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REAL ESTATE

PRIMER

Introduction

Any gain made upon the sale of real property may be taxed as capital or as ordinary income depending on whether that property is classed as a "capital asset" under § 1221 of the Internal Revenue Code (IRC).[1] This primer discusses how to determine whether real property may be considered a capital asset for federal tax purposes.

The difference between capital gains and ordinary income can be significant for sellers as capital gains are usually taxed at a lower rate than ordinary income. For example, in 2019, an individual paid a maximum federal income tax rate of 37% on ordinary income, but only 20% on long-term capital gain.[2] For corporations, capital losses can be used to offset capital gains and decrease overall tax liability,[3] however, qualifying for capital gain treatment is a complex and multi-faceted legal question.

Capital gains are derived from the sale of capital assets and real property is generally categorized as a capital asset, unless specifically excluded by § 1221. This primer focuses on subsection 1221(a)(1), which excludes property held by the taxpayer primarily for sale to customers in the ordinary course of that taxpayer's trade or business. The courts apply a three-part test to determine whether the property qualifies for the § 1221(a)(1) exclusion by analyzing seven key factors, which are explored below.

Key Concepts

Capital Gains: gains from the sale or exchange of a capital asset.

Capital Gain Tax: a seller is taxed at the long-term capital gains rate for property held longer than one year before sale. The rates are 0%, 15%, or 20% in 2019, depending on the total gain. If an asset is held for one year or less before sale, the net short-term capital gain will be taxed at the relevant ordinary income tax rates.[4]

Ordinary Income: includes any gain from the sale or exchange of property (for example, earnings from interest, dividends, employment, royalties, or self-employment) but does not include a capital asset nor property described under § 1231(b).[5]

Key Legislation

IRC § 1221: Capital Assets

All property is classified as a capital asset unless specifically excluded by § 1221. This means that the individual taxpayer's real property will be considered a capital asset unless it falls under one of the exclusions stated in § 1221.[6] This primer focuses on the exclusion outlined in § 1221(a)(1), which states that property will not be considered a capital asset if it is held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.[7]

In *Malat v. Riddell* ("*Malat*"), the Supreme Court explained that the purpose of § 1221(a)(1) is to differentiate between "profits and losses arising from the everyday operation of a business", which would be classified as income, from "the realization of appreciation in value accrued over a substantial period of time", which would be classified as capital gains.[8]

The courts have narrowly construed the term "capital asset" in order to afford capital gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation on the entire gain in one year.[9]

Legal Test

The Court's factual analysis can be framed by the following three-step test as confirmed in Suburban *Realty Co. v. United States* ("*Suburban*").[10] If the answer to all three of these guiding questions is yes, the property is not a capital asset and will be taxed as ordinary income rather than a capital gain.

1. Was the taxpayer engaged in a trade or business?
2. Did the taxpayer hold the specific property at issue primarily for sale in that business?
3. Were the sales made in the ordinary course of that business?

Key Factors

Whether property is held by a taxpayer primarily for sale to customers in the ordinary course of a trade or business is a factual question that depends on the following seven factors as articulated in *United States v. Winthrop*:[11]

1. The nature and purpose of the acquisition of the property and duration of ownership;
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 advertising 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 any representative selling the property; and
7. The time and effort the taxpayer habitually

devoted to the sales.

These key factors are used to distinguish between profits and losses arising from the everyday operation of a business (income) rather than the profits and losses from the realization of the appreciation in value accrued over a substantial period of time (capital gains).

Any factor may inform one or all of the questions, depending on the circumstances of the case.[12] However, in *Biedenharn Realty Co., Inc. v Commissioner* ("*Biedenharn*"), the Fifth Circuit stated that the frequency of sales is the most important factor to be considered.[13]

Key Factor Discussion

1. The Nature and Purpose of the Acquisition of the Property and the Duration of the Ownership.

As per *Suburban Realty*, this factor involves tracing the taxpayer's primary holding purpose over the entire course of their ownership of the property.[14] The courts will determine the taxpayer's primary purpose for acquiring the property and will also consider evidence of any change in this purpose. For example, if the taxpayer originally intended to hold the property as an investment and there is no evidence of a change in purpose, this will likely support a finding that the property is a capital asset. In contrast, when the primary intent for holding the property has changed, an original investment purpose is unlikely to outweigh evidence of a different present business purpose.[15] Thus, *Suburban Realty* prescribes an approach that looks for changes in intention throughout the holding period. Facts relevant to this inquiry include changes in development activity, development plans, sales activity, unexpected events, and involuntary changes in intention.[16]

Lastly, the longer the property was held, the more likely it will be treated as a capital asset. A longer duration of ownership is consistent with "the realization of appreciation in value accrued over a substantial period of time," per *Malat*.[17]

2. The Nature and Extent of the Taxpayer's Efforts to Sell the Property.

The greater the taxpayer's solicitation and sales efforts, the more likely the sale proceeds will be treated as ordinary income.[18] However, significant sales efforts are not always required for an ordinary income treatment. For example, in a seller's market, sales may arise passively, and this does not prevent a finding of ordinary income.[19]

3. Number, Frequency, and Continuity of Sales.

As per *Biedenharn*, this is arguably the most significant factor.[20] The more frequent and substantial the taxpayer's sales activities, the more likely the gains from the sale at issue will count as ordinary income. Note that the key indicator is the number of transactions, not the number of lots sold. For example, disposing of multiple parcels of land in a single transaction is likely to result in capital gains treatment because it can indicate the one-off transaction was not in the ordinary course of business.[21]

4. The Extent of Subdividing, Developing and Advertising to Increase Sales.

Generally, the development and improvement of land is seen as a method to promote sales. If a taxpayer develops real property by subdividing, grading, rezoning or installing roads and utilities, this makes an ordinary income characterization more likely.[22]

5. The Use of a Business Office for the Sale of the Property.

If a taxpayer maintains offices to dispose of the property, the proceeds are more likely to be treated as ordinary income.[23]

6. The Character and Degree of Supervision or Control Exercised by the Taxpayer Over Any Representative Selling the Property.

In some cases, the employment of brokers, along with the delegation of substantial responsibility to them, has helped to shield the taxpayer from ordinary income treatment (i.e., the taxpayer engaged an expert to help them with a task they normally do not engage in).[24] In contrast, other cases consider a taxpayer's limited delegation of responsibility to their broker as an indicator that the taxpayer is engaging in the trade or business of selling real estate.[25]

7. The Time and Effort the Taxpayer Habitually Devoted to the Sales.

If a taxpayer devotes a significant portion of their time and effort to selling parcels of real estate, those parcels take on the appearance of inventory.[26] Additionally, if a taxpayer's primary source of revenue is generated from the sale of real property, the parcels are more likely to be characterized as ordinary income-producing assets.[27]

Tax Foresight

Is your client's property a "capital asset" under § 1221(a)(1) of the IRC? Find out!

Tax Foresight's **US Real Estate Classifier** requires you to complete a questionnaire about the facts of your case. Each of the questions represents a factor found to inform court decisions regarding the characterization of a gain or loss from the sale of real estate. Once you answer all of the questions, Tax Foresight will compute the likelihood of the property being characterized as a "capital asset", comparing your scenario to all relevant cases from the past 50 years.save you valuable time in your reading and research by finding cases by outcome, transaction characteristics, relationship between parties, financial circumstances of the issuer, terms of repayment, etc. The Case Finder can find the most relevant cases for a specific combination of factors.

Endnotes

1 26 U.S.C.
2 Internal Revenue Services, *Topic No. 409 Capital Gains and Losses*, (May 2019), online: https://www.irs.gov/taxtopics/tc409.
3 *Id.*
4 *Id.*
5 Sec. 64.
6 *Tollis v. Commissioner*, 46 F.3d 1132 (6th Cir., 1995).
7 Sec. 1221(a)(1).
8 *Malat v. Riddell*, 383 US 568 (1966).
9 *Suburban Realty Co. v. United States*, 615 F.2d 171, 178 (5th Cir. 1980).
10 *Id*.
11 *United States v. Winthrop*, 417 F.2d 905 (5th Cir., 1969).
12 *Id.*
13 *Biedenharn Realty Co., Inc. v. Commissioner*, 526 F.2d 409 (5th Cir. 1976).
14 *Suburban Realty, supra* note 9.
15 *Biedenharn Realty, supra* note 13.
16 *Suburban Realty, supra* note 9.
17 *Malat v. Riddell*, *supra* note 8.
18 *Flood v. Commissioner* (USTC, 2012), TC Memo 2012-243.
19 *Biedenharn Realty, supra* note 13.
20 *Id.*
21 *Sugar Land Ranch Dev., LLC v. Commissioner* (USTC, 2018).
22 *Biedenharn Realty, supra* note 13.
23 *Winthrop, supra* note 11.
24 *Byram v. Commissioner*, 705 F.2d 1418 (5th Cir. 1983); *Bidenharn Realty Co., Inc. v. Commissioner*, 526 F.2d 409 (5th Cir. 1976).
25 *Biedenharn Realty, supra* note 13.
26 *Flood, supra* note 18.
27 *Winthrop, supra* note 11.