You "Dealing"?

Why is being classified as a Dealer important?

Congress is most discriminating. For example, if two investors each purchased adjacent and identical properties for exactly the same price, spent exactly the same on improving each property and sold the properties for the same price to the same buyer, one investor might pay double the taxes of the other…..and the difference in taxes paid would be even larger when measured in terms of *when* paid. Specifically, a property acquired and later sold by an "Investor":

- Generates depreciation deductions;
- Is taxed at favorable capital gains rates when sold;
- May qualify for deferral of gains under IRC Section 1031;
- May qualify for deferral of gains as an Installment Sale.

The same property sold by a "Dealer" (in other words, "flipped") is simply taxed at full ordinary rates upon sale, with no deferrals. Dealers also get no depreciation deductions. Sometimes simpler is not better.

What makes one a Dealer instead of an Investor?

Congress differentiates between the "identical" situations described above based upon the intent of each investor. Intent is determined based on actual activities…actions speak much louder than words. Generally, if an entrepreneur purchased a property with the intent to sell it, then he would be a Dealer with respect to that property[1]. If, on the other hand, the entrepreneur purchased the property with an eye towards holding it for the income and appreciation benefits, the more favorable Investor status would apply. That's right, the same outfit that is consistently unable to distinguish between "Trust Fund" (Social Security in theory) and "Pork Piggy Bank" (Social Security in fact) wants to know what you were thinking when you bought that property. Maybe Dealers need better lobbyists.

Fortunately, technological capacity is not quite up to the demands of Congressional mind-reading intent, so we can keep our tinfoil helmets in the closet. Unable to peer into one's head, the IRS must make do with peering into one's business. The courts and the IRS consider the following factors in determining whether a real estate entrepreneur is a Dealer:

- Duration of Ownership- Properties held for less than two years will likely be treated as Dealer inventory. Properties held for more than two years are often, but not always, treated as investments;

[1] The entrepreneur could argue that he is not in the business of selling properties on a regular basis, and that isolated sales should not be treated as "Dealer" sales.

- Manifestations of Intent- statements of intent will be held against you if resale ideas were expressed. A firm representation made to investors of intent to buy and hold may be of some slight help;
- Extent and Nature of Efforts to Sell the Property- Strong and constant advertising, use of agents and personal sales efforts are the hallmarks of dealers. However, this factor is rarely fatal, because investors liquidating property must also advertise and use brokers. Basically, the more constant and intense the activity over time, the greater the likelihood that this factor will point towards an intent to sell;
- Number, Substance and Continuity of Sales- The greater the number of sales over time, the more likely a sales intent exists. This factor alone can be fatal to investor status. This factor is also neutral at best- a lack of sales does not necessarily indicate a lack of sales intent (just a lack of skill or luck!);
- Extent of subdivision and development- Subdivision and development tend to indicate an intent to sell, though subsequent sustained rental of developed properties may nullify this factor;
- Use of a business office for the sale of property- Not generally an important factor, but it can tip the balance in close cases.
- Degree of control exercised over selling agents- A close degree of control over agents gives the appearance of a sales operation. This factor is rarely applied in practice.
- Time and Effort Habitually Devoted to Sales- This factor is more properly part of the third factor described above. The more habitual the effort, the more likely a sales intent exists.

Which factors are most important? Nobody- including the courts- knows for certain. Number of sales, duration of holding and extent and consistency of sales efforts seem to weigh most heavily. However, this area is very heavily litigated and the court opinions are all over the map- and often inconsistent. Much depends upon the judges':

- "Feel" for the individual taxpayer and the equities in the case (I suspect that fast-talking guys in Hawaiian shirts with 50-pound gold necklaces and Jimmy Carter smiles fare poorly. But that's just a guess);
- Pet ideology;
- Degree of nocturnal activity the preceding night (Some say that this factor is directly related to "pet ideology").

If homes are advertised and resold within two years on a pretty consistent basis for cash or on Contract for Deed/Land Contract ("CFD/LC"), you probably have a Dealer issue. The lines are a bit murkier where lease-options ("L/O's") are concerned (more on that below). Personally, I think Dealer status is like the Supreme Court's definition of pornography- you'll know it when you see it, all pretenses at "art" & "Investor status" aside. The amount of litigation in this area is intense, which means that the IRS is quite aware of the issue and willing to fight it. Expect scrutiny on audit.

Planning Issues

The first priority is to ensure that Dealer status is not attributed to non-Dealer properties. For example, if an investor held some rentals with his "flip" properties, the rentals could end up tainted as Dealer property when sold. One pretty certain means of segregating Dealer and Investment properties is to put each class of property into different entities. Generally, the dealer properties go into a corporation and the investor properties are placed in an LLC or limited partnership.

However, contrary to popular belief, one can also hold Dealer and non-Dealer properties in the same entity while preserving the favorable tax status of the latter. The key is good bookkeeping to prove the segregation between the property types. Using separate entities to segregate the property types is the safer approach, but holding them in one entity is still feasible for those who cannot afford multiple entities from the get-go.

The Dealer classification is especially troublesome where contract-for-deed or land contract transactions ("CFD/LC") are concerned. Remember that Dealers may use neither the installment sales method nor enter into tax-free exchanges…so any tax on a sale is due when the sale is made. Because a Dealer selling on CFD/LC takes payments instead of cash, he may have to go out of pocket to pay income taxes. For example:

- Investor purchases property for $50,000 cash;
- Investor sells property on CFD/LC for $100,000 with $7,500 down;
- Assuming a 40% bracket, the tax due equals $20,000 ($50,000 gain x 40%).

Our Dealer would have to go $12,500 out of pocket ($20,000 tax due less the $7,500 down payment received) just to pay Uncle Sugar…and that doesn't include Social Security or State income taxes! That sort of hit could turn a good pre-tax return into a dismal after-tax return.

Solution: Aggressive use of the cash method of accounting could help defer some of the tax hit if the note would hypothetically sell at a large discount on the market. Be sure to document examples of note sales to back your position!

Even better- use L/O's. Taxation on the option consideration should be deferred (even for dealers) on well-structured L/O's. Lease payments are included in income as received. Sale proceeds are taxed *if* and when the option is exercised. To ensure that a lease-option is not treated as a CFD/LC and taxed immediately, it must be *carefully* structured.

For aggressive taxpayers, L/O's with low exercise rates may avoid Dealer issues altogether. Basically, the taxpayer could argue that the options are present to attract good tenants, as opposed to good buyers, and that few of the tenants in fact exercise their options. Viola, few sales and no intent to generate them! Overall, well-structured L/O's provide superior tax deferral opportunities when compared to CFD/ LCs. Of course, the tax benefits of L/O's must be weighed against any business or legal downside when compared to CFD/LC's….decisions, decisions!

What Not to Do

Last, but not least- some investors claim that less than five (or seven, or whatever) sales per year exempts one from Dealer status. Based on this theory, some investors create multiple entities and ensure that each entity conducts no more than five (or seven, or whatever) sales per year to avoid ever being classified as a Dealer. This technique is dubious from a legal standpoint. It is true that a few isolated sales are less likely to trigger dealer issues. However, using multiple entities to make a lot of sales look like a few sales is an exercise in form over substance. Upon audit, the IRS can look through the pretense of multiple "non-Dealers" and reclassify ALL of the transactions as Dealer sales…and levy the appropriate penalties, compounded with interest.

Whether one is a Dealer depends on a pattern of action *over time*. For example, of you did one deal in year one and ten deals per year for the next ten years, the year one transaction could easily be treated as a Dealer transaction. Minor deviations from an overall pattern of buying and holding should not be a problem. If a consistent pattern of sales or solicitation efforts exists, such transactions should be isolated from buy and hold activities. Given that commercial properties are often large enough to put each in its own entity, such segregation is often built-in to the existing business structure.

To reiterate:

- Dealer properties are taxed at ordinary rates and are not permitted to:
  - take depreciation deductions;
  - be used in tax-free exchanges; and
  - be used in installment sales.
- "Flippers" and most investors that regularly sell properties for cash or on CFD/LC are dealers with respect to those properties;
- A few *genuinely* isolated sales are unlikely to attract dealer issues;
- The well-planned use of L/O's and the aggressive use of the cash method of accounting can take some of the sting out of the dealer rules.

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