// TAX TALK

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From the Chair

By Andrea B. Gillespie, Esq.

I couldn't practice law without the help of my many assistants, consultants and support staff. How do those without access to this knowledge base keep up in this dynamic profession? My insecurities grow in correlation to the evolution and expansion of the law and the manner of its practice. So, in response, like most of us, I limit my legal practice to just a few, controlled areas of the law. I try to stay informed about these areas and refer clients with other needs to an appropriate consultant. This system works well for me.

I like to think that by limiting the breadth of my practice, there is a corresponding limitation on potential malpractice claims. This seemed like a reasonable solution until it became apparent that most of my clients' problems did not fall neatly within the bounds of these few categories of law. They were much messier. It was rarely just about the contract at hand. Unlike the facts described in law school exams, their issues leaked outside my immediate course of study into pension law, employment law, elder law and family law. Although I could comfortably navigate within my chosen fields, there remains this doubt that something I don't know could hurt me, not to mention my client.

But, fortunately, I have my consultants. They come to my office to warn me about the recent changes in the IRS Offer in Compromise program. They alert me to surprising court decisions and offer suggestions on how to plan in response. They are the very best. I have no difficulty finding someone to advise me on just about any tax topic: pension, income, gift and estate, mergers and acquisitions. They work for practically nothing, just a well deserved thank you. So, thank you to my support staff, the members of this Tax Section.

Actually, I am a sole practitioner, with no paid staff other than my overworked laptop. I recently made the switch to sole practice from a small business law firm. I switched from the comfort of access to a large paper library, full time bookkeeper, capable secretaries and compatriots, to a laptop. Fortunately, it's a great laptop. But even with this great laptop, I couldn't have successfully made this move without the Tax Section.

Attorneys must not only contend with the annoyance of constant changes in the law, the limits of our physical practices are changing and expanding as quickly. I have recently installed an "air card" in my laptop. An air card brings the internet and email instantly to my laptop, almost everywhere I happen to be. My office has expanded to include my porch, Acadia National Park, the Magothy River and the anchorage at St. Michaels. I carry a fax/scanner/copier in my car, or my boat, because you never know. I seem to be able to work just

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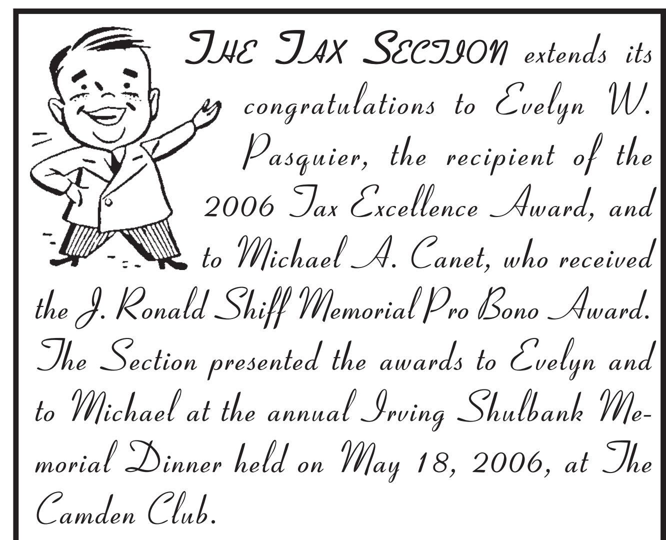

The Tax Section extends its congratulations to Evelyn W. Pasquier, the recipient of the 2006 Tax Excellence Award, and to Michael A. Canet, who received the J. Ronald Shiff Memorial Pro Bono Award. The Section presented the awards to Evelyn and to Michael at the annual Irving Shulbank Memorial Dinner held on May 18, 2006, at The Camden Club.

Have You Dug Yourself Into a Hole on the "Held For Investment" Issue Under Section 1031? Stop Digging.

By David Borinsky

When it comes to like-kind exchanges, why does the requirement about holding property for investment or for productive use in a trade or business generate so much caselaw? Because big money is at stake, and the issue is intensely fact-specific. Translation: there's a lot of room to maneuver, and there are lots of players willing to pay the experts big dollars to exploit that maneuver space.

I call upon you to suspend disbelief and assume that the *held for* issue breaks down neatly into three discrete problems.

The first is the "shovel in the ground" problem. Phrased as a question, when do value-enhancing actions, such as installing sewer and water infrastructure, constitute a change in motive from investment to held for sale?

The second is the "guilt by association" problem. Phrased as a question, when are the activities of an entity's owners or affiliates attributed to the entity for purposes of discerning whether property is held for investment or for sale?

The third is the "tax shoes" problem. Phrased as a question, when the taxpayer transfers either relinquished or replacement property to affiliates immediately before or immediately after an acquisition or disposition, does the transferee inherit the investment motive of the transferor?

This article will be published in three parts. This is part one, which discusses the shovel in the ground problem. Parts two and three, concerning guilt by association and stepping into the tax shoes of an affiliated transferor, will be published in subsequent issues of *Tax Talk*.

The Shovel in the Ground Problem

Few cases relevant to the shovel in the ground problem turn on the question of whether or not the taxpayer actually stuck a shovel in the ground, that is, installed infrastructure. As a result, rather than combing the lawbooks for a color-coded guide to the matter or a secret map, let's begin with first principles — in this case, the definition of investment property.[1]

The relevant regulation under IRC Section 1031, Treas. Reg. § 1.1031(a)-1(b), refers to investment property as property held "by a non-dealer for *future use or future realization* of the increment in value." Similarly, the Tax Court has described investment property as property held with the intent to realize "appreciation in value accrued over a substantial period of time."[2] The owner, in other words, cannot look to improvements it makes to create gain on resale.[3] These attempts at a definition bespeak an essentially passive relationship between a piece of property and its owner.

The problem of line drawing (given the inconsistency of caselaw, one might cynically call it mind reading) arises when a passive owner takes steps to liquidate the investment. By definition, even the most slug-like passive owner is at this point holding his or her property for sale. How to distinguish, therefore, the tax-favored slug from the enterprising, value-creating entrepreneur who, for his trouble, must pay an additional twenty percent of his profits to the government?

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From The Chair...

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as efficiently at a shaded picnic table overlooking a quiet creek as I do in my office. My clients can reach me, and as long as my work remains satisfactory, they are happy.

It's an enticing, yet frightening new world that we face when our office walls dissolve. Our options grow as our privacy shrinks. The more time spent working outside our physical offices, the more our work weaves its way into our personal lives and interests. There becomes no true escape. Accustomed to instant communication and response, clients expect answers now, not when the boat gets back into port. To be fair, their world is changing as quickly. A deal that would have taken months to analyze, must now be decided quickly or it is lost. So, to have a successful practice, we must stay flexible, responsive and informed.

This is why membership in this Tax Section is so important. No one can practice law alone. So thank-you to all members that take the time to share their knowledge, lead a committee, ask a question, teach a course and attend events. We couldn't do this without you.

I wish to specifically thank my Tax Council; a more dedicated, hard-working and informed group would be impossible to find. They have worked tirelessly to plan all of the Section events. The annual meeting along with its program was a great success thanks to the work of many individuals, including David Polashuk, Caroline Ciraolo, Chaya Kundra, David DeJong and Robert Rombro.

At the annual meeting, a new slate of officers and board members were elected. They are listed herein. We are very fortunate to have Bryan Young as our new Chair, Jim Dawson as Chair-elect and Caroline Ciraolo as Secretary/Treasurer. With these officers, there is no doubt that 2006/2007 will be a great year.

NOMINATIONS COMMITTEE REPORT

The Nominations Committee of the Section of Taxation is pleased to announce the election of the following individuals to the stated offices for the 2006-2007 year. The election took place at the Taxation Section's business meeting, held at 8:00 a.m. on June 15, 2006, at The Clarion Resort Fontainebleau Hotel during the MSBA Annual Meeting in Ocean City, Maryland.

2006-2007 OFFICERS:

Bryan W. Young, Chair

James W. Dawson, Chair-Elect

Caroline D. Ciraolo, Secretary/Treasurer

In addition, the following members were elected to the Tax Section Council for the terms shown:

TERM EXPIRING IN 2007:

G. Evans Hubbard, II

TERM EXPIRING IN 2009:

David S. DeJong

Steven M. Gevarte

Katrina Kamantauskas-Holder

Evelyn W. Pasquier

Catherine Mary Rafferty

Congratulations to the new officers and members of the Tax Section Council!

2006 Maryland Legislative Summary

The Maryland General Assembly was rather good to tax practitioners this year. In an unusual twist, few, if any, controversial tax bills were enacted this year. This dearth of excitement may have occurred because it is an election year, or it may just be due to general Annapolis discord. In any event, we shouldn't complain.

Listed below is a synopsis of most of the tax bills that were enacted this year. It is not a complete list. In order to save room, we have omitted those tax laws only effecting individual counties. Also omitted are the Maryland estate and inheritance tax laws. The estate tax law changes pertain to a very specialized area of tax law and are better addressed and explained by members of the Estate & Trust Law Section.

Please be warned that the following bill synopses are far from complete and a material and important provision of a bill may have been inadvertently omitted or misstated. Therefore, we strongly recommend that practitioners refer to, and rely on, the actual enacted bill.

Evelyn Pasquier monitored and reported on all tax legislation during the past General Assembly session. Bryan Young, Andrea Gillespie and Kimberly Mattonen assisted with the editing of this report.

INDIVIDUAL INCOME TAX: CREDITS, DEDUCTIONS, EXEMPTIONS

- ***Retired Military and Senior Citizen Tax Reduction Act:*** The existing $2,500 military subtraction is repealed in favor of a subtraction equal to the first $5,000 of military retirement income for qualifying individuals who served in the armed forces, Maryland National Guard, or separated from active duty with the Commissioned Corps of the Public Health Service, National Oceanic and Atmospheric Administration, or the Coast and Geodetic Survey, after July 1, 1991. Effective July 1, 2006 and applicable to all taxable years beginning after December 31, 2006. (SB22)

- ***Subtraction Modification for U.S. Government Employees' Foreign Earned Income:*** For 2007, 2008 and 2009 tax years, foreign earned income of an individual, earned while an employee of the United States or an employee of an agency of the United States, shall be subtracted from federal gross adjusted income to determine Maryland gross adjusted income. The subtraction shall not exceed $3,500 for any taxable year. (HB994)

- ***Tax Credit - Structures Using Qualifying Energy Devices for the Generation of Electricity:*** The generation of electricity, using specific energy devices, such as solar power, was added as a purpose for which Maryland counties may grant a local tax credit. Effective June 1, 2006 and applicable to all taxable years after June 30, 2006. (HB1532)

- ***Electronic Filing and Payment:*** If an individual electronically files a Maryland tax return by April 15th, the tax due may be paid on or before April 30th, if paid electronically. This provision is subject to the exceptions provided in Tax-General §10-820(A)(3). Effective for 2006 returns. (SB93)

- ***Annual Interest Rate on Tax Refunds:*** The interest owed on tax refunds is increased to the greater of 13% or 3 percentage points above the prime rate quoted by commercial banks to large business during the state's previous fiscal year. Effective July 1, 2006 and applicable to all refunds issued for overpayments made on or after July 1, 2006. (HB859)

BUSINESS TAX MATTERS

- ***Business Trusts:*** For income tax purposes, beneficiaries of a business trust, not taxed as a corporation, must recognize trust income in a manner similar to S Corporation shareholders and LLC members. Effective July 1, 2006 and applicable to all taxable years beginning after December 31, 2005. (SB319)

- ***Extensions for Filing Returns:*** The Comptroller may now extend the time a corporation has to file an income tax return by up to 7 months. Effective July 1, 2006 and applicable to all taxable years after December 31, 2005. (SB484)

- ***Withholding - Annual Statements:*** An employer or payor required to submit 150 or more annual statements in 2006 or 100 or more after December 31, 2006, must submit annual statements on magnetic media. The Comptroller may waive the above requirement if it would result in undue hardship to the employer or payor. Effective July 1, 2006. (SB94)

- ***Requirements for Employer Withholding Tax Returns:*** If a person is allowed to file federal withholding tax returns on a monthly basis, he/she may apply to the Comptroller for a waiver of the requirement that an income tax withholding return be filed within 3 days following each payroll for a person who was required to withhold $15,000 or more in the preceding calendar year. Effective July 1, 2006 and applicable to all calendar years beginning after December 31, 2006. (HB 1248)

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♦ ***Tax Credits for Hiring Ex-Felons:*** Reestablishes a program that gives businesses a tax credit of 30% of the first $6,000 of wages paid to an ex-felon during his or her first year of employment and 20% of the first $6,000 of wages paid during his or her second year of employment. Effective July 1, 2006 and applicable to all calendar years beginning after December 31, 2006. (SB 193)

♦ ***Neighborhood and Community Assistance Tax Credit:*** Expands the eligibility for a tax credit to include contributions of real property by businesses to a nonprofit organization in a Priority Funding Area conducting a project approved by the Department of Housing and Community Development and increases the maximum tax credit allowed to $250,000 for specified contributions. Effective October 1, 2006 and applicable to all calendar years beginning after December 31, 2006. (SB 1391)

PROPERTY TAX

♦ ***Homestead Tax Credit - Razed or Substantially Improved Property*:** Provides that a homeowner, who has owned and occupied a dwelling as his/her principal residence for at least 3 years preceding the razing or substantial improvement of such dwelling, but is not currently occupying the dwelling (vacated due to the rebuilding or substantial improvement), may be eligible for the homestead property tax credit for the tax year in which the razing or improvements commenced and one succeeding tax year. The full benefit of the credit at commencement of the razing or improvements shall not be diminished. Effective June 1, 2006 and applicable to all tax years beginning after June 30, 2006. There is also a refund opportunity for homeowners who overpaid their property tax by applying this provision for tax years beginning after June 30, 2003, but before July 1, 2006. (HB275)

♦ ***Homestead Tax Credit - Transferred Property:*** Clarifies an application procedure for a dwelling transferred between January 1 and June 30 if the deed is not recorded before the next taxable year (July 1). If a dwelling is transferred for consideration in a deed dated between January 1 and June 30, and the deed is recorded with the Clerk of the Circuit Court on or after July 1, the owner may submit a written application within 60 days of settlement, requesting SDAT to recognize the taxpayer as the new owner of the property. Effective July 1, 2006. (HB173)

♦ ***Homeowners' Property Tax Credit Program - Local Supplement:*** The governing body of a municipal corporation may provide for eligibility limitations on local supplemental credits and may alter the calculation of the credit, subject to certain restrictions. Effective June 1, 2006 and applicable to all taxable years beginning June 30, 2006. (SB853)

♦ ***Property Tax Assessment Appeals Board - Request for Comparables:*** In response to a written request for comparables, a supervisor shall supply a list at least 30 days before the date of the hearing if the request was made at least 35 days before the hearing. If the request was made between 35 days and 15 days, the supervisors shall send the list within 5 days of the request. Effective July 1, 2006. (HB208)

♦ ***Local Property Tax Credit:*** The Mayor and City Council of Baltimore City or the governing body of a county or municipal corporation may grant a local property tax credit for property owned and used as a principal residence of a person at least 70 years old and of limited income. They may also provide for duration limits, eligibility requirements, and application procedures. Effective June 1, 2006 and applicable to all taxable years beginning after June 30, 2006. (HB288)

♦ ***Local Property Tax Credit:*** The Mayor and City Council of Baltimore City or the governing body of a county or municipal corporation may grant a local property tax credit imposed on a non-profit swim club, used exclusively for providing a recreational outlet for the community. They may also provide for the amount, duration limits, eligibility requirements, and application procedures. Effective June 1, 2006 and applicable to all taxable years beginning after June 30, 2006. (SB982)

♦ ***Homeowners' Property Tax Credit and Renters' Property Tax Relief:*** Provides that the maximum Renter's Property Tax Credit shall not be more than $750 (prior max $600) and may not be granted in certain circumstances. The maximum assessed value of a dwelling on which a homeowners' property tax credit is calculated is $300,000 (prior amount $150,000). The computation of the tax has been altered as well. Effective June 1, 2006. The renters' tax relief is applicable to all calendar years beginning after December 31, 2005. The tax credits are applicable to all taxable years beginning after June 30, 2006. (SB382)

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♦***Property Tax Credit for Repaired or Reconstructed Dwelling:*** Applies to dwellings damaged or destroyed due to natural disaster. Repeals the mandatory local tax credit, making it a local option tax credit. Allows local governments to consider additional credit eligibility criteria. Provides the credit cannot be claimed for repairs or reconstruction completed before September 18, 2003. Removed the requirement that the repairs or reconstruction must be completed before December 31, 2006. Effective June 1, 2006. (HB354)

♦***Assessment of Conservation Property*:** For taxation purposes, conservation property is a newly added subclass of real property. Conservation property shall be valued at a rate equal to the highest rate that is used to value land eligible for agricultural use assessment. Effective June 1, 2006 and applicable to all taxable years beginning after June 30, 2006. (HB1275)

♦***Assessment of Agricultural Use Property:*** The Director of Assessments and Taxation may waive the requirements of two specific sections (one relating to criteria for assessing land and the other relating to land of less than 20 acres: single contiguous parcels) for property owners who are at least 70 years of age or are disabled and meet specified conditions regarding ownership of the property. Effective July 1, 2006 and applicable to all taxable years beginning after June 30, 2006. (HB724)

♦***Real Property Information - Web Based Services:*** Property owners in the State of Maryland have the right to receive information concerning the calculation of the assessment and description of the property from the SDAT website free of charge. Effective October 1, 2006 and applicable to all assessment notices sent after October 31, 2008. (HB953)

♦***Housing Programs and Homeowners' Property Tax Credit:*** A "family of limited income" now includes two kinds of trusts: a trust as described in 42 U.S.C. §1396P(D)(4) or a trust established for the benefit of an individual with a disability (subject to other limitations). These trusts only qualify as a "family of limited income" if the income of the trust does not exceed the established limits and the beneficiary of the trust is an individual who resides in the residential building owned by the trust. The Department of Housing and Community Development may limit the cumulative outstanding debt for loans made to the trust. A program loan to a trust may be secured by a recorded mortgage, deed of trust, or other security device. The definition for "homeowner" has changed for purposes of the homeowners' property tax credit. Effective June 1, 2006 and applicable to all taxable years beginning after June 30, 2006. (HB717)

♦***Property Tax Exemption - Surviving Spouse of Veteran:*** Intended to provide property tax credit for the surviving spouses of Vietnam War veterans who died from exposure to Agent Orange and prior to Agent Orange exposure being considered a service-connected disability by the federal government. Effective June 1, 2006 and applicable to all tax years beginning after June 30, 2006. (HB114)

♦***Enterprise Zones – Property Tax Credit Extension:*** Provides an extension of the credit after the enterprise zone designation expires. Any business in an enterprise zone (that continues to meet all qualifications for the credit under current law) is eligible for enterprise zone property tax credit for an additional five years after the enterprise zone designation expires. Effective July 1, 2006. (HB941)

SALES AND USE TAX

♦***Sales and Use Tax Exemption for Veterans' Organizations:*** Exempts nationally organized and recognized veterans' organizations that are also exempt under 501(c)(19) of the Internal Revenue Code, from the sales and use tax for a period of 3 years ending on June 30, 2009. Effective July 1, 2006. (SB227)

♦***Sales and Use Tax Exemption for Sales by Religious and Non-Profit Organizations:*** Exempts that portion of the sales price that qualifies as a charitable contribution paid to a bona fide church, religious organization, or non-profit §501(c)(3), if it is paid at an auction and the proceeds are used to carry on the exempt purpose of the church or organization. (HB1624)

♦***Sales and Use Tax - Bulk Vending Machines:*** The exemption from the sale and use tax for bulk vending machine sales is increased from 25 cents to 75 cents. Effective July 1, 2006. (HB951)

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♦***Sales and Use Tax - Laundering Services:*** Expands the sales and use tax exemption to include commercial laundries by increasing definition of "production activity" to include laundering, and maintaining or preparing textile products. Effective July 1, 2006. (HB1223)

MISCELLANEOUS

♦***SDAT Filing Fees - Family Farms:*** The annual SDAT filing fee is reduced from $300 to $100 for family farms. Effective October 1, 2006. (HB1083)

♦***Reciprocal Agreement to Intercept Federal and State Payments:*** Authorizing the Comptroller to enter into a reciprocal agreement whereby the Comptroller or the Federal government can intercept tax refunds or vendor payments made to individuals that owe either non-tax Federal liabilities or state tax liabilities, as the case may be. Effective July 1, 2006. (SB640)

♦***Motor Vehicle Excise Tax:*** Reducing from $640 to $320 the minimum fair market value on which the vehicle excise tax is calculated for a used trailer sold by a person other than a licensed dealer. Effective October 1, 2006. (HB51)

♦***Vessel Excise Tax:*** For a limited time, certain military personnel are exempt from the 5% vessel excise tax. Effective on enactment. (SB316)

♦***Vessel Excise Tax Exemption:*** Exempting from the vessel excise tax a vessel purchased in Maryland if: (1) it is purchased from a licensed dealer, (2) title is not sought or required, (3) the principal use of the vessel is outside of Maryland, (4) the vessel is promptly registered in another jurisdiction, and (5) the dealer and purchaser execute an agreement to certify the state of principal use within 30 days of the date of purchase. Effective June 1, 2006. (SB317)

♦***Vessel Excise Tax Exemption:*** Expanding the exemption from the vessel excise tax to include transfers of a documented vessel between members of the immediate family in which the transferor applied for and was issued a valid use sticker. Effective October 1, 2006. (SB318)

♦***Tax Credit for Maryland Mined Coal:*** The Maryland Mined Coal Tax Credit for a calendar year beginning on or after January 1, 2007, shall be limited annually to a total amount of: (i) $9 million for the years 2007 through 2010; (ii) $6 million for the years 2011 through 2014; and (iii) $3 million for the years 2015 through 2020. Effective July 1, 2006 and applicable to all taxable years beginning after December 1, 2006. (SB335)

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Although the caselaw defies easy categorization, it is clear that there is no *per se* rule against owners of investment property attempting to enhance the value of their property or to otherwise position it for sale.[4] As the Tax Court put it in *Buono v. Commissioner*,[5] "this blanket interdiction of capital gains treatment where there has been any laying on of hands is belied by the past decisions of this court."

In *Buono,* the IRS claimed that the taxpayer purchased property for the primary purpose of subdividing and reselling it. It argued, in addition, that the taxpayer's efforts to subdivide the property constituted a trade or business. According to the IRS, therefore, the property did not qualify as a capital asset, because the taxpayer held it primarily for sale in the ordinary course of its trade or business.[6]

The court agreed that the property had been purchased for the purpose of subdividing and reselling, but it concluded nonetheless that purchasing with that exit strategy in mind did not preclude the existence of an investment motive. It further stated that pursuing purely legal steps, such as subdivision, to enhance value does not defeat an owner's investment motive. The Court did observe that had the owner physically improved the lots it may not have prevailed on the held for investment issue.

There is a line of cases, in which *Buono* figures prominently, on the question of whether or not the sale of real estate is taxable at capital gains or ordinary income rates. These cases are relevant to the question of qualifying for deferral under the like-kind exchange rules, because the elements applicable to each, the capital asset question embodied in Section 1221 and the held for investment question embodied in Section 1031, overlap.

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While the factors relevant to the two inquiries overlap, they are not identical. It is easier to qualify for capital gains treatment under Section 1221 than to qualify for like-kind deferral under Section 1031. Property flunks the capital asset test if three elements are present: the property is *primarily held for* sale, the seller is engaged in a *trade or business*, and the sale takes place *in the ordinary course* of that trade or business. In other words, it's possible for a taxpayer to hold property for sale, but to qualify nevertheless for capital gains on its sale, because the taxpayer was not engaged in the trade or business of selling that type of asset.

Bear in mind, therefore, when consulting the *Buono* line of cases, that a taxpayer can flunk the Section 1031 test – that is, not qualify for deferral – merely because the property in question is held for sale, *irrespective of whether or not* that taxpayer is in the trade or business of selling that type of property — or any other type of property.[7]

This was the fate of the taxpayer in *Ethel Black v. Commissioner,*[8] in which Ms. Black acquired as replacement property in a like-kind exchange a single family home which she spruced up and sold for cash. The court concluded that she had held the replacement property for resale rather than for investment, and that therefore the sale did not qualify for deferral under Section 1031. The taxpayer had not acquired the replacement property, the court stated, with the intent of holding it as "an unliquidated continuation of the old property and for investment."

In *Bolker v. Commissioner,*[9] the Ninth Circuit stated that unless replacement property is acquired either for personal use or with the intention of converting it to cash or other not like-kind property, it is held for investment.[10] Under this rather lax "what is not prohibited is permitted" formulation of the 'held for' rule, one could argue that had Ms. Black taken title to the replacement property with the intent of exchanging *that* property for yet another which was to be held as a long term investment, she would have satisfied the held for standard articulated in *Bolker*.[11]

Because of the *Ethel Black* problem – and despite the taxpayer's victory in *Buono* — taxpayers who buy property with "subdivide and sell" on the brain generally lose when they try to defer the gain in a like-kind exchange. In *Jersey Land & Development Corp v. Commissioner,* a capital gains case, the court concluded, based on the taxpayer's efforts to subdivide the property in question, that it had "looked to the extensive improvements it made to the property, rather than market appreciation, to create gain on resale."[12] Taxpayers get nailed when they 'look to extensive improvements' rather than waiting 'for value accrued over a substantial period of time.'

Despite allowing capital gains in *Buono* based on a finding that the taxpayer held the property for investment rather than for sale, the court seemed to take comfort in the existence of the additional line of defense found in Section 1221 – the 'was there a trade or business' question. A conclusion on that issue, however, was not essential to the resolution of the case. In other words, stripped of the "trade or business' *dicta, Buono* is really just a better dressed version of *Ethel Black.*

Or is it? One detects an unstated premise in *Buono*, as well as in other cases addressing the question of whether or not a property was held for sale for *capital gains* purposes. Specifically, there is a tendency to conclude that property is held for sale if a court finds that the taxpayer is engaged in a trade or business, and, conversely, to conclude that a taxpayer lacks the motive to sell *because* it is not engaged in a trade or business. Despite the actual language of the case, therefore, *Buono* is less of a win than it appears for taxpayers seeking to qualify a transaction for deferral under Section 1031.

If *Buono* is a better dressed version of *Ethel Black*, then perhaps it can be said that *Neal T. Baker Enterprises, Inc. v. Commissioner*[13] is *Buono* mugged by reality. The issue in *Baker* was whether or not the taxpayer could defer gain under Section 1031 on the exchange of land previously held for sale in the trade or business of creating and selling residences and residential lots. The taxpayer in *Baker* developed and owned commercial properties and had a history of developing residentially zoned land into building lots.

Despite its initial intent to hold the property in question for sale as subdivided lots, the taxpayer argued that changed economic conditions and other events beyond its control caused a change in motive by the time it unloaded building lots to a homebuilder. Unfortunately for Baker, the court concluded, in effect, that the critical mass of 'dealer' facts was too great to overlook (not least the fact that the taxpayer had carried the property in question on its books for years as 'work-in-progress'). Result: no Section 1031 deferral of gain.

Baker is, in a sense, an anachronism in a tax environment that includes corporate level gain on distributions of appreciated property and the opportunities for tax flexibility ushered in with limited liability companies. All the same, this case brings to mind a client's favorite comment to me when the going got tough: "I may be dumb, but I'm not stupid." The courts get a lot of these cases wrong, but clients need to appreciate the likelihood of a *Baker*-like outcome at the IRS administrative level and before some courts.

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Regarding the laying on of hands, other taxpayers have engaged in more extensive development activities than the taxpayers in either *Buono* or *Baker* and still qualified for capital gains. Each case, however, involved other counterbalancing factors indicating investment motive.

These counterbalancing factors include the original purpose of the acquisition, the frequency and continuity of sales and the extent of presale development and marketing activity.[14] No one factor is controlling, but all are relevant.[15] Courts allow the longest leash on these other factors when the taxpayer has held the property for a long time or when events beyond the control of the taxpayer intervene to dictate a change in business strategy.

For example, in *W.T. Thrift v. Commissioner*,[16] the taxpayer owned property for five years before being approached by builders looking to purchase finished lots. The taxpayer subdivided the land and installed infrastructure, selling the lots in groups to several builders over a short period of time. The Tax Court concluded that the gain on those sales was taxable at capital gains rates, reasoning that the subdivision and infrastructure activity were merely preparatory to maximizing liquidation of the five-year old investment.

Thrift teaches us that you can get away with shovel in the ground activity if you begin with an unassailable investment-like motive in purchasing the property and if you hold the property in that status for some period of time. "There will be instances," as one court put it, "where an initial investment purpose endures … notwithstanding continuing [development]."[17]

Regarding events beyond the taxpayer's control, in *Erfuth v. Commissioner,*[18] a taxpayer in the business of constructing and operating rental properties converted one of its projects to condominiums under threat of foreclosure. The court ruled that gain from unit sales was taxable at capital gains rates because the threat of foreclosure was an "unanticipated, externally induced factor…which ma[d]e impossible the continued pre-existing use of the realty."[19] Interestingly, the court ruled that sales of units after the threat of foreclosure had passed were taxable at ordinary income rates.[20] Despite the kick in the pants on the post-foreclosure sales, *Erfuth* teaches us that the taxpayer wins when events outside his or her control force a shift in business strategy.

Similarly, in *Paullus v. Commissioner*,[21] a corporate taxpayer which was primarily engaged in the business of developing golf courses subdivided residential land adjacent to one of its projects and completed some in-ground improvements prior to selling. The taxpayer argued that the in-ground improvement had been installed at the request of the buyer, rather than in advance of seeking buyers. It also argued that the property was held for investment at the time of sale because the seller had an exogenous reason for selling: the need to raise capital to fund its primary business.[22]

Paullus is a kind of 'advanced placement' version of *Thrift* and *Erfuth.* In addition to teaching us the value of an unassailable investment-like purchase motive, it can be mined for lessons relating to physical improvements and for what constitutes an event beyond the control of the taxpayer.

Regarding physical improvements, while there is no 'blanket interdiction' on physical improvements, the installation of infrastructure is a factor to be weighed. Indeed, it would likely prove the decisive factor in an otherwise close case. The taxpayer in *Paullus* disarmed the problem by casting it as a buyer requested act. In other words, installing infrastructure reflected the intent of the buyer, according to the taxpayer, rather than that of the seller.

In a fairly recent case, the taxpayer succeeded in extending the 'buyer made me do it' logic of *Paullus* to affiliates of the seller. In *Phelan v. Commissioner,*[23] an affiliate of the owner of the property installed infrastructure on the property in question. The court didn't attribute the infrastructure activity to the taxpayer, reasoning that the related party had its own business motives and faced its own business risk.

In fact, while the affiliate was obligated on substantial bond obligations which would have gone into default if the affiliate had not completed the infrastructure, it was obvious that the affiliate would not have put itself at risk on the bonds had the commonly controlled company not owned the land at issue. One could easily say that the IRS had the better of the argument on the issue. Perhaps the IRS just got outlawyered, or perhaps this case is the fruit of the Tax Court's iffy reasoning in *Buono*. In any event, it's a good case for taxpayers on the shovel in the ground issue.

Just as the Tax Court seemed determined to go the taxpayer's way in *Phelan*, the IRS itself, in PLR 9337027, seems to have lost its focus in addressing what constitutes an event beyond the control of a taxpayer. According to the facts recited in PLR 9337027, a religious order planned to subdivide surplus property that it had owned for seventy years into 75 or 80 lots, as well as to install infrastructure. In the words of the ruling, the owner planned to install "the minimum physical improvements necessary to sell the lots to *individual* purchasers."[24] (emphasis added)

The organization wanted to sell the otherwise unused land to meet a funding gap caused by a decrease in other revenue sources. It proposed doing its own development, moreover, and involving itself in sales, even including hiring a broker. The IRS found it relevant, somehow, that the seller

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involved itself so deeply in the disposition of the lots "in order to maintain a quiet, peaceful environment consistent with its continued use of the [adjacent property]." Amazingly, the IRS concluded that the plan qualified as a "one time liquidation of an investment asset" rather than the conduct of a trade or business.

In the case of an event beyond the control of the taxpayer, can IRS absolution be based on a *funding gap*? That's the argument to be had from both *Paullus* and PLR 9337027. In fairness to the IRS, the actual issue in the letter request from the religious order did not involve the question of capital gains. Instead, it involved whether or not the organization would be subject to the unrelated business taxable income tax. Although the IRS relied heavily on capital gains cases to reach its conclusion, the result likely reflects a measure of tolerance for transactions, which, while marginal taxwise, do not tend to invite abuse. In *Paullus*, however, the court did cite funding needs as a factor tending to show an "enduring" investment motive.[25]

When it comes to outside events, *Charles R. Gangi v. Commissioner*[26] occupies something of a middle ground between the wobbly "funding gap" theory of *Paullus* and PLR 9337097 on the one hand and the foreclosure drama faced by the taxpayers in *Erfurth* on the other. The taxpayer in *Gangi* owned a multi-family project for almost ten years and then converted the project to condos and sold out because of the deterioration of the owners' business relationship. The owners advertised, although only to a limited extent, and maintained a sales office. The court took some comfort in the fact that the owners had not made any structural improvements on the property and had incurred minimal brokerage expenses.

It is not cynical to suggest that practitioners should ponder whether it is feasible to tease out a funding gap or deterioration of business relationship argument when their own clients are challenged on the 'held for' issue.

Although a detailed examination of the shovel in the ground problem yields some planning insights, it is more retrospective and diagnostic in nature than the discussion to come of the attribution issue (guilt by association) and the matter of transfers immediately before or immediately after an exchange (tax shoes). That makes sense because the client only looks for tax advice on a like-kind exchange around the time he or she contemplates doing one. The challenge of determining whether the property in question has been held for sale or held for investment is, at that point, more in the nature of an historical inquiry than a planning task.

Parts two and three, covering the guilt by association problem and the tax shoes problem, will yield more in the way of planning prescriptions and opportunities.

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Footnotes

[1] IRC Section 1031 applies to property held for investment and to property held for productive use in a trade or business. This article focuses entirely on the former of the two categories.

[2] *Howell v. Commissioner*, 57 T.C. 546 (1972).

[3] *Jersey Land & Development, Inc. v. Commissioner,* 539 F.2d 311 (3rd Cir. 1976).

[4] The taxpayer does bear the burden of proving the proper investment motive. *Click v. Commissioner*, 78 T.C. 225 (1982).

[5] 74 T.C. 187 (1980), quoting *United States v. Winthrop*, 417 F.2d 905 (5th Cir. 1969).

[6] IRC Section 1221(a)(1) provides that the term capital asset does not include property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

[7] "[T]he words 'for sale to customers in the ordinary course of' the taxpayer's trade or business are quite conspicuous by their absence" from Section 1031. *Bernard v. Commissioner*, T.C. Memo 1967-176.

[8] 35 T.C. 90 (1955).

[9] 760 F.2d 1039 (9th Cir. 1985).

[10] In *Click v. Commissioner,* 78 T.C. 225 (1982), the Tax Court ruled that replacement property was not held for investment because the taxpayer had intended from the day it acquired it to gift it to her children, which she in fact did several months later.

[11] An interesting case on this issue is *Bernard v. Commissioner,* T.C Memo 1967-176, in which the purchaser of the taxpayers' relinquished property insisted that the taxpayer accept payment in kind, that is, like-kind property. Although the taxpayers briefly farmed the replacement property, the record showed clearly that they had no intention of holding it with the intent of realizing, as the Tax Court put it in *Howell v. Commissioner,* "appreciation in value accrued over a substantial period of time."

[12] 539 F.2d 311 (3rd Cir. 1976) (Note to self: recommend that developer clients not include the phrase "Land & Development" in company names.)

[13] T.C. Memo 1998-302.

[14] *Adam v. Commissioner*, 60 T.C. 996 (1973).

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[15] Id.

[16] 15 T.C. 366 (1950).

[17] *Biedenharn Realty Co. v United States,* 526 F.2d409 (5th Cir. 1976).

[18] T.C. Memo 1987-232.

[19] Quoting *Biedenharn, supra.*

[20] Given the Tax Court's own prior decisions in this area, it was probably too tough on the taxpayer regarding the post-foreclosure threat sales. It is unreasonable to expect a sophisticated, high volume apartment developer to hang on to an odd group of here and there condominium units.

[21] T.C. Memo 1996-419.

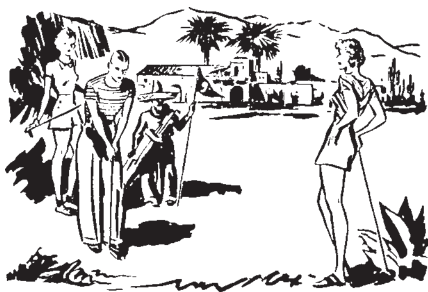
[22] The taxpayer in *Baker, supra,* also claimed that its need to raise capital removed the 'held for' taint from its sale of investment property, although it failed to convince the Tax Court.

[23] T.C. Memo 2004-206.

[24] The property owner, a tax-exempt organization, sought an advanced ruling on the issue of whether the profits from the sale would be taxed as unrelated business taxable income. However, as the IRS acknowledged in the ruling, caselaw on the capital gains issue bears directly on the issue of unrelated business taxable income.

[25] Although not emphasized in the *Paullus* opinion, the lot development activities complemented the taxpayer's primary, golf course development business. In that sense, *Paullus* resembles the private letter ruling concerning the religious order, as the religious order had argued that its need for development compatible with its continuing activities on neighboring land justified an unusual level of involvement in development activities.

[26] T.C. Memo 1987-561.



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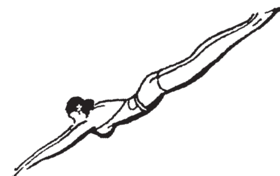

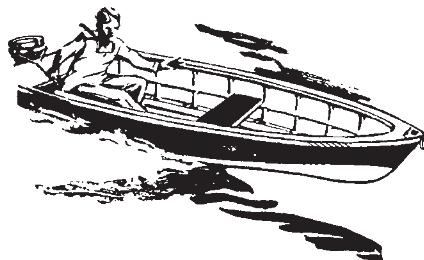

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