When an Owner of Real Estate Contemplates a Sale

As the real estate market continues to gather steam, many owners of rental properties are again contemplating the sale or exchange of their holdings. Questions facing a number of these owners are whether the gain or loss on the sale qualifies for capital gain treatment (rather than being taxed at ordinary income rates); or whether the property is eligible to be exchanged tax-free in a like-kind exchange. The purpose for which the property is held at the time of its sale determines the tax consequences, not the purpose for which it was originally acquired. Temporary use of the property for a different purpose however, does not change the primary purpose.

Change in Original Purpose

Circumstances change and as a result, the purpose for holding the property also may change. An office building may have been converted to condominiums; a personal residence may have become a rental unit, or vice versa; a developer may have purchased a tract of land with the intent of sub-dividing and building single family homes but because of market conditions was forced to sell the remaining undeveloped land, a contractor may have acquired property to flip and sell but in order to hold onto the property it was converted to rental units.

Ordinary Income vs. Capital Gain

For the sale of real estate to qualify for capital gain treatment, or for it to be eligible for a like-kind, tax-free exchange, the primary purpose of holding it should be appreciation in value. At the time of its sale, the real estate had to have been either held as income-producing or investment purposes (such as rental property) or held for use in the owner’s business (such as a factory, office, etc.).

Nine Factors

When exactly does the purpose of holding the real estate change either from resale to investment or investment to resale? This is a question that the IRS and the tax courts have been wrestling with for years. In Klarkowski, a 1965 case, the court considered nine non-weighted, relevant factors which other courts still use as precedence:

1. The purpose for which the property was initially acquired;
2. the purpose for which the property was subsequently held;
3. the extent to which improvements, if any, were made to the property by the taxpayer;
4. the frequency, number, and continuity of sales;
5. the extent and nature of the transactions involved;
6. the ordinary business of the taxpayer;
7. the extent of advertising, promotion, or other active efforts used in soliciting buyers for the sale of the property;
8. the listing of property with brokers; and
9. the purpose for which the property was held at the time of sale

As you can see, there is a lot of room for interpretation.

The tax courts have ruled that temporary use for different purposes does not change the character of the property. Real estate acquired and held for resale continued to be held for resale at the time of its sale, notwithstanding the fact that it temporarily became rental property during a downturn in the real estate market. Similarly, holding a property for many years has indicated an investment purpose.

Examples of When the Primary Purpose of Holding the Property Changed

- Land originally acquired to construct rental apartments (investment purpose) became ordinary income property when it was developed as condominiums.
- A taxpayer acquired land for use as a nursery (investment purpose). The business was not profitable and he fell behind on his mortgage. He found that he could make more by subdividing and improving the land, and then advertising the land for sale. The court found he had gone into the business of selling lots (ordinary income).
- Land purchased and farmed by a taxpayer (investment purpose) suffered because of a water shortage and parasite infection of the soil. Over the next eight years, the land was subdivided into residential lots, roads were built, and sewers and water mains installed. The sale of the lots was controlled by the taxpayer. The court ruled the lots were held for sale (ordinary income), and not for liquidation of an investment asset.
- A taxpayer who had acquired land to develop a mobile home park (investment purpose) began selling lots in the park when FHA and other financing for the mobile homes began drying up. The sales were deemed to be taxable in the course of business as ordinary income.

Examples When the Primary Purpose of Holding the Property Did Not Change

- A taxpayer purchased land for development. Over the next eight years he paid for engineering plans and took out a second mortgage. He was unsuccessful in his attempt to find a developer partner and performed no additional work on the
property. Four years later, the property was sold to a developer for a down payment plus future payments based on a percentage of profits from the sale of developed units. He reported the final payment as a capital gain. The court found that the land was held for resale and taxable as ordinary income. The purpose in owning the land (resale) had not changed.

- A taxpayer who was not in the real estate business (he was a politician/engineer) purchased three lots he thought were “ripe” for development. He prepared his own development plans as an engineer, and had the properties rezoned. The properties were sold to a developer. The court held that he was not in the business of selling real estate, and therefore, the property was held for investment and qualified for capital gains.

- A taxpayer held property for investment. Shortly after acquiring the property, the taxpayer listed the property, prepared sales brochures and began advertising. The court found that these actions were consistent with his purpose of seeking to sell a costly investment.

**Protect Yourself**

As you can see, when circumstances change it is extremely important that you seek professional advice from a real estate tax expert. The difference between qualifying for capital gain tax treatment and being taxed at ordinary rates on the sale of real estate can be substantial and the fine line that separates eligibility for one over the other is tenuous.