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Real Estate in the Time of COVID-19: Documenting Changes in Intent and the Dealer Property Analysis

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Market disruption brought on by COVID-19 will cause many real property owners and developers to re-evaluate their plans (either voluntarily or involuntarily) with respect to property that they hold. This article discusses a number of points to consider with respect to such property that could affect taxation upon a current or future sale.

The COVID-19 global challenge has rocked financial and real estate markets, making it difficult to predict the demand for various types of real estate properties in the near term. As a result, many developers and investors may be reevaluating their plans with respect to the development or holding of property. Financial distress resulting from COVID-19 also may force taxpayers to part with ownership of their property, either voluntarily in an effort to lessen distress, or involuntarily through foreclosure, etc. These circumstances can be highly relevant in a number of ways to determining the character of gain or loss upon the immediate or ultimate sale of property.

The tax consequences upon the disposition of real property, specifically, the character of gain or loss, can differ drastically depending upon whether property is treated as so-called "dealer property," or instead is held for investment or use in a non-dealer trade or business. This determination is highly fact-specific, and courts look at many factors in making this determination.

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This article is intended to highlight the dealer/investor considerations that arise as a result of the current environment. In some circumstances, there are steps that taxpayers may take in order to improve their treatment, and this article provides suggestions to help further this goal.

Tax Consequences Relating to Characterization of Property

A taxpayer's purpose for holding property figures significantly into the analysis of the tax consequences upon the property's disposition. Generally, gain on the disposition of property held for more than one year is taxed at preferential rates as long-term capital gains. However, gain on "property held by the taxpayer primarily for sale to customers in the ordinary course of their trade or business," often referred to as "dealer property," does not qualify for this treatment and is instead taxed at ordinary income rates.[1] A special rule applies to real property that is held for more than one year for use in a trade or business (referred to as "section 1231 property").[2] Under this special rule, dispositions of section 1231 property resulting in a gain may be subject to tax at capital gains rates, and dispositions of such property resulting in a loss may give rise to ordinary losses.[3] Dealer property, however, does not qualify for this special rule. [4]

The characterization of real property affects other tax considerations of a taxpayer. For example, dealer property is not eligible property for purposes of a tax-deferred, like-kind exchange under section 1031.[5] In addition, upon a contribution of dealer property to a charity, a taxpayer's charitable deduction is limited to the basis of the property.[6] Gain upon the sale of dealer property raises unrelated business taxable income concerns for tax-exempt investors, and prohibited transaction concerns for REIT investors. On the other hand, when sales are anticipated to generate losses, treatment as dealer property may confer a tax benefit, as loss upon sale of such property generates an ordinary loss.

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[1] Section 1221(a)(1). Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

[2] Section 1231.

[3] Specifically, if gains from section 1231 property exceed losses from section 1231 property, then gains and losses from section 1231 property are treated as long-term capital gains or long-term capital losses. However, if losses from section 1231 property exceed gains from section 1231 property, then section gains and losses from section 1231 property are not treated as gains and losses from the sales or exchanges of capital assets. Section 1231(a)(1) and (2). A look-back rule applies such that a net section 1231 gain for the taxable year otherwise treated as capital gain is recaptured as ordinary income to the extent net section 1231 losses in the five preceding taxable years, to the extent not previously recaptured. Section 1231(c).

[4] Section 1231(b)(1)(B).

[5] Section 1031(a)(2). Note, however, that the section 1031(a)(2) statutory language seems to create a broader exception, excluding from non-recognition treatment "real property held primarily for sale" without the requirement that it be held for sale to "customers in the ordinary course of the taxpayer's trade or business."

[6] Section 170(e)(1)(A) (excluding from the charitable deduction "the amount of gain which would not have been long-term capital gain…if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution)…").

Dealer Property Analysis

Property is treated as dealer property, and hence is excluded both from treatment as a capital asset and as property subject to the special rule of section 1231, if:

- The taxpayer primarily intends to hold the property for sale
- The sales are to "customers,"[7] and
- The sales occur in the ordinary course of the taxpayer's trade or business.

Courts analyzing whether property is dealer property typically apply an analysis that examines several factors. These factors vary depending on the circumstances, but often include:

- The nature and purpose of the acquisition of the property and the duration of the ownership
- The extent and nature of the taxpayer's efforts to sell the property
- The number, extent, continuity and substantiality of the sales
- The extent of subdividing, developing, and advertising to increase sales
- The use of a business office for the sale of the property
- The character and degree of supervision or control exercised by the taxpayer over any representative selling the property
- The time and effort the taxpayer habitually devoted to the sales[8]

The courts have been clear that the factors do not present a specific formula, but application of the factors should depend on the context.[9] The factors are intended to provide insight into the three requirements of the statute (i.e., held primarily for sale, to customers, and in the ordinary course of a trade or business).[10] If a taxpayer can show that it does not hold the property primarily for sale, it can disprove one of the statutory requirements and seemingly avoid dealer status.

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[7] The "customer" requirement is easily satisfied. Pointer v. Commissioner, 48 T.C. 906, 917 (1967) ("it has been said that in real estate transactions a sale to any purchaser is, in effect, a sale to a 'customer'"), *aff'd*, 419 F.2d 213 (9th Cir. 1969); Bush v. Commissioner, T.C. Memo. 1977-75, *aff'd*, 610 F.2d 426 (6th Cir. 1979); S&H, Inc. v. Commissioner, 78 T.C. 234 (1982).

[8] *See, e.g.*, United States v. Winthrop, 417 F.2d 905 (5th Cir. 1969).

[9] Byram v Commissioner, 705 F.2d 1418, 1424 (5th Cir. 1983) (references that cases have focused on substantiality of sales, improvements, and advertising; court then states "each case must be decided on its own peculiar facts…Specific factors, or combinations of them, are not necessarily controlling."); Jersey Land & Dev. Corp. v. United States, 539 F.2d 311, 315-16 (3d Cir. 1976) (same); Pennroad Corp v. Commissioner, 261 F.2d 325, 330 (3d Cir. 1958) (analysis is decidedly different in looking to residential versus industrial property), *cert. denied*, 359 U.S. 958 (1959); Pleasant Summit Land Corp v. Commissioner, 863 F.2d 263, 270-71 (3d Cir. 1988) (same) (abrogating *Jersey Land* and *Pennroad* on other grounds), *cert. denied*, 493 U.S. 901 (1989).

[10] Cappuccilli v. Commissioner, T.C. Memo. 1980-347, at *44 ("Rather than list the factors deemed relevant by the courts…we shall only discuss those relevant to our decision herein. The relationship among the factors and their mutual interaction

In determining whether a taxpayer intends to hold the property primarily for sale, the Supreme Court has held that "held primarily for sale" means "of first importance" or "principally."[11] Where a taxpayer has multiple purposes for holding property, courts look to the primary reason for holding the property. Accordingly, when rental property is being sold, courts have focused on the taxpayer's primary intent in acquiring or constructing the property (i.e., whether the primary purpose was to hold for rental or to hold for sale).[12] Because courts look to objective evidence in determining intent (e.g., stated purpose for holding property on a mortgage application or on an application for a loan guarantee),[13] documentation of the purpose for holding property is critically important, both upon the acquisition and throughout the duration of the property's holding period.

Voluntary Changes of Purpose

As previously mentioned, many developers and investors may now be reevaluating their plans in developing or holding property. It is not unusual for a taxpayer's primary intent for holding property to change, especially in the wake of changing external circumstances, leading a taxpayer to pursue a different disposition strategy or abandon its original plans. Indeed, courts have acknowledged that a taxpayer's intent may change over time from an intent to hold property as an investment to an intent to hold property primarily for sale in the ordinary course of the taxpayer's trade or business,[14] or conversely, from an intent to hold primarily for sale to an intent to hold for investment.[15] The burden in proving change of intent, however, is not easily met. As one court noted, "the original purpose is important, for to counterbalance it, there must be significant objective evidence of a change in that purpose."[16]

The disruption in the markets caused by the COVID-19 global challenge presents an external circumstance that may be recognized as justifying a real estate holder's change in intent for holding real property. For example, a commercial real estate developer developing an office building to rent,

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changes in each case depending on the facts…The focus of the factual inquiry is the statutory tests…"), *aff'd*, 668 F.2d 138 (2d Cir. 1981), *cert. denied*, 459 U.S. 822 (1982); Devine v. Commissioner, 558 F.2d 807, 814 (5th Cir. 1977) ("In short, though all of the listed factors may serve as guides in the decisional process, no one factor, and no one list of factors, may control. The sole test remains the application of the statute to the totality of the circumstances presented. Though the statute may be imprecise and difficult of application, it must be applied on a case-by-case basis.").

11 Malat v. Riddell, 383 U.S. 569 (1966).

12 *See* Victory Housing No. 2 v. Commissioner, 205 F.2d 371 (10th Cir. 1953); Grace v. Commissioner, T.C. Memo. 1961-252; Cousins Properties, Inc. v. United States, 77-2 USTC ¶9508 (Ct. Cl. 1977).

13 *Grace*, T.C. Memo. 1961-252 (noting purpose for holding property as, "for rental" on mortgage application); Goldberg v. Commissioner, 223 F.2d 709, 710-11 (5th Cir. 1955) (purpose for holding on application for FHA guarantee of loan).

14 *See, e.g.*, Suburban Realty Co. v. United States, 615 F.2d 171 (5th Cir. 1980), *cert. denied*, 449 U.S. 920 (1980); Biedenharn Realty Co., Inc. v. United States, 526 F.2d 409, 423-25 (5th Cir. 1976) (stating that "we do caution in words of red that once an investment does not mean always an investment. A simon-pure investor forty 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."), *cert. denied*, 420 U.S. 819 (1976).

15 *See* Tibbals v. United States, 362 F.2d 266 (Ct. Cl. 1966); Lomas & Nettlecon Financial Corp. v. United States, 486 F. Supp. 652 (N.D. Tex. 1980); Maddux Constr. Co. v. Commissioner, 54 T.C. 1278 (1970).

16 *Goldberg*, 223 F.2d at 712.

stabilize, and quickly sell may re-evaluate those plans, given the current market conditions. The developer may decide that it is preferable not to sell the building, but instead to plan to hold the building long-term as a rental property. Similarly, a residential developer may alter its plans with respect to property purchased for subdivision, instead deciding to hold for market appreciation and eventually sell in bulk as an unimproved property.

Both the commercial developer and the residential developer would be well-served to contemporaneously document their change in intent. Documentation could take the form of meeting minutes discussing the planned change in intent, a resolution of the investment committee of the developer entity, or other corporate documents evidencing the change in intent. Further, care should be taken to ensure that any loan or guarantee paperwork filed after the change in intent characterizes the purpose of the real estate holding consistently. In addition, corresponding changes should be made to how property is reflected on the owner’s books and records, and tax positions taken on returns should be examined for consistency with the new intent. Finally, in the case of the commercial developer, undertaking modeling of projections based upon long-term rentals is helpful in illustrating an intent to implement a new business strategy. Documentation will be especially important if the property owner unexpectedly receives an unsolicited offer for the property within a short time period after the change in purpose.

Obviously, other factors of the dealer analysis will also be relevant in evaluating the ultimate availability of capital gains treatment or section 1231 treatment upon sale, including the efforts expended to advertise and broker the property. If a taxpayer documents a change in intent to hold property long-term for investment, but then hires a broker to market the property soon after the declared change in intent, the declaration could be viewed with skepticism by the Internal Revenue Service (IRS) or a judge. Subjective intent will be evaluated in light of objective facts, so a change in stated intent, standing alone, will not carry the day if the surrounding circumstances are not consistent with the stated change.

Financial Distress and Involuntary Dispositions

As discussed above, it is often the case that a change of circumstances can lead a taxpayer to voluntarily change its purpose for holding property. Sometimes, however, a taxpayer may be forced into an involuntary sale or exchange of one or more properties due to circumstances that involve financial hardship. In some circumstances, it may appear that the sale is “voluntary” in the sense that the taxpayer initiates the marketing and sale of the property in order to mitigate or resolve unanticipated financial distress. In reality, however, the sale is involuntary in that it must be undertaken in order to address the economic hardship. In other circumstances, the disposition may be wholly involuntary, such as a transfer in foreclosure or pursuant to a deed-in-lieu of foreclosure.[17]

Given the sudden and drastic turn of events due to the onset of the COVID-19 challenge, developers and investors who acquired property recently may find themselves in a difficult financial situation or

[17] Property condemnation is another obvious example of an involuntary disposition, although such a disposition is not necessarily associated with financial distress.

facing impending foreclosure prior to having the opportunity to take any action in furtherance of their initial acquisition intent for the property. Other long-time property owners may find it necessary to dispose of a significant number of properties in a short period of time due to financial distress.

A sale of property soon after purchase may imply that a taxpayer purchased with an intent to sell, thus indicating dealer status. A significant number of property sales also may imply dealer status. But what if the quick sales or large number of sales are necessitated by factors beyond the property owner's control?

Courts have noted the relevance of a property's holding period in analyzing dealer status.[18] Although the cases are not explicit as to the time period that invokes scrutiny, when property is sold fairly soon (i.e., one to four years) after acquisition or construction, there has been significant attention paid to determining the initial "intent" in holding the property, as the short holding period is somewhat inconsistent with an intent to hold for investment. The cases holding favorably for the taxpayer generally found a change in circumstances that led to the sale.[19] Unexpected financial distress creating a need for immediate liquidity represents a change in circumstances that should not invalidate an initial investment intent.

Often, courts support continuing investor status by finding that the taxpayer was "liquidating" its investments due to a change in circumstances, and liquidating to address unanticipated financial distress would seem to fit within the spirit of those cases. In this regard, courts have found a large number of sales to be consistent with an investment intent when the taxpayer was compelled by external circumstances to liquidate the property, and selling units of property rather than the overall property was the most productive way to liquidate the property.[20]

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[18] *Jersey Land*, 539 F.2d at 317 (reference to relatively short holding period, indicating that gain did not come from market factors over substantial period of time); Baumgart v. Commissioner, T.C. Memo. 1983-738, at *28 ("The fact that there was such a short period of ownership of the cars also is indicative of business rather than investment behavior."); Starke v. Commissioner, 312 F.2d 608, 609 (9th Cir. 1963) ("[o]ne great factor (but not the only one) in our decision is the length of holding").

[19] *Victory Housing No. 2*, 205 F.2d at 373 (change in corporate policy indicating a desire to make property available for ownership by veterans); Rouse v. Commissioner, 39 T.C. 70, 73-74 (1962) (became difficult to locate desirable tenants), *acq.* 1963-2 C.B. 3, *overruled on other grounds*, Macabe Co. v. Commissioner, 42 T.C. 1105 (1964); Cousins Properties, 77-2 USTC ¶9508, at *14 (numerous properties, all with changed circumstances; court stated: "If the evidence indicates that at this prior period the taxpayer would not have made the sale in question but for the occurrence of a changed condition or a sudden and unexpected opportunity it will be presumed that he was not holding the property 'primarily' for sale."); Cottle v. Commissioner, 89 T.C. 467 (1987) (other owners in four-plex development began selling, and taxpayer feared he would lose ability to control activities in development, which in turn would hurt value of his properties).

[20] *See, e.g.*, Heller Trust v. Commissioner, 382 F.2d 675 (9th Cir. 1967) (capital gains allowed when taxpayer held duplex units for rental; due to poor performance of the rental units and his own deteriorating health, liquidated the duplex units, selling 169 units within a three-year period; initial rental intent remained and not changed by an intention to liquidate the investment..); Gangi v. Commissioner, T.C. Memo. 1987-561 (1987) (rental purpose endured and capital gains allowed when apartment building constructed and managed for rental converted to condominium units and sold due to decline in the real estate market and disintegration of the partners' business relationship).

In cases involving circumstances leading to dispositions that are explicitly involuntary (e.g., foreclosure, deed-in-lieu of foreclosure, condemnation, etc.), the taxpayer's purpose for holding the property prior to the event that caused the involuntary sale typically determines the outcome as to the treatment of the property as dealer property or investment property.[21] Often the court will look to whether the taxpayer's purpose for holding the property changed at some point prior to the event that caused the involuntary sale or exchange, or instead, whether the taxpayer's purpose endured.[22] Courts generally hold that the involuntary transfer itself does not evidence a change of intent.[23]

In these circumstances, the case law generally characterizes the treatment on disposition in accordance with the initial intent for holding the property, despite the sudden involuntary sale or sales. For example, if an investor acquires a building to hold as a rental property, but the property is foreclosed upon shortly after its acquisition and prior to entering into any leases, case law tends to support treating the sale consistent with the intent to hold for rental. A taxpayer in these circumstances generally will not be treated as a dealer, absent evidence that the owner had otherwise changed its purpose to holding for sale before the foreclosure occurred. The same analysis would apply if a residential real estate developer purchases property to subdivide, improve, and sell to customers in the ordinary course, but is forced to transfer the property in a foreclosure proceeding prior to subdividing the property or making any improvements. As a result, if the sale of property in the latter circumstance gave rise to a loss, treatment of the property as dealer property consistent with the original intent would cause the loss to be an ordinary loss.

Conclusion

As the COVID-19 global challenge continues to create a quickly changing and uncertain economic environment, real estate developers and investors may find it necessary to reconsider their business strategies with respect to their real estate holdings in light of the sudden and unexpected turn of the economic outlook. In some cases, property holders may experience financial distress and may need to quickly dispose of property or may be subject to foreclosure procedures. The tax treatment upon a property holder's disposition of property can vary significantly depending upon the purpose for which the property was held, and often, changes in circumstances may affect the taxpayer's purpose for holding property. The authorities relevant to the determination of a taxpayer's treatment upon a

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[21] *See, e.g.*, Daugherty v. Commissioner, 78 T.C. 623 (1982) (holding that the petitioner held property for sale to customers in the ordinary course of their business at the time the condemnation sale to the state was consummated, and repudiating prior Tax Court holdings in Tri-S Corp. v. Commissioner, 48 T.C. 316 (1967), *nonacq.*, 1967 WL 16265 (1967), *aff'd*, 400 F.2d 862 (10th Cir. 1968); Juleo Inc. v. Commissioner, T.C. Memo. 1971-68, *nonacq.*, 1971 WL 29362 (1971), *rev'd,* 483 F.2d 47 (3d Cir. 1973), *cert. denied*, 414 U.S. 1103 (1973); and Ridgewood Land Co. v. Commissioner, T.C. Memo. 1972-16*, acq. in part, and nonacq. in part*, 1972 WL 32720 (1972), *aff'd per curiam*, 477 F.2d 135 (5th Cir. 1973), that such an event changed the purpose for which property was held.).

[22] Pettit v. Commissioner, T.C. Memo. 1997-438 (1997) (holding that when individual acquired property for purposes of improving to sell, loss upon deed in lieu of foreclosure was ordinary); Case v. United States, 633 F.2d 1240 (6th Cir. 1980) (holding that property was held for investment when taxpayer intended to transfer property to a corporation prior to undertaking development activities, applying similar analysis as *Daugherty*).

[23] *See Juleo*, 483 F.2d 47; *Daugherty*, 78 T.C. 623.

property's disposition are highly fact-specific and often look to objective evidence documenting a taxpayer's intent for holding property.

Rapidly changing economic conditions and ensuing financial distress due to the COVID-19 challenge may impact the dealer analysis for real property in a number of ways. Some taxpayers may reevaluate their intent in holding property in a way that would be relevant to the taxpayer's status as a dealer with respect to the property. Other taxpayers may be forced to dispose of property under circumstances that arguably are inconsistent with the taxpayer's primary intent in holding the property.

If circumstances cause a real estate owner to voluntarily change its purpose for holding the property in a manner that is more consistent with status as an investor, steps should be taken to document this change since such documentation can greatly improve the ability to support the intended tax treatment upon the sale of the property. If financial distress causes a taxpayer to sell property under circumstances that are explicitly or implicitly involuntary, those circumstances generally will not change the taxpayer's status as a dealer or investor.

