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CHECK-THE-BOX *BRAMBLETT*? ALTERNATIVE STRUCTURES FOR CAPITAL GAIN STEP-UP PLANNING

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Who Cares? Why *Bramblett* Matters

- Under the Internal Revenue Code, capital gain characterization is an all-or-nothing proposition based upon the intent and activities of the seller at the time of a sale or exchange. *See* IRC § 1221.

- If land appreciates, the owner can only capture the appreciation as long-term capital gain if the land is held as a capital asset at the time of sale (before development or dealer activity).

- If the land is not sold before development or dealer activities begin, the prior appreciation that would otherwise be capital gain becomes ordinary income. Taxpayers do not like this, because they lose the benefit of the long-term capital gain tax rate preference on the pre-development/dealer activity appreciation.

- In addition to providing asset protection benefits, transactions patterned after *Bramblett v. Commissioner*, 960 F.2d 526 (5th Cir. 1992) bifurcate capital appreciation that should be capital gain from ordinary income arising from subsequent development or dealer activities, without forcing the "owner" to be divested of an economic interest in the property. The basic mechanism to accomplish this result is a sale to a related entity before development or dealer activities begin (i.e., intent changes).

Bramblett v. Commissioner (Facts)

- In *Bramblett,* a partnership held undeveloped land for more than one year.
- Prior to developing a portion of the land, the partnership sold the property to a newly formed S corporation owned by the partnership's partners in the same proportions as their ownership in the partnership.
- The corporation gave the partnership unsecured promissory notes as consideration for the land. The corporation developed and resold the land, using resale proceeds to pay the balance of the promissory notes.
- The partnership characterized the income it realized from the sale of the land as long-term capital gain.

Bramblett v. Commissioner (Fifth Circuit Opinion)

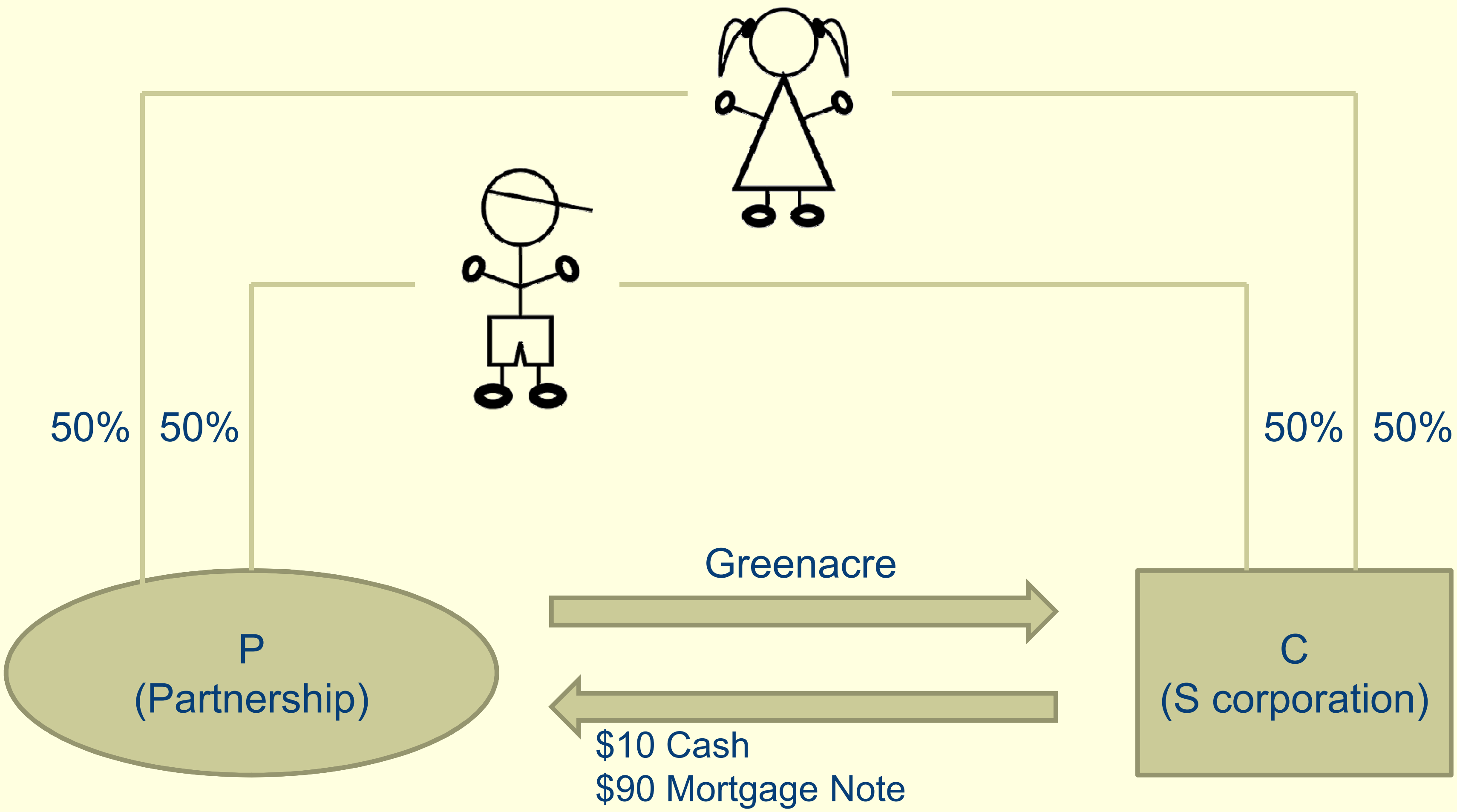
- The partnership's five sales in three years did not make it a dealer in land.
- The corporation's developer activities were not attributable to the partnership. There was no agency under *Bollinger v. Commissioner*, 485 U.S. 340 (1988).
- Business purpose existed to protect the partnership's other property from the corporation's development-related liabilities. Also, the partnership had purchased the land "as an investment, hoping its value would appreciate[, but also] bore the risk that the land would not appreciate."
- The partnership was entitled to long-term capital gain treatment on the land sales.
- Although the Tax Court had held against the taxpayer in *Bramblett*, it later followed the 5th Circuit's *Bramblett* opinion in a similar case, *Phelan v. Commissioner*, TC Memo 2004-206.

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).

What's Wrong with *Bramblett*? Taxpayer Problems

- State deed taxes may reduce the net tax benefit, or planning to avoid such taxes may result in complicated or convoluted land transfer structures.

- Related party sales complicate financing
  - Some lenders may not allow transfers or subordinated related-party debt. Most mortgages contain due-on-sale clauses.
  - Institutional investors may not be permitted S corporation owners.
  - Multi-layered equity distribution waterfalls may not be possible because:
    - An S corporation party can have only one class of stock for distribution and liquidation purposes.
    - "Crossing" returns between the entities may result in a deemed partnership-to-partnership transaction subject to IRC § 707(b) or result in a *Bollinger* agency relationship, in either case causing ordinary income re-characterization.

- Related-party sales may not always be the only option to protect development assets from other assets.

Check-the-Box *Bramblett* Overview: A Partial Solution Under Current Law

- To mitigate some of these problems, a taxpayer who plans ahead probably can use the Check-the-Box entity classification rules and the IRC § 336 deemed sale rules together to replicate the income tax results of an all-cash *Bramblett* transaction (but not a *Bramblett* transaction using the installment method to defer gain recognition).
  - Treas. Reg. §§ 301.7701-1, -2, & -3 (a.k.a. the "Check-the-Box" regulations) permit domestic LLCs to alternate between corporate and non-corporate tax classification by filing a voluntary election with IRS.
  - IRC § 336(a) causes a deemed sale of a corporation's assets when it "liquidates," including a liquidation caused by a corporation-to-partnership conversion. Treas. Reg. § 301.7701-3(g)(1)(ii).
- Taxpayers therefore may be able to cause a deemed sale for income tax purposes that generates long-term capital gain by filing a Check-the-Box election for an LLC taxed as an S corporation before the LLC engages in developer/dealer activity.

Check-the-Box *Bramblett* Mechanics

- Form a new LLC and elect to cause the LLC to be taxed as an S corporation effective on the date of its formation.

- Initially take title to target property through the newly-formed LLC and hold such property solely for investment (i.e., not as a developer/dealer).

- On a future date more than one year later when the property has appreciated, but before developer/dealer activity has begun, file a new Check-the-Box election to treat the LLC as a partnership as of such date.

Check-the-Box *Bramblett:* Tax Consequences

- The LLC taxed as an S corporation should be treated as holding the property as a capital asset under the same standards as the partnership in *Bramblett*.

- So long as the LLC is eligible to file a Check-the-Box election (i.e., it has been five years since the last election or the original Check-the-Box election coincided with the LLC's formation), a new election to change the LLC's tax classification to a partnership should be treated as a liquidation of the S corporation followed by the formation of a new partnership with the same owners. Treas. Reg. §§ 301.7701- 3(c)(1)(iv), -3(g)(1)(ii), & -3(g)(2)(i).

  – Under IRC § 336, the S corporation is deemed to have sold all of its assets.
  – If the LLC held the property as a capital asset for more than one year, gain on the sale may be long-term capital gain.
  – The resulting partnership will have a stepped-up basis in the property.

- Business purpose/economic substance may be irrelevant because the "transaction" is the consequence of a specifically authorized regulatory election, not a "real world" transaction. *See Dover Corp. v. Commissioner*, 122 T.C. 324, 351 n. 19 (2004).

Check-the-Box *Bramblett:* Advantages

- There is no transfer under state law. Title to the property is held by the same LLC before and after the election.
  - No state real estate transfer, deed, or document taxes.
  - Due-on-sale clauses and other traditional restrictive loan covenants usually are not triggered.
- Legal expense is reduced, because it is less time consuming and complicated to prepare and file a Check-the-Box election, than to form a new entity and prepare and close a seller financed sale to that entity. Ongoing accounting expenses may also be reduced because there may be fewer entities filing income tax returns, and it is not necessary to track payments and accruals on a related-party installment note.

Check-the-Box *Bramblett:* Limitations

- The installment method is unavailable.
  - The taxpayer must have the money to pay the capital gain tax at the time of the change of purpose and Check-the-Box election.
  - For those (few) with liquidity, this is not all bad, since in the event of a reversal the taxpayer will have a stepped-up tax basis against which to take an ordinary developer/dealer loss.
  - This could create a net tax benefit because of the long-term capital gain vs. ordinary income rate difference, as compared to a tax-neutral installment sale scenario involving an IRC § 1038 unwind or IRC § 108(e)(5) purchase price adjustment.

- To use the plan optimally, the taxpayer must be thinking ahead from the beginning.

- If a second Check-the-Box election will be filed within five years of first election, the first Check-the-Box election must be made on the LLC's formation date. Treas. Reg. § 301.7701-3(c)(1)(iv).

Check-the-Box *Bramblett:* More Limitations

- There is an added administrative expense in using multiple single purpose entities that each files a separate income tax return. Alternatively, bunching properties in a single entity requires that all the properties be deemed sold when the taxable Section 336(a) liquidation transaction occurs. Genuine *Bramblett* transactions avoid this limitation because separate properties can be sold separately and at different times.

- Using a corporation at the outset reduces flexibility
  - Only individuals/certain trusts can be shareholders.
  - S corporation format limits flexibility in future unexpected transactions as compared to the initial entity being a tax partnership.
  - Does not solve equity financing problem arising from desire or need to use multiple distribution waterfalls.

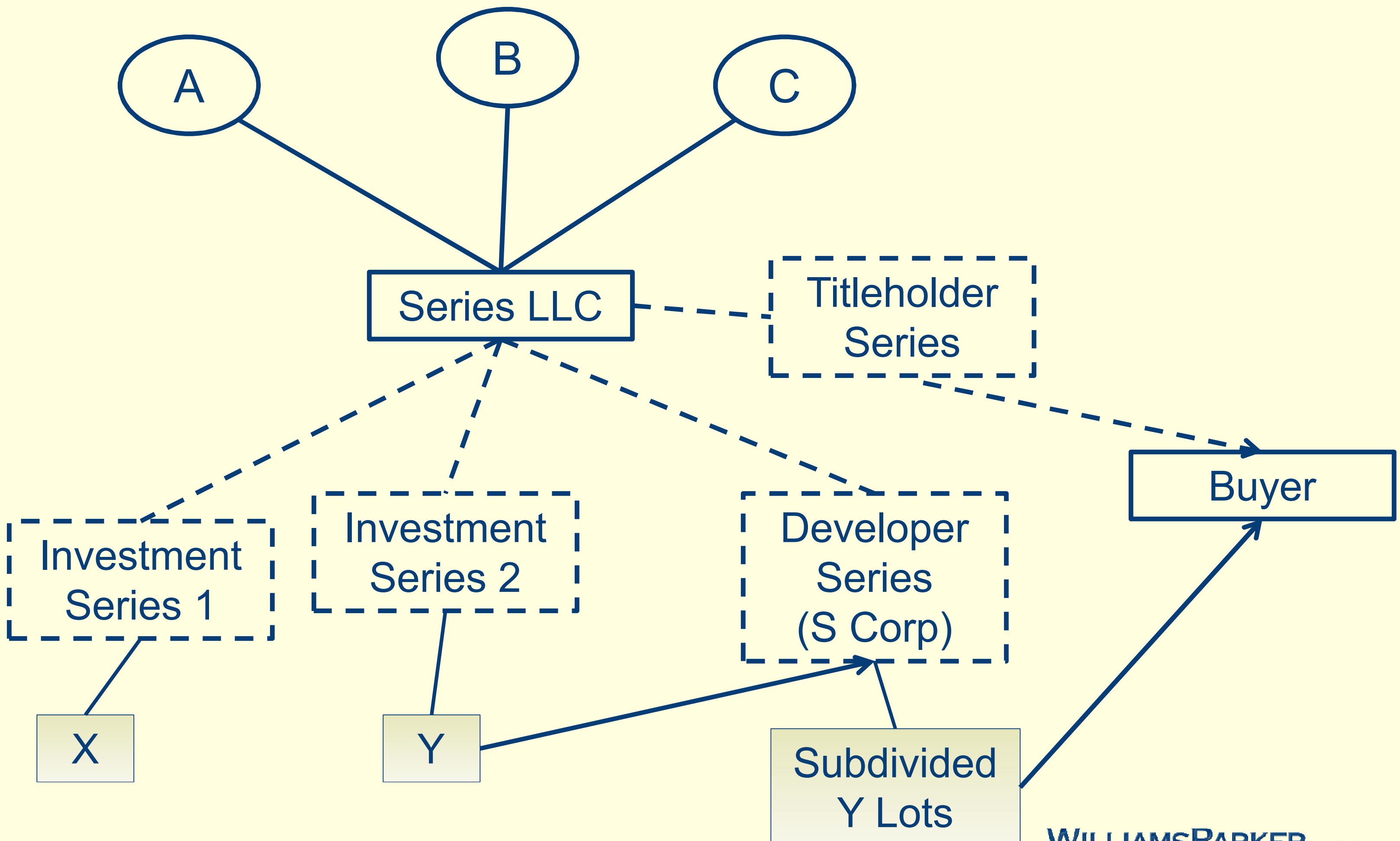
- Not feasible for C corporations.

Another Variation: “Conversion” *Bramblett*

- If title to investment property is held by a state-law corporation, similar advantages to a pure Check-the-Box transaction might be achieved by converting or merging the corporation into an LLC taxed as a partnership using a state law conversion or merger statute. See, e.g., PLR 200606009 ; PLR 9543017.

- If a conversion or merger statute is used, however, the form of the transaction may be deemed a contribution of the land by the corporation to the partnership, followed by a corporate liquidation. Consider whether an IRC § 754 election should be made for the partnership to preserve the “inside” basis increase in the land. Compare, e.g., above-cited rulings (treating a state law merger as an assets-over liquidation), with Treas. Reg. § 301.7701-3(g)(1)(ii) (treating Check-the-Box liquidation as an assets-up liquidating distribution and re-contribution to a newly-formed partnership).

Yet Another Variation: “Series” *Bramblett*



Legislative Solutions: A Proposal

- Regulatory election to treat property as changing status from a capital asset to developer/dealer property, when the election is filed. By filing the election, a taxpayer could lock in some or all of the tax benefits of built-in capital gain without actually transferring the property.
  - Could lock in pre-election appreciation as capital gain and deem additional income as ordinary income, replicating *Bramblett* without an actual related party sale.
  - Could create mixed income regime, 60-40 or 80-20 capital gain-ordinary income.

- In either case, legislation could require immediate gain recognition or allow installment sale-type deferral.

Legislative Solutions: Mechanics

- To avoid giving taxpayers too much hindsight in making the election, legislation could use Section 83(b) or Check-the-Box entity classification elections as a framework.
  - Election must be filed within a certain number of days of its effective date.
  - Election must state tax basis, fair market value of property, and any applicable recapture characteristics as of election date.
  - Include copy of election with tax return for year including election effective date.

A Practical Question: Why Would Congress Help?

- The current rules are bad policy because they result in:
  - Material transaction costs to recognize pure capital appreciation as long-term capital gain.
  - Lack of transparency by forcing taxpayers to use more complicated entity and capital structures.
  - Distortions to capital market activities.
- BUT changing the rules would likely be scored as a net tax expenditure.

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