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SPECIAL PROBLEMS INCIDENT TO THE DISPOSITION OF REAL ESTATE USED IN THE BUSINESS

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SECTION 1231 DISPOSITIONS

When property is to be disposed of at a gain, it is, of course, generally advantageous to be able to treat that gain as long-term capital gain. If it is to be disposed of at a loss, however, it is generally advantageous to be able to treat the loss as ordinary, and fully deductible from ordinary income. Section 1231 is unique in the tax law in that it affords one the opportunity of obtaining both of those advantages. In a large measure the statute is a one-way street for the taxpayer. If the sale of a section 1231 asset results in a gain, that gain may be capital. If the sale of that same asset results in a loss, the loss may be ordinary. There is one important limitation on that favorable treatment, however. One may not enjoy both ordinary loss treatment on the losses and capital gain treatment on the gains in the same year. Therefore, a premium is placed upon planning and timing.

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Before discussing the operation of section 1231, it is first necessary to identify the types of transactions falling within the scope of the section. For our purposes it is probably easiest first to classify the types of transactions in terms of exclusion. Section 1231 never applies to inventory property, nor to property held primarily for sale to customers in the ordinary course of business.[1] Also, by virtue of a 1958 amendment, it does not apply to a loss from casualty or theft which was not compensated for by insurance.[2] Such a loss is treated as a casualty loss, unaffected by section 1231, and will always be ordinary.

With those exceptions, the statute applies to recognized gains and losses on specific types of transactions, including principally the sale

1. INT. REV. CODE OF 1954, § 1231(b)(1).

2. INT. REV. CODE OF 1954, § 1231(a), as amended, Technical Amendments Act of 1958, § 49(a), 17 Stat. 1606.

or exchange, or involuntary conversion of property used in the business and held for more than six months, which is either real property or depreciable property. Thus, it applies to sales of a factory building or other real estate used in the business, and to machinery and equipment.

Turning now to the operation of section 1231, the statute, in effect, requires that all the recognized gains on section 1231 dispositions be aggregated, and that all the recognized losses on section 1231 dispositions be aggregated separately. If the gains exceed the losses, then all are considered long-term capital gains and losses. In that case, however, the losses receive disadvantageous treatment, since they are considered not ordinary losses, but long-term capital losses.[3]

On the other hand, if the losses exceed the gains, then all are considered ordinary gains and losses. In such case, the gains receive disadvantageous treatment, since they are considered as ordinary and not as capital gains.[4]

It is readily seen that those rules place a great premium on timing. The maximum tax advantage will be gained if one can avoid taking section 1231 gains and section 1231 losses in the same year. One feature of section 1231 that may be helpful in this connection is that only *recognized* gains and losses are taken into account. Thus, if it is necessary to dispose of two section 1231 assets in the same year, one at a gain and one at a loss, one possibility would be to sell the gain asset for installment payments, taking a minimum or zero payment in the first year, and electing the installment method of reporting the gain.[5] The result would be to obtain ordinary loss treatment for the loss; and when the gain is recognized on the installments as collected, if there are no section 1231 losses in those years, the

3. For example, assume two section 1231 assets (and no others) are to be disposed of by an individual, one at a $15,000 loss, and one at a $20,000 gain. (a) Result if both dispositions are made in 1959: $15,000 loss on #1 in 1959; $20,000 gain on #2 in 1959; since gain exceeds loss, both gain and loss are considered capital. Net capital gain is $5,000, of which $2,500 is included in net income. (b) Result if loss asset is sold in 1959 and gain asset is sold in 1960: $15,000 loss on #1 in 1959; $20,000 gain on #2 in 1960; loss in 1959 is ordinary; amount deducted is $15,000. Gain in 1960 is capital; amount included in net income is $10,000. (c) Conclusion: spreading sales over two years has changed the $15,000 loss from capital to ordinary, and, thus, has converted $2,500 taxable income ((a) above) into net $5,000 loss deduction ((b) above).

4. For example, assume two section 1231 assets (and no others) are to be disposed of, one at a $20,000 loss and one at a $15,000 gain. (a) Result if both dispositions are made in 1959: $20,000 loss on #1 in 1959; $15,000 gain on #2 in 1959; since loss exceeds gain, both loss and gain are considered ordinary. Deductible net loss is $5,000. (b) Result if loss asset is sold in 1959 and gain asset is sold in 1960: $20,000 loss on #1 in 1959; $15,000 gain on #2 in 1960; loss in 1959 is ordinary; amount deducted is $20,000. Gain in 1960 is capital; amount included in net income is $7,500. (c) Conclusion: spreading sales over two years has changed the $15,000 gain from ordinary to capital, and, thus, has converted net $5,000 loss deduction ((a) above) into net $12,500 loss deduction ((b) above), subject, of course, to the limitations on capital losses and carryovers. INT. REV. CODE OF 1954, §§ 1211-12.

5. INT. REV. CODE OF 1954, § 453. See p. 222.

gain will then be treated as long-term capital gain. Thus, the installment method can be a valuable tool in section 1231 planning.

Another alternative would be to sell only one of the two properties, and to effect a like kind exchange for the other. As has previously been noted, if property used in the trade or business, for example machinery or real estate, is exchanged for property of like kind to be used in the trade or business, and if no cash is received, then no gain or loss will be recognized.[6] Thus, property disposed of in such an exchange will not enter into the section 1231 computation.

Obviously, an exchange will not be possible in all cases. However, the important point to bear in mind is that attention to planning and timing can be very rewarding under section 1231.

Lease Cancellations — Section 1241

It was held even prior to 1954 that the receipt by a lessee of a payment for the cancellation of his lease constituted a sale of an asset.[7] In 1954, a provision was added to the Internal Revenue Code writing that rule into the statute.[8] Now, by express provision of the code, an amount received by a lessee for cancellation of a lease is considered as received in exchange for that lease; and in this context "exchange" is equivalent to "sale." Cancellation includes a partial cancellation, for example, as to a portion of the premises, or as to a portion of the term (that is, a reduction in the unexpired term).[9]

Section 1241 does not specify whether the gain is capital or ordinary. That will depend upon the character of the lease in the lessee's hands. If the lessee is a broker who is in the business of marketing leases, the amount received by him for cancellation of a lease would be ordinary income. In the more usual case, however, where the leased space is used in the taxpayer's business, the lease will normally be either a capital asset or a section 1231 asset, and the gain will be either capital gain, or section 1231 gain and subject to the rules of section 1231 discussed above.

Sale-and-Leaseback Transactions

The sale and leaseback as a method of financing the acquisition of a piece of real estate has been discussed elsewhere in this Symposium.[10] The sale and leaseback of property used in the business may be advantageous as a method of converting property into cash, which in turn may enhance the working capital of the business. The tax

6. INT. REV. CODE OF 1954, § 1031. See p. 207.

7. See Commissioner v. Ray, 210 F.2d 390 (5th Cir. 1954), *cert. denied,* 348 U.S. 829 (1954); Commissioner v. McCue Bros. & Drummond, Inc., 210 F.2d 752 (2d Cir. 1954); Rev. Rul. 531, 1956-2 CUM. BULL. 983.

8. INT. REV. CODE OF 1954, § 1241.

9. Treas. Reg. § 1.1241-1(b) (1959).

10. See p. 202.

treatment of the sale-and-leaseback transaction, with particular reference to property used in the business, must now be considered.

Turning first to the sale itself, consideration must be given to whether the sale will result in a gain or in a loss. If a gain will be realized, then, of course, the tax on that gain will have to be taken into account. However, the asset will normally be a section 1231 asset, and the gain may, therefore, be taxed as long-term capital gain. Accordingly, the net amount realized on the sale, even after taking into account the tax on the gain, may justify the sale, and may justify the rent deductions which will have to be paid thereafter to continue to occupy the property.

On the other hand, if a loss will be realized on the sale, then the loss deduction which may result may be still a further factor making the sale and leaseback attractive. If the property is a section 1231 asset, which it ordinarily will be, then the loss may be deductible as an ordinary loss.

If a loss will be realized on the sale, there are several pitfalls that must be avoided, lest the loss be disallowed. First, care must be taken that the sale is not between related persons or entities.[11]

Second, one must make certain that the sale will be treated as a sale, and not as a tax-free exchange. If the transaction is classified as an exchange of property held for productive use in trade or business, or for investment for property of like kind to be held for productive use in trade or business, or for investment, then no loss will be recognized.[12] By hypothesis, the sale in question is to be accompanied by a leaseback. Thus, if the leasehold interest taken back is property of like kind, and if it is received in exchange for the fee, then the taxpayer may be in a danger zone.

Taking the "like kind" question first, the regulations have long provided that a fee interest in real estate and a leasehold with thirty years or more to run are property of like kind.[13] Thus, if the lease taken back (including renewals) is for less than thirty years, the transaction is unlikely to be attacked as constituting a "like kind" exchange.[14]

Frequently, however, in a sale-and-leaseback transaction it will be desired to make the term of the lease longer than thirty years (including renewals). That leads to the second question: assuming that the lease is property of like kind, has there been an *exchange?* Here the terms of the transaction, principally the sale price and the lease rental, become extremely important. If the property is sold for a stipulated sale price which is less than the worth of the property, and a

11. INT. REV. CODE OF 1954, § 267(c).

12. INT. REV. CODE OF 1954, § 1031. For a more complete discussion of the rules relating to "like kind" exchanges see p. 207.

13. See Treas. Reg. § 1.1031(a)-1(c) (1959).

14. See p. 202.

lease is received calling for a less-than-fair-market rental, then there has been an exchange of the fee for cash plus a valuable lease (that is, any lease which calls for rent that is lower than the fair rental value of the property, has value in and of itself). In that case, if the lease is for more than thirty years and, hence, is classed as property of like kind, there will have been a tax-free exchange. The result will be that none of the loss will be allowed. The seller's basis for the property, reduced by the amount of cash received in the transaction, will be treated as the basis of the lease and amortized over the lease term.

On the other hand, if the property is sold for its fair market value and is leased back for a fair rental value, the Court of Appeals for the Second Circuit, in *Jordan Marsh Company v. Commissioner*,[15] has held that the seller has converted his real estate into cash equal to the value of the fee; that that is a sale; that the lease, being for a fair rental, has no premium value as such, and, thus, is not property received in exchange for the fee; and that the loss on the sale is deductible.

One word of caution is in order, however. It is not unlikely that the Commissioner might contend, as he did in the *Jordan Marsh* case, that where the leaseback is for longer than thirty years, there is a tax-free exchange even though the selling price and the lease rental are fair.[16] Therefore, it would perhaps be wise to keep the term of the leaseback to less than thirty years (including renewal periods) wherever possible, if one desires to be assured of the deduction for the loss on the sale without controversy.

There is still a third ground upon which the loss on the sale and leaseback may be disallowed, namely, that because the seller has reserved a repurchase option, the transaction is not a sale at all but merely a mortgage loan. Ordinarily, a bona fide sale and leaseback will be very different from a mortgage. Moreover, a sale for fair market value, coupled with a leaseback for a fair rental, even if it gives the seller-lessee an option to repurchase the property at some future date for the then fair market value, should not be classed as a loan transaction. Nevertheless, in view of the fact that in the one case involving a sale and leaseback with an option to repurchase, it was held that the transaction was not a sale but merely a loan transaction,[17] it would probably be advisable to omit from the sale-and-leaseback transaction any repurchase option.

Turning to the deductibility of the rental payments, ordinarily, if

15. Jordan Marsh Co. v. Commissioner, 269 F.2d 453 (2d Cir. 1959); *cf.* Century Elec. Co. v. Commissioner, 192 F.2d 155 (8th Cir. 1951), *cert. denied,* 342 U.S. 954 (1952), which was distinguished in the *Jordan Marsh* case on the ground that in *Century Electric* the fee which the taxpayer had "exchanged" may have had a value substantially in excess of the cash received.

16. The Internal Revenue Service has announced that it will not follow the *Jordan Marsh* case. T.I.R. 194, 4 P-H 1959 FED. TAX SERV. ¶ 55,160.

17. Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939).

the parties are unrelated, there will be no question about the rental payments being deductible.[18] If the parties are related, however, the question may be raised whether the lessor is the true owner, and whether the payments are really rent. If both answers are affirmative, the rental payments are deductible.[19] If the sale is not bona fide, however, and if the lessor is not recognized as the true owner, then the payments will not be allowed as rent.[20]

18. INT. REV. CODE OF 1954, § 162(a)(3).

19. Brown v. Commissioner, 180 F.2d 926 (3d Cir. 1950); Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948) (both cases involved gift and leaseback).

20. W. H. Armston Co. v. Commissioner, 188 F.2d 531 (5th Cir. 1951) (sale and lease back between stockholder and corporation disregarded).