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When Are You an Investor versus a Dealer in Real Property? (PowerPoint)

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When are you an Investor versus a Dealer in Real Property?

William and Mary Tax Conference

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November 8, 2018

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The “Dealer” Property Standard

The "Dealer" Property Standard

Section 1221(1) applies where property is "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

Section 1221(1) can be broken down into three separate requirements:

— the taxpayer primarily intends to hold the property for sale;

— the sales occur in the ordinary course of the taxpayer's trade or business; and

— the sales are to "customers."

- The "customer" requirement is easily satisfied. Pointer v. Commissioner, 48 T.C. 906 (1967), aff'd 419 F.2d 213 (9th Cir. 1969).

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Primary Intent is “Held for Sale”

Primary Intent is "Held for Sale"

In Malat v. Riddell, 383 U.S. 604 (1966), the Supreme Court determined that "held primarily for sale" means "of first importance" or "principally."

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Sales in the Ordinary Course of the Taxpayer's Trade or Business

Sales in the Ordinary Course of the Taxpayer's Trade or Business

Early cases indicate that frequency and continuity are important tests in determining that a party is engaged in a trade or business.

— Williams v. Commissioner, 256 F.2d 152 (5th Cir. 1958); Thomas v. Commissioner, 254 F.2d 233 (5th Cir. 1958); Reese v. Commissioner, 615 F.2d 226 (5th Cir. 1980); Buono v. Commissioner, 74 T.C. 187 (1980).

Later cases seem to take a very broad view of "trade or business" where a taxpayer acquires property for the purpose of reselling – repudiating the "one-free-bite" theory.

— Jersey Land & Development Corp. v. Commissioner, 539 F.2d 311 (3rd Cir. 1976); S&H Inc. v. Commissioner, 78 T.C. 234 (1982); Baumgart v. Commissioner, T.C. Memo. 1983-738; Morley v. Commissioner, 87 T.C. 1206 (1986); Compare Pleasant Summit Land Corp. v. Commissioner, 863 F.2d 263 (3rd Cir. 1988).

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Factors Used in the Analysis

Factors Used in the Analysis

Courts have identified a number of factors that may be relevant in determining whether property should be treated as "dealer" property. See Winthrop, 417 F.2d 905 (5th Cir. 1969).

— The taxpayer's purpose in acquiring the property;

— the purpose for which the property was subsequently held;

— the taxpayer's everyday business and the relationship of the income from the property to total income;

— the frequency, continuity, and substantiality of sales of property; the extent of developing and improving the property to increase the sales;

— the extent to which the taxpayer used advertising, promotion, or other activities to increase sales;

— the use of a business office for the sale of property;

— the character and degree of supervision or control the taxpayer exercised over any representative selling the property; and

— the time and effort the taxpayer habitually devoted to the sales.

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Sales in the Ordinary Course of the Taxpayer's Trade or Business

The relevance of, and weight given to, the specific factors vary based upon the circumstances and the context in which property is being sold.

— The analysis used in the context of a subdivider, condo developer, etc. varies materially from the analysis for commercial office developers.

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Issues Specific to Residential Developers

Frequency of Sales - A Super Factor?

Some cases addressing residential developer/subdivider scenarios identify the "frequency and substantiality" of sales as the "most important factor." See, e.g., Biedenharn Realty Co., 526 F.2d 409 (5th Cir. 1976); Byram, 705 F.2d 1418 (5th Cir. 1983).

However, there are numerous examples where such a developer sells property in bulk and is found to be a dealer.

— In order for a single bulk sale to give rise to dealer status after a significant holding period, there generally has been a clear and continuing intent to sell coupled with material activities aimed at developing the property. See, e.g., Allen, 2014-1 U.S.T.C. ¶50,300 (N.D. Cal. 2014) (single parcel held for 11 years was dealer property where, during this period, taxpayer consistently pursued efforts to develop the property for sale); Fargo v. Commissioner, T.C. Memo. 2015-96 (single parcel held 13 years for development of townhomes; unsolicited offer for the entire parcel after 13 years gave rise to dealer sale).

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Frequency of Sales - A Super Factor?

When a taxpayer undertakes activity relating to zoning, permitting, etc. with respect to a single property but makes no physical improvements, there is authority holding that such property may not be dealer property even though the taxpayer always intended to sell such property.

- Buono v. Commissioner, 74 T.C. 187 (1980) (taxpayer purchased residential development property with intent to sell in 1 ½ years – once received approval for subdivision, sold property – lack of frequent and substantial sales activities prevented from being in trade or business, and solitary nature of acquisition and single sale precluded finding that was engaged in substantial and frequent sales activities).
- Buono court distinguished Jersey Land & Development Corp v. U.S., 539 F.2d 311 (3rd Cir. 1976), where court "concluded that the taxayer's acquisition, improvement, and sale of the property, which was part of a pattern of similar activities carried on by associated corporations, established that the taxpayer held the tract primarily for sale in the ordinary course of its business" See also Jarrett, T.C. Memo 1993-516 (taxpayer engaged in broader real estate business).

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Improvements to Property

Cases have highlighted the significance of constructing property improvements, such as roads, sewage equipment, etc., as negative factors in the dealer analysis. See, e.g., Gault, T.C. Memo. 1963-178; Kaltreider, 255 F.2d 833 (3rd Cir. 1958); Sanders, 740 F.2d 886 (11th Cir. 1984); Boree, 837 F.3d 1093 (11th Cir. 2016).

But it appears clear that the mere fact that property is improved does not, standing alone, cause the property to become dealer property. See, e.g., Gartrell, 619 F.2d 1150 (6th Cir. 1980); Simpson, T.C. Memo 1962-71.

See generally B. Schippel, Developing Without a Shovel: A New Look at the "Old, Familiar, Recurring, Vexing and Often Elusive" Problem, J. of P-thru Entities (July 1, 2006).

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Improvements to Property

The Tax Court in Buono, 74 T.C. 187 (1980), made the following statements, seemingly leaving open the possiblity that a subdivider selling in bulk might avoid dealer status even after making significant improvements to the subject property.

— "In our view, Marlboro Improvement's efforts in obtaining subdivision approval and selling the major parcel as a single tract, coupled with two separate dispositions of the highway and shopping center parcels, do not put the corporation in a trade or business. Admittedly, subdivision of the tract into half-acre building lots takes us in the direction of the indistinct line of demarcation between investment and dealership. It may confidently be expected that eventually another case will present us with a fact situation where the taxpayer not only subdivides, but also physically lays out streets and puts in utilities before disposing of the tract in one single transaction. That decision, of course, is for another day."

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Contracting for Improvements After Sale

The courts seem to analyze differently situations where a taxpayer agrees to construct improvements on the property on behalf of the buyer after sale of the property.

— If the property is raw land at the time of sale, courts have given less significance to post-sale improvements even if the seller is required to provide such improvements pursuant to the terms of the sales contract. See Reithmeyer, 26 T.C. 804 (1956); Wray, T.C. Memo. 1978-488; Paullus, T.C. Memo. 1996-419; Pool, T.C. Memo. 2014-3.

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Bifurcating Dealer and Non-Dealer Property

The court in Suburban Realty, 615 F.2d 171 (5th Cir. 1980), acknowledged that, in some circumstances it may be possible to establish that certain properties are held for investment, but "the burden is on the taxpayer to establish that the parcels held primarily for investment were segregated from other properties held primarily for sale. The mere lack of development activity with respect to the large property does not sufficiently separate those parts from the whole to meet the taxpayer's burden."

There are cases recognizing that a party can hold different parcels with different purposes. See Wood, 276 F.2d 586 (5th Cir. 1960); Maddux Const., 54 T.C. 1278 (1970); Eline Realty, 35 T.C. 1 (1960); Malat, 275 F. Supp. 358 (S.D. Cal. 1966).

— These cases all involved property that clearly was designated to a different purpose (either rental, or property that could not be developed), and the separate parcels were sold to separate buyers under different circumstances.

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Issues Specific to Commercial Property

Commercial Property Standard is Different

Courts recognize that the analysis with respect to commercial properties is different from residential developments (where most of the cases arise), such that the factors in the typical residential sale cases (e.g., frequency of sales, soliciation of sale, sales office, etc.) are not necessarily determinative. See Jersey Land & Development Corp. v. U.S., 539 F.2d 311 (3rd Cir. 1976); Pleasant Summit Land Corp. v. Commissioner, 863 F.2d 263 (3rd Cir. 1988); Pennroad Corp. v. Commissioner, 261 F.2d 325 (3rd Cir. 1958).

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Primary Intent in the Commercial Context

In analyzing intent as to holding property, one must look to see what is the primary reason for holding the property.

— The fact that parties are currently renting property does not mean that they are holding the property primarily for rental.

— Where rental property is being sold, courts have focused on what was the taxpayer's primary intent in acquiring or constructing the property: (1) to hold for rental, or (2) to hold for sale. See Victory Housing No. 2 v. Commissioner, 205 F.2d 371 (10th Cir. 1953); Grace v. Commissioner, 20 T.C.M. (CCH) 1313 (1961); Cousins Properties, Inc. v. U.S., 77-2 USTC ¶9508 (Ct. Cl. 1977).

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Primary Intent in the Commercial Context

Although the cases are not explicit, when property is sold fairly soon (i.e., 1-4 years) after acquisition or construction, there has been significant attention paid to determining the initial "intent", since the short holding period is somewhat inconsistent with an intent to hold for investment.

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Primary Intent in the Commercial Context

The cases holding favorably for the taxpayer generally have found a change in circumstances that have led to the sale.

— Victory Housing No. 2 v. Commissioner, 205 F.2d 371 (10th Cir. 1953) (change in corporate policy indicating a desire to make property available for ownership by veterans).

— Rouse v. Commissioner, 39 T.C. 70 (1962) (became difficult to locate desirable tenants).

— Cousins Properties, Inc. v. U.S., 77-2 USTC ¶9508 (Ct. Cl. 1977) (numerous properties, all with changed circumstances; court stated: "If the evidence indicates that at the prior period the taxpayer would not have made the sale in question but for the occurrence of a changed condition or a sudden and unexpected opportunity it will be presumed that he was not holding the property 'primarily' for sale.").

— Cottle v. Commissioner, 89 T.C. 467 (1987) (other owners in four-plex development began selling, and taxpayer feared he would lose ability to control activities in development, which in turn would hurt value or his properties).

— Other "liquidation of investment" cases: Heller Trust, 382 F.2d 675; Carter-Colton Cigar Co., 9 T.C. 219; Toll v. Comm'r, 32 T.C. 1314.

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Primary Intent in the Commercial Context

Most of the favorable cases find that the taxpayer was “liquidating” its investments due to a change in circumstances.

— If the initial purpose is to hold the property primarily for sale, the liquidating theory will not be available unless intent changed to holding for investment during interim period.

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Primary Intent in the Commercial Context

Objective evidence is important in determining intent.

— Important factors include purpose for holding property as "for rental" on mortgage application (Grace v. Commissioner, 20 T.C.M. (CCH) 1313 (1961)) or application for FHA guarantee of loan (Goldberg v. Commissioner, 223 F.2d 709 (5th Cir. 1955)).

— Underwriting, investment committee, and investor documents are important.

In all cases cited above where courts have held that property was capital gain property in a context where property was sold relatively soon (1-4 years) after being acquired or constructed, no broker had been engaged, and all sales were prompted by unsolicited offers.

Cases have looked to activities of related parties in determining intent to taxpayer that owns the subject property. Baumgart v. Commissioner, T.C. Memo. 1983-738; Jersey Land & Development Corp. v. U.S., 539 F.2d 311 (3rd Cir. 1976).

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Primary Intent in the Commercial Context

If efforts in improving and renting property are aimed at making the property more marketable for sale, the fact that the property is being rented may not carry significant weight in determining whether the property is “held for sale.”

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Sales in the Ordinary Course of the Taxpayer's Trade or Business

Real estate development clearly comprises a trade or business, so issue becomes whether development activity encompasses trade or business of selling property.

— Bush v. Commissioner, T.C. Memo. 1977-75; Heebner v. Commissioner, 280 F.2d 228 (3rd Cir. 1960); but see Reese v. Commissioner, 615 F.2d 226 (5th Cir. 1980) (assuming arguendo that the taxpayer was the builder, developer, and general contractor of the project, the taxpayer was not engaged in a trade or business with respect to the isolated project).

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Sales in the Ordinary Course of the Taxpayer's Trade or Business

Cases that look to taxpayer's other activities for purposes of determining whether the property activities give rise to a trade or business sometimes look to relative quantum of efforts with respect to the multiple activities.

- These cases may not be as relevant where you have a single-purpose entity.
- But a single-purpose entity can hold property for investment. Buono v. Commissioner, 74 T.C. 187 (1980).

Must focus on what is the primary purpose for the taxpayer's activities in determining the nature of the taxpayer's trade or business activities.

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Policy Arguments in Dealer Analysis

Although not dispositive, courts have looked to whether gain resulted from market forces or activities of taxpayer as a factor in determining whether gain was capital gain or ordinary income.

— Jersey Land & Development Corp. v. Commissioner, 539 F.2d 311 (3rd Cir. 1976) (taxpayer looked to value added by improvements rather than market appreciation, indicating that taxpayer held property primarily for sale).

— Compare U.S. v. Winthrop, 417 F.2d 905 (5th Cir. 1969 (court refused to adopt a per se rule denying capital gain treatment where the taxpayer's efforts, rather than market forces, result in property's appreciation); Buono v. Commissioner, 74 T.C. 187 (1980) (same).

— Nonetheless, the mere fact that the gain results primarily from market factors will not, standing alone, justify capital gain treatment. Boree, 837 F.3d 1093 (11th Cir. 2016).

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Evaluating a Hypothetical

Hypothetical Underwriting and Sales Scenario

January 1, Year 1: LLC acquires land.

— The underwriting pro forma indicates that the strategy most likely to return the highest value to investors is to lease-up the building (estimated end of Year 3) one year after substantial completion (estimated end of Year 2), with a plan to market the building for sale as soon as possible after lease-up (estimated beginning, during or end of Year 4).

— The Parties understand that there is significant development, leasing and market risk related to the development of a speculative office building development in X Market and that the optimal scenario outlined above may or may not go according to plan.

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Hypothetical Underwriting and Sales Scenario

January 1, Year 1 – December 31, Year 2: LLC constructs the building.

January 1, Year 3 – December 31, Year 3: LLC markets the building to tenants and leases up the building.

January 1, Year 4: Based on an analysis of the Project and the underwriting pro forma, the Parties decide to direct the LLC to market the building for sale.

Year 4: Building is sold.

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Applying Analysis to Hypothetical

Facts indicate that leasing of property is aimed at making the property more attractive for sale, and that income from rent itself will not form a significant part of the expected return.

While the LLC holds only a single property, there is significant activity with respect to that property in constructing and leasing the property with an eye towards a primary reward in the form of a profitable sale.

Although the property ultimately is held for rent for two years after construction, the facts indicate a significant risk of a dealer sale.

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Applying Analysis to Hypothetical

If things don't work out as planned, and the LLC holds the property for rental for a significantly longer period, the facts start to look better.

The intial intent starts to look more ambiguous if the property is actually held for rental for a significant period of time.

The longer holding period also provides some indication that profit with respect to the property derives from market forces instead of efforts in constructing and leasing the property.

Nonetheless, if the evidence indicates that the LLC always intends to sell as soon as the market turns, avoiding dealer status still could be a challenge.

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Liqudating a Fund

Liquidating a Fund

A Real Estate Fund will almost always have a limited life so that, when a property is acquired, it will be a virtual certainty that the property will be sold within a pre-determined period.

The liquidation of a Real Estate Fund also may involve significant activity in selling a number of properties in a relatively short period of time.

PLRs 201340004, 201346005, and 201609004 are helpful in analyzing such situations. Cf. PLR 201640007 (public REIT); PLR 201707010 (public REIT).

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Liquidating a Fund

In the these PLRs, it appears that a Real Estate Fund held a significant number of properties through a private REIT.

REIT owned and leased residential properties to third parties.

In order to facilitate a winding up and liquidation of the Real Estate Fund, REIT proposed to adopt a plan of liquidation and, pursuant to that plan, dispose of all of its assets and liquidate.

REIT requested a ruling that the sales pursuant to the plan of liquidation would not give rise to prohibited transactions under section 857(b)(6).

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Liquidating a Fund

In PLR 201340004, the following representations were made to address the taxpayer's purposes in holding the property:

— REIT acquired the properties with the intent to own the properties for a long-term holding period and to derive its profits from capital appreciation and rental income from the properties;

— The disposition of the properties is pursuant to a plan of liquidation;

— No individual property to be disposed of has been owned for fewer than 7 years;

— All the individual properties have been operated as rental properties for at least two years; and

— REIT will use one or more independent third party brokers from which REIT derives no income to dispose of the properties.

PLRs 201346005 and 201609004 contain similar representations, although timing of holding properties is less specific.

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Liquidating a Fund

Based on these representations, the IRS ruled that the sales would not give rise to income from prohibited transactions.

REIT did not qualify for the prohibited transaction safe harbor, so the IRS must have concluded that the property would not be treated as dealer property.

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Liquidating a Fund

In PLR 201346005, REIT held one Project that did not meet the constraints of the representations

— Project was a collaboration with University to develop a community that provides student housing.

— A subsidiary of Taxpayer entered a joint venture in Initial Year to be the University's development partner for phase one of Project.

— Due to circumstances beyond Taxpayer's control, a master ground lease for Project was not signed until Date 2, over d years behind schedule.

— The intent of the parties at that time was to operate Project as rental property and derive profit from long-term holdings of the property.

— Project began receiving rental income on Date 3, when part of the first phase was completed.

— The last phase of Project is scheduled to be complete on Date 4.

— The expenditures relating to the first phase account for approximately f percent of the total cost of Project.

— Accordingly, by the end of Year 2, prior to the anticipated sale date of Project, Taxpayer will have derived rental income for 2 years from over half of the total investment in Project.

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Liquidating a Fund

In PLR 201346005, the IRS held that all properties considered in the ruling, including the Project, were sold pursuant to a plan of liquidation and such sales did not constitute prohibited transactions.

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