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Revisiting Dealer and Investor Status

By Robert W. Wood • Wood LLP • San Francisco

Investors who buy and hold land for investment can generally claim capital gain treatment on the appreciation in value of their land. Developers, on the other hand, are generally treated as earning ordinary income when they develop and sell parcels of land or when they construct and sell individual homes. It is not a stretch to imagine investors wanting to develop and developers wanting to bifurcate investment gains from development gains.

Mostly, this dichotomy is helpful for what it expressly discusses. However, it can also be relevant in other dealer vs. investor contexts that do not involve real estate. For example, the dealer vs. investor distinction occasionally comes up with securities too.

For investors, it is usually possible to buy, hold and improve real estate for investment and to claim capital gains tax treatment for some or all of the gain. But in the case of a developer, is it possible to have an investment phase where the property is held for much later development? Is it possible even if the property is thereafter subdivided and individual homes are thereafter constructed and sold?

The latter gain attributable to development would clearly be treated as sales of inventory and would be taxed as ordinary income. The question is whether the former (the initial-investment gain) might be viewed as long-term capital gains if it is properly segmented from the development activity. The mechanics and timing of the segmentation are crucial.

Under one model, an investor or investment company could distribute the property. The property could then be held by a development company. The distribution could be viewed as the dividing line between the investor (capital) role and the inventory (ordinary) function. But that is not the only possibility.

Under another potential model, an investment company could sell the subject property to the developer company for fair market value in what would presumably be a taxable sale. The presence of related parties would increase the likelihood that the ordinary income taint from the development activity could negatively impact the

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initial-investment phase, where capital gain treatment is desired. Still, in many circumstances, a sale to capture the initial appreciation would seem preferable to a distribution.

Mechanics

Segregating the pre-development appreciation in the land does not seem to be an unreasonable goal, particularly if the transaction is arm's length, the gain is reported and the tax is paid. The investment and development functions would be housed in separate companies. The undeveloped land could initially be held by an investment company until the property is ready to be developed. When the property is ready to be developed, the investment company could sell the property to the development company in an arm's-length transaction.

The development company could then develop the land, market the property and sell individual units of the property to realize ordinary income.

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There is no clear path to ensure capital gains rates for the investment phase of the project. The case law is inherently fact specific.

In fact, the IRS has attacked land sale transactions reported as capital gains under a variety of theories. The IRS has mounted attacks under the related-party rules, a general agency theory, and using the substance-over-form doctrine. The latter is the doctrine that allows the IRS and courts to recharacterize transactions that appear artificial, those that are designed to achieve a particular tax result, but that have no independent legal significance.

To help reduce the risk of capital gain treatment being disallowed, it is worth considering these planning ideas:

1. an arm's-length sale of the property by the investment company based on a third-party appraisal;
2. the sale to occur prior to subdivision of the property and prior to any significant or continuous development activity;
3. thorough and contemporaneous documentation of the sale; and
4. a contemporaneous tax opinion to support the tax returns on which capital gains is reported.

Capital Gain Treatment

Sales of long-term capital assets are taxed at preferential rates to reduce the hardship of taxing an asset's entire gain in one tax year. Under Code Sec. 1221(a)(1), a capital asset is defined as property that is not "held by the taxpayer primarily *for sale* to customers in the ordinary course of his trade or business." Code Sec. 1221(a)(2) also excludes real property *used* in a taxpayer's trade or business from the definition of a capital asset.

However, real property *used* in a trade or business and held for more than one year can receive capital gain treatment under Code Sec. 1231. Notably, Code Sec. 1231 does not extend capital gain treatment to "property held by the taxpayer primarily *for sale* to customers in the ordinary course of his trade or business."

Whether a particular parcel of land is held by a taxpayer for sale to customers in the ordinary course of his business is a question of fact. The courts consider a number of factors when making this determination and there is some variation on this point in different federal

circuits around the country. For example, some courts have considered:

- the nature of acquisition of the property;
- the frequency and continuity of sales over an extended period;
- the nature and the extent of the taxpayer's business;
- the activity of the seller with respect to the property; and
- the extent and substantiality of the transactions. [*See Allen*, DC-CA, 2014 US Dist LEXIS 73367, at *7.]

The Ninth Circuit Court of Appeals has held that the "ultimate question is the purpose for which the property is held." [*See E. Pool*, CA-9, 58-1 USTC ¶9154, 251 F2d 233, 236.] The determination is highly fact dependent. A court may consider other factors as well.

Development or Pre-Development?

Courts generally hold that a taxpayer who waits for his property to appreciate in value is an investor. But an investor may sometimes engage in pre-development activities without losing its status as an investor. At the same time, any development activity runs the risk of causing the taxpayer to be treated as a dealer.

Moreover, if the taxpayer seeks to increase the value of its property through continuous or extensive improvements, courts are likely to deem the taxpayer a dealer. Any of the following activities may cause a taxpayer to be treated as a dealer:

1. surveying property;
2. subdividing property;
3. building roads;
4. paving streets;
5. installing mains;
6. installing fire hydrants;
7. building drainage; and
8. adding utilities.

Not surprisingly, if the taxpayer engages in more than one of these activities, courts are more likely to find the taxpayer to be a dealer. Even so, the outcome in these cases is highly dependent on the facts.

The nature, number and magnitude of the taxpayer's activities are all likely to be examined. For example, in *G.R. Gault* [CA-2, 64-2 USTC ¶9517, 332 F2d 94, 96], the Second Circuit concluded the taxpayer's primary purpose for holding the property was to sell the property to customers. In *Gault,* the taxpayer had his property surveyed and subdivided, built roads and installed mains and fire hydrants. Similarly, in *Biedenharn Realty Co.* [CA-5, 76-1 USTC ¶9194, 526 F2d 409, 418], the Fifth Circuit held that the taxpayer was engaged in the trade or business of developing real property.

The activities that resulted in this conclusion included adding streets, drainage, sewerage and utilities. Similarly, in *B.H. Sanders* [CA-11, 84-2 USTC ¶9767, 740 F2d 886, 889], the Eleventh Circuit determined that a taxpayer's gains on sales of real property were subject to ordinary income treatment. The court found that the taxpayer subdivided the property and improved it with water service, paved streets and gas and power lines. That was enough to preclude investor status.

Pre-Development Activities

On the positive side, not everything that might ultimately *lead* to development is always considered to actually *be* development. The courts have found that engaging in subdivision alone is not sufficient to tax the investor as a dealer. But the facts and nuances matter.

In *G.V. Buono* [74 TC 187, Dec. 36,925 (1980)], the Tax Court found that the taxpayer's gain from the sale of his lots was not subject to ordinary income treatment. The court found that the taxpayer's only activity was subdivision and that subdividing the property was not an improvement. Similarly, in *F.E. and M.L. Gartrell* [CA-6, 80-1 USTC ¶9329 619 F2d 1150 (1980)], the Sixth Circuit did not consider the property's subdivision an improvement.

However, the taxpayer in *Gartrell* did engage in other activity. Nonetheless, the court concluded that the taxpayer's installation of a few gravel roads did not constitute development activity.

Another factor that may have influenced the Sixth Circuit's decision in *Gartrell* was the fact that the taxpayer had a full-time job separate from real estate. These cases suggest that the number of activities, as well as the degree of activity, may influence the determination of whether the taxpayer is an investor or a dealer.

Sales Between Related Parties

A taxable sale by the investment company should trigger mandatory reporting of the gain. With the

purchase price being pegged to an appraised fair market value, the sales price should hopefully be unassailable. Thus, the primary question should be whether the sale can be reported as capital gains or must be ordinary.

Plainly, related parties could complicate the situation. Having a development company that is related to the investment company increases the risk that capital gain treatment will fail. Nevertheless, the case law reflects that the involvement of related parties, by itself, is not sufficient to require ordinary income treatment.

In *R.H. Bramblett* [CA-5, 92-1 USTC ¶50, 252, 960 F2d 526, 528], the Fifth Circuit considered a taxpayer and his partners who formed an investment partnership. The partnership bought property and then had a development corporation develop it. The Fifth Circuit respected the taxpayer's arrangement.

The court rejected the IRS's arguments that the partners held the property for sale to customers in the ordinary course of their business. At least a portion of the taxpayers' victory can be attributed to a careful division between quiet investor-type activity and more active development. The partners in *Bramblett* held the property for over three years.

During that time, they conducted no advertising, did not hire brokers and did not develop the property or maintain an office. They made only four other sales, which had yielded approximately $70,000 in profit. In contrast, the sale in question yielded more than $7 million, which the taxpayers reported as long-term capital gains.

The IRS treated the gain as ordinary income and the Tax Court agreed with the IRS. On appeal, however, the Fifth Circuit ruled for the taxpayer. The Fifth Circuit holding can be read to suggest that a sale of undeveloped real property to a related company for development may often qualify for capital gain treatment, provided one has good facts.

In contrast, in *C.D. Pool* [107 TCM 1011, Dec. 59,804(M), TC Memo. 2014-3], the Tax Court denied capital gain treatment. The taxpayers had organized a development corporation to purchase investment property from an LLC. The agreement specified that the investment LLC had the exclusive right to purchase the land and that the development company was required to make specified improvements.

The investment LLC had reached an agreement with the local government, under which the LLC was obligated to make improvements to the land. The agreement identified the LLC as the subdivider of the land and as the developer of a proposed subdivision. The Tax Court focused on the agreement with the local government, which plainly suggested that the investment LLC would in fact be developing the land for sale to customers.

The fact pattern was really a continuum and the Tax Court was unwilling to bifurcate it. Moreover, the Tax Court found that there was insufficient documentation to support the taxpayer's assertion that the previous sales were infrequent and insubstantial. Finally, the Tax Court also found that the investment LLC made water and wastewater improvements.

The Tax Court characterized these undertakings as "akin to a real estate developer's involvement in a development project than to an investor increasing the value of his holdings." Accordingly, the Tax Court held that the investment LLC was holding the land primarily for sale to customers in the ordinary course of its business. The profit from the sale of land was therefore ordinary income.

In *Allen* [DC-CA, 2014 US Dist LEXIS 73367], a California District Court held against a taxpayer who unsuccessfully attempted to develop property. The taxpayer eventually sold the land in bulk and reported the sale as long-term capital gains. The District Court considered the factors identified by the Ninth Circuit, but ultimately held that the profits from the sale of land were ordinary income.

The primary explanation for the decision appears to be the taxpayer's actions. Although they were not successful development efforts, the court noted that the taxpayer actively engaged in *attempts* to develop the property. Sometimes, it appears, intent can be pivotal even when not all plays out as intended.

According to the court, it was important that the taxpayer always intended to sell the property to customers in the ordinary course of his business. Furthermore, the taxpayer was a civil engineer who worked primarily for developers. This kind of professional expertise can be a disadvantage when one is hoping for investor status.

It is difficult to summarize the landscape on these issues. The opinions in *Pool* and

Allen suggest that the courts may scrutinize a taxpayer's conduct for any hint of development activity. Indeed, even an unfulfilled *intent* to develop the property (as distinguished from an intent to hold it for passive investment) could be harmful.

At the same time, the authorities do not suggest that bifurcating investment from development activity is impossible. On the contrary, the authorities show that it is possible to do so with the right facts. Even if the sale involves related parties, if the sale is at arm's length and the development activities do not occur while the property is held by the investment company, the prospects for long-term capital gains reporting seem viable.

Development Attributed to Investors

When one is discussing the possibility of bifurcating investment from development activity, the topic of related parties usually comes up. Needless to say, it will complicate the matter if the same or related parties own the investment company and the development company. Attribution worries may arise directly (from company to company).

They also may arise *via* ownership from the development company up to the common owners and then back down to the investment company. The cases that consider such issues in this specific context can be most enlightening. In *Bramblett*, the Fifth Circuit determined that common ownership between the investment and development companies was not enough, in itself, to attribute the actions of the developer to the investor.

Nevertheless, the IRS may use other legal methods to attribute the development activities of the development company to a related investment company. These avenues of attack include general agency theory and the doctrine of substance over form.

Agency

In *Bramblett*, four individuals created a partnership for the stated purpose of purchasing land for investment. Less than a month later, the same four individuals formed a corporation for the purpose of developing and selling real estate. Each individual's interest in the corporation mirrored his respective interest in the partnership.

The IRS argued that the development corporation was acting as an agent of the partnership. Under agency principles, the IRS then attributed the development activities to the partnership. The Tax Court agreed with the IRS.

However, the Fifth Circuit rejected this argument. The court relied on a multi-factor test for agency, as articulated by the Supreme Court in *National Carbide Corp.* [*See* SCt, 49-1 USTC ¶9223, 336 US 422, 69 SCt 726.] The multi-factor agency test reviews whether the corporation operates in the name of the principal and for the principal's account, binds the principal by its actions and transmits money received to the principal.

Finally, this multi-factor agency test asks whether income received is attributable to the services of the principal's employees and assets. The Fifth Circuit then went on to apply this multi-factor agency test to the two entities before the court. First, the court noted that the development corporation did not transfer money to the investment partnership.

In fact, the investment partnership *sold* the land for its fair market value. Plainly, the business purpose of the development corporation was not to act as an agent. Thus, the only factor the Fifth Circuit found arguing in favor of an agency relationship was common ownership.

The Fifth Circuit held that common ownership was not enough to prove an agency relationship. Many investors and perhaps many developers have been emboldened by the court's decision in *Bramblett*.

Substance Over Form

Describing the substance-over-form doctrine to a client can be difficult. Assessing—much less opining—when it is likely to be applied can be fraught with uncertainty. Courts look to objective economic realities, or the substance of a transaction, rather than the form a taxpayer employs.

A court will not respect a transaction that is carried out solely for tax avoidance. In order for a transaction's form to control its tax consequences, a transaction must have genuine economic substance. That is, the transaction must be "compelled or encouraged by business or regulatory realities" or other tax-independent reasons.

Therefore, a court will look to the investment company's purpose for holding the land and the economic substance of the transaction

as a whole. In *Bramblett*, the IRS also argued that substance-over-form principles should attribute the development corporation's actions to the investment partnership. The Tax Court agreed with the IRS.

It found the activities of both the development corporation and investment partnership supported the conclusion that the investment corporation was selling land to customers and its gains should be taxed as ordinary income. The Fifth Circuit rejected this argument. The Court of Appeals found that the transaction was *not* a sham.

Indeed, the Fifth Circuit noted that the parties engaged in an arm's-length transaction with legal formalities. The parties were related, but the transaction was real. It was fairly priced and fully documented. Moreover, the investment partnership and development corporation were separate taxable entities. Finally, the investment partnership bore the risk that the land would not appreciate.

The Fifth Circuit highlighted the fact that there was a legitimate business purpose to separate the development corporation from the investment partnership. The Fifth Circuit found that the corporation was formed because the parties wanted to "insulate the partnership and the partners from unlimited liability from a multitude of sources." Documentation can be terribly important.

In that sense, planners should consider whether there are nontax business purposes for bifurcating the investment holding of property from its subsequent development. Obviously, the presence of nontax business and liability reasons for dividing investment from development activities would be helpful, and having written evidence of same—even minutes or other writings that may be viewed as self-serving—can clearly be too.

The topic of a nontax business purpose was also recognized by the Tax Court in *T.J. Phelan*. [*See* 88 TCM 223, Dec. 55,745(M), TC Memo. 2004-206.] In this case, the investment LLC's members were not exposed to the same liabilities as the partners in *Bramblett*. Accordingly, the IRS argued in *Phelan* that there was no independent business purpose for creating the development corporation.

However, the Tax Court disagreed with the IRS. The court found that the investment LLC *still* had an independent business purpose for creating a development corporation. The LLC's business purpose was to protect the land remaining in the LLC from obligations arising from the development corporation's development activity.

Choice of Entity

If one is writing on a clean sheet of paper, some thought should be given to the nature and tax status of the investment entity on the one hand and the development entity on the other. In general, the company conducting the development work and the company conducting the later inventory selling should not both be LLCs or partnerships. Entities taxed as partnerships carry the possibility of additional taint when there is a transfer of land between the investment company and the development company.

Code Sec. 707(b)(2) applies if a partnership sells to another partnership and if the selling partnership owns (directly or indirectly) more than 50 percent of the capital or profits interests of the purchasing partnership. If Code Sec. 707(b)(2) applies, the gain from sale of property can be recharacterized as ordinary if the property is not a capital asset in the hands of the purchasing partnership. Code Sec. 707(b)(2) also recharacterizes gain that would be treated as capital gains under Code Sec. 1231 as ordinary income.

Forming the development company as an S corporation seems appropriate. On the surface, the sale of land from an investment company or partnership would appear to avoid recharacterization even if the buyer and seller share common ownership. S corporations are not subject to provisions comparable to Code Sec. 707(b)(2).

Nonetheless, the related party rules for corporations still apply. Therefore, the investment partnership could sell to a development company that is a related party, but not to an S corporation that it controls. If the investment partnership sells property to an S corporation it controls, then the marketing, developing and selling actions of the development company can be attributed to the investment company. As a result of the attribution rules, the investment partnership would not receive capital gain treatment on the sale.

Separate Investment and Development

Although there is no perfect structure, a few principles do seem to emerge. Ideally, an investment company should hold the undeveloped land in a company that is taxed as a partnership (an LLC or a partnership). The development company, on the other hand, might appropriately be an S corporation.

If the owners can accommodate that structure, the mostly passthrough nature of the S corporation coupled with it distinct tax status may help to minimize the parity between the investment and development companies. In contrast, the investment company should not be a single-member LLC owned by the S corporation development company. It would be considered a disregarded entity for tax purposes, putting the capital gain treatment on the investment company sale at risk.

What of the ultimate ownership of each entity? Ideally, the ownership structure of the investment company should not be identical to that of the development company, despite the favorable holding in *Bramblett.* Even slight (but hopefully still meaningful) variations in the respective holdings could be helpful.

Moreover, both companies should be separate and distinct. Each should have their own bank accounts, books and records. Both should be capitalized with sufficient assets to cover reasonably anticipated liabilities. Both should certainly be capitalized with more than *de minimis* cash or assets. The organizational documents of the investment company should not make reference to selling, marketing or developing land.

Bona Fide Sale

The investment company should engage an independent appraiser to value the land and should retain extensive documentation of the land's value at the time of sale. The investment company should sell the land to the development company at the appraised price and on commercial terms. The sales price of the pre-developed land should not be contingent on the profits of the development company.

There should not be any other mechanism under which the development company bears the risk (or shares in the benefit) of post-development sales. In addition, the development company should not pre-sell any land prior to the acquisition of the land from the investment company. Finally, the deed and any mortgage should be recorded.

Purchase of Land with Notes

The development company should pay cash and/or receive third-party financing to purchase the undeveloped land if that is at all possible. If the transaction is financed by the investment company, the development company should put down cash at closing and provide adequate security for the purchase money note. The terms should be consistent with those prevailing among unrelated parties.

The development company's promise to repay the debt should not be contingent on how much property it can sell. If the development company does not repay the full amount of the loan, the investment company should pursue legal remedies. The development company and the investment company should record a deed of trust or Uniform Commercial Code (UCC) financing statement to secure the debt.

Development

The investment company should not make any improvements to the land and should not develop or market the land. Development activities can include subdivision, surveying, grading, zoning and improvements to roads, water and utilities. The development company should refrain from making any improvements to the land until it has purchased the land. The development company should hold itself out as the developer without reference to the investment company or the period of time during which the property was held by the investment company.

Conclusion

As long as there are capital gains rates, there will be incentives for the taxpayers who qualify. Whenever possible, they will want their losses to be treated as ordinary and their gains to be treated as capital and long-term capital gains at that. For the taxpayers that qualify for capital gains rates, the incentive to look at the course of gains and to consider whether the appreciation can be bifurcated between investment and development gains is only natural. Of course, the devil is in the details.