

**INTERNAL REVENUE SERVICE**

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GENIN-160610-01



Dear [REDACTED]:

This letter responds to your e-mailed request for assistance dated October 3, 2001, regarding a question you received from [REDACTED]. Specifically, you asked whether a business entity may buy raw land and hold it for more than one year while obtaining approval to subdivide, then, once approval to subdivide has been obtained, sell the land to another business entity owned by the same persons and pay taxes on the transaction at capital gains rates.

Generally, gain from the sale or exchange of a capital asset held for more than one year is long-term capital gain. Section 1221(a)(3) of the Internal Revenue Code. Section 1221(a)(1) defines "capital asset" as property held by the taxpayer (whether or not connected with its trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. *See also* § 1.1221-1(a) of the Income Tax Regulations.

Where one business entity buys raw land, holds it for more than one year, then sells it to a related business entity, whether or not the first business entity will realize capital gain on the transaction turns on whether or not the first business entity is considered to have held the land primarily for sale to customers in the ordinary course of its trade or business. The intent of the seller entity is determinative. In a sale between related parties, the seller entity typically argues that characterization of gain or

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loss realized by it should be determined based only upon its own intent and activities with respect to the land. In other words, if the seller entity intended to hold the land as an investment, the fact that the related purchaser entity held the land primarily for sale to customers in the ordinary course of its trade or business is irrelevant. The Service, on the other hand, typically argues that an agency relationship exists between the seller entity and the related purchaser entity and, therefore, the purchaser entity's activities are relevant to the determination of whether the seller entity intended to hold the land as an investment.

### **Magnitude of Activity with Respect to the Property**

Courts that have addressed the issue have emphasized a variety of factors as determinative of whether an agency relationship existed and the seller entity held the land primarily for sale to customers in the ordinary course of its trade or business. The most important factor appears to be the magnitude of the seller entity's pre- and post-transfer activity with respect to the property. In *Brown v. Commissioner*, 448 F.2d 514, 517 (10th Cir. 1971), the seller contacted an engineering company to find out where streets and utilities would be located and had the land platted and approved by his local planning commission prior to selling the land to his corporation. With respect to another tract of land, the seller had his attorney initiate the formation of a local public works authority for the purpose of having the city construct a sewer system on the tract before selling the land to his corporation. *Id.* at 517. In *Tibbals v. United States*, 362 F.2d 266, 269-70 (Ct. Cl. 1966), the seller successfully sponsored petitions for the construction by the county of water mains, sewer and street improvements on his land before selling it to his corporations. In *Boyer v. Commissioner*, 58 T.C. 316, 318-325 (1972), the sellers, although never acting in their individual capacities, participated in the development of the land after selling it to their corporation by surveying and platting the land, installing streets, sewers and other improvements, and getting it re-zoned. In each of these cases, the court held the seller's high magnitude of pre- and post-transfer activity with respect to the property was evidence that an agency relationship existed between the seller and the related purchaser. In each of these cases, the court held the seller was developing the property in anticipation of the related purchaser's sale of the property to the public and, therefore, the purchaser's intent to sell the property was attributable back to the seller.

In *Bramblett v. Commissioner*, 960 F.2d 526, 531 (5th Cir. 1992), on the other hand, the selling partnership held the property for over three years without advertising or hiring brokers, developing the property, maintaining an office, or making more than four minimal sales aside from the final one at issue to a related corporation. The partners did not spend more than a minimal amount of time on the activities of the partnership. *Id.* at 531. Similarly, in *Ronhovde v. Commissioner*, T.C. Memo 1967-243 (1967) (distinguished in *Brown* at 517-518), the court found the selling partnership's failure to acquire any other land than the land at issue and failure to plat or develop the land indicative of a one-time transaction for investment purposes, rather than for sale to

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customers in the ordinary course of its trade or business. In both of these cases the courts held the sellers' minimal activities with respect to the properties were indicative of the sellers' investment intent.

### **Length of Time Between the Seller's Purchase and Sale of the Land**

Another important factor indicating the seller entity held the land primarily for sale to customers in the ordinary course of its trade or business is the length of time between the seller entity's purchase of the land and its sale of the land to the purchaser entity. In *Brown*, the seller purchased his first tract of land in June 1958, completed platting his property and had it approved by his local planning commission in January 1959, and sold it to his corporation in the same month. *Brown* at 517. He purchased his second tract of land in December 1958, successfully established a public works authority to construct a sewer system in the area in March 1959, and sold the property to his corporation in September 1959. *Id.* The *Brown* court held the short period between the seller's purchase of his properties, his initiation of their development, and the sale of his properties to a related purchaser was evidence the seller held his properties primarily for sale to customers in the ordinary course of the trade or business. *Id.*

In *Tibbals*, the seller originally purchased his property in February 1950. A few days later, he began petitioning the county for water, sewer and street improvements, which were begun in autumn 1951 and completed in early 1953. *Tibbals* at 269-270. Meanwhile, the seller sold two lots to one of his corporations in April 1951 for the purpose of constructing experimental prefabricated homes and sold 100 lots to another of his corporations in June 1952. *Id.* at 270. The court held the seller's immediate initiation of development and his sale of the property to related purchasers before the development was even complete was indicative that the seller held his properties primarily for sale to customers in the ordinary course of his trade or business. *Id.* at 271.

In *Boyer*, the sellers entered into a contract to purchase land on April 4, 1966 and closed on May 25, 1966. *Boyer* at 318. Meanwhile, prior to closing, they had already entered into a contract to sell their land to their corporation on May 12, 1966, for twice what they paid for it. *Id.* at 319 and 324. The court viewed the immediate sale to a related corporation, coupled with the artificially high price, as evidence of lack of arm's length dealing and evidence of an intent to prematurely squeeze out all potential gain from the finished operation at capital gain rates. *Id.* at 323, 324, and 326.

In *Bramblett*, the selling partnership purchased its property in late 1979 and early 1980 and held it for over three years without developing it before finally selling a substantial portion of it to a related corporation in 1982. *Bramblett* at 528 and 531. The *Bramblett* court held the length of time between the selling partnership's purchase of

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the property and its sale to a related party indicated the seller was holding the property as investment property. *Id.*

The selling partnership in *Ronhovde* purchased its property in February 1963 and sold the land to the related corporation in September 1963 for development and sale to third parties. In January 1963, however, before the selling partnership had even purchased the property, one of its partners began promoting a related corporation to develop the land. Although the court noted the sale to the related corporation was made shortly after the land was acquired, the court held the seller was holding the property as investment property. The court based its decision that the seller possessed investment intent on evidence that the sale was a one-time transaction. The court found the reason a favorable sale was possible in such a short time was due to the promotion activities of the partner and viewed the activities of this partner as done in his capacity as promoter of the corporation and not in his capacity as managing partner of the partnership.<sup>1</sup>

#### **Seller's Purchase and Sale of Other Properties And General Experience and Involvement in Real Estate**

Courts have also considered the seller entity's purchase and sale of other properties and general experience and involvement in the real estate business as determinative of the seller entity's intent to hold the land primarily for sale to customers in the ordinary course of its trade or business. In *Brown*, the court cited the fact that the seller had purchased and developed four other tracts of land during the same period of the transactions at issue as evidence of his involvement in the real estate business and, therefore, his lack of investment intent. *Brown* at 517. In *H-H Ranch, Inc. v. Commissioner*, 357 F.2d 885 (7th Cir. 1966), the court approved the Tax Court's determination that the selling corporation lacked investment intent based on a ultimate finding that, during the years at issue (1958 and 1959), the selling corporation was in the business of subdividing real property into improved lots and selling such lots to customers. *H-H Ranch* at 887. The *H-H Ranch* court also cited the fact that the shareholder of the selling corporation had been in the building business since 1914. *Id.* at 886.

#### **Seller's Purpose with Respect to the Land**

Where the magnitude of the seller's activity with respect to the property is not great, there is a considerable length of time between the seller's purchase and sale of the land, and the seller is not involved in the sale of other properties, courts look

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<sup>1</sup> *Ronhovde* was distinguished by the *Brown* court, which considered the *Ronhovde* decision to be based on the seller's failure to subdivide. *Brown* at 517-518.

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favorably on stated investment purposes with respect to land. In *Bramblett*, the court took into consideration the selling partnership's stated purpose of acquiring property for investment purposes. *Bramblett* at 531. The court found this purpose further evident in the partnership's actions in seeking professional advice on how to structure its purchase of the land to preserve its investment purpose. *Id.* at 531. On the other hand, in *Boyer*, the court seized upon a statement in the earnest-money agreement with the original owners to the effect that the sellers intended to subdivide and sell the land as evidence of intent to sell the land to customers in the ordinary course of its trade or business. *Boyer* at 324-325.

We hope this general information is helpful. For more specific guidance, a taxpayer may request a private letter ruling from the national office of the Internal Revenue Service. We have enclosed a copy of Rev. Proc. 2001-1, 2001-1 I.R.B. 1, which contains the procedures for a taxpayer to request a private letter ruling. If we can be of further assistance to you regarding this matter, please contact (ID # ) of the Income Tax and Accounting Division at ( ) .

Sincerely,

PAUL M. RITENOUR  
Chief, Branch 1  
Office of Associate Chief Counsel  
(Income Tax and Accounting)

Enclosure: Rev. Proc. 2001-1

cc: Supervisory Internal Revenue Agent, S:C:CP:RC:ES C9-468