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Like-Kind Exchanges —Inattentive Accounting Dooms Change-of-Purpose Argument

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The Tax Court recently revisited an often overlooked issue—whether real property exchanged for other real property, in a transaction intended to constitute a tax-free exchange under section 1031 of the Internal Revenue Code, was property held "primarily for sale," such that gain must be recognized. (*Neal T. Baker Enterprises, Inc. v. Commissioner*, T.C. Memo 1998-302.) The conclusion of the court that the property was held "primarily for sale" is not surprising under the circumstances of the case, but the manner in which the court reached this conclusion offers some lessons for other taxpayers confronting the same issue.

Background

The taxpayer, a corporation, was formed in 1957 for two stated purposes: to operate drive-in restaurants and to purchase and develop real property. In 1969, the fast-food business was incorporated separately, and the corporation's assets thereafter consisted mainly of real property suitable for fast-food locations (leased to the fast-food company), and other real estate, some held for investment and some for development.

Apart from the fast-food establishments, the corporation's development activity consisted principally or entirely of the purchase of vacant land, subdivision, and the construction (through subcontractors) of single family homes for ultimate sale through brokers.

In 1978, the corporation acquired vacant land referred to as the Beaumont property. In 1981, the corporation commenced "offsite" improvements (including gutters and sidewalks) with respect to 14 lots in a portion of the property fronting on an avenue then being improved by the City of Beaumont. A final map for those lots was approved in 1982.

In 1986, the taxpayer entered into contracts with subcontractors to build "entry-level" houses on the 14 lots. The houses were completed and sold from 1987 to 1989 for prices in the range of $77,000 to $90,000. The corporation also filed a tentative map for 48 lots occupying the remainder of the Beaumont Property (referred to in the opinion as the "Exchange Property"), which was approved in 1986. No improvements were made on that property.

In 1988, the corporation received an unsolicited offer to purchase the Exchange Property. The corporation declined to sell the property, but indicated that it was willing to enter into an exchange. In April, 1989, the corporation entered into an exchange agreement to dispose of the Exchange Property and acquire other real property. The Exchange Property was transferred in May, 1989, and four replacement properties were designated by the corporation and transferred to it later in the same year.

The corporation reported a gain realized of approximately $429,000 on Schedule M-1 of its return, but did not include the gain in its taxable income. The IRS asserted a deficiency in tax, however, arguing that section 1031 did not apply by reason of the purpose for which the corporation held the property. Specifically, the IRS argued that the Exchange Property was “property held primarily for sale,” to which section 1031(a) cannot apply.

Tax Court’s Decision

The court, in a lengthy opinion, held for the IRS. In doing so, the court made reference to several important legal principles and to important omissions and inconsistencies in the taxpayer’s factual presentation.

First, the court noted crucial differences between the language of section 1031 and the language of the provision (Code section 1221) that establishes the distinction between ordinary income and capital gain. Under section 1221, property is not a “capital asset” if it is “held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.” Section 1031, by contrast, does not contain the words “to customers in the ordinary course of his trade or business.” Thus, to be denied like-kind exchange treatment under section 1031, it is not necessary to find sales to “customers” or to find an “ordinary course of . . . trade or business.” It is sufficient to find that the property was “held primarily for sale”—a more difficult hurdle for the taxpayer to overcome.

The court found, based on the evidence, that the corporation’s initial purpose in acquiring the Beaumont Property was to hold the property for sale (*i.e.*, to subdivide the property into lots for single-family residential houses). That brought into play the second important legal principle—that the purpose for which property is held is subject to change, and the determining factor is the purpose for which the property is held at the time of disposition, which may be different from the purpose at the time of acquisition. Thus, the principal focus of the court’s analysis was on whether the corporation could establish that it abandoned its original intent and thereafter, through the time of the exchange, held the property for investment. The taxpayer’s attempt to establish a change in purpose ran head on into some troublesome facts.

First, the corporation had purchased, developed and sold similar property continually through the years in issue. Although it is clear that a taxpayer may be a “dealer” in some property while holding other property for investment, the mere presence of “dealer” property may color the view taken by the trier of fact, and makes it more difficult to establish a change of purpose in the absence of solid evidence to that effect.

The corporation, through evidence consisting almost entirely of the testimony of its president, made several arguments in support of its assertion that the development purposes had been abandoned, including: that excessive “off-site” development costs made subdivision and development impossible; that weakness in the market and an unsuccessful sales record with 14 adjacent lots made sales of lots economically unfeasible; and that the personal health problems of the principal shareholder required him to abandon real estate development. Ultimately, the court did not find any of these assertions to be convincing.

Facts that apparently were given weight by the court included the successful improvement of the tract by a successor to the person who acquired it from the corporation (who built and sold single-family homes on the lots on the site); and the fact that the president's health problems did not prevent the corporation from continuing development of residential and fast-food sites at other locations.

The court also observed that the Exchange Property continued to be carried on its books in a work-in-progress account, rather than an investment property account, throughout the years at issue, although other property was booked as unimproved land when acquired or, in some cases, transferred from work-in-progress to the unimproved land account after improvements were completed. The court even pointed to the fact that the corporation's tax returns listed its principal business activity as "real estate subdivider and developer," when it could have selected "real estate operator and lessor of buildings." A good tax planner will pay attention to such details of presentation, but all too many lawyers and accountants do not concern themselves with things that appear to have little or no direct bearing on the tasks they are charged with carrying out.

Finally, the court noted that the corporation listed its accountants as witnesses in its pretrial memorandum, but never called the accountants to explain why properties were recorded in a particular manner, suggesting that this failure weighed against the corporation. Based on the records presented at trial, the president's statements, and other evidence, the court was not persuaded that the accountants had misclassified the property.

Observation

Under the circumstances, the court's conclusion seems correct. An earlier Tax Court decision, *Paullus v. Commissioner* (cited by the taxpayer and previously discussed in this column), which had reached a pro-taxpayer conclusion, was distinguished by the court based on the different facts present in that case. Whenever it is necessary to establish a taxpayer's purpose or intent, the inquiry will necessarily be a factual one and the outcome in most cases will be difficult to predict. It is clear, however, that with greater attention to detail, such as the manner in which the property was reflected on the books and tax returns of the corporation, and with contemporaneous evidence to support a change in the corporation's purpose for holding the property, a more convincing case for a change of purpose could have been made.