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Tax Problems Incident To the Disposition of Real Estate

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SPECIAL PROBLEMS OF REAL ESTATE — CHARITABLE GIFTS, APPORTIONING COSTS, AND DEALER VERSUS INVESTOR STATUS

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CHARITABLE CONTRIBUTION DEDUCTIONS AND GIFTS OF REAL ESTATE

The use of appreciated stocks and securities when making charitable contributions is a rather common practice. This same possibility for tax saving is sometimes overlooked where the donor has appreciated real estate. By donating the real estate to a charitable organization, educational institution, or other organization designated in section 170(c) of the Internal Revenue Code of 1954, the donor avoids the payment of the capital gain tax that would result if he were to sell the appreciated property,[1] and he is permitted to take a charitable contribution deduction based on the fair market value of the property at the time of the gift.[2] The tax savings will depend upon the tax bracket of the donor.

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Even greater tax benefits are available where appreciated property is sold to a charitable organization at cost. For example, suppose a taxpayer who holds real estate for investment which cost him $1,000 and which now has a fair market value of $1,500, desires to make a charitable contribution of $500. The individual could contribute $500 in cash, which would be the most expensive way, to him, of making the contribution; or he could contribute one-third of the parcel, which would be a less expensive way of making an equivalent contribution.[3] However, the least expensive way of making the contribution would be for the taxpayer to sell the entire parcel to the charitable organization for his original cost of $1,000. By so doing, he would be allowed to recover his original cost tax free, and, in addition, he would be entitled to a charitable contribution deduction of

1. Rev. Rul. 138, 1955-1 CUM. BULL. 223. A dealer in real estate could avoid *ordinary* income tax by a contribution of appreciated real estate to a charitable organization.

2. Treas. Reg. § 1.170-1(e) (1958).

3. This assumes that $500 would be the equitably apportioned cost basis for the one-third parcel. For a discussion of apportioning the cost see notes 7-10 *infra* and accompanying text.

$500, the difference between the fair market value of the property and the selling price of the property to the charitable organization. Thereafter, if the individual so desires, he could purchase a similar parcel and obtain a new basis for the property equal to its purchase price, which, assuming the purchase price to be $1,500, would step-up his basis by $500 without his ever having incurred any income tax liability to obtain such a step-up.[4]

Where there is a possibility that the limitation on charitable contribution deductions will apply,[5] the taxpayer may spread a gift of real property over two or more years by giving only a part of the property in each year.[6]

APPORTIONING COST WHERE LESS THAN THE ENTIRE TRACT IS SOLD

Where a tract of land has been carried as one account and a sale is made of less than the whole, it is necessary to treat each such sale as a separate and complete transaction. This means that the cost of the entire tract must be apportioned between or among the parts, and, further, that this apportionment must be done on an equitable basis, as distinguished from a ratable basis.[7]

Some of the methods that are commonly used are the front footage method,[8] the assessed valuation method,[9] and the tentative sales price method.[10] This third method is especially useful in the case of a subdivision for a housing development, where some lots will carry higher selling prices than others. Under this method, each lot will carry the same percentage of the overall cost as its estimated selling price is to the total estimated selling price.

In determining the apportionment of cost among the various lots of a subdivision, it is important to include an estimate of future expenditures that will be made and which will benefit all of the lots of the subdivision.[11]

4. If the property were sold to a charitable organization for $1,200, the transaction would have the dual nature of a part sale, part gift; the transferor is entitled to a $300 charitable contribution deduction and is required to report a $200 capital gain as a result of the transaction. See Treasury Department Letter Rulings to Robert L. Merritt, Esq., dated September 15, 1959, and October 1, 1959, signed by Lester W. Utter, Chief, Individual Income Tax Branch, bearing symbols "T:R:I: DMO-3."

5. See INT. REV. CODE OF 1954, § 170(b).

6. See Merritt, *The Tax Incentives for Charitable Giving*, 36 TAXES 646, 647, 653-54 (1958).

7. Treas. Reg. § 1.61-6 (1951).

8. Biscayne Bay Islands Co., 23 B.T.A. 731 (1931).

9. J. S. Cullinan, 5 B.T.A. 996 (1927).

10. R. W. Ewing, 27 P-H Tax. Ct. Mem. 533 (1958).

11. The Colony, Inc., 26 T.C. 30 (1956), *aff'd* and *rev'd on other issues*, 244 F.2d 75 (6th Cir. 1957) and 357 U.S. 28 (1958).

DEALER AND INVESTOR PROBLEMS

The continuing attempt on the part of taxpayers to have profits treated as capital gains rather than ordinary income has been especially apparent in transactions involving real estate. The basic rule that a dealer in real estate has ordinary income and an investor has capital gain is well recognized.[12] The problem is to determine who is a dealer and who is an investor, and further, at what point an investor takes on the dealer label.

Numerous courts have decided these questions, based upon the particular facts of each case. These decisions provide a pattern as to what can and what cannot be done if a dealer status is to be avoided. Generally, a dealer status may be recognized when one or more of the following factors are present:

1. Sales of real property are frequent and continuous rather than isolated and casual;[13]
2. The taxpayer or his agent engages in advertising and promotional work with respect to the sale of the real estate;[14]
3. The taxpayer either maintains a real estate office or is a licensed real estate broker;[15]
4. The taxpayer expends funds in improving the property;[16]
5. The taxpayer subdivides a large tract and sells lots;[17]
6. The taxpayer acquires real estate under circumstances that indicate a non-investment intent.[18]

On the other hand, the absence of the above factors would work in favor of an investor status.

It is interesting to note that one taxpayer may be considered an investor with respect to some transactions and a dealer with respect to others.[19] Anyone who anticipates this position should make a special effort to maintain records which will show clearly his status as to each transaction entered into. Consideration should also be given to the use of one or more corporations in this type of situation, if the use of multi-corporations can be justified.[20]

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12. INT. REV. CODE OF 1954, § 1221.

13. Burgher v. Campbell, 244 F.2d 863 (5th Cir. 1957); Estate of E. M. Webb, 30 T.C. 1202 (1958); E. Aldine Lakin, 28 T.C. 462 (1957); August Engasser, 28 T.C. 1173 (1957).

14. J. M. Philbin, 26 T.C. 1159 (1956); T. W. Briggs, 25 P-H Tax Ct. Mem. 350 (1956).

15. Jones v. Commissioner, 209 F.2d 415 (9th Cir. 1954); Durr v. Usry, 163 F. Supp. 355 (E.D. La. 1958).

16. Ray E. Dugan, 26 P-H Tax Ct. Mem. 706 (1957).

17. Lewis L. Culley, 29 T.C. 1076 (1958).

18. Clark v. United States, 143 F. Supp. 165 (S.D. Cal. 1956); Albert Winnick, 21 T.C. 1029 (1954), *aff'd without opin.*, 223 F.2d 266 (6th Cir. 1955).

19. Rev. Rul. 565, 1957-2 CUM. BULL. 546; D. G. Bradley, 26 T.C. 970 (1956), *acq.*, 1957-1 CUM. BULL. 3; D. L. Phillips, 24 T.C. 435 (1955), *acq.*, 1956-2 CUM. BULL. 7; J. O. Chapman, 13 P-H Tax Ct. Mem. 44 (1944).

20. But see James Realty Co. v. United States, 176 F. Supp. 306 (D. Minn. 1959).

SUBDIVISION OF REAL ESTATE

Prior to the enactment of section 1237 of the Internal Revenue Code of 1954, an investor who subdivided and sold real estate was likely to be taxed at ordinary income rates.[21] Section 1237 was added to give relief to individual or corporate investors who found it necessary to subdivide a tract in order to realize the greatest profit on their investment.[22]

In order to qualify as an investor under this section, an individual must show that: (1) he was not a dealer in other real estate in the year of sale; (2) he never held the subdivided tract as a dealer; (3) he had held the tract for at least five years, if it was not inherited; and (4) he did not make substantial improvements.[23] With regard to improvements, the code provides that they shall be deemed to have been made by the taxpayer if such improvements were made by the taxpayer or members of his family,[24] by a corporation controlled by the taxpayer, or by a partnership in which the taxpayer is a partner;[25] or if made by a lessee (provided such improvement constituted income to the taxpayer);[26] or if made by any governmental or political subdivision (provided the improvement constituted an addition to basis for the taxpayer).[27]

In addition to the above tests, in order for a corporation to qualify under section 1237 it must not have a shareholder who holds property as a dealer, or who holds a controlling interest in another corporation which so holds real property or which, except for section 1237, would be so considered to hold real property.[28] Further, the property involved must have been acquired through the foreclosure of a lien, which lien secured the payment of an indebtedness to a creditor who has transferred the foreclosure bid to the corporation in exchange for all of the stock of the corporation and other consideration.[29]

If the above tests are met, the code provides that the property shall not be considered as being held primarily for sale to customers in the ordinary course of trade or business *solely* because of the sub-

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21. Palos Verdes Corp. v. United States, 201 F.2d 256 (9th Cir. 1952); Mauldin v. Commissioner, 195 F.2d 714 (10th Cir. 1952); Brown v. Commissioner, 143 F.2d 468 (5th Cir. 1944); Shearer v. Smyth, 116 F. Supp. 230 (N.D. Cal. 1953).

22. INT. REV. CODE OF 1954, § 1237. See Senate Finance Comm. Reports, S. REP. NO. 1622, 83d Cong., 2d Sess. (1954); Conference Report, H.R. REP. NO. 2543, 83d Cong., 2d Sess. (1954).

23. INT. REV. CODE OF 1954, §§ 1237(a)(1), (2), (3).

24. "Members of family" is defined in INT. REV. CODE OF 1954, § 267(c)(4).

25. INT REV. CODE OF 1954, § 1237 (a)(2)(A).

26. INT. REV. CODE OF 1954, § 1237(a)(2)(B). For a discussion of when improvements by lessee may constitute income to the lessor see p. 189.

27. INT. REV. CODE OF 1954, § 1237 (a)(2)(C).

28. INT. REV. CODE OF 1954, § 1237(a).

29. *Ibid.;* Treas. Reg. § 1.1237-1(c)(5)(iv) (1957).

division and sale of such property or because of any activity incident to this subdivision or sale.[30]

In addition to the above provisions, even if the owner of the tract makes improvements, they will not be deemed to be "substantial improvements,"[31] if the tract is held for ten years[32] and if: (1) the improvement consists of the building or installation of water, sewer, or drainage facilities or of the construction of roads; (2) the lot or parcel would not have been marketable at the prevailing price for similar building sites without such improvements; and (3) the taxpayer elects to make no adjustment to the basis of the lot or parcel, or any other property owned by the taxpayer, on account of the expenditures for such improvements.[33]

The tax benefits which a taxpayer may derive from qualifying under section 1237 are of notable significance and should not be overlooked by anyone involved in this type of enterprise. If no more than five lots or parcels contained in the same tract of real estate are sold or exchanged, the gain from such sale or exchange will be considered a capital gain.[34] If a sixth lot or parcel is sold, however, the gain from all lots sold in the year of the sixth sale or subsequent years will be deemed to have been gained from the sale of property held primarily for sale to customers in the ordinary course of business.[35] But even in this situation the taxpayer is benefited under section 1237 because the gain will be taxed as ordinary income only to the extent of five per cent of the selling price; the balance of the gain will still be capital in nature. Moreover, the expenditures incurred in connection with such sales or exchanges may be offset against that portion of the gain that is taxed as ordinary income.[36] Thus, even when more than five lots are sold or exchanged, the entire gain may be taxed as a capital one after the expenditures have been taken into consideration. In view of this, any real estate investor who may have to subdivide a tract should engage in careful planning and timing in order to insure that he will come within the provisions of section 1237 and that he will be able to obtain the maximum benefits which this section offers.

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30. INT. REV. CODE OF 1954, § 1237(a).

31. Which, under § 1237(a)(2) would disqualify the land as being held for an investment.

32. It should be noted that the property must be held a full ten years. Compare this with the general five-year rule, § 1237(a)(3).

33. INT. REV. CODE OF 1954, § 1237(b)(3). The second and third requirements need not be met if the property was acquired by foreclosure of a lien thereon which secured an indebtedness to the taxpayer, or, if the property is adjacent to property so acquired if at least 80% of the property owned by the taxpayer is property acquired in that manner. *Ibid.* For a discussion of the similar provision in regard to corporations, see note 28 *supra* and accompanying text.

34. INT. REV. CODE OF 1954, § 1237(b)(1).

35. *Ibid.;* Treas. Reg. § 1.1237-1(e)(2) (1957). This section of the regulations provides that in computing the number of lots sold, two or more contiguous lots sold to a single buyer in a single sale will be counted as only one lot.

36. INT. REV. CODE OF 1954, § 1237(b)(2); Treas. Reg. § 1.1237-1(e)(2) (1957).