the scope of this provision.

ii. **Sale to S Corporation.** Subchapter S does not have a provision comparable to Section 707(b)(2). Assuming the seller prefers to retain as much control as possible over the real estate post-transfer, this technique is the better of the two because it allows the seller to transfer real estate to a related but not controlled S corporation. See Par V.A above for issues affecting transfers to controlled corporations (at least 80% ownership). Section 1239, which is discussed below, remains a concern for sales of depreciable real property to an S corporation.

4. **SECTION 1239 – SALE OF DEPRECIABLE REAL PROPERTY.**

Section 1239(a) treats any gain recognized on the sale or exchange of property between related persons as ordinary income if the property is depreciable in the hands of the related party transferee.

a. **Related Persons.** Section 1239(b) defines "related persons" to mean:

i. a person and all entities that are "controlled entities" with respect to that person (i.e. generally more than 50% ownership);

ii. a taxpayer and any trust in which the taxpayer (or his spouse) is a beneficiary, unless such beneficiary's interest in the trust is a remote contingent interest; and

ii. an executor of an estate and a beneficiary of such estate, except in the case of a sale of exchange in satisfaction of a pecuniary request.

b. **Available Planning Techniques.** Under Section 1239(b)'s definition of "related persons", taxpayers that own appreciated real property that will be depreciable in the hands of the transferee may not only lock-in capital gains treatment on the appreciation realized to date but also retain an interest in the property's upside potential so long as the transferee is not a related person. This, a taxpayer may sell such property to a new
or existing entity in which the taxpayer holds a non-controlling interest without triggering the recharacterization rule of Section 1239(a).

i. If the owner decides to form a new entity to acquire the property, the following considerations should be taken into account prior to formation:

   (1) Choice of Entity – In most situations, in order to protect against potential liability from a myriad of possible problems, the use of a corporation or limited liability company will be preferable. However, due to state tax issues in some states, the better alternative may be to form a limited partnership with a corporation or limited liability company as the general partner. In light of the double taxation inherent in a C corporation, the S corporation will probably be preferable, as long as corporate formalities are followed and it is capitalized with sufficient equity to avoid the risk of a creditor "piercing the corporate veil".

   (2) Identify Unrelated Co-Owner – As noted above, to qualify as a genuine unrelated party, the entity must be at least 50% owned by someone else. There are several persons who might desire to fill the role of the controlling owner, yet allow the current owner of the real estate to retain a significant, but non-controlling, interest in the newly formed entity that will purchase the real estate. This arrangement may appeal to a condominium converter or a sales or marketing agent because it allows them to share in the upside potential of the real estate, which may exceed their normal fee for their services.

ii. Additional Planning Issues

   (1) The unrelated party should pay value for his percentage of ownership. Absent this, the value of the property must be sufficiently extracted on the sale into the corporation or partnership so that there is no concern that too much has been left on the table. Second, it is desirable to limit the unrelated co-owner's share of the profits. Thus, a cap on the share of profits, or an offset for any fees earned directly, or a buy-sell enabling the unrelated co-owner to be taken out of the corporation or partnership at a later time are all factors to consider, but with a great deal of caution.

   (2) Another important issue arises when the sale to the unrelated corporation is made on the installment method, which is often the case because the new entity probably has not obtained sufficient financing to enable it to pay the purchase price in full. When installment sales are at issue, there are a couple of considerations that deserve attention.

      (a) If the terms of the obligations are long enough that they are not considered debt, but rather a form of equity, the equity might be deemed a second class of stock. This would disqualify an S
corporation if that was the vehicle used to buy the taxpayer's property. If the debt obligations are in the same proportion as the stock as to the face amount and ownership, the obligations are likely to be deemed equity. See e.g., Gamman v. Comm'r, 46 T.C.1 (1966); Lewis Building & Supplies, Inc. v. Comm'r, 25 T.C.M. 844 (1966); and Raynor v. Comm'r, 50 T.C. 762 (1968).

(b) Furthermore, assuming the installment debt is treated as debt, if the duration is too long, then the interest on the debt will consume a substantial portion of the profits that might otherwise qualify as capital gains. This could also result in the installment notes not being paid in full on the eventual sell-out of the project, which, in turn, would result in the mismatch of a capital loss from a non-business bad debt to the taxpayer and ordinary income from the discharge of indebtedness at the entity level. Successful conversion requires that the participants have a clear grasp of the numbers and timing.

E. Practice Tips for Preserving Capital Gain.

To be in the best position to defend against a potential IRS challenge, the parties should adhere to the following guidelines as closely as possible:

a. Capitalize the developer corporation with more than just a de minimis amount of cash or other assets.

b. The terms of the sale (e.g. the purchase price and any financing terms) should be set on a strictly arms'-length basis and the purchase price should be documented with an appraisal.

c. The purchase price should not be contingent on the developer corporation's receipt of proceeds from its sales of lots.

d. The terms of the sale should be set such that the developer corporation has a realistic opportunity to realize a profit upon its sales of lots.

e. Although the courts have approved sales in which the sellers financed the full purchase price and accepted unsecured notes from the purchasing corporations, the more prudent course is to require the developer corporation to (a) make a cash down payment at closing and (b) provide adequate security for the purchase money debt.

f. The payment schedule under the installment note can be tied to the developer corporation's receipt of proceeds from its sales of lots by virtue of release clauses. (To qualify for the installment method of reporting, the note must provide that at least one payment is to be received after the close of the taxable year of the sale.) The note
should require the developer corporation to repay the note even if, for whatever reason, it cannot sell some or all of the lots.

g. All formalities of the sale should be respected by the parties. For example, the parties should record a deed of trust, or file a UCC financing statement, to secure the purchase money debt.

h. The developer corporation should not pre-sell any of the property prior to its purchase of the undeveloped land from the investment partnership.

i. The developer corporation should consistently fulfill its payment obligations under the note; if it does not do so, the investment partnership should pursue legal remedies.

j. Notwithstanding any common ownership between the investment partnership and the development corporation, the separate entities should be respected in all of their activities (e.g., separate books and records and bank accounts should be maintained).

k. To the extent the related entities have any business dealings between themselves, in addition to the property transfer, they should conduct the transactions on arms'-length terms.

l. The investment partnership should refrain from constructing infrastructure and otherwise physically improving the property before conveying the transfer to the developer corporation. Along these lines, the developer corporation (rather than the investment partnership) should record the plat.

m. The owners of the investment partnership should alter the ownership of the developer corporation so that its ownership structure is not identical to that of the investment partnership. (For example, one or more new owners might be admitted into the investment partnership or the developer corporation.) Although several cases have approved a capital gain result on a sale between two mirror entities, litigating risks can be improved by introducing variations between the ownership of these related entities.

n. In certain situations, it may be preferable for the investment partnership to acquire the target investment property through a single-member LLC and sell interests in that entity to the developer corporation in order to avoid transfer and recordation taxes.

o. Finally, the investors should form a new LLC (or partnership) for each new development project, rather than using the same entity for multiple transactions.
F. INSTALLMENT SALES WITH RELATED ENTITIES

1. SECOND DISPOSITION BY RELATED PERSON.
   a. General Rule. If any person disposes of property to a related person (the "first disposition"), and if before the person making the first disposition has received all payments with respect to that disposition, the related person disposes of the property (the "second disposition") less than 2 years after the first disposition, the amount realized with respect to the second disposition will be treated as received at the time of the second disposition by the person who made the first disposition. Section 453(e)(1).

   i. The 2-year cutoff does not apply in the case of marketable securities. Section 453(e)(2).

   ii. The running of the 2-year period is suspended for any period during which the related person's risk of loss with respect to the property is substantially diminished by (1) the holding of a put with respect to the property, (ii) the holding by another person of a right to acquire the property, or (iii) a short sale of any other transaction. Section 453(e)(2).

   b. Amount Realized Limitation. The amount treated as received by the person that made the first disposition shall not exceed the excess of (a) the lesser of the total amount realized with respect to any second disposition or the total contract price for the first disposition, over (b) the sum of the aggregate amount of payments received with respect to the first disposition, plus the aggregate amount treated as received with respect to the first disposition for prior taxable years. Section 453(e)(3).

   c. Later Payments. Section 453(e)(5) provides that payments received in taxable years subsequent to the two-year period by the person that made the first disposition will not be treated as the receipt of payments with respect to the first disposition to the extent that the aggregate of such payments does not exceed the amount treated as received under the general rule.

2. SALE OF DEPRECIABLE PROPERTY TO CONTROLLED ENTITY.

   a. General Rule. Section 453(g)(1) provides that the installment sale method is not available for an installment sale of depreciable property between related persons. Thus, all payments to be received under the installment note are deemed received in the year of disposition. For purposes of Section 453(g), the term "related persons" has the same meaning as in Section 1239(b), except that such term here also shall include 2 or more partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interests. Section 453(g)(3).

   b. Contingent Payments. In the case of contingent payments that are contingent as the amount but with respect to which the fair market value may not be reasonable ascertained the basis may be recovered ratably. Section 453(g)(1)(B)(ii).
c. Purchaser's Basis in Acquired Property. The purchaser may not increase the basis of any property acquired before the seller includes such amount in gross income.

3. DISGUISED PURCHASES.

A lease payment that is really consideration for the purchase of property is not deductible. See Section 162(a)(3), which provides that a taxpayer may deduct as a trade or business expenses "rentals or other payments required to be made as a condition to the continued use of possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity." See also Oesterreich v. Comm'r, 226 F.2d 798 (9th Cir. 1955); Minneapolis Security Bldg. Corp. v. Comm'r, 38 B.T.A. 1220 (1938); Home News Pub. Co. v. Comm'r, 38 T.C.M. 834 (1969); and Private Letter Ruling 9026033 (March 28, 1990). In determining whether a transaction is in fact a sale or a lease, several factors must be examined at the initiation of the transaction rather than retroactively.

a. Rent Significantly Exceed Fair Rental Value. When the rent under the lease significantly exceeds the fair rental value of the property, the lease may be recharacterized as a sale. See, e.g., Haggard v. Comm'r, 241 F.2d 288 (7th Cir. 1956). Courts have generally examined the overall reasonableness of the rent based on the fair market value of the property.

b. Option to Purchase the Property During the Lease.

i. If there is an option to purchase the property at some time during the lease term with some part (or even all) of the lease payments, the transaction will more likely resemble an installment sale than a lease. For example, in Bowen v. Commissioner, 12 T.C. 466 (1949), the Court held the transaction was a sale where title to the property would be transferred to the tenant when monthly rental payment equaled the stated value plus one percent, or, if payments had not equaled the stated value plus one percent at the time of expiration of the lease, the tenant would nonetheless have the option to purchase the property at that time. But in Smith v. Commissioner, 51 T.C. 429 (1968), the Court ruled that the fact that there was an option to purchase would not, in and of itself, be considered as conclusively indicating a sale. It is clear, however, that no rent deduction will be allowed if, without further act or consideration, the tenant acquires title to the property after a certain number of lease payments. See Chicago Stoker Corp. v. Comm'r, 14 T.C. 441 (1950); and St. John v. Comm'r, 29 T.C.M. 621 (1970).

ii. It should also be recognized that transactions involving certain purported option arrangements may be subject to recharacterization as lease arrangements. The determining factor in the cases addressing this issue is the level of control over and right of access to the "optioned" property which is granted to the purported optionee prior to the exercise of the option. See Howlett v. Comm'r, 56 T.C. 951
(1971); and Private Letter Ruling 9129002 (March 26, 1991) (citing Virginia Iron Coal & Coke Co. v. Comm'r, 99 F.2d 919 (4th Cir. 1938)).

c. Part of Lease Payment Designated as Interest.

i. If any part of the lease payments is either designated as interest or easily seen as such, recharacterization of the lease as a sale is likely.

ii. For example, in Judson Mills v. Commissioner, 11 T.C. 25 (1948), the Court held that the monthly amounts paid were not deductible as rent because the taxpayer thereby acquired an equity interest in the machinery. The Court also held that a portion of the monthly payments equal to the factor designated as interest in the letters explaining the terms of the agreement was deductible as interest. The taxpayer, a textile producer, acquired new mill machinery through lease payments of a relatively small additional amount. As set forth in the correspondence, the amounts payable in monthly installments were computed to include 5% or 6% interest on the principal; interest tables were attached to the manufacturer's explanatory letters.

d. Significant Tenant Improvements. A sale rather than a lease will likely be found where the tenant makes significant improvements to the property that either are not recoverable through depreciation or amortization deductions (such as land improvements) or can only be protected through the exercise of an option. See, e.g., M&W Gear Co. v. Comm'r, 446 F.2d 841 (7th Cir. 1971); and Oesterreich v. Comm'r, 226 F.2d 798 (9th Cir. 1955).
TAX PLANNING FOR REAL ESTATE DEVELOPERS: UPDATES

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TAX PLANNING FOR REAL ESTATE DEVELOPERS: UPDATES

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Taxpayers/partners and shareholders in a commonly controlled development co. and real estate partnership incorrectly characterized as long-term gain ordinary partnership income from the sale of undeveloped property that the partnership divided and sold in lots to the co. Facts and circumstances showed that the property was held for sale to customers in the ordinary course of the partnership's business where the partnership appeared to have made real estate sales to customers other than the co.; made and paid for improvements to property; and charged co. inflated price.


Payment which pro se real estate developer/construction co. owner-operator received from 3d party/assignee who purchased co.'s position in its suit for breach of land sales contract was taxable as ordinary income, not capital gain: record showed that taxpayer intended that land subject to said contract would have been property held by him primarily for sale to his customers in course of his business. Key factors included that at time of suit taxpayer intended that co. would acquire property, develop condominium building and then sell land to purchaser; that his full-time activity was developing land for that building; that he hired architects, obtained zoning permit, negotiated contracts with residential customers and obtained deposits, in effort to develop property; and that he used his business office to sell condominium units.

C. Sutton v. Comm., TC Summary Opinion 2013-6 (Feb. 6, 2013)

Taxpayer, a real estate developer's general manager, who also bought real estate on his own account with the intent to improve it and resell it at a profit, was entitled to an ordinary loss on his abandonment of an option to purchase real property that he had intended to buy on his own account, improve and resell. The character of taxpayer’s loss was the same as the underlying property to which the option relates and that property would have been an ordinary asset in taxpayer’s hands, since taxpayer would have primarily held that property for sale in the ordinary course of his trade or business, as opposed to some other purpose such as an investment. In the two years before entering into the option, taxpayer had purchased dilapidated properties, improved them and listed them for resale with several real estate firms but was unable to find any buyers because of the economic downturn.
D. Bennett v. Comm., TC Memo 2012-193 (July 12, 2012)

Self-proclaimed “serial entrepreneur,” who engaged in various businesses but listed himself as in jewelry sales for years at issue, and wife/ins. broker had to treat loss on sale of property, which they designed and developed as new residence, as capital rather than ordinary loss. Although rejecting IRS's no-Code Sec. 165 ordinary loss deduction theory that taxpayers constructed residence for personal use, Tax Court ultimately agreed with IRS's alternate capital loss determination that residence was capital asset that didn't, under relevant factors test, qualify for exception for property primarily held for sale to customers in ordinary course of business. Factors considered included that taxpayers weren't real estate brokers, didn't have preexisting contract to sell residence, didn't do anything in particular to prepare it for sale, and in end were “just trying to be rid of property.”