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Capital Gains Treatment for Gain Realized in Condominium Conversions

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CAPITAL GAINS TREATMENT FOR GAIN REALIZED IN CONDOMINIUM CONVERSIONS

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I. INTRODUCTION

Gain realized by the owner of an apartment building who converts the apartments into condominiums and sells them himself usually will be taxed as ordinary income.¹ Capital gains treatment will be denied because the condominium units are property held primarily for sale in the ordinary course of the owner's trade or business.² By selling the apartment building to a corporation before conversion, however, the owner's gain on that sale will be a capital gain.³ The corporation then may convert the apartments into condominiums. Although the corporation will recognize ordinary income on the sales of the condominium units, it can be liquidated once the conversion is complete and one-third or more of the gain expected from sale of the converted units has been realized.⁴ Thus, the shareholders would receive

1. If the conversion of an apartment building to condominiums is performed by the building owner himself, it is termed a "straight" condominium conversion.

2. See Part II. *infra*. The Internal Revenue Service has ruled that I.R.C. § 1237, which provides for capital treatment of sales of subdivided realty, does not apply to condominium conversions. Rev. Rul. 80-216, 1980-2 C.B. 239.

3. See Part III. *infra*. To qualify for the 60 % capital gains deduction provided by I.R.C. § 1202, the building must be a capital asset as defined in *id.* § 1221 and there must be a sale or exchange. Capital gain treatment on the sale is ensured if the building is a capital asset in the owner's hands.

4. See Part IV. *infra*.

cash and the remaining unsold units at capital gains rates and avoid the ordinary income treatment that would result if they converted and sold the units themselves.

This Comment will summarize the tax problems encountered in a straight condominium conversion, a conversion by an individual owner. This summary will illustrate why more sophisticated techniques should be used. This Comment then will discuss the issues raised by the sale of an apartment building to a corporation for conversion. Finally, the use of a collapsible corporation to increase the amount of gain that will qualify for capital gains treatment will be examined.

II. THE STRAIGHT CONVERSION

For any sale of condominium units to qualify for capital gains treatment,⁵ the units must be capital assets.⁶ Thus, for the individual owner to achieve capital gain treatment for gains realized from the conversion and sale of the condominium units, he must prove that the units are capital assets as defined in Internal Revenue Code section 1221. The first clause of section 1221 defines "capital assets" as "property held by the taxpayer (whether or not connected with his trade or business)."⁷ The rest of the section lists exceptions to this broad definition. Section 1221(1) lists general types of property that are not capital assets: stock in trade, inventory, and property held primarily for sale in the ordinary course of a trade or business.⁸

In *Malat v. Riddell*,⁹ the United States Supreme Court held that section 1221(1) distinguishes "between the 'profits and losses arising from the everyday operation of a business' on the one hand . . . and the 'realization of appreciation in value accrued over a substantial period of time' on the other."¹⁰ Given the vagueness of the section 1221(1) definition of capital assets and the limited guidance tendered by the Supreme Court in *Malat*, courts examine the following factors to determine if property is held primarily for

5. The maximum tax rate on corporate net capital gains is 28%, I.R.C. § 1201(a)(2) (alternative tax), compared with a maximum 46% marginal rate on ordinary corporate income, *Id.* § 11(b)(5). A taxpayer other than a corporation may deduct 60% of his net capital gains from his gross income. *Id.* § 1202(a). Thus, an individual is taxed at his individual rates on 40% of his net capital gains, whereas he is taxed at his individual rates on all ordinary income. See generally Hooton, *Permanent Tax Savings Provided by Properly Structured Real Estate Transactions*, 58 TAXES 643 (1980); Miller, *Can a Straight Condominium Conversion Produce a Capital Gain? An Analysis*, 54 J. TAX. 8 (1981).

6. If the asset is not a capital asset under I.R.C. § 1221, gain recognized on its sale will not qualify for net capital gain treatment under *id.* § 1201(a). Therefore, the gain will be included in the corporation's ordinary income under *id.* § 61(a)(3).

7. *Id.* § 1221(1).

8. *Id.*

9. 383 U.S. 569 (1966) (per curiam).

10. *Id.* at 572 (citations omitted).

sale in the taxpayer's trade or business:¹¹ the frequency and substantiality of sales,¹² the seller's activities to improve and sell the property,¹³ the purpose for which the seller held the property during the taxable year,¹⁴ and the subdivision of the property by the seller.¹⁵ Although each transaction is to be decided on its own facts and no one factor is dispositive,¹⁶ these fac-

11. See *Suburban Realty Co. v. United States*, 615 F.2d 171, 173-87 (5th Cir.), *cert. denied*, 449 U.S. 920 (1980); *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 420-24 (5th Cir.), *cert. denied*, 429 U.S. 819 (1976); *United States v. Winthrop*, 417 F.2d 905, 909-12 (5th Cir. 1969); *Municipal Bond Corp. v. Commissioner*, 382 F.2d 184, 187-88 (8th Cir. 1967); *Redwood Empire Sav. & Loan Ass'n v. Commissioner*, 628 F.2d 516, 518-20 (9th Cir. 1980). One author discovered 17 such factors. Taylor, *Dealers and Investor in Real Estate*, 7 J. REAL EST. TAX. 396, 397 (1980).

12. Substantial and frequent sales indicate a trade or business. *Suburban Realty Co. v. United States*, 615 F.2d 171, 178 (5th Cir.), *cert. denied*, 449 U.S. 920 (1980); *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 416 (5th Cir.), *cert. denied*, 429 U.S. 819 (1976); *Municipal Bond Corp. v. Commissioner*, 382 F.2d 184, 188 (8th Cir. 1967).

13. A seller who improves and sells the property is more likely to be characterized as a dealer. *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 417 (5th Cir.), *cert. denied*, 429 U.S. 819 (1976); *Bush v. Commissioner*, 36 TAX CT. MEM. DEC. (CCH) 340, 348 (Mar. 22, 1977). Conversely, a seller who does not improve and sell the property is more likely to receive capital treatment. *Estate of Barrios v. Commissioner*, 265 F.2d 517, 520 (5th Cir. 1959); *Municipal Bond Corp. v. Commissioner*, 382 F.2d 184, 187 (8th Cir. 1967); *Johnson v. United States*, 280 F. Supp. 412, 418 (N.D.N.Y. 1967).

14. The taxpayer's purpose for holding at the time of the sale is the ultimate question in determining if property was held for sale in the ordinary course of business. The taxpayer's purpose in acquiring the property is relevant in determining the ultimate question of the holding purpose at the time of sale. See *Suburban Realty Co. v. United States*, 615 F.2d 171, 178 (5th Cir.), *cert. denied*, 449 U.S. 920 (1980); *Redwood Empire Sav. & Loan Ass'n. v. Commissioner*, 628 F.2d 516, 518 (9th Cir. 1980).

15. Subdivision of property by a seller bolsters the argument that the property was held for sale in the ordinary course of business. See *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 417 (5th Cir.), *cert. denied*, 429 U.S. 819 (1976); *Bauschard v. Commissioner*, 279 F.2d 115, 118 (6th Cir. 1960). Courts recognize, however, that a taxpayer is not necessarily in the real estate business simply because he subdivides property to obtain a better price. *Estate of Barrios v. Commissioner*, 265 F.2d 517, 520 (5th Cir. 1959); *Yunker v. Commissioner*, 256 F.2d 130, 132 (6th Cir. 1958); *Estate of Mundy*, 36 T.C. 703, 710 (1961).

16. *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 415 (5th Cir.), *cert. denied*, 429 U.S. 819 (1976); *United States v. Winthrop*, 417 F.2d 905, 911 (5th Cir. 1969); *Gartrell v. United States*, 619 F.2d 1150, 1153 (6th Cir. 1980); *Municipal Bond Corp. v. Commissioner*, 382 F.2d 184, 186 (8th Cir. 1967); *Redwood Empire Sav. & Loan Ass'n v. Commissioner*, 628 F.2d 516, 517 (9th Cir. 1980); *Estate of Freeland v. Commissioner*, 393 F.2d 573, 583 (9th Cir. 1968); *Mauldin v. Commissioner*, 195 F.2d 714, 716 (10th Cir. 1952).

tors are applied in the test for determining if an asset is a capital asset.

In *Suburban Realty Co. v. United States*,¹⁷ the United States Court of Appeals for the Fifth Circuit recently adopted a three element test to determine if an asset is a capital asset:¹⁸ (1) was the taxpayer engaged in a trade or business,¹⁹ (2) was the taxpayer holding the asset primarily for sale in that business,²⁰ and (3) were sales contemplated by the taxpayer "ordinary" in the course of that business?²¹ If the taxpayer cannot negate one of the three elements of this test, units sold by an individual after a straight conversion will be business assets and not capital assets; gain realized on the sales will be ordinary income and not capital gains.

A. Trade or Business

First, the *Suburban Realty* test determines if the taxpayer's activities are sufficient to be a trade or business.²² To resolve this issue, courts focus on the taxpayer's activities rather than on the property in question. They look for the factors previously outlined,²³ particularly emphasizing the substantiality and frequency of sales and any subdivision or development of the property by the seller.²⁴ In *Biedenharn Realty Co. v. United States*,²⁵ the United States Court of Appeals for the Fifth Circuit found that the individual was engaged in a trade or business. The court said that the substantiality and frequency of the taxpayer's sales, coupled with the subdivision and improvement of the lots, was sufficient activity to constitute a trade or business.²⁶ *Biedenharn* thus illustrates the major obstacle for an individual condominium converter who wishes to have the units treated as capital assets: because condominium sales are substantial and frequent, courts are likely to find that the individual converter was engaged in the trade or business of condominium conversions and sales. In addition, conversion activities are analogous to subdivision ac-

17. 615 F.2d 171 (5th Cir.), *cert. denied*, 449 U.S. 920 (1980). In *Suburban Realty*, the taxpayer claimed that sales of six tracts of land by a realty company were sales of capital assets and not sales in the ordinary course of business. 615 F.2d at 174.

18. 615 F.2d at 178.

19. See Part II.A. *infra*.

20. See Part II.B. *infra*.

21. See Part II.C. *infra*. See, e.g., *McManus v. Commissioner*, 583 F.2d 443, 446-47 (9th Cir.), *cert. denied*, 448 U.S. 959 (1978); *Morrison v. United States*, 449 F. Supp. 663, 669 (N.D. Ohio 1979).

22. *Suburban Realty Co. v. United States*, 615 F.2d 171, 181-82 (5th Cir.), *cert. denied*, 449 U.S. 920 (1980).

23. See notes 12-16 and accompanying text *supra*.

24. *Suburban Realty Co. v. United States*, 615 F.2d 171, 178 (5th Cir.), *cert. denied*, 449 U.S. 920 (1980); *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 416 (5th Cir.), *cert. denied*, 429 U.S. 819 (1976).

25. 526 F.2d 409 (5th Cir.), *cert. denied*, 429 U.S. 819 (1976).

26. 526 F.2d. at 417.

tivities, which have supported findings that a taxpayer was conducting a trade or business.²⁷

Taxpayers who sell property argue routinely that they were not engaged in a trade or business, but merely were liquidating an investment. This argument has experienced limited success²⁸ because it only restates the taxpayer's claim that he was not engaged in a trade or business. Thus, the Internal Revenue Service has stated that if in the process of liquidating an investment the taxpayer holds property for sale in the ordinary course of business, he must report resulting gain as ordinary income.²⁹ Similarly, in *Continental Can Co. v. United States*,³⁰ the Court of Claims held that if an individual transacts business using appreciated property as inventory, any gain realized is ordinary income.³¹ Thus, the liquidation argument should only be used as a last resort.

In a recent letter ruling, the Internal Revenue Service held that a labor union that converted two floors of a building into condominium units was engaged in the trade or business of converting and selling condominiums because those activities were not substantially related to the union's normal functions as a tax-exempt organization.³² This ruling and the attitude of the courts as typified by *Biedenharn* and *Continental Can* indicate that an individual owner who converts an apartment building into condominiums is engaged in a trade or business. Thus, the individual converter probably cannot escape the first element of the *Suburban Realty* test.

B. *Holding Property Primarily for Sale*

Second, *Suburban Realty* asks whether the property was held primarily for sale in the taxpayer's business.³³ If the owner was engaged in the real

27. See Stewart & Klein, *How to Convert an Apartment Complex into Condominium Units at Capital Gain Rates*, 8 TAX. FOR LAW. 342, 342-43 (1980).

28. See, e.g., *Kaltreider v. Commissioner*, 255 F.2d 833, 837-38 (3d Cir. 1958); *Estate of Barrios v. Commissioner*, 265 F.2d 517, 520 (5th Cir. 1959); *Bauschard v. Commissioner*, 279 F.2d 115, 118 (6th Cir. 1960); *Dillon v. Commissioner*, 213 F.2d 218, 220 (8th Cir. 1954); *Parkside, Inc. v. Commissioner*, 571 F.2d 1092, 1096 (9th Cir. 1977); *Gibson v. Commissioner*, 41 TAX. CT. MEM. DEC. (CCH) 1484, 1488 (May 14, 1981); *Frick v. Commissioner*, 31 TAX. CT. MEM. DEC. (CCH) 286, 288 (Mar. 22, 1972).

29. Ltr. Rul. 7730021 (Apr. 27, 1977).

30. 442 F.2d 405 (Ct. Cl.), cert. denied, 400 U.S. 819 (1970).

31. 442 F.2d at 409-15.

32. Ltr. Rul. 8028117 (Apr. 21, 1980).

33. *Suburban Realty Co. v. United States*, 615 F.2d 171, 182-85 (5th Cir.), cert. denied, 449 U.S. 920 (1980). I.R.C. § 1231(b)(1) defines "property used in the trade or business" as that property classified as inventory, *id.* § 1231(b)(1)(A), or that held primarily for sale to customers, *id.* § 1231(b)(1)(B). In *Malat v. Riddell*, 383 U.S. 569 (1966) (per curiam), the Court held that "primarily" meant "of first importance" rather than the lower standard of "substantial." *Id.* at 572.

estate business and held the property primarily for sale in that business, the gain on its sale would be ordinary income. Conversely, if a dealer in real estate holds real property as an investment, the property will be treated as a capital asset.³⁴ Therefore, the real estate dealer must prove that the investment property was segregated from property he held primarily for sale in his business.³⁵

The taxpayer's intent often indicates if the asset is held primarily for sale in a trade or business. Most courts have held that the original purpose for the acquisition of the property is relevant but not determinative of the primary holding purpose at the time of sale.³⁶ A dealer must show that his intent at sale was to hold the property as an investment.³⁷ Although a relatively long holding period may evidence an investment intent,³⁸ the majority of courts looks only to the seller's intent at the time of sale.³⁹

In addition, courts look to several factors to determine if a taxpayer held property for sale in his business. The substantiality and frequency of property sales strongly indicates and, alone, may be sufficient to support a finding that the property was held primarily for sale.⁴⁰ Additionally, condominium conversions are subdivisions of a building; they are analogous to real property that is subdivided, which generally is held for sale in a trade or business.⁴¹ Thus, if the condominium sales are frequent, substantial, and analogous to a subdivision of property, as they usually are, both the first

34. *Municipal Bond Corp. v. Commissioner*, 382 F.2d 184, 188 (8th Cir. 1967); *Hicks v. Commissioner*, 37 TAX CT. MEM. DEC. (CCH) 1540, 1543 (Sept. 19, 1978); *Harbour Properties, Inc. v. Commissioner*, 32 TAX CT. MEM. DEC. (CCH) 580, 632 (June 25, 1973).

35. *See* *Municipal Bond Corp. v. Commissioner*, 382 F.2d 184, 188 (8th Cir. 1967); *Crosswhite v. United States*, 438 F. Supp. 368, 371 (D. Or. 1977).

36. *See* *Suburban Realty Co. v. United States*, 615 F.2d 171, 183-84 (5th Cir.), *cert. denied*, 449 U.S. 920 (1980); *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 421-22 (5th Cir.), *cert. denied*, 429 U.S. 819 (1976); *Continental Can Co. v. United States*, 422 F.2d 405, 410 (Ct. Cl.), *cert. denied*, 400 U.S. 819 (1970).

37. *Continental Can Co. v. United States*, 422 F.2d 405, 410 (Ct. Cl.), *cert. denied*, 400 U.S. 819 (1970); *Maddux Constr. Co. v. Commissioner*, 54 T.C. 1278, 1286 (1970). *See* note 14 *supra*.

38. *Tidwell v. Commissioner*, 298 F.2d 864, 867 (4th Cir. 1962); *Municipal Bond Corp. v. Commissioner*, 382 F.2d 184, 189 (8th Cir. 1967); *Jones v. Commissioner*, 209 F.2d 415, 416 (9th Cir. 1954).

39. *See* *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 422 (5th Cir.), *cert. denied*, 429 U.S. 819 (1976); *Bauschard v. Commissioner*, 279 F.2d 115, 118 (6th Cir. 1960); *Continental Can Co. v. United States*, 422 F.2d 405, 410-11 (Ct. Cl.), *cert. denied*, 400 U.S. 819 (1970); *Maddux Constr. Co. v. Commissioner*, 54 T.C. 1278, 1284 (1970).

40. *See* note 24 and accompanying text *supra*.

41. *See* *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 416 (5th Cir.), *cert. denied*, 429 U.S. 819 (1976); *Crosswhite v. United States*, 369 F.2d 989, 992 (Ct. Cl. 1966); note 15 *supra*.

and second elements of the *Suburban Realty* test are met, and it will be difficult for the individual converter to receive capital gains treatment.

C. Sales "Ordinary" in the Course of Business

The third element of the *Suburban Realty* test requires a sale contemplated by the taxpayer to be "ordinary" in the course of his business.⁴² This issue typically arises when property has been sold while condemnation proceedings were pending, and generally it is not relevant to condominium conversions. The history and chronology of the condominium sales normally will indicate whether the sales of the units were ordinary in the course of the individual converter's business.⁴³

The provisions of the Internal Revenue Code that allow for capital gain treatment traditionally have been interpreted narrowly.⁴⁴ An apartment building owner who engages in a straight condominium conversion should anticipate that the Internal Revenue Service will challenge any attempt to have gain on the transaction treated as capital gain. Consequently, an apartment building owner who wishes to avoid having the proceeds of the conversion treated as ordinary income should consider transferring the apartment building to a corporation that will convert the building into condominiums.⁴⁵

III. SALES TO A RELATED CORPORATION

The individual who owns an apartment building can avoid the ordinary income treatment incurred in a straight conversion and obtain other tax benefits by selling the building to a corporation that will convert the building into condominiums. The owner will recognize a capital gain on the sale to the corporation,⁴⁶ and the corporation will own the building with a stepped-up basis equal to the sales price.⁴⁷ Gains realized by the corporation on the subse-

42. *Suburban Realty Co. v. United States*, 615 F.2d 171, 185-86 (5th Cir.), *cert. denied*, 449 U.S. 920 (1980).

43. 615 F.2d at 185-86.

44. *See generally* *Corn Prods. Ref. Co. v. Commissioner*, 350 U.S. 46, 52 (1955); *Gartrell v. United States*, 619 F.2d 1150, 1153 (6th Cir. 1980).

45. *See generally* *Hooton*, *supra* note 5; Price, *Using "Collapsing" Corporations To Maximize Returns From Development Ventures*, 7 J. REAL EST. TAX. 260 (1980); Stewart & Klein, *supra* note 27.

46. Property held for lease, such as an apartment building, usually is considered property used in the trade or business under I.R.C. § 1231 (b)(1). Therefore, gain from the sale of the building to a corporation qualifies for the 60 % capital gains deduction provided by *id.* § 1202(a). *See id.* § 1231(a). The amount of gain recognized by the apartment building owner on the sale is the excess of the amount realized from the sale over the owner's adjusted basis in the building. *Id.* § 1001(a).

47. The basis of the building in the hands of the purchasing corporation shall be equal to its cost. *Id.* § 1012.

quent sale of the condominium units will be ordinary income to the corporation,⁴⁸ taxed at corporate rates.⁴⁹

The owner, however, may wish to maintain constructive control over the conversion of the property and to share in the profit realized from the sale of the condominium units. Thus, the owner may wish to sell the apartment building to a related corporation, *i. e.*, one in which he owns, directly or indirectly, a controlling interest. There are five main dangers with such a sale to a related corporation, all of which could limit or negate the tax advantages. First, the Internal Revenue Service may characterize the sale of the building as a contribution to the corporation's capital.⁵⁰ Second, the Internal Revenue Service may impose dealer status on the owner who sells the building to the corporation.⁵¹ Third, Internal Revenue Code section 1239, which disallows capital gains treatment on transactions between related persons, must also be avoided to obtain capital gains status.⁵² Fourth, the corporation may be disregarded for tax purposes if it does not engage in a substantial business activity or have a business purpose.⁵³ Finally, the Internal Revenue Service may utilize Internal Revenue Code section 482, which permits the Service to reallocate income between related parties if income is not attributed to the proper party.⁵⁴

A. Contribution to Capital

Sales of property to related corporations have been successfully challenged on the theory that the transactions were contributions of equity capital to the corporation.⁵⁵ If such an attack were successful, the owner would recognize no gain on the contribution,⁵⁶ and the corporation would assume the owner's basis in the building.⁵⁷ Consequently, the corporation would recognize ordinary income to the extent that the receipts from the subsequent condominium sales exceeded the transferor's basis.⁵⁸ In comparison,

48. *Id.* § 1001(c). This is based on the assumption that the condominium units are dealer property in the converting corporation's hands.

49. Therefore, the conversion appreciation will be taxed as ordinary income either in a straight conversion or in a conversion by a corporation. The latter is beneficial, however, because the marginal tax rates for corporations are lower than the marginal tax rates for individuals with high incomes. Compare *id.* § 11(a) (corporate rates) with *id.* § 1 (individual rates).

50. See Part III.A. *infra*.

51. See Part III.B. *infra*.

52. See Part III.C. *infra*.

53. See Part III.D. *infra*.

54. See Part III.E. *infra*.

55. *E.g.*, *Aqualane Shores, Inc. v. Commissioner*, 269 F.2d 116, 120 (5th Cir. 1959); *Burr Oaks Corp. v. Commissioner*, 365 F.2d 24, 27 (7th Cir. 1966).

56. Treas. Reg. § 1.118-1 (1956) (payments by shareholder represent additional price paid for stock).

57. See I.R.C. § 362(a) (transferor's basis carries over to corporate transferee).

58. See *id.* § 1001.

if the transaction were an actual sale, the owner would recognize a capital gain to the extent of the property's appreciated value, and the corporation would recognize ordinary income only to the extent that the receipts from sales of the units exceeded their stepped-up basis in the apartment building.⁵⁹

The most important factor in determining if the transaction was a sale or a contribution to capital is the relationship between the sales price and the fair market value of the property.⁶⁰ Primarily, the Internal Revenue Service is concerned that if the value given by the corporation for the property exceeds the property's fair market value, the depreciable basis in the property will be increased at the cost of capital gains.⁶¹ The corporation benefits fully from the increased basis,⁶² but in exchange the owner only pays taxes on forty percent of that amount.⁶³ Thus, the Internal Revenue Service seeks to recharacterize this type of sale as a contribution to capital. In *Burr Oaks Corp. v. Commissioner*,⁶⁴ the taxpayers transferred property to a corporation owned by their wives and brothers and received promissory notes in return. The court noted that the fair market value of the property was less than half of the face value of the notes and held that the transaction was a contribution to capital. The excessive sales price, coupled with the gross undercapitalization of the corporation, compelled the court to find that the transferors were preferred stockholders, rather than creditors.⁶⁵

*Sun Properties Inc. v. United States*⁶⁶ exemplifies the importance of selling property at a price equal to its fair market value. In that case, the sole stockholder of the taxpayer corporation transferred ownership of a warehouse building to the corporation. In return, the stockholder was to be paid the fair market value of the property in equal semi-annual installment payments. The corporation made no down payment, and the purchase price neither

59. *See id.* §§ 1001(c), 1012.

60. Transfers have been upheld as sales when the sales price equals the transferred property's fair market value. *See, e.g.,* *Piedmont Corp. v. Commissioner*, 388 F.2d 886 (4th Cir. 1968); *Sun Properties, Inc. v. United States*, 220 F.2d 171 (5th Cir. 1955); *Gyro Eng'r Corp. v. United States*, 417 F.2d 437 (9th Cir. 1969). When the sales price exceeds the property's fair market value, transfers have been found to be contributions of capital. *See, e.g.,* *Burr Oaks Corp. v. Commissioner*, 365 F.2d 24 (7th Cir. 1966).

61. Taxpayers often attempt to sell depreciable assets used in a trade or business, as defined in I.R.C. § 1231, to a related entity. The seller will recognize only capital gains on the sale, and the purchaser will benefit from increased depreciation expense deductions. The taxpayer, therefore, "buys" depreciation expense deductions at the "cost" of a tax on capital gains.

62. The amount of the capital gain at sale is the excess of the sale price over the adjusted basis of the property. *Id.* § 1001(a).

63. *See* I.R.C. § 1202(a); note 6 *supra*.

64. 365 F.2d 24 (7th Cir. 1966).

65. *Id.* at 26.

66. 220 F.2d 171 (5th Cir. 1955).

provided separately for interest nor was it secured by a mortgage. The Internal Revenue Service challenged the transaction as being a contribution of capital, instead of a sale.⁶⁷ The United States Court of Appeals for the Fifth Circuit held, however, that the transaction was a sale.⁶⁸ The court found that none of the irregularities in the sale were sufficient to prove that the transaction was a contribution of capital and emphasized that the property was sold at its fair market value, that the property could generate enough income to pay the installment payments as they became due, and that the payments were to be made, even if corporate earnings were insufficient.⁶⁹ Therefore, the prudent tax advisor should recommend that the sale price equal the property's fair market value.

In addition, other factors may indicate whether a transaction is a sale or a contribution to capital. The corporation's ability to pay for the property and the payment of installments when they are due are two such factors.⁷⁰ To determine the corporation's ability to pay, courts consider whether the purchased property can produce enough income to pay the purchase price and whether the assets will meet day-to-day operating expenses.⁷¹ Other important factors in determining if the transaction is a sale or contribution to capital are the debt-to-equity ratio,⁷² the formal indicia of the transaction,⁷³

67. *Id.* at 172.

68. *Id.* at 173.

69. *Id.* at 175-76.

70. Courts are more likely to hold that a transaction is a contribution to capital if the corporation cannot or does not make payments for the property as due and if the creditors take no action to collect the debt. *See Aqualane Shores, Inc. v. Commissioner*, 269 F.2d 116, 118-19 (5th Cir. 1959); *Burr Oaks Corp. v. Commissioner*, 365 F.2d 24, 27 (7th Cir. 1966). Courts have held that the transaction is a sale if the corporation has the ability to make payments on the note, even if only because the property produces sufficient income. *E.g.*, *Sun Properties, Inc. v. United States*, 220 F.2d 171, 177 (5th Cir. 1955); *Gyro Eng'r Corp. v. United States*, 417 F.2d 437, 439 (9th Cir. 1969).

71. If corporate assets are insufficient to meet operating expenses and pay off the debt incurred to purchase the property, the transaction more closely resembles a contribution of capital because a disinterested seller would not take a note if the purchaser lacked assets to pay off the debt. *See Sun Properties, Inc. v. United States*, 220 F.2d 171, 175 (5th Cir. 1955); *Gyro Eng'r Corp. v. United States*, 417 F.2d 437, 439 (9th Cir. 1969).

72. If a thinly capitalized corporation acquires property in exchange for a note, the transaction looks more like a contribution of capital. *See Aqualane Shores, Inc. v. Commissioner*, 269 F.2d 116, 119 (5th Cir. 1959); *Burr Oaks Corp. v. Commissioner*, 365 F.2d 24, 27 (7th Cir. 1966). Insufficient equity capital, however, does not always cause a purported sale to be characterized as a contribution of capital. *See Sun Properties, Inc. v. United States*, 220 F.2d 171 (5th Cir. 1955).

73. Formal indicia of debt incurred in a transaction indicate that the transaction actually is a sale. *See Piedmont Corp. v. Commissioner*, 388 F.2d 886, 889 (4th Cir. 1968); *Burr Oaks Corp. v. Commissioner*, 365 F.2d 24, 26 (7th Cir. 1966).

who bears the risk of the enterprise,⁷⁴ and whether the seller taking a note as payment is subordinated to the rights of other creditors.⁷⁵ Thus, by selling the apartment building to a properly capitalized corporation at the building's fair market value, the owner can recognize capital gain on the sale. As long as the transaction is structured with reasonable care, the exchange will be treated as a sale.

B. *Avoiding Dealer Status Prior to Sale to a Corporation*

An individual who sells an apartment building to a corporation must avoid any of the activities necessary to convert the building into condominium units because those activities could support the argument that the owner was a dealer in real estate. In *Browne v. United States*,⁷⁶ the three shareholders of a corporation bought and subdivided land, installed streets and sewers, arranged for the installation of utilities, and built a model home on one lot. The shareholders then sold the subdivided and improved land to their corporation, which built homes on the lots and sold them. The Court of Claims held that the activities of the shareholders prior to transfer made them real estate dealers; thus, the gain on the sale to the corporation was treated as ordinary income.⁷⁷ The main purpose of having a corporation convert the building to condominiums is to allow the building owner to avoid dealer status. Therefore, the purchasing corporation should perform all of the activities required to complete the conversion.

C. *Section 1239: Sales to Related Persons*

Section 1239(a) provides that any gain recognized on the sale or exchange of depreciable property between related persons is ordinary income.⁷⁸ Sec-

74. If the noteholder bears the risk of the enterprise, the transaction more closely resembles a contribution of capital. *See Burr Oaks Corp. v. Commissioner*, 365 F.2d 24, 27 (7th Cir. 1966).

75. If the noteholder is subordinated to the rights of other creditors, the transaction resembles a contribution of capital. *See Piedmont Corp. v. Commissioner*, 388 F.2d 886, 889 (4th Cir. 1968); *Burr Oaks Corp. v. Commissioner*, 365 F.2d 24, 27 (7th Cir. 1966).

76. 356 F.2d 546 (Ct. Cl. 1966).

77. *Id.* at 547. *See also* *Brown v. Commissioner*, 448 F.2d 514, 517 (10th Cir. 1971) (prior to sale, land was subdivided, sewer systems were installed, and engineering services were contracted). In *Gordy v. Commissioner*, 36 T.C. 855 (1961), a taxpayer sold interests in land to two corporations in which he owned 60% of the stock. The Internal Revenue Service attempted to attribute the corporation's business activities to the taxpayer so that he would recognize gain on the sale as ordinary income. Holding that a corporation's business activities were separate from those of the taxpayer, the court allowed capital gains treatment on the sale. *Id.* at 859-61. *Accord*, *Glasgow Village Dev. Corp. v. Commissioner*, 36 T.C. 691, 701-02 (1961) (corporation's president bought land in his individual capacity and later sold it to corporation; capital gains treatment upheld).

78. I.R.C. § 1239(a).

tion 1239(b) defines "related persons" as a taxpayer and the taxpayer's spouse, a taxpayer and an eighty percent owned entity, or two eighty percent owned entities.⁷⁹ An "eighty percent owned entity" is defined as a corporation of which eighty percent or more in value of the outstanding stock is owned by or for the taxpayer.⁸⁰

Generally, if the taxpayer and his spouse jointly or individually own eighty percent of the value of a corporation's stock, they are related to the corporation. Courts have construed the "in value" language of section 1239 as meaning eighty percent of the value of the corporation, instead of eighty percent of the outstanding shares of stock.⁸¹ Thus, a taxpayer is not insulated from section 1239 merely because he owns less than eighty percent of the outstanding shares. The taxpayer in *Dahlgren v. United States*⁸² owned less than eighty percent of the shares of the corporation. The court held, however, that the inherent value of the taxpayer's majority or controlling interest increased his share of the value of the corporation to over eighty percent.⁸³ Thus, the taxpayer and the corporation were related entities, and gain on a sale to the corporation was ordinary income to the taxpayer.⁸⁴

The professional who is to handle the condominium conversion could own the remaining interest in the corporation. Thus, the seller can avoid the ordinary income treatment imposed by section 1239, and the professional converter can own an equity interest in the corporation. If the corporate

79. *Id.* § 1239(b)(1)-(3).

80. *Id.* § 1239(c)(1)(A).

81. *United States v. Parker*, 376 F.2d 402, 408 (5th Cir. 1967) (taxpayer who owned 80% of corporation's stock held to own more than 80% in value due to voting control that 80% ownership gave him and limits on transferability of minority shares); *Trotz v. Commissioner*, 361 F.2d 927, 930 (10th Cir. 1966) (numerical count of outstanding shares, in and of itself, does not determine percentage of value).

82. 553 F.2d 434 (5th Cir. 1977).

83. *Id.* at 445.

84. No conclusion can be derived as to what level of stock ownership is sufficiently low to avoid a finding that the stockholder owned 80% or more in value of the corporation. Shareholders who owned 79.975%, *Dahlgren v. United States*, 553 F.2d 434, 436 (5th Cir. 1977), and 79%, *Trotz v. Commissioner*, 361 F.2d 927, 928 (5th Cir. 1967), of the corporation's stock have been imputed, under I.R.C. § 1239, to have ownership of 80% in value. No case has imputed ownership of 80% in value from stock ownership of less than 79%. Therefore, ownership of significantly less than that amount may provide safety.

Under the current statute, the jury determines the amount of a corporation owned in value by a shareholder. *See Dahlgren v. United States*, 553 F.2d at 438-40; *Trotz v. Commissioner*, 361 F.2d at 930. In *Dahlgren*, the court found the following elements significant in remanding for such a determination: restrictions on transferability of minority shares; absolute control of the corporation by the majority shareholder; and power to change management, to hire and fire employees, to fix salaries, to elect directors, and to set policy. 553 F.2d at 438-39. Thus, the majority shareholder should not be vested with an excess of these powers.

ownership is so structured, the building owner benefits from the converter's expertise, the converter benefits from stock ownership,⁸⁵ and the conversion of capital gains into ordinary income under section 1239 is avoided.

D. *The Sham Corporation*

The corporation that purchases an apartment building must conduct some business activity or have a sufficient business purpose other than to avoid taxation. Otherwise, the entity risks characterization as a sham corporation, and the sale of a building to the corporation would be disregarded for tax purposes.⁸⁶ The amount realized on the sale of the condominium units would be treated as ordinary income to the individual seller. Consequently, the gain realized from the condominium conversion would be taxed to the individual as ordinary income,⁸⁷ just as in a straight condominium conversion.

If the purchasing corporation performs the complete conversion, as it should to insulate the seller from dealer status, the corporate entity will not be disregarded for tax purposes. Furthermore, corporations that perform less than all of the conversion activities have been held not to be a sham.⁸⁸ Although the corporation need not keep corporate books, accounts, meetings, and offices for it to be considered a viable entity,⁸⁹ the seller of the apartment building should ensure that separate corporate books and accounts are kept.

85. A professional converter may benefit by having equity in the corporation, as opposed to a straight fee arrangement, because he can share in the profits of the corporation. Also, he will recognize only capital gains when he disposes of his stock, instead of recognizing ordinary income in receipt of his fees. The converter will have to contribute something other than mere services to acquire the stock without recognizing any ordinary income. I.R.C. § 351(a).

86. In *Gregory v. Helvering*, 293 U.S. 465 (1935), the Court held that the corporate entity will be disregarded if it serves no business purpose. *Id.* at 469-70. See *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 439 (1943); *Shaw Constr. Co. v. Commissioner*, 323 F.2d 316, 321-22 (9th Cir. 1963); *Aldon Homes, Inc. v. Commissioner*, 33 T.C. 582, 604-05 (1959). If the purchasing entity is disregarded, there can be no sale because there is no separate purchasing entity.

87. Cf. *Kimbrell v. Commissioner*, 371 F.2d 897, 902 (5th Cir. 1967) (corporate commissions taxed to majority shareholder); *Shaw v. Commissioner*, 59 T.C. 375, 385 (1972) (assignment of income principles used to tax corporate income to sole shareholder); *Aldon Homes, Inc. v. Commissioner*, 33 T.C. 582, 605-06 (1959) (corporate entity disregarded and income taxed to controlling stockholders).

88. See *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949) (corporate owner of taxpayer directed all affairs, provided all assets, and received all profits in excess of six percent by contract); *Carver v. United States*, 412 F.2d 233 (Ct. Cl. 1969) (corporation only a title holding company, used in shareholder's real estate dealings); *Siegel v. Commissioner*, 45 T.C. 566 (1966) (corporation formed to invest in joint venture).

89. *Paymer v. Commissioner*, 150 F.2d 334, 336 (2d Cir. 1945); *Love v. United States*, 96 F. Supp. 919, 922 (Ct. Cl. 1951).

E. Section 482: Reallocation of Income

Under section 482,⁹⁰ the Internal Revenue Service may reallocate income and deductions between organizations⁹¹ or businesses⁹² controlled⁹³ by the same interests. Section 482 applies when the sales price of the apartment building is higher than the fair market value of the property.⁹⁴ The excess price paid over the fair market value will be allocated to the shareholder as a constructive dividend, thereby negating the tax benefits the shareholder hoped to obtain by charging an excessive sales price.⁹⁵ Therefore, to avoid reallocation under section 482, the sales price must reflect a proper arm's length transaction.⁹⁶

If an apartment building owner avoids these problems, he can sell the building to a related corporation and recognize a capital gain on the transaction. By owning an interest in the corporation, the owner can share in the profits generated by the conversion. In addition, the owner could then "collapse" the corporation and recognize a capital gain on a portion of the gain attributable to the conversion process.

IV. LIQUIDATION OF THE CORPORATION AND AVOIDANCE OF SECTION 341

If a corporation performs the conversion of an apartment building into condominiums and sells the units, the gain realized from the conversion will be ordinary income to the corporation and taxed at corporate rates.⁹⁷ When these proceeds are then distributed to the shareholders as dividends, they generally will be taxed again as ordinary income to the shareholders.⁹⁸ To

90. I.R.C. § 482. See generally Loening, *Section 482 Allocations Resulting in the Creation of Income or in Constructive Dividends to Shareholders*, 30 N.Y.U. INST. FED. TAX. 1247 (1972).

91. The term "organization" includes sole proprietorships, partnerships, trusts, and corporations. Treas. Reg. § 1.482-1(a)(1) (1962).

92. The term "business" includes business activity of any kind. *Id.* § 1.482-1(a)(2).

93. The term "controlled" refers to any kind of control, direct or indirect. *Id.* § 1.482-1(a)(3).

94. *Id.* § 1.482-1(c), -1(d)(1).

95. *Equitable Publishing Co. v. Commissioner*, 356 F.2d 514 (3rd Cir. 1966) (per curiam); Rev. Rul. 78-83, 1978-1 C.B. 79; Rev. Rul. 69-630, 1969-2 C.B. 112. By charging an excessive sales price, shareholders attempt to obtain increased depreciation deductions and reduce the corporation's taxable income on the subsequent sale of the property.

96. Treas. Reg. § 1.482-1(b)(1) (1962).

97. The corporation would hold the units primarily for sale in the ordinary course of its trade or business. Thus, the units would not be capital assets, see I.R.C. § 1221(1), and gain from their sale would be taxed at corporate rates.

98. *Id.* § 301(c)(1). A dividend is "any distribution of property made by a corporation to its shareholders" out of current and accumulated earnings and profits.

avoid double taxation on the conversion profits, the corporation can be liquidated after one-third⁹⁹ of the taxable income expected from the sale of the converted units is realized. By liquidating the corporation under section 336¹⁰⁰ or 337,¹⁰¹ the corporation can take a stepped-up basis in the units equal to their fair market value¹⁰² and recognize two-thirds of the appreciation in value due to the conversion as a capital gain at liquidation.¹⁰³ Thus, instead of having the gain taxed once as ordinary income to the corporation and once as ordinary income to the shareholders, two-thirds of the appreciation in value due to the condominium conversion can be recognized as capital gain on liquidation.

Under section 331(a)(1), amounts distributed by a corporation in complete liquidation shall be treated as full payment for stock.¹⁰⁴ If, as in the usual case, the stock is a capital asset in the shareholder's hands, the increased value of the building due to the conversion to condominiums will be recognized by the shareholders as a capital gain when the corporation is liquidated. Section 334(a) provides that if property is received in a complete liquidation and if gain is recognized by the shareholder on the receipt of such property, the distributee's basis in the property shall be its fair market value at the distribution.¹⁰⁵ Thus, if the condominium units sell quickly, no further gain will be realized by the shareholder. The corporation ordinarily will recognize no gain or loss on the liquidating distribution.¹⁰⁶

The corporation to be liquidated, however, must avoid being characterized as a "collapsible" corporation, which would result in characterization of the gain as ordinary income under section 341.¹⁰⁷ Section 341 converts capital gains into ordinary income to a shareholder when his stock is liquidated.¹⁰⁸ This occurs when the corporation is collapsible, as defined in

Id. § 316(a). Dividends are taxed to the shareholders as ordinary income to the shareholders, unless they are distributions in redemption or liquidation. *Id.* § 301(c)(1).

99. A corporation is not collapsible if it liquidates after a substantial part of the income to be derived from its assets is realized. I.R.C. § 341(b)(1)(A). One-third of a corporation's assets has been held to be a substantial part of the income to be derived from the assets. *Commissioner v. Kelley*, 293 F.2d 904, 907 (5th Cir. 1961). See notes 113-17 and accompanying text *infra*.

100. I.R.C. § 336.

101. *Id.* § 337. In general, *id.* § 337 applies to a sale of corporate assets followed by a liquidation, whereas *id.* § 336 applies to a liquidation of the corporation followed by sale of the distributed assets.

102. *Id.* § 334(a).

103. See *id.* § 331(a)(1).

104. *Id.*

105. *Id.* § 334(a).

106. *Id.* § 336(a).

107. *Id.* § 341. See generally B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 12.01-.07 (4th ed. 1979).

108. I.R.C. § 341(a).

section 341(b)(1). This definition consists of two elements. First, the corporation must be formed or availed of principally for the production of property or for the purchase of section 341 assets.¹⁰⁹ Second, the corporation must have been formed with a view to liquidate before it realized a substantial part of the taxable income to be derived from the property, and the shareholders actually must have realized gain attributable to such property.¹¹⁰ "Section 341 assets" is defined as including property held by the corporation primarily for sale to customers in the ordinary course of its trade or business.¹¹¹ The converted condominium units would be held by the corporation primarily for sale in its business.¹¹² Therefore, the corporation would be considered formed principally to produce section 341 assets.

The corporation can avoid collapsible status under the second element of the section 341 test, however, by careful documentation that the corporation was not formed with a view to liquidate before it realized one-third of the taxable income expected from the sale of the converted units. Although the amount of gain that constitutes a *substantial* realization is relative and determined by the facts of each case,¹¹³ the Internal Revenue Service has acquiesced¹¹⁴ to the fifth circuit court of appeals' holding in *Commissioner v. Kelley*¹¹⁵ that a realization of one-third of the taxable income to be derived from section 341 property is realization of a substantial part of the taxable income to be derived. The *Kelley* court noted that by interpreting the word "substantial" to mean one-third or more, the loophole that section 341 was enacted to close remained two-thirds of the way open.¹¹⁶ Thus, the *Kelley* decision and the Service's acquiescence to *Kelley* indicate that a corporation could convert an apartment building into condominiums, realize at least one-third of the gain expected from the sale of the converted units, liquidate the corporation, and avoid being characterized as a collapsible corporation. If the corporation liquidates after realizing one-third of the expected gain, therefore, two-thirds of the gain attributed to the conversion can be recognized as capital gain.¹¹⁷

Three alternative methods may be used to liquidate a shareholder's interest in a corporation. First, the shareholder could sell his stock.¹¹⁸ Second,

109. *Id.* § 341(b)(1).

110. *Id.* § 341(b)(1)(A).

111. *Id.* § 341(b)(3).

112. *See* Part II.B. *supra*.

113. *Commissioner v. Kelley*, 293 F.2d 904, 913-14 (5th Cir. 1961).

114. Rev. Rul. 72-48, 1972-1 C.B. 102.

115. 293 F.2d 904 (5th Cir. 1961).

116. *Id.* at 913.

117. *Commissioner v. Kelley*, 293 F.2d 904, 907 (5th Cir. 1961); *Commissioner v. Zongker*, 334 F.2d 44, 45-46 (10th Cir. 1964). *See also* *Day v. Commissioner*, 55 T.C. 257, 260 (1970) (56% is substantial).

118. Sales of stock will not be discussed. A purchaser of stock must worry about the corporation having a low basis in its assets, a large earnings and profits account,

he could liquidate the corporation under section 336 and sell the property he receives in the liquidating distribution.¹¹⁹ Third, and preferably, he could have the corporation sell all of its assets tax-free under section 337 and then liquidate.¹²⁰

Under the second method, a shareholder who liquidates the corporation under section 336, receives the units in kind, and then sells the units received in the distribution, faces a major obstacle to favorable tax treatment: reattribution of the gain to the corporation. In *Commissioner v. Court Holding Co.*,¹²¹ a corporation was negotiating the sale of its sole asset, an apartment building, liquidated immediately before the sale, and distributed the apartment building to its shareholders. The shareholders then sold the building to the party with whom the corporation had been negotiating prior to the liquidation. The Court held that the gain from the sale was attributable to the corporation and not to the shareholders.¹²² The corporation was forced to recognize ordinary income on the sale, and the shareholders were taxed again at liquidation. The Court said that "[a] sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title."¹²³

Five years later in *United States v. Cumberland Public Service Co.*,¹²⁴ gain from the sale of assets distributed to shareholders in a corporate liquidation was attributed to the shareholders. The Court found that the liquidation in *Court Holding Co.* was a mere sham, whereas the liquidation in *Cumberland* was genuine.¹²⁵ Despite the difficulty of making this distinction, the *Cumberland* Court held that such a distinction does exist for tax purposes.¹²⁶ The Court found that regardless of the motives of the shareholders, a sale following a *genuine* liquidation cannot be attributed to the corporation for tax purposes. Although a distinction may exist, to avoid unnecessary litigation, a shareholder should not negotiate to sell appreciated condominium units before liquidation is completed. Shareholders are not harmed by the delay in negotiating sales if the units are sold rapidly after liquidation. The delay may slow sales, however, and the resultant lower sales proceeds may not provide the distributees with enough cash to pay taxes on the distribution. Therefore, if the parties foresee problems in delaying sales negotiations until after liquidation, they can liquidate the corporation under section 337.

an undesirable accounting method, or contingent liabilities not disclosed on the balance sheet. See B. BITTKER & J. EUSTICE, *supra* note 107, ¶ 11.63.

119. See notes 121-26 and accompanying text *infra*.

120. See notes 127-30 and accompanying text *infra*.

121. 324 U.S. 331 (1945).

122. *Id.* at 333-34.

123. *Id.* at 334 (footnote omitted).

124. 338 U.S. 451 (1950).

125. *Id.* at 454-55.

126. *Id.* at 455.

Section 337, which was enacted to alleviate the problems presented by the *Court Holding Co.* doctrine,¹²⁷ provides for nonrecognition of gain realized by the distributing corporation on the sale of assets in anticipation of liquidation.¹²⁸ Section 337(a) provides that if, pursuant to a plan of complete liquidation, all of the assets of a corporation are distributed within twelve months of the plan's adoption, the corporation will not recognize any gain on sales within the twelve month period. This section, however, generally does not apply to sales of a corporation's inventory.¹²⁹ Under section 337(b)(1)(A), if the converted condominium units are held primarily for sale in the ordinary course of business, section 337 would not apply to the sales of the units because they are inventory, and the *Court Holding Co.* doctrine may be used to bar capital gains treatment.

Notwithstanding section 337(b)(1)(A)'s exclusion of inventory property from the general rule of section 337(a), section 337(b)(2) provides that if substantially all of the inventory is sold to one person in one transaction, the sale will qualify for nonrecognition treatment. "Substantially all" refers to the inventory at the time of the sale.¹³⁰ Assuming that the converted units are inventory in the converting corporation's hands, section 337(b)(2) would require that substantially all of the remaining units be sold to one purchaser. The purchaser of substantially all of the remaining units presumably would pay the seller less than could be received if the units were sold individually. The time, effort, and expense associated with piecemeal sales of the remaining units, however, would be avoided.

If section 341 is not applicable, a sale and liquidation under section 337, after one-third of the units have been sold, is the safest and easiest way to ensure capital gains treatment for the liquidation of the corporation.

V. CONCLUSION

The individual who sells an apartment building to a related corporation for conversion will achieve optimal capital gains treatment if these steps are followed:

- (1) the building is sold to the corporation at its fair market value in an arm's length transaction,
- (2) the corporation is adequately capitalized,
- (3) the corporation performs all aspects of the conversion,
- (4) the individual owns less than eighty percent of the value of the corporation,
- (5) corporate books and accounts are kept separate from those of the individual,
- (6) one-third or more of the gain expected from the sale of the con-

127. S. REP. NO. 1622, 83d Cong., 2d Sess., 48-49 (1954).

128. I.R.C. § 337(a).

129. *Id.* § 337(b)(1)(A).

130. Treas. Reg. § 1.337-3(b)(2) (1955).

- verted units is realized before the corporation is liquidated, and
- (7) (a) negotiations for sale of the remaining units do not begin until after the corporation is liquidated under section 336, or
 - (b) substantially all of the remaining units are sold to one person in one transaction before liquidation and the proceeds are distributed within twelve months pursuant to a plan of complete liquidation under section 337.

If these steps are followed, the individual owner of an apartment building may recognize both the gain from the prior appreciation of the building and two-thirds of the gain attributable to the conversion as a capital gain.

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