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DID YOU KNOW?

Did you know if you sell a capital asset to a related company you might accidentally trigger ordinary income?

You might be thinking "why would I ever do that in the first place?" You might do it to avoid having ordinary income on the sale of subdivided property. For example, let's say you have owned a parcel of property for a while that is in the path of development and you would like to subdivide it and sell the subdivided lots to homeowners or home builders. If you make enough improvements to the property and/or sell enough lots, you may be considered a "dealer" and the gain on the sales will be taxed as ordinary income not capital gain.

In order to harvest the existing gains in the undeveloped property at capital gains tax rates, you could form a development company, sell the property to it for a note, then the development company subdivides land and sells it to the homeowners and home builders and uses the proceeds to pay the note (a Bramblett transaction). The gain on sale to the development company would be taxed as long-term capital gain (assuming the land was held longer than one year) and the development company gain would be taxed at ordinary income tax rates.

There is a potential trap for the unwary in this strategy. If the development company that you form is taxed as a partnership, the gain on the sale to it would be taxable as ordinary income. This can be avoided by simply forming the development company as an S corporation. However, even if the development company is an S corporation, there is the potential for the gain on the sale to it to be treated as ordinary income if the property transferred is depreciable by the development company. If the property is bare land, it would clearly not be depreciable. No problem. Even if the land was improved it should not be depreciable to the development company if the development company holds it solely for improvement and sale to customers (and is not using it in another business such as rental in the interim) and it should not be an issue.

Bottom Line: Sale of property to a commonly owned development company prior to subdivision and resale can be a great strategy to minimize ordinary income but care must be taken to avoid traps for the unwary.

"The best way to appreciate your job is to imagine yourself without one." – Oscar Wilde.

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