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Real Estate Bulletin

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The Quest for Capital Gains

It's no secret that virtually all segments of the real estate market have been losing ground in recent times. However, given the unprecedented increase in market values in recent years, many real estate owners could have a significant gain, for tax purposes, even if they were to sell their property in today's market.

Clearly, one of the most significant factors in determining the tax associated with a sale of property is whether the gain will be taxed at ordinary tax rates or capital gains rates. Currently, the top individual federal tax rate is 35% and the most common long term capital gain rate is 15%, leading to a potential 20% difference. (It is important to note that the lower capital gains does not apply to C corporations.) The determination of whether the gain should be taxed as a capital gain or ordinary income is often as clear as dense fog. This article will look at the factors which help taxpayers address this issue.

Under the tax law, in order to have a capital gain, there must be a sale of a capital asset. A capital asset is defined by what it is not. Among other exceptions, a capital asset does not include property which would be considered to be held by taxpayer "primarily for sale to customers in the ordinary course of his trade or business". Therefore, the key issue turns on whether the property is considered to effectively be inventory or otherwise held for resale.

The extreme cases are easy to recognize. For example, a farmer who has used land as farmland for decades decides to retire and sell the land in one transaction would likely be eligible for capital gains treatment. The farmer is considered to be an investor in real estate. On the other hand, a real estate developer who acquires land, subdivides it and constructs hundreds of homes would almost certainly be considered a dealer in property and be taxed at ordinary rates. The homes, to this developer, represent inventory and therefore, the favorable capital gains rate would not apply. The developer is considered to be a dealer in real estate.

But most taxpayers are faced with facts that are in between these two extremes. The lack of a statutory definition of when a taxpayer has crossed the line from being an investor in real estate to a dealer in real estate has spurred much litigation and controversy between taxpayers and the Internal Revenue Service.

Factors to Consider

The many cases in this area analyze the following factors:

- ***Acquisition Intent.*** The taxpayers intent upon acquisition of the property is relevant to the determination of the treatment of the gain. A taxpayer who acquires property and immediately starts taking steps to subdivide or otherwise prepare the property for

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resale has likely evidenced an intent to be a dealer rather than an investor.

- ***Holding Period.*** The longer the property is held, the more investor status is favored. (In addition, remember that property must be held for over one year in order to benefit from the long-term capital gains rate.) A short-term holding period, by itself, is indicative of dealer status.

- ***Disposition Circumstances.*** Can the taxpayer point to an unusual factor to support each real estate sale? For example, a taxpayer who purchases a building for rental may choose to sell it shortly thereafter if he or she faces unforeseen obstacles in renting the building due to changes in rent control laws. A different example could be a real estate owner who is forced to sell real estate to fund a divorce settlement. Factors such as these may help to distinguish the taxpayer as an investor rather than a dealer.

- ***Frequency of sales.*** Looking at the current year, the past several years and anticipated future activity, is there a pattern of frequent real estate dispositions? A real estate investor is likely to have a low number of dispositions in absolute terms when looking at several years together.

- ***Selling Activities.*** How sophisticated and organized are the taxpayer's selling activities? A taxpayer who does not hold out property for sale at all but rather is approached directly by buyers favors investor treatment. The more active steps a taxpayer makes towards marketing the real estate weakens this position. Having a full-time sales office on the property or subdividing the property for sale is likely fatal to achieving investor status, regardless of the holding period.

- ***Real Estate Focus.*** How much of the taxpayer's income is derived from real estate activities versus other activities? An individual with a full-time job outside of the real estate industry who has gains from real estate sales may have a stronger argument for capital gains treatment than a taxpayer whose entire income and time spent are derived from real estate.

Who is the Seller?

A taxpayer may be a real estate dealer but at the same time acquire property with the intention of long-term growth for which investor status is sought. In addition to other possible benefits, use of a Limited Liability Company (LLC) to separately own this property helps, at least subjectively, to segregate this investment from the taxpayer's other real estate activities. It may be beneficial to explicitly state that the purpose of the LLC is to acquire property for the benefit of long-term growth in the organizing documents. While beyond the scope of this article, since an LLC owned by one person is disregarded for tax purposes, taxpayers should consider the possibility of ensuring partnership treatment of the LLC (rather than disregarded entity status) to further emphasize the separation of this investment from the taxpayer's other real estate holdings.

Limited Safe Harbor for Land Sale

For taxpayers who own undeveloped land, a special statutory rule (Internal Revenue Code Section 1237) exists which provides a safe harbor for certain sales. While all of the details of this provision are outside the scope of this article, up to five sales of subdivided land from a single tract can qualify for long-term capital sale treatment. Two major hurdles in taking advantage of this provision is that the tract of land has to be owned for more than five years and the land cannot be substantially improved.

Impact with Like-Kind Exchanges

What's better than paying long-term capital gain rates on the sale of property? How about deferring the tax by structuring the disposition as a like-kind exchange!

In brief, a like-kind exchange is a transaction in which, using a qualified intermediary, the taxpayer disposes of real estate and acquires replacement real estate property in an amount and within a time period which meet IRS rules. If done properly, taxes associated with the gain can be deferred and the gain can be "rolled over" into the replacement property.

Continued on page 3

While like-kind exchanges are common with real estate, it is relevant to note that real estate which is considered to be inventory is ineligible to qualify for the tax benefits associated with a like-kind exchange.

Therefore, the determination of whether a disposition will be treated as a capital gain is also relevant in exploring whether a like-kind exchange is an alternative to be explored.

Conclusion

If you've made it this far, you're probably asking yourself "What's the answer?" Unfortunately, in most cases there will be no clear answer. Taxpayers, in conjunction with their tax advisors, have to consider the two extremes of a clear investor and a clear dealer and assess, under the totality of all relevant facts, how strong the position is for investor status.

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