Dealer or No Dealer:
Unlocking Capital Gains Treatment in Land Sales

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The road to bankruptcy is paved with well-intentioned investments. This new take on an old adage seems quite fitting given the events of the past year. No doubt the shareholders of Circuit City, Chesapeake Corporation and LandAmerica thought they were making good investments. And any of us who have seen the balances on our quarterly 401(k) and Individual Retirement Account quarterly statements plummet likely did not start our savings thinking that contributing to our retirement accounts would be a bad investment. Of course, investments carry inherent risks. But the risks currently associated with stocks for some investors may seem more like picking the million-dollar case on a game show than like making an evaluated and reasoned investment decision. So even as the stock markets begin to rally and sources indicate that the worst may be over, investors have good reasons to be gun-shy about investing in the stock market.

While an investment in land is far from a sure thing, the two greatest risks associated with such an investment are appreciation in value and tax treatment.

Fortunately, the stock market is not the only game in town. Other investment opportunities allow investors to funnel capital into various sources with the hopes of generating a return over time. One particularly attractive investment is land. While an investment in land is far from a sure thing, the two greatest risks associated with such an investment are appreciation in value and tax treatment. Appreciation in value is largely outside of the investor's control. Timing and improvements impact the value of land, but market—although not necessarily stock market—forces have the greatest impact on appreciation in land values. However, the other primary risk, tax treatment, is more controlled by the investor. Investors can reduce taxes by 20 percent by maximizing the likelihood of being classified as an investor rather than as a dealer.

General Lay of the Land

Internal Revenue Code Section 1222 states that the sale of a capital asset will generate capital gain or capital loss. Under Section 1221, land will generally be treated as a capital asset as long as it is not held by the investor "primarily for sale to customers in the ordinary course of [the investor's] trade or business." The investor who sells land in the ordinary course is considered a dealer and is subject to ordinary income tax on all gains or losses on the land sales.

The classification of taxpayers as dealers versus investors has been litigated and has been frequently discussed in IRS guidance. Ultimately, the tax treatment of gains and losses in real estate sales hinges on this classification. The line between investor and dealer is unclear and subject to change; someone initially holding property for investment can later become a dealer if he or she acts like a dealer.

Fortunately for investors, in the specific context of real estate transactions the courts have developed numerous factors to aid the analysis involved in identifying a dealer.[1] These factors include:

- **Number and frequency of sales**: The greater the number and the more frequent the land sales, the more likely the taxpayer will be treated as a dealer.

- **Purpose for acquisition and reason for holding the property**: The intent of the taxpayer affects the analysis; however, authorities are unclear as to when intent is determined. What is clear is that intent can change over time.[2]

- **Development activities**: The more extensive the development activities, the more likely the taxpayer will be treated as a dealer; however, the motivation for development impacts the determination.

- **Sales activities**: Advertising and marketing activities or the use of brokers or agents in selling the property indicates dealer status.

- **Duration of Ownership**: The longer the property is held the more likely the taxpayer will be classified as an investor.

- **Relationship of Property to Business**: If the sale of the property benefits the taxpayer's primary business, the taxpayer will be a dealer for that parcel.

- **Maintenance of an office and requisite licenses**: The maintenance of a sales office and the appropriate license for conducting sales activities indicates dealer status.

- **Substantiality of sales**: If the income derived from land sales comprises a significant portion of the taxpayer's net income, the taxpayer will likely be a dealer.

- **Replacement Property:** The acquisition of new property to replace property sold indicates an intent to trade in real estate and thus supports dealer status.

Most courts are of the opinion that no one factor is determinative; each case is evaluated individually on its specific facts. Additionally, a taxpayer may be considered an investor as to one parcel of property, even though he or she is clearly in the real estate business and is a dealer of other properties.[3] The multifactored analysis contributes to the uncertainty, and thus the risk, in receiving capital gains treatment for land investments. However, armed with the proper information and legal guidance, investors can structure transactions and holdings to maximize the likelihood of preserving investment treatment for those parcels held for investment purposes.

More than a Game of Chance

Investors at the greatest risk of being classified as dealers in land are those who hold multiple parcels and who wish to develop the land to improve its resale value. Take the following three examples:

Case One: Taxpayer owns seven lots, six of which have been held for just over one year. All seven lots are sold by Taxpayer in unadvertised sales during the course of the year. Taxpayer has sold twenty-two lots over the prior three years.

Dealer or no dealer? No dealer. The facts of this case were presented in *Byram v. United States*[4] and although the government argued that the short holding period along with the frequency and substantiality of the sales argued in favor of finding dealer status, the court disagreed. The court determined that because the sales were unadvertised and no broker was used, the substantiality and frequency of sales alone was not sufficient to sustain a finding of dealer status.

Case Two: Taxpayer owns six tracts of unimproved property. Taxpayer sells all six tracts over a four-year period in five separate sales. Over a thirty-two-year period Taxpayer has made 244 land sales, or seven per year on average. Taxpayer's development of the parcels was minimal and Taxpayer did not advertise or otherwise actively solicit the sales.

Dealer or no dealer? Dealer. These facts are similar to those considered in *Suburban Realty Co. v. United States*[5] in which the court determined that the continuous sales over a long period of time supported a finding of dealer status even though there were minimal improvements and no active advertising activities. The court also indicated that the taxpayer's lack of other business activity supported its finding that the primary business of the taxpayer was dealing in land.

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Case Three: Taxpayer owns a tract of land that has been subdivided into 152 lots. Taxpayer received approval for a subdivision plat and engaged a construction company to build streets and install sewer and water systems. Taxpayer then sold the improved tract in six different sales to six contractors.

Dealer? Or no dealer? No Dealer. In *Thrift v. Commissioner*[6] the court reviewed similar facts and determined that the taxpayer was not a dealer. The court found that the improvements and subdivision of the land were made only to promote the sales of the land. The court noted that the taxpayer never advertised the sales to individuals and never held a license as a real estate dealer.

Like the taxpayers in the cases above, typical land investors want to capture gain as capital gain but also want to improve or develop the property in order to make the property more saleable. Ideally, investors want to separate the gain attributable to general appreciation of the property over time (capital gain) from gain attributable to active business efforts of the investor (ordinary income).

This separation is sometimes accomplished by having the investor establish both an "investment entity" and a "development entity." The involvement of multiple entities owned by the same or similar taxpayers carries the risk that the IRS will treat the investment and the development activities as being conducted by the same taxpayer (or agents of the same taxpayer), thus supporting a finding of dealer status. However, there may be legitimate reasons to separate a taxpayer's investment and development activities into separate entities — for example, the protection against liability arising from the taxpayer's development activities. Furthermore, the taxpayer's subsequent involvement in the development of land does not necessarily negate the taxpayer's earlier investment intent or investor status.

Conclusion

The classification of the investor as a dealer or as an investor determines whether the taxpayer will receive the benefit of tax savings in the form of a current 20 percent difference between ordinary income and long-term capital gain rates. Planning may not eliminate market risks associated with real estate, but with advanced planning and proper structuring a landowner may be able to separate investment activities from development activities with respect to the same land and receive capital gains treatment on the appreciation of the investment land. ■

Endnotes:

1 *See e.g.*, *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 415 n.22 (5th Cir. 1976), *cert. denied*, 429 U.S. 819 (1976).
2 *See e.g.*, *Maddux Construction Co. v. Commissioner*, 54 T.C. 1278 (1970) (permitting capital gains treatment for the sale of land even though the parcel was originally acquired to be developed and sold as part of a subdivision).
3 *See e.g.*, *Scheuber v. Commissioner*, 371 F.2d 996 (7th Cir. 1967) (finding that a parcel sold by the dealer-taxpayer was a capital asset even though the other parcels held by the investor were dealer assets).
4 705 F.2d 1418 (5th Cir. 1983).
5 615 F.2d 171 (5th Cir. 1980).
6 15 T.C. 366 (1950).