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Change of Intent And Capital Gains

By Jerrold J. Stern

Real estate developers are typically classified as “dealers” for tax purposes, so gains from sales are taxed as ordinary income, rather than capital gains. But when a developer sells a parcel of land rather than develops it, an argument can be made that the sale represents a change of intent. In such a case, with proper documentation, the proceeds from the sale may be taxable as capital gains rather than ordinary income.

The difference between the two tax treatments is dramatic: ordinary income can be taxed at a rate as high as 37.9 percent (35 percent tax bracket rate plus 2.9 percent self-employment tax), while capital gains are generally taxed at a 15 percent maximum rate if the property is held more than one year.

A recent court case illustrates how one developer secured capital gains treatment on the sale of lots that were originally acquired to develop and sell individually to homebuyers. At the time the lots were sold, the developer’s intent had changed and they were sold in bulk to another developer rather than to homebuyers. Therefore, the lots were considered a capital asset rather than

inventory, and the resulting gains were capital gains.

The developer, Dan, acquired a tract of land and subdivided it into 133 lots. Single-family homes were constructed on 77 lots and sold to individual homebuyers with all gains taxable as ordinary income. The homeowners became dissatisfied with the workmanship of the homes and filed suit against Dan. Dan’s reputation became tarnished, and the municipality subsequently withheld approval for development of the remaining 56 lots. Dan sold the 56 lots in three blocks to another developer, Denise.

Denise paid cash for one block of lots, gave cash and a note for the second block, and agreed to purchase the third block two years later. Denise defaulted on the note. Dan and Denise filed lawsuits against each other. Ultimately, they agreed that the lots for which Dan had not yet received payment would be contributed to a partnership that he controlled. According to the agreement, Denise would perform all the activities necessary to develop, market and sell the lots and would receive 4

percent of the sales proceeds. Dan would receive 96 percent of the proceeds.

Because Dan’s original intent was to sell the lots individually, the IRS considered the 96 percent of proceeds received by him to be revenue from sales of inventory, making the gains taxable as ordinary income. The U.S. Tax Court disagreed, however, and held that Dan’s share of the proceeds was traceable back to the actual intent of the bulk sale of land to Denise, which was a capital asset transaction and, therefore, resulted in capital gains.

To prove change of intent, the developer must provide appropriate documentation. If a change of intent occurs because of financial difficulty, the facts could be documented through bank records, financial statements and prior-year tax returns. New or revised contractual agreements regarding the property can serve as documentation of depressed market conditions, changes in control over development and sales strategy and changes in regional land use.

Written reports from land planning experts can be used as evidence of land-use changes; in 1980, such a report helped

convince a Texas district court that a developer's intent had changed.

Municipalities can be the source of a change of intent for a developer. For example, a municipality condemned a tract of land to use it for "fill dirt" for highway construction. The developer then sold the tract

to the municipality's highway contractor. An appellate court decision confirmed the sale as a capital transaction.

Capital gains versus ordinary income tax treatment for developers is a complicated issue. Consultation with an accountant, attorney or real estate professional is recommended. ♣

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