Real Estate Dealers: Capital Gain or Ordinary Income?

By David M. Fogel, EA, CPA

With such a wide disparity between the maximum capital gains tax rate (15%) and the tax rate on ordinary income (35%), your clients who are real estate dealers or developers may be motivated to claim that their sales of real estate should be taxed as capital gains. What are the rules for taxing real estate dealers and developers on their sales of real estate? Do all sales result in ordinary income, or can some result in capital gain? This article will explain the rules.

Who is a real estate dealer, and who is an investor?

A real estate **dealer** is someone who sells real estate to customers in the ordinary course of his or her business. This usually includes land developers, subdividers and home builders. A real estate dealer who sells a parcel of real estate in the ordinary course of his or her business has essentially sold inventory, resulting in ordinary income or loss.

In contrast, a real estate **investor** is someone who purchases and holds real estate for its appreciation over a period of time. An investor who sells a parcel of real estate realizes capital gain or loss on the sale.

Also in contrast is someone who purchases and holds real estate for use in a trade or business, such as rental property or a factory building. Someone who sells real estate that was used in a trade or business generally realizes capital gain or ordinary loss[1], although there are some exceptions[2].

Can a real estate dealer hold a piece of real estate as an investment?

It is well established that a real estate dealer may, under appropriate circumstances, hold a piece of real estate as an investment[3]. However, the evidence must show that when the real estate dealer sold that piece of real estate, he or she was wearing the hat of an investor rather than that of a dealer[4].

To determine whether a real estate dealer may claim capital gains treatment for the sale of a parcel of real estate, it must be determined whether, at the time of sale, the property was held **primarily** for sale to customers in the ordinary course of the real estate business[5]. This determination is a question of fact[6]. "Primarily" means "of first importance" or "principally."[7] Ordinary income will result if the following three requirements are met:

(1) The taxpayer is engaged in a trade or business;
(2) The taxpayer is holding the property primarily for sale in that business; and
(3) The sale of the property is "ordinary" for that business[8].

What factors are considered in deciding whether property was held primarily for sale?

The courts have developed nine factors to be considered in deciding whether a taxpayer was holding property primarily for sale or for some other purpose:

(1) The purpose for which the property was initially acquired,
(2) The purpose for which the property was subsequently held,
(3) The extent of improvements that the taxpayer made to the property,
(4) The frequency, number and continuity of sales,
(5) The extent and substantiality of the disposition of the property,
(6) The extent and the nature of the taxpayer's business,
(7) The extent of advertising, promotion, or other active efforts used in soliciting buyers for the sale of the property,
(8) The listing of the property for sale through a broker, and
(9) The purpose for which the property was held at the time of disposition[9].

No single factor or combination of factors is controlling[10]. However, the court cases demonstrate that the most important factors are the frequency, number, continuity and substantiality of sales (factors 4 and 5), the taxpayer's intent in acquiring and holding the property (factors 1, 2 and 9), and the extent of the taxpayer's improvements to the property (factor 3), in that order.

A taxpayer's testimony as to his or her purpose for holding the property, although not determinative, must be considered[11]. However, objective factors carry more weight than a taxpayer's subjective statement of intent[12].

To what extent may someone sell real estate before the sales are considered "frequent, continuous and substantial?"

This is a difficult question to answer, because there are no hard-and-fast rules. Some court cases have viewed as little as one sale a year to be frequent, continuous and substantial[13]. It depends upon the facts. However, as a general principle, if there are sales of properties that extend over a period of several years, and the sales generate profits that comprise a substantial portion

of the taxpayer's income, then the sales will usually be considered to be frequent, continuous and substantial.

How do you determine whether your client, who is engaged in a real estate business, is holding a particular parcel of real estate primarily for sale or for some other purpose?

Determining a client's intent in this area is not an easy task. Again, it is entirely a factual question. Certain activities, such as advertising, subdividing and selling individual lots, and making improvements are consistent with an intention to hold the property primarily for sale, although this isn't always true. Someone who simply holds property for several years in order to reap the benefits of appreciation, and who conducts minimal development of the property is probably holding the property for investment purposes. Property that is rented to tenants or used in a trade or business for several years is probably not held for sale.

To obtain capital gains treatment, someone engaged in the real estate business must be able to show that he or she was not holding the property primarily for sale to customers at the time of the sale. A client who holds properties primarily for sale as well as properties for investment must hold the "investment" properties separate and apart from the "sale" properties.

One of the objective factors that the courts have looked at in determining whether property was held separate and apart from property held for sale is how the property was reflected on the taxpayer's books and records (*e.g.* as inventory, investment property, or rental property)[14].

In addition, if the intent to hold the property at the time of sale (*e.g.*, investment) is different than the taxpayer's original intent for acquiring the property (*e.g.*, sale), corporate minutes, notes of partnership meetings, or other contemporaneous documents should reflect when and why the taxpayer changed his or her intent. This can be critical. There are numerous court cases involving taxpayers who originally acquired properties with the intent of holding them for sale, and changed their intent so that at the time of sale, the property was held for some other purpose[15]. The courts held that they weren't holding the properties primarily for sale at the time of sale. A change in intent for holding the property should be contemporaneously documented.

To what extent may a real estate developer conduct development work on a particular parcel of real estate before the property will be considered "held for sale?"

A real estate developer can usually conduct "legal" development work such as having engineering and topographic surveys performed, pursuing zoning changes, and having preliminary and tentative maps drawn and approved by local authorities without "crossing the line" for holding the property from "investment" to "sale." However, "physical" development work, such as subdividing, grading, and installing roads, sewers and other utilities usually increases the risk that future sales of the property will result in ordinary income[16].

The extent of development work is not always important in the analysis if there are other factors that will demonstrate the taxpayer's intent. For example, in a few court cases involving real estate developers, taxpayers conducted either "legal" or no development work and the court still found that they held the property primarily for sale[17]. In these cases, the developers clearly had the intention of subdividing and developing the property for residential, commercial or industrial purposes, and that intention had not changed as of the date that the property was sold. The extent of development work was not a controlling factor.

Conclusion

Your clients who are real estate dealers or developers who primarily hold properties for sale to land developers or builders may hold one or more properties for investment or other non-sale purposes, the sales of which could result in more favorable capital gains treatment. However, your clients must be able to prove that at the time of sale, the "investment" or "non-sale" properties were held differently from the "sale" properties. Many factors are considered in making this determination. You may be able to assist your real estate clients preserve their entitlement to capital gains for such sales by ensuring that they have satisfied the rules outlined above and possess documentation to support their "investment" or "non-sale" holding intent.

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1 See Code section 1231(a).

2 See Code sections 1245 and 1250, which treat the gain as either ordinary income or subject to a 25% capital gains tax rate.

3 *Eline Realty Co. v. Commissioner*, 35 T.C. 1, 5 (1960); *Maddux Construction Co. v. Commissioner*, 54 T.C. 1278, 1286 (1970); *Turner v. Commissioner*, 76-2 USTC ¶9660, 540 F.2d 1249, 1252 (4th Cir. 1976), *rev'g* T.C. Memo. 1974 264; *Municipal Bond Corporation v. Commissioner*, 67-2 USTC ¶9633, 382 F.2d 184, 188 (8th Cir. 1967), *rev'g in part and aff'g in part* 46 T.C. 219 (1966);' *Mieg v. Commissioner*, 32 T.C. 1314, 1321 (1959); *Phillips v. Commissioner*, 24 T.C. 435, 445 (1955); *Crabtree v. Commissioner*, 20 T.C. 841, 846 (1953).

4 *Municipal Bond Corporation v. Commissioner, supra* (note 3).

5 Code section 1221(a)(1) excludes from the definition of a capital asset property that is held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

6 *Pasqualini v. Commissioner*, 103 T.C. 1, 6 (1994); *Pritchett v. Commissioner*, 63 T.C. 149, 162 (1974).

[7] *Malat v. Riddell*, 66-1 USTC ¶9317, 383 U.S. 569, 572 (1966), *vacating and remanding* 65-2 USTC ¶9452, 347 F.2d 23 (9th Cir. 1965), *on remand from Supreme Court*, 66-2 USTC ¶9612, 275 F.Supp. 358 (S.D. Calif. 1966).

[8] *Suburban Realty Co. v. United States*, 801 USTC ¶9351, 615 F.2d 171 (5th Cir. 1980), *cert. denied* 449 U.S. 920 (1980); *Major Realty Corp. v. Commissioner*, 85-1 USTC ¶9124, 749 F.2d 1483 (11th Cir. 1985); *Sanders v. United States*, 84-2 USTC ¶9767, 740 F.2d 886 (11th Cir. 1984); *Williams v. United States*, 84-1 USTC ¶9384 (N.D. Tex. 1983); *Parker v. United States*, 84-1 USTC ¶9139, Civ. No. 81-817 LE (Dist. Ore. 1983).

[9] *Maddux Construction Co. v. Commissioner, supra* (note 3) at 1284; *Hoover v. Commissioner*, 32 T.C. 618, 625 (1959); *Oace v. Commissioner*, 39 T.C. 743, 747 (1963); *Graves v. Commissioner*, 89-1 USTC ¶9170, 867 F.2d 199, 202 (4th Cir. 1989); *Guardian Industries Corp. v. Commissioner*, 97 T.C. 308, 316 (1991), *aff'd without published opinion* 21 F.3d 427 (6th Cir. 1994); *DuVal v. Commissioner*, T.C. Memo. 1994 603.

[10] Guardian Industries Corp. v. Commissioner, supra (note 9), 97 T.C. at 316.

[11] *Olivieri v. Commissioner*, T.C. Memo. 1966 177.

[12] *Guardian Industries Corp. v. Commissioner, supra* (note 9), 97 T.C. at 316.

[13] See, *e.g., Suburban Realty Co. v. United States, supra* (note 8) (average of 7 sales per year, some years with only 1 sale); *Tollis v. Commissioner*, T.C. Memo. 1993-63, *aff'd per curiam by an unpublished opinion* 95-1 USTC ¶50,076, 46 F.3d 1132 (6th Cir. 1995) (5 parcels sold over 1-year period, but sales were substantial).

[14] *Walsh v. Commissioner*, T.C. Memo. 1994-293, *aff'd per curiam* 95-1 USTC ¶50,398 (8th Cir. 1995); *Tollis v. Commissioner, supra* (note 13); *Olivieri v. Commissioner, supra* (note 11); *Gordy v. Commissioner*, 36 T.C. 855 (1961, *Acq.* 1964-1 C.B. (Part 1), p.4).

[15] See, *e.g., Biedermann v. Commissioner*, 68 T.C. 1 (1977); *Eline Realty Company v. Commissioner, supra* (note 3); *Olstein v. Commissioner*, T.C. Memo. 1999-290; *Pritchett v. Commissioner, supra* (note 6); *Ridgewood Land Co. v. Commissioner*, T.C. Memo. 1972-16, *aff'd per curiam* 73-1 USTC ¶9308, 477 F.2d 135 (5th Cir. 1973); *Silversmith v. United States*, 84-2 USTC ¶9767, 740 F.2d 886 (11th Cir. 1984); *Yamamoto v. Commissioner*, T.C. Memo. 1986-316, *aff'd by unpublished order* 891 F.2d 297 (9th Cir. 1989).

[16] See Revenue Ruling 59-91, 1959-1 C.B. 15 (gain realized by a corporation from the sale of lots subdivided from land it held as an investment resulted in ordinary income since the corporation made substantial improvements such as installing streets and utilities which facilitated the sale of the lots).

[17] See, *e.g., Lindsley v. Commissioner*, T.C. Memo. 1983-729; *Van Sickle v. Commissioner*, T.C. Memo. 1988-115; *Walsh v. Commissioner, supra* (note 14); *Westchester Development Co. v. Commissioner*, 63 T.C. 198 (1974).