Real Estate Developers - Proper Planning is Key to Maximizing The After-Tax Return on a Development Project

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Before starting a new development project, residential and commercial real estate developers should focus on properly structuring the acquisition and development of the property to minimize taxes. Proper planning on the front end can result in major tax savings (and more cash for the developer) on the back end. This article will provide developers with an overview of how they can structure residential or commercial real estate development projects to maximize after-tax returns.

The strategies discussed in this article are applicable to all single-family residential developments and other residential and commercial real estate developments where a number of lots or outparcels will be sold. However, these strategies generally will not be applicable to multi-family residential developments or commercial developments where the developer does not intend to sell outparcels.

The Goal - Maximize Capital Gains!

The goal of any real estate developer is to make the most amount of money possible and simultaneously pay the least allowable amount of taxes. In order to accomplish this goal, it is important for the developer to:

- Properly structure the acquisition of the raw, unimproved land where the project will be developed;
- Properly structure the transfer of the land from the acquisition entity to the entity that will develop the project; and,
- Properly structure the entity that will develop the project.

All three of these steps require sophisticated tax and real estate planning.

Overview - Ordinary Income Tax vs. Long-Term Capital Gains Tax

The developer will want to maximize the amount of long-term capital gains taxes paid on the development transaction since long-term capital gains tax rates are significantly lower than ordinary income tax rates. The difference in these tax rates can be as high as 24.6%. This 24.6% difference means the difference between netting $792,500 after-tax on a $1,000,000 sale, as opposed to only $546,500. This significant difference in tax rates should provide a real incentive for a developer to structure projects to maximize the transactions that qualify for long-term capital gains treatment.

Overview - Dealer Versus Investor Issues

In the development context, the sale of land that is held for investment purposes will qualify for long-term capital gains treatment if the land has been held for more than one year prior to the sale, whereas the sale of land that is held as inventory by the seller will be subject to tax at the higher ordinary income tax rates. In "tax speak," this is referred to as the real estate dealer (ordinary income treatment) versus investor (long-term capital gains treatment) issue. At the extremes, a parcel of real estate that is purchased as an investment and held for more than one year, without improvement, will qualify for long-term capital gains treatment, whereas a large number of lots that are sold by a development entity that has constructed major improvements in a subdivision will be considered inventory with the sales subject to tax at the higher ordinary income tax rates.

Additionally, it is important to note that the Internal Revenue Service ("IRS") generally analyzes the real estate dealer versus investor issue on a parcel-by-parcel basis. This means that a developer otherwise classified as a real estate dealer due to the fact that the developer engages in a high volume of real estate transactions can hold certain parcels for investment and be deemed to be a real estate investor with respect to the latter.

However, real estate developers should not take this risk. Proper transaction structuring can greatly reduce the risk that a developer will be deemed to be a real estate dealer with respect to a particular tract the developer intended to be an investment property. Proper structuring involves, at a minimum, holding dealer properties (inventory) in one legal entity and holding investment properties in a separate legal entity. For example, a limited liability company owned by a real estate developer who engages in a substantial amount of real estate transactions will not necessarily be "tainted" by the developer's frequent real estate transactions, which means that, if properly structured, the limited liability company will qualify as a real estate investor and obtain long-term capital gains tax treatment on sales of investment properties.

Steps in the Process - Turning Raw, Unimproved Real Estate Into Cash and Minimizing Taxes Along the Way

The major steps involved in most single-family residential and large commercial real estate developments are outlined below. While these steps are relatively common in all such developments, it is important for developers to pay attention to each step in order to minimize the amount of taxes imposed on the overall development deal. Proper tax and real estate advice during the various phases of the project is crucial to ensuring that the after-tax return on a project is maximized.

- Step One - Acquire the Real Estate: The first step in a real estate development project is the acquisition of the real estate upon which the project will be located. This step requires sophisticated real estate and tax planning to ensure that the developer is positioned to maximize the economic return on the project and minimize the taxes that are paid. Among other things, the developer will need to:
    - Properly structure the acquisition entity; and,
    - Conduct proper due diligence inquiries to identify any issues with the project tract.
- Step Two - Transfer the Real Estate to the Development Entity: The next step generally involves the transfer of the real estate from the acquisition entity to the development entity. There are two main goals in this phase of the development process:
    - Maximizing the amount of long-term capital gain that will be recognized on the sale of the property by the acquisition entity to the development entity; and,
    - Properly structuring the development entity to maximize economic return and minimize taxes paid on the development of the project.

It is important to focus on the type of entity used as the development entity to avoid unexpected tax issues. It also is important to properly structure the deal terms for the sale of the property by the acquisition entity to the development entity to avoid the IRS re-characterizing the sale as a capital contribution by the acquisition entity to the development entity, which would destroy the tax planning for the project.

- Step Three - Obtain Entitlements and Construct Improvements: Next, the development entity will obtain all of the entitlements for the project, such as zoning approvals, water and sewer allocations, and permits to construct the project as designed. Once all of the entitlements have been obtained, the development entity can begin constructing the infrastructure improvements, such as the roads, common areas, amenities, and the houses or buildings.

  At this stage of a single-family residential development, some developers will have an in-house construction group that will build the houses, whereas others will not and will opt to sell the subdivision lots to third-party builders who will then construct the houses and sell them to the ultimate owners. Some developers will opt for a hybrid approach where they or their in-house construction group builds some houses and the development entity sells some lots to other builders.

- Step Four - Sell the Project: During this phase of the process, it is important to properly structure compensation and other operational aspects of the development entity to minimize the amount of taxes that are paid as the developer exits the project.

  In the single-family residential development context, as discussed above, the developer may exit the project by either selling all of the lots to third-party builders, constructing all of the houses in the development and selling them directly to home buyers, or adopting a hybrid approach. Regardless of the developer's exit strategy, proper planning and implementation of the prior steps will yield significant tax savings.

  In the large commercial real estate development context, the development entity may exit the project by selling the entire project to a third party or by selling a portion of the project (such as designated outparcels) to a third party and then operating the remaining portion of the project until that portion of the project is sold to a third party.

Admittedly, this is a simplified explanation of the steps that need to be addressed in the development of a single-family residential subdivision or a large commercial development project. Other steps that are outside the scope of this article, but that need to be addressed include:

- Structuring an owners' association that is favorable to the development entity's interest;
- Considering whether to "condominium-ize" the project if it is a commercial or mixed use development; and,
- Implementing restrictive covenants that maximize the long-term sustainability of the development.

However, as outlined above, there are several key phases of any real estate development project that require significant tax and real estate planning. At the end of the day, proper planning beginning with the acquisition of the development tract will result in the developer pocketing substantially more after-tax cash from the development transaction than if attention is not paid to structuring the entire transaction from the beginning.

IRS Safe Harbor? Don't Count on It

Section 1237 of the Internal Revenue Code contains a safe harbor that allows a taxpayer to sell up to five lots and pay tax at the long-term capital gains rate if certain requirements are satisfied. However, the safe harbor generally cannot be used by real estate developers because the development entity must hold the project tract for at least five years and not construct any significant improvements during that holding period. While the safe harbor was of benefit during the Great Recession, in the current economic climate, most developers do not plan on holding land for such a significant period. Therefore, the safe harbor provision is of little practical value these days.

Conclusion

As can be seen, there are a number of steps in the single-family residential and large commercial real estate development process that must be well thought out in order to ensure maximization of profit on a development deal while paying as little tax as possible. When planning future development transactions, developers should consult with experienced tax and real estate attorneys in order to obtain the best possible financial outcome for their investors and themselves.

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