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No Free Bites: Taxpayer Has Ordinary Income from Single Sale of Land

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Property that is "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" (commonly referred to as dealer property) is excluded from the definition of "capital asset." Therefore, the sale of this property is taxed at ordinary income rates, as opposed to the lower capital gains rates that apply to the sale of a capital asset. While the classic example is a developer selling individual condominium units, this provision also applies in certain less obvious situations. A recent case held that a taxpayer had ordinary income in a circumstance that some may find surprising—the sale of a single parcel of undeveloped real estate.

Background

Long term capital gain (i.e., gain from the sale or exchange of a "capital asset" held for more than one year) is taxed at lower Federal income tax rates than ordinary income. Currently, long term capital gain is subject to a maximum Federal income tax rate of 20%, whereas ordinary income is subject to a maximum Federal income tax rate of 39.6%.

Internal Revenue Code section 1221 provides that, subject to certain exceptions, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business). One of the exceptions to the definition of capital asset is property that is "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." As articulated by the Supreme Court, the function of this exclusion from the definition of capital asset is "to differentiate between the profits and losses arising from the everyday operation of a business on the one hand and the realization of appreciation in value accrued over a substantial period of time on the other."[1]

Allen v. United States

In the recent case of *Allen v. United States*,[2] a Federal district court in California considered whether a taxpayer's income from the sale of land was capital gain. The taxpayer, Frederic Allen, was a civil engineer who worked for developers. He purchased undeveloped land in 1987 and then sold it as undeveloped land more than ten years later. He had attempted to develop the property on his own for the first seven years after he acquired it, and then he had attempted to develop it together with partners before ultimately selling the property.

Allen took the position that he had long term capital gain from the sale. The IRS determined that Allen recognized ordinary income from the sale of property "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." This position of the IRS was based on a determination that Allen had acquired and held the property with the intention to develop it and sell it.

Allen paid the extra amount of tax assessed by the IRS and sued for a refund in Federal district court. The government then made a motion for summary judgment (which is granted where the movant shows that there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law).

In its recent decision, the district court granted the government's summary judgment motion and held in favor of the government, finding that Allen had failed to raise a material question of fact to rebut the government's evidence supporting the determination that Allen purchased and held the land in order to develop and sell it in the ordinary course of his trade or business.

The court explained that it had considered the following five factors in making its determination: (1) the nature of the acquisition of the property, (2) the frequency and continuity of sales over an extended period, (3) the nature and extent of the taxpayer's business, (4) the activity of the seller with respect to the property, and (5) the extent and substantiality of the transactions. The court found the first and fourth factors in this list to be "outcome determinative." With respect to the first factor, the court stated

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that the government had provided "substantial" support to show that Allen purchased the property in order to develop and sell it, including testimony from Allen himself at his deposition. The court found that there was no evidence that Allen's intent with respect to the property had changed thereafter. With respect to the fourth factor, the court focused on the fact that Allen had been actively involved in "significant and extensive efforts" to develop the property. The court found that these two factors together showed that both (1) the property was held by the taxpayer primarily for sale to customers and that (2) it was held for sale in the ordinary course of his trade or business.

With respect to the second factor, the court explained that "the fact that Allen purchased only one [property] for development (or as an investment) is not determinative, as the 'one-bite' rule, such that a taxpayer who engaged only in one venture or one sale cannot under any circumstances be held to be in a trade or business as to that venture or sale, has been rejected." Therefore, notwithstanding that this was Allen's only sale of real property, the court concluded that Allen held the property for sale to customers in the ordinary course of his trade or business and that Allen had ordinary income upon the sale.

Analysis

The fact that a taxpayer acquires real property with the intention of developing it does not by itself mean that an ultimate sale of the real property will result in ordinary income. A taxpayer should generally have capital gain if it buys land with the intention of constructing a building to hold as rental real estate and then changes its mind and sells the land in a single sale. Similarly, the taxpayer also should generally have capital gain if it goes ahead and constructs the building and then at some later point decides to sell the building to a single buyer. In addition, there could be a circumstance where a taxpayer initially acquires land with the intention to develop and sell it, and then subsequently changes its intention and decides to hold the property for investment. In such a case, the taxpayer should generally have capital gain upon sale if a sufficient amount of time has elapsed from when the taxpayer began holding the property for investment (although exactly how long would need to elapse may be unclear).

Therefore, Allen's testimony at his deposition that he acquired the property with the intention to develop *and sell* it—and the absence of evidence that he ever changed the purpose for which he held it—was central to the court's decision. (Interestingly, the quote from Allen's deposition that the decision cited is that "I started out to develop this property and concluded that a sale was more in line with my capacity." This statement does not appear to be inconsistent with him having initially acquired the land with the intention of developing it for investment and then subsequently changing his mind and deciding to sell, but perhaps the context in the deposition transcript would suggest otherwise.)

The decision in *Allen v. United States* may have only limited applicability to other cases, since the court may have come to a different conclusion if Allen had just consistently contended that his initial intention was to develop the land as rental real estate and that he only subsequently changed his mind and decided to sell it. It is also noteworthy that certain other courts appear to give greater weight to the frequency of sales than did the court in *Allen v. United States*. In addition, the weight of this California district court case as precedent may be limited, especially outside of the jurisdiction of the Court of Appeals for the Ninth Circuit. However, *Allen v. United States* is important in that it provides taxpayers with a reminder that they can have ordinary income from a sale of real property in situations that are far from a developer selling hundreds of condominium units—and in certain circumstances even from just one sale.

[1] *Malat v Riddel*, 17 AFTR 2d 604 (U.S. 1996).

[2] 113 AFTR 2d 2014-2262 (DC CA 2014).