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A CASE FOR SIMPLER GAIN BIFURCATION FOR REAL ESTATE DEVELOPERS

by

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Abstract

This Article examines the judicially sanctioned bifurcation of real estate developers' gain. The Article recognizes that even though some commentators oppose granting favorable tax treatment to capital gains, the law most likely will not change. With that in mind, the Article examines the all-or-nothing approach of characterizing gain from the sale of real estate as either capital gain or ordinary income. The Article rejects the all-or-nothing approach of characterizing income under the current statutory system. Instead, it embraces gain bifurcation in the second-best setting that taxes capital gains and ordinary income differently. Illustrating the policy justification for gain bifurcation and judicially sanctioned bifurcation structures, the Article recommends that lawmakers should more fully embrace gain bifurcation for real estate developers by creating a simple statutory election for bifurcating gain that would enhance equity, accuracy, and transparency of gain bifurcation. Although the Article limits its analysis to real estate developers, the idea of gain bifurcation, once improved in this area, could be a catalyst for exploring bifurcation in other areas.

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I. INTRODUCTION

Long-term capital gains recognized by individuals qualify for favorable tax treatment.[1] If property comes within the definition of capital asset and the owner holds the property for at least one year, all of the gain from the sale of the property generally qualifies for the favorable tax

1. I.R.C. §§ 1(h)(l)(C), 1(h)(3), 1221(a), 1222. C corporations do not, however, qualify for such favorable tax treatment, *see* I.R.C. § 11, so this Article applies to gain and loss recognized by individuals, either directly from the disposition of property or indirectly from allocations from flow-through entities such as tax partnerships and S corporations.

treatment.[2] If the property does not come within the definition of capital asset at the time of its disposition, all of the gain from the disposition will be ordinary income, taxed at ordinary income rates.[3] The draconian all-or-nothing treatment can trap the unwary, distort economic aspects of transactions, and change property-owner behavior. The all-or-nothing treatment is often in stark contrast to the sliding scale of economic reality. The economic reality is that gain from the disposition of property often derives from sources that would qualify for capital gain treatment and sources that would be ordinary income. Thus, gain bifurcation would appear to be appropriate in many situations.

Stated generally, ordinary income derives from a property owner's efforts to increase the value of the property, and capital gain results from the unaided increase in the value of property over time.[4] Often, gain is a combination of both of those sources because property appreciates in value due to market conditions, and the property owner may expend effort to improve the property, increasing its value. Accurately identifying the source of income can be a challenge. Indeed, the difficulty faced in distinguishing between capital gain from the unaided appreciation in value and income from the efforts of a property owner is a strong reason not to provide preferential treatment to capital gains.[5] Nonetheless, the law treats the two types of gain differently, and as long as it does, the all-or-nothing approach creates bad results. Courts appear to recognize this and bifurcate developers' gain in some situations, but such treatment requires a complicated structure to bifurcate the gain, which equity justifies to some extent[6] and which the law could improve by simplifying.

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2. *See* I.R.C. §§ 1(h)(l)(C), 1(h)(3), 1221(a), 1222. Nonetheless, gain attributable to depreciation recapture and other types of gain may not qualify for favorable rates. *See* I.R.C. §§ 1245(a), 1250.

3. *See* I.R.C. §§ 1, 64, 1221, 1222.

4. *See* Malat v. Riddell, 383 U.S. 569, 572 (1966) ("The purpose . . . is to differentiate between the profits and losses arising from 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." (citations omitted) (internal quotation marks omitted)); Commissioner v. Gillette Motor Transp., Inc., 364 U.S. 130, 134 (1960) ("[T]he term 'capital asset' is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time . . . ."); Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46, 52 (1955) ("Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss.").

5. *See* Peter Diamond & Emmanuel Saez, *The Case for a Progressive Tax: From Basic Research to Policy Recommendations*, 25 J. ECON. PERSP. 165, 181 (2011) [hereinafter Diamond & Saez, *The Case for a Progressive Tax*].

6. *See infra* Part III. *See also* Bradley T. Borden, *Quantitative Model for Measuring Line-Drawing Analysis*, 98 IOWA L. REV. 971, 1030–38 (2013)

Converting capital gains into ordinary income can have enormous financial ramifications because capital gains are taxed at a maximum rate of 23.8 percent, whereas ordinary income generally is taxed at a maximum rate of 39.6 percent, but for passive investors (including passive investors in an entity taxed as a partnership or S corporation), the maximum rate on passed-through ordinary income is 43.4 percent.[7] The favorable tax treatment for capital gains is worth almost a twenty-percentage-point reduction in tax rate. That twenty-percentage-point difference represents the profit that a property owner can recognize by preserving the capital gain character of the property. It is equivalent to saving almost twenty cents on every dollar of gain. To illustrate, a property owner who recognizes $1,000,000 of gain would take home and reinvest almost an extra $196,000 ($1,000,000 x (43.4% − 23.8%)) if the gain recognized is long-term capital gain instead of ordinary income. Thus, tax law's all-or-nothing approach has significant, and often deleterious, financial consequences, which explains why property owners have worked to create a method to bifurcate the gain.

Preserving as much capital gain as possible is particularly important to property owners who hold real property for investment and then decide to subdivide and sell it. One strategy such property owners employ to preserve capital gain is the so-called *Bramblett* structure, which derives its name from the Fifth Circuit decision, *Bramblett v. Commissioner*,[8] that sanctioned the structure.[9] Stated simply, the *Bramblett* structure allows property owners to hold property as a capital asset while the property increases in value, locking in that increase as long-term capital gain, and then to transfer it to a related-

(illustrating how bifurcating income based upon its source creates and promotes equity).

7. I.R.C. §§ 1, 1411. These rates include the maximum income tax rates (20 percent for long-term capital gain and 39.6 percent for ordinary income), plus the 3.8 percent Medicare surtax, which applies to net investment income, including capital gains on income over $250,000 for married individuals filing jointly. The analysis in this article assumes that the income of the property holders always exceeds the section 1411 threshold and the gain from the disposition of the property is gain from the sale of a capital asset or is passive income to which the surtax applies. I.R.C. § 1411(c)(1)(A)(iii), (2)(A). This assumption is reasonable even though development deals often include a mix of passive financial investors and an active developer. In the current financial environment (where debt financing is less common and equity is a larger component of the total capital structure), most of the whole dollar development profit goes to the financial investors. Of course, active investors would be exempt from the 3.8 percent surtax, but for the sake of simplicity, this analysis does not account for that relatively small portion of the total income of *Bramblett* structures. The rates also disregard the effects of deductions or credit phaseouts, or other factors, and ignore depreciation recapture, which otherwise could be capital gain under the general definition.

8. 960 F.2d 526 (5th Cir. 1992).

9. *Infra* Part III (describing the structure in detail).

party entity for development. The property in the hands of the developer entity is not a capital asset, so the developer entity must pay ordinary income tax rates on any gain recognized on the property's subsequent disposition. The structure allows property owners to bifurcate the gain and preserve capital gain treatment of a significant portion of the property's increase in value. Even though sound policy warrants bifurcating the gain that results from a *Bramblett* structure, the structure is cumbersome, and lawmakers should provide a more efficient way to bifurcate gain. This Article articulates that argument in detail.

Part II of the Article discusses the place capital gains occupy in the United States tax system, both historically and currently. That discussion reveals that despite questionable rationales for providing favorable capital gains rates, the favorable treatment is a fixed part of the current federal income tax system, so the focus should be on making the law as fair as possible in this second-best setting. Part III discusses current strategies that implement the *Bramblett* structure to bifurcate gain on the disposition of developed property between long-term capital gain and ordinary income. The discussion reveals that policy supports gain bifurcation under a system that provides favorable rates to capital gains, but the *Bramblett* structure is not the ideal method for bifurcating gain. Part IV suggests legislative action that would explicitly provide for gain bifurcation and allow property owners to explicitly elect such treatment. This Part also recommends that, as part of the legislation that makes the bifurcation election explicit, Congress should require property owners to obtain a qualified appraisal of the property at the date of conversion and prohibit the use of the *Bramblett* structure to bifurcate gain. Part V concludes.

II. FAVORABLE TREATMENT FOR CAPITAL GAINS

Gross income includes "[g]ains derived from dealings in property."[10] Unless a specific nonrecognition provision applies,[11] a property owner must report as income for the taxable year in which the sale occurs the difference between the amount realized on the disposition and the property owner's adjusted basis in the property.[12] The gain recognized on such disposition is

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10. I.R.C. § 61(a)(3).

11. *See, e.g.*, I.R.C. §§ 453(a) (providing for installment sale treatment for certain dispositions), 1031 (providing nonrecognition of gain realized on exchanges of properties of a like kind), 1033 (providing nonrecognition of gain realized on involuntary conversions of property).

12. I.R.C. § 1001(a), (c). Amount realized is the sum of money plus the fair market value of property received plus the amount of liability relief on the transaction. I.R.C. § 1001(b); Reg. § 1.1001-2(a)(1). The adjusted basis of property is its cost adjusted to reflect capital improvements, allowable depreciation, and other items. I.R.C. §§ 1011(a), 1012(a), 1016(a).

characterized as either ordinary income or capital gain, and the character determines the applicable tax rate. Currently, long-term capital gains are taxed at a maximum 23.8 percent rate, whereas ordinary income is taxed at a maximum 43.4 percent rate.[13] To obtain the favorable tax rate, gain on the disposition of property must come within the definition of long-term capital gain.[14]

Long-term capital gain is "gain from the sale or exchange of a capital asset held for more than [one] year."[15] That definition has two components: (1) the property owner must hold the property for more than one year (holding-period requirement); and (2) the property sold or exchanged must be a capital asset (capital-asset requirement). The holding-period requirement is the more straightforward of the two requirements.

Tax law allows for tacking holding periods in certain situations.[16] For example, an individual who receives property by gift generally will take the basis the transferor had in the property.[17] The recipient's holding period will also include the period for which the transferor held the property. If a tacking rule does not apply, the holding period begins when the property owner acquires the property and ends upon disposition.[18] Although determining the timing of those events can be difficult in some situations,[19] most often the dates of acquisition and disposition are known. As a result, a transfer of property in exchange for consideration will generally be the beginning or end of the property owner's holding period. As a general matter, determining the holding period is not difficult. Instead, the focus often turns to the capital-asset requirement.

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13. *See supra* note 7.

14. Capital gain can also be used to offset capital losses, which for individuals are only deductible to the extent of capital gains plus $3,000 of ordinary income. I.R.C. § 1211.

15. I.R.C. § 1222(3).

16. I.R.C. § 1223(1). The holding period of an asset is very important because preferential rate treatment is only available if you have net capital gain for the year. Net capital gain is the excess of net long-term capital gain over the net short-term capital loss for the year. I.R.C. § 1222(11). A net long-term capital gain is the excess of long-term capital gains for the year over long-term capital losses for the year. I.R.C. § 1222(7). A net short-term capital loss is the excess of short-term capital losses for the year over short-term capital gains for the year. I.R.C. § 1222(6). Short-term capital gains and short-term capital losses are gains or losses on the sale of capital assets held for less than one year. I.R.C. § 1222(1), (2).

17. I.R.C. § 1015.

18. Rev. Rul. 66−7, 1966−1 C.B. 188 (ruling that the holding period does not include the day of acquisition, but it does include the day of disposition).

19. *See, e.g.*, Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237–38 (1981) (listing factors courts consider to determine whether tax ownership of property has transferred).

The definition of capital asset includes all property, other than properties specifically enumerated by statute as exclusions.[20] The focus of this Article, and that of property owners who may consider developing property, is the provision that excludes from the definition of capital asset "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[21] If property comes within that definition on the date of disposition,[22] the property will not be a capital asset, and any gain recognized on the disposition will be ordinary income taxed at the higher ordinary income tax rate. If a property owner can avoid that definition, the property will be a capital asset and the gain on the disposition of the property may qualify for favorable capital gains rates.[23] A definition of capital asset is necessary because Congress has granted capital gains favorable treatment, tracing back to 1921.

A. *Origins of Capital Gain Treatment*

Capital gains have been subject to taxation since the enactment of the Internal Revenue Code ("Code") in 1913. It was not until 1921, however, that capital gains received preferential treatment. The Revenue Act of 1921 imposed a 12.5 percent tax rate on capital gains when tax rates on ordinary income were as high as 73 percent.[24] The 12.5 percent rate applied to all gains on property held for profit or investment for more than two years.[25] Between 1921 and today, the capital gains tax rate has gone through numerous changes that at times granted favorable rates to capital gains, but at other times did not.[26] For example, in 1924, Congress eliminated the profit or investment requirement, effectively allowing for personally held property to qualify for capital gain treatment.[27] In 1934, Congress adopted a new

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20. I.R.C. § 1221(a)(1)–(8).

21. I.R.C. § 1221(a)(1).

22. *See* Friend v. Commissioner, 198 F.2d 285, 288 (10th Cir. 1952) ("While his intention at the time of acquiring the property, at the time of the making of further improvements, and at the time of causing the property to be rezoned was a matter for appropriate consideration of the Tax Court, it was not controlling. The ultimate question of decisive consequence was the purpose for which he was holding the property at the time of the sales.").

23. To qualify for the favorable rates, the property must also satisfy the holding-period requirement discussed above, *see* sources cited *supra* notes 16–19 and accompanying text, and the gain must not include any recapture. *E.g.*, I.R.C. § 1245(a) (subjecting depreciation recapture to ordinary income tax rates).

24. Revenue Act of 1921, ch. 136, 42 Stat. 227, 233–35.

25. Revenue Act of 1921, ch. 136, 42 Stat. 227, 232–33.

26. Citizens for Tax Justice, *Top Federal Income Tax Rates Since 1913* (top brackets in nominal dollars) (Nov. 2011), http://www.ctj.org/pdf/regcg.pdf.

27. Revenue Act of 1924, ch. 234, § 208(a)(8), 43 Stat. 253, 263.

approach for dealing with capital gains. Rather than directly applying a special tax rate to capital gains, it adopted a mechanism whereby the amount of capital gain to be included in income, and taxed at the ordinary income rates, was dependent on the property owner's holding period.[28] The Revenue Act of 1942 provided for a partial or complete exclusion from gross income for noncorporate capital gains or losses on property held for more than six months.[29] The excluded amount changed over the years, and settled at 60 percent in 1978.[30] The Tax Reform Act of 1986 repealed the exclusion for capital gains and increased the maximum capital gains rates to 28 percent.[31] In 1997, Congress reduced the maximum capital gains rates to 20 percent.[32] In 2003, the 20 percent rate was reduced to 15 percent.[33] For tax years beginning after 2012, the maximum capital gains rate can be as high as 23.8 percent.[34] Some commentators struggle to justify the favorable rates afforded to long-term capital gains, but the favorable rates have enjoyed a significant place in the income tax for many years.

B. Arguments for Favorable Capital Gains Rates

The legislative history accompanying the 1921 Act suggests that the primary reason for providing a preferential rate to capital gains was to stimulate taxable transactions as a means of increasing revenue.[35] The Report of the House Ways and Means Committee accompanying the 1921 Act stated that such an incentive was necessary because sales of capital assets were being inhibited because "gains and profits earned over a series of years are under present law taxed as a lump sum . . . in the year in which the profit is realized."[36] Echoing the legislative history, the Supreme Court stated that the

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28. Revenue Act of 1934, ch. 227, § 117(a), 48 Stat. 680, 714. The Act established five inclusion amounts ranging from 30 percent inclusion in income for assets held for more than ten years to 100 percent inclusion in income for assets held for not more than one year.

29. Revenue Act of 1942, Pub. L. No. 753, § 150(c), 56 Stat. 798, 843. The holding period requirement was increased to nine months in 1977 and to the current one year holding period after 1977. Tax Reform Act of 1976, Pub. L. No. 94−455, § 1402(a), 90 Stat. 1520, 1731.

30. Revenue Act of 1978, Pub. L. No. 95−600, § 402(a), 92 Stat. 2763, 2867.

31. Tax Reform Act of 1986, Pub. L. No. 99−514, §§ 301, 311, 100 Stat. 2085, 2216, 2219.

32. Taxpayer Relief Act of 1997, Pub. L. No. 105−34, § 311, 111 Stat. 788, 831–32.

33. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108−27, § 301, 117 Stat. 752, 758.

34. *See* sources cited *supra* note 7.

35. H.R. REP. NO. 350 (1921), *reprinted in* 1939-1 (Part 2) C.B. 168, 176.

36. *Id.* The reports provides as follows:

purpose of a special preferential capital gains rate was to "relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions."[37] Commentators have recast this rationale into two main arguments, claiming that the preferential treatment helps reduce income bunching and relieve the lock-in effect.[38]

1. Income Bunching

Income bunching exists because property owners do not take gains or losses into account as they accrue,[39] but only take them into account upon the occurrence of a realization event.[40] As a result, property owners report the entire amount of gain in the year of disposition even though the gain may

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> The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. Many such sales, with their possible profit taking and consequent increase of the tax revenue, have been blocked by this feature of the present law. In order to permit such transactions to go forward without fear of a prohibitive tax, the proposed bill, in section 206, adds a new section (207) to the income tax, providing that where the net gain derived from the sale or other disposition of capital assets would, under the ordinary procedure, be subjected to an income tax in excess of 15 per cent, the tax upon capital net gain shall be limited to that rate. It is believed that the passage of this provision would materially increase the revenue, not only because it would stimulate profit-taking transactions but because the limitation of 15 per cent is also applied to capital losses.
>
> *Id.*

37. Burnet v. Harmel, 287 U.S. 103, 106 (1932).

38. *See* Joseph B. Cartee, Note, *A Historical Essay and Economic Assay of the Capital Asset Definition: The Taxpayer and Courts are Still Mindfully Guessing While Congress Doesn't Seem to (Have a) Mind*, 34 WM. & MARY L. REV. 885, 887 n.13 (1993) [hereinafter Cartee, *A Historical Essay*] (citing BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶ 3.5.7 (2d ed. 1981)).

39. *See* Jane G. Gravelle & Lawrence B. Lindsey, *Capital Gains*, 38 TAX NOTES 397, 400 (Jan. 25, 1988) (providing that on average, only 3.1% of accrued capital gains are realized in any given year).

40. Although the realization requirement is not explicitly found in the Code, case law has interpreted the tax law in this manner. *See* Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955) (providing that gross income includes "undeniable accessions to wealth, clearly *realized*, and over which the taxpayers have complete dominion" (emphasis added)).

be attributable to an increase in value over the entire period the property owners hold the property.[41] Proponents of favorable capital gains rates claim that by taxing in one year the gains accrued over several years, tax law imposes a higher nominal rate of tax than would apply if the gain were taxed as it accrued.[42] The higher nominal rate in the year of disposition arguably creates the problem. An example illustrates the effect of income bunching.

Assume Ebube holds property with a $100,000 cost basis. Ebube purchased the property at the beginning of Year 1. The property appreciates $5,000 per year until Ebube sells it at the end of Year 10. At the time of sale the property is worth $150,000, resulting in a gain of $50,000. If Ebube had no other income in Year Ten, the $50,000 of gain in Ebube's income would push Ebube into the 36 percent rate bracket resulting in a Year Ten tax liability of $18,000. Compare that result to the tax consequences of paying tax as gain accrues. If Ebube's marginal rate on the $5,000 of annual accrual were 28 percent, his tax for each year would be $1,400. Over ten years, the total tax liability would only be $14,000 ($1,400/year × 10 years). Thus, income bunching appears to result in an additional $4,000 of tax (almost 30 percent more than the tax without income-bunching) for Ebube on the $50,000 of income.

Proponents of preferential rates for capital gains therefore argue that providing a preferential rate to capital gains is a "rough justice" attempt to average out the negative effects of income bunching. Despite its appeal to proponents of favorable capital gains rates, income-bunching is subject to criticism. First, skeptics recognize that although the realization requirement may push a property owner into a higher tax bracket, it provides the property owner with the benefit of tax deferral.[43] Thus, the time value of money provides a benefit to property owners that other taxpayers do not have. Second, taxing gain as it accrues is a more accurate way to offset the effects

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41. Increases in value of property may not in fact be uniform over the period of time that a person owns property. For example, property may decrease in value during some years and increase in value during other years. Perhaps the increase in value of a piece of property occurs over the last year or two that a person holds a piece of property, even if the person has held it for ten years. Income-bunching proponents do not account for this possibility.

42. *See* INTERNAL REVENUE: HEARING ON H.R. 8245 BEFORE THE COMM. ON FINANCE, UNITED STATES SENATE, 67th Cong., 1st Sess., 36–37 (1921) (statement of Dr. T.S. Adams, Tax Advisor, Treasury Department), *reprinted in* 95A REVENUE ACTS 1909-1950, THE LAWS, LEGISLATIVE HISTORIES & ADMINISTRATIVE DOCUMENTS (Bernard D. Reams, Jr., ed., 1979).

43. *See* Noël B. Cunningham & Deborah H. Schenk, *Colloquium on Capital Gains: The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 328 (1993) [hereinafter Cunningham & Schenk, *Colloquium on Capital Gains*].

of income bunching.[44] Tax law could easily do away with income-bunching by taxing increases in value on an annual basis. Tax law also could reduce the effects of income bunching by estimating the rate of tax that would have applied to the appreciation as it accrued. Under current law, a single rate applies to long-term capital gains recognized on the disposition of real property. The fixed rate that applies to long-term capital gains may be different from the tax rate that would have applied in real time to the appreciation. In some situations, the rate that applies at the time of the realization event could be higher than the rate that would apply to the accrual, and in others it could be lower. Therefore, income-bunching does not justify applying a single rate to realized gain that would have been lower than the rate that would have applied to accrued gain.

2. *The Lock-in Effect*

Proponents of favorable capital gains rates also argue that the lock-in effect justifies the preferential rate.[45] The lock-in effect describes property owners' reluctance to dispose of property if the disposition will be taxable. The lock-in effect purportedly distorts behavior and "create[s] inefficiency that impedes the flow of capital to its most productive uses."[46] The realization requirement and the estate tax are primarily responsible for the lock-in effect. If a property owner holds property until death, the transfer and gain would not be taxed as income, and the person receiving the property from the estate would take a stepped-up basis equal to the property's fair market value.[47] Estimates suggest that approximately 50 percent of accrued

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44. *See id. See also* Jane G. Gravelle, *Capital Gains Taxes: An Overview*, 2011 TAX NOTES TODAY 7–27 (Jan. 5, 2011) [hereinafter Gravelle, *Capital Gains Taxes*]. For additional arguments, see Michelle A. Cecil, *Toward Adding Further Complexity to the Internal Revenue Code: A New Paradigm for the Deducibility of Capital Losses*, 99 U. ILL. L. REV. 1083 (1999) [hereinafter Cecil, *Toward Adding Further Complexity*]; Jay A. Soled, *The Sale of Donors' Eggs: A Case Study of Why Congress Must Modify the Capital Asset Definition*, 32 U.C. DAVIS L. REV. 919 (1999) [hereinafter Soled, *The Sale of Donors' Eggs*]; Williams D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974) [hereinafter Andrews, *A Consumption*].

45. The Committee Report on Pub. L. No. 98−369 stated that it was believed that reducing the holding period requirement for capital gains treatment from twelve months to six months would reduce the effects of lock-in. HOUSE WAYS AND MEANS COMMITTEE, DEFICIT REDUCTION ACT OF 1984, H.R. REP. 98−432 (1984), *reprinted in* 1984 U.S.C.C.A.N. 2140, 2142.

46. Cunningham & Schenk, *Colloquium on Capital Gains*, *supra* note 43, at 344–45.

47. *See* I.R.C. §§ 102 (providing the value of bequests and inheritances are not part of the transferee's gross income), 1014 (providing that "the basis of property in the hands of a person acquiring the property from a decedent or to whom the

gains are held until death and never subject to tax.[48] Under the current system, the choice may be to tax gain at a lower rate and free up the property for its highest and best use or to lose out completely on any tax revenue and relegate property to a lower use subjecting gain to a high tax rate. With these alternatives, proponents of favorable capital gains rates argue Congress has ample reason to create incentives for property owners to enter into transactions, hoping to have a significantly higher percentage of accrued gains subject to taxation.

The Joint Committee on Taxation illustrates the lock-in effect as presented in the following example.[49] Assume Orly paid $500 for a stock which is now worth $1,000, and that the stock's value will grow by an additional ten percent over the next year with no prospect of further gain thereafter. Assuming a 28 percent tax rate, if Orly sells the stock one year from now for $1,100, she will receive $932 after payment of $168 tax on the gain of $600. With a tax rate of 28 percent, if Orly sold the stock today, she would receive only $860 after payment of $140 tax on a gain of $500. If she were to reinvest that amount, it would be worth $946 in one year after increasing in value ten percent. If she sold the new investment and recognized $86 of gain, she would owe an additional $24 of tax ($86 x 28%). Consequently, she would be left with $922 ($946 – $24). Because she is better off holding the property, and selling it after one year, she will hold it unless someone is willing to pay a higher price currently. If buyers are unwilling to do that, Orly will lock in ownership of the property and may not put it to its best use. To induce property owners to dispose of their assets prior to death, thereby subjecting them to taxation and increasing tax revenue, Congress decided to sweeten the deal for property owners by reducing the tax rate that would apply to such dispositions. Despite the lower tax rate applied to capital gains, commentators claim that the government is still able to maximize revenue due to an increase in the number of transactions.[50]

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property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death").

48. Cunningham & Schenk, *Colloquium on Capital Gains*, *supra* note 43, at 323 n.12.

49. *See* STAFF OF THE JOINT COMM. ON TAX'N, PROPOSALS AND ISSUES RELATING TO TAXATION OF CAPITAL GAINS AND LOSSES (JCS-10-90, (Mar. 23, 1990).

50. Cunningham & Schenk, *Colloquium on Capital Gains*, *supra* note 43, at 321.

C. *Embedded Stature of Favorable Capital Gains Rates*

Despite the arguments in favor of the current favorable capital gains rates, some recent empirical research disfavors such rates.[51] Although scholars have proposed alternative solutions to address the problems a preferential capital gains rate was meant to alleviate,[52] the current system of taxing capital gains appears to be well-embedded in the tax system. Consequently, this Article does not contend with the legitimacy of favorable tax rates for capital gains. Instead, it assumes that they will continue to be part of the income tax system and focuses on improving the law in the context of the current second-best structure. Repeal of the preferential rates would, however, eliminate the aspects of complexity and inequity that this Article addresses. Thus, the Article focuses narrowly on a second—or third—best solution, acknowledging that the problem would disappear if Congress eliminated preferential capital gains rates. In this second-best setting, the law should do a better job of attempting to tax gain based upon its identifiable source. The appropriate taxation of gain turns on the reason for taxing the gains differently, as reflected in the definition of capital asset.

D. *The Definition of Capital Asset*

The stated justifications for favorable capital gains rates assume a definition of capital asset and capital gain. A system that taxes capital gains and ordinary income at different rates must, nonetheless, distinguish between the two types of income. The United States income tax system does that by providing that only gains from the sale or exchange of capital assets qualify for the favorable rates. It thus uses the definition of capital asset to distinguish the two types of income. Speaking in general terms, the definition of capital asset "differentiate[s] 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."[53] Tax law differentiates the two types of profits with a general

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51. *See* Diamond & Saez, *The Case for a Progressive Tax*, *supra* note 5.

52. *See* Cunningham & Schenk, *Colloquium on Capital Gains*, *supra* note 43, at 328; Gravelle, *Capital Gaines Taxes*, *supra* note 44. For additional arguments, see Cecil, *Toward Adding Further Complexity*, supra note 44; Soled, *The Sale of Donors' Eggs*, *supra* note 44; Andrews, *A Consumption*, *supra* note 44; Cartee, *A Historical Essay*, *supra* note 38, at 886.

53. *See* Malat v. Riddell, 383 U.S. 569, 572 (1966) (citation omitted) (internal quotation marks omitted). *See also* Cartee, *A Historical Essay*, *supra* note 38, at 913 ("The statutory exclusions in the capital asset definition allude to an intent to restrict capital asset treatment to those transactions realizing gain or loss that do not indicate recurrent and normally expected returns from wealth (capital), management and entrepreneurship, or plain labor in the context of a business

definition of capital asset that would include all property and exclude from that definition property that derives value from the owners' efforts.[54] For example, property a person holds primarily for sale to customers in the ordinary course of the person's trade or business is not a capital asset[55] because the value of such property derives in large part from the effort to sell the property and maintain the trade or business related to the property. A capital asset, by contrast, would be property held for investment to realize income over time in the form of appreciation in the value of property.[56]

Courts struggle to identify the line that differentiates property held for investment and property held primarily for sale to customers in the ordinary course of a trade or business.[57] Traditionally, courts used a multiple-factor test when considering whether property is held primarily for sale to customers in the ordinary course of a trade or business. The Fifth Circuit formulated the following seven nonexclusive factors, often referred to as the "seven pillars of capital gain," to help determine whether one holds property as a dealer or as an investor:

(1) the nature and purpose of the acquisition of the property and the duration of the ownership;
(2) the extent and nature of the taxpayer's efforts to sell the property;
(3) the number, extent, continuity and substantiality of the sales;
(4) the extent of subdividing, developing, and advertising to increase sales;
(5) the use of a business office to sell property;
(6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and
(7) the time and effort the taxpayer habitually devoted to the sales.[58]

In applying these factors the courts stress that no one factor is determinative, and neither is the presence or absence of any single factor

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enterprise."); MARTIN DAVID, ALTERNATIVE APPROACHES TO CAPITAL GAINS TAXATION 2 (1968).

54. *See* I.R.C. § 1221(a)(1)–(8).

55. *See* I.R.C. § 1221(a)(l).

56. *See* cases cited *supra* note 4.

57. Biedenharn Realty Co. v. United States, 526 F.2d 409, 414 (5th Cir. 1976) ("The difficulty in large part stems from ad-hoc application of the numerous permissible criteria set forth in our multitudinous prior opinions.").

58. United States v. Winthrop, 417 F.2d 905, 910 (5th Cir. 1969).

determinative.[59] Each case must be evaluated in light of its own facts and circumstances.[60] Furthermore, many of the factors are overlapping and intertwined, and not all courts apply the same set of factors.[61]

Since the Fifth Circuit's formulation of the "seven pillars of capital gain," a number of cases have attempted to bring context to these factors by evaluating them in light of the statutory definition of capital asset.[62] For instance, the Fifth Circuit has since identified three factual inquiries in the statutory definition that help answer whether property is not a capital asset:

(1) was taxpayer engaged in a trade or business, and, if so, what business?
(2) was taxpayer holding the property primarily for sale in that business? and
(3) were the sales contemplated by taxpayer "ordinary" in the course of that business?[63]

In answering each of these questions, courts consider the frequency and substantiality of sales to be the most important factor.[64] Frequent and substantial sales of real estate indicate sales in the ordinary course of business derived from the property owner's efforts, resulting in ordinary income treatment. Frequent and substantial sales are intuitively related to the business of selling property to customers because sales require effort to subdivide, market, and otherwise prepare the property for sale. Such effort

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59. *Biedenharn Realty Co.*, 526 F.2d at 415 ("No one set of criteria is applicable to all economic structures. Moreover, within a collection of tests, individual factors have varying weights and magnitudes, depending on the facts of the case. The relationship among the factors and their mutual interaction is altered as each criteria increases or diminishes in strength, sometimes changing the controversy's outcome.").

60. *See* Burgher v. Campbell, 244 F.2d 863, 864 (5th Cir. 1957); Miller v. United States, 339 F.2d 661, 663–64 (Ct. Cl. 1964); Victory Housing No. 2, Inc. v. Commissioner, 205 F.2d 371, 372 (10th Cir. 1953); Phelan v. Commissioner, 88 T.C.M. (CCH) 223, 226 (2004), 2004 T.C.M. (RIA) 2004-206 at 1253.

61. *See, e.g.*, Houston Endowment, Inc. v. United States, 606 F.2d 77, 81 (5th Cir. 1979) (using four factors); Estate of Segel v. Commissioner, 370 F.2d 107, 108 (2d Cir. 1966) (using nine factors).

62. *See Biedenharn Realty Co.*, 526 F.2d 409; Suburban Realty Co. v. Commissioner, 615 F.2d 171 (5th Cir. 1980).

63. *Suburban Realty Co.*, 615 F.2d at 178.

64. *Id.* at 176; *Biedenharn Realty Co.*, 526 F.2d at 416; Bramblett v. Commissioner, 960 F.2d 526, 531 (5th Cir. 1992); *Phelan*, 88 T.C.M. (CCH) 223, 228, 2004 T.C.M. (RIA) 2004-206 at 1255–56; Medlin v. Commissioner, 86 T.C.M. (CCH) 141, 163 n.51 (2003), 2003 T.C.M. (RIA) 2003-224 at 1255 n.51; Hancock v. Commissioner, 78 T.C.M. (CCH) 569, 573 (1999), 1999 T.C.M. (RIA) ¶ 99,336 at 2097.

should increase the value of property beyond the value attributed solely to the property's appreciation in value over time. In fact, "[a] taxpayer who engages in frequent and substantial sales is almost inevitably engaged in the real estate business."[65] On the other hand, "infrequent sales for significant profits are more indicative of real estate held for investment," resulting in capital gain.[66] Other factors have a varying degree of relevancy depending on the particular factual situation, and all may not be applicable to any given case.[67] It is this definition that results in an all-or-nothing approach that generally must tax all gain at favorable capital gains rates or at ordinary-income rates. The discussion will reveal that gain often derives from both appreciation in value and the property owner's efforts, so the all-or-nothing approach often generates an imperfect result.

1. Engaged in a Trade or Business

The first question turns on whether the taxpayer has engaged in a "sufficient quantum of focused activity" to be considered to be engaged in a trade or business.[68] "The precise quantum necessary [is] difficult to establish, and cases close to the line on this issue will arise."[69] Factors most relevant to this inquiry appear to include: (1) the frequency and substantiality of sales; (2) the extent of subdividing, developing, and advertising activities; (3) the extent and nature of the efforts of the owner to sell the property; and (4) the use of a business office to sell the property. The more significant any of these activities, the more likely it is that the property owner is in the real estate business. As noted above, the frequency and substantiality of sales is the most important factor,[70] but there is no bright-line test for applying this factor and the courts have been far from consistent in its application.

In some cases, the number of sales is so significant that the inquiry is rather straightforward. For example, a property owner who had at least 244 sales over a thirty-three-year period was engaged in the real estate business.[71] Where the number of sales is less substantial, however, the determination is

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65. *Suburban Realty Co.*, 615 F.2d at 178.

66. *See Phelan*, 88 T.C.M. (CCH) 223, 228, 2004 T.C.M. (RIA) 2004-206 at 1256.

67. *See* Matz v. Commissioner, 76 T.C.M. (CCH) 465, 468 (1998), 1998 T.C.M. (RIA) ¶ 98,334 at 1945; *Suburban Realty Co.*, 615 F.2d at 178; Morley v. Commissioner, 87 T.C. 1206, 1213 (1986).

68. *Suburban Realty Co.*, 615 F.2d at 181.

69. *Id*.

70. *See* cases cited *supra* note 64 and accompanying text.

71. *Suburban Realty Co.*, 616 F.2d at 174. *See also Biedenharn Realty Co.*, 526 F.2d at 411 (taxpayer sold 208 lots and 12 individual parcels over thirty-one year period); United States v. Winthrop, 417 F.2d 905, 907 (taxpayer sold 456 lots over a nineteen-year period).

much more inconsistent. For example, the Tax Court disallowed capital gains treatment where a property owner sold twenty-six properties over five years, but it allowed capital gains treatment where the property owner sold twenty-eight properties over three years.[72] Thus, the number and frequency of sales are not always sufficient to establish the existence of a trade or business and outcomes are often unpredictable.

If a property owner engages in substantial development of the property, such as subdividing land, dedicating streets, or installing sewers and utilities, the courts are likely to treat the property owner as engaged in the real estate business.[73] Courts view such actions as comparable to the functions performed by a manufacturer of personal property.[74] Additionally, if a property owner or an agent of the property owner engages in advertising activities, the property owner is likely to be considered engaged in the real estate business. For example, the Fifth Circuit found that a property owner was in the real estate business, stating "[t]he flexing of commercial muscles with frequency and continuity . . . is a reality here. This reality is further buttressed by [the property owner's] sales efforts, including those carried on through brokers."[75] Despite such language, courts struggle to determine the level of activity required before the property owner will be deemed to be in the real estate business.

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72. *See, e.g.*, Rice v. Commissioner, 97 T.C.M. (CCH) 1807, 1810, 2009 T.C.M. (RIA) 2009-142 at 1165 (seven lots in eight years eligible for capital gains); Ayling v. Commissioner, 32 T.C. 704 (1959) (thirteen lots over four years eligible for capital gains treatment); Olstein v. Commissioner, 78 T.C.M. (CCH) 383, 384 (1999), 1999 T.C.M. (RIA) ¶ 99,290 at 1874 (sale of twenty-eight developed lots resulted in capital gain); Jenkins v. Commissioner, 29 T.C.M. (CCH) 240, 243 (1970), 1970 T.C.M. (RIA) ¶ 70,053 at 276 (taxpayer is investor when ten properties sold in two years). *See also* Byram v. United States, 705 F.2d 1418, 1425 (5th Cir. 1983) (holding that the property owner did not hold the property in question for sale despite the taxpayer having made twenty-two sales over a three year period). In reaching its conclusion, the *Byram* court stated:

> Though these amounts are substantial by anyone's yardstick, the district court did not clearly err in determining that 22 such sales in three years were not sufficiently frequent or continuous to compel an inference of intent to hold the property for sale rather than investment. This is particularly true in a case where the other relevant factors weigh so heavily in favor of the taxpayer.

Id. (internal citation omitted).

73. *See* Bush v. Commissioner, 610 F.2d 426, 427–28 (6th Cir. 1979); Jersey Land & Dev. Co. v. United States, 539 F.2d 311, 316–17 (3rd Cir. 1976); United States v. Winthrop, 417 F.2d 905, 911–12 (5th Cir. 1969); Bynum v. Commissioner, 46 T.C. 295, 299–301 (1966).

74. *See* Jersey Land & Dev. Co. v. United States, 539 F.2d 311, 315–16 (3rd Cir. 1976).

75. *See Biedenharn Realty Co.*, 526 F.2d at 418 (internal citation omitted).

This trade-or-business analysis illustrates the difficulty courts face in identifying whether a property owner is in a trade or business of subdividing and selling real estate. Part of the difficulty arises because courts face an all-or-nothing proposition—they must find that a trade or business does or does not exist. In doing so, they are determining the source of all of the gain realized on the disposition. A finding that the property owner was not engaged in a trade or business suggests that gain is from the property's appreciation in value. A finding that the property owner was engaged in a trade or business suggests that gain is from the property owner's efforts. In reality, the gain generally derives from both sources. Perhaps greater effort suggests that a larger percentage of gain derives from that effort, but that may not be the case if the property owner has held the property for a long time. Nonetheless, once a court concludes the property owner is in the real estate business, all the gain the property owner recognizes could be ordinary income. Even though the difficulty could be compounded if the courts had to bifurcate gain into capital and ordinary based upon business activity, bifurcation would allow for greater accuracy in taxing the gain. The impracticality of bifurcation based solely upon the extent of development and sales activity suggests a different test may be in order.

2. *Property Held "Primarily" for Sale*

The next part of the analysis sheds light on temporal aspects of the source of gain. It provides hope that at least in some situations the source of gain may be divided temporally. If, after evaluating all of the factors, it is determined that the property owner is in the real estate business, the next question is whether the property owner holds the property primarily for sale to customers in that business. A property owner's primary purpose for holding property is his or her purpose of "first importance" or his or her "principal" purpose for holding the property.[76] Generally, a property owner's purpose at the time of acquisition is controlling unless there is evidence of a change in purpose.[77] In determining whether a holding purpose has changed, courts look to the property owner's subjective intent in holding the property at issue.[78] A property owner's subjective intent can usually be ascertained by looking at the purpose for which the owner acquired the property. Very often property owners purchase land with the intent to hold it as an investment, intending to sell it at some time far off in the future after the property has appreciated in value. Such property owners might discover, however, that they can realize the greatest profit by subdividing or developing the land

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76. *See* Malat v. Riddell, 383 U.S. 569, 572 (1966).

77. *See Suburban Realty Co.*, 615 F.2d at 183–84; Tollis v. Commissioner, 65 T.C.M. (CCH) 1951, 1956 (1993), 1993 T.C.M. (RIA) ¶ 93,063 at 282.

78. *See Malat*, 383 U.S. at 570–72.

prior to sale. If the activities to subdivide and sell the property are significant, the IRS and the courts reclassify the holding intent from investment to held primarily for sale.[79] In such situations, any gain from the prior investment holding period becomes ordinary income, even though such gain clearly derives from appreciation in value over time.

In many instances, property owners could clearly demonstrate a specific point in time when the intent changes, but that would be futile under the current system. The Fifth Circuit categorically delineated the consequences of a changed holding purpose:

> [I]n most subdivided-improvement situations, an investment purpose of antecedent origin will not survive into a present era of intense retail selling. The antiquated purpose, when overborne by later, but substantial and frequent selling activity, will not prevent ordinary income from being visited upon the taxpayer. Generally, investment purpose has no built-in perpetuity nor a guarantee of capital gains forever more.[80]

Nonetheless, in some instances the property owner's initial investment purpose will continue to be important despite subsequent sales activity that otherwise tends to establish dealer status.[81] Such situations

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79. *See* Ackerman v. U.S., 335 F.2d 521, 524–26 (5th Cir. 1964). *See also* Thompson v. Commissioner, 322 F.2d 122, 127–28 (5th Cir. 1963). In reaching its conclusion, the *Thompson* court stated:

> But what was once an investment, or what may start out as a liquidation of an investment, may become something else. The Tax Court was eminently justified in concluding that this took place here. It was a regular part of the trade or business of Taxpayer to sell these lots to any and all comers who would meet his price. From 1944 on when the sales commenced, there is no evidence that he thereafter held the lots for any purpose other than the sale to prospective purchasers. It is true that he testified in conclusory terms that he was trying to 'liquidate' but on objective standards the Tax Court could equate held solely with 'held primarily.' And, of course, there can be no question at all that purchasers of these lots were 'customers' and that whether we call Taxpayer a 'dealer' or a 'trader', a real estate man or otherwise, the continuous sales of these lots down to the point of exhaustion was a regular and ordinary (and profitable) part of his business activity.

Id. (footnote omitted).

80. *See Biedenharn Realty Co.*, 526 F.2d at 421 (internal citations omitted).

81. *See id.* at 422 ("[This] distinction . . . reflects our belief that Congress did not intend to automatically disqualify from capital gains bona fide investors forced to abandon prior purposes for reasons beyond their control. . . . However, we

include a change in purpose resulting from unanticipated, externally induced factors, which make it impossible to continue the original investment use.[82] Another factor to consider when determining the purpose for which the property owner holds property is the length of time the property owner has held the property. Generally, holding an asset for a long period of time evidences an investment purpose.[83] Even though a prior investment holding purpose can influence the character of gain on the disposition of subdivided property, the character of the gain will be either ordinary or capital—an all-or-nothing classification.

An example illustrates the draconian effect of changing holding purpose and the all-or-nothing treatment following such change. Assume Paul purchased a parcel of land in Year 1 for $200,000 with the intent of holding it long term and allowing it to appreciate in value. In Year 10, when the fair market value of the land is $1,000,000, Paul believes that he can realize an even greater profit if he subdivides the land and sells it off in individual lots. If Paul were to sell the property currently, without doing any development activities, he would recognize $800,000 of gain, all of which should be long-term capital gain subject to favorable rates. Assuming a 23.8 percent tax rate, his tax liability would be $190,400 on the gain from appreciation.

Paul believes, however, that if he pays $1,000,000 to subdivide the land, its fair market value will increase to $3,000,000. The basis of the land would become $1,200,000 if he subdivides it ($200,000 cost basis + $1,000,000 subdivision costs).[84] If Paul sells the property for $3,000,000 he would recognize $1,800,000 of gain. Paul's development activities would almost certainly convert the property from a capital asset to property held primarily for sale to customers in the ordinary course of his trade or business. As a result, the entire $1,800,000 gain would be treated as ordinary income taxed at 43.4 percent, resulting in a tax liability of $788,400. This is the case even though $800,000 of the gain resulted from appreciation of the property's value during the ten years Paul clearly held it for investment. As a result of the change in purpose, Paul would pay $347,200 of tax ($800,000 x 43.4%) on the appreciation, $156,800 more than he would pay if the land had

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caution that although permitting a land owner substantial sales flexibility where there is a forced change from original investment purpose, we do not absolutely shield the constrained taxpayer from ordinary income.").

82. Such situations include a pressing need for funds in general, illness or old age, the necessity for liquidating a partnership on the death of a partner, the threat of condemnation, and municipal zoning restrictions. Philip D. Levin, *Capital Gains or Income Tax on Real Estate Sales*, 37 B.U. L. REV. 165, 194–5 (1957).

83. *See* Pritchett v. Commissioner, 63 T.C. 149, 166–67 (1974) (holding that "th[e] lengthy retention of the property is indicative of [the taxpayer's] intention to hold it for investment purposes").

84. I.R.C. §§ 1011, 1012, 1016.

retained its original character or the law had allowed him to bifurcate the gain.[85]

This example illustrates how the law completely ignores any prior holding purpose in determining the character of gain realized on the disposition of property. Courts acknowledge the prior investment purpose can illustrate that a portion of gain derives solely from appreciation prior to the change in purpose.[86] Nonetheless, the law appears to prohibit courts from bifurcating the gain. The law results in similar treatment of property owners whose situations may be quite different.

To illustrate, $1,000,000 of Paul's gain is derived from his efforts and $800,000 is derived from appreciation in value, i.e., 40 percent of Paul's gain is derived from the property's appreciation over time. The ratios of sources will likely vary from situation to situation, but the results will often be the same—all of the gain will be taxed the same, regardless of its source. Despite close to 40 percent of Paul's gain deriving from appreciation, it would all be subject to ordinary income tax rates. That treatment is the same treatment that the law affords gain that derives almost exclusively from the owner's efforts. For example, if Peter purchased a piece of property and immediately began working to subdivide and sell it, he would recognize ordinary income on the sale of property. Paul and Peter would be taxed similarly, even though a significant portion of Paul's gain derived from appreciation in value over time. Treating different situations similarly violates equity, making the all-or-nothing outcome undesirable.

3. Sales to Customers in the Ordinary Course of Business

Whether sales are ordinary in the property owner's trade or business turns on whether they are usual, as opposed to an abnormal or unexpected event.[87] As with the first two questions, frequent and substantial sales support a finding that the sales are in the ordinary course of business.[88] The concept of what is ordinary "requires for its application a chronology and a history to determine if the sales of lots to customers were the usual or a departure from the norm."[89] For example, sales were ordinary where the property owner began selling shortly after acquiring the land and never used the land for any other purpose, and continued selling the property.[90] Despite

85. Note that if Paul originally held the land primarily for sale in the ordinary course of his trade or business, he would not be entitled to capital gains treatment even if he never undertook development activities.

86. *See infra* Part III.A (describing the *Bramblett* structure).

87. *See* United States v. Winthrop, 417 F.2d 905, 912 (5th Cir. 1969).

88. *See* Biedenharn Realty Co. v. United States, 526 F.2d 409, 416 (5th Cir. 1976); Suburban Realty Co. v. Commissioner, 615 F.2d 171, 178 (5th Cir. 1980).

89. *Winthrop*, 417 F.2d at 912.

90. *See Suburban Realty Co.*, 615 F.2d at 185–86.

the development of factors and tests in the case law, in many circumstances, property owners are still left guessing whether or not the real estate they hold is a capital asset.[91]

The inability to clearly and unambiguously draw a line between capital asset and property held primarily for sale to customers in the ordinary course of a trade or business results in similar gain being taxed differently. Property owners with seemingly similar levels of activity may be taxed differently depending upon the court's interpretation and application of the factors. The all-or-nothing approach also casts too wide a net, resulting in some gain from appreciation being taxed as ordinary income if the property is classified as held for sale. Gain from a property owner's efforts will be fixed as a capital gain, on the other hand, if the property is classified as a capital asset. These inconsistencies make the law inequitable.

E. Current Regime is Second-Best Setting

As stated above, the support for favorable rates for capital gains is tenuous at best,[92] so the current system is a second-best situation. All of the difficulty of differentiating gain would be eliminated if tax law taxed all gain at the same rates. Nonetheless, the law attempts to tax gain from appreciation over time differently from gain from owners' efforts, so the distinction between ordinary income and capital gains should be whether the gain derives from the owners' efforts to increase the value of the property.[93] Unfortunately, the law does not do a sufficient job of identifying the source

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91. Section 1237 provides a capital gain safe harbor to taxpayers on the sale of subdivided land, provided certain requirements are satisfied. If section 1237 applies, the taxpayer will not be treated as holding property primarily for sale despite having engaged in subdivision activity. In order for section 1237 to apply the following requirements must be met: (1) the taxpayer cannot be a C Corporation; (2) the taxpayer cannot have previously held the *tract in question* for sale to customers in the ordinary course of business; (3) the taxpayer cannot hold *any* other real property primarily for sale to customers in the ordinary course of business; (4) the taxpayer must have held the tract for at least five years; and (5) the taxpayer cannot make any improvements to the property that substantially enhance its value. Section 1237 is not applicable to real estate dealers, therefore necessitating a determination of whether the taxpayer is a dealer or investor. This analysis is the same as discussed above. If the taxpayer is able to satisfy all of the above requirements, gains from the sale of the first five lots are taxed as capital gains. Beginning in the year in which the sixth lot is sold, five percent of the gain on the sale of all lots will be characterized as ordinary income, with the remaining 95 percent receiving capital gains treatment. Often times taxpayers seek to sell their land prior to holding it for five years, therefore making section 1237 of no use.

92. *See* Diamond & Saez, *The Case for a Progressive Tax*, *supra* note 5, at 177–83.

93. *See* cases cited *supra* note 4.

of the gain on the sale of property and properly taxing gain based upon its source. The law uses a complicated test to determine whether gain is ordinary or capital, but it places all gain from a single piece of property into one category, even though the gain may derive from both sources. Property owners recognized these deficiencies and engaged in self-help to address them. Courts appear to have recognized that the law should tax gain based upon its source and have ruled in favor of the self-help methods, approving gain bifurcation.

III. THE *BRAMBLETT* STRUCTURE

Even though the law does not ostensibly provide for gain bifurcation, property owners have devised a structure that bifurcates gain. Several courts have sanctioned these structures,[94] but the Fifth Circuit's decision in *Bramblett v. Commissioner*[95] is the most famous. Consequently, these structures have come to be known as *Bramblett* structures. *Bramblett* structures separate gain attributable to appreciation in a property's value from gain attributable to the property owner's efforts to improve the property. *Bramblett* structures accomplish this result by separating the property owner's holding purposes. Gain from holding the property prior to implementing the *Bramblett* structure derives primarily from appreciation in value over time, and gain following the implementation of the structure derives primarily from the property owner's efforts. Because the bifurcation is based upon a temporal divide, it cannot perfectly separate gain from appreciation and gain from efforts (surely some of the post-implementation gain derives from unaided appreciation), but *Bramblett* bifurcation is a vast improvement over the all-or-nothing approach in the general law. The *Bramblett* structure facilitates the bifurcation of gain with a somewhat complicated series of transactions.

A. *Use of Multiple Commonly-Controlled Entities*

Bramblett structures are common in a very typical situation: a tax partnership owns a piece of property for investment, but the property becomes ripe for development and disposition. If the tax partnership expends effort to develop the property and dispose of it, the efforts will likely convert the property from a capital asset to property held primarily for sale to customers in the ordinary course of a trade or business.[96] That outcome

94. *See, e.g.*, Bradshaw v. United States, 683 F.2d 365 (Ct. Cl. 1982); Phelan v. Commissioner, 88 T.C.M. (CCH) 223, 227–28 (2004), 2004 T.C.M. (RIA) 2004-206 at 1255.

95. Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1980).

96. *See supra* Part II.D.2.

seems to be inappropriate because the tax partnership can roughly identify any gain that accrued prior to the development was from appreciation, and any gain following the development was largely from the owner's efforts.

In such a situation the line dividing the two types of income appears to be obvious (gain prior to development derives primarily from appreciation and gain following the start of development derives primarily from efforts to improve the property), so bifurcation would appear to be appropriate. Nonetheless, the Code does not explicitly allow bifurcation. To avoid the harsh statutory result, the tax partnership could sell the undeveloped property prior to developing or marketing it. Any gain resulting from such sale should be capital gain.[97] To also capture the gain from the development activity, the members of the tax partnership could cause the tax partnership to sell the undeveloped property to a related-entity wholly owned by the members of the tax partnership. The development entity would develop, market, and sell the property and realize ordinary income on the disposition. This basic series of transactions with the related entities is the essence of the *Bramblett* structure.[98]

The following example illustrates how the *Bramblett* structure can bifurcate gain that would otherwise only be ordinary income. First, consider the result without the structure. Investor LLC, a tax partnership, has held the property for fifteen years, and it comes within the definition of capital asset. Investor LLC incurs $2,000,000 of costs to subdivide the property for sale as single-family-home lots. After subdivision, the property's basis will be $2,500,000. Investor LLC sells the property as individual lots for $10,000,000, resulting in a gain of $7,500,000 ($10,000,000 amount realized – $2,500,000 adjusted basis). Because Investor LLC engaged in substantial development of the land prior to sale, its holding purpose converted from investment to sale to customers in the ordinary course of its trade or business, so the entire $7,500,000 of gain will be ordinary income. The character of that gain will flow through to Investor LLC's members and they will be taxed at ordinary income rates on all of the gain. At 43.4 percent, the total tax liability will be $3,255,000.

Now consider how the members of Investor LLC could avoid this harsh result by using a *Bramblett* structure. They would implement the structure by creating a related developer entity that they own. The developer entity can be a state-law partnership or a limited liability company, but it must be taxed as a corporation, not as a partnership, to preserve Investor

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97. This is only true if the taxpayer establishes, under the guidelines discussed above, that they were holding the land for investment purposes prior to the sale to the related-entity.

98. Because the related-entity holds the land for the stated purpose of developing and selling the real estate, the property will be excluded from capital asset treatment under section 1221(a)(1).

LLC's capital gain treatment.[99] The corporation would most likely elect to be an S corporation to obtain flow-through taxation.[100] Assume the members form that developer entity as a state-law corporation and name it Developer Inc. that elects to be an S corporation. The members will cause Investor LLC to transfer the property to Developer Inc. in exchange for a $6,000,000 promissory note. On the transfer, Investor LLC would realize $5,500,000 of gain ($6,000,000 amount realized – $500,000 adjusted basis). Because Developer Inc. issued a promissory note in exchange for the property, Investor LLC should be able to defer gain recognition until Developer Inc. makes payments on the note.[101] When Investor LLC recognizes the gain, that gain would be long-term capital gain, which would flow through to the members of Investor LLC and should qualify for favorable capital gains rates of 23.8 percent. Their total tax liability on that gain would be $1,309,000.

Developer Inc. would incur $2,000,000 of expenses to subdivide and dispose of the property in individual lots. That amount would be added to the $6,000,000 cost basis that Developer Inc. took in the property when it acquired it from Investor LLC.[102] Thus, Developer Inc.'s basis in the property would be $8,000,000 when it disposes of the improved property for $10,000,000, and it would recognize $2,000,000 of gain on the disposition ($10,000,000 amount realized – $8,000,000 adjusted basis). That gain should be ordinary income. Assuming the members of Developer Inc. cause it to make an election to be an S corporation, the gain would flow through to the members as ordinary income, and they would pay tax on it at ordinary income tax rates. The total tax on that gain at 43.4 percent would be $468,000. Thus, if parties use a *Bramblett* structure, the total tax liability would be $2,177,000.

Notice that the *Bramblett* structure creates complexity for the members of Investor LLC and Developer Inc., but the tax benefits justify the cost of that complexity to the property owners. The structure lowers their tax liability from $3,225,000 to $2,177,000. Thus, the *Bramblett* structure helps the property owners save $1,078,000 in taxes. Such savings motivate property owners to use the *Bramblett* structure and justify the complexity of

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99. The gain recognized by a partnership on the sale of property to a related partnership is ordinary income, if the property is not a capital asset in the hands of the related-party transferee. I.R.C. § 707(b)(2). Because the property would not be a capital asset in the hands of the developer entity and the developer entity will generally be related to the investor entity, the developer entity must be a tax corporation to ensure that the investor entity can recognize capital gain on the transfer to the developer entity.

100. *See* I.R.C. §§ 1361–63.

101. *See* Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1980).

102. *See* I.R.C. §§ 1011 (defining adjusted basis to include the section 1012 cost plus section 1016 adjustments), 1012 (providing that a property's basis is its cost), 1016(a)(1) (providing that costs to improve property are part of basis).

the structure for them. Furthermore, the bifurcated result is good from a policy perspective because it taxes gain from appreciation in value at favorable capital gain rates and gain from the owner's efforts at ordinary income rates. Thus, the result appears to be good, but the structure is not without its defects, which suggest the preference for an explicit election.

B. Potential Federal Tax Pitfalls

Courts have approved the *Bramblett* structure, but the structure is susceptible to attacks and is beset by some shortcomings. Anyone interested in creating a *Bramblett* structure must avoid numerous pitfalls. In particular, to bifurcate gain using the *Bramblett* structure, a property owner must properly classify the developer entity, preserve installment-sale treatment, and ensure the developer entity's activities are not attributed to the investor entity. The requirement for careful structuring thus makes the *Bramblett* structure and gain bifurcation the exclusive province of well-advised and well-healed property owners. Other property owners must pay tax on all their gain at ordinary rates.[103]

1. Properly Classify the Developer Entity

Assuming the investor entity is a tax partnership, the developer entity must be properly classified as a tax corporation because tax law effectively prohibits bifurcating gain on sales between related tax partnerships by taxing all of the gain recognized by the investor entity as ordinary income.[104] To avoid that problem, property owners could break the relationship by having a third party own at least 50 percent of the developer entity.[105] Property owners typically are not willing to give up more than 50 percent of post-development profits and therefore often will have at least a 50 percent interest in the developer entity. As a result, property owners generally form the developer entity as a tax corporation, which elects to be an S corporation.

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103. *See*, *e.g.*, Pool v. Commissioner, 107 T.C.M. (CCH) 1011 (2014), 2014 T.C.M. (RIA) 2014-003 at 23 (denying capital gain treatment to a limited liability company that did not transfer property to the related developer corporation before improving and selling lots).

104. *See* I.R.C. § 707(b)(2). Ownership of a capital or profits interest is determined by taking into consideration the constructive ownership rules of section 267(c). I.R.C. § 707(b)(3).

105. *See* I.R.C. § 707(b)(2)(B) (defining related partnerships as those in which the same persons own more than 50 percent of the capital or profits interests).

2. *Preserve Installment-Sale Treatment*

Generally, the sale to the developer entity is made on an installment-sale basis.[106] Installment-sale treatment allows the investor entity to defer gain until the developer entity disposes of the property. To qualify for installment-sale treatment, the transaction must reflect arms' length value, the developer entity's note must come within the tax definition of debt, the developer entity must be recognized as separate from the investor entity, and the sale must satisfy the technical requirements of section 453.[107] The IRS may argue that the installment note should be treated as equity rather than as bona fide indebtedness and that the transaction should be properly characterized as a corporate contribution rather than a sale.[108]

If the IRS successfully reclassifies the transaction as a contribution, instead of a sale, the investor entity will not recognize any gain on the transfer and the developer entity will take the investor entity's basis in the land.[109] When the developer entity disposes of the property it would recognize all of the gain attributable to the period during which the investor entity held the property. All of that gain would be characterized based upon the developer entity's holding purpose, so it would all be ordinary income.

The potential for reclassification suggests that property owners must take great care to ensure that the IRS and courts will respect *Bramblett* structures and that the transfer to the developer entity is a sale for debt and

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106. Generally, for each payment, a percentage of the gain is recognized corresponding to that payment's percentage of all payments. Tax is paid at the tax rate in effect when the gain is recognized, not the rate in effect at the time of the sale. *See* I.R.C. § 453(c).

107. *See* I.R.C. § 453.

108. *See* Cynthia E. Bird, *Planning for the Sale of Land to a Controlled Corporation*, 21 J. REAL ESTATE TAX'N 264 (Spring 1994) (discussing cases that address this issue). In order for the section 351 corporate contribution rules to apply, the transfer must be solely in exchange for stock and the taxpayer must hold 80 percent of vote and 80 percent of the total number of all other shares of the corporation immediately after the exchange. *See* I.R.C. §§ 351 and 368(c). Section 368(c) provides that the "term 'control' means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."

109. *See* I.R.C. §§ 351(a) ("No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation."), 362(a) (providing that if property was acquired by a corporation in connection with a transaction to which section 351 applies "then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer").

not a contribution for equity. The distinction between debt and equity is not always obvious and is the subject of numerous decided cases.[110] These cases help property owners structure the sale of the property and also illustrate the complexity of the law in this area. Courts have respected installment sales to controlled corporations when: (1) the property is sold to the controlled corporation at its fair market value;[111] (2) the controlled corporation is adequately capitalized;[112] (3) the appropriate formalities are followed; and (4) if an installment note is used, the note is enforced.[113] Property owners planning to make an installment sale to a developer entity as part of a *Bramblett* structure should make every effort to structure their transactions in a manner that coincides with the above factors. They would be wise to err on the side of caution and ensure that the debt instrument clearly comes within the definition of debt.

Additionally, property owners must be aware of the possible application of related-party rules applicable to installment sales. Under those rules, gain recognition is accelerated following a related-party installment sale if the related-party purchaser disposes of the property prior to satisfying the installment obligation and less than two years after the installment

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110. *See* Thomas D. Greenaway & Michelle L. Marion, *A Simpler Debt-Equity Test*, 66 TAX LAW. 73 (2012) (describing courts' struggle to distinguish between debt and equity and citing several cases that have considered the issue).

111. The taxpayer will want to seek the highest supportable appraisal possible in order to maximize the amount of capital gain and minimize the amount of ordinary income.

112. The development corporation should have sufficient capital to have the ability to pay the note. Net equity capitalization of ten percent is considered to be sufficient. *See, e.g.*, P.L.R. 1995-35-026 (May 31, 1995); ALAN R. ELBER, ASSET PROTECTION STRATEGIES AND FORMS § 4:197 (Ward Miller et al. eds., 2008); Michael D. Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 EST. PLAN. 3, 7 (Jan. 1996).

113. *See* Bradshaw v. United States, 683 F.2d 365, 378–83 (Ct. Cl. 1982); Piedmont Corp. v. Commissioner, 388 F.2d 886, 889–91 (4th Cir. 1968); Ronhovde v. Commissioner, 26 T.C.M. (CCH) 1251, 1256–59 (1967), 1967 T.C.M. (RIA) ¶ 67,243 at 1378–82; Gordy v. Commissioner, 36 T.C. 855, 859–61 (1961). *Brown v. Commissioner* provides an additional set of helpful guidelines for determining whether an installment sale to a controlled corporation will be respected. 27 T.C. 27 (1956). Factors to be considered include: (1) the apparent intention of the parties; (2) the reservation of title or security interest in the land by the shareholder until the full purchase price is paid; (3) business considerations causing the adoption of the form of the transaction; (4) the capitalization of the corporation; (5) whether the price is at fair market value; (6) whether fixed payments are required under the promissory note without regard to the success of the corporation; (7) reasonable interest rates; (8) actual payment of installments; and (9) whether there is an agreement not to enforce collection. *Id.* at 35–36.

acquisition.[114] Related-party rules can also trigger immediate gain recognition if the investor entity transfers depreciable property to the developer entity.[115] Notice that the loss of installment-sale treatment will not change the character of gain that the investor entity recognizes; it merely affects the timing of the recognition. Thus, the primary concern is to take steps to ensure that the IRS and courts will respect the sale. If the timing of the subsequent sales allows for gain deferral under the installment method, that deferral is an added benefit.

3. Prevent Attribution of Developer's Activities to Investor

The IRS may also attack the related-entity sale by arguing that the dealer activities of the developer entity should be attributed to the investor entity, under either an agency theory or the sham transaction doctrine.[116] Attribution of the developer entity's activities to the investor entity would most likely cause the investor entity to be deemed to be engaged in the trade or business of selling property to customers. Thus, any gain it recognizes would be taxed at ordinary income tax rates. In determining whether or not an agency relationship exists, the courts focus on the selling entity's pre- and post-transfer activities with respect to the land at issue.

In several cases, courts have found that activities performed by the seller after a transfer created an agency relationship, so the courts disregarded the transfer. In one case the seller contacted an engineering company to find out where streets and utilities would be located and had the land platted and approved by the local planning commission prior to selling the land to a controlled corporation.[117] With respect to another tract of land, the seller had his attorney initiate the formation of a local public works

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114. *See* I.R.C. § 453(e)(1)−(2). The amount treated as received by the person that made the first disposition cannot exceed the excess of (a) the lesser of the total amount realized with respect to any second disposition or the total contract price for the first disposition, over (b) the sum of the aggregate amount of payments received with respect to the first disposition, plus the aggregate amount treated as received with respect to the first disposition for prior taxable years. I.R.C. § 453(e)(3).

115. *See* I.R.C. § 453(g); *see also* Bradley T. Borden & Matthew E. Rappaport, *Accounting for Pre-Transfer Development in Bramblett Transactions*, 41 REAL EST. TAX'N 162 (3d Quarter, 2014) (discussing the potential loss of installment-sale treatment on the transfer of depreciable property).

116. *See* Burgher v. Campbell, 244 F.2d 863, 864–65 (5th Cir. 1957); Tibbals v. United States, 362 F.2d 266, 272–73 (Ct. Cl. 1966); Brown v. Commissioner, 448 F.2d 514, 518 (10th Cir. 1971); Bramblett v. Commissioner, 960 F.2d 526, 533–34 (5th Cir. 1992); Phelan v. Commissioner, 88 T.C.M. (CCH) 223, 227–28 (2004), 2004 T.C.M. (RIA) 2004-206 at 1255.

117. *Brown*, 448 F.2d at 517.

authority for the purpose of having the city construct a sewer system on the tract before selling the land to his corporation.[118] In another case, the seller successfully sponsored petitions for the construction, by the county, of water mains, sewer, and street improvements on the land before selling it to a controlled corporation.[119] In another case, the sellers, although never acting in their individual capacities, participated in the development of the land after selling it to a controlled corporation by surveying and platting the land, installing streets, sewers and other improvements, and getting it re-zoned.[120] In each of these cases, the court held the high magnitude of the seller's activity with respect to the property was evidence that an agency relationship existed between the seller and the related purchaser and, therefore, the purchaser's intent to sell the property was attributed back to the seller.

Two cases provide a blueprint for avoiding this problem. They also illustrate the effort and care required to bifurcate gain. The first is none other than *Bramblett v. Commissioner*.[121] In that case, the taxpayer was a partner in a tax partnership that held land for investment. The taxpayer and his partners subsequently formed a corporation to subdivide the land and sell it in individual lots. The partners held identical ownership interests in both the investor partnership and the developer corporation. The investor partnership sold the land to the developer corporation, and the developer corporation subdivided the property and sold the lots. The court rejected the IRS's agency argument after analyzing agency principles.[122] The court found that common ownership of both entities was not enough to prove an agency relationship.[123] The court also rejected the IRS's substance-over-form argument. Quoting the Supreme Court, the court stated that where the form

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118. *Id.*

119. *Tibbals*, 362 F.2d at 269–70.

120. *See* Boyer v. Commissioner, 58 T.C. 316, 318–25 (1972).

121. 960 F.2d 526.

122. The *Bramblett* court cited *National Carbide v. Commissioner*, 336 U.S. 422 (1949) and *Commissioner v. Bollinger*, 485 U.S. 340 (1988). According to those cases, relevant considerations in determining whether a true agency exists include: (1) whether the corporation operates in the name and for the account of the principal; (2) whether the corporation binds the principal by its actions; (3) whether the corporation transmits money received to the principal; (4) whether the receipt of income is attributable to the services of the employees of the principal and to the assets belonging to the principal; and (5) whether the corporation's relationship with the principal is not dependent on the fact that it is owned by the principal. *National Carbide*, 336 U.S. at 437. An agency relationship is established when "the fact that the corporation is acting as its shareholders' agent with respect to a particular asset is set forth in a written agreement at the time the asset is acquired, the corporation functions as agent and not principal with respect to the asset for all purposes, and the corporation is held out as the agent and not the principal in all dealings with third parties relating to the asset." *Bollinger*, 485 U.S. at 340–41.

123. *See Bramblett*, 960 F.2d at 532.

chosen by the taxpayer "is compelled or encouraged by business or regulatory realities, is imbued with tax-interdependent considerations, and is not shaped solely by tax-avoidance features" the form should be honored.[124] The court found that protecting the partnership from unlimited liability that could arise from developing the land constituted an independent business purpose to form the developer corporation.[125] The court also found that no evidence existed to suggest that the sale to the developer corporation was not an arm's length transaction or that formalities were not followed.[126] Lastly, the court considered the purpose for which the investor partnership had originally acquired the land. Finding that the partnership acquired the land for investment purposes, the court stated that allowing capital gain treatment to the partnership would not thwart the main objective of the definition of capital asset.[127]

In *Phelan v. Commissioner*, the taxpayer was a member of a limited liability company that held undeveloped land.[128] The limited liability company sold a portion of the land to a developer corporation.[129] The ownership of the developer corporation was identical to that of the limited liability company.[130] The developer corporation developed the land and subsequently sold it.[131] The IRS argued that the sale to the developer corporation had no valid business purpose because a limited liability company provides the same protection from personal liability as a corporation (the business reason supporting the transaction in *Bramblett*).[132] The court held, however, that forming a controlled corporation protected the limited liability company's remaining assets from obligations arising from the corporation's development activities and that this was also a valid

124. *Id.* at 533 (citing Frank Lyon Co. v. United States, 435 U.S. 561, 583–84 (1978)).

125. *Id*.

126. *Id.*

127. *Id.* at 534. "The main objective of the § 1221(1) exclusion is to distinguish between business and investment, and to disallow capital gains treatment on the everyday profits of the business and commercial world. A taxpayer who sells a parcel of undeveloped land bought as an investment is clearly entitled to capital gains treatment on the gain realized by the sale." *Id.* at 534 n.2 (citing Stanley S. Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985, 990 (1956)).

128. Phelan v. Commissioner, 88 T.C.M. (CCH) 223, 224 (2004), 2004 T.C.M. (RIA) 2004-206 at 1249.

129. *Phelan*, 88 T.C.M. (CCH) at 225, 2004 T.C.M. (RIA) 2004-206 at 1250.

130. *Phelan*, 88 T.C.M. (CCH) at 225, 2004 T.C.M. (RIA) 2004-206 at 1251.

131. *Id.*

132. *Phelan*, 88 T.C.M. (CCH) at 227, 2004 T.C.M. (RIA) 2004-206 at 1255.

business purpose.[133] Additionally, the *Phelan* court noted that, just as in *Bramblett*, all corporate formalities were observed.[134]

These two cases illustrate that property owners can avoid attribution of development activities to the investor entity by taking several precautions. First, they must ensure that the investor entity and developer entity are separate legal entities that each follows all of the appropriate legal formalities related to the entity. Second, they must ensure that the developer entity, not the investor entity or individual owners, perform the development activities. Third, the purpose for dividing the investment function from the development function should have a non-tax purpose. Such purpose could be to protect the investor entity from potential liability that could arise from the development activity. If the property owners satisfy these several formalistic requirements, courts should recognize the two entities as separate and distinct and respect the transaction.

This discussion illustrates that a property owner must carefully structure a series of transactions to bifurcate the gain using the *Bramblett* structure. Of course, failure to adhere to the approved form could cause the bifurcation to fail and burden the property owners with excessive and inappropriate ordinary income. The need to create such a structure favors the wealthy, well-advised property owner and provides preferential treatment to such property owners. The structure also elevates form over substance. Even though policy supports bifurcation in this situation, the only justification for the complex structural form is the lack of any explicit statutory or regulatory approval of bifurcation.

C. State Tax Considerations

In some states, related-entity transactions are further complicated by state transfer taxes. For example, Florida imposes a documentary stamp tax equal to $0.70 on each $100 (0.7 percent) of consideration on all deeds, instruments, or writings whereby any land or other real property is transferred or otherwise conveyed.[135] Thus, if an investor entity was located in Florida, the transfer of property to a developer entity would be subject to Florida's documentary stamp tax. If the investor entity receives $3,000,000 of consideration for the property, it would have to pay a documentary stamp tax of $21,000 ($3,000,000 x 0.7%).

One potential way to avoid the documentary stamp tax is to use a disregarded limited liability company to hold title to the property and transfer the interests in the limited liability company to the developer entity rather

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133. *Phelan*, 88 T.C.M. (CCH) at 228, 2004 T.C.M. (RIA) 2004-206 at 1255.

134. *Id.*

135. FLA. STAT. § 201.02 (2011).

than title to the real estate itself. Because federal tax law generally disregards single-member limited liability companies,[136] an investor entity that is the sole member of a limited liability company will be treated as owning the limited liability company's property for federal tax purposes. Tax law also treats the transfer of all of the limited liability company interests to the developer entity as a transfer of the limited liability company's property to the developer entity. Since the Florida transfer tax applies only to transfers of real estate, it is inapplicable to the sale of the limited liability company interests, because, under Florida law, the limited liability company interests are not deemed to be a transfer of the underlying real estate. The first step the property owner must take is to get the undeveloped land into a limited liability company.

This type of planning is fairly simple if the investor entity creates a single-member limited liability company to acquire the property. If the investor entity holds the property directly, however, then it must form a limited liability company and transfer the property to the new limited liability company. Such measures create more costs and complexity. In either instance, once the undeveloped land is in the limited liability company, it will remain there for at least one year to ensure long-term capital gains. When the investor entity decides to develop the land, it will sell all of its membership interests in the single-member limited liability company to the developer corporation. This results in the limited liability company becoming a disregarded subsidiary of the developer entity. The developer entity can thereafter keep the land in the single-member limited liability company or dissolve the limited liability company. The extra limited liability company may help avoid some state transfer taxes, but states are aware of the strategy and may attempt to stop the avoidance.

Florida, for instance, deals with this matter by providing that documentary stamp taxes are owed when Florida real property is conveyed to a subsidiary entity for less than full consideration, and an ownership interest in the subsidiary entity is transferred for consideration within three years following the conveyance to the subsidiary entity.[137] Accordingly, if the selling entity contributes property to a subsidiary limited liability company for no consideration other than interests in the limited liability company, a documentary stamp tax will be imposed on the subsequent sale of the single-member limited liability company interests, unless more than three years have passed since the contribution.

Planning to avoid state transfer taxes in a *Bramblett* structure transaction illustrates the absurdity of the structure. The owners do state transfer tax planning because they realize that they are the economic owners of the property from initial acquisition to the ultimate disposition of the

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136. *See* Regs. §§ 301.7701-2, 301.7701-3.

137. FLA. STAT. § 201.02(b)(2).

property. They use the disregarded entity to transfer property and avoid the transfer tax until the related-party economic unit ultimately disposes of the property. Despite such a tacit acknowledgement that the structure is purely formal, state and federal tax law appears to respect it. Nonetheless, the use of the disregarded limited liability company may strip an arrangement of one of its significant non-tax purposes for transferring property to a developer entity. In particular, the disregarded limited liability company provides liability protection, so the investor entity may have no non-tax reason to transfer it to the developer entity. All of this illustrates that even though the *Bramblett* structure provides a good tax result by bifurcating gain, the structure is cumbersome and imposes additional costs on the ownership and disposition of property. Consequently, the law should make gain bifurcation easier to obtain.

IV. PROPOSED METHOD FOR BIFURCATING GAIN

The several potential pitfalls of the *Bramblett* structure taint the current bifurcation method. Although policy justifies bifurcating gain, the trouble required to bifurcate gain using a *Bramblett* structure suggests that better methods must exist. The discussion to this point establishes the virtues of gain bifurcation in a second-best setting. It also illustrates that the court-sanctioned *Bramblett* structure leaves much to be desired. The *Bramblett* structure is a rudimentary tool for bifurcating gain in a roughly accurate, but somewhat costly, manner. The formalistic nature of *Bramblett* structures requires property owners to carefully construct their transactions. Such efforts are costly and can trip up many property owners and deprive them of benefits others can obtain. As one can imagine, the more complex these transactions become, the more expensive it is for the property owner. Not only are such transactions costly to the property owner, they also create a number of costs for the government. For example, the IRS has contested numerous related-entity sales on a number of different grounds.[138] The time and money expended to take these cases from audit, through the Appeals Office, and to the courts are significant. Even if the IRS does not challenge a *Bramblett* structure transaction, the mass of documents it must examine in order to make the decision not to challenge the transaction can be enormous.

After *Bramblett*, many property owners have a choice respecting the tax treatment of property they hold for investment but wish to subdivide and sell. They can merely subdivide and sell the property and recognize all of the gain from the disposition as ordinary income. Alternatively, they can choose to structure the disposition as part of a *Bramblett* structure transaction and bifurcate the gain between that recognized from the property's appreciation in value prior to the related-party sale and that recognized from the property

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138. *See supra* Part III.B.

owner's development and sales efforts after the sale. Subject to cost restrictions, property owners can elect which treatment they prefer. The one limit to the election is the cost of doing a *Bramblett* structure. If the cost of the structure is higher than the potential tax savings, electing to use a *Bramblett* structure would make no sense. The cost therefore can prohibit some property owners from electing to bifurcate the gain and dissuade them from selling their property. Nonetheless, the opportunity to elect to do a *Bramblett* structure does exist, but it is not available to everyone. Lawmakers should rectify this problem by making the election explicit and available without the complicated structure. Several undesirable aspects of the current system support that change.

A. Reasons for Change

Bramblett structures lead to three undesirable consequences: (1) they create unnecessary complexity; (2) they decrease transparency; and (3) they cause economic distortions. First, the *Bramblett* structure increases the complexity of tax reporting because it requires the creation of multiple legal and tax entities with separate tax return filing obligations, and it requires the reporting of transfers from the investment entity to the developer entity. It also requires additional title transfers. A move to an elective regime would eliminate the need to form additional legal and tax entities, reduce the number of title transfers, and reduce the number of required return filings.

Second, the relationships and transactions between related entities required by the *Bramblett* structure may not always be obvious from the examination of any one entity's return. The return for the investor entity reports a disposition of the property. The return for the developer entity reports the disposition of property to purchasers. Neither return reports that the property is part of a *Bramblett* structure transaction. Several years may separate the investor entity's disposition from the developer entity's, so the IRS may not recognize that the two sales are related by examining both returns. This makes it difficult for the IRS to identify and examine the underlying transactions in which these entities engage, including transactions other than the related-party transactions. An explicit election, without the complexity of the *Bramblett* structure, would disclose the actions of the parties.

Third, related-party sales can also be burdensome to property owners. Restrictions upon capitalization structures available to different types of entities can result in convoluted capital structures, adding complexity and further decreasing transparency for IRS examinations. Transfers between related parties also can result in the imposition of state real estate transfer taxes or force property owners to employ even more convoluted structures to avoid such state real estate transfer taxes. Related-party sales may also be restricted or prohibited under loan agreements or as a

result of land use entitlement transfer restrictions related to the property, therefore requiring negotiation with lenders or governmental bodies to prevent loan defaults or loss of valuable entitlements. Such a restriction may prevent owners from doing *Bramblett* structures and deprive them of favorable tax treatment that is available to others. Creating *Bramblett* structures thus increases costs of transactions. Permitting property owners to elect to bifurcate income would eliminate those costs.

B. Check-the-box Bramblett Election

Because the law is currently elective but cumbersome, prudence suggests that lawmakers should consciously eliminate the election or make it simpler. Policy supports bifurcation, so a move to a simpler election is in order. Instead of using the complicated *Bramblett* structure to bifurcate gain, property owners should be able to make an election that accomplishes the same result. The election would make bifurcation widely available to qualifying property owners regardless of the value of their property. The election would allow the difference between the property owner's basis and the fair market value of the property at the time of the election to be taxed at long-term capital gains rates upon a subsequent taxable disposition of the property, but *only if* the property owner would have realized long-term capital gain in a taxable sale occurring at the time of the election. Qualification for capital gains treatment would be determined based upon the property owner's pre-election activities and intent.[139] All post-election gain from the sale of the property would be taxed in accordance with the property owner's post-election activities, so it would generally be ordinary.

The explicit election should be the only way that property owners can bifurcate gain, so property owners should no longer have the option of using *Bramblett* structures if the election becomes law. Those wishing to bifurcate gain would be required to follow the election procedure. The procedure should require the property owner to provide relevant information about the property. This would provide additional information to the IRS, increasing transparency for examinations, while still enabling taxpayers to achieve *Bramblett*-like results through a simplified process. To ensure that real estate developers qualify for gain bifurcation only if they use the elective regime, the law should treat gain recognized on a related-party sale as ordinary income, if the related-party transferee holds the property primarily

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139. The application of ordinary income recharacterization rules, such as section 1239, would also be taken into consideration. In the case of applying section 707(b)(2) to a partnership taxpayer, the "buyer" would be presumed to be an S corporation, not a tax partnership, only if the taxpayer could qualify as an S corporation if the taxpayer was a corporation, the shareholders of which constituted its indirect owners.

for sale to customers in the ordinary course of its business. The rule should adopt the definition of related-party in sections 267(b) and 707(b).[140] This rule would expand the application of the prescriptive rule in section 707(b)(2) to transactions between any investor and any related developer. The elective regime should also require the developer to obtain a qualified appraisal of the property at the time of the election,[141] which would further enhance the transparency of the transactions. Consequently, the new regime would grant gain bifurcation only if the owners made the election and obtained a qualified appraisal, and it would prohibit gain bifurcation with respect to any transactions between related parties.

The election would only have the effect of preserving the character of whatever capital gain existed, as such, on the effective date of the election (mirroring the *Bramblett* court's recognition of the investor entity's related-party sale as a "sale" in that case). The election would not prevent the IRS from challenging the property owner's positions on other issues, such as the property's value on the effective date of the election or the property owner's qualification for capital gain treatment based upon the property owner's activities and intent prior to and at the time of the election.[142]

Although the property owner could preserve the character of built-in capital gain that existed at the time of the election (assuming such treatment is supported by the facts), the property owner would not realize or recognize

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140. Section 267(b) provides that the following parties are related: (1) members of a family; (2) an individual and a corporation, if the individual owns more than 50 percent in value of the corporation's outstanding stock; (3) two corporations that are members of the same control group; (4) a grantor and fiduciary of a trust; (5) fiduciaries of trusts that have the same grantor; (6) a fiduciary and beneficiary of a trust; (7) a fiduciary of a trust and a beneficiary of another trust, if the trusts have the same grantor; (8) a fiduciary of a trust and a corporation, if the trust owns more than 50 percent in value of the corporation's outstanding stock; (9) a person and certain tax-exempt entities controlled by the person or the person's family (if the person is an individual); (10) a corporation and a partnership if the same persons own more than 50 percent in value of the corporation's outstanding stock and more than 50 percent of the capital or profits interests of the partnership; (11) two S corporations, if the same persons own more than 50 percent in value of the corporations' outstanding stock; (12) an S corporation and a C corporation, if the same persons own more than 50 percent in value of the corporations' outstanding stock; and (13) the executor and beneficiary of most estates. Under section 707(b)(1), a partnership is related to a person owning more than 50 percent of the capital or profits interests of the partnership, and two partnerships are related if the same persons own more than 50 percent of the capital or profits interest of the partnerships.

141. The qualified appraisal should be similar to that required for certain charitable contributions. *See* I.R.C. § 170(f)(11)(C); Reg. § 1.170A-13(c)(3).

142. This is a nonexclusive list of issues. For other issues, *see supra* Part III.B.

that pre-election gain until the ultimate taxable disposition of the property.[143] Upon a taxable disposition of the property, gain recognized up to the amount of the pre-election, built-in gain would be long-term capital gain.[144] The character of gain in excess of the pre-election, built-in gain would be determined in accordance with the post-election activities of the property owner. In most situations, that gain would be ordinary income because the property owner would subdivide it and expend efforts to sell the individual lots. Gain recognition at the time of the actual sale would substantially replicate the result obtained using an installment note in a *Bramblett* structure.[145] In a *Bramblett* structure, the investor entity recognizes gain as the developer entity sells units of property and makes payments on the note. The elective regime would therefore require the property owner to recognize both capital gain and ordinary income upon sale of the property. The following discussion considers several technical aspects of an elective regime.

C. *Time and Manner of Making Election*

An elective regime must establish the manner in which property owners will make the bifurcation election and the time period during which they must make the election. The rule should require the property owner to file an election with the IRS within a reasonable period of time after the desired effective date of the election.[146] Perhaps the election should

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143. Immediate gain recognition would be required to the extent it would be required if the taxpayer had engaged in an installment sale transaction with a related-party under section 453. So, for example, if section 453(g) would require immediate gain recognition if the taxpayer had engaged in a related-party installment sale of depreciable property, the taxpayer would recognize gain upon making the election rather than deferring such gain until the time of an actual disposition.

144. In a *Bramblett* structure, a section 453 installment obligation is used to defer the recognition of the long-term capital gain until the related-party buyer entity develops, subdivides, and sells the property. In some situations the section 453(e) rules require that the related-party seller recognize gain upon the related-party buyer's resales. Even when section 453(e) does not apply, *Bramblett* structure transactions are often structured such that the related-party seller recognizes gain as the related-party buyer completes resales.

145. One difference is the absence of interest on the related-party section 453 installment obligation often used as a financing tool in *Bramblett* structures. Under the elective regime, the seller of the property would not report taxable income on an installment obligation; however, there also would not be a buyer reporting an interest deduction or addition to tax basis for interest payments to a seller.

146. Taxpayers should be provided with a limited period of time after the desired effective date of the election to make the election, similar to the 75-day period during which a taxpayer is permitted to make a retroactive check-the-box election on Form 8832. This alternative, therefore, would provide the Service with

accompany the federal income tax return of the electing taxpayer for the tax year including the election's effective date. The election should also include the following:

(1) The property owner's identifying information;
(2) A description of the property;
(3) The property owner's holding period with respect to the property, which must exceed one year on the effective date of the election;
(4) A description of the property owner's use and holding intent with respect to the property prior to the effective date of the election;
(5) A statement of the property owner's basis in the property on the effective date of the election;
(6) A statement of the fair market value of the property on the effective date of the election substantiated by a qualified appraisal;[147] and
(7) A statement regarding the amount and character of gain that the property owner would recognize if the property owner sold the property at its fair market value on the effective date of the election, including sub-categorization of gain components (such as depreciation recapture) that may be treated differently for federal income tax purposes.

The information on the election generally would be information that property owners need to do a *Bramblett* structure transaction. For instance, property owners doing a *Bramblett* structure transaction must know the property's fair market value to create an arm's length transaction between the investor entity and the developer entity. They also must know the property's basis at that time to compute the investor entity's gain. Consequently, providing information on the election form would not require any extra effort on the part of the property owners. Property owners already are able to accomplish substantially similar consequences to this elective regime by

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the authority to prescribe the due date for the election, with guidance in legislative history that such due date would provide for a limited period of time after the desired effective date to make the election retroactively, in the manner to be provided in administrative guidance or forms and instructions.

147. The qualified appraisal should satisfy requirements similar to those in section 170(f)(11) and Reg. § 1.170A-13(c) for certain charitable deductions. *See supra* note 141 and accompanying text.

engaging in *Bramblett* structure transactions.[148] An explicit election is, however, preferable over the status quo.

Because the elective regime would be mandatory, property owners wishing to achieve *Bramblett*-like results would follow the election procedure. Consequently, under an elective regime, tax planning would become more transparent because the election form would disclose the change of purpose and the information needed to evaluate the tax treatment. The IRS would be better equipped to identify and review valuation and holding purpose issues associated with such transactions. At the same time, the transaction costs, complexities, and economic distortions required to achieve these results under current law using the *Bramblett* structure would be substantially reduced.

The alternatives to an elective regime are: (1) maintaining status quo; (2) moving beyond the elective regime to allow property owners to bifurcate gain upon the disposition of property; or (3) eliminating bifurcation. The elective regime solves many of the problems that arise with *Bramblett* structure transactions, and it requires disclosure. Bifurcation reporting, on the other hand, may not capture the same information that the election captures. Eliminating bifurcation causes the inequity discussed above.[149] Consequently, the elective regime appears to be the best of three alternatives.

1. Timing of Election

With multiple timing alternatives, rules establishing the proper timing of the election would be crucial. One alternative would require the property owner to make the election at the time it changes its holding intent. Another alternative would require the property owner to make the election at the time of the ultimate disposition of the developed property. An example illustrates how the timing of the election may affect the property owner's decision to bifurcate the gain. It also illustrates that the timing of the election may affect how closely the tax treatment under the elective regime mirrors the tax treatment of a *Bramblett* structure transaction.

Assume Squibb LLC holds land for investment with a basis of $300,000 and a fair market value of $500,000. In January of this year, Squibb LLC decides to develop the land. In developing the property, Squibb LLC incurs $100,000 in capital expenditures and converts the property from

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148. Consequently, an elective regime generally should not have a material effect upon tax revenues. As compared to a *Bramblett* structure related-party sale, the proposed election regime could result in a reduction in tax revenue from interest on deferred tax liabilities under section 453A, for those transactions to which section 453A would otherwise apply.

149. *See supra* Part III.B.3.

a capital asset to property held primarily for sale to its customers in the ordinary course of its trade or business. Despite the improvements, market conditions deteriorate, and Squibb LLC ends up selling the property for only $200,000. With no election, Squibb LLC would have a $400,000 adjusted basis in the property ($300,000 cost basis + $100,000 of improvements). On disposition of the property, Squibb LLC would recognize $200,000 of ordinary loss ($400,000 adjusted basis − $200,000 amount realized).

If Squibb LLC elected bifurcation, the outcome would be different. The election would give Squibb LLC a $200,000 long-term capital gain at the time of conversion ($500,000 deemed amount realized − the $300,000 adjusted basis). Squibb LLC's new post-election basis in the property would be $600,000 (the $500,000 from the deemed acquisition + the $100,000 improvements). Squibb LLC would recognize $400,000 of ordinary loss on the disposition of the property ($600,000 adjusted basis − $200,000 amount realized). The net effect would be the same $200,000 of loss Squibb LLC would recognize without the election, but the election would affect the timing and character of the gain.

If Squibb LLC can make the election at the time of disposition, it can consider which outcome would provide it with the best tax savings. If the members of Squibb LLC have ordinary income that they can offset with the $400,000 of ordinary losses, they may prefer to make the election. Otherwise, they may prefer to take the smaller loss and recognize no capital gains. The question is whether the law should allow such leeway. Property owners appear to have leeway under the current regime, but lawmakers could decide to be more restrictive with an elective regime. Under the current regime, if Squibb LLC had acquired the property for $500,000 from a related-investor entity, developed it for an additional $100,000, and then sold it for only $200,000, it could consider paying off the outstanding $500,000 note or doing a purchase price adjustment.[150] The purchase price adjustment would leave Squibb LLC with $200,000 of ordinary loss, and the investor LLC would recognize no gain. If the members contributed additional capital to Squibb LLC, so it could repay the note in full, Squibb LLC would recognize $400,000 of ordinary loss, and the investor entity would recognize $200,000 of long-term capital gain. Lawmakers should consider whether this component of the current regime should carry over to an elective regime.

The elective regime could require property owners to make the election within a certain number of days after development begins.[151] For

150. *See* I.R.C. § 108(e)(5) (allowing a purchase price reduction if the taxpayer is solvent).

151. Such an election is similar to section 83(b). Section 83(b) allows a taxpayer receiving property in exchange for services to elect to have the excess of the fair market value of the property received over the amount paid for the property

instance, in order for the election to be effective, the taxpayer could be required to make the election within 30 days (or some other number of days) after the date of conversion, or the law could require the property owner to make the election on the tax return for the year in which the conversion occurs. Requiring the election to be made at the time of conversion would help ensure that the property owners determine the fair market value of the property at that time and reduce the potential for manipulation later. In exchange for receiving capital gains treatment on the appreciation prior to development, property owners would bear the risk that their property would decrease in value and generate ordinary losses that have no gain to offset.

To further prevent the possibility of taxpayer manipulation, the election, once made, should be irrevocable. Property owners could, however, subsequently alter their holding purpose and the property could revert back to being a capital asset. By requiring property owners to make the election at the time they change their holding intent from investment to development, the law places the burden on them to identify at that time. Failure to make the election would result in loss of capital gains treatment. Requiring the election to be made at the time of conversion would remove flexibility that is present under the current regime, but it would also help eliminate opportunities to manipulate the actual economic result.

2. *Manner of Making the Election*

If the law requires property owners to make the election when they file their tax return for the year in which the conversion takes place, they would make the election by simply checking a box on the tax return, indicating the election has been made and providing the requisite information. Conversely, if the election is required to be made at the time of the conversion, they would make the election by filing a written statement with the IRS office with which they file their tax returns. Under the latter approach, a copy of the statement should be submitted with the tax return for the taxable year in which the conversion occurred.

D. *Effect of Election on Timing of Taxation of Capital Gain*

An elective regime provides greater opportunity to determine the appropriate time to tax the pre-election appreciation. One alternative would be to require pre-election gain inclusion in income in the year in which the property owners make the election. The property owners would be required to pay tax on the difference between the fair market value at time of conversion and their basis in the property at that time. At that point, the

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included in gross income in the year of receipt, despite the fact that the property remains subject to a substantial risk of forfeiture.

property owners would not have liquidated the investment, so they may not have cash readily available to pay the tax. Thus, perhaps the elective regime should allow property owners to defer gain recognition until they dispose of the property.

If the elective regime allowed gain deferral, a portion of any subsequent gain would be taxed as capital gain, and a portion would be taxed as ordinary income. This second alternative requires a method that would determine which portion of the gain is capital gain and which portion is ordinary income. This most taxpayer-friendly alternative is to allow the property owners capital gains treatment on all of the subsequent gain until the property owner has recognized gain in an amount equal to pre-election gain.

To illustrate the first alternative, assume Alpha Partnership owns land it purchased several years ago for $500,000 to hold for investment. It makes the election at a time when the land is worth $3,000,000, so its pre-election gain is $2,500,000, the amount of gain that will be taxed as capital gain upon the eventual sale or disposition. Assume further that Alpha Partnership subdivides the land into 30 single-family home lots, and sells each lot for a gain of $250,000. Under the first alternative, all gain from the sale of first ten lots would be taxed as capital gain, while all gain from the remaining 20 lots would be taxed as ordinary income.

Under the second alternative, gain resulting from sales after development would be bifurcated between capital gain and ordinary income. The amount taxed as capital gain would be equal to the gain recognized on the sale multiplied by a fraction, the numerator of which is equal to the pre-election gain and the denominator of which is equal to the fair market value of the entire property after development ("capital gain ratio"). Thus, Alpha Partnership's pre-election gain would be $2,500,000. Assume that after developing and subdividing the land for $2,000,000, the total fair market value of all of the lots is $7,500,000. Thus, the total gain from the sale of the lots would be $5,000,000 ($7,500,000 amount realized − $500,000 cost and $2,000,000 improvements). The amount of gain taxed as capital gain would be equal to the gain on the sale of the individual lot multiplied by $2,500,000 / $5,000,000, resulting in a capital gain ratio of 50 percent. If Alpha Partnership recognized $166,667 of gain on the sale of a single lot, $83,333 ($166,667 x 50%) would be taxed as capital gain and $83,333 ($166,667 x 50%) would be taxed as ordinary income. The application of this method may become more complicated when the development and sales occur in stages because the property owner cannot know the total gain recognized until it sells all of its lots. Consequently, the property owner cannot ascertain a fair market value of the entire tract of land to use as a denominator. Perhaps the elective regime could allow for reasonable estimates of such future income.

Lawmakers could solve these accounting issues by looking to other areas of tax law that already have mechanisms that account for this type of complexity. In place of a "capital gain ratio," the law could adopt a set percentage that will be taxed as capital gain until the entire pre-election gain is recognized. Section 1256, which applies to marked-to-market contracts, uses such an approach. Under that section the gain resulting from the holding of marked-to-market contracts is bifurcated 40 percent capital gain and 60 percent ordinary income. The determination of what percentages to use for the elective gain bifurcation regime would be somewhat arbitrary, with taxpayers likely desiring a greater percentage of each transaction taxed as capital gain (due to the benefits of deferring higher tax rates) and the government likely desiring a greater percentage of each transaction taxed as ordinary income. As long as the rule allows capital gains only to the extent of pre-election gain, imperfections would primarily relate to timing and not type of gain.

Partnership tax rules also have bifurcation concepts. For instance, section 704(c) requires tax partnerships to track pre-contribution gain and loss and properly allocate it to the contributing partners.[152] Similarly, tax partnerships must track and properly allocate reverse section 704(c) gain and loss when a new member joins a tax partnership.[153] The elective bifurcation regime could similarly develop a method for tracking pre-election gain and recognizing it over time. Because tax law employs such sophisticated bifurcation techniques in other areas of the law, it should be able to do so with respect to developed property.

V. CONCLUSION

The United States income tax system, like many tax systems, treats capital gains and ordinary income differently. That different tax treatment creates complexity and inequity. The inequity is exacerbated by the all-or-nothing treatment of gain recognized on the disposition of property. In some situations, bifurcating gain may be extremely difficult, or impossible, but this Article identifies one situation in which bifurcation is possible and desirable. The Article presents the policy basis for bifurcating gain and illustrates how real property developers and courts have found a way to circumvent the all-or-nothing approach in the statute to bifurcate gain. The Article illustrates that policy supports that outcome, but it recognizes that the current *Bramblett* structure mechanism is cumbersome, complex, and not transparent. Lawmakers should take steps to improve the taxation of gain recognized by real estate developers by allowing them to bifurcate gain without having to resort to the cumbersome *Bramblett* structure currently available. The

152. I.R.C. § 704(c)(1)(A); Reg. § 1.704-3.
153. Reg. § 1.704-3(a)(6).

elective regime would increase transparency and equity. The Article presents the framework for such a regime.