RICHEY MAY & CO

Preserving Capital Gain Treatment on Development Land

It has been famously said that, "you are entitled to your own opinion, but not your own facts." In constructing an effective tax plan, laying out the story effectively can often serve as the most important "fact" when the time comes to explain it all to Uncle Sam. There are two examples, one that has been around a bit and another new situation, that illustrates this point. I am covering one this month and the other next month.

Real estate, more so than most other assets, can take on more than one identity depending upon circumstances (primarily). If a piece of land is purchased and held unimproved for an adequate amount of time, it will be treated as a long-term capital gain asset. If improved, marketed and sold in pieces, it will become an ordinary income asset (same property, different result). We all know that there is a significant tax rate differential between capital gain and ordinary income, significant enough to go to some effort to claim.

A landowner that does intend to improve and sell real estate in a way that will bring it within ordinary income territory can capture the built in pre-development appreciation and carve out that part of the gain as capital in nature by selling the capital gain asset to a related party, which then develops the property for retail sale. Note that the related party sale need not be a cash sale; an installment sale can be used to preserve cash and defer gain. The related party can then develop the property and report ordinary income earned from the development activity. In order to claim these beneficial tax results, the taxpayer must identify and document the right set of facts – that is, tell a good story.

In order for the land sold prior to improvement to obtain capital gain treatment, the taxpayer must be able to demonstrate that they meet all (or a majority of) the qualifications for capital gain (of which there are many). Most importantly, it is not simply the fact that the property actually qualifies for capital gain treatment, but being able to establish the correct pattern of actions and documentation that it does qualify. Only the broadest of definitions exist in the statute so the courts have taken a, "I know it when I see it," approach to determining if an asset is "capital". Obviously, avoiding physical development and major sales and marketing activity is essential, but beyond that it is up to the taxpayer to sell their story.

Establishing that the owner's actions and intent with respect to the asset reflect a capital gain position is largely a matter of documenting those actions and the intent – which is not something that can be measured by looking at the asset in question. Also, remember that the "story" must be told many years after the event so building up the proper files and documents to satisfy the IRS and perhaps eventually a court that you were on the right side of the facts at the point of sale is critical. And by that, I mean information assembled in real time, not something after the fact. (Many references, but see, in combination, *Bramblett v. Commissioner, Pritchett v. Commissioner and Malat v. Riddell*). As a counterpoint, also see a 2014 ruling, *Pool v. Commissioner*, which illustrates the wrong way to go about establishing the capital gain position. In this case, they failed to tell the story well and paid the price by losing capital gain treatment.

If you think you might benefit from capturing pre-development appreciation as capital gain, talk to your tax advisor about your situation and how you can write your story in such a way that you put the IRS at rest quickly when they ask for that story. To learn more about this tax planning opportunity, please contact Zane Dennis at zane@richeymay.com or 303-721-6131.