

Don't Stray into Enemy Territory

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The border between investing in real estate and dealing in real estate is muddy. It is also packed with landmines. Investors should know the border and give it a wide berth when possible. When that is not possible, following the few well marked local roads may be an option. When traveling off road is the only option, take a local guide. Unwary investors who strayed briefly on the wrong side of this border have had their tax deferrals shot down by auditors at the IRS.

Which side of the border do you want to be on?

There are actually a few circumstances when taxpayers have argued (with varying degrees of success) that they are dealers in real estate, not investors, and that the property they sold was stock in trade (a/k/a “inventory”) and not a capital investment. For example, when there have been losses from the sale of property, taxpayers have argued that the property was inventory, so that they could offset their losses against regular income. If the property is an investment, only \$3,000 in capital losses per year in excess of capital gains can be claimed, and the excess capital losses will have to be carried over from one year to the next until they can finally be used to offset gains.

However, in the overwhelming majority of cases, for the ordinary investor – especially for the successful investor – it is a huge advantage when property qualifies as an investment and *not* as stock in trade. This is true for two principal reasons:

First, as every real estate investor knows, profits from real estate investments held for one year or more are generally taxed at the maximum federal capital gains rate of 15% (or 25% to the extent that depreciation is being recaptured), while profits from the

sale of stock in trade are taxed at substantially higher regular federal tax rates of up to 35%.

Second, tax on gains from the sale of investment property can be deferred through a like-kind exchange pursuant to IRC §1031, while gains from the sale of stock in trade cannot be deferred at all. Therefore, the difference between *stock in trade* and *investment* is often the difference between **tax** and **no tax**.

A test has been used by the courts on many occasions in order to distinguish between investments and stock in trade. Seven factors are examined:

(1) (T)he nature and purpose of the acquisition of the property and the duration of the ownership; (2) the extent and nature of the taxpayer's efforts to sell the property; (3) the number, extent, continuity and substantiality of the sales; (4) the extent of subdividing, developing and advertising to increase sales; (5) the use of a business office for the sale of the property; (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and (7) the time and effort the taxpayer habitually devoted to the sales. (*U.S. v Winthrop*, 417 F.2d 905 (U.S.C.A. 5TH Cir., 1969) at 909-910; *Paulus v. CIR*, T.C. Memo 1996-419 (U.S. Tax Court, 1996), quoting *Winthrop*, *supra.*; *Klarkowski v. CIR*, T.C. Memo 1965-328, (U.S. Tax Court, 1965), affirmed at 385 F.2d 398 (U.S.C.A. 7TH Cir., 1967); *Maddux Construction Co. v. Commissioner*, 54 T.C. 1278, 1284 (U.S. Tax Court, 1970).)

“This question is purely a factual question, the burden of proof being upon petitioner.... None of the above factors are conclusive standing alone, but rather all of the factors taken as a whole govern.” [*Maddux, supra.*, at 1284 citing *W. T. Thrift, Sr.*, 15 T.C. 366 (U.S. Tax Court 1950).]

Most investors should have no trouble steering clear of the grey areas when they understand the issues in advance. Sometimes, however, they may find themselves inching closer to the border. For example:

- The buyer may require extensive renovations as a condition of sale.
- Just before an offer to purchase is received, the taxpayer may have completed renovations in order to accommodate a tenant or in order for the taxpayer, himself, to use the property for his own business.

- The buyer may be a real estate developer who wants to subdivide the property and to begin construction – or even to complete construction – prior to taking title.
- While the taxpayer’s contract to purchase property is still pending, she may receive an offer to purchase in the property as a “flip.”
- The taxpayer may have a substantial portfolio that needs to be liquidated.

In all of these cases and in hundreds of others, the border is near at hand. If the taxpayer wants to reinvest the proceeds of sale in a tax deferred exchange or if the taxpayer simply wants to pay capital gains taxes, rather than regular income taxes on the profits, it is essential to know the lay of the land as soon as possible in order to avoid unintentional actions that could place the taxpayer into an unfriendly territory where the natives take no prisoners.

In this and in all other complex transactions, please seek expert tax and legal advice.