Tax Tip

May Dealers in Real Property Hold Some Properties for Investment?

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Code Sec. 1222(3) defines "long-term capital gain" as gain from the sale or exchange of a capital asset held for more than one year. A "capital asset" is defined generally as "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."[1] Such property is commonly referred to as "dealer property." The characterization of real property as either a capital asset or dealer property has historically been one of the most frequently litigated issues in the tax law. More often than not, the distinction between investment property and dealer property is difficult to discern. Indeed, one appellate judge referred to the issue as an "old, familiar, recurring, vexing and often elusive" problem.[2]

The classification of property as dealer property has three important ramifications for federal income tax purposes. First, gain from the sale of dealer property is taxed as ordinary income rather than long-term capital gain. For noncorporate taxpayers, the rate spread between ordinary income and long-term capital gain has widened to the point that significant incentives now exist for preserving the capital asset status of real properties that are to be disposed of.[3]

Second, if a taxpayer sells real property that is dealer property, any gain realized from such sale will not be eligible for reporting on the installment method. Code Sec. 453(b)(2)(A) provides that an installment sale does not include a "dealer disposition." A "dealer disposition" is defined to include any disposition of real property that is dealer property in the hands of the taxpayer.[4] Thus, any gains derived from a dealer disposition may not be deferred under Code Sec. 453.[5]

Finally, real property that is dealer property in the hands of a taxpayer will not qualify for nonrecognition treatment under Code Sec. 1031. In order for an exchange of property to qualify for nonrecognition under Code Sec. 1031, such property must be held for productive use in a trade or business or for investment. Dealer property fails to meet this requirement, as it is held primarily for sale to customers rather than for productive use in such trade or business or for investment.

Given the high stakes associated with property being classified as dealer property rather than investment property, a common issue faced by dealers in real property is whether all real property held by such dealer will be treated as dealer property, or whether there is a possibility that the dealer can establish that certain real properties are held by her or him either for investment purposes or for productive use in a separate (nondealer) trade or business. Fortunately, for taxpayers, a number of court decisions have accepted the fact that it is possible for a dealer in real property to also hold other properties for investment purposes.[6] This recognition by the courts has sometimes been referred to as the "dual-purpose doctrine." In each of these cases, the Tax Court permitted taxpayers, all of whom were primarily engaged in developing and selling real property to customers in the ordinary course of conducting their businesses, to report gain from the sale of certain of their properties as long-term capital gain. Each case was decided based upon its unique set of facts, but all of them shared a common element—the taxpayer was able to introduce sufficient evidence to convince the Tax Court that these discrete parcels of land had been set aside and held for investment purposes, such as for future development as commercial rental properties or as residential rental properties.

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Even though a taxpayer may be able to establish the fact that certain parcels of real estate are held primarily for investment while at the same time holding other parcels for a clear dealer purpose, there is a heavy burden on the taxpayer to establish that its investment motives with respect to such parcels were predominant. In *Slappey Drive Industrial Park*,[7] the taxpayer, a real estate developer, sought to have the sale of three small lots isolated from the larger tracts of which they were originally a part treated as investment properties with the resultant gain taxed as long-term capital gain. Unlike the larger tracts that were divided into numerous distinct residential lots, the sales of the three small lots included no development or improvements to the property and no purchasers were solicited. However, the Fifth Circuit declined to ignore the taxpayer's predominant development activities and narrowed its focus "to three carefully excised slivers from the land they sought to develop." The court noted that a taxpayer engaged in the business of real estate development bears a heavy burden in attempting to separate a small fragment of a tract bought for development and sale, concluding that the "record contains no indication that these taxpayers had completely severed the contested lots and abandoned their intent to sell them to customers."

Similarly, in *R.L. Graves*,[8] the taxpayer, also a real estate developer, subdivided a piece of property into four parcels. The taxpayer's plan was to develop all four parcels together as part of an overall master plan. In fact, three of the four parcels were developed, and condominium units were constructed and sold thereon. The fourth parcel, although part of the master plan for development, was never developed and was eventually sold to a third-party developer. The taxpayer contended that he held the undeveloped parcel as an investment, rather than for development, and therefore, the profit he realized from its sale should be characterized as a capital gain.

The Fourth Circuit held that the taxpayer in *Graves* held the undeveloped parcel for development purposes, just as he held the remaining three developed parcels. In so holding, the court declined to view the undeveloped parcel in isolation from the other three parcels. Development of the undeveloped parcel was anticipated, as the sales literature and promotional materials on the other parcels indicated. Additionally, actual models of condominium units located on the undeveloped parcel were part of the models exhibited to the public in connection with the sale of units on the other parcels, and preliminary and final planning commission applications for development of the other parcels all included the undeveloped parcel as property to be developed. The court also stated that the fact a parcel is undeveloped, in and of itself, is not dispositive when there is evidence that shows that there were plans to develop the property. The Fourth Circuit cited *Slappey Drive* for the proposition that even though a taxpayer may be able to establish that certain parcels are held primarily for investment while other parcels are held for development, there is a heavy burden on the taxpayer to establish the segregation of the parcels.

The lesson to be learned from *Slappey Drive* and *Graves* is that a taxpayer who is or has been a dealer in real property, but who desires to claim long-term capital gain treatment from the sale of certain of its other property, should do everything reasonably possible to segregate such nondealer property from its other dealer properties. A prudent first step might be to transfer title to the intended investment property into a separate entity, such as a single-member limited liability company treated as a disregarded entity or to a Q-Sub (if the taxpayer is an S corporation). The name of the entity should emphasize the investment or rental purpose for which the property will be held by the entity, and the governing instruments should also reflect that the business purpose of the entity is to hold property either for investment purposes or for productive use in a trade or business (whichever is applicable). Of course, these steps may be disregarded as nothing more than meaningless window-dressing unless the taxpayer causes this newly created entity to hold and use the property in a manner consistent with its stated purposes. In addition, the taxpayer should maintain a record of all of its activities with respect to such property that will bolster its case, such as, for example, retaining copies of all applications for rezoning of the property to commercial or residential rental use, correspondence to lenders setting forth its intent to either hold the property for investment or to develop and operate the property as rental property and similar letters to its shareholders, partners or potential investors. It should always be remembered that the IRS and the courts will have the benefit of hindsight, and the taxpayer/dealer who had the requisite investment intent with respect to one or more of its properties should not wait to build its case until after its claimed long-term capital gain treatment from the sale of such property has been challenged. It should carefully and systematically build its case from the time that it either acquires title to the property or from the time its intent with respect to the property shifts from a dealer purpose to an investment purpose. In short, a taxpayer/dealer must be ever mindful of the "heavy burden" that it must bear to establish that its properties were held primarily for investment purposes or for productive use in a separate and unrelated (to its dealer activities) trade or business and should be proactive in building its case beginning at the earliest possible time.

ENDNOTES

1 Code Sec. 1221(a)(1).

2 *F. Thompson*, CA-5, 63-2 USTC ¶9676, 322 F2d 122.

3 Ordinary income for noncorporate taxpayers is taxed at marginal rates arranging from 15 percent to 39.6 percent under Code Sec. 1(a)–(e), 1(h)(1)(A). This effective rate can be increased for individuals under Code Sec. 68 by limiting itemized deductions and under Code Sec. 151(d)(3) by phasing out personal and dependent deductions, thereby collectively increasing the effective maximum rate on ordinary income to proximately 41.5 percent . By contrast, the "regular" long-term capital gain marginal rates are either 15 percent or 20 percent under Code Sec. 1(h)(1)(C) and (D), but unrecaptured Code Sec. 1250 gain is subject to a 25-percent rate under Code Sec. 1(h)(1)(E) and "collectibles" are subject to a special 28-percent rate under Code Sec. 1(h)(1)(F). In addition, long-term capital gain may also be subject to the 3.8-percent tax on net investment income under Code Sec. 1411(a).

4 Code Sec. 453(*l*)(1)(B).

5 There is a limited exception to this rule for residential lots under Code Sec. 453(*l*)(2)(B) if neither the taxpayer nor a related party makes any improvements to such lots, subject to the requirement that the taxpayer pay interest on the deferred tax as a price for the right to defer payment as computed under Code Sec. 453(*l*)(3).

6 *See, e.g., O.M. Fraley*, 66 TCM 100, Dec. 49,146(M), TC Memo. 1993-304; *D.R. Cottle*, 89 TC 467, Dec. 44,175 (1987); *Planned Communities, Inc.*, 41 TCM 552, Dec. 37,461(M), TC Memo. 1980-555; *Maddux Construction Co.*, 54 TC 1278, Dec. 30,174 (1970); *Eline Realty Co.*, 35 TC 1, Dec. 24,388 (1960); and *R.D. Rouse*, 39 TC 70, Dec. 25,701 (1962).

7 *Slappey Drive Industrial Park*, CA-5, 77-2 USTC ¶9696, 561 F2d 572.

8 *R.L. Graves*, CA-4, 89-1 USTC ¶9170, 867 F2d 199.

