REAL ESTATE TRANSACTIONS AND CAPITAL GAINS TREATMENT: A THIRD CIRCUIT PERSPECTIVE

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Today's investor is undoubtedly attracted to real estate; while its value has tended to increase steadily,[1] the performance of other investment media has been characterized by uncertainty.[2] Because this steady increase in value has generally exceeded the prevailing rate of inflation, real estate investment has come to be regarded as an effective method of preserving capital and hedging against the erosion of purchasing power.[3] It is not surprising, therefore, that an increasing number of taxpayers have included real property in their investment portfolios.

The Internal Revenue Code of 1954 (Code)[4] is, however, inlaid with potential tax consequences which may adversely affect the relative attractiveness of a real estate investment.[5] Principal among these is the possibility that a person who considers himself an investor may be denied capital gains treatment upon liquidation of his investment.[6] This Article will survey the various methods of analysis employed by courts to determine whether real property dispositions are eligible for preferential tax treatment; review decisions in the Third Circuit; and suggest planning techniques which will help to assure that investment goals are attained.

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[1] INSTITUTE FOR BUSINESS PLANNING, REAL ESTATE TAX SHELTER DESK BOOK ¶ 103, at 3 (1975).

[2] *See id.*

[3] *Id.*

[4] All cites to the Internal Revenue Code of 1954 are to the Code as amended by the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.

[5] P. ANDERSON, TAX PLANNING OF REAL ESTATE 212–17 (6th ed. 1970).

[6] *Id.* at 212.

QUALIFYING FOR CAPITAL GAINS TREATMENT—THE DEALER/INVESTOR DILEMMA

Although there are a number of tax advantages available to those who invest in real estate,[7] the potential for capital gains treatment upon disposition is clearly among the most attractive.[8] The Code pro-

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[7] These potential tax advantages include accelerated depreciation, I.R.C. § 167(b)(2)–(4), tax free exchanges, *id.* § 1031, deferral of income from installment sales, *id.* § 453, and an election to capitalize interest expenses and real estate taxes, *id.* § 266.

Accelerated depreciation includes the declining balance method and the sum of the years-digits method, both of which result in a greater amount of depreciation in the earlier years than does the straight line method. H. SIMONS, INTERMEDIATE ACCOUNTING 483 (5th ed. 1972). The declining balance method gives the greatest depreciation allowance in the first year and a gradually declining allowance in each subsequent year. *See* Treas. Reg. § 1.167(b)-2(b) example (1) (1964). The rate of depreciation will range from 125% to 200% of the straight line method. New commercial property will be entitled to a 150% declining balance rate, I.R.C. § 167(j)(1)(B), whereas new residential rental property can be depreciated at a 200% rate, *id.* § 167(j)(2)(A), and used residential rental property at a 125% rate, *id.* § 167(j)(5)(B).

The sum of the years-digit method applies a "changing fractio[n] to the cost or other basis of the property reduced by estimated salvage" value. Treas. Reg. § 1.167(b)-3(a)(1). The denominator of each fraction is the sum of the numbers which represent "the estimated useful life of the asset," (*i.e.*, 5 year life, 5 + 4 + 3 + 2 + 1 = 15). *Id.* The numerator for the first year is the number of years of the estimated life of the asset and declines by one each subsequent year (*i.e.*, 5/15 the first year, 4/15 the second year, etc.). *See id.* § 1.167(b)-3(a)(i) example (1) (1956).

The section on tax free exchanges provides that

> [n]o gain or loss shall be recognized if property held for productive use in [a] trade or business or for investment . . . is exchanged solely for property of a like kind to be held either for productive use in [a] trade or business or for investment.

I.R.C. § 1031(a).

A deferral of gains, under the installment method of reporting gains on a sale of real property, is available at the taxpayer's election, if the payments received in the year of sale are not more than 30% of the selling price. *Id.* § 453(b)(2)(A)(ii). Therefore, a taxpayer can defer a capital gain over a period of years to avoid a "bunching" of income. *See id.* § 453(b).

The Code and the regulations provide than an election may be made to capitalize certain taxes or other carrying charges. *Id.* § 266; Treas. Reg. § 1.266-1(a),(b) (1960). Once an election has been made to capitalize a given charge incurred, with respect to a particular project, all similar charges for that project, in future years, must likewise be capitalized. *See* Treas. Reg. § 1.266-1(c)(1), (d) example (2) (1960). However, an election for a single year may be made for annual taxes, interest on mortgages and other carrying charges on unimproved and unproductive real property. *Id.* § 1.266-1(c)(2)(i) (1960).

[8] The real estate investor will be entitled to long-term capital gains treatment if the property disposed of was held for more than one year (nine months if disposed of before December 31, 1977). I.R.C. § 1222(3). This would give the investor a pronounced tax advantage. For example, if a $50,000 gain accrued to a 70% taxpayer, at capital gains rates the tax would be $12,500 whereas if it were classified as ordinary income the tax would be $35,000. *See id.* § 1201(b). Offsetting this tax advantage is the limited deductibility of net long-term capital losses. *Id.* § 1211(b). They are only deductible at a one-to-two ratio—for every two dollars of loss only one dollar can be deducted. *See id.*

visions which provide for taxation of gains realized from capital transactions at rates effectively lower than those applied to ordinary income were specifically designed to benefit investors.[9] Congress did not intend, however, to permit preferential treatment of "profits and losses arising from the everyday operation of a business."[10] If an "investor" in real estate intends to take advantage of the capital gains preference—a major investment goal—he would be wise to refrain, when possible, from activities characteristic of a "real-estate dealer."[11]

Pursuant to relevant Code provisions, an "investor" in real estate is entitled, in theory, to preferential tax treatment upon disposition of his property.[12] In order to qualify, however, the "investor" would be

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§ 1211(b)(1)(C). Furthermore, the amount of the deduction in any given year is limited to the lesser of $3,000 ($2,000 if before December 31, 1977), or "the sum of—(i) the excess of the net short-term capital loss over the net long-term capital gain, and (ii) one-half of the excess of the net long-term capital loss over the net short-term capital gain," or taxable income. *Id.* § 1211. Any loss not deducted in the current tax year may be carried forward and subsequently deducted subject to the same limitations. *Id.* § 1212(b)(1).

The Code also imposes a minimum tax on preference items. *Id.* § 56. The preference items that are relevant to a real estate investor would be the excess of accelerated depreciation over the straight line method, *id.* § 57(a)(2), and "one-half of the net capital gain." *Id.* § 57(a)(9)(A). The preference tax is applied at a flat rate of 15% to the excess of the tax preference items over the greater of $10,000 or one-half of the taxpayer's income tax liability for the current year. *Id.* § 56(a)(1),(2). It would appear that even considering the possible imposition of this tax on preferential items, *ceteris paribus*, an investor's tax liability would be less than if taxed at ordinary income rates.

[9] *See* Burnet v. Harmel, 287 U.S. 103, 106 (1932). Prior to 1921, gains resulting from the conversion or liquidation of capital investments were taxed as ordinary income. *Id.* Such treatment tended to deter capital transactions because "gains, often accruing over long periods of time, were taxed in the year of realization at the high rates resulting from their inclusion in the higher surtax brackets." *Id.*; *accord*, H.R. REP. NO. 350, 67th Cong., 1st Sess. 10–11 (1921). The preferential capital gains provisions were enacted by Congress "to relieve . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to" stimulate such transactions. 287 U.S. at 106.

[10] Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46, 52 (1955).

[11] Definitions of "real-estate dealer" and "investor" are set forth in the Regulations of the Code:

> In general, an individual who is engaged in the business of selling real estate to customers with a view to the gains and profits that may be derived from such sales is a real-estate dealer. On the other hand, an individual who merely holds real estate for investment or speculation and receives rentals therefrom is not considered a real-estate dealer.

Treas. Reg. § 1.1402(a)-4(a) (1963).

Although not statutorily precluded, a "real-estate dealer" has a more difficult time qualifying for the capital gains preference on disposition of real property. *See* notes 33–37 *infra* and accompanying text.

[12] *See* I.R.C. §1221; P. ANDERSON, *supra* note 5, at 87; INSTITUTE FOR BUSINESS PLANNING, *supra* note 1, ¶ 902, at 86; M. LEVINE, REAL ESTATE TRANSACTIONS, TAX PLANNING AND CONSEQUENCES § 592, at 375 (1973).

required to substantiate that the property sold was a "capital asset."[13] Section 1221(1) specifically precludes "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" from the capital asset classification.[14] Its purpose is to exclude from capital gains treatment all of those profits which are regarded as arising from the daily operation of a business.[15] Since a "real estate dealer" normally holds his property in inventory for sale to customers,[16] his profit on a sale of the property would not qualify for capital gains treatment. A sale of such property by a dealer may be considered analogous to a sale of inventory by a manufacturing or retailing firm, or a sale of stock by a securities dealer; and the gain thereon is taxable at ordinary income rates.[17]

Distinguishing and defining "business" as opposed to "investment," then, is a critical step in determining whether property sold by a taxpayer was, in fact, a capital asset. There is, however, no single definition of "trade" or "business" that can be applied satisfactorily to all situations; and the result has been uncertainty and confusion in this area of the tax law.[18]

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[13] Estate of Freeland v. Commissioner, 393 F.2d 573, 574–75, 583 (9th Cir. 1968); Municipal Bond Corp. v. Commissioner, 382 F.2d 184, 188 (8th Cir. 1967).

[14] I.R.C. § 1221(1). In addition, this provision also excludes from capital assets "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year. . . ." *Id.*

A taxpayer holding property which falls within a § 1221 exclusion will not be permitted capital gains treatment. *See id.* §§ 1221, 1222(1)–(4), (9), (10). However, if a real estate dealer incurs a "net operating loss," total losses and other deductions exceed gross income, *id.* § 172(c), then the loss may be used as an income-averaging device to offset gains. J. CHOMMIE, FEDERAL INCOME TAXATION § 94, at 281 (2d ed. 1973). The loss can be carried back three years, forward seven or until totally used whichever is less. I.R.C. § 172(b)(1).

[15] *See* Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46, 52 (1955) (interpreting I.R.C. § 117—predecessor of I.R.C. § 1221).

[16] 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 a trade or business. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 282, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4017, 4424.

[17] Inventory is expressly excluded from receiving capital gains treatment pursuant to I.R.C. § 1221(1). A dealer in securities would be denied capital gains treatment under the Code which states that "[g]ain by a dealer in securities from the sale or exchange of any security *shall in no event* be considered as gain from the sale or exchange of a capital asset . . . ." *Id.* § 1236(a) (emphasis added).

[18] *See* United States v. Winthrop, 417 F.2d 905, 906 (5th Cir. 1969). The Fifth Circuit, in attempting to distinguish the situation where capital gain rather than ordinary income is produced, found "[them]selves engulfed in a fog of decisions with gossamer like distinctions, and a quagmire of unworkable, unreliable, and often irrelevant tests." *Id.*

The term "business" usually connotes a line of work or an occupation pursued for profit, and often involves the purchase and sale, or exchange, of commodities.[19] This is distinguishable from the concept of "investment," whereby a profit is realized not from inventory turnover, but from disposition following an "appreciation in value."[20] The corner grocery, the large department store and the manufacturing concern are all businesses whose daily sales receipts generate ordinary income for tax purposes.[21] By way of comparison, the profit which results from the sale of a residence or a sale of stock by an average investor may properly be called a capital gain.[22]

In obvious cases, such as those noted above, the business/investment dichotomy is clear and the capital asset determination can be made with relative ease. The apparent simplicity of the "ordinary course of business" test is, however, deceptive. An investor must sell or exchange his investment in order to realize any increase in its value. To accomplish this, he will often engage in activities similar to those undertaken by a business whose profit from sales is regarded as ordinary income.[23] For example, an investor who desires to sell a tract of land, purchased many years before as an investment, may be obliged to advertise, add improvements, employ agents and subdivide in order to entice buyers.[24] If such an investor were not familiar with the federal income tax laws, he might be disquieted to discover that he is considered a "real estate dealer" for tax purposes.[25]

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[19] *See* Deputy v. du Pont, 308 U.S. 488, 499 (1940) (Frankfurter, J., concurring); Helvering v. Wilmington Trust Co., 124 F.2d 156, 158 (3d Cir. 1941); M. LEVINE, *supra* note 12, § 474, at 323.

[20] *See* Commissioner v. Gillette Motor Transp., Inc., 364 U.S. 130, 134 (1960); Burnet v. Harmel, 287 U.S. 103, 106 (1932).

[21] *See generally* Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46, 52 (1955).

[22] *See* J. CHOMMIE, *supra* note 14, § 127, at 374 (sale of securities); M. LEVINE, *supra* note 12, § 621, at 397 (sale of residence).

[23] *See, e.g.*, Chandler v. United States, 226 F.2d 403, 405–06 (7th Cir. 1955); Huey v. United States, 504 F.2d 1388, 1392 (Ct. Cl. 1974); Oahu Sugar Co. v. United States, 300 F.2d 773, 778 (Ct. Cl. 1962).

[24] *See, e.g.*, cases cited in note 23 *supra*.

[25] *See* notes 11–17 *supra* and accompanying text. Even though an investor subdivides his property he will still be entitled to capital gains treatment if he can meet the limitations of section 1237 which contains detailed rules regarding tax treatment of land subdivided for sale. I.R.C. § 1237. This section was enacted to eliminate the inequitable tax treatment that resulted when a taxpayer, who was holding property for appreciation, eventually subdivided and advertised his realty as a means of disposal. *See* Weithorn, *Subdivisions of Real Estate—"Dealer" v. "Investor" Problem*, 11 TAX L. REV. 157, 165–66 (1956).

This section was hailed at first as a panacea to the dealer-investor problem. *See id.* at 173. However, since its enactment in 1954, taxpayers have experienced great difficulty in meeting the rigid confines of section 1237. *See id.* at 166–69. In order for a

In distinguishing between "investment" and "business," the courts are left to proceed without specific statutory guidance.[26] They must attempt to define "trade or business" as contemplated by Congress.[27] In a concurring opinion in *Deputy v. duPont*,[28] Justice Frankfurter proposed such a definition, stating that " 'carrying on any trade or business' . . . involves holding one's self out to others as engaged in the selling of goods or services."[29] On this basis, it may

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taxpayer to qualify for this relief provision, specific requirements must be met. First, the property must be held for at least five years unless it was inherited. I.R.C. § 1237(a)(3). If the property was inherited it need only be held for the period required by section 1222. Treas. Reg. § 1.1237-1(d)(2) (1960). Secondly, the tract of land or any part thereof must not have been held primarily for sale to customers. I.R.C. § 1237(a)(1). Also, the taxpayer must not hold any other property in a similar capacity during the current year. *Id.* Thus, it is evident that this provision is not applicable to real-estate dealers. The third and final requirement is that "no substantial improvement that substantially enhances the [property's] value" be made by the taxpayer, his relatives, or any related entities. *Id.* § 1237(a)(2). Note that the Code states that the improvement must be "substantial" to prevent the application of I.R.C. § 1237. The Treasury Regulations identify substantial improvements:

> [T]he improvements considered substantial are shopping centers, other commercial or residential buildings, and the installation of hard surface roads or utilities such as sewers, water, gas, or electric lines. On the other hand a temporary structure used as a field office, surveying, filling, draining, leveling and clearing operations, and the construction of minimum all-weather access roads, including gravel roads where required by the climate, are not substantial improvements.

Treas. Reg. § 1.1237-1(c)(4) (1960); *see id.* § 1.1237-1(c).

However, a substantial improvement will prevent the application of I.R.C. § 1237, only if it "substantially enhances" the value of the property sold. In order to "substantially enhance" the value of the lots, the improvements must directly increase their value by more than 10%. Treas. Reg. § 1.1237-1(c)(3).

Furthermore, if a parcel of property is considered to be "substantially enhanced" under these rules, it can still qualify for capital gains treatment under I.R.C. § 1237 if the improvement was deemed necessary. An improvement is necessary, and therefore not substantial, if the following conditions are met:

> (a) The taxpayer has held the property for 10 years. . . .
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> (b) The improvement consists of the building or installation of water, sewer, or drainage facilities (either surface, sub-surface, or both) or roads, including hard surface roads, curbs, and gutters.
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> (c) The district director . . . is satisfied that, without such improvement, the lot sold would not have brought the prevailing local price for similar building sites.
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> (d) The taxpayer elects . . . not to adjust the basis of the lot sold or any other property held by him for any part of the cost of such improvement attributable to such lot and not to deduct any part of such cost as an expense.

Treas. Reg. § 1.1237-1(c)(5)(i) (1960).

[26] *See* note 18 *supra* and accompanying text.

[27] *See* Deputy v. du Pont, 308 U.S. 488, 499 (1940) (Frankfurter, J., concurring).

[28] 308 U.S. 488 (1940).

[29] *Id.* at 499 (Frankfurter, J., concurring).

be contended that a person is in a "trade or business" if the activity in question occupies the time, attention and labor of the taxpayer for the purpose of livelihood or profit.[30]

Once a court has made an initial determination that a particular taxpayer is in the business of selling real estate, it must further determine whether the particular piece of property involved was being held for investment or " 'primarily for sale to customers in the ordinary course of [his] trade or business.' "[31] Prior to the Supreme Court's 1966 decision in *Malat v. Riddell*,[32] it was extremely difficult for one in the "business" of selling real estate to assert that a gain resulting from a disposition of real property could qualify for capital gains treatment.[33] Although a dealer was not precluded, in theory, from holding a parcel of real estate as an investment, in reality, a claim to that effect was considered highly suspect.[34] The Internal Revenue Service and many courts were of the opinion that a dealer's gain on real estate transactions constituted ordinary income.[35] This position was premised upon the view that the definition of "capital asset" should be strictly interpreted,[36] and that the exclusions should be broadly construed.[37]

In *Corn Products Refining Co. v. Commissioner*,[38] the Supreme Court gave an expansive reading to the capital asset exclusion provisions. The taxpayer was a corporation engaged in refining corn sugar.[39] In order to protect its operations against short supplies and fluctuating prices, the company began to trade in corn futures,[40] and

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[30] M. LEVINE, *supra* note 12, § 474, at 323.

[31] Andrew Tell Inv. Co. v. Commissioner, 473 F.2d 1032, 1034 (9th Cir. 1973); *accord*, Municipal Bond Corp. v. Commissioner, 382 F.2d 184, 186 (8th Cir. 1967); Scheuber v. Commissioner, 371 F.2d 996, 998 (7th Cir. 1967).

[32] 383 U.S. 569 (1966) (per curiam). For a discussion of *Malat*, see notes 53–59 *infra* and accompanying text.

[33] *See, e.g.*, Malat v. Riddell, 347 F.2d 23, 26–27 (9th Cir. 1965), *vacated and remanded*, 383 U.S. 569 (1966) (per curiam); Rollingwood Corp. v. Commissioner, 190 F.2d 263, 266 (9th Cir. 1951).

[34] *E.g.*, Scheuber v. Commissioner, 371 F.2d 996, 998 (7th Cir. 1967); Malat v. Riddell, 347 F.2d 23, 27 (9th Cir. 1965), *vacated and remanded*, 383 U.S. 569 (1966) (per curiam).

[35] *See, e.g.*, Scheuber v. Commissioner, 371 F.2d 996, 998 (7th Cir. 1967); Rollingwood v. Commissioner, 190 F.2d 263, 266 (9th Cir. 1951).

[36] Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46, 52 (1955); Hansche v. Commissioner, 457 F.2d 429, 432 (7th Cir. 1972); United States v. Winthrop, 417 F.2d 905, 911 (5th Cir. 1969).

[37] *See* cases cited in note 36 *supra*.

[38] 350 U.S. 46 (1955).

[39] *Id.* at 48. In addition to sugar the company also produced starch, syrup, feeds and oil from raw corn. *Id.*

[40] *Id.* at 48–49.

claimed that the trading profits were entitled to capital gains treatment.[41] The Court determined that the futures contracts "were vitally important to the company's business as a form of [market] insurance."[42] Relying on a perceived congressional intent to tax as ordinary income those gains realized through normal, day-to-day business activities,[43] the Court excluded the futures from capital asset classification,[44] foreclosing the possibility of preferential tax treatment.

The *Corn Products* decision is regarded as standing for the proposition that transactions which are an " 'integral part' " of daily business operations are not capital transactions and, therefore, cannot give rise to capital gains.[45] Applying such a rationale to a real estate dealer's investment in property of a type similar to that involved in his business operations, it is apparent that gain realized upon disposition of such property would rarely qualify for a tax preference.

While the *Corn Products* doctrine assures the intended exclusion of "profits and losses arising from the everyday operation of a business,"[46] when applied indiscriminately to the genuine investment transactions of a real estate dealer, it fails to fulfill the coordinate congressional purpose in enacting the capital asset provisions—preferential treatment of gains realized from "appreciation in value . . . over a substantial period of time."[47] Better reasoned decisions have

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[41] *Id.* at 47, 49. This contention presented the Court with the issue of whether " 'transactions in commodity futures which are not "true hedges" ' " qualify for capital gains treatment. *Id.* at 47 n.2.

[42] *Id.* at 50. Although the futures transactions provided protection solely against an increase in prices, it was evident that Corn Products "feared the possibility of a price rise more than that of a price decline." *Id.* at 51.

[43] *Id.* at 52.

[44] *Id.* at 53–54.

[45] *Id.* at 51–54; *accord*, Schlumberger Technology Corp. v. United States, 443 F.2d 1115, 1120–22 (5th Cir. 1971) (electronic measuring business acquired a corporation which designed and manufactured electronic systems; upon sale ordinary loss resulted because of integral relationship to taxpayer's business).

[46] 350 U.S. at 52. In Booth Newspaper, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962), the court in explaining the *Corn Products* doctrine stated

> if securities are purchased by a taxpayer as an integral and necessary act in the conduct of his business, and continue to be so held until the time of their sale, any loss incurred as a result thereof may be fully deducted from gross income as a business expense or ordinary loss. If, on the other hand, an investment purpose be found to have motivated the purchase or holding of the securities, any loss realized upon their ultimate disposition must be treated in accord with the capital asset provisions of the Code.

Id. at 921.

[47] Commissioner v. Gillette Motor Transp., Inc., 364 U.S. 130, 134 (1960). For a discussion of the congressional purpose underlying the capital asset provisions, see notes 12–22 *supra* and accompanying text.

recognized the shortcomings of a broad application of the *Corn Products* doctrine to real estate transactions and have departed from its formalism,[48] relying instead upon statutory language to determine whether the asset sold was capital in nature.[49]

As noted, property will not be considered a capital asset if it falls within the scope of section 1221(1).[50] Thus, if a taxpayer desires the profit resulting from a sale of property to be treated as a capital gain, he must be able to show that he did not hold the property in question "primarily for sale to customers in the ordinary course of his trade or business."[51] Such a demonstration normally requires the taxpayer to prove, in an adversarial proceeding, that he did not commercially trade in the subject real estate.[52]

In *Malat v. Riddell*,[53] the Supreme Court attempted to resolve a conflict which had developed among the lower courts in their applica-

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[48] *See, e.g.*, United States v. Winthrop, 417 F.2d 905, 907–08 (5th Cir. 1969). While it was argued that the *Corn Products* doctrine supported a "taxpayer effort rule"—increase in value due in part to taxpayer's activity resulting in ordinary gain—the Fifth Circuit rejected such an interpretation. *Id.*

[49] *Id.* at 911. The *Winthrop* court proceeded to develop from the statutory language of section 1221(1) a two-pronged test—whether or not the property was held " 'primarily for sale' " and whether the sales were "made in the ordinary course of the taxpayer's trade or business." *Id.*; *see* notes 136–47 *infra* and accompanying text.

[50] *See* notes 14–15 *supra* and accompanying text.

[51] I.R.C. § 1221(1). This subsection excludes from capital asset classification

> stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Id. § 1221(1).

[52] *See, e.g.*, Hansche v. Commissioner, 457 F.2d 429, 431 (7th Cir. 1972); Crosswhite v. United States, 369 F.2d 989, 992 (Ct. Cl. 1966); Clark v. United States, 200 F. Supp. 668, 673 (E.D. Tenn. 1961).

[53] 383 U.S. 569 (1966), *vacating and remanding per curiam* 347 F.2d 23 (9th Cir. 1965). In *Malat*, the taxpayer was a member of a real estate partnership which regularly held parcels of land for development. Malat v. Riddell, 64-1 U.S. Tax Cas. ¶ 9432, at 92,153–55 (S.D. Cal. 1964). On occasion, when the partnership came across realty that appeared suitable for development, it would purchase, develop and hold the land for investment purposes. *Id.* In the course of this activity, the partnership entered a joint venture and acquired a forty-five acre tract of land for the alleged purpose of building an apartment complex. 383 U.S. at 569. Because of financing difficulties, "interior lots of the tract were subdivided and sold." *Id.* at 570. The return on these sales was reported as ordinary income and therefore not in question. *See id.* Zoning restrictions made development of the exterior lots difficult, therefore the taxpayer decided to sell his interest in the unsold portion of the property. *Id.* Thus the dual purpose of either selling or developing the property continued throughout the course of the proposed deal. *Id.* at 570–71. The Commissioner argued that the land was being held "primarily" for sale since "a primary purpose" for holding the property was to eventually sell it. 347 F.2d at 25. The Commissioner's argument was accepted by both the federal district court, 64-1 U.S. Tax Cas. ¶ 9432, at 92,157, and the Ninth Circuit, 347 F.2d at 27.

tion of the section 1221(1) exclusion to purported investment transactions by real estate dealers.[54] The focus of the dispute was the word "primarily" as used in the exclusionary clause "primarily for sale to customers."[55] Depending on a court's interpretation of "primarily," the threshold of proof necessary to establish the "primary" purpose for holding certain property might vary in degree.[56] *Malat* ended this conflict by deciding that "primarily" meant "principally" or "of first importance."[57] This holding permits a taxpayer with multiple purposes for holding realty to qualify for capital gains treatment unless it is established that only one purpose distinctly predominates—that of holding the property for sale in the ordinary course of business.[58]

By opting for the "principally" or "of first importance" definition, the *Malat* Court recognized the possibility of a dealer's profits upon disposition of investment property qualifying for capital gains treatment. The determination that a taxpayer's occupation is that of real estate dealer no longer provides a conclusive answer as to how that taxpayer's return on the disposition of real estate should be treated. A dealer may hold certain properties solely for investment purposes while an investor may occasionally trade in real estate as part of a business venture. Thus, courts cannot solve the problem of income classification merely by determining whether the property owner is a dealer or an investor. They must also decide whether the

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[54] For example, some courts held that "primarily" should be interpreted to mean "essentially" or "substantially." *E.g.*, American Can Co. v. Commissioner, 317 F.2d 604, 605 (2d Cir. 1963); Rollingwood Corp. v. Commissioner, 190 F.2d 263, 266 (9th Cir. 1951); Municipal Bond Corp. v. Commissioner, 41 T.C. 20, 29 (1963).

Other jurisdictions came to the conclusion that it meant "principally" or "of first importance." *E.g.*, Municipal Bond Corp. v. Commissioner, 341 F.2d 683, 688 (8th Cir. 1965).

Under the first interpretation, if the property was being held for a dual purpose, *e.g.*, for rental and later sale, it would be construed that one of the essential purposes was to hold the property for sale. Such a determination would preclude capital gains treatment. *E.g.*, Rollingwood Corp. v. Commissioner, 190 F.2d 263, 266 (9th Cir. 1951); Municipal Bond Corp. v. Commissioner, 41 T.C. 20, 29 (1963).

Under the second interpretation, a court faced with the same factual situation would have to make a more particular decision as to which of the two purposes predominated. *E.g.*, Municipal Bond Corp. v. Commissioner, 341 F.2d 683, 689–90 (8th Cir. 1965).

[55] 383 U.S. at 571 (emphasis omitted).

[56] *Compare* Malat v. Riddell, 64-1 U.S. Tax. Cas. ¶ 9432, at 92,153, 92,157 (S.D. Cal. 1964) *with* Malat v. Riddell, 275 F. Supp. 358, 361 (S.D. Cal. 1966).

[57] 383 U.S. at 572.

[58] *See id.* Applying the newly-defined "primary purpose test," the Supreme Court remanded *Malat* to the district court for findings of fact as to which purpose for holding the property was "of first importance" or "principal." *Id.* On remand, the district court held that the real estate in question was not being held "primarily for sale." Malat v. Riddell, 275 F. Supp. 358, 361 (S.D. Cal. 1966).

taxpayer was, in fact, holding the subject property primarily as an investment or primarily for sale to customers. Post-*Malat*, the terms "dealer" and "investor" have become shorthand statements of a legal conclusion—that the taxpayer was or was not in the real estate business with respect to the particular piece of property in question.[59]

TESTS USED TO DISTINGUISH REAL ESTATE BUSINESS ACTIVITY FROM THAT OF REAL ESTATE INVESTMENT

The particular criteria which the courts have articulated in deciding whether a taxpayer's property has been held for investment or for sale in the ordinary course of business have grown steadily in number, complexity, and refinement. Ten such tests are clearly identifiable.[60] Although only tenuous generalizations may be made concerning judicial application of these tests,[61] two are consistently given greater emphasis than the others. Following a brief examination of the tests as they are utilized in various jurisdictions, their application in the Third Circuit will be reviewed.

ONE: *Number, Frequency, and Substance of Real Estate Transactions Entered into by the Taxpayer*

This test may be given the most weight by the judiciary in ultimately determining the type of income realized from a real estate transaction.[62] When sales of property by a taxpayer were numerous, frequent and substantial, courts have frequently found that the taxpayer was a real estate dealer.[63] They apparently surmised that the taxpayer is a merchant with respect to such property, and therefore the property is being held primarily for sale to customers in the ordi-

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[59] *See* Bynum v. Commissioner, 46 T.C. 295, 300 (1966).

[60] Although this article examines ten tests, it should be noted that courts will vary the number of tests they employ. *See* notes 131, 133 and 178 *infra*.

[61] *See* notes 119–50 *infra* and accompanying text.

[62] *See, e.g.*, United States v. Winthrop, 417 F.2d 905, 911 (5th Cir. 1969) (taxpayer's gain on sale of real estate held to be ordinary income where "magnitude and continuity of his operations and design all point to these sales being part of a business"); Gault v. Commissioner, 332 F.2d 94, 97 (2d Cir. 1964) (court stated that "petitioner's sales and other activities with regard to this tract were sufficiently frequent and continuous to categorize the petitioner as a dealer in real estate"); Anderson v. Commissioner, 23 TAX CT. MEM. DEC. (CCH) 1170, 1178 (1964) (statement that "evidence with respect to the frequency, continuity, extent, and substantiality of the transactions strongly supports the conclusion that the petitioner was in the trade or business of selling real estate").

[63] *See id.*

nary course of a trade or business.[64] On the other hand, when sales were infrequent it has generally been determined that the taxpayer was an investor with respect to the property.[65]

In applying this test, however, courts have been responsive to other facets of the particular factual situations presented. Thus, gain resulting from frequent and continuous sales may be allowed capital gains treatment if the sales were made in order to liquidate a business or investment.[66] In such situations, the courts tend to overlook a large number of sales made in a relatively short period of time, particularly if they were not the result of promotional or developmental activities and the proceeds were not reinvested in similar property.[67]

Since, in most situations, the courts favor the taxpayer who has not engaged in numerous sales, it is preferable from a tax point of view, to sell large tracts intact rather than portions.[68] Where this is not eco-

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[64] *See, e.g.*, United States v. Winthrop, 417 F.2d 905, 911 (5th Cir. 1969); Gault v. Commissioner, 322 F.2d 94, 97 (2d Cir. 1964).

[65] *See, e.g.*, Scheuber v. Commissioner, 371 F.2d 996, 997, 999 (7th Cir. 1967) (24 transactions over 10-year period does not indicate "that . . . properties were held primarily for sale to customers in the ordinary course of business"); Cole v. Usry, 294 F.2d 426, 428 (5th Cir. 1961) (61 transactions involving 93 lots over six years); Estate of Barrios v. Commissioner, 265 F.2d 517, 520 (5th Cir. 1959) (88 sales during a three-year period); Gordon v. United States, 159 F. Supp. 360, 364 (Ct. Cl. 1958) (per curiam) (26 parcels sold in two years); Adam v. Commissioner, 60 T.C. 996, 997 (1973) (purchase and sale of 12 parcels over four years); Ayling v. Commissioner, 32 T.C. 704, 709 (1959) (sale of 13 lots over a four-year period); Scottwood Dev. Co. v. Commissioner, 26 TAX CT. MEM. DEC. (CCH) 855, 856 (1967) (single transaction involving sale of 47 houses); Smith v. Commissioner, 20 TAX CT. MEM. DEC. (CCH) 232, 235 (1961) (eight sales in three years). *But see* Crosswhite v. United States, 369 F.2d 989, 990, 992 (Ct. Cl. 1966) (income derived from five transactions over 30 months held not to qualify for capital gains treatment).

[66] *See, e.g.*, Austin v. Commissioner, 263 F.2d 460, 465 (9th Cir. 1959) ("based upon the entire record," taxpayer would be allowed capital gain benefit on income resulting from 48 real estate transactions over three-year period); Alabama Mineral Land Co. v. Commissioner, 250 F.2d 870, 872 (5th Cir. 1957) (taxpayer disposing of property "in the course of gradual and passive liquidation" permitted capital gains treatment "even though sales have been frequent and continuous"); Oahu Sugar Co. v. United States, 300 F.2d 773, 776, 778 (Ct. Cl. 1962) ("[l]ooking at the facts in their totality," income derived from sale of 336 parcels over three-year period held to be capital gain); Van Drunen v. Commissioner, 23 TAX CT. MEM. DEC. (CCH) 903, 908 (1964) (93 lots over six years); Estate of Simpson v. Commissioner, 21 TAX CT. MEM. DEC. (CCH) 371, 377 (1962) (court concluded "fact that sales were frequent and continuous is not conclusive that the owners were in a business"); Estate of Walton v. Commissioner, 21 TAX CT. MEM. DEC. (CCH) 346, 351 (1962) (same).

[67] *E.g.*, Alabama Mineral Land Co. v. Commissioner, 250 F.2d 870, 872 (5th Cir. 1957) (sales not the result of promotional or developmental activity); Oahu Sugar Co. v. United States, 300 F.2d 773, 778 (Ct. Cl. 1962) (gains received from sales were not used to purchase property for resale).

[68] *E.g.*, Chandler v. United States, 226 F.2d 403, 406 (7th Cir. 1955); *see, e.g.*, Mitchell v. Commissioner, 47 T.C. 120, 126–27 (1966); Thrift v. Commissioner, 15 T.C. 366, 371 (1950).

nomically feasible, subdivision would presumably be permitted in order to make the investment return a profit.[69] However, the limits of permissible subdivision are difficult to define, and liquidation after extensive subdivision may make the owner of the formerly large tract of land a "frequent" seller. Judicial determination of the term "frequency" has not been consistent; predictability is a major problem.[70] For instance, in differing factual contexts, seventy-one sales in three years have been found to be too frequent,[71] while ninety sales in one year were found not to be so excessive as to make the taxpayer-seller a "dealer."[72]

TWO: *Taxpayer's Activities During the Period of Ownership*

The extent of the taxpayer's activity in improving the property, whether such activity is performed by the taxpayer, his agents, or independent contractors, is another influential factor employed in the determination of dealer or investor classification.[73] One commen-

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[69] *E.g.*, Chandler v. United States, 226 F.2d 403, 406 (7th Cir. 1955); *see, e.g.*, Ayling v. Commissioner, 32 T.C. 704, 709 (1959). The proposition that subdivision is permissible without losing capital asset status when the subdivision is necessitated by economic circumstances is frequently stated in cases involving the sale of inherited property. *E.g.*, Nadalin v. United States, 364 F.2d 431, 437 (Ct. Cl. 1966); Mundy v. Commissioner, 23 TAX CT. MEM. DEC. (CCH) 539, 546–47 (1964); Estate of Simpson v. Commissioner, 21 TAX CT. MEM. DEC. (CCH) 371, 377 (1962); Estate of Walton v. Commissioner, 21 TAX CT. MEM. DEC. (CCH) 346, 350 (1962).

[70] Pointer v. Commissioner, 48 T.C. 906, 917 (1967), *aff'd*, 419 F.2d 213 (9th Cir. 1969). Taking note of this inconsistency, one court has stated that "[t]he decided cases are of little aid in establishing the 'frequency and continuity' of sales sufficient to constitute a regular course of business." 48 T.C. at 917.

[71] Sottong v. Commissioner, 25 TAX CT. MEM. DEC. (CCH) 1366, 1369, 1371 (1966).

[72] Goldberg v. Commissioner, 223 F.2d 709, 711, 713 (5th Cir. 1955).

[73] *See, e.g.*, Gault v. Commissioner, 332 F.2d 94, 96 (2d Cir. 1964); Lazarus v. United States, 172 F. Supp. 421, 426 (Ct. Cl. 1959); Turner v. Commissioner, 33 TAX CT. MEM. DEC. (CCH) 1167, 1182, *rev'd in part and remanded in part*, 540 F.2d 1249 (4th Cir. 1976). Section 1237 allows a limited amount of improvements. *See* note 25 *supra*.

In *Turner*, the taxpayer was engaged in the construction business but purchased three parcels of unimproved land in his individual capacity. 33 TAX CT. MEM. DEC. at 1168, 1171, 1174. He subsequently sold portions of the property to his closely-held corporation, ostensibly for construction purposes, after he had procured water and sewer service and had prepared subdivision plans for two of the three parcels. *Id.* at 1169–73, 1177. In finding income derived from the sale of all three parcels to be ordinary income, the court stated that Turner's "frequent and substantial purchases and sales . . . coupled with his own substantial development activities . . . [were] sufficient . . . to put him in the business of buying and selling real estate." *Id.* at 1182.

On appeal, the Fourth Circuit reversed the lower court's conclusion with regard to the one parcel on which the taxpayer had not prepared subdivision plans. 540 F.2d 1249, 1251–53 (4th Cir. 1976). The circuit court found that Turner's treatment of this property differed with respect to the length of time and purpose for which it was held and the activity of the taxpayer in improving and disposing of the parcel. *Id.* at 1252.

tary has noted that the courts have taken the position that substantial improvements made by the taxpayer, which have the effect of rendering the property more marketable, genuinely reveal an intent to hold the property for sale to customers rather than for investment.[74] For this reason, the courts do not hesitate to assign ordinary income status to gain realized from the disposition of improved property.[75]

Application of the "improvements" test has resulted in a very fact-oriented analysis. Such an application permits various types and degrees of improvements to be properly evaluated within the factual context of the particular transaction in question. For instance, even though other improvements have been made, the subdivision and sale of a large tract of land may be regarded as a liquidation of an investment if the tract would have been difficult to sell without subdivision.[76] This may be true even if the property was initially ac-

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Except for a boundary survey, it was determined that Turner had made no improvements during the four years he owned the parcel. *Id.* at 1251.

[74] Schlenger & Embry, *Capital Gains Through Real Estate*, 27 MD. L. REV. 19, 26–27 (1967).

[75] Kaltreider v. Commissioner, 255 F.2d 833 (3d Cir. 1958); Miller v. United States, 339 F.2d 661 (Ct. Cl. 1965). In *Miller*, the taxpayer purchased a 94-acre tract outside of Norfolk, Virginia, purportedly for use in the farming business. 339 F.2d at 662. The land was actually conveyed to the taxpayer in four unequal parcels as the taxpayer made installment payments of the purchase price. *Id.* Immediately upon acquisition, the taxpayer surveyed and subdivided the first tract, had streets and sidewalks laid out, and engaged two real estate agents to act as salesmen. *Id.* The remaining tracts were similarly improved as acquired. The total cost of the improvements exceeded the purchase price of the property by more than $10,000. *Id.* at 663.

The taxpayer attempted to treat the gain realized from the sale of the lots as capital gain. *See id.* While the court considered several factors in denying capital asset status to the property, it relied heavily upon the fact that extensive improvements had been made by the taxpayer. *Id.* at 664.

Kaltreider presented a situation in which the taxpayer's "dealer" activities were less blatant than in *Miller*, *compare* 255 F.2d at 837 *with* 339 F.2d at 662–63, but in which capital asset treatment was nevertheless denied. 255 F.2d at 838. In *Kaltreider*, taxpayers purchased land which they farmed for twelve years. *Id.* at 835. At the end of this period the taxpayers abandoned the farming business and, with their son, formed a family corporation to subdivide a seven-acre portion of the farm. *Id.* The corporation built homes on some lots which the taxpayers subsequently sold. *Id.* at 835–36. In addition, the taxpayers disposed of a number of the vacant lots. *Id.* at 836.

The taxpayers allocated the profit between the sale of the land and the sale of homes, treating the former as a capital gain. *Id.* at 836. Profit derived from the sale of homes was treated as ordinary income. *Id.* The court, however, attributed all improvement activity performed by the corporation to the taxpayer, and affirmed the Tax Court's denial of capital gains treatment. *Id.* at 837–39; *see* Rev. Rul. 59-91, 1959-1 C. B. 15.

[76] *E.g.*, Biedenharn Realty Co. v. United States, 509 F.2d 171, 173–74 (5th Cir. 1975), *rev'd*, 526 F.2d 409 (5th Cir.) (en banc), *cert. denied*, 429 U.S. 819 (1976); Yunker v. Commissioner, 256 F.2d 130, 136 (6th Cir. 1958); Temple v. United States, 229 F. Supp. 687, 692–93 (S.D. Miss. 1964), *aff'd*, 355 F.2d 67 (5th Cir. 1966); Clark v. United States, 200 F. Supp. 668, 673 (E.D. Tenn. 1961).

quired for a commercial venture which later became unprofitable.[77]

While improvements and frequency of sales are generally accorded greatest weight in determining tax classifications,[78] the tests outlined below may also come into play on a lesser scale. As will be demonstrated, the courts have been inconsistent in their application of these tests.[79] Thus, these lesser-weighted factors remain important insofar as any combination of them may be considered determinative of dealer/investor status depending on the forum court.

THREE: *Purpose of Acquisition*

Various courts have found that the taxpayer's initial purpose for acquiring real property is a factor to be considered when ascertaining whether a subsequent sale should be accorded capital gains treat-

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In United States v. Winthrop, 417 F.2d 905 (5th Cir. 1969), the taxpayer "platted and developed" inherited real property prior to sale. *Id.* at 906. Challenging the taxpayer's capital treatment of the resulting gain on sale, the government attempted a new approach, the "blanket interdiction of capital gains treatment where" the increase in value was due to the efforts of the taxpayer. *Id.* at 907–09. The court rejected this approach finding not only that prior case law failed to support it, but that, in fact, "the cases [were] many where taxpayer efforts have contributed to value and have been accorded capital gains treatment." *Id.* at 909; *accord*, Temple v. United States, 229 F. Supp. at 692–93 (Commissioner's position "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 his business" rejected by the court).

[77] In Barker v. United States, 65-2 U.S. Tax Cas. ¶ 9736, at 97,004–06 (S.D. Cal. 1965), the taxpayers, husband and wife, subdivided and sold their farm after a long drought made farming unprofitable, and were permitted to treat the resulting gain as capital in nature. Sixty-seven lots were sold by the taxpayers over a 10-year period, but during this time neither taxpayer became actively engaged in the sales. *Id.* at 97,005. In fact, the husband was engaged full-time in another business during most of this period. *Id.*

Bynum v. Commissioner, 46 T.C. 295 (1966), presents a striking factual contrast to the *Barker* case. In *Bynum*, losses in the taxpayers' nursery business year after year caused them to be burdened by debt. *Id.* at 297. The taxpayers subdivided and sold a portion of their farm to relieve the debt. *Id.* Once the sale decision was made, however, the taxpayers actively engaged in the real estate business; installing many improvements, advertising the sale of the property, and listing the husband as one of the persons to call for sale information. *Id.* at 297–98.

In denying capital gains treatment the Tax Court found that the improvements, costing "over $1,000 per acre," as well as the taxpayers' other sales activities, "went far beyond" a mere attempt to reduce their mortgage debt. *Id.* at 300–01. Instead, the court found that the petitioner-husband had made a business of subdividing and selling a portion of his farm. *Id.* Thus, the taxable gain "was generated by petitioners' actions and activities with regard to this property . . . and as such, it [was] taxable as ordinary income." *Id.* at 301 (citations omitted).

[78] *See* notes 62–77 *supra* and accompanying text.

[79] *See* notes 80–118 *infra* and accompanying text.

ment.[80] This test is premised on the proposition that the purpose for acquiring the property is deemed to remain constant throughout ownership unless that purpose is shown to have changed.[81] However, if the taxpayer's intent in holding the property has changed, the courts will attach minimal weight to this factor.[82] Therefore, if property was acquired as an investment and the taxpayer treated it as such until sale, it should be deemed a capital asset.[83] On the other hand, if the property was acquired as an inventory item, the taxpayer must then establish that his purpose for holding the asset had changed in order to obtain capital treatment for any gain realized upon the sale.[84]

FOUR: *Manner of Acquisition*

The manner in which a taxpayer acquired property has also been accorded weight in determining whether capital asset treatment

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[80] *See, e.g.*, United States v. Winthrop, 417 F.2d 905, 909–10 (5th Cir. 1969); Gault v. Commissioner, 322 F.2d 94, 96 (2d Cir. 1964); Bruning v. United States, 273 F. Supp. 349, 352 (M.D. Fla. 1967).

[81] Schlenger & Embry, *supra* note 74, at 22. Case discussion of this principle may be found in Temple v. United States, 229 F. Supp. 687, 693 (S.D. Miss. 1964), *aff'd*, 355 F.2d 67 (5th Cir. 1966); Lawrie v. Commissioner, 36 T.C. 1117, 1120–21 (1961); Eline Realty Co. v. Commissioner, 35 T.C. 1, 5–6 (1960); Cohn v. Commissioner, 21 T.C. 90,100–01 (1953).

In Estate of Dean v. Commissioner, 34 TAX CT. MEM. DEC. (CCH) 631 (1975), the government argued that any claimed "change must either be the result of some material change of circumstances beyond the control of the taxpayer or there must be an objective manifestation of the new intent." *Id.* at 636. The court did not explicitly reject this argument, and did not attempt "to reconcile all of [the government's] cases." *Id.* at 638. However, the government's approach was rejected as the court found that the totality of the record indicated the taxpayer had changed his intent to that of investment. *Id.*

[82] Klarkowski v. Commissioner, 385 F.2d 398, 400 (7th Cir. 1969); Howell v. Commissioner, 57 T.C. 546, 554, 555 (1972); Maddux Constr. Co. v. Commissioner, 54 T.C. 1278, 1284, 1286 (1970).

[83] Temple v. United States, 229 F. Supp. 687, 692 (S.D. Miss. 1964), *aff'd*, 355 F.2d 67 (5th Cir. 1966); *see* Howell v. Commissioner, 57 T.C. 546, 555 (1972) (taxpayer acquired, held and sold property as an investment).

[84] *E.g.*, Commissioner v. TRI-S Corp., 400 F.2d 862, 863, 864 (10th Cir. 1968) (intent of taxpayer changed when portion of property taken by state); Tibbals v. United States, 362 F.2d 266, 272–73 (Ct. Cl. 1966) (intent of taxpayer changed when profit picture went sour); Nevin v. Commissioner, 24 TAX CT. MEM. DEC. (CCH) 294, 303–04 (1965) (evidence of taxpayer's changed intent as to part of property gleaned from fact that he never promoted or developed part while bulk of the acquisition was actively promoted).

For a brief discussion of the area of changed purpose as a means of obtaining capital gains treatment, see Simmons, *The Realities of "Planning" for Capital Gains in Light of Dealer Status: New Case Law Tools for Dealer's "Investment Property,"* 44 L.A.B.A. BULL. 15, 37–38 (1969). The author concluded that in determining whether a taxpayer's purpose in holding real property has changed from a dealer purpose to an investor purpose, three factors should be evaluated: the length of time the property was held, the incentive for sale, and any unforeseen or uncontrollable events. *Id.* at 38.

should be permitted upon sale.[85] Once a court has ascertained how property was acquired, it may be easier for the tribunal to determine if the stated reason for retaining the real estate has been consistent with the method by which the land was obtained.

The courts have been most lenient in permitting capital gains treatment when the property was inherited by the taxpayer.[86] The reason for such leniency may be that the acquisition of such property can rarely be attributed directly to the activities of the heir-taxpayer.

While capital gains treatment is possible when the property is acquired by gift,[87] the courts do not treat these situations with the same leniency accorded inherited property. Thus, the court may resolve the question of whether the gain should receive capital or ordi-

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[85] *E.g.*, United States v. Winthrop, 417 F.2d 905, 909–10 (5th Cir. 1969); Pool v. Commissioner, 251 F.2d 233, 235 (9th Cir. 1957), *cert. denied*, 356 U.S. 938 (1958); Temple v. United States, 229 F. Supp. 687, 693 (S.D. Miss. 1964), *aff'd*, 355 F.2d 67 (5th Cir. 1966); Estate of Mundy v. Commissioner, 36 T.C. 703, 710 (1961).

[86] *See, e.g.*, Camp v. Murray, 226 F.2d 931, 932, 934 (4th Cir. 1955) (subdivision and sale of inherited property accorded capital gains treatment); Gordon v. United States, 159 F. Supp. 360, 360, 364, 366 (Ct. Cl. 1958) (per curiam) (same); Mackall v. United States, 162 F. Supp. 522, 523–24, 525, 527 (E.D. Va. 1957) (sale of inherited property accorded capital gains treatment even though one heir was a real-estate broker); Estate of Simpson v. Commissioner, 21 TAX CT. MEM. DEC. (CCH) 371, 375, 378 (1962) (subdivision and sale of inherited farmland found to be entitled to capital gains treatment).

In Estate of Mundy v. Commissioner, 36 T.C. 703 (1961), devisees of the testator received a large tract of land and contracted with a real estate firm to develop and sell the property. *Id.* at 705, 706. A partnership was formed among the heirs to distribute the proceeds. *See id.* at 707–08 & 708n.2. The real estate firm, however, was given complete authority to subdivide, develop and sell the property as a residential development. *Id.* at 706–07. The tax court ruled that since the devisees were not in the real estate business, but instead merely wished to liquidate their inherited property, the gain realized should receive capital treatment. *Id.* at 710, 713–14.

Estate of Walton v. Commissioner, 21 TAX CT. MEM. DEC. (CCH) 346 (1962), involved a factual pattern similar to *Mundy*. The *Walton* court indicated that if inherited property was sold in separate parcels rather than in one unit "in order to realize a better price, [then] that fact alone does not convert the parts into property held for sale to customers." *Id.* at 350. The court further found that to show that the heir was "holding real property for sale to customers in the ordinary course of [a] trade or business," evidence must be presented which indicated that the intention of the heir had changed from simply liquidating inherited real property to "engaging in the real estate business for profit." *Id.*

In a situation involving the liquidation of inherited property, however, the courts may deny capital gains treatment, if the "dealer" activities of the heirs' agent are imputed to the heirs. *See* Brown v. Commissioner, 143 F.2d 468, 469, 470 (5th Cir. 1944). *See also* Nadalin v. United States, 364 F.2d 431, 438 (Ct. Cl. 1966) (per curiam) (dictum).

[87] *See* Rosebrook v. United States, 191 F. Supp. 356, 357, 359 (N.D. Cal. 1960), *aff'd*, 318 F.2d 316, 319 (9th Cir. 1963) (property acquired upon dissolution of trust); Berryman v. Commissioner, 37 T.C. 45, 51 (1961) (same).

nary treatment by attributing the activities of the donor to the donee.[88]

FIVE: *Apparent Purpose for Holding the Property*

Another inquiry conducted by the courts in this area concerns the apparent purpose for which the property was held.[89] Once it has been determined that property was acquired for an investment purpose, courts often attempt to decide if such purpose remained constant during the entire holding period. This test requires that the owner of the real estate remain passive,[90] or nearly

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[88] In Bistline v. United States, 260 F.2d 77 (9th Cir. 1958), the taxpayer received a gift of real property from her father, a real-estate dealer. *Id.* at 78. Shortly after the gratuitous transfer, several parcels were sold. *Id.* at 79. The taxpayer's father advised her concerning the property as a "business agent," leading the court to conclude that the taxpayer "was 'frequently and continuously engaged in the negotiation and/or consummation of the sale of her properties.' " *Id.* The court found "it . . . difficult to separate [the taxpayer's] activities from" those of her father and consequently denied capital gains treatment. *Id.* at 79–80.

Apart from property acquired by gift or inheritance, *see* notes 86–87 *supra* and accompanying text, property may be acquired through foreclosure. For instance, in Alabama Mineral Land Co. v. Commissioner, 250 F.2d 870 (5th Cir. 1957), certain individuals acquired a large quantity of land through foreclosure. *Id.* at 871. They traded the property to the corporate taxpayer "in exchange for its stock" in order to facilitate the sale of the land. *Id.* The corporation, which "was engaged in the business of buying and selling timber, timber lands and cut-over lands," sold the property and reported the resulting income as a capital gain. *Id.* The corporation had neither subdivided, improved, advertised, nor listed the subject property. *Id.* at 872.

The Fifth Circuit agreed that the property was a capital asset as the land was not acquired for use in a trade or business, but rather was "gradual[ly] and passive[ly] liquidat[ed]." *Id.* The court found that the sales were merely a means of recovering capital from the foreclosure. *See id.* at 871; *accord*, Cebrian v. United States, 181 F. Supp. 412, 420 (Ct. Cl. 1960) (sale of real estate by bondholders after foreclosure a liquidation of investment entitled to capital gains treatment).

[89] *See, e.g.*, Gault v. Commissioner, 332 F.2d 94, 96 (2d Cir. 1964); Mathews v. Commissioner, 315 F.2d 101, 107 (6th Cir. 1963); Industrial Life Ins. Co. v. United States, 344 F. Supp. 870, 879 (D.S.C. 1972), *aff'd per curiam*, 481 F.2d 609 (4th Cir. 1973), *cert. denied*, 414 U.S. 1143 (1974); Johnson v. United States, 280 F. Supp. 412, 417–18 (N.D.N.Y. 1967); Bruning v. United States, 273 F. Supp. 349, 352 (M.D. Fla. 1967); Miller v. United States, 339 F.2d 661, 663 (Ct. Cl. 1964); Howell v. Commissioner, 57 T.C. 546, 555 (1972).

This test has been considered by some commentators as the most important, since it applies the literal language of the code. *See* I.R.C. § 1221(1); 26 U. CINN. L. REV. 130, 133 (1957).

[90] In Van Drunen v. Commissioner, 23 TAX CT. MEM. DEC. (CCH) 903 (1964), a physician joined a real estate broker in the purchase of a tract of land for investment. *Id.* at 903. Neither co-owner improved the property in any respect. Instead, both continued to hold it "strictly . . . as an investment." *Id.* Later, at the urging of the broker, sale of the entire tract was attempted in order to generate capital for another venture. When this alternative proved unworkable, the tract was subdivided and sold in small lots. *Id.* at 904.

so,[91] thus keeping his activities consistent with the original investment purpose of his acquisition. This test is frequently stated in conjunction with the "purpose for acquisition" test,[92] since the latter purpose is deemed controlling throughout the holding period unless a change in the taxpayer's purpose is shown.[93]

SIX: *Degree of Promotional Activity*

An additional criterion which the courts consider pertinent in determining whether a sale of real estate is a liquidation of an investment or a sale in the ordinary course of the seller's business is the extent of promotional activity performed by the taxpayer.[94] The rationale underlying this test is that dealer or investor status may be determined by the amount of solicitation or advertisement engaged in by the taxpayer. An investor would be expected to play a passive

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Pursuant to an agreement between the parties, all activities relating to subdivision and sale were performed by the broker, who received the "usual broker's commission" of 10%; the physician took no part in these activities. *Id.* The court found that profits realized by the physician were entitled to capital gains treatment since his passivity indicated that his purpose in holding the property had remained one of investment. *Id.* at 908–09; *accord*, Voss v. United States, 329 F.2d 164, 167 (1964).

[91] *See* Cohen v. Commissioner, 39 T.C. 886, 892 (1963) (owner's activities with respect to zoning classification and water and sewage permits found not to bar capital gains treatment on sale of real estate since they were performed "to protect their interests"); Estate of Dean v. Commissioner, 33 TAX CT. MEM. DEC. (CCH) 1041, 1044 (1974) (activities in obtaining zoning classifications not a bar to capital gains treatment).

[92] *E.g.*, Estate of Segel v. Commissioner, 370 F.2d 107, 108 (2d Cir. 1966); Gault v. Commissioner, 332 F.2d 94, 96 (2d Cir. 1964); Carlson v. Commissioner, 288 F.2d 228, 231 (7th Cir. 1961); Consolidated Naval Stores Co. v. Fahs, 227 F.2d 923, 926 (5th Cir. 1955); Bruning v. United States, 273 F. Supp. 349, 352 (M.D. Fla. 1967); Mensik v. Commissioner, 27 TAX. CT. MEM. DEC. (CCH) 28, 34 (1968).

[93] *See* note 81 *supra* and accompanying text.

[94] *E.g.*, Carlson v. Commissioner, 288 F.2d 228, 231 (7th Cir. 1961); Temple v. United States, 229 F. Supp. 687, 693 (S.D. Miss. 1964), *aff'd*, 355 F.2d 67 (5th Cir. 1966); Fishback v. United States, 215 F. Supp. 621, 624 (D.S.D. 1963); Huey v. United States, 504 F.2d 1388, 1392 (Ct. Cl. 1974). Examples of activity considered promotional by the courts "include maintaining a sales office, sales staff, advertising, placing 'For Sale' signs on the property and listing the property with licensed real estate brokers." Schlenger & Embry, *supra* note 74, at 34 (footnotes omitted); *see* Austin v. Commissioner, 263 F.2d 460, 464 (9th Cir. 1959).

A number of commentators have stressed that the test of promotional activity is a crucial one. For example, capital gains treatment is generally granted when the taxpayer is seen as liquidating an asset. However, when heavy sales activities are employed in cases of liquidation, the courts will frequently find that the taxpayer has become a dealer in real estate. *See* Kohn, *Controlling the Character or Basis of the Asset to be Sold or Exchanged*, 12 W. RES. L. REV. 273, 274 (1961); Levin, *Capital Gains or Income Tax on Real Estate Sales*, 37 B. U. L. REV. 165, 190 (1957).

This test is sometimes referred to as the "[r]eluctancy of sale test" since it requires a determination of whether the taxpayer actually solicited the sale or "entered into [it] with some reluctance." Simmons & O'Hara, *Three new tests appear for obtaining capital gains on real estate sales*, 28 J. TAX 218, 221 (1968).

role, involving himself in little or no advertising or solicitation.[95] However, "the absence of sales promotional activity due to the existence of a seller's market will not [be sufficient to] overcome the thrust of . . . other" factors indicating that the property was held primarily for sale in the ordinary course of business.[96] Similarly, the absence of the need to advertise, standing alone, "will not rebut the investment-holding conclusion."[97]

SEVEN: *Employment of Agents*

This factor involves an inquiry as to whether the taxpayer has acted through agents in order to "insulate himself from" being personally labeled a dealer.[98] If the inquiry discloses the presence of an agency relationship in which the taxpayer is the principal, the court must determine whether the agent's activities as a dealer should be imputed to the taxpayer. The crucial determination of this test in-

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[95] Starke v. Commissioner, 312 F.2d 608, 609 (9th Cir. 1963); Austin v. Commissioner, 263 F.2d 460, 464–65 (9th Cir. 1959); Adam v. Commissioner, 60 T.C. 996, 1000 (1973); Ayling v. Commissioner, 32 T.C. 704, 709 (1959); Hoover v. Commissioner, 32 T.C. 618, 626 (1959); Frick v. Commissioner, 31 TAX CT. MEM. DEC. (CCH) 286, 289 (1972); Lowery v. Commissioner, 23 TAX CT. MEM. DEC. (CCH) 152, 156 (1964).

Typical of the cases reciting the lack of advertising as indicative of an investment motive is Howell v. Commissioner, 57 T.C. 546 (1972). In *Howell*, a corporation held a tract of land as its only asset. *Id.* at 548, 553. The entire property was liquidated in three sales, but "the first two [were] merely incidental to the final sale which disposed of over 90 percent of the initial tract of land." *Id.* at 554. In granting the corporation capital gains treatment, the court noted that "[t]he property was not advertised for sale," and also that the sale idea originated with others, who then approached the officers of the corporation. *Id.* at 555.

[96] Koch v. United States, 457 F.2d 230, 235 (7th Cir. 1972); *accord*, Patrick v. Commissioner, 275 F.2d 437, 439 (7th Cir. 1960); *see* United States v. Winthrop, 417 F.2d 905, 906–07, 912 (5th Cir. 1969); Thompson v. Commissioner, 322 F.2d 122, 126, 128 (5th Cir. 1963).

A number of courts have found that the lack of sales solicitations and advertising is insufficient to establish that property is held for investment purposes when circumstances are such that the property was readily saleable without such activities. *E.g.*, Miller v. United States, 339 F.2d 661, 663 (Ct. Cl. 1964); Estate of Broadhead, 41 TAX CT. MEM. DEC. (P-H) ¶ 72,195, at 993, 1009 (1972); Barney v. Commissioner, 26 TAX CT. MEM. DEC. (CCH) 109, 113 (1967).

[97] Koch v. United States, 457 F.2d 230, 235 (7th Cir. 1972) (citation omitted); *see* Scheuber v. Commissioner, 371 F.2d 996, 998–99 (7th Cir. 1967).

[98] Voss v. United States, 329 F.2d 164, 166 (7th Cir. 1964). The Fifth Circuit, in deciding the imputation question, inquired

> whether those activities were carried on by the representative as a part of his own business and at his own expense or primarily in behalf of the taxpayer, and particularly [into] the character and degree of supervision or control exercised by the taxpayer over the representative?

Smith v. Dunn, 224 F.2d 353, 356 (5th Cir. 1955). As the foregoing statement implies, "[t]he mere retention of an independent real estate broker does not per se" guarantee capital gains treatment. Hansche v. Commissioner, 457 F.2d 429, 434 (7th Cir. 1972).

volves the amount of actual control delegated by the taxpayer-principal to the agent.[99] If the agent's activities are, for the most part, independent, they will not be imputed to the taxpayer-principal.[100] However, if the taxpayer retains significant control over the agent, such as a general supervisory role or veto power over the sale price, courts have attributed the agent's dealer activities to the taxpayer.[101]

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[99] Smith v. Dunn, 224 F.2d 353, 357 (5th Cir. 1955). In Voss v. United States, 329 F.2d 164 (7th Cir. 1964), a taxpayer purchased tracts of land in 1929 and again in 1931. *Id.* at 165. However, as time went on it became clear that the value of the property was declining. *Id.* Deciding to rid himself of the ill-fated investment, taxpayer made repeated efforts to dispose of the entire tract. *Id.* at 165–66. Since these efforts were to no avail, the taxpayer authorized his broker to subdivide and improve the property. *Id.* The broker

> [p]ursuant to a broad delegation of power . . . graded the land, and installed streets, sewage facilities, and water mains; he also caused the land to be rezoned and annexed to the City of Racine and qualified it for Federal Housing Administration loans. The expenditures for these improvements were paid out of the gross sales proceeds, so that the project was self-financing. [The broker] paid all advertising costs. He received ten per cent commission on all sales, five per cent as a broker's fee and five per cent as a developing fee. After paying requisite amounts for land improvements and his commission, [the broker] periodically remitted the net proceeds to taxpayer. [The taxpayer] did not actively participate in the development of the land, nor did he supervise the subdivision. The only activity he engaged in was the routine execution of deeds to purchasers.

Id. The Seventh Circuit, relying upon these facts, held that the real estate was deserving of capital asset treatment and that the district court should have directed a verdict for the taxpayer. *Id.* at 167. The court rejected the government's position that "[t]he crucial inquiry . . . is not the amount of actual control exercised by taxpayer but the *right* to control." *Id.* at 166 (emphasis in original).

[100] *See, e.g.*, Estate of Mundy v. Commissioner, 36 T.C. 703, 711–12 (1961) (taxpayers "were completely divorced from all control and supervision over . . . the sale"); Estate of Walton v. Commissioner, 21 TAX CT. MEM. DEC. (CCH) 346, 350–51 (1962) (taxpayer retained no control over sale).

In Brown v. Commissioner, 143 F.2d 468 (5th Cir. 1944), although the "taxpayer knew nothing about business" and left all details to her agent, including plotting subdivisions and arranging for off-lot improvements, capital gains treatment was denied on the sale of inherited property. *Id.* at 469–70. The court did not state whether the taxpayer or her agent had control over the sales price. *See id.* This factor may have been irrelevant, as the court reasoned that "[w]hile the petitioner did not personally conduct the business of selling lots she did conduct it through another." *Id.* at 470. It appears that the *Brown* court would have, in all cases, attributed to taxpayers the acts of their agents despite the extent of the taxpayers' control.

Nadalin v. United States, 364 F.2d 431 (Ct. Cl. 1966) (per curiam), is a more recent example of a situation in which a court denied capital gains treatment despite the fact that the taxpayer exercised little control over his agent. *Id.* at 436, 439. In *Nadalin*, the Court of Claims relied on the fact that the taxpayer had not inherited the property but had purchased it for resale with the intent of subdividing and improving it before sale. *Id.* at 437. The court thus found that the taxpayer's plans were fulfilled "[d]espite the intervention of the [agent]." *Id.*

[101] *See, e.g.*, Hansche v. Commissioner, 457 F.2d 429, 434 (7th Cir. 1972) (failure of taxpayer to prove whether principal or agent had power to set sales price warrants a

EIGHT: *Length of Time the Property was Held*

The length of time which the taxpayer held the property has been found to be of some significance in determining the character of any resulting gain.[102] The Code requires that property, to be considered for long-term capital gains treatment, must be held for at least nine months if disposed of prior to December 31, 1977 and twelve months if disposed of thereafter.[103] The courts have generally associated a holding period substantially in excess of the statutory minimum with investment property,[104] and a relatively shorter holding period with property held "primarily for sale . . . in the ordinary course of a trade or business."[105]

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finding of ordinary income); Miller v. United States, 339 F.2d 661, 663 (Ct. Cl. 1965) (taxpayer retained control over sales price); Pointer v. Commissioner, 48 T.C. 906, 916 (1967), *aff'd*, 419 F.2d 213 (9th Cir. 1969) (taxpayer retained "pervasive influence over a substantial business enterprise"); Freberg v. Commissioner, 23 TAX CT. MEM. DEC. (CCH) 784, 788 (1964) (taxpayers made improvements and retained some control over sales price).

The courts may also impute the actions of a developer to the land-owning taxpayer by finding that the two were involved in a joint venture. *See, e.g.*, Bauschard v. Commissioner, 31 T.C. 910, 916–17 (1959), *aff'd*, 279 F.2d 115 (6th Cir. 1960).

[102] *E.g.*, United States v. Winthrop, 417 F.2d 905, 909–10 (5th Cir. 1969); Estate of Segel v. Commissioner, 370 F.2d 107, 108 (2d Cir. 1966); Gault v. Commissioner, 332 F.2d 94, 96 (2d Cir. 1964); Lloyd E. Mitchell, Inc. v. United States, 259 F. Supp. 345, 349 (D. Md. 1966).

[103] *See* I.R.C. § 1222(3). It must be noted that the statutory holding period does not affect the determination of whether a taxpayer is a dealer or an investor. *See* Treas. Reg. § 1.1221-1(a) (1960). It is merely a requirement which must be met before the courts will begin to consider whether the taxpayer is entitled to long term capital gain. Schlenger & Embry, *supra* note 74, at 24–25.

[104] *See, e.g.*, Turner v. Commissioner, 540 F.2d 1249, 1253 (4th Cir. 1976) (property acquired "many years away from" ultimate enhancement in value entitled to capital asset treatment); Municipal Bond Corp. v. Commissioner, 382 F.2d 184, 189 (8th Cir. 1967) (held for 12 years); Scheuber v. Commissioner, 371 F.2d 996, 997, 999 (7th Cir. 1967), *rev'g* 25 TAX CT. MEM. DEC. (CCH) 559 (1966) (held for nine years); Starke v. Commissioner, 312 F.2d 608, 609 (9th Cir. 1963) (held for an average of 10 years).

It must be noted, however, that in several cases the courts have denied capital gains treatment even though the property was held for a relatively long period of time. *See, e.g.*, Barney v. Commissioner, 26 TAX CT. MEM. DEC. (CCH) 109, 113 (1967); Yara Engineering Corp. v. Commissioner, 22 TAX CT. MEM. DEC. (CCH) 1448, 1461 (1963), *aff'd per curiam*, 344 F.2d 113 (3d Cir. 1965). In each of these cases, the length of the holding period was insignificant because other factors made clear that the taxpayers were dealers. Additional cases involving lengthy holding periods, but in which capital gains treatment was denied may be found in Schlenger & Embry, *supra* note 74, at 25 & nn.38–39. The authors theorized that "where a holding period is forced upon the taxpayer by government restrictions against sale, or by an economically depressed market, its length does not encourage capital gain treatment." *Id.* at 25 (footnotes omitted).

[105] *See, e.g.*, Mathews v. Commissioner, 315 F.2d 101, 106–07 (6th Cir. 1963) (majority of parcels sold within two years of acquisition); Crosswhite v. United States, 369 F.2d 989, 990 (Ct. Cl. 1966) (property subdivided and sold within four years of acquisi-

NINE: *Claimed Motive for Disposition*

The taxpayer's possible motives for disposing of the property are considered in determining whether gain realized from the sale of realty should be accorded capital treatment.[106] As the taxpayer's motive for disposing of property may embody many considerations, the courts generally examine all possible motives in conjunction with the total circumstances surrounding the disposition.[107] If dealer characteristics predominate, then a non-business motive for disposition will not be determinative.[108] Likewise, if investor characteristics are more prevalent, disposal motives that indicate business activity will be of less importance.[109] Much the same as any other factor considered by the courts, therefore, the taxpayer's claimed motive is by no means dispositive.

The intentions of the taxpayer at the time he decides to sell or exchange real estate must be determined. This may be accomplished by reviewing loan applications and representations made by the seller in his dealings with the purchasing party. Once the actual motive for

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tion); Bauschard v. Commissioner, 31 T.C. 910, 917 (1959), *aff'd*, 279 F.2d 115 (6th Cir. 1960) (sales made shortly after property acquired). For cases with shorter holding periods allowing capital gains treatment, however, *see* Hoover v. Commissioner, 32 T.C. 618, 627 (1959) (some parcels held for only 18 months); Lowery v. Commissioner, 23 TAX CT. MEM. DEC. (CCH) 152, 154, 156 (1964) (held for two to five years).

[106] *E.g.*, Municipal Bond Corp. v. Commissioner, 341 F.2d 683, 689 (8th Cir. 1965); Huey v. United States, 504 F.2d 1388, 1392 (Ct. Cl. 1974); Miller v. United States, 339 F.2d 661, 663 (Ct. Cl. 1964).

[107] *See* Municipal Bond Corp. v. Commissioner, 341 F.2d 683, 689–90 (8th Cir. 1965).

[108] *See, e.g.*, Bynum v. Commissioner, 46 T.C. 295, 300 (1966) (subdivision of farm and sale of lots to pay off a mortgage resulted in ordinary income treatment due to extensive activities indicating that the property was held primarily for sale in ordinary course of business); Vidican v. Commissioner, 28 TAX CT. MEM. DEC. (CCH) 1099, 1102 (1969) (sale of rental properties resulted in ordinary-income treatment because of a "pattern" of sales indicating that the taxpayer was building the rental units primarily to sell them).

[109] *See, e.g.*, Climate Control, Inc., 43 TAX. CT. MEM. DEC. (P-H) 852, 857 (1974) (property originally acquired to build rental units; activities, until shortly before sale, consistent with investment purposes).

Examples of motives for disposition leading to capital gains treatment include cash shortages, age or illness of investor, liquidation of a partnership, and condemnation. Schlenger & Embry, *supra* note 74, at 37. For a discussion of condemnation as the motive for disposition and its effect when the condemned property was admittedly held for sale in the ordinary course of business, see Comment, *Federal Income Taxation: The Effect of Condemnation on Property Held Primarily for Sale to Customers in the Ordinary Course of the Taxpayer's Business*, 6 LOY. CHI. L. J. 622 (1975). The comment concluded that a taxpayer attempting to show that his motive had changed to that of investment as a result of a condemnation "can hardly be assured of success" due to the uncertainties created by existing case law. *Id.* at 642–43.

disposition has been established, it will be compared with the motive existing at the time of acquisition.[110] If the motive for disposition is found to be the legitimate liquidation of an investment, capital gains treatment will be granted.[111] In the alternative, if the motive for disposition is to realize profits from the operation of a business, capital gains treatment will be prohibited.[112]

TEN: *Proportion of Taxpayer's Income Derived from the Transactions*

A further inquiry which courts often make is concerned with the contrast between income derived from the taxpayer's real estate activities and income derived from other activities.[113] In effect, this enables a court to determine which activities are primary, since the test is premised on the analysis that relatively small amounts of income derived from real estate transactions, as opposed to other income, indicate investor status.[114] On the other hand, if the taxpayer earns a

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[110] *See* notes 81–85 *supra* and accompany text.

[111] *See, e.g.*, Heller Trust v. Commissioner, 382 F.2d 675, 679–80 (9th Cir. 1967), *rev'g and remanding*, 24 TAX CT. MEM. DEC. (CCH) 1663 (1965) (liquidation of rental properties due to ill health and poor rental market); Keliher v. Brownell, 192 F. Supp. 548, 550–51 (M.D. Pa. 1961) (sale of abandoned homesite); Estate of Mundy v. Commissioner, 36 T.C. 703, 713 (1961) (liquidation of inherited property); Fabiani v. Commissioner, 32 TAX CT. MEM. DEC. (CCH) 941, 945–47 (1973) (sale of condemned property entitled to capital asset treatment because taxpayer's investment motive in holding found not to have changed); Toll v. Commissioner, 20 TAX CT. MEM. DEC. (CCH) 1548, 1549–51 (1961) (sale of real property purchased to facilitate the later purchase of other property). *See also* Crosswhite v. United States, 369 F.2d 989, 991–92 (Ct. Cl. 1966) (liquidation situations warranting capital gains treatment include "inherited or unwanted investments," or liquidations "to raise funds to satisfy the needs of other businesses").

[112] United States v. Winthrop, 417 F.2d 905, 911, 912 (5th Cir. 1969) (only motive being the sale of the tract, lot-by-lot, and level of activity of such "magnitude and continuity" as to constitute a business); Vidican v. Commissioner, 28 TAX CT. MEM. DEC. (CCH) 1099, 1102 (1969) (taxpayers' "reli[ance] on the sale of apartment properties rather than on rentals for the great bulk of their income").

[113] *E.g.*, Estate of Segel v. Commissioner, 370 F.2d 107, 108 (2d Cir. 1966); Gault v. Commissioner, 332 F.2d 94, 96 (2d Cir. 1964); Huey v. United States, 504 F.2d 1388, 1392 (Ct. Cl. 1974); Lewis v. United States, 389 F.2d 818, 824 (Ct. Cl. 1968); Crosswhite v. United States, 369 F.2d 989, 991 (Ct. Cl. 1966); Miller v. United States, 339 F.2d 661, 663 (Ct. Cl. 1964). Some courts have found relevant the similar consideration that capital gains treatment should be permitted when the taxpayer has foregone an opportunity to maximize his profit. *E.g.*, Tibbals v. United States, 362 F.2d 266, 272–73, 273 n.12 (Ct. Cl. 1966); Tibbals v. Commissioner, 17 TAX CT. MEM. DEC. (CCH) 228, 232 (1958). *See also* Camp v. Murray, 226 F.2d 931, 934 (4th Cir. 1955).

[114] *See, e.g.*, Hoover v. Commissioner, 32 T.C. 618, 627–28 (1959) (income from real estate sales substantially exceeded income from other business activities).

In Scheuber v. Commissioner, 371 F.2d 996 (7th Cir. 1967), the court appeared to reverse the logic of this test. The taxpayer was in the business of selling real estate. *Id.*

substantial proportion of his income from the subject property, the courts reason that the taxpayer has engaged in the real estate business.[115]

Standing alone, however, the comparison of income derived from real estate with other income is not usually a satisfactory indication of dealer or investor status.[116] In order to make this test more worthwhile, the courts sometimes inquire into the time and effort the taxpayer has expended on the property.[117] Thus, the devotion of relative-

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at 997. He purchased an unimproved tract in 1945 for $10,000, which was condemned by the City of Milwaukee in 1959 and for which he received a condemnation award of approximately $130,000. *Id.* at 997–99. The court did not compare the amount received from the sale with the taxpayer's other income. The court reasoned, however, that the amount received should be afforded capital gains treatment since the "eventual returns on the amounts initially invested were unrealistically high for items held for resale in day to day operation of a business." *Id.* at 999.

Thus, while substantial income from the sale of real property over a course of years will probably result in ordinary income treatment, the profit from a large, one-time sale may be found to be a capital gain. For a discussion of the *Scheuber* case, see Simmons and O'Hara, *supra* note 94, at 220–21. The authors characterized *Scheuber* as an "explicit statement that the magnitude of the gain to the taxpayer may justify capital gains treatment." *Id.* at 220.

[115] *E.g.*, Tomlinson v. Dwelle, 318 F.2d 60, 62 (5th Cir. 1963) (income from sales of apartment buildings exceeded income from rents); Nadalin v. United States, 364 F.2d 431, 439 (Ct. Cl. 1966) (per curiam) (income from real estate sales almost 20 times the amount of other income); Miller v. United States, 339 F.2d 661, 663 (Ct. Cl. 1964) (93% of income from sale of real property); Vidican v. Commissioner, 28 TAX CT. MEM. DEC. (CCH) 1099, 1102 (1969) (income from sale of apartment buildings exceeded income from rents); Barney v. Commissioner, 26 TAX CT. MEM. DEC. (CCH) 109, 114 (1967) (compared with other income, gains from sales were substantial—approximately 26%).

[116] Austin v. Commissioner, 263 F.2d 460, 465 (9th Cir. 1959), suggested that the percentage-of-income test was not determinative in the absence of evidence that the taxpayer devoted considerable time to the real-estate transactions.

At least one commentary has noted that the substantiality of income from real estate sales, as a factor in determining whether gain should be treated as capital or ordinary, is not a valid criteria in all fact patterns, reasoning that

> [i]t is reasonable to conclude that one who spends a major portion of his time selling real estate is in that business. It is not so clear that a person who receives a major portion of his income from such sales is in that business. . . . [I]f there is a seller's market . . . the sales will produce substantial income in a short period of time.

Schlenger & Embry, *supra* note 74, at 36–37.

[117] *E.g.*, Lloyd E. Mitchell, Inc. v. United States, 259 F. Supp. 345, 349 (D. Md. 1966) (time spent on real estate transactions slight, 1%, and the amount of income from transactions small); Adam v. Commissioner, 60 T.C. 996, 1000, 1003 (1973) (small amount of time spent on real estate transactions and for the three years in question the percentage of income was 5%, 16% and 30%).

Some courts have relied on Snell v. Commissioner, 97 F.2d 891, 892 (5th Cir. 1938), in interpreting the amount of time spent in terms of "busyness." *See, e.g.*, 60 T.C. at 1000. That is, in deciding whether the taxpayer was in the business of selling the real estate, they look to see how "busy" he was in the transactions. 97 F.2d at 892.

ly large amounts of time and effort to the management of the property, along with a substantial amount of income derived directly from the sale of real estate, may be determinative of dealer status.[118]

SECTION 1221(1)—THE TWO-PRONGED TEST

Although the ten tests noted above may be identified with certainty, it is virtually impossible to predict the manner in which they will be applied by any given tribunal. Depending on a particular court's reaction to the factual situation presented by a case, it may disregard certain tests altogether,[119] emphasize some over others,[120] or attempt to discard them wholesale.[121] Illustrative of this situation is the case of *United States v. Winthrop*,[122] decided by the Fifth Circuit in 1969.

In *Winthrop*, the taxpayer had inherited land near the city of Tallahassee, Florida.[123] As the city expanded, a majority of the taxpayer's property was brought within its boundary.[124] Four years after receiving the property, the taxpayer began subdividing and selling lots. When "most of the lots in one subdivision" had been sold, he would proceed to develop and sell another subdivision.[125] The taxpayer employed no brokers, nor did he conduct any advertising.[126] Although the taxpayer was a civil engineer, he devoted most of his time to the development of the land. Profits from these sales amounted to over fifty-two percent of his total gross income.[127] Originally reporting all the profits as capital gains, when assessed for self-

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[118] *See* Crosswhite v. United States, 369 F.2d 989, 992 (Ct. Cl. 1966); Industrial Life Ins. Co. v. United States, 344 F. Supp. 870, 878 (D.S.C. 1972), *aff'd per curiam*, 481 F.2d 609 (4th Cir. 1973), *cert. denied*, 414 U.S. 1143 (1974). In *Crosswhite* the taxpayer subdivided five tracts of land and sold off 168 of the resulting lots over a two and one-half year period. 369 F.2d at 990. The court refused to permit capital asset treatment of the gain, basing its finding on the fact that gains from the real estate sales exceeded other income during the relevant period and that the taxpayers were personally involved in the transactions. *Id.* at 992. The court did note that the "transactions . . . were neither frequent nor continuous"—factors frequently mentioned as indicative of a sale of a capital asset—but concluded that no single factor is determinative and that the situation must be viewed as a whole. *Id.*

[119] *See* notes 96–97 and 104 *supra* and accompanying text.

[120] *See* Biedenharn Realty Co. v. United States, 526 F.2d 409, 415–20 (5th Cir.), *cert. denied*, 429 U.S. 819 (1976)

[121] *See* United States v. Winthrop, 417 F.2d 905, 910 (5th Cir. 1969).

[122] 417 F.2d 905 (5th Cir. 1969).

[123] *Id.* at 906.

[124] *Id.*

[125] *Id.*

[126] *Id.*

[127] *Id.* at 906–07.

employment taxes, the taxpayer began to characterize the return on his real estate transactions as arising from a business.[128] Thus, these profits were taxed at ordinary income rates.[129]

After the taxpayer died, his widow sought a refund of taxes paid in excess of the capital gain rate.[130] The district court, emphasizing six factors,[131] agreed with the taxpayer's widow that her husband was not engaged in the business of selling real estate. It therefore found that capital gains treatment was warranted.[132]

Although acknowledging seven tests,[133] the court of appeals proclaimed "that these seven pillars of capital gains treatment 'in and of themselves . . . have no independent significance.' "[134] In light of this, the Fifth Circuit stated it would "take the route of ad hoc exploration to find ordinary income" rather than become "engulfed in a fog of decisions with gossamer like distinctions, and a quagmire of unworkable, unreliable, and often irrelevant tests."[135]

A final determination of the capital gains issue, the opinion noted, must be made by analyzing the facts of a given case in light of the statutory exclusions.[136] The Fifth Circuit reasoned that the denial of capital gains, pursuant to section 1221(1), required two findings: that the property was held primarily for sale, and that such sales were

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[128] *Id.* at 907.

[129] *Id.*

[130] *Id.*

[131] *Id.* at 909. The six factors used by the district court were:

> (1) The proceeds from the sales of the property were not reinvested in real estate; (2) the taxpayer had other investments, none of which involved the sale of real estate; (3) the subdivided property was acquired by inheritance, not by purchase for the purpose of resale; (4) the taxpayer's holding period was twenty-five years; (5) the taxpayer maintained no office, made most of the sales from his home, spent no time whatever promoting sales and did not advertise; and (6) the purchasers came to him and he was selective in making the sales.

Id.

[132] *Id.*

[133] *Id.* at 909–10. The seven tests mentioned by the court of appeals were:

> (1) the nature and purpose of the acquisition of the property and the duration of the ownership; (2) the extent and nature of the taxpayer's efforts to sell the property; (3) the number, extent, continuity and substantiality of the sales; (4) the extent of subdividing, developing, and advertising to increase sales; (5) the use of a business office for the sale of the property; (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and (7) the time and effort the taxpayer habitually devoted to the sales.

Id. at 910.

[134] *Id.*

[135] *Id.* at 906.

[136] *Id.* at 911. The court reiterated that the exclusions from capital assets are to be broadly construed. *Id.*; *see* note 37 *supra* and accompanying text.

made in the ordinary course of the taxpayer's trade or business.[137] Interpreting the statutory language as presenting a two-pronged test,[138] the court noted that although the property had been inherited, the taxpayer made no personal use of it.[139] All improvements and development activities were motivated by the sole purpose of producing a more "saleable" tract of land.[140] The court concluded from the evidence that the taxpayer never intended to hold the property as an investment but rather held it primarily for sale.[141] With the first prong of the test satisfied, the court proceeded to determine whether the sales were in the ordinary course of a trade or business.[142] The taxpayer's widow argued that her husband was not in a realty business, pointing to "the fact that no office was used, no brokers were employed, no time was spent promoting sales, and no advertising was used."[143] The court acknowledged that although the presence of such factors indicate a business, they are not essential.[144] The court noted that over a period of twenty-five years the taxpayer continuously subdivided and sold parcels of land, "devoted [most] of his time, skill and financial resources" to the property's development, and derived over fifty percent of his income from the sales.[145] The court found from such facts that he was in the realty business.[146] Upon the court's findings that the property was held primarily for sale and in the ordinary course of the taxpayer's business, the claim for capital gains treatment was denied.[147]

Thus, although the court had initially stated that the tests or factors utilized by the trial court were "unreliable" and "irrelevant,"[148] nevertheless, under the guise of statutory interpretation, the circuit court itself considered some of the same factors in reaching its deci-

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[137] 417 F.2d at 911.

[138] *See id.*

[139] *Id.* Although the taxpayer never used the land, he did allow a city employee to live on the land rent free. Another city employee was later allowed to rent a house on the property but not the land itself. *Id.*

[140] *Id.* These improvements included the installation of utilities and the paving of roads. *Id.*

[141] *Id.*

[142] *Id.*

[143] *Id.* at 912.

[144] *Id.*

[145] *Id.* at 911.

[146] *Id.* The court noted that the "[h]istory and chronology . . . combine to demonstrate that Winthrop did not sell his lots as an abnormal or unexpected event. . . . Thus, the sales were not only ordinary, they were the sole object of Winthrop's business." *Id.* at 912.

[147] *Id.*

[148] *Id.* at 906.

sion.[149] The opinion analyzed the facts related to at least five of the "seven pillars" previously followed in the circuit: the nature and purpose of the property acquisition; the extent and nature of the taxpayer's efforts to sell the property; the number, extent, continuity and substantiality of the sales; the extent of subdividing and developing to increase sales; and the time and effort devoted to the sales.[150]

THE THIRD CIRCUIT

Appellate Review

The determination of whether real property is classified as a capital asset or as an asset "held for sale in the ordinary course of business" requires a factual finding by the court.[151] The factual and legal determinations of a trial court affect the scope of review if a decision is appealed.[152]

Rule 52(a) of the Federal Rules of Civil Procedure limits appellate review of the factual determinations of a lower court by providing that the "[f]indings of fact shall not be set aside unless clearly erroneous."[153] The majority of appellate courts has strictly applied this rule.[154] However, the "clearly erroneous" rule has been given a more liberal interpretation by the Third Circuit.[155]

The Third Circuit analyzes a trial court's determination on two

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[149] *See id.* at 910–12.

[150] *See id.* at 911.

[151] *E.g.*, Koch v. United States, 457 F.2d 230, 233 (7th Cir. 1972); United States v. Burket, 402 F.2d 426, 429 (5th Cir. 1968); Commissioner v. TRI-S Corp., 400 F.2d 862, 864 (10th Cir. 1968) (citing Friend v. Commissioner, 198 F.2d 285, 287 (10th Cir. 1952)).

[152] *See* 9 C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE §§ 2583, 2585, 2589 (1971).

[153] FED. R. CIV. P. 52(a). An appellate court's jurisdiction includes review of Tax Court decisions "in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury." 26 U.S.C. § 7482(a) (1970).

[154] *See, e.g.*, Commissioner v. Smith, 397 F.2d 804, 804 (9th Cir. 1968); Estate of Broadhead v. Commissioner, 391 F.2d 841, 843 (5th Cir. 1968); J.S. Biritz Constr. Co. v. Commissioner, 387 F.2d 451, 455 (8th Cir. 1967). For an extensive compilation of courts strictly adhering to this rule, see 5A MOORE'S FEDERAL PRACTICE ¶ 52.03[5], at 2675 n.3 (2d ed. 1977).

[155] *See* Jersey Land & Dev. Corp. v. United States, 539 F.2d 311, 315 (3d Cir. 1976); Heebner v. Commissioner, 280 F.2d 228, 231–32 (3d Cir.), *cert. denied*, 364 U.S. 921 (1960); Pennroad Corp. v. Commissioner, 261 F.2d 325, 328 (3d Cir. 1958), *cert. denied*, 359 U.S. 958 (1959); Kaltreider v. Commissioner, 255 F.2d 833, 837 (3d Cir. 1958); Philber Equip. Corp. v. Commissioner, 237 F.2d 129, 131 (3d Cir. 1956). *See also* Juleo, Inc. v. Commissioner, 483 F.2d 47, 50 (3d Cir.) (Gibbons, J., dissenting), *cert. denied*, 414 U.S. 1103 (1973). While still a minority view, the trend toward increased review of the capital gains determination has been followed by the Third, Fourth, and Fifth Circuits. *See* 46 J. TAX. 25, 25 (1977).

levels. On the first level, a taxpayer's activities in connection with real property, as exemplified by the "ten tests," are viewed as ordinary findings of fact which are subject to the clearly erroneous rule. The second level concerns the "ultimate conclusion" of whether or not the property is a capital asset, which is considered a question of law reviewable independently of the clearly erroneous standard of Rule 52(a).[156]

The analysis rendered by the Third Circuit should motivate taxpayers to appeal lower court decisions since the Third Circuit will review fully the "ultimate conclusion," thereby strengthening a taxpayer's chances upon appeal.

Case Law Development

An historical analysis of Third Circuit decisions indicates the necessity of analyzing each case upon its particular facts. It should be noted, however, that in deciding the capital gains issue, the court of appeals has adhered to a strict interpretation of the capital asset definition, as mandated by the Supreme Court in the *Corn Products* decision.[157]

One of the early Third Circuit cases to strictly construe the capital asset statute was the pre-*Malat* decision of *Kaltreider v. Commissioner.*[158] In *Kaltreider*, the taxpayers acquired a twenty-seven acre tract of farmland which they utilized for several years for farming purposes and upon which they constructed their residence.[159] Approximately eleven years after the purchase of the property, the taxpayers organized a closely-held corporation to engage in the construction business.[160] Shortly thereafter, certain portions of the property were subdivided by the taxpayers. The corporation constructed homes upon a majority of these lots.[161] The income from the sale of

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[156] *E.g.*, Jersey Land & Dev. Corp. v. United States, 539 F.2d 311, 315 (3d Cir. 1976); Heebner v. Commissioner, 280 F.2d 228, 231–32 (3d Cir.), *cert. denied*, 364 U.S. 921 (1960); Pennroad Corp. v. Commissioner, 261 F.2d 325, 328 (3d Cir. 1958), *cert. denied*, 359 U.S. 958 (1959). *See also* Kaltreider v. Commissioner, 255 F.2d 833, 837 (3d Cir. 1958).

The "ultimate finding of fact" resolving the capital gains issue is "a legal inference" derived from the ordinary findings of fact. *E.g.*, Pennroad Corp. v. Commissioner, 261 F.2d at 328. Accordingly, a trial court's ultimate finding as to capital or ordinary asset treatment will stand when the Third Circuit finds that "the ultimate fact reasonably flows from the basic facts" determined. *Id.*

[157] For a discussion of the *Corn Products* decision, see notes 38–49 *supra* and accompanying text.

[158] 255 F.2d 833, 838 & n.15 (3d Cir. 1958), *aff'g* 28 T.C. 121 (1957).

[159] 255 F.2d at 835.

[160] 28 T.C. at 125.

[161] *Id.*

these lots and homes was reported in an inconsistent manner by the taxpayers in their personal tax returns for the years 1948 through 1952. For the taxable years 1949 and 1950, all income was reported as ordinary.[162] In the tax returns for 1951 and 1952, however, profit realized from sale of the homes was reported as ordinary income, while profit attributable to disposition of the lots was reported as long-term capital gain.[163]

Finding that the taxpayers had been engaged in the "business of subdividing, improving, and selling real estate,"[164] the Tax Court denied capital gains treatment.[165] In substantiating this conclusion, the Tax Court attributed several property-related activities of the corporation to the taxpayers.[166] Principal among these was the subdivision of the acreage at the taxpayers' expense.[167] In addition, the lower court determined that an agency relationship existed between the taxpayers and the corporation since the corporation's activities were performed solely for the Kaltreiders' benefit.[168] Consequently, the court imputed the company's trade or business activities to the taxpayer.[169] The Tax Court also supported its finding that the corporation had acted on behalf of the taxpayer, by an examination of the Kaltreiders' personal income tax returns for the years 1949 to 1952. On these returns, the Kaltreiders had included the income from the sales of houses and lots.[170] The taxpayers amended their personal return for calendar year 1952 in order to remove the income from home sales and to cause that income to be included in the corporation's return.[171] The Tax Court nevertheless identified "the original returns [as] more truly representative of the relationship . . . between" the Kaltreiders and their closely-held corporation.[172]

On appeal, the Third Circuit affirmed the Tax Court's denial of

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[162] *Id.*

[163] *Id.* at 123.

[164] *Id.* at 125.

[165] *Id.*

[166] *Id.* at 124.

[167] *See id.* at 125.

[168] *Id.* at 125-26. The taxpayers contended that an "agreement" had been established between the corporation and the taxpayer, providing for the transfer of title held by the taxpayer to the corporation upon the corporation's construction and profitable sale of the homes. *Id.* at 125. The Tax Court, however, concluded that the corporation's activities, as those of an agent, were actually "done at the instance and for the benefit of the" taxpayers. *Id.*

[169] *See id.* at 124–26.

[170] *Id.* at 125.

[171] *Id.* at 123–24, 125–26. The 1952 tax return was amended after the case was docketed for trial before the Tax Court. *Id.* at 126.

[172] *Id.* at 126.

capital gains status,[173] stressing those facts that precluded capital gains treatment. The "critical" facts identified by the court included the failure of the Kaltreiders to resume farming activities after the initial subdivision in 1948, "extensive" improvements to the property, and the transference of title directly to purchasers by the taxpayer when the homes were sold by the corporation.[174] The circuit court noted that the Kaltreiders had included the income from both the sales of the homes and the lots in their personal returns,[175] and emphasized that the taxpayers had identified their occupation on their tax return as " 'Contractors' " and their business as " 'Sales of Homes.' "[176] The court considered this "self-description of business or occupation" relevant as "evidence of [the] taxpayers' business."[177]

Although the Third Circuit alluded to eight factual tests,[178] the taxpayers' self-characterization and the requirement of strictly construing the capital asset classification dominated the court's analysis.[179] This is perhaps understandable in light of the fact that the decision was rendered shortly after *Corn Products* but prior to *Malat*. It appears, however, that the question of statutory construction and application of the tests to the facts are independent elements requiring separate analysis.

In *Pennroad Corp. v. Commissioner*,[180] another pre-*Malat* decision, the Third Circuit distinguished between tests utilized in fact patterns involving residential real estate sales and those tests applicable to industrial land transactions.[181] Recognizing that the standard

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[173] 255 F.2d at 838.

[174] *See id.* at 838–39.

[175] *See id.* at 839.

[176] *Id.*

[177] *Id.* This self-description of the taxpayers' occupation would no longer be controlling due to the Supreme Court decision of Malat v. Riddell, 383 U.S. 569 (1966). *See* notes 53–59 *supra* and accompanying text.

[178] *Id.* at 838. After stating that "[n]o single factor or test is dispositive," the Third Circuit listed the "[f]actors considered" in resolving the capital gains issue to be

> (1) the purpose for which the property was acquired; (2) the purpose for which it was held; (3) improvements, and their extent, made to the property by taxpayer; (4) frequency, number and continuity of sales; (5) the extent and substantiality of the transactions; (6) the nature and extent of taxpayer's business; (7) the extent of advertising to promote sales, or the lack of such advertising; and (8) listing of the property for sale directly or through brokers.

Id.

[179] *See id.* at 838 & n.15. The *Kaltreider* court, in analyzing the character of the gain, stated that it would "keep in mind the teaching that the term 'capital assets' as used in Section [1221] must be 'construed narrowly.' " *Id.* at 838 (quoting from Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46, 52 (1955)).

[180] 261 F.2d 325 (3d Cir. 1958), *cert. denied*, 359 U.S. 958 (1959).

[181] 261 F.2d at 330. The issue before the court involved gain realized from real

tests used in categorizing real estate transactions had evolved from disputes involving residential property, the Third Circuit stated that the tests were "decidedly different where dealing with industrial property."[182] The court stressed that this "most important factor" was unnoticed by the taxpayer.[183]

Reviewing the taxpayer's activities, the court concluded that the real estate sales had occurred in the ordinary course of business and that an ordinary gain should have been recognized.[184] As in the *Kaltreider* case, the court took notice of the taxpayer's "self-characterization"[185] of its business, including references to " 'Industrial Real Estate' " in the firm's advertising brochures, " 'sale and/or rental of real estate' " as stated in the firm's annual reports, and self-identification of the business on the firm's tax returns as " 'Real Estate—Active.' "[186] In reaching its conclusion, the court recognized that improvements made by the taxpayer's subsidiary to adjacent property had resulted in increased commercial and industrial attractiveness of the property sold.[187] The court considered the purchase of additional land by the corporation in order to straighten boundary lines as a further effort to enhance the property's marketability.[188] In holding that these factors of self-characterization and commercial improvements supported a finding of ordinary income, the Third Circuit reasoned that the small percentage of income from real estate sales and the lack of subdivision were irrelevant in cases involving commercial property.[189]

Heebner v. Commissioner[190] illustrates the Third Circuit's application of the *Corn Products* doctrine that sales forming an integral part of a taxpayer's business will result in ordinary gain. *Heebner* involved the characterization of the gain realized on the sale of land upon which the taxpayer's closely-held corporation[191] had constructed

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estate sales during the years 1950 to 1952 by the Canton Company, a subsidiary of the taxpayer, Pennroad Corporation. *Id.* at 326.

[182] *Id.* at 330.

[183] *Id.*

[184] *Id.* at 331.

[185] *Id.* As noted earlier, *see* note 177 *supra*, the taxpayer's business will not affect the determination of whether the land sold was a capital asset. *See* notes 53–59 *supra* and accompanying text.

[186] 261 F.2d at 327–28.

[187] *See id.* at 327, 329, 330.

[188] *Id.* at 327.

[189] *Id.* at 330, 331.

[190] 280 F.2d 228 (3d Cir.), *cert. denied*, 364 U.S. 921 (1960).

[191] 280 F.2d at 229. The "[t]axpayer owned 89.54 per cent of the [firm's] outstanding" shares, while the remaining stock was owned by the taxpayer's two brothers. *Id.*

a warehouse.[192] The taxpayer, who held title to the real estate,[193] was involved in the transaction as a package builder—an activity where the builder designs, locates, financially arranges, and constructs a building project.[194]

The taxpayer contended that he had acquired the land solely for investment purposes.[195] Accordingly, it was the taxpayer's position that the profit from the disposition of the property was distinguishable from a "builder's profit."[196] The Tax Court identified the gain recognized by the taxpayer as ordinary upon its finding that the real estate transaction was a part of the taxpayer's normal business of constructing and selling commercial sites.[197]

In affirming the Tax Court's recognition of ordinary gain on the real estate sale,[198] the Third Circuit was cognizant of the Supreme Court's instruction to strictly interpret the capital asset statute.[199] Without substantive analysis of the tests cited in the *Kaltreider* decision,[200] the Third Circuit applied the *Corn Products* doctrine, finding that the gain was attributable to an activity which was an integral part of the taxpayer's ordinary business.[201] As the taxpayer's business was that of a package builder,[202] the court determined that the acquisition and sale of the property by the taxpayer was "merely one step in effectuating the" sale of the commercial construction project.[203] The land was viewed by the court as one "commodity" used in the development of the site.[204] The court found no evidence that the land had been held by the taxpayer for investment purposes.[205] Thus, the Third Circuit determined that the profit from the property's sale had been generated from the taxpayer's everyday business operations[206]

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[192] *Id.* at 230.

[193] *Id.* at 229.

[194] *Id.* at 229–30.

[195] *Id.* at 232.

[196] *Id.*

[197] Heebner v. Commissioner, 32 T.C. 1162, 1169 (1959), *aff'd*, 280 F.2d 228 (3d Cir.), *cert. denied*, 364 U.S. 921 (1960).

[198] 280 F.2d at 234.

[199] *Id.* at 232.

[200] *See id.* at 232–33.

[201] *Id.* at 232–34.

[202] *Id.* at 233.

[203] *Id.* at 234.

[204] *Id.* at 233.

[205] *Id.* at 234. The Third Circuit reasoned that the taxpayer's business agreement, involving the property's sale following the construction of the warehouse, indicated that the taxpayer had never intended to hold the property for investment purposes. *Id.*

[206] *Id.* at 233, 234.

and was consequently identified as ordinary gain.[207] Thus the *Heebner* decision appears to indicate that whenever property-related activities are an integral part of the taxpayer's business the established tests will be of minimal importance.

In *Yara Engineering Corp. v. Commissioner*,[208] the Third Circuit rendered a per curiam opinion affirming the Tax Court's decision. *Yara* involved the determination of whether a corporation engaged, *inter alia*, in the business of buying and selling real estate should recognize ordinary gain on the sale of property.[209] The dispute in *Yara* concerned the taxpayer's claim of capital gains on the sale of sixteen tracts of land during the years 1955 and 1956.[210] These properties had neither been improved nor subdivided by the taxpayer.[211] The taxpayer's principal stockholder, having considerable experience and recognition in the local real estate community, had managed the corporation's real estate activities since the time of the taxpayer's incorporation in 1932.[212]

The circuit court did not review the factual determinations made by the Tax Court, stating that the findings were "not clearly erroneous."[213] By affirming the lower court's opinion in this manner, the Third Circuit adopted the Tax Court's in-depth, substantive analysis of the facts.[214]

In determining that Yara was a dealer in real estate, the Tax Court analyzed the capital gains issue by employing factual tests used by other courts.[215] Recognizing that a dealer could hold property for investment purposes in addition to holding land for sale in the ordinary course of business,[216] the Tax Court examined the taxpayer's motives for purchasing, holding and disposing of each tract of land in dispute.[217] The Tax Court concluded that two tracts were purchased and held by the taxpayer principally for the protection of other busi-

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[207] *Id.* at 234.

[208] 344 F.2d 113, 114 (3d Cir. 1965), *aff'g* Yara Eng'r Corp. v. Commissioner, 22 TAX CT. MEM. DEC. 1448 (1963).

[209] 22 TAX CT. MEM. DEC. at 1448–49.

[210] *Id.* at 1448–49, 1452.

[211] *See id.* at 1453–58.

[212] *Id.* at 1449–50.

[213] 344 F.2d at 114. For a discussion of the extent of review in the Third Circuit of "clearly erroneous" fact findings, see notes 151–56 *supra* and accompanying text.

[214] *See* 344 F.2d at 114.

[215] 22 TAX CT. MEM. DEC. at 1459.

[216] *Id.* Within a year of the *Yara* decision the Supreme Court reached a similar conclusion in Malat v. Riddell, 383 U.S. 569 (1966). *See* notes 53–59 *supra* and accompanying text.

[217] *See id.* at 1459–61.

ness property and constituted property not held for sale to customers in the ordinary course of business.[218] For these two properties, the Tax Court allowed the recognition of capital gains.[219]

The profit realized from the sale of the remaining tracts was designated ordinary income by the Tax Court since it was determined that these properties had been held for sale in the ordinary course of the taxpayer's business.[220] This decision was predicated upon the finding that the corporation's sales and purchases of real estate had been "numerous and continuous"[221] and had involved "successive sales from the same parcels."[222] In dismissing the taxpayer's contention that the lack of conventional real estate advertising was indicative of an investment motive, the Tax Court considered the necessity for sales promotion in reference to the taxpayer's business operations.[223] The court observed that Yara's opportunities for land transactions were not dependent upon commercial advertising since the corporation's agent was well known within the real estate community and was contacted by interested purchasers.[224] Additional findings persuasive in reaching the conclusion that the taxpayer was in the business of buying and selling these tracts included the facts that the taxpayer's basis in real estate had increased as a result of the sale and purchase of property[225] and that the taxpayer's total "income . . . from [its] real estate sales was substantial" in proportion to the corporation's taxable income.[226]

In the 1976 decision of *Jersey Land & Development Corp. v. United States*,[227] the Third Circuit again confronted the issue of whether the profits on the sale of commercial real estate constituted a capital gain.[228] In *Jersey Land*, Bigley Brothers, Inc., in order to establish additional storage facilities for its trucking business, created Jersey Land & Development Corporation.[229] Jersey Land acquired approximately seventy-five acres of marshland pursuant to a lease-option agreement with a municipality.[230] Under this contract, Jersey Land

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[218] *Id.* at 1460.
[219] *Id.*
[220] *Id.* at 1460, 1462.
[221] *Id.* at 1460.
[222] *Id.* at 1461.
[223] *Id.*
[224] *Id.*
[225] *Id.* at 1462.
[226] *Id.* at 1461; *see* notes 113–18 *supra* and accompanying text.
[227] 539 F.2d 311 (3d Cir. 1976).
[228] *Id.* at 312.
[229] *Id.* at 313.
[230] *Id.*

had the option of purchasing the property after compliance with certain filling and grading activities required by the lease-option agreement.[231] Due to a decline in the trucking firm's business in 1961, Bigley Brothers was sold to Youngstown Cartage Corporation. Youngstown continued to lease the meadowland storage facilities from Jersey Land.[232] After the sale of the trucking enterprise, Jersey Land "continued its filling and grading" activities and exercised its option by purchasing the majority of the land subject to the agreement.[233] Between 1961 and 1968, Jersey Land sold forty acres in six transactions.[234] The Commissioner challenged the taxpayer's claim that it was entitled to capital gains treatment on the disposition of this property.[235]

The Third Circuit reversed the district court's allowance of capital gains treatment, holding that ordinary income treatment was warranted.[236] The circuit court deemed the taxpayer's motive for holding the property at the time of the sale a critical factor in its decision.[237] It was ascertained that the taxpayer's motive for holding the property at the time of the sale could not have been connected with the trucking business since the majority of Jersey Land's improvement and sales activities occurred after the sale of the trucking concern.[238]

The court of appeals stated that the ultimate determination of the capital gains issue must depend upon the total factual context of the case.[239] The court reasoned that the tests developed in cases involving residential property were "of limited utility" when applied to fact patterns involving industrial and commerical real estate.[240] Furthermore, the court found that reliance upon sales promotion activities, even in disputes involving residential real estate, was "deceptive" because of its emphasis on the taxpayer's marketing methods rather than on the taxpayer's motivation for holding the property.[241]

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[231] *Id.*

[232] *Id.*

[233] *Id.*

[234] *Id.* The court recognized the substantial difference in Jersey Land's property-related activities before and after the trucking company's sale. *See id.* at 315–16. The facts indicated that Jersey Land spent nearly $50,000 for land improvements and acquired only five acres of the tract before the sale of the trucking firm, while following the sale, approximately $600,000 was spent in land development and 70 more acres were obtained. *Id.* at 313.

[235] *See id.* at 313–14.

[236] *Id.* at 317.

[237] *Id.* at 315.

[238] *Id.* at 315–16.

[239] *Id.* at 315.

[240] *Id.* at 316.

[241] *Id.*

In holding that Jersey Land was not entitled to capital gains treatment, the court emphasized that the increase in the property's value was due to the taxpayer's extensive improvements rather than the result of market appreciation.[242] This finding, together with the short holding period, indicated that Jersey Land had "held the property for current sale rather than investment purposes."[243] The court's reasoning in *Jersey Land* would seem to indicate that a new test will be employed in situations involving commercial real estate. Whether the increase in value is attributable to improvements or to market appreciation will be the crucial inquiry in determining the availability of capital gains treatment.[244]

MAINTAINING AND PLANNING CAPITAL GAINS TREATMENT FOR INVESTORS AND DEALERS

When will an investor's activities cause him to be classified, for tax purposes, as a dealer? From the investor's point of view, this is the critical question that must be answered in order to determine whether preferential capital gains treatment will be available. As the previous discussion has indicated, the casual investor may find that he has crossed the line drawn by the court and will be deemed a dealer. Investors can profit from a study of the courts' analysis when determining whether a dealer is holding property for sale to customers in the ordinary course of business or for investment purposes. The caveats that are applicable to dealers also pertain to potential investors who, based upon their activities, might be considered as dealers by the Internal Revenue Service.

The *Malat* case enables a dealer to contend that his principal purpose for holding property was for reasons other than sale in the ordinary course of business. As previously discussed, the courts in determining this issue will analyze all the facts and circumstances of a particular case. However, a dealer may undertake certain preventive measures, adding weight to his contention that the property is held for investment purposes and, therefore, qualifies for capital gains treatment upon disposition.

A dealer should highlight those attributes of the property which will categorize it as an investment. The following preventive mea-

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[242] *See id.* at 317.

[243] *Id.* In addition, the court viewed the land improvement and sales activities of affiliated corporations as "highly relevant in determining" Jersey Land's motive for holding the property. *Id.*

[244] *See id.* at 316–17.

sures may be helpful in convincing a court that the property was held as an investment:

— maintenance of separate records of title;[245]
— establishment of separate accounting and financial records;[246]
— utilization of separate checking accounts for inventory and investment properties;
— capitalization of expenses related to the investment property rather than a deduction in the year it is incurred;[247]
— identification of realty on tax returns, loan applications, and financial statements as an investment;
— categorization of employment status as other than a real estate dealer; and if the taxpayer has another source of income or another job to which he devotes his time, this designation should be noted on the return;
— documentation, both business and legal, should state that property was purchased for reasons other than for immediate resale to customers; purposes such as holding property for appreciation, security, homesite, or extra income are all reasons which will point toward investor status;
— avoidance of improvements which may create possible adverse tax consequences, *i.e.*, subdividing, clearing title, cutting timber, installing roads and utilities, and leveling the property;
— promotion and solicitation of dealer-inventory property only;
— retention of investment property for as long as possible to allow long term market appreciation indicating an investment motive;
— preparation of a corporate resolution indicating that the property is being held for investment purposes.

Although the above suggestions cannot be instituted in every case, these preventive measures should be brought to the attention of the dealer/investor so that he may attempt to insulate himself from ordinary income treatment.

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[245] *See* Simmons, *supra* note 84, at 39.
[246] *Id.*
[247] *Id.*