

HASHEM and SIMMS, PLLC
CERTIFIED PUBLIC ACCOUNTANTS

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Dear Client,

This letter is in response to your request for general information regarding the possible subdivision of a large tract of land that you own.

Let's assume the following situation, that you inherited 40 acres of farm land approximately 10 years ago and that the farm has substantially increased in value since that time. You further stated that you feel that the land, which you intend to sell, would be more marketable if you subdivide it before sale. To that end, you have asked for preliminary information on the tax effects of subdividing the property.

In general, taxpayers who sell numerous lots of property run the risk of being classified as a real estate dealer (i.e., one engaged in the trade or business of selling real property to customers) and having all gain from the sale of such properties taxed as ordinary income. However, a safe harbor rule provides that noncorporate taxpayers and S corporations who hold real property ("the tract") as an investment, but then subdivide it in order to make it more marketable, qualify for capital gains treatment on the sale of the tract provided: (1) the tract was not previously held for sale to others in the ordinary course of the taxpayer's trade or business; (2) the taxpayer does not hold any other real property for sale to others during the year in which the sale of the tract occurs; (3) the taxpayer did not substantially improve the value of the tract; and (4) the taxpayer has held the tract for at least five years, unless it was acquired by inheritance.

For purposes of the safe harbor, a "tract" is a single piece of real property. Two or more pieces of property that are contiguous constitute a single tract if they are separated only by a road, railroad, stream or similar property, or if they were at some time in the past contiguous in the hands of the taxpayer.

If you sell five or fewer lots from your tract, all of the gains are treated as capital gains. However, any gain realized from any sale occurring in or after the taxable year in which the sixth lot is sold is ordinary income to the extent of 5% of the selling price.

As stated above, if you make a substantial improvement to your tract that substantially increases the value of the lot sold, the improvement precludes the use of the safe harbor. Whether any improvements have substantially increased the value of a lot depends on the circumstances in each case. If improvements increase the value of a lot by 10% or less, the increase is not considered substantial. If, on the other hand, the value of the lot is increased by more than 10%, then all relevant factors must be considered to determine whether, under such circumstances, the increase is substantial.



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We suggest we meet to discuss this further if you are planning on doing any improvements to your tract so that we can determine whether such planned improvements will preclude the use of the safe harbor.

If you have any questions regarding the above information, please call us at our office. Once you have decided on your course of action regarding your tract, we can meet again to review the specifics of your proposed transactions and how such specifics interplay with the rules of the safe harbor.

Sincerely,

George K Hashem

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