

Tax practitioner judgements and client advocacy: the blurred boundary between capital gains vs. ordinary income

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Abstract

Tax planning often involves ambiguous law, necessitating the exercise of professional judgement. In this article, we review prior scholarly literature on client advocacy of tax practitioners. Tax planning in the US and elsewhere often involves a distinction in whether income is subject to taxable treatment as capital gains, or as ordinary income, under the tax code. As a case example we focus on one particular tax case that has been repeatedly used by US tax accounting researchers (originally based on Cloyd & Spilker, 1999) to show how professionals' judgements and decisions can be affected by the underlying incentives of the client case. We discuss the implications of our findings in relation to the contribution that can be made by behavioural tax researchers to tax policy debates and also link in our findings to wider policy objectives involving regulation of tax preparers and the complexity of tax laws.

Key words: Capital gains, ordinary income, code of conduct, professional judgement, client advocacy

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1. INTRODUCTION

Prior literature, for example Evans and Sandford (1999) and Evans (2000), shows that capital gains tax regimes are complex in their detail and often associated with significant administrative and compliance costs, while not necessarily raising significant tax revenue. This is true for capital gains taxes in Australia and the UK, and likely true elsewhere, and may contribute to the reluctance of some countries to introduce a CGT (e.g., New Zealand) despite calls for its introduction (White, 2017).

Although there are very few (or no) research studies of the costs of operating capital gains tax in the US, it seems a reasonable axiom that the Capital Gains and Losses rules contained in Title 26 US Code, Subchapter P are just as complex as in other countries. For instance, accounting students seeking to work in tax will need to grapple with distinctions between short and long-term gains, issues relating to sales of businesses, capital gains deferrals, like kind exchanges, etc., and keep up-to-date with the frequent changes made to the Code.

A common response when individual taxpayers and small firms face high compliance costs and/or tax complexity is to engage the services of a tax preparer. Extensive prior research (e.g., Christensen, 1992; Stephenson, 2007) shows that some of the common motivations for seeking return preparation and planning services from tax professionals include the desire to file an accurate return, opportunity to save tax, problems with perceived complexity, lack of knowledge, avoidance of audits and penalties etc.

Tax professionals are bound by the ethical code of conduct of the professional association of which they are professional members (e.g., American Institute of Certified Public Accountants (AICPA), 2014), and additionally, contingent on the jurisdiction where they practice, by regulation by the tax agency. While many researchers (e.g., Walpole & Salter, 2014) have discussed specific details of these regimes elsewhere, and there is a continuing saga in the US in terms of regulating preparers, this article does not focus on tax agency registration or regulation. Rather, the focus here is on the role of professionals and how the code of conduct rules placed upon them by their professional associations might impact professionals' judgements and reporting recommendations to their clients.

In Australia, Tran-Nam, Lignier and Evans (2016) use survey evidence to explore practitioners' attitudes to tax law changes affecting tax complexity and compliance costs. Whereas in the US, behavioural tax researchers in accounting tend to utilise experiments that are often grounded in social psychology, and similar to but distinguishable from the experimental economics literature (e.g., Alm, Bloomquist & and McKee, 2017). For example, drawing on mental accounting (Thaler, 1985), a high profile study by Falsetta, Rupert and Wright (2013) demonstrated that the manner in which capital gains tax law changes are implemented affects the amount of investment in a risky asset. Specifically, taxpayers invest more in a risky asset when there is a capital gain tax decrease that is implemented gradually rather than all at once (as individuals prefer several 'small gains' rather than one 'large gain'), notwithstanding that there may be increased complexity associated with this option.

The purpose of this article is to showcase the contribution that behavioural tax experiments can make in tax research. The construct of tax professionals' client advocacy is used as an example (see Jackson & Milliron, 1989), in particular, an experimental case originally developed and used by Cloyd and Spilker (1999), to

showcase how experimental work can help explain the behaviour of taxpayers and tax professionals.

This article is structured as follows. Section 2 defines client advocacy and presents prior research on client advocacy in an accounting setting. Section 3 outlines the case developed by Cloyd and Spilker (1999) where practitioners were asked to judge a case, and consider whether a taxpayer should be a dealer (reporting ordinary taxable income) or an investor (reporting capital gains – taxable at a lower rate) and outlines the contribution of five extensions/replications using this case. In section 4, the article discusses the contribution of such experimental research and how this method can contribute to wider policy issues including tax complexity, tax reform, and tax professionals' judgements and decisions – particularly those involving client advocacy.

2. PRIOR LITERATURE ON CLIENT ADVOCACY

Nickerson (1998, p. 175) states that 'confirmation bias, as the term is typically used in the psychological literature, connotes the seeking or interpreting of evidence in ways that are partial to existing beliefs, expectations, or a hypothesis in hand'. It has been extensively researched in psychology (Klayman, 1995; Oswald & Grosjean, 2004) and prior research in accounting has shown that auditors can be influenced by client preferences (McMillan & White, 1993; Salterio & Koonce, 1997), although it is also influenced by whether the audit client is low-risk or high-risk (Hackenbrack & Nelson, 1996). In a tax setting, Mason and Levy (2001, p. 127) define client advocacy as: '.... a state of mind in which one feels one's primary loyalty belongs to the taxpayer. It is exhibited by a desire to represent the taxpayer zealously within the bounds of the law, and by a desire to be a fighter on behalf of the taxpayer'.

Bobek, Hageman and Hatfield (2010) highlight the 'within the bounds of the law' aspect noting that professionals should be unbiased in their evaluation of evidence and in their reporting recommendations to tax clients, and may even face preparer penalties from the Internal Revenue Service (IRS) under §6694 of the Internal Revenue Code where there is an understatement of a taxpayer's liability by a tax return preparer. Bobek et al. (2010) review prior advocacy research, noting that about half of the prior studies have not measured participants' advocacy attitudes, but rather researchers have experimentally created a treatment effect for advocacy by stating the client's preference. Some studies have however measured advocacy attitude, primarily relying on a scale developed by Mason and Levy (2001) and Levy (1996).

Table 1 reports summarised details from eight prior studies on client advocacy. Results have been mixed in that some studies have found a significant effect for measured advocacy attitude on the respective tax judgements (Johnson, 1993), while others have not (Kadous & Magro, 2001). Of the eight studies, six have been conducted in a tax setting, with two studies using both auditors and tax professionals.

Pinsker, Pennington and Schafer (2009) found that the effect of decision context (tax versus audit) was moderated by the professional's attitude toward advocacy, and that advocacy attitude was significantly lower for the auditors than for the tax accountants, which they attribute to auditor professional scepticism. Pinsker et al. found that advocacy attitude significantly correlated with the final decision, regarding disclosure of a contingent liability, for the auditors but not for the tax professionals. Roberts (2010) posited a tendency toward pro-client decision making in a financial setting, finding that

auditors conform their professional judgements to a client's demand for earnings management when client preferences are explicit.

Table 1: Exemplars of Prior Literature Investigating Client Advocacy in a Tax Setting

Johnson (1993)

Advocacy Scale:	developed 17 questions
Audit / Tax:	Tax
Students / Professionals:	Professionals (mean 3 year experience)
IVs:	½ cases labeled as Favourable (Unfavourable)
DVs:	Net score of weight on Fav less weight on Unfav cases; Strength of advice
Case:	Salary or Dividend
Result:	Higher advocacy increases higher weight on supportive evidence

Cuccia et al. (1995)

Advocacy Scale:	1 question, 1 (pro-client) – 11(pro-government) scale
Audit / Tax:	Tax
Students/ Professionals:	Professionals, mean age 33
IVs:	Verbal standards (More likely than not) vs. numeric standards (55%); Conservative client vs Aggressive but legitimate preference
DVs:	interpretation of standard; assessment of evidence; Recommend income or exclusion
Case:	Income or Exclusions of proceeds from defamation of character lawsuit
Result:	Tax professionals interpret stringent standards more liberally, thus, equally as aggressive as less stringent standards. When verbal standard, they used latitude in words to support aggressive decision; When numerical standards in place, they used latitude in assessing the evidential support.

Cloyd and Spilker (1999)

Advocacy Scale:	None
Students / Professionals:	Professionals (mean 31 months experience)
IVs:	Client implicit pref (Dealer w/loss or Investor w/gain) states as client preference is to save tax
DVs:	Search time / Probability a court will support client preference (%) Recommended treatment as Dealer vs. Investor
Case:	Classify expense or capitalise when lacking authoritative guidance
Result:	Professionals spent more time searching for supporting cases, and this confirmation bias is correlated with probability assessment and rec.

Table 1 (cont): Exemplars of Prior Literature Investigating Client Advocacy in a Tax Setting*Kadous and Magro (2001)*

Advocacy Scale:	Davis & Mason (1994)
Audit / Tax:	Tax
Students / Professionals:	Practitioners (mean 12 years exp.)
IVs:	Practice Risk (high vs. low) Outcome Information [Absent, Present (positive), Present (negative)]
DVs:	Strength of Recommendation for aggressive position
Case:	Used the Accumulated Earnings Tax
Result:	Tax professionals process outcome information difference high vs. low risk clients. Less likely to recommend aggressive return if high practice risk. Advocacy scale included as covariate but did not explain variance so subsequently excluded

Kahle and White (2004)

Advocacy Scale:	None
Audit / Tax:	Tax
Students / Professionals:	Professionals (mean 7 years)
IVs:	Evidence Direction, Client Preference (manipulated)
DVs:	Magnitude of Belief Revision
Case:	Worker classification of contractor vs. employee
Result:	Test of Belief Adjustment Model. More belief revision if supportive of client preference.

Pinsker et al. (2009)

Advocacy Scale:	Revised Mason and Levy [M&L] (2001) to 5 questions for audit or tax
Audit / Tax:	Both
Students / Professionals:	Professionals
IVs:	Professional job as auditor or tax
DVs:	Disclose lawsuit or not; Deduct salary or Not
Case:	Disclose probable or reasonable lawsuit; Salary/dividend (Johnson 1993)
Result:	Auditors more sceptical on tax and audit decisions; Greater correlation of advocacy and DV for auditors but more sceptical so implies conservative decision was more likely to disclose. Means on DV decisions not given. Professional role affects judgement

Bobek et al. (2010)

Advocacy Scale:	Used Mason and Levy [M&L] (2001) 9 question scale
Audit / Tax:	Tax
Students / Professionals:	Professionals
IVs:	Low/High risk clients; Low/High Client importance
DVs:	Probability of IRS approval; Advice to client

Table 1 (cont): Exemplars of Prior Literature Investigating Client Advocacy in a Tax Setting*Bobek et al. (2010) (cont)*

Case:	Hobby Loss
Result:	Client-specific characteristics affect advocacy which affects judgements Decreased advocacy if risky client High-importance client increases weight of evidence

Roberts (2010)

Advocacy Scale:	None
Audit / Tax:	Both
Students / Professionals:	Professionals (AICPA mostly small firms)
IVs:	Audit or tax decision and within-subject 3 risk measures: Probability of 3rd party oversight/Probability of losing client/strong-weak NOI
DVs:	Capitalise or expense for average of 8 cases = Prof Judgement scale
Case:	Classify as expense or capitalise it when lacking authoritative guidance
Result:	No difference in tax and audit judgement and concludes that it is equally biased toward client preference for expensing it on tax return and capitalising it on financial statement.

The studies in Table 1 are exemplars and are not an exhaustive set of prior client advocacy studies in accounting, and the article now focuses on six specific client advocacy studies in a capital gains versus ordinary income tax decision setting.

3. THE DISTINCTION BETWEEN CAPITAL GAINS AND ORDINARY INCOME

This section reports on several studies that have all used a tax case originally developed by Cloyd and Spilker (1999). As originally used, a client taxpayer (Jim Hunt) purchased land which he had intended to sell on, but was unable to. With a zoning change, he subdivided the land into 110 lots, sold six of them, and then sold the remaining 104 lots to a residential builder. The facts of this scenario are described in ‘Client Facts’ in the Appendix.

The case can be set to contain a clear client preference for Investor status (taxing as capital gains), but the facts suggest Dealer status with the land being ‘stock in trade’ (inventory), so any gain is taxed as ordinary income. McClelland (2017) notes that over the period 1954–2014 the incentive to report capital gains instead of taxable income if a gain is made on sale has varied as the difference between maximum marginal income tax rates has either varied widely (or aligned closely) from maximum tax rates on capital gains. Currently, at the federal level, the maximum long-term capital gains tax rate is 20% and the maximum marginal income tax rate for individuals is 37%.

If the underlying land is deemed not to be ‘stock in trade’ (inventory) then the taxpayer is classified as an Investor, and any gain or loss is capital. Over time, and with many precedents, the courts have considered several factors (shown in the Appendix) that contribute to classifying the taxpayers as ‘Investor’ or ‘Dealer’ status, although no one factor is determinative.

In an experimental setting of the case, researchers can adjust the cost (basis) of the land, but without altering any other client facts, and therefore a loss from the land sale can result. Ordinary losses can be deducted in a tax return without limit, but capital losses are limited to \$3,000 per year. Accordingly, if a loss results, then the client taxpayer would prefer to be classed as a Dealer (and not an Investor), a mirror reversal of the preferred status if a gain had been realised.

Cloyd and Spilker (1999) use the Jim Hunt case to report the results of two studies that examine causes and effects of confirmation bias in tax information search. They find that the 66 tax professionals' information searches emphasised cases with conclusions consistent with the client's desired outcome (i.e., positive cases) over cases inconsistent with the client's desired outcome (i.e., negative cases), despite the fact that positive cases were no more similar to the client's facts.

In their study, overall responses showed that 58% perceived the courts would rule Jim Hunt was an investor; however, this was split between the manipulated 'investor' group with a mean of 66% vs. the 'dealer' group, with a mean of 49% (significant at $p < 0.01$). Cloyd and Spilker note (1999, p. 310) that the actual likelihood of a court finding the taxpayer is an investor (or dealer) should not vary by client preference condition as the case's facts were identical between the two groups (except for the original purchase price that was experimentally manipulated).

Before Cloyd and Spilker embarked on their second study, they had a panel of four real estate experts independently evaluate the case facts (a partner, a principal, and two senior managers). The expert panel indicated there was a 13.75% chance of courts concluding the client was an investor. In the second study, Cloyd and Spilker manipulated client preference to be an 'investor'. For the 41 tax professionals who participated, the mean assessment of court support for Investor status was 48%. While this is certainly lower than the manipulated 'investor' group in Study 1 (66%), suggesting they were sensitive to the weaker client facts, 18 of the 39 participants still indicated they would likely recommend investor treatment.

Cloyd and Spilker (1999) has been extended by at least five studies, which are now briefly discussed. Cloyd and Spilker (2000) used a similar case to compare the information search behaviours of law students and accounting students and provide evidence that the nature of academic training influences the magnitude to which student proxies of tax professionals are subject to confirmation bias. They find that law students are less prone to confirmation bias when conducting research to resolve an ambiguous tax issue, and suggest that this has implications for professional education and practice.

Since Cloyd and Spilker's (2000) study comparing law and accounting students, legal scholars have begun to study tax avoidance from a legal perspective, such as Bogenschneider (2016) who suggests tax planners search out tax arrangements with determinate legal outcomes in favour of clients. Field (2017) also notes that legal advisers need to identify their own personal philosophy of tax lawyering, where there is no one 'right' approach.

Barrick, Cloyd and Spilker (2004) examine the effects of confirmation bias from staff-level tax accountants' research on their supervisors' initial assessments and recommendations made during the review process for tax research memoranda. The 55 professionals with supervisory experience read a client scenario in which both accuracy and advocacy objectives could not be met because the client-preferred position had no

‘realistic possibility’ of a successful defence on its merits. Barrick et al. (2004) find that when either a biased or an unbiased memorandum did not meet an accuracy objective, supervisors were more persuaded by memoranda that offered encouragement that their advocacy objective might be met than by those that did not. Their results also showed that supervisors tried to remedy confirmation bias by asking more rework from staff who prepared biased memos, than from staff who prepared unbiased memos.

Kadous, Magro and Spilker (2008) used 63 tax professionals to examine whether high practice risk (i.e., exposure to monetary and non-monetary costs of making inappropriate recommendations) reduces client advocacy effects. They report that when professionals face a client with high (vs. low) practice risk, their participants performed a more balanced search, reducing the indirect impact of client preference on judgements. Specifically, participants’ assessment of the probability of a court finding Investor status was: (1) Dealer-status preferred – 28% (low risk client) vs. 51% (high risk client); (2) Investor-status preferred – 69% (low risk client) vs. 53% (high risk client). Recall that earlier Cloyd and Spilker (1999) reported average means for the Dealer group of 49% vs. 66% for the Investor group. Kadous et al. (2008) thus replicate Cloyd and Spilker’s client advocacy results for low risk clients, but their findings demonstrate that high practice risk can serve as a boundary condition on confirmation bias and on client preference effects.

Cloyd, Spilker and Wood (2012) is similar to Barrick et al. (2004) but they focus on whether staff accountants’ confirmation bias in information search is influenced by their supervisor’s initial belief concerning whether the client-preferred tax position can or cannot be supported. Using 83 experienced tax professionals they experimentally manipulated the client’s preferred tax position and the supervisor’s initial belief in a 2×2 between-subjects design and find that confirmation bias is positively associated with subordinates’ assessments of the evidential support for the client-preferred position and that evidential support assessments are positively associated with the strength of recommendations for the client-preferred position.

Spilker et al. (2016) compare the client advocacy attitudes of US tax professionals who perform US tax compliance work with Indian tax professionals who perform US tax compliance work offshore. They find that experienced US tax professionals have stronger client advocacy attitudes than experienced Indian tax professionals, although there was no significant difference between inexperienced US and Indian tax professionals. In further comparisons, they show that client advocacy attitudes of experienced US tax professionals are stronger than those of inexperienced US tax professionals, whereas the client advocacy attitudes of experienced Indian tax professionals were not different from those of inexperienced Indian tax professionals. Spilker et al. (2016) report significant correlations between the client advocacy attitudes of experienced US tax professionals and their recommendations of the client-preferred position, whereas this link was insignificant for experienced Indian tax professionals.

In sum, the research studies relying on the Jim Hunt case have a collective significance. The research cited in this section has largely held the facts as shown in the Appendix constant, and as extensions have been published, more insight into client advocacy effects has been obtained. For instance, initial work showed the tendency of tax professionals to act as client advocates, possibly to the point of being inappropriately aggressive, given Cloyd and Spilker’s (1999) expert panel indicating the case was conservative and only indicating a 14% likelihood of the facts supporting an Investor status finding by a court. More recent work suggests that the inherent practice risk

associated with a specific client can mitigate client advocacy measures. Finally, there is also some support that biased assessments given by either a subordinate (e.g., a staff accountant) or a supervisor may influence client advocacy measures such as recommended treatment as a dealer or investor, and assessments of the likelihood that a court will support a finding of Investor status.

4. DISCUSSION AND CONCLUDING REMARKS

Tax practitioners' judgements and decisions have been extensively researched in the US (for an early comprehensive review, see Roberts, 1998). A bias toward client advocacy on the part of professional accountants was demonstrated almost three decades ago by Ayres, Jackson and Hite (1989), although since then actual findings have been mixed (Bobek et al., 2010). This article continues to explore the tension created between professionals' responsibility to act as a client advocate together with their responsibility for accuracy (i.e., acting 'within the bounds of the law').

Cloyd and Spilker (1999) rely on the disparate tax treatment of land sales as either ordinary or as capital gains, under the US tax code. In their 'Jim Hunt' tax case, treatment groups were experimentally manipulated (by adjusting the basis of the land in the case) to have a clear client preference, even when the facts of the case and court precedents suggested a particular outcome, and hence recommended treatment. Following on from Cloyd and Spilker (1999), a further five studies show in aggregate that this client advocacy bias is persistent across time and samples, and applicable to both professionals at the staff accountant level and those in supervisory positions. The bias does, however, seem to be moderated by the practice risk associated with the particular client.

Understanding the causes of a tax professional's bias of client advocacy can be attributed to specific individual attributes of both the client and the professional, as well as situational environmental characteristics (Roberts, 1998). Fogarty and Jones (2014) interviewed 29 tax professionals, who essentially confirm that tax work is professional practice within an ethical environment. Yet, individual and organisational incentives (including the continuation of client fee revenues, firm reputation, satisfying partners' expectations and maintaining professional ethical standards) are always in the mind of tax professionals (Suddaby, Gendron & Lam, 2009).

Several recent papers such as Fogarty and Jones (2014), Mulligan and Oats (2016) and Suddaby et al. (2009) provide a 'big picture' approach to 'tax practice at the coalface'. Such research on tax planning links to the growing interest in tax avoidance throughout the world, particularly how it interfaces with individuals' decisions, society and morality (Hashimzade & Epifantseva, 2017).

This article highlights studies in client advocacy that use an experimental design that allows researchers to use a controlled environment to explore cause and effect, and to extend and replicate prior work over time, similar to the concluding remarks of Falsetta et al. (2013) in relation to capital gains tax policy research. Of course, using experimental approaches to study client advocacy effects especially using the same experimental scenario (e.g., the Jim Hunt case) is obviously constrained to the one jurisdiction (i.e., the US for this article), although the classification of real estate gains as ordinary income or as capital is a common issue over many jurisdictions.

Finally, at a broad level, a client advocacy bias is one feature that policy-makers and tax administrations in general, may wish to take into account when considering the regulation of the tax profession. The strategic approach of the IRS to tax agents has been highlighted as a problem by the US National Taxpayer Advocate in prior annual reports, and the IRS currently relies heavily on tax preparers, with the possible creation of a ‘pay to play’ system of personalised tax advice (National Taxpayer Advocate, 2016). Apart from the US (Soled & Thomas, 2017), the regulation of tax preparers has also been subject to recent change in other countries, notably Australia (Walpole & Salter, 2014).

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APPENDIX: TAX REPORTING CASE BASED ON CLOYD AND SPILKER (1999)**A TAX REPORTING DECISION**

Assume a client, Jim Hunt, asks you whether he must classify some land sales as ordinary or capital. He believes it is an ambiguous tax issue and has asked for your opinion on how it should be reported. Once you have read the scenario, please respond to the follow-up questions regarding your beliefs.

Jim Hunt is the CEO of Delta Electronics, Inc., an important corporate client for whom we have done audit and tax work for many years. You are in the process of preparing Jim's current income tax return and need to determine whether a \$500,000 gain he realized on sales of real estate should be treated as ordinary or capital. I.R.C. Section 1221 defines a "capital asset" by exception. The relevant exception in this case is provided in Section 1221(1), which provides that "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" is NOT a capital asset.

If Jim's real estate is considered a Section 1221(1) asset (i.e., Jim is viewed as a "dealer"), then the gain will be treated as ordinary. In contrast, if the property is not considered a Section 1221(1) asset (i.e., Jim is viewed as an "investor"), then the gain will be treated as a long-term capital gain. Obviously, Jim would prefer to be treated as an investor with respect to this property so that his gain will be taxed at the lower, alternative rate for long-term capital gains. Jim's marginal tax rate on ordinary income is in the highest bracket, approximately 40%.

Summary of Factors

Factors considered by the courts as indicative of dealer vs. investor status are summarized below. Courts have stressed that no one factor is determinative and that each case must be considered on its own facts. Moreover, these factors have not always been applied on a consistent basis.

Remember that whether an asset is considered a Section 1221(1) asset affects the character of the taxpayer's income or loss as follows:

Section 1221(1) asset: → Dealer → Ordinary Income or Loss

NOT Section 1221 (1) asset: → Investor → Capital Gain or Loss

NUMBER AND FREQUENCY OF SALES. Generally, the greater the number of sales, the more frequent the sales, and the more continuity in sales activities, the greater the likelihood that the taxpayer will be considered a dealer.

DEVELOPMENT ACTIVITIES. Generally, the greater the development activities, the more likely the taxpayer will be considered a dealer.

SALES ACTIVITIES. Generally, the more the taxpayer advertises, solicits customers, lists the property and otherwise promotes the sale of the property, the more likely the taxpayer will be considered a dealer.

PURPOSE OF ACQUISITION. Generally, the purpose for which the property was originally acquired AND the purpose for which the property was held at the time of its disposition are important in deciding whether the taxpayer is a dealer or investor.

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Client Facts: On June 1, 2009, Jim Hunt purchased 40 acres of undeveloped land for \$1.3 million. At the time, Jim was confident that the land would appreciate in value due to the planned construction of a regional shopping mall nearby. The land was already zoned for “retail/commercial” use and he hoped to sell the land in a single transaction after construction on the shopping mall began. Unfortunately, plans for the shopping mall fell through in early 2010, and Jim was unable to find a buyer for his property. He began placing advertisements in the local paper once a month, and he put on the property a “for sale” sign that was visible from the highway. Despite Jim’s sales efforts, he was unable to locate a buyer.

In June 2012, Jim decided that the property would be much more marketable if he subdivided the land into individual lots for residential development. Jim solicited the help of a friend (a real estate developer), part time, to assist him in the process of developing and selling the land, to be referred to as “Mountain View Estates.” Jim hired an engineer to plat the property into 110 individual lots and to determine the location of streets, etc. Jim submitted the engineer’s drawings to the City Planning Board along with his application to have the property’s zoning changed to “single family residential.” The zoning change was approved in September 2012. Jim incurred engineering and legal costs of \$30,000 in this process.

In October 2012, Jim hired a contractor to build the necessary streets, curbs and drainage systems, and to connect the property to the city’s utility systems (e.g., water, sewer, and electricity). This development was completed by June 2013 at a total cost of \$780,000.

Between August and October 2013, Jim sold six developed lots from the Mountain View Estates development for a total of \$150,000. In October, a residential builder offered \$2.5 million for the remaining 104 lots. Jim accepted the offer and ceased other sales activities. The sale was completed on November 1, 2013. After accounting for the property improvements and selling expenses, Jim had an overall gain of \$500,000 computed as follows:

Bulk sale proceeds	\$2,500,000	
Sale of six individual lots	150,000	
Less: Selling expenses	(10,000)	
Compensation for friend	<u>(30,000)</u>	
Total amount realized		\$2,610,000
Original basis	\$1,300,000	
Engineering & Legal Costs	30,000	
Development costs	<u>780,000</u>	
Adjusted basis		<u>\$2,110,000</u>
Realized gain		<u>\$ 500,000</u>

In January 2013, having become knowledgeable about residential land development, Jim decided to purchase and subdivide an additional 60 acres adjacent to Mountain View Estates. An engineer was hired to plat the land into 200 residential lots, known as “Mountain View Estates, Phase II” and the plans were approved by the City Planning Board in April 2013. In July 2013, Jim hired the same contractor who did the development work on Mountain View Estates to do similar work on Mountain View Estates, Phase II. The contractor constructed the streets, curbs and drainage systems for the Phase II development. The contractor also connected the Phase II lots to the city’s utility system. Although development of the Phase II lots was nearly complete by December 2013, none of the Phase II lots had been sold as of the end of 2013. Jim plans to begin selling the Phase II lots to individual buyers during 2014.