When a Dealer's Real Estate Sales May Qualify for Capital Gain Treatment Under Section 1221(1)

Martin J. Gregorcich

Follow this and additional works at: http://scholarship.law.marquette.edu/mulr

Part of the Law Commons

Repository Citation
Martin J. Gregorcich, When a Dealer's Real Estate Sales May Qualify for Capital Gain Treatment Under Section 1221(1), 57 Marq. L. Rev. 691 (1974).
Available at: http://scholarship.law.marquette.edu/mulr/vol57/iss4/8

This Article is brought to you for free and open access by the Journals at Marquette Law Scholarly Commons. It has been accepted for inclusion in Marquette Law Review by an authorized administrator of Marquette Law Scholarly Commons. For more information, please contact megan.obrians@marquette.edu.
COMMENT

WHEN A DEALER’S REAL ESTATE SALES MAY QUALIFY FOR CAPITAL GAIN TREATMENT UNDER SECTION 1221(1)

Counsel has a difficult problem when analyzing the tax law applicable to the buying and selling of real estate. Those often forced to litigate the eligibility for capital gain treatment include corporations, partnerships and individuals, such as executives, doctors or lawyers, involved in land development through the construction of houses, subdivisions, apartment complexes or condominums for sale. Formerly, if the taxpayer was classified as a “dealer,” the real estate was defined as a non-capital asset and the profit from its sale or exchange was taxed as ordinary income. Only “non-dealers” could hold property eligible for the more advantageous capital gain treatment. It has recently been recognized, however, that a dealer might also acquire and hold property which, under appropriate circumstances, could qualify for capital gain. While dealers may now be eligible for capital gain, any change in judicial reasoning must be viewed as a two-edged sword in that nondealers may now be subject to ordinary income treatment by reason of the scope and character of their activities.

The purpose of this article is to analyze the shift in judicial reasoning, to suggest practical rules for coping with the evidentiary burden under the current state of the law, and to suggest techniques which may be helpful at the planning stages.

I. INTRODUCTION

Congressional intent is the necessary initial touchstone for the construction of any tax statute. The congressional purpose for

1. There are also two ways in which a loss may be deducted—as an ordinary or capital loss; but this article assumes sales at a profit. For a general discussion of the topic under analysis, see Simmons, The Realities of “Planning” for Capital Gains in Light of Dealer Status: New Case Law Tools for Dealer’s “Investment Property,” 44 Los Angeles B. Bull. 15 (1968).

2. To provide a comparison, characterizing gain from the sale of securities, like real estate, begins with § 1221(1). While a “dealer” in real estate might be anyone who engages in selling activity with some frequency, a “dealer” in securities is one whose activities fit within a well established and fairly narrow definition. Int. Rev. Code of 1954 § 1236 (“Dealers in Securities”). The reason for the difference is found in the legislative intent of § 1221(1)’s predecessor to prevent wealthy traders, buying and selling for their own account, from fitting within the exclusion and claiming large ordinary losses on stocks unloaded during the Depression years. Libin, “Transactions Entered Into for Profit,” “Regular Trade or Business,” and/or “Investment”: Some Distinctions and Differences, N.Y.U. 27th Inst. on Fed. Tax. 1209, 1222-25 (1969).
providing preferential capital gain treatment, in essence, was to favor profits resulting from a gradual "appreciation in value accrued over a substantial period of time," or, from a sudden increase in value in the event of fortuitous circumstances, without the taxpayer doing much to cause that increase. On the other hand, ordinary income was intended for profits "arising from the everyday operation of a business," or from a rapid increase in price as a result of the taxpayer's performance of a production or marketing service. Since only the foregoing general congressional principles are available, the courts have been left to fashion their own specific guidelines for applying the exception to the capital asset definition contained in section 1221(1). The result of the judicial free rein is to be analyzed by this article.

A simple example would best explain the significance of the difference between tax treatments. Assume that taxpayer's only income during 1973 was salary of $40,000 and profit from the sale of real estate, held for a number of years, of $70,000. Taxpayer is married, filing jointly, has no dependents, and has exemptions and itemized deductions from adjusted gross income totalling $10,000. If the real estate profit is reportable as capital gain, the tax payable would be $24,970. If reported as ordinary income, the tax would be $45,180. The difference of $20,210 would most likely be the subject matter of a dispute with the IRS.

Before analyzing the statutory tests, the discussion of capital gain philosophy must begin with *Corn Products Refining Co. v. Commissioner.* The taxpayer hedged against a rise in the cost of

3. Commissioner v. Gillette Motor Transp., Inc., 364 U.S. 130, 134 (1960). The "substantial period of time" idea was eroded by the shortening of the holding period necessary for a long-term gain to six months.
6. Salary of $40,000 plus $35,000 (gain of $70,000 less long term capital gain deduction of $35,000), equals adjusted gross income of $75,000. After subtracting exemptions and itemized deductions of $10,000, the taxable income of $65,000 produces a tax from the rate schedule of $24,970. The minimum 10% tax on preference items is not applicable since the $30,000 exclusion plus the regular tax payable is greater than the $35,000 preference item—the long term capital gain deduction. The alternative tax is not used since it results in a larger tax payable. If the sale occurred before December 31, 1972, and if the net long term capital gain were more than $50,000, a different alternative computation would be used.
7. Salary of $40,000 plus $70,000 equals adjusted gross income of $110,000. After subtracting the exclusions and itemized deductions of $10,000, the taxable income of $100,000 produces a tax from the rate schedule of $45,180.
corn, the raw material for its manufacturing operations, by buying and selling corn futures (i.e., contracts to purchase corn at a future date for a fixed price) on the commodity market. The futures dealings, if engaged in independently, would have yielded capital gain. In rejecting capital gain in this case, the Supreme Court's reasoning proceeded as follows: Corn futures do not come within the literal language of the exclusions from the capital asset definition set out in what is now section 1221. Nevertheless, the underlying purpose of the capital gain provisions is to exclude from ordinary taxation only those "gains resulting from a conversion of capital investments" and not those that are a "normal source of business income." Since the futures in this case were an integral part of the taxpayer's manufacturing operations, ordinary income treatment is required. The precedent thus set is that property which would otherwise be defined as a capital asset will nevertheless produce ordinary income if its sale is integrally related to the everyday conduct of a business.

Corn Products has affected virtually every subsequent capital gain case by the edict that "the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly." On a narrower plane, by establishing the integral-part-of-the-business test, Corn Products formulated a principle which must be kept in mind when reading any of the exclusions from the capital asset definition. When certain items which are essential to, directly related to or at the core of a business are sold, any profit must constitute ordinary income.

II. THE INTERPRETATIONAL PROBLEMS WITH SECTION 1221(1)

Section 1221(1) of the 1954 Code, unaffected by the Tax Reform Act of 1969, is a paragraph of the section captioned "Capital Asset Defined," and provides in relevant part as follows:

[T]he term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) . . . property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
A narrow interpretation of the above exception indicates that a given parcel of real estate is either a capital asset subject to preferential treatment upon sale, or a non-capital asset because a court could conclude that any one of the following elements were present: (a) the land was held "primarily for sale to customers," or (b) the land was sold "in the ordinary course" of the taxpayer's business, or (c) the taxpayer's activities constituted a "trade or business." 13

Formerly, the courts emphasized the first element, the primarily-for-sale language. 14 However, changing judicial attitudes and the inherent difficulties in determining the intent of the taxpayer for holding property caused confusing and apparently inconsistent decisions. 15 A handful of recent cases may be read as shifting the emphasis to the second and third elements. If the trend continues, the reasoning of the courts should become more objective, consistent and predictable.

A. The Traditional Method of Analysis

To aid its assertion of non-capital asset status and ordinary income treatment under the primarily-for-sale language, the IRS developed two techniques: the characterization of dealership and a distorted definition of "primarily."

As in any search for subjective intent, circumstantial evidence was relied upon to indicate the taxpayer's prime purpose for holding property. The most readily available circumstance was the character of the taxpayer, as opposed to the character of the property. The Treasury's basic theory was that a class of real estate arising from the disposition of real estate is also governed by § 1231 (property used in the trade or business and involuntary conversions), § 1237 (real property subdivided for sale), § 1245 (depreciable property), § 1250 (depreciable realty). See also, the applicable provisions of INT. REV. CODE OF 1954, subch. O, and § 1201-1212. This article assumes that the above sections are not usable and in issue. Note also that § 1221(l) especially applies to taxpayers failing to qualify under § 1237. 12

13. The elements were broken down in a similar manner in the concurring opinion of S. O. Bynum, 46 T.C. 295, 302 (1966), the first case reviewed by the Tax Court after the Supreme Court's decision in Malat v. Riddell, 383 U.S. 569 (1966), discussed subsequently, which had a significant effect on the capital asset definition.


developers, conveniently termed "dealers," were totally barred from capital gain treatment.16 Past and present activities concerning similar properties were used to infer whether the taxpayer intended to resell after a short time to realize a normal trading profit, or to resell only after a long holding period to realize substantial appreciation in value.17 The opportunity to assert dealer status, and the probability that the assertion would be sustained, gave the Revenue Agent an invaluable tool which usually led the taxpayer to seek some compromise.

The problem was intensified by the meaning of the word "primarily." The "ordinary, everyday" definition is "principally," or "of first importance."18 However, before 1966, the Commissioner, the Tax Court, a number of District Courts and the Ninth Circuit had adopted the view that a purpose is "primary" so long as it is "substantial" or "essential."19 The IRS then argued that most taxpayers held property for the dual purpose of investment or sale. The obvious reason was that a person normally wishes to maximize profits on investment property by keeping in mind the possibility of resale if the expected appreciation either does or does not become a reality.20 Since sale then becomes an essential purpose for the holding, the taxpayer would be precluded from capital gain treatment. Such reasoning made it almost impossible for anyone bearing the stigma of dealership to achieve capital gain where he in fact purchased and held choice real estate for long-term appreciation.21

In analyzing whether property was held "primarily for sale," the courts developed a list of considerations most indicative of the taxpayer's intentions: (1) Purposes for which the property was acquired, held and sold; (2) Length of time the property was held;

17. Simmons, supra note 1.
19. Compare Rollingwood Corp. v. Commissioner, 190 F.2d 263, 266 (9th Cir. 1951); American Can Co. v. Commissioner, 317 F.2d 604, 605 (2d Cir. 1963), with United States v. Bennett, 186 F.2d 407, 410-11 (5th Cir. 1951); Municipal Bond Corp. v. Commissioner, 341 F.2d 683, 688-89 (8th Cir. 1965). Cf. Recordak Corp. v. United States, 325 F.2d 460, 463-64 (Ct. Cl. 1963).
21. On the courts' dilemma over the "investor" vs. "dealer" dichotomy, see Gault v. Commissioner, 332 F.2d 94 (2d Cir. 1964); and Surrey, Definitional Problems in Capital Gains, 69 HARV. L. REV. 985 (1956).
Improvement and development activities; (4) Extent of efforts to solicit buyers or actually dispose of the property; (5) Frequency, number and continuity of purchases and sales; (6) Nature and extent of the taxpayer’s principal business; and (7) Extent and substantiality of the transactions involved. Enumeration of the factors in court opinions was inevitably accompanied by the statement that no single factor controlled; they had a cumulative effect. Nevertheless, the outcome of cases was usually justified by stressing one or two items while apparently disregarding the applicability of others. To complicate the matter further, courts appeared prepared to consider a variety of other relevant factors. The cases were often described as being in hopeless conflict. For every authority supporting a position there was at least one case contra. Attempts to reconcile the cases and formulate a more specific rule of law concluded, out of frustration, with the tired maxim that each case turns on its own facts.

The controversy persisted and focused on the word “primarily.” It was believed that if the IRS’s major premise could be overturned the prospects for capital gain treatment would be more favorable. Then in 1965 the Eighth Circuit struck a blow for lan-

22. E.g., Libin, supra note 2 at 1212; J. MERTENS, 3B LAW OF FEDERAL INCOME TAXATION § 22.138 (1)-(6) (1966); Maddux Constr. Co., 54 T.C. 1278, 1284 (1970); George W. Mitchell, 47 T.C. 120, 126 (1966); Broughton v. Commissioner, 333 F.2d 492 (6th Cir. 1964); Gault v. Commissioner, 332 F.2d 94 (2d Cir. 1964); Raymond Bauschard, 31 T.C. 910 (1959), aff’d 279 F.2d 115 (6th Cir. 1960); Kaltreider v. Commissioner, 255 F.2d 833 (3d Cir. 1958); Smith v. Dunn, 224 F.2d 353 (5th Cir. 1955); Friend v. Commissioner, 198 F.2d 285 (10th Cir. 1952).

23. Parsons, The Major Real Estate Tax Problems Faced by Builders and Contractors, 24 J. TAX. 262 (1966): E.g., in Koch v. United States, 457 F.2d 230, 234-35 (7th Cir. 1972) the court considered “whether the plaintiff replaced the property sold with additional and continuing purchases of real estate,” and the court placed weight on a prior judgment which held that, ten years before those in issue, similar “property was not held primarily for the sale to customers in the ordinary course of business.” “[A]bsence of motive to make a greater profit” was an element considered in Tibbals v. United States, 362 F.2d 266, 279 (Ct. Cl. 1966). The court considered the taxpayer’s financial ability to hold on to the property as an investment and his preparation to do so in Maddux Constr. Co., 54 T.C. 1278 (1970).

24. “Because there is a good deal of overlapping between business and investment property in this area, the cases are legion. ‘Indeed, the case law has grown to a jungle-like abundance accompanied by much of the welter and impenetrability which such fertility produces.’” Gault v. Commissioner, 332 F.2d 94, 95 (2d Cir. 1964), citing Kelly v. Commissioner, 281 F.2d 527, 528 (9th Cir. 1960). “Whether assets are held primarily for sale to customers in the ordinary course of a taxpayer’s trade or business and, consequently, are excluded from capital assets, is essentially a factual question to be determined from the evidence in each particular case. . . . Extensive litigation on this question has developed no single test of general applicability.” Municipal Bond Corp., 41 T.C. 20, 29 (1963).
guage purity by holding that the dictionary meaning of "primarily," as being "of first importance" or "principally," was more appropriate. In the same year a conflicting Ninth Circuit case reaffirmed the Commissioner's revenue-increasing definition. 

Certiorari was granted, and Malat v. Riddel decided the winner in the battle of semantics.

B. The Key to Capital Gain Treatment for Dealers

The Malat decision in 1966 was a landmark in the much litigated capital gain area. The taxpayer had acquired a tract of land with the intention of either developing it for apartment rentals or selling the entire parcel in bulk, "depending upon which course appeared to be . . . [more] profitable." The plans were frustrated by difficulties in obtaining mortgage money and zoning and because of a rift that developed among the partners. The tract was subsequently subdivided into lots to facilitate its liquidation. Both the District Court and the Ninth Circuit seized upon the evidence of a dual-purpose holding, i.e., for investment and for sale. Since one of the essential purposes for holding the property was for sale, the taxpayer did not hold a capital asset, making his gain ordinary.

The Supreme Court reversed, holding that the lower courts had applied an incorrect legal standard. The per curiam opinion, while analyzing neither the facts nor the problems of statutory interpretation, stated:

The purpose of the statutory provision with which we deal is to differentiate between the 'profits and losses arising from the everyday operation of a business' on the one hand . . . and 'the realization of appreciation in value accrued over a substantial period of time' on the other. . . . A literal reading of the statute is consistent with this legislative purpose. We hold that, as used in § 1221(1), 'primarily' means 'of first importance' or 'principally.'

Unfortunately, the brief opinion lacked practical guidelines for

30. Supra note 26.
31. 383 U.S. at 572.
predicting the judicial reasoning which would be employed in future cases involving inventory-like real estate. Except for giving "primarily" its commonly accepted meaning, the decision did not noticeably ease the interpretive confusion and has, indeed, caused more problems.

Malat has been interpreted as requiring a parcel-by-parcel analysis to determine if property is held "primarily" for sale. The courts began to recognize that the reason for holding might vary with different parcels, and therefore intentions as to one parcel may no longer be inferred from the taxpayer's activities on similar property. The test which came to be applied for capital gain treatment appears to have been whether the ultimate sale was of "principal" or "first importance" in motivating the taxpayer's activities with respect to each parcel or each transaction reviewed separately.

It is helpful to view Malat as extending the concept of the Corn Products case to negate the IRS's characterization of dealer status. Corn Products indicated that the relationship between the property in question and the taxpayer's business operations was a factor to be considered. The courts prior to Malat interpreted the business-operations element for every taxpayer as being composed of his total real estate activities, thereby putting "dealers" at a disadvantage. The evolution in judicial thinking arrived at in Malat is that, for some taxpayers, the business-operations element is restricted to the activities with respect to the particular parcel and its sale that is in issue. It now appears that the Malat concept is being further clarified by the cases subsequently discussed in this article.

C. After Malat—Judicial Uncertainty

Tax attorneys had hoped that destruction of the IRS's key premise would make capital gain treatment more readily available. However, any advantage was slow in coming. It appears that confusion revolved around the function of the list of seven considerations indicative of the taxpayer's intentions (supra at section II, A). In the pre-Malat era there was the need to look only at the activi-

32. Tucker, supra note 10 at 68; Municipal Bond Corp. v. Commissioner, 382 F.2d 184, 188 (8th Cir. 1967); Goodman v. United States, 390 F.2d 915, 920 (Ct. Cl. 1968). Nevertheless, evidence concerning sales and other activities of the taxpayer in years subsequent to those in question is admissible when such information tends to establish a pattern that began in the years in issue. Sapphire Lands, Inc., ¶ 73,023 P-H Tax Ct. Mem. at 91 (1973).

ties of the taxpayer and to classify him as a dealer or non-dealer. Malat's parcel-by-parcel, sale-by-sale search for a primary purpose did not really comport with the traditional analysis. Following precedent, the courts simply quoted the evidentiary factors, cited Malat, then made the decision that the taxpayer either did or did not "hold the property primarily for sale to customers in the ordinary course of his trade or business."34 The application of "law" to the facts remained a matter of imprecise analysis. Attempts to formulate an on-going rule met with frustration. Judicial reasoning based on considerations not a part of the basic seven elements were viewed as additions to the list.35

Then, beginning around 1969, a group of cases shed some light by suggesting a viable approach to the problem of reconciling the cases dealing with eligibility for capital gain treatment for real estate sales under section 1221(1). There appears to have been a shift in the elements of section 1221(1) relied upon, as well as a shift in the function of the list of evidentiary factors. The move is away from the primarily-for-sale language, and from using the factors to characterize the taxpayer's intentions while holding the property. The trend is toward using the seven considerations to characterize the taxpayer's method of selling the property as either constituting a "trade or business," or being within the "ordinary course" of business.

III. ARGUMENT FOR THE FURTHERANCE OF A TREND

The tax planner seeks certainty in the law in the form of a general rule to guide clients in avoiding expensive controversies. When the same "law" is quoted in case after case, yet different lines of reasoning are followed in applying the "law," then there is an indication that the "law" is in need of restatement to bring it more in tune with the ratio decidendi of the cases. The goal is to demonstrate how recent Tax Court and Circuit Courts of Appeals cases suggest a framework for a clearer and more precise analysis which could put the difficult-to-reconcile cases to rest.

The cases appear to draw a distinction between two types of

34. For a discussion of the difficulty in adjusting to the Malat opinion, see J. Rabkin & M. Johnson, supra note 16 at § 43.05(10) at 4345b; and Tucker, supra note 10 at 69; Hanson, When Will the Dealer in Real Estate Receive Capital Gains?, 32 J. Tax. 40 (1970); Outlaw, Gains on Sales of Real Estate, 46 Taxes 466 (1968).

35. See the cases discussed in Simmons & O'Hara, Three New Tests Appear for Obtaining Capital Gains on Real Estate Sales, 28 J. Tax. 218 (1968).
fact situations, relying upon different elements of section 1221(1) for each. One emphasizes the nature of the taxpayer's activities with respect to the particular real estate. Capital gain treatment would be available if the activities did not constitute a "business." The other analysis emphasizes the relationship which the sale in question had to the taxpayer's entire scheme of profit-motivated business activities. Capital gain treatment would then be available if the sale was not made in the "ordinary course" of the taxpayer's business.

Since tax planning and evidentiary burdens would be different depending upon which analysis applies to a particular client, the task now is to ferret out the factual setting which appears to evoke one train of reasoning as opposed to the other. The determinative elements should then be tied together to articulate a proposition or general rule of law. That is, where the court finds certain factual elements present, a certain legal consequence should follow. The court's reasoning as to whether the ultimate facts are present serves as a guide for the conduct of future affairs of persons similarly situated.

The approach of the subsequent discussion is first to set forth a proposition synthesized from the particular category of cases, and then to illustrate its application through the explanation of the determinative elements of a number of recent cases in view of the components of the general rule. The case analyses become successively condensed until the evidentiary facts can be succinctly enumerated parallel to the elements of the general rule.

A. Analysis of Whether the Taxpayer's Activities With Respect to the Property Constituted a "Business"

The first category of cases concentrates on whether the merchandising activities were of such extent as to be considered a "trade or business" which had as its primary purpose the customer-oriented holding of the property for sale. The taxpayer's objective is to establish that he was merely nurturing the natural appreciation in the value of an investment.

36. The ultimate question in this area remains purely factual. Municipal Bond Corp. v. Commissioner, 341 F.2d 683 (8th Cir. 1965); Bauschard v. Commissioner, 279 F.2d 115 (6th Cir. 1960), and cases cited therein. The IRS recognizes that this type of case is decided entirely on its facts. The Courts of Appeals are bound, in the absence of clearly erroneous findings, to accept the factual findings of the trial court or tax court. Fed. R. Civ. P. 52(a); INT. REV. CODE OF 1954 § 7482(a). Tucker, supra note 10 at 68-69. Therefore, this article attempts to concentrate on distinguishing the cases on their facts.
An adequate restatement or capsulization of the law which the courts seem to apply is as follows:

Where 1) an individual’s occupation does not depend upon real estate sales, or, a corporation or partnership’s main purpose is the search for the best use and the ultimate sale of a particular property, and

2) the taxpayer is able to sustain the burden of proving that his activities with respect to the particular property sold, (a) to enhance the value, (b) to attract customers, and (c) to effect the sale, were minimal enough to raise the inference of the passive holding of an investment,

then the taxpayer was not engaged in the “trade or business” of selling the property, and capital gain treatment is appropriate.

The analysis, at first blush, appears to the traditional reasoning leading to the decision of dealer or non-dealer status. However, a closer inspection of the opinions causes a realization that the reasoning is quite a bit more subtle.

The case of *Koch v. United States*\(^{37}\) involved sales of raw Florida land for residential purposes for which capital gain treatment was allowed in five of the six years in question. The first element was satisfied, thereby triggering the activities-constituting-a-business analysis, by the fact that the taxpayer was a retired person who lived far from the land.

Second element: The taxpayer made no improvements and even voted against special assessments for improvements. Unsolicited offers to purchase the raw land were forwarded to him in Illinois after prospective purchasers looked up ownership in the county records. Sales were made only when the offered price reflected substantial appreciation. Also, one third of the total profit resulted from sales made under threat of condemnation. Thus, the activities enhancing the value of the land or attracting customers were minimal. However, the court reached opposite results as to the legal effect of the frequency, continuity and number of sales effected. The sales activity for five years, when considered in relation to his total holdings, did not constitute a “business” because (1) on the average he sold less than one percent of his holdings per year, (2) the average holding period of lots sold was between eight and fourteen years, and (3) the average cost of a lot was $90 while the average selling price was $1,650.

---

37. 457 F.2d 230 (7th Cir. 1972).
The reasons given for the decision as to ordinary income for the one year were

[T]he number of lots sold and the number of transactions were much higher in 1959 than in the other years in question. The profit was higher . . . [and] a seller's market existed during 1959 making extensive advertising unnecessary in that year.\textsuperscript{38}

The court allowed a relatively stable amount of transactions and lots sold to be eligible for capital gain treatment. For the years capital gain was allowed, between 7 and 55 lots were sold in 5 to 25 transactions; but for the other year there were 103 lots sold in 31 transactions.

Capital gain treatment was denied in \textit{Hansche v. Commissioner}\textsuperscript{39} for sales of lots upon which homes could be constructed. First element: The taxpayer was a partner in the Hansche Produce Co. which, among other things, sold mink pelts. During the years in question, one of the partnership purposes was the subdivision and orderly development of farmland, the sale of lots, and the subsequent regulation through use and construction restrictions. Since the lot sales were the largest source of partnership income, it was considered the main business.

Second element: The development and promotional activities were too extensive. The court found in the partnership agreement "evidence of a well conceived and successful plan to develop this land for sale to individual home owners" and "to sell the aforesaid premises in parcels."\textsuperscript{40} A Board of Regulations, composed of the partners, was established and insisted that proposed building plans strictly comply with plat restrictions. The developed acreage increased in value from $29,500 to $880,000, while surrounding land increased only one-third as much. The value grew, not from passive holding, but from the expenditure of $121,768 (approximately $1,050 per acre) for tiling, surface draining, subdividing, water supply, sewers, streets and other improvements. During the years in question an average of eight lots were sold, while in prior years an average of only four lots were sold. The merchandising activities of brokers were imputed to the taxpayer. The court described the partnership's activities as a real estate business "engaged in subdivision development"\textsuperscript{41} requiring the profit from sales to be

\textsuperscript{38} Id. at 236.
\textsuperscript{39} 457 F.2d 429 (7th Cir. 1972).
\textsuperscript{40} Id. at 430.
\textsuperscript{41} Id. at 434. In William B. Howell, 57 T.C. 546 (1972), the taxpayer won capital gain
treated as ordinary income.

In *George W. Mitchell*42 the profit on the sale of an old hospital which had been purchased at an auction was permitted capital gain treatment. First element: The taxpayer was an individual engaged in mechanical and general contracting who participated in a joint venture seeking the best income-producing use for the property. The taxpayer had never before bought or sold real estate, other than his home. Second element: The only expenditures were to maintain the property and protect it against vandalism. Feasible uses were thoroughly explored over several months, but the taxpayer did not solicit the sale—he merely followed up on the numerous inquiries received. The property was not listed with a broker, not advertised, nor was there even a for-sale sign erected. Thus, his activities were minimal.

The enumerated determinative facts of the next two cases should be compared with the corresponding elements of the above-mentioned proposition so that a basic grasp of this particular analysis can be obtained. In *S. O. Bynum*43 the court reasoned that since 1) the individual, involved in the landscaping and nursery business, subdivided his farm and sold lots in order to raise money to pay off the mortgage, and since 2) (a) he spent over double the cost and fair market value per acre on improvements, (b) he advertised the lots for sale and listed them with realtors, and (c) regardless of the fact that he devoted only 5-10% of his time to selling, the second business of selling subdivided lots became of principal or first importance to the taxpayer, therefore, the real estate did not fit within the definition of a section 1221(1) capital asset and ordinary income treatment was appropriate.

The reasoning in *Robert W. Pointer*44 was that since 1) the

---

43. 46 T.C. 295 (1966).
44. 48 T.C. 906 (1967), aff'd 419 F.2d 213 (9th Cir. 1969). Municipal Bond Corp. v. Commissioner, 382 F.2d 184 (8th Cir. 1967), rev'd 46 T.C. 219 (1966), which was on remand from 341 F.2d 683 (8th Cir. 1965), rev'd 41 T.C. 20 (1963), permitted capital gain treatment on the sale of an industrial site. "[T]he principal purpose of the corporation . . . [was] to
owner of a manufacturing and construction business, who derived additional income from patent royalties and sales of invention ideas, subdivided, developed and sold about ten acres to a group of builders, and since 2) (a) he spent $24,000 on improvements, and exerted influence in the community to prevent the erection of a structure which would obstruct the view from the lots, (b) the court imputed advertising and other activities of builders, and (c) he approved building plans, financed construction, and retained title as security for the purchase price until a lot and house were sold as a package to a third party, thus, the taxpayer's activities with respect to the property were characterized as a "business," and capital gain treatment was denied.

Recognition of this category of case analysis was received in the 1973 District Court opinion in Biedenharn Realty Co., Inc. v. United States where the court stated

... holding primarily for sale ... is by itself insufficient to disqualify the taxpayer from capital gains privileges. The sales must also be made in the ordinary course of taxpayer's trade or business. The next issue, therefore, is whether the taxpayer's activities constituted a trade or business.45

As a conclusion to this section it would be helpful to formulate a definition of "business" as used in section 1221(1) and applied to real estate sales when the activities-constituting-a-business analysis is employed. The courts' strongest hints that a section 1221(1) "business" is different from other uses of the word come from peculiar comments such as, "the size of the business is insufficient to transfer a taxpayer's land activities into a business;"46 the taxpayer's extensive "land holdings alone ... [do not] constitute business activity;"47 and that a corporation with no "business" for section 1221(1) purposes nevertheless may be a "small business

hold [the property] until the price goes up and then [to] sell it at a profit." 41 T.C. at 20. The taxpayer recognized the property "as a bargain which would yield a good profit if held for a substantial period of time." 382 F.2d at 189. Since the value increased from the government's building of a road which gave access to the land, and since the "taxpayer's efforts to advertise or offer the property for sale were minimal," Id., and since sale was effected merely by the purchaser's execution of an option in the lease, therefore, the property was a true "investment" as to which the taxpayer merely nurtured passively the natural appreciation.


47. Id.
corporation” under section 1371.48 (Emphasis added) Over the years the concept of a “busyness” developed. The idea was that the selling of small items to many customers requiring constant efforts indicated that the assets were probably of the type which Congress intended to be subject to ordinary income taxation. To be considered a “business” for purposes of section 1221(1) it appears that there must be continuous and frequent purchases and sales of the type of property in question. One purchase and one sale do not constitute a “business.” There must be continuous, regularly conducted activity geared toward attracting customers and effecting sales.

B. Analysis of Whether the Particular Sale Was Outside the “Ordinary Course of His Trade or Business”

This second category of cases concentrates on the relationship of the sale to the taxpayer’s entire scheme of real estate activities. The basic issue is whether the sale was made within or without the usual business operations. Again, the subsequent discussion first sets forth a proposition constructed from this group of cases, and then illustrates its application by means of a successively condensed enumeration, parallel to the elements of the general rule, of the facts relied upon in reaching the decision in a number of cases.

In order to begin the case analysis with a point of reference, the following proposition is believed to be a restatement of the law applied by the courts.

Where the taxpayer is able to sustain the burden of proving
1) that at the time of sale his main business activities involved property other than that sold and in issue, and
2) the sale of the property in question was (a) incidental and not integral to the main business, or (b) isolated from the normal stream of regularly conducted activity,
then, regardless of the taxpayer’s reasonable activities designed to enhance the value, attract customers, or to sell the particular property, sale was not in “the ordinary course of his trade or business,” and capital gain treatment is appropriate.

The analysis appears to begin with the assumption that the taxpayer would have been classified as a dealer under the traditional judicial reasoning explained in section II, A, supra. The

influence of *Corn Products* and *Malat* are more noticeable in this category of cases to provide the justification for a real estate dealer's eligibility for capital gain treatment.

*Maddux Construction Co.* involved undeveloped land the sale of which as a shopping center location produced capital gain. First element: The tract was purchased pursuant to the corporation's main business of subdividing and developing residential real estate and constructing houses thereon for sale.

Second element: One year after purchase it became apparent that the character of the property was changing with the approach of highways. The residential purpose was abandoned since a commercial use of the location would be more profitable. Although the corporate charter was broad enough to authorize nonresidential dealings, the taxpayer's operations were not geared to attract customers for commercial property. The taxpayer negotiated with numerous prospective renters and purchasers, used brokers and salesmen and distributed flyers to commercial prospects in efforts to dispose of the property. Finally, the still undeveloped land was sold in bulk, in the largest transaction ever participated in by the taxpayer. The court concluded that the ultimate sale was an occurrence isolated from the corporation's purpose, and not within the stream of regularly conducted business activity. Therefore, capital gain treatment was justified.

A similar case was *Commissioner v. Tri-State Corp.* wherein a corporation which ordinarily developed land and sold improved lots and houses to individuals, purchased a tract with the intent of selling it to the state only after it was suitably improved for a shopping center site. However, before anything was done, the state threatened condemnation proceedings to acquire the land for a highway. The profit from such a forced sale of the still undeveloped land was allowed capital gain treatment.

Contrast the above two cases with *Royce W. Brown* in which

---

49. 54 T.C. 1278 (1970). In Parker C. Folse, Jr., ¶ 73,097 P-H Tax Ct. Mem. at 438-39 (1973), capital gain was permitted. The court found an intention to develop the property into apartments, not to sell the land. Because of a disagreement between the two participants in the joint venture, petitioner chose to sever his connections with the venture and sold his interest to the other venturer.

50. 400 F.2d 862 (10th Cir. 1968), aff'd 48 T.C. 316 (1967).

51. 54 T.C. 1475 (1970), aff'd 448 F.2d 514 (10th Cir. 1971). Two cases involving standing timber illustrate how the classification of the main business at the time of sale could determine the relationship of the sales in question to the main business. In *Huxford v. United States*, 441 F.2d 1371 (5th Cir. 1971); Note, *Capital Gains on Proceeds of Timber Sales*, 33 LA. L. REV. 160 (1972), the sale of the right to use land for twenty years and to
capital gain was denied. The individual was in the business of purchasing developed lots, building houses thereon and then selling the property to individuals. Deviating from normal operations, the taxpayer purchased forty acres of unimproved farmland and then sold his interest to a controlled corporation which he formed to do development activities. The court stated that although the taxpayer had never before acquired raw land for subdivision and development purposes, it is clear that beginning in 1958 he expanded his real estate business to include this closely related activity. The sale was not isolated sufficiently from the original business.

_United States v. Winthrop_\(^{52}\) points out that where the course-of-business analysis is employed, eligibility for capital gain treatment will not be affected by the taxpayer's activities to enhance the value of the property, attract customers or effect the sale. The court said that the taxpayer may subdivide land for advantageous sale, and that reasonable expenditures and efforts to provide for necessities, which the idea of selling a large tract of land in lots embraces, is permissible where the land could not have been sold without the performance of such activities. Unfortunately for the taxpayer, capital gain treatment was denied because the court reasoned that the individual, originally a civil engineer, had changed his occupation to a real estate salesman, and the sales in question were within the ordinary course of his reclassified occupation.

The concept of normalcy requires for its application a chronology and a history to determine if the sales of lots to customers were the usual or a departure from the norm. History and chronology here combine to demonstrate that Winthrop did not sell his lots as an abnormal or unexpected event. He began selling shortly after he acquired the land; he never used the land for any other purpose; and he continued this course of conduct over a number of years. Thus, the sales were not only ordinary, they were the sole object of Winthrop's business.\(^{53}\)

---

\(^{52}\) 417 F.2d 905 (5th Cir. 1969).

\(^{53}\) _Id._ at 911.
The following two cases demonstrate how a change in the purpose for holding land could establish that the sale was outside the normal stream of business activity. In *Heller Trust v. Commissioner* the taxpayer won capital gain treatment on the sale of houses he had built. The court reasoned that the original business of building and selling homes had been changed to the rental of duplexes, and then, because of a weak rental market and ill health, the taxpayer decided to dispose of all the duplexes. Such a sale for liquidation purposes was not normal for a rental business, therefore the property fell within the definition of a section 1221(1) capital asset. The court disregarded the extensive advertising, the staff of salesmen and the amount spent for reconditioning and redecorating the duplexes for sale. In effect the taxpayer's contention was adopted that "anything may be done to further the liquidation." In *Sapphire Lands, Inc.* the taxpayer lost because the change in purpose was not sufficiently established. The corporations involved were in the business of selling real estate until mortgagees and holders of promissory notes took over control. The taxpayer argued that the main business at the time of sale was to hold the land for appreciation and to sell only to pay the debts. But the court found that the business was not sufficiently changed because the charter was not amended, resolutions and statements by the person in control reaffirmed the selling business, and sales in subsequent years indicated that the transactions in issue were merely the first in an overall plan for subdividing and selling the corporations' land holdings.

The enumerated determinative facts of the next two cases should be compared with the corresponding elements of the above-mentioned proposition so that a basic grasp of this particular analysis may be obtained. The facts of *Jerome S. Murray* indicated that (1) the business of the taxpayer was to participate in various speculative ventures involving both residential and commercial property sales. (2) The bakery business acquired was unusual in the sense that it was originally held for a relative to manage until the taxpayer decided the business was too complex. After repeated efforts to find a use for the property, the building was demolished.
and the premises sold to a purchaser interested in acquiring only unimproved real estate. The sale was thus outside the ordinary course of the taxpayer's normal business and capital gain treatment was permissible.

*Scheuber v. Commissioner* involved (1) a licensed and well-established real estate broker who sold three and one-half city blocks of unimproved real estate. (2) Because the taxpayer sufficiently established that the land was held to provide his wife with annuity income upon retirement, pursuant to a planned and regular program of investment, and that after a nine year holding period the sale was prompted by zoning changes and condemnation proceedings, and because the profit was unusually high, the court was convinced that the property was not of the type in which he normally dealt. Therefore, capital gain treatment was permitted.

The taxpayer who would probably be subject to the ordinary-course-of-business analysis has the task, first, of defining what his main business was at the time of sale, and then establishing that the sale was outside of the normal conduct of that business. The search is for an unusual condition or event which would distinguish the property in question.

**IV. THE PLANNING STAGE**

Most clients rely on a purely intuitive judgment as to whether a given property should be purchased, or more important, should be sold, and then look to the tax practitioner for assurance that the profit will receive the preferential long-term capital gain treatment. For the rare situation in which advice is sought beforehand, the transactions may be structured to enhance the likelihood of the property's fitting the section 1221(1) capital asset definition, thereby making the sale eligible for capital gain treatment under the rules synthesized from the preceding cases. Keep in mind that

---

58. 371 F.2d 996 (7th Cir. 1967); Note, Large Profit is a Factor In Determining Whether to Allow Capital Gain Treatment on Sale of Property By Real Estate Dealer, 5 Houston L. REV. 150 (1967). In Clinton E. Gates, 52 T.C. 898 (1969), the court's reasoning proceeded as follows: since (1) the taxpayer, whose main business was selling materials and supplies to builders of homes, sold most of the lots which he had subdivided and improved to builders, and since (2) the policy was to tie the sale of a lot to the sale of materials and supplies, the legal effect was that the taxpayer held the lots primarily for sale to his builder-customers in the ordinary course of his lumber business, therefore ordinary income treatment was appropriate.

the trend in judicial reasoning, while making it somewhat easier for "dealers" of obtain capital gain rates, is a two-edged sword in that "non-dealers" may now be more susceptible to ordinary income treatment.

At the first conference the client should be classified by comparing his situation to the factual distinction which seems to trigger the different analyses. To avoid the confusion which could be engendered by the use of the term "dealer," the two categories are described, for convenience, as casual investor and real estate specialist.

The casual investor is one who considers real estate as a sideline because his usual source of income is from an occupation or profession. In general, advice should concentrate on either minimizing the taxpayer's activities, or insulating the development, promotion and sales functions from being imputed to the client. But if the activities already were substantial, the sale should be distinguished as resulting from some unusual condition or event which prompted the liquidation of the investment.

On the other hand, the specialist is one devoting full time to an entrepreneurial activity in which real property acquisitions and dispositions are integral to or at the core of a recognizable business operation. Advice should be geared toward separating the property from the type usually dealt with, or toward establishing that the reason for selling was due to a change in circumstances.

The next step for the tax planner will depend upon when the advice is sought—before or after the purchase.

A. Where Counsel is Sought Prior to Acquisition of Real Estate

Before purchasing property, both classes should be advised concerning the use of a corporation. The specialist's information should also concern the best methods for segregating and treating the property as an investment.

1. The Use of Corporate Entities

An individual taxpayer, as a stockholder, officer or director, is legally separate from his corporation, and the real estate activities of one generally will not be imputed to the other.60 The principal exception is where a controlled corporation is not sufficiently au-

60. Unless the collapsible corporation rule of INT. REV. CODE OF 1954 § 341 applies. See § 341(e) where stock ownership by a dealer taints the corporation (if the corporation makes the sale) and all of the other stockholders (if they sell their stock).
tonomous because it is used as an agent, co-participant, or joint venturer to implement or further the taxpayer's personal business. Therefore, the corporation's viability must be planned with painful recognition of the statutory formalities of directors, minutes, meetings, and so forth to enable the corporate veil to withstand the inevitable attack by the IRS.

The casual investor who foresees profitable sales to ultimate users only if property is sufficiently developed would probably be well advised to (1) purchase the land, (2) organize a corporation, (3) sell the property to the corporation, and (4) then have the corporation proceed to develop and market the property. Capital gain hopefully would be realized on the profit from the sale to his corporation, and the problems of Hansche, Bynum and Pointer, supra, would then be obviated since the activities would not be considered the individual taxpayer's business. Control over the corporation would assure that, if the taxpayer's expectations are fulfilled, the increased property values will eventually end up in his pocket in one form or another.

The real estate specialist's advice would involve the organization of a separate Subchapter S corporation to purchase, hold and sell the particular property. If the activities with respect to the property are minimal, the corporation would be classified as a casual investor, the sale would be eligible for capital gain treatment, and the tax advantages would "pass through" to the individual. The specialist could thereby utilize his real estate expertise without jeopardizing the status of the property as a section 1221 capital asset. William B. Howell illustrates the procedure. Two real estate agents and a builder formed Hectare, Inc. solely for the purpose of purchasing and eventually selling a tract of land for use as an industrial park. The Tax Court found that the corporation's


62. See generally, Robert A. Boyer, 58 T.C. 316 (1972); Royce W. Brown, 54 T.C. 1475 (1970); Tibbals v. United States, 362 F.2d 266 (Cl. Ct. 1966). Robert E. Ronhovde, ¶ 67,243 P-H Tax Ct. Mem. (1967) (promotion of a corporation as a customer for property held by a partnership). Rubin, supra note 15 at 434-42. Depending upon the tax situation of the parties involved, it may be more advantageous to organize the corporation and then to have the corporation purchase the property from the third party seller.

63. But see, Int. Rev. Code of 1954 § 1378 imposing corporate capital gain tax on a Subchapter S corporation, in some cases, where the election was made in the year of the sale.

64. 57 T.C. 546 (1972); supra note 41.
almost negligible activities were insufficient to constitute a "business" of selling. The IRS then argued that since Subchapter S treatment is dependent upon falling within the definition of a "small business corporation," and since it was decided that the corporation's activities did not constitute a business, Subchapter S treatment should be denied. Nevertheless, the Tax Court permitted the individuals the pass through of capital gain by relying upon different interpretations of the word "business" as used in the two sections. For section 1221(1), a "business" connotes a continuous, regularly conducted activity with respect to a property. For section 1371, a "business" is a corporation with the aim of making money. Since Hectare, Inc. was attempting to make a profit, it thereby qualified as a Subchapter S "small business corporation."

2. Segregation and Treatment of the Property as an Investment

Advice for a real estate specialist must recognize that he will probably be subject to the ordinary-course-of-business analysis. So his burden, unlike the causal investor's, is to distinguish property purportedly held for investment purposes from other realty which admittedly is the regular source of his business income. If a given parcel is in fact an investment, it should be treated as such for all purposes. The acts of the taxpayer should accordingly provide an evidential basis raising the inference of separateness or uniqueness.

When planning the purchase of investment property, the taxpayer should search for and document the characteristics which, when considered in relation to the type of property usually handled, have influenced courts in separating property. A considera-

65. INT. REV. CODE OF 1954 § 1371.
66. 57 T.C. at 554.
67. Id. at 556.
68. Outlaw, supra note 34 at 468-69.
69. E.g., Sapphire Lands, Inc., ¶ 73,023 P-H Tax Ct. Mem. (1973) (resolutions in corporate minutes); Hansche v. Commissioner, 457 F.2d 429 (7th Cir. 1972) (statements in a partnership agreement); Royce v. Brown, 54 T.C. 1475 (1970) (configuration, location, zoning, proposed use, stage of development); Maddux Constr. Co., 54 T.C. 1278 (1970) (size); United States v. Winthrop, 417 F.2d 905 (5th Cir. 1969), and Sapphire Lands, Inc., ¶ 73,023 P-H Tax Ct. Mem. (1973) (lack of a pre-planned program for subdividing and selling); Scheuber v. Commissioner, 371 F.2d 996 (7th Cir. 1967) (purchase pursuant to a regular program of investment to provide ventual retirement income); Jerome S. Murray, ¶ 65,148 P-H Tax Ct. Mem. (1965) (hope that a son or son-in-law would like to manage a bakery business); Carl E. Metz, ¶ 55,303 P-H Tax Ct. Mem. (1955) (the alleged investment property was of better-than-average construction); and Parsons, supra
tion which has set apart sales is the magnitude of the profit derived, both absolutely, and in relation to the taxpayer’s total income. By extending the rationale to apply to the planning stage, the attorney should sufficiently document the facts, studies and hunches relied upon by the taxpayer to form a belief that holding the property for a time will result in a large profit. Such evidence will provide a basis for an argument that the taxpayer should not be penalized merely because he did not realize all the profit he had hoped on his “investment.”

The tax planner should suggest that record title be obtained and maintained separate from other real properties. An accounting system should be established and appropriate entries made which distinguish the “investment” property from inventory-like holdings. Expenditures should be capitalized rather than deducted as expenses. In general, all acts which would enhance the value of the property in the long run should be separated from those activities which might be considered his “trade or business.”

B. Where Counsel is Sought Prior to Sale of the Property

The strategy for structuring a sales transaction to qualify for capital gain treatment depends again upon the taxpayer’s classification. The casual investor must either minimize his activities, or insulate himself from them. If activities already constitute a “business,” he should establish that the sale was prompted by a condition or event unusual to the “business.” A specialist’s only possibility is to establish that the sale was a deviation from the ordinary course of business.

As seen in the Hansche, Huxford and Kirby cases, supra, the definition of the type of business or occupation the taxpayer will be engaged in at the time of sale could determine which analysis is to be used as well as whether a sale was outside the “ordinary course” of the business so defined. A stipulation in doubtful areas could work to the disadvantage of the taxpayer, such as in United States v. Winthrop where the taxpayer stipulated that “Winthrop

note 23 at 262 (a long-term mortgage loan with substantial prepayment penalties may refute an argument that property was acquired for sale in the usual turnover time for the business).

70. Scheuber v. Commissioner, 371 F.2d 996 (7th Cir. 1967).

71. Koch v. United States, 457 F.2d 230 (7th Cir. 1972); Camp v. Murray, 226 F.2d 931 (4th Cir. 1955).

72. Simmons & O’Hare, supra note 35 at 220-21.

73. Hansche is discussed at text accompanying note 39, supra; Huxford and Kirby are discussed in note 51, supra.

74. 417 F.2d 905 (5th Cir. 1969).
was primarily engaged in selling the Betton Hills property and that though he was a civil engineer by profession, he did little work of this type during the period in question save that done on the Betton Hills property.\textsuperscript{75} The guiding principle for preparing an argument comes from Corn Products, \textit{supra}, in that, the business as defined must not have the sale of the particular property integral to its normal operations.

Bits of evidence which the courts have mentioned in their classification of the taxpayer's occupation or business included advertisements in telephone books,\textsuperscript{76} statements on motel registration cards and tax returns,\textsuperscript{77} and liability for self-employment tax.\textsuperscript{78}

1. The Use of Independent Contractors

A casual investor's eligibility for capital gain treatment will turn on the extent of his development, promotional and sales activities. If the taxpayer engages in such through an agent or servant, the activities will be imputed to him. If the activities are placed exclusively in the hands of a broker or developer who acts on his own behalf, then the concept of an independent contractor might insulate the taxpayer. However, blending agency concepts with tax law could further confuse the real estate situations under consideration, and could be risky since any complicated arrangement will be subject to close scrutiny by both the IRS and the courts.

The Restatement of Agency uses the word "servant" to classify persons for whose physical conduct the master is responsible.\textsuperscript{78} The opposite of a servant is an "independent contractor" whose physical conduct in the performance of an undertaking is neither controlled, nor subject to the master's right to control.\textsuperscript{80} The taxpayer's right to interfere with details appears to be the theory which negates independent contractor status and causes activities to be imputed.

An enlightening recent case is \textit{Voss v. United States},\textsuperscript{81} in which the court refused to attribute extensive development, promotional

\textsuperscript{75} Id. at 906-07.
\textsuperscript{76} Huxford v. United States, 441 F.2d 1371 (5th Cir. 1971).
\textsuperscript{77} United States v. Winthrop, 417 F.2d 905 (5th Cir. 1969).
\textsuperscript{78} Id.
\textsuperscript{79} \textit{Restatement (Second) of Agency} § 2, Comment b (1957).
\textsuperscript{80} Id. at § 2(3); see also, \textit{supra} note 61.
\textsuperscript{81} 329 F.2d 164 (7th Cir. 1964). The court refined the principle of agency law by its statement of the rule that "a taxpayer may not insulate himself from the acts of those whose efforts are combined with his in an endeavor to make a profit." Id. at 166.
and sales activities to a landowner who was thereby permitted capital gain treatment. The taxpayer, a dentist, owned a farm which could not profitably be sold as an entire tract. A realtor was engaged to sell the property pursuant to a broad oral delegation of power. The realtor did all the planning, had the land graded, rezoned, annexed and qualified for F.H.A. loans; he installed streets, sewage facilities and water mains; he also paid all subdividing and advertising costs. All expenditures were paid out of gross sales proceeds so that the project was self-financing. The realtor received a 10% commission on all sales. The only activities of the taxpayer in connection with the entire transaction seemed to have been the routine signing of deeds, while he continued his dentistry practice, and the cashing of net proceeds checks sent to him periodically by the realtor.

In Hansche v. Commissioner the taxpayer relied on Voss unsuccessfully. The realtors had placed signs on lots, advertised periodically in the local newspaper, found interested prospects, checked with the taxpayer for approval of building plans, and handled all lot sales. The promotion and advertising activities apparently were not imputed since the court relied on a stipulation that such activities were handled exclusively by the realtors, and on the statement that "the lay seller of real estate very seldom engages in commercial promotion or advertising of property which he has placed in the hands of a broker for sale." However, the development activities of the taxpayer were so extensive that the case was lost on that ground alone. In the next area of activity, effecting the sale, the court provided more helpful comments.

The record does not indicate the terms of the oral agreements with the real estate brokers such as how sales prices were to be determined and there is no record indication that there was authority on the agent's part to fix the price of lots or the terms of sale.

The analysis continued and compared cases where activity was imputed. In those cases,

the owner had set or controlled the price of the lots and was in close contact with the developer of the property. . . . the record in the case before us is silent as to who set the price of the lots

---

82. 457 F.2d 429, 433-34 (7th Cir. 1972).
83. Id. at 434.
84. Id. at 431.
the burden of proof in this connection was on the taxpayer.\textsuperscript{85}

The conclusion was that the sales "activities of the broker were legally the activities of the taxpayer."\textsuperscript{86}

Another example of a case where activities were imputed is \textit{Robert W. Pointer}\textsuperscript{87} in which the taxpayer sold land to builders who developed, advertised and resold the completed subdivision. The element of control came from the taxpayer's retention of title, in the nature of a conditional sales agreement, as security for the purchase price until a lot and house were sold as a package to a third party. The taxpayer also financed construction and actively controlled the quality of houses built through his approval of building plans.\textsuperscript{88}

A casual investor who does not want to jeopardize his eligibility for capital gain treatment does not have much choice, especially where the property cannot be profitably sold without development and subdivision. Someone will have to engage in the activities. If a corporation is not used, it appears that the investor's only alternative is the method used in \textit{Voss}, i.e., he would have to wash his hands of all interest in the property from the time the independent contractor is engaged until the property is sold.

2. Collection of Evidence of Deviation from Ordinary Course of Business

The principal task of the real estate specialist is to sustain the burden of proving that the sale of the property was an isolated event, incidental and not integral to the normally conducted business activity. The intentions at the time of purchase and the circumstances which prompted their reversal become relevant. The best type of evidence is "changed intention," motivated by unanticipated and undesirable events beyond the control of the taxpayer, which caused the liquidation of the investment properties. The burden can be satisfied by proving situations akin to the doctrine of commercial frustration.\textsuperscript{89}

\begin{itemize}
  \item \textsuperscript{85} \textit{Id.} at 434.
  \item \textsuperscript{86} \textit{Id.}
  \item \textsuperscript{87} 48 T.C. 906 (1967), \textit{aff'd} 419 F.2d 213 (9th Cir. 1969).
  \item \textsuperscript{88} The development and sales activities of builders and realtors in \textit{James H. Merritt, Sr.}, 47 T.C. 519 (1967), were imputed as not sufficiently independent of the taxpayer, again, because of retention of legal title to the lots and houses.
  \item \textsuperscript{89} \textit{E.g.}, \textit{Maddux Constr. Co.}, 54 T.C. 1278 (1970) (the normal business operations did not provide the type of customers which would buy the particular parcel); \textit{Commissioner v. Tri-State Corp.}, 400 F.2d 862 (10th Cir. 1968), \textit{aff'g} 48 T.C. 316 (1967) (threats of or actual
V. CONCLUSION

The current state of the law, as formulated and discussed above, indicates the apparent shift in the elements of section 1221(1) relied upon in determining when property will be defined as a capital asset. The change affects the planning techniques and evidentiary burdens of all clients engaged in the buying and selling of real estate—both dealers and non-dealers under the former classification. This article’s breakdown of the cases should provide a starting point for a more precise and consistent analysis. Although most of the litigated situations involved sales of residential land, the same type of reasoning could be applied to any asset not covered by other sections of the Code. In any event, awareness must be had of the complexities inherent in the phrase “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.”

MARTIN J. GREGORCICH

condemnation): Heller Trust v. Commissioner, 382 F.2d 675 (9th Cir. 1967) (weak rental market); Municipal Bond Corp. v. Commissioner, 382 F.2d 184 (8th Cir. 1967) and 341 F.2d 683 (8th Cir. 1965) (the taxpayer entered into the sale with some reluctance or without express satisfaction); Scheuber v. Commissioner, 371 F.2d 996 (7th Cir. 1967) (profit substantially more than can reasonably be expected in day-to-day business operations); Mulat v. Riddell, 383 U.S. 569 (1966) (disputes among business associates); Louis Lesser, 42 T.C. 688 (1964) (the reason for the sale might be a change in zoning); Sylvester A. Lowery, ¶ 64,030 P-H Tax Ct. Mem. (1964) (bad health or retirement); Charles T. Grace, ¶ 61,252 P-H Tax Ct. Mem. (1961) (unexpected requirements for improvements); D. G. Bradley, 26 T.C. 970 (1956), acquiesced in, 1957-1 Cum. Bull. 3 (competition in apartment rentals forced an upgrading of investments).