How Can a Developer Qualify for Capital Gain Treatment? A Recent Case Means New Opportunity!

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No one wants to pay taxes!

Certainly this statement reflects the feeling of most taxpayers, be they connected with real estate or otherwise.

Thus, as the title to this Note reflects, if there is a "legal" approach to avoid paying taxes at ordinary income rates, this topic should create excitement for most taxpayers.

But, it might help to backup for a moment and reflect on a few fundamental maxims that relate to the field of federal income taxes.

1. No one wants to pay any taxes.
2. If taxes are owing, the taxpayer wants to pay at the lowest rate.
3. The longer the taxpayer can delay paying taxes, ceteris paribus, the better it normally is for the taxpayer.

How do the three maxims present above relate then to the question at hand: How does a developer qualify to pay tax at capital gain rates?

This point relates to the first two items listed above, viz., "No one wants to pay taxes"; but, if you must pay taxes, "the taxpayer wants to pay at the lowest rate."

Given that income is clearly subject to taxation[1] under the Internal Revenue Code,[2] generally by referring to Code Section 61,[3] there is little likelihood that the developer in the above scenario could avoid paying tax on the income earned in connection with a real estate development.

Thus, #1, above, cannot be avoided.

Maxim #2, above, acknowledges that if taxes must be paid, the taxpayer will attempt to pay at the lowest rates available. This axiom begets the discussion of how taxpayers, in this case a developer, can pay at a low rate.

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The general rule is that the federal income tax rate for ordinary income is that rate stated in the Code under Section 1.[4] However, the rate is only part of what determines the amount of the tax calculation.[5] That is, the table tells the taxpayer the rate to utilize or the multiple that is applied againt the net taxable income. Yet, there is one other important adjustment, prior to applying the rate. The Code has various Sections that classify income into different types.[6] This is important for one simple reason: The classification of the income can mean that different rates under Section 1 and other Sections of the Code apply. Not all income is taxed at the same rate given a certain set of circumstances. What circumstances? One of the most important classifications, which classification became very, very important in the *Long* Case,[8] discussed below, as to the developer in question, is one which looks to types of income or loss generated by the taxpayer.

The Code provides that some types of income, such as capital gain income, can be taxed at a rate lower than ordinary income.[9] To suffice for now as to this differential, the approximate spread, on the larger side of this demarcation, is the difference of a rate of 39.6 percent, the highest ordinary income tax rate, generally speaking, and the highest capital gain rate of 20 percent.[10]

The essence of the discussion in this Note must, therefore, given the axioms stated above, determine how one can generate, as a developer, the lower, capital gain rate. The rules to qualify for this lower rate have normally made that goal fleeting and difficult for the developer to achieve, since, as noted below, the developer normally is unable to meet the requirements under the Code for the more favorable, lower tax rate treatment.

A recent case however, the *Long* Case,[11] from the 11th Circuit Court of Appeals, reversed the Tax Court, as discussed below, and supported the position of the Developer—in the limited setting of this case—to treat the millions of dollars in gain by the taxpayer as capital gain, taxed at a lower rate.

The necessary steps to follow the path of the *Long* Case for the capital gain treatment are discussed below.

WHAT DOES IT REQUIRE TO MEET THE CAPITAL GAIN TYPE TREATMENT? (HOW DID THE LONG CASE DO IT?)

Under the auspices of the Internal Revenue Code, one element that a taxpayer must meet to obtain the special lower rates for capital gain is the definition of a ***capital asset***.[12] For purposes of this discussion, it should suffice that to obtain the capital transaction treatment, there needs to be a showing of two factors in the Code: a capital asset and a recognized disposition, such as a sale.[13]

There is little dispute in the *Long* Case and the other items in this Note as to what is a "disposition." That is, normally this factor is not an area of focus as it typically is clear that there was a sale. This is true in this discussion for the most part. Thus, the focal point is on whether the asset sold by the taxpayer, to obtain the favorable tax rate, noted above, is in fact a "capital asset." Code Section 1221, defining such asset, approaches this issue in the negative. That is, it defines a Capital Asset as everything other than eight (8) categories.[14] All eight of the items referred to are not of much import for this examination, aside from two of the eight factors. Under Section 1221, the Code excludes from this special treatment of a capital asset, under its first of the eight exceptions, and hence, capital gain treatment, those assets that are held primarily for sale to customers in the ordinary course of business. Stated succinctly, the Code does not allow an asset to be a capital asset if the asset is inventory.

Historically, one who sells inventory is normally a "dealer." Therefore, we often see in the tax law and in other parts of business undertakings referred to as a "dealer," that is, one who is selling inventory and not holding the property for longer term investments or use of the asset in business.[15]

Thus, again, the capital gain treatment will not apply if the asset is "inventory property," that is, "dealer property."

The other category, mentioned above, a second exception under the eight areas excluded as capital assets, involves property that is used in the trade or business of the taxpayer or is held for investment. To be clear on this setting, this means that a cash register in a shop is property "used in" (employed in) the business. It is not a capital asset. Also, property that is held for investment, such as a piece of land that was purchased many years ago with the hope for appreciation, is not a capital asset. These assets would be labeled as Code Section 1231 Assets, not as capital assets.[16]

Although, as mentioned, the dealer property will NOT receive the use of the lower capital gain rates, the property used in the trade or business or held for investment, i.e., the Code Section 1231 Property, has a special—and favorable—rule. Such property, although not a "capital asset," receives in most instances the favorable capital gain treatment. That is, the gain from the sale of these assets can obtain the effective beneficial treatment of capital gain rates. This result exists because Congress endowed this Section with a special rule under Code Section 1231, allowing gain generated from the sale of such Section 1231 property to generally utilize the capital gain rates, thus helping businesses and investments.[17]

The taxpayer that is held to be a dealer on a given property is prevented, normally, from the capital gain/Section 1231 favorable use of the capital gain rates. However, IF—IF the taxpayer can avoid the classification of being a Dealer *on the given property in question* and can argue that the asset that was sold and generated the gain, was either a Section 1231 asset or a capital asset, the taxpayer will have "part of" the ingredients to employ the special capital gain rates on the net taxable income.[18] The discussion that follows addresses some of the above issues, but the discussion is in the context of many cases that have been litigated on the issue of capital gain treatment and the elements necessary to produce such result.

Thus, in summary, a Dealer is one that is selling property in the normal course of business. The property being sold is the inventory, otherwise known as property held for resale (not for use in the business or for investment purposes). The focal point of concern with this distinction, as stated earlier, is the tax rate that applies to gain by a dealer. The tax rate for gain by a dealer can increase to about 40 percent, whereas the maximum tax rate on gain produced from a long-term capital gain transaction is generally, on the high side, at 20 percent. This huge percent difference is what raises the interest level for taxpayers to purse the long-term capital gain treatment in place of the ordinary income treatment.

The *Long* Case also mentioned another important ingredient to generate the favorable lower long-term capital gain treatment, viz., that the taxpayer has held the property "long-term." That is, to gain the favorable, lower rate noted above for capital gain, the taxpayer must show that the disposition of the property was after the property was held for a "long term" period, defined in the Code as in excess of one year. This issue is examined in-depth, below.

The *Long* Case is examined in detail along with other cases that have shaped this area of Dealer taxation. However, as also discussed, this issue of being a Dealer selling inventory is NOT only important as to the rate of tax employed. The treatment of an asset as a capital asset (or Section 1231 asset) as opposed to an ordinary income asset can also be very important for other reasons, as mentioned below. For example, the issue of an asset classified as an ordinary income asset can be crucial in Tax Deferred Exchanges.[19] (Once again, this point is discussed later in the article.)

EXISTING "DEALER" DECISIONS PRIOR TO THE *LONG* CASE:

As mentioned, there have been many decisions that have addressed the issue as to whether a given party was or was not a dealer on a given property. This determination rests on the intent of the party/taxpayer. That is, did the taxpayer have the intent to sell/dispose of the property when it was acquired? Was it a type of property that was purchased as inventory, such as cars on an auto dealer's lot? Was the taxpayer a builder of homes, creating them with the intent of immediate sale?

These issues are not difficult to state. But, some cases are confusing and it is often trying to find the "intent" of the taxpayer. Thus, the courts, via many cases, have developed a list of factors that *might* be important in a given case to resolve the issue of "intent." In this setting, the courts have considered the following factors when dealing with a property in question:

1. What was the intent of the taxpayer when the property was purchased?
2. Did the intent change?
3. Did the taxpayer acquire the property and immediately place the property up for sale?
4. How did the sale come about? That is, for example, did the buyer solicit the seller for the sale?
5. How does the seller normally conduct his or her business? That is, if one normally sells cars for a living as a dealer, it is likely that all the cars held by the dealer will be inventory, unless the taxpayer can show some difference on a given car that the taxpayer alleges is not inventory? This same point applies to a builder of homes for sale, where the builder takes the position that a given home was **Not** for resale. That is, it was an investment property, not dealer property.
6. What is the history of the seller as to the type of property in question?
7. Did the circumstances change for the taxpayer, thus causing a change in the intent? As an example, did the taxpayer move from being a home builder to a landlord of leased houses?
8. What other factors impacted the activity of the seller and that might have affected the sale?

There are many cases, as noted, that have addressed this issue of intent. For example, there is the case of *Raymond v. CIR*.[20] The Tax Court concluded the taxpayer/seller was a dealer on the property in question. To test for intent, the Court looked to some of the following factors:

a. The taxpayer's purpose when acquiring the property;
b. The taxpayer's purpose when holding the property;
c. The extent to which the taxpayer made improvements to the property (and the type of improvements that would suggest or not suggest a longer term hold of the property);
d. The frequency, number and continuity of dispositions of property; and
e. Other factors.

Sometimes the courts have stressed the *primary* purpose of holding the property. See, for example, the case of *Malat v. Riddell*,[21] an older but often cited case.

Other cases have considered many of the above factors to derive intent; and, many courts have added other factors to consider. In *Klarkowski v. CIR*,[22] the Tax Court considered factors such as the purpose of acquisition, the subsequent use of the property, improvements made to the real estate, the business of the taxpayer, how much advertising and promotion was undertaken for the sale, whether the property was listed for sale, etc.

In the *Adam* Case, (*Adam v. Comm., 60 TC 996 (1973*)) a CPA was arguing for capital gain on the sale of property.

The taxpayer sold different property over a number of years. Since there were many factors to consider, and the taxpayer was in the accounting business a good part of the time, the Court concluded the intent was to hold for the longer term, not for resale. Thus, capital gain treatment was allowed.

Can the intent change? Yes.

In *Maddux Construction Co.*,[23] the Court concluded that the taxpayer bought property to build homes on it. However, with part of the property, the taxpayer retired before building homes on it. As such, the Court concluded that the intent with some of the property changed from dealer property to holding it for investment, not for resale as a dealer. Hence, on part of the gain, capital gain treatment was allowed. *Maddux* is an important older case that continues to support the position — that if the taxpayer can show a change in circumstances — moving the taxpayer from a dealer building homes to owning property for investment, the sale of the property can produce capital gain treatment. *Maddux* changed the intent for the use of the land when the taxpayer concluded that it would no longer build homes on the land in question, but rather, the property would be held for long term investment use. Of course, the taxpayer has the burden to show this change and the intended use of the property when sold.

LONG CASE:

There are many other cases that have taken place over the years and that could be cited on this topic of intent. The recently decided *Long* Case,[24] cited earlier, is one such case. This case involved a developer.

It is well established, as mentioned above, that when one acquires property with the intent to sell the property in the ordinary course of business, that property being "inventory," the gain or loss generated from the activity is ordinary income.[25]

In the Case of *Long*, the Tax Court followed the above reasoning and held the income generated was subject to ordinary income tax rates. The fact pattern was a bit unusual, but the result, per the Tax Court, was the same: Ordinary income was produced from the sale of property held primarily for re-sale.

Factually, the Taxpayer, Mr. Long, was a developer of land to build various types of properties. In the first instance with the property in question, Long was planning to develop the property for condos. He contracted to buy the property in Las Vegas. He, after being under contract, started the approval work necessary to build and sell condominiums. However, as things moved along, the seller refused to convey the property to the buyer, Long (and his entity). Long sued. Long won a multi-million dollar judgment.

Long, having the judgment, determined he wanted the cash; thus, he sold the claim which was in the form of the judgment; it was sold by use of an assignment to the buyer.

Long reported his gain as capital gain. The IRS, on audit, asserted the position that the gain was ordinary income. The Tax Court agreed with the IRS.

However, on appeal to the 11th Circuit, the Court of Appeals reversed the Tax Court and held the gain, via the sale of the right to collect the judgment, was capital gain, not ordinary income.

The Tax Court reviewed the normal factors that courts have considered to show the intent of the taxpayer to hold property for investment or business use, which could generate a capital transaction, vis-à-vis the actions that show an intent to hold property as inventory or for re-sale.[26] The Court of Appeals held that such matters were not controlling in the *Long* Case. The Appellate Court held that the intent by the Taxpayer was to develop the property. But, the Court said that this Case was different. The language of the Court on this point was clear:

"We have already held that selling a right to *earn* future undetermined income, as opposed to selling a right to *earned* income, is a critical feature of a capital asset. *United States v. Dresser Indus., Inc., 324 F.2d 56, 59 (5th Cir. 1963)*. The fact that the income earned from developing the project would otherwise be considered ordinary income is immaterial." [27]

This characterization of the gain is very important under the tax rates, since the highest level of federal income tax for ordinary income is close to 40 percent, yet the rate for the capital gain would be at a maximum of 20 percent. This huge difference gave rise to the aggressive positions of both the Taxpayer and the IRS in the Long Case as well as in many of the other cases mentioned earlier.[28]

ANOTHER IMPORTANT ELEMENT TO EMPLOY CAPITAL GAIN RATES: THE HOLDING PERIOD

Although only mentioned in passing, another element to obtain the favorable lower capital gain rates includes a requirement to show that the holding period of the asset by the taxpayer is "long term." That is, as discussed, if the taxpayer can show that the asset is a capital asset and that it was sold or exchanged, this will produce a capital transaction. But, that does not mean the lower rates can be used. The taxpayer must also show that the *holding period* was long-term.[29]

Why is this holding period necessary? Because Congress said that the favorable, lower rates, noted above, do not apply unless the taxpayer can show the holding period is long term, that is, in excess of one year.[30]

That is, the taxpayer cannot simply have a capital asset or property held for investment or business use, sell it and gain the lower rates, if the taxpayer has not *held* the property in excess of one year.

This stumbling block comes up very often when a taxpayer is approached by a buyer, enthusiastically wanting to buy the property, yet the seller has not owned the real estate in question the prerequisite time frame of "in excess of one year."

This holding period was an issue the IRS raised in the *Long* Case. And, as to this issue, the Taxpayer might have won the battle on the character of the asset being non-inventory, but lost the war to apply the lower rates, if the Court would have concluded that the holding period was one year or less. However, the Court sided with the position of the Taxpayer. The Court said that the Taxpayer established his holding period from the time it brought suit to enforce the contract. What the Taxpayer sold were the rights to a judgment, not land held for resale. He gained these rights when he signed the contract to buy the land. Thus, the gain was characterized as *long term* capital gain (*i.e.*, the asset was held over one year).

The Court of Appeals concluded that the income from selling the judgment gained via the contractual position was very different than selling the land that was to have been developed. The decision by the Court of Appeals was that the holding period of the asset began when the suit was filed. As such, it produced long term capital gain.

Thus, Mr. Long gained the benefit of long term capital gain treatment and thus the lower tax rate applied! Effectively, much like the *Maddux* Case mentioned earlier,[31] the intent of the Taxpayer changed. Had he developed the condos and sold those in the normal course of business, this would have produced ordinary income to the Taxpayer. However, the Taxpayer, as the Court of Appeals stated, changed his position, and sold a claim, via the judgment. This was not dealer property.

CONCLUSION

A well informed taxpayer (with his or her advisors) might consider not so easily giving up on the position to report gain as capital gain. Even if one might normally be a dealer on most of the transactions undertaken by the taxpayer, there may be enough changes in the present transaction to support the capital gain treatment.

In the *Long* Case, the Taxpayer not only showed the intent to hold the property (contract and judgment) for investment, not for resale, but the Taxpayer also showed that the holding period was long term. Both factors were crucial to the Court's conclusion that the lower long term capital gain rate was applicable.

The conclusion that the property in question was capital gain property is important to obtain the lower tax rates for capital gain as mentioned in this article. However, it is also crucial to have the determination of a ***capital asset***, not inventory property, when considering the use of other Code sections, such as installment sales,[32] tax deferred exchanges,[33] etc.[34] These are topics to explore for the future. ■

ENDNOTES

1. There are only a few exceptions to this point, since the Internal Revenue Code of 1986, herein often referred to as the "Code," as amended, Provides under Code Section 61, effectively, that all income, with rare exception, is subject to tax.
2. Id.
3. Id.

4. Code Section 1 details the rates for various classes of taxpayers, such as those that are single, those that are married and filing jointly, etc. This part of the Code gives the rates/tables for the number to be used to calculate the percentage of the net taxable income that must be paid for the income tax. This rate depends in part on the amount of taxable earnings the taxpayer develops during the year. See Section 1 of the Code as noted. See also, Real Estate Transactions, Tax Planning,) by Levine, Mark Lee and Segev, Libbi R., Appendix A, Thomson/West (2015).
5. This part of the Code gives the rates/tables for the number to be used to calculate the percentage of the net taxable income that must be paid for income tax. This rate depends in part on the amount of taxable earnings the taxpayer develops during the year. See Section 1 of the Code as noted. See also, Real Estate Transactions, Tax Planning, by Levine, Mark Lee and Segev, Libbi R., Appendix A, Thomson/West (2015).
6. See the Levine and Segev text, Note 5, supra, under Chapter 7 of this authority.
7. Id.
8. 114 AFTR 2nd Paragraph 2014-5446.
9. Capital gain income, as discussed below, requires a showing by the taxpayer that it is, under Code Section 1221, entitled to this special treatment. In such setting, the taxpayer may qualify, again, as discussed below, for a tax rate that is less than the ordinary rate. The current rates under the Code, Section 1, can move as high as 39.6% for an individual, without other adjustments. Generally, the highest tax rate for capital gain, where qualified, will be at 20%, as stated earlier. Thus, this becomes very important to qualify for this special, lower capital gain rate.
10. For more on this issue, see the Levine and Segev text, cited supra note 5, Chapter 8 of said text.
11. See supra, Note 8.
12. This definition is under Code Section 1221. Without being too obtuse, the capital gain treatment noted above can be obtained by selling a capital asset. Such favorable treatment can also be obtained when selling qualified investment property and/or other property used in the trade of business of the taxpayer. This latter rule is called Section 1231 Property; however, for the purpose of this discussion and the *Long* Case mentioned earlier, this Note discussed capital assets/capital gain and the trade or Business property, Code Section 1231, together. Distinctions will be made in this Note only in a few instances where the demarcation is important under the tax rules as they relate to this Note.
13. For more on this issue, see the Levine and Segev text, cited supra, Note 5.
14. Refer to Code Section 1221 and the Levine and Segev text, cited supra Note 5.
15. See this issue discussed in the Levine and Segev text, Chapters 8 and 16, this Work cited above in Note 5.
16. See Code Section 1231 and Chapter 7 of the Levine and Segev text, cited supra, Note 5.
17. Id.
18. The reference was to "part of the ingredients" in the prior sentence, since there are some other limitations that must also be addressed. For example, the taxpayer must show that there was a "long term holding" of the property in question if the taxpayer desires to be taxed at the lower capital gain rate. This issue, in connection with the *Long* Case, is discussed below.
19. This area of Tax Deferred Exchanges under Code Section 1031 is also raised in the material, below, as it relates to this question of "dealer" property.
20. TC Memo 2001-96.
21. 1966-1 CB, 184, 383 US 569 (1966).
22. TC Memo 1965-328.
23. 54 TC 1278 (1970).
24. See Note 11, cited supra.
25. See Code Section 1221 and the earlier discussion in this Note.
26. See supra, Notes 21-23.
27. See supra, Note 11.
28. See supra Note 11 and Notes 21-23.
29. See Code Section 1222.
30. Id.
31. See supra, Note 23.
32. See Code Section 453 and the Levine and Segev text, Chapter 25, cited supra, Note 5.
33. See Code Section 1031 and the Levine and Segev text, Chapter 29, cited supra, Note 5. See also Levine, Mark Lee, Exchanging Real Estate, 7 Volumes, (PP & E, Inc., 2014), available at Amazon.com and CreateSpace.com
34. See Note 5, cited supra, under Chapters 1 ,7, and 8 of the Levine and Segev text.