A SWITCH IN TIME: CHANGE YOUR MIND AND CHANGE YOUR TAX RATE

Posted on **March 7, 2018** by **James R. Malone, Jr.**

Savvy taxpayers prefer to have their income treated as a long-term capital gain, rather than as ordinary income, because long-term capital gains are taxed at lower rates. I.R.C. § 1(h). Long-term capital gains are derived "from the sale or exchange of a capital asset held for more than 1 year." I.R.C. § 1222(3). Not all assets, however, are capital assets; for example, inventory, "or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" do not qualify as capital assets. I.R.C. § 1221(a)(1).

While the terminology sounds clear-cut, the dividing line between non-capital assets and capital assets rests largely on the facts and circumstances of particular cases. On February 22nd, the Tax Court ruled that a change in the taxpayer's intent could change the categorization of an asset. *Sugar Land Ranch Dev., LLC v. Comm'r*, Docket No. 5835-16, T.C. Memo 2018-21, 2018 Tax Ct. Memo LEXIS 20 (Feb. 22, 2018).

Sugar Land Ranch Development, LLC ("Sugar Land" or the "Partnership") was formed in 1998 to acquire various tracts of land in Sugar Land, Texas, which is southwest of Houston. T.C. Memo 2018-21 at *2. The Partnership's plan was to clean up the property (which had been an oil field) and then subdivide it into residential units to be included in a related development. *Id.* at *3. To that end, the Partnership spent ten years remediating the property by capping oil wells and removing extraction equipment. It also entered into a development agreement with the City of Sugar Land. *Id.*

During this period, the Partnership sold a few small portions of property. By 2008, it held just under 825 acres of land that was divided by three easements:

- One at the eastern end of the property, which was known as the HLP easement and ran north to south;
- The second, for a planned road known as University Boulevard, ran east to west; and
- The third, for a levee, ran north to south at the west end of the property.

Id. at *4. The land west of the HLP easement consisted of a parcel that was ultimately conveyed to the City of Sugar Land. *Id.* The remaining three parcels were sold to another developer, Taylor Morrison, in 2011 and

2012.

While the original plan had been to subdivide the available property into residential lots and develop them, the subprime mortgage crisis intervened. By late 2008, the managers of the Partnership concluded that it would not be able to follow through on its original development plan because of the general unavailability of financing. *Id.* at *4-*5. As a consequence, the Partnership adopted a formal policy of holding its land for investment purposes until the real estate market recovered, which it memorialized in contemporaneous formal records, including a unanimous consent signed by its managers and a subsequent member resolution. *Id.* at *5.

In light of this decision, the property "just sat there." *Id.* Sugar Land made no effort to market the land by retaining brokers or otherwise because its managers believed there was no market for the property. The Partnership also did not subdivide the property or take other measures to develop it.

In 2011, Taylor Morrison approached the Partnership to inquire about two of the parcels, which were both situated above the University Boulevard easement. Ultimately, Taylor Morrison decided to purchase all three of the available parcels; the first, TM-1 was sold in 2011. The second and third, TM-2 and TM-3, were sold in 2012 and generated the dispute over the appropriate tax treatment. *Id.* at *5-*6.

The contract for the sale of TM-2 provided for a lump sum payment for the parcel; the Partnership would also receive two percent of the final sale price of each home, which would accrue as each sale of a home closed. Sugar Land also was to receive a fee of $3,500 for each plat recorded on the parcel. *Id.* at *6. The contract for TM-3 provided for a lump sum payment for the land, plus a fee of $2,000 for each plat recorded, but it did not provide for payment on the sale of individual homes. *Id.* The only contractual payments at issue in the case were the initial lump sum payments. *Id.* at *7.

The Partnership then elected to dispose of its other holdings. It sold a group of properties that were east of the HLP easement to related parties for development. *Id.* It conveyed the property on the far side of the levee easement to the City of Sugar Land for no consideration, and it sold a single acre to a county.

The Partnership's tax returns, including its return for 2012, indicated that its principal business activity was "Development" and its product offering was "Real Estate." *Id.* at *7-*8. The Partnership reported a capital gain of $11,086,640 from the sale of TM-2, and a capital loss of $1,569,393 from the sale of TM-3. The IRS audited and determined that it was appropriate to treat the net income as ordinary and not as a long-term capital gain.

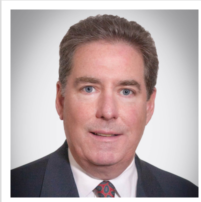
The Tax Court began its analysis by focusing on the standards applied in the Fifth Circuit to distinguish capital gains from ordinary income: "1) [W]as taxpayer engaged in a trade or business, and, if so, what business? (2) [W]as taxpayer holding the property primarily for sale in that business? And (3) [W]ere the sales contemplated by taxpayer 'ordinary' in the course of that business?" *Id.* at *9 (quoting *Suburban Realty Co. v. United States*, 615 F.2d 171, 178 (5th Cir. 1980)). The court then outlined a variety of specific factors that the Fifth Circuit had identified as relevant in prior cases, including the size and frequency of sales of property, the reason why the property was acquired and subsequently held, development efforts, and marketing efforts. *Id.* at *9-*10.

In applying these factors, the Tax Court acknowledged that the Partnership was plainly formed to develop the real estate into single-family homes, which supported ordinary income treatment. *Id.* at *10. But the court was also persuaded that the Partnership ceased to hold the property for sale in 2008 and began to hold it for investment. The Tax Court specifically cited "the highly credible testimony" of the two managers,

Messrs. Johnson and Wong, as well as the formal internal records documenting the change in policy. *Id.* at *10-*11. Other factors supporting the Partnership's position that the land was a capital asset included the fact that no lots were developed or sold after 2008, that the parcels were never subdivided, and the fact that the Partnership had not sold "even a single residential or commercial lot to a customer at any point in its existence." *Id.* at *11.

The facts and circumstances surrounding the ultimate sale of the TM parcels also played a role. The Tax Court observed that the parcels were not sold in the ordinary course, as the Partnership did not market them, did not solicit purchasers, and did not devote "any time or effort to selling the property." *Id.* The court also noted that the buyer approached the Partnership, and the fact that the sale of the three tracts of land "was essentially a bulk sale of a single, large, and contiguous tract of land (which was clearly separated from any other properties by the HLP easement and the levee) to a single seller–clearly not a frequent occurrence in [Sugar Land's] ordinary business." *Id.*

This is a taxpayer-friendly decision, but it is probably limited to its facts. The change in the purpose for which the property was held was the result of a major economic event, and the Partnership contemporaneously documented the change in its plans. Those two corroborating factors appear to have played a role in making the testimony of the Partnership's managers "highly credible." The case should not be taken as an indication that a flat statement that "I changed my mind" supported only by self-serving testimony will be received as favorably.



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