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Conversions to cooperative and condominium ownership of real estate

Introduction

Conversions of residential rental units to cooperative or condominium ownership have become increasingly common in recent years. Although they are often the result of acquisition of the property by professional "converters," many such transactions involve the conversion of property by long-time landlord/owners who see the conversion as a means of getting the highest possible sales price. Liquidations of such real estate investments have accelerated due to the combined effect of rent control/stabilization and increases in overhead, as well as the growing acceptance by tenants of ownership opportunities. A major consideration for these landlords in choosing to liquidate their investment through conversion is the potential tax cost and/or timing of realized gains. This article will set out the tax consequences of a typical conversion by a former landlord/owner.

Although there are differences between condominium and cooperative conversions, many of the tax problems faced by the prospective "converter" are similar. Often the choice is based not on the tax consequences of choosing co-op versus condominium, but rather the intricacies of local real estate, corporate and banking laws, as well as local custom and usage. In the New York area such considerations have led to a predominance of co-op conversions; in others, to condominium.

In a cooperative, the building is owned in its entirety by a cooperative corporation. Its shareholders are given proprietary leases for a particular apartment associated with their particular shares and joint use and obligations for common areas. In a condominium, the individual owns a particular space in a building together with an undivided interest in the building's common areas.

Typically, buildings undergoing conversion by long-time landlord/owners from rental to cooperative or condominium status are held in partnership or sole proprietorship form. Until recently, corporate ownership was the exception because loss, interest and depreciation "pass through deductions" were unavailable to owners under prior law. Now, under the S corporation rules, passive income restrictions have been eased and a major impediment to corporate ownership of rental realty has been removed.[1] As a result, an increasing number of rental buildings are being held in corporate names. The corporation generally terminates, dissolves or remains in business solely to wind up its affairs after the conversion.

Transfer of the building to a cooperative often involves payment in cash and notes of the co-op corporation and/or its stockholders, assumption of

[1] Secs. 1361 through 1379.

any underlying mortgage and payment of the balance with unsold shares. The holders of the unsold shares generally have the right to sell or rent unsold units and should sell to individuals within three years.[2] The holders usually plan a quick sale of unsold shares to outsiders. Transfer to condominium owners usually involves consecutive sales to individual apartment owners for cash and notes, and rental of remaining units pending sale. In this article, the focus will be on property that has been held by the taxpayer for rental purposes for a substantial period of time and was originally acquired without the intent to resell. In our hypothetical example neither the selling entity nor its members are dealers in real estate or involved in other retail real estate sales activity. No substantial improvements have been made to the property in contemplation of sale, nor have the partners or proprietors individually engaged in substantial retail sales of the premises. The selling entity is on the cash method of accounting. No less than 35% of the shares or units will be subscribed to at "insider" prices.

"Sale" vs. Sec. 351 transaction

The typical conversion often involves a sale to a corporation, either the eventual cooperative or a corporation, controlled at least in part by the seller, set up to dispose of condominium units. The seller gets cash, assumption of any preexisting mortgage, mortgage notes issued by the purchaser and, in the case of a corporate purchaser, the balance of the purchase price by notes of the individual purchasers and/or corporation together with all unsold shares. If unsold co-op shares are received, the seller then attempts to quickly sell all shares received in the transaction independently, either in bulk or, as is more likely, individually. Depending on market conditions, the premises represented by the unsold shares may be rented pending eventual sale.

Sale. The transfer of the property to a purchasing corporation may be characterized as either a sale or a tax-free incorporation under Sec. 351. If the transfer is a sale, the gain will be based on the total consideration received, including the fair market value of any unsold shares. Assuming the seller is not a dealer (see below), if at least 80% of the stock is owned by the sponsor or related parties, a sale would produce ordinary income treatment of all gains under Sec. 1239. If more shares are sold to unrelated parties, gains would be from the sale of Sec. 1231 assets and, assuming no offsetting Sec. 1231 losses, would be long-term capital gains. Therefore, it is extremely important that a corporation formed to facilitate disposal be more than 20% "unrelated" to the seller.

In a sale transaction, notes of the purchasing corporation are eligible for Sec. 453 installment reporting. The profit on the notes is reportable as payments are received, either as regular installment payments or on subsequent resale of the note at a discount, and has the same long-term capital gain characterization as the gain on the underlying sale. Only the notes of the purchasing corporation can be excluded from recognition as a payment in the year of sale.[3] Both the notes of the individual shareholders and the fair market value of the unsold shares would be taxed in the year of sale. In such a transaction, it is therefore suggested that any debt instruments received by the sellers be that of the purchasing corporation and not that of the individual future tenant/shareholders.

Section 504(B) of the New York Business Corporation Law prohibits issuing stock for debt. This statute is typical of nationwide restrictions on capitalization. Setting the purchase price of shares at a minimal dollar amount with the balance as contribution to capital seems to resolve the problem of converting shareholder debt to cooperative corporation debt. The substantial capital contribution required of purchasing tenants could be funded by a mix of cash and debt to the co-op secured by their shares. The purchase of the building could take place by having the purchasing corporation pay the seller an amount equal to the cash receipts from the subscribing tenant/shareholders, and paying the balance of the selling price with its own notes issued at fair market values. These amounts would be net of assumed mortgage or any "wrap" mortgage given. The purchasing corporation would in turn finance the purchase of cooperative stock or apartments by tenants by collecting cash down, and accepting purchasers' notes on terms similar, but not identical, to those provided by the sponsor/seller. The corporation would then essentially pass through the shareholder payments to the seller as payments on the installment obligations. There should be some real economic variation in the amount and terms of various notes to counter any arguments that the cooperative was substantially an agent or alter ego of the sponsor/seller.

A major advantage of sale treatment is that it gives the seller strong arguments against dealer status, ensuring capital gain treatment. The disadvantage is that any property received, other than the

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[2] Sec. 216. (Unless otherwise noted, all references to the Internal Revenue Code of 1954, as amended, are designated as "Sec.")

[3] Sec. 453(f)(3).

installment notes, is taxed immediately. The value of unsold shares received by the seller must be reported as income in the year of sale, with attendant cash flow problems. The greater the potential profit from selling to outsiders rather than insiders, the greater the cash flow problems in the year of receipt. However, the increase in the basis of the unsold shares caused by the immediate taxation will prevent these amounts from being taxed when the shares are finally sold to outsiders. A quick sale should produce little or no further gain on the shares. This avoids any problems with dealer status for the unsold shares.

Another way to avoid dealer problems for unsold shares is to sell the entire property to an at least 21% "unrelated" corporation for its fair market value before the sale to a co-op or individual apartment sales. The purchase price would be payable in cash and notes. With this technique, the seller could defer gain on the notes under the installment sale rules.[4] The "unrelated purchaser" clearly holds the property for resale as ordinary income inventory. However, the high basis obtained by purchase at fair market value, and the likelihood of no further or substantial appreciation prior to resale, makes the tax impact of dealer status relatively insignificant. However, there is some risk of an IRS recharacterization of the third-party transaction to pass the gain through directly to the seller under agency theory or substance versus form arguments.[5] Note also that if the purchasing entity is 50% or more controlled by the seller, the gain deferral will be lost when the property is resold within two years.[6]

Sec. 351. There is a possibility that a cooperative conversion would not be treated as a sale, but rather as a tax-free incorporation under Sec. 351. Cash and notes (other than securities) received in the sale would be immediately taxable as boot, generating an early tax cost despite Sec. 351. Any stock or securities in the corporation would be received tax free and have an adjusted tax basis equal to the basis of the property exchanged.[7] Gain would be postponed and recognized only on the later sale of the stock and/or collection of the securities. The substantial risk inherent in the outwardly appealing prospect of postponing tax under Sec. 351 is that gains on the later stock sale will be ordinary income. The underlying stock will have always been held primarily for sale, not investment.

Sec. 351 applies only if the transferors have control of the corporation, 80% or more stock ownership, after the transaction is complete.[8] The tax-free exchange treatment of Sec. 351 is not elective; it is imposed on those who have control. In *Labrot*,[9] the incorporators purchased corporate stock for cash, which was then used to "purchase" the property. The mere form of the transaction was disregarded. The acquisition was solely of stock and securities, so a Sec. 351 transaction was held to exist. Even if property other than stock and securities is received, it is conceivable that a Sec. 351 transaction would still exist. The property other than stock and securities could be boot, taxable on receipt. One would have the worst of both worlds: a deferral of the gain on the unsold shares, eventually taxed as ordinary income, plus immediate taxation of all property other than stock and securities of the purchasing corporation. Boot is likely to include all installment obligations other than those of the purchasing corporation itself, as well as any of its short-term notes. The use of corporate notes for the purchase of apartments, although meeting the requirements of Sec. 453 for installment reporting, may also meet the definition of "security" under Sec. 351.[10] Whether or not the installment obligations of the cooperative are securities, which must be considered in determining the control required by Sec. 351, is a question of fact in each case. Frequently, installment sales contracts have been held not to be securities, as that term is used in Sec. 351.[11] In *Brown*,[12] the Court considered as crucial the distinction between an instrument that implies "a continuing interest in the affairs of the corporation" and one that is intended "to effect a termination of such a continuing interest," a difficult distinction.[13] It is clear that whether or not the proposed transaction constitutes an exchange under Sec. 351, requiring taxation only of boot and deferral of all other gain, is a question of fact. Such a question was presented by *Winterburn*,[14] in which the taxpayer and two

[4] Sec. 453.

[5] See F&R Lazarus & Co., 308 US 252 (1939) (23 AFTR 778, 39-2 USTC ¶9793).

[6] Secs. 453(e) and 318(a).

[7] Sec. 358(a).

[8] Secs. 351(a) and 368(c).

[9] Sylvester W. Labrot, 57 F2d 413 (D.C. Cir. 1932) (10 AFTR 1558, 1932 CCH ¶9091).

[10] See Baker Commodities, Inc., 48 TC 374 (1967), aff'd, 415 F2d 519 (9th Cir. 1969) (24 AFTR2d 69-5516, 69-2 USTC ¶9589).

[11] See Jolana S. Bradshaw, 683 F2d 365 (Ct. Cl. 1982) (50 AFTR2d 82-5238, 82-2 USTC ¶9454); Warren H. Brown, 27 TC 27 (1956), acq. 1957-2 CB 4.

[12] *Brown*, id.

[13] See also V.L. Le Tulle, 308 US 415 (1940) (23 AFTR 789, 40-1 USTC ¶9150); Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (4th Ed. 1979), ¶3.15 at 3-63.

[14] William I. Winterburn, TC Memo 1968-187. Cf. Howard K. Borggaard, TC Memo 1979-458; Rev. Rul. 78-357, 1978-2 CB 227.

other promoters sold their real estate to a corporation, receiving in payment cash plus stock to the extent that the corporation was unable to make full cash payment. The Court regarded this transaction as a true sale. The Court held that, although a bona fide exchange of property for stock under Sec. 351 may sometimes be cast as a sale,[15] no exceptional circumstances justified treating the *Winterburn* sale as anything else.

The facts in the typical conversion are clear. The seller's intention is to sell all the apartments as expeditiously as possible in a business-like manner. The seller's members or proprietors receive unsold shares and installment obligations of the cooperative only to the extent that shares cannot be sold. The intent is that of a sale and not a continuing business relationship with the cooperative or the property. The transaction should not be characterized as a nonrecognition situation under Sec. 351. In fact, the IRS frequently takes the same position. Stock that the transferors have committed themselves to sell is not counted towards the 80% required for Sec. 351.[16]

The most recent examination of the issue of Sec. 351 versus installment sale was dealt with in *Bradshaw*,[17] in which undeveloped land was transferred to a corporation controlled by the transferor for a price equal to its fair market value, payable solely in notes. (No Sec. 1239 problem existed with respect to this nondepreciable asset.) The Court of Claims rejected the IRS contention that the notes constituted securities under Sec. 351, in contrast to *Aqualane Shores*,[18] *Burr Oakes Corp.*[19] and *Hertwig*.[20] The critical distinction made by the Court in *Bradshaw* was that "the promise of repayment was never in jeopardy, for the properties' self-liquidating potential guaranteed that repayment of the notes would not be subject to the fortunes of the business." Had the notes' payment been dependent on the corporation's profitability, a finding that they were securities would have been appropriate.[21] The fact that stock received in the transaction is later sold in other than a mandatory prearranged sale should have no effect on whether or not the transaction comes under Sec. 351.[22]

Generally, transactions of this type are sales rather than Sec. 351 transactions.[23] However, since questions of fact are at issue in problems of this type, there is always a possibility that the IRS will successfully characterize a transaction as one that is in fact governed by Sec. 351. This characterization would equal a finding that the sponsor and all other stock purchasers who have total holdings of at least 80% are part of the same control group. Such a finding is unlikely, but a possibility. If sale treatment prevails, as is most probable, the cooperative's notes will qualify for Sec. 453 installment reporting. The unsold shares received would be taxed immediately at fair market value, with a corresponding "step-up" in basis. Third-party notes and cash would also be taxable immediately at fair market value.

Dealer status vs. Sec. 1231

A major question presented by a proposed co-op or condominium conversion is whether or not the property is considered inventory (i.e., property held for sale to customers in the ordinary course of a trade or business) or a Sec. 1231 asset used in a trade or business. Gain from the sale of inventory is taxed as ordinary income. The Sec. 1231 asset sale, absent substantial losses from Sec. 1231 assets, would produce long-term capital gain.

The problem presented by the typical conversion is whether the sponsor/seller or its members are dealers holding the apartment units as inventory, or nondealers holding the assets as property used in a trade or business (rental). Whether or not the item is inventory depends on whether it is held primarily for sale to customers in the ordinary course of a trade or business. "Primarily" was held by the Supreme Court to mean "principally" and "of first importance."[24] If property is held primarily for sale to customers in the ordinary course of a taxpayer's business it cannot be either a capital asset or a Sec. 1231 asset. Ordinary income treatment is mandatory.

Problems similar to those presented in co-op or condominium conversions are often found in cases regarding subdivisions of real property that was not originally acquired for sale to customers. Many of those cases provide guidance as to the potential characterization of gains from conversion transac-

[15] See Aqualane Shores, Inc., 30 TC 519 (1958), aff'd, 269 F2d 116 (5th Cir. 1959) (4 AFTR2d 5346, 59-2 USTC ¶9632).

[16] See S. Klein on the Square, Inc., 188 F2d 127 (2d Cir. 1951) (40 AFTR 369, 51-1 USTC ¶66,010), *cert. denied* 342 US 824 (1954); *Baris*, note 30, *infra*.

[17] *Bradshaw*, note 11.

[18] *Aqualane Shores*, note 15.

[19] Burr Oakes Corp., 365 F2d 24 (7th Cir. 1966) (18 AFTR2d 5018, 66-2 USTC ¶9506), *cert. denied* 385 US 1007 (1967).

[20] Charles C. Hertwig (trustee of reorg. of Precision Recapping Equipment Co.), 398 F2d 452 (5th Cir. 1968) (22 AFTR2d 5249, 68-2 USTC ¶9495).

[21] Id.

[22] See Boyle Ice Co. of Delaware, 33 BTA 420 (1935).

[23] See Horace E. Oliver, 13 TCM 67 (1954); Penn-Dixie Steel Corp., 69 TC 837 (1978).

[24] See William Malat, 383 US 569 (1966) (17 AFTR2d 604, 66-1 USTC ¶9317).

tions, although they are most analogous to the individual sales of a condominium. Sec. 1237 provides a relief provision for certain subdivision activities that would otherwise be characterized as sales of inventory. However, the IRS has specifically ruled that Sec. 1237 does not apply to condominium conversions;[25] one can assume that the same rationale applies to cooperative conversions as well. In a recent letter ruling, the IRS stated that Rev. Rul. 80-216 related to situations ". . . where interests in realty are sold that do not include separate fee interests in the land that underlies the building. The Service, therefore, will not apply section 1237 to multi-story apartments."[26] Presumably, Sec. 1237 will apply when a condominium provides separate fee interests in the land. Sec. 1237 relief is unnecessary if the property is Sec. 1231 property rather than inventory.[27]

Determining whether real property is inventory has generated enormous amounts of litigation. Whether or not an item is inventory is a question of fact. The circumstances of each case control whether, at the time of sale, a given item of property is inventory. Inventory characterization questions are determined by examining the extent of the real estate selling, subdivision and development activities and other evidences of a real estate sales business; the purpose or manner of the property's acquisition; and the manner of sale and events leading up to it.

One major factor scrutinized in retail sales of real estate is the frequency and continuity of the taxpayer's real estate sales activity, both as to the current transaction and earlier transactions. Substantial subdivision and improvement of the realty sold, particularly if taxpayers show a history of such activity, tends to indicate dealer status. The extent of solicitation of sales and advertising is also a frequently considered factor, as is the selling activity of the taxpayer's agents, whose activities are attributed to the selling taxpayer.[28]

[25] Rev. Rul. 80-216, 1980-2 CB 239.

[26] IRS Letter Ruling (TAM) 8204031 (10/27/81).

[27] Regs. Sec. 1.1237-1(f).

[28] See, e.g., Fritz Thompson, 322 F2d 122 (5th Cir. 1963) (12 AFTR2d 5451, 63-1 USTC ¶9676); Est. of Clinton C. Millett, TC Memo 1964-159, dism'd, 8th Cir., 1965; Stanley, Inc., 295 F Supp 812 (S.D. Oh. 1969) (23 AFTR2d 69-715, 69-1 USTC ¶9225); Est. of M.A. Collins, 31 TC 238 (1958), dism'd, 5th Cir., 1959; Robert W. Pointer, 419 F2d 213 (9th Cir. 1969) (25 AFTR2d 70-312, 70-1 USTC ¶9118), aff'g 48 TC 906 (1967); Biedenharn Realty Co., Inc., 526 F2d 409 (5th Cir. 1976) (37 AFTR2d 76-679, 76-1 USTC ¶9194); William A. Scheuber, 371 F2d 996 (7th Cir. 1967) (19 AFTR2d 639, 67-1 USTC ¶9219); Hugh D. Camp, 226 F2d 931 (4th Cir. 1955) (48 AFTR 343, 55-2 USTC ¶9766); Industrial Life Insurance Co., 344 F Supp 870 (DC S.C. 1972) (29 AFTR2d 72-1016, 72-1 USTC ¶9381).

In the typical building conversion, there are usually many factors indicating that the property in question is not dealer property. A single isolated sales transaction is generally not enough to elevate a taxpayer to dealer status.[29] In such circumstances the author believes any gain recognized on the sale of the apartment building would be long-term capital gain under Sec. 1231. However, the question of dealer status is one of fact. The risk that an unfavorable determination would hold the property to be inventory and impose a tax on ordinary income is always present. This risk is exemplified by the one reported decision, *Baris*,[30] involving characterization of gain on a co-op conversion. The Tax Court determined that the taxpayer's profit was ordinary income.

In *Baris*, a real estate partnership was formed to acquire two contiguous apartment buildings. In 16 months, after attempts to make the buildings viable rental investments had failed, they were transferred to a co-op in a taxable (not within Sec. 351) transaction. In the conversion, 30% of the shares were purchased from the co-op by tenants. The partners attempted to obtain long-term capital gain on their share of the profits. All the partners were involved in some prior real estate association, and approximately one-third of the partnership interests were held by active real estate dealers. The Court determined that the sale of the buildings to the co-op was a sale to customers in the ordinary course of business, despite the fact that a substantial number of the co-op's shares were purchased by unaffiliated parties.

As the only reported decision in this area, *Baris* is somewhat disheartening. Nevertheless, it can be easily distinguished. The partnership's holding period was short, and the buildings were acquired for development. The sponsor/partners were heavily involved as real estate dealers in other activities. The very fact that there are so few reported decisions despite the substantial number of cooperative and condominium conversions in recent years would cause one to assume that most ordinary co-op and condominium conversions, usually a single sale to an intervening corporation by nondealer sponsors, qualify for Sec. 1231 treatment. A sale to a single corporate buyer is not ordinarily a business. While the sale could be recharacterized as one between the seller/sponsor and individual tenant purchasers, the IRS has not asserted such re-

[29] But see, e.g., Gerson A. Bush, TC Memo 1977-75, aff'd, 610 F2d 426 (6th Cir. 1979) (45 AFTR2d 80-356, 80-1 USTC ¶9118); Cummins Diesel Sales of Colorado Co., 263 F Supp 677 (DC Colo. 1967) (19 AFTR2d 969, 67-1 USTC ¶9265).

[30] Alexander L. Baris, TC Memo 1965-182, dism'd, 2d Cir., 1967.

characterization in prior litigation.[31] This view is borne out by the decisions regarding single sales in *Bush*,[32] *Cummins Diesel*[33] and *DeMars*.[34]

In the typical conversion, units were not acquired for sale to customers, but rather for rental. They have been held for many years and a decision is made to sell as a condominium or to a cooperative based on the economic problems of the rental market as compared to the opportunity for profit from a sale of the building. The individual members of a sponsor are not generally real estate dealers and are not actively involved in merchandising cooperative units, although a risk of agent activities being imputed to them does exist. It is unlikely, although possible, for the IRS to successfully argue that the promoter and/or its partners are dealers and that the building is inventory. Gain should be Sec. 1231 gain, eligible for the Sec. 1202 long-term capital gain deduction of 60%.

The risk of unsold shares or apartments

A very different situation arises as to later sales of the unsold stock received in the sale to the cooperative or other intervening corporation, or of apartments held for sale individually after a condominium conversion. From the very first moment these shares or units are obtained by the sponsors, there is an intention to resell them. Further, whether or not the units are rented, the intent of resale is always present, and resale activities will probably occur until the eventual sale of all shares or apartments. Any gains realized on the unsold shares or units as inventory would be ordinary income.

If a transaction in which shares are acquired from a purchasing corporation, co-op or otherwise, is in fact a sale, rather than a Sec. 351 transaction, ordinary income characterization of the gain on the stock does not present a substantial problem. Since the stock was taxed at its fair market value on receipt, the sponsor's basis in that stock was stepped up to that fair market value. Because this initial gain should be long-term capital gain, it would be appropriate to set the highest possible outsider value to it. On subsequent resale, the gain would be the relatively small amount represented by the difference between the fair market value determined for the stock on the date of conversion and the subsequent resale price to outsiders. The tax cost would be dramatically increased if the earlier transaction fell within Sec. 351. No gain would have been recognized on the receipt of the stock at the time of conversion, and the basis of the sponsor/shareholder would be a relatively low carryover from the initial building. On subsequent sale, characterization of the stock as inventory would produce ordinary income taxation of the enormous gain potential between the low basis and the high subsequent sale price.

While arguments are available for capital asset characterization under liquidation of investment theory and other similar rationales, the risk of ordinary income/inventory characterization for stock or individual units is significantly higher than the risk of such characterization for the building in its entirety.[35] Taxpayers should avoid any transaction that would result in the sponsor's obtaining the stock or units at a low original basis. Even allowing for some deferral, the substantial risks of ordinary income characterization on the eventual resale of the stock or individual units make it unwise (see the suggestions that follow).

These problems with regard to cooperative conversions were addressed by the House of Representatives in proposed Sec. 1257 as part of the proposed Tax Reform Act of 1984 (Section 801 of H.R. 4170). The provision was deleted in conference and was not enacted as part of the legislation finally adopted as the Deficit Reduction Act of 1984. The reasons set out by the House Ways and Means Committee for the proposed change included a need to provide owner/sellers with capital gains; at least to the extent of preconversion appreciation. Further, the Committee pointed out that there is an inappropriate incentive under current law to deflect conversion income to professional converters in an attempt to protect pre-conversion capital gain status. Without this legislation, the numerous uncertainties inherent in current law for owner conversions, and the necessity of careful planning if capital gains are to be protected still exist. This applies for both condominium and cooperative conversions.

Installment obligations

For those obligations that qualify for deferred reporting under Sec. 453, each payment will consist in part of gain on the original sale, return of the original capital investment and interest. It is assumed that such obligations will be self-liquidating. To the ex-

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[31] See Kaster, "Residential Co-ops and Condominiums Development Projects and Conversions Promoter's Tax Techniques," *NYU 38th Annual Institute on Federal Taxation* (1979), Vol. 1, at Chapter 13.

[32] *Bush*, note 29.

[33] *Cummins Diesel*, note 29.

[34] Richard B. DeMars, S.D. Ind., 1968 (27 AFTR2d 71-925, 71-1 USTC ¶9288).

[35] See Frieda E.J. Farley, 7 TC 198 (1946); Parkside, Inc., 571 F2d 1092 (9th Cir. 1977) (41 AFTR2d 78-451, 78-1 USTC ¶9147); *Biedenharn Realty*, note 28.

tent a payment represents gain on the original sale transaction, such gain is reported as capital gain. To the extent each payment represents interest on the obligation, it would be reportable as ordinary income. It is in the sponsor's best interest to adjust the transaction to provide for a lower interest rate in return for a higher purchase price. For each dollar of what would otherwise be interest converted to additional sales price, there would be a tax savings of 60%, representing the difference between the ordinary income rate on interest and the capital gains rate. When the sponsor and purchaser have almost reached agreement, the sponsor should compute the monthly self-liquidating payment that the proposed price and interest would give. He should then determine what purchase price per share or unit the same figure (or a slightly lower figure to make up for the loss of the interest deduction to tenants) would amortize at 9%, which is the minimum rate of interest provided by Sec. 483. The increase in sales price represented will be the amount of what would have been ordinary income that would effectively have been converted to capital gains by this procedure.

Suggestions

It would appear that the best balance of tax saving, deferral and security from adverse tax affects would be a conversion transaction involving a sale (not a Sec. 351 transaction) in which the sponsor receives cash, assumption of mortgage and notes of a single purchasing corporation. Because of the very substantial risk associated with dealings in the unsold shares or units, as well as Sec. 351 and inventory characterization problems, it is strongly suggested that no unsold shares or units be delivered to the sponsor in the sale transaction. Instead, a substantially unrelated party (at least 21%) should purchase the entire building for resale to eventual cooperative or individual condominium purchasers. This eliminates any risk of Sec. 351 characterization and limits the risk of dealer status for the sponsor. The purchasing corporation would buy the building at fair market value and in turn deliver the cash proceeds of sales and its own obligation to the seller. All obligations would be secured by the underlying stock or units with a due on sale clause for all stock or unit secured debt. If the corporation is less than 50% controlled by or related to the sponsor, the due on sale clause could be eliminated and additional deferral may be obtained.[36] The independent corporation would then sell or distribute the stock or units to individuals. Of course, since the stock or units will be inventory for the corporation, the sale should be made at the high outsider prices to decrease the ordinary income gain on the resale. However, there should be some gain for the purchaser to encourage the purchase and to counter any alter ego/agency assertions by the IRS. Such a course of conduct by the sponsor would provide the best possible opportunity to minimize tax, coupled with the least possible risk of tax problems or litigation.

The risks that a series of sales of condominium units will be characterized as dealer sales of apartments held as inventory is particularly high. Although liquidation of investment theory is an available argument for capital gain treatment, such sequential, numerous sales are to be avoided. This problem is not present in a single sale of the building to a cooperative corporation except to the extent unsold shares are taken "in payment" and later sold to individual apartment purchasers. To the maximum extent possible, the sale of the building should be to a single purchaser in a single transaction. For a condominium conversion, this requires the formation of an intervening corporate seller who is more than 20% unrelated;[37] for a cooperative conversion, it requires the avoidance of unsold shares. ■

[36] Sec. 453(e).

[37] Sec. 1239.