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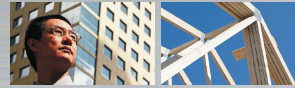

Tax Consequences: When the Purpose of Your Project Changes from Development to Investment

A recent ruling from a federal district court in California illustrates the undesirable tax consequences an owner can face when he or she changes plans.

By Steven D. Asher, CPA, Partner | NSBN LLP

What happens if an owner originally purchased a property for development and subsequently treats it as investment property? In a 2014 court case, *Allen v. United States*, an owner discovered the undesirable tax consequences of his change in plans.

Owner sells land to developer

A taxpayer purchased land in East Palo Alto in 1987. Between 1987 and 1995, he attempted to develop the property on his own, spending money on engineering plans and taking out a second mortgage on the property. His development company created about 10 sets of plans for the property as he attempted to find a partner to develop the land.

In 1999, he sold the property to a developer for a lump sum and future contingent payments based on a percentage of profits from the future sale of developed units. His firm did some of the engineering work on the property until the developer changed the project's direction and hired another engineer.

In 2004, the taxpayer received a final installment payment of $63,662 and reported the money as long-term capital gain. The IRS challenged this treatment of the payment, asserting that the land was "held primarily for sale to customers in the ordinary course of business."

Sale proceeds were ordinary income

The U.S. District Court for the Northern District of California sided with the IRS, finding that the taxpayer was a real estate *dealer* subject to ordinary income tax rates, rather than an *investor* subject to capital gains rates — even though he'd sold only a single piece of property. It reached this conclusion after weighing several factors that courts commonly consider to determine whether a property has been held as inventory or a capital asset:

1.) The nature of the property's acquisition,
2.) The frequency and continuity of sales over an extended period,
3.) The nature and extent of the taxpayer's business,
4.) The seller's activity regarding the property, and
5.) The extent and substantiality of the transactions.

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According to the court, while some attention is paid to the reason for the property's purchase, **particular weight is given to the purpose for which it was held**.

The court concluded that the first and fourth factors were determinative in this case. As to the first, the taxpayer testified that his intent to develop the property had changed to an intent to sell it because he lacked the requisite expertise to develop the land. The court acknowledged that a purchaser's intent toward property can change over time. But it wasn't convinced that the taxpayer's intent had changed, because he provided no evidence explaining how, when or why his goals for the property had changed.

The court also found that the fourth factor favored the IRS position. The taxpayer engaged in significant development activity for the property, creating multiple development plans and seeking partners until shortly after the sale. Further, some of his debts to former partners were paid out of the sale proceeds.

Protect yourself

Sometimes a downturn in the market or other circumstances will lead you to change your plans for property from development to investment. If you hope to take advantage of this change from a tax perspective, you'll need clear evidence of how, when and why your intent changed.

Steven D. Asher, CPA, Partner in the Real Estate Department, assists clients in the real estate industry with tax services, cash flow analyses, IRS Section 1031 exchanges, review of cost segregation studies and evaluation of real estate transactions. He also serves clients in the affordable housing industry and closely-held businesses.

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