TAX ADVANTAGED CONDOMINIUM CONVERSIONS ©

Written and Presented By

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I. FACT PATTERN

- Owner (Taxpayer) owns a 36-unit apartment complex each with 2 bedrooms and a bathroom in a wealthy suburban town.

- Each unit can be sold as a condominium for about $300,000.

- Total revenue from sale $10,800,000.

- Taxpayer's other net rental income is $350,000 for year.

- Assume no fix-up expenses and no sales fees.

- Taxpayer's basis in property is zero having built the complex 40 years ago and is fully depreciated.

- Taxpayer has been offered $7,000,000 for the complex "as is" and with all faults.

- Federal ordinary income tax rate
(using 2004 inflated adjusted rates) are as follows:

2004 FEDERAL INDIVIDUAL INCOME TAX RATES

Unmarried Individuals

Taxable Income				
Over	**But not Over**	**Tax +**	**% on Excess**	**Of the Amount Over**
$ 0	$ 7,150	$ 0.00	10%	$ 0
7,150	29,050	715.00	15%	7,150
29,050	70,350	4,000.00	25%	29,050
70,350	146,750	14,325.00	28%	70,350
146,750	319,100	35,717.00	33%	146,750
319,100	…	92,592.50	35%	319,100

Joint Returns and Surviving Spouses

Taxable Income				
Over	**But not Over**	**Tax +**	**% on Excess**	**Of the Amount Over**
$ 0	$ 14,300	$ 0.00	10%	$ 0
14,300	58,100	1,430.00	15%	14,300
58,100	117,250	8,000.00	25%	58,100
117,250	178,650	22,787.50	28%	117,250
178,650	319,100	39,979.50	33%	178,650
319,100	…	86,328.00	35%	319,100

Federal long term capital gain tax rate is: 15% [25% on depreciation Recapture, § 1(h)(6)(A)]

Massachusetts capital gain tax rate is: 5.3%

Massachusetts ordinary income tax rate is: 5.3%

- Should owner sell for $7,000,000 or do the conversion and sell as condominiums?

II. OBJECTIVE

Maximize the return to taxpayer by converting the apartments to condominiums and selling units.

III. PROBLEM

Sale of units will be taxed as ordinary income as though taxpayer sold inventory.
Federal income tax rate is: 35%
Federal capital gain rate is: 15%

IV. SOLUTIONS:

Convert income to capital gain – but how? Do it yourself or use a "facilitator"!

V. WHAT IS THE TAX DIFFERENCE

Computation of Tax:

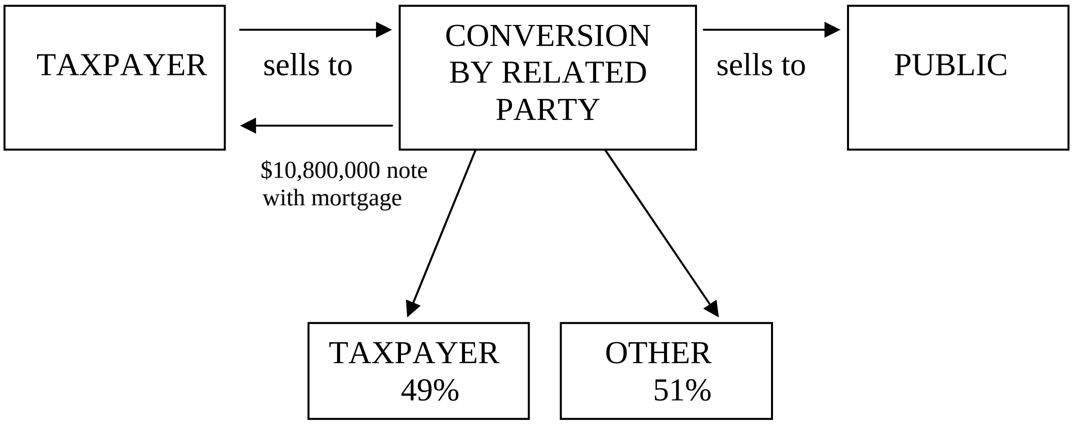
	Ordinary Income	**Capital Gain**	**Difference**
Sale Proceeds	$10,800,000	$10,800,000	$ 0
Other Income	$ 350,000	$ 350,000	$ 0
Total Income	$11,150,000	$11,150,000	$ 0
Federal Tax	$ 3,881,710	$ 1,721,710	$ 2,160,000
State Tax	$ 590,950	$ 590,950	$ 0
Total Taxes	$ 4,472,660	$ 2,312,660	$ 2,160,000
Net Cash to Taxpayer after Income taxes	$ 6,677,340	$ 8,837,340	$ 2,160,000

Reconciliation:

	Ordinary Income	**Capital Gain**	**Difference**
Sale Proceeds	$10,800,000	$10,800,000	$10,800,000
Ordinary Income Tax Rate	35%	15%	20%
Federal Tax	$ 3,780,000	$ 1,620,000	$ 2,160,000
Net to Taxpayer after Federal taxes	$ 7,020,000	$ 9,180,000	$ 2,160,000

VI. DIAGRAM – HOW TO GET CAPITAL GAIN TREATMENT

Sell condominiums to "related party" before the conversion the "related party" does the conversion and sells the units to the public.



VII. RESULTS

1. No gain to "related party" when units are sold to public because it purchased the property for $10,800,000 and sold the condominium units for $10,800,000.

2. The gain to taxpayer is all long-term capital gain.

3. The federal income tax savings is $2,160,000 or stated otherwise. This step will put an additional $2,160,000 into the taxpayer's pocket.

4. The property would need to be sold for $8,258,000, for the taxpayer to receive $7,020,000 after federal income taxes ($8,258,000 – 15% = $7,020,000).

5. If the property is converted to condominiums and the units by the taxpayer are sold, then the taxpayer needs $10,800,000 to have the same $7,020,000 after federal income taxes ($10,800,000 less 35% = $7,020,000).

VIII TAX DISCUSSION - CAVEAT

Taxpayer cannot own more than the 50% of the related party (See IRC § 1239 and 453(g).

IRC § 1239

GAIN FROM SALE OF DEPRECIABLE PROEPRTY BETWEEN CERTAIN RELATED TAXPAYERS.

(a) TREATMENT OF GAIN AS ORDINARY INCOME – In the case of a sale or exchange of property, directly or indirectly, between related persons, any gain recognized to the transferor shall be treated as ordinary income if such property is, in the hands of the transferee, of a character which is subject to the allowance for depreciation provided in section 167.

(b) RELATED PERSONS – For purposes of subsection (a), the term "related persons" means –

(1) a person and all entities which are controlled entities with respect to such person…

(c) CONTROLLED ENTITY DEFINED –

(1) GENERAL RULE – for purposes of this section, the term "controlled entity" means, with respect to any person –

(A) a corporation more than 50 percent of the value of the outstanding stock of which is owned (directly or indirectly) by or for such person,

(B) a partnership more than 50 percent of the capital interest or profits interest in which is owned (directly or indirectly) by or for such person, and

(C) any entity which is a related person to such person under paragraph (3), (10), (11), or (12) of section 267(b).

(2) CONSTRUCTIVE OWNERSHIP – for purposes of this section, ownership shall be determined in accordance with the rules similar to the rules under section 267(c) (other than paragraph (3) thereof).

IRC § 267(c)

(c) CONSTRUCTIVE OWNERSHIPO OF STOCK – For purposes of determining, in applying subsection (b), ownership of stock –

(1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust, shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

(3) An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(5) Stock constructively owned by a person by reason of the application of paragraph (1) shall be for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person but stock constructively owned by an individual by reason of the application of paragraph (2) only.

IRC § 453(a)

(a) SALE OF DEPRECIABLE PROPERTY TO CONTROLLED ENTITY –

(1) GENERAL RULE – Except as otherwise provided in this section, income from an installment sale shall be taken into account for purposes of this title under the installment method.

(2) IN GENERAL – In the case of an installment sale of depreciable property between related persons –

(A) subsection (a) shall not apply,

(B) for purposes of this title –

(i) except as provided in clause (ii), all payments to be received shall be treated as received in the year of the disposition, and

(ii) in the case of any payments which are contingent as to the amount but with respect to which the fair market value may not be reasonably ascertained, the basis shall be recovered ratably, and

(C) the purchaser may not increase the basis of any property acquired in such sale by any amount before the time such an amount is includible in the gross income of the seller.

(3) EXCEPTION WHERE TAX AVOIDANCE NOT A PRINCIPAL PURPOSE – Paragraph (1) shall not apply if it is established to the satisfaction of the Secretary that the disposition did not have as one of its principal purposes the avoidance of federal income tax.

(4) RELATED PERSONS – For purposes of this subsection, the term “related persons” has the meaning given to such term by section 1239(b), except that such term shall include 2 or more partnerships having a relationship to each other described in section 707(b)(1)(B).

IX. HOW TO USE A CONDOMINIUM CONVERSION FACILITATOR (sm)

1. Take the net cash proceeds based on a sale of the individual units ($10,800,000).

2. Subtract out the federal income taxes at 35% ($3,780,000).

3. The difference ($7,020,000) is then grossed-up by 85% to determine the initial sale price to the related party ($7,020,000 ÷ $8,258,000).

4. This will get the taxpayer the same cash as though the taxpayer did the conversion.

5. 50% of the excess of the sale proceeds over the $8,258,000 will be paid as a contingent purchase price to the taxpayer at capital gain rates ($10,800,000 - $8,258,000 x 50% = $1,271,000).

6. The other 50% is paid to the condominium converter facilitator for services.

7. The taxpayer receives an additional $1,080,350 ($1,271,000 x 85%) after federal income taxes and does no work!

8. The cost of the condo documents and legal services are paid by the facilitator.