WHEN IS A TAXPAYER A REAL ESTATE DEALER?

by J. Russell Hardin and Morris H. Stocks

With the anticipated reduction in the capital gains tax making headway in Congress, the correct classification of real estate transactions once again is being regarded with renewed interest and importance. When the Internal Revenue Service determines that a taxpayer is a real estate dealer and not an investor, the income generated from the taxpayer's real estate transactions is considered as ordinary income rather than capital gain income. This tax issue has been litigated numerous times throughout recent tax history. Chief Judge Brown previously stated that the problem of real estate capital gains vs. ordinary income is "old, familiar, recurring, vexing and ofttimes elusive."[1]

The issue remains complicated since neither the Internal Revenue Code nor the Treasury regulations include an authoritative list of criteria to differentiate the real estate dealer from an investor. Consequently, the various courts have had to generate their own list of identifying factors to make a proper determination based on the facts presented. Since numerous cases on the same tax issue have produced inconsistent decisions, this suggests that a specific factor or combination of factors does not always control such decisions. In *United States v. Winthrop,* the judge said that the factors identified in the law do not separate "sellers garlanded with capital gains from those beflowered in the garden of ordinary income."[2]

Without the existence of an authoritative list of differentiating factors, the various court opinions must be looked at for critical criteria. This article presents a list of those factors used by the courts to distinguish a real estate dealer from an investor. The information it provides should prove useful in tax planning for real estate transactions.

Legislative History Of Capital Gains Taxation

When the language of a federal statute is not clear and the intent of Congress needs to be determined, Congress plays a decisive role in interpreting tax laws.[3] The taxation of profits on the sale of real property and other capital assets in the year of realization originated with the Revenue Act of 1864. However, the capital gains provision was first introduced with the 1921 Revenue Act, and it has remained in the Internal Revenue Code although modified many times. The purpose of the capital gains provision was to save the taxpayer/investor from excessive taxes on profits derived from the sale of capital assets where the profit was

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incremented over a period of time. The first capital gains provision provided for reduced taxes of assets held more than two years. Under prior law, capital gains were taxed as ordinary income.[4]

The 1939 Code, as amended by the Revenue Act of 1939, continued to provide for preferential tax treatment of capital gains. However, a significant provision of the 1939 Act specified that stock in trade or inventory, property held primarily for sale to customers in the ordinary course of a trade, or business and depreciable property used in a trade or business are not considered as capital assets for purposes of taxation. The 1939 Act also set the holding period for long-term capital gains at 18 months.[5]

There were adjustments to the capital gains tax provisions between 1939 and 1976, but the basic law remained the same throughout that period. The Tax Reform Act of 1976 established the capital gains taxation rules that remained in effect until the repeal of preferential treatment by the Tax Reform Act of 1986. The 1976 Act set a $3,000 limit on deduction of capital losses against ordinary income. The act also set the holding period for long-term capital gain treatment at 12 months and established the 60 percent deduction for long-term capital gains of non-corporate taxpayers. The 1986 Act effectively repealed preferential treatment of long-term capital gains except for setting the maximum tax rate at 28 percent for non-corporate taxpayers. The original intent of the capital gain holding period provisions was to encourage taxpayers to invest in long-term investments.[6]

Current Capital Gains Tax Law

Sections 1201–1288 of the 1986 Internal Revenue Code deal with property transactions and capital gains and losses. The code sections 1221, 1222, 1223, and 1237 are mentioned most often in court decisions relative to transactions involving real estate and the capital gain/ordinary income question.

Section 1221 defines a capital asset as property held by the taxpayer, but it differentiates capital assets from depreciable property or real property used in trade or business and from stock in trade or inventory. Section 1222 essentially defines long-term vs. short-term and other related capital gains terms. A long-term capital gain results from the sale or exchange of property held for more than one year. Section 1223 further describes the holding period for capital assets. It also includes a discussion of the holding period for special situations such as involuntary conversions and sale of a personal residence.

Section 1237 deals specifically with subdivided real property. The topic of subdivided real estate has been the basis for many court cases. Section 1237 can be very important, because it provides an exemption from ordinary income taxation for certain subdivided real estate. Section 1237(a) states that just because a taxpayer, other than a corporation, subdivides real estate, the resulting sales do not automatically generate ordinary income. The rules for this exception are found in Section 1237(a) paragraphs 1, 2, and 3. Paragraph (1) of subsection (a) states that no part of the property may have been previously held primarily for sale to customers in the ordinary course of business. Paragraph (1) goes on to say that the taxpayer must not have held any other realty for sale to customers in the ordinary course of business at any time during the year of sale. In addition, paragraph (2) states that the taxpayer must not have made substantial improvements to the property so that the value of the property was substantially enhanced. Paragraph (2) also says that improvements made by a family member or other related party, by a lessee, or by a governmental entity shall be treated as if they had been made by the taxpayer. Paragraph (3) concludes subsection (a) by stating that the property must have been held by the taxpayer for at least five years unless acquired by inheritance or devise.

With reference to the foregoing code sections, the various courts have indicated that three questions must be answered to resolve the question of capital gain—ordinary income on real estate transactions: "1. What was the taxpayer's trade or business? 2. Did the taxpayer hold the property primarily for sale in that business? 3. Were the sales ordinary in the course of business?"[7] Once these questions are answered, capital gain or ordinary income also must be addressed. In answering these questions, the courts have considered a number of specific factors to determine whether the taxpayer sold real property in the ordinary course of business or as an investor. One approach, macro-case analysis, has been used to identify the factors that are critical to deciding a given case.

Research Methodology

In macro-case analysis, a number of cases are analyzed over a time period for a tax topic. The cases are grouped by whether they result in positive or negative consequences to the taxpayer. Next, a preliminary set of cases are analyzed to identify the apparent relevant factors or those factors that are mentioned frequently in the cases. Next, the factors are analyzed to determine which are critical to winning or losing a court case. Factors identified in this way can provide a pattern of information that is useful in tax planning.[8]

The critical factors for the capital gain/ordinary income question in real estate transactions were determined by first selecting 60 cases at random from

1970-1992. These cases were then divided into two samples of 30, assigning numbers to each and using a random number table for the division. The cases in the first sample (listed in Appendix 1) were analyzed and the relevant factors in each were noted. Nine relevant factors were identified as a result of this process including:

1. The nature and purpose the property was acquired and held (intent).
2. The extent and nature of the taxpayer's efforts to sell the property.
3. The number, extent, continuity and substantiality of the sales.
4. The extent of subdividing, developing and improving the property to increase sales.
5. The use of a business office for the sale of the property.
6. The character and degree of supervision or control exercised by the taxpayer over the representative selling the property.
7. The time and effort the taxpayer habitually devoted to the sale of the property.
8. The duration of ownership (proximity of the sale to the purchase).
9. The extent of advertising and solicitation by the taxpayer or others on his/her behalf.

The second sample of 30 cases (listed in Appendix 2) was then analyzed to verify the list of factors developed from the first sample. The same nine factors were identified from Sample Two. The cases in the second sample were further divided into two subgroups. Subgroup One consisted of cases in which the taxpayer was considered by the courts to be a real estate dealer and Subgroup Two consisted of cases in which the taxpayer was determined to be an investor in real estate rather than a dealer. In 11 of the cases (Subgroup Two) the taxpayer was allowed the preferential capital gains treatment. In the other 19 cases (Subgroup One) the taxpayer was held to be a real estate dealer with ordinary income.

Each case in the two subgroups was analyzed to identify which factors the courts held important in determining the issue for that particular case. Scores were assigned to each factor according to the following coding scheme:

+1 a factor in favor of the taxpayer
−1 a factor against the taxpayer
0 if the factor was deemed irrelevant by the court or the factor was not mentioned by the court.

The scores for each subgroup were summed and divided by the number of cases in the subgroup to arrive at an average score for each factor.[9] A factor in Subgroup One with a high negative score indicates a factor that will more than likely work against the taxpayer by helping to define the taxpayer as a real estate dealer when capital gains treatment was sought. A factor in Subgroup Two with a high positive score indicates a factor that will usually work for the taxpayer in defining the taxpayer as an investor eligible for capital gains treatment.

Research Results

Exhibit 1 provides a summary of the scores assigned to each factor for each subgroup. While the courts have consistently mentioned the nine factors listed in the previous section, only a few of these have been critical to the court's decision in most cases. The pivotal issue, consistently, has been the purpose for which the taxpayer held the property *immediately prior* to sale. This means that property purchased originally as an investment may be considered, by the courts, as having been converted to inventory. Alternatively, property purchased originally for sale to customers in the ordinary course of business may have been, in the opinion of the court, converted to investment property.

Another critical factor in identifying a taxpayer as a dealer appears to be the extent to which the property was subdivided, developed and improved in order to increase sales. If the taxpayer subdivides real property or makes substantial improvements to the property so that its value is greatly enhanced, then the taxpayer will most likely be deemed a real estate dealer. The courts also have frequently noted the number, extent, continuity and substantiality of sales. The greater the number of real estate sales the taxpayer makes, the more likely the taxpayer will be designated a real estate dealer.

Several factors identified in the cases do not appear important in classifying a taxpayer as a real estate dealer. For example, the degree of supervision over the representative selling the property was only used in one case out of 30. Also of minor importance was whether or not a business office was used to sell the property.

EXHIBIT 1

Relative Scores of the Nine Factors

	Taxable as Ordinary Income	Taxable as Capital Gain
1. Purpose and intent	−1.000	+.909
2. Extent of efforts to sell	− .368	+.818
3. Substantiality of sales	− .526	+.545
4. Extent of subdividing	− .737	+.727
5. Use of a business office	− .053	+.182
6. Supervision over sales rep.	− .000	+.091
7. Time and effort devoted	− .158	+.455
8. Duration of ownership	− .158	+.727
9. Extent of advertising	− .316	+.636

Conversely, seven of the nine factors appear to be important or fairly important in designating the taxpayer as an investor with the resulting capital gains treatment. The purpose or intent (Factor 1), the extent of efforts to sell (Factor 2), the extent of subdividing (Factor 4) and the duration of ownership (Factor 8) were all important in the cases where the taxpayer was allowed capital gains treatment. In addition, the substantiality of sales (Factor 3) and the extent of advertising and solicitation (Factor 9) appear to have lesser importance. The taxpayer awarded capital gain treatment had put forth very little effort to sell with little or no advertising. Finally, the time and effort the taxpayer devoted to selling the property was important (Factor 7). Again, the taxpayer had put forth little time and effort or had engaged a licensed real estate broker to sell the property.

Tax Planning Implications

There are at least three reasons why tax planners and tax practitioners should continue to help their clients properly structure real estate transactions. The first reason is because there is a real possibility that Congress will enact some sort of capital gains tax break in the near future. According to a recent *Journal of Accountancy* article, the probability that Congress will pass a capital gains tax reduction appears to be quite high.[10] If enacted, the Republican's Contract with America would allow a non-corporate taxpayer to exclude 50 percent of their capital gains.

This potential 50 percent tax savings makes the real estate investor vs. real estate dealer question even more important than it is under the current tax law. However, even under current tax law, the distinction remains important. Currently, the maximum tax rate on capital gains of non-corporate taxpayers is 28 percent while the maximum tax rate on ordinary income is 39.6 percent. The difference in tax liability can be substantial when a net long-term capital gain is reclassified by the IRS or courts as ordinary income. The exact difference will obviously depend on the taxpayer's particular tax situation. Two examples, however, demonstrate the potential tax savings under the current tax law when real estate transactions are deemed the result of investment rather than ordinary income (See Exhibit 2). The single taxpayer in Example 1 would, under current tax law, save $4,000 in federal income taxes. The married couple in Example 2 would reduce their federal tax burden by more than $11,000. Obviously, even without the enactment of the proposed capital gains tax cut, proper planning in real estate transactions can result in significant tax savings.

EXHIBIT 2

Potential Tax Savings from Net Long-Term Capital Gains Tax Treatment

Example 1 – A single taxpayer with $175,000 of taxable income. Taxable income includes a $50,000 net long-term capital gain.	
Real estate dealer ordinary income tax liability	$52,371*
Real estate investor net capital gains alternative tax liability	48,371
Tax savings	4,000
Example 2 – A married taxpayer filing jointly with $350,000 of taxable income. Taxable income includes a $100,000 net long-term capital gain.	
Real estate dealer ordinary income tax liability	$114,289*
Real estate investor net capital gains alternative tax liability	102,923
Tax savings	11,366

*Tax liability in each example determined using 1995 enacted tax rates.

The third reason tax planners should continue to help their clients properly structure real estate transactions is that real estate prices have fallen dramatically in some parts of the country. "Real estate values have fallen by as much as 30 percent throughout New England and by 50 percent in parts of the South and Southwest."[11] A taxpayer living in one of these areas could structure real estate sales so that the taxpayer could *purposefully* be classified as a real estate dealer. Thus, a loss on the sale would be deductible in full as an ordinary loss in the year of sale rather than being subject to the $3,000 per year limitation on offsetting capital losses against other income. By demonstrating the intent to be a dealer and/or by subdividing and improving the property, a taxpayer could take advantage of substantial capital losses.

Finally, a word of caution to taxpayers who are actually full-time realtors. The courts have frequently said that a dealer can also own property as an investor. "However, a dealer is subject to a greater burden of proof than a nondealer. Segregation of the property on his books and records is important for the dealer in obtaining his capital gain treatment."[12]

Conclusion

The nine factors enumerated by the courts over the last 22 years have remained basically the same. This

suggests that the tax planner or taxpayer may place a reasonable degree of reliance on the continued use of these factors. In approximately one-third of the cases analyzed, the taxpayer was successful in being granted capital gains treatment by the court.

The most important factor was the intent of the taxpayer in holding the property immediately before the sale. The other two factors of primary importance were the extent of subdividing or improving and the extent of efforts to sell the property. These factors should be kept in mind when planning the disposal of real estate. In addition, when representing a client in litigation concerning the real estate dealer/investor question, it may prove useful to understand the factors that the various courts have identified as critical in the decision. Finally, the tax planner or taxpayer should remember that the burden of proof in these matters is on the taxpayer. The Supreme Court has "admonished that courts should narrowly construe the definition of a capital asset"[13] because the preferential treatment accorded capital gains has always been an exception to the ordinary income provision found in Section 64 of the Internal Revenue Code.

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NOTES

1. Thompson v. Commissioner, 322 F.2d 122 (5th Cir. 1963).
2. United States v. Winthrop, 417 F.2d 905 (5th Cir. 1969).
3. J. S. Seidman, *Seidman's Legislative History of Federal Income Tax Laws: 1938-1861* (New York: Prentice-Hall, Inc., 1938), vii.
4. Jacob Mertens, Jr., *Mertens Law of Federal Income Taxation* (Deerfield, Ill.: Callaghan & Company, 1990), Vol. 4, Ch. 22:10.
5. Ibid., 14.
6. Ibid., 25-26.
7. Suburban Realty Company v. United States, 615 F.2d 171 (5th Cir. 1980).
8. Kevin M. Misiewicz, "A Macro-Case Analysis Approach to Tax Research," *The Accounting Review* (October 1977): 935-938.
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10. R. Willens and A.J. Phillips, "The Contract with America," *Journal of Accountancy* (April 1995): 33-37.
11. Geoffrey N. Smith, "Why We Are in a Funk," *Financial World* 161, no. 7 (31 March 1992): 8.
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13. Commissioner v. P. G. Lake, Inc., 356 U.S. 260(1958).

APPENDIX 1

Sample One Cases

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APPENDIX 2

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