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Ordinary capital gain treatment from the sale of real property

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A partnership of which a married couple were directly or indirectly majority partners, wasn't entitled to capital gain treatment on gain from the sale of property to an unrelated entity where overall evidence showed that the property was purchased and held primarily for development and sale to customers as part of regular business activities, rather than as an investment. Although the partnership never substantially improved or made extensive efforts to sell the property and had never sold real estate before, overall evidence showed that the partnership did incur significant development costs and that the property was sold at a fair price with the plan for the partnership and husband to share in the development profits at the time of sale.

In Victor Fargo, et ux. et al. v. Commissioner; T.C. Memo. 2015-96; Nos. 28970-11, 166-13 (26 May, 2015), the tax court held that real property owned for over a decade produced ordinary income when sold.

Beginning in 1988, Victor Fargo and Virginia King (the "taxpayer(s)"), through a controlled entity, acquired a leasehold interest in a property ("La Jolla") including a tenant-occupied medical building and certain plans, drawings, reports, surveys, and permits. The taxpayer's intention at that time was to develop a 72-unit apartment complex and retail space. Over the following 10 years, the taxpayers through a group of controlled entities incurred significant costs primarily comprised of architecture, engineering, appraisal, permits, and licensing fees. Eventually in 2001, the taxpayers, through a related entity (GDLP), received and accepted an unsolicited offer to sell the property to an unrelated entity (Centex). The buyer purchased the property intending to develop townhouses largely based on previous plans developed by the taxpayers. The gain on the sale of the property was reported as a capital gain by the taxpayers.

The tax court noted that Sec. 1221 (a)(1) defines capital gain on real estate held by taxpayer, but excludes "property held by the taxpayer primarily for sale to customers in the ordinary course of their trade or business." Therefore, the court must make a fact-based analysis to determine whether the property is held for sale in the ordinary course of the owner's business.

There were eight factors in this determination.

1. Acquisition Purpose: The property was acquired for residential development.

2. Holding Purpose: While the property was held for over a decade, GDLP had always intended to complete the residential development.

3. Improvements: There were no substantial improvements by GDLP.

4. Frequency of Sales: GDLP is not a regular and frequent seller of real estate. While other businesses of the taxpayers were active sellers, this factor did not impact the GDLP determination.

5. Nature of Realty Transactions: The La Jolla property was held only for sale.

6. Extent of Advertising for Buyers: The Centex offer was unsolicited and GDLP did not engage in extensive advertising.

7. Listing the Property: The parcel was listed for sale with a real estate corporation owned by one owner.

8. Purpose at Time of Sale: GDLP "continually engaged in efforts to plan and develop the La Jolla property up until the purchase date."

Based upon the eight factors, the court held "that GDLP sold the La Jolla property in the ordinary course of business under Section 1221(a)(1)." Therefore, the sale produced ordinary income.

The court acknowledged that, under a question-of-fact analysis, the unsolicited nature of the sale as well as lack of repeated sales activity indicated capital gain may have been the appropriate treatment. However, more compelling, according to the court, was the fact that the property had been initially acquired for development purposes and the taxpayers continued to hold the property primarily to develop it until the offer was presented, thus their "intent" was the controlling fact for the court's decision.

Sometimes a change in market conditions or other circumstances will lead you to change your plans from development to investment. If the taxpayer doesn't contemporaneously document facts that support the position, then ultimately, the taxpayer will have the burden of proving the government's determinations to be incorrect, and a failure of evidence may be as costly as bad facts.

Therefore, we recommend consulting with your tax advisor so as to avoid the results of this case.

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