Real Estate Investor or Dealer? Converting Ordinary Income into Capital Gain

As the real estate market continues to improve and values increase, it may be time for real estate owners to revisit a tax planning strategy. Real estate developers should consider locking in capital gains treatment by selling real estate they hold for investment to a related development corporation. The gain on the sale to a development corporation will be taxed as capital gain and the subsequent gain on the sale of the developed real estate as ordinary income. The development corporation handles all post-sale development of the real estate, including grading, installing roads, sewers and other utilities, and construction of homes.

The character of gain resulting from the sale of real estate depends upon the classification of the seller as an investor or dealer. For investors, the gain is capital and for dealers, the gain is ordinary income. Investors generally purchase and hold real estate for its appreciation over a period of time. A dealer sells real estate to customers in the ordinary course of its trade or business. Dealers typically include real estate developers, subdividers, and home builders. The primary factor in characterizing a taxpayer as a dealer is whether the real estate is sold in the "ordinary course of a trade or business." The term "capital asset" expressly excludes property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business (inventory). The intent of the seller and the purpose the seller purchased the property are the determining factors. Other requirements, including ones that the real estate be sold to customers and the property be "held primarily for sale," are relevant, but not necessarily dispositive in characterizing gain.

The courts have developed a framework for determining whether a real estate sale should be considered a sale of a capital asset or inventory. The framework focuses on answering the following three principle questions:

1. Is the taxpayer engaged in a trade or business, and if so, what business?
2. Is the taxpayer holding the property primarily for sale in that business?
3. Are the sales contemplated by the taxpayer "ordinary" in the course of that business?

In attempting to define whether a taxpayer is engaged in a trade or business and what type of trade or business, courts consider the following factors to be relevant, with no single factor or combination of factors controlling:

1. The Nature and Purpose of the Acquisition of the Property and the Duration of Ownership.

   The nature and purpose of the acquisition is reflected in the taxpayer's motivation in holding the property prior to the sale. The course of conduct over a period of time, and not a specific moment in time, is relevant. A taxpayer should contemporaneously document its motivation for the real estate acquisition and any subsequent change of purpose.

   Not all courts have identified the length of the holding period as a factor. However, courts that have considered it have generally indicated that holding an asset for a long time evidences an investment purpose. The distinction between capital and ordinary gains lay between profits arising from the everyday operating of a business on the one hand and the realization of appreciation in value over a substantial period of time on the other. The lengthy retention of property is indicative of an intention to hold such property for investment purposes.

2. The Extent and Nature of Efforts to Sell the Property.

   Solicitation and marketing efforts may indicate that the purpose of holding property is not for investment. The relevant question is whether any solicitation and marketing efforts are undertaken, rather than who performed such activities (e.g. the taxpayer, real estate agent, or real estate broker). Solicitation and advertising efforts suggest that the taxpayer is looking for customers and is no longer willing to hold the real estate for future appreciation.

3. The Number, Extent, Continuity and Substantiality of Sales.

   Although there is no bright line test with respect to frequency, number or continuity of sales, court decisions provide some guidance. In one case, 244 lot sales in a single year and average lot sales of 15 per year during a 5-year period constituted a trade or business. In another, the sale of 63 properties over more than 20 years was not a trade or business. The substantiality of income derived from sales, as well as its proportion to the taxpayer's total income, is a factor in deciding whether or not a taxpayer is engaged in a real estate trade or business.

4. The Extent of Subdividing, Developing and Advertising to Increase Sales.

   Taxpayers with an investment strategy are usually waiting for the value of their property to appreciate on its own over a period of time; they do not seek to increase the property's value through improvements. By contrast, extensive development and improvement activities more likely indicate that the owner is selling property in its real estate business. Subdividing property into residential lots, grading and surfacing the streets, and installing drainage facilities and utilities indicate dealer status. Steps to enhance the marketability of the property later sold, where those activities are "purely legal" (subdividing) does not change the character of the property from investment to dealer.

One issue that arises is whether a taxpayer who is a real estate dealer can hold real estate for investment, notwithstanding that the taxpayer is a dealer with respect to certain real estate holdings. Courts decisions have firmly established that a dealer may also hold real estate for investment. The fact that a taxpayer is a real estate dealer does not automatically taint its other real estate holdings. The critical question is the taxpayer's intent at the time of the sale. Actions prior to the sale are indicative of a taxpayer's intent at the time of the sale, but not necessarily conclusive. The taxpayer's purpose and intent may change over time. As discussed above, certain actions the taxpayer takes such as advertising, physical improvements to the property and sales of individual lots tend to indicate that the real estate is held primarily for sale. Real estate held for a long period of time that appreciates in value and minimal improvements are made indicates that the real estate is held for investment.

Because of this, a taxpayer who is a dealer should hold its investment properties in separate entities apart from its dealer properties. The formation documents for the entity should state that it is being formed for real estate investment purposes. The purpose that a specific real estate interest was acquired should be memorialized in the company's records. The name of the entity should avoid the word "developer" or "development", but may include "investments" or "investor". The taxpayer's real estate holdings should be properly identified on its books and records, and tax returns (e.g., inventory, investment property, rental property).

There are significant tax and non tax complexities in structuring this capital gains tax planning strategy. However, certain formal steps can be taken to support an investment purpose and intent, and preserve capital gain treatment.

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www.fletchertilton.com

FletcherTilton PC
Attorneys at law

THE GUARANTY BUILDING
370 Main Street, 12th Floor
Worcester, MA 01608
TEL 508.459.8000 FAX 508.459.8300

THE MEADOWS
161 Worcester Road, Suite 501
Framingham, MA 01701
TEL 508.532.3500 FAX 508.532.3100

CAPE COD
1579 Falmouth Road, Suite 3
Centerville, MA 02632
TEL 508.815.2500 FAX 508.459.8300

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