Compliments of Ira Feldman
Reprint from PRACTICAL TAX STRATEGIES
RIA/ November 2005

PLAN NOW TO AVOID DEALER STATUS FOR 'INVESTMENT' REAL ESTATE

The increased involvement of real estate investors can unintentionally turn their capital gains into ordinary income unless they take appropriate steps to solidify their investor status.

IRA S. FELDMAN, CPA

The problem is quite simple: By being classified as a dealer in real estate, a taxpayer can owe at least double the tax an investor would have paid. Without proper knowledge and planning, an "investor" can fall into the "dealer" trap even before Uncle Sam asks why the investor reported the gain as long-term capital gain. To add insult to injury, a dealer in real estate also could incur self-employment taxes on his or her "dealer" income.

Proper classification depends on a subjective analysis of all the facts and circumstances. Fortunately for the taxpayer, planning can help structure the "facts and circumstances" in his or her favor. As the cases cited below reveal, this is one area where "how you do it" may be as important as "what you do." Said another way, substance and form are both important.

IRA S. FELDMAN, CPA, CVA, CEP, *of Phoenix, Arizona, is a tax consultant to several CPA firms and a member of the Editorial Board of* Practical Tax Strategies. *He is a former member of the Board of Directors of the Arizona Society of CPAs, former Chairman of their Taxation Division, and currently is Chairman of the Phoenix Tax Workshop and a Director of Small Business Council of America. He currently edits the Arizona Income Tax Guide and Arizona Sales & Use Tax Guide, published by the Phoenix Tax Workshop. The author thanks* Joseph J. Moritz, Jr., *a Phoenix attorney specializing in real estate law, for his assistance in compiling definitions of terminology for this article.*

Growing concern

Why is this classification issue more of a problem today? While the dealer versus investor issue has been the subject of many tax controversies over the last 50 years, the manner in which real estate progresses from investment to development (investor to user) has significantly changed in recent years. In high growth areas of our country, the old investment scenario of buying a "chunk" of undeveloped land (raw land), holding it for many years until the growth pattern of the communities nearby caught up, and then selling the "chunk" to a homebuilder who would convert it into usable plats, lots, or subdivisions is no longer viable. Today, the homebuilders and shopping center developers use "just in time" inventory control mechanisms (just like their manufacturing brethren) to control their supply of ready-to-build lots. Meanwhile, governments have matured in their regulatory processes so that it is very difficult for the unsophisticated investor to make much out of his "chunk."

The result is that the size of such chunks are increasing, the number of speculative

investors are decreasing, and those that remain must do much more to advance the status of their property as a maturing investment. Raw land investing has become almost as sophisticated as "going public" in the corporate world. Just as in the corporate world, more time, planning, and sophisticated knowledge (requiring more money) are necessary ingredients. The upside is that the numbers are larger, but so is the incentive for the IRS to challenge the "investor's" status.

Before diving into the technical discussion, consider this perspective: Real estate prices have been skyrocketing in booming areas of the country. Investors are rushing to maximize their gains. Most of those investors have no real intent to "develop" their property by becoming dealers in real estate. Yet, the combination of "maximizing gain" and participating too much in the real estate life cycle—combined with the lack of proper planning or even knowledge that such planning is necessary—can give the IRS much fodder. Just as in the family limited partnership/discount cases,[1] the IRS is likely to select the worst fact situations (i.e., best for it), and many of the tax accountants and attorneys do not have a sufficient understanding of the difference between the real estate life cycle today and that of many years ago when the "foundation" cases in this dealer vs. investor area were litigated. Hopefully, the discussion in this article will help in assisting taxpayers to preserve their desired investor status.

Legal principals

The operative Code provision is Section 1221(a)(1). It defines the term "capital asset" as **property held by the taxpayer (whether or not connected with the taxpayer's trade or business)**, but expressly **excludes**, among other items, "property held by the taxpayer **primarily for sale to customers** in the **ordinary course of his trade or business**." The words in bold are the ones contained in this definition that have caused most of the controversy over the years. The U.S. Supreme Court has noted that the purpose of this provision is to differentiate between profits and losses arising from the everyday operation of a business on the one hand, and the realization of appreciation in value accrued over a substantial period on the other. The word "primarily" has been held by the Supreme Court to mean, "of first importance" or "principally."[2]

Over the years, many court cases have dealt with this "dealership" issue. Most of the cases are rather old and involve factual settings that occurred prior to the more recent years' regulatory requirements for the entitlement process in enhancing the value of the real estate. Many of these old cases involved situations where substantial improvements were made to the property (the word improvements in this context always related to a physical type of improvement) or situations where the taxpayer sold off multiple lots out of one parcel. Only in recent years have property owners had to go through a specific plan and other entitlement processes to subdivide and develop their lots (whether they did so themselves or a subsequent buyer did). If the owner does not intend to make any physical improvements, the significant issue sometimes raised is whether the present owner of the property, who is either participating in or facilitating the entitlement process prior to the close of escrow of a sale, will be adding a substantial negative attribute, causing the IRS to reclassify successfully the investment intent to that of a dealer.

Perhaps the best case illustrating the attributes that need to be examined is *Fraley*,[3] where the Tax Court confirmed the "attribute" laundry list that needs to be examined to determine the owner's intent. This list of attributes was detailed in a series of Sixth Circuit decisions (some discussed below) issued in the late

Business Coaching Can Help You and Your Client's Bottom Line.

Join Accounting Firms nationwide that are entering into a strategic relationship with The GROWTH COACH®, America's most recognized name in Small Business and Self-Employed Coaching. The GROWTH COACH® offers a proven, strategic quarterly process and one-on-one coaching that is guaranteed to help your clients focus and become more accountable for their actions. To drive Success. To work smarter, not harder.

Call today to see how you can profit through our exclusive "fee share program" while at the same time helping your clients achieve greater success. In the end, they'll thank you for it.

Recognized by Entrepreneur Magazine, Wall Street Journal and other National Publications.

America's Proven Coaching Process with Guaranteed Results.

THE GROWTH COACH®
Driving Success. Balancing Life.™

For more information call 1 (888) 292-7992

www.TheGrowthCoach.com

DEALERS MAY SEGREGATE CERTAIN TRANSACTIONS IN PROPERTY SIMILAR TO THEIR STOCK IN TRADE IN ORDER TO QUALIFY FOR CAPITAL GAINS TREATMENT.

1970s, in which the court upheld the axiom that, "whether land is held primarily for sale to customers in the ordinary course of a taxpayer's trade or business is a purely factual determination." The 1993 *Fraley* case merely reconfirms these attributes. They are:

1. The purpose for which the property was acquired.
2. The purpose for which the property was held.
3. The extent of improvements made to the property.
4. The frequency of sales.
5. The nature and substantiality of the transactions.
6. The nature and extent of the taxpayer's dealings in similar property.
7. The extent of advertising to promote sales.
8. Whether the property was listed for sale either directly or through brokers.

No one attribute is clearly determinative of the holding intent. Rather, all of the attributes are weighed with consideration of the importance or applicability of each.

While *Fraley* is a minor Tax Court decision issued in 1993, its holding was based on a line of cases dating back to 1963. In that 30-year time span, the basic framework was relatively unaltered. With the exception of the last two years, over the past 40-plus years (a period during which substantial change has occurred in the way one prepares property for sale), standards or attributes examined with regard to the dealership issue remained unchanged. In fact, the courts focused on many specific facts to which they applied these attributes. For example:

- Dealers may segregate certain transactions in property similar to their stock in trade in order to qualify for capital gains treatment.[4]
- Merely holding property with the ultimate intention of selling is insufficient to disqualify income from characterization as capital gains; a taxpayer's activity with regard to the property must be the conduct of a trade or business.[5]
- Is the property held primarily for sale to customers in the ordinary course of the taxpayer's business *at the time of sale or disposition?* Consider both whether the taxpayer held the property primarily for sale to customers and whether the property was for sale in the ordinary course of the taxpayer's trade or business.
- Even if a parcel of land was originally acquired for sale to customers, that purpose is not conclusive. The purpose could change before the sale occurred, and the purpose for which the land is held at the time of sale is determinative.

REAL ESTATE NOMENCLATURE

Real estate terms used in this article do not necessarily have the same meaning for tax and general business or legal purposes. In some instances, a term may connote something of importance in tax parlance that is completely different than the context used in general business or for real estate regulatory purposes. Below are legal definitions of key real estate terms:

Developed. **The purposeful modification of property from its original state in a manner that effectuates a condition of gainful or productive use.**

Planned area development. **A development that is intended to correlate city ordinances comprehensively to provide a stable environment in harmony with that of the surrounding area to permit flexibility in design, placement of buildings, use of open spaces, and circulation facilities.**

Development agreement. **An agreement between a municipality and either a community facilities district pursuant to state law, a landowner, or any other person having an interest in real property that may specify details, such as use conditions and timing of use.**

Onsite improvements. **These are improvements constructed on the applicant's property or improvements constructed on abutting property.**

Infrastructure improvement. **This includes sanitary sewage systems, drainage and flood control systems, water systems, landscaping, lighting systems, and all physical types of construction.**

Subdivider. **A person or other legal entity that files applications and initiates proceedings for the subdivision of land.**

Subdivision. **Improved or unimproved land or lands divided for the purpose of financing, sale, or lease—whether immediate or future—into multiple (e.g., at least four under Arizona law) lots, tracts, or parcels of land.**

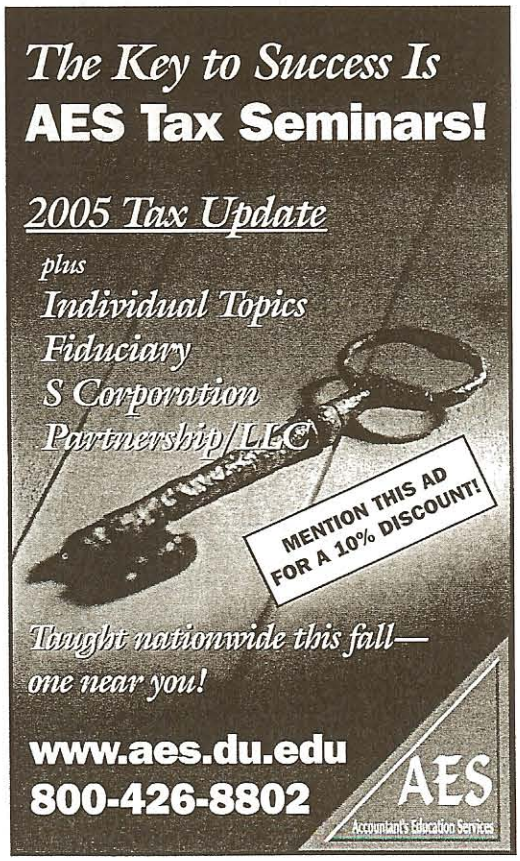
- Section 1221(1) defines the term "capital asset" as property held by the taxpayer (whether or not connected with the taxpayer's trade or business). The provision expressly excludes, among other items, "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." Thus, the provision differentiates between the profits and losses arising from everyday operation of a business, and the realization of appreciation that accrued over a substantial period.

More recent clarification

One recent Tax Court case and three very recent private letter rulings (all favorable for the taxpayer) add much improved definition to interpretation of dealer versus investor in light of today's real estate cycle.

In *Phalen*,[6] the Tax Court applied the taxpayer's factual situation to the attributes in its previous *Fraley* decision and to several other Tax Court and circuit court decisions dealing with specific individual factual attributes. It further considered the factors articulated by the Tenth Circuit, to which this case would be appealed. The activities articulated in the *Phalen* decision are very similar to those an investor may have to undertake today to maximize the value of his or her investment without crossing the line to engage in "dealership." The *Phalen* attributes include:

- The owners of the development entity (some of whom were real estate developers in their other activities and owned their interests in the same percentages as investors) did not taint the taxpayer partnership's investment status. The court applied this principal in *Bramblett*,[7] which held that the business activities of the corporation were not attributed to the partnership when the taxpayer and his partners formed a separate corporation to develop and sell real estate they owned in the same proportions as their stock ownership in the corporation.
- A guarantee by the investment partnership of the performance of the development agreement with the municipal improvement district was not fatal.
- The investment partnership succeeded to rights under the master plan and the development agreement put in place by the former bankrupt developer/owner, and assumption of these rights did not taint the investment purpose.
- The sale of multiple tracts to different buyers (who also were developers) over four years, in this case, was acceptable.
- The investment partnership's participation in financing the activity of the developer who was the buyer and financing the municipal improvement district (which was obligated to construct the improvements) was not fatal.
- Soil testing to evaluate the development alternatives for the property was acceptable.
- The investor partnership's participation in amended and final site plans was acceptable.
- All corporate and partnership formalities were carefully followed—even between related investor/dealer entities.
- Good business reasons existed for the sale to related (through ownership) development entities and for structuring of activity among the investment part-



nership, municipal improvement district, and the financing.
- The individuals, personally, were not real estate brokers or agents.
- All sales were unsolicited.
- "Development" activities (in this context, physical improvements) were not directly undertaken by the investor partnership.

Three recent private letter rulings reveal how the IRS views activities that owners undertake in their "maturing" real estate investment markets. The three rulings cited below were issued to tax-exempt organizations that were concerned their investment activities would classify them as dealers, thus yielding unrelated business income tax (UBIT). While the specific issue was UBIT, the Service essentially had to examine the organizations' real estate attributes to determine if they were investors or dealers. If an organization was an investor, the gain would not be UBIT. In an abundance of caution, these charitable organizations decided to apply for a private letter ruling so that they could determine their status in advance by "volunteering" their specific factual situations. Of course, they received favorable rulings because unfavorable viewed ones are usually withdrawn. Yet, the facts considered by the Service as positive or negative on the issue are instructive of how it might view a client's specific facts.

TAXPAYERS HAVE RUSHED TO TAKE ADVANTAGE OF THE MARKET SITUATION WHILE THROWING CAUTION TO THE WINDS WITH REGARD TO TAX PLANNING.

In Ltr. Rul. 200510029, the sale of nine land parcels was not unrelated business income. The charity, a school for disadvantaged children, owned farmland which was now suitable for development. The facts examined by the Service include:
- The proposed buyers would bear the cost of the site plan and improvements. (The discussion there by the Service seems to imply it is concerned with "physical" not "paper" improvements.)
- They will use a passive, patient, market approach.
- The historic use of the land was for farming, an activity related to their exempt purpose.
- The parcel was too large to sell to one buyer to "receive maximum value." (This implied that the investor could maximize value by selling to multiple buyers in different market segments.)
- Multiple sales would allow the seller to "control the pace and type of development."
- The buyers (developers) were responsible for on-site and off-site construction activities.
- No improvement was required to make the property more attractive for sale. Utilities already abutted the site. (This implies again that the Service is concerned about physical improvements.)
- The buyer would plat the subdivision of the lots.
- There was a definitive change in ability to use for farming resulting in a "surplus land" status.

The taxpayer in Ltr. Rul. 200242041 was a religious school situated on a portion of the land to be sold. The land had been held for a long time. Attributes examined in this positive (for the taxpayer) ruling include:
- This portion of the land was not suitable for school purposes (i.e., surplus property).
- The parcel (45 acres) had to be divided in order to sell and maximize the gain.
- A roadway needed to be constructed for access to the parcel, which was to be subdivided into three residential lots. The charity proposed to build the roadway, drainage, landscape, and trails as required by the township in which the parcel was located, and the charity was required to enter into a subdivision agreement with the town.
- No active marketing would occur, although the charity may list with a realtor, if necessary, after a period of "self marketing."
- The charity has no history of subdividing real estate.

Also see Ltr. Rul. 200532057 for a similar fact pattern and a favorable ruling.

In Ltr. Rul. 200530029, a private foundation received, over time, various parcels of unimproved land from its founder, including several from his estate. It could not sell these parcels due to a depressed real estate market. However, at the time of the ruling, the real estate market was hot. Also, zoning changes (including changes to the Foundation's parcels on its application) and large property tax increases made

it unfeasible to continue to own the parcels. Again, they were too large for most single buyers. The Service examined the following attributes in its positive ruling:

- The parcels were to be subdivided into lots no smaller than 20 acres each.
- A passive marketing approach was to be used. The foundation would attempt to sell through its prospectus sent to interested parties (sounds like a sales flyer/brochure). (Note the passive marketing approach that appears in all three rulings and several cases.)
- There would be a maximum of two sales per year over 20 years. (Is that good or bad? Could one not say they were regularly carrying on a trade or business?)
- The foundation performed land planning and preliminary engineering to determine how to maximize the value of its investment.
- All parcels were sold to developers.
- The words "improvement" is connected to "construction" to connote a physical change in the property, not a paper change.

One final note. While the courts seem to focus on and accept the attributes articulated in *Fraley*, they occasionally have different interpretations of one or more specific attributes as being positive or negative. For example in *Wood*,[8] the Eleventh Circuit said that when examining the intent of the taxpayer, "the 'holding purpose' inquiry may appropriately be conducted by attempting to trace the taxpayer's primary holding purpose over the entire course his ownership of the property ... thus, the inquiry should start at the time the property is acquired." However, the standard usually has been that the relevant intent is to be examined at the time the property is sold since one's intent can change over time.

Conclusion

The dealer versus investor issue with regard to real estate recently has become the object of more attention because of the overheated real estate market. The growth of cities and urban areas has brought many long-held parcels to their ultimate market—i.e., residential and commercial development. The old attributes articulated in *Fraley* in 1993, and cited in many cases thereafter, have been reexamined, confirmed, and given new application to recent market trends in real estate. Fortunately, there now is quite a bit of guidance, and at least in this area, favorable application for those investors who are willing to carefully structure their activities in bringing their investment property to market.

Like in many other areas of taxation, the problem is that taxpayers have rushed to take advantage of the market situation while throwing caution to the winds with regard to tax planning. That may mean we will be seeing much more in the way of interpretive guidance from the IRS and the courts. ■

NOTES

[1] See, e.g., Feldman, "Ensure the Economics of Charitable Remainder Trusts," 75 PTS 226 (October 2005).
[2] Malat v. Riddell, 383 U.S. 569, 17 AFTR2d 604 (1966).
[3] TCM 1993-304.
[4] Case, 46 AFTR2d 80-5981 (CA-6, 1980).
[5] Ferguson, TCM 1987-257.
[6] TCM 2004-206 .
[7] 960 F.2d 526, 69 AFTR2d 92-1344 (CA-5, 1992).
[8] 95 AFTR2d 2005-2778 (CA-11, 2005).