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Capital Gains

Akin Gump's David Burton and Richard Page review *Fargo v. Commissioner*, the Tax Court's most recent opinion analyzing the capital asset treatment of real property, and offer practice tips on how to maximize the possibility that a renewable energy plant will be treated as a capital asset.

How Can a Renewable Energy Plant Be Sold For a Capital Gain as Opposed to an Ordinary Gain?

BY DAVID K. BURTON AND RICHARD T. PAGE

How can a renewable energy plant be sold for a capital gain as opposed to an ordinary gain? This is a question we are asked often.

Accordingly, in this article we provide an overview of basic capital asset concepts, review the Tax Court's most recent judicial opinion analyzing the capital asset treatment of real property and conclude by offering practice tips on how to maximize the possibility of your renewable energy plant being respected as a capital asset.

There are three preliminary matters to address. First, we note that capital gain is generated only to the extent an asset's sale price exceeds its original acquisition cost (gains attributable to basis reductions resulting from depreciation deductions must face a ''depreciation recapture'' regime that generally imposes taxation at either ordinary rates or at 25 percent,[1] depending on the type of property sold).

[1] I.R.C. Section 1(h)(1)(E). The 25 percent rate applies to ''unrecaptured section 1250 gain,'' in reference to I.R.C. Section 1250 real property. Id. Section 1250 real property doesn't include all types of real property and isn't applicable to energy projects. See I.R.C. Sections 1250(c), 1245(a)(3)(B)(i).

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Second, we note that U.S.-based renewable energy projects are typically not sold for more than their original acquisition cost, because U.S. federal investment tax credits are available to only the first owner of such a project[2] and U.S. federal production tax credits are available for only the first 10 years of a project's operation (irrespective of ownership).[3] Accordingly, renewable energy capital gains projects are generally projects that don't implicate the U.S. tax credit regime because either the project is located abroad or the project is first purchased by the seller after the relevant tax credit period.

And third, we note that any such project must have been operated by its seller for more than a year for the gain recognized to be taxed at a preferential long-term capital gain rate.[4]

Overview: What's at Stake?

For individual taxpayers (and correspondingly, for flow-through entities owned by the same) long-term capital gains have historically typically been taxed at a significantly lower rate than ordinary gains. We generally see renewable energy plants owned by flow-through entities, such as partnerships and limited liability companies (LLCs) treated as partnerships.

[2] I.R.C. Section 48(a)(5)(D)(iv) (there is a narrow exception for certain sale-leasebacks provided for in I.R.C. Section 50(d)(4)).

[3] I.R.C. Section 45(a)(2)(A)(ii).

[4] A capital asset is considered held long-term by a taxpayer if it is held by that taxpayer for more than one year. I.R.C. Section 1222(3)-(4).

Currently, the highest marginal ordinary income tax rate for individuals is 39.6 percent[5] and the highest marginal long-term capital gains tax rate for individuals is generally 20 percent.[6] This creates a strong incentive for individuals to treat the sale of assets as a sale of capital assets.

A C corporation that owns a renewable energy plant may also wish to treat the sale of such property as a capital gain but not due to a lower tax rate. Unlike individuals, C corporations aren't given preferential tax rates for recognizing long-term capital gains.[7] However, C corporations must still track capital gains and losses, as capital losses may only be applied against capital gains.[8] Moreover, depending on which requirements are met, a C corporation's capital losses can be carried back for at most three years or carried forward for at most 10 years,[9] meaning that C corporations often seek capital gain treatment solely to ensure that capital losses don't expire without providing any offset. In contrast, individual taxpayers can generally offset up to $3,000 a year of ordinary income with capital losses,[10] and excess losses can be carried forward indefinitely.

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Regardless of entity status, how can a business entity ensure that a renewable energy plant (which consists of both personal property and in many instances land rights) can be sold for a capital gain as opposed to an ordinary gain? The Tax Court's most recent case involving the issue of whether real estate assets are capital or ordinary in nature provides insights into this issue.

Tax Court's Analysis In 'Fargo v. Commissioner'

The U.S. Tax Court, on May 26, released *Fargo v. Commissioner* (2015 BL 165387, T. Ct., No. 28970, T.C. Memo. 2015-96, 5/26/15), a judicial opinion upholding a position of the U.S. Internal Revenue Service (IRS) that a partnership's real property was sold not as a capital asset but instead as ''property [held] primarily for sale to customers in the ordinary course of business.''[11]

Relevant Facts

The partners in the partnership were engaged in the realty business throughout the years under the IRS's review, relying on several business entities (including both C corporations and flow-through entities) to conduct their operations.[12] In 1991, the partnership in question took a leasehold interest in the property in dispute (the ''La Jolla Property'').[13] The partnership sought financing for the development of the La Jolla Property, and in 1997 decided to buy the property in fee simple (for $1.75 million) in hopes that the change from holding a leasehold interest to holding a fee simple interest would facilitate raising financing.[14]

Through 2001, when the La Jolla Property was ultimately sold, physical improvements were limited to general repairs such as replacing a roof, totaling $70,000.[15] One of the heating systems and an elevator were permitted to lapse into disrepair.[16] Nonetheless, the partnership incurred substantial development costs comprising architecture, engineering, appraisal, permit and licensing fees, to carry out development plans that weren't consummated.[17]

To put these costs in perspective in relation to the 1997 $1.75 million purchase price, from 1991 to 2001 the partnership capitalized $1.8 million of ''construction in progress'' costs for the property.[18] Costs were incurred in each of these years, indicating ongoing development efforts.[19] The year with the greatest incurred costs, totaling almost $1 million, was 2001, the final year of ownership.

The La Jolla Property didn't sit idle during this time. Part of the property was rented out to generate rental income and another part of the property was used by the partners to conduct their business operations, which included performing tasks such as accounting.[20]

In 2001 an unsolicited buyer, Centrex Homes, unrelated to the partnership, made an offer to buy the property.[21] The partnership had never made substantial efforts to sell the property and had never listed it for sale or marketed it to real estate developers.[22] Furthermore, the partnership had never sold realty before; although, the partners' other business entities had.[23] The partnership had, however, once reached out to a broker regarding selling the property, in 1993.[24] This broker was a related party (a company owned by one of the partners)[25]

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[5] I.R.C. Section 1(a)-(d).

[6] I.R.C. Section 1(h). There are exceptions where long-term capital gains of individuals can be taxed at higher rates. See id. (discussed at Borris Bittker et al., Fed. Income Tax'n of Individuals ¶ 31.02).

[7] See I.R.C. Section 1201(a).

[8] I.R.C. Section 1211(a) (''In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges.'').

[9] I.R.C. Section 1212(a).

[10] I.R.C. Section 1211(b) (noting that for a married individual filing a separate return the allowance is just $1,500).

[11] *Fargo*, T.C. Memo. 2015-96 at 12.

[12] Id. at 4.

[13] Id. at 6.

[14] Id.

[15] Id. at 15.

[16] Id.

[17] Id. at 7.

[18] Id. (describing the ''construction in progress'' costs as primarily comprising ''architecture, engineering, appraisal, permits, and licensing fees'').

[19] Id. at 15.

[20] Id. at 7.

[21] Id. at 8.

[22] Id.

[23] Id. at 16.

[24] Id. at 17.

[25] Id. at 8.

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and ultimately was paid a fee based on the 2001 sale price,[26] despite having ''never [undertaken] substantial efforts to sell the property.''[27]

The buyer ultimately agreed to pay $14.5 million plus a share of sales from selling townhouses, in exchange for both the property and the partnership's ''best efforts'' to consummate its development plans for the townhouses.[28] Subsequent development costs incurred by the partnership were reimbursed by Centrex Homes.[29]

The Law

The court immediately turned to the statutory definition of ''capital asset'' in Internal Revenue Code (I.R.C.) Section 1221, noting that a capital asset is ''property held by the taxpayer . . . but does not include . . . property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.''[30]

In its analysis, the court emphasized that the Supreme Court has held that it is appropriate to interpret the statutory definition of capital asset narrowly and to interpret statutory exceptions to the capital asset definition broadly.[31]

With respect to the requirement that a capital asset is an asset not held ''primarily'' for sale to customers, the Tax Court noted that ''primarily'' means ''of first importance'' or ''principally.''[32] These synonyms appear to be additional platitudes that lead to similar questions as to understanding the term ''primarily'' as applied to real world fact patterns.

The court then explained that it must look at the totality of the facts and circumstances in such cases.[33] Further, the court added that in the specific context of determining whether a property was held primarily for sale to customers in the ordinary course of business, various relevant factors have previously been identified by the court,[34] with no single factor or factors being dispositive in any case.[35]

Application of the Law to the Facts

In this case, the court decided to focus on the following eight factors to determine whether the La Jolla Property was held primarily for sale to customers in the ordinary course of business:

- the purpose for which the property was initially acquired;
- the purpose for which the property was subsequently held;
- the extent of improvements to the property;
- the frequency, number and continuity of sales;
- the extent and nature of the transactions involved;
- the extent of advertising, promotion or other active efforts used in soliciting buyers for the sale of the property;
- the listing of the property with brokers; and
- the purpose for which the property was held at the time of sale.

First, the Tax Court considered the purpose for which the La Jolla Property was initially acquired. The court noted that the partnership conceded that the purpose for which the property was initially acquired was for active development purposes; however, the court defanged the relevancy of this factor by stating that ''although a taxpayer's initial motivation in acquiring property is relevant, the ultimate question is the taxpayer's purpose at the time of sale.''[36] That is to say, this factor may carry relatively little weight.

Second, the court considered the purpose for which the La Jolla Property was subsequently held after the initial acquisition.[37] The court found unpersuasive the partnership's argument that it subsequently held onto the property simply as an investment as the local realty market recovered from a recession.[38] The court acknowledged that the partnership may have been waiting for the market to recover, but the court found that the partnership's ''primary purpose'' throughout this period continued to be fulfillment of its development plan, as was evidenced by both the partnership's attempts to gain financing for the development of townhouses to be sold and the partnership's incurrence of development expenses.[39] The court specifically noted the ''substantial'' expenditures incurred and the fact that the expenditures were incurred each year, indicat-

Keys to Capital Asset Treatment

Practical tips for ensuring capital asset treatment upon sale of an energy project:

- Establish the ongoing sale of energy (or lease of the project) as the primary purpose for the property.
- Ensure the project has a ''regarded'' owner with no history of selling energy projects.
- Don't incur substantial development or improvement expenses, or stop incurring them at least two years before a sale.
- Engage a broker to market the project.
- At sale, don't contract to share in the buyer's future profits.

[26] Id. at 17.
[27] Id. at 8.
[28] Id.
[29] Id. at 8-9.
[30] Id. at 12 (quoting I.R.C. Section 1221(a)(1)).
[31] Id. (citing *Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 134-35 (1960)).
[32] Id. (citing *Malat v. Riddell*, 383 U.S. 569, 572 (1966)).
[33] Id. at 12-13 (citing *Rockwell v. Commissioner*, 512 F.2d 882, 884 (9th Cir. 1975), aff'g T.C. Memo. 1972-133; *Redwood Empire Sav. & Loan Ass'n v. Commissioner*, 628 F.2d 516, 517 (9th Cir. 1980), aff'g 68 T.C. 960 (1977)).
[34] Id. at 13 (citing *Maddux Constr. Co. v. Commissioner*, 54 T.C. 1278, 1284 (1970)).
[35] Id. (citing *Redwood Empire Sav. & Loan Ass'n*, 628 F.2d 516, 517).
[36] Id. at 14 (citing *Maddux Constr. Co.*, 54 T.C. 1278, 1286).
[37] Id.
[38] Id. at 14-15.
[39] Id.

ing that development was ongoing.[40] This factor weighed in favor of the property being considered related to ordinary income.[41]

Third, the court considered the extent of improvements made to the La Jolla Property.[42] The court found that this factor favored a finding of the property being a capital asset, because the partnership never took substantial actions to improve the property beyond performing maintenance and completing general repairs, such as replacing a roof.[43]

Fourth, the court considered the frequency, number and continuity of sales by the partnership. The court noted that when a business entity has infrequent sales of real property for significant profits, capital asset recognition may be warranted.[44] Interestingly, the court observed that at least one of the partners involved developed and sold realty as a normal course of business, using other business entities, but that only the activity of the partnership at issue should be considered for this case.[45] Because the specific partnership in question had never before sold real property, this factor weighed in favor of a capital asset finding.[46]

The court focused on the fact that the partnership's development costs increased significantly in the years just prior to the sale, which the court deemed indicative of ordinary business operations as opposed to the property being "held simply as an investment."

Fifth, the court considered "[t]he [e]xtent and [n]ature of the [t]ransactions [i]nvolved," an apparent catch-all phrase.[47] Here, the court emphasized that the partnership would share in the profit of the buyer from the sale of the townhouses to be constructed, Centex Homes, in exchange for providing services, and that accordingly the partnership was "clearly interested in the development profit at the time of the sale."[48] This factor, the court believed, weighed in favor of the property not being considered a capital asset.[49]

Sixth, the court considered the extent of advertising, promotion or other active efforts used in soliciting buyers for the sale of the property. This factor weighed in favor of capital asset treatment, because the partnership "did not make extensive efforts to sell" the La Jolla Property, as the buyer had reached out unsolicited and the partnership "did not engage in marketing, selling, or advertising out of contracting with [its broker]."[50] Moreover, the broker didn't contact any buyers or perform substantial marketing services.[51]

Seventh, the court considered whether the La Jolla Property was listed with brokers.[52] The court concluded that because the property was listed with a broker—rather than marketed directly by the owner, which would suggest that marketing and sales are part of the ordinary course of business to the owner—the property was more akin to a capital asset than property held primarily for sale to customers in the ordinary course of business.[53] The fact that the broker was a related party was perhaps mitigated by the fact that the broker "never contacted any buyers or performed substantial marketing or advertising services."[54]

Eighth, the court considered the purpose for which the property was held at the time of sale. Here, the court focused on the fact that the partnership's development costs increased significantly in the years just prior to the sale, which the court deemed indicative of ordinary business operations as opposed to the property being "held simply as an investment."[55] Further, the court distinguished this case from *Maddux Constr. Co. v. Commissioner*, 54 T.C. 1278 (1970), where the taxpayer had ceased developing the property in question two years before its sale and the Tax Court found the property to be a capital asset.[56]

Finally, the Tax Court summarized the most important aspects of the eight-factor analysis. The two facts noted here were the following:

- the partnership "never abandoned" its initial motivation (with the initial motivation having been conceded)[57] to develop and sell the property to customers in the ordinary course of business; and
- the partnership "incurred significant development expenses."[58]

The court then added that although the partnership used the La Jolla Property to generate rental income and to provide its own office space, these purposes were never the "primary" purpose of why the property was held, and this case was thus distinguishable from *Cottle v. Commissioner*, 89 T.C. 467 (1987), where capital gain treatment was respected when "rental property [was] subsequently sold to liquidate the investment."[59]

Given the statutory standard and case law precedent, it appears that the Tax Court applied the proper factors to determine whether an asset is capital or ordinary in nature and properly applied those factors to the facts of the case.

[40] Id.
[41] Id. at 15.
[42] Id.
[43] Id.
[44] Id. at 15-16 (citing *Phelan v. Commissioner*, T.C. Memo. 2004-206 (2004)).
[45] Id. at 16.
[46] Id.
[47] Id.
[48] Id.
[49] Id.
[50] Id. at 17.
[51] Id.
[52] Id.
[53] Id.
[54] Id.
[55] Id. at 18.
[56] Id. (citing *Maddux Constr. Co.*, 54 T.C. 1278, 1287).
[57] Id. at 13.
[58] Id. at 18.
[59] Id. at 18-19 (citing *Cottle v. Commissioner*, 89 T.C. 467). The capital gain treatment in *Cottle v. Commissioner* was conferred via I.R.C. Section 1231. Id. at 19.

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Practice Tips for Owners Of Renewable Energy Projects

In light of the Tax Court's analysis in *Fargo v. Commissioner*[60] the tax-savvy owner of an energy project that is increasing in value (or has increased in value) should keep the following six considerations in mind, in rough chronological order, in order to ensure that capital asset treatment will be respected by the IRS and the courts:

■ In governing documents and throughout the operation of the business entity, establish the ongoing sale of energy (or lease of the project) as the primary purpose for the property, leaving the property's ultimate sale to reflect a mere liquidation of the investment.[61]

■ Ensure that the energy project is owned by a business entity that has no history of selling energy projects and is ''regarded'' for federal income tax purposes (this can prove useful even if the individuals involved own a portfolio of other business entities that have sold energy projects).[62]

■ Don't incur substantial development or improvement expenses that go beyond the scope of general maintenance and general repair.[63]

[60] Id.
[61] See id. at 19; see *Cottle*, 89 T.C. 467.
[62] See id. at 16. A partnership was the form of business entity used to own the property in this case.
[63] See id. at 15.

■ If such development or improvement expenses are incurred, stop incurring them at least two years before a potential sale.[64] In determining the purpose of the property, disproportionate weight will be given to the purpose of the property at the time of the sale.[65]

■ Engage a broker to market the project and don't actively manage this broker or otherwise directly attempt to solicit offers to buy the project through what might be considered marketing, advertising, promotion or selling.[66]

■ At the time of selling the energy project, don't contract to share in the buyer's subsequent profits in exchange for providing active business advice related to the energy project or the real property it is on.[67]

[64] See id. at 18.
[65] Id. at 14 (''[T]he ultimate question is the taxpayer's purpose at the time of sale.'').
[66] See id. at 17.
[67] See id. at 16. The profit sharing in this instance appears distinguishable from a purchase price with a ''contingent'' element based upon future performance of the asset or a re-sale of the asset by the buyer at an incremental gain. The distinguishing factor is that the profit sharing in this instance was conditioned upon the seller assisting the buyer with the development of the real estate project, while a more typical contingent element of a purchase price isn't conditioned upon the seller providing services to the buyer.