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Defining “Real Estate Investor” and “Real Estate Dealer”

Let’s start with the big-time tax consequences.

Profits on dealer sales are generally subject to taxes at both

- ordinary income rates of up to 37 percent,¹ and
- self-employment rates of up to 14.13 percent.²

In addition, dealers may not

- depreciate property held for sale to customers,
- use the tax-favored installment method to report their property dispositions, or
- defer taxes by using the Section 1031 tax-deferred exchange on dealer properties.

Good Tax Breaks for Dealers

Tax law treats the dealer just as it does any business, and that includes some good things for tax purposes.

- Dealers treat real estate selling expenses, commissions, legal fees, and advertising as ordinary business deductions.
- Losses on the sale of dealer properties are *not* limited by the \$3,000 capital loss cap that exists for investor properties.
- Dealers deduct the loss as an ordinary loss.
- Dealers deduct the entire loss (either immediately or over time using the new net operating loss rules that allow carryforward forever).

Good Tax Breaks for Investors

Profits on investor sales are

- taxed at tax-favored capital gains rates of 20 percent or less, and
- not subject to self-employment taxes.

Say you have a \$90,000 profit on the sale of a property.

- **Dealer taxes** could be as high as \$46,017.³
- **Investor taxes** could be as high as \$18,000.

The investor potentially saves a whopping \$28,017 in taxes.

In addition, the investor

- depreciates the property,
- may sell using the tax-favored installment method, and
- may defer the taxes by using the Section 1031 tax-deferred exchange.

Investors face the \$3,000 limit on net capital losses (after offsetting gains against losses).

Investors also suffer the disadvantage of treating selling expenses as reductions in sales proceeds, meaning that selling expenses produce benefits only at capital-gains tax rates.

You Can Be Part Dealer and Part Investor

You, the individual taxpayer, can be both a dealer and an investor! The law does not cut you in half or anything. No, the law simply looks at each property in its respective light.⁴

But you need to make the light shine on your properties by making a clear distinction in your books and records as to which properties are investment properties and which are dealer properties.

Should you fail to make the distinction, you place yourself at the mercy of the IRS. (The word “mercy” does not exist in the tax code, so expect a very unhappy result if you rely on mercy.) The courts look at your intent in buying and holding the property. Your books and records help establish that intent.

Notice the word “help.” Your purpose in buying and holding does not control, it only helps. When push comes to shove, the courts examine the sale when they rule on your dealer or investor status.⁵

Establish Intent

Set yourself up to make a strong case. Establish your intent

- when you buy the property,
- while you own the property, and
- when you sell the property.

This article helps you do just that.

True, circumstances can change. You may buy the property for one purpose and then something may happen to change your purpose. This article will help you realize what that change means and how, if at all, you can plan for a better result.

The Critical Point-of-Sale Aspect

Before getting to the planning part of this article, which revolves around the attributes of a dealer and an investor, you need to focus on one major aspect: the way your property looks at the time of sale. This point-of-sale look gets the full focus of the IRS and the courts, and often it determines the property's classification as dealer or investor property.

Understanding the attributes of a dealer, described below, and the attributes of an investor that follow will help you look at your property in the correct light.

The Real Estate Dealer's Tax Attributes

Remember, each property stands alone as a dealer or an investor property.

Your property might possess some attributes of a dealer property and some attributes of an investor property. When you have mixed attributes, the court will base its decision on its interpretation of your facts as to this property.

Allowing the court to do this for you is a bad idea.

Most people who have trouble with the dealer and investor property classification have that trouble after the fact, meaning they did not know what they were doing beforehand.

You will not have this problem. This article gives you a clear understanding of how your property could be classified as a dealer or an investor property. Then, once you have the differences clearly in mind, you simply plant as many of the appropriate attributes as possible on your property.

Definition of "Dealer Property"

Dealer property is property you hold for sale to customers in the ordinary course of a trade or business.⁶

Attributes of Dealer Property

The more properties you buy, and the more properties you sell during a calendar year, the greater the chances that you are a dealer with respect to those properties.⁷

If you are hoping that the courts, the IRS, or some other friendly critter has set *the number* of transactions that classify property as dealer property, you are flat out of luck. No such number exists.

Just to make sure that you don't even think of some magic number, the courts have ruled that

- one sale earned S & H, Inc., dealer status because, before the property's acquisition, it agreed to sell the property to a third party,⁸ and yet
- the sale of 90 homes in one year did not earn dealer status for Nathan Goldberg.⁹

To show you how things can get confused, the *Goldberg* case was decided against Nathan Goldberg by the Tax Court and then overturned by the Fifth Circuit. In *Goldberg*, the homes were built as rentals during World War II.

When the war ended, rentals ended and thus the homes could be, and were, sold. Here, the homes were

- built for rental,
- used for rental, and
- sold.

The homes were never built for resale to customers in the ordinary course of business.

From all this, you can rightly conclude that there is no right number of sales and purchases that automatically makes property a dealer or an investor property.

But the general rule that you can recognize by reviewing a great number of court cases is that the greater the number of properties bought and sold, the greater the chances that these are dealer properties.

Properties that you buy, fix up, and sell generally are dealer properties.¹⁰

Also, properties that you subdivide have a great chance of being dealer property,¹¹ except when those subdivisions are done under the very limited rules of Section 1237.¹² Even the removal of the lien to make the property more salable can indicate dealer status.¹³

Sales efforts can indicate dealer status. The courts often declare properties to be dealer properties when the taxpayer engages in extensive marketing and sales efforts, especially compared with the taxpayer who takes a passive marketing approach.¹⁴

Properties held for short periods of time indicate dealer status.¹⁵ The courts know that good cash and profit management make the dealer want to turn over the properties in a hurry.

If you generally make your living from dealer income, your properties are more likely to be classified by the courts as dealer properties.¹⁶

Making a living is only one measure of dealer status. Time spent is also an important factor. If you spend the majority of your time buying and selling property for your own account, your properties are looking a lot like dealer properties.¹⁷

If you sell the property and take the proceeds from the sale to purchase additional real estate, the court is more likely to conclude that you are a dealer rather than an investor.¹⁸

Taint of One Dealer Attribute

We have just covered the attributes that could make some or all of your properties into dealer properties. But the fact that a property carries the taint of one dealer attribute does not by itself make that property a dealer property.

Further, the fact that your portfolio contains dealer properties does not mean that your portfolio may not also include investor properties. Remember, each property stands alone.

When you look at the dealer attributes and how they apply to your property, think of those attributes as signs on the road to help you get to your destination. Try to get the attributes lined up, from the time you buy your property until you sell it.

The Real Estate Investor's Tax Attributes

Unlike with dealer property, where the dealer's principal purpose for owning the property is to sell it to customers in the ordinary course of business, the investor's purpose in owning property is to

- have it appreciate in value, and/or
- produce rental income.

Investor properties are sold infrequently.¹⁹

Properties bought for the primary purpose of producing rental income are investor properties.²⁰

Generally, the courts deem that you hold property as an investor when you acquire the property by

- inheritance,²¹
- dissolution of a trust,²² or
- foreclosure of a mortgage.²³

You can even make significant improvements to a decedent's real estate and still realize investor status.²⁴ But be careful here. Should you sell the decedent's real estate and then reinvest the proceeds in other real estate, you will have a much harder time convincing the court that you are merely an investor.

Further, should you now start subdividing the land and otherwise act as a dealer, the courts will make you a dealer.²⁵

In general, investors hold property longer than dealers do. And the longer you hold property, the better the chance that your property is investment property.²⁶

The investor does not buy, remodel, and then sell. Investors may remodel, but they do so to realize an increase in rental income. They do not remodel for the sole purpose of selling the property in the ordinary course of business.²⁷

Takeaways

Keep two general rules in mind:

- The dealer buys property for the purpose of reselling the property to customers in the ordinary course of business.
- The investor buys property for appreciation, rental income, or both appreciation and rental income.

If your property does not fall at one end of the spectrum, make sure it meets as many of the attributes for your desired outcome as possible.

Each property stands alone with respect to its status as a dealer or an investor property.

Thus, you (the individual taxpayer) or your corporation may own both dealer and investor properties.²⁸ In such a case, make absolutely certain that you are classifying your properties correctly. The tax consequences of failing to do so are enormous.

If you have both types of properties, make a clear distinction in your books and records as to which properties are investment properties and which are dealer properties.

References

- 1 2018 Federal Tax Rates.
- 2 Self-employment rate of 15.3 percent times 92.65 percent Schedule SE adjustment equals the effective rate of 14.13 percent.
- 3 For instance, if you were married to a spouse with good income and this was your only income.
- 4 *Tollis v Commr.*, T.C. Memo 1993-63.
- 5 *Sanders v U.S.*, 740 F2d 886.
- 6 IRC Section 1221(a)(1).
- 7 *Sanders v U.S.*, 740 F2d 886; *Suburban Realty Co. v U.S.*, 615 F2d 171.
- 8 *S & H, Inc. v Commr.*, 78 T.C. 234.
- 9 *Goldberg v Commr.*, 223 F2d 709, 55-1 USTC paragraph 9519 (5th Cir. 1955).
- 10 *Jarret v Commr.*, T.C. Memo 1993-516.
- 11 Revenue Ruling 57-565 allowed capital gain treatment for the land not subdivided when the taxpayer had subdivided 40 percent into lots and sold those lots.
- 12 IRC Section 1237.
- 13 *Miller v Commr.*, T.C. Memo 1962-198.
- 14 *Hancock v Commr.*, T.C. Memo 1999-336.

- 15 Stanley In. v Schuster, aff'd per curiam 421 F2d 1360, 70-1 USTC paragraph 9276 (6th Cir.), cert den 400 US 822 (1970); 295 F. Supp. 812 (S.D. Ohio 1969).
- 16 Suburban Realty Co. v U.S., 615 F2d 171.
- 17 Armstrong v Commr., 41 T.C.M. 524, T.C. Memo 1980-548.
- 18 Mathews v Commr., 315 F2d 101.
- 19 Rymer v Commr., T.C. Memo 1986-534.
- 20 Planned Communities, Inc. v Commr., 41 T.C.M. 552.
- 21 Estate of Mundy v Commr., 36 T.C. 703.
- 22 U.S. v Rosbrook, 318 F2d 316, 63-2 USTC paragraph 9500 (9th Cir. 1963).23
- Cebrian v U.S., 181 F Supp 412, 420 (Ct. Cl. 1960).
- 24 Yunker v Commr., 256 F2d 130, 1 AFTR2d 1559 (6th Cir. 1958).
- 25 U.S. v Winthrop, 417 F2d 905, 69-2 USTC paragraph 9686 (5th Cir. 1969).
- 26 Nash v Commr., 60 T.C. 503, acq. 1974-2 CB 3.
- 27 Metz v Commr., 14 T.C.M. 1166.
- 28 Harbour Properties, Inc. v Commr., T.C. Memo 1973-134; Howell v Commr., 57 T.C. 546; Real Estate Corp. v Commr., 35 T.C. 610 (1961), aff'd. 301 F.2d 423 (10th Cir. 1962); Mieg v Commr., 32 T.C. 1314 (1959).

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