



## **Tax Alert: Tax Characteristics of Real Estate Dealers versus Real Estate Investors**

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### **Introduction**

Real estate dealers and investors are taxed in completely different manners. Why is this important? The proper structuring of your clients' real estate transactions helps achieve favorable tax treatment on their real estate gains and may lead to substantial tax savings.

### **Dealers and Investors Defined**

The basic distinction between dealers and investors is that dealers buy and sell real estate as part of their day-to-day business, and investors purchase real estate with the intention of holding their property and gaining a financial return in the future.

### **How are Dealers and Investors Taxed?**

When a real estate dealer sells property, that property is considered inventory of the business, and the gain is taxed at ordinary income tax rates. Federal income tax rates on ordinary income can be as high as thirty-five percent.

When a real estate investor sells property that has been held for more than one year, gain generated on the sale of such property is considered long term capital gain and taxed at favorable federal capital gains tax rates of only fifteen percent.

### **How Does the IRS Determine Whether to Tax Your Client as a Dealer or Investor?**

- The IRS will look at the purpose for which the subject property is held. The courts have enumerated the following nine factors as being determinative\*:

- Nature and purpose the property was acquired and held (i.e., intent)
- Extent and nature of the taxpayer's efforts to sell the property
- Number, extent, continuity and substantiality of the sales
- Extent of subdividing, developing and improving the property to increase sales
- Use of a business office for the sale of the property
- Character and degree of supervision or control exercised by the taxpayer over the representative selling the property
- Time and effort the taxpayer habitually devoted to the sale of the property
- Duration of ownership (proximity of the sale to the purchase)
- Extent of advertising and solicitation by the taxpayer or others on his behalf

In finding capital gains tax treatment, courts tend to rely most heavily upon the taxpayer's purpose or intent (whether the intent is to hold it for investment); the extent of the taxpayer's efforts (the more time and effort expended by the taxpayer the more likely the court was to find that the property was inventory in nature); the extent

of subdividing (if the property was subdivided and sold piecemeal, it was likely inventory property); and, duration of ownership (the longer the property was held, the more likely it was to be characterized as investment property).

It is important to note that the classification of dealer versus investor is determined on a property by property basis. Thus, a dealer in a certain type of property can hold investment real estate, and an investor in real estate can hold other real estate as inventory for sale to customers in his ordinary course of business.

It is also important to note that a taxpayer's intent with respect to property can change over time. The taxpayer's intent with regard to the property immediately prior to the sale is the determining factor.

### **Tax Planning Implications**

If there is any leeway in structuring a sale of real property and your client is expecting to have a gain on the sale, by structuring the transaction as a sale of investment property your client should pay only fifteen percent tax on the gain, assuming that the property was held as investment property for more than one year. If your client is expecting a loss on the sale transaction, by structuring the transaction as a sale of business property, if possible, your client should generate fully deductible ordinary losses on the transaction. It might not be possible to structure the transaction to meet these objectives immediately before the sale. Thus, it is encouraged that the client seek tax advice at the point he is investing in the property so as to be aware of the various factors that contribute to the level of taxation on ultimate disposition.

In addition to structuring and disposing of real estate to achieve favorable taxation, it is also worth noting that other related tax regimes might only apply to an investor

as opposed to a dealer. For example, a dealer in property cannot utilize the tax deferral benefit of a 1031 exchange. Furthermore, a dealer cannot use the installment sales method to report the gain incrementally, but rather must report and pay tax on the entire amount of the gain in the year of the sale even if payments are received in installments. If the client would like to plan for the tax benefits that are most important to him then it is encouraged he seeks tax counsel early on in the acquisition and sale process.

### **Circular 230 Disclosure**

**To ensure compliance with requirements imposed by the IRS, unless we expressly state otherwise, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.**

**The discussion contained herein shall not constitute a legal opinion of any kind. The facts and circumstances will vary from one taxpayer to another, each taxpayer should seek advice on the taxpayer's particular circumstances from its own independent tax counsel or advisor as to all tax matters discussed herein.**

*For any questions or issues related to the taxation of real estate transactions, please contact L. Ryan Pinder.*

Special thanks to Andrea Cortés for her contributions to this article.

\* See , e.g. , U.S. v. Winthrop , 417 F.2d 905 (5 th Cir. 1969); Biedenharn Realty Co., Inc. v. U.S. , 526 F.2d 409 (5 th Cir. 1976); Byram v. U.S. , 705 F.2d 1418 (5 th Cir. 1983); Pleasant Summit Land Corp. v. Comr. , 863 F.2d 263 (3d Cir. 1988).

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