

PRESERVING CAPITAL GAIN TREATMENT FOR REAL ESTATE DEALERS

The character of gain or loss from the sale of real estate will depend in part on the classification of the seller. An investor will generally get favorable capital gain tax treatment. A real estate dealer will generally have ordinary income. Although the real estate dealer, including developers, will generally be subject to ordinary income tax treatment, there are a variety of strategies that can preserve some capital gains treatment.

Capital gains rates apply to those assets defined as “capital assets”. The Internal Revenue Code expressly excludes dealer property, which is property held primarily for sale in the ordinary course of business. Income is ordinary if the profits and losses arise from the everyday operation of a business. The profit is capital gain if the gain is appreciation in value accrued over a substantial period of time.

Property sold following development activity is likely to be treated as property held for sale in the ordinary course of business rather than as investment property. Improvements are considered indicative of a trade or business.

Developers and other taxpayers may hold some property for investment and hold other property for sale. Taxpayers who deal in real estate should exercise care to create a clear distinction between investment activities and dealer activities.

Taxpayers owning real estate subject to differing tax treatment should consider separate legal entities for different types of real estate. Segregation of investment activities will assist in achieving the desired tax treatment.

Taxpayers purchasing property for development should always consider whether there is an investment feature of purchased real estate. If so, the taxpayer should separate the purchase into investment components and development components. For example, if a developer purchases a property that has a 40 unit apartment building and several acres of undeveloped land and the developer plans to hold the apartments but develop the balance of the land into condos to sell, the purchase should be treated as two separate purchases. Distinctions should be maintained.

Some strategies that can be used to preserve capital gain treatment include use of the safe harbor under Internal Revenue Code Section 1237, the transfer of real property to a related entity, and an installment sale to a related entity. The usefulness of each possible strategy depends on the specific facts of the real estate owned and any the development plans. Significant tax savings can result by analyzing tax issues and strategies to preserve capital gains treatment prior to the purchase of real estate.