

Capital Gain vs. Ordinary Income

How Property Sales are Taxed

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November 29, 2021

Publication 2329



When selling property, it's not uncommon for the seller to hope the sale will be taxed as capital gains rather than as ordinary income because of the former's tax benefits.

For example, take someone who inherited some land or acquired raw land years ago anticipating growth of a nearby city. Perhaps she wanted to maximize the profit from the property and took steps to subdivide the property and sell the property in lots or smaller parcels. Will she be able to sell the properties and be taxed as capital gains? Alternatively, if she wishes to undertake a like-kind exchange of all land for other real property, will the like-kind exchange rules permit the exchange to be tax-free?

The two questions are simple but complicated. Both involve the same issue: Is the person an investor or a dealer in real estate? The tax consequences differ materially.

To achieve a capital gain on sale or obtain a like-kind exchange, the question is whether the real property is held primarily for sale (as opposed to held for investment).

Takeaway

Taxing the sale of a large piece of property as capital gains rather than as ordinary income generally works to the seller's advantage, but the tax laws are complicated. Three landmark decisions continue to guide courts' rulings on such cases in southern states, including Texas.

Generally, a taxpayer must recognize the entire amount of gain or loss on the sale or exchange of property. Exceptions to favorable tax treatment provided by capital gain sale rules and the like-kind exchange include property held primarily for sale to customers in the ordinary course of trade or business by a real estate dealer. The term "dealer" is shorthand for someone in the real estate business, as opposed to a real estate investor.

The tax law would ask whether the person intended to be an investor or a dealer. Because intent is difficult for a court to determine, courts derive intent from circumstantial facts.

For persons living in Texas and in the southern states (governed by the Fifth or Eleventh Circuit), the question of whether someone is an investor or a dealer is resolved by examining three cases decided from 1969 to 1980. Although federal circuit court decisions are usually decided by a panel of three judges, with the writing of the opinions rotated among the three, the three key opinions on this issue of investor versus dealer were all written by Judge Irving Goldberg. He was a long-time lawyer working mostly in the labor law area, but in 1966 President Johnson appointed Goldberg to the Fifth Circuit, where he served until shortly before his death in 1989.

The triad of cases are *Winthrop*, *Biedenharn Realty Co. Inc.*, and *Suburban Realty*. All three involved prolonged liquidation of large real estate tracts combined with various degrees of organized subdivisions and platting, including streets, sewers, electricity, and some form of organized sales of lots. These cases guide courts even to this day.

United States v. Winthrop

The first case, *United States v. Winthrop*, involved land a taxpayer had inherited near Tallahassee, Florida. The land had been in his family for a century. He wanted to sell the property as the city expanded in its direction. He subdivided and improved the property, then sold lots as home sites. He bore the cost of the improvements, such as surveys, streets, and installation of utilities. He sold the lots himself.

Goldberg found the taxpayer was a real estate dealer and concluded that the income from the property sales should be ordinary income, not capital gain. Goldberg framed the ultimate issue:

We must emerge with a solution to the 'old, familiar, recurring, vexing and oftentimes elusive' problem . . . concerning capital gains versus ordinary income arising out of the sale of subdivided real estate. Finding ourselves engulfed in a fog of decisions with gossamer-like distinctions and a quagmire of unworkable, unreliable, and often irrelevant tests, we take the route of ad hoc exploration to find ordinary income.

Goldberg pointed out that the tax issue turns on the facts:

In analyzing a case of this sort, no rubrics of decision or rubbings from the philosopher's stone separate the sellers garlanded with capital gains from those beflowered in

the garden of ordinary income. Each case and its facts must be compared with the mandate of the statute.

To decide whether Winthrop was a real estate dealer, the court considered three questions:

1. Did Winthrop hold the property "primary for sale" as that phrase is used in Section 1221?
2. Were the sales made in the ordinary course of the taxpayer's trade or business (i.e., did the taxpayer's activities constitute a trade or business)?
3. Were the sales ordinary?

To answer these questions, Goldberg fashioned seven factors that have come to be known as the Winthrop Factors:

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

The court concluded that Winthrop was motivated only to sell his inherited property. He was engaged in a substantial enterprise spanning a quarter of a century, producing over half of his income during that period. Winthrop sold the lots informally, beginning when he inherited the property and continuing for 25 years. His sales were routine and ordinary. His subdividing activities were "not adventitious, but on the contrary was consistently advertent." Goldberg and his panel found Winthrop was a dealer, concluding his gains should be taxed as ordinary income.

Biedenharn Realty Co. Inc. v. United States

Biedenharn Realty Co. Inc. v. United States involved a taxpayer who platted and improved real estate subdivisions outside of Monroe, Louisiana, to sell the property (called Hardtimes Plantation).

The taxpayer improved the land and added streets, drainage, water, sewerage, and electricity but undertook no other development activities and did not solicit or advertise. What piqued Goldberg's interest most were the frequency and substantiality of the taxpayer's sales activities, which Goldberg characterized as frequent and abundant. As a result, the court determined the taxpayer was a dealer, and the sales were taxed as ordinary income.

The Internal Revenue Service argued, and the court found, that the taxpayer changed his intent from investment to dealer status. Although the taxpayer had an investment intent at the beginning, Goldberg cautioned that he would not be granted "carte blanche to undertake intensely all aspects of a full-blown real estate business. Instead, in cases of forced change of purpose, we will continue to utilize the Winthrop [factors] discussed earlier but will place unusually strong taxpayer-favored emphasis on Winthrop's first factor."

Goldberg summarized the role of investment intent:

We cannot write black letter law for all realty subdividers and for all times, but we do caution . . . that once an investment does not mean always an investment. A simon-pure investor 40 years ago could by his subsequent activities become a seller in the ordinary course four decades later. The period of Biedenharn's passivity is in the distant past; and the taxpayer has since undertaken the role of real estate protagonist. The Hardtimes Plantation in its day may have been one thing, but as the plantation was developed and sold, Hardtimes became by the very fact of change and activity a different holding than it had been at its inception. No longer could resort to initial purpose preserve taxpayer's once upon a time opportunity for favored treatment.

Suburban Realty Company v. United States

The last case, *Suburban Realty Company v. United States*, involved a taxpayer who acquired a one-fourth interest in 1,742 acres on the north side of Houston in the path of the city's expansion in the late 1950s. The North Loop was constructed over his property. He sold most of the properties from 1939 to 1956. He undertook no development or subdivision activity. His full-time job was not real estate sales.

Goldberg said the predominant issue was the taxpayer's purpose or intent in holding the property, and he looked at the Winthrop factors:

A taxpayer who engages in frequent and substantial sales is almost inevitably engaged in the real estate business. The frequency and substantiality of sales are highly probative on the issue of holding purpose because the presence of frequent sales ordinarily belies the contention that property is being held "for investment" rather than "for sale." And the frequency of sales may often be a key factor in determining the "ordinariness" question.

Development activity and improvements are peripherally relevant to dealer status but less conclusive than substantiality and frequency of sales. One can be in the real estate business and need not "engage in promotional exertions in the face of a favorable market."

The taxpayer sold 244 properties over a 33-year period, averaging seven sales per year. Goldberg measured the taxpayer's intent "at some point before he decided to make the sales in dispute." He concluded that the taxpayer's primary purpose in holding the real estate was to sell. The taxpayer was found to be a dealer.

Goldberg's Continued Influence

Years later, *Winthrop*, *Biedenharn*, and *Suburban Realty* remain vital influential cases. The issue of subdivided real estate as ordinary income versus capital gains (or like-kind exchange) has ebbed and flowed in cases through the years, but later courts continue to rely on Judge Goldberg's three decisions.

Taxpayers who wish to dispose of large real estate tracts by sale over time or through like-kind exchanges are faced with the question of whether they are changing from an investor to a real estate dealer. The courts look to a variety of factors to decide the issue. No single factor predominates. However, the frequency and duration of sales activities tends to be among the most important issues.

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