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Jacques T. Schlenger

Robert C. Embry Jr.

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## CAPITAL GAINS THROUGH REAL ESTATE

By JACQUES T. SCHLENGER\* and  
ROBERT C. EMBRY, JR.\*\*

For one to be a prudent investor in our modern society with its complex tax structure, it is not enough that he select a property which may eventually be sold at a gain. He must also be aware of the tax implications of his investment so that when it is disposed of he will be entitled to treat his profit as an investor's capital gain rather than as a dealer's ordinary income. In preparing for such a result, the corollary must always be kept in mind that if a loss is produced, this prudent planning will backfire and produce a capital rather than an ordinary loss.

For tax purposes, real estate investments may be divided into three categories, the intent measured immediately prior to the sale determining placement in the respective category.<sup>1</sup> The category determines how the gain or loss upon disposition of the real estate is to be treated.

The first category is that of "capital assets," defined in section 1221 of the Internal Revenue Code of 1954 to include all property except that held by a taxpayer and used in his trade or business, or "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

The second category consists of "Section 1231 Property."<sup>2</sup> This is property held for more than six months and used in one's trade or business, such as buildings and land. Real property held for rental is also included, as the renting of real estate is considered the conduct of a business if a minimum of time is devoted by the owner or his agents to the management of the property.<sup>3</sup> Section 1231 property does not include "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."<sup>4</sup>

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\* B.S. 1948, University of Virginia; LL.B. 1951, Yale University; Partner, Venable, Baetjer and Howard, Baltimore, Maryland.

\*\* A.B. 1959, Williams College; LL.B. 1964, Harvard University; Associate, Venable, Baetjer and Howard, Baltimore, Maryland.

1. See Angvire, *Capital Gains for the Wise Investor in Real Estate*, 14 *TUL. TAX INST.* 302 (1965); Primmer, *Sales of Subdivided Realty — Capital Gains v. Ordinary Income*, 19 *SW. L.J.* 116 (1965); Levin, *Capital Gains or Income Tax on Real Estate Sales*, 37 *B.U.L. REV.* 165 (1957); Weithorn, *Subdivisions of Real Estate — "Dealer" v. "Investor" Problems*, 11 *TAX L. REV.* 157 (1956).

2. In 1942, § 117(j) was added to the Int. Rev. Code of 1939 by ch. 619, 56 Stat. 846 (1942). (Now, *INT. REV. CODE OF 1954*, § 1231). If the gains from sales, exchanges or involuntary conversions of "Property used in the trade or business" and held for more than six months exceed the losses realized on similar dispositions of such property, § 117(j) (now § 1231) permits the taxpayer to receive capital gains benefits. If the losses exceed gains, the taxpayer is entitled to ordinary loss treatment. But to qualify under this section, the property involved must not be "held by the taxpayer primarily for sale to customers in the ordinary course of business."

3. *Gilford v. Commissioner*, 201 F.2d 735 (2d Cir. 1953) (rental property operated by an agent). See cases cited in 5 *CCH 1966 Stand. Fed. Tax Rep.* ¶ 4729.51, where the rental of even one property may constitute the carrying on of a trade or business.

4. See *Workmen's Mut. Fire Ins. Soc'y, Inc. v. A'Hearn*, 286 F.2d 718 (2d Cir. 1961); Charles A. Foehl, Jr., 20 *CCH Tax Ct. Mem.* 418 (1961). Also relevant here is section 1031 of the Internal Revenue Code of 1954, which provides that no gain "shall be recognized if property held for productive use in trade or business or for

The third category is property which is excluded by definition from the two previous categories, *i.e.*, "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." Often, the taxpayer who holds such real property is referred as to a real estate *dealer*, as opposed to an *investor*, who may hold either of the first two types of property, though these terms are not used in the relevant statutes. Real estate falling into this third category will produce ordinary income or ordinary loss upon its disposition. In contrast, upon the disposition of a "capital asset" held for more than six months, any gain will be taxable as a long-term capital gain. The same tax treatment results if the section 1231 gains for the year exceed such losses. Thus, the essential question is whether or not the property involved was held primarily for sale to customers in the ordinary course of business.<sup>5</sup>

Attempts by various courts to answer this question when considering varied fact situations have produced a plethora of imprecise and contradictory statements. A definitional distinction often found is that between the owner who buys with the thought of realizing long-term appreciation in value and the owner who looks to an eventual sale for the profit he seeks.<sup>6</sup> The difficulty with this approach is that the investor's appreciation in value can usually only be realized by a sale, so he too is looking to an eventual sale for his profit. Such an approach would nullify the statutory provisions conferring capital gains treatment.<sup>7</sup> Another distinction is the description of an investor as one who acquires property for the income it will yield rather than the profit he may obtain upon a resale.<sup>8</sup> This distinction has been rejected many times over by decisions holding property to be an investment though it generates no income while held by the owner.<sup>9</sup>

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investment . . . is exchanged . . . for property of a like kind. . . ." Two things should be noted about this provision. First, among the items excluded from coverage is "property held primarily for sale." This exclusion does not go on to add "to customers in the ordinary course of a trade or business" as do the section 1221 and 1231 exclusions, and is therefore arguably broader in coverage. Second, the regulations do not contain a requirement that such exchanges be reported.

5. Section 206(a)(6) of the Revenue Act of 1921, ch. 136, 42 Stat. 233 (1921), the first "capital gain" provision, explicitly excluded from its definition of capital assets "stock in trade of a taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the first of the year." In 1924, the exception was extended by the addition of the words "or property held by the taxpayer for sale in the course of his trade or business." Revenue Act of 1924, ch. 234, 43 Stat. 263, § 208(a)(8) (1924). The purpose of this change was to except from capital gains treatment property held primarily for resale although not includible in inventory. See John M. Welch, Sr., 19 B.T.A. 394, 398 (1930), *modified*, 59 F.2d 1085 (6th Cir. 1932). The present language was added by amendment in 1934, Revenue Act of 1934, ch. 277, 48 Stat. 714, § 117(b), and now reads "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." For a more complete legislative history, see MERTENS, FEDERAL INCOME TAXATION § 22.02 (1966).

6. "A dealer, in the popular, and therefore in the statutory, sense of the word, is not one who buys to keep, or makes to sell, but one who buys to sell again." *In re Hemming*, 51 F.2d 850, 852 (S.D. Miss. 1931), quoting *Norris Brothers v. Commonwealth*, 27 Pa. 494 (1856).

7. *Municipal Bond Corp. v. Commissioner*, 341 F.2d 683 (8th Cir. 1965), *on remand*, 46 T.C. 219 (1966); *McGah v. Commissioner*, 193 F.2d 662 (9th Cir. 1952), *on remand*, 17 T.C. 1458 (1952), *rev'd*, 210 F.2d 769 (9th Cir. 1954).

8. *United States v. Chinook Investment Co.*, 136 F.2d 984 (9th Cir. 1943).

9. See *Emilio Olivieri*, 25 CCH Tax Ct. Mem. 920 (1966); *William A. Belcher, Jr.*, 24 CCH Tax Ct. Mem. 1 (1965).

In practice, the courts do not rely on a definitional distinction between investors and dealers; instead, they treat the question as one of fact dependent on the status of the particular property and the activity of the owner prior to sale. In resolving this question of fact, a number of tests have been developed. Though each test contributes to an answer, it has been stated that:

[I]n the final analysis . . . each case must be decided upon its particular facts and the presence of any one or more of these factors may or may not be determinative of a particular case. It is rare indeed that one will find any precedent value in applying the decision of one case to the facts of another case. At the most, other cases decided by the courts on this subject may be persuasive or suggestive of the approach of the courts to cases where the facts may be somewhat similar.<sup>10</sup>

Even with detailed factual inquiry, the judicial approach to the investment-dealer distinction is usually too heavy-handed in its analysis. There are several reasons why land increases in value, most of which have nothing to do with the owner's activity. First, the mere passage of time produces gain in an economy such as ours which is, at least in recent times, mildly inflationary. The continuing increase in population also contributes to higher land values as the years pass. Second, the location of the land may increase its value if it is in the path of residential or commercial development or located over a mineral deposit. Third, the development of new land uses or their increased feasibility may increase land value. Finally, as a general rule, the value of a tract per unit of measurement increases as its size decreases to lot size.<sup>11</sup> The value may then be further increased by activity on the part of the seller such as improving the land or promoting its sale.

Unfortunately, neither Congress nor the courts separate those elements of gain due to factors outside the owner's control and those attributable to the owner's activity.<sup>12</sup> The decision is either all or nothing. If the value of an owner's land has increased ninety per cent because of the general market and the owner engages in subdivision activities extensive enough to be described as a business which increases the value an additional ten per cent, the whole gain is taxed at ordinary income rates.

In broad terms, the law declares that an owner will fall into the dealer class if he does either of two things, separately or in combination: (1) makes frequent and continuous sales of property which has increased in value due to causes unconnected with the owner's activity, or (2) engages in activities which increase the value of the land beyond that which it had before the activity was undertaken.

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10. *Austin v. Commissioner*, 263 F.2d 460, 462 (9th Cir. 1959).

11. See *Gault v. Commissioner*, 332 F.2d 94 (2d Cir. 1964); *Estate of Clinton C. Millett*, 23 CCH Tax Ct. Mem. 945 (1964); *Allen Moore*, 30 T.C. 1306, 1315 (1958); *Benjamin*, *REAL ESTATE AND TAXES*, 18 Bull. of the Section of Taxation, ABA, pp. 8-9 (1965).

12. *S. O. Bynum*, 46 T.C. 295 (1966) (Tannenwald, J., concurring). See *Surrey, Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985, 990 (1956).

The question being one of fact, there are various factors which are considered by the courts as being of particular relevance.

### 1. THE PURPOSE OF ACQUISITION

Though the owner's purpose at time of sale is determinative, the purpose for which the property was acquired is often given substantial weight. The original purpose is deemed to continue unless the Internal Revenue Service can show a subsequent change.<sup>13</sup>

In considering this factor, owners must be separated into those who are dealers and those who are not. Generally, when a real estate dealer acquires property, it is immediately treated as being part of his inventory.<sup>14</sup> The court's first inquiry at the time of ultimate disposition almost certainly will be as to the owner's past involvement in real estate transactions, whether prior to acquisition or merely prior to sale.<sup>15</sup> It is not likely that it will be helpful to the taxpayer that his former dealings involved residential property while the sale under consideration was of a commercial building,<sup>16</sup> sales of realty apparently are not differentiated for these purposes. Indeed, it was former housing contractors, engaging in the rental of housing for the first time during the war, who were deemed to have received ordinary income from the post-war sale of the dwellings, largely because of their former activities in building.<sup>17</sup>

To mitigate the effect of his status, the dealer may place himself in a position of a non-dealer by (1) promptly segregating investment property on his books from all inventory-type property,<sup>18</sup> (2) showing that he acquired such property for a special and different intended use,

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13. *King v. Jackson*, 48 Amer. Fed. Tax R. 1251 (W.D. Tex. 1954), *rev'd*, 223 F.2d 714 (5th Cir. 1955), *reconsidered*, 51 Amer. Fed. Tax R. 1536 (W.D. Tex. 1956); *Albert Winnick*, 17 T.C. 538 (1951), *remanded per curiam*, 199 F.2d 374 (6th Cir. 1952), *reconsidered*, 21 T.C. 1029 (1954), *aff'd per curiam*, 223 F.2d 266 (6th Cir. 1955); *Victory Housing No. 2 Inc.*, 18 T.C. 466 (1952), *rev'd*, 205 F.2d 371 (10th Cir. 1953).

14. *Ralph A. Horton*, 13 CCH Tax Ct. Mem. 899 (1954). "Real estate dealers are not given specific opportunities under present law to segregate their personal investments in real estate from their real estate business activities. Such segregation is generally limited to occasional instances of inherited property or unrelated types of real property investment." Sen. Rep. No. 1622, 83d Cong., 2d Sess. p. 114 (1954). A recent Tax Court decision appears to hold that a dealer may not realize capital gain on property which he acquired solely with the view of making a profit on resale. *William A. Scheuber*, 25 CCH Tax Ct. Mem. 559 (1966). This decision was reversed in 371 F.2d 996 (7th Cir. 1967). See text accompanying footnote 96 *infra*.

15. *Greene v. Commissioner*, 141 F.2d 645 (5th Cir. 1944), *cert. denied*, 323 U.S. 717 (1944); *Factoria Land Co.*, 6 CCH Tax Ct. Mem. 234 (1947). *Contra*, *Phipps v. Commissioner*, 54 F.2d 469 (2d Cir. 1931), where the scope of authority was limited to the taxable year in question.

16. *Charles H. Black, Sr.*, 45 B.T.A. 204 (1941). See *I. N. Burman*, 23 B.T.A. 639 (1931).

17. *King v. Commissioner*, 189 F.2d 122 (5th Cir. 1951), *cert. denied*, 342 U.S. 829 (1951); *Reuben Eckstrom*, 12 CCH Tax Ct. Mem. 214 (1953); *John P. Dougherty*, 12 CCH Tax Ct. Mem. 425 (1953). *But see* *Ben L. Carroll*, 21 B.T.A. 724 (1930), where the court gave capital gain treatment to a builder because of the absence of former dealings in land *per se*.

18. Failure to segregate not only deprives the dealer of a strong capital gains argument, but such failure itself tends strongly to dictate ordinary income treatment. *William S. Grimaldi*, 22 CCH Tax Ct. Mem. 739 (1963); *Hugh F. Little*, 13 CCH Tax Ct. Mem. 115 (1954); *F. R. McAbee, Inc.*, 12 CCH Tax Ct. Mem. 633 (1953); *The Home Co., Inc.*, 12 CCH Tax Ct. Mem. 741 (1953).

and (3) not selling such property so frequently as to raise a question as to whether the sales of such property amount to a regular business.

When, on the other hand, the non-dealer acquires property, he has the advantage of the assumption that the property is not to be sold to customers in the ordinary course of business because he does not have a business. To tax any gain on the disposition of such property as ordinary income, it must be shown that there was a change in status at some earlier time so that the sale may be described as one to customers.

The grant by a government of the power to deal in real estate is sometimes considered. Courts have tended to dismiss powers granted in a corporate charter<sup>19</sup> unless they are actually exercised.<sup>20</sup> Powers in a trust are treated like charter powers. If actively exercised, they will contribute to an ordinary income determination.<sup>21</sup>

Where the owner acquires land for reasons unrelated to its profit making potential, the courts will be more likely to hold it to be a capital asset. Such a situation arises where an acquisition is the necessary incident to another transaction,<sup>22</sup> or is made to acquire land on which to operate a business<sup>23</sup> (the subsequent sale being required by an unforeseeable change of circumstances), or where the land is obtained by a mortgagee on the foreclosure of his mortgage.<sup>24</sup>

## 2. METHOD OF ACQUISITION

An extremely powerful indicator of an investment is the fact that the acquisition of the property resulted from the unsolicited act of a third party, often described as an "involuntary acquisition." Such a situation arises where the land is acquired by inheritance,<sup>25</sup> or by gift<sup>26</sup> (such an acquisition differs from one by inheritance in that the courts

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19. *Houston Deepwater Land Co. v. Scofield*, 110 F. Supp. 394 (S.D. Tex. 1952); *W. B. Leedy & Co., Inc.*, 11 CCH Tax Ct. Mem. 861 (1952); *South Texas Properties Co.*, 16 T.C. 1003 (1951).

20. *The Home Co., Inc.*, 12 CCH Tax Ct. Mem. 741 (1953); *Spanish Trail Land Co.*, 10 T.C. 430 (1948).

21. See *Welch v. Solomon*, 99 F.2d 41 (9th Cir. 1938). See *Chandler v. United States*, 121 F. Supp. 722 (N.D. Ill. 1954), where a testamentary trust was set up to administer realty bequeathed by the testator, a power to sell, in the absence of any extensive sales activity, failed to preclude capital gains treatment. See also *Helen Jane Martina Schwerin Trust*, 13 CCH Tax Ct. Mem. 202 (1954).

22. *Norman A. Grant*, 22 CCH Tax Ct. Mem. 771 (1963), *aff'd per curiam*, 333 F.2d 603 (4th Cir. 1964); *Ralph J. Oace*, 39 T.C. 743 (1963); *Wellesley A. Ayling*, 32 T.C. 704 (1959).

23. *Carter-Colton Cigar Co.*, 9 T.C. 219 (1947).

24. *Alabama Mineral Land Co. v. Commissioner*, 250 F.2d 870 (5th Cir. 1957); *Cebrian v. United States*, 181 F. Supp. 412 (Ct. Cl. 1960); *Guthrie v. Jones*, 72 F. Supp. 784 (W.D. Okla. 1947); *Ethel M. Hauk*, 10 CCH Tax Ct. Mem. 925 (1951); *Minnie Steinau Lowenberg*, 7 CCH Tax Ct. Mem. 702 (1948); *Kanawha Valley Bank*, 4 T.C. 252 (1944). *But see White v. Commissioner*, 172 F.2d 629 (5th Cir. 1949) (vacant lots acquired by a paving contractor upon foreclosure of paving liens held "ordinary" assets); GCM 21497, 1939-2 CUM. BULL. 187, amended by GCM 24910, 1946-1 CUM. BULL. 101; GCM 26690, 1951-1 CUM. BULL. 28; *Spanish Trail Land Co.*, 10 T.C. 430 (1948).

25. *Smith v. Dunn*, 224 F.2d 353 (5th Cir. 1955); *Camp v. Murray*, 226 F.2d 931 (4th Cir. 1955); *Estate of William D. Mundy*, 36 T.C. 703 (1961); *Estate of Josephine C. Simpson*, 21 CCH Tax Ct. Mem. 371 (1962); *Estate of Samuel B. Walton*, 21 CCH Tax Ct. Mem. 346 (1962); *Allen Moore*, 30 T.C. 1306 (1958).

26. *Allen Moore*, 30 T.C. 1306 (1958); *Sparks v. United States*, 55 F. Supp. 941 (M.D. Ga. 1944).

appear more ready to attribute to the new owner the activities of the former owner).<sup>27</sup> Evidently the transfer of the land by the recipient to a trust or a corporation does not affect the mitigating influence of the original involuntary acquisition.<sup>28</sup>

Almost invariably, land acquired by inheritance stands a good chance for capital-asset classification when it is resold, often regardless of the volume involved,<sup>29</sup> or the presence of fairly substantial development,<sup>30</sup> or sales activity, or both,<sup>31</sup> and regardless of the taxpayer's prior real estate involvement. In all cases where liquidation is claimed, however, the owner's case is weakened if the proceeds of the sale in question are used to purchase other real estate.<sup>32</sup>

The method of financing an acquisition may also be important. Though no case appears to explicitly rely on this factor, most decisions imply its relevance by referring to the terms of the financing. This probably indicates that a purchase inadequately financed for long-term retention of the property (that is, financed through an obviously excessive interest charge or with an insignificant down payment on property which is not income producing) was purchased for prompt resale.

### 3. THE LENGTH OF THE HOLDING PERIOD

As a general rule, the longer a tract is held, the more likely it will be held to be an investment. A short holding period<sup>33</sup> or the sale of a house immediately upon completion and without prior rental<sup>34</sup> will contribute to the conclusion that the sales proceeds be taxed at ordinary rates. When, however, a property owner dies, the party receiving the property from the decedent obtains a stepped up basis equal to the property's fair market value, and thus the question of length of holding period is rendered academic.<sup>35</sup>

The six-month statutory holding period has no probative value, however, for it is a prerequisite before consideration can even begin

27. *Bistline v. United States*, 260 F.2d 77 (9th Cir. 1958).

28. *Allen Moore*, 30 T.C. 1306 (1958) (trust).

29. *Riedel v. Commissioner*, 261 F.2d 371 (5th Cir. 1958); *Camp v. Murray*, 226 F.2d 931 (4th Cir. 1955); *United States v. Robinson*, 129 F.2d 297 (5th Cir. 1942); *Estate of Jacques Ferber*, 22 T.C. 261 (1954); *Dagmar Gruy*, 8 CCH Tax Ct. Mem. 787 (1949).

30. *Smith v. Dunn*, 224 F.2d 353 (5th Cir. 1955); *Daniel W. Ellis*, 13 CCH Tax Ct. Mem. 15 (1954). The Sixth Circuit has adopted the view that where a person can only dispose of inherited land advantageously by having it sold in smaller parcels through a dealer who, to make the property salable, builds an access road, capital gains treatment cannot be denied. *Yunker v. Commissioner*, 256 F.2d 130 (6th Cir. 1958); *Clark v. United States*, 200 F. Supp. 668 (E.D. Tenn. 1961); *Estate of Samuel B. Walton*, 21 CCH Tax Ct. Mem. 346 (1962).

31. *Boomhower v. United States*, 74 F. Supp. 997 (N.D. Iowa 1947); *Estate of Josephine Clay Simpson*, 21 CCH Tax Ct. Mem. 371 (1962).

32. *J. Stewart Matthews*, 20 CCH Tax Ct. Mem. 1058 (1961), *aff'd*, 315 F.2d 101 (6th Cir. 1963).

33. *Mathews v. Commissioner*, 315 F.2d 101 (6th Cir. 1963); *Starke v. Commissioner*, 312 F.2d 608 (9th Cir. 1963); *Wineberg v. Commissioner*, 326 F.2d 157 (9th Cir. 1963); *Austin v. Commissioner*, 263 F.2d 460 (9th Cir. 1959); *Sylvester A. Lowery*, 23 CCH Tax Ct. Mem. 152 (1964); *Abe Pickus*, 22 CCH Tax Ct. Mem. 1791 (1963); *James G. Hoover*, 32 T.C. 618 (1959).

34. *San Jacinto Homes*, 11 CCH Tax Ct. Mem. 1089 (1952); *Russ Prater, Inc.*, 11 CCH Tax Ct. Mem. 538 (1952).

35. INT. REV. CODE OF 1954, § 1014 [hereinafter 1954 Code is referred to only by section].

as to whether the owner is an investor.<sup>36</sup> To be of positive relevance, the holding period generally has to be too substantial a number of years to be availed of by a developer who seeks his profit from improvements rather than a general rise in land values.<sup>37</sup> However, where a holding period is forced upon the taxpayer by government restrictions against sale,<sup>38</sup> or by an economically depressed market,<sup>39</sup> its length does not encourage capital gain treatment.

#### 4. THE USE AND AVAILABILITY OF PROPERTY

Related to the length of holding factor is the nature of the owner's use of the property. Even if the land is purchased, if in addition it is held for several years to produce income, as from ranching or orchard operations, a capital gain would more likely result.<sup>40</sup>

Another factor is the availability of the property for sale. Where the property is held for rental, a lease which facilitates sale by the lessor may negate the investment aspects of the rental activities. This result is true where the lease is short-term,<sup>41</sup> or contains an option to purchase,<sup>42</sup> and especially where the option to purchase permits the buyer to apply his rental payments against the purchase price.<sup>43</sup> In the absence of an option to purchase, making sales to tenants is not necessarily inconsistent with the liquidation of an investment.<sup>44</sup>

If the taxpayer acquires only an option to purchase the land and then sells the option, not only is the sale treated in the same manner as if the owner had acquired and then sold the land, but the fact that an option was obtained indicates a purpose to resell.<sup>45</sup>

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36. This test is to distinguish the investor from the speculator. Sen. Rep. No. 1631, 77th Cong., 2d Sess. 50 (1941); Miller, *The Capital Asset Concept*, 59 YALE L.J. 837, 839 (1950).

37. *Palos Verdes Corp. v. United States*, 201 F.2d 256 (9th Cir. 1952) (31 years) (taxed as ordinary income); *Hariss v. Commissioner*, 143 F.2d 279 (2d Cir. 1944) (13 years); *Martin Dressen*, 17 T.C. 1443 (1952) (15 years). See also *Curtis Co.*, 23 T.C. 740 (1955), where an investment intent was found from an average holding period of three years. But this factor is not conclusive. See *Yara Engineering Corp.*, 22 CCH Tax Ct. Mem. 1448 (1963), *aff'd per curiam*, 344 F.2d 113 (3d Cir. 1965) (20 years).

38. *Rollingwood Corp. v. Commissioner*, 190 F.2d 263 (9th Cir. 1951); *F. R. McAbee, Inc.*, 12 CCH Tax Ct. Mem. 633 (1953); *Reuben Eckstrom*, 12 CCH Tax Ct. Mem. 214 (1953).

39. *Ambassador, Inc.*, 11 CCH Tax Ct. Mem. 974 (1952); *Factoria Land Co.*, 6 CCH Tax Ct. Mem. 234 (1947). The courts have ignored without comment the fact that an absence of sales activity was attributable to a depressed market. *Dunlap v. Oldham Lumber Co.*, 178 F.2d 781 (5th Cir. 1950); *Ethel M. Hauk*, 10 CCH Tax Ct. Mem. 925 (1951).

40. *Dean*, *Tax Aspects of Real Estate Development*, 18 N.Y.U. TAX INST. 137, 141 (1960). See *Hariss v. Commissioner*, 143 F.2d 279 (2d Cir. 1944); *Wineman Realty Co.*, 1 CCH Tax Ct. Mem. 791 (1943).

41. *Factoria Land Co.*, 6 CCH Tax Ct. Mem. 234 (1947).

42. *Pacific Homes, Inc. v. United States*, 230 F.2d 755 (9th Cir. 1956); *Louis Rubino v. Commissioner*, 8 CCH Tax Ct. Mem. 1095 (1949), *aff'd per curiam*, 186 F.2d 304 (9th Cir. 1951), *cert. denied*, 342 U.S. 814 (1951).

43. *Homann v. Commissioner*, 230 F.2d 671 (9th Cir. 1956).

44. *Clyde H. Laper*, 10 CCH Tax Ct. Mem. 23 (1951).

45. *Norman A. Grant*, 22 CCH Tax Ct. Mem. 771 (1963), *aff'd per curiam*, 333 F.2d 603 (4th Cir. 1964). *But see* *Ralph F. Gordy*, 36 T.C. 855 (1961), where the option aspect was disregarded. Query: Would not the same adverse inference be drawn if contracts to purchase were sold before settlement?



## 5. OCCUPATION OF THE HOLDER

The owner is helped for capital gain purposes — but not insulated — by being engaged in another business or profession.<sup>46</sup> Strangely enough, whether this other profession is in real estate activities other than subdivision or in a completely non-real estate area of activity does not seem to matter.

It has been repeatedly held, however, that a property owner may be in more than one business.<sup>47</sup> He may be in the business of selling real estate even though that is not his only business or even his principal business.<sup>48</sup> Even if the owner is completely passive, he may be held to be a dealer if there is a seller's market and the volume of his sales is frequent and continuous.<sup>49</sup> As a general rule, however, the less time the owner devotes to the land (other than producing income from it), the more likely it is that property sold by him will be classified as a capital asset.<sup>50</sup> A real estate dealer can conduct his business without an office or employees or the other indices which are normal to the carrying on of a business.<sup>51</sup>

If the owner holds a real estate broker's license, he has a substantially greater burden than other taxpayers in establishing that he is an investor with respect to specific assets. A broker may have purchased the property for others, for resale at a profit, or as a permanent investment. The burden is on the broker to prove in which capacity he acted. At a minimum, a broker must keep separate accounts and avoid treating expenses attributable thereto as reducing earnings from activities as a real estate dealer.<sup>52</sup> Though it is difficult, it is nevertheless possible for a dealer to make an investment in real estate and realize a capital gain on its disposition.<sup>53</sup>

## 6. IMPROVEMENTS TO THE PROPERTY

Again, as a general rule, the owner is more likely to obtain capital gain treatment if he does not make any improvements on the tract which increase the marketability of the land and thereby indicate an

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46. *Austin v. Commissioner*, 263 F.2d 460 (9th Cir. 1959) (lawyer); *Camp v. Murray*, 226 F.2d 931 (4th Cir. 1955) (corporate executive); *Ross v. Commissioner*, 227 F.2d 265 (5th Cir. 1955) (lawyer); *Daniel W. Ellis*, 13 CCH Tax Ct. Mem. 15 (1954) (doctor and professor of medicine).

47. *Friend v. Commissioner*, 198 F.2d 285 (10th Cir. 1952) (attorney); *Julian Ross*, 13 CCH Tax Ct. Mem. 974 (1954), *rev'd*, 227 F.2d 265 (5th Cir. 1955) (attorney).

48. *Crosswhite v. United States*, 369 F.2d 898 (Ct. Cl. 1966); *S. O. Bynum*, 46 T.C. 295 (1966).

49. *Real Estate Corp., Inc.*, 22 CCH Tax Ct. Mem. 654 (1963); *Yara Engineering Corp.*, 22 CCH Tax Ct. Mem. 1448 (1963), *aff'd per curiam*, 344 F.2d 113 (3d Cir. 1965).

50. *Lloyd E. Mitchell, Inc. v. United States*, 259 F. Supp. 345 (D. Md. 1966).

51. *William H. Miller*, 21 CCH Tax Ct. Mem. 1070 (1962).

52. The Self-Employment Tax Regulations provide that real estate dealers should include gain, losses and rentals derived from real estate held for sale to customers while excluding expenses on property that is held for speculation or investment. *Treas. Reg. § 1.1402(a)-4(a)* (1963).

53. *Thomas v. Commissioner*, 254 F.2d 233 (5th Cir. 1958); *Louis Lesser*, 42 T.C. 688 (1964). *But see White v. Commissioner*, 172 F.2d 629 (5th Cir. 1949).

intention to sell to customers.<sup>54</sup> Such improvements include not only subdivision activity<sup>55</sup> but also activity in the clearing of title and removal of liens.<sup>56</sup> The probative value of the improvements as showing a business may be neutralized if required by municipal ordinance as a prerequisite to sale by lots.<sup>57</sup>

The improvement and subdivision of part of a tract does not necessarily taint the whole tract.<sup>58</sup> Unimproved land remaining in the tract may be disposed of at capital gain rates unless the owner is also found to be dealing in such large unimproved tracts.<sup>59</sup> But there is a risk that subdivision activity will bring a determination of dealership status as to a different piece of property otherwise taxable at capital gains rates,<sup>60</sup> just as a taxpayer's prior activities may foredoom his future sales to ordinary income treatment. In addition, if a tract is improved and subdivided for sale to customers, the sale of it in bulk will produce ordinary income.<sup>61</sup>

Improvements and subdivision have been permitted without affecting investment status where such activity is seen as a reasonable and accepted means of disposing of investment property.<sup>62</sup> The Internal Revenue Service, however, does not accept this distinction.<sup>63</sup> Furthermore, as soon as other dealer characteristics are added, the owner will usually be held to have realized ordinary income from the sale.<sup>64</sup>

The foregoing discussion assumed that the owner did the subdividing. Where, however, the taxpayer acquires the property already subdivided, generally the fact of subdivision will be neutralized as a factor adverse to capital gains treatment,<sup>65</sup> even if the subdivided land

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54. The size of the investment in improvements will be considered, William A. Scheuber, 20 UCCTCM 282 (1961). Courts may compare the cost of the improvements to the cost of the land to determine how significant the improvement is. *Kaltreider v. Commissioner*, 255 F.2d 833, 838 (3d Cir. 1958). An exception is found where the improvements increase the present income from the property. Such improvements may include buildings to be rented or access roads to portions of the tract to be rented, particularly if the primary use is for rental purposes. Note that rental properties themselves can be held primarily for sale to customers. If rental properties are not held primarily for sale to customers, an agent's management of rental properties causes the rental business to be attributed to the owner, which can be helpful to reduce the owner's dealership hazard from ownership of other tracts. Benjamin, *op. cit. supra* note 11, at 14.

55. Maxine Development Co., Inc., 22 CCH Tax Ct. Mem. 1579 (1963). The mere platting of land may prove determinative. See Thomas W. Nevin, 24 CCH Tax Ct. Mem. 294 (1965).

56. William H. Miller, 21 CCH Tax Ct. Mem. 1070, 1075 (1962).

57. *Oahu Sugar Co. v. U.S.*, 300 F.2d 773, 777-78 (Ct. Cl. 1962); Harold C. Smith, 20 CCH Tax Ct. Mem. 232 (1961); Wellesley A. Ayling, 32 T.C. 704 (1959).

58. J. O. Chapman, 3 CCH Tax Ct. Mem. 604 (1944); Alexander Weil, 3 CCH Tax Ct. Mem. 528 (1944); Rev. Rul. 57-565, 1957-2 CUM. BULL. 546.

59. J. Kirby Reppell, 20 CCH Tax Ct. Mem. 295 (1961); Stanley H. Klarkowski, 24 CCH Tax Ct. Mem. 1827 (1965).

60. George Wibbelsman, 12 T.C. 1022 (1949).

61. Donald J. Lawrie, 36 T.C. 1117 (1961).

62. *Estate of Barrios v. Commissioner*, 265 F.2d 517 (5th Cir. 1959).

63. Rev. Rul. 59-91, 1959-1 CUM. BULL. 15.

64. *Thompson v. Commissioner*, 322 F.2d 122 (5th Cir. 1963) (prompt subdivision and substantial real estate activities); *Murray v. Commissioner*, 238 F.2d 137 (10th Cir. 1956) (subdivision one year after acquisition); *Shearer v. Smyth*, 116 F. Supp. 230 (N.D. Cal. 1953), *aff'd*, 221 F.2d 478 (9th Cir. 1955), *cert. denied*, 350 U.S. 840 (subdivision by real estate agents).

65. *Martin Dressen*, 17 T.C. 1443 (1952); J. O. Chapman, 3 CCH Tax Ct. Mem. 604 (1944).

contain substantial improvements when acquired.<sup>66</sup> Moreover, the owner who purchases land already subdivided may be allowed more extensive improvement than if he himself had done the subdividing.<sup>67</sup>

There is also a limited statutory exception to this general rule that subdivision improvements hurt the taxpayer's chances for capital gains treatment. Often an owner, to dispose of real estate which has been held as an investment, finds it necessary to subdivide or engage in some other activity in order to liquidate in a satisfactory manner. Section 1237 was enacted primarily to deal with this situation by permitting a taxpayer "who is not otherwise a dealer . . . to dispose of a tract of real property, held for investment purposes, by subdividing it without necessarily being treated as a real estate dealer."<sup>68</sup> If the requirements of this section are met, an owner does not become a "dealer" merely by reason of subdivision.

The protection of this section is of use primarily where the taxpayer is a noncorporate taxpayer,<sup>69</sup> which means an individual, a partnership, a trust or an estate.<sup>70</sup> Certain principal requirements must be met by an owner to qualify for section 1237 treatment: (a) he must not have held any part of the tract at any time for sale to customers, nor can any other property have been so held during the year in question; (b) no improvements which substantially increase the value of the lot sold can have occurred;<sup>71</sup> and (c) he must have owned the land for five years unless inherited. If these requirements are met, then the gain on the sale of the lots is taxed at a special rate.<sup>72</sup> This treatment is available even though the owner has subdivided the tract and engaged in extensive selling activity.<sup>73</sup> Failure to meet the requirements, however, does not necessarily mean that the property is being held for sale to customers.<sup>74</sup>

The utility of this section is extremely limited. What it does, in effect, is to provide that two factors, sub-division and sales activity, may no longer be the sole support for a finding that the owner was in the business of selling real estate. But few cases rely on these factors alone.<sup>75</sup>

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66. Minnie Steinau Loewenberg, 7 CCH Tax Ct. Mem. 702 (1948) (streets, sidewalks, utilities); Ben L. Carroll, 21 B.T.A. 724 (1930) (streets, water, sewerage, buildings).

67. Dunlap v. Oldham Lumber Co., 178 F.2d 781 (5th Cir. 1950); Beatrice Breneman, 11 CCH Tax Ct. Mem. 628 (1952); Freida E. J. Farley, 7 T.C. 198 (1946).

68. Hvidsten v. United States, 185 F. Supp. 856 (D.N.D. 1960).

69. Corporations are eligible only if they meet certain additional requirements: (1) neither the corporation nor its stockholders may directly or indirectly hold real estate for sale to customers; and (2) the property must have been originally acquired through foreclosure of a lien thereon.

70. See Estate of Peter Finder, 37 T.C. 411 (1961).

71. An improvement is deemed to have been made by the owner if made by members of his family (see § 267(c)(4)), by a corporation controlled by the owner, by a partnership in which the owner is a partner, by a lessee if the improvement constitutes income to the owner, or by a public body if it constitutes an addition to the owner's basis.

72. If more than five lots contained in the same tract are sold or exchanged and the section otherwise applies, the gain is taxed as ordinary income to the extent of five per cent of the selling price. § 1237(b)(1).

73. Treas. Reg. § 1.1237-1(a)(2).

74. Treas. Reg. § 1.1237-1(a)(4).

75. See Weithorn, *Subdivisions of Real Estate — "Dealer" v. "Investor" Problem*, 11 TAX L. REV. 157, 165 (1956) and Hirsch, *Income Tax Changes Affecting Real*

## 7. PROPERTY HOLDING ENTITIES

### A. Corporations

It may be possible to obtain capital gains treatment by use of a corporation. The mere fact that the land is the only asset of the corporation does not mean it is being held for sale to customers.<sup>76</sup> Incorporating may insulate the tract from the stockholder's dealer status;<sup>77</sup> conversely, it may insulate the non-dealer stockholder from his controlled corporation's activities in making improvements, advertising and generally holding the property for sale to customers.<sup>78</sup> It may also be useful in permitting the owner to sell in one non-business transaction to a single buyer, the corporation, thus realizing a capital gain. The corporation could then improve and subdivide the property with only the value added by the corporation taxed as ordinary income. Such a transaction is, of course, helpful only where the owner is not in the business of selling large undeveloped tracts, for in such a situation his own corporation would be just as much a customer as any other buyer. Where this is not the case, the use of a corporation to develop the land should be a permissible device because the owner is adding the additional distinction needed but not found in the tax law. In other words, he is paying a capital gain on the appreciation in value due to general market conditions when the property is transferred to his corporation and then paying an ordinary income tax as to the value added by the corporation's business activity.<sup>79</sup>

If the owner is a dealer, then he might use the tax free transfer provisions of section 351 to pass the property to a corporation which would in turn hold it as its value increases, carefully avoiding any activity that might raise the question of collapsibility. If the corporation does not actively attempt to sell the land, it should be able to realize a capital gain on disposition.<sup>80</sup> There must, however, be a valid

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*Property*, 32 TAXES 739, 747 (1954), for an extensive discussion of the limitations of this section.

76. Harchester Realty Corp., 20 CCH Tax Ct. Mem. 922 (1961).

77. There is substantial risk, however, that when a dealer transfers property to a newly formed corporation which then sells it, that the corporation will be deemed collapsible. Guy A. Van Heusden, 44 T.C. 491 (1965). The regulations under section 1237 also indicate that if the stockholder held the property for sale to customers and transferred it to a corporation in a transaction under which the corporation's basis is determined by reference to the stockholder's basis, then the corporation will be seen as holding the land for that purpose. Treas. Reg. § 1.1237(b)(3).

78. George W. Mitchell, 47 T.C. \_\_\_\_ (1966); Robert Binda, 22 CCH Tax Ct. Mem. 1195 (1963); Ralph E. Gordy, 36 T.C. 855 (1961). *But see* William S. Grimaldi, 22 CCH Tax Ct. Mem. 739 (1963). See Lloyd E. Mitchell, Inc. v. United States, 259 F. Supp. 345 (D. Md. 1966), where a non-dealer corporation realized capital gains on the sale of 21 properties to a dealer corporation owned by the same parties.

79. Sections 269 and 1551, and section 357 if the tract is subject to any liability, require some business purpose as the only or at least the principal or major purpose for the corporation's existence, other than just to hold the tract. In addition, section 357 will cause the taxpayer to have income upon the formation of a controlled corporation without regard to purpose, to the extent that the liabilities to which the land is subject exceed the owner's basis for the tract. This of course will not be a factor when the transfer is structured so as to avoid section 351 and recognize a gain.

80. Houston Deepwater Land Co. v. Scofield, 110 F. Supp. 394 (S.D. Tex. 1952). It was there held that just because the corporation has no other business, it does not mean that it is in the business of selling land unless there is a sufficient amount of activity to justify a finding of business.

business purpose behind the transaction in order that some function is served by the corporation's existence, or it may be disregarded as a part of a pre-arranged plan, the purpose of which is the sale of the property to a third party. In such a case, if the stock is sold, the proceeds may be held to represent proceeds from the sale of the property itself.<sup>81</sup> In the *Jacobs* case,<sup>82</sup> the taxpayer went through all the formal steps of activating a dormant corporation, transferring real property in exchange solely for the stock of the corporation and then selling the stock to a third party anxious to acquire the land. Because the transaction was all part of a pre-arranged plan, the corporate entity was disregarded and was held to be only a conduit through which the taxpayer was enabled to effect the sale of his property in the ordinary course of his real estate business.

While the investor's position is strengthened by avoiding development and sale activities, care should be exercised to separate the activities of the corporation in order to avoid the argument that the corporation is not to be held the agent of the shareholders so as to place them in the real estate business. There is a great wealth of authority both attributing and refusing to attribute to the individual taxpayer the activities of the corporation in which he is or was a stockholder. The older authority refuses to make such attribution.<sup>83</sup> More recent cases, without specifically considering the question, have lumped corporate and individual activities into one ball of wax.<sup>84</sup>

In *Tibbals v. United States*,<sup>85</sup> the owner purchased a tract of land already subdivided into lots. He actively solicited the county to improve or provide water, sewer and street facilities for the land. Two years later, he sold 100 lots to one of his corporations, which proceeded to develop and sell them to customers. This sale to the corporation was held to produce ordinary income though a subsequent sale to an unrelated corporation of another large group of lots produced a capital gain. The majority held that where the owner had engaged in substantial development activities of his own, a conveyance to a controlled corporation which continued development would produce an ordinary gain. In permitting capital treatment of the later sale, it was held that the owner had narrowed his development plans to the lots already sold to the controlled corporations. Though the opinion specifically stated that it had not attributed the corporation's activity to the shareholder, the dissent read the opinion as doing just that and vigorously protested.

81. *Virginia W. Stettinius Dudley*, 32 T.C. 564 (1959), *aff'd per curiam*, 279 F.2d 219 (2d Cir. 1960).

82. 21 T.C. 165 (1954), *aff'd*, 224 F.2d 412 (9th Cir. 1955).

83. *Phipps v. Commissioner*, 54 F.2d 469 (2d Cir. 1931); 512 West 56th Street Corp., 4 CCH Tax Ct. Mem. 53 (1945), *aff'd*, 151 F.2d 942 (2d Cir. 1945); *Julius Goodman*, 40 B.T.A. 22 (1939); *Peter Miller*, 20 B.T.A. 230 (1930).

84. *Eugene L. Freeland*, 25 CCH Tax Ct. Mem. 1473 (1966); *Ralph A. Horton*, 13 CCH Tax Ct. Mem. 899 (1954); *F. R. McAbee, Inc.*, 12 CCH Tax Ct. Mem. 633 (1953); *Estate of Alice Kleberg*, 5 CCH Tax Ct. Mem. 858 (1946). *But see Morse v. United States*, 371 F.2d 474 (Ct. Cl. 1967); *Winding River Ranch, Inc.*, 25 CCH Tax Ct. Mem. 1335 (1966).

85. 362 F.2d 266 (Ct. Cl. 1966).

The majority's disclaimer and prior decisions specifically holding that the sale by an owner who is not a dealer to a wholly-owned dealer corporation will produce a capital gain<sup>86</sup> would support the view that attribution of corporate activity to the shareholder is not proper and thus indicates that this decision has not changed the law. However, it was clear in this case that the owner was a dealer in real estate in his own right. The puzzle comes from the favorable holding that the sale to the unrelated corporation was a capital transaction because the owner no longer looked to development of the land.

### B. Trust

The owner may be helped in his effort to obtain capital gain treatment by placing the property in a trust. Such a step may insulate the tract from the grantor's (and the beneficiary's) dealer status, but the courts are not reluctant to disregard the trust.<sup>87</sup> Perhaps the best reason for placing the land in a trust is to insulate the non-dealer owner (grantor) from dealership status by providing that a real estate broker, who purports to act as an independent contractor and trustee, has the complete control in subdividing the land. However, the creation of an irrevocable trust causes a gift tax to be incurred by the grantor in all but the unusual situation of the grantor's reservation of all possible benefits from the trust.

### C. Partnership

Problems similar to those occurring when a corporation or trust is employed are found when an owner participates in a partnership which in turn engages in land transactions.<sup>88</sup> To start with a point of certainty in this confused area of the law, it is clear that the partnership activities of one partner will be attributed to all of the other partners no matter how passive they might be.<sup>89</sup> The same principle applies to joint venturers.<sup>90</sup>

The difficult question is whether the status of the individual partners in their non-partnership activities is attributed to the partner-

86. Ralph E. Gordy, 36 T.C. 855 (1961).

87. See B. B. Margolis, 337 F.2d 1001 (9th Cir. 1964); Stanley H. Klarkowski, 24 CCH Tax Ct. Mem. 1827 (1965).

88. Joint owners may be helped for capital gains purposes by taking a tract in co-ownership, rather than as partners. Joint ownership is ordinarily a partnership for tax purposes. However, any partnership for tax purposes is referred to in the Code as by definition carrying on a business, financial operation, or business venture. If an unimproved tract is acquired by a group for investment only, the only business likely to be imputed to the group would be the holding of the tract for sale. To negate any such business inference, co-owners can elect not to be a partnership for tax purposes under section 761(a)(1), if the co-ownership is availed of for investment purposes only and not for active conduct of a business and if the income of each co-owner can be adequately determined separately. Benjamin, *op. cit. supra* note 11, at 16.

89. Hugh F. Little, 13 CCH Tax Ct. Mem. 115 (1954); Frederick L. Meagher, 12 CCH Tax Ct. Mem. 609 (1953). It has been held that the activity of a corporation owned by one of the partners will be imputed to the other partners where the corporation purchases land from the partnership and develops it. Eugene L. Freeland, 25 CCH Tax Ct. Mem. 1473 (1966); Neils Schultz, 44 B.T.A. 146 (1941).

90. Edward Pool, 15 CCH Tax Ct. Mem. 296 (1956), *aff'd*, 251 F.2d 233 (9th Cir. 1957), *cert. denied*, 356 U.S. 938 (1958); W. J. Lewis, 13 CCH Tax Ct. Mem. 1161 (1954).

ship. In other words, if a non-dealer and a dealer contribute land to a partnership which makes one sale, how is the gain taxed? There is no clear answer to this question.<sup>91</sup> Section 702(b) provides that the character of the income<sup>92</sup> in the hands of the partner shall be the same as if it had been realized by the partner directly from the source from which it was realized by the partnership. This language appears to mean that the character of the income is fixed by reference to the business of the partner rather than that of the partnership. Thus, under this interpretation, the dealer-partner would receive ordinary income from the partnership even though the partnership is not a dealer. Neither the Congressional Committee Reports nor the regulations shed any light on the section's meaning.<sup>93</sup> An example in the regulations, however, fixes the character at the partnership level without reference to the partners' status.<sup>94</sup> This has led some commentators to conclude that the character is determined at the partnership level.<sup>95</sup> Thus, under this interpretation, it would be capital gain.

A recent case is of interest. The Tax Court in *Louis J. Kersch*<sup>96</sup> indicated that the activity of the partners outside the partnership was not to be attributed to the partnership. There a real estate dealer joined with another dealer, with whom he had associated before in other real estate ventures, and a non-dealer to purchase vacant land for industrial use. The land was held for two years and sold, and the court held the profit taxable at capital gains rates. The court noted that this was the only transaction undertaken by the partnership. The force of the opinion on the point here at issue was weakened somewhat by the court's reference to the fact that none of the partners had ever dealt in industrial lands previously.

## 8. PROPERTY HELD PRIMARILY FOR THE SALE TO CUSTOMERS — *Malat v. Riddell*

The statutory exclusion from capital gains treatment is not property held for sale to customers but property held *primarily* for such

91. George I. Bauman, 23 CCH Tax Ct. Mem. 1064 (1964). See Wolfman, *Level for Determining Character of Partnership Income — "Entity" v. "Conduit" Principle in Partnership Taxation*, 19 N.Y.U. TAX INST. 287, 292 (1961); McDonald, *Income Taxation of Partnerships — A Critique*, 44 VA. L. REV. 903 (1958). See also Horace E. Oliver, 13 CCH Tax Ct. Mem. 67 (1954), *aff'd per curiam*, 218 F.2d 352 (5th Cir. 1955) (court assumed all land held by partnership is stock in trade); Harry Simberg, 13 CCH Tax Ct. Mem. 477 (1954) (court looked only to activity of the partner before the court and did not consider that of other partners or of the partnership alone).

92. Those items of income specified in section 702(a).

93. See WILLIS, HANDBOOK OF PARTNERSHIP TAXATION 39 (1957), where ALL comments on the draft which led to the statute indicate the character is fixed at the partnership level.

94. Treas. Reg. § 1.702-1(b).

95. See WILLIS, *op. cit. supra* note 93. Legislation was proposed in 1959 which would have amended section 702(b) to clearly provide that the character should be determined at the partner level. H.R. 9662, 86th Cong., 2d Sess. 85 (1959); H.R. Rep. No. 1231, 86th Cong., 2d Sess., Comm. on Ways and Means, p. 21 (1959). See RABKIN & JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION ¶ 16.07(13) (1954).

96. 20 CCH Tax Ct. Mem. 89 (1961). See George W. Mitchell, 37 T.C. \_\_\_\_\_ (1966).

sale. Courts have given differing interpretations to this concept, some holding that it meant that sale need only be a "substantial" purpose<sup>97</sup> while others read it as meaning "principally."<sup>98</sup> This dispute was resolved last term by the United States Supreme Court in *Malat v. Riddell* which accepted the latter definition that property is held primarily for sale to customers only if that is the "principal" purpose or the one "of first importance."<sup>99</sup> The Court noted that the distinction was between profits arising from everyday business operations, on the one hand, and the realization of appreciation in value accrued over a substantial period of time, on the other.

In that case, the taxpayer, a member of a partnership developing rental properties, entered into a joint venture with four individuals to purchase 45 acres of agriculturally zoned land fronting on two boulevards. The other four joint venturers were engaged in various real estate activities. It was the hope and expectation of the venturers that the land could be improved by a garden-type rental development, but they were unable to finance it. The purchase and all of the sales were made in 1954.

When it was determined that financing was unavailable and because the carrying costs of the land were onerous, an interior tract was subdivided, improved by streets and sewers, and distributed to the partners, who conveyed it to another joint venture, which in turn sold the lots to the public. The gain on the sale of this land was reported as ordinary income. The original joint venture retained the land bordering on the main thoroughfares in the hope of changing the zoning to commercial and developing it accordingly. This hope also proved groundless, and, when discord divided the partners, the remaining tract was sold to two purchasers, one an unrelated developer and the other a joint venture formed by two of the partners to develop the land. These partners were also developers. It was on this sale that the sellers claimed capital gains.

The District Court, affirmed by the Court of Appeals for the Ninth Circuit, ruled that the gain on this sale was ordinary income because the owner had two purposes in acquiring the land, to either rent or sell it. Such being the case, sale was a "substantial" purpose. The Court of Appeals distinguished this case from one where the owner intends to rent, and if that proves unprofitable, then to liquidate. Here, the Court felt that the owners were ready to follow any alternative that produced the most profit. The Supreme Court reversed and remanded, holding that sale must be the "principal," not just a "substantial," purpose. On remand, the District Court held that the owner was entitled to capital gain treatment. The net result of this decision is that a rental developer joined in a venture with dealers, developed part of a tract for sale to customers, then sold the remainder to two

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97. *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).

98. *Municipal Bond Corp. v. Commissioner*, 341 F.2d 683, 688-89 (8th Cir. 1965); *United States v. Bennett*, 186 F.2d 407, 410, 411 (5th Cir. 1951).

99. *Malat v. Riddell*, 383 U.S. 569 (1966).



developers, one of whom was a joint venture made up of two of the partners, and yet received capital gains treatment.<sup>100</sup>

## 9. METHOD OF DISPOSITION

The statutory exception to capital gains treatment provides not only that the land be held "primarily for sale," a subjective test looking to the intent of the owner, but also that the contemplated sale be to customers in the ordinary course of business. This second, more objective, test is concerned with whether the activities of the owner in disposing of property amount to a business. To determine this, the courts look to the extent of sales activity, the frequency and continuity of the sales, the substantiality of the sales when compared to the owner's other business, and the extent to which the owner has engaged in other real estate dealings. These indicators of a business will be considered below.

### A. Sales Activity

The surest way to lose a capital gain is to engage in extensive sales activities. Possible sales activities include maintaining a sales office,<sup>101</sup> sales staff, advertising,<sup>102</sup> placing "For Sale" signs on the property<sup>103</sup> and listing the property with licensed real estate brokers. If an owner desires to dispose of his property, he has several routes open to him: he may remain passive and wait for an acceptable offer, carry on sales activity himself, hire an agent, enter into a joint venture with a dealer, or list the property with an independent broker. The use of any but the first alternative raises the risk of losing capital gain status.

The next most prudent technique is to place the property in the hands of a broker who assumes complete control over sale of the land. The risk here is that the broker's activity will be imputed to the owner, which will happen unless the owner minimizes all incidents of control and supervision. In *Boomhower v. United States*,<sup>104</sup> the owner turned the land over to a lumber company which built the houses, sold the land, and paid the owner a certain amount per lot sold. It was held

100. *Malat v. Riddell*, 347 F.2d 23 (9th Cir. 1965), *rev'd*, 383 U.S. 569 (1966). On remand, the land was found not to be held primarily for sale to customers, 66-2 U.S. Tax Cas. ¶ 9613 (S.D. Cal. 1966).

101. See *Snell v. Commissioner*, 97 F.2d 891 (5th Cir. 1938); Arthur E. Wood, 25 T.C. 468 (1955).

102. See *Galena Oaks Corp. v. Scofield*, 116 F. Supp. 333 (S.D. Tex. 1953), *aff'd*, 218 F.2d 217 (5th Cir. 1954).

103. See *George v. Sottong*, 25 CCH Tax Ct. Mem. 1366 (1966); *Palos Verdes Corp. v. United States*, 201 F.2d 256 (9th Cir. 1952).

104. 74 F. Supp. 997 (N.D. Iowa 1947). The same result was reached in *Camp v. Murray*, 226 F.2d 931 (4th Cir. 1955). It has been held that where the owner in fact exercised no control, it was not crucial that he had the power to control. *Voss v. United States*, 329 F.2d 164 (7th Cir. 1964). The owner's experience is relevant. *Glienke v. United States*, 14 Amer. Fed. Tax. R.2d 5555 (S.D. Ill. 1964). Also consider who pays for the improvements and supervises sales. *J. G. Mendoza*, 22 CCH Tax Ct. Mem. 528 (1963). And consider who fixed the price and size of the lots. *Houghten v. United States*, 11 Amer. Fed. Tax. R.2d 1099 (W.D. Mich. 1963); *Estate of Samuel B. Walton*, 21 CCH Tax Ct. Mem. 346 (1962); *Estate of William D. Mundy*, 36 T.C. 703 (1961).

that the builder's activity could not be imputed to the owner.<sup>105</sup> Other decisions have attributed the seller's activities to the owner where the seller was seen as the owner's agent.<sup>106</sup> Another risk is that the owner may be held to be a joint venturer with the broker whose activities will be attributed to him.<sup>107</sup> Furthermore, since the work is being done for the owner's benefit regardless of the form of contract signed, it is questionable how long capital gains treatment based on lack of control will continue to be recognized.

### B. *Frequency and Continuity*

The word "business" is often read by the courts as "busyness," thereby implying that if an owner is busy selling land, he must be in the business of doing so. Early decisions relied on this factor almost exclusively.<sup>108</sup> More recent Ninth Circuit decisions have continued this emphasis.<sup>109</sup>

The Fifth Circuit, on the other hand, has questioned the validity of the frequency and continuity test in liquidation cases by reasoning that, if a taxpayer intends to dispose of a large amount of property, it is only natural to expect that there will be a great number of sales in a relatively short period of time.<sup>110</sup> If there is no showing of either sales activity by the owner himself or of an intent to hold the property primarily for sale, the frequency factor should not by itself require ordinary income treatment. In addition, several cases hold that frequent or continuous sales do not transform the owner into a dealer if development and sales activities are lacking.<sup>111</sup>

It is still advisable, however, to sell the tract as a whole, thereby reducing the frequency-of-sales factor.<sup>112</sup> The mere fact of fragmentation by subdivision is often held to indicate that the property is being

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105. The "reluctancy" principle was discussed in *Municipal Bond Corporation*, 46 T.C. 219 (1966).

106. *Nadalin v. United States*, 364 F.2d 431 (Ct. Cl. 1966); *Bauschard v. Commissioner*, 31 T.C. 910 (1959), *aff'd*, 279 F.2d 115 (6th Cir. 1960); *Ehrman v. Commissioner*, 120 F.2d 607 (9th Cir. 1941); *James H. Merritt, Sr.*, 47 T.C. \_\_\_\_ (1967); *John Nadalin*, 26 CCH Tax Ct. Mem. 73 (1967); *Floyd L. Freberg*, 23 CCH Tax Ct. Mem. 784 (1964). *But see* *Smith v. Dunn*, 224 F.2d 353 (5th Cir. 1955).

107. *Ackerman v. United States*, 335 F.2d 521 (5th Cir. 1964); *W. E. Anderson*, 23 CCH Tax Ct. Mem. 1170 (1964); *Bauschard v. Commissioner*, 31 T.C. 910 (1959); *Walter H. Kaltreider*, 28 T.C. 121 (1957).

108. *512 West Fifty-Sixth St. Corp. v. Commissioner*, 151 F.2d 942 (2d Cir. 1945); *Ehrman v. Commissioner*, 120 F.2d 607 (9th Cir. 1941); *Snell v. Commissioner*, 97 F.2d 891 (5th Cir. 1938).

109. *Palos Verdes Corp. v. United States*, 201 F.2d 256 (9th Cir. 1952); *Rollingwood Corp. v. Commissioner*, 190 F.2d 263 (9th Cir. 1951).

110. *Smith v. Commissioner*, 232 F.2d 142 (5th Cir. 1956); *Goldberg v. Commissioner*, 223 F.2d 709 (5th Cir. 1955).

111. *Austin v. Commissioner*, 263 F.2d 460 (9th Cir. 1959); *Ralph J. Oace*, 39 T.C. 743 (1963); *Allen Moore*, 30 T.C. 1306 (1958). *But see* *Yara Engineering Corp.*, 22 CCH Tax Ct. Mem. 1448 (1963), *aff'd per curiam*, 344 F.2d 113 (3d Cir. 1965).

112. *George W. Mitchell*, 47 T.C. 120 (1966). See *Gardens of Faith, Inc.*, 23 CCH Tax Ct. Mem. 1045 (1964), *aff'd per curiam*, 345 F.2d 180 (4th Cir. 1965), *cert. denied*, 382 U.S. 927 (1965). See also *Winding River Ranch, Inc.*, 25 CCH Tax Ct. Mem. 1335 (1966), where capital gain treatment was accorded a sale in which the buyer was allowed to pay for and obtain small portions of the tract over an extended period of time.

held for sale or that there is a business.<sup>113</sup> But the reverse situation often leads to the same result; that is, the acquisition of small parcels which are combined into a large tract may be seen as being advantageous to a certain class of purchasers, and the owners may be held to be in the business of making such sales.<sup>114</sup>

It is difficult to determine what is considered frequent and continuous and what is sporadic. The sale of 24 lots in three years has been held too frequent to qualify for capital gains treatment,<sup>115</sup> while the sale of 90 houses in one year has not been considered excessive.<sup>116</sup> Both the Commissioner and the owner can find generous support in the many decisions for holding a certain number of sales to be either frequent or casual. The one certain thing is that the more the owner can reduce the number of sales and space their occurrence, the more likely he is to attain capital gain treatment.

### C. *Substantiality of Sales in Relation to Principal Business*

In determining how busy an owner is in disposing of his land, many courts measure his income from<sup>117</sup> and time spent<sup>118</sup> in the sale of real property against the amount of those measures involved in his other occupation. Again, there is no formula or bright line that is universally accepted. Nor should these two factors, relative income and time spent, be given equal weight. Although it must be recognized that a taxpayer may be in more than one business at any point in time,<sup>119</sup> not every activity is a business within the meaning of section 1221. It 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

113. *Tidwell v. Commissioner*, 298 F.2d 864 (4th Cir. 1962). When property is sold in lots or sections, any one sale may be the first or last in a sales program and therefore the number of sales prior to, during and subsequent to the tax year in question are subject to inquiry. *Thompson v. Commissioner*, 322 F.2d 122 (5th Cir. 1963).

114. *Stockton Harbor Industrial Co. v. Commissioner*, 216 F.2d 638 (9th Cir. 1954).

115. *Kelley v. Commissioner*, 281 F.2d 527 (9th Cir. 1960). Similarly nine transactions in five years has been deemed a business. *George v. Sottong*, 25 CCH Tax Ct. Mem. 1366 (1966). The size of the property being sold is of course relevant in determining whether the sales are frequent. *Charles R. Kines*, 20 CCH Tax Ct. Mem. 1561 (1961).

116. *Goldberg v. Commissioner*, 223 F.2d 709 (5th Cir. 1955). See *Wibbelsman*, 12 T.C. 1022 (1949) (seven sales were too many); *Fahs v. Crawford*, 161 F.2d 315 (5th Cir. 1947) (95 in two years was moderate).

117. *Thompson v. Commissioner*, 322 F.2d 122 (5th Cir. 1963); *L. P. Barney*, 26 CCH Tax Ct. Mem. 109 (1967). See *Real Estate Corporation*, 301 F.2d 423 (10th Cir. 1962), where a comparison of net income was considered more relevant than a comparison of gross receipts. *Harold C. Smith*, 20 CCH Tax Ct. Mem. 232 (1961).

118. In *Lloyd E. Mitchell, Inc. v. United States*, 259 F. Supp. 345 (D. Md. 1966), the taxpayer was an acoustical engineering firm. For over 20 years it invested excess funds in real estate. During this period there were 84 sales. The gain on these sales was held to be capital, the court noting that one officer dedicated less than 1 per cent of his time to land transactions. None of the land was improved and there was no advertising. Query: What effect would such a ruling have on the defense to a charge that excess funds have been unreasonably accumulated under § 531, I.R.C. 1954?

119. *Mauldin v. Commissioner*, 195 F.2d 714 (10th Cir. 1952); *Fahs v. Crawford*, 161 F.2d 315 (5th Cir. 1947).

sales is in that business. As noted with respect to the frequency test, if there is a seller's market when the asset is liquidated, the sales will produce substantial income in a short period of time. If the court is to use this factor to deny capital gains treatment, it is subverting the very consideration which originally gave rise to capital gains relief. Some cases have recognized that substantiality of income is important only if it shows there was also a substantial amount of time and activity expended by the taxpayer in making his sales.<sup>120</sup>

A strong indication of investment liquidation meriting capital asset treatment occurs when the taxpayer is compelled to sell by some external circumstances, such as a pressing need for funds in general,<sup>121</sup> the need to support the owner in illness or old age<sup>122</sup> or to liquidate a partnership on the death of a partner,<sup>123</sup> where sale is forced by a threat of condemnation,<sup>124</sup> where pressure is exerted by the owner's creditors for more liquidity in his assets,<sup>125</sup> or where the investment value of the land is lessened by a restrictive covenant<sup>126</sup> or by zoning restrictions.<sup>127</sup>

#### CONCLUSION

Judicial analysis of the factors has yielded a loose web of decisions with generally erratic seams. Except in polar situations, tax results in this area are difficult and sometimes almost impossible to predict to the dismay of the taxpayer and his advisers.

Changes in the law of real estate capital gains taxation are a distinct possibility. According to Mr. Surrey, the Treasury Department and its computers are endeavoring to discover what does happen in real estate transactions.<sup>128</sup> What direction changes might take is unknown. Perhaps one will not be accused of being overly cynical if he expects little improvement and increasingly complex legislation. Past statutory attempts at providing certainty or simplification, as exemplified by sections 1237 (subdividing), 341 (collapsible corporations), and a host of other Code sections, do not encourage optimism.

Pending legislative reform, or perhaps only change, the case by case, common law, approach will continue. History offers scant hope, but the courts may fashion some improvements. One would be to take the initiative and distinguish, as to a single property, between

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120. *Austin v. Commissioner*, 263 F.2d 460 (9th Cir. 1959); *Crosswhite v. United States*, 369 F.2d 989 (Ct. Cl. 1966). *But see Miller v. United States*, 339 F.2d 661 (Ct. Cl. 1964).

121. But an increase in property taxes has been held insufficient to support the owner's contention that he was liquidating. *L. P. Barney*, 26 CCH Tax Ct. Mem. 109 (1967); *Martin Dressen*, 17 T.C. 1443 (1952); *H. D. Lewis*, 11 CCH Tax Ct. Mem. 80 (1952).

122. *Austin v. United States*, 116 F. Supp. 283 (S.D. Tex. 1953); *Estate of Douglas S. Mackall, Sr.*, 3 CCH Tax Ct. Mem. 701 (1944).

123. *Estate of W. D. Haden*, 12 CCH Tax Ct. Mem. 825 (1953).

124. *Maudine Neese*, 12 CCH Tax Ct. Mem. 1058 (1953); *Louis J. Hexter*, 11 CCH Tax Ct. Mem. 337 (1952).

125. *Claude M. Ferguson*, 9 CCH Tax Ct. Mem. 243 (1950).

126. *Freida E. J. Farley*, 7 T.C. 198 (1946).

127. *P. S. Edwards*, 12 CCH Tax Ct. Mem. 1045 (1953).

128. Conference on Impact of Computers on Tax Practice, George Washington University, June 9-10, 1966.

that portion of value growth representing general appreciation and deserving capital gains treatment and that part of value growth attributable to business activities of the owner and justifying ordinary income treatment.

The advisor and his client-owner will have to predict as best they can, using checklists of "good" and "bad" factors such as developed in this article. Lest they be overwhelmed with the idea of a crusade for certainty, let them remember that legislative changes will probably bring more restrictions than relief.

The advisor and his client may also, out of prudence or fear, begin considering different ways of handling transactions in order to avoid or delay the dealership issue. Some of these other possibilities, requiring many additional articles for full development, are:

1. The use of land leases, possibly followed by loans made on the security of the lease. Be aware, however, of section 1055, the so-called Friedel amendment, dealing with ground rents.

2. Exchanges of real property for real property under section 1031.

3. Contribution of appreciated property to partnerships or corporations in a tax-free manner, so as to pool interests, thus facilitating diversification or development. In some situations, corporate stock may subsequently be exchanged, in a tax-free reorganization, for stock of a publicly traded corporation.

4. For older taxpayers, borrowing on the property and holding it until death, when it achieves a stepped-up basis for income tax purposes, may be helpful.

5. Selling property on an installment basis under section 453 will at least spread the burden should ordinary income be realized. Income averaging under section 1301 offers another vehicle for relief.

In summary, tax life in the real estate area will remain risky and relatively unpredictable. Seekers of capital gains must be prepared to use imagination and to assume these risks.