FEDERAL INCOME TAX TREATMENT OF REAL ESTATE SALES: HOW ARE YOU TREATING YOUR GAINS AND LOSSES?

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If you are a real estate owner or developer, you may be under the impression that your profits and losses from the sale of property must be treated as ordinary income or losses, and that you are therefore subject to federal income tax rates that can be as high as 39.6%. However, it is possible that profits you have received from the sale of property may instead be treated as capital gains, which are generally taxed at a maximum rate of only 20% for noncorporate taxpayers.

Under Section 1221(a)(1) of the Internal Revenue Code (the "Code"), income or losses from the sale of property "held primarily for sale to customers in the ordinary course of a taxpayer's trade or business" are treated as ordinary. Any income or losses from the sale of property outside this classification are treated as capital gains or losses.

Determining whether the sale of property qualifies as the sale of a capital asset first requires an analysis of whether the property was held "primarily" for sale. This is not necessarily as straightforward as it may seem, since property can be used for more than one purpose. In addition, taxpayers may change their purpose for holding property during their term of ownership. For example, you may own an apartment building that you later decide to convert to condominiums; or, you may own and rent several properties and later decide to sell a handful of them over a period of a few years. How do these decisions affect the federal income tax treatment of your gains and losses?

The U.S. Supreme Court provided some guidance in its decision in Malat v. Ridell, 383 U.S. 569 (1966). There, the taxpayer was a member of a joint venture that purchased real estate to develop and operate an apartment complex. When the joint venture members had trouble obtaining financing, a portion of the property was subdivided and sold, and the profit from the sales was reported and taxed as ordinary income. The members continued to have difficulties developing the remaining parcels, and the taxpayer sold his interest in the joint venture and treated his profit from that sale as a capital gain. The IRS contended that the property was held by the taxpayer "primarily for sale to customers in the ordinary course of his trade or business," and that, therefore, the profits should be taxed as ordinary income.

The Federal District Court and the Court of Appeals agreed with the IRS position, but the U.S. Supreme Court disagreed. The Supreme Court held that purpose of Section 1221 of the Code is to distinguish between "profits and losses arising from the everyday operation of a business" and "the realization of appreciation in value accrued over a substantial period of time", and that, based on this purpose, the word "primarily" as used in Section 1221 means "of first importance" or "principally". The case was remanded to the District Court to

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decide the case using the legal standard articulated by the Supreme Court. The District Court found that the properties were not held primarily for sale to customers in the ordinary course of a trade or business, and that the taxpayer (and the other members of the joint venture) could report their profits as capital gains. *See* Malat v. Riddell, 275 F. Supp. 358 (1966).

While the U.S. Supreme Court's decision in Malat v. Riddell is helpful in applying Section 1221, it is important to note that holding property primarily for sale "is by itself insufficient to disqualify the taxpayer from capital gains privileges". *See* U.S. v. Winthrop, 417 F.2d 905 at 911 (5th Cir. 1969). The Courts have identified three main questions to consider when determining whether an asset is a "capital asset" under the Code:

1. Was the taxpayer engaged in a trade or business, and if so, what business?
2. Was the taxpayer holding the property primarily for sale in that business?
3. Were the sales contemplated by the taxpayer "ordinary" in the course of that business?

Suburban Realty Co. v. U.S., 615 F.2d 171 at 178 (5th Cir.), cert. denied, 449 U.S. 920 (1980).

In addition, the Courts have articulated and applied a series of factors to determine whether a sale occurred in the ordinary course of a trade or business:

1. What is the nature and purpose of the acquisition of the property and the duration of the ownership?
2. What is the extent and nature of a taxpayer's efforts to sell the property?
3. What is the number, extent, continuity, and substantiality of the sales?
4. What is the extent of subdividing, developing, and advertising to increase sales?
5. Was a business office used for the sale of the property?
6. What is the character and degree of supervision or control exercised by the taxpayer over a representative selling the property?
7. How much time and effort did the taxpayer habitually devote to the sales?

See U.S. v. Winthrop, 417 F.2d 905 at 910 (citing Smith v. Dunn, 224 F.2d 353, 356 (5th Cir. 1955)); *See also* Byram v. U.S., 705 F.2d 1418, 1424 (5th Cir. 1983).

In applying these factors, Courts have emphasized that no single factor should be determinative; instead, each case must be evaluated on its own facts. Biedenharn Realty Co., Inc. v. U.S., 526 F.2d 409 (5th Cir. 1976), cert. denied, 429 U.S. 819 (1976).

Based on the foregoing, if you are a real estate owner or developer, and you are making decisions regarding your property, the tax treatment of your gains and losses will depend on an analysis of your individual facts and circumstances under Section 1221 of the Code and related

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Court opinions and IRS decisions. Thus, it is important to consult with your tax advisor to review your sales activities, as it could positively impact your federal income tax liability.

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