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Losing Hand For Taxpayer in Dealer Property Case

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The tax consequences from the sale of real estate are vastly different depending on whether or not the real estate is considered to be "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" (commonly referred to as "dealer property"). Unfortunately, there are many circumstances where it is unclear whether real estate constitutes dealer property. One difficult question that sometimes arises is when a change in circumstances causes real estate that initially was dealer property to no longer be classified as such. In a recent case, a taxpayer was unsuccessful in its argument that a change in its intentions caused dealer property to be converted into property held for investment.

Background

Long term capital gain (i.e., gain from the sale or exchange of a capital asset held for more than one year) is currently subject to a maximum Federal income tax rate of 20% for individuals, compared to the 39.6% rate for ordinary income. The definition of "capital asset" excludes property that is "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" ("dealer property").

While a developer selling residential condominium units is a classic example of dealer property, real estate can constitute dealer property under much less obvious circumstances. Courts determine whether property is dealer property based on a facts and circumstances test, which generally includes the following criteria (among others):

- The purpose of the acquisition and duration of ownership.
- The extent of the taxpayer's efforts to sell the property.
- The frequency of the sales.
- The extent of subdividing, developing, and advertising to increase sales.

Boree v. Commissioner

The Tax Court's 2014 decision in the case of *Boree v. Commissioner* (TC Memo 2014-85) addressed a real estate developer ("Glen Forest") that acquired 1,892 acres of vacant real estate in 2002. In 2003, a zoning commission approved a proposal from Glen Forest to create a residential development on this land consisting of more than 100 ten-acre lots. In 2003 and 2004, Glen Forest engaged in development activities including obtaining county approvals for the first three phases of development, applying for an environmental resources permit, establishing and recording easements, and constructing an unpaved road on the property. In 2005, in response to new rules that required the paving of roads within subdivisions, Glen Forest requested that the property be rezoned with a higher density development plan (including both residential and commercial areas) intended to justify the higher costs. Then, another rule was enacted in January 2006 that would require Glen Forest to also pave roads leading to the subdivision.

Around that time, Glen Forest learned that a developer was planning a large development on an adjacent property. Glen Forest entered into a contract to sell most of its remaining land to that developer in April 2006, and the sale closed in February 2007. Glen Forest continued to pursue the rezoning of the property even after entering into the contract to sell in April 2006.

From 2002 to 2006, Glen Forest had sold approximately 60 lots comprising around 600 acres of its subdivision.

Glen Forest reported its gain from the 2007 sale as capital gain. The IRS issued a deficiency notice to Mr. and Mrs. Boree (the members of Glen Forest), which (i) determined that the gain should have been characterized as ordinary income and (ii) imposed a 20% penalty for substantial understatement of income tax. In its 2014 decision, the Tax Court agreed with the IRS that the gain was ordinary income and upheld the penalty.

The taxpayers appealed to the Court of Appeals for the Eleventh Circuit. They conceded that the property was originally dealer property, but argued that they began holding the property for investment as a result of the new land use restrictions enacted in 2005 and 2006

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that made further development "so expensive as to be practically impossible."

In a 2016 decision (*Boree v. Commissioner*, 837 F.3d 1093 (11th Cir. 2016)), the Court of Appeals for the Eleventh Circuit agreed with the IRS that the gain from the 2007 sale was ordinary income. The Court focused on the fact that after the new land use restrictions were enacted, Glen Forest responded by having the property rezoned to a more densely zoned development, and continued to pursue that approach even in 2006. As a result, the Court found that the taxpayers continued to act as developers up to the time of sale, and never began passively holding the property for investment. The Court also found it to be significant that Glen Forest deducted their expenses related to the property in all years, which is inconsistent with the property being held for investment.

The Court disallowed the assessment of penalties, though, since it found that the taxpayers had acted "with reasonable cause and good faith" in relying on their accountants.

Analysis

Taxpayers have sometimes been successful in arguing that they stopped acting as a developer and started holding real property for investment, although there are many circumstances in which there will be uncertainty regarding whether courts will accept that argument. For example, suppose that Glen Forest had immediately stopped all of its development activity when the new land-use restrictions were enacted and started looking for a buyer to purchase the property as a bulk sale. Would the taxpayers have been able to argue that Glen Forest had started holding the property for investment prior to the sale? Or does that require passively holding the property for some amount of time in anticipation of it appreciating in value?

Unfortunately for the taxpayers in *Boree v. Commissioner*, the facts in that case were worse than this hypothetical, since Glen Forest never stopped engaging in development activities. That made it easier for the courts to conclude that Glen Forest still had the status of a dealer in 2007 and had ordinary income from the sale. In addition, it was also very unhelpful for the taxpayers that they had undermined their position that the property was held for investment by deducting their expenses even in the year of sale.

Given the frequency with which questions arise regarding when a taxpayer will be considered to have changed its intent and started holding property for investment, it is particularly unfortunate that the analysis of this issue is often complex and uncertain. While *Boree v. Commissioner* leaves it unclear what it would have taken for the taxpayers to convince the courts that they changed their holding purpose, this case serves as a reminder that nuances in the facts can be the difference between being taxed at a rate of 20% or 39.6%.