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Donald McDonald

John W. Fawcett, III

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FEDERAL INCOME TAX AND DEALINGS IN REAL ESTATE

DONALD McDONALD* and JOHN W. FAWCETT, III*

A great many people have purchased real estate in the last few profitable years and have approached counsel for tax advice in connection with it. If counsel has been fortunate his clients have consulted him before actually buying, but no matter how real estate is acquired it is well to know the income tax consequences of (1) the manner of holding it, and (2) its sale.

As used here, the term "real estate" includes both unimproved land and any depreciable improvements on it. The manner of holding real estate determines the tax treatment of the proceeds from its sale.

The Internal Revenue Code taxes "... gains, profits, and income derived from ... sales or dealings in property, whether real or personal...."[1] At the same time, it provides special treatment for gain or loss on the "sales or exchanges of capital assets," whether held less or more than six months.[2] Capital losses are deductible only to offset capital gains (and not over $1,000 of other income in the case of individuals),[3] and may be carried over for five successive years.[4] Net capital gains on assets held over six months are subject to a fifty percent deduction.[5]

The Code defines "capital assets" to include "... property held by the taxpayer (whether or not connected with his trade or business)...."[6] Then it makes certain exclusions.

The application of the first two of these exclusions to transactions in real estate has led to a great deal of litigation. Subsection (A) ex-

*Member of the Philadelphia Bar.

[1]Internal Revenue Code, § 22(a); cf. Merchants' Loan and Trust Co. v. Semitanka, 255 U. S. 509 (1921).

[2]Code, §§ 117(b), (c), (d) and (e).

[3]Code, § 117 (d).

[4]Code, § 117 (e).

[5]Code, § 117(b).

[6]Code, § 117 (a)(1).

cludes from capital assets "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[7]

Subsection (B) excludes from capital assets "property used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), or real property used in his trade or business."[8]

Capital gain treatment was originally conceived to avoid the unfairness of taxing in one year at progressive rates gains which have accumulated unrealized over many years.[9] To exclude "inventory," therefore, from the definition of capital assets is probably justified. Normally, it turns over rapidly. Moreover, it would be impossible to determine a holding period for each item of an ordinary inventory. Ordinary rates were for ordinary business profits. Such profits probably arise more from salesmanship or service than from any increase in the value of the property.

In real estate dealings turnover is slower, and gain results more from long-term value increase. The distinction is recognized, because real estate cannot be inventoried in computing income.[10] Also, a dealer is allowed depreciation on houses held for sale.[11] Notwithstanding these differences, the dealer pays an ordinary rate on his sales, because "capital assets" do not include "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[12] This exclusion gives the investor who wants to dabble in real estate his greatest tax trouble.

In 1942 Congress saw the hardship of paying tax at ordinary rates on the gains from sales of land and depreciable property used in business;[13] that is, the property covered in the "(B)" exclusion. Section 117 (j) provided relief.[14] In effect it provides that net gains from the sale or exchange of exclusion "(B)" assets held over six months, which

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[7]Code, § 117(a)(1)(A).

[8]Code, § 117(a)(1)(B).

[9]Sen. Rep. No. 275, 67th Cong. 1st Sess., p. 12 (1921), 1939-1 Pt. 2 C. B. 181, 189; H. Rep. No. 350, 67th Cong. 1st Sess., p. 10 (1921), 1939-1 Pt. 2 C. B. 168, 176.

[10]Richards v. Com'r, 81 F. (2d) 369 (C. C. A. 9th, 1936); Welch v. Com'r, 59 F. (2d) 1085 (C. C. A. 6th, 1932): O. D. 848, 4 C. B. 47 (1921).

[11]I. T. 1342, 1922-1 C. B. 169.

[12]Code, § 117(a)(1)(A).

[13]H. Rep. No. 2333, 77th Cong. 1st Sess. (1942), 1942-2 C. B. 372, 415, 445; Sen. Rep. No. 1631, 77th Cong. 2nd Sess. (1942), 1942-2 C. B. 504, 545, 549.

[14]Revenue Act of 1942, § 151 (b).

are not also excluded under "(A)", shall be considered as gains from sales or exchange of capital assets held for more than six months. On the other hand, if losses predominate, they are not considered as arising from capital assets and they are deductible in full.[15]

The Code thus sets up three important classifications into which real estate may fall: (1) Capital asset; (2) real estate held primarily for sale to customers, and (3) real estate held over six months and used in a trade or business.

A net gain from sales of either capital asset or business real estate is reduced fifty percent and subject to a maximum individual tax of twenty-six percent.[16] The taxpayer who profits usually seeks this result. If the real estate was primarily for sale, the full gain is taxable. Naturally, revenue agents seek this result.

A loss from the sale of capital assets does not reduce ordinary income. The revenue agents prefer this position. The taxpayer who loses usually insists that he always held the property primarily for sale or used it in his business. Therefore, in two of the three categories, "capital assets" or "for sale," whether there is gain or loss determines the litigants' positions.

The best position for the taxpayer to establish is that the property is used in his business but not primarily for sale. The gain, then, is only half taxable and the loss fully deductible. Beyond that, the position the property owner prefers depends upon his expectation of the trend of real estate values between the dates of purchase and sale. If he is bullish, he should remain a passive investor; if he is bearish, he should become a dealer.

These general principles are easy to state. The problem is to control the tax result, to predict the ultimate decision. There are a multitude of factors. None controls.[17]

The first factual question is whether the taxpayer is in a trade or business where real estate is used or held for sale. This does not have to be the real estate business. It is easy to enter a business in which real estate is used. The rental of a single property is enough. When the general counsel of Pittsburg Plate Glass moved to Pittsburg, he rented his former residence in Kansas City. When he sold it, his loss

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[15]Code, § 117(j)(2).

[16]Code, § 117(c).

[17]Trapp v. United States, 79 F. Supp. 320 (W. D. Okla. 1948); Boomhower v. United States, 74 F. Supp. 997 (N. D. Iowa 1947); Guthrie v. Jones, 72 F. Supp. 784 (W. D. Okla. 1947).

was held fully deductible because he had been engaged in the rental business.[18] Conversely, the commissioner successfully contended that a lawyer's gain on the sale of a 99-year leasehold was from the sale of "property used in his trade or business."[19] The leasehold covered a six-story business building rented to several tenants. Even the rental of part of an apartment building under construction is "business" within the meaning of the statute.[20]

It is not even necessary that the taxpayer himself be active. The business may be entirely conducted through agents.[21] For example, three sisters inherited interests in eight New York buildings rented for stores and apartments. Their agents handled all business dealings. One sister contended her $130,000 loss on the sale was a capital loss and carried it over into the next tax year. The United States Court of Appeals for the Second Circuit denied the carry-over, holding that the sisters, though inactive, were using the real estate in a trade or business.[22]

Rental real estate usually has improvements on the property. It is difficult to use unimproved land in a trade or business. A mere nominal rental will be disregarded.[23] Although it has been contended that any property held by a corporation was used in a trade or business,[24] it is now clear that even a corporation may hold, but not "use," property in its business.[25] Once used in business, the property need not be actively used in the year of sale.[26] The mere purchase with the intention of using the land in the business is sufficient, even if the intended use may be impossible.[27] But if the business use is pro-

[18]Leland v. Hazard, 7 T. C. 372 (1946), Acq. 1946-2 C. B. 3.

[19]Fackler v. Com'r, 133 F. (2d) 509 (C. C. A. 6th, 1943), affirming 45 B. T. A. 708 (1941).

[20]M. A. Paul, 18 T. C. 601 (No. 71) (1952), affirmed 205 F. (2d) 38 (C. A. 3d, 1953).

[21]Fackler v. Com'r, 133 F. (2d) 509 (C. C. A. 6th, 1943); John E. Good, 16 T. C. 906 (1951).

[22]Gilford v. Com'r, 201 F. (2d) 735 (C. A. 2d, 1953).

[23]Susan P. Emery, 17 T. C. 308 (1951); cf. Houston Deepwater Land Co. v. Schofield, 110 F. Supp. 394 (S. D. Tex. 1952).

[24]Graves Brothers Co., 17 T. C. 1499, 1506 (1952); cf. Levin, "Capital Gain and Loss Problems Pertaining to Real Estate" (1953) 26 Temple L. Q. 262.

[25]Graves Brothers Co., 17 T. C. 1499, 1506 (1952); Dunlap v. Oldham Lumber Co., 178 F. (2d) 781 (C. A. 5th, 1950); although the point is not mentioned, the decision is inconsistent with its truth.

[26]Graves Brothers Co., 17 T. C. 1499 (1952); Carter Colgan Cigar Co., 9 T. C. 219 (1947).

[27]P. S. Edwards, 12 T. C. M. 1045, P-H Memo T. C. 53,307 (1953); Alamo Broadcasting Co., 15 T. C. 534 (1950).

hibited at the time of purchase, a subsequent loss on sale will be only a capital loss.[28]

A change of real estate from one category to another, e.g., investment to business use or for sale can be effected.[29] If your client's unimproved real estate has fallen in value, he should try to put it to some business use before selling, for example, farming, or a parking lot, or storage space for a related business, or have a subdivision plan approved and hold it primarily for sale.

As the above cases indicate, the business taking real estate out of the class of capital assets need not be an exclusive or even predominant business.[30] Because of the ease with which a taxpayer can find himself in the rental business, it is probably safe to say that the only real estate which is a capital asset is that which is unrented and held only for investment.

More litigation arises over the issue of whether real estate admittedly used in a trade or business is held "primarily for sale to customers in the ordinary course of his trade or business."

Analytically, sections 117(a)(1)(A) and 117(j)(1) of the Code establish the following requirements, all of which must be present to put the gain, or loss, in the category of ordinary income:

1. The seller must be in a "trade or business."
2. He must hold the property involved "*primarily* for *sale.*"
3. This "sale" must be "to customers."[31]
4. This "sale," for which the property is held, must be "in the ordinary course" of that "trade or business."

The words "primarily for sale" also include for trade or exchange.[32] The word "customers" has been held to include brokers, dealers or speculators,[33] even where the only sales are to such persons. The holding seems unwarrantedly contrary to the decisions involving securities. A speculator in stocks and bonds is not a dealer, because stock brokers are not "customers" of individuals selling securities through them.[34]

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[28]Montell Davis, 11 T. C. 538 (1948).

[29]Mauldin, 16 T. C. 698 (1951); affirmed 195 F. (2d) 714 (C. A. 10th, 1952).

[30]Friend v. Com'r, 198 F. (2d) 285 (C. A. 10th, 1952); C. E. Mauldin, 16 T. C. 698 (1951), affirmed 195 F. (2d) 714 (C. A. 10th, 1952).

[31]Added by Revenue Act of 1934, § 117(b).

[32]Jacob S. Gruver, 1 T. C. 1204 (1943), affirmed 142 F. (2d) 363 (C. C. A. 4th, 1944).

[33]Jacob S. Gruver, 1 T. C. 1204 (1943), affirmed 142 F. (2d) 363 (C. C. A. 4th, 1944).

[34]Van Suetendael v. Com'r, 152 F. (2d) 654 (C. C. A. 2d, 1945); Com'r v. Burnett, 118 F. (2d) 659 (C. C. A. 5th, 1941).

Most of the decisions have blended the findings to obscure the two-fold required facts (1) the taxpayer must be in a "business" where real estate is sold, and (2) the property sold must have been held primarily for sale in the ordinary course of business.

"The business" in the ordinary course of which property is held for sale need not be the real estate business as commonly understood.[35] However, if the client is in the real estate business, the burden of proving that specific property or properties were not held primarily for sale becomes much more difficult.[36] Conversely, if he is not in the real estate business, while the property may be primarily for sale to customers, it is easier to prove that it is not so held.[37] What leads to a finding that the taxpayer is in the real estate business? The courts have mentioned many facts. With the dual nature of the ultimate findings in mind, I separate the factors into those primarily relevant to a finding on the taxpayer's business and those primarily relevant to a finding on the specific property.

Each fact alone only points toward the conclusion. Only the direction each points is clear.

Fundamentally, a real estate dealer is an active merchant whose stock in trade is a quantity of real properties and whose income is based upon the difference between costs and sales prices; the investor buys for long term increase in value or high current income from the property itself, or both.

The frequency and continuity test often mentioned concerns mainly the business of the taxpayer. Frequent sales or a large number of sales in a tax year tend to indicate a "dealer."[38] Infrequent sales or few sales in the period may mark an investor.[39]

Incidentally, it may be worth thinking about the unit in applying the frequency test. Do you count acres? Or lots? Or agreements of

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[35]Brown v. Com'r, 143 F. (2d) 468 (C. C. A. 5th, 1944); subdivision to liquidate inheritance from husband.

[36]The deal was successful in Malouf v. Riddell, 52-1 U. S. T. C. § 9296, 72,460 P-H Fed. 1952 (D. Calif., 1952); Charles S. Guggenheimer, 18 T. C. 81 (No. 10) (1952); Robert M. Hariss, 44 B. T. A. 999 (1941), affirmed 143 F. (2d) 279 (C. C. A. 2d, 1944.)

[37]Dunlap v. Oldham Lumber Co., 178 F. (2d) 781 (C. A. 5th, 1950); Thompson Lumber Co., 43 B. T. A. 726 (1941).

[38]Field v. Com'r, 180 F. (2d) 170 (C. A. 9th, 1950), affirmed 8 T. C. M. 170, 49,043 P-H Memo T. C. (1949); White v. Com'r, 172 F. (2d) 629 (C. A. 5th, 1949); McFadden v. Com'r, 148 F. (2d) 570 (C. C. A. 5th, 1945); Brown v. Com'r, 143 F. (2d) 468 (C. C. A. 5th, 1944); Ehrman v. Com'r, 120 F. (2d) 607 (C. C. A. 9th, 1944).

[39]Estate of W. D. Haden, 12 T. C. M. 825, 53,250 P-H Memo T. C. (1953); James L. Vaughan, 7 T. C. M. 288, 48,076 P-H Memo T. C. (1948); 512 West 56th St. Corp. v. Com'r, 151 F. (2d) 942 (C. C. A. 2d, 1945).

sale? There is judicial approval of counting only contracts of sale.[40]

Similarly, in applying the frequency test, it must be put in the proper perspective by using not the number but the percentage of the holdings sold. Twenty lots sold in a block might be either the liquidation of one-tenth of an investor's holdings or the turnover of two-thirds of a dealer's stock-in-trade. Just as in the merchandising of personal property, a high turnover in proportion to total holdings indicates the dealer who buys to sell again. The investor is more likely to have held most of his properties for a long time[41] with a low percentage turnover.

If an investor has held all his real estate through the upward swing of the market, the concentration of sales on which he determines to realize his gains before the break should not militate against him. If a large number of properties have suddenly been sold, inquiry should be made whether any extraneous need for funds made the sale necessary so as to lessen the effect of the frequency test.[42]

The continuity test is closely allied to the frequency test and looks to the duration of the period in which sales have been frequent. If the taxable sale was in 1950, how many sales were made in 1949? How many in 1951?[43] If there are many sales in many years, the taxpayer is probably a dealer. Even if there are many sales, but they are all in one year, he need not be a dealer. This is true if he can show that when he was buying he was not selling, and when he was selling he was not buying.[44]

Once the taxpayer has clearly entered the real estate business, the fact that he made no sales for several years does not indicate that he is no longer in business, particularly when those lean years are years of general depression in real estate.[45] But other evidence, such as other *full time* employment, obviously isolated sales, one each year, at salvage prices,[46] may lead a court to find that the "business" has been abandoned.

Apart from the number of sales and the time during which they are continuously made, incidental factors may be important. Some of these

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[40]W. T. Thrift, Sr., 15 T. C. 366 (1950).

[41]Phipps v. Com'r, 54 F. (2d) 469 (C. C. A. 2d, 1931); cf. Palos Verdes Corp. v. United States, 201 F. (2d) 256 (C. A. 9th, 1952).

[42]See the futile use of this argument in Ehrman v. Com'r, 120 F. (2d) 607 (C. C. A. 9th, 1941) and Richards v. Com'r, 81 F. (2d) 369 (C. C. A. 9th, 1936).

[43]Ehrman v. Com'r, 120 F. (2d) 607 (C. C. A. 9th, 1941).

[44]Austin v. United States, 116 F. Supp. 283 (S. D. Tex. 1953).

[45]Walter G. Morley, 8 T. C. 904 (1947).

[46]James L. Vaughan, 7 T. C. M. 288, 48,076 P-H Memo T. C. (1948).

may unwittingly trip a taxpayer who considers the tax consequences of his acts only after he has acted. Unless your client is satisfied to become a real estate dealer with the probability that all his gains will be ordinary income, he should avoid any written entries describing his business as dealing in real estate. The most obvious of these is the entry on schedule C of his tax return. The Government can offer this in evidence as an admission.[47] While the taxpayer can also use such evidence, it loses force as a self-serving statement.[48] Similarly, the taxpayer should pause to consider the tax implications before putting on his letterhead "real estate dealer," or "broker," or listing himself as a "realtor" in the yellow pages of the telephone book. Even his own books and records may embarrass him; for example, an entry "costs of houses built *for sale,*" when, in fact, he subsequently rented them. Akin to these possibly damaging statements is the problem of the broker's license usually required by state law.[49] The taxpayer is more likely to be held a dealer if he is so licensed than to be found an investor if he is not. If the taxpayer is not licensed and all sales are made through a broker, the fact should be emphasized in an argument, but its weight is small because the principal may conduct a business through an agent.[50] Of course, if the client is well known in the city as a real estate dealer, this will sway the court,[51] and little can be done by manipulating the minor indicia mentioned above.

Since the merchant generally has an established place of business, the courts look to the maintenance of an office as implying that a real estate dealer is involved.[52] The implication is weak, however, since many large investors maintain offices for the collection of income and the management of income-producing property. One court has pointed to a "rental office" as showing the lack of intention to sell.[53]

More important by far, and probably on a par with the frequency and continuity tests, is the activity test. The courts give considerable weight to sales activity both in discovering the taxpayer's business and the purpose for which specific property has been held. Sales activity

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[47]Delsing v. Com'r, 186 F. (2d) 59 (C. A. 5th, 1951) cert. den.; White v. Com'r, 172 F. (2d) 629 (C. A. 5th, 1949).

[48]Henry H. Jackson, 303 P-H Memo T. C. (1942).

[49]In Pennsylvania the Act of May 25, 1945, P. L. 1023, 63 PS 431-481.

[50]White v. Com'r, 172 F. (2d) 629 (C. A. 5th, 1949); James L. C. McFadden, 2 T. C. 395 (1943), affirmed 148 F. (2d) 570 (C. C. A. 5th, 1945).

[51]Dobson et ux. v. United States, 53-1 U. S. T. C. § 9362 (W. D. Tenn. 1953).

[52]E. D. Field, 8 T. C. M. 170 (1949); Snell v. Com'r, 97 F. (2d) 891 (C. C. A. 5th, 1938).

[53]Delsing v. United States, 186 F. (2d) 59 (C. A. 5th, 1951) cert. den.

shows that the property was held primiarly for sale. No sales activity means probably the property was primarily for business use or investment. Merely listing a property for sale is not considered sufficient activity to make the seller a dealer.[54] However, it seems that in at least one Texas district court, little more is needed. In an opinion favoring the collector, the judge stated:

"There was no advertising or listing, but it is rather difficult for the court to conclude that Mr. Lobello was riding with a lady just for fun when he passed by this tract"[55]—which she subsequently bought. The most obvious form of sales activity is advertising, either generally or of specific properties. The courts have even pointed to the placing of signs on the property, a usual incident of any sale, as suggesting that the property was held primarily for sale.[56]

Also important is the amount of time spent in sales effort and activity. Obviously, the man who spends full time attempting to sell his and others' properties, alone or with the help of salesmen, is a real estate dealer or broker.[57]

Basically, the decision turns on whether the seller is seeking buyers or the buyers are seeking out the seller. An investor normally only accepts satisfactory unsolicited offers from purchasers.[58] Once a prospective purchaser shows interest, the seller may safely negotiate actively.[59]

What determines whether the property itself is held primarily for sale to customers?

First, it should be carefully noted that the statute merely requires that the property be held for sale to customers in the ordinary course of the business, not that the taxable sale be made to a customer, or even be made in the ordinary course of the business.[60] This explains why the courts do not give capital gain treatment solely because sales are in liquidation.[61] The fact of liquidation is neutral. When other

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[54]John Randolph Hopkins, 15 T. C. 160 (1950).

[55]Lobello v. Dunlap, 53-1 U. S. T. C. § 9307 (N. D. Tex. 1953).

[56]Dobson et ux. v. United States, 53-1 U. S. T. C. § 9362 (W. D. Tenn. 1953).

[57]Marsch v. Com'r, 110 F. (2d) 423 (C. C. A. 7th, 1940).

[58]Victory Housing No. 2 v. Com'r, 205 F. (2d) 371 (C. A. 10th, 1953), revising 18 T. C. 466 (1952); Dagmar Gruy, 8 T. C. M. 787, 49,217 P-H Memo T. C. (1949); Fahs v. Crawford, 161 F. (2d) 315 (C. C. A. 5th, 1947); Frieda Farley, 7 T. C. 198 (1946).

[59]Austin v. United States, 116 F. Supp. 283 (S. D. Tex. 1953).

[60]Code, §§ 117(a)(1)(A) and 117(j)(1).

[61]Liquidation produced ordinary income in the following cases: Palos Verdes Corp. v. United States, 201 F. (2d) 256 (C. A. 9th, 1952); Spanish Trail Land Co., 10 T. C. 430 (1948); C. W. Oliver, 2 T. C. M. 78, 43,229 P-H Memo T. C. (1943); Ehrman v. Com'r, 120 F. (2d) 607 (C. C. A. 9th, 1941); R. J. Richards, 30 B. T. A. 1131 (1934), affirmed 81 F. (2d) 369 (C. C. A. 9th, 1936). Liquidation gain, passively

evidence shows that property was not held for sale in the ordinary course of the business, only half the gain has been taxed.[62]

While the original purpose for which the land has been acquired is considered, it is not controlling.[63] The regulations state that the statute is concerned with the status of the property only "at the time of sale."[64] Nevertheless, the courts persist in noting the manner and purpose of acquiring the property; whether as an incident to another business,[65] by inheritance,[66] in satisfaction of a debt,[67] as a sales promotion scheme,[68] because of expected improvement of adjacent property,[69] or to protect a mortgage investment.[70]

One class of cases in which there has been much recent litigation arises from the sale of houses built for rental with priorities material under Government restrictions on sale. Rental property is not usually held for sale. The Government, contending for tax at ordinary rates, has been more successful than the taxpayer.[71] Those taxpayers who have secured capital gain treatment have been able to show that the houses were rented after restrictions were lifted, notwithstanding the market favorable for sale, that the purchasers were unsolicited and that the property was not advertised.[72]

The Government's success shows there can be a conversion from section 117(j) assets to ordinary assets.[73] Conversely, there can be a

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accomplished, held capital in the following cases: D. T. Austin v. United States, 116 F. Supp. 283 (S. D. Tex. 1953); South Texas Properties Co., 16 T. C. 1003 (1951).

[62]Martin Dressen, 17 T. C. 1443 (1952); Thomas E. Wood, 16 T. C. 213 (1951); White v. Com'r, 172 F. (2d) 629 (C. A. 5th, 1949).

[63]Maudlin v. Com'r, 195 F. (2d) 714 (C. A. 10th, 1952); Richards v. Com'r, 81 F. (2d) 369 (C. C. A. 9th, 1936).

[64]Regs. 111, § 29 117-1; cf. Maudine Neese, 12 T. C. M. 1058, 53,309 P-H Memo T. C. (1953).

[65]Three States Lumber Co. v. Com'r, 158 F. (2d) 61 (C. C. A. 7th, 1946), land sold after timber cut; Frieda Farley, 7 T. C. 198 (1946), for use in nursery.

[66]Estate of W. D. Haden, 12 T. C. M. 825, 53,250 P-H Memo T. C. (1953); Smith v. Gallagher, Coll., 52-2 U. S. T. C. § 9482, 72,639 P-H Fed. 1952 (S. D. Ohio 1952); Kelm v. Chicago, St. P., M. & O. Ry. Co., 206 F. (2d) 831 (C. A. 8th, 1953); Beck v. Com'r, 179 F. (2d) 688 (C. A. 7th, 1950).

[67]Kanawha Valley Bank, 4 T. C. 252 (1944).

[68]Dunlap v. Oldham Lumber Co., 178 F. (2d) 781 (C. A. 5th, 1950).

[69]Metropolis Holding Corp., 1942 C. C. H. 7851A, 42,542 P-H Memo T. C. (1942)

[70]Steinegger v. Stuart, 52-1 U. S. T. C. § 9182 (D. Ariz. 1952).

[71]To September 30, 1953, for the government, 19 Tax Court, 2 district court and 3 court of appeals' decisions: for the taxpayer 2 Tax Court, 1 district court and 2 court of appeals victories.

[72]Victory Housing No. 2 v. Com'r, 205 F. (2d) 371 (C. A. 10th, 1953); Delsing v. United States, 186 F. (2d) 59 (C. A. 5th, 1951).

[73]Rollingwood Corp. v. Com'r, 190 F. (2d) 263 (C. A. 9th, 1951); King v. Com'r, 189 F. (2d) 122 (C. A. 5th, 1951) cert. den. 342 U. S. 829 (1951).

conversion from ordinary assets to section 117(j) or to true capital assets.[74] Similarly, even a real estate dealer may hold some of his real estate as a personal investment.[75] In these cases it is essential to maintain a clear factual separation or segregation of the properties. To do so various steps are helpful, such as personal ownership of one type and corporate ownership of other properties with separate records for each class of property and, most important of all, no on-again-off-again dealings with properties supposedly converted or segregated.

In considering specific rental properties the duration of the lease or leases is important. Month-to-month oral leases have been held to indicate an intention to sell.[76] The reasoning is that the property is kept free of leases to which a purchaser would be subject.

The most critical and important factor applicable to the specific property is whether the seller has subdivided it. Commonly, the numerous lots in a subdivision are held "primarily for sale to customers." The factor has had great weight, even if the entire subdivision is sold as a unit.[77] The cases disregarding the factor are rare.[78] In most cases, where subdivided property had been found not primarily for sale, the subdivision has been carried out by others.[79]

Improving the property by putting in streets and sewers and a water supply also tends to show that the owner intends to hold for sale. This does not always determine the case against the taxpayer, however. In *W. T. Thrift,*[80] the gain on a sale of 152 lots, a property the taxpayer had subdivided and provided with streets, sewers and water, was held only one half taxable. The court emphasized the distinguishing fact as follows:

> "The petitioner improved and developed the property... solely for the purpose of facilitating the disposition of all or a

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[74]Maudine Neese, 12 T. C. M. 1058, 53,309 P-H Memo T. C. (1953); James L. Vaughan, 7 T. C. M. 288, 48,076 P-H Memo T. C. (1948).

[75]Walter R. Crabtree et al., 20 T. C.(No. 120) C. C. H. § 7616 (1953); Charles S. Guggenheimer, 18 T. C. 81 (No. 10) (1952); Nelson A. Farry, 13 T. C. 8 (1949); Elgin Building Corp., 8 T. C. M. 114, 49,015 P-H Memo T. C. (1949).

[76]Rubino v. Com'r, 186 F. (2d) 304 (C. A. 9th, 1951), cert. den.; Walter R. Crabtree et al., 20 T. C. (No. 120) C. C. H. § 7616 (1953).

[77]Dobson et ux. v. United States, 53-1 U. S. T. C. § 9362 (W. D. Tenn. 1953); C. Dorrance, 6 T. C. M. 675.

[78]P. S. Edwards, 12 T. C. M. 1045, 53,307 P-H Memo T. C. (1953); Collin v. United States, 57 F. Supp. 217 (D. C. Ohio 1944).

[79]Fahs v. Crawford, 161 F. (2d) 315 (C. C. A. 5th, 1947); Freida Farley, 7 T. C. 198 (1946).

[80]15 T. C. 366 (1950), Acq. 1951-1 C. B. 3.

> large part of the property to a specific and limited group of builders *with whom he had already reached an understanding.*"[81]

Faced with the multitude of factors, some of which suggest a dealer and some an investor, what can the owner of real estate do? He may own real estate he bought cheaply in the thirties which he now wants to liquidate. It is manifestly inequitable if he has held it passively and patiently all these years, to tax him at ordinary income rates on the difference between its cost and its present fair market value.

If the land is unimproved, one suggestion would be to form a corporation to deal in real estate, then sell the investment real estate to it. The gain would then be taxed at capital gain rates. In making the sale, however, short cuts which might bring section 112 (b)(5) of the Code into the picture must be avoided. Also section 117 (o) bars this solution if the property is depreciable. Then, capital gain tax rates are available if the investment is sold as passively as possible, preferably in a single sale. Or, it may be converted for a relatively long period to the production of rental income and sold with capital gain benefits.

Beyond the tax planning and income reporting stage, the taxpayer may have to litigate. Recently, as in other issues where the Code is general and a jury approaches the question with untutored common understanding, it may be wiser to pay tribute and sue for its refund.

The continuity, frequency, activity, and subdivision tests must be met in every case. Beyond that, as in any issue of fact, argument is limited only by counsel's ingenuity. There will, of course, always be some cases in which even the best counsel cannot make black into white.

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[81] 15 T. C. 366, 371 (1950) [italics supplied].