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Loss on sale of real estate may be ordinary loss even if not a dealer in real estate

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With falling real estate values, a taxpayer that undertakes a construction or renovation project with the intention to make a profit may sustain a loss when the project is ultimately sold. Ideally, the loss will qualify as an ordinary loss, which can offset other income. Otherwise, individuals may deduct capital losses only to the extent of capital gains, plus, if the loss exceeds the gains, up to an additional $3,000. Excess capital losses may be carried forward to subsequent years, but the obvious advantage of ordinary loss treatment is that ordinary losses are not subject to the capital loss limitations. These rules do not apply to a loss on the sale of a personal residence, which is not deductible.

The character of a loss as ordinary or capital depends on whether the property comes within the definition of a "capital asset" as defined by the Internal Revenue Code. Property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business is excluded from the definition of a capital asset. The purpose of this exclusion is to differentiate between gain derived from the everyday operations of a business and gain derived from assets that have appreciated in value over a substantial period of time.

Generally, if a taxpayer is considered a "dealer" in real estate, the loss will qualify for ordinary loss treatment. In determining whether a taxpayer is a dealer in real estate, the Internal Revenue Service considers a number of factors, such as frequency and continuity of sales of similar property. However, what if the project was the taxpayer's first construction or renovation project? For example, consider an architect who purchases a property with the intent to renovate it and sell it for a profit.

The focus in that case should be on the extent of the taxpayer's participation in the renovation of the property. For example, if the taxpayer actively participates in the renovation of the property, then that would support the position that the renovation is a business activity in and of itself. In contrast, if the taxpayer's role is that of a passive investor and the taxpayer does not actively participate in the renovation of the property, then that would support the position that the property was a capital asset.

As ordinary losses are generally considered more valuable than capital losses, taxpayers should carefully document their participation in a construction or renovation project in order to demonstrate to the Internal Revenue Service that they are entitled to an ordinary loss if a loss is sustained on the sale.

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