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Culp

Dealer vs. Investor

Richardson

Tax lawyers spend about a third of their time converting ordinary income into capital gain.[1]

This quote may overstate reality, but protecting the investment character of real estate is a critical element of tax planning for real estate investors and developers. The distinction between investment property and dealer property is important upon the sale of property. Investment property is eligible for capital gain treatment. Dealer property receives ordinary income treatment.

Substantial Tax Difference

The current federal rate for ordinary income reaches 38.6%. The current federal rate for long-term capital gain reaches 20%. The difference in tax rates is so substantial that in certain cases it is economically prohibitive for a taxpayer holding investment property to develop the property and pay tax at ordinary income rates rather than simply sell the property to a third party developer and pay tax at capital gain rates.

Like-Kind Exchange Issues

The distinction between investment property and dealer property is also important in the like-kind exchange area. Dealer property is not eligible for like-kind exchange treatment. The recognition of a taxable gain on an exchange of real estate can be an unpleasant surprise for taxpayers.

A Person Cannot be a Dealer

We want to focus on a subtle in this area can be critically and sometimes overlooked concept. The determination of whether property is dealer property is made on a property-by-property basis. A person or entity is not categorized as a dealer. The issue is not whether a taxpayer (whether an entity or an individual) is an investor or a dealer in real estate. The issue is whether the specific piece of property is "held primarily for sale to customers in the ordinary course of a trade or business." If the answer is yes, then it is dealer property. If no, it is generally investment property.

With proper planning, a taxpayer that owns dealer property can also hold other property for investment. In certain circumstances, a taxpayer that is holding a piece of property

as dealer property can change his purpose for holding the property prior to sale. This "change of intent" can occur if a taxpayer acquired a piece of property with the original intent to develop it but later sells part or all of the property without developing it. Capital gain treatment can be achieved if a taxpayer is forced to liquidate dealer property, for example because of financial adversity.

Further, with proper planning, a taxpayer that has held property for investment can "lock in" the appreciation that is attributable to holding the investment property as capital gain prior to undertaking any development activity. Planning important for taxpayers who decide to develop property that has previously been held for investment purposes.

Use Separate Entities

It is also important to note that while a taxpayer can in certain circumstances change the character of property from dealer to investment status it is infinitely better if property is never characterized as dealer property. It is usually important for developers to segregate their dealer property and investment property in separate entities.

Proper tax planning, implemented in advance of a sale or like-kind exchange, will help distinguish investor property from dealer property and can yield tremendous tax savings.

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[1] Quote attributed to Walter Blum and is taken from article entitled "As Certain as Death - Quotations About Taxes" published in Tax Notes Today.

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