Don’t Fall In: *Pool v. Commissioner*’s Impact Upon Capital Gain Preservation Transactions

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What is a *Bramblett* Transaction?

The *Bramblett* transaction derives its name from a Fifth Circuit case, *Bramblett v. Commissioner*, 960 F 2d 526 (5^{th} Cir. 1992).

The objective of a *Bramblett* transaction is to preserve the capital character of undeveloped real property. Such property would otherwise be converted upon its development to ordinary property used in a trade or business.

How does a *Bramblett* Transaction Work?

1. A tax partnership acquires raw, undeveloped land and holds the land for at least one year.
2. The tax partnership then sells the raw, undeveloped land to a tax corporation with identical ownership, a transaction which results in the tax partnership realizing long-term capital gain to the extent of appreciation in the land's fair market value after the tax partnership's purchase.
3. The tax corporation performs all necessary subdivision and development of the land.
4. The tax corporation sells the subdivided and developed land to third parties, a transaction which results in the tax corporation's recognition of ordinary gain to the extent of appreciation in the land's fair market value after the related-party sale of the land from the tax partnership to the tax corporation.

Note that the entities may employ an installment sale structure for one or both of the sales in a *Bramblett* transaction to reap even further tax benefits.

Illustrating the Benefit of a *Bramblett* Transaction: The Default Scenario

Without a *Bramblett* transaction, a single entity (usually a tax partnership) would complete each of the aforementioned steps: (1) acquiring raw, undeveloped land; (2) subdividing and developing the land; and (3) selling the land to third parties, including concomitant efforts such as advertising and marketing.

Note that under the default approach, **<u>all</u>** of the gain from the sale of the developed land to third parties would be ordinary gain because the land would be converted to property used in a trade or business by virtue of the entity's activities. Contrast this outcome with the outcome of a *Bramblett* transaction, in which part of the overall gain is capital and part of the overall gain is ordinary. Depending on (1) how much time it takes for the entity's owners to start development after acquiring the raw land and (2) changes in market conditions during that time, the entity's owners may avoid a substantial amount of taxes by using the *Bramblett* structure.

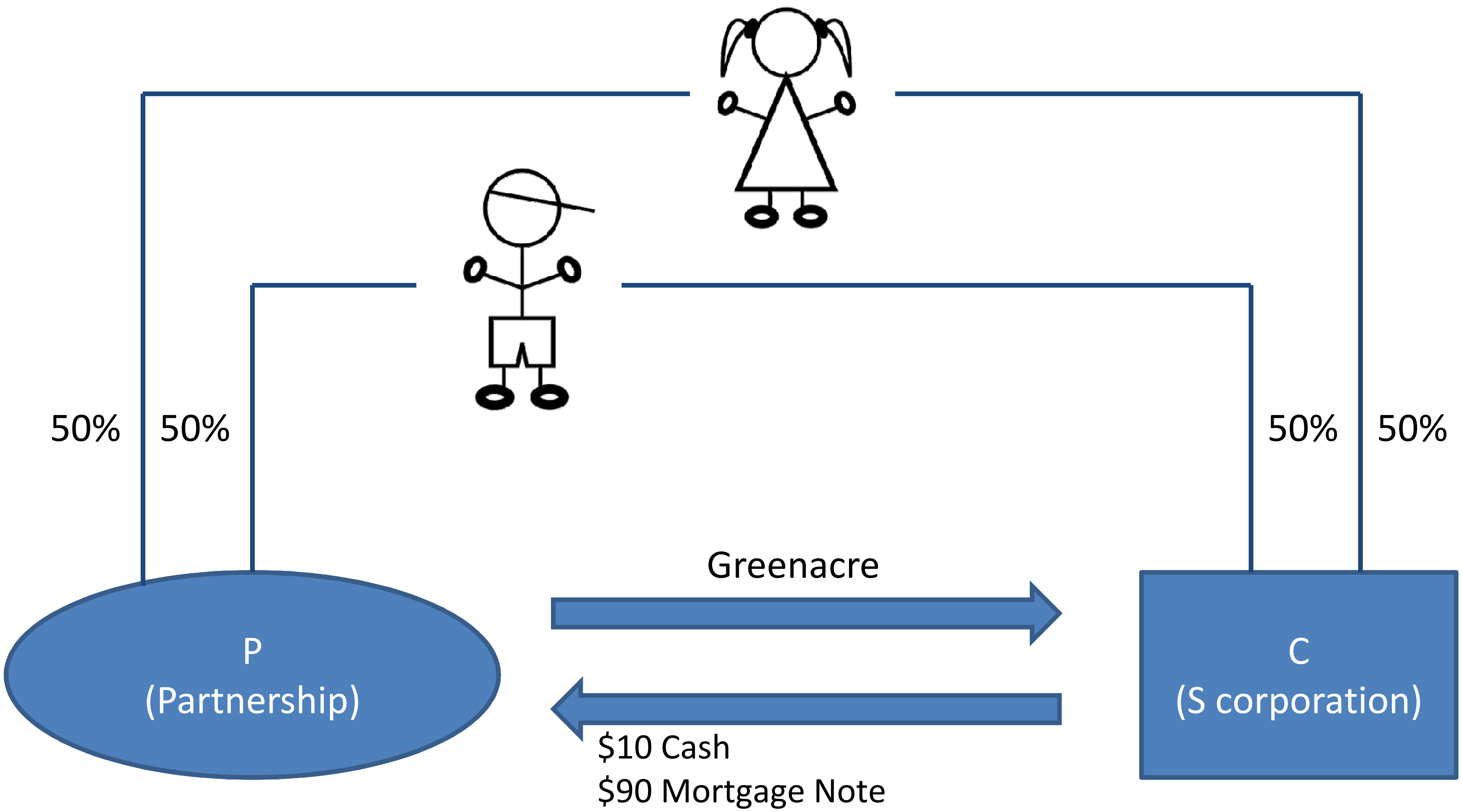
Once again, note that using an installment sale for one or both dispositions would result in additional tax benefits.

Anatomy of a Typical *Bramblett* Transaction

Assume:

- Partnership "P" and Subchapter S Corporation "C" have identical ownership.
- P has held Greenacre, which consists entirely of raw land, as a capital asset for many years. P had a $10 tax basis in Greenacre.
- P sells Greenacre to C in exchange for $10 cash payable at closing and a $90 purchase money mortgage note. The note requires annual interest payments, with the principal and unpaid interest due on its tenth anniversary.
- C intends to develop Greenacre as a single-family residential development. The mortgage includes a lot-sale release price which is proportionate to the price of each lot, as compared to the anticipated selling prices of all the lots to be developed.
- Other transaction terms are arms length. P has good business purpose in protecting its other properties from liabilities associated with the development of Greenacre.

Anatomy of a Typical *Bramblett* Transaction



Anatomy of a Typical Bramblett Transaction

- P and C are related parties under all applicable related party rules. IRC §§ 267(b); 318(a).

- P may nevertheless qualify for the installment method because it held Greenacre as a capital asset, and raw land is not depreciable property. IRC §§ 453(g); 453(f)(7). P recognizes $9 of gain and will recognize the remaining gain as the mortgage is repaid, unless IRC § 453(e) requires acceleration.

- There is no acceleration of gain under the related-party disposition rules until C disposes of all or part of Greenacre. IRC § 453(e)(1).

Anatomy of a Typical *Bramblett* Transaction

- C's lot sales are subject to gain acceleration under IRC § 453(e), unless one of the following is true:
  - The lot sales occur more than two years in the future (excluding any period in which C's customer contracts have substantially diminished C's risk of loss). IRC § 453(e)(2)(B).
  - P can demonstrate that the release price arrangement in the mortgage precludes tax-avoidance as a principal purpose. IRC § 453(e)(7). C may be able to meet this burden if the release price arrangement requires that C pay P in such a way that P recognizes gain at least as quickly as would occur were C directly engaging in the sale transactions. *See* S. Rep. No. 96-1000 (1980).

Anatomy of a Typical *Bramblett* Transaction

- What if Greenacre was an apartment building (i.e. property that is normally “depreciable”) the developer wants to convert into condominiums for resale as separate units? Would § 453(g) prevent the installment sale method from being available? Would the § 1239 capital gain-to-ordinary income re-characterization rules apply?
  - If the developer can depreciate the apartment building, then § 453(g) and § 1239 may apply.
  - But the installment method *arguably* nevertheless is still available because the developer taxpayer cannot depreciate the building. The developer’s primary purpose—resale to customers—controls. *Cf.* Rev. Rul. 89-25 (builder could not depreciate homes temporarily used as model or sales office, but expected to be sold in foreseeable future); CCA 201025049 (similar holding re: equipment company).

Bramblett v. Commissioner, 960 F.2d 526 (5^{th} Cir. 1992)

Facts:

• A taxpayer and his co-investors set up an investor partnership and a developer corporation with identical ownership.

• The investor partnership bought and held raw land for more than one year and then sold the land in installments to the developer corporation. The investor partnership never subdivided or developed the land prior to the related-party sale.

• The developer corporation subdivided and developed the land, then sold the developed lots to multiple unrelated buyers.

• The investor partnership reported the gain from its sale as long-term capital gain; the developer corporation reported the gain from its sales as ordinary gain.

Inquiry: Did the investor partnership properly report its gain from the related-party sale as long-term capital gain?

Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1992)

Analytical Framework:

- Was the investor partnership involved in a "trade or business" under Code § 1221?
  - –The court employed the three-question *Suburban Realty* test to answer this question. *Suburban Realty Co. v. U.S.*, 615 F.2d 171 (5th Cir. 1980).
    - (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?
  - –The court looked to the *Winthrop* factors to answer the *Suburban Realty* questions. *U.S. v. Winthrop*, 417 F.2d 905 (5th Cir. 1969).
    - (1) The nature and purpose of 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 sue 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 sales.

Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1992)

Analytical Framework (continued):

- Was the developer corporation an agent of the investor partnership?
  - The court looked to *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949) and *Commissioner v. Bollinger*, 485 U.S. 340 (1988). The non-exclusive list of factors to be considered:
    - (1) Whether the corporation operates in the name and for the account of the principal;
    - (2) Whether the corporation binds the principal by its actions;
    - (3) Whether the corporation transmits money received to the principal; and
    - (4) Whether the receipt of income is attributable to the services of the employees of the principal and to assets belonging to the principal.

Bramblett v. Commissioner, 960 F.2d 526 (5^{th} Cir. 1992)

The Fifth Circuit's holdings:

- The investor partnership was <u>**not**</u> engaged in a trade or business.
  - –The only *Winthrop* factor at issue was the third factor ("number, extent, continuity, and substantiality of sales").
    - The investor partnership's five sales in a three-year period were not enough to qualify the investor partnership's activities as a "trade or business."
- The developer corporation was <u>**not**</u> the agent of the investor partnership.
  - –The only *National Carbide* factor at issue was the third factor ("whether the corporation transmits money received to the principal").
    - The developer corporation bought the raw, undeveloped land from the investor partnership at fair market value in an arm's-length transaction, which disproved an agency relationship.

Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1992)

The Fifth Circuit's holdings (continued):

- The taxpayer's structure had a legitimate non-tax business purpose, so the substance-over-form doctrine of *Frank Lyon* should not nullify the structure.
  - –The taxpayer and his co-investors used a corporation to insulate them from the unlimited liability of a partnership.

The Fifth Circuit's conclusion: The decision of the Tax Court is reversed; the investor partnership properly reported its gain from the related-party sale as long-term capital gain.

Phelan v. Commissioner, T.C. Memo. 2004-206

Phelan's facts were very similar to *Bramblett*'s facts, but there were a few notable differences:

- The investor entity was a limited liability company (LLC) taxed as a partnership.
- The investor entity divided the land into several parcels; the investor entity sold two of them directly to third-party buyers and at least two more to the developer entity.
- The investor entity engaged in slightly more development activity: it commissioned a soil test and submitted development plans to a local municipality.
- The investor entity's predecessors had already entered into agreements to develop the land, and the investor entity was eventually party to agreements (along with the developer entity) with local utility companies and banks to develop the land's infrastructure.

Phelan v. Commissioner, T.C. Memo. 2004-206

The *Phelan* court found that the investor entity's activities were not substantial enough to amount to a "trade or business." Perhaps the more interesting question was whether the taxpayer's structure had a legitimate non-tax business purpose.

Recall that *Bramblett*'s investor entity was a partnership. *Phelan*'s was a limited liability company. Thus, the taxpayer could no longer cite liability limitation for the investor entity's owners as the structure's business purpose.

Instead, the taxpayer in *Phelan* said that since only a portion of the land was conveyed to the developer corporation, the business purpose of the structure was to shield the remainder of the land retained by the LLC from liability. The *Phelan* court accepted this business purpose.

Important note: had the investor LLC in *Phelan* conveyed all of its land to the developer corporation, the taxpayer would have had to cite a different business purpose to avoid the application of the substance-over-form doctrine.

Pool v. Commissioner, T.C. Memo. 2014-3

Facts:

• A taxpayer and his co-investors formed an investor LLC and a developer corporation.

• The LLC bought 300 acres of undeveloped land that already been divided into four sections. The purchase price was $1.4 million.

• Using the land as collateral, the LLC obtained two mortgage loans from a local bank and another mortgage loan from a group of individuals.

• The developer corporation purchased sections 1-3 of the land from the LLC. The Land Exclusive Option Agreement between the entities called for the developer corporation to make all necessary infrastructure improvements.

• The LLC entered into an agreement with a local municipality to "pay for the improvements" to the land at its "sole cost and expense." The LLC also filed an affidavit in accordance with local law that stated "the LLC is the developer of the land" and that "the LLC entered into buy-sell agreements to sell [subdivided] lots within the land for an average FMV of $41,000 per lot."

Inquiry: Did the investor partnership properly report its gain from the related-party sale as long-term capital gain?

Pool v. Commissioner, T.C. Memo. 2014-3

Analytical Framework and Tax Court Holdings:

- Rather than using the *Suburban Realty* questions, the *Pool* court simply asked whether the land was held "primarily" for investment or sale, as discussed in *Malat v. Riddell*, 383 U.S. 569 (1966).
- Rather than using the *Winthrop* factors, the *Pool* court used a similar set of factors listed in *Austin v. Commissioner*, 263 F.2d 460 (9th Cir. 1959):
  - –(1) The nature of the acquisition of the property;
    - The court held that the LLC acquired the property for subdivision and sale.
      - –The LLC's Form 1065 indicated that "development" was its principal business activity.
      - –The court also looked to the LLC's agreements with the local government and its affidavit, in which it agreed to pay for improvements and stated that it had already entered into buy-sell agreements for subdivided lots.
  - –(2) The frequency and continuity of sales over an extended period;
    - The court held that the frequency and continuity of sales could not be established from the record.

Pool v. Commissioner, T.C. Memo. 2014-3

Analytical Framework and Tax Court Holdings (continued):

- (3) The nature and extent of the taxpayer's business;
  - –The LLC obtained a mortgage for section 1 of the land after the LLC had purportedly conveyed it to the developer corporation. The court commented that this was "not indicative of a bona fide sale."
  - –The court held that the taxpayers did not show that the LLC's activities were insufficient to establish a trade or business. The court did note that under *Estate of Freeland v. Commissioner*, T.C. Memo. 1996-419, investor entities can undertake some development activity without establishing a trade or business, but the taxpayers offered no evidence to this effect.
- (4) The activity of the seller about the property;
  - – The court held that the taxpayer did not meet its burden of showing that the LLC did not spend significant time actively participating in sales of the land. The IRS offered the LLC's 81 buy-sell agreements for individual lots as evidence that the LLC did spend significant time actively participating in such sales.

Pool v. Commissioner, T.C. Memo. 2014-3

Analytical Framework and Tax Court Holdings (continued):

- (5) The extent and substantiality of the transactions.
  - –This factor implicates the structure's legitimate non-tax business purpose. The court held that there was no legitimate non-tax business purpose, and other facts showed that the structure lacked substance.
    - The LLC mortgaged section 1 of the land after it had purportedly sold the land to the developer corporation.
    - The LLC acquired the land for a total purchase price of $1.4 million, but the LLC sold sections 1-3 of the land to the developer corporation for $7.6 million shortly thereafter. The taxpayer offered no evidence to explain the discrepancy in price.

Conclusion: The taxpayers failed to meet their burden to disprove the IRS determinations. The LLC was engaged in a "trade or business" and thus improperly reported its gain as long-term capital gain.

What does *Pool* mean for *Bramblett* transactions?

Pool is a "bad facts" case. It should serve as a cautionary tale for planners who set up *Bramblett* transactions in the future. If *Bramblett* transactions are structured correctly, the IRS will still honor their form. *Pool* is an example of "low-hanging fruit;" with a few highly damaging facts, the IRS pounced on an eminently winnable case.

Whereas *Bramblett* and *Phelan* serve as instances of how to properly structure a capital gain preservation transaction, *Pool* provides examples of pitfalls to avoid. *Bramblett* transactions can go wrong in two ways:

- –(1) The investor entity's activities can amount to the conduct of a trade or business; or
- –(2) The structure can lack a legitimate non-tax business purpose.

Pool had the unfortunate distinction of coming up short in both respects.

Bramblett Transactions: "Dos and Don'ts"

DO:

- **Strictly adhere to formalities**. The investor entity's activities should be absolutely limited to investment. The investor entity should avoid:
  - –Becoming party to any agreements with private persons or governmental entities that stipulate that the investor entity will develop property, or even fund others' development activities at its own cost and expense.
  - –Making any assertion that it is involved in development activity (recall the municipal affidavit in *Pool*). Keep in mind that even routine filings such as IRS Form 1065, IRS Form SS-4, and similar documents can provide damning evidence against taxpayers.
  - –Taking any action that would suggest ownership of the land after the land is conveyed (recall the post-conveyance mortgage in *Pool*). Recall that the *Pool* court said that such actions are "not indicative of a bona fide sale."

Bramblett Transactions: "Dos and Don'ts"

DO:

- **Keep all related-party activities between the investor entity and the developer entity at arm's length**. Violating this principle may result in (1) the finding of an agency relationship between the entities and/or (2) the application of the substance-over-form doctrine to nullify the transaction. Be sure to take the following steps:
  - When the investor entity conveys the land to the developer entity, determine the purchase price by reference to a current real estate appraisal.
  - If the related-party conveyance is structured as an installment sale, determine the interest rate by reference to the prevailing Applicable Federal Rate (AFR).
  - Ensure that the developer corporation meets its payment obligations to the investor corporation. The developer corporation in *Bramblett* never paid interest on its promissory note to the investor corporation, and the developer corporation did not pay off the principal until it received the proceeds from its third-party sales. While these facts did not prove fatal for the transaction's structure, practitioners should avoid repeating the same mistake.

Bramblett Transactions: "Dos and Don'ts"

DON'T:

- **Involve the investor entity in multiple, continuous, and/or frequent sales of property**. The investor entity should convey the undeveloped land to the developer corporation in as few transactions as possible. The investor entity should not be party to any other sale transactions. Recall that the courts consider substantiality and frequency of sales as the most important factor when determining whether the investor entity is engaged in a trade or business.
- **Neglect to consider a legitimate non-tax business purpose**. Depending on the individual facts and circumstances of each structure, the business purposes in *Bramblett* and *Phelan* may not apply. When structuring a *Bramblett* transaction, consider which business purpose(s) can justify the structure.

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