Tax Treatment of Real Estate Dealers, Investors, and Professionals

WEDNESDAY, FEBRUARY 1, 2023, 1:00-2:50 pm Eastern

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Tax Treatment of Real Estate Dealers, Investors, and Professionals

Capital Gains vs. Ordinary Income Treatment, Opportunity Zones and 199A

Why Classification Matters

1. Rates:

   Capital Gain for Investors v Ordinary income for Dealers

2. Limits on Capital Loss Deductions:

   The net capital loss deduction for noncorporate taxpayers is limited to $3,000 for each tax year.

3. Self Employment Taxes:

   Earnings from a Dealer's trade or business are treated as net earnings from self-employment.

   Investment income is not subject to SE Taxes

Why Classification Matters (continued)

4. Section 1031:

   Property that is held for sale as inventory is not eligible for like-kind exchange

5. Installment Sales Reporting:

   Installment sale reporting is available for the sale of real estate held as a capital asset by Investor

   installment sale reporting is generally not available for sales of real property that is held as inventory by Dealer

Dealer v Investor:
Frank H. Taylor & Son 32 T.C.M. 362

Factors include:

1. purpose for which the property was acquired;

2. the purpose for which the property was held;

3. improvements, and the extent of the improvements made to the property by the taxpayer;

4. frequency, number and continuity of sales;

5. extent and substantiality of the transactions;

6. nature and extent of the taxpayer's business;

7. extent of advertising to promote sales, or the lack of advertising; and,

8. listing of property for sale directly through brokers.

Capital Asset or Inventory

1. Capital assets include all property, except property that is specifically excluded under Code Sec. 1221(a)

2. Exception: property held by the taxpayer
   a) primarily for sale to
   b) Customers
   c) in the ordinary course of his trade or business

Activities Which May Cause Dealer Treatment

1. Surveying property
2. Subdividing property
3. Building roads
4. Paving streets
5. Installing mains
6. Installing fire hydrants
7. Building drainage
8. Adding utilities

In G.R. Gault: 332 F2d 94

Taxpayer:

1. surveyed
2. subdivided
3. built roads
4. installed mains
5. fire hydrants.

The court concluded the taxpayer's primary purpose for holding the property was to sell the property to customers

G.V. Buono: 74 TC 187

1. Only activity was subdivision
2. Subdividing the property was not an improvement
3. Not subject to ordinary income treatment

F.E. and M.L. Gartrell: 619 F2d 1150

1. Subdivision
2. Added gravel roads
3. Taxpayer had a full-time non-real estate job
4. Not enough to constitute development activity
5. Not subject to ordinary income treatment

What is a Real Estate Professional

Sec. 469 provides that losses from a "passive activity," including real estate rental activity, may only be used to offset income from a passive activity

Taxpayers who meet the qualification of a real estate professional under Sec. 469(c)(7), however, overcome the presumption that all rental activities are passive.

What is a Real Estate Professional(continued)

1. There are, in general, two types of passive activities:
   1. Any rental activity, regardless of the taxpayer's level of participation.
   2. Any non-rental activity in which the taxpayer does not "materially participate.“
2. Taxpayers can only overcome the presumption that all rental activities are passive if the taxpayer qualifies as a real estate professional by satisfying the two quantitative tests of Sec. 469(c)(7)(B):
   1. More than one-half of the personal services performed in trades or businesses by the taxpayer during the tax year are performed in real property trades or businesses in which the taxpayer materially participates, and
   2. The taxpayer performs more than 750 hours of services during the tax year in real property trades or businesses in which the taxpayer materially participates.

Steps to Qualify As Real Estate Professional

Step 1: Identify and group the taxpayer's real property trades or businesses.

Step 2: Identify the taxpayer's real property trades or businesses in which the taxpayer material participates.

Step 3*:* Total the hours of participation in those real property trades or businesses in which the taxpayer materially participates. If the taxpayer is married, only count the hours from the spouse seeking to qualify as a real estate professional.

Steps to Qualify As Real Estate Professional

Step 4: Apply the hours from Step 3 to the two quantitative tests of Sec. 469(c)(7)(B):

1. Do the hours represent more than one-half of the total personal service hours the taxpayer performed during the year in all trades or businesses?
2. Do the hours exceed 750?

Step 5: A taxpayer who passes both tests in Step 4 is a qualifying real estate professional. The qualifying real estate professional must next establish ***material participation*** in his or her rental activities.

Steps to Qualify As Real Estate Professional

Does the taxpayer materially participate in each separate rental activity? If so, each rental activity in which a qualifying real estate professional materially participates is nonpassive.

Any rental activity in which the taxpayer fails to materially participate, however, is passive despite the taxpayer's qualification as a real estate professional.

A real estate professional may elect to aggregate *all of his or her rental activities* for purposes of establishing material participation.

If the taxpayer elects to aggregate all rental activities, does the taxpayer materially participate in the combined activity? If the taxpayer materially participates in the combined rental activities, all of the rental activities are nonpassive. If the taxpayer fails to materially participate in the combined activity, all of the rental activities will remain passive.

Final Section 199A Regulations

- On Feb. 8, 2019, final regulations were published with guidance on Sec. 199A to regarding implementation of the new qualified business income (QBI) deduction (T.D. 9847).
- Aggregation effectively results in trades or businesses that would otherwise be treated as separate and distinct being combined into one trade or business for purposes of calculating the QBI deduction.
- Allows the wage and qualified property limitations of Sec. 199A to be calculated for the combined trade or business rather than for each trade or business individually.
- Depending on the facts, aggregation may allow a taxpayer to claim a greater QBI deduction than if the wages and capital limitation was applied separately.

Example

- Ivan who is over the applicable taxable income threshold has QBI of $100,000 each from two trades or businesses A and B. A has $50,000 of W-2 wages, and B has $20,000 of W-2 wages. Neither business owns any qualified property. If the QBI deduction is computed separately for A and B, A would generate a QBI deduction of $20,000, since 50% of W-2 wages, $25,000 exceeds 20% of QBI, $20,000. B would receive a QBI deduction of $10,000 since 50% of W-2 wages, $10,000 is less than 20% of QBI, $20,000.
- QBI deduction for both A and B is $30,000 ($20,000 for A plus $10,000 for B). If A and B were aggregated, the total QBI of the combined trade or business would be $200,000 and the total W-2 wages would be $70,000.
- The QBI deduction for the aggregated group would be $35,000 since 50% of the W-2 wages, $35,000 is lower than 20% of the QBI of the combined group, $40,000.
- Aggregation of A and B increases the QBI deduction by $5,000 compared to not aggregating the businesses.

Trade or business for Sec. 199A?

- Each trade or business to be aggregated must meet the definition of a trade or business under Regs. Sec. 1.199A-1(b)(14). Those regulations provide that for Sec. 199A purposes, "trade or business" generally has the same meaning as under Sec. 162.
- If the rental activity does not rise to the level of a Sec. 162 trade or business, is the property is rented or licensed to a trade or business conducted by an individual or passthrough entity that is commonly controlled?
- In the case of a self-rental activity between an individual or RPE and a commonly controlled trade or business, the self-rental activity will be considered a trade or business for Sec. 199A purposes even if it does not meet the Sec. 162 definition of trade or business.

Aggregation Criteria

- The final regulations provide that trades or businesses may only be aggregated together if they meet the following criteria:
  - The same person, or group of persons, must own a majority interest in each of the businesses; such ownership must exist for the majority of the taxable year in which businesses are to be aggregated.
    - For S corporations, a majority interest means 50% or more of the issued and outstanding shares in the corporation (including direct or indirect ownership).
    - For partnerships, a majority interest means 50% or more of the capital or profits in the partnership (including direct and indirect ownership).
  - All of the items attributable to the aggregated businesses must be reported on returns with the same taxable year.
  - None of the aggregated businesses can be an SSTB.
  - The aggregated QTorB must meet two of the following three factors:
    - Provide products and services that are the same, or that are customarily provided together
    - Share facilities or centralized business elements
    - Operate in coordination with or reliance on the other businesses

Example

- Alan, Betty, and Chuck have 50%, 49%, and 1% interests, respectively, in Partnership X profits; and Betty, Chuck, and Don have 1%, 49%, and 50% interests, respectively, in Partnership Y profits. None of the ownership by Alan in Partnership X or by Don in Partnership Y is attributable to Betty or Chuck under either Sec. 267(b) or 707(b).
- Even though Betty and Chuck don't have a majority of profit interests in either partnership, their common ownership between the two entities is at least 50% and, consequently, they meet the 50%-or-more common ownership test.

Aggregation Reporting Requirements

- Aggregation under Sec. 199A must be disclosed annually for ALL taxpayers even if there is no change in the trades or businesses aggregated.
- A statement must be included with the return, in the case of an individual, or with each Schedule K-1, in the case of an RPE, reporting the following information for every trade or business in the aggregated group:
  - A description of each trade or business;
  - The name and employer identification number of each entity in which a trade or business is operated;
  - Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the tax year;
  - Information identifying any aggregated trade or business of an RPE in which either the individual or upper-tier RPE holds an ownership interest; and
  - Any other information as the IRS may require in forms, instructions, or other published guidance.

Aggregation Consistency Requirement

- Aggregation election must be followed in all subsequent tax years unless there is a significant change in facts and circumstances
- Disposition of a trade or business would be considered a significant change in facts and circumstances
- When prior aggregation no longer qualifies due to a significant change in facts and circumstances, taxpayer is required to reapply the aggregation rules and determine a new permissible aggregation, if any.
- Taxpayers are allowed to add newly created or newly acquired trades or businesses to an existing aggregation group, assuming all applicable criteria are met.

Consequences of Failure To Aggregate

- Failure to aggregate will not itself be considered an aggregation.
- Failure to aggregate in one year does not prevent a taxpayer from aggregating in a subsequent tax year, even if there have been no changes in facts and circumstances.
- Aggregation cannot be made on an amended tax return
- If taxpayer treats a group of trades or businesses as aggregated, without providing the required disclosure statement, the IRS has discretionary authority to disaggregate those trades or businesses.
- Taxpayer is then not permitted to aggregate those trades or businesses for the subsequent three tax years.

When Not to Aggregate

- Two or more trades or businesses do not all have the same limitation under the wages and capital limitation.
- One trade or business would have a greater QBI deduction using the 50% of W-2 wages limitation, and another trade or business would have a greater QBI deduction under the 25% of W-2 wages plus 2.5% of UBIA limitation.
- If one of the trades or businesses to be aggregated is generating negative QBI.

Opportunity Zones

- Designation of certain low-income community population tracts as “Qualified Opportunity Zones”
- Deferral of "eligible gain" that is reinvested into a QOZ within 180 days of the sale or exchange that gives rise to the gain.
- Eligible gain is gain that

  a) is "treated as capital" for federal income tax purposes;

  b) would be recognized for federal income tax purposes before Jan. 1, 2027; and

  c) Does not arise from a sale or exchange with a related party.

Who Qualifies for Opportunity Zones

All taxpayers that realize eligible gain for federal tax purposes may elect to defer that gain if all of the requirements are met

Timing Considerations

- Taxpayer must reinvest the gain into a QOF within 180 days from the date of the sale or exchange that gives rise to the gain

- 180-day period begins on the day on which the gain would be recognized for federal income tax purposes without election

How to Make the Election

- Election is made on Form 8949, Sales and Other Dispositions of Capital Assets
- Eligible gain is reported as a positive number before then removing the gain on a separate line as a negative adjustment
- A taxpayer is not required to reinvest the entire proceeds
- Taxpayer must reinvest **only** the gain amount
- Taxpayer can both take cash off the table and defer the full amount of gain resulting from the sale

Holding Period Requirements

- Taxpayer who holds the QOF interest for a five-year period, 10% of the deferred gain is permanently excluded.
- If holding period reaches seven years, an additional 5% of the gain is excluded.
- If holding period reaches 10 years, the gain arising after the 2026 recognition date is entirely excluded.
- 5 and 7 year adjustments are largely unavailable now
- Talk of potential legislation that will extend the 2026 date and potential reinstate some of the above benefits