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Vol.35 No.5 SEPTEMBER • OCTOBER 2017

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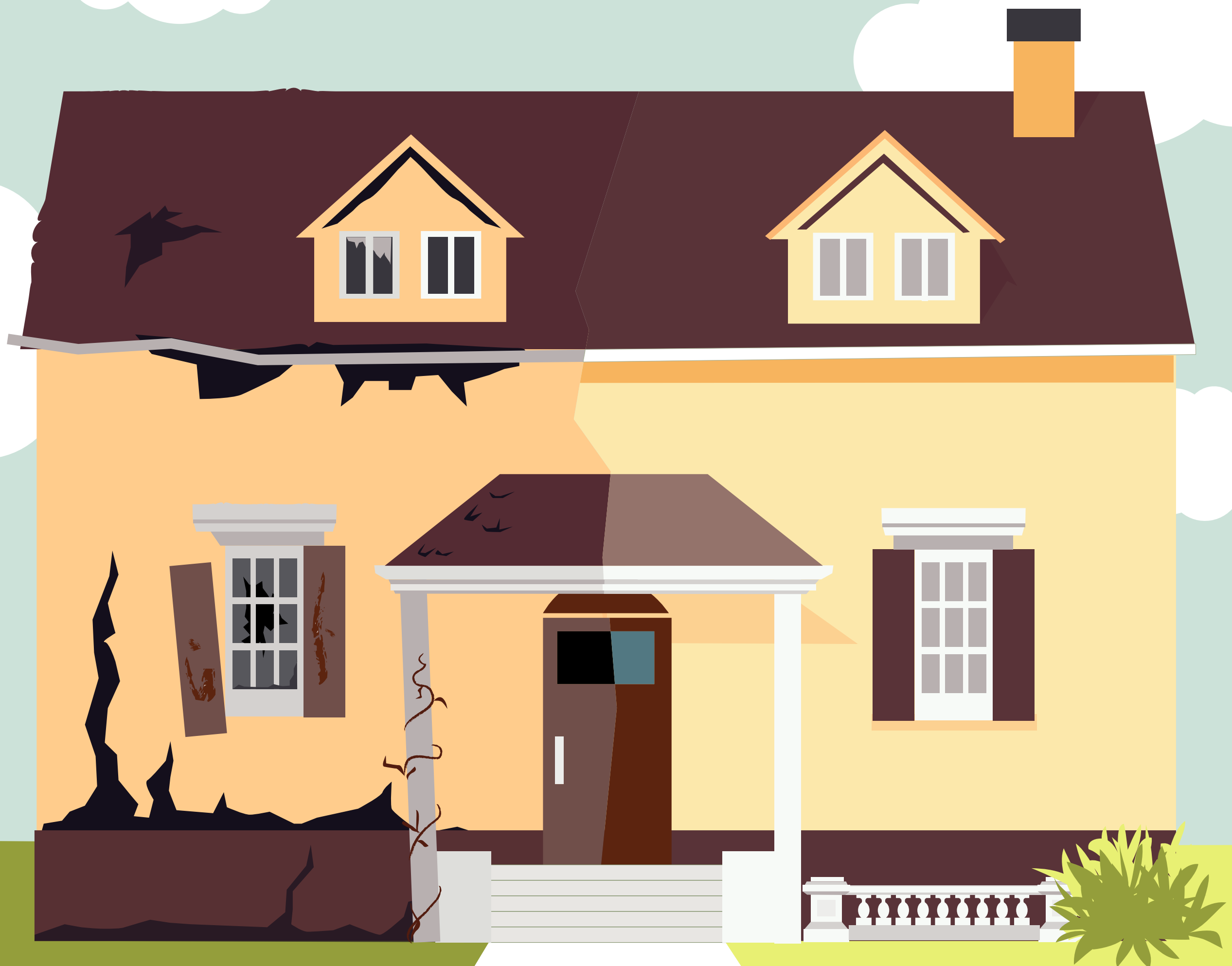

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DEALER OR INVESTOR?

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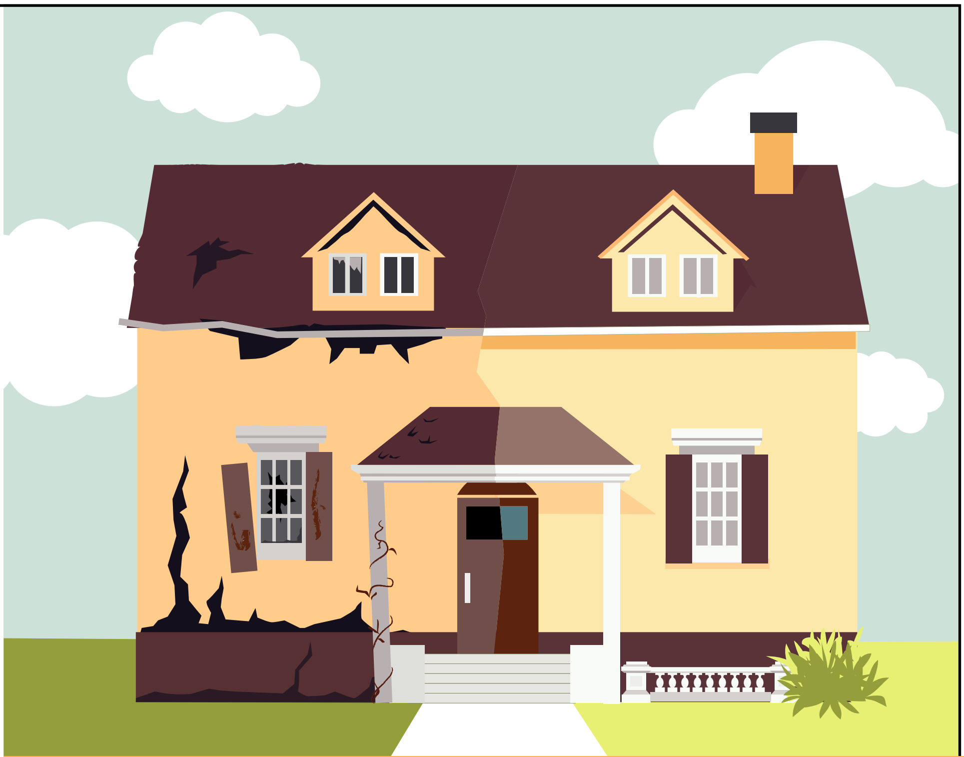

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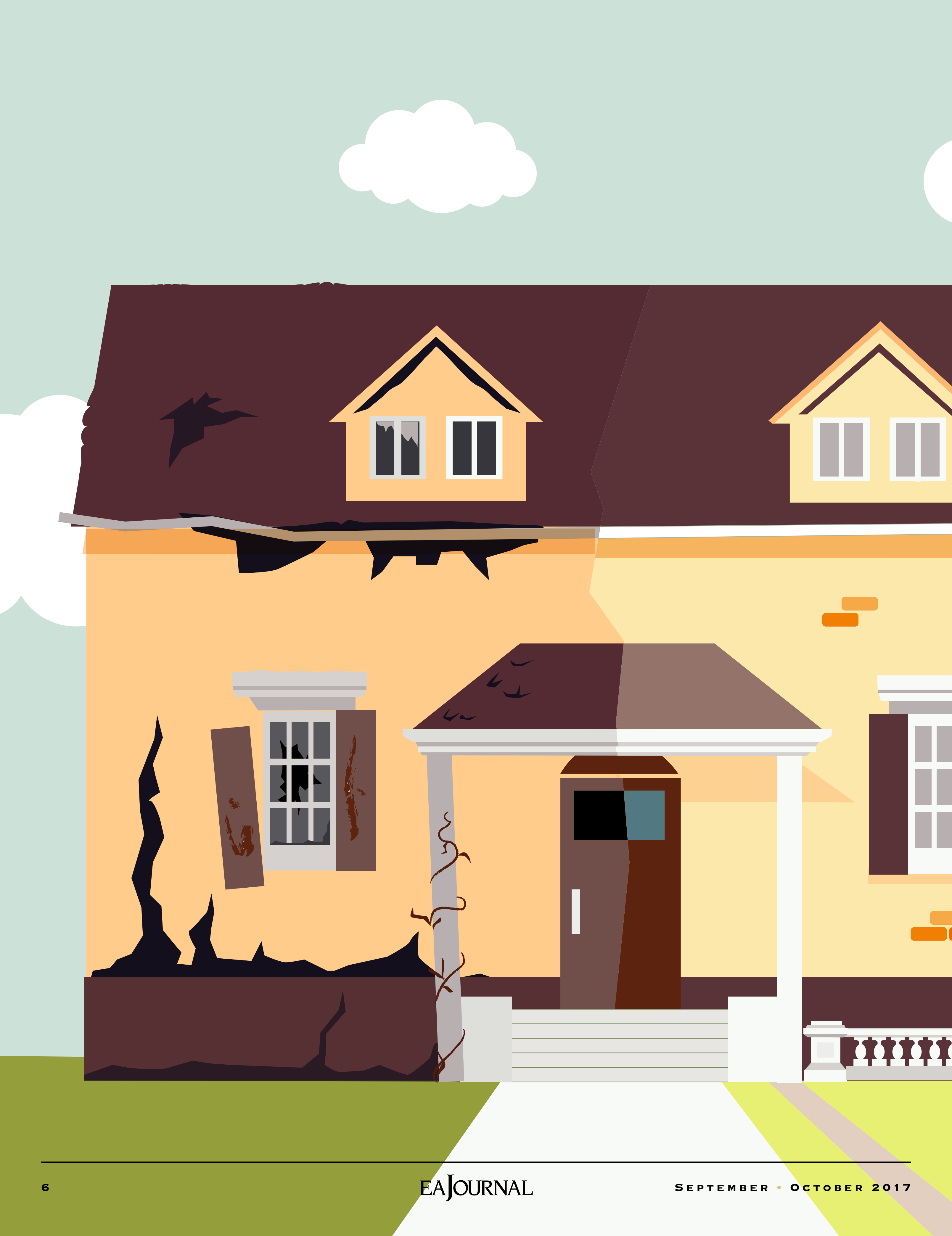
EA Journal (ISSN #1091-8256) is published bi-monthly for $215 per year (membership and associate dues include subscription price) by the National Association of Enrolled Agents, 1730 Rhode Island Ave., NW, Ste 400, Washington, DC 20036, 202/822-6232, e-mail: ***pposas@naea.org***, online: ***www.naea.org***. Periodicals postage paid at Washington, DC 20036 and at additional mailing offices. This publication is designed to provide accurate and authoritative information on the subject matter covered. It is distributed with the understanding that neither the publisher nor the author is engaged in rendering specific legal, tax, or accounting advice or other professional services. Only a qualified professional with all the facts at his or her disposal can determine the appropriateness of the application of any law to a given fact situation. If assistance is required, a competent professional should be consulted. ***Postmaster***: Send address changes to: *EA Journal*, 1730 Rhode Island Ave., NW, Ste 400, Washington, DC 20036.



Tax Implications of Home Flipping: DEALER OR INVESTOR?

With today's hot real estate market and rapidly escalating property values, many clients are engaging in real estate investing and house flipping.

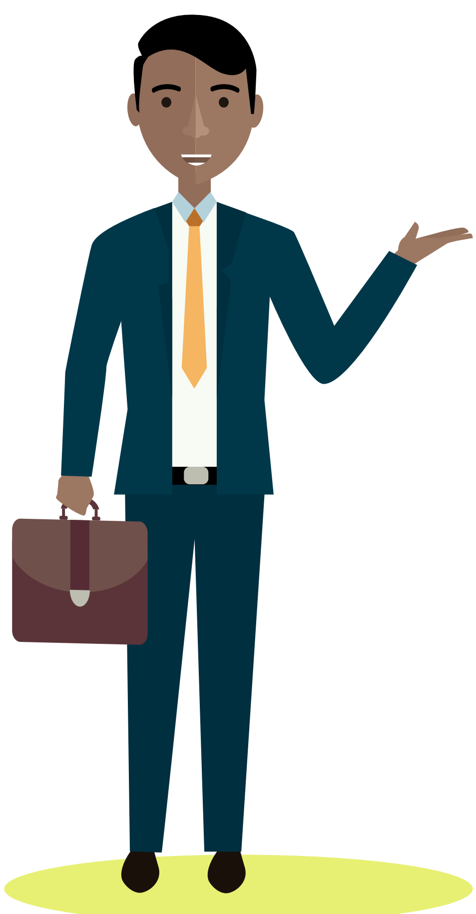
BY: KEITH A. ESPINOZA, EA

Tax Implications of Home Flipping:

DEALER OR INVESTOR?

Indeed, there are many reality TV shows and real estate networks dedicated to glamorizing the quick profits that can be made in these activities. What these programs fail to mention are the tax consequences of these transactions.

As tax professionals, that's where we come in. Our clients rely on our expertise to not only prepare their tax returns properly, but also to advise and guide them on the proper way to structure their deals. The proactive roles we are thrust into require us to give advice that can mean big differences in the bottom line to the client and to the IRS.



Real Estate Dealer or Investor?

Is your client primarily a real estate dealer or real estate investor? A real estate dealer is someone who sells real estate to customers in the ordinary course of his or her business. When dealers sell property in the ordinary course of business, they have sold inventory and have generated ordinary income or loss. A real estate dealer's income can be potentially taxed in excess of 50 percent (when self-employment tax is figured in). Losses, however, can offset other sources of ordinary income.

A real estate investor, on the other hand, is one who buys and holds real estate for its appreciation over a period of time. Income from the sale of the real estate can be classified as capital gain. The taxes on capital gain are much lower than on ordinary income, and they can sometimes be as low as 0 percent. A real estate investor's losses, however, are limited to a net deduction of $3,000 per year, with the unused losses carried forward to future years.

The client whose sole source of income is from flipping many homes is obviously a dealer. But what about the client who works a 40-hour-a-week job doing something else, who has flipped her first house? Is she a dealer or an investor? Is it possible to be both a dealer and an investor? Sometimes the character of the transaction or deal is very obvious, and other times it is not so clear and is open to interpretation.

There is no Internal Revenue Code (IRC) section that specifically defines a dealer. The answer lies in the facts and circumstances of each case. Each is unique, and we can sometimes find ourselves in a role similar to that of an NFL replay referee, having to "go under the hood" and review the play multiple times and from different angles, to make the correct call.

In this article, we will explore some of the rules and regulations, court cases, and rulings that can help shed light on the proper classification of these deals. We want to pay particular attention to the small-time flipper, because this is where the grayest area is located, and it is the inspiration for this article.

Capital Gain Treatment

Let's begin our analysis by looking at the definition of capital assets, which are defined by way of exclusions. IRC Sec. 1221 tells us that all assets are capital in nature unless there is an exclusion. One such exclusion is found in Sec. 1221(a)(1): property held by a taxpayer primarily for sale to customers in the ordinary course of a trade or business (inventory).[1]

We must determine whether our client is: engaged in the business of selling real estate, holds the property in question primarily for sale in that business, and made the sale in the ordinary course of that business. If all three conditions are met, ordinary income or loss will be the result.

Winthrop Factors

Answering the above questions is not always easy, but the courts have developed guidelines, or several factors that they consider, in answering those questions. These are the so-called "Winthrop Factors."[2]

1. The nature and purpose of the acquisition of the property and the duration of the ownership.
2. The extent and nature of the taxpayer's efforts to sell the property.
3. The number, extent, continuity, and substantiality of the sales.
4. The extent of subdividing, developing, and advertising to increase sales.
5. The use of a business office for the sale of a property.
6. The character and degree of supervision or control exercised by the taxpayer over any representative selling the property.
7. The time and effort the taxpayer habitually devoted to the sales.

Now let's examine each factor a little closer and see how each can affect our result:

1. What was the taxpayer's intent when the property was purchased? Was it bought to be used for sale, or was the intent to hold it for appreciation? Did the taxpayer hold the investment property or properties separate from the sale property or properties, *i.e.*, in a separate entity? How long did the taxpayer own the property? The longer it was owned, the more we may be able to lean toward capital gain treatment. Did the intent change during the course of owning the property or at the time of sale?
2. How did the taxpayer advertise or try to attract buyers? How does this differ from what was done on other properties? Is there repeated advertising? If so, we lean more toward "in the ordinary course of business," resulting in ordinary treatment.
3. The larger the volume of sales that are made and the larger their share of the client's income, the more we see a repeat pattern quickly tilt the verdict toward ordinary treatment. At the same time, when sales are low and isolated, it can lean more toward capital treatment.
4. The more development and improvements that are done to the property, the more we tilt toward ordinary treatment. Conversely, when minimal work is done to the property, it is probably being held for investment purposes.
5. The use of a business office obviously leans toward ordinary and in the course of business.
6. This factor measures the extent of sales controls used in the ordinary course of business. More control means more likely a trade or business.
7. More time and effort devoted to sales probably tilts toward ordinary course of business.

In theory, each factor is just as important as the next, and no one factor is controlling. In reality, though, there are many cases, and different courts at different times have emphasized one or a group of factors over the others.

Importance of Each Factor

In theory, each factor is just as important as the next, and no one factor is controlling. In reality, though, there are many cases, and different courts at different times have emphasized one or a group of factors over the others.

In *Biedenharn Realty Co. Inc. v. Commissioner*,[3] the court used frequency of sales as the most important factor, saying that this factor alone could determine ordinary status and prevent capital status. It added further that few and isolated sales give a greater argument toward capital status. And other courts have said that frequent sales coupled with improvement activity alone will usually result in ordinary gain or loss treatment.

In *Lewellen v. Commissioner*,[4] the court disregarded sales measures entirely (factors two, five, six, and seven), stating that a client who has high demand for his or her asset has no need for advertising. In other words, someone who does not advertise might still be considered a dealer. The reverse can also be true: the presence of sales measurers does not necessarily exclude capital gain treatment, as a taxpayer wishing to sell his or her capital asset may need to advertise, as was found in *Chandler v. Commissioner*.[5] In other words, someone who does advertise might still be considered an investor.

Your Client vs. Uncle Sam

While it is better for your client to have gains that are capital and losses that are ordinary, the exact opposite is true for the IRS. The IRS is the victor if your gains are ordinary and your losses are capital. The IRS has been very effective at bending the rules in its favor, making the rules fit whatever outcome is best for Uncle Sam. The IRS will emphasize one factor or group of factors while deemphasizing others.[6]

In cases where there is a gain, the IRS wants ordinary treatment and will deemphasize the sales measures as unimportant, and it will argue that the redevelopment level

Tax Implications of Home Flipping:

DEALER OR INVESTOR?

The IRS is very aggressive with its arguments, and the burden of proof to refute them is on you and your client.

necessary to convert the property to inventory is low. Instead, the IRS will argue that the taxpayer's intent to develop a property is the most important factor, even if the intended result never occurred.

In cases where there is a loss, the IRS will argue the opposite, wanting capital treatment. The IRS will say there must be a history of significant and repeated sales in order for the client's activity to rise to the level of a trade or business, adding that taxpayer intent is meaningless without the redevelopment activity, because it will not rise to the level of a business.

In 2014's Allen v. US,[7] the IRS successfully argued that a one-time sale of raw land was ordinary income. And in 2016's *Jeffrey J. Evans v. Commissioner*,[8] the IRS successfully argued that a scrape and rebuild of a property was a capital loss!

Being Proactive

Taxpayers and their advisors need to be proactive and structure their deals looking at these factors at the beginning of each deal. This way, the taxpayer can rack up points and tilt the scale toward the desired outcome.[9]

There is so much judgement involved and controversy with the issues in these cases, that IRS audits are frequent. The burden is on you and your client to refute the government's arguments.[10] The best way to do this? Have your clients keep detailed records and document everything. Have them keep their investment properties separate from their inventory assets on their balance sheets.

It is even better to have your clients hold their investment properties in separate entities from their sale properties.[11] Make sure they keep logs and detailed records of their sales activities. Advise them to keep detailed corporate minutes and partnership agreements, stating their intentions concerning specific assets and properties. If their intent changes on a specific property, make sure they record when and why it changed.

The Tax Professional's Role

We wear multiple hats as tax professionals: tax preparer and tax planner/advisor. As preparers, we are dealing with transactions after the fact. The deal has already occurred, and we are simply reporting it on the tax return.

As tax planners and advisors, we take on even more risk. The transactions have not occurred yet, and the client is placing even more faith in us. Rather than playing the role of replay referee, we are being asked to play quarterback.

As we have seen, the tax treatment of these deals results in big swings in the bottom line to both the client and the IRS. Be very careful. Do your due diligence when preparing returns with these types of transactions. Do not hesitate to disengage a client if he or she disagrees with your judgement. It is much better to lose out on a fee than to risk a preparer penalty.

Show your clients the factors that the courts look at, advise them on the possible outcomes, show them how to structure their deals accordingly, and make them keep detailed records. And of course, always protect yourself with a detailed engagement letter and E&O insurance.

Tread Carefully

Real estate investing and house flipping is an area of your practice that is fertile ground for controversy and audits, especially for the low-volume flipper or client who holds both business and investment properties. While the courts have issued guidelines that can be followed, there is still very much judgement involved. The IRS is very aggressive with its arguments, and the burden of proof to refute them is on you and your client.

Ultimately, it is up to us as tax professionals to assess our level of skill and confidence in this area and to assess how much risk we would be willing to assume. Be careful! **EA**

About the Author

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ENDNOTES

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