JO Knows ordinary versus capital treatment on the sale of real property

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If you own real property, should it be treated as a capital asset or inventory? The determination of this treatment will have a major effect on the ultimate tax paid on the sale of that asset, with a capital asset enjoying the preferred capital gain/loss rate of up to 20% (plus a possible 3.8% for the net investment tax which is beyond the scope of this article) while the sale of inventory would be subject to the ordinary tax rates which go as high as 37%. Of course, the categorization of a particular real property sale is not necessarily black and white.

Let's look at Section 1221 which provides the definition of a capital asset. Section 1221(a)(1) states that real property is not considered a capital asset if it is "property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business". Generally speaking, the IRS has looked at businesses that acquire property, improve and sell it as dealers in property and will treat this property as inventory and therefore subject to ordinary income rates. But how do they arrive at this determination? We first need to understand whether the taxpayer is engaged in a trade or business, whether the property owned is primarily for sale in that business, and whether the taxpayer made the sale in the ordinary course of the business. There is no law or regulation on this subject so we look to court cases and there have been plenty. The Bramblett and Winthrop cases are particularly important because they outline the following determining factors in the argument for capital over ordinary income treatment, the "Winthrop Factors:"

1. The nature and purpose of the acquisition of the property and the duration of ownership
2. The extent and nature of the taxpayer's efforts to sell the property
3. The number, extent, continuity and substantiality of the sales
4. The extent of subdividing, developing, and advertising to increase sales
5. The use of a business office for the sale of the property
6. The character and degree of supervision or control exercised by the taxpayer over any representative selling the property
7. The time and effort the taxpayer habitually devoted to the sales

There is no set weighting to these factors making one more important than another. However, in practice the IRS has asserted competing arguments for different cases, and as you can imagine, the IRS wants income to be taxed at ordinary rates and losses to be considered capital. It's important to understand these factors and to document their applicability as you go. Of course, you can change your original intent as to whether the property is held for development versus investment or rental, but you should have a clear fact pattern and document these fully in real time. This is a facts and circumstances issue.

Let us help you through your journey with real property. Not only can we help you to understand these 7 factors, but we can help you through the life span of the property from the purchase through the eventual sale and everything in between. Please reach out to any member of the Real Estate Team.

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