

**PAULLUS V. COMMISSIONER:**

***A CASE STUDY  
IN AVOIDING DEALER STATUS  
UNDER IRC §1031***

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### **INTRODUCTION**

In this article, we address the “old, familiar, recurring, vexing and oft-times elusive” problem of the meaning of “property held primarily for sale.” See Thompson v. Commissioner, 322 F.2d 122, 123 (5th Cir. 1963). But we do so in a different context, seeking the meaning of this phrase under §1031(a)(2). By reason of §1031(a)(2), such property is excluded from nonrecognition treatment under §1031(a)(1). This means that if a taxpayer transfers or receives “property held primarily for sale” in an exchange, Section 1031 will not apply to the exchange, and the exchange will generally be taxable.

The sale or exchange of “property held primarily for sale” may generate ordinary income or capital gains treatment depending on whether the property is a “capital asset.” The definition of a capital asset excludes property held primarily for sale to customers in the ordinary course of the taxpayer’s trade or business. See §1221(1). In certain cases, property may be excluded from nonrecognition treatment by reason of §1031(a)(2), but still qualify as a capital asset under §1221(1). This result could occur if the property is held primarily for sale, but not for sale to customers in the ordinary course of the taxpayer’s trade or business (e.g., the taxpayer does not carry on a trade or business).

In the recent Tax Court Memorandum decision of Paullus v. Commissioner, T.C. Memo 1996-419 (“Paullus”), the meaning of the phrase “property held primarily for sale” under §1031(a)(2)(A) was at issue. The court in Paullus accepted, without analysis or explanation, the

taxpayer's argument that the meaning of this phrase should be determined by reference to §1221(1). As noted above, §1221(1) provides that a capital asset does not include "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." Applying the legal tests and cases under §1221(1), the court held that subdivided land sold in bulk to a single purchaser qualified as investment property and could be exchanged without recognition of gain under §1031(a)(1).

Prior to Paullus, court opinions under §1031 indicated that the phrase "property held primarily for sale" under §1031(a)(2) was defined by "an entirely different statute [than §1221(1)], namely section 1031, and as to that section the words 'for sale to customers in the ordinary course of' the taxpayer's trade or business are quite conspicuous by their absence." Black v. Commissioner, 35 T.C. 90, 96 (1960). The court in Black went on to say:

*"For the exception in section 1031 to apply, there is no requirement that the taxpayer be conducting a trade or business, or that the property in question be held 'for sale to customers in the ordinary course of' a trade or business carried on by the taxpayer. There can be no question, we think, that had it been intended that the scope of the exception in section 1031 should be so limited, language comparable to that used in the capital gains provisions ... would likewise have been used in section 1031." Id.*

See also Woodbury v. Commissioner, 49 T.C. 180, 197 (1967); Klarkowski v. Commissioner, T.C. Memo 1965-378; Land Dynamics v. Commissioner, T.C. Memo 1978-259.

If the property transferred or received in an exchange is held "primarily for sale," it is excluded from nonrecognition treatment. Prior §1031 cases have focused on whether the replacement property was held primarily for sale. See Regals Realty Co. v. Commissioner, 43 B.T.A. 194 (1940), acq. 1941-1 C.B. 9, aff'd 127 F.2d 931 (2d. Cir. 1942) (replacement property was acquired primarily for sale where a corporate resolution evidenced an intent to sell the property, and a contribution to a newly formed corporation was made in the next tax year when the property could not be sold); Black v. Commissioner, 35 T.C. 90 (1960) (desert land was exchanged for residential property, and the replacement property was held primarily for sale where it was fixed up and sold in 8 months without any rental); Griffin v. Commissioner, 49 T.C. 253 (1967) (replacement property was received subject to executory contract to sell to third

party); Bernard v. Commissioner, T.C. Memo 1967-176 (farmland received in exchange was sold two weeks thereafter); Land Dynamics v. Commissioner, 37 T.C.M. 1119 (1978) (grazing land received in exchange was held primarily for sale by a dealer); Klarkowski v. Commissioner, T.C. Memo 1965-328, aff'd on other grounds, 385 F.2d 398 (7th Cir. 1967) (exchange of rental property for 66 acres of unimproved land did not qualify because land was acquired primarily for sale even though it was held for more than six years). Compare Burkhard Investment Co. v. United States, 22 F. Supp. 23 (S.D. Ca. 1938) (commercial property received in exchange was not held primarily for sale, although taxpayer acted at times as a dealer). See also Biblin, "Can a Like-Kind Exchange Be Combined With Another Tax-Free Transfer in Shifting Assets?" 78 J. Tax'n 22 (January 1993) (discussion of whether property is held primarily for sale or for a qualified purpose when an exchange is combined with another tax-free transfer, including contributions, distributions and gifts).

Paullus is the first case under §1031 to analyze in detail whether the relinquished property was held for investment or primarily for sale. Several older cases under §1031 involved the dealer versus investor issue but these cases were decided on an ad hoc basis. See, e.g., Winter Holding Corporation v. Commissioner, 31 B.T.A. 1185 (1935); Loughborough Development Corporation v. Commissioner, 29 B.T.A. 95 (1933); Biscayne Trust Co. v. Commissioner, 18 B.T.A. 1015 (1930). See also Margolis v. Commissioner, 337 F.2d 1001, 1005 (9th Cir. 1964) (relinquished property was held for investment because it had income-producing potential, was offered for lease but never sale, was held for significant period of time, and was exchanged for other commercial property that was later leased out rather than sold). However, Paullus is the first §1031 case to address the issue in detail and apply the analytical framework of the §1221(1) cases in resolving this issue.

## **QUESTIONS PRESENTED**

In addition to the question of the correct legal standard under §1031(a)(2), Paullus raises other intriguing questions that will be the focus of this article:

- May a taxpayer avoid its prior status as a dealer by transferring land to a related development corporation?
- Does having another primary business (e.g., a golf course business) insulate the taxpayer with respect to “incidental” real estate activities?
- Does the legal subdivision of land (e.g., obtaining a tentative and final map) indicate that the property is held primarily for sale?
- Does development work (e.g., off-site improvements to obtain finished lots) that is required to be done under contract with the buyer cause the land to be held primarily for sale?
- Does the sale of a large tract of land in a single transaction necessarily mean that the land was not held primarily for sale?
- Does a bulk sale of subdivided land, rather than sales of individual lots, indicate that the land is not property held primarily for sale?
- Does the existence of a real estate sales office and an extensive list of potential purchasers for lots necessarily mean that the land is held primarily for sale?
- Does holding “surplus land” unnecessary for the operating of the taxpayer’s primary golf course business indicate that the land was held for investment or primarily for sale?
- Does a liquidation intent to sell the land and invest in a new golf and resort facility indicate that the land was held primarily for sale?
- Does a lengthy holding period necessarily mean that property is held for investment?

- Are sales to related development corporations an effective means of reducing the taxpayer's frequency of sales and segregating its holdings and activities?
- How are frequency of sales and duration of ownership measured?

## **OVERVIEW TO THE PAULLUS CASE**

This article will analyze the facts of Paullus in detail, as well as the legal standards used and the holding in the case. We will examine the legal briefs of the taxpayer and government in the Paullus case, and point out facts and arguments that are not stated in the court's opinion. In this connection, we will also survey the cases addressing the dealer versus investor issue, both under §1031 and §1221(1). Finally, we will summarize the answers to the above questions and the lessons that may be learned from Paullus and other cases to avoid dealer status both for purposes of §1031 exchanges and for qualifying for capital gains treatment under §1221(1).

The legal tests and cases under §1221(1) are relevant in determining whether property is held primarily for sale under §1031(a)(2). However, neither the §1031 nor the regulations thereunder define "property held primarily for sale" by reference to §1221(1). Accordingly, while any property that is not a capital asset under §1221(1) ("ordinary asset") should be excluded property under §1031, not every capital asset under §1221 will be qualified property under §1031. In other words, comparing the language in these provisions, "property held primarily for sale" under §1031(a)(2) necessarily includes, but is not limited to, ordinary assets under §1221(1).

Having said this, the following conclusion should come as no surprise. Technically speaking, Paullus applied an incorrect legal standard in basing the decision upon the legal tests and cases under §1221(1). The court should have also analyzed the facts in light of the broader prohibition contained in §1031(a)(2) against any "property held primarily for sale." If the court had applied the correct standard under §1031(a)(2), we shall see that the taxpayer's own arguments may have produced a different result.

But this does not mean that the holding in Paullus was incorrect, or that the case is worthless in determining qualified property under §1031. Putting aside the above technical question, we find that Paullus contains a veritable “gold mine” of techniques to avoid dealer status under §1031. These techniques include documentation of the purpose for acquiring or disposing of property, entity documentation (including articles of incorporation, board resolutions and filings with the state), the use of separate entities, financial and tax reporting, contract documentation, correspondence and dealings with third parties, and the segregation, timing and extent of development and selling activities.

Some may challenge the above assertion and find only “fool’s gold” in Paullus. After all, each case is based on its own facts and circumstances. A key distinguishing fact in Paullus may be the operation of another primary business, that of the golf and resort facilities. The real estate activities were described as “peripheral” and “incidental” to this primary business. Further, Paullus is only a single-judge, memorandum decision having little, if any, precedential value. But is hard to argue against luck and success, and the taxpayer in Paullus had both. By employing a sufficient number of techniques, the taxpayer developed facts sufficient to avoid dealer status under §1031. Weighing all of the facts, the court concluded that the subdivided and improved land was held for investment and not primarily for sale. To these facts, we now turn.

### **THE COURT’S FINDINGS OF FACTS**

The Internal Revenue Service (“Service”) determined a deficiency in the taxpayer’s 1989 Federal income tax of \$2,488,051 and a negligence penalty of \$497,610. The deficiency was based on the Service’s disallowance of the taxpayer’s §1031 exchange of the Unit 10 property for the Paicines property. The Service argued that the Unit 10 property was “property held primarily for sale” under §1031(a)(2) and thus §1031 did not apply.

The Unit 10 property was a 42.15 acre segment of the Bushmont property acquired by the taxpayer in February 1985. The taxpayer obtained approval for a tentative subdivision map for the Unit 10 property on April 6, 1988. The bulk of the Unit 10 property (containing 120

subdivided lots) was transferred in a three-party simultaneous exchange on March 27, 1989. The taxpayer obtained a final map and made substantial offsite improvements in order to deliver finished lots to the purchaser as required by the contract.

The property received by the taxpayer in the exchange consisted of approximately 2,261 acres (the “Pacines property”). This property was acquired with the intention of developing a new and expanded golf course and resort facility. Approximately 1,000 acres were contemplated for five or six golf courses, clubhouses and other facilities.

The parties agreed that the taxpayer “exchanged” the Unit 10 property for the Paicines property. The issue was whether the Unit 10 property was held primarily for sale and thus did not qualify for nonrecognition treatment under §1031. To resolve this issue, the court analyzed the history and extent of the taxpayer’s activities from the date of its incorporation. The court made the following findings of fact.

- Petitioner Ridgemark Corporation (“Ridgemark” or the “taxpayer”) was incorporated on or about November 4, 1971 and had its principal place in Hollister, California. Loren F. Paullus (“Paullus”) was president of Ridgemark from 1971 until March 1992.
- Paullus owned and operated a 110-acre turkey ranch in Hollister, California which he considered developing into a golf course as early as 1960. Paullus decided to proceed after determining that a substantial water supply existed to support the proposed golf course operation. Paullus contributed the 110-acre turkey farm to Ridgemark in exchange for stock. The other investors contributed cash and real property to Ridgemark in exchange for stock. At the time of incorporation in 1971, Paullus acquired 59.3% of Ridgemark’s outstanding stock.
- The Pre-Incorporation Subscription Agreement provided that Ridgemark would “transact and carry on the business of acquiring, owning and improving land for recreational and residential purposes, selling memberships in and playing privileges in a golf course, and subdividing and selling improved or unimproved lots for residential purposes...”

Ridgemark's articles of incorporation provided that its business purposes included engaging "primarily in the specific business of acquiring, developing, owning and selling real property."

- After incorporation, Ridgemark purchased golf course irrigation equipment and 102-acre and 70-acre parcels for the golf course project. Including the 110-acre turkey ranch, the original property consisted of about 282 acres.
- On June 22, 1972, Ridgemark filed a Declaration of Covenants and Restrictions with San Benito County for Ridgemark Estates, a planned development, located adjacent to the golf course. An unincorporated association, Ridgemark Homes Association, was formed to enforce and administer covenants and restrictions and to approve home construction and lot improvements.
- Ridgemark constructed the golf course and related recreational facility. Upon completion of the Ridgemark Golf and Country Club, golf memberships were sold by Ridgemark, in part, to fund the construction, operation and expansion of the golf course facility.
- For a few years, Ridgemark sold unimproved and unsubdivided lots. Ridgemark also sold improved residential lots to purchasers for cash for the construction by such purchasers of single family houses. Through April 1997, Ridgemark had sold approximately 200 lots. After that, Ridgemark was not involved in the improvement and sale of lots to individual purchasers.
- Ridgemark acquired a real estate brokerage license. Paullus' daughter ran the sales department. The brokerage activities focused primarily on resales of existing homes near the golf course.
- On or about April 1997, Ridgemark's board of directors terminated its practice of selling improved residential lots. The board decided to limit Ridgemark's activities to the "sale

of unimproved and improved land, the operation of Ridgemark Gold and Country Club, and the conduct of the real estate brokerage business.” The board desired to protect Ridgemark from liabilities that might arise from the construction and financing business.

- Consequently, on May 3, 1997, Ridgemark Construction Corp. (“Construction”) and Ridgemark Financial Corp. (“Financial”) were formed to segregate the residential lot activity from Ridgemark’s golf operations.
- Construction was to engage in construction, subdivision, development, and sale of residential units and townhomes. Financial was to engage in financing, development, improvement and sale of single family lots. Ridgemark’s board resolved to “sell improved lots to Construction and Financial at prices equivalent to cost plus no less than 25% profit.” Before Construction and Financial were formed, Ridgemark had sold approximately 200 lots to builders and home buyers. After that, Ridgemark did not sell lots or other real estate except in bulk to Construction and Financial.
- Between April 1977 and 1989, Ridgemark sold seven parcels of land to either Construction or Financial as follows:

<b>Property Sold</b>	<b>Sale Price</b>	<b>Acquisition Cost</b>	<b>Improvement Cost</b>	<b>Sale Date</b>
35 acres, Unit #4	\$350,880	\$153,732.00	\$77,550.00	12/31/77
7 acres, Unit #5	175,000	58,670.00	80,901.72	10/18/77
7.3 acres, Unit #6	300,000	32,802.22	49,496.61	03/31/81
41 acres, Unit #7	2,460,000	369,583.00	249,550.00	04/12/85
13.43 acres, Unit #8 <i>(phase one)</i>	1,347,000	121,060.00	137,123.96	11/18/85
10.53 acres, Unit #8 <i>(phase two)</i>	1,053,000	94,919.74	5,718.20	08/24/87
16.23 acres, Unit #9	<u>1,054,950</u>	<u>146,300.79</u>	<u>63,122.23</u>	06/30/87
<b>TOTALS:</b>	<u>\$6,740,830.00</u>	<u>\$977,067.75</u>	<u>\$663,462.72</u>	

- From its golf operations, Ridgemark had operating revenue of \$23,231,311, cost of sales of \$20,600,902, and gross income of \$2,630,409 for the years 1977 through 1989. From its real estate operations, Ridgemark had operating revenue of \$10,534,331, cost of sales of \$2,745,086, and gross income of \$7,789,245 for the years 1977 through 1989.
- The properties were zoned for the highest possible use (residential) in order to maximize possible loans by third parties.
- Units 4, 5, and 6 were part of the original property and were sold to Construction or Financial prior to obtaining a final subdivision map.

- Ridgemark acquired only two properties after April 1997: (1) on March 27, 1984, 1.89 acres at the corner of a major highway, and (2) on February 14, 1985, 269 acres from Bushmont properties (the “Bushmont property”). Ridgemark paid \$1,825,379.90 for the Bushmont property.
- Ridgemark built a second 18-hole golf course, a tennis center and a new clubhouse facility on approximately 130 acres of the Bushmont property. Part of the remaining acreage of the Bushmont property involved the property relinquished in the exchange (the “Unit 10 property”).
- By the time Ridgemark agreed to sell Units 7, 8 and 9 to Construction or Financial, Ridgemark had acquired tentative subdivision maps. The sales agreements provided that these properties would be transferred after the recording of the final maps. (Although not stated in the court’s opinion, the Unit 7, 8, and 9 properties were part of the Bushmont property. See Petitioner’s Opening Brief, p.31; Petitioner’s Reply Brief, p.47.)
- Ridgemark’s attorney did the preliminary filing of the subdivision applications with the State of California Department of Real Estate (“DRE”), and preliminary approval for subdividing was obtained in Ridgemark’s name. The final reports, however, were issued in the name of the subdivider, either Construction or Financial, who then developed and sold the lots.
- On February 24, 1987, in an effort to “increase the marketability of lots and townhomes,” Ridgemark’s board voted to restrict the sale of new golf memberships to people who owned property in and resided in Ridgemark Estates.
- On May 26, 1987, the board reversed its decision of February 24, 1987 and resolved to market limited golf subscriptions to persons who were not owners and residents of Ridgemark Estates. The board also explored the possibility of future development of all the remaining land South of Airline Highway, including the Unit 10 property.

Ridgemark's engineer estimated that approximately 300 lots could be produced at an average net sales price of \$60,000, which would produce a gross amount of \$18 million. An addition \$9 million could be produced by selling the lots improved with houses.

- In the same meeting on May 26, 1987, the board also authorized Paullus to have preliminary discussions with representatives of potential purchasers regarding the sale of Ridgemark. By that time, certain shareholders sought to dispose of their shares. Paullus also desired to be relieved of his management responsibilities, and sought to liquidate Ridgemark's assets in order to expand into a new venture, the proposed "Paicines property." The Paicines property eventually became the replacement property received by Ridgemark in exchange for the Unit 10 property.
- On February 23, 1988, the corporate minutes reflected the fact that a tentative subdivision map for the Unit 10 property, comprising 164 lots, had been filed with San Benito County. The tentative map was approved on April 6, 1988.
- On May 5, 1988, the board discussed whether Ridgemark should perform as "subdivider" of the Unit 10 property, or whether the property should be sold to Construction and it should act as subdivider. The board determined that the development of the Unit 10 property by Construction would be preferable.
- On August 8, 1988, a representative of the ultimate buyer contacted Ridgemark regarding the purchase of all of its developable land. Land formerly conveyed to Financial would be reconveyed to Ridgemark and included within its assets upon sale.
- On August 8, 1988, Ridgemark represented that it intended to subdivide land to the local water utility. Ridgemark was referred to as "subdivider" in the agreement and agreed to pay for the installation of water and sewerage facilities.

- On August 12, 1988, Ridgemark's board met to discuss the offer by the buyer. Paullus advised the meeting that legal and tax advisors were developing a transaction structure to include a tax free exchange in the sale of Ridgemark and the purchase of the Paicines property. In order to implement the structure, Paullus and his associates were willing to purchase shares from the other shareholders.
- On August 23, 1988, the board further discussed the buyer's proposal. Paullus reported that he had reached an agreement with the buyer that, once approval of the final map for the Unit 10 property was obtained, the sales of lots in Unit 10 would commence. The minutes contained the notation that there were 97 people interest in purchasing lots in Unit 10.
- In an August 27, 1988 letter, the buyer was informed that Ridgemark's board authorized its corporate officers to engage in negotiations to sell Ridgemark. Neither the assets nor the stock of Construction or Financial were involved in any proposed sale. Initially , the negotiations contemplated a sale of all of Ridgemark's stock to the buyer.
- On September 22, 1988 an agreement with San Benito County recorded stated that Ridgemark was "in the process of developing or improving" the Unit 10 property. Ridgemark was required to make improvements, including the necessary paving, curbs, gutters, catch basins, pipes, culverts, water mains, storm drainage systems, and sanitary sewers. Ridgemark and the County agreed that Ridgemark was contractually liable to complete these improvements after the issuance of the final map.
- On September 23, 1988, Ridgemark notified DRE that as subdivider of Unit 10, it would grant nonexclusive easements to certain streets to the owners of lots in Unit 10.
- On September 26, 1988, Ridgemark entered into a Subdivision Services Agreement. Ridgemark agreed to be represented by the consultant in filing the Preliminary and Final

Public Report for Ridgemark Estates, Unit 10. On the same date, the consultant filed an application for a Final Public Report for Ridgemark Estates, Unit 10. Ridgemark was reflected as the subdivider, with Paullus as its representative. The Notice of Intention for Unit 10 indicated that the property would be used solely for single family residential homes. The lots would be sold as vacant lots. The ultimate purchaser would be responsible for special impact fees charged for the lot, either when the purchaser obtained a building permit or prior to occupancy. Membership in Ridgemark Golf and Country Club would be used as an inducement for the Unit 10 lots.

- On November 14, 1988, Ridgemark's board determined that the buyer's initial proposal was unacceptable, and Paullus was authorized to terminate negotiations and "proceed with the sales of lots in the Unit 10 subdivision." Notwithstanding the above, a letter of intent was signed for the stock sale on December 6, 1988. But the buyer rejected the proposed stock sale a day later because of "an adverse unresolved tax problem." The buyer remained interested in purchasing Ridgemark but did not want to purchase the Ridgemark Golf and Country Club unless Paullus agreed to manage the operation for 10 years. Paullus was unwilling to do so.
- On December 13, 1988, Ridgemark's board met to discuss the buyer's new offer to purchase 120 lots in Unit 10 subdivision. Due to a boundary dispute, Ridgemark decided to exclude the disputed strip of land and reduced the land in question from 164 to 120 lots.
- In a December 15, 1988 letter, Ridgemark offered to sell the Unit 10 property for a price of \$10 million, with the buyer to complete the improvements necessary for finished lots at the buyer's own cost. An alternative offer for \$11.5 million was made under which Ridgemark would complete the improvements at Ridgemark's cost. The letter included Ridgemark's tax-free exchange requirement.

- Ridgemark obtained approval of the final subdivision map and constructed certain offsite improvements for the Unit 10 property. The buyer wanted to be able to build houses and sell lots as soon as possible after closing.
- On January 9, 1989, Ridgemark's board removed the restriction that preferred memberships must be sold only to owners of lots who resided in Ridgemark Estates. Paullus offered to purchase the shares of Ridgemark's shareholders who did not want to participate in the development of the Paicines property.
- On January 23, 1989, the Loan, Option and Purchase Agreement was approved by Ridgemark's board. The purchase agreement provided that Ridgemark, as seller, would diligently complete, at its expense, all offsite improvements. Ridgemark completed the offsite improvements after execution of the contract at a cost of about \$1.6 million. The purchase agreement provided that Ridgemark had the right to structure a tax-deferred exchange, and the buyer was required to cooperate to effect such an exchange.
- The purchase agreement also provided that the buyer had two options to purchase, in increments, any remaining developable land owned by Ridgemark. Neither option was exercised, and the optioned land reverted to Ridgemark.
- The buyer was expected to complete the purchase of the Unit 10 lots by March 27, 1989. If the buyer did not complete the purchase, Paullus outlined a plan to the board for a joint venture with outside investors.
- The purchase and transfer of the Unit 10 property was completed on March 27, 1989, for a final gross selling price of \$11.25 million.
- The property required by Ridgemark in the exchange consisted of approximately 2,261 acres (the "Paicines property"). The property was acquired with the intention of developing a new and expanded golf course and resort facility. Approximately 1,000

acres were contemplated for five or six golf courses, clubhouses and appurtenant buildings. To obtain better financing, the property was zoned for residential purposes.

- On April 27, 1989, Paullus exercised his option to purchase the outstanding shares of his fellow shareholders in Ridgemark. After the transaction, Paullus personally owned 36.32% of Ridgemark's stock. Paullus and his wife were also the trustees of a family trust which owned 35.02% of the shares.
- In 1990, Ridgemark sold its golf courses, clubhouses and recreational facilities for \$12 million to the members of the Ridgemark Golf and Country Club. The membership fees increased from \$700 in 1971, when Ridgemark was formed, to approximately \$14,000 in 1990, when the facilities were sold to the members.
- At time the petition was filed, Ridgemark still owned approximately 146 acres of land in the area of the golf course.

### **THE COURT'S OPINION**

The court noted that §1031(a) treatment does not apply to any exchange of “property held primarily for sale,” citing §1031(a)(2). However, the court then turned to a discussion of §1221(1), and the cases involving whether property is held by a taxpayer primarily for sale to customers in the ordinary course of a trade or business. While the court's opinion contains an excellent summary and discussion of the legal standard under §1221(1), it simply assumes, without analysis or explanation, that §1031(a)(2) is determined by reference to §1221(1). Such an assumption should not be taken for granted in light of Black and its progeny cited above.

In its brief, the Service cited Land Dynamics and Woodbury, *supra*, for the proposition that §1031(a)(2) is a different statute than §1221(1). The Service pointed out that there is no requirement under §1031(a)(2) that the property be held primarily for sale “to customers in the course of a trade or business” carried on by the taxpayer. Accordingly, the Service argued, it is

irrelevant whether the taxpayer was in the business of developing or selling real estate. The only issue is whether the Unit 10 property was held by the taxpayer “primarily for sale.”

But the Service devoted only about 4 pages of its 95-page brief to this argument. It failed to cite Black and Klarkowski, *supra*, as additional support for a separate standard under §1031(a)(2). The Service was also confused and inconsistent in making this point. After quoting §1031(a)(1) in its brief, the Service began its argument by stating: “Petitioner Ridgemark must show that both the property it exchanged was a capital asset and that the property it acquired was a capital asset.” The Service also stated in a footnote: “The ‘stock in trade or property held primarily for sale’ listed in I.R.C. §1031(a)(2) has the same meaning as ‘stock in trade and property held primarily for sale’ in the ordinary course of the taxpayer’s trade or business listed in I.R.C. §1221. Rockwell v. Commissioner, T.C. Memo 1972-133.” Finally, the Service concluded its argument about a separate standard with the following: “If property is not held passively and there is a definite, continuing and active plan to acquire, develop and hold property primarily for sale to customers in the ordinary course of the business, the courts have held that the profits from their sale are taxable as ordinary income.”

Thus, it is not surprising that the court did not take the Service’s argument about a separate standard under §1031(a)(2) very seriously. The Service fell right into the taxpayer’s trap and devoted most of its brief to whether the taxpayer was engaged in the business of developing and selling land and thus was a “dealer” in real estate under §1221(1). In its opinion, the court framed the Service’s argument in exactly those terms.

The taxpayer noted that the language used in §1031(a)(2)(A) (“stock in trade or other property held primarily for sale”) is not defined in §1031 or Treasury Regulations thereunder. For the court to determine whether the Unit 10 property constitutes “stock in trade or other property held primarily for sale,” the taxpayer argued that the court must evaluate and analyze the following factors:

- (1) the nature and purpose of the acquisition of the property and the duration of the ownership;

- (2) the extent and nature of the taxpayer's efforts to sell the property;
- (3) the number, extent, continuity and substantiality of the sales;
- (4) the extent of subdividing, developing, and advertising to increase sales;
- (5) the use of a business office for the sale of the property;
- (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and
- (7) the time and effort the taxpayer habitually devoted to the sales.

See United States v. Winthrop, 417 F.2d 905, 910 (5th Cir. 1969) (hereinafter referred to as the "Winthrop factors"). The court adopted this line of reasoning and applied the Winthrop factors to determine that the Unit 10 property was held for investment purposes and not primarily for sale.

It might be argued that Paullus is authority for a new legal standard under §1031(a)(2), and requires that the taxpayer be engaged in the "business" of developing or selling real estate. But the court never says this, and there is no discussion of Black and its progeny in the opinion. Section 1031(a)(2) refers to "stock in trade or other property held primarily for sale." The term "other" may indicate that "property held primarily for sale" is intended to mean "dealer" or inventory-type property. In this respect, the statute might be construed as analogous to §1221(1). See, e.g., Biedermann v. Commissioner, 68 T.C. 1 (1977) (§1033(g) construed by reference to §1221(1) in condemnation case); Rockwell v. Commissioner, T.C. Memo 1972-133.

### **APPLICATION TO THE WINTHROP FACTORS TO §1031(a)(2)**

Before reviewing the court's analysis of the Winthrop factors, we should at least question why and how these factors are relevant under §1031(a)(2). These factors are often referred to as the "seven pillars of capital gains treatment," and really go to three principal questions raised by §1221(1):

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

- (3) were the sales contemplated by the taxpayer “ordinary” in the course of that business?

Suburban Realty Co. v. United States, 615 F.2d 171, 178 (5th Cir.), cert. denied, 449 U.S. 920 (1980).

In his concurring opinion in Bynum v. Commissioner, 46 T.C. 295 (1966), Judge Tannenwald stated:

*"Since this is the first case reviewed by the Court after Malat v. Riddell, I think it extremely important that we be crystal clear as to the basis for our decision. Otherwise we will simply provide more fuel for the fires of further litigation in this area.*

*There are three elements in the identical language of sections 1221(1) and 1231 (b)(1)(B):*

1. *‘Primarily’ which, as the Supreme Court has mandated, means of ‘first importance.’ The element of substantiality is no longer enough. By the same token, the proscribed purpose does not, I believe, have to be capable of a quantitative measurement of more than 50 percent. It should be sufficient if such purpose is primus inter pares.*

2. *‘For sale to customers.’ This is the least significant element. Unquestionably, any person who proposes to sell his property has ‘for sale’ as his purpose. Equally clearly, anyone who buys the property is a ‘customer.’*

3. *‘In the ordinary course of business.’ This phrase is crucial. Thus, the taxpayer must be in a business of which the sale is a part. In addition, even though a sale is usually the "ordinary" way of disposing of property, it must also be in the ‘ordinary course’ of the business. Thus, a decision by a manufacturer to sell an outmoded plant would not be within the proscribed purpose. These are the distinctions which I think the Supreme Court had in mind when it said in Malat v. Riddell:*

*The purpose of the statutory provision with which we deal is to differentiate between the ‘profits and losses arising from the everyday operating of a business’ on the one hand (Corn Products Co. v. Commissioner, 350 U.S. 46, 52) and the ‘realization of appreciation in value accrued over a substantial period of time’ on the other (Commissioner v. Gillette Motor Co., 364 U.S. 130, 134.)*

*All of the foregoing are essential elements which must be satisfied when the witching hour of sale arrives.”*

The Winthrop factors (as well as the other factors suggested in the §1221(1) cases) are relevant under §1031(a)(2) insofar as they go to the issue of whether property is held “primarily for sale.” But they should not be relevant under §1031(a)(2) insofar as they go to the other statutory tests under §1221(1). Each of the Winthrop factors may be relevant in determining the primary holding purpose of the taxpayer at the time of the exchange. For example, the courts have stated: “The frequency and substantiality of sales are highly probative on the issue of holding purpose because the presence of frequent sales ordinarily belies the contention that the property is being held ‘for investment’ rather than ‘for sale.’” Suburban Realty Co., supra. See also Biedenharn Realty Co., Inc. v. United States, 526 F.2d 409 (5th Cir.) (en banc), cert. denied 429 U.S. 819 (1976).

The existence of development activity and improvements is highly relevant to the question of whether the taxpayer is a real estate developer and may also be relevant to the taxpayer’s holding purpose. But, standing alone, some degree of development activity is not inconsistent with holding property for purposes other than sale. Thus, the extent of development activity and improvements, although an important factor, may be less conclusive than the substantiality and frequency of sales. Suburban Realty Co., supra.

The nature and purpose of the acquisition of the property, the duration of ownership, and changes in the taxpayer’s holding purpose over the entire course of ownership, are also very relevant in determining the taxpayer’s holding purpose. In Malat v. Riddell, 383 U.S. 569 (1966), the Supreme Court defined “primarily,” as used in §1221(1), as meaning of “first importance” or “principally.” Such definition should also apply for purposes of §1031(a)(2). See Land Dynamics, supra. According, where the taxpayer has a dual intention, such as developing land or rental property or selling it, the court must ascertain whether the taxpayer’s predominant purpose is holding for sale. It is not sufficient if that purpose is merely a substantial or significant purpose.

At what point in time is the taxpayer's holding purpose determined? The Malat decision does not specify whether "primarily" means predominates at a certain point in time (and, if so, at what time?), or predominates over the life of the taxpayer's ownership of the asset or over some other relevant period. The appropriate test could be critical if, for example, a taxpayer held land primarily for sale over many years, but then, for some time shortly but not immediately before the exchange, switched his primary holding purpose from sale to investment. If the appropriate measure of "primarily" is at a fixed instant of time shortly before the exchange, the taxpayer may qualify under §1031. However, the taxpayer's primary holding purpose over the length of his ownership of the property may still be "for sale." If that were the proper test, §1031 may not apply to the exchange.

It is often stated that the taxpayer's intent is determined at the time of the exchange. While this may be true for replacement property, it cannot be literally true for property relinquished in an exchange. At the very moment of sale, all relinquished property is held "for sale." No property could be exchanged under §1031 if the determining factor is the holding purpose exactly at the time of the exchange. As the court stated in Suburban Realty Co., "the appropriate question certainly must be the taxpayer's primarily holding purpose at some point before he decided to make the sale [or exchange] in dispute." 615 F.2d at 182-83. See also Maddux Const. Co. v. Commissioner, 54 T.C. 1278 (1970) (court should look at earlier events to determine precisely what the purpose was at the time of sale).

Thus, the inquiry should start at the time the property is acquired. The taxpayer's primary holding purpose should then be traced over the entire course of his ownership of the property. Any change in the taxpayer's primary holding purpose should be taken into account. The taxpayer's primary holding purpose nearest to the time of the sale or exchange (i.e., immediately before the decision or agreement to sell or exchange the property) may be determinative.

With respect to changes in purpose, discrete events should mark the change, such as when “unanticipated, externally induced factors...make impossible the continued pre-existing use of the realty.” Biedenharn, supra at 421. The court stated in Suburban Realty Co.:

*“Some of our skepticism over Suburban’s claim to have changed its holding purpose stems from the fact that it points to so many separate times when its purpose may have changed. This leads us to believe that Suburban was merely gradually shifting its strategies as market conditions changed in an effort to maximize sales profits. We do not reject outright the possibility that a sequence of events separate in time may indicate a gradual change in holding purpose from ‘for sale’ to ‘for investment.’ However, we would be more likely to find a ‘change of purpose’ argument convincing if a discrete event were followed by a string of zero’s in the annual sales column figures, especially if this were followed by a sale of the remainder of taxpayer’s property in a small number of transactions.”*

The manner of disposition may or may not evidence a change in holding purpose. In Reithmeyer v. Commissioner, 26 T.C. 804, 811-12 (1956), the court stated:

*“For what purpose was it [the mined-out land] held after the mining operation? It was not being held for farming. We think the land was then being held by petitioners for sale. But it was a holding for sale in the sense of disposal of an asset no longer of use to petitioners in their business, and not a holding primarily for sale to customers in the ordinary course of petitioners’ business. Such a holding to liquidate an asset would not preclude capital gains [or exchange] treatment ... [B]ut is also true petitioners could enter the real estate business in order to dispose of some or all of this mined-out land and as to such sales, the benefits of [capital gains or exchange treatment] would be lost.”*

Solicitation and advertising efforts, use of a business office for sales, control over sales representatives, and substantial time and effort devoted to sales, are relevant both to the existence of a real estate business and to the taxpayer’s holding purpose. Their presence may indicate that the property is held primarily for sale. However, their absence does not establish that the property was held for investment since a seller “need not engage in promotional exertions in the face of a favorable market.” Biedenharn, supra at 418.

The ultimately inquiry is whether the property is held “primarily for sale” within the meaning of §1031(a)(2). “Essential as they are in the adjudication of cases, we must take guard lest we be so carried away by the proliferation of tests that we forget that the statute excludes from [capital gain or exchange treatment] property held primarily for sale...” Thompson v. Commissioner, 322 F.2d. 122, 127 (5th Cir. 1963) (referring to the factors determining capital gains under §1221(1)). Depending on the facts of the case, the Winthrop factors and other tests are relevant, to a greater or lesser extent, to this ultimate question posed by §1031(a)(2).

In this respect, the §1221(1) cases provide guidance to resolving the issue under §1031(a)(2). While the frequency and substantiality of sales over an extended period of time are integral indicia to be considered, the courts have held that these factors are not exclusive. Rather, each case must be decided on its own peculiar facts. Specific factors, or a combination thereof, are not necessarily controlling. Biedenharn Realty Co., *supra* at 415.

## **THE COURT’S APPLICATION OF THE FACTORS IN PAULLUS**

### 1. Nature and Purpose of the Acquisition of the Property and the Duration of Ownership.

Analyzing this factor, the court found that the Unit 10 property was held for relatively long period of time and was acquired for investment purposes. The court found that the Bushmont property was acquired and used to expand Ridgemark Golf and Country Club. As noted above, the Unit 10 property was a 42.15 acre segment of the 269 acre Bushmont property. About 130 acres of the Bushmont property was used to create a second 18-hole gold course, a tennis center and a new club house facility.

The court found that the taxpayer’s primary activity was the development and operation of golf courses. Throughout the period 1980 through 1989, the court stated that Ridgemark consistently reported its business activity as the operator of a golf and country club. The court rejected the Service’s argument that Ridgemark was also engaged in a second business of developing and selling real estate.

The court found that appreciation in value of the Unit 10 property stemmed from its proximity to the golf course facilities, as well as the existing residential developments that Construction and Financial developed and sold. The fact that the Unit 10 property required development to be done under contract for the purchasers did not show that the land was held primarily for sale.

The court noted that Ridgemark held the Unit 10 property for approximately 4 years prior to the exchange. This relatively long holding period supported the conclusion that Ridgemark held the property for investment purposes. The court also noted that Ridgemark held a relatively significant amount of real estate from 1977 with only limited sales to related companies. This was indicative of an investment motive in Ridgemark.

The court also determined that Ridgemark did not intend to sell the Unit 10 property on an individual lot-by-lot basis. Ridgemark did not have a history of continuously and regularly purchasing raw land that was later sold for development. The court concluded that the relative paucity of purchases and sales, coupled with other factors, showed that the real property held by Ridgemark was “peripheral” to the business of operating Ridgemark golf and country club.

2. The Extent in Nature of the Taxpayer’s Efforts to Sell the Property.

Analyzing this factor, the court held that Ridgemark should not be deprived of its investor status simply because it prepared to sell the land to third parties. The court found that Ridgemark and Paullus sought to sell the assets in order to concentrate on developing a golf resort in Paicines. Although there were acts of sales promotion on the part of Ridgemark or its agents, including improving and developing the land as a possible avenue to promote sales, these acts were consistent with the established principle that a person holding land under such circumstances may subdivide it for advantageous sale. See Estate of Barrios, infra.

The court found it “troublesome” that Ridgemark maintained a sales office and that there was a list of 97 people interested in purchasing lots in the Unit 10 property. The court stated that this fact was indicative of an intention to sell the Unit 10 property in the ordinary course of

Ridgemark's business. Ridgemark also conceded that before the exchange of the Unit 10 property, it was taking steps to develop and sell the property in the process of liquidating its holdings. However, the court determined that, on balance, the taxpayer's efforts to sell the property were consistent with an investment intent. Ridgemark simply sought to liquidate its assets so that it could maximize the amount of cash and attention it could focus on the proposed Paicines golf and resort facility.

3. The Number, Extent, Continuity, and Substantiality of the Sales.

Analyzing this factor, the court held that Ridgemark fit the pattern of infrequent but substantial sales of property. This indicated that the Unit 10 property was held for investment purposes. The court noted that frequent sales that generate substantial income tend to show that property was held for sale rather than investment. Conversely, infrequent sales resulting in large profits tend to show that property was held for investment. The Unit 10 property was sold at a tax gain of approximately \$9 million dollars, which was evidence of "long term appreciation in value as opposed to normal inventory markup." In addition, the court found that the golf operating revenue was approximately twice the revenue from real estate transactions, showing that Ridgemark's primary source of income was the golf course facility.

The court stressed that Ridgemark sold only 8 parcels of land in a 12-year period between 1977 and 1989, including the Unit 10 property. The 7 sales before the Unit 10 property were made exclusively to Construction or Financial at a significant profit. Construction or Financial then developed and sold the lots as separate corporate entities. By comparison, only one significant purchase of property was made subsequent to Ridgemark's 1971 formation (the Bushmont property in 1985). The court found that Ridgemark successfully segregated its business of operating Ridgemark golf and country club from the development and sale of lots. No attempt was made to impute the development and sales of lots by Constructions and Financial to Ridgemark. Further, the court disregarded the fact that Ridgemark sold approximately 200 lots to purchasers before the formation of Construction and Financial in 1977.

The court noted that a sale of a large tract in a single transaction does not necessarily mean that the property was not held primarily for sale. However, the court found that Ridgemark did not have a history of continuously and regularly purchasing land that was later sold for development.

4. The Extent of Subdividing, Developing, and Advertising to Increase Sales.

Analyzing this factor, the court held that the subdivision and development undertaken by Ridgemark were not inconsistent with its holding the Unit 10 property for investment purposes. The court noted that the 7 sales of real property to Construction or Financial between 1977 and 1989 involved 3 sales of large unsubdivided parcels, and 4 sales in which title could not be transferred without a new map being recorded to create a separate legal parcel. The court found that the recordation of a final map was simply a condition precedent to Ridgemark's ability to convey legal title to the 4 parcels to Construction or Financial.

Further, the court stated that properties sold as undeveloped land with development to be done by the seller under contract for the purchasers did not automatically cause the land to be held primarily for sale. Thus, the offsite improvements required by the buyer did not disqualify the transaction from §1031 treatment. The court also found that Ridgemark's rezoning of the property from agricultural land to its highest and best use (residential) did not convert the property to inventory status. The court stated that the zoning classification was necessary to maximize possible loans by third parties.

5. The Use of a Business Office For the Sale of the Property.

Analyzing this factor, the court held that the existence of a sales office was a "weakness" in Ridgemark's position, but not a fatal one, because the existence of the sales office did not result in sales for Ridgemark. The Service placed heavy reliance on the fact that Ridgemark had a sales office and compiled a list of names of people interested in purchasing lots in the Unit 10 property. The taxpayer pointed out that the sales office was used for resales of existing homes, and that the list was created several months after it had decided to proceed with the sale of all its

assets. Therefore, the taxpayer argued that the list of potential purchasers was not relevant to its purpose for holding the Unit 10 property.

The court found that Ridgemark had simply explored all of the options available to it with the intention of disposing of all its assets. Given that the buyer had backed out of an earlier deal, the court found it credible that Ridgemark sought alternatives in the event the transaction was not consummated.

6. The Character in Degree of Supervision or Control Exercised By the Taxpayer Over Any Representative Selling the Property.

The court did not discuss this factor. The court noted that the record did not show that Ridgemark utilized any agent or broker. It appeared from the corporate minutes that Ridgemark did not want an agent to negotiate for it, but was willing to pay a commission or a finder's fee if a successful sale was finalized. The absence of this factor was not deemed significant in showing an investment purpose.

7. The Time and Effort the Taxpayer Habitually Devoted to the Sales.

Analyzing this factor, the court found that Ridgemark was primarily involved in the development and expansion of its golfing and recreational business and not real estate sales after the formation of the sister corporations, Construction and Financial. Although Ridgemark pursued the sale of the Unit 10 property, the court held that such activity did not rise to the level of a trade or business. Instead the court stated that the real estate aspect was "incidental" to the primary business (golf) and constituted an investment. In the court's opinion, there was merely a symbiotic relationship between the operation of Ridgemark golf and country club and Ridgemark's sales of land, not distinct business activities.

After analyzing the above factors, the court held that Ridgemark was entitled to nonrecognition of gain from the exchange of the Unit 10 property under §1031, and thus there was no underpayment to which §6662(a) applied.

## **ADDITIONAL FACTS AND ARGUMENTS FROM THE BRIEFS**

In this section, we focus on the legal briefs of the taxpayer and Service in the Paullus case. We will see the arguments that were made and point out arguments that could have been made. Paullus provides a “case study” of virtually every important issue arising under §1031(a)(2)(A) and §1221(1). These issues include: (1) the taxpayer’s holding purpose, and specifically whether holding property as “surplus land” (as alleged by the taxpayer) is really an “investment” purpose; (2) determining the taxpayer’s business, and specifically whether the taxpayer is engaged (or also engaged) in a real estate business; (3) the nature and extent of permissible development activities, including land-use studies, rezoning, subdivision, physical improvements and lot sales; (4) the meaning and effect of having a liquidation intent with respect to the property; (5) the use of separate entities to minimize frequency of sales, to segregate holdings and activities, and to qualify for capital gain or exchange treatment when property is ripe for development; (6) the impact of frequent sales in determining dealer or investor status, including a detailed survey of the cases finding frequent or infrequent sales; (7) the significance of duration of ownership, including the relationship of this factor to holding property for a “qualified use” under §1031(a)(1); and (8) standards for determining any “change of purpose” for holding the property.

1. **“Surplus Land.”** The taxpayer noted that Ridgemark’s business plan was to develop a golf course and related resort facilities and to sell “surplus land” to provide funding for this primary business. For example, between 1971 and 1977, Ridgemark sold certain parcels of “surplus land,” including approximately 200 “improved subdivided lots,” in order to finance the development of the golf course and resort facility. The Service objected to this proposed finding, stating that there was no evidence categorizing the land as “surplus land,” or showing that the golf course operation experienced cash flow problems requiring the liquidation of the land. The taxpayer responded that Ridgemark was formed for the development and operation of the golf course and resort facility and acquired land solely to support that objective. Any land not utilized for the development of the golf course and resort facility was “surplus”. The surplus land was sold to finance the costs of the initial development of the golf course and resort facility,

as opposed to the later day-to-day operations which generated increasing levels of income from 1979 to 1989.

The taxpayer also made this “surplus land” argument with respect to sales of portions of the “surplus” Bushmont property. Although this is not stated in the court’s opinion or in the Service’s brief, the Unit 7, 8 and 9 parcels sold to Construction or Financial before the exchange were part of the 269 acre Bushmont property acquired on February 14, 1985. (See Petitioner’s Opening Brief, p.31; Petitioner’s Reply Brief, p.47) As indicated in the court’s findings of fact above, the 41 acre Unit 7 property was sold to Financial for \$2,460,000 on 4/12/85, the 13.43 acre Unit 8 property (phase one) was sold to Construction for \$1,347,000 on 11/18/85, the 10.53 acre Unit 8 property (phase two) was sold to Construction for \$1,053,000 on 8/24/87, and the 16.23 acre Unit 9 property was sold to Financial for \$1,054,950 on 6/30/87.

The taxpayer stated that Ridgemark was “required” to sell these portions of the “surplus” Bushmont property to finance the construction of the new golf course and other expanded facilities. Construction and Financial paid the purchase price for these parcels by short-term promissory notes with terms of two to four years, requiring large annual installment payments. Neither the Service nor the court found it significant that the Unit 7, 8 and 9 properties were part of the relevant Bushmont property acquired in February 1985, or that these parts of the Bushmont property were sold prior to the exchange of the Unit 10 property (also part of the Bushmont property.) In fact, a reader of only the court’s opinion and the Service’s brief would never even learn this fact.

In making its “surplus land” argument, the taxpayer relied on Padadena Golf Course, Inc. and Hollands Corporation v. Commissioner, T.C. Memo 1975-237. In Pasadena, the taxpayer owned and operated a golf course and acquired a 275 acre property located adjacent to its golf course property. The property at the time of purchase was submerged under approximately 1 to 4 feet of water. The taxpayer in Pasadena argued that the land was acquired for possible golf course expansion, although expansion never occurred. Thereafter, the taxpayer dredged and filled the land, constructed a seawall bulkhead, and installed streets, water and drainage. In the 10-year period following completion of the improvements, the taxpayer made 8 sales of portions of the

filled land. Based on the limited number of sales and the absence of a number of other objective factors, the court held that the taxpayer qualified for capital gains treatment on the sales.

The Service attempted to distinguish Pasadena by arguing that the taxpayer in that case had to sell portions of the land because it did not earn consistent income from its golf operation and because it incurred significant debt to improve the property. The Service noted that Ridgemark never showed or contended that it had to sell its land to maintain an adequate cash flow. But the taxpayer argued that Ridgemark sold the land to help finance development and expansion of the golf course and resort facilities, which expansion did in fact occur.

Overall, the court accepted the thrust of Ridgemark's argument, although it never referred to the land as "surplus land." By making the "surplus land" argument, Ridgemark helped to establish that it was not engaged in a real estate business, and that the land sales were only "incidental" or "peripheral" to its golf and resort business. Accordingly, this was a key distinguishing factor from other land subdivision and sales cases under §1221(1).

However, the "surplus land" argument could have been turned on its head against the taxpayer. If the land was "surplus" and not needed in the golf and resort operation, that fact may indicate that the taxpayer was engaged in only one business (the golf and recreation business) and not in the real estate business. Accordingly, the taxpayer may have qualified for capital gains treatment Under §1221(1) if the land sales were not made in the "ordinary course" of a "business" selling land.

But that fact is not determinative with respect to the question presented by §1031(a)(2) -- namely, whether the land was "property held primarily for sale." The fact that the land was admittedly "surplus" and was regularly disposed of by the taxpayer (for whatever reason) may indicate that the land was held primarily for sale under §1031(a)(2). See, e.g., Major Realty Corporation and Subsidiaries v. Commissioner, 749 F.2d 1483 (11th Cir. 1985) (taxpayer held to be a dealer based in part on the fact that the 2,500 acre tract was much too large for the taxpayer to develop itself, and some of the land had to be sold in order to continue developing other

sections of the property). For this and other reasons, we believe that if the court had correctly applied the legal standard of §1031(a)(2), the result in Paullus could have been different.

The taxpayer deemed it necessary to make this “surplus land” argument in order to explain the land sales by Ridgemark, including the prompt sales of the Unit 7, 8 and 9 properties after the Bushmont property was acquired. But we repeat that this is a dangerous argument to make, and should not be repeated by others without due consideration of the risk involved. We believe that holding “surplus land” for sale (including sales for business financing purposes) is contrary to holding property for investment purposes, such as long-term appreciation in value and speculation.

2. **“The Taxpayer’s Business.”** The taxpayer referred to its annual Statements By Domestic Stock Corporation filed with the California Secretary of State. The “type of business” indicated on these statements was “Golf and Country Club.” The taxpayer argued that the statements proved that this was Ridgemark’s only “business.” The Service responded that the type of business was left blank for at least six years and in one year was described as “Ranch Properties.” The Service also pointed out that the finding of fact requested by the taxpayer was inconsistent with Form 1120 for the tax year ending October 31, 1989 (the year at issue). On the return, the taxpayer stated on Schedule J at paragraph H that its Business Activity Code No. was 6550. Code 6550 refers to “Subdividers and developers” which is under the category “Finance, Insurance, and Real Estate.” The tax return further stated that the taxpayer’s business activity was “Sales/Golf Course” and its product or Service was “Real Estate/Golf.” Thus, the taxpayer’s own return indicated that one of Ridgemark’s business activities was “sales” and that the product or service sold was “real estate.” The taxpayer also listed the real estate activity before its golf course business on its Form 1120.

In its brief, the Service argued that the taxpayer was engaged in two businesses: one involving the golf course operation and the other involving land development and sales. The Service pointed to the dual purposes for which Ridgemark was incorporated in 1971. One of these purposes included engaging “primarily in the specific business of acquiring, developing, owning and selling real property.” After the formation of Construction and Financial in 1977,

Ridgemark was still involved in the “sale of unimproved and improved land” and the conduct of a “real estate brokerage business” pursuant to its own corporate minutes. Ridgemark never filed an amendment to its articles of incorporation to show that it reduced its business activities.

The Service further argued that the new corporations, Construction and Financial, were formed to expand Ridgemark’s business to include constructing and financing homes. Ridgemark did not perform these functions prior to 1977, and had been selling finished residential lots to builders and home buyers. After the formation of Construction and Financial, Ridgemark simply sold subdivided and unsubdivided land to the related entities who, in turn, earned additional profits by building and financing homes. Accordingly, the Service argued that Ridgemark did not limit or contract its business activities.

The Service also pointed to the relative percentages of gross profits (as opposed to gross revenues) derived from real estate sales and the golf operation. As reported by the taxpayer on its financial statements from 1977 through 1989, the real estate activities accounted for 74.8% of its gross profits and the golf and related activities accounted for only 25.2%. The Service also calculated the ratio of development costs to acquisition price for the seven properties sold prior to the Unit 10 property. The taxpayer had development costs equal to 67.9% of the original acquisition prices for these properties.

The taxpayer responded that gross revenues was the proper measure of the taxpayer’s primary business, and that the golf operating revenue accounted for 69% of the taxpayer’s total revenues. The taxpayer also noted that the total costs prior to sale were only about \$5,100 per acre for the seven parcels compared to about \$52,200 per acre for the Unit 10 property. This was a more than tenfold per acre cost increase to produce finished lots for the buyer of the Unit 10 property, and showed that the taxpayer merely subdivided but did not make physical improvements to the seven parcels.

The taxpayer and the Service spent most of their briefs arguing over this business issue. The determination that the taxpayer was engaged in a business of developing or selling land, including the Unit 10 property, would have been fatal both for capital gains treatment under

§1221 and for exchange treatment under §1031. As a definitional matter, §1031(a)(2) necessarily includes property which is not a capital asset under §1221(1). But the converse is not true: a capital asset under §1221 may be excluded from exchange treatment under §1031(a)(2) if the property is held “primarily for sale.” Accordingly, a finding that the taxpayer was engaged in the business of developing and selling land, including the Unit 10 property, would have condemned the taxpayer to recognize gain on the exchange. But a contrary finding (that the taxpayer was not engaged in such a business) should not be determinative of whether the property is held “primarily for sale” under §1031(a)(2). See Black and its progeny cited above. When confronted with the business issue under §1031(a)(2), the taxpayer must take a defensive posture, and raise his shield without a sword.

Ultimately, the court held that “although Ridgemark pursued the sale of the Unit 10 property, that activity did not rise to the level of a trade or business.” The court stated that the real estate was “incidental” to the primary business (golf), and constituted an investment and not part of Ridgemark’s inventory. Neither the court nor any of the parties defined a “trade or business” as opposed to an “investment” activity. This presents the question of what a “business” is.

In English v. Commissioner, T.C. Memo 1993-111, the court stated: “In order to be considered to be engaged in a trade or business: the taxpayer must be involved in the activity with continuity and regularity and ... the taxpayer’s primary purpose for engaging in the activity must be for income and profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.” (Quoting Commissioner v. Groetzinger, 480 U.S. 23, 25 (1987)). The question is whether the taxpayer has engaged in a “sufficient quantum of focused activity,” which may include continuous and substantial sales of real estate, development activity and improvements, solicitation and advertising efforts, and time and effort devoted to sales. Suburban Realty Co., supra at 181. In Byram v. United States, 705 F.2d 1418, 1424 (5th Cir. 1983), the court reaffirmed the “common sense observation that the word ‘business’ means ‘busyness’; it implies that one is kept more or less busy, that the activity is an occupation” and that a “court should not be quick to put a man in business ... simply because he has been successful in earning extra

income through a hobby or some other endeavor which takes a relatively small part of his time.” (Internal citations omitted.) One court has stated:

*“It would seem that to carry on a business conveys the idea of progression, continuity and sustained activity, and does not mean the performance of single disconnected acts. The occasional purchase and resale of land by an investor speculating on a rise in real estate values, does not, in the absence of other circumstances, give rise to the status of his being a dealer in real estate.”*

See also Bedell v. Commissioner 30 F.2d 622, 625 (2d Cir. 1929), aff’d 9 B.T.A. 270 (1927).

In at least one §1031 case, the taxpayer’s business was important in determining that the replacement property was held primarily for sale and excluded from §1031. In Land Dynamics, supra, the taxpayer was in the business of real estate development and sales, and exchanged a property (consisting of orange trees, building and pipeline) for 1,315 acres of grazing land (the “Tulare property”). The taxpayer’s own prospectus stated that the taxpayer “acquires land for use in its real estate programs and not investment” and gave time frames for development and sale. The grazing land was not listed or offered for sale prior to its sale 2 years after its acquisition in the exchange.

The court stated:

*“We recognize that it is well established that petitioner, a dealer in land, may also acquire and hold real property for investment. A subsequent sale is not conclusive on the question of the primary purpose in acquiring and holding real estate. However, the fact that the land was held for many years does not establish an intention to hold the property for investment rather than sale. In short, petitioner has been active as a dealer in the purchase and sale of realty. It has the burden of proving that when it dealt with the parcels of land ... it was wearing the hat of an investor rather than that of a dealer. Herein petitioner has not submitted on iota of evidence to prove its investor status in connection with the holding of the Tulare property.” (Citations and internal quotations omitted.)*

The court’s holding that Ridgemark was not engaged in a real estate business is open to serious question, given the corporation’s dual purpose, the real estate sales before and after 1977, the corporate minutes, the sales office, the list of interested purchasers, the rezoning and subdivision activity, the profits realized each year from the real estate sales, and the taxpayer’s

own reporting of its business on tax returns and financial statements. Further, the fact that a real estate business may have been “incidental” or “peripheral” to another primary business (golf) does not mean that a real estate business did not exist. This was a very “close call” that could have gone the other way.

3. **Development Activities.** The taxpayer noted that at the time the Unit 4, 5 and 6 properties were transferred, the parcels were sold to Construction or Financial as bulk parcels and subdivision maps had not been recorded. The taxpayer admitted that final subdivision maps for the Unit 7, 8, and 9 properties were obtained and recorded prior to the transfer of title to Construction or Financial. But the taxpayer argued that it was legally required to do so in order to convey separate parcels in accordance with the contracts. If the taxpayer could have made a bulk transfer of the Unit 7, 8 and 9 properties without a final map, the taxpayer stated that it would have done so just as in the case of the Unit 4, 5 and 6 properties. The court accepted the taxpayer’s argument.

The Service committed one of its biggest blunders in the case by referring to the rezoning of the relevant Bushmont property (including the Unit 10 relinquished property) as “development efforts for Unit 4.” The “zoning contract” and “master development plan” referred to by the Service was obtained and recorded in 1984, which was approximately seven years after Ridgemark sold Unit 4 to Financial. The taxpayer took full advantage of the blunder and claimed that the Service was “either intentionally or mistakenly representing the facts.” The Service apparently did not understand the significance of this evidence, and relegated it to ancient history by referring to Unit 4.

The Bushmont Property. The true facts are that the taxpayer acquired the 269.2 acre Bushmont property on February 14, 1985 for \$1,825,379.90, including \$159,884.22 in purchasing costs. Prior to the acquisition of the Bushmont property (and presumably while it was under option to the taxpayer), the taxpayer entered into a Zoning Contract with San Benito County to rezone the Bushmont property (not the Unit 4 property). The Zoning Contract was recorded on July 10, 1984. The taxpayer obtained a R-3 or Low Density Multiple Family District Classification for 1200 dwelling units. The taxpayer agreed to build a golf course and sewage disposal facility.

Prior to the construction of the first 120 residential units, the taxpayer was required to provide a second access onto Airline Highway. The taxpayer also had to prepare a Master Development Plan for the total project by the time the first phase of the project started. Thus, it appears that the taxpayer successfully rezoned the property from agricultural land to residential before it actually acquired title.

The Unit 7, 8 and 9 Properties. As noted above, Unit 7 (consisting of 41 acres of the Bushmont property) was sold to Financial on April 12, 1985 (less than 2 months after the Bushmont property was acquired on February 14, 1985). Unit 8, phase 1 (consisting of 13.43 acres of the Bushmont property) was sold to Construction on November 18, 1985 (about 9 months after the Bushmont property was acquired). Unit 8, phase 2 (consisting of 10.53 acres of the Bushmont property) was sold to Construction on August 24, 1987 (about 2 1/2 years after the Bushmont property was acquired). Unit 9 (consisting of 16.23 acres of the Bushmont property) was sold to Financial on June 30, 1987 (about 2 1/3 after the Bushmont property was acquired). In each case, tentative and final subdivision maps were obtained and recorded prior to the transfer of title to Construction or Financial. The Bushmont Property was designated as a development known as “Ridgemark South” on June 25, 1985. Ridgemark’s board of directors made the following allocations to the Bushmont property:

- A) 1/3 of the cost was to be allocated to 50% of the land which was to be used for the golf course, tennis and swimming complex, sewer facility, water retention ponds and other open space; and
- B) 2/3 of the cost was to be allocated to the 50% which was to be used for subdivision purposes, including open space (1/3) and subdivision lots (2/3).

The above facts relating to the Bushmont property indicate, at a minimum, that the Unit 7, 8 and 9 properties were held primarily for sale. If this point is conceded, the Unit 10 property may have been held primarily for sale because it appeared to be held in the similar manner and for the same purpose as the Unit 7, 8 and 9 properties. The taxpayer might have argued that the Unit 10 property was distinctive and held for another purpose. But we have found no evidence in the record to support this position. The only real difference is the holding period for the Unit

10 property (about 4 years). This is not, in and of itself, dispositive. (See discussion of “duration of ownership” below.)

The Unit 10 Property. The facts relating to the Unit 10 property were set forth above and adequately described in the court’s opinion. The Service devoted at least 6 pages of its brief to the activities undertaken with respect to Unit 10. The Service began with the engineer’s estimate as of May 26, 1987 that approximately 300 lots could be developed and sold for \$60,000 each, and ended with Paullus’ testimony that when the lots were transferred to the buyer, they were in such a condition that the buyer was “never ... refused a building permit for any reason.” Thus, the taxpayer was involved in each phase of the development process up to and including finished lots.

The taxpayer responded as follows:

*“Ridgemark has acknowledged that it obtained a subdivision map for the Unit 10 Property and completed certain offsite improvements to the Unit 10 Property. These efforts were undertaken by Ridgemark in an effort to liquidate all of its assets and have to be viewed in the context of its negotiations with the ultimate purchaser of the Unit 10 Property .... Ridgemark presented extensive evidence that its efforts in completing the offsite improvements to the Unit 10 property were unique to that transaction and were completely different from its activities in connection with the limited number of prior sales it made to Ridgemark Financial and Ridgemark Construction (entire record). For this reason, Respondent’s excruciatingly detailed, paragraph after paragraph recital of the documents reflecting Ridgemark’s efforts undertaken in connection with the sale of the Unit 10 Property are unnecessary and irrelevant.” (Petitioner’s Reply Brief, p. 25)*

Again, the court accepted the taxpayer’s arguments with respect to the Unit 10 property. In and of themselves, these arguments were persuasive. However, the court and the Service never really focused on the history of the Bushmont property. This history included the fact that the prior sales of Units 7, 8 and 9 were sales of part of the Bushmont property and these sales start occurring almost immediately after the Bushmont property was acquired. As noted above, such an analysis may have indicated that the Unit 10 property was held primarily for sale.

In the cases under §1221(1), taxpayers are permitted some latitude in developing the property. Even substantial development activity, in and of itself, may not result in dealer status. See Estate of Barrios, *infra*; Ayling, *infra*; Smith v. Commissioner, 232 F.2d 142 (5th Cir. 1956). But where development activity results in subdivided lots and such lots are sold off on a regular and continuous basis, “the likelihood of capital gains is very slight indeed. Conversely, when sales are few and isolated, the taxpayer’s claim to capital gain is accorded greater deference.” Biedenharn Realty Co., *supra* at 416.

The Development Process. Development activity may begin with land-use studies and topographical surveys to determine the property’s highest and best use. The taxpayer may then try to obtain the desired zoning classification, including rezoning the property if necessary. Through rezoning and related activities, the taxpayer develops “entitled property” (e.g., property on which so many residential lots of a certain size may be obtained). Other issues may need to be explored during this phase, such as compliance with laws restricting the rezoning of agricultural land, water rights, access to roads, environmental and wildlife considerations, and how the development fits within the county’s plans.

The taxpayer may then attempt to obtain a tentative subdivision map for the property pursuant to which the property would be divided into separate legal parcels. In California, a “tentative map” refers to a map for the purpose of showing the design and improvement of a propose subdivision and the existing conditions in and around it and need not be based upon an accurate or detailed final survey of the property. See California Government Code §66424.5. Obtaining approval of the tentative map is a key phase in the development process. By then, the developer will have addressed most or all of the issues relating to the proposed development, including soil and engineering issues, lot configurations, required land dedications, and compliance with local plans and other requirements.

A local authority may condition or withhold its approval of the tentative map application based on a variety of factors, including:

- (1) the proposed map, design or improvements is inconsistent with general and specific plans;
- (2) the site is not physically suitable for the type or proposed density of the development;
- (3) the design or improvements are likely to cause substantial environmental damage, injury to fish, wildlife or their habitat, or serious public health problems;
- (4) the design or improvements conflict with easements acquired by the public at large;
- (5) failure to provide a required environmental impact report, or a finding that mitigation measures or project alternatives are feasible;
- (6) the proposed subdivision would result in violation of water quality standards; and
- (7) the proposed map provides for parcels that are too small to sustain their agriculture use, such as the Williamson Act in California.

Based on such considerations, significant time, effort and resources may be required to obtain approval of a tentative map.

An approved tentative map will state certain conditions that must be met to obtain a final map. Among these conditions may be the formation of a special assessment district (in California, “Mello-Roos” district) to finance infrastructure on the project. When these conditions are met, a final subdivision map may be recorded for the property. At that time, the taxpayer will have created separate legal parcels which may be lawfully conveyed.

Under the California law which was applicable in Paullus, Ridgemark could not transfer title to a portion of property that is a part of a larger legal parcel. An effective and lawful conveyance requires that a separate legal parcel be created. The California Subdivision Map Act, (California Government Code §66410 et seq) provides that no lot or parcel which results from the division of a larger parcel can be sold or leased without compliance with the requirements of the Subdivision Map Act. A division of land can be accomplished only by the

recordation of a approved final subdivision map or parcel map (See Miller and Starr, California Real Estate 2, §20:78 (1990)). California Government Code §66426 provides:

*“A tentative and final map shall be required for all subdivisions creating five or more parcels, five or more condominiums as defined in Section 783 of the Civil Code, the community apartment project containing five or more parcels, or for the conversion of a dwelling to a stock cooperative containing five or more dwelling units...”*

Another stage in the development process may involve physical improvements, including streets, sewers and other offsite improvements. These improvements are necessary to create “finished lots.” When the lots are “finished,” a builder or home buyer need only obtain a building permit and begin construction of the home.

A final stage in the development process leads into the sales process. The developer may be required to obtain a “Subdivision Report” when the subdivided lots are offered to the general public for sale. This report may come before or after physical improvements are made, and the lots may be sold as “unimproved lots” or as “finished lots.” In California for example, Final Subdivision Reports are required by the California Subdivided Lands Act, California Business and Professions Code §11000 et seq. The California Subdivided Lands Act (“the Lands Act”) contain requirements that differ from the Subdivision Map Act discussed earlier and applies when a subdivider offers subdivided real property to the general public for sale. The Lands Act requires each subdivider or developer to file a application with the California Department of Real Estate (“DRE”) containing detailed information to enable the DRE to issue a final public report (see California Business and Professions Code §11010) which is available to each prospective purchaser. California Business and Professions Code §11018.1 provides that:

*“No person shall sell or lease or offer for sale or lease in this state any lots or parcels in a subdivision without first obtaining a public report from the Real Estate Commissioner.”*

In the Paullus case, the taxpayer admitted that it engaged in the first stage of the development process: it had the property rezoned from agricultural to residential. But the taxpayer claimed that it did so to maximize loans from third parties. The court accepted this

explanation, although details concerning the need for any financing were not discussed. Through rezoning, the taxpayer thereby created “entitled property” upon which residential dwelling units could be constructed. In the case of the Unit 4, 5 and 6 properties (sold to Construction or Financial between 1977 and 1981), the properties were conveyed by a “metes and bounds” description for a large parcel, and no reference was made to a recorded subdivision map. Since these parcels were sold as bulk parcels prior to the recordation of a final subdivision map, the development activity of the taxpayer was fairly limited. The final maps were obtained in the name of Construction or Financial who became the “subdividers” of the property.

In the case of the Unit 7, 8 and 9 properties (sold to Construction or Financial between 1985 and 1987), these properties were part of the 269 acre Bushmont property which was one property when acquired in 1985. Accordingly, the taxpayer had to obtain in its name tentative and final maps for portions of the Bushmont property in order to convey to Construction or Financial the separate legal parcels (i.e., the Unit 7, 8 and 9 properties). Recordation of the final map was a legal condition precedent to the taxpayer’s ability to transfer title to the properties. Accordingly, the taxpayer argued that it completed the recording of the final map only because it was legally required to do, that it conveyed title as soon as possible thereafter and that it took the only minimum steps required under California law to effect such conveyances.

With respect to physical improvements, all streets, sewers and other offsite improvements to the Unit 4 through 9 properties were done by Construction or Financial. The taxpayer admitted that it incurred certain costs in connection with zoning and obtaining a final subdivision map for the certain parcels sold from 1977 through 1987, but claimed that these costs (about \$600,000) were insignificant compared to Construction’s costs (about \$15,000,000 from 1986 to 1989) and Financial’s costs (over \$7,490,000 from 1986 to 1989). However, the taxpayer conceded that it did make physical improvements costing about \$1,600,000 as required by the purchase contract in connection with the Unit 10 property.

Finally, with respect to offering of subdivided lots for sale, the Final Subdivision Reports issued by the DRE indicated that Ridgemark was not involved with the offering or sale of lots from any of the seven parcels. In each case, the name “subdivider” was either Construction or

Financial. The Subdivision Reports stated that the subdivider (Construction or Financial) was responsible for completion of streets, curbs, gutters and other offsite and common area improvements. Thus, the improvements were not completed at the time the reports were issued, which was well after the parcels were sold by Ridgemark.

In connection with the Unit 10 property, the taxpayer admittedly went through the entire development process, from rezoning, tentative map, final map, applying for a Final Subdivision Report with the DRE, and making physical improvements. The taxpayer conceded that such development activities might otherwise cause the taxpayer to be characterized as a dealer in the absence of special circumstances. The special circumstances in Paullus were:

- 1) the taxpayer's plan to sell or otherwise dispose of all of its assets ("liquidation intent"), and
- 2) the contractual obligations imposed upon the taxpayer by the buyer ("contract requirements").

Liquidation Intent. The taxpayer argued that in May of 1987, Ridgemark's board adopted an informal plan to sell or otherwise dispose of all of its assets. This was in response to the desires of two shareholder groups. One group was advancing in age and desired not to participate in the expansion of the golf and recreational business in Paicines. Paullus' decision to sell the Ridgemark assets was motivated by a desire to free himself from the day-to-day golf and resort management duties which were burdensome, and his belief that the proceeds derived from this liquidation would enable Ridgemark to acquire the Paicines property which would accommodate a large recreational resort facility with six eighteen hole golf courses.

For both groups of shareholders, therefore, it became necessary for Ridgemark to sell substantially all of its assets. No brokers or agents were employed by Ridgemark in this process. Ridgemark desired to sell all of its assets in bulk. Thus, the Ridgemark Golf and Resort business, together with any remaining land, of which Unit 10 property was a part, were offered in the form of the proposed sale of one hundred percent (100%) of Ridgemark's stock.

Mr. Y. L. Shen ("Shen"), represented by Joseph Drosihn, emerged as the leading candidate to purchase Ridgemark's business. In early 1988 he advised Ridgemark that they were unwilling, for tax reasons, to purchase all the stock of Ridgemark but, instead, would purchase all of its developable land, including the Unit 10 property. He declined to purchase the golf courses and resort facilities because Mr. Paullus refused to continue in his employ to manage them.

Contract Requirements. The principal economic provisions of the final Purchase Agreement between Ridgemark and Shen were:

- a) a purchase price of \$11,500,000;
- b) the requirement that Ridgemark complete, as its expense, all offsite and common area improvements, including streets and sewers; and
- c) the payment by Seller of all required San Benito County fees (utility fee of \$151,000, traffic fee of \$37,500).

The actual amount paid by Ridgemark in satisfaction of items (b) and (c) above was approximately \$2,200,000 of which \$1,785,000 was incurred and paid after the execution of the contract with Shen. Accordingly, the taxpayer argued that Ridgemark was contractually obligated to perform these improvements as a result of negotiations involving the sale of Unit 10 in the course of implementing a plan to dispose of all of its assets. The Unit 10 improvement costs were substantial and greater both in terms of the extent of improvements and in the dollar amount than any of Ridgemark's previous sales.

Improvement Cases. A taxpayer may hold property "for investment" even though it undertakes certain improvement activities in connection with the sale of the property that might otherwise cause taxpayer to be characterized as a dealer. These cases hold that when improvements to property are made incident to the taxpayer's liquidation of its investment, such improvements are not indicative of an intent to sell the property in the ordinary course of business. See Estate of Barrios v. Commissioner, 265 F.2d 517 (5th Cir. 1959); Charles R. Gangi v. Commissioner, TCM 1987-561 (1987); Heller Trust v. Commissioner, 382 F.2d 675 (9th Cir. 1967).

In the Barrios case, the taxpayer liquidated its investment in real property previously held for farming because construction of a government canal created drainage problems. The taxpayer subdivided the land and began selling lots. The Tax Court held that the taxpayer's action in subdividing and platting the land for sale and the installation of landscaping, streets, water mains and culverts caused the taxpayer to hold the property primarily for sale in the ordinary course of its business as a dealer. The Fifth Circuit reversed the Tax Court and held that the taxpayer was entitled to capital gains treatment on the sale of the land. The court noted that selling a large tract of land lots may necessarily involve the construction of streets for access to them, provision of drainage and water, and other improvements. The court also reaffirmed the established principle that a person holding land for investment may subdivide it for an advantageous sale in a liquidation context.

In the Gangi case, the taxpayer was a partner in a partnership which constructed a 36-unit apartment building in 1970. The apartment units were rented for eight years. In 1977, the relationship between the partners deteriorated and they sought to liquidate their investment. They determined that a conversion of the rental units to condominiums would be most profitable. The partnership incurred approximately \$30,000 in engineering and legal expenses in connection with the conversion of the building to condominium units and an additional \$100,000 to prepare the units for sale. A real estate broker was retained to market the condominiums and sales of the units were advertised in the local newspaper and sales brochures were printed. During 1979, the partnership sold 26 of the 36 condominium units to 26 different purchasers. The issue before the court was whether the taxpayers would realize capital gain or ordinary income from the sales of the condominium units. The Service's position was that the conversion of the apartment building into condominiums and the subsequent sales efforts changed the taxpayers' purpose from investment to sale in the ordinary course of business. The Tax Court held in favor of the taxpayers and determined that the property was not held primarily for sale to customers in the ordinary course of the taxpayers' business. The taxpayers had originally purchased the property as an investment. Their decision to convert the building to condominiums was made in connection with their real estate investment and not in the ordinary course of a sales business.

In Paullus, the buyer was interested only in purchasing the property in a condition ready for construction of homes, with the offsite improvements completed. The buyer insisted that purchase agreement require Ridgemark to complete all offsite improvements. Ridgemark offered to sell the property for \$10,000,000, with the buyer assuming responsibility for the improvements. In compliance with the contract, Ridgemark undertook and completed construction of certain offsite improvements, including streets and gutters and installation of electrical utilities and water hookups. Ridgemark had not made any similar improvements to other property previously sold by it from 1977 to 1989. Even though Ridgemark undertook the responsibility to complete these offsite improvements, Ridgemark did not sell any of the individual lots. Accordingly, the taxpayer argued that its efforts were of a lesser degree than those found in Barrios supra.

A number of cases have held that the activities of a taxpayer in improving property after it is under contract for sale should be disregarded in determining whether the property was held for investment or primarily for sale. See Wray v. Commissioner, T.C. Memo 1978-488 (1978); Reithmeyer v. Commissioner 26 T.C. 804, 813 (1956).

In Wray, the taxpayer was a developer involved in the acquisition, development, subdivision and sale of single family lots and homes. Taxpayer held a 23-acre parcel for a number of years and during that time engaged in significant activities regarding potential development of the property, either as condominiums or as rental apartments. The taxpayer obtained certain development approvals in connection with the property and ended up selling the entire 23-acre parcel to a third party developer who developed condominiums on the property. The purchase and sale agreement with the third party developer provided that prior to closing, the seller would construct a seawall on the seaside boundary of the property, install sewer and water lines, fill the property to grade, construct a 32-ft wide road in accordance with city specifications, remove an existing road and compact any fill to the extent necessary, remove existing power lines and underground replacement thereof, install all necessary electrical and telephone lines and plat the property as required by the city. The court held that the 23-acre property in question was held for investment and not primarily for sale.

In entering its decision, the court stated:

*"Respondent argues that the fact that the sales contract ... provided for extensive construction improvements that the Partnership ... was required to perform indicates that the 23-acres was being prepared by the Partnership for sale. Certainly the amount of development of land is a factor to be considered in determining whether property is held for sale in the ordinary course of a taxpayer's trade or business. However, the improvements required by the contract were to be made between April 24, 1972 when the contract ... to purchase the property became binding, and the August 1, 1972 closing date of sale." In ... we held that the improvements to be considered were those made prior to the sale."*

4. **"Liquidation Intent."** The argument based on "liquidation intent" was ingeniously developed by the taxpayer. The taxpayer may have won its case with this argument. Others should be more cautious, however, in relying on "liquidation intent." A "liquidation intent" does not prove that property was not held primarily for sale, especially where a voluntary liquidation occurs after frequent prior sales of real estate. See Biedenharn Realty Co., *supra* at 421-422 and Suburban Realty Co., *supra* at 184-185. It is amazing that the Service did not reply to the taxpayer's argument with the instructive language in these cases concerning "liquidation intent".

In Biedenharn, the court stated:

*"We reject the Government's sweeping contention that prior investment intent is always irrelevant. There will be instances where an initial investment purpose endures in controlling fashion notwithstanding continuing sales activity. We doubt that this aperture, where an active subdivider and improver receives capital gains, is very wide; yet we believe it exists. We would most generally find such an opening where the change from investment holding to sales activity results from unanticipated, externally induced factors which make impossible the continued pre-existing use of the realty. Barrios Estate, *supra*, is such a case. There the taxpayer farmed the land until drainage problems created by the newly completed intercoastal canal rendered the property agriculturally unfit. The Court found that taxpayer was dispossessed of the farming operation through no act of her own." Supra at 518. Similarly, Acts of God, condemnation of part of one's property, new and unfavorable zoning regulations, or other events forcing alteration of taxpayer's plans create situations making possible subdivision and improvement as part of a capital gains disposition." 526 F.2d at 421.*

The court added in a footnote:

*“A Boston University Law Review article canvassing factors including involuntary changes of purpose in subdivided realty cases enumerates among others the following: a pressing need for funds in general, illness or old age or both, the necessity for liquidating a partnership on the death of a partner, the threat of condemnation, and municipal zoning restrictions. Levin, Capital Gains or Income Tax on Real Estate Sales, 37 B.U.L. Rev. 1965,194-95 (1957). Although we might not accept all of these events as sufficient to cause an outcome favorable to taxpayer, they are suggestive of the sort of change of purpose provoking events delineated above as worthy of special consideration.”*

The court further stated:

*“However, cases of the ilk of Ackerman, supra, Thompson, supra, and Winthrop, supra, remain unaffected in their ordinary income conclusion. There, the transformations in purpose were not coerced. Rather, the changes ensued from taxpayers’ purely voluntary responses to increased economic opportunity-albeit at times externally created-in order to enhance their gain through the subdivision, improvement, and sale of lots. Thus reinforced by the trend of these recent decisions, we gravitate toward the Government’s view in instances of willful taxpayer change of purpose and grant the taxpayer little, if any, benefit from Winthrop’s first criterion in such cases.” 526 F.2d at 422.*

The court concluded:

*“We caution that although permitting a land owner substantial sales flexibility where there is a forced change from original investment purpose, we do not absolutely shield the constrained taxpayer from ordinary income. That taxpayer is not granted carte blanche to undertake intensely all aspects of a full blown real estate business. Instead, in cases of forced change of purpose, we will continue to utilize the Winthrop analysis discussed earlier but will place unusually strong taxpayer-favored emphasis on Winthrop’s first factor.” Id.*

In Suburban Realty, the court stated:

*“We attach no independent significance to ‘liquidation discussions.’ As we said in Biedenharn, “a taxpayer’s claim that he is liquidating a prior investment does not really present a separate theory but rather restates the main question ... under scrutiny.” Biedenharn, 526 F.2d at 417.*

*“[S]uburban uses the term “liquidation” to refer to discussions about winding up Suburban as a corporate entity and distributing its assets, as well as discussions about converting its investments into cash. Discussions about each of these matters may evidence a change in holding purpose, but a corporation’s actions may speak louder than ‘its’ words. The latter is the case here. When*

*investigating a corporation's intent, courts must be skeptical of words spoken at board meetings.*

*Although Suburban uses the word "liquidation" in an effort to place itself in Biedenharn's "liquidation niche," Biedenharn, 526 F.2d at 417, that concept is not applicable here. Rather, it refers to the possibility that a holding purpose other than 'for sale' might be found to continue through a period of relatively substantial sales activity when 'unanticipated, externally induced factors ... make impossible the continued pre-existing use of the realty.'" 615 F.2d at 185, n. 39.*

The court contrasted the withdrawal of plats by the taxpayer in Suburban Realty with liquidation discussions. The court stated:

*"This withdrawal of plats could be quite significant. Unlike liquidation discussions, which were apparently a dime a dozen for Suburban, withdrawal of the plats was an action taken by Suburban which may evince a different relationship to the land. The critical question is whether this withdrawal indicated that henceforth the land was being held principally as an investment or simply showed that Suburban was attempting to maximize sales profits by selling to commercial users. The continuing sales activity is strong evidence that the latter interpretation is the correct one." 615 F.2d at 184-85.*

Following Biedenharn and Suburban Realty, the taxpayer's "liquidation intent" could have been cited as evidence that the taxpayer in fact held the property primarily for sale and not for investment purposes. Again, the Service could have turned this argument around against the taxpayer. The sales of parcels from the Bushmont property began almost immediately after the property was acquired (Unit 7 was sold within two months) Could that be when the taxpayer's "liquidation intent" was formed? If so, such a "liquidation intent" seems tantamount to holding property primarily for sale.

The proposed liquidation of assets in Paullus was not involuntary or externally induced. However, there were facts other than maximizing profits driving the sales of real estate (e.g., the need to finance the golf course expansion and other improvements in the Bushmont property, the desire of other shareholders to be bought out, Paullus' unwillingness to continue managing the operation, and the proposed Paicines venture). In at least Fifth Circuit, these facts are likely to be insufficient to justify substantial development and sales activity. Compare Heller Trust, infra, a Ninth Circuit case, which takes a more liberal, pro-taxpayer view of this issue. But it

remains true in any jurisdiction that, if the taxpayer was a dealer in property before he decided to liquidate the remaining assets, he is likely to remain a dealer with respect to the liquidation sale.

Conversely, sales made in the process of liquidating investment properties are likely to qualify both for capital gains and exchange treatment. See, e.g., Gangi, supra (apartment building converted to condominiums to maximize profits in connection with the liquidation of a partnership); PLR 9331013 (May 6, 1993) (property management firm's sale of condominiums unit by unit after lease operations failed to generate a profit and where sales activities were handled by a third party constituted liquidation of capital assets entitled to installment sale treatment); Heller Trust, infra (169 rental duplexes sold over 4-year period).

The taxpayer's activities should be consistent with its liquidation intent. The courts have stated that improvement activities on the properties after the decision to sell has been made and reinvestment of the sales proceeds in similar property may be inconsistent with a liquidation intent. See Bush v. Commissioner, T.C. Memo 1977-75, aff'd 610 F.2d 426 (6th Cir. 1979). In Paullus, the taxpayer engaged in pre-sale subdivision and improvements, as well as reinvestment in similar property through the exchange. These facts were arguably inconsistent with a true "liquidation intent."

When considered under §1031, the taxpayer's "liquidation intent" argument presents a paradox. On the one hand, the taxpayer claims to be liquidating an investment to avoid dealer status under the §1221(1) cases. On the other hand, the taxpayer claims to be entitled to the benefits of §1031 whose underlying theory is continuity of investment!

5. **"Separate Entities."** The taxpayer requested a finding of fact that Ridgemark, Construction and Financial were maintained and operated as separate entities, with separate businesses. The taxpayer noted that the formalities, recordkeeping, tax returns and documentation for each corporation were separately observed. The Service could not prove otherwise, and the court accepted the taxpayer's position. The taxpayer also argued that the sales prices to Construction and Financial were based on the fair market value of comparable property, with certain prices increased to account for the proximity of the parcels to the

Ridgemark Golf and Country Club. The Service conceded that the sales prices were “at arm’s length.”

Use of the separate entities proved to be of enormous tax benefit to the taxpayer. If the taxpayer had itself conducted the activities of Construction or Financial, or if such activities were imputed to the taxpayer under an agency or substance-over-form theory, the taxpayer clearly could not have exchanged the Unit 10 property under §1031.

The Service argued that the separate entities were “irrelevant” to whether Ridgemark held the Unit 10 property primarily for sale. It is true that respect for the separate entities would not establish, in and of itself, that Ridgemark held the Unit 10 property for investment purposes. But it is also true that disregard of the separate entities would have likely established that Ridgemark was a dealer with respect to the Unit 10 property and therefore not entitled to the benefits of §1031. The Service made no attempt to impute the activities of Construction or Financial to Ridgemark, even though they were sister corporations owned by the same shareholders, had the same president (Paullus), and acquired the properties with Ridgemark’s financing.

The taxpayer argued that the issue is extremely relevant to the issue of whether Ridgemark sold Unit 10 in the ordinary course of its business activity. The taxpayer stated in its Reply Brief (p.7):

*“The issue in this case is whether Ridgemark was engaged in the development and sale of real property in the ordinary course of its business. Respondent repeatedly seeks to blur the distinction and the activities of Petitioner Ridgemark and the activities of Ridgemark Financial and Ridgemark Construction and attempts to assert that Ridgemark routinely continued to develop and sell residential lots when in fact the development, improvement and sale of residential lots and townhomes were pursued by Ridgemark Financial and Ridgemark Construction and not petitioner Ridgemark.”*

One might naively credit the taxpayer with excellent tax planning and foresight in creating Construction and Financial in 1977. But these entities were formed almost by accident and independent of tax considerations. The entities were incorporated some 8

years before the Bushmont property was acquired and 12 years before the exchange of the Unit 10 property. Construction and Financial were formed because the principals of Ridgemark wanted to pursue construction and financing of homes based on two sales of land to third party developers who were successful. The shareholders saw the potential profits from construction and financing that they were leaving on the table. Separate entities were formed to isolate the businesses and limit liabilities, not to qualify for future capital gain or exchange treatment.

Notwithstanding the above, Paullus is likely to be cited in the future as approving the use of separate entities to avoid dealer status under §1221(1) and/or excluded property under §1031. In addition to various business, legal, regulatory and financial reasons, taxpayers may desire to use separate entities in connection with their real estate activities for at least three tax reasons: (1) to avoid frequent sales by an investor; (2) to segregate holdings and activities; and (3) to qualify for capital gain or exchange treatment, now or in the future.

A. **Avoid Frequent Sales**. The taxpayer argued that the infrequent sales by Ridgemark to Construction and Financial were similar to those approved in Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1992), reversing 59 T.C.M. 876 (1990). The court cited Bramblett with approval for the proposition that infrequent sales resulting in large profits tend to show that property is held for investment. This is one way, of course, to reduce the number, extent, continuity and substantiality of sales. (See discussion below regarding the importance of this Winthrop factor). By selling property in bulk to a related development entity on an infrequent basis, the taxpayer may preserve investor status for itself.

In Bramblett, a partnership purchased raw land, held it for three years, and sold it to a corporation owned by the partners in the same percentage interests. The corporation developed the land and sold most of it to third parties in eight different transactions. The partnership had previously engaged in four insubstantial sales and made a profit of \$68,394.80. On the fifth sale at issue, the partnership made a profit of over \$7,000,000.

The Tax Court held that the partnership was in the business of selling land, “either directly or through the corporation.” The Tax Court noted that the entities were owned by the same persons in identical interests, that the corporation was formed less than a month after the partnership, that the corporation only developed land acquired from the partnership, that the corporation routinely entered into sales contracts before buying the property, that the corporation made no principal payments to the partnership until funds were received from third parties, and that the required interest payments were never made. The Tax Court found that “the evidence of the corporation’s activities and their correlation with activities of the joint venture is proof of the nature of the business of the joint venture.” Based on this evidence, the court concluded that “the business of the joint venture was the sale of land and that the resulting gains should be taxed as ordinary income.”

The Fifth Circuit reversed the decision of the Tax Court. The court held that any finding by the Tax Court that the partnership was directly in the business of selling land was clearly erroneous. The court also held that the corporation was not the agent of the partnership and its activities could not be attributed to the partnership under “substance over form” principles.

The court’s review of the Winthrop factors indicated that the partnership was not directly in the business of selling land. The court noted that “this record of frequency [5 sales over 3 years] does not rise to the level necessary to reach the conclusion that the taxpayer held the property for sale rather than for investment.” 960 F.2d at 531. The court found that all of the other factors weighed heavily in favor of the taxpayer:

- (1) the stated purpose of the partnership was to acquire the property for investment purposes, it sought advice as to how to structure the transaction to preserve its investment purpose, and it held the property in question for over 3 years;
- (2) the partnership did not advertise or hire brokers;
- (3) the partnership did not subdivide or develop the property;

- (4) the partnership did not maintain a sales office; and
- (5) the partners did not spend more than a minimal amount of time on the partnership's activities.

With respect to the agency issue, the Fifth Circuit relied on the Supreme Court's agency tests set forth in National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949) and Bollinger v. Commissioner, 485 U.S. 340 (1988). The court found that:

- (1) the corporation did not act in the name of the partnership or have authority to bind the partnership;
- (2) the corporation did not transmit money received to the partnership in excess of the fair market value of the property at the time of the sale;
- (3) the corporation's income was not attributable to the services, employees or assets of the partnership;
- (4) the corporation retained all development profits, which was much larger than a typical agency fee; and
- (5) the business purpose of the corporation was not carrying on the normal duties of an agent.

The other factor, common ownership of both entities, is not enough to prove an agency relationship. Accordingly, the court concluded that the corporation was not selling or developing property as an agent of the partnership or the partner-shareholders.

With respect to the "substance over form" issue, the Fifth Circuit rejected the Service's argument that the economic substance of the transactions required the attribution of the corporation's activities to the partnership. The court cited the Supreme Court's decision in Frank Lyon v. United States, 435 U.S. 561 (1978) as authority limiting the application of the "substance over form" doctrine. The Supreme Court stated that the form chosen by the taxpayer should be respected when it has genuine economic substance, "is compelled or encouraged by business or regulatory realities, is imbued with

tax-independent considerations, and is not shaped solely by tax-avoidance features.”  
Frank Lyon, 435 U.S. at 583-84.

In Bramblett, the court concluded that:

- (1) there was no suggestion that the corporation was a sham;
- (2) at least one non-tax business reason existing to form the corporation (insulation of the partners from personal liability);
- (3) the related party sale was conducted at arm’s length and business and legal formalities were observed; and
- (4) the partnership purchased the land as an investment and bore the risk that it would not appreciate.

Thus, the court held that the corporation’s activities could not be attributed to the partnership under the “substance over form” doctrine.

In Paullus, the Service attempted to distinguish Bramblett on its facts. The Service pointed out that:

- (1) the taxpayer in Bramblett stated a business purpose of acquiring the property for investment, while Ridgemark did not state an investment purpose;
- (2) the taxpayer in Bramblett did not develop the property, while Ridgemark spent significant funds after acquisition in connection with rezoning (all parcels), obtaining subdivision maps (Units 7, 8, 9 and 10), and physical improvements (Unit 10);
- (3) the taxpayer in Bramblett did not have a sales office or extensive list of potential purchasers like Ridgemark did;
- (4) the taxpayer in Bramblett spent minimal time on activities relating to the property, while Ridgemark spent more time in its board meetings discussing its real estate than its golf business; and

- (5) the taxpayer in Bramblett had an insignificant gross profit of \$68,394.80 from the four prior sales, while Ridgemark had a \$5,100,309 gross profit from the seven sales prior to the Unit 10 property which accounted for nearly 75% of Ridgemark's total profits.

The taxpayer responded to each of these points at outlined above, and minimized the importance of these distinctions. In the end, the taxpayer was successful in persuading the court of at least one key similarity in the cases: the relatively low frequency of sales. As noted above, this factor tended to show that the property was held for investment. In addition, after reading Bramblett, the Service was likely deterred from making any "agency" or "substance over form" arguments in an attempt to attribute the activities of Construction and Financial to Ridgemark. Ordinarily, the business of a corporation is not attributed to its shareholders or sister corporations. See, Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943); Brown v. Commissioner 448 F.2d 514, 518 (10th Cir. 1971).

B. **Segregate Property Holdings.** The separate entities in Paullus also had the effect of segregating large parcels of land held by Ridgemark (arguably, investment property) from subdivided, finished lots held for sale by Construction and Financial (clearly, dealer property). In this way, Ridgemark was able to argue that it was "wearing the hat of an investor rather than that of a dealer" with respect to the Unit 10 property. Similarly, in Pritchett v. Commissioner, 63 T.C. 149 (1974), acq. 1975-1 C.B. 2, the taxpayer successfully segregated his real estate investments from his dealer activities. He did so by taking title to his investment real estate in his own name, while keeping his "dealer" land in partnerships and corporations. "Through the scrupulous maintenance of this distinction," the taxpayer claimed that "a clear and consistent pattern evolves which makes the identification of his investment real estate easy." 63 T.C. at 164.

In Pritchett, the court found that the apparent segregation of the taxpayer's investment real estate from dealer activities was certainly a "factor to be considered," but was not conclusive. The court agreed that when the taxpayer acquired land which was

subdivided, developed and sold in lots, the activity was usually conducted in partnership or corporate form. But the court cautioned that this fact, in and of itself, did not prove the taxpayer's case. The taxpayer could have also bought other real estate for resale without subdivision or development as a dealer. Accordingly, each of the four sales at issue in Pritchett had to be examined separately to determine the taxpayer's principal purpose for holding each parcel.

In summary, separate entities may be used to segregate property holdings in two types of cases:

- (1) where the taxpayer claims that he is not a dealer at all, such as Paullus ("single status cases") and
- (2) where the taxpayer admits that his is a dealer with respect to some properties, but claims to be an investor with respect to the property at issue, such as Pritchett ("dual status cases").

Although not argued as such, Paullus was in some ways a dual status case because Ridgemark sold approximately 200 subdivided and finished lots prior to the formation of Construction and Financial. Ridgemark then arguably changed its purpose for holding land and limited its development and sale activities. It was crucial for the taxpayer, however, that Paullus be viewed as a single status case. If Ridgemark admitted to being a dealer after 1977 with respect to Unit 4 through 9 properties, the taxpayer had no real way of distinguishing the Unit 10 property from its prior dealer activities.

For a recent dual status case, see Tollis v. Commissioner, T.C. Memo 1993-63, aff'd per curiam 95-1 USTC Par. 50,076 (6th Cir. 1995) (sale of condominium units held in connection with a real estate management business was separate and apart from the taxpayer's development and sales business, and thus entitled to capital gain treatment under §1231). See also Planned Communities, Inc. v. Commissioner, T.C. Memo 1980-555; Hicks v. Commissioner, T.C. Memo 1978-373; Harbour Properties, Inc. v. Commissioner, T.C. Memo 1973-134; Maddux Construction Co. v. Commissioner, 54

T.C. 1278 (1970); Rouse v. Commissioner, 39 T.C. 70 (1962); Eline Realty Com. V. Commissioner, 35 T.C. 1 (1960); Myers v. United States, 345 F. Supp. 197 (N.D. Miss. 1972), aff'd per curiam, 469 F.2d 1393 (5th Cir. 1973).

In Municipal Bond Corporation v. Commissioner, 382 F.2d 184 (8th Cir. 1967), reversing in part 46 T.C. 219 (1966), the Eighth Circuit stated:

*“As we interpret Malat, a real estate dealer may under appropriate circumstances acquire and hold a tract of real estate primarily for the purpose of investment with hope of long term appreciation and if such is the case, a subsequent sale is not conclusive on the question of primary purpose in acquiring and holding the real estate.”*

See also Scheuber v. Commissioner, 371 F.2d 996 (7th Cir. 1967) (property that was held for 9 years by real estate dealer with no intensive effort to improve or sell it entitled to capital gains treatment); Mathews v. Commissioner, 317 F.2d 360 (6th Cir. 1963); Wood v. Commissioner, 276 F.2d 586 (5th Cir. 1960) (industrial tract held by a dealer was primarily acquired for rental, and sales of land were for financing and to make remainder of land more attractive to prospective tenants); Farry v. Commissioner, 13 T.C. 8 (1949).

C. **Qualify For Capital Gain or Exchange Treatment.** When land is ripe for development, an investor may want to sell the land to a related development corporation. This may allow an individual investor to freeze the pre-transfer appreciation in land value as long-term capital gain taxed at a maximum rate of 28% (or lower rate under proposed legislation), instead of realizing ordinary income subject to a maximum rate of 39.6% if the investor develops and sells off subdivided parcels himself. Further, the investor retains the opportunity to participate in future profits from the development of the land as a shareholder of the corporation, instead of being deprived of sharing in the development profits. If the sale is structured as a seller-financed transaction, the taxpayer may recognize capital gain under the installment method of accounting subject to the related-party sale provisions of §453(e).

If the related corporation has or can obtain adequate funds, the investor may also consider a §1031 exchange of the land into other income or investment property. The transaction would not be taxable under §1031(f) as long as the investor and the corporation hold the properties for at least 2 years after the exchange. See also §1031(g). Section 1031(f) does not require that the property received by the related party (the corporation) have a qualified use under §1031 during the 2-year period. In other words, the property received by the related party may be “inventory” in its hands, and the exchange will not be taxable as long as the related party does not dispose of the property in the 2-year period.

Use of this tax planning technique presents a number of issues:

- (1) Whether the individual (or entity) will qualify for capital gain, installment sale or exchange treatment on the transfer of the appreciated property to the related entity;
- (2) Whether the transfer of the property is treated as a bona fide sale or exchange or as a contribution to the capital of the related entity;
- (3) Whether other provisions of Code will prevent realization of the intended tax benefits.

With respect to the first issue, the owner must avoid dealer status under §1221(1) and §453(l)(1) or avoid excluded property held primarily for sale under §1031(a)(2). An excellent primer has been written on this issue. See Bird, “Treatment of Capital Gain on Sale of Land to a Related Development Corporation,” 22 Journal of Real Estate Taxation 255 (No. 3, Spring 1995). To qualify for capital gain or exchange treatment, the owner should have an investment purpose for acquiring and holding the land and a significant holding period. The owner should consistently report the property as an “investment” on tax returns, financial statements and other documents. The owner should avoid direct engagement in a real estate business involving the property; limit activities to leasing for grazing and similar uses and land-use studies; avoid subdivision, development and improvements in its own name; refrain from actively marketing the property by

advertising, placing “For Sale” signs on the land or listing the property with brokers; and minimize the number, extent and continuity of sales by selling land to developers in as few as possible isolated, bulk sales.

In addition, a business purpose for the related party transaction, independent of tax consequences, should be documented. For example, the use of a corporation to develop and sell the land in order to insulate the individuals from liability should be an acceptable business purpose. The need for obtaining outside investment capital or a change in the intended use of the property may also constitute a valid business purpose. The investor’s position is also buttressed if there is not a complete identity of ownership interest. The parties should transact their business on an arm’s length basis observing normal commercial and legal formalities.

The properties should be sold to the corporation at its fair market value, as determined by an independent appraisal, comparable sales or other objective evidence. An inflated sales price indicates a bad faith attempt to realize development profits at capital gains rates. If the investor provides financing to the corporation, the terms of the financing should provide for a reasonable down payment, adequate security, a reasonable rate of interest, minimum payments over time, and a fixed maturity date. Corporations should take title to the property, and the deed should be recorded. The parties should not attempt to save transfer tax and other costs by transferring title directly from the investor to third party purchasers. The corporation should arrange for its own development financing, and the investors may guarantee the loan as a shareholder of the corporation if necessary. Finally, the related parties should act independently, or in their appropriate capacities, when dealing with third parties, such as administrative agencies, lenders, brokers, and potential purchasers.

Cases upholding capital gain treatment in such transactions include Bramblett, *supra*; Gordy v. Commissioner, 36 T.C. 855 (1961), *acq.*; Cary v. Commissioner, 32 T.C.M. 913 (1973); Ronhovde v. Commissioner, 26 T.C.M. 1251 (1967). See also the cases involving sale versus capital contribution cited below. Cases denying capital gain

treatment and holding the taxpayer to be a dealer include Bayer v. Commissioner 58 T.C. 316 (1972); Brown v. Commissioner, 54 T.C. 1475 (1970), aff'd 448 F.2d 514 (10th Cir. 1971); Cappuccilli v. Commissioner, 40 T.C.M. 1084 (1980), aff'd 668 F.2d 138 (2nd Cir. 1981), cert. denied.

In the cases denying capital gain treatment, the Service was successful in attributing the corporation's activities to the taxpayer on various theories, including agency, joint venture, substance over form, and the taxpayer's failure to act in a separate capacity. See also Estate of Freeland, 393 F.2d 573 (9th Cir. 1968); Ackerman v. United States, 335 F.2d 521 (5th Cir. 1964), aff'd 215 F. Supp. 867 (N.D. Tex. 1963); Burgher v. Campbell 244 F.2d 863 (5th Cir. 1957); Browne v. United States, 356 F.2d 546 (Ct. Cl. 1966); Tibbals v. United States, 362 F.2d 266 (Ct. Cl. 1966); Engassar v. Commissioner, 28 T.C. 1173 (1967); Lakin v. Commissioner, 28 T.C. 462 (1957), aff'd 249 F.2d 781 (4th Cir. 1957); Parker v. United States, 53 AFTR2d 84-349 (D.C. Ore. 1983)

If the related corporation sells the property pursuant to a prearranged plan, the corporation's sale may also be attributed to the taxpayer. See Commissioner v. Court Holding Co., 342 U.S. 331 (1945); Chase v. Commissioner, 92 T.C. 874 (1989). Compare Anders v. Commissioner, 68 T.C. 474 (1977) (seller financed sale of option qualified for capital gain treatment, although option was sold to the taxpayer's accountant who exercised the option and sold off parcels to different purchasers).

With respect to the second issue, the Service may attempt to recharacterize a seller-financed sale of the property to a controlled corporation as a capital contribution. If the Service is successful in doing so, the individual will suffer several adverse tax consequences. First, the corporation's tax basis in the land will be decreased by the difference between the cost basis and the investor's basis at the date of transfer. This adjustment will increase the corporation's gross profit on completed sales and its taxable income. Second, the corporate notes issued in connection with the investor's financing of the sale will be reclassified as equity. This will result in disallowance of the

corporation's interest expense deduction and taxation of the note payments as dividends to the individual to the extent of the corporation's earnings and profits. Thus, the tax liabilities of the corporation and the individual may increase significantly as a result of such a recharacterization and corresponding adjustments.

The basic question in these cases is whether the corporate notes issued to the individual represent bona fide debt resulting from a purchase and sale of land, or whether they represent an equity interest resulting from a capital contribution. See Kolkey v. Commissioner, 27 T.C. 37 (1956), aff'd 254 F.2d 51 (7th Cir 1958). The following factors are considered:

- (i) sales price (whether the consideration received is disproportionate to the fair market value of the property);
- (ii) issuance and terms of notes (whether the corporation issued notes evidencing the indebtedness and whether the terms were commercially reasonable for a lender);
- (iii) capital structure (whether the corporation is adequately capitalized);
- (iv) risk transfer (whether the noteholders bear a high degree of risk inconsistent with creditor status); and
- (v) enforcement of obligations (whether the noteholders can and do enforce the obligation if the corporation is in default).

If thin capitalization of the corporation is the only factor supporting reclassification of the debt to equity, the courts have held that thin capitalization, standing alone, is insufficient cause to recharacterize a sale as a capital contribution.

Cases upholding treatment of the transfer as a sale include Bradshaw v. United States, 683 F.2d 365 (Ct. Cl. 1982); Piedmont Corp v. Commissioner, 388 F.2d 886 (4th Cir. 1968), reversing 25 T.C.M. 1344 (1966). See also Sun Properties, Inc. v. United States, 220 F.2d 171 (5th Cir. 1955). Granite Trust Co. v. United States, 238 F.2d 670

(1st Cir. 1956); Husdman v. United States, 827 F.2d 1409 (9th Cir. 1987); Jerome v. Commissioner, 24 T.C.M. 1763 (1965); Hobby v. Commissioner, 2 T.C. 980 (1943).

Cases recharacterizing the sale to be a capital contribution include Burr Oaks Corp. v. Commissioner, 43 T.C. 635 (1965), aff'd 365 F.2d 24 (7th Cir. 1986), cert. den.; Aqualane Shares, Inc. v. Commissioner, 30 T.C. 519 (1958), aff'd 269 F.2d 116 (5th Cir. 1959). For further discussion of this issue, see Bird, "Planning For the Sale of Land to a Controlled Corporation," 21 Journal of Real Estate Taxation 264 (No. 3, Spring 1994).

The techniques discussed above could also be used in connection with an apartment building or office complex to be subdivided into condominiums. Upon conversion to condominiums, the taxpayer's intent may be deemed to have changed from holding the property for rental to holding the property primarily for sale. In such a case, the entire gain may be treated as ordinary income, and the property may not qualify for exchange treatment under §1031. See Ferguson v. Commissioner, T.C. Memo 1987-257 (sale of condominium units after conversion of apartment building resulted in ordinary income). See Gangi, supra; Tollis, supra; PLR 9331013.

Other provisions of Code may apply to prevent realization of the intended tax benefits. For example, such transactions should also take into account whether §1239 recharacterizes any gain recognized on the sale or exchange as ordinary income. If the transferee corporation is a dealer or it receives only raw land, the property should not be subject to depreciation in the hands of the transferee, and §1239 should not apply. See also §453(g) (concerning installment sales of depreciable property to a controlled entity). Similarly, the impact of any depreciation and tax credit recapture should be reviewed. Section 453(i) provides for recognition of any depreciation recapture in the year of sale.

If the related party disposes of the property in the 2-year period after the sale or exchange, gain may be accelerated under §453(e) or recognized under §1031(f). Thus, tax deferral (as opposed to permanent rate savings) may be of little or no benefit if the related entity immediately sells the property. Taxpayers should also be careful to avoid

contracts or arrangements that reduce the related party's risk of loss and toll the running of the 2-year period.

The Service may argue that §482 applies to reallocate income among commonly controlled businesses. Section 482 reallocations may be made by the Service if necessary to prevent evasion of taxes or clearly to reflect the income of any such businesses. See, e.g., Foster v. Commissioner, (9th Cir. 1986) (gain on sale of lots reallocated for development partnership after it had transferred appreciated real estate to related hotel corporation having net operating losses).

If property is dealer property in the hands of the transferor, a dealer taint will attach to property contributed to or distributed from a partnership under §724 or §735. If the transferee sells the property within the 5-year period from the date of contribution or distribution, all gain on the property (including subsequent appreciation) will constitute ordinary income. The effect on subsequent appreciation can be avoided only if §724 and §735 are inapplicable to the transaction. For example, the property may be transferred to or from the partnership in a sale or exchange transaction as opposed to a tax-free contribution or distribution.

With respect to subsequent sales of interests in controlled entities, advisors should consider whether the corporation or partnership holds appreciated dealer property. All or part of the gain on the sale of stock or a partnership interest may be considered ordinary income under §341 or §751.

It should be noted that in some cases the taxpayer may desire dealer treatment with respect to its holdings and activities. Losses from the sale of real property by a dealer may be fully deductible, while an investor may have the deductibility of any capital loss limited by §1211. Different treatment is also given to operating income and expenses, and expenses of sale. If the taxpayer is a real estate professional, the passive loss limitations should not apply. See §469(c)(7).

The above summarizes a few of the tax considerations involving the use of related entities to acquire, hold, develop and sell real estate. In Paullus, the separate entities had non-tax business purposes, dealt with each other at arm's length, and maintained their separate identities in dealing with third parties. Moreover, the separate entities were formed 8 years before the acquisition of the Bushmont property and 12 years before the exchange. If Construction and Financial were formed in 1985, the related party transactions might have been given more scrutiny. But under Bramblett and the other favorable cases cited above, it is likely that the separate entities would still have been respected.

The use of related entities to avoid frequent sales, segregate holdings and activities, and qualify for capital gain or exchange treatment is alive and well after Paullus. This planning technique continues to be one of the most powerful "tricks" in the real estate tax advisor's bag.

6. **Frequency of Sales.** The Service conceded that the taxpayer made only 7 sales of land during the 12-year period prior to the exchange of the Unit 10 property. As noted above, it did not attempt to attribute the sales of lots by Construction or Financial to Ridgemark or argue that they were engaged in a joint venture. See, e.g., Parker v. United States, 53 AFTR 2d 84-349 (D.C. Ore. 1983) (partnership realized ordinary income on sale of building lots to construction company owned by partners since partnership and corporation were engaged in joint business venture). Moreover, the Service accepted the taxpayer's 12-year time frame (1977 to 1989), and did not argue that at least 207 sales were made over the 18-year period from Ridgemark's incorporation (1971 to 1989). See Biedenharn, *infra* (suggesting longer time frames should be used to measure sales frequency).

The Service only argued that the sales were "substantial" in the sense that they resulted in large profits. But without frequency of sales, this fact tended to show the property was held for investment. For example, the court noted that the taxpayer's gain of approximately \$9,000,000 on the Unit 10 property was evidence of "long-term appreciation as opposed to normal inventory

markup.” The finding of substantial, but infrequent, sales was a very favorable fact for the taxpayers, and the Service basically conceded it.

Some courts, including the Fifth and Eleventh Circuits, have held that frequency of sales is the most important of the Winthrop factors. See Biedenharn Realty Co., *supra* at 416 (“although frequency and substantiality of sales are not usually conclusive, they occupy the preeminent ground in our analysis”); Suburban Realty Co., *supra* at 178 (“the presence of frequent sales ordinarily belies the contention that property is being held ‘for investment’ rather than ‘for sale’”); Major Realty, *supra* at 1488 (“the most important factor is the frequency and substantiality of the taxpayer’s sales”). See also Byram v. United States, 705 F.2d 1418 (5th Cir. 1983); Houston Endowment, Inc. v. United States, 606 F.2d 77, 81 (5th Cir. 1979); Little v. Commissioner, T.C. Memo 1993-281. However, “substantial and frequent sales activity, standing alone, has never been held to be automatically sufficient to trigger ordinary income treatment.” Suburban Realty, *supra* at 176.

Conversely, when the sales are few and isolated, or when frequent sales are the result of a passive and gradual liquidation, the taxpayer’s claim to capital gain is accorded greater deference. See Byram, *supra* at 1425; Bramblett, *supra* at 531; Biedenharn, *supra* at 416; Gamble v. Commissioner, 242 F.2d 586, 591 (5th Cir. 1957); Estate of Barrios, *supra* at 520; Dunlap v. Oldman Lumber Company, 178 F.2d 781, 784 (5th Cir. 11950); Brown v. Commissioner, 143 F.2d 468, 470 (5th Cir. 1944).

The following cases involve frequent and continuous sales sufficient to show an intent to hold the property for sale rather than investment.

1. Suburban Realty Co. v. United States, 615 F.2d 171, 174 (5th Cir. 1980) (at least 244 sales were made over a 32-year period out of 1,742.6 acres of land). The court also noted that: in each year there was at least one sale and in most years, there were four or more sales; at least 149 sales were from plotted property restricted to residential development; 83% of Suburban’s proceeds emanated from real estate sales; the corporation was engaged in no other business; the taxpayer originally reported the profits from sales of

all properties, including the six tracts at issue between 1968 and 1971, as ordinary income, but filed a claim for refund with respect to six tracts and three similar tracts sold later; and at the time of sale, the tracts were subject to a gross lease but were otherwise never put to any substantial use.

2. Biedenharn Realty Co., Inc. v. United States, 526 F.2d 409, 411-12 (5th Cir.) (en banc), cert. denied 429 U.S. 819 (1976) at 411-12 (during 31-year period, taxpayer sold 208 lots and 12 individual parcels from subdivision in question; 477 lots were sold from other properties). The court also noted that: the taxpayer had lot sales in all but two years from 1923 inception through 1971; before selling the lots, the taxpayer made physical improvements, adding in most instances streets, drainage water, sewerage and electricity; the taxpayer had no sales office at the property and avoided advertising or other solicitation of customers, but did employ brokers, determined original prices and credit policy, and had no need to engage in promotional exertions in the face of a favorable market; and the taxpayer's original investment purpose and passivity were in the distant past. The court stated:

*“We cannot write black letter law for all realty subdividers for all times, but we do caution in words of red that once an investment does not mean always an investment. A simon-pure investor forty years ago could by his subsequent activities become a seller in the ordinary course four decades later.” 526 F.2d at 423.*

Five of the 13 judges dissented from the en banc majority opinion. The dissent stated that:

- (a) the land had been and continued to be farmed by the taxpayer, and sales of lots were not the sole object of the taxpayer's business;
- (b) real estate sales represented only 11.1% of the taxpayer's income as opposed to 48.8% in Thompson and 52.4% in Winthrop;
- (c) the majority's limitation of the “liquidation niche” suggested in prior cases generally to “unanticipated, externally induced factors” makes impossible any voluntary disposition at capital gains rates and exalts one factor -- sales activity -- over all others;

- (d) holding that property is not part of a sales business only so long as it is sold in large blocks discriminates irrationally against an investor who wants to liquidate but cannot find purchasers interested in large acquisitions; and
  - (e) while agreeing with the majority's redundant warning that "once an investment does not mean always an investment," the dissent retorted "once a sale does not mean always a business." 526 F.2d at 425-27.
- 3. Thompson v. Commissioner, 322 F.2d 122, 124-25 (5th Cir. 1963) (taxpayer sold 376 ½ lots over a 15-year period). The court also noted that: the contested years involved 10 sales of 28 lots which it found to be "significant"; the taxpayer earned 48.8% of income from the real estate sales in question; and once sales began, the taxpayer did not hold the lots for any purpose other than sales.
- 4. United States v. Winthrop, 417 F.2d 905 (5th Cir. 1969) (taxpayer sold 456 lots over a 19-year period). The court also noted that: the taxpayer used the land for nothing but subdividing and selling and there were no multiple, dual or changes of holding purpose during the relevant years; the taxpayer's primary activity was real estate sales from which she earned 52.4% of her income; and the taxpayer began selling shortly after the land was acquired, never using it for any other purpose.
- 5. Major Realty Corporation and Subsidiaries v. Commissioner, 749 F.2d 1483, 1488 (11th Cir. 1985) (taxpayer sold approximately 16% of the total value of the 2,500 acre property and sold and repurchased another 175 acres prior to the bulk sale in 1972). The court also noted that: all of the taxpayer's sales during 1971 and 1972 were parcels from the property; the taxpayer spent over \$1,500,000 in development costs for platting subdivisions covering 415 acres and for physical improvements; prior to 1968 all of the taxpayer's land was classified as property "held for sale," and thereafter the property in question was classified as "held for development"; the taxpayer was incorporated in 1959 for the stated purpose of acquiring, developing, holding and selling real estate; in anticipation of nearby Disney World, the taxpayer devised a master plan for the

development of the tract in 1967 which called for retaining the property for development, leasing the property or, if sales were necessary, to become a joint venturer in the development of the property sold; due to its financial condition, the taxpayer was unable to develop and retain the property; therefore, the taxpayer entered into a limited partnership agreement and the property was sold to the partnership; even if the taxpayer's original intent were to hold the property for investment, there was a "thoroughgoing change of purpose from investment to sales"; and the taxpayer was not liquidating its business and used the sales proceeds to invest further in property and development.

6. Little v. Commissioner, T.C. Memo 1993-281 (over 3-year period, taxpayer completed 163 purchases and 321 sales of rental properties, an average of 161 transactions per year). The court also noted that: in December 1986, the taxpayer transferred 31 properties to three real estate agents in sham transactions to claim capital gains before the repeal of the capital gains deduction; the taxpayer's average holding period for all of the properties at issue was 58 months; the taxpayer's sales proceeds were 2.3 times higher than gross rental receipts, and after deducting expenses and depreciation, the rental business produced large net losses; the large difference between sales proceeds and rental receipts was deemed significant in determining taxpayer's "primary" holding purpose; taxpayer employed 30 or 40 people for the management of his properties, devoted substantial time and effort to the business, and exercised close and direct supervision and control over all representatives involved in sales; the taxpayer bought properties at foreclosure depending on certain factors, including whether the property would realize at least a \$20,000 profit; the taxpayer signed month-to-month rental agreements with tenants, giving him the right to terminate upon 30-day prior notice; the taxpayer formed an S corporation for the purpose of acquiring and selling properties as a dealer; the real estate purchased for the corporation primarily consisted of properties resold very shortly after acquisition and reported as ordinary income on the corporation's return; from 1984 to 1986, the corporation averaged 50 to 75 sales and 60 to 75 purchases per year; the foreclosure properties to be held for the long term - more than 6 months - were held individually by the taxpayer; the taxpayer's individual activities and those of the

corporation were, at times, indistinguishable, with commingling of funds, use of employees, and properties being reported on the wrong tax returns; the question of whether the corporation was “alter ego” of the taxpayer was not at issue, but the relationship between the activities was “relevant” in determining whether taxpayer was also a “dealer” with regard to long-term properties; the fact that the corporation was a dealer did not automatically relieve the taxpayer of also being a dealer in his individual capacity; the lengthy holding period (average of 58 months per property) was not dispositive and did not prevent the properties from being excluded from capital asset status; while property used in a rental business may be entitled to long-term capital gains treatment under §1231, the taxpayer’s rental properties were held “primarily for sale in the ordinary course of his business” and thus excluded from such treatment under §1231(b)(1)(B); even if the taxpayer’s purpose at the time of buying and holding properties were rental or investment, at the time of sale, the taxpayer held the properties primarily for sale to customers, which was dispositive in determining tax treatment; and the taxpayer could not attack the form of the 31 sham transactions because he had “unclean hands” and failed his “duty of consistency.” Negligence and substantial understatement penalties were sustained under §6653(a) and §6661 respectively. The total tax deficiency was \$4,211,681, the substantial understatement penalty was \$1,052,919, and the negligence penalties were at least \$298,403. (Ouch!)

7. Reithmeyer v. Commissioner, 26 T.C. 804, 813 (1956) (from 1946 to 1951, taxpayers subdivided and sold 25 vacant lots and 24 lots with houses thereon from subdivision created out of mined-out land). The court held that the lots were property held primarily for sale to customers in the ordinary course of business. But the court also held that two other sales of raw, mined-out land consisting of 18.61 acres and 7.27 acres qualified for capital gain treatment, even though the taxpayer was required to develop the property pursuant to the sales contract and they agreed to clear and level the land, plat and subdivide the property into lots, construct streets and gutters, and final payment of the purchase price was deferred until this was done. In the first situation involving the lots, the taxpayers entered into the real estate business to dispose of the land and engaged in subdivision and sales activity before the sales. In the second situation involving the two

parcels, the taxpayers were merely liquidating an asset no longer useful without being engaged in a real estate business. See also Rev. Rul. 57-565, 1957-2 C.B. 546 (taxpayer who sells unsubdivided part of a tract of land is not in the business of selling real estate as to the unsubdivided part, and the sale thereof constitutes the sale of a capital asset under §1221).

8. Municipal Bond Corp. v. Commissioner, 382 F.2d 184 (8th Cir. 1967) (19 sales of real estate over 5-year period and 15 prior installment sales). The court noted that of the 19 sales, one was conceded to qualify for capital gain treatment and the Tax Court found six additional sales that qualified, but held the remaining 12 sales were property held primarily for sale. The Eight Circuit held that one of the remaining 12 sales involving the “Frisco tract” was entitled to capital gains treatment, but Tax Court’s findings with respect to other 11 properties were not “clearly erroneous.” In holding that no substantial evidence supported the Tax Court’s finding with respect to the Frisco tract, the Eight Circuit noted that:

- (a) the sale of part of the Frisco tract began 6 years after the taxpayer perfected title and 12 years after the tax sale purchase;
- (b) no immediate demand was present for the highest and best use of the property as an industrial site with trackage;
- (c) in 1953 the taxpayer entered into a 10-year lease at \$100 per acre per year rental, with option to renew for 89 years, and option to purchase at \$4,000 per acre;
- (d) the lessee purchased 7.91 acre tract in 1954 and tracts of 2 acres and .92 acres in 1956;
- (e) the taxpayer’s efforts to advertise or offer the property for sale were minimal; and
- (f) obtaining an extremely favorable long-term lease showed the taxpayer’s intent to acquire and hold this property for investment.

9. Parkside, Inc. v. Commissioner, 571 F.2d 1092 (9th Cir. 1977) (47 rental duplexes sold over 20-month period). The court noted that: the corporate taxpayer held the 47 duplex houses for rent since 1960; the shareholders inherited financial difficulty along with the companies in 1960, and decided the realty would have to be sold in 1964 rather than unprofitably rented indefinitely; the taxpayers tried to sell the properties through the efforts of their president; and real estate agents were then employed to dispose of the 47 units from January 1965 to October 1966. The taxpayer argued that the 47 duplexes were held primarily for sale to avoid personal holding company income under §543(b)(3). The Ninth Circuit found that the properties were held primarily for sale, reversing the Tax Court. By a 2 to 1 vote, the Ninth Circuit panel held that:

- (a) the large number of sales over 2 years and the efforts of the president indicated the properties were held primarily for sale;
- (b) additional factors supported this conclusion, such as the fact that the properties were at all times held for rental or sale, the substantial advertising and sums paid in brokerage commissions; and
- (c) while these factors were relied on in the instant case, they “do not establish a precise balance of factors as a rule of law for all cases of this type.” 571 F.2d at 1096.

Judge Kennedy, now a Supreme Court Justice, dissented, stating that:

- (a) while a prior investment intent may be eclipsed at some later time, the “new direction taken by the corporation was not so complete a change in purpose or business objective” to compel the conclusion that the taxpayers held the property primarily for sale;
- (b) this was simply a case of two corporations going out of business as quickly and efficiently as possible, and the minimal sales efforts were consistent with this objective;

- (c) of the 26 duplexes sold by one corporation, 21 were sold to the same two parties, and of the 21 sales by the other corporation, 16 were sold to four buyers;
- (d) sales activities and management skills did not enhance the value of the assets;
- (e) no improvements were made before sale; and
- (f) while the operation of the personal holding company provisions was “harsh” to the taxpayers, the decision of the Tax Court was correct and should have been affirmed. 571 F.2d at 1097-98

10. Tollis v. Commissioner, T.C. Memo 1993-63, aff’d per curiam, 95-1 USTC Par. 50,076 (6th Cir. 1995) (taxpayer or its wholly owned development corporation built approximately 400 condominium units on a portion of a 69 acre parcel, the vast majority of which were sold to the public in the ordinary course of business). The court noted that the 69-acre parcel was originally acquired to build and sell single-family houses. At issue were five large undeveloped parcels. The court held that these five parcels were sold in the ordinary course of the taxpayer’s development business, even though he never sold undeveloped land before and four of the sales began after his decision to retire. The sale of one parcel was made to the taxpayer’s development corporation which subsequently built and sold condominium units thereon. If these sales had not occurred, the taxpayer planned to develop residential housing on the parcels while he pursued new buyers. The court observed that this was unlike the situation in Hale v. Commissioner, T.C. Memo 1965-274, where zoning obstacles, drainage problems and financial difficulties prevented development of single-family houses and the parcels thereafter became isolated from the partnership’s development business and were held for investment at the time of sale.

Also at issue were 9 condominium sales. The taxpayer retained (or acquired from his corporation) ownership of several condominium units, most of which were leased to tenants, because he believed owning them would make it easier to manage and maintain the condominium buildings. Until 1979 when he decided to retire, these condominiums

were not advertised for sale, but if offered an acceptable price for a unit, the taxpayer would sell it. The Tax Court held that the sales of 8 of these 9 condominium units qualified for capital gain treatment under §1231, with one sale was not qualified because the taxpayer didn't prove a holding period of at least 1 year. The court found that these condominiums were held in connection with a separate real estate management business, that 6 out of 9 of the units at issue were held for approximately 4 years (4 of them for at least 8 years) prior to the sale, and that it was unlikely the taxpayer would have waited all these years to sell if he were holding the units for sale in the ordinary course of his development and sales business.

The taxpayer appealed and the Sixth Circuit affirmed with respect to the five undeveloped parcels, finding that the taxpayer did not meet his "heavy burden" of establishing the segregation of parcels held primarily for investment from those held for development. See also Daughtery v. Commissioner, 78 T.C. 623 (1982) (while a real estate dealer can be in the real estate business with certain properties and, at the same time, hold other properties for investment, the dealer must make a clear distinction on his books and records of the various properties; when he fails to make that segregation, he is subject to ordinary income treatment for all sales).

11. Brady v. Commissioner, 25 T.C. 682 (1955) (taxpayer and 3 other persons purchased 68 already finished lots and 64 lots were sold within 16 months from purchase). The court also noted that short-term financing was obtained by the taxpayer, showing that he intended to sell the lots immediately to repay the debt.
12. Turner v. Commissioner, T.C. Memo 1974-264 (taxpayer sold 595 lots in one subdivision in over 40 separate transactions). The court also noted that the taxpayer was in the business of developing and made frequent purchases over a 12-year period. The taxpayer developed property into lots prior to selling them to third party buyers or to his controlled corporation which build and sold homes on the subdivided property.

13. Williams v. United States, 329 F.2d 430 (5th Cir. 1964) (taxpayer's building and selling activities from 1952 through 1957 resulted in the sale of 128 houses, with the taxpayer operating variously as a sale proprietor, partner and through a corporation). The court noted that: the taxpayer was in the residential construction business since 1937, buying unimproved land, subdividing it, building houses on the lots, and selling the houses and lots to the general public; the property in question involved 41 lots without homes sold to a single purchaser in 1954; and the lots were from subdividing a 14-acre tract of unimproved land purchased in 1953. The court held that the lots were sold in the ordinary course of the taxpayer's business, although the taxpayer claimed that he was never engaged in the business of selling lots alone (without houses built thereon) and that the lots were sold in liquidation necessitated by bad health and a depressed money market.
14. Ferguson v. Commissioner, T.C. Memo 1987-257 (apartment building converted to condominiums and 150 units were sold to 101 purchasers in 5-month period). The court noted that: the taxpayer had a history and was engaged in a business of converting between 38 and 44 buildings to condominiums from 1971 through 1976, the year at issue; when the property was purchased in 1971, it was intended to be converted to condominiums in 2 to 5 years; the taxpayer made improvements of about \$158,000 prior to the sales; the sales were advertised and listed for sale through brokerage services; and as of late 1975 and early 1976, the condominiums were held primarily for sale in the ordinary course of the taxpayer's business.
15. Other Cases. Other decisions have found "sufficient sales" (although not as frequent as some of the cases above), in addition to other factors supporting ordinary income treatment. See, e.g., Yunker v. Commissioner, 26 T.C. 161 (1956) (17 sales completed in 2 years of 5-acre parcels resulting from taxpayer's subdivision of 65-acre area); Lowrie v. Commissioner, 36 T.C. 1117 (1961) (13 prior sales of houses and lots by contractor, with remaining 21 lots sold without houses to a single purchaser); English v. Commissioner, 1993-111 (taxpayer sold 22 lots over 4 years from subdivision and failed to show that he did not hold lots primarily for sale under §1221(1)); Los Angeles

Extension Company v. United States, 315 F.2d 1 (9th Cir. 1963) (district court's finding of fact that 4 parcels of land were held primarily for sale was not clearly erroneous. Byrum v. Commissioner, 46 T.C. 295 (1966) (20 lot sales in 2 years after the taxpayers subdivided nursery farm property to reduce mortgage, initial subdivision was 38 lots which was more than sufficient to pay off mortgage, advertising indicated a total of 233 lots would eventually be offered and 17 lots were added in next year, the taxpayers were held to be actively engaged in a second business - selling subdivided lots - and sales were made in the ordinary course of this business); Pointer v. Commissioner, 48 T.C. 906 (1967), aff'd 419 F.2d 213 (9th Cir. 1969) (16 houses sold on subdivided lots over 6-year period, acts of developer-agent were imputed to the taxpayer); Curtis Co. v. Commissioner, 23 T.C. 740 (1955), rev'd on other issue, 232 F.2d (3d Cir. 1956) (18 sales of undeveloped and over 4-year period where parcels were acquired for the purpose of reselling whenever a satisfactory profit could be made); Sovereign v. Commissioner, 32 T.C. 1350 (1959) (18 properties sold within a year after purchase and 23 within 2 years); Brady v. Commissioner, 25 T.C. 682 (1955) (taxpayer sold 7 properties after 1 year and 37 after 16 months); Walsh v. Commissioner, T.C. Memo 1994-293, aff'd per curiam, 95-2 USTC Par. 50,398 (8th Cir. 1995) (four separate subdivisions out of 35-acre parcel had been created and the lots were sold over an 8-year period, remaining 13-acre was held for 13 years but only 2 years after the sale of last subdivided lots, for 8 years taxpayer attempted to sell 13-acre parcel by posting signs and placing ads, the taxpayer was a real estate broker and ran a small home construction business, the 13-acre parcel was included in taxpayer's Schedule C inventory and treated the same as subdivided property). Walsh was decided by Judge Gerber who also decided Paullus.

In Estate of Freeland v. Commissioner, 393 F.2d 573 (9th Cir. 1968), the partnership's only sales (aside from 300 acres immediately optioned to development corporation) were the sale of fractional acre to telephone company and the sale of approximately 4 acres to the city for a reservoir site, and the partnership never purchased any other real estate except the 4,500 acres at issue. The Tax Court found, and the Ninth Circuit agreed, that the "normal criteria" - the Winthrop factors - did not apply in this case and were not the exclusive benchmarks where there was indirect participation in

development activities and the partnership intended to sell the acreage involved in slices of varying sizes as promptly as possible. Evidence of a dispute between the partnership and corporation, the failure of the development corporation, and the sale of one partner's interest to a third party was insufficient to establish a change of purpose for the partnership's holding of the property. Accordingly, the sale of a partnership interest by the taxpayer nearly 2 years after the partnership bought property was subject to ordinary income treatment under §751.

Further, the sale of a large tract in a single transaction does not necessarily mean that the property was not held primarily for sale in the ordinary course of a taxpayer's trade or business. See Major Realty, supra at 1489; Williams, supra; Laurrie, supra at 1121; Dunwoody v. Commissioner, T.C. Memo 1992-721 (bulk sale of subdivided lots within a year after purchase generated ordinary income where taxpayer had a history of purchasing land which he later sold for development, although frequent prior sales was not discussed); Stockton Harbor Industrial Co. v. Commissioner, 216 F.2d 638 (9th Cir. 1954), cert. denied 349 U.S. 904 (1954) (bulk sale of unimproved, unsubdivided acreage that also had been leased for grazing and exploration gave rise to ordinary income because dominant motive of taxpayer was sale to customers); Houston Endowment, Inc. v. United States, 606 F.2d 77 (5th Cir. 1979); Jarret v. Commissioner, T.C. Memo 1993-516 (bulk sale of back parcel once subdivision map was approved).

Conversely, bulk sales which are isolated, dissimilar from other transactions, and unrelated to a history of development or sales activities may qualify for capital gain treatment. See Goodman v. Commissioner, 40 B.T.A. 22, 24 (1939); Howell v. Commissioner, 57 T.C. 546 (1972); Buono v. Commissioner, 74 T.C. 187 (1980); Bramblett, supra.

Frequent sales are strong evidence that the taxpayer was engaged in a real estate sales business, as well as holding property primarily for sale. But frequent sales are not necessary condition for ordinary income treatment. A taxpayer may be engaged in another form of real estate development business, in connection with one or more sales

are made. See, e.g., Philhall Corp. v. United States, 546 F.2d 210, 215 (6th Cir. 1976) (intent to hold property for sale shown by taxpayer's efforts to obtain planning commission's approval to develop property as a subdivision); Browne v. Commissioner, 356 F.2d 546 (Ct. Cl. 1966) (taxpayer's substantial development activities, use of and sale to controlled corporation which continued development, and taxpayer's purposes of other real estate for development, indicated taxpayer held tract for sale in the ordinary course of development business); Jersey Land & Development Corp. v. United States, 539 F.2d 311 (3d Cir. 1976) (taxpayer filled and graded marshland each year, exercised option to purchase 5-acre segments and sold approximately 40 of its 75 acres in 6 transactions within 7 years, where similar activities were carried on by associated corporations).

In Jarret v. Commissioner, T.C. Memo 1993-516, the taxpayer acquired a 140-acre parcel. He immediately subdivided part of the parcel fronting a public roadway into 21 lots and contributed the parcel to a related corporation which sold the lots within 60 days. The back portion of the property did not front any road, and the taxpayer worked for 1 1/2 years to obtain approval for a subdivision for this back portion. The taxpayer filed a Schedule C for his own real estate development business, in addition to his ownership of the development corporation. The court found that the taxpayer held the back portion to obtain approval for a subdivision and immediately sell it at a profit, and not for investment purposes.

In addition to Paullus and Bramblett discussed above, the following cases have found infrequent sales, and held that the taxpayer qualified for capital gain treatment.

1. Byram v. United States, 705 F.2d 1418 (5th Cir. 1983) (during a 3-year period, taxpayer sold 22 parcels of real estate for over \$9,000,000, making a profit of approximately \$3,400,000). The Fifth Circuit stated that, although the amounts involved were substantial, the district court did not clearly err in determining that 22 such sales in 3 years were not sufficiently frequent or continuous. Other factors weighed in favor of the taxpayer: there was no personal effort to initiate sales; he did not advertise, have a sales office or employ brokers; properties at issue were not improved or developed; he

devoted minimal time and effort to the transactions; he occupied most of his time with his rental properties and received substantial amounts of rental and interest income; and he was not a licensed real estate broker or associated with a real estate company. The court noted that short holding periods for some properties ranging from 6 to 9 months did not necessarily show the properties were held for sale, and such ownership exceeded the then-applicable threshold of 6 months for long-term capital gain treatment. To avoid frustration of Congressional intent in setting forth such a capital gains holding period, the court stated that “a court should avoid placing too much weight on duration of ownership when other indicia of intent to hold property for sale are minimal.” The fact that taxpayer may have executed contracts to sell two properties before acquiring title to them favored the government’s position, but the district court reasonably could have found it outweighed by other evidence.

2. Ayling v. Commissioner, 32 T.C. 704 (1959), acq. 1959-2 C.B. 3 (sale of 13 lots over 4 years, constituting taxpayer’s entire holdings other than his house). The court held that this did not establish a frequency or continuity of sales characteristic of a trade or business. Other factors indicated that taxpayer was not engaged in a real estate business: the acquisition of 6 acres was a by-product of acquisition of family home; taxpayer remained full-time employee elsewhere; development expenses were just enough to make the lots saleable; taxpayer had no prior development experience; the only advertising done was the running of a few classified adds of 2 or 3 lines in the newspaper on 12 occasions; and taxpayer wanted to sell the excess land as a single tract but had to subdivide it and put restrictions to protect against low-cost homes. Taxpayer began subdivision immediately after acquisition of the property and sold 3 lots in the first year.
3. Howell v. Commissioner, 57 T.C. 546 (1972) (corporation purchased 42.86 acres of unimproved land as an investment in 1962 and in 1964 through 1966 sold property in three transactions, with the first two being incidental to the final sale which disposed of the remaining 90% of the land). The court noted that, although the taxpayer was a corporation and the property was its only asset, it could hold the property for investment and need not be engaged in a business. The taxpayer made no attempt to improve,

subdivide or advertise the property. Although property may have been acquired with ultimate intention of reselling, property must not only have been “held primarily for sale,” but also for sale “in the ordinary course of business” under §1221(1). But the court also stated that the profit was the realization of appreciation in value accruing over a period of time consistent with holding the property for investment.

4. Buono v. Commissioner, 74 T.C. 187 (1980) (corporation’s efforts in obtaining subdivision approval and selling the major parcel as a single tract with a map in place, coupled with two dispositions of a highway parcel and a shopping center parcel, did not put the taxpayer in a trade or business). The court noted that: where there was a lack of physical improvements, construction or the sale of the tract in individual lots; the taxpayer merely enhanced the property by taking legal steps to subdivide it and make it more marketable; the crucial fact was the corporation’s intention at all times to sell the unimproved property as a single tract; and the fact that taxpayer’s efforts in connection with obtaining subdivision approval contributed to value did not preclude capital gain treatment.
5. Fraley v. Commissioner, T.C. Memo 1993-304 (taxpayer held property for 8 years seeking top dollar from a nearby commercial developer and qualified for capital gain treatment). The court noted that: the taxpayer was a building contractor almost 40 years; he made various purchases of finished lots and sold them after he build homes; about 13 sales were made in a 10-year period; he worked on a relatively small scale and did not customarily buy large tracts of land, subdivided them and sell lots as such; the original purpose of the acquisition was not clear as the taxpayer improved the house on the property, rented it for 2 years and then removed the house from the land and sold it; and the treatment of the retained land was consistent with an investment and not merely a variation on the taxpayer’s usual residential construction business.
6. Pritchett v. Commissioner, 63 T.C. 149 (1974) (taxpayer sold 26 properties over 6-year period and one property was exchanged). The Service conceded that 5 sales in two years at issue qualified for capital gain treatment and challenged four sales. The court analyzed

each of the four sales and found that each property was held for investment purposes, even though the taxpayer was admittedly a dealer through partnerships and corporations with respect to other properties not at issue.

7. Gangi v. Commissioner, T.C. Memo 1987-561. (apartment building held for rental for 8 years was converted to condominium units and 28 units were sold in 2 years). The court detailed the relevant facts as follows:
- (a) the partnership was formed in 1970 to construct the apartment building and the property was held through 1978 as rental property;
  - (b) the partnership had no history of other real estate purchases or sales;
  - (c) in 1977 the relationship between the partners deteriorated and they decided that the most profitable way of liquidating their investment was to convert the building to condominiums and sell each unit individually;
  - (d) at the time, rental property was not in demand and the rental income did not justify holding onto the building;
  - (e) from June 1977 to August 1978, \$29,220.51 was spent to convert the building to 36 condominium units and \$100,163.93 was spent on paint, floors, carpets and the like;
  - (f) no structural changes were made to the units themselves and no work was done requiring a building permit;
  - (g) in September 1978 the units were listed for sale with a broker at a 1.75% commission, the units were advertised for sale in the newspaper, sales brochures were printed, and the broker used one of the units as a model unit and placed a salesperson there to market and sell the units;
  - (h) the partnership sold 26 units to 26 different purchasers in 1979, 2 units to 2 purchasers in 1980, and distributed 4 units each to the two partners;
  - (i) the partnership liquidated in 1980 after the last unit was sold, it never constructed or acquired another apartment building which was converted into condominium units for sale, and the partners never carried on business activities with each other after the liquidation of the partnership.

The court that the partnership's original investment intent survived, and that the conversion into condominium units and subsequent sales were merely a means of liquidating the investment in a profitable manner and terminating the partnership. The court relied on Heller, infra, and indicated that the taxpayer might also have fit into the "liquidation niche" left open by Biedenharn. The court distinguished Parkside, supra, on its facts. For example, in Parkside, the taxpayer argued for ordinary income treatment on the sale of the 47 rental duplexes to avoid personal holding company income, and testified that the primary holding purpose was for sale in the ordinary course of business.

8. Adams v. Commissioner, T.C. Memo 1973 (10 sales out of 12 Maine waterfront properties over 3-year period). The court commented that "in no case has a court found a taxpayer to be engaged in a business when his sales are as few as Mr. Adam's and when he was not performing some activities to develop or otherwise enhance the value of the properties." The taxpayer purchased the properties anticipating that they would appreciate in value and intending to resell them when he could make a satisfactory profit. The taxpayer held the properties for an average of only 11 months. The court concluded that the taxpayer was not in the business of selling real estate, and that the greater frequency of transactions and shorter holding period did not lead to a different conclusion than was reached in Howell. The court stated:

*"When a taxpayer buys and sells undeveloped real estate, when he performs no significant activities in purchasing, developing, or selling the properties, when he engages in only a few transactions, and those sporadically, when he devotes no substantial time to the real estate transactions and derives relatively little of his income from them, his activities resemble those of a person who invests in the stock market with the objective of buying and selling speculative stocks. Only occasional purchases and sales of real estate or stocks with the hope of realizing a gain on their subsequent increase in value, without more, does not constitute a trade or business. In our judgment, Mr. Adam was merely investing in speculative real estate properties."*

In cases involving rental property, the courts have permitted much greater frequency of sales without ordinary income treatment. These cases include Heller Trust

and Curtis. The Service has also ruled that the sale of approximately 225 condominium units in about 2 years after acquisition will constitute the sale of Section 1231 property and not be a "dealer disposition" as defined in Section 453(l)(1). See PLR 9331013 (May 6, 1993). Since a bulk sale to one purchaser was unlikely with 25% of the units privately held, the taxpayer was allowed to make condominium sales, unit by unit, through a direct sales campaign conducted by an outside auction house or real estate sales firm.

In Heller Trust v. Commissioner, 382 F.2d 675, 680 (9th Cir. 1967) (the taxpayer held 169 duplexes as rental and investment property and sold them off over a 4-year period). The court stated that where this investment purpose "continued until shortly before the time of sale, and ... the sale is prompted by a liquidation intent, the taxpayer should not lose the benefits provided by the capital gains provisions." To facilitate the sale of the 169 rental duplexes between 1955 and 1958, the taxpayer hired a staff advertised the sale, and opened a model unit. The Ninth Circuit noted that the taxpayer's declining health and poor economic conditions of the area resulted in the liquidation of the properties. If it followed the lower court's treatment of the duplexes as being for sale in the ordinary course of business, the court could not conceive of "how persons with an investment ... could bring themselves within the purview of the capital gains provisions" in cases where "they had to abandon a disappointing investment by means of a series of sales." Id.

In Curtis v. Commissioner, 232 F.2d 167 (3d Cir. 1956) rev'g on this issue 23 T.C. 740 (1955), the Third Circuit held that the sales of over 1,000 rental properties, in connection with a liquidation of that portion of the taxpayer's business, qualified for capital gain treatment. The taxpayer build over 1,000 residences for rental purposes between 1942 and 1944, although it had previously been in the business of building and selling homes. In 1946, restrictions on the sales prices of residences were removed while limitations on rents were not, and the taxpayer decided to sell the rental houses and close this line of business. The sales were made by the corporation's staff, some advertising was used, but the properties were sold "as is" with not attempt to improve their appearance.

In dissent, Judge McLaughlin cited cases from other circuits indicating a contrary result, including Home Co. v. Commissioner, 212 F.2d 637 (10th Cir. 1954). The majority thesis (that property once "used in a trade or business" retains that character) was challenged on the ground that the manner and purpose of holding property may change or be twofold. The dissent asked:

*"The circumstance that these properties are not readily salable as investment real estate, reflects back on the purpose for which taxpayer built them. An apartment house is typical investment housing. It is salable as such and capital gain results. But suppose it is divided into 1,000 cooperative apartments, should not the 'sale to customers' exclusion deny the favored treatment?"*

In addition to Heller and Curtis (involving frequent sales of rental property), there are other pre-Biedenharn cases in which taxpayer's with a prior investment intent subdivided their property and qualified for capital gain treatment, even though sales were effected by numerous dispositions of individual lots. See, e.g., Estate of Barrios v. Commissioner, 265 F.2d 517 (5th Cir. 1959) (taxpayer closed 88 lot sales in 3 years without leaving her home). The court noted that: the taxpayer's chief occupation was looking after her mortally sick husband; the land was originally acquired for farming purposes and for more than 10 years a farm was operated with success; the taxpayer was dispossessed of her farming operation when the government completed a canal that created drainage problems. The taxpayer thereafter subdivided the land, made physical improvements and sold off individual lots. Purchasers were unsolicited, with no advertising done, agents employed or effort to show lots to prospective buyers.

See also Goldberg v. Commissioner, 223 F.2d 709 (5th Cir. 1953) (taxpayer sold 90 houses in one year); Consolidated Naval Stores Co. v. Fahs, 227 F.2d 923 (5th Cir. 1955) (over 100 sales in one year, aggregating nearly 200,000 acres of land); Mundy v. Commissioner, 36 T.C. 703 (1961) (65 lots sold over 3-year period after taxpayers inherited property and turned development and sales over to a development company). To the extent that these cases fit within the "liquidation niche" left open in Biedenharn

and other cases they have continuing viability. While Biedenharn distinguished rather than overruled this line of cases, taxpayers should heed the court's caution in red that "once an investment does not mean always an investment."

7. **Duration of Ownership.** Citing its 4-year holding period, the taxpayer in Paullus argued that the Unit 10 property was held for investment purposes. The Service did not attempt to rebut this argument. The court accepted the taxpayer's position that this was a "relatively long" holding period. The Service could have argued that the duration of ownership should not have been viewed in isolation with respect to the Unit 10 property. Rather, the duration of ownership for all of the "surplus land" in the Bushmont property should have been examined. As noted above, Unit 7 of the Bushmont property was held for less than 2 months before being sold by the taxpayer. Unit 8 and Unit 9 were held for only about 2 years before being sold. The taxpayer also admitted to having the intention of selling the Unit 10 property only 2 years after the Bushmont property was acquired. Thus, the impact of the 4-year holding period could have been minimized by the Service.

If the Service had examined the duration of ownership as indicated above, it should have found a receptive ear in Judge Gerber who decided Walsh supra. In Walsh, Judge Gerber indicated that 13 years of ownership "would be helpful in isolation," but was insufficient where the sale of the 13-acre parcel occurred only 2 years after the sale of the last subdivision. The same argument could have been made in Paullus.

The courts have held that a lengthy holding period is not conclusive in showing investment intent, and has not prevented property from being excluded from capital asset status. See, e.g., Little v. Commissioner, T.C. Memo 1993-281 (rental properties held an average of 58 months were held primarily for sale in taxpayer's business); Suburban Realty, supra; Biedenharn, supra; Margolis v. Commissioner, 337 F.2d 1001, 1004-1005 (9th Cir. 1964), aff'g in part and rev'g in part T.C. Memo 1962-86. (where real estate dealer intended to sell certain property for a profit and held it until he could do so, holding property for a long time did not make it an investment).

However, the courts have also held that passively holding an asset for many years may indicate an intention to realize long-term appreciation in value, and may be inconsistent with being engaged in a business. See, e.g., Redwood Empire Savings and Loan Association v. Commissioner, T.C. Memo 1985-332 (unimproved land held for 9 years generated capital loss for corporation); Austin v. Commissioner, 263 F.2d 460, 465 (9th Cir. 1959); Hoover v. Commissioner, 32 T.C. 618, 627 (1959).

Conversely, a short duration of ownership may show that the taxpayer held the property primarily for sale. See, e.g., Dunwood v. Commissioner, T.C. Memo 1992-721 (properties held for less than a year); Nash v. Commissioner, 60 T.C. 503 (1973). But see Byram v. United States, *supra* (holding period of 6 to 9 months was sufficient to receive capital gain treatment); Adam, *supra* (average holding period of 11 months).

Neither §1031 nor §1221(1) provide any safe harbor or minimum holding period to ensure investor status. In one §1031 case, the replacement property consisted of 66 acres of farmland in a rapidly changing area. The property was deemed to be held primarily for sale, even though the land was held for 6 years after the exchange and then sold in bulk to a single purchaser. See Klarkowski v. Commissioner, T.C. Memo 1965-328, *aff'd on other grounds* 385 F.2d 398 (7th Cir. 1967) (purchase of adjoining 94 acres of land shortly after the exchange, together with an agreement to sell the entire 160 acres to a contractor if the property could be rezoned, showed that the 66 acres were held primarily for sale at the time of the exchange).

Under §1031, duration of ownership is one factor in determining whether property has been held for productive use in a trade or business or for investment (“qualified use”). The Service has taken the position that if the relinquished property was acquired immediately before the exchange, or if the replacement property is disposed of immediately after the exchange, the taxpayer held the property primarily to dispose of it rather than for a qualified use. However, the courts have taken a more liberal and flexible approach, viewing duration of ownership as only one factor in determining a taxpayer’s intent in holding property. The interrelationship under §1031 between holding

period and qualified use is now examined with respect to (i) property relinquished in the exchange, (ii) property received in the exchange, and (iii) the taxpayer's purpose in holding property generally.

A. **Relinquished Property.** Due to a very short holding period, the property transferred in the exchange may not be held for a qualified purpose. See Barker, II v. U.S., 688 F. Supp. 1199 (C.D. Ill. 1987) (a restaurant relinquished in an exchange was not held for a qualified purpose where the taxpayer [a farmer who wanted to purchase farmland] accommodated the seller's exchange by purchasing a restaurant selected by the seller and immediately exchanging it for the farmland). In Barker, II, the IRS argued (contrary to its own rulings) that the taxpayer effected a §1031 exchange under Bolker, infra, and disallowed investment tax credits and depreciation on the farm improvements. But the court disagreed, finding that the taxpayer had no intent to hold the restaurant for productive use or investment. Thus, the taxpayer acquired the farm property outside of §1031 by purchase.

See also Rev. Rul. 84-121, 1984-2 C.B. 168 (optionee did not hold property for a qualified purpose where he exercised his option to acquire land and paid the option price by transferring real estate that he purchased solely to exercise the option); Rev. Rul. 77-337, 1977-2 C.B. 305 (taxpayer did not hold a shopping center received upon liquidation of his corporation for a qualified purpose where, pursuant to a prearranged plan, the shopping center was immediately exchanged for another one); Rev. Rul. 77-297, 1977-2 C.B. 304 (a buyer-accommodation does not qualify under §1031 on an immediate exchange of property acquired solely for purposes of exchange); Rev. Rul. 75-291, 1975-2 C.B. 333 (a build-to-suit accommodator does not qualify under §1031 on an exchange of land and a factory that it acquired and constructed solely for purposes of an exchange).

Further, the relinquished property may not be treated as having been transferred by the taxpayer. See Appeal of Brookfield Manor, Inc. v. California Board of Equalization (No. 89-SBE-002 1989) (corporation, not shareholder who received property on liquidation, sold property before any exchange); Chase v. Commissioner 92

T.C. 874 (1989) (partnership sold entire interest in partnership property and attempted exchange of a tenancy-in-common interest was without substance); Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

On the other hand, the relinquished property may be owned for only a short period of time and still qualify under §1031(a)(1). See Bolker v. Commissioner, 81 T.C. 782 (1983), aff'd 760 F.2d 1039 (9th Cir. 1985) (taxpayer held real estate received in liquidation of corporation for 3 months before exchange and an "intent to exchange property for like-kind property satisfies the holding requirement, because it is not an intent to liquidate the investment or to use it for personal pursuits"). However, the IRS's step-transaction argument (that the corporation really sold the property) was not properly before the court in Bolker. A different result was possible if that doctrine applied. See also Mason v. Commissioner, 1988-273 (a §1031 exchange by former partners occurred immediately after a general partnership liquidation under §731(a), but the court did not analyze whether the undivided interests were held for a qualified purpose); Crenshaw v. U.S., supra (taxpayer received an undivided interest in partnership property and exchanged it for other real estate owned by her husband's estate, but the exchange was treated as a taxable disposition under §741 due to the subsequent recontribution of the interest back to the partnership).

Other cases have allowed a short holding period for the relinquished property. 124 Front St., Inc. v. Commissioner, 65 T.C. 6 (1975), acq. 1976-2 C.B. 3 (taxpayer relinquished property in exchange after 6 months); Bennie D. Rutherford v. Commissioner, T.C. Memo 1978-505 (taxpayer relinquished property in exchange immediately on acquiring it); Allegheny County Auto Mart, Inc. v. Commissioner, 12 T.C.M. 427 (1953), aff'd 208 F.2d 693 (3rd Cir. 1953) (taxpayer relinquished property in exchange after 5 days). See also Wagensen v. Commissioner, 74 T.C. 653, 660 (1980) (dictum that taxpayer's receipt of relinquished property by a gift, followed immediately by an exchange, may qualify under §1031).

B. **Replacement Property.** Due to a short holding period, the property received in the exchange may not be held for a qualified purpose. See Starker v. U.S., *supra* (the two properties conveyed directly to the taxpayer's daughter were never received by the taxpayer, let alone held for a qualified purpose); Click v. Commissioner, 78 T.C. 223 (1982) (two residences received in exchange for a farm were never held by the taxpayer for productive use or investment where the taxpayer's children occupied the residences rent free, acted as owners and were given title 7 months after the exchange); Rev. Rul. 75-292, 1975-2 C.B. 333 (replacement property immediately transferred to newly formed corporation in a prearranged §351 transaction); PLR 8915012 (replacement property did not qualify since taxpayer intended to use it as his personal residence). See also the cases above where replacement property was held primarily for sale, rather than for business or investment purposes.

On the other hand, the replacement property may be held for only a short period of time and still qualify under §1031. See Magneson v. Commissioner, 81 T.C. 767 (1983), *aff'd* 753 F.2d 1490 (9th Cir. 1985) (tenancy-in-common interest immediately contributed for general partnership interest before §1031(a)(2)(D) was in effect); Maloney v. Commissioner, 93 T.C. 89 (1989) (corporation's exchange qualified under §1031 even though the corporation was "liquidated" under old §333 within one month after the exchange since the corporation's dissolution was a mere change in the form of ownership and was not a liquidation in which the investment was cashed out); Wagnesen v. Commissioner, 74 T.C. 653 (1980) (ranch gifted to taxpayer's son 9 months after the exchange was not disqualified since the ranch was held for productive use during that period and used thereafter in a business operated by the taxpayer and his son). While the taxpayer in Wagnesen had a general intention to make gifts for estate planning purposes, he had no specific intent to gift the replacement property at the time of the exchange. Compare Click, *supra*. See also Rev. Rul. 57-244, 1957-1 C.B. 247 (exchange approved even though taxpayer sold replacement property after exchange). PLR 8126070 ("involuntary termination" of a testamentary trust a "few months" after an exchange will not disqualify the transaction since the trust will receive title to the replacement property

and continue to hold it for a qualified purpose until the trust terminates when the beneficiary attains age 25).

C. **Taxpayer's Purpose.** As noted above, the taxpayer's intent at the time the replacement property is acquired dictates whether property is held primarily for sale or for a qualified use. Advertising or listing the property for sale, obtaining a short-term title insurance binder, short-term financing, evicting tenants and leaving the property vacant, pre-sale fixing-up expenses, and similar facts may indicate an intent to resell the property. The courts have stated: "Acquiring and holding property with the expectation of selling as soon as a reasonable profit can be realized is not holding for investment." Real Estate Corporation v. Commissioner, 35 T.C. 610, 615 (1961), aff'd 301 F.2d 423 (10th Cir. 1962), cert. denied 371 U.S. 822 (1962), rehearing denied 371 U.S. 917 (1962).

With respect to the relinquished property, however, the taxpayer's intent should not be determined literally at the exact moment of the exchange. No property would qualify under Section 1031 if this were the case. For example, the mere fact that an option is granted does not change the character of the property to property held primarily for sale. See Everett v. Commissioner, T.C. Memo 1978-53. In addition, it is now well established that the taxpayer may enter into a binding contract to sell the property without eliminating the ability to restructure the transaction as an exchange before title transfers. See Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963). However, it is good practice to document an intent to exchange as early as possible in the transaction. The purchase and sale contract may provide that the buyer will "cooperate" with the taxpayer in restructuring the transaction as an exchange.

While the relinquished property must be "held" for productive use or for investment, the replacement property is only required "to be held" for productive use or for investment. See §1031(a)(1). The taxpayer's intention is determined at the time of the exchange. Subsequent events that alter a taxpayer's intention should not disqualify a prior, completed exchange. See Wagnesen, supra. Nonetheless, the proximity of a subsequent sale (or other failure to continue the investment) may be evidence that the

replacement property was not acquired "to be held" for a qualified purpose. See Regals Realty Co., *supra*. In PLR 8429039 (supplementing PLR 8310016), the acquisition of a residence to be rented for a minimum of two years was sufficient to meet the "holding period test." The IRS issued this ruling even though the taxpayer previously represented that it would sell the residence immediately.

While no specific "holding period" is prescribed by §1031, a two-year holding period may be considered fairly safe for non-dealers. A "de facto" two-year period may also apply to exchanges between related persons. See §1031(f)(1)(C) (for a two-year period following a related party exchange, gain is recognized in the year of the subsequent disposition and certain dispositions are not taken into account). In 1989, a proposal to create a one-year holding requirement (both before and after the exchange) was passed by the House, but excluded from the Senate amendment, and ultimately rejected by the Conference Committee. The one-year holding period may have been viewed as "too restrictive," at least with respect to nonrecognition transactions before or after an exchange.

8. **Change of Purpose.** Paullus is a variation of a "change of purpose" case. The taxpayer argued that it changed its purpose for holding land from dealer to investor, and that it did so in 1977 when Construction and Financial were formed. In other cases, a "change of purpose" was supported by external facts. For example, in Biedermann v. Commissioner, 68 T.C. 1 (1977) the court held that the taxpayer's holding purpose changed when county officials prevented the development of certain land and later condemned it. The taxpayer was a dealer and reported ordinary income on 68 lots sales from 1952 to 1958. However, the taxpayer's development activities ceased after he learned of a proposed park impacting his property in 1958. For 10 years thereafter, the taxpayer held the land. The court held that the taxpayer was entitled to capital gain treatment upon the condemnation sale in 1968. In addition, the taxpayer was able to reinvest the proceeds in improved property under the like-kind rule of §1033(g) because the land was not held primarily for sale.

In another case, a developer in the business of subdividing and selling improved land demonstrated that the disposition of 17 acres of unimproved land was an economically necessitated sale. The court found that, by the time of the sale, the taxpayer's purpose with regard to the property sold had been so altered that its character no longer could be considered as being held primarily for sale to customers in the ordinary course of trade or business. Commissioner v. Pontchartrain Park Homes, Inc., 349 F.2d 416 (5th Cir. 1965).

Subsequent cases, citing Malat, have recognized the concept of change in intent. The courts have recognized such factors as change in profitability, change in zoning, and condemnation as evidence to support the fact that the taxpayer changed his intent in holding the property. However, in the absence of significant factors evidencing a change of intent, it is difficult for a taxpayer to cross the line from dealer to investor. The need for more significant evidence is obvious from the 1982 Tax Court decision in Daugherty, *supra*. In this case, the court reversed its position in Tri-S Corporation and held that a condemnation notice would not by itself change the intent of holding property. See also Maddux Constr Co. v. Commissioner, 54 T.C. 1278 (1970); Scheuber v. Commissioner, 371 F.2d 996 (7th Cir. 1967); Tri-S Corp v. Commissioner, 48 T.C. 316 (1967), *aff'd* 400 F.2d 862 (10th Cir. 1968); Silversmith v. United States, 44 AFTR2d 79-5757 (D.C. Col. 1978).

In summary, the taxpayer in Paullus won by portraying the facts in a light most favorable to itself and without deceiving the court or the Service. The taxpayer made very clever arguments and had superior briefs. Some of the arguments by the taxpayer were almost "too clever" and could have been turned around against it. For example, the arguments concerning "surplus land" and "liquidation intent" may have been cited as evidence of an intent to hold primarily for sale rather than investment. The taxpayer's argument about "infrequent sales" was based on only 8 sales over a 12-year period after Construction and Financial were formed. But over the 18-year period beginning with Ridgemark's incorporation, at least 208 sales were made, which is comparable to the cases discussed above finding frequent sales. Finally, the taxpayer's claim to a

“relatively long” holding period should not have been viewed in isolation, given the immediate subdivision and sale of other parts of the Bushmont property.

In the end, one is left wondering what it really means to hold property “for investment.” If the Unit 10 property was held for investment, were the Unit 7, 8, and 9 properties also held for investment? Where is the line drawn?

In Klarkowski, the court made the following “common sense” distinction between an investor and a dealer:

*“An ‘investor’ or speculator in real estate is usually anticipating a gradual appreciation in value of the real estate, or a rather sudden increase in value in the event of fortuitous circumstances, without doing much to cause that increase in value; whereas the ‘dealer’ in real estate is typically looking for a rapid increase in price over a relatively short time, most frequently as a result of some efforts on his part to cause the increase. Unfortunately, these categories are only the extremes and do not cover the entire spectrum of real estate transactions. Those that fall in between are the most difficult to characterize for tax purposes.”*

Paullus was a very close case that fell in between the extremes. With respect to such cases, the Fifth Circuit in Byram observed:

*“If a client asks you in any but an extreme case whether, in your opinion, his sale will result in capital gain, your answer should probably be, ‘I don’t know, and no one else in town can tell you.’” 705 F.2d at 1419 (Citations in n.1).*

## ANSWERS TO QUESTIONS PRESENTED

By now, the answers to the questions presented in the beginning of this article should be clear. For convenience we summarize the answers here:

- Paullus indicates that a taxpayer may avoid its prior status as a dealer by transferring land to a related development corporation. The related entities are useful to avoid frequent sales by the taxpayer, segregate holdings and activities, and qualify for future capital gain or exchange treatment.
- Paullus shows that having another primary business (e.g., a golf course business) may insulate the taxpayer with respect to “incidental” real estate activities.
- Paullus and Estate of Barrios hold that the legal subdivision of land (e.g., obtaining a tentative and final map) does not necessarily mean that the property is held primarily for sale.
- Paullus, Wray and Reithmeyer indicate that development work (e.g., off-site improvements to obtain finished lots) that is required to be done under contract with the buyer should not cause the land to be held primarily for sale. However, such activity should be conducted in connection with a bulk liquidation sale or pursuant to a purchaser’s requirements.
- The sale of a large tract of land in a single transaction does not necessarily mean that the land was not held primarily for sale. Many cases have found taxpayers to be dealers despite this fact.
- Bulk sales of subdivided land are preferable to the sale of individual lots since a bulk sale is more likely to indicate that the taxpayer is not engaged in a real estate sales business and that the land is not held primarily for sale.

- Paullus shows that the existence of a real estate sales office and an extensive list of potential purchasers for lots does not necessarily mean that the land is held primarily for sale. Although the court found this to be “troublesome” and a definite weakness in the taxpayer’s case, lot sales were merely a possible alternative in the event the buyer backed out of the deal.
- Holding “surplus land” unnecessary for the operating of the taxpayer’s primary golf course business may indicate that the land is held for investment purposes, but it also may show that the land is held primarily for sale.
- A liquidation intent to sell the land and invest in other property is neutral evidence under the §1221(1) cases. It may indicate that the land was held for investment purposes as in Paullus, but it may also indicate that the land was held primarily for sale as in Major Realty.
- A lengthy holding period is a factor indicating that the property is held for investment, but is not conclusive.
- Paullus shows that sales to related development corporations may be an effective means of reducing the taxpayer’s frequency of sales and segregating its holdings and activities.
- Frequency of sales and duration of ownership are objective factors, but the relevant time frames for measuring these factors are subject to argument and manipulation.

### **AVOIDING DEALER STATUS UNDER §1031(a)(2)**

We close with 15 tips about how to acquire and maintain investor status and thus qualify for capital gain and exchange treatment. These ideas are gleaned from Paullus and the cases discussed above and may be summarized as follows:

1. Document initial investment purpose in the purchase contract and any entity formation documents. Indicate expectation of long-term holding period and appreciation in value. Do not recite that the taxpayer is in the business of developing and selling real estate if it is intended to qualify as an investor. Do not specify intention to develop or subdivide in the short term. Filings with the state and correspondence with third parties should indicate the taxpayer's investor status.
2. Consistently show that the property is held as an "investment" on tax returns, financial statements and similar documents. Report any investment income and investment expenses (including investment interest expense) on tax returns consistent with an investment activity. Do not file Schedule C for the property or classify it as "inventory" or "held for development." Do not use Business Activity Code No. 6550 referring to "Subdividers and Developers."
3. Hold the property for a substantial period of time in order to realize long-term appreciation in value.
4. If possible, limit activity to leasing the land for grazing or exploration and to land-use studies to determine the property's highest and best use. Rezoning the property to obtain financing or maximize value upon sale should be permissible.
5. In the case of rental property, limit services to tenants to leasing, maintenance, repairs and the provisions of utilities. Use longer term leases and not merely 30-day rental agreements. For extensive holdings, use independent property management companies to manage the day-to-day operations, instead of the taxpayer's own employees. Do not personally participate in tenant evictions and repairs.
6. Consider selling land in bulk to a single purchaser without development or sales activities. Limit development activities as much as possible. But rezoning, subdivision

and even physical improvements may be allowed if required under a purchase contract by the buyer.

7. Do not subdivide unless required by contract. Do not maintain a sales office, advertise, solicit sales or spend significant time and effort on the property. If the taxpayer must do so, attempt to fit within the “liquidation niche” of Biedenharn or document a liquidation intent as in Gangi.
8. Time any development activity to occur late in the holding period in connection with a disposition.
9. Document the purpose for disposing of the property, such as favorable unsolicited offer, target value reached, desire to exchange for other realty, need for income, health, retirement, or unfavorable changes in the area.
10. If land is ripe for development and taxpayer is not content with land profits, consider selling or exchanging the land to a new development company owned by the taxpayer as in Bramblett.
11. Avoid frequent purchases and sales or other active involvement in the real estate business. If the taxpayer has a history of frequent purchases, development and sales, use a different entity to acquire the land if investor status is desired. If the taxpayer himself does not have such a history, use separate entities to segregate development and sales activities from investment holdings as in Pritchett.
12. Review corporate minutes and other documentation to ensure separate business and legal formalities are observed, and authorized actions are consistent with desired status.
13. If land is sold to an unrelated developer, perhaps some overriding interest can be maintained, to a limited degree, in future gross proceeds from development. This involves the risk, however, that the arrangement may be viewed as a joint venture in a

dealer activity which could taint the income received by the taxpayer. Basing the interest on gross proceeds or some measure other than net profits may reduce this risk.

14. Rely on professional advice from accountants and attorneys in structuring activities and transactions consistent with an investment motive.
15. Avoid arrangements in which dealer status will be imputed to the taxpayer (e.g., acts of agents, brokers, contract developers and joint ventures).

## **CONCLUSION**

In Winthrop, the court stated:

*“In analyzing a case of this sort no rubrics of decision or rubbings from the philosopher’s stone separate the sellers garlanded with capital gains from those beflowered in the garden of ordinary income. Each case and its facts must be compared with the mandate of the statute. In so doing we note that the enunciations of the Supreme Court are clarion as they enjoin us to construe narrowly the definition of a capital asset and as a corollary interpret its definitional exclusions broadly.” 417 F.2d at 911.*

The same holds true for §1031(a)(2). Although Paullus was a taxpayer victory, it should not be relied on too heavily. With better advocacy and legal analysis by the Service, an entirely different result was possible.