

Sales (100 lots at \$1,500).....	\$150,000
Costs of lots.....	2,000
Gross profit.....	148,000
Selling expenses (100 lots times \$75).....	7,500
Profit to be reported.....	140,500
So, you have a before-tax profit of \$140,500. But the big question still has to be answered—will any of this gain be highly taxed ordinary income? Or, will it all be tax-favored long-term capital gain? Here's how it breaks down:	
Potential ordinary income: 5 percent of \$150,000 (selling price).....	\$7,500
Selling expenses allocated to ordinary income.....	7,500
Ordinary income.....	0

Result.—The selling expenses completely cancel out the ordinary income element. All the gain will be capital gain, despite the fact that all the lots were sold within one year. Your maximum tax on the \$140,500 is \$35,125. Your net after-tax profit: \$105,375.

Is it as easy as all that? Yes it is—if, as we said earlier, you meet all these other requirements of the tax law:

- (1) You are not otherwise a dealer in real estate in the year of sale;
- (2) You never held the subdivided tract as a dealer;
- (3) You have held the property at least 5 years—unless it was inherited, in which case the 5-year rule does not apply; and
- (4) You haven't made "substantial improvements" which increased the value of the property.

Important.—Most people overlook the fact that the 5% ordinary-income rule is not as dangerous as it looks. In many cases it will be completely offset by selling expenses you must incur anyway. And, even if the selling expenses don't completely offset it, what's left may be a very small price to pay for being able to receive the lion's share of your profit as favorably taxed capital gain.

INVESTOR OR DEALER? IT MAKES A BIG DIFFERENCE

Making money in real estate isn't simply a matter of buying low and selling high. You've also got to make sure that taxes won't eat up the bulk of your profits. For instance, take the real estate investor who wants to subdivide and develop his property to get the best price for his investment. If he's too active in developing or selling, he runs the risk of losing his "investor" status—and being hit with ordinary income on the deals he makes. But here's—

Good news.—If he handles things right, he can still develop his property and get favored capital-gain treatment on his profits. To illustrate, look at this—

Actual case.—Van Drunen and Baldwin were co-owners of a tract of land in Indiana for a number of years. Van Drunen was an insurance salesman who was heavily engaged—about 70 hours a week—with his selling job. Baldwin was a real estate broker.

They wanted to liquidate their holdings but couldn't sell the property in its "underdeveloped" state. So, they agreed to subdivide and improve it. Baldwin handled all the details: development, advertising, selling and so on. They even agreed to allow Baldwin the usual broker's commission on the sales.

Van Drunen did absolutely nothing except pay his share of the costs. He reported his profits as capital gain. But the Revenue Service said ordinary income—insisting he was a dealer. **Result:** The Tax Court tossed the Revenue Service's "dealer" argument out of the window. **Reason:** Van Drunen had handled things the—

Right way.—He let his "broker"—Baldwin—take care of all the details. The Court pointed out the complete lack of dealer-type business on Van Drunen's part. He was just liquidating his investment in the best possible way. Unfortunately, not every investor is as careful as Van Drunen was. Look at this—