TAXATION AND BUSINESS PLANNING FOR REAL ESTATE TRANSACTIONS

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TAXATION AND BUSINESS PLANNING FOR REAL ESTATE TRANSACTIONS

Bradley T. Borden
Professor of Law
Brooklyn Law School

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Editorial Offices
121 Chanlon Rd., New Providence, NJ 07974 (908) 464-6800
201 Mission St., San Francisco, CA 94105-1831 (415) 908-3200
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MATTHEW BENDER

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DEDICATION

To Sam and Claire

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In attempting to acknowledge all the people who have contributed to this book, I will invariably leave someone out, and I offer my apologies in advance for such oversight. I have been blessed with tremendous mentors, friends, family, associates, research assistants, students, and others who made direct and indirect contributions to this project. In particular, my wife Sam and daughter Claire support my efforts to write. I would be lost without them. Several people have been important mentors — their tutelage regarding the law, writing about the law, and the practice of law are an important part of all I do. They include Stanley Blend, Erik Jensen, and Marty McMahon. Margaret Robertson helped compile and edit the cases, rulings, and other primary-source legal material in this book and provided valuable feedback on the content. Her work ethic and skill were very important to the production of this book. Sarah Cranganu provided invaluable secretarial support throughout this project. Her creativity, skill, and diligence helped solve many problems relating to the compilation and presentation of the material. She created a plat map in a way that was useful for this project. Bobbi Bullock helped prepare the final manuscript for submission. Richey Wyatt and Lucky DeFries helped me develop the entity and loan documents that appear in the book. Quintin Nelson prepared the diagrams. Deborah Launer and the people at Civic Research Institute granted permission to reproduce documents published in one of their books. Paul Caron and the editorial board of the Graduate Tax Series and Leslie Levin at LexisNexis helped refine the idea and scope of the book. Cristina Gegenschatz edited the final manuscript and prepared it for publication. I thank all of these people and more for their assistance and encouragement. I nonetheless retain full responsibility for the contents of this book.

INTRODUCTION

This book focuses on tax planning in the real estate context. To adequately provide tax-planning advice, attorneys must be familiar with the transactional tax attorney's analytical process. Transactional tax attorneys must recognize opportunities for tax planning and address issues that such planning may raise. Recognizing opportunities and addressing issues generally require a thorough understanding of the transaction and the relevant law. Such knowledge often derives from legal research and an in-depth study of primary-source legal resources, such as statutes, cases, regulations, and rulings. Legal research generally begins with treatises or articles that address the questions relevant to the tax-planning opportunity. That initial research leads the attorney to primary-source legal resources. The attorney then must interpret the law and apply it to a set of facts and provide advice. The advice helps clients structure transactions. Generally such work results in a finished product in the form of a memorandum or letter to the client or a legal document such as a contract.

This book embraces the transactional attorney's analytical process. The book presents a single fact pattern that it uses throughout the book. The fact pattern may appear relatively simple, but it is filled with nuances and provides an opportunity to do sophisticated tax planning. The book helps students begin asking the appropriate questions and considering the relevant issues by posing a few questions at the beginning of each chapter. The questions are often more general than questions found in typical tax law casebooks. Nonetheless, a proper analysis of most questions requires detailed knowledge of the relevant law and results in detailed answers to the questions. The boundary of the questions may not always appear to be clear and some questions may appear to overlap. The nature of the questions is intuitional. They present general ideas that students use to get started in the analysis and develop skills through application that will help them identify issues in a nebulous practice environment that most tax planners face.

To replicate the research process, each chapter of the book provides commentary that could be similar to (but perhaps less detailed than) material typically found in a treatise, article, or other secondary source of legal authority. The commentary introduces ideas and legal concepts that apply to the questions and directs the reader to relevant primary legal authority. Ultimately, the students must carefully study, interpret, and apply relevant law to the issues raised by the questions. The commentary cites legal sources in the footnotes. The chapters reproduce relevant case law and rulings, but students will have to access the cited tax statutes and regulations in sources outside this book. The knowledge students will need to properly approach the material is largely contained in the law. In fact, students generally will not be able to fully understand and answer the questions until they have carefully studied the relevant law.

The book is organized to introduce the setting and provide background in the first several chapters. Chapter 1 introduces the fact pattern. Thoroughly understanding a client matter is critical in giving tax advice. Chapter 1 encourages students to spend time thinking about the fact pattern and considering the work a successful tax plan will require. It presents questions a tax planner must consider when deciding whether to accept tax planning work. To adequately answer the questions the chapter presents, students will have to understand the transaction and contemplate advice they will give. To do that, they will generally have to consider the table of contents, which lists the topics that will be important in providing advice with respect to the fact pattern. Chapter 1 also includes provisions of the Model Rules of Professional Conduct. Invariably, ethics issues arise in tax-planning engagements, and having the rules handy to consider when such issues arise helps resolve ethics questions.

Chapters 2 and 3 provide background regarding choice of entity. Choice of entity considerations should not consume the course, but issues relating to choice of state-law entity and tax entity often arise when planning for real estate transactions. Those chapters contain a significant amount of commentary to introduce topics and concepts. Students also must consider general provisions of state law, tax law, and the entity's governing document to adequately consider the questions presented in those chapters. The focus in those chapters is to introduce concepts and provide background information. Chapter 2 presents provisions of state entity laws. Access to those laws will help students analyze issues presented in Chapter 2 and may help in subsequent chapters as state-law issues arise. If most students in the course have already completed business law and business tax courses, the chapters may be less relevant to the class and require little or no attention. A more thorough review may be appropriate if many students have not studied those topics.

Chapter 4 introduces finance principles and provides an opportunity to consider how tax affects financial analyses and business decisions. Although tax attorneys generally would not provide financial advice (a possible exception to this rule would be an attorney who is a licensed financial planner and could competently and legally provide financial advice), clients expect tax attorneys to understand the language property owners use to discuss their investments. They also expect tax attorneys to understand the effect tax law has on their investments. When discussing matters with clients, attorneys often must make rough estimates of tax effects to facilitate the decision-making process and illustrate concepts. To be able to competently respond in discussions with clients, attorneys must be familiar with basic finance concepts and have some proficiency with basic tax computations. Chapter 4 introduces concepts with which students should be familiar, provides opportunities to consider the effect tax will have on a real estate investment and transaction decisions, and allows students to practice using those concepts. Working with numbers will help students develop familiarity with numeric aspects that arise with respect to almost all transactions.

Chapter 5 is the final background chapter. It introduces students to the standards of tax practice. Tax attorneys find themselves between a proverbial rock and hard spot. They feel pressure from clients to reduce their clients' tax liabilities. Tax attorneys also must adhere to statutory and regulatory standards. Chapter 5 introduces the standards of tax practice, which students will have to consider as they enter subsequent chapters that require them to provide tax-planning advice. Transactional tax attorneys must learn to balance duties they owe to clients with duties they owe to the system, as expressed in standards of tax practice. Although students may cover these concepts in depth in other courses, the concepts are vital to tax practice, and a brief review will reinforce the importance of the standards and prepare students to apply them in the practice setting that arises in subsequent chapters.

All chapters following Chapter 5 focus on tax planning in earnest. The amount of commentary decreases in these chapters as the focus turns to the relevant primary-source material, which contains the law, explains important tax concepts, and introduces important tax-planning ideas. The focus in these subsequent chapters is on ownership and transactional structures that best serve the objectives of real-estate investors. Thus, capital-gain and gain-deferral planning take center stage. Much of the law relating to property ownership and character of gain recognition is found in cases. Consequently, much of the early chapters on tax planning are predominantly case oriented. Students will find many of their planning ideas as they read the cases.

Topics that appear in traditional courses on taxation of property transactions as discrete subjects are often incorporated in chapters as they would arise in the tax-planning process. Therefore, rules governing gain and loss computation (covered in Chapter 4), depreciation deductions (covered in Chapter 4), and installment-sale method (covered in Chapter 8) appear in chapters in which those concepts are a relevant part of the structuring process. Chapter 18 discusses specific loss limitation rules. Inevitably, section 1031 becomes important as it drives much of the structuring in real estate acquisition, ownership, and disposition. Leases and construction have become important to the more sophisticated section 1031 transactions. Two chapters (Chapter 9 on construction and Chapter 14 on leases) are devoted to these topics to lay the groundwork needed to seriously consider leasehold improvements exchanges and other topics. Professors wishing to focus on traditional real-estate tax topics can focus on those chapters that cover such topics and focus less on the chapters that cover some of the more sophisticated section 1031 planning structures.

Some chapters include practice materials, such as entity and loan documents that may be important in the tax-planning process. A significant portion of real estate law is found in the contracts. Often tax planners must consider existing documents to determine whether a particular tax-planning transaction is feasible. The best-laid tax plans may be frustrated by provisions in governing documents, if the tax planner fails to consider the relevant documents and plan accordingly. The inclusion of documents in the book provides an opportunity to consider them in the planning process. The documents are not necessarily intended to be models of perfection. In studying the documents, students may find that particular language does not adequately serve clients. They may recommend changes that would improve the documents.

For the most part, each chapter of the book is self-contained. Nonetheless, to a certain extent, Chapters 6, 7, and 8 build on one another. Chapters 11, 16, and 17 refer to an ownership structure that develops in Chapters 7 and 8. Studying those subsequent chapters without first studying Chapters 7 and 8 will require some background development.

The rationale for the book's planning perspective is fourfold. First, many students will enter private practice after completing their formal study of law. The market will require that they possess the tax-planning skills this book is designed to teach. Second, the classroom provides an opportunity to teach the techniques of responsible tax planning. Undoubtedly, every lawyer will be exposed to ideas and techniques that violate the standards of tax practice and professional ethics. By covering such topics in a law school course, students can learn the rules and be prepared to face charlatans in practice and adhere to standards of tax practice and rules of ethical conduct. Third, students who enter government service will gain an understanding of tax-planning techniques that exist in private practice. With that understanding, they will be better prepared to draft rules that accomplish the government's objectives. Finally, studying the rules in a practice setting will help reinforce the rules and provide an opportunity to study them in the broader context in which they are most relevant.

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