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# The Failure of Section 1237 in Dealing with Sales of Subdivided Realty

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Land sales, one of the most common forms of capital transactions, are exceeded in dollar volume only by the sale of corporate stock.[1] Unlike stockholders, however, landowners have available neither the "trader" classification under section 1221(1) of the Internal Revenue Code[2] nor any other statutory means of recording their assets as "investments."[3] Consequently, they often are unable to take advantage of the preferential capital gains rates at which gains realized from the sale of their land would otherwise be taxed. Thus courts, in seeking to protect landowners who might fairly be regarded as investors, have had to develop a convoluted tax treatment of land transactions.

The central tax problem in real estate sales is whether property sold by the taxpayer will be treated as an investment

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1. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME—1962, SUPPLEMENTAL REPORT, SALES OF CAPITAL ASSETS REPORTED ON INDIVIDUAL INCOME TAX RETURNS 5 (1966) (The 1972 statistics are not as yet available).

2. Under section 1221(1), a stockholder, if not a mere passive "investor," may still be classified as a "trader" rather than a "dealer" so that his shares may be regarded as capital assets. A landowner may only be an "investor" or a "dealer." *Compare* Commissioner v. Burnett, 118 F.2d 659 (5th Cir. 1941) (taxpayer characterized as a trader in securities), *with* Black v. Commissioner, 45 B.T.A. 204 (1941) (trader status rejected as inapplicable to real estate transactions).

In George R. Kemon, 16 T.C. 1026 (1951), the court observed that both dealers and traders in securities purchase stock with the expectation of selling it at a profit. The court concluded that a dealer derives his profit from selling his stock to a subsequent purchaser at a price greater than his original cost. The profit thus represents remuneration for the efforts he has expended in performing this merchandising function. *Id.* at 1033. On the other hand, the court characterized a trader in securities as a person who realizes his profit not from any merchandising function that he performs, but rather from merely disposing of his securities after they have appreciated in value as a consequence of the natural forces of the market. *Id.* at 1032.

3. Even a dealer in securities may secure nondealer treatment by designating specific securities as held for investment so that at disposition they will be considered capital assets. INT. REV. CODE OF 1954, § 1236. All statutory references are to the Internal Revenue Code of 1954, as amended, unless otherwise specified.

or as inventory. If the taxpayer is regarded as holding the property as an "investor," the resulting gain on its sale will be taxed as capital gains;[4] but if he is regarded as holding inventory property "primarily for sale to customers in the ordinary course of his trade or business," he will be treated as a "dealer,"[5] and the resulting gain will be taxed as ordinary income.[6]

To realize the maximum return from his investment, an owner of real estate often must subdivide[7] his property before selling it; but, by engaging in such activity, he begins to move toward dealer status[8] and higher tax rates.[9] Because investor

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4. *Id.* § 1201.

5. A dealer in real property is a person who holds real property as inventory or stock in trade, or as property held for sale to customers in the ordinary course of trade or business.

H.R. REP. No. 1337, 83d Cong., 2d Sess. 282 (1954).

While not appearing in the statutes, the terms "dealer" and "investor" are often used to distinguish a taxpayer who holds property primarily for sale to customers in the ordinary course of his trade or business from one who does not—a critical question when dealing with the statutory language of sections 1221(1), 1231, or 1237 of the Code.

6. *See* INT. REV. CODE OF 1954, § 61(a)(3).

7. Ordinarily, subdivision of real estate involves planning, engineering, appearing before local governing bodies, and filing a subdivision map. *See* D. HAGMAN, URBAN PLANNING AND LAND DEVELOPMENT CONTROL LAW 252 (1971).

8. The court in Boomhower v. United States, 74 F. Supp. 997 (N.D. Iowa 1947) (decided under sections 22 and 117 of the 1939 Code), recognized that

> [t]he line between the situation where a taxpayer is merely holding property for sale and the situation where his activities in connection with the sale of property constitutes the doing of business under the tax statutes is frequently difficult to draw.

*Id.* at 1005. From its examination of the relevant case law, however, the court discerned an appropriate distinction between dealers and investors in real estate:

> It would seem that to carry on a business conveys the idea of progression, continuity and sustained and normally incident activity, and does not mean the performance of single disconnected acts. Continuity, in the case of a real estate enterprise, would hence seem to connote that characteristic of the business as a "going concern," as distinguished from sporadic activity lacking the studied purpose or continuing objective of the entrepreneur-realtor. The occasional purchase and resale of land by an investor speculating on a rise in real estate values, does not, in the absence of other circumstances, give rise to the status of his being a dealer in real estate. . . . On the other hand, [a] taxpayer who through his agent was actively engaged in subdivision, improvement, and selling work during the tax years in question for the obvious reason of obtaining a larger profit [has been] held to be in the business of selling real estate. Such management activity by [a] taxpayer, his agents, or servants, is generally held to supply the continuity requisite for a business . . . .

*Id.* at 1002-03.

9. Assume, for example, that an individual taxpayer in the 70 percent bracket sells real property and that he realizes and recognizes a gain

status and dealer status overlap, many cases have arisen in which courts have attempted to determine whether property has been held as an investment or as inventory.[10]

Until 1954, the only statutory guidance available to courts facing this problem was that of section 117(a)(1) of the 1939 Code (now section 1221(1)), which excluded from capital asset treatment "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[11] Drawing from this feeble assistance by Congress, the courts produced a confusing and inconsistent body of case law.[12] Then, in 1954 Congress enacted section 1237,[13] which contains detailed rules regarding tax treatment of land subdivided for purposes of sale. This section was hailed as an important and necessary

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of $50,000 in the year of sale. If the property sold is treated as a capital asset and if it has been held for over six months, tax liability will range from $12,500 under section 1202 of the Code to $17,500 under section 1201. On the other hand, classification of the taxpayer as a dealer will result in ordinary income treatment and tax liability under section 1 of $35,000.

10. *See* cases cited in notes 33 and 36 *infra.*

11. INT. REV. CODE OF 1939, § 117(a)(1), 53 Stat. 50 (now INT. REV. CODE OF 1954, § 1221(1)).

12. *See* Primmer, *Sales of Subdivided Realty—Capital Gains v. Ordinary Income*, 19 Sw. L.J. 116 (1965).

13. (a) GENERAL. Any lot or parcel which is part of a tract of real property in the hands of a taxpayer other than a corporation shall not be deemed to be held primarily for sale to customers in the ordinary course of trade or business at the time of sale solely because of the taxpayer having subdivided such tract for purposes of sale or because of any activity incident to such subdivision or sale, if—

(1) such tract, or any lot or parcel thereof, had not previously been held by such taxpayer primarily for sale to customers in the ordinary course of trade or business (unless such tract at such previous time would have been covered by this section) and, in the same taxable year in which the sale occurs, such taxpayer does not so hold any other real property; and

(2) no substantial improvement that substantially enhances the value of the lot or parcel sold is made by the taxpayer on such tract while held by the taxpayer or is made pursuant to a contract of sale entered into between the taxpayer and the buyer. For purposes of this paragraph, an improvement shall be deemed to be made by the taxpayer if such improvement was made by—

(A) the taxpayer or members of his family (as defined in section 267(c)(4)), by a corporation controlled by the taxpayer, or by a partnership which included the taxpayer as a partner; or

(B) a lessee, but only if the improvement constitutes income to the taxpayer; or

(C) Federal, State, or local government, or political subdivision thereof, but only if the improvement constitutes an addition to basis for the taxpayer; and

(3) such lot or parcel, except in the case of real property acquired by inheritance or devise, is held by the taxpayer for a period of 5 years.

addition to the Code, a statute that would provide taxpayers with proper guideposts that they could follow without fear of becoming involved in litigation with the Internal Revenue Service

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(b) SPECIAL RULES FOR APPLICATION OF SECTION.

(1) GAINS. If more than 5 lots or parcels contained in the same tract of real property are sold or exchanged, gain from any sale or exchange (which occurs in or after the taxable year in which the sixth lot or parcel is sold or exchanged) of any lot or parcel which comes within the provisions of paragraphs (1), (2) and (3) of subsection (a) of this section shall be deemed to be gain from the sale of property held primarily for sale to customers in the ordinary course of the trade or business to the extent of 5 percent of the selling price.

(2) EXPENDITURES OF SALE. For the purpose of computing gain under paragraph (1) of this subsection, expenditures incurred in connection with the sale or exchange of any lot or parcel shall neither be allowed as a deduction in computing taxable income, nor treated as reducing the amount realized on such sale or exchange; but so much of such expenditures as does not exceed the portion of gain deemed under paragraph (1) of this subsection to be gain from the sale of property held primarily for sale to customers in the ordinary course of trade or business shall be so allowed as a deduction, and the remainder, if any, shall be treated as reducing the amount realized on such sale or exchange.

(3) NECESSARY IMPROVEMENTS. No improvement shall be deemed a substantial improvement for purposes of subsection (a) if the lot or parcel is held by the taxpayer for a period of 10 years and if—

(A) such improvement is the building or installation of water, sewer, or drainage facilities or roads (if such improvement would except for this paragraph constitute a substantial improvement);

(B) it is shown to the satisfaction of the Secretary or his delegate that the lot or parcel, the value of which was substantially enhanced by such improvement, would not have been marketable at the prevailing local price for similar building sites without such improvement; and

(C) the taxpayer elects, in accordance with regulations prescribed by the Secretary or his delegate, to make no adjustment to basis of the lot or parcel, or of any other property owned by the taxpayer, on account of the expenditures for such improvements. Such election shall not make any item deductible which would not otherwise be deductible.

(c) TRACT DEFINED. For purposes of this section, the term "tract of real property" means a single piece of real property, except that 2 or more pieces of real property shall be considered a tract if at any time they were contiguous in the hands of the taxpayer or if they would be contiguous except for the interposition of a road, street, railroad, stream, or similar property. If, following the sale or exchange of any lot or parcel from a tract of real property, no further sales or exchanges of any other lots or parcels from the remainder of such tract are made for a period of 5 years, such remainder shall be deemed a tract.

(d) EFFECTIVE DATE. This section shall apply only with respect to sales of property occurring after December 31, 1953, except that, for purposes of subsection (c) (defining tract of real property) and for determining the number of sales under paragraph (1) of subsection (b), all sales of lots and parcels from any tract of real property during the period of 5 years before December 31, 1953, shall be taken into account, except as provided in subsection (c).

INT. REV. CODE OF 1954, § 1237.

(IRS).[14] Disappointingly, the statute has failed to live up to those expectations.

## I. GENERAL APPLICABILITY OF SECTION 1237

### A. KEY LANGUAGE

To qualify for favorable treatment of gains from the sale of subdivided realty under section 1237, the taxpayer[15] must satisfy three principal conditions: (1) he must not have previously held the subject property for sale to customers in the ordinary course of business; moreover, during the year of sale he must not so hold any other property;[16] (2) he must have held the property for at least five years unless he acquired it by inheritance or devise;[17] and (3) he must not have made any "substantial improvements" to the property that have "substantially enhanced" the value of the lots sold.[18]

If a taxpayer satisfies these conditions, land that he sells will be deemed *not* to have been "held primarily for sale to customers

14. *See, e.g.*, Weithorn, *Subdivisions of Real Estate—"Dealer" v. "Investor" Problem*, 11 TAX L. REV. 157, 173 (1956).

15. Until 1971, any "taxpayer other than a corporation" was eligible for the benefits of section 1237. INT. REV. CODE *6 1954, § 1237(a). While this might have been taken to imply that a subdividing corporation automatically becomes a dealer, nothing in the legislative history suggests that Congress intended such a result. Moreover, in amending this language in 1971, Congress specified certain circumstances under which a lot or parcel of real property that is sold or exchanged by a corporation is not to be treated as property held primarily for sale to customers in the ordinary course of trade or business. Generally, a corporation can qualify for capital gains treatment under section 1237 if it holds land for 25 years before sale, if it acquired such property through a lien foreclosure prior to 1934, and, with certain limited exceptions, if it acquires no additional property after 1956. Property can be acquired after 1956 to fill gaps in previously acquired property, to adjust boundaries, or to facilitate the installation of streets, utilities, and other public facilities, or if the property is a reacquisition of property previously owned by the corporation. Property acquired prior to 1957 in the near vicinity of qualified pre-1934 property will not, if sold, disqualify the corporation from capital gains treatment. Such treatment will be denied to a corporation, however, if any stockholder is directly or indirectly a dealer in real property. Gain from the sale or exchange of any of this property is deemed to be gain from the sale of property held primarily for sale to customers in the ordinary course of trade or business to the extent of five percent of the selling price. 26 U.S.C.A. §§ 1237(a), (b)(3) (Supp. 1976), *amending* INT. REV. CODE OF 1954, § 1237(a).

16. INT. REV. CODE OF 1954, § 1237(a)(1).

17. *Id.* § 1237(a)(3). If the taxpayer inherited the property, no five-year holding period is required for purposes of section 1237. Treas. Reg. § 1.1237-1(d)(2) (1957).

18. INT. REV. CODE OF 1954, § 1237(a)(2).

in the ordinary course of trade or business."[19] Instead, the property will be treated as a "capital asset" under section 1221, and the gain realized by a taxpayer on its sale or exchange will be taxed as capital gain[20] rather than as ordinary income.[21]

Assuming that the phrase "primarily for sale to customers in the ordinary course of [his] trade or business"[22] means the same thing in both section 1221(1) and section 1237,[23] the two statutes overlap. A question thus arises as to which section should first be applied when characterizing gain realized from the sale of subdivided realty. Consistent with the suggestion that section 1237 is the appropriate starting point,[24] the Court of Appeals for the Second Circuit in *Gault v. Commissioner*[25] looked first to that section, but concluded that since the taxpayer had failed to satisfy its conditions, it afforded him no relief. The court observed, however, that section 1237 was not the exclusive route to capital gains treatment and proceeded to resolve the case on the basis of the traditional "investor" versus "dealer" distinction under section 1221(1).[26]

On the other hand, the Tax Court has looked first to section 1221(1); only after resolving that under that section the taxpayer is a dealer has it gone on to determine whether he qualifies for relief under section 1237.[27] The regulations promulgated under

19. *Id.* § 1237(a).

20. *Id.* § 1201. The taxpayer must hold the asset for more than six months in order to qualify for the preferential rates afforded long-term capital gains. *Id.* § 1223.

21. *Id.* § 61(a)(3). "Capital asset" is defined to exclude "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." *Id.* § 1221(1).

22. The word "his" appears in section 1221(1) of the 1954 Code but is omitted from the corresponding phrases in subsections (a) and (a)(1) of section 1237.

23. One may pause momentarily over whether the phrase "primarily for sale to customers" necessarily means the same thing under both sections. The phrase arises in a somewhat different context in section 1237, which contains no specific reference to section 1221(1). Section 1237 is directed specifically to real property while section 1221(1) covers all types of property; capital asset treatment under 1221(1) ordinarily produces only capital gain while such treatment under 1237 may produce a combination of capital gain and ordinary income. *See* text accompanying notes 79-92 *infra*.

24. Boughner, *Getting Capital Gain Treatment on Sale of Land—With or Without Section 1237*, 25 J. TAX. 172 (1966).

25. 332 F.2d 94 (2d Cir. 1965).

26. *Id.* at 97. The court held that the taxpayer was a dealer.

27. *See* Estate of Peter Finder, 37 T.C. 411 (1961); Gordy v. Commissioner, 36 T.C. 855 (1961). *But see* Robert W. Pointer, 48 T.C. 906 (1967), *aff'd on other grounds*, 419 F.2d 213 (9th Cir. 1969).

section 1237 also reflect this approach.[28] In any event, the starting point makes a difference only if, in a particular case, *both* sections are satisfied. Then, section 1221(1) would provide complete capital gains treatment, while section 1237 would reserve a small portion of the gain for taxation at ordinary rates.[29]

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28. *See* Treas. Reg. § 1.1237-1(a)(4)(i) (1957).

29. Under section 1237(b)(1) of the Code, gain from any sale of the property occurring in or after the taxable year in which the sixth sale is made is taxable as ordinary income to the extent of five percent of the selling price. *See* text accompanying notes 79-92 *infra.*

Conclusive resolution of which section is the starting point is unlikely since it is not clear whether Congress originally intended section 1237 to apply mandatorily to a taxpayer who meets all of its requirements. Since section 1237 is not an elective provision, this possibility was at least left open. Moreover, the statutory language is of a mandatory nature, with subsection (a) providing that "[a]ny lot or parcel . . . *shall not* be deemed to be held primarily for sale to customers . . . ." (Emphasis added.) Early reaction to the section was that it was, in fact, a mandatory provision. *See* Weithorn, *Subdivisions of Real Estate—"Dealer" v. "Investor" Problem,* 11 TAX. L. REV. 157, 173 (1956). If this were indeed the case, it would then follow that the taxpayer who meets all of the requirements of section 1237 is automatically subject to the section, even if he does not desire such a result. The Commissioner, however, has not treated section 1237 as mandatory, *see* Treas. Reg. § 1.1237-1(a)(4)(i) (1957). On the other hand, if it were treated as mandatory, its impact could produce questionable results in the following areas: (1) ordinary income under the five percent rule, (2) overlap with section 1231, and (3) characterization of losses.

*Ordinary Income Under the Five Percent Rule.* If a taxpayer, intentionally or otherwise, fulfills all of the requirements of section 1237 but sells more than five lots, up to five percent of his gain could be treated as ordinary income. *See* text accompanying notes 79-92 *infra.* Under section 1221(1), however, the same taxpayer might be entitled to full capital gain treatment simply by avoiding classification as a dealer. *See* notes 31-33 *infra* and accompanying text. But if the Commissioner took the position that section 1237 is mandatory, he could claim that the taxpayer owes the higher tax that might result under that section.

*Overlap with Section 1231.* Property subdivided and sold by the taxpayer that is not "held primarily for sale to customers," but that is "used in his trade or business," is not a capital asset under section 1221(1); it may be subject to section 1231, however. *See* INT. REV. CODE OF 1954, § 1231(b). Under the special treatment of that section, the taxpayer would be entitled to long-term capital gains treatment of the full amount of his gain from the sale of a 1231 asset. *See id.* § 1231(a). If section 1237 were mandatory, a portion of the selling price could be considered "gain from the sale of property held primarily for sale to customers in the ordinary course of trade or business" provided the five percent rule of that section was applicable. *See* text accompanying notes 79-86 *infra.* Since such property is excluded from section 1231, INT. REV. CODE OF 1954, § 1231(b)(1)(A), the portion of 1231 property so classified would arguably not be afforded capital gains treatment under that section. The Regulations promulgated under section 1237, however, provide that if property is used in the taxpayer's trade or business, subdivision

B. BACKGROUND AND PURPOSE OF SECTION 1237

Section 1237 represents the first attempt by Congress to specifically distinguish investors from dealers in real estate. The distinction is important because of the substantially higher rates at which dealers are taxed.[30]

Before the enactment of section 1237, courts had frequently been asked to determine the point at which the activities of a taxpayer resulted in a change in his status from investor to dealer. Under the controlling statute, now section 1221(1),[31] real property could not have been deemed an investment if it had been held by the taxpayer primarily for sale to customers in the ordinary course of business. Courts treated this question as one of fact, setting forth various evidentiary tests by which it could be resolved.[32] No single factor was viewed as determinative. Rather, the courts considered the relationship throughout the relevant time period of (1) the purpose of

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activities are to be disregarded and gain from its sale is to be treated under section 1231. Treas. Reg. § 1.1237.1(f) (1957).

*Characterization of Losses.* Under both sections 1221(1) and 1237, an asset apparently is characterized as capital or as held primarily for sale to customers in the ordinary course of business regardless of whether a particular transaction resulted in a gain or a loss. And while section 1237 makes no specific provision for losses, the mandatory language of subsection (a) certainly suggests that, provided all the 1237 requirements are met, losses realized on sales of subdivided realty would necessarily be characterized as capital losses. If this were so, and since capital losses are subject to severe limitations of deductibility, *see* INT. REV. CODE OF 1954, §§ 165(f), 1211, 1212, the taxpayer facing losses on his real estate dealings would want the parcels in question to be treated as property held primarily for sale to customers in the ordinary course of business so that he could claim ordinary loss deductions.

A taxpayer would never have to face this particular problem, however, since the regulations specifically provide that section 1237 is inapplicable to losses. *See* Treas. Reg. § 1.1237-1(a)(4)(i) (1957). Thus a taxpayer could secure capital gains treatment of the gains realized from the sale of certain lots in a subdivided tract and, at the same time, deduct the losses suffered on the sale of other lots in the same tract. But to achieve such a result, the taxpayer would have to walk a tightrope. He would first have to satisfy the statutory requirements of section 1237 to secure capital gains treatment, *see* text accompanying note 54 *infra*; then, to be able to deduct ordinary losses he must establish himself as a dealer in real estate under the dealer-investor decisions, *see* cases cited in notes 33 and 36 *infra*, relying on those subdivision activities that were permitted under section 1237. *See* text accompanying notes 40-48 *infra*.

30. *See* note 6 *supra* and accompanying text.

31. INT. REV. CODE OF 1939, § 117(a)(1), 53 Stat. 50 (now INT. REV. CODE OF 1954, § 1221(1)).

32. *See* Miller, *Tax Status of Subdivisions under the Internal Revenue Code*, 33 CHI.-KENT L. REV. 201 (1955).

acquisition, (2) the historical and recent use of the property, (3) the lapse of time between acquisition and sale, (4) improvements to the property, (5) the frequency, continuity, and substantiality of sales, (6) the activities of the taxpayer or his agent, including time expended in development and sales, (7) the primary occupation of the taxpayer, and (8) the purpose of the disposition.[33]

Inasmuch as this case-by-case approach was unpredictable, Congress sought to devise a form of statutory relief for the taxpayer.[34] The focus of congressional attention was the investor who found himself in the position of having to subdivide his land in order to liquidate it in a financially reasonable manner.[35] Under prior case law, an investor who subdivided and sold his property usually had been held, perhaps often to his surprise, to be a dealer and therefore unentitled to capital gains treatment.[36] By enacting section 1237, Congress intended to remove this "uncertainty" and "inequity."[37]

### C. Application of Section 1237 to Dealer-Investor Problems

Under both section 1221(1) and section 1237, holding real property for sale to customers in the ordinary course of business

33. *See, e.g.*, Friend v. Commissioner, 198 F.2d 285 (10th Cir. 1952); Dunlap v. Oldham Lumber Co., 178 F.2d 781 (5th Cir. 1950); Snell v. Commissioner, 97 F.2d 891 (5th Cir. 1938); Austin v. United States, 116 F. Supp. 283 (S.D. Tex. 1953); Boomhower v. United States, 74 F. Supp. 997 (N.D. Iowa 1947); W.T. Thrift, 15 T.C. 366 (1950).

34. *See* Brodsky, *Converting Ordinary Assets into Capital Assets*, N.Y.U. 13TH INST. ON FED. TAX 1173, 1178 (1955); Weithorn, *Subdivisions of Real Estate—"Dealer" v. "Investor" Problem*, 11 TAX. L. REV. 157, 165 (1956); *cf.* Mann, *Tax Consequences of Subdividing Real Estate*, 15 WASH. & LEE L. REV. 303 (1958).

35. At present, an individual who subdivides real property held for investment purposes is likely to be held a dealer and subjected to ordinary income tax rates on the entire long-term gain. However, an individual holding real property for investment may find that the only way to dispose of it at a reasonable price is to subdivide it into lots.

H.R. REP. No. 1337, 83d Cong., 2d Sess. 84 (1954).

36. *See, e.g.*, Palos Verdes Corp. v. United States, 201 F.2d 256 (9th Cir. 1952); Mauldin v. Commissioner, 195 F.2d 714 (10th Cir. 1952); McFaddin v. Commissioner, 148 F.2d 570 (5th Cir. 1945); Brown v. Commissioner, 143 F.2d 468 (5th Cir. 1944); Gruver v. Commissioner, 142 F.2d 363 (4th Cir. 1944); Oliver v. Commissioner, 138 F.2d 910 (4th Cir. 1943); Ehrman v. Commissioner, 120 F.2d 607 (9th Cir.), *cert. denied*, 314 U.S. 668 (1941).

37. Representative Reed, Chairman of the House Ways and Means Committee, indicated such an intent when he first introduced his committee's draft of the 1954 Internal Revenue Code. 100 CONG. REC. 3423 (1954).

is fatal to capital gains treatment. The relevant provisions are structured differently, however; section 1221(1) simply excludes such property from capital asset classification, while section 1237 provides that a taxpayer will not be deemed to be holding property for sale to customers "solely because"[38] he has subdivided it or engaged in certain related activities.

Section 1237 has achieved its greatest impact by allowing certain activities to be disregarded in determining whether a taxpayer is a dealer, activities that before 1954 would have made him a dealer in most cases.[39] No specific definition of these activities appears in the statute; instead, they merely are referred to as "subdividing a tract for purposes of sale" and "any activity incident to such subdivision or sale."[40] The Regulations define incidental activities as advertising, promotion, and related selling activities, including the use of sales agents.[41] Amplifying the statutory language, "solely because," the Regulations also provide that such subdividing and related activities are to be disregarded when they are the only substantial evidence that the taxpayer has ever held real property primarily for sale to customers in the ordinary course of his business.[42] Conversely, when other substantial evidence does tend to show that the taxpayer has so held real property, subdividing activities are to be considered as well.[43]

While statutory approval of subdivision and related activities seemed at first to represent a significant departure from prior case law, the Commissioner's examples of "other substantial evidence" that may disqualify the taxpayer are extremely broad; consequently, they have significantly narrowed the potential scope of section 1237. These examples include (1) selling activities by the taxpayer in connection with other property in prior years, if he had engaged at the same time in subdividing and selling activities with respect to the subject tract, (2) intention of the taxpayer in prior years or at the time of acquisition to

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38. In the Regulations, the Commissioner translates "solely" to mean "merely," stating:

> This rule is to permit taxpayers qualifying under it to sell real estate from a single tract held for investment without the income being treated as ordinary income merely because of subdividing the tract or of active efforts to sell it.

Treas. Reg. § 1.1237-1(a)(1) (1957).

39. *See* cases cited in note 36 *supra*.

40. INT. REV. CODE OF 1954, § 1237(a).

41. Treas. Reg. § 1.1237-1(a)(2)(ii) (1957).

42. *Id.* § 1.1237-1(a)(2).

43. *Id.* § 1.1237-1(a)(3).

hold the tract primarily for sale in the ordinary course of his business, (3) subdivision of other tracts in the same year, (4) holding other real property for sale to customers in the same year,[44] and (5) construction of a permanent real estate office that the taxpayer could use in selling other property.[45]

If the taxpayer has avoided all of these obstacles, the Regulations then provide a "break"[46] by excluding from "other substantial evidence" the following activities, if the taxpayer has engaged in *no more* than one of them: (1) holding a real estate dealer's license, (2) selling other real property held clearly for investment, (3) acting as a salesman for a real estate dealer, but without any financial interest in the business, and (4) merely owning other vacant real property without engaging in any selling activity with respect to it.[47] If, however, he has engaged in *more* than one of these activities, "the circumstances may or may not constitute substantial evidence that the taxpayer held real property for sale in his business, depending upon the particular facts in each case."[48]

Thus the Commissioner has taken an already narrowly drawn statute and further restricted it. The result is what appears to be an elaborate system designed not merely to limit application of the statute to "investors," but also tending to limit its application to only an obvious nondealer engaged in a one-shot transaction. To demonstrate the narrow scope of the statute and the Regulations, consider the following situations:

(1) In the first year, the taxpayer subdivides a tract, sells a few lots, and receives capital gain treatment because he satisfied the requirements of section 1237. In the second year,

44. It should be noted that this particular example is drawn directly from the statute. *See* INT. REV. CODE OF 1954, § 1237(a)(1).

45. Treas. Reg. § 1.1237-1(a)(3) (1957).

46. This is a "break" in the limited sense that permitting one of these activities provides some relief from prior case law. *Cf.* Levin, *Capital Gains or Income Tax on Real Estate Sales*, 37 BOSTON U.L. REV. 165, 202 (1957).

47. Treas. Reg. § 1.1237-1(a)(3) (1957).

48. *Id.* The Regulations clearly reflect the position that satisfaction of the requirements of section 1237 is not the exclusive means by which a taxpayer can preserve his status as an investor in real property. *Id.* § 1.1237-1(a)(4)(i); text accompanying notes 39-43 *supra*. Under the approach of treating section 1237 as evidentiary, the inquiry becomes whether there is a lack of substantial other evidence of dealership so that the court may disregard the subdivision activities in question. Once the question of substantial other evidence is resolved against the taxpayer, he would be unable to rely on section 1237 and would probably be considered a dealer under section 1221(1) case law. *See* cases cited in note 36 *supra*.

the taxpayer sells additional lots from the same tract, but also becomes a dealer with respect to property other than the subdivided tract. He loses his section 1237 qualification in the second year because in that year, the year of the subject sales, he held other real property for sale to customers in the ordinary course of business.[49]

(2) The taxpayer, a real estate dealer with wide holdings, retires and disposes of all of his property except one ranch. He leases the ranch, holds it as an investment for five years, then subdivides and sells it in compliance with the requirements of section 1237. He will lose his section 1237 qualification because the subject property was "previously held" for sale to customers.[50]

(3) A taxpayer who owns three tracts of land subdivides and sells tract *1*, complying with all of the requirements of section 1237. He also sells tract *2*, which he clearly held as an investment; he continues to passively hold vacant tract *3*. Unassuringly to the taxpayer, the Commissioner "may or may not" take the position that these circumstances constitute substantial other evidence that the taxpayer has held real property for sale to customers.[51]

(4) The taxpayer holds two separate tracts of land as investments for more than five years. Complying with all of the requirements of section 1237, he subdivides both tracts and sells all of the lots. Here the Commissioner asserts that, with respect to each tract, the activities of the taxpayer in connection with the subdivision and sale of the other tract must be considered in determining whether the subject tract has been held for sale to customers in the ordinary course of business.[52]

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49. INT. REV. CODE OF 1954, § 1237(a)(1). That the taxpayer must not hold any other real property for sale to customers in the ordinary course of business is thus an ongoing requirement.

50. *Id.* By requiring that the tract must not have been previously held for sale to customers in the ordinary course of business, this section codifies prior cases holding that the earlier intent of the taxpayer is a *factor* that must be *considered* in determining dealership status. *See* Friend v. Commissioner, 198 F.2d 285 (10th Cir. 1952); Boomhower v. United States, 74 F. Supp. 997 (N.D. Iowa 1947). In contrast to the case law, however, section 1237 fails to take into account a possible change in such intent.

51. Treas. Reg. § 1.1237-1(a)(3) (1957).

52. *Id.* The Commissioner's interpretation of section 1237(a)(1) is consistent with the relevant legislative history:

> [E]ngaging in the subdivision of other pieces of real property . . . shall be taken into consideration in determining whether the

In view of these Regulations, all that this "relief" section provides, if anything, is a rather shallow safe harbor for capital gain that is available only to the relatively few taxpayers who might qualify under its complex provisions. And most of the rare taxpayers who could thread the needle of section 1237 and the accompanying Regulations would probably qualify for capital gains treatment anyway under section 1221(1) case law.[53]

## II. SPECIFIC APPLICATION OF SECTION 1237

Assuming that the taxpayer satisfies the threshold requirement of section 1237—he has never held the subject property for sale to customers in the ordinary course of business and, during the year of sale, does not so hold any other property[54]—he must then carefully follow the detailed recipe of the section and the Regulations relating to the manner of subdividing the tract, the five-year holding period, permissible improvements, and attribution of improvements, and at all times remain wary of the five percent ordinary income rule.

### A. Subdividing a "Tract" into "Lots or Parcels"

Since application of section 1237 centers on the concept of subdividing a "tract of real property" into "lots or parcels," the meaning of these terms is critical. At issue are the length of the period during which the taxpayer must hold the "lot or parcel" sold,[55] the manner in which he may trigger the five percent ordinary income rule by selling "more than 5 lots or parcels contained in the same tract,"[56] and the nature of a substantial improvement on the "tract" that substantially enhances the value of the "lot or parcel" sold.[57]

Section 1237(c) defines "tract of real property" as a "single piece of real property,"[58] but with two exceptions. First, two

specific property in question has ever been or is being held for sale to customers.

S. Rep. No. 1622, 83d Cong., 2d Sess. 441 (1954). Thus very limited activities involving two small tracts may disqualify the taxpayer from section 1237 treatment, while the same activities, engaged in on a much larger scale on a much larger tract, would not be fatal to qualification under the section—an uneven result at best.

53. *See* cases cited in note 33 *supra*.
54. Int. Rev. Code of 1954, § 1237(a)(1).
55. *Id.* § 1237(a)(3).
56. *Id.* § 1237(b)(1).
57. *Id.* § 1237(a)(2).
58. Treas. Reg. § 1.1237-1(g)(1) (1957).

or more pieces are to be considered a single tract if they would be contiguous but for interposition of "a road, street, railroad, stream, or similar property."[59] Second, two or more pieces are to be considered one tract if at any time while held by the taxpayer[60] they were contiguous.[61]

Both of these exceptions may statutorily amalgamate into a single tract property that otherwise might be regarded as two or more tracts—a result that sometimes may be unrealistic. Consider, for example, two sections of timber land divided by a large river, not linked by a bridge, perhaps under separate local taxing authorities, and regarded by the owner as functionally separate tracts. For the purpose of section 1237, they would constitute a single tract.[62] Or suppose that a taxpayer who owns a row of three city blocks sells the middle block. While the two remaining blocks are now separated, they nevertheless would be deemed a single tract for the purpose of section 1237 since they were once held contiguously by the taxpayer.[63]

As a result of such amalgamation, section 1237 may be of limited use to the taxpayer. In one instance, he would need to be concerned with whether substantial improvements made on one tract would substantially enhance the value of lots on the other tract, since these physically separate pieces may be amalgamated rather than regarded as separate tracts.[64] In another,

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59. This rule means that if the boundary lines of the pieces of real property were continued in the same direction in which they were running at the time they met the road, street, railroad, stream, or similar property, the two pieces of real property then would meet at more than a single point.

S. REP. No. 1622, 83d Cong., 2d Sess. 443 (1954).

60. Congress apparently meant any time in the previous five years. *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. A285 (1954); S. REP. No. 1662, 83d Cong., 2d Sess. 443 (1954).

61. The taxpayer need not have acquired such contiguous properties by a single deed, and he may hold them individually, jointly, or as a partner. Treas. Reg. § 1.1237-1(g)(1) (1957).

62. *See* note 59 *supra.*

63. INT. REV. CODE OF 1954, § 1237(c). If the taxpayer does not sell another lot from the tract for a period of five years from the sale of the middle lot, however, the remainder of the tract will then be considered a "new tract." *Id.* The basic definition of "tract" as including pieces of real property that at any time had been held contiguously by the taxpayer presumably would be unaffected by this result since the Regulations provide that "[t]he pieces in the new tract need not be contiguous." Treas. Reg. § 1.1237-1(g)(2) (1957).

For the effect of this provision on the five percent ordinary income rule, see text accompanying notes 81-82 *infra.*

64. *See* text accompanying notes 107-08 *infra.* On the other hand, amalgamation would eliminate the problem of how subdividing and selling activities as to one tract affect the characterization of other tracts. *See* note 52 *supra* and accompanying text.

he might sell five lots from tract *1*, complying with the requirements of section 1237, and in the same year sell tract *2* to a single buyer. Ordinarily, the sale of tract *2* would receive full capital gains treatment under section 1221;[65] but, since there is deemed to be but one tract, the sixth sale would trigger the five percent ordinary income rule of section 1237.[66]

To receive full capital gains treatment, the taxpayer must sell no more than five "lots or parcels" from the subdivided tract within a five-year period.[67] The Code, however, fails to define these terms, leaving wide and varied the range of the size and type of tracts that might be permissibly or impermissibly subdivided under section 1237. Consider, for example, these possibilities: a 100,000 acre ranch in arid southern New Mexico divided into "small" 20,000 acre ranches; a 25 acre farm in Pennsylvania divided into five-acre "farmettes"; a 10 acre lemon grove in California divided into two-acre "ranchettes"; a five-acre tract in Cleveland's Shaker Heights divided into one-acre "estates"; one acre in Ocean City, New Jersey divided into one-fifth acre lots for construction of summer vacation homes; one-fourth acre in Manhattan divided to accommodate five walk-up townhouses, each occupying one-twentieth of an acre.

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65. In this situation, however, the Commissioner "may or may not" take the position that engaging in selling activities with respect to more than one tract indicates that the property was held for sale to customers in the ordinary course of business. *See* note 51 *supra* and accompanying text.

66. *See* text accompanying notes 79-92 *infra*. To avoid these unfavorable results, the taxpayer could create two tracts by making a gift of a portion of land that would otherwise be deemed a single tract under section 1237. Since the length of time for which the donee holds the property is tacked to that of the donor, the required five-year holding period would run from the date of original acquisition of the whole tract rather than from the date a portion of it was received by the donee. *See* Treas. Reg. § 1.1237-1(d)(1) (1957); text accompanying notes 70-78 *infra*. Thus, for example, a family member holding real property could extend the coverage of section 1237 to other members of his family by giving them pieces of his land, thereby establishing new tracts in their hands. Such gifts probably should be made before subdividing since the Code and Regulations refer to taxpayers who have subdivided a tract before attempting to sell it. *See* INT. REV. CODE OF 1954, § 1237(a); Treas. Reg. § 1.1237-1(a)(1) (1957). It is unclear whether donees of an already subdivided tract could rely on section 1237.

If the donee is to be able to qualify under section 1237, the donor, prior to the gift, must not have made any substantial improvements to the tract that substantially enhance the value of the parcels sold by the donee from the subsequent subdivision of *his* new tract. *See* note 123 *infra* and accompanying text.

67. *See* text accompanying notes 79-90 *infra*.

Presumably, all of these divisions would be permissible under section 1237. Assuming that in each instance the size of the smaller parcel is best suited for the market, the goal of Congress to make it easier from a tax standpoint for a taxpayer to subdivide his property in order to sell it at a reasonable price would be realized.[68] But what of the many situations where dividing the property into but five parcels may be economically infeasible, such as would probably be true of a 250 acre farm in Pennsylvania or a 100 acre lemon grove in California? In these instances, by limiting full capital gains treatment to the sale of only five parcels, the impact of the statute is to penalize owners of larger tracts;[69] yet, nothing in the legislative history suggests that Congress intended the statute to have such an effect.

B. FIVE-YEAR HOLDING PERIOD

For section 1237 to apply, the taxpayer must have held the "lot or parcel" for a period of five years before selling it.[70] While on its face the statute could be interpreted as meaning that after subdividing his tract the taxpayer must then hold the resulting lot or parcel for five years,[71] the Regulations make it clear that the taxpayer must merely have "owned" the property for the requisite five years.[72]

No holding period is required if the property is "acquired by inheritance or devise";[73] neither the beneficiary selling the parcels nor the decedent from whom the property was acquired

68. *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. A284 (1954); S. REP. No. 1662, 83d Cong., 2d Sess. 441 (1954).

69. *See* text accompanying notes 79-87 *infra.* That this penalty may indeed be theoretical seems quite evident. A taxpayer faced with having to subdivide his tract into more than five lots or parcels to achieve optimal marketability would be penalized by the five percent ordinary income rule of section 1237 only if his selling expenses were relatively low in comparison to the magnitude of the sales. *See* text accompanying notes 87-92 *infra.* And, of course, the taxpayer would have to weigh the disadvantage of paying a limited amount of tax at ordinary rates against the necessity of selling more than five lots to capitalize on favorable market conditions.

70. INT. REV. CODE OF 1954, § 1237(a)(3). The holding period is computed by excluding the first and including the last day. Harriet M. Hooper, 26 B.T.A. 758 (1932); Rev. Rul. 66-5, 1966-1 CUM. BULL. 91.

71. *See* INT. REV. CODE OF 1954, § 1237(a)(3).

72. Treas. Reg. § 1.1237-1(a)(5) (1957).

73. INT. REV. CODE OF 1954, § 1237(a)(3). Compare this statutory rule to the prior case law under which gain from the sale of inherited land that subsequently had been subdivided was rarely treated as ordinary income. *See, e.g.*, Camp v. Murray, 226 F.2d 931 (4th Cir. 1955).

is required to have held the property for five years.[74] This exception for property acquired by inheritance or devise is inapplicable to property acquired through joint tenancy survivorship;[75] however, the survivor's holding period commences as of the date on which the property was originally acquired.[76]

Since tacking of holding periods is permitted under the general provisions of section 1223,[77] the holding period of the taxpayer would include that of the party from whom property with a carried-over basis had been acquired.[78]

### C. THE FIVE PERCENT ORDINARY INCOME RULE

Assume that in year number *1*, a calendar-year taxpayer paid $44,000 for a 10 acre tract of unimproved land and commenced holding it as an investment. After holding it for five years, in the sixth year he subdivided the tract into 10 one-acre building sites and constructed some gravel roads. He then advertised the lots and sold five of them, each to different individuals for $15,000 cash. Assume further that his cost basis for each lot sold was $4400 and his selling expenses, including legal fees and real estate commissions, amounted to $600 per lot. Thus the taxpayer would realize a taxable gain on each lot of $10,000.[79]

Provided that all requirements of section 1237 are met, the taxpayer will be entitled to full capital gains treatment if he sells

74. The beneficiary would have to hold the property for longer than six months in order to qualify for long-term capital gains treatment under section 1222(3), however. Treas. Reg. § 1.1237-1(d)(2) (1957).

75. *Id.* This provision is consistent with the general rule that the interest of a surviving joint tenant is not acquired by bequest, devise, or inheritance. The theory is that, subject to the rights of other joint tenants, the survivor owns all of the property from the beginning of the joint tenancy. *See* C. SMITH & R. BOYER, SURVEY OF THE LAW OF PROPERTY 56 (2d ed. 1971). The Regulations also provide that for purposes of section 1237 the survivor's one-half of community property is not to be regarded as property acquired by devise or inheritance. Treas. Reg. § 1.1237-1(d)(2) (1957).

76. Treas. Reg. § 1.1237-1(d)(2) (1957).

77. *Id.* § 1.1237-1(d)(1).

78. INT. REV. CODE OF 1954, §§ 1223(2), 1015(a). Thus a gift of property from a mother to her daughter would not start the five-year holding period running anew. Treas. Reg. § 1.1237-1(d)(1) ex. (1) (1957). But improvements made by the mother while she held the land would be attributed to the daughter, possibly nullifying application of section 1237. *See* INT. REV. CODE OF 1954, § 1237(a)(2)(A); text accompanying notes 122-27 *infra*.

79. $15,000 amount received offset by selling expenses of $600 less $4400 adjusted basis equals $10,000 gain realized on each lot. INT. REV.

no more than five lots during the sixth taxable year.[80] If he sold a sixth lot during that year, however, this advantage would be diminished, since the sale would trigger the five percent ordinary income rule of section 1237.[81] Under that rule, gain from the sale of *any* lot in or after the taxable year in which the sixth lot is sold is taxable as ordinary income to the extent of five percent of the selling price, with the remainder treated as capital gain.

If, for example, the taxpayer in the sixth year sells six lots instead of five, the five percent ordinary income rule will apply to all six lots. To compute tax liability for each lot, the taxpayer would commence by calculating the excess of $15,000 selling price over the $4400 cost basis—$10,600. He would then calculate five percent of the selling price—$750. Of the $10,600 gain, then, the amount by which $750 exceeds the $600 selling expense[82] would be characterized as ordinary income; the remainder of the gain would be characterized as capital gain. Thus the taxpayer would realize taxable ordinary income of $150 ($750-$600) per lot and capital gain of $9,9850 ($10,600-$750).[83] If, however, instead of $600, the taxpayer's selling expenses per lot were $1000, his potential taxable ordinary income would be completely offset and the $250 excess would be applied to reduce the amount of capital gain realized from the sale to $9600 (($10,600-$750)-$250).[84]

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CODE OF 1954, § 1001. For cases dealing with selling expenses, see Lucien Jouvand, 11 P-H Tax Ct. Mem. 1770 (1942) (legal fees); E. A. Griffin, 19 B.T.A. 1243 (1930) (brokerage commissions); L. Metzger, 5 B.T.A. 1230 (1927) (brokerage fees).

80. In computing the number of lots sold, a sale of two or more contiguous lots to one buyer is counted as only one sale. Treas. Reg. § 1.-1237-1(e)(2) (1957).

81. INT. REV. CODE OF 1954, § 1237(b)(1).

82. *Id.* § 1237(b)(2).

83. *Id.*; Treas. Reg. § 1.1237-1(e)(2)(ii) & ex. (2) (1957).

84. INT. REV. CODE OF 1954, § 1237(b)(2); Treas. Reg. § 1.1237-1(e)(2)(ii) ex. 1 (1957). Thus the effect of excess selling expense is to reduce the amount of the taxpayer's capital gain, while that part of selling expense deducted from five percent of the selling price essentially is a deduction from ordinary income. The five percent ordinary income rule operates only to characterize some of the taxpayer's gain as ordinary income; it does not affect the overall amount of taxable gain. The Regulations provide that the five percent ordinary income gain is to be *excluded* from the gain recognized on the sale of each lot up to the amount of selling expenses. *Id.* By contrast, it appears that Congress intended the five percent to be included in the taxpayer's gross income and the selling expenses, up to the same five per-

On the other hand, if after selling five lots in his first year of 1237 eligibility, the taxpayer sells lot 6 in the following taxable year, the full capital gains treatment afforded the first five lots would be unaffected; however, the five percent ordinary income rule would apply to the sixth sale and all subsequent sales.[85] But if the taxpayer abstains from making any additional sales for a period of five years, he may then treat the remaining lots as a "new" tract and repeat the section 1237 process, selling up to five lots at full capital gains treatment.[86]

Thus, while section 1237 may provide for capital gains treatment even though a taxpayer subdivided his property and sold several lots, the statute imposes a penalty for selling too many lots too soon. This penalty is a statutory reflection of prior cases in which courts had viewed volume and frequency of sales as factors pointing toward dealership classification.[87] But even if it is assumed that some penalty is appropriate, the five percent ordinary income rule of section 1237 fails to serve that purpose. By permitting deduction of selling expenses from five percent of the selling price, often little or no ordinary income will be recognized. For example, the payment of a five percent sales commission alone will wipe out the effect of the five percent ordinary income rule, resulting in taxation of the gain at only capital gain rates and, moreover, reducing that gain by five percent of the selling price.[88]

While commissions charged for the sale of land rarely fall below five percent of the selling price and often range upward to 10 percent,[89] Congress, in formulating the five percent ordinary income rule, apparently assumed that a five percent commission was the norm.[90] The theory is that if the taxpayer

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cent of selling price, to be deducted from that gross amount. H.R. REP. No. 1337, 83d Cong., 2d Sess. A283 (1954).

85. Treas. Reg. § 1.1237-1(e)(2)(ii) (1957).

86. Section 1237(a) of the Code covers "[a]ny lot or parcel which is part of a tract of real property in the hands of a taxpayer" provided that under section 1237(a)(3) the lot or parcel in question has been held for five years. In defining "tract," section 1237(c) provides:

> If, following the sale or exchange of any lot or parcel from a tract of real property, no further sales or exchanges of any other lots or parcels from the remainder of such tract are made for a period of 5 years, such remainder shall be deemed a tract.

87. *See* cases cited in note 33 *supra*.

88. *See* notes 82-84 *supra* and accompanying text.

89. *See, e.g.*, Rogers, *Compensation of the Georgia Real Estate Broker*, 6 GA. L. REV. 375, 388-89 n.67 (1972).

90. *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. A283 (1954). The five percent figure may have been realistic in 1954.

sells a parcel without the assistance of a broker, he will "earn" the five percent commission for himself,[91] which will be taxed as ordinary income[92] if he sells too many parcels too soon. The statutory approach is therefore resigned to treat that portion of gain attributable to the taxpayer's own selling efforts as ordinary income, just as a sales commission would be treated if earned by a broker.

While explainable in theory, the five percent ordinary income rule has failed dismally in practice. It requires a complex mechanical computation that, after selling expenses are deducted from what would otherwise be ordinary income, will often result in little or no additional tax being levied against the taxpayer. Hence the rule serves neither as an effective means of raising revenue nor as an inhibition on the dealer-like activities of those who engage in frequent and high volume sales.

### D. Substantial Improvement of the Tract

To satisfy the substantial improvement requirement of section 1237, the taxpayer must meet a two-fold test: he must not have made substantial improvements to the *tract* that substantially enhance the value of the *lots* sold.[93]

Under prior case law, a taxpayer was almost invariably classified as a dealer and subjected to taxation at ordinary rates after subdividing and selling property on which he had made improvements.[94] Section 1237 was intended to provide relief to the subdividing taxpayer by permitting him to make some improvements to his tract so long as they were not "substantial."[95] The effect of this limitation has been to prevent taxpayers from receiving capital gain treatment on profits arising from the "sale" of the *improvements* rather than from long-term appreciation of the land itself.[96]

While the statute fails to define "substantial," examples of both substantial and insubstantial improvements are provided

91. *See, e.g.*, George E. Bailey, 41 T.C. 663 (1964) (life insurance agent entitled to 50 percent commission on policy sales remitted a net premium of $257.40 for policy purchased on his own life; balance of the $514.80 full premium held to be ordinary income to the agent even though not actually paid out as a commission by the company).

92. *See* Int. Rev. Code of 1954, § 61(a)(1).

93. *Id.* § 1237(a)(2).

94. *See, e.g.*, DiLisio v. Vidal, 233 F.2d 909 (10th Cir. 1956); Friend v. Commissioner, 198 F.2d 285 (10th Cir. 1952); McFaddin v. Commissioner, 148 F.2d 570 (5th Cir. 1945).

95. *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess. A285 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 442 (1954).

96. *See* text accompanying note 182 *infra*.

in the Regulations.[97] The improvements that the taxpayer may make are: building a temporary office, surveying, filling, draining, leveling, clearing, and installing minimum all-weather access roads.[98] The list of forbidden improvements includes: constructing shopping centers or other commercial or residential buildings, and installing hard surface roads or utilities such as sewer, water, gas, or electric lines.[99] Both this list[100] and the list of improvements permitted as insubstantial[101] are intended to be illustrative but not exclusive. Thus the taxpayer who makes an "unlisted" improvement necessarily proceeds with some uncertainty, since it is difficult to draw with any precision a line between an improvement that is "substantial"[102] and one that is "minor."[103]

Moreover, even where an item does appear on one of the two lists, basic weaknesses inhere in such categorical predeterminations of the character of certain improvements. For example, because installation of a "permitted" improvement does not technically constitute substantial improvement to the tract,

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97. The examples are derived generally from the Senate and House Reports cited in note 95 *supra*.

98. Treas. Reg. § 1.1237-1(c)(4) (1957). The Regulation also provides that the roads may not be hard surfaced, but that they may be equal in quality to gravel roads if required by the climate. Moreover, legislative history indicates that such roads may be built "to each lot sold." H.R. REP. No. 1337, 83d Cong., 2d Sess. A285 (1954).

99. Treas. Reg. § 1.1237-1(c)(4) (1957).

100. "*Among the improvements* considered substantial are . . . ." *Id.* (emphasis added). The Senate Report refers to only shopping centers and utilities as examples. S. REP. No. 1622, 83d Cong., 2d Sess. 442 (1954).

101. Although the Regulation can be read as making the permissible list exclusive, legislative history suggests otherwise. The House Report states that "[t]he permissible improvements include, but are not limited to, clearing operations and the construction of minimum all-weather access roads to each lot." H.R. REP. No. 1337, 83d Cong., 2d Sess. A285 (1954).

102. That the use of the word "substantial" causes the courts some difficulty in construing this section is evidenced in Robert W. Pointer, 48 T.C. 906, 915 (1967), *aff'd on other grounds*, 419 F.2d 213 (9th Cir. 1969), where the Tax Court stated:

> 'Substantial' is an elusive word. It refers to that which is large, valuable, or noteworthy, or in a negative sense, to that which is not trivial, nominal, or incomplete.

103. The Senate Report states that

> . . . the use of the word substantial was intended to permit the taxpayer to make certain improvements without losing the benefits of this section if either the improvements were minor or they resulted in but slight enhancement of the value of the lots sold from the tract.

S. REP. No. 1622, 83d Cong., 2d Sess. 442 (1954).

the taxpayer apparently will not be disqualified from section 1237 treatment regardless of how much that particular improvement enhances the value of the lots that are sold.[104] While the permissible activities of filling and draining a high and dry tract may cost little and cause only a small increase in value, the same improvements to poorly drained land will typically cost very much and greatly enhance the value of the property; yet both situations will qualify under section 1237.

These predetermined lists of permissible and impermissible improvements should, of course, promote taxpayer reliance and judicial economy, at least with respect to the listed items.[105] But considering their shortcomings, perhaps a better (or supplemental) approach would be that suggested by the Court of Appeals for the Ninth Circuit in *Kelly v. Commissioner*.[106] In that case, the court ignored the lists in the Regulations and instead held that the taxpayer's improvements were substantial because they cost more than 12 times the acquisition cost of the land on which they were made. This method of comparing the taxpayer's cost basis in the property with the cost of the improvements might be less than satisfactory, however, where inflation injects artificiality into a comparison of the present high cost of improvements with an earlier low cost of land acquisition. An alternative method of arriving at an appropriate measure of substantiality would be to compare the current market value of the tract with the cost of the currently installed improvements; the two factors thus would be drawn from the same

104. "Improvements which are not substantial in and of themselves, although resulting in a substantial increase in the value of the lots of the tract . . . are intended to be permitted." *Id.* A literal reading of the statute supports this result. *See* INT. REV. CODE OF 1954, § 1237(a) (2).

105. Utilizing the lists in their deliberations regarding section 1237, the courts have applied a uniform approach only in unanimously ruling against the taxpayer. Holding that the "no substantial improvement" requirement was fatally violated, some courts have cited both the substantial and insubstantial lists. Hvidsten v. United States, 185 F. Supp. 856, 860-61 (D.N.D. 1960) (taxpayer constructed four residences); Robert W. Pointer, 48 T.C. 906, 914 (1967), *aff'd on other grounds*, 419 F.2d 213 (9th Cir. 1969) (taxpayer paved street and installed utilities). Another court cited only construction of residences. Estate of Peter Finder, 37 T.C. 411, 421 (1961). Another court failed to cite either list, but narrowly applied the listed item of road construction against the taxpayer, finding that minimum all-weather "access" roads were not access roads but main streets. Revell v. United States, 72-1 U.S. Tax. Cas. 84,060, 84,062-63, 29 Am. Fed. Tax R. 2d 877, 880 (D.S.C. 1972).

106. 281 F.2d 527 (9th Cir. 1960).

economic context. But this method would be inequitable since a taxpayer whose property had greatly appreciated not only would realize a larger profit, but would also be able to make more improvements than would a taxpayer whose property had not appreciated as much.

E. SUBSTANTIAL ENHANCEMENT OF THE LOT VALUE

Even though the taxpayer has made "substantial improvements" to his tract, the benefits of section 1237 are still available if those improvements have not substantially enhanced the value of the lot sold.[107] Accordingly, if the taxpayer makes a substantial improvement to lot *1* but sells lots *4* and *5*, and if the improvement to lot *1* does not substantially enhance the value of lots *4* and *5*, those lots are eligible for section 1237 treatment.[108] There are two logical steps in making this determination: (1) How much is the value of the lot increased? and (2) is this increase substantial?

*1. Measuring the* Amount *of Enchancement*

The approach set forth in the Regulations is to measure the increase as the difference between the improved value of the lot and its value had the improvement not been made.[109] Applying this test, the Tax Court in *Robert W. Pointer*[110] found that an increment of $2500 to $3000, attributable solely to improvements which doubled the value of the unimproved lots, constituted substantial enhancement in value.

The Regulations provide that enhancement is to be measured as of the date by which the improvements were completed and that changes in value arising from factors other than improvements made by the seller are to be ignored.[111] From a practical standpoint, this formula could become extremely com-

107. *See* INT. REV. CODE OF 1954, § 1237(a)(2).

108. *See* Treas. Reg. § 1.1237-1(c)(3)(iii) (1957). The example appearing in the Senate Report is that of a taxpayer who builds his own residence on one of the lots in the tract. It is suggested that this substantial improvement may increase the salability of the other lots, but it probably would not substantially enhance their value. S. REP. No. 1622, 83d Cong., 2d Sess. 442 (1954). A better, less questionable, example is that of erecting a barn, included in the House Report. *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. A285 (1954).

109. Treas. Reg. § 1.1237-1(c)(3)(i) (1957).

110. 48 T.C. 906 (1967), *aff'd on other grounds*, 419 F.2d 213 (9th Cir. 1969).

111. Treas. Reg. § 1.1237-1(c)(3)(i) (1957).

plex and difficult to apply. Consider, for example, the taxpayer who makes several improvements to his land, each completed on a different date, and who must calculate enhancement when land values generally are declining while at the same time land values in the taxpayer's suburban area are rising because of a soon-to-be-constructed high-speed rail line running into the city.[112]

A simpler approach, but questionable in light of the Regulations, is that suggested by the Ninth Circuit in *Kelly v. Commissioner*; drawing on the standard that it developed to measure the substantiality of the improvement, the court asserted that an inference of enhancement might be drawn by comparing the cost of the improvement with the acquisition cost of the land.[113] But besides leading to an artificial conclusion where the land had been acquired at low cost, this approach seems to miss the mark statutorily since it focuses on the substantiality of the *improvement* made on the *tract* rather than the substantiality of the enhancement of the *value* of the *lot*.[114] It is possible that very costly improvements could be made on a tract without significantly increasing the value of the lot.[115] Thus, despite difficulty of application under some circumstances, the approach of the Regulations, calculating that portion of the present market value of a lot that is attributable to improvement of the tract, seems to reflect most accurately the measure of enhancement.

### 2. *What is* Substantial *Enhancement*

If it is determined that improvements to the tract have enhanced the value of a lot, a further question arises as to whether the incremental value is substantial within the meaning of section 1237. The statute fails to define "substantial enhancement," and the legislative history affords little guidance other than the statement that the question is one of fact in each case and that "slight" enhancement might be permissible.[116]

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112. For consideration of the difficulty of proving changes in value, see note 120 *infra* and accompanying text.

113. 218 F.2d 527, 529 (9th Cir. 1960). The court did not have to specifically reach the issue of measurement, however, since the seller failed to sustain his burden of establishing that his substantial improvements did not substantially enhance the value of the lots.

114. *See* text accompanying note 106 *supra*.

115. Certain improvements may in fact diminish the value of some lots. Consider, for example, how installation of a firing range on part of the tract would affect the value of nearby residential lots.

116. S. REP. No. 1622, 83d Cong., 2d Sess. 442 (1954).

The Regulations provide that improvements to the tract enhancing the value of the lots sold by 10 percent or less do not constitute substantial enhancement; but if they enhance the value by more than 10 percent, all relevant factors must be considered in determining whether the enhancement is substantial.[117] The taxpayer thus has a clear guideline to the extent that he remains within the 10 percent limitation; if his activities result in value enhancement exceeding that percentage, however, the guideline becomes blurred. For example, where a taxpayer had made substantial improvements by constructing paved roads, and as a result the value of certain frontage lots increased by 12 and one-half percent, a district court concluded that section 1237 was unavailable.[118]

Apparently, the taxpayer has never prevailed in a case in which "substantial enhancement" was at issue.[119] Once a substantial improvement to the tract was found, in no case has the taxpayer been able to sustain the burden of proving that the value of the lot sold had not been substantially enhanced.[120] The courts have tended to intermingle the two issues—improvement and enhancement[121]—and their confusion has denied the tax-

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117. Treas. Reg. § 1.1237-1(c)(3)(ii) (1957).

118. Revell v. United States, 72-1 U.S. Tax Cas. 84,060, 29 Am. Fed. Tax. R. 2d 877 (D.S.C. 1972).

119. *See, e.g.*, Kelley v. Commissioner, 218 F.2d 527 (9th Cir. 1960) (amount of enhancement undetermined); Revell v. United States, 72-1 U.S. Tax Cas. 84,060, 29 Am. Fed. Tax R. 2d 877 (D.S.C. 1972) (12½ percent enhancement); Robert W. Pointer, 48 T.C. 906 (1967), *aff'd on other grounds*, 419 F.2d 213 (9th Cir. 1969) (100 percent enhancement).

120. In order to meet this difficult burden of proof, the taxpayer planning a substantial improvement to his tract but wishing to qualify the subsequent sale of some of his lots under section 1237 should consider obtaining an independent appraisal of the value of the lots both before and after making the improvement.

121. In Hvidsten v. United States, 185 F. Supp. 856, 863 (D.N.D. 1960), the court reasoned that because the building of residences on the tract was found to be substantial,

> [t]he only fair and reasonable conclusion is that such construction was for the purpose of increasing and would and did increase the sale of other lots in the tract by increasing their desirability and marketability from a residential standpoint, which factor would of necessity enhance and affect market value. It is beyond dispute that such improvements were substantial and in the court's opinion, from the evidence, such improvements substantially increased the value of the remaining lots thereafter sold.

No figures or other concrete evidence were included in the opinion. *See also* Kelley v. Commissioner, 281 F.2d 527 (9th Cir. 1960); Revell v. United States, 72-1 U.S. Tax Cas. 84,060, 29 Am. Fed. Tax R. 2d 877 (D.S.C. 1972).

payer most of the benefit that the distinct two-part test of the statute should provide.

### F. ATTRIBUTION OF SUBSTANTIAL IMPROVEMENTS

A taxpayer cannot protect his eligibility to utilize section 1237 merely by refraining from making substantial improvements to a tract of land, since the actions of another person may be attributed to him. For purposes of section 1237, a taxpayer will be deemed to have made improvements if they are made by certain specified parties or if they are made under a contract of sale. In addition, improvements made by an agent probably would be attributed to the taxpayer.

#### 1. *Improvements by Specified Parties*

Under section 1237 the taxpayer will be deemed to have made improvements if they are made by certain members of his family: a spouse, whole or half brothers and sisters, ancestors, or lineal descendants.[122] Assume, for example, that the taxpayer's father, having held a tract of land for two years, subdivides it and makes substantial improvements that substantially enhance the value of the resultant lots. He then gives the tract to the taxpayer, who does nothing to it and sells it after four years. The taxpayer will be deemed to have made the improvements made by his father during the initial two-year period and therefore will be ineligible for section 1237 treatment.[123] On the other hand, had the father made no improvements, the taxpayer could qualify under section 1237 since he would have satisfied the five-year holding requirement of the statute.[124] The taxpayer tacks to his holding period the two years that his father held the property, not by virtue of the family attribution rules, which are inapplicable when calculating the holding period of real property,[125] but rather because he is a donee with a carry-over basis;[126] hence he will be treated as having held the property for a total of six years.[127]

122. INT. REV. CODE OF 1954, § 1237(a) (2) (A). *Compare id.* § 318(a) (1) (attribution of stock ownership to spouse, children, grandchildren, and parents).

123. *See* Treas. Reg. § 1.1237-1(c) (2) (ii) ex. (1957).

124. INT. REV. CODE OF 1954, § 1237(a) (3); Treas. Reg. § 1.1237-1(d) (1) (1957).

125. *See* Treas. Reg. § 1.1237-1(b) (3) (1957).

126. INT. REV. CODE OF 1954, § 1015.

127. *Id.* § 1223(2). *See* notes 77-78 *supra* and accompanying text. Moreover, if his father were a real estate dealer, that status would

In addition to improvements made by members of the taxpayer's family, the statute specifies that those made by the following parties will be deemed to have been made by the taxpayer: a corporation controlled by the taxpayer;[128] a partnership of which the taxpayer was a member at the time the improvements were made;[129] the government, if the improvement constitutes an addition to the taxpayer's cost basis in the property;[130] and a lessee, if the improvement constitutes income to the taxpayer.[131]

Improvements made by lessees present a special case. If such an improvement is made as a rental payment, it not only will be treated as income to the taxpayer,[132] but it also will be regarded as having been made by him.[133] Conversely, even a substantial improvement made by a lessee will not nullify section 1237 provided it does not constitute payment of rent.[134] Whether an improvement will be regarded as a rental payment depends on the intent of the parties;[135] thus an improvement

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be attributed to the taxpayer to defeat his use of section 1237 even though his father had made no improvements to the tract. Treas. Reg. § 1.1237-1(b)(3) ex. (1957). There is no statutory basis for this extension of the attribution rules of the "substantial improvements" subsection to the "dealer" subsection of the statute, however; and in the case of a bona fide gift to a nondealer child, it produces an unfair result.

128. INT. REV. CODE OF 1954, § 1237(a)(2)(A). Control is defined as "direct ownership, constructive ownership, or otherwise, of more than 50 percent of the corporation's voting stock." Treas. Reg. § 1.1237-1(c)(2)(i)(b) (1957). For other statutory definitions of control, compare INT. REV. CODE OF 1954, § 267(b) (more than 50 percent), § 368(c) (at least 80 percent), and § 1239 (more than 80 percent).

129. INT. REV. CODE OF 1954, § 1237(a)(2)(A). With respect to partnerships, neither the Code nor the Regulations specify any particular percentage of ownership. Thus membership appears to be all that is necessary.

130. *Id.* § 1237(a)(2)(C). "Government" includes federal, state, or local government, or any political subdivision thereof. Here the taxpayer may lose eligibility for section 1237 because of circumstances over which he has no control. If, for example, the municipality constructed a paved street on the taxpayer's property and assessed him the cost, such improvement would increase his basis and would be attributed to him under section 1237. *See* Treas. Reg. § 1.1237-1(c)(2)(i)(e) (1957).

131. INT. REV. CODE OF 1954, § 1237(a)(2)(B).

132. *Id.* § 61(a)(5).

133. *Id.* § 1237(a)(2)(B).

134. *Id.* § 109. The taxpayer's basis in the property must not be adjusted, however. *Id.* § 1019.

rental income to the lessor in a particular case depends upon the
intention of the parties, which may be indicated either by the
135. Whether or not improvements made by a lessee result in

made by a volunteer or a trespasser clearly would not be attributed to the taxpayer. And a lessee conceivably might enter into a term ground lease of part of a subdivided tract and construct a large shopping center that would substantially enhance the value of the remaining parcels; yet this improvement would not be attributed to the taxpayer if it were not intended as rent.[136]

*2. Contract Attribution*

Improvements made by the purchaser of a lot also may be charged back to the taxpayer since the Code covers not only the improvements made by the taxpayer while he holds the tract but also those "made pursuant to a contract of sale entered into between the taxpayer and the buyer."[137] While the language of the Code is unclear, the Regulations provide that this rule covers improvements made by either the taxpayer or the buyer.[138]

The Commissioner goes further, however, taking the position that section 1237 is unavailable if the taxpayer enters into a contract of sale that merely *obligates* either the taxpayer or the buyer to make substantial improvements that substantially enhance the value of the lot.[139] The taxpayer may escape this result, however, if the obligation ceases within the period of time during which he may file for a refund of the tax paid on the gain from the sale of the lot.[140] In effect, he can retroactively qualify for section 1237 merely by filing an amended return for the year of sale.[141]

What does the Commissioner's position mean? Assume that the taxpayer sells a lot and the contract of sale obligates either the taxpayer or the buyer to make "forbidden" improvements.[142] According to the Regulations, if the obligation remains in force for three or more years, the taxpayer will be unable to avail himself of section 1237 even though the improve-

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terms of the lease or by the surrounding circumstances. Treas. Reg. § 1.61-8(c) (1957). *See* Grace H. Cunningham, 28 T.C. 670 (1957).

136. Assuming, of course, that no other relationship between the taxpayer and the lessee supported attribution of the lessee's improvements. *See* notes 122-30 *supra* and accompanying text.

137. INT. REV. CODE OF 1954, § 1237(a)(2).

138. Treas. Reg. § 1.1237-1(c)(2)(iii) (1957).

139. *Id.* § 1.1237-1(c)(2)(iii)(a).

140. *Id.*

141. *Id.* ex.

142. *See* note 99 *supra* and accompanying text.

ments are never made. Inasmuch as the Code specifies improvements "made" pursuant to a contract,[143] by including unfulfilled obligations the Commissioner may have gone too far.[144]

Moreover, this retroactive approach of the Regulations is predicated on the taxpayer otherwise fully qualifying for section 1237 in the year of the sale in question.[145] Where this is indeed the case and the taxpayer has sold a lot to an unrelated purchaser, section 1237 would very likely be irrelevant, since the taxpayer otherwise qualifying under section 1237 probably would qualify for full capital gains treatment under section 1221(1) as well. For example, in cases decided before the enactment of section 1237, taxpayers received capital gains treatment despite selling to unrelated purchasers who agreed to build on the property and pay off the taxpayers upon selling the buildings.[146] And early predictions notwithstanding,[147] section 1237 has failed to change this result.[148]

According to the Regulations, an improvements contract is permissible if it merely restricts the improvements that either party may make.[149] Assume that the contract prohibits the buyer from building any structure on his lot unless it is a residence costing more than $30,000. Even though the buyer may in fact build such a residence, he was under no "obligation" to make any improvements, and section 1237 would still apply.[150]

*3. Agency Attribution*

Under the contract rule, improvements made by others will not be attributed to the taxpayer if there is no contract of sale,[151] nor will they under the specified party rule, absent one of

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143. INT. REV. CODE OF 1954, § 1237(a)(2).

144. On the other hand, the parties have, in effect, contracted to violate the requirements of section 1237, and the Commissioner's rule does provide the taxpayer three years within which to return to compliance.

145. Treas. Reg. §§ 1.1237-1(c)(1), (2)(ii) (1957).

146. *See, e.g.*, Fahs v. Crawford, 161 F.2d 315 (5th Cir. 1947); Boomhower v. United States, 74 F. Supp. 997 (N.D. Iowa 1947).

147. *See* Levin, *Capital Gains or Income Tax on Real Estate Sales*, 37 BOSTON U.L. REV. 165, 205 (1957).

148. *See, e.g.*, Voss v. United States, 329 F.2d 164 (7th Cir. 1964); Yunker v. Commissioner, 256 F.2d 130 (6th Cir. 1958); Houghten v. United States, 63-1 U.S. Tax Cas. 87,872, 11 Am. Fed. Tax R. 2d 1099 (W.D. Mich. 1963); Schuhmacher v. United States, 58-1 U.S. Tax Cas. 68,075, 1 Am. Fed. Tax R. 2d 1329 (S.D. Tex. 1958).

149. Treas. Reg. § 1.1237-1(c)(2)(iii)(b) (1957).

150. *Id.*

151. *See* text accompanying notes 137-50 *supra*.

the statutory relationships.[152] Does it necessarily follow that improvements made by persons not enumerated in the statute and not under a sales contract will escape attribution to the taxpayer? It would appear so from the Regulations.[153] Clearly falling into this category are improvements made by mere volunteers or trespassers.[154] Uncertainty arises, however, in situations where the taxpayer engages another to make improvements. Here the basic questions are whether the other person will be deemed the taxpayer's agent and whether his improvements will be attributed to the taxpayer.[155] The problem might arise in the following context.

After subdividing a tract of land, the taxpayer contracts with a developer to construct houses on each lot and to advertise and sell them as packages. He approves and finances the construction and passes title to the ultimate purchaser as the developer sells each residential package. The developer obviously has made substantial improvements,[156] and if they are attributed to the taxpayer, he cannot utilize section 1237.[157] Under these circumstances, the significant degree to which the taxpayer controls the developer is doubtless sufficient to constitute an agency relationship such that the taxpayer simply will be considered to have made the improvements himself.[158]

But closer cases may arise. Assume that a taxpayer engages a real estate broker, grants him broad powers, but retains title to the land and the right to control its ultimate disposition. The broker then subdivides, substantially improves, advertises,

152. *See* text accompanying notes 122-36 *supra.*

153. "Improvements made by a bona fide lessee (other than as rent) or by others not described in section 1237(a)(2) do not preclude the use of section 1237." Treas. Reg. § 1.1237-1(c)(2)(iv) (1957).

154. *See* S. REP. No. 1622, 83d Cong., 2d Sess. 442-43 (1954).

155. This determination would necessarily have to be made in light of the federal case law that has evolved under the Internal Revenue Code rather than in strict accordance with agency doctrine that has evolved as a matter of state law. *See, e.g.,* cases cited in note 148 *supra.*

156. *See* Estate of Peter Finder, 37 T.C. 411 (1961); Treas. Reg. § 1.-1237-1(c)(4) (1957).

157. *See* note 99 *supra* and accompanying text.

158. In a similar situation, the Tax Court held that the taxpayer himself made substantial improvements. It did not bother to discuss how the improvements were imputed to the taxpayer for purposes of section 1237, however. Rather, it turned to section 1221(1), considered whether the developer's activities should be attributed to the taxpayer for purposes of that section, and concluded that they should be. Robert W. Pointer, 48 T.C. 906 (1967), *aff'd,* 419 F.2d 213 (9th Cir. 1969).

and sells the lots, reimbursing himself out of the sale proceeds for the costs of development. The taxpayer did not finance or participate in subdividing and developing the tract and never exercised his retained right to control. His only direct involvement was merely to execute deeds to buyers. In a section 1221(1) case in which the taxpayer's investor status was at issue, the Court of Appeals for the Seventh Circuit held that under such circumstances the broker was carrying on his own business and that his activities could not be imputed to the taxpayer.[159] Thus, if the taxpayer grants full control over his property to a developer and remains passive except for signing conveyances, there is a chance that the activities of the developer, including improvements that he makes, will not be attributed to the taxpayer.[160]

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159. Voss v. United States, 329 F.2d 164 (7th Cir. 1964) (relying heavily on Estate of William Mundy, 36 T.C. 703 (1961), and Smith v. Dunn, 224 F.2d 353 (5th Cir. 1955)). The right to control an agent should result in attribution. Thus the Seventh Circuit in *Voss* seems to be incorrect in excluding attribution on the ground that while the taxpayer had the right to control the developer he did not, in fact, exercise that right. Moreover, the *Voss* decision is conceptually inconsistent with the Regulations, which provide that the mere existence of a contractual obligation by the buyer to make improvements may be charged to the taxpayer even where no improvements are made. *See* text accompanying notes 137-44 *supra*.

160. But even to have this chance, the taxpayer must remain very passive; even slight activity and the developer will be considered the taxpayer's agent. *See, e.g.*, Robert L. Hamilton, 33 CCH Tax Ct. Mem. 463 (1974) (applicability of *Voss* and *Mundy* denied).

Moreover, it should be noted that this analysis is based not on cases involving the attribution of improvement issue under section 1237(a)(2), but rather on cases arising under section 1221(1) in which the taxpayer's dealership status has been determined, that is, whether he held property "for sale to customers in the ordinary course of his trade or business." And since the underlying question with respect to improvement attribution is merely one of agency and control, the section 1221(1) cases are only applicable indirectly; they focus on a broader issue encompassing many additional factors. Typically in those cases, the developer's activities were but one indication of the taxpayer's status as a dealer. Other factors, such as how the property was acquired, whether the taxpayer could dispose of the property without making improvements, and other sales activity, were also considered by the courts in making this determination. Thus the weight ultimately ascribed to attribution in those cases has depended on whether attributed activities plus all other factors taken together led to dealer classification. *See* Voss v. United States, 329 F.2d 164 (7th Cir. 1964); Lunker v. Commissioner, 256 F.2d 130 (6th Cir. 1958); Achong v. Commissioner, 246 F.2d 441 (9th Cir. 1957); Smith v. Dunn, 224 F.2d 353 (5th Cir. 1955); Fahs v. Crawford, 161 F.2d 315 (5th Cir. 1947); Houghten v. United States, 63-1 U.S. Tax Cas. 87,872, 11 Am. Fed. Tax. R. 2d 1099 (W.D. Mich. 1963); Johnson v. United States, 188 F. Supp. 939 (N.D. Calif. 1960); Schuhmacher v. United States, 58-1 U.S. Tax Cas. 68,075, 1 Am. Fed. Tax. R. 2d 1329 (S.D. Tex. 1958); Robert

G. NECESSARY-IMPROVEMENT EXCEPTION

If, after subdividing, the taxpayer holds the lots or parcels for a period of 10 years and meets certain other conditions, he may make some substantial improvements that substantially enhance the value of the lots sold and yet still qualify for section 1237 treatment.[161] Permissible improvements include building or installing facilities such as water, sewer, drainage, and roads.[162] The taxpayer must establish that without such improvements the lots that were sold would not have been marketable at the prevailing local price for similar real estate.[163] He also must elect not to increase his basis to reflect the expenditures for such improvements, nor may he deduct the expenditures from his ordinary income.[164]

Apparently, no court has decided a case involving this provision of the statute. This is so probably because of the difficulty the taxpayer would face in satisfying the detailed requirements of the Regulations, such as furnishing the IRS the selling price of comparable real estate in the vicinity of his property.[165]

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L. Hamilton, 33 CCH Tax Ct. Mem. 463 (1974); Estate of William Mundy, 36 T.C. 703 (1961).

The requirement of section 1221(1) that the taxpayer must not be a dealer is also the threshold requirement of section 1237, except that under the latter section the taxpayer's subdividing and selling activities under certain circumstances may be ignored. *See* text accompanying notes 39-48 *supra*. Suppose, for example, that the taxpayer has engaged directly in subdividing and selling activities but that a developer has installed improvements and it is unclear whether he is an agent of the taxpayer or an independent contractor. Assume further that the improvements, even if charged against the taxpayer, would be insufficient when taken alone to result in dealer classification under section 1221(1), but that the taxpayer's subdividing and selling activities do lead to such a result under that section. The issue of whether improvements made by the developer will be attributed to the taxpayer is brought clearly into focus when the taxpayer attempts to qualify under section 1237.

161. INT. REV. CODE OF 1954, § 1237(b)(3) (added by Senate Floor Amendment, 1954 U.S. CODE CONG. & AD. NEWS 5331). The taxpayer must hold the property for 10 years even if he inherited it. Treas. Reg. § 1.1237-1(c)(5)(i)(a) (1957).

162. Treas. Reg. § 1.1237-1(c)(5)(i)(b) (1957).

163. *Id.* § 1.1237-1(c)(5)(i)(c). How difficult may it be to convince the IRS that the taxpayer should receive capital gains treatment?

164. *Id.* § 1.1237-1(c)(5)(i)(d).

165. *Id.* § 1.1237-1(c)(5)(ii); *see id.* § 1.1237-1(c)(5)(iii). It is clear that section 1237 would have little impact on the decision of a subdividing taxpayer to make substantial improvements when he can earn a greater profit, even after paying taxes on ordinary income, by making the improvements forbidden by the section. Assume, for example, that a taxpayer in the 50 percent bracket holds a tract of land that

## III. SECTION 1237 IMPACT ON CASE LAW

While recognizing that its stringent requirements preclude frequent application, some commentators have suggested that section 1237 could provide persuasive authority for limiting the scope of judicial inquiry into subdividing and sales activity in providing guidelines for characterization of assets as capital or ordinary under section 1221(1).[166] Since the courts apparently have felt no compulsion to limit the weight ascribed to subdividing and sales activities when making such determinations, however, section 1237 has had little, if any, impact.[167]

In the case law that developed under the 1939 Code, the courts regarded subdividing as inconclusive, but substantial, evidence that the taxpayer was in the real estate business and therefore was a dealer.[168] Congress was probably aware of the

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he has subdivided. Assume further that the cost basis of each lot is $2000 and that the fair market value of each is $3000. If the taxpayer has qualified under section 1237, his gain from the sale of one lot will be $1000, his tax liability (at capital gains rates) will be $250, and his net profit will be $750. Assume, alternatively, that before selling any lots, the taxpayer clears, grades, and surveys his subdivided tract and then constructs gravel roads, water lines, and sewers, all at a cost of $1000 per lot, increasing the cost basis of each to $3000 and the fair market value to $6000 per lot. Here the taxpayer's gain will be $3000 and his tax liability (at ordinary income rates) will be $1500, for a net profit of $1500. Hence a taxpayer seeking to maximize his profit would most assuredly elect to make the forbidden improvements. Moreover, in many areas, local ordinances do not permit subdivision unless the taxpayer agrees to make certain improvements, such as constructing paved roads or installing utilities, *see* J. DELAFONS, LAND-USE CONTROLS IN THE UNITED STATES 69-70 (2d ed. 1969), which may exceed the maximum improvements permitted under section 1237. *See* text accompanying notes 93-104 *supra*.

In some areas, however, concern for the environment has been reflected in zoning ordinances that, instead of requiring substantial improvements, require the builder to minimize the impact of improvements on the environment. *See generally* NATIONAL ASSOCIATION OF HOME BUILDERS, LAND DEVELOPMENT MANUAL 15-20 (1969). Such zoning law changes could make section 1237 available to some taxpayers for the first time—particularly since more taxpayers would probably have attempted to use section 1237 in the first place if, instead of imposing rather arbitrary limits on permissible improvements, the statute had been geared to local zoning ordinances so that the taxpayer could still qualify under the section by making the *minimum* improvements required for local subdivision approval.

166. *See* Weithorn, *Subdivisions of Real Estate—"Dealer" v. "Investor" Problem*, 11 TAX L. REV. 157 (1956); Note, *Federal Income Taxation of Subdivided Realty—The Impact of Section 1237 on Capital Asset Characterization*, 31 IND. L.J. 516 (1956).

167. *See* cases cited in note 173 *infra*; Primmer, *Sales of Subdivided Realty—Capital Gains v. Ordinary Income*, 19 SW. L.J. 116, 136-37 n.113 (1965).

168. *See* cases cited in note 36 *supra*; Emmanuel, *Capital Gains for*

importance ascribed by the courts to these activities when it enacted section 1237;[169] but the cases suggest that except where the taxpayer has specifically attempted to satisfy the strict requirements of the statute, section 1237 has had little effect on judicial attitudes toward subdividing and selling real estate.[170]

Inasmuch as the courts have continued to cite pre-section 1237 cases in resolving when subdividing activities will result in ordinary gain,[171] they apparently have concluded that, 1237 notwithstanding, the cases that evolved under section 117(a)(1) of the 1939 Code retain their vitality.[172] Thus the courts, when construing section 1221(1), have continued to rely heavily on subdividing and sales activity as important indications that property is held primarily for sale to customers in the ordinary course of business.[173] The Commissioner has shared the disre-

*Real Estate Operators*, 12 U. FLA. L. REV. 280, 287 (1959); Levin, *Capital Gains or Income Tax on Real Estate Sales*, 37 BOSTON U.L. REV. 165, 186-87 (1957); Pennell, *Capital Gains in Real Estate Transactions*, TULANE 8TH TAX INST. 23, 55 (1959); Repetti, *What Constitutes a Dealer Under Section 1237*, N.Y.U. 17TH INST. ON FED. TAX. 651, 655 (1959). A rather well-established exception to this rule has been the case of property acquired by inheritance, which is usually afforded capital gains treatment. *See* Schlenger & Embry, *Capital Gains Through Real Estate*, 27 MD. L. REV. 19, 24 (1967).

169. *See* authorities cited in note 34 *supra*.

170. In the cases litigated under section 1237, no taxpayer has satisfied its strict requirements. *See* Kelley v. Commissioner, 281 F.2d 527 (9th Cir. 1960); Revell v. United States, 72-1 U.S. Tax Cas. 84,060, 29 Am. Fed. Tax. R. 2d 877 (D.S.C. 1972); Hvidsten v. United States, 185 F. Supp. 856 (D.N.D. 1960); Robert W. Pointer, 48 T.C. 906 (1967), *aff'd*, 419 F.2d 213 (9th Cir. 1969); Estate of Peter Finder, 37 T.C. 411 (1961). It is only because a taxpayer has attempted to apply the statute that the courts have even recognized its potential effect. But in each case, the courts, after rejecting specific application of section 1237, have returned to the criteria established under sections 1221 and 1231 to characterize the gain, ignoring any broader intent of Congress in enacting section 1237.

171. *See, e.g.*, Kelley v. Commissioner, 281 F.2d 527 (9th Cir. 1960); Nadalin v. United States, 364 F.2d 431 (Ct. Cl. 1966); Thomas W. Nevin, 34 P-H Tax Ct. Mem. 325 (1965); J.G. Mendoza, 32 P-H Tax Ct. Mem. 596 (1963).

172. INT. REV. CODE OF 1939, § 117(a)(1), 53 Stat. 50 (now INT. REV. CODE OF 1954, § 1221(1)). *See* cases cited in note 33 *supra*.

173. *See, e.g.*, Koch v. United States, 457 F.2d 230 (7th Cir. 1972); United States v. Winthrop, 417 F.2d 905 (5th Cir. 1969); Estate of Segel v. Commissioner, 370 F.2d 107 (2d Cir. 1966); Coffey v. United States, 333 F.2d 945 (10th Cir. 1964); Broughton v. Commissioner, 333 F.2d 492 (6th Cir. 1964); Kaltreider v. Commissioner, 255 F.2d 833 (3d Cir. 1958); Jeanese, Inc. v. United States, 227 F. Supp. 304 (N.D. Cal. 1964); Casalina Corp., 60 T.C. 694 (1973). The importance of these two factors may have been somewhat mitigated by the addition of other factors such as the owner's primary occupation, his use of the property, and the percentage of his income that he derives from the property. These additions are

gard of the courts for any general legislative intent underlying section 1237 by occasionally arguing that subdivision *per se* indicates that the taxpayer is a dealer.[174]

The dearth of cases in which section 1237 has been so much as cited suggests that neither courts nor attorneys have looked to the statute as controlling or persuasive authority in resolving or arguing subdivision cases. In some instances, section 1237 is obviously inapplicable, the taxpayer having gone far beyond its restrictive requirements.[175] But even where its burdensome provisions have been arguably satisfied, the section has had no perceptible impact whatsoever.[176] Thus the clear intent of Congress to provide relief to those taxpayers who must subdivide real estate in order to successfully liquidate their investment has been ignored.[177]

At least one court, however, has been persuaded by the policy underlying section 1237. In *Estate of Barrios v. Commissioner*[178] the Court of Appeals for the Fifth Circuit acknowl-

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more likely attributable to the gradual complexity that inheres in the evolution of judicial doctrine than to any effect of section 1237.

174. *See, e.g.*, Biedenharn Realty Co. v. United States, 356 F. Supp. 1331 (W.D. La. 1973). The Commissioner has also taken the position that a lack of subdividing activity is a strong indication that a particular property is a capital asset. *See* Rev. Rul. 57-565, 1957-2 CUM. BULL. 546.

175. *See, e.g.*, Hansche v. Commissioner, 457 F.2d 429 (7th Cir. 1972); United States v. Winthrop, 417 F.2d 905 (5th Cir. 1969); Carruth v. United States, 167 F. Supp. 294 (S.D. Tex. 1957); Lewis v. United States, 389 F.2d 818 (Ct. Cl. 1968); S.O. Bynum, 46 T.C. 295 (1966); J.G. Mendoza, 32 P-H Tax Ct. Mem. 596 (1963).

176. *See, e.g.*, Gault v. Commissioner, 332 F.2d 94 (2d Cir. 1964); Estate of William Mundy, 36 T.C. 703 (1961); Wellesley A. Ayling, 32 T.C. 704 (1959); Mark B. Lloyd, 39 P-H Tax Ct. Mem. 504 (1970); Adolph Dantagman, 29 P-H Tax Ct. Mem. 849 (1960).

177. *See* notes 35-37 *supra* and accompanying text. Perhaps the failure to consider section 1237 is due in part to unfamiliarity, to its narrow focus, or to the confusion as to its role in the dealer versus investor issue. In some cases, section 1237 may have been intentionally ignored. For cases where the taxpayer has subdivided his land and made substantial improvements to the tract, as defined by section 1237, and yet was afforded capital gains treatment without reference to the section, see Estate of Barrios v. Commissioner, 265 F.2d 517 (5th Cir. 1959); Biedenharn Realty v. United States, 356 F. Supp. 1331 (D. La. 1973); Temple v. United States, 229 F. Supp. 687 (S.D. Miss. 1964); Oahu Sugar Co. v. United States, 300 F.2d 773 (Ct. Cl. 1962); Lazarus v. United States, 172 F. Supp. 421 (Ct. Cl. 1959); Wellesley A. Ayling, 32 T.C. 704 (1959); Allen Moore, 30 T.C. 1306 (1958). These cases provide further evidence that section 1237 can make it more difficult for the taxpayer to obtain capital gains treatment than under the section 1221(1) case law.

178. 265 F.2d 517 (5th Cir. 1959). Among other courts of appeals, only the Seventh Circuit has also acknowledged the significance of section

edged that selling a large tract of land in lots often necessitates constructing access roads, providing drainage, and furnishing water. Therefore, the court held a taxpayer must be able to subdivide his land to effect an advantageous sale, and reasonable efforts in carrying out the subdivision must not defeat capital gains treatment.[179] Moreover, the court specifically noted that cases in disagreement with this reasoning are also in disharmony with the legislative purpose of section 1237.[180]

## IV. SUMMARY

Dealers in real property are taxed at ordinary income rates, while investors who liquidate their holdings are taxed at preferential capital gains rates. Prior to 1954, the only statutory guideline for resolving whether a taxpayer was a dealer or an investor was the vague test under section 117(a)(1)[181], which provided that an asset was not capital for tax purposes if it was held primarily for sale to customers in the ordinary course of business. The vigorous pursuit by taxpayers for capital gains treatment, often opposed by the IRS, thus spawned a large volume of complex and confusing case law. Congress responded by enacting section 1237, apparently motivated by a desire to inject clarity into an area of tax law that had become confused by bewildering court decisions and to at least provide a safe

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1237, stating in dicta that it is a new and further definition of the capital asset concept; it has said nothing more on the subject. Chandler v. United States, 226 F.2d 403 (7th Cir. 1955) (decided under the 1939 Code). The court recognized, however, the necessity of subdividing very large tracts of land in order to dispose of them and therefore concluded that capital gains treatment would be appropriate.

179. 265 F.2d at 520.

180. *Id.* n.6. It should be noted that this case was decided under the 1939 Code, and section 1237 therefore was technically inapplicable. Within the same circuit, a district court has suggested that Congress had a broader intent in enacting section 1237, observing that the section is

> an effort on the part of Congress to straighten out the Commissioner because he had gone so far afield from the intentions of Congress as to capital assets and capital gains treatment for the income derived from the sale of such capital assets.
>
> The Commissioner had taken the position over the years with increasing regularity and some support from courts other than the Fifth Circuit that the mere fact of subdivision of real estate put the owner in the real estate business and, ipso facto, constituted the owner as holding the lots for sale to customers in the ordinary course of business. This will not do. It is not the law.

Temple v. United States, 229 F. Supp. 687, 692-93 (S.D. Miss. 1964) (also decided under the 1939 Code).

181. INT. REV. CODE OF 1939, § 117(a)(1), 53 Stat. 50 (now INT. REV. CODE OF 1954, § 1221(1)).

harbor for capital gains for the investor who must subdivide his property in order to obtain a reasonable price for it. The section was thus termed a taxpayer "relief" provision.

The Commissioner's Regulations, however, have so restricted an already narrowly drawn statute that relatively few taxpayers could, or would even wish to, comply with it. In the relatively few cases that have arisen under the statute, it has also been narrowly construed against the taxpayer. Moreover, in resolving dealer-investor issues, the courts have been influenced very little by section 1237, demonstrating small interest in the relief that Congress intended to provide by enacting it.

## V. PROPOSALS

For most landowners, the uncertainties that existed before the enactment of section 1237 remain. The problem is still in need of a workable solution. Apart from their function as a tax incentive, capital gains theoretically should be regarded as gains that result simply from changes in the market for capital assets—from fluctuations in the market price for land unrelated to anything the landowner might do to enhance its value. If the landowner simply buys land at one price, holds it for a time during which its value rises, and then later sells it at an increased price, the gain should be treated as capital gain.

On the other hand, to the extent that the gain is attributable to the personal efforts of the landowner to enhance the value of the land, the gain is really an indirect form of compensation for personal services and, as such, should be treated as ordinary income. Such personal efforts may be of the "manufacturing" type, whereby the landowner develops the land, subdivides it, and improves it to the point where he has truly "manufactured" new assets from the old one. They also may be of the "retailing" type, whereby the profit realized by the owner is really compensation for his services in creating or enhancing a market that becomes intent on buying the product *from him* because of advertising, a convenient location, his reputation for honesty and fair dealing, or his possession of information and expertise.

Applying this theory of capital gains to the taxation of land transactions, a complete lack of manufacturing and retailing activities by a taxpayer should conclusively preclude classification as a dealer. Mere sales or exchanges of land are not in themselves manufacturing or retailing activities. These transactions are more consistent with "investor" or "trader" status than with "dealer" status.[182] Thus, section 1237 should be amended to provide that:

> The mere sale or exchange of real estate shall not be considered a factor in determining whether the real estate was held primarily for sale to customers in the ordinary course of trade or business.

Moreover, this rule should hold true regardless of the frequency with which a landowner buys and sells parcels of real estate. Just as with frequent trading in shares of stock, the fact that the taxpayer buys and sells in large volume, if that is all that he does, should merely establish him as a trader, not a dealer.[183] Section 1237 therefore should be further amended to provide that:

> No person shall be deemed to have held real estate primarily for sale to customers in the ordinary course of his trade or business solely by reason of the frequency of the sales or exchanges of such property and similar property.

Thus the effect of these two proposals would be to eliminate the present conditions of section 1237 that a lot or parcel sold must not previously have been held for sale to customers in the ordinary course of business and that in the same tax year in which such lot or parcel is sold the taxpayer must not have held any other real property for sale in the ordinary course of business.[184] Also eliminated would be the condition that the taxpayer must have held the property for the years prior to sale unless it had been acquired by inheritance or devise.[185]

But what if the landowner does engage in some retailing or manufacturing activities (something other than mere buying and selling)? At what point does he become a dealer? Section 1237 looks both to the quantity and to the nature of such activities. Thus the protection of that section vanishes if the taxpayer makes a "substantial improvement [to the tract] that substantially enhances the value of the lot or parcel sold" by, for example, constructing streets, curbs, sewers, and water lines.[186] If such activities are not "substantial improvements," however,

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182. *See* notes 2-5 *supra* and accompanying text.

183. *See* notes 2-3 *supra* and accompanying text. Of course, if he held a parcel of land for less than six months, the taxpayer would be entitled only to *short-term* capital gains treatment; but this would be equally true had he traded in corporate stock. INT. REV. CODE OF 1954, § 1233.

184. INT. REV. CODE OF 1954, § 1237(a)(1).

185. *Id.* § 1237(a)(3).

186. *See* notes 94 and 99 *supra* and accompanying text.

they will be disregarded and the taxpayer will be allowed to retain his status as an investor.[187]

This approach of section 1237 is valid and should be preserved. But there is no compelling reason why *insubstantial* manufacturing or retailing activities in respect of one lot or parcel that would be disregarded under section 1237 should become *substantial* simply because the landowner repeats them on separate lots or parcels with great frequency. Accordingly, section 1237 should also provide that:

> No person shall be deemed to hold a lot or parcel of real estate primarily for sale to customers in the ordinary course of his trade or business unless expenditures in excess of acquisition cost that are related to such lot or parcel substantially enhance the value of such lot or parcel.

Direct expenditures related to particular lots or parcels would be easy to allocate. Indirect expenditures related to more than one lot or parcel would have to be prorated. The Commissioner could develop a method for such allocations—perhaps on the basis of the acquisition costs of all lots or parcels owned. For example, if the acquisition cost of lot *A* accounts for 10 percent of the acquisition cost of all lots owned during the period in which $1000 of indirect expenditures were made, $100 of these indirect expenditures could be allocated to lot *A*.

Because "substantial enhancement in value" is such a vague concept, it might be wise to also include a safe harbor in section 1237.[188] The taxpayer would then have a choice. He could rely on the safe harbor or he could battle against "substantial enhancement" parcel by parcel on the merits. The following proposed safe harbor limits permissible expenditures to a fixed percentage of the original cost of the parcel:

> No expenditures in excess of the acquisition cost of a lot or parcel of real estate that are related to such lot or parcel shall be deemed to substantially enhance the value of such lot or parcel so long as such expenditures do not exceed 10 percent of the acquisition cost of such lot or parcel.

It should be pointed out that this proposal for a safe harbor ignores the fact that the personal efforts of the landowner (which cost him nothing except his own time) might have a significant impact on the market price for the land. Similarly,

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187. *See* note 98 *supra* and accompanying text.

188. This proposed safe harbor would essentially be an adaptation of the guideline that currently appears in the Regulations. *See* note 117 *supra* and accompanying text. It is intended to cover improvements made to individual lots or parcels, however, as well as to the tract as a whole.

even though it would be protected by the safe harbor, a small expenditure might result in a large increase in market price. Moreover, the landowner would continue to have some protection should an impermissibly large expenditure fail to substantially enhance the value of his property. While such an expenditure might take him outside the safe harbor, he could nevertheless argue on the merits that the large expenditure did not result in substantial enhancement in the value of the parcel.

Other landowners merit consideration in addition to those who engage in a high volume of sales or exchanges but make only insubstantial improvements and insubstantial retailing efforts relating to each separate lot or parcel. A landowner may engage in substantial retailing or manufacturing activities but do so only once or twice or over a short length of time. These activities should not put him in the "trade or business" of selling real estate, since "trade or business" connotes ongoing regular activities.[189]

If real estate is held for personal use, this principle is well established. Consider, for example, a taxpayer who spends considerable time and energy completely renovating his personal residence and then, through extensive advertising and other selling activities, sells it at a handsome profit. No one would suggest that he is in the trade or business of selling real estate. Of course, if the taxpayer repeatedly engages in such activity over an extended period of time, he may then have established a sufficient pattern of regularity to be deemed to be engaged in a "trade or business."

The same should hold true for all types of real estate sales. No taxpayer should be deemed a real estate dealer (even if his activities serving to enhance the value of a particular lot or parcel are substantial) unless his sales occur with *regularity*. Because the courts generally have failed to recognize this proposition, at least when favorable to the taxpayer,[190] another safe harbor should be included in section 1237. A taxpayer should be allowed to slowly "leak out" his real estate holdings and still escape classification as a dealer even though his improvements on each parcel had been substantial:

> No person shall be deemed to have held a lot or parcel of real estate primarily for sale to customers in the ordinary course of

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189. *See* Higgens v. Commissioner, 312 U.S. 212, 215 (1941); Flint v. Stone Tracy Co., 220 U.S. 107, 171-72 (1911); note 8 *supra*.

190. *See* cases cited in notes 33 and 35 *supra*.

his trade or business, regardless of the amount of his expenditures related to such lot or parcel, unless he enters into contracts for or completes at least five separate sales, including the sale in question, within any three-year period.

This proposal is similar to the "leak out" provisions of rule 144 promulgated under the Securities Act of 1933.[191] If a stockholder abides by that rule, he may sell restricted securities in brokers' transactions in an amount no greater than the lesser of (1) one percent of the total outstanding shares of the class or (2) the weekly average of trading in such shares on all securities exchanges. If the safe harbor of rule 144 is successfully invoked, the stockholder will not be deemed a statutory underwriter solely because he had engaged in the distribution of such securities.

In summary, these proposals are aimed first at extending trader status to taxpayers engaged in real estate transactions. They provide that dealer status cannot be established merely because of the high frequency of sales, that high frequency is not even to be considered in determining dealer status, and that insubstantial lot-by-lot manufacturing and retailing activities will not lead to dealer status. Second, these proposals provide safe harbors for both traders and investor status. Thus a taxpayer could rely on the "10 percent" safe harbor and be assured of trader status, or he could rely on the "leak out" safe harbor and be assured of investor status.

After two decades, section 1237 has proved to be an almost worthless provision, and the dealer versus investor problems that prompted its enactment still remain. The time is ripe for Congress to consider the failure of its earlier effort and enact legislation that will provide some workable guidelines and infuse some certainty into this chaotic area of tax law. The proposals advanced in this Article are offered as one approach to that end.

191. 17 C.F.R. § 230.144 (1975).