

## *Investor vs. Dealer Status in Real Estate Development Activities*

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An entity actively engaged in the trade or business of development and sale of real estate creates ordinary income from its activities. Alternatively, real property owners engaging in investment activity may sell real estate using capital gains treatment resulting from the sale of an investment.

How does one determine whether the income resulting from the sale of real estate is capital or ordinary in nature? The Internal Revenue Code only offers general guidelines regarding activities that reach the level of a trade or business. The codes do not provide specific guidance regarding real estate activities. Court cases have been the primary source for determining what level of activity determines a trade or business in real estate development and hence the nature of the income.

The original case most often cited is *United States v. Winthrop*.

The taxpayer, Guy L. Winthrop, owned real property near Tallahassee, Florida. Winthrop first received a share of the property in 1932 upon the death of his mother. Additional portions of the property were received by him in 1946, 1948, and 1960 through inheritance and partition. The first subdivision was undertaken in 1936, and the first sales were made in that year. Thereafter, eight other subdivisions were developed by the taxpayer. The streets were graded and paved and utility service installed at Winthrop's expense. He also built five sales models on the premises.

In determining whether the gain from these sales was ordinary or capital in nature, the court relied on a series of facts and circumstances which it arranged into what have become known as the "Winthrop Factors." These factors have since been dissected and arranged into anywhere from 4 to 9 factors, depending on the current authority.<sup>1</sup>

However, primary authority, in this case the 5th Circuit Court of Appeals, cited the "Winthrop Factors" in the case of *Biedenharn Realty Co., Inc v. United States* as follows:

1. Frequency and Substantiality of Sales
2. Improvements
3. Solicitation and Advertising Efforts
4. Brokerage Activities

### *1. Frequency and Substantiality of Sales*

This is cited the first and most important of the Winthrop factors. The Court stated that numerous dispositions of property over an extended period of time generally will be afforded ordinary gain treatment. Conversely, infrequent sales over a limited time span are more likely to generate capital gain treatment.

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## ***2. Improvements***

Improvements are a significant measure of taxpayer activity. So, the more significant the improvements, the more likely dealer status will be determined, resulting in ordinary income.

## ***3. Solicitation and Advertising Efforts***

The third Winthrop factor cited is an additional measure of taxpayer activity. The more extensive the promotional activities engaged in to create a sale; the more likely ordinary income is the result. These can be activities undertaken directly by the taxpayer or through a third party contracted by the taxpayer.

## ***4. Brokerage Activities***

Regardless of whether promotional and sales activities are conducted by the taxpayer or a third party (broker), the activities will indicate dealer status and ordinary gain treatment. The courts found no distinction between activities conducted by the taxpayer or those conducted on the taxpayer's behalf by third parties. This includes traditional sales activities of brokers. <sup>2</sup>

Subsequent court cases have segregated this list into 9 factors, listed in importance, from 1 to 9.

1. The purpose for which the property was initially acquired
2. The purpose for which the property was subsequently held
3. The extent of improvements made to the property
4. The number and frequency of sales over time
5. The extent to which the property has been disposed
6. The nature of the taxpayer's business, including other activities and assets
7. The amount of advertising/promotion, either directly or through a third party
8. The listing of the property for sale through a broker
9. The purpose of the held property at time of sale <sup>3</sup>

## ***Intent in Holding Property***

Often, the intent in holding property changes between the time of original acquisition and the time of development/sale. Courts have generally held that the intent at time of development/sale is more significant than the original intent of the owner.

Factors used by these courts to determine the intent of the taxpayer included:

- How the property sale is reflected on company books and records
- Corporate minutes or Partnership notes
- Other documentation regarding any change of status <sup>4</sup>
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## *Safe Harbor Under IRS §1237*

The Internal Revenue Code provides a safe harbor for determining investment status of land under IRC §1237. The intent is really about subdivisions, meaning that subdividing land for resale does not create dealer status. However, the safe harbor has severe limitations:

1. Does not apply to corporations, including S-corporations
2. Does not apply to land previously held by the taxpayer primarily for sale to customers
3. The taxpayer cannot hold any other real property primarily for sale to customers in the same taxable year of the sale.
4. No substantial improvement that enhances value can be made to the land.
5. The lot or parcel must be held by the taxpayer for five years or otherwise acquired through inheritance.

What does the safe harbor provide the taxpayer?

- The first five lots are deemed to be sold or exchanged as investments
- Subsequent income is taxed at ordinary gain rates to the lesser of:
  - Gain from the sale, or
  - 5% of the gross proceeds <sup>5</sup>

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1. United States v. Winthrop, 24 AFTR 2d 69-5760 (10/22/1969)
  2. Biedenharn Realty Co., Inc. v. United States, AFTR 2d 76-679 (01/26/1976)
  3. Maddox Construction Co. v. Commissioner, 54 T.C. 1284 (1970); Hoover v. Commissioner, 32 T.C. 618, 625 (1959); Oace v. Commissioner, 39 T.C. 743,747 (1963); Graves v. Commissioner, 89-1 USTC ¶9170, 867 F.2d 199, 202 (4th Cir. 1989); Guardian Industries Corp. v. Commissioner, 97 T.C. 308, 316 (1991); DuVal v. Commissioner, T.C. Memo. 1994 603
  4. Biedermann v. Commissioner, 68 T.C. 1 (1977); Eline Realty Company v. Commissioner, 35 T.C. 1,5 (1960); Olstein v. Commissioner, T.C. Memo. 1999-290; Pritchett v. Commissioner, 63 T.C. 146, 162 (1974); Silver-smith v. United States, 84-2 USTC ¶9767 (11th Cir. 1984)
  5. IRC §1237