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SUBDIVISION OF REALTY - TAXATION

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Many farmers have land suitable for subdivision and development. In fact, the sale of lots (parcels) adjoining the highway and utilities may have negligible, if any, impact on the agricultural productivity of the remaining farm land. With the reduction in the capital gain rates, the logical question is: how may a farmer sell-off and or develop such property without the property being deemed as "held for sale to customers in the ordinary course of trade or business"? The point of tax planning is to structure transactions such that their "form and substance" yield the desired tax consequence, which in this case is the realization of capital gain rather than ordinary income on the sale of subdivided parcels.

Given the popularity of urban/suburban development, the tax advantages that have normally flowed from not being deemed "in the business of developing realty", and in an attempt to minimize the litigation between the IRS and taxpayers, Congress enacted some safe-haven provisions. These provisions provide taxpayers, who are not dealers in real estate, guidelines for subdividing realty while maintaining eligibility for capital gains treatment.

With the nature and scope of most realty ventures, this area of taxation warrants the expense of advice from a tax specialist. However, the following is a brief overview of the subdivided realty rules. If five (5) or fewer parcels from the same tract have been sold by the end of the tax year, the entire gain is recognized as capital gain. In the tax year when the sixth (6th) parcel is sold, and in subsequent years, gain from all such sales are ordinary income to the extent of five (5) percent of the selling price.

Subdivided real estate is not considered to be held primarily for sale to customers in the normal course of trade or business if all three of the following tests are met.

1. The taxpayer is not considered as a dealer in real estate, and this tract has never been held primarily for sale by the taxpayer in the normal course of business.
2. The taxpayer has not made any improvements that substantially increase the value of the property, other than certain "necessary" improvements.
3. The parcel has been held by the taxpayer for at least five (5) years, unless acquired by inheritance or device.

These subdivisions rules apply to each tract of land. A period of five (5) years or more from the last sale of a parcel from a tract, redefines the property as a new tract. If the taxpayer is deemed to be a dealer, the gain from the sale of parcels would all be ordinary income.

An improvement for the purposes of this rule must be both substantial and one that substantially enhances the value of the parcel sold. It is possible that an improvement would not substantially enhance the value of all parcels. References indicate the installation of water or sewer facilities or roads that are necessary to make a parcel marketable at the prevailing local price of similar building sites are not deemed a substantial improvement if the taxpayer has held the parcel for ten (10) years and elects not to add the cost to the basis of any of the property.

While farming and development of realty for division has been somewhat mutually exclusive, the nature of the two enterprises suggest they should not be so separate. Most farms have some choice development sites which could be sold with little impact on the productivity of the farm and perhaps substantially improve the financial soundness of the operation.



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