Dealers in Real Estate: At Least Three Big Tax Problems

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Even the novice in real estate tax issues has heard the warning that one normally does not want to be classified as a "dealer."

A "dealer" is probably best defined as one who is involved in the sale of goods, not with the intent to hold those goods. That is, they are primarily inventory items, or goods primarily for resale—they are not for purposes of holding the assets for trade or business or for investment.

This is the basic approach that is utilized in the Internal Revenue Code, 26 U.S.C.A. §1221(1). However, technical definitions aside, the more basic question is: "Why is it important if one is a dealer?" And then the question: "Who cares?"

This short Note emphasizes three of the many important reasons why most real estate practitioners and taxpayers generally would not like to be classified as a "dealer" for tax purposes for a given piece of property.

1. Capital Gains vs. Ordinary Income
2. Installment Sales and the dealer question
3. Tax Deferred Exchanges

No person is necessarily a dealer for all property held by that individual.

AN EXAMPLE

As an example, Taxpayer X may hold liquor bottles in a liquor store owned by X, or real estate lots owned by X, for sale to the general public. These are inventory items. However, that does not make X a dealer for all assets that X may own.

Each item that X owns or handles as X's property, and disposes of the same, would be questioned as to the intent and use of the property by X. This is to determine whether the intent by X was to hold the property primarily for sale (inventory) or whether the intent was to hold the property for longer-term investment or for use in a trade or business.

To contrast the situation, if X also owns a liquor store and had a cash register, the cash register is not dealer property. That is, X is not holding the register primarily for resale, even though X is holding the liquor bottles for resale.

Likewise, the equipment used in the trade or business of construction by X is not dealer property, even though the lots that X might hold for sale can be and would normally be "inventory" in the circumstances described.

Why is it important that one is a "dealer" of the liquor bottles that X held, or the lots that X held? This article refreshes the reader on this issue, and the continued import of the classification of one as a "dealer" in many settings.

THREE GOOD REASONS NOT TO BE A "DEALER" (NORMALLY)

A "dealer" is generally a status or position that one, as a taxpayer, would not normally wish to hold. Why is the dealer status a disadvantage and shunned by most taxpayers?

The answer to this question, at least in three primary cases, is easily addressed. As noted below, there is concern as to whether one is a dealer in circumstances where one will receive income ("capital gain" as opposed to "ordinary income"), and the ability to postpone that income ("installment sale") or exchange property.

These are three areas of concern to taxpayers relative to the dealer question.

CAPITAL GAIN VS. ORDINARY INCOME

A fundamental concern for taxpayers is the impact of selling "dealer property," mentioned earlier, not with the intent to hold, when a gain is generated. A gain is taxed for Federal tax purposes at the tax bracket that the taxpayer is in for the given year.

Although the highest tax bracket for ordinary income received by a taxpayer in the year 2003 is 38.6%, that rate is reduced to a maximum of 20% (subject to change by the most recent Congressional changes), under most circumstances, for the sale of unimproved ground.

As an example, X sold a lot for a gain of the $400,000. This gain could be taxed at a maximum ordinary rate of 38.6%. However, the maximum capital gain rate in this setting would be 20%. Which rate to use depends on whether the taxpayer was a "dealer," or not. IF classified as a dealer, the sale could generate the higher taxable rate of 38.6%. But, if the taxpayer was holding the property for "investment," it could generate the long-term capital gain maximum rate of 20%.

There are some exceptions and qualifications in the Examples and rules stated. However, the basic idea illustrates that long-term capital gain, which is generally property held in excess of one (1) year, is taxed at a lower rate than property that is deemed to be "dealer property," as defined earlier. Thus, taxpayers would not want to appear to be dealers in most gain circumstances.

INSTALLMENT SALES AND THE DEALER QUESTION

If the taxpayer is deemed to be a dealer on the property in question, such as X in the lots that were sold, the taxpayer would not be able to use the installment sale method. The reason is very simple: The Internal Revenue Code, Code §453, dealing with installment sales, specifically prohibits the use of the installment sale technique for a taxpayer who is a dealer, on most real estate transactions. Thus, Mr. X, in the example of selling lots, would be disqualified from the use of the Installment Sale Method.

To back up a moment, the Installment Sale Method allows the taxpayer to spread the gain, or payments received, over a number of years, if payments are received over a number of years.

However, Code §453(b)(2) provides that the installment sale does not include "dealer dispositions."

Code §453(l)(1)(B) provides that a dealer disposition is one where the real property is held by the taxpayer for sale to customers in the ordinary course of business.

Although there are a few exceptions to this rule, where the Installment Sale Method can be used, most of the time taxpayers cannot use the Installment Sale Method if they are a dealer.

If the taxpayer cannot use the Installment Sale Method to spread the gain over a number of years, the Taxpayer must pick up all of the gain in the tax year in which the sale occurs.

To illustrate this point, assume that X sold a lot for $1 million. If X's adjusted basis (normally cost) is $600,000, the $400,000 gain would be taxed to X in the year of sale, even if X was receiving payments for the purchase price over a 5-year period.

Thus, this is one of the most basic illustrations of why taxpayers do not want to be a dealer for the sale of real estate: They cannot use the Installment Sale Method in most circumstances, and, therefore, the gain that is generated must be taxed immediately, even if payments are received over a number of years.

THIRD REASON NOT TO BE A DEALER: TAX-DEFERRED EXCHANGES

Under the Internal Revenue Code, under Code §1031, taxpayers, if they can qualify under this Section, can defer the gain on an exchange of qualified trade or business or investment property.

To illustrate this point, assume that X, owning X-1 land, exchanges this land with Y, with X acquiring the Y-1 property.

Although gain could exist, such gain would not be taxed, currently, if X took the Y-1 Property and otherwise qualified under Code §1031 for an exchange, which defers the tax.

The problem for X, related to the subject at hand in this Note, is that X cannot qualify for the deferral of the gain when X acquires the Y-1 property, if the property that X transferred, X-1, is property that is deemed to be inventory, or property held primarily for sale in the hands of X. That is, as to the X-1 property, X is a dealer. In such case, X cannot use the tax-deferred exchange rules of Code §1031. (X is also disqualified for the use of §1031 if the Y-1 property is acquired by X for resale.)

Thus, this is the third example of why one does not wish to be classified as a dealer: Use of the tax-deferral Section, Code §1031, would be excluded.

CASE STUDY

This short Note acted as a mere tax baedeker to emphasize the importance of determining whether a taxpayer is or is not a dealer relative to a property in question.

Under one recent case, Raymond v. Comm., T. C. Memo 2001-96, the Tax Court concluded that the taxpayer in question was a dealer for the purpose of selling homes. As such, the Tax Court specifically denied the use of the Installment Sale Method, emphasizing that a taxpayer under Code §453(a) is disqualified from the use of the installment sale technique if the taxpayer is a dealer as to the property in question. In that case, the Court cited numerous decisions supporting the position of denying the installment sale treatment and denying capital gain treatment.

The Court said the determination as to whether one is or is not a dealer is a "facts and circumstance" test, looking to the intent of the taxpayer at the time of disposing of the property.

The Court said that to determine if one is a dealer, there are a number of factors that should be considered. The Court listed some of these:

1. The taxpayer's purpose when acquiring the property;
2. The taxpayer's purpose when holding the property;
3. The extent to which the taxpayer makes improvements to the property;
4. The frequency, number and continuity of the dispositions in question;
5. The extent and nature of the taxpayer's effort to try to have the property sold;
6. The activity or degree of action by the taxpayer in trying to sell the property;
7. The number, extent and nature of transactions in which the taxpayer is involved;
8. The taxpayer's business on an everyday basis.

These factors, and others, have been named in many cases. The Court noted that no single factor controls whether one is a dealer.

CONCLUSION

There are many other considerations for dealers. For example, there are issues as to whether losses can be currently deducted, the character of the loss (capital or ordinary) whether expenses can be currently deducted, and other implications to being a dealer. However, the three areas noted above are among the most crucial considerations for taxpayers who are concerned with the issue of whether they will have a capital gain, whether they wish to use the installment sale method, and whether they can use the tax-deferred exchange method under Code §1031.

All of these factors hinge, at least in part, on whether the taxpayer will be deemed to be a dealer on the subject property.

For more in this area, see Levine, Mark Lee, *Real Estate Transactions, Tax Planning*, The West Group, St. Paul, Minnesota (2003).