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Subdividing Investment Property and Dealer Status in an IRC Section 1031 Exchange

Taxpayers holding raw land for investment may wish to maximize their investment by subdividing their property prior to its sale. If they do so, can they still qualify for capital gains tax deferral under I.R. C. Section 1031? The answer is *maybe*, and a number of factors are considered.

I.R.C. Section 1031 provides that neither gain nor loss is recognized if property held for investment is exchanged for like-kind property held for investment or productive use in a trade or business. Whether property is held for investment is a question of intent and is determined by the facts.

I.R.C. Section 1031 (a) (2) (A) specifically excludes "property held primarily for sale" from qualifying for capital gains deferral.

Real property held primarily for sale to customers in the taxpayer's ordinary course of business is considered "dealer" property and any gain from the sale of such property is taxed at the higher ordinary income tax rates. IRC Section 1221 (a)(2). The term "primarily" is defined as "of first importance" or "principally". Malat v. Riddell, (1966) 383 U.S. 569. Dealer status is determined by reference to the particular property. In other words, a taxpayer can hold some property that qualifies as investment property, but also hold other property that is "dealer" property" which does not qualify for capital gains tax deferral.

What factors will cause property acquired as investment property to be treated as dealer property?

In addressing this issue, the courts have articulated a number of factors to consider:

1. The holding period of the property in question;
2. The nature of the taxpayer's business;
3. The construction of improvements and extent of subdivision activity undertaken on the property;
4. Whether the property had income producing potential;
5. The number and frequency of real property sales by the taxpayer; and
6. The percentage of the taxpayer's income derived from real property sales.

In Buono v. Commissioner, (1980) 74 T.C. 187, the court found that merely obtaining subdivision approval does not cause the property to become "dealer" property. The fact that the taxpayer's original intent was to hold the property as a single tract for investment was persuasive to the court's decision.

Consistent with Buono, I.R.C. Section 1237 provides that property will not be considered to be held "primarily for sale to customers" solely because of a subdivision or activities incident to a subdivision or sale. See, I.R.C. Section 1237 for specific guidelines and note that under Section 1237(b) that if more than 5 lots are sold or exchanged from the same tract or parcel, the gain from the sale of the lots will be deemed to be gain from property "held for sale" up to 5 percent of the selling price.

What if the taxpayer obtains subdivision approval and performs some infrastructure improvements?

Some courts have permitted subdivision and limited infrastructure improvements where the holding period was several years and the taxpayer was not otherwise engaged in buying and selling of real estate. See, Loren F. Paullus., T.C. Memo 1996-419.

Investors are urged to consult with their tax or legal advisor about the inherent risks of exchanging investment property which has been subdivided prior to exchange.

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