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TAX STATUS OF SUBDIVISIONS UNDER THE INTERNAL REVENUE CODE

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PROCEEDS ARISING FROM the sale of lots in a subdivision project are taxable under the provisions of the Internal Revenue Code as either ordinary or capital gains income depending upon the accounting asset classification pursuant to which the property is held, whether held by an individual, a partnership, a trustee, or a corporation. From an accounting standpoint, in terms of balance sheet classification, the asset land, whether owned by a natural or juristic person, may be listed as "for sale," as an investment, or as a fixed asset, but in the terminology of the Internal Revenue Code, land is classified as a capital or non-capital asset.[1] After the accounting asset classification of the land has been determined, the tax liability of the subdivision owner is then expressed in terms of capital or non-capital assets, and ordinary or capital gains income.

Typical of the way in which the tax issue may arise and illustrative of the consequences which may follow is the case of *Mauldin* v. *Commissioner*[2] wherein the court indicated that the

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1 The accounting equivalent of a capital asset, is one held for investment; the non-capital assets being those held for sale and those described as fixed assets. The Code definition of capital assets, as well as the exclusions therefrom, is to be found in 26 U. S. C. A. § 117(a)(1), for the 1939 Code, and in Section 1221 of the 1954 Code.

2 195 F. (2d) 714 (1952).

problem was one as to whether or not certain lots sold were "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" within the exclusionary clause of Section 117(a)(1) of the Code. If so, the gain from the sale of the lots constituted ordinary income taxable under Section 117(a)(1); if not, a capital gains tax became payable.

For the purpose of arriving at a solution to this problem, certain tests have been devised. These tests were once succinctly stated in the following manner:

> determining whether the sales . . . involve properties held primarily for sale to customers in the ordinary course of business or properties held for investment presents a factual question involving a consideration of all the pertinent facts and circumstances. . . . Among the factors primarily emphasized are the taxpayer's purpose in acquiring the property, the continuity, frequency, and substantiality of the transactions, and the sales activity in relation thereto. No one of such tests is determinative.[3]

But it cannot be said that the mere making of statements concerning these rules, as expressed in decisions and in articles on the subject,[4] is enough to make them either understood or capable

[3] See Ralph H. Horton, TCM (CCH Dec. 20,573M, 1954). See also Austin v. United States, 116 F. Supp. 283 at 285 (1953), and Boomhower v. United States, 74 F. Supp. 997 (1947).

[4] Texts on the subject include Mertens, Law of Federal Income Taxation (Callaghan & Co., Chicago, 1942), § 22.08; Paul and Mertens, Law of Federal Income Taxation (Callaghan & Co., Chicago, 1934-5), § 19.15; Montgomery, Federal Taxes (Ronald Press Co., New York, 1954), 35th Ed., pp. 9-11; Plaxton, Canadian Income Tax Law (Carswell & Co., Ltd., Toronto, 1947), 2d Ed., pp. 213 and 248; 17 C. J. S., Internal Revenue, § 161. Articles include those by P. Miller, "The 'Capital Asset' Concept," 59 Yale L. J. 837 and 1057 (1950); Malley, "Is Original Purpose Controlling," Eighth Ann. Inst. on Fed. Taxation (1950), p. 845; Clark, "Distinguishing Between Dealer and Investor Sales by Same Taxpayer," op. cit., p. 855; Shaw, "When Does a Seller of Real Estate Become a Dealer," U. of So. Cal. Tax Inst. Proceedings, 1950 Major Problems, p. 325; Allison, "When and How to be a Dealer Rather Than an Investor," N. Y. U. Sixth Ann. Inst. on Fed. Taxation, pp. 444 and 454; Reznick, "Tax Problems in Liquidation," 26 Taxes 1109 (1948); Troll, "The Sale of Unimproved or Subdivided Land," 25 Taxes 441 (1947); Fink, "Dealing in Real Estate," 2 Tax L. Rev. 111 (1946); Lerner, "When is One a Real Estate Dealer," 24 Taxes 645 (1946); Brodsky, "Converting

of being applied for nowhere in the statute does the term "dealer" or the term "investor" appear[5] although most writers proceed to discuss the issue from the standpoint of when an individual is to be considered a dealer and when an investor.[6]

In the language of the Code, the question is one as to whether or not the property is held "primarily for sale," and is a fact question. This could be rephrased as whether the property is held in the accounting classification describing property held for sale. An eminent legal author has written on the subject of the Law of Accounting.[7] Upon the briefest reflection, then, it should be apparent that when, under a statute, the question of the accounting classification of the asset land arises, it is a legal question, and the courts, in determining and applying Section 117(a)(1), have been determining legal questions even though such decisions have accounting consequences.

No problem will arise in the case of a corporate holder because, as noted hereafter, the issue would be determined by the extent of the corporate powers as measured by the law relating to corporations. Nor will it arise in the case of a dealer whose principal and actual occupation is the real estate business. It is only with respect to the individual taxpayer whose principal occupation is not in the real estate business that there is a problem. As to such a person, the issue as to whether land is held in the "for sale" classification turns on a further question concerning the intention of the particular individual. As the net result of the decisions on the subject has been the formulation of certain rules of evidence to be used to ascertain this intention,

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Ordinary Assets into Capital Assets," N. Y. U. Thirteenth Annual Inst. on Fed. Taxation (1955); and Piper, "Certain Changes in Capital Gain or Loss Treatment Under the 1954 Code," ibid. See also Seltzer, The Nature and Tax Treatment of Capital Gains and Losses (Nat. Bur. of Econ. Research, 1951), pp. 211-5, and McMichael, Subdivisions (Prentice-Hall, Inc., New York, 1953). The latter presents the matter from the real estate point of view.

[5] Note, in particular, Allison, "When and How to be a Dealer Rather than an Investor," N. Y. U. Sixth Ann. Inst. on Fed. Taxation, pp. 444 and 454; Shaw "When Does a Seller of Real Estate Become a Dealer," U. of So. Cal. Tax Inst. Proceedings, 1950 Major Problems, p. 325.

[6] It may be noted that courts occasionally mention these terms but, when they do so, it is not by way of statutory construction.

[7] See Hills, "The Law of Accounting," 54 Col. L. Rev. 1 and 1049 (1954).

it is believed that a discussion of these cases should be of benefit. To eliminate confusion, however, the discussion will be restricted to cases involving subdivisions, with only occasional mention being made as to separate parcels. From this discussion, it will be made to appear that the governing rules are of a character which could be classed as being reasonably definite and the application thereof has produced results which may be said to be understandable.

I. Basic Statutory Considerations

Before proceeding to an analysis of these cases, it is important to notice certain fundamental theories which underly the Code provisions on the point. The draftsmen of the Revenue Act of 1921, a statute which provided that land was a capital asset,[8] apparently overlooked the accounting process by which income arising from the sale of land should be computed as well as the relationship of asset classification thereto. The nature of a business determines the classification or purpose for which its assets are held, and the asset classification in turn determines the accounting techniques by which the income on the sale of the respective types of assets is computed. The computation of taxable income is ordinarily made according to accepted principles of accounting in the manner and to the extent modified by the provisions of the Internal Revenue Code, special sections of which provide the method of computing taxable income with respect to the major classes of balance sheet assets such as inventories, investments and fixed assets.[9] By providing that land was a capital asset, without specifying whether the owner was engaged in business or not, this entire process was disregarded.

The accounting aspect involved became inescapable when the Bureau issued an Office Decision which stated: "A taxpayer engaged in the real estate business is not permitted to inventory real estate for the purpose of calculating net income subject to Federal income tax."[10] Stated differently, land, as an asset,

[8] 42 Stat. at L. Ch. 136, § 202 (1921).
[9] See, for example, Int. Rev. Code 1954, §§ 471-2.
[10] O. D. 848; 4 C. B. 47 (1921).

could not be included in inventory for the purpose of computing income from the sale thereof because of the problem of pricing or valuing the inventory. This was due in no small part to the fact that, as a matter of cost and convenience, it would be inexpedient if not impossible to make periodic appraisals of land to arrive at a valuation to be used in an inventory accounting computation. If, instead of professional appraisals, each individual taxpayer were permitted to make his own periodic estimate of value, considerable administrative difficulties would undoubtedly have arisen.[11] As a consequence, the basis provisions controlled and gain or loss was not computed until value was established by an actual sale.

By an amendment included in the 1924 Act,[12] written to prevent the taxation of income at capital gain rates as to land sold by real estate dealers, the principle was recognized that land held for sale by a business was in the nature of inventory and, as a consequence, the profit or income from such sales came to be taxable as ordinary business income even though the principles of inventory accounting could not be used to make the computation. Pursuant thereto, the real estate dealer who holds land in the "for sale" classification reports income from the sale thereof as ordinary business income. The section, however, had a far more reaching application since it could extend to the activities of any individual, whether a dealer or not. If the operation of a subdivision project or the purchase and sale of separate parcels of land forms a known and defined part of the real estate business when carried on to the exclusion of other activities by a corporation or individual, what reason would there be to suppose the same result should not follow when the project represented a venture on the part of an individual who only incidentally engaged in the real estate business and then only with reference to a particular project? Ownership of land being almost universal and the type of business being one "in

[11] Albert F. Keeney, 17 BTA 560 (1929); Atlantic Coast Realty Co., 11 BTA 416 (1928).

[12] 43 Stat. at L., Ch. 234, § 208(a)(8).

which the prime prerequisite is capital in the form of land,'"[13] the problem which faced the courts, therefore, was one to determine whether the individual who had participated in a subdivision project could be said to have engaged therein to a sufficient extent that it might be said he had engaged in the real estate business. If the answer was in the affirmative, the profit derived therefrom was to be taxed as ordinary business income.[14]

II. Judicial Construction of the Code

A. General Intent to do Business

Approaching the problem from the standpoint of the adjudicated cases, it is important, at the outset, to ascertain whether the taxpayer has engaged in business at all. The question as to whether or not an individual can be said to have engaged in business, as well as the meaning to be given to the term "business," has caused interpretation to be given to other sections of the Code as well as in law generally. The results of these prior explorations would appear to be implicit, although not expressly stated, in the cases falling under this topic. For example, the definition of business found in *Flint* v. *Stone Tracy Company*[15] and *Von Baumbach* v. *Sargent Land Company*,[16] relied upon in the leading subdivision tax case of *Richards* v. *Commissioner*,[17] appears to have had its origin in the first edition of Noah Webster's Dictionary. This definition was taken over by the Imperial Dictionary, was referred to in the English case of *Smith* v. *Anderson*,[18] and was there applied to real estate transactions by a court which said that

> anything which occupies the time and attention and labour of a man for the purpose of profit is business. . . . It is a

13 Myra C. Brown, 2 TCM 714 at 717 (1943), affirmed in 143 F. (2d) 468 (1944).

14 Changes made by the 1954 code are noted hereafter. See notes 90 to 92, post.

15 220 U. S. 107, 31 S. Ct. 342, 55 L. Ed. 289 (1911).

16 242 U. S. 503, 37 S. Ct. 201, 61 L. Ed. 460 (1917).

17 81 F. (2d) 369, 106 A. L. R. 249 (1936). See also Miller, "The 'Capital Asset' Concept," 59 Yale L. J. 369 (1950), particularly pp. 854, 885 and 1083. The definition appears to have originated with Noah Webster.

18 L. R. 15 Chan. 247 (1880). See also Buckley, The Companies Act, 12th Ed. pp. 763-4.

> word of extensive use and indefinite signification. . . . There are many things which in common colloquial English would not be called a business, even when carried on by a single person, which would be so called when carried on by a number of persons. . . . The same observation may be made as regards a single individual buying or selling land, with this addition, that he may make it a business and then it is a question of continuity. A man occasionally buys and sells land, as many landowners do, and nobody would say that he was a land-jobber or dealer in land, but if a man made it his particular business to buy and sell land to obtain a profit, he would be designated as a land-jobber or dealer in land. . . . [I]nasmuch as the legislature could not particularize every kind of business which they intended to include, they have, in order to confine the meaning of that large word "business," stated that it is to be a business that "has for its object the acquisition of gain."[19]

Obviously, the acts of the individual are the best evidence of his intention to engage in business and the purpose for so doing. With reference to the subdivision business, however, the determination of intention would appear to involve two types of conditions, those precedent and those subsequent. After evidence of the purpose of acquisition has ben introduced, the factor of frequency and continuity of sales would be in the nature of a condition precedent for it would distinguish business from an isolated or an occasional transaction.[20] Similarly, the showing of a profit purpose would evidence an intention to engage in business, hence would tend to establish the existence of a business. In the average subdivision project there is both a pre-existing intention to engage in frequent and continuous sales and also a purpose to derive profit therefrom so it is hardly necessary to engage in an extended process of induction calling for the evaluation of a multiplicity of factors, the deduction being one

[19] L. R. 15 Chan. 247 at 258-60 and 278.

[20] It might be noted that sales of separate parcels would evidence a profit purpose if made with sufficient frequency and continuity.

which can be quickly drawn from the extent of the taxpayer's participation therein.[21] Nevertheless, the general profit purpose is only prima facie evidence and it may be rebutted by what might be called conditions subsequent. As the various factors mentioned by the courts when considered in their entirety are thus relevant to the extent of the participation, it follows that, if the extent of the participation is inadequate, this fact would operate to defeat the pre-existing intention and would operate in the nature of a condition subsequent.

The impression has been given that the personal participation of the individual in the activities of the business would be necessary for, as one court put it, business is "busyness."[22] While this may be true for some commercial activities, the job involved in subdividing and selling land is usually a major undertaking which calls for the services of others in some or all of its phases. As it is a business which may be managed or carried on by an agent, it would seem that personal participation by the owner would be unnecessary so long as he is responsible as principal. Participation, therefore, should be understood in terms of transactions for which the owner would be legally responsible. Closely related is the idea that, in order to be engaged in business, the individual must be exclusively engaged therein. If there were such a requirement, it could be said that the lot sales from many large-scale subdivision projects would escape taxation as ordinary business income. It is doubtful that this is the law and, in a case under another section of the Code, it was stated: "Nowhere has it been . . . said that the man engaged in trade or business must give his habitual or principal attention to the occupation or employment."[23]

By way of illustrating these points, attention is directed to the case of *Phipps* v. *Commissioner*,[24] the first of the cases in

21 In the case of Ethel M. Hauk, 10 TCM 925 (1951), the Tax Court said that the "extent of the taxpayer's activity with or concerning the subject matter is the predominating test."

22 Snell v. Commissioner, 97 F. (2d) 891 at 892 (1938).

23 See the opinion of Manton, C. J., in Mente v. Eisner, 266 F. 161 at 164 (1920).

24 54 F. (2d) 469 (1931).

which application of this section was attempted to a subdivision project conducted by an individual who was not otherwise actually engaged in the real estate business. The Circuit Court of Appeals for the Second Circuit there held that the individuals were not engaged in the real estate business but, in the "wisdom of retrospect," and in the light of subsequent decisions, the court appears to have decided erroneously on every point involved.[25] The Phipps family there concerned possessed vast wealth, most of which was invested in real estate located in various parts of the United States and owned and managed by a family corporation. The petitioners, apart from the activities of their corporation, had individually purchased several tracts of Florida land, one of which had been subdivided into seventy-one lots. After title had been taken in the name of an agent, the tract was surveyed, cleared, plotted, ornamented with trees, and furnished with roads, water, sewers, and electric lights. In the seven years preceding the two taxable years in question, approximately 76% of the lots had been sold at an approximate gross sales price of $337,800. For the two taxable years, gross sales[26] were $105,700 and $84,300 respectively. It was the opinion of the Board of Tax Appeals that the subdivision was a joint venture and that "the petitioners were dealers as well as investors in real estate."[27]

On further review, the Circuit Court of Appeals reversed this decision, basing its opinion on the fact that the real estate transactions which occurred were too limited and the sales were not sufficiently frequent. In that connection, the court said:

> There should be a greater continuity and a larger absorption of time in such transactions to make the taxpayers more than investors. . . . [N]othing was done . . . but to hold land for sale . . . and to accept such offers . . . as were presented by brokers and seemed satisfactory. There was

[25] While the Phipps case has not been expressly reversed, the holding in the case of Richards v. Commissioner, 81 F. (2d) 369, 106 A. L. R. 249 (1936), and in subsequent decisions, would appear to indicate an implied reversal.

[26] No sales office was maintained, all sales apparently originating through independent real estate brokers who operated in the vicinity of the property.

[27] See 19 BTA 1293 at 1297.

> . . . no activity amounting to a trade or business. . . . [W]hether there was such a . . . business depended on the situation of the taxpayers at the time of sale. They had not continuously engaged in the development and sale, or the purchase and sale of land.[28]

Without doubt the court considered all of the elements involved but, in the light of subsequent decisions, not only improperly evaluated all of them but also disregarded the holding in *Mente* v. *Eisner*,[29] a case which had been decided in the same circuit some eleven years previously, wherein it was held that a man did not have to give his habitual or principal attention to his occupation or employment.

B. INTENT TO DO SUBDIVISION BUSINESS

The extent of the participation of the individual in a defined and particular business, that of subdividing and selling land or in purchasing and selling separate parcels, being evidence of his intention to engage in business, hence evidence of such business, it would be desirable to give first consideration to the factor of frequency and continuity of sales. Before this can be done, however, it is necessary to find answers to two subordinate questions, *i. e.*, the frequency and continuity of what sales and in what way are the elements of time and quantity involved?

Using the language previously quoted from the case of *Smith* v. *Anderson,* a business exists when an individual carries on a series of acts "having the acquisition of gain for their object."[30] In the case of sales of separate parcels, otherwise unrelated transactions become related by means of the profit purpose, the cumulative effect of such sales or the frequency and continuity of taking profits indicating the intention to engage in business. In contrast, again where separate parcels are involved, a prolonged holding period by the taxpayer would

28 54 F. (2d) 469 at 471.
29 266 F. 161 (1920).
30 L. R. 15 Chan. 247 at 278 (1880).

indicate an insufficient frequency and continuity to amount to "active current trading," so the asset would be considered as being held in the investment classification.[31]

But, in the case of subdivisions, the length of the holding period prior to sale cannot defeat the pre-existing profit purpose nor the existence of the business which it evidences. A subdivision being a single venture for the purpose of profit, the court in the Phipps case was in error in attempting to isolate the sales for particular taxable years for the purpose of determining the existence of a business in each and every year. If this were to be permitted, the taxpayer might be considered as engaging in business in all of the years, in none of them, or in some years but not in others. Since the profit purpose is the essential element, the quantitative aspects of any given subdivision project should be immaterial.

This fact is borne out by the cases. They do not specify that a subdivision must comprise a specified number of lots, or acres, or dollar volume of sales and, with the exception of the Phipps case in which it was held that profits of approximately $42,000 in each of two consecutive years indicated sales 'too limited to amount to a business in real estate,"[32] the question of the sufficiency of the financial magnitude of sales has not arisen in any subdivision case.[33] It is true that most of the cases which have reached the Tax Court have involved subdivisions on a major scale, but even in the small-scale subdivision cases no issue of quantum or magnitude has been raised. Thus, in the case entitled *Amelie M. Staff*,[34] the taxpayer was held to be engaged in the business of subdividing and selling real estate when she subdivided eight acres into twenty-six lots, about fifteen of

[31] Harriss v. Commissioner, 143 F. (2d) 279 (1944); James L. Vaughan, 7 TCM 288 (1948).

[32] Phipps v. Commissioner, 54 F. (2d) 469 at 470 (1931).

[33] Austin v. United States, 116 F. Supp. 283 (1953). On the basis of the explanations there provided, the continuous sales of substantial values in real estate lose much of their normal force as an indication of real estate activity.

[34] 3 TCM 1145 (1944).

which were sold over a ten-year period, despite the remark that the operations of the petitioner "were not extensive."[35]

The fact that the taxpayer, a real estate dealer, has engaged exclusively in the real estate business is evidence of his profit purpose, hence the frequency and continuity rule would be immaterial with respect to him.[36] It should be noted, however, that if the rule has no application to the business as a whole, it has no application to any component activity thereof, so it cannot be used for the purpose of determining the accounting or balance sheet classification of any land which he may hold as a dealer. Thus, in the case of *Charles H. Black, Sr.*,[37] an attempt by the Commissioner to classify the purpose of holding of various parcels of land by a real estate dealer on the basis of the frequency and continuity rule was rejected and the fact that most of the dealer's sales were of residential property was not considered material. However, the frequency and continuity rule is applicable to sales made by a dealer on his own account apart from the sales made in the course of his business.[38]

What is the inference to be drawn as to the purpose of holding when the frequency and continuity of sales ceases for a long period of years, or when there is a prolonged holding period? The answer might depend on whether the person is a dealer or an individual and whether the prolonged holding is the product of his voluntary act. In the case of an individual not otherwise engaged in the real estate business, a prolonged holding period would be evidence that the land was held in the investment classification for, to evidence the profit purpose necessary to the existence of

[35] 3 TCM 1145 at 1150.

[36] Lobelle v. Dunlap, 210 F. (2d) 465 (1954); Martin v. United States, 119 F. Supp. 468 (1954).

[37] 45 BTA 204 (1941). See also Weyman Willingham, 12 TCM 584 (1953).

[38] Eddy D. Field, 8 TCM 170 (1949), affirmed in a per curiam opinion in 180 F. (2d) 170 (1950). See also Robert C. Symonds, 10 TCM 721 (1951); Dan D. Jones, 10 TCM 781 (1951); Helga Carlen, sub. nom. McKay v. Bowers, 20 TC 573 (1953). The House Committee Report on the Internal Revenue Code of 1954 included a proposed Section 1237 designed to permit dealers to hold real estate for investment in a separate account: U. S. Code Cong. and Admin. News, No. 5, April 5, 1954, p. 962. The Senate Committee deleted this provision: ibid., No. 12, July 5, 1954, p. 2745.

a business, there must be a sufficient frequency and continuity of sales. In the case of a dealer, as to whom no such profit purpose must be established, the answer would depend upon whether the holding was the consequence of his voluntary act. Thus, in the case of *Walter G. Morley,*[39] the petitioner had carried on real estate operations for gain for many years prior to 1931. After 1931, his purchases and sales virtually ceased, but the court said it was "not convinced that he abandoned his business of selling real estate." It noted that the taxpayer's activity "was not restricted or halted by reason of any change in his plans or purpose, but rather by the force of economic circumstances beyond his control and not of his making. The general business depression of the past decade was the reason for the curtailment of petitioner's activity."[40] It might be noted that this rule has been applied to real estate dealers who have engaged in subdivision projects[41] as well as to dealers in separate parcels.[42]

C. IN BUSINESS OR IN LIQUIDATION?

It has been pointed out that, in the first instance, asset classification is to be determined by the purpose of acquisition. Occasionally, the circumstances of acquisition may conclusively establish the purpose thereof, as was true in the case of *George W. Wibbelsman*[43] wherein it was held that the syndicate agreement established that the land was held in the "for sale" classification. The taxpayer there, in order to acquire a certain tract desired for subdivision, had been obliged to purchase seventeen additional sites of an undesirable nature. The agreement provided that the lands were to be sold as a whole, either in separate parcels or as subdivided land, the "sole purpose of the venture being to buy and sell lands for a profit,—not to hold them for investment."[44] The classification of the various tracts being

[39] 8 TC 904 (1947).
[40] 8 TC 904 at 915-6.
[41] Harry F. Payer, 5 TCM 917 (1946); Julius Goodman, 40 BTA 22 (1939).
[42] Jay Burns, 21 TC—(No. 100, 1954); Walter G. Morley, 8 TC 904 (1947).
[43] 12 TC 1022 (1949). See also Friend v. Commissioner, 198 F. (2d) 285 (1952).
[44] 12 TC 1022 at 1026.

governed by an indivisible contract directed toward the accomplishment of a single purpose, the only way in which a change in asset classification could have occurred would have been by a change in the contract itself, namely, by a novation. Since a novation did not appear, the purpose so established was both prima facie and conclusive evidence on the point.

Asset classification, established by the purpose of acquisition, being no more than prima facie evidence, the presumption may be rebutted by circumstances in effect or controlling at the time of disposition. For example, even though the purpose of acquisition supported an initial classification as an investment or fixed asset, this original purpose may have to yield if the owner should later engage in a business in which the asset is thereafter held in the "for sale" classification. In that connection, an owner may desire to liquidate an investment or fixed asset. Is it possible for him to do this without engaging in business? Since liquidation may include business, the distinction between business and liquidation must be made in terms of purpose. The ultimate respective purposes are divergent. Liquidation looks toward the termination of the particular business, trust or fund, profit not being the primary object or purpose. Business, on the other hand, envisages creation, a continuous expanding growth, with profit the primary and essential purpose without which growth could not occur.

The contention was made, in all of the cases discussed hereafter under this topic, that the owner was engaged in liquidation rather than business. In the Richards, Ehrman and Snell cases, the contention was apparently based on the Phipps case. These cases, however, rejected the holding of the Phipps case and established the point that engaging in a subdivision project is engaging in a business, thereby rebutting the purpose of holding which had been established prior thereto. Since the normal reason for engaging in a subdivision project would be because of the profit purpose, it could hardly be claimed that the project was no more than a vehicle for liquidation. Nevertheless, the method by which the sales were made would become important

in determining whether the purpose was or was not one for profit. If the land was subdivided subsequent to acquisition, the conduct of the subdivision and the solicitation of sales would evidence a profit purpose. If, in contrast, the land had been subdivided prior to acquisition, and the lots were sold without active solicitation by the taxpayer, evidence of a profit purpose would probably be lacking, hence the circumstance of acquisition would establish the asset classification rather than the circumstances existing at the time of disposition.

1. *Subdivision After Acquisition.*

On the first of these points, it could be said that the leading case with respect to the tax consequences attendant upon subdivision after acquisition is the case of *Richards* v. *Commissioner.*[45] The petitioner there had purchased lands near Los Angeles which he used for truck gardening purposes. The subdivision of adjacent property caused his property to increase in value to such an extent that it became unprofitable to continue to use the land as a truck garden, so petitioner determined to subdivide a portion of the property. For this purpose, he conveyed to a corporate trustee not only to secure his note but also upon the further trust to subdivide and sell the property conveyed, the trust deed appointing an exclusive agent to subdivide, improve and sell. Petitioner took no active part in the subdivision or sale of the lots and, while conceding that he held the property primarily for sale, he urged that it was not held for sale in the course of his business because the planned disposition really constituted a liquidation. The Board of Tax Appeals denied this contention by pointing out that the petitioner had not liquidated his business of farming, but rather had enlarged it by the lease or purchase of other properties. What he had done was to take certain assets individually owned and devote them to a new purpose.[46] The Circuit Court of Appeals concurred, say-

[45] 81 F. (2d) 369, 106 A. L. R. 249 (1936). See also Chandler v. U. S., 121 F. Supp. 722 (1954).

[46] 30 BTA 1131 at 1135 (1934).

ing that it was quite obvious that the reason the petitioner had subdivided the land for sale was to obtain a larger profit.

Similarly, in the case of *Ehrman* v. *Commissioner*,[47] the initial intention was not to engage in a subdivision project but, when faced with the alternative of selling as a single tract or subdividing, the actual conduct of the project became dominated by the profit motive. Having elected to change his intention, the taxpayer was unable to rely on the circumstance of acquisition as a basis for the claim of liquidation. In that case, the taxpayer and other heirs had inherited a ranch worth about four million dollars. The heirs were opposed to a subdivision project, so they sold the ranch outright to a corporation in a single transaction with a down payment of $250,000 and with the balance payable over a ten-year period. The corporation subdivided the property but, upon its default, the property was reacquired by the taxpayer and the other heirs in the form of a subdivision. Upon advice, the heirs employed a selling corporation to carry on the work of the subdivision but asserted they were engaged in a liquidation of the property because they had been forced into the position "by reason of the condition of the property when it was reacquired by them" after the default. The Court of Appeals, nevertheless, relying on the Richards case, held the heirs were engaged in business.[48]

The question has also arisen as to whether a real estate man could be said to be liquidating his business because he had not continuously engaged therein nor was vigorously promoting it to the maximum extent possible. Since the taxpayer in *Snell* v. *Commissioner*[49] had been exclusively engaged in the real estate

47 41 BTA 652 (1940), affirmed in 120 F. (2d) 607 (1941), cert. den. 314 U. S. 668, 62 S. Ct. 129, 86 L. Ed. 534 (1941). See also Shearer v. Smyth, 116 F. Supp. 230 (1953).

48 The Board of Tax Appeals had clearly stated the profit purpose when it said: "We are not convinced that a sale as acreage, as investment property, without going into business with it would have been disastrous, but rather, on the contrary, that it could have been so sold in some reasonable transaction. A better financial result, and not necessity, thus appears as the reason for carrying on with the subdivision." See 41 BTA 653 at 663.

49 97 F. (2d) 891 (1938). See also Estate of Wilson Critzer, CCH ¶ 20,691M, TCM 1954-211.

business, it would appear to have been unnecessary to find that he had continuously engaged therein. Even so, his claim that he was liquidating his business was not well substantiated when it appeared that he was one of the largest real estate operators in the vicinity and had made sales of approximately $1,803,000 for the four taxable years in question. The fact that he had purchased no additional land was a circumstance of minor significance when compared to the large-scale nature of his operations which involved sufficient promotional and developmental activity to preclude the inference of an intention to liquidate.[50]

Apparently, both from an analogy drawn from the law of trusts and from the interpretation given by the courts to the provisions of the Code pertaining to the taxation of trusts as associations,[51] an attempt has been made to claim that liquidation rather than business was the principal motive when land sales were passively made. The nature of the sales, whether active or passive, however, should be considered in connection with the owner's intention to engage in a subdivision project for the fact that the taxpayer was able to make sales without active promotion should not be deemed to be a circumstance of controlling significance if the taxpayer has a clear intention to engage in such a project. In *Oliver* v. *Commissioner*,[52] for example, the petitioner found that his property was in demand because of its proximity to the nation's capital. He surveyed and subdivided the tract and improved the property with streets and drainage. The only advertising he did was to erect a "for sale"

[50] In that connection, the court said: "The word . . . business . . . implies that . . . the activity is an occupation. It need not be one's sole occupation, nor take all his time. It may be only seasonal, and not active the year round. It ordinarily is implied that one's own attention and effort is involved, but the maxim qui facit per alium facit per se applies, and one may carry on a business through agents whom he supervises. The present taxpayer therefore does not demonstrate that he was not engaged in business because he also rented his buildings and operated a golf course; nor because he was usually absent from Florida for five months in the year when there was no business activity in St. Petersburg; nor because he made most of his sales through brokers as his agents." 97 F. (2d) 891 at 892-3.

[51] See Dean, "Federal Taxation of Trusts as Associations," 14 Temp. L. Q. 333 (1940).

[52] 138 F. (2d) 910 (1943). See also Mauldin v. Commissioner, 195 F. (2d) 714 (1952); Ralph A. Horton, TCM (CCH Dec. 20,573M, 1954), and the companion case of Julian E. Ross, TCM (CCH Dec. 20,615M, 1954). Contra: Daniel W. Ellis, TCM (CCH Dec. 20,106M, 1954).

sign. He did not employ solicitors, personally taking prospective buyers on tours of inspection. The court denied his contention that he was merely liquidating a capital asset.

Likewise, in the case of *Lizzie May Jackson,*[53] the taxpayer's intention to engage in a subdivision project could be inferred from the surveying and platting of the property into lots and the preparation of deeds and abstracts of title so that she could transfer title to any lot without difficulty, all done in accordance with the advice of her attorney. The passive nature of the several items of the taxpayer's conduct in not making any improvements, or putting up of "for sale" signs, or listing the lots with real estate agents, or holding herself out to the public as being in the real estate business in that she had no office or license, were all held to be immaterial.[54]

While, in the two cases last mentioned, there was evidence of an intention to engage in a subdivision project, the case of *R. H. Hutchinson*[55] indicates that there may be times when no such intention exists and that passive sales could be made in a manner to demonstrate an attendant circumstance of liquidation. The petitioner there, in order to acquire a site for his factory at an advantageous price, had been obliged to purchase an eight-acre tract which he platted into thirty-seven lots. Twenty-one of these lots he reserved for the factory site and he planned to dispose of the remainder. Since the site selected was principally suitable for factory uses, the property presented limited opportunity, if any, for residential development or use and the excess property had only a salvage value at best. Limited improvements were put in, primarily for the benefit of the factory. The taxpayer did not advertise, all sales resulting from approaches made by prospective purchasers. The small-

53 5 TCM 271 (1946).

54 The taxpayer was held to have been engaged in the real estate business when, over a seven-year period, she sold 32 lots at a gross selling price of $32,720 to purchasers who sought her out: 5 TCM 271 at 272.

55 8 TCM 597 (1949). See also Wells V. Kelm, 52-2 USTC ¶ 947; W. T. Thrift, Sr., 15 TC 366 (1950); Maudine Neese, 12 TCM 1058 (1953); Nathan Schwartz, 10 TCM 400 (1945); Barber v. Edwards, Adm'r, 55-5 CCH ¶ 9329.

scale nature of the operation, the limited developmental activity, and the fact that nothing was done to evidence the conduct of a subdivision project or to engage therein was enough to defeat the usual conclusion which would have treated the income as being ordinary income.

2. *Subdivision Before Acquisition*

The remaining cases which have bearing on the tax liability of the owner of a subdivision are those in which the property was subdivided prior to acquisition. In these cases, the fact of subdivision was considered relevant to an intention to engage in a subdivision project only if the land was acquired for that purpose or was actually so used even though not acquired for such purpose. In contrast, the fact of subdivision has been held to be irrelevant to the purpose of acquisition in those cases discussed hereafter in which it was shown that the acquisition came by way of inheritance, by foreclosure, or to protect liens. Since, in a subdivision project, the subdividing of the land, its development, and the sale thereof are related, with the principal and only purpose being that of disposition at a profit, it follows that, in the last mentioned instances, provided there is no development or improvement of the tract and the sales are passive, the resulting disposition of the lots cannot be said to resemble the subdivision business but are really an attendant circumstance upon a liquidation.[56] Evidence disclosing a solicitation of sales, however, would give rise to the inference that the owner has engaged in a subdivision project even though the land had not been acquired for that purpose.

In *White* v. *Commissioner*,[57] for example, the petitioner acquired a number of different subdivisions in 1930 in order to protect sizable liens thereon for paving and other work done. No sales of lots took place for several years because of the depression. Following acquisition, some houses were constructed

[56] Ethel M. Hauk, 10 TCM 925 (1951); Dagmar Gruy, 9 TCM 235 (1950); Ashton C. Jones, Jr., 1 TCM 816 (1943).

[57] 172 F. (2d) 629 (1949). See also Beatrice Brenneman, 11 TCM 628 (1952).

on parts of the property, which represented the only improvements of any kind made by petitioner. Sales resulted from offers made by the public at the office of the petitioner's paving business and, for the years in question, a profit accrued from such sales. The petitioner claimed that he had been forced to acquire the properties to protect liens and to collect what was due for work done in relation to the paving business, so the sales constituted no more than a liquidation of an investment. Despite this, the court, relying on the frequency and continuity rule, was of the opinion that the number of lots sold, the consideration received, and the profits realized revealed that the sales were not casual but rather indicated a frequency, a continuity, and a volume characteristic of one engaged in the real estate business on a rather substantial scale. No intention to engaged in a subdivision project could be inferred from the purpose of acquisition, for the expressed purpose was to protect the liens. The actual use made of the land, as indicated by the frequency and continuity of sales, however, did operate to establish the necessary intention. Moreover, the sales were not passively made but were solicited. Since solicitation may be either direct or indirect, the court also regarded the construction of the houses as an indirect form of solicitation which, when added to the frequency and continuity of sales, served to indicate an intention to engage in, or at least to complete, a subdivision project.

The facts in the case of *Guthrie* v. *Jones*[58] were slightly different in that the taxpayer, engaged in the loan and investment business, had acquired a subdivided addition to a city by the process of foreclosure. While the opinion in the case does not disclose the total number of lots in the subdivision, some 213 lots were sold in a three-year period with 84 sales falling in the taxable years. The lots were sold in the condition in which they had been acquired, no improvement having been made. The taxpayer did not directly solicit or promote these sales as the

58 72 F. Supp. 784 (1947). See also Brodsky, "Houses Originally Built for Investment," N. Y. U. Twelfth Ann. Inst. on Fed. Taxation, p. 109.

purchasers either sought him out or were brought in by an independent real estate salesman who had been permitted by the taxpayer to maintain an office on the premises. The salesman was not subject to supervision. The District Court was of the opinion that the taxpayer had not engaged in business, stating: "The sale of the lots . . . was made to regain the amount of the loan; . . . the sales were irregular and lacking in continuity for over eight years; the bulk [having been] due to the growth of the community and the change of economic conditions."[59] After an appeal had been docketed in the Circuit Court of Appeals,[60] the case was dismissed on a stipulation of the parties. The lower court's decision is a questionable one for, by permitting an independent salesman to maintain an office at the subdivision, the taxpayer was holding out to the public the fact that the lots were for sale, was extending an implied invitation to the public to make offers, and was, in effect, indirectly soliciting such offers.

Contrast is provided by the case of *Frieda E. J. Farley.*[61] The petitioner there had purchased a tract of unimproved pasture land near the outskirts of a city and had, for a long period of years, used the property for a nursery. Prior to this purchase, the tract had been platted and divided into numbered lots and streets delineated officially on a map of record in the appropriate public office. Subsequent to acquisition, the city improved certain of the streets but no improvements which had any relation to a subdivision project or which were designed to enhance residential occupancy had been made by the taxpayer. Because of restrictive covenants in the deed, petitioner had been unable to erect fences to protect the nursery from encroachment. Eventually, when approached by friends, the taxpayer sold twenty-five of the 175 lots in the tract. The taxpayer did not engage in any activity whatsoever to promote these sales, did no advertising, hired no agents, did not list the property nor erect

59 72 F. Supp. 784 at 785-6.

60 See 163 F. (2d) 1018 (1947).

61 7 TC 198 (1946). See also Thomas E. Wood, 16 TC 213 (1951).

any signs. The Tax Court, noting that the taxpayer "could have maintained a more passive role only by refusing to sell at all,"[62] reached the conclusion that the taxpayer was engaged in liquidation and not in business. As the property had been subdivided prior to acquisition and had not been purchased or used for a subdivision project, any intention on the point necessarily had to be inferred from the circumstances of sale. The sales occurred in one taxable year and no mention was made as to the manner of disposition, if any, of the remainder of the lots. The question could well be raised, therefore, whether an intention to engage in a subdivision project could be said to exist in the event the remainder of the lots were sold in subsequent years.

The one remaining case, that entitled *Estate of Alice Kleberg, deceased,*[63] involved a situation wherein property which had already been subdivided had been acquired from the estate of the taxpayer's deceased husband when, in the course of the administration of the husband's estate, the executrix had been obliged to discharge his liability on the note of a certain land company in which he had been a stockholder. The executrix paid one-half of the liability and the balance was paid by another member of the family who was also an endorser. In return, the entire assets of the land company were turned over to the endorsers and the executrix acquired the outstanding interest in the land upon payment of half of the stipulated value to the other endorser. No improvements were made and the lots were never advertised for sale. Such sales as were made occurred when someone desiring to buy a lot would make a bid, with the bidder being told that the lots were not for sale in the event the bid was too low. No commissions were paid or received by anyone connected with these sales. The only act performed by the taxpayer in relation to the real estate, other than paying the taxes thereon, was to sign a deed whenever a sale was

[62] 7 TC 198 at 203.

[63] 5 TCM 858 (1946). See also Shearer v. Smyth, 116 F. Supp. 230 (1953); Martin Dressin, 17 TC 1443 (1952); Estate of W. D. Haden, deceased, 12 TCM 825 (1953).

made. It should occasion no surprise, therefore, to learn that the Tax Court held that the income from these sales was to be taxed only as a long-term capital gain.

D. DOING BUSINESS THROUGH OTHERS

The owner of land in no way alters his tax liability if he refrains from personally operating the subdivision business and leaves the conduct thereof to his agents[64] or to trustees[65] for, as noted above, the question is not one which requires that the taxpayer give his exclusive or even his personal attention to the activity.[66] Whether the relationship of principal and agent exists depends, of course, upon the degree of control over the transactions retained by the owner of the land[67] and, if sufficient control is retained, an agency exists even though the contract between the parties provides for the shifting of a major part of the cost of development and sales activity to another.[68]

In the event the taxpayer chooses to use a trust device, he should remember that a trustee may engage in a subdivision project either pursuant to an express power[69] or by reason of an implied power needed to accomplish the purposes of the trust.[70] If the power has been expressly stated, the settlor-beneficiary will not be permitted to claim that the income is not ordinary business income or that the acts of the trustee are unrelated to the purposes expressed simply because the trustee could dispose

64 Snell v. Commissioner, 97 F. (2d) 891 (1938).

65 Bogert, Trusts and Trustees, Vol. 2, § 250. In Richards v. Commissioner, 81 F. (2d) 369, 106 A. L. R. 249 (1936), the trustee employed an agent to subdivide and sell the land.

66 See notes 22 to 29, ante.

67 Fahs v. Crawford, 161 F. (2d) 315 (1947); Boomhower v. United States, 74 F. Supp. 997 (1947); Martin v. United States, 128 F. Supp. 576 (1954).

68 Brown v. Commissioner, 143 F. (2d) 468 (1944); W. D. Haden, 2 TCM 1029 (1943); Rosalie H. Bosworth, 2 TCM 773 (1943).

69 Bogert, op. cit., Vol. 2, § 250. See also Sections 267 and 307, and Vol. 3, Part 1, § 551. Compare with Welch v. Solomon, 99 F. (2d) 41 (1938), and Richards v. Commissioner, 81 F. (2d) 369, 106 A. L. R. 249 (1936).

70 If reliance is placed on the implied powers of the trustee, the intention as to the holding must be determined from the acts of the trustee rather than from the terms of the trust instrument, in the event the instrument fails to designate the purpose of holding or is not introduced in evidence: William R. Watson, 6 TCM 772 (1947); W. N. Foster, 2 TCM 595 (1943).

of the land in his uncontrolled discretion.[71] When, however, the power to engage in a subdivision project is merely incidental to the principal purpose of the trust, it will be deemed to be without significance particularly when only a small percentage of the total number of lots has been sold and, in effect, the power has not been exercised.[72]

E. CORPORATE HELD LANDS

1. *Business Corporations.*

As the basic purpose of every business corporation is to make a profit, the asset classification to be given to land held by corporations, even for income tax purposes, will be determined by the law relating to corporations and not by the Internal Revenue Code.[73] In that connection, it must be noted that land may be acquired pursuant to an express power contained in the corporate charter, under an implied power, or as the result of an ultra vires transaction. In much the same way, the asset classification to be given to land, whether held for sale, for investment, or as a fixed asset, will be dependent upon the power pursuant to which it is acquired. The power to "buy, sell and deal in land," that is to hold it in the "for sale" classification, must usually be expressly authorized by the charter, either as the principal or at least a fundamental purpose of the corporation,[74] but every corporation has an implied, if not an express, power to "own such real property as is reasonable necessary" to the corporate business and purposes.[75] Land of this character, including the buildings thereon, would be placed in the

[71] Thornton v. United States, 53-2 USTC ¶ 9536 (1953).

[72] Helen Schwerin Trust, 13 TCM —, CCH Dec. 20,203M (1954).

[73] See Bartlett, "The Impact of State Law on Federal Income Taxation," 25 CHICAGO-KENT LAW REVIEW 103 (1947), particularly pp. 106-13.

[74] Fletcher, Corporations, Vol. 6A, § 2804, and Vol. 1, § 96, pp. 335-8. See also Palos Verdes Corp. v. United States, 201 F. (2d) 256 (1952); Spanish Trail Land Co., 10 TC 430 (1948). It should be noted that land may be acquired pursuant to implied power, even though the corporation possesses an express power to engage in the real estate business, if in fact the acquisition was not pursuant to the express power.

[75] Fletcher, op. cit., Vol. 6A, §§ 2789 and 2796.

fixed asset classification. Corporations also have an implied power to acquire land, as a proper incident to the conduct of authorized principal transactions, in the event it is necessary to do so in order to secure satisfaction of debts due them.[76] Such land would be classified as an investment and the corporation might well be placed under a duty to dispose of it at the earliest practicable time.[77] Land acquired as a result of an ultra vires transaction has also been held to fall in the investment classification.[78]

The foregoing propositions as to corporate held lands could well have bearing on the matter of tax liability. In addition, while courts have discussed the matter of frequency and continuity of sales in the corporation cases, it should be kept clearly in mind that, this rule being merely a rule of evidence, it is relevant only on the question of the exercise of an existing power and does not go to the existence of the power itself.[79]

The tax consequences attendant upon corporate land holding may be illustrated by a few cases. In the one entitled *Thompson Lumber Company*,[80] the land represented security for unpaid accounts and was acquired by foreclosure and by voluntary conveyance. The unpaid accounts arose from the conduct of the principal business, that of furnishing lumber and building material. While the corporate charter authorized the company to engage in the real estate business, it did not appear that it was so engaged or that the land was acquired pursuant to such power. When this land was sold at a loss, a question arose as to whether a deduction could be taken in the full amount or only as to a part thereof. It was held that the taxpayer, despite its charter, was not engaged in the real estate business, hence the extent of the deductible loss with respect to these capital assets was limited.

76 Thompson Lumber Co., 43 BTA 726 (1941).

77 Three States Lumber Co. v. Commissioner, 158 F. (2d) 61 (1946). See also Fletcher, op. cit., Vol. 6A, §§ 2789 and 2802.

78 Dunlap v. Oldham Lumber Co., 178 F. (2d) 781 (1950).

79 Section 1237 of the 1954 Code is apparently intended to indicate this.

80 43 BTA 726 (1941).

In another case, that of *Wineman Realty Company,*[81] the corporation was engaged in the business of renting improved properties which it either acquired or constructed. In twenty years, only three of the properties had been sold because unprofitable from a rental standpoint. The building concerned in the tax dispute had been constructed for rental to a merchandising chain and was finally sold to that company at a loss. While the taxpayer possessed a charter power to "purchase, hold and deal in real estate," the property in question was neither acquired or disposed of pursuant to such power but represented a unique type of transaction on the taxpayer's part. It was decided that, under these unique circumstances, the property was held apart from any aspect of the ordinary course of the business.

Even though a corporation would have implied power to acquire land as an incident to its authorized transactions, subject to the obligation to dispose of the same within a reasonable time, the corporation involved in the case entitled *Thompson Yards, Incorporated,*[82] enjoyed an express power to this effect. Under the circumstances, it was not difficult to uphold a contention that land of this character fell into the investment or capital asset type. In *Dunlap* v. *Oldham Lumber Company,*[83] however, the charter of the corporation restricted its power to "buying and sale of lumber, building materials, coal and agricultural products of any description." Contrary to this charter power, fifty lots in a platted and approved subdivision, improved only by streets, were acquired with the probable thought in mind of selling the same to customers who would purchase lumber and the like with which to erect houses thereon. The lots were disposed of irregularly over a period of eighteen years and the sales were not made as a part of and did not forward in any way the principal authorized lumber business. The ultra vires

81 1 TCM 791 (1943). See also Houston Deep Water Land Co. v. Schofield, 110 F. Supp. 394 (1952) ; South Texas Properties Co., 16 TC 1003 (1951).

82 1 TCM 822 (1943).

83 178 F. (2d) 781 (1950).

manner of acquisition and the method of disposition of these lots also resulted in their inclusion in the investment classification.

2. *Specialized Corporations*

Unlike the principles which control with respect to ordinary business corporations, the asset classification to be given to land held by certain specialized corporations, such as insurance companies, railroads, banks and trust companies, would be likely to be governed by the charter powers thereof or be open to special statutory regulation. Banks, for example, may hold real estate only in accordance with those purposes enumerated in the state banking laws or the National Bank Act.[84] If the real estate is acquired as a site for the bank's place of business, such real estate becomes a fixed asset. When acquired in the course of securing satisfaction for debts due, the bank is usually under a limitation with respect to the period during which such land may be held.[85] Whether this land can be held in the "for sale" classification would be dependent upon the power of the bank to engage in the real estate business under state law.[86] As most banks lack such authority, the classification would normally be governed by the nature of the property rather than by the method of acquisition. The Commissioner, for example, has attempted to have land acquired by banks pursuant to foreclosure excluded from capital assets but, as long as he has advanced the contention that such land was held for sale to customers, he has been unsuccessful.[87] The Tax Court has, however, sustained a General Counsel's Memorandum which directs that "productive" real property, *i. e.*, rented property, should be considered as used in the trade or business of the lending institution[88] and, in accordance therewith, this sort of

[84] Fletcher, op. cit., Vol. 6A, §§ 2806-7.

[85] See, for example, Ill. Rev. Stat. 1953, Vol. 1, Ch. 16½, § 9, which places a five-year limitation period on the right to hold land acquired in this fashion.

[86] Harr v. McLaughlin, 15 F. Supp. 1004 (1936); Kanawha Valley Bank, 4 TC 252 (1944).

[87] GCM 2, 1947—2 CB 187 (1939); GCM 24910—1 CB 28 (1946); Kanawha Valley Bank, 4 TC 252 (1944).

[88] GCM 26690—1 CB 28 (1951).

property has been excluded from the capital assets described in Section 117(j) of the Code.[89] Nevertheless, both under the ruling and the decision, subdivided "non-productive" property would be specifically excluded as an asset and would still be governed by Section 117(a)(1).

F. CHANGES MADE BY 1954 CODE

At the time of enacting the 1954 Code, Congress included a new Section 1237 which deals with the topic of real property subdivided for sale.[90] The provisions of this section would appear to have a highly restricted application but it does amplify on some of the points previously noted. As indicated above, the intention to engage in a subdivision project would be controlling unless that intention is defeated by a condition subsequent. The statute now supplies such a condition subsequent which is made up of three concurrent conditions, namely, lack of intention to hold the property for sale, either this tract previously or other property at the time of sale; lack of substantial improvements; and a five-year holding period. No definition of the term "substantial improvements" appears except as it is spelled out in a proviso to the effect that the installation of water and sewer facilities and roads shall not be so considered if the lots should be held for a ten-year period.[91] In the event the three concurrent conditions are satisfied, gains realized on the sale of the first five lots are to be considered as capital gains. On the sale of the remainder of the lots, 5% of the selling price thereof, less properly deductible expense, is taxable as ordinary income.[92] There is reason to think that the draftsman of this section could have been more liberal and might well have extended relief to a wider class of taxpayers but it remains to be seen whether the Com-

[89] Girard Trust Corn Exchange Bank v. Commissioner, 22 TC — (No. 168), CCH Dec. 20,585 (1954).

[90] Section 1237 of the 1954 Internal Revenue Code falls within Part IV of the statute. That part is devoted to the setting forth of certain special rules for determining the presence of capital gains and losses.

[91] 1954 Int. Rev. Code, § 1237(b)(3)(A).

[92] Ibid., § 1237(b)(1)-(2).

missioner will devise new regulations and what the courts will have to say when they are called upon to construe the term "substantial improvements" as used in the statute.[93]

III. Conclusions

By way of brief summary, it can be said that if an individual subdivides land or engages in any activity related to the sale thereof, the land will generally be considered as held for sale with the proceeds of sale being taxable as ordinary income rather than at capital gains rates. Frequency and continuity of sales for the purpose of profit are evidence of an intention to engage in this business, from which intention the existence of a business and a consequent classification of its assets can be made. The rule applies exclusively to individuals and to their agents, as the asset classification of land held by corporations will be determined by the powers thereof measured by the law of corporations. If land is subdivided subsequent to acquisition, the conduct of the subdivision and the solicitation of sales will be evidence of a profit purpose. If, however, the land has been subdivided prior to acquisition and the lots are sold off without solicitation by the owner, evidence of a profit purpose will be lacking. Under these circumstances, the purpose of acquisition will establish the asset classification rather than the circumstances of disposition, for the latter could be of too passive a nature to support an inference of any kind. The 1954 Code provisions on the point grant relief of a sort but burdens the same with highly restricted concurrent conditions, so the law with respect to the tax liability of the subdivider is, as yet, not without its problems.

[93] An extensive discussion of Section 1237 of the 1954 Internal Revenue Code appears in Manella, "Capital Gains and Losses Under the Internal Revenue Code of 1954," So. Cal. Tax Inst. Proceedings, 1955 Major Problems, pp. 735, 750-71.