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TAX CONSEQUENCES OF SUBDIVIDING REAL ESTATE

A taxpayer selling securities through a broker who sells in one or several lots obtains capital gain treatment with a maximum tax rate of 25 per cent when the securities are held longer than six months.[1] The taxpayer who sells real estate through a real estate agent who subdivides the tract in order to sell in lots cannot so confidently expect to receive capital gain treatment.[2] The tax treatment may depend upon the circuit in which the case arises and, since 1954, upon whether section 1237[3] is applicable to the taxpayer or not. The Code definition of a capital asset is little assistance to the taxpayer.[4] Real property is a capital asset unless it is "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[5] Because of this last provision a taxpayer may be surprised to find that the Commissioner of Internal Revenue has considered him to be in the real estate business and has treated his gain as ordinary income.[6]

Achong v. Commissioner[7] illustrates the extent to which the Court of Appeals for the Ninth Circuit goes in upholding a finding that a taxpayer has gone into the real estate business and that the sale of lots from a subdivided tract is a sale in the ordinary course of his trade or business.

The taxpayer in this case acquired in 1923 the small tract of land on which he was living. He has lived there since, and during these years has been employed as a cashier in a meat market. He has never owned any other real estate and has never been engaged in the real estate business. In 1946 he entered into an agreement with King, a real estate agent, for subdivision and sale of most of the tract of land. The terms of the agreement gave the taxpayer a substantial power of control in several important aspects over the actions of the real estate agent. The

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[1]U.S. Treas. Reg. 118, § 39.22(c)-5 (1953); Comment, 29 So. Calif. L. Rev. 116, 119 (1955).

[2]Grogan, Capital Gains v. Ordinary Income, 30 Taxes 574, 585 (1952).

[3]Int. Rev. Code of 1954, § 1237.

[4]Id. § 1221.

[5]Id. § 1221(1).

[6]Compare Brown v. Commissioner, 143 F.2d 468 (5th Cir. 1946); Ehrman v. Commissioner, 120 F.2d 607 (9th Cir. 1941); Welch v. Solomon, 99 F.2d 41 (9th Cir. 1938); and Richards v. Commissioner, 81 F.2d 369 (9th Cir. 1936), with Dunlap v. Oldham Lumber Co., 178 F.2d 781 (5th Cir. 1950); Fahs v. Crawford, 161 F.2d 315 (5th Cir. 1947); Three States Lumber Co. v. Commissioner, 158 F.2d 61 (7th Cir. 1946); Guthrie v. Jones, 72 F. Supp. 784 (W.D. Okla. 1947); Sparks v. United States, 55 F. Supp. 941 (M.D. Ga. 1944); W. T. Thrift, Sr., 15 T.C. 366 (1950); and Thompson Lumber Co., 43 B.T.A. 726 (1941).

[7]246 F.2d 445 (9th Cir. 1957).

taxpayer took no part in the solicitation of prospects or in the sale of the lots. King did not advertise the property but contacted parties he thought might be interested. The taxpayer contended that he had not entered the real estate business; but the Court of Appeals upheld the Commissioner's contention that the taxpayer went into business through his agent, basing its finding upon the degree of control retained by the taxpayer.

The decision seems to represent an extreme application of section 1221(1)[8] of the Internal Revenue Code of 1954 and the type of holding of which Congress disapproved in enacting section 1237 of the 1954 Code.

In *Ehrman v. Commissioner*,[9] decided in 1941, the Court of Appeals for the Ninth Circuit found that the taxpayers were in the real estate business and that the gain was ordinary. Here, the taxpayers, heirs to the land, had sold the tract as a whole but bought it back at a trustee's sale. They continued the subsidivision started by the mortgagor-buyer, sold a number of lots, and reported the gain as long-term capital gain. Their contention that the purpose of continuing the subdivision and sale of lots was to liquidate a capital asset was not considered controlling.[10] The court said, "The sole question is were the taxpayers in the business of subdividing real estate?"[11] This case represents the extreme positions sometimes taken by the Ninth Circuit.[12]

The extremity of the holding in the principal case can be pointed up readily and effectively by comparing the facts and holding with those of similar cases in other circuits. The courts are guided by several factors in determining whether a sale of real estate is the sale of a capital asset or of property held for sale to customers in the ordinary course of trade or business.[13] These are judicially approved guides to be taken into account, although no single test is determinative of the question. The factors are as follows: (1) the intent of the taxpayer; (2) history and use of the property involved; (3) the purpose of the

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[8]Int. Rev. Code of 1939, § 117(a)(1)(A).

[9]120 F.2d 607 (9th Cir. 1941).

[10]The Ninth Circuit has been consistent in considering the intent of liquidation of a capital asset as not controlling. See Pool v. Commissioner, 251 F.2d 233, 236 (9th Cir. 1957).

[11]120 F.2d at 610.

[12]See note 15 infra.

[13]Williamson v. Commissioner, 201 F.2d 564 (4th Cir. 1953); Friend v. Commissioner, 198 F.2d 285 (10th Cir. 1952); Mauldin v. Commissioner, 195 F.2d 714 (10th Cir. 1952); Dunlap v. Oldham Lumber Co., 178 F.2d 781 (5th Cir. 1950); Reis v. Commissioner, 142 F.2d 900 (6th Cir. 1944); Greene v. Commissioner, 141 F.2d 645 (5th Cir. 1944); W. T. Thrift, Sr., 15 T.C. 366 (1950). See also Grogan, Capital Gains v. Ordinary Income, 30 Taxes 574, 585 (1952).

acquisition, holding, and disposition of the property; (4) the lapse of time between the acquisition and sale; (5) the general conduct of the operation: the number, frequency, and continuity of transactions; the extent or substantiality of the transactions; and (6) the activities of the taxpayer or those acting for him in promoting sales, such as (a) making improvements to real property or (b) advertising the property to attract purchasers.[14]

The application of these factors has resulted in such diversity of holdings in the different circuits as to amount to conflict.[15] Several circuits have retained some of the dictionary meaning of the words found in section 1221(1) of the 1954 Code, while the Ninth seems to have given the words a peculiar meaning.[16] The following comparison of the facts and holdings in three different circuits when the same question is involved will show that the present case is an extreme holding. The two cases chosen to be compared with *Achong* are *Smith v. Dunn*,[17] decided in the Fifth Circuit, and *Three States Lumber Co. v. Commissioner*,[18] decided in the Seventh Circuit. The order of the facts in the present case and in those chosen for comparison and the tests set forth in the preceding paragraph have been placed in parallel. The tests and the parallel facts in each case are preceded by the same number or letter. The reader can thereby readily determine by cross reference and comparison of the facts and tests the soundness of the contention that the Ninth Circuit holding in the *Achong* case is extreme.

Achong v. Commissioner. (1) The avowed intention of the taxpayer was liquidation of a capital asset. (2) He acquired the land through a homestead agreement and he lived on the land and rented it for farming. (3) He acquired the land for his residential and farming purposes. (4) He lived on the land prior to acquiring it and, since acquiring it, has held it for twenty-three years. (5) The taxpayer had

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[14]See note 13 supra.

[15]Compare Ehrman v. Commissioner, 120 F.2d 607 (9th Cir. 1941), with Dillon v. Commissioner, 213 F.2d 218 (8th Cir. 1954); Home Co. v. Commissioner, 212 F.2d 637 (10th Cir. 1954); Dunlap v. Oldham Lumber Co., 178 F.2d 781 (5th Cir. 1950); Fahs v. Crawford, 161 F.2d 315 (5th Cir. 1947); Guthrie v. Jones, 72 F. Supp. 784 (W.D. Okla. 1947); Sparks v. United States, 55 F. Supp. 941 (M.D. Ga. 1944); W. T. Thrift, Sr., 15 T.C. 366 (1950); Thompson Lumber Co., 43 B.T.A. 726 (1941). Also compare Curtis Co. v. Commissioner, 232 F.2d 167 (3d Cir. 1957); Chandler v. United States, 226 F.2d 403 (7th Cir. 1955); and Dillon v. Commissioner, 213 F.2d 218 (8th Cir. 1954), with Rollingwood Corp. v. Commissioner, 190 F.2d 263 (9th Cir. 1951), and with McGah v. Commissioner, 210 F.2d 769 (9th Cir. 1954).

[16]See note 15 supra.

[17]224 F.2d 353 (5th Cir. 1955).

[18]158 F.2d 61 (7th Cir. 1946).

never previously sold any lots or held any other property for sale, and the extent of the sales was the selling of most of the 11.5 acres over a two-year period. (6) The taxpayer was a full-time cashier in a meat market during all the time he held the land, but he hired an agent to sell the land and maintained control over the actions of the real estate agent in relation to the subdivision in several important aspects. It appears that (a) the sales were made by representing that improvements would be constructed and that (b) there was no advertising by either the taxpayer or his agent. In holding against the taxpayer, the activity of the agent was imputed to the taxpayer and the avowed intent of liquidation was given no weight.

Smith v. Dunn. (1) The taxpayers' avowed intent was liquidation of a capital asset. (2) He inherited the land and made no use of it. (3) He had no purpose of acquisition. (4) He held the land fifty years. (5) There were fifty-one lots sold in two years, but there had been no previous selling activity by the taxpayer. (6) The taxpayer was a full-time architect and hired an agent to subdivide and sell the lots. He had the right of control over his agent but did not exercise it. As to the activities of the taxpayer: (a) the improvements on the tract amounted to $32,000, a sum nearly equal to the taxpayer's basis in the land, and (b) the agent carried on a continuous advertising campaign. The court held that this taxpayer sold a capital asset and allowed him to treat his income as long-term capital gain. The contentions of the taxpayer that his intent was to liquidate and that the agent was an independent contractor[19] weighed heavily in his favor.[20]

Three States Lumber Co. v. Commissioner. (1) The taxpayer's intent in subdividing and selling was liquidation of an asset. (2) The taxpayer had bought large areas of land for the timber thereon. (3) He cut the timber and sawed it into lumber. (4) He last bought land in 1914; in 1922 he started selling the land and he continued until 1935. (5) He sold tracts ranging from ten acres to 3,200 acres in size over a period of thirteen years. (6) The taxpayer hired one employee who worked full-time until 1929 and half-time thereafter in selling lots. To

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[19]In Pool v. Commissioner, 251 F.2d 233, 237 (9th Cir. 1957), the Court of Appeals for the Ninth Circuit cites Snell v. Commissioner, 97 F.2d 891, 892 (5th Cir. 1938), a Fifth Circuit decision, to support the contention that one may go into the real estate business through an agent. Considering the liberality shown by the Fifth Circuit to taxpayers and the conservatism shown by the Ninth, this situation at first glance seems ironical. But when one reads the Snell case, he finds an overwhelming case against the taxpayer. The extent of the activities of the taxpayer in the Snell case was much greater than that of the taxpayer in the Achong case. The decision against the taxpayer in Snell is readily accepted as just. See Three States Lumber Co. v. Commissioner, 158 F.2d 61, 64 (7th Cir. 1946).

[20]See 224 F.2d at 357.

assist this man he employed a bookkeeper-stenographer and another man who spent his time in the office on the property, showing the land at times to prospective purchasers. The taxpayer (a) surveyed tracts when necessary in connection with sales and frequently loaned money for purchase of equipment and planting of crops to people with whom he had contracted to sell or lease land, and (b) he ran some newspaper advertising in 1923 and placed some posters on the land itself. The court, in holding that the taxpayer had sold a capital asset, said the facts were consistent only with a desire to liquidate a capital asset.[21]

Under section 1237 of the 1954 Code it would seem that the taxpayer's gain in the *Achong* case on the sale of lots would be long-term capital gain. The provisions of section 1237 can be summarized and their applicability to the facts in the instant case stated as follows:[22]

1. A taxpayer will not be deemed to have gone into the real estate business merely because he subdivides and sells lots from a tract of land if the tract has been held for five years or was acquired by inheritance or devise; and he can treat the gain from the first five lots wholly as capital gain, if: (a) the lots or tract had not been previously held for sale to customers or if the taxpayer, in the year in question, holds no other real estate for sale to customers; (b) no substantial improvement has been made by the taxpayer while he has held the real estate or is made pursuant to a contract of sale between the buyer and taxpaper.

In the year the sixth and subsequent lots are sold 95 per cent of the gain is treated as capital gain (unless five years elapses between the sale of the fifth lot and the sixth), but 5 per cent is treated as ordinary income. The 5 per cent is an amount comparable to a broker's fee and is presumably the amount realized from selling activity. Expenses of selling are to be deducted first from the 5 per cent ordinary gain and then from the capital gain.[23]

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[21]It is noticeable from this comparison that in every instance but one the parallel facts are more adverse to the position of the taxpayers in the Fifth and Ninth Circuits. This exception is that the taxpayer in the present case did control the activities of his agent more than the taxpayer did in the Fifth Circuit case. But it should not be overlooked that the taxpayer in the Seventh Circuit case hired employees for the specific job of selling lots and he had complete control over their activities. Furthermore, as will be pointed out, under § 1237 this fact of control is of consequence no longer.

[22]Int. Rev. Code of 1954, § 1237; Alexander, Federal Taxation § 1315 (21st ed. 1957); Comment, 29 So. Calif. L. Rev. 116, 121 (1955).

[23]The result is that if the taxpayer does his own selling the 5% is ordinary income realized from the selling activity, and if he has a broker sell the lots the 5% goes to pay his fees and the 95% is all gain as it would have been under the old law. Comment, 29 So. Calif. L. Rev. 116, 123 (1955).

2. The section further provides that no improvement shall be deemed a substantial improvement if the lot or parcel is held by the taxpayer for a period of ten years and if: (a) such improvement is the building or installation of water, sewer, or drainage facilities or roads; (b) such improvement is satisfactorily shown to have been necessary to make the lot marketable at prevailing local prices for similar building sites; and (c) the taxpayer elects to make no adjustment to the basis of the lot or parcel, or of any other property owned by the taxpayer, on account of expenditures for such improvement.

The limitations upon improvements in section 1237 and in the case law are to prevent a taxpayer from realizing capital gain treatment on profits resulting from substantial investment in improvements on a tract or lot. It would seem that even unimproved lots are denied the benefit of favorable tax treatment if the improvement on an adjacent lot is so substantial as to raise the value of the adjoining unimproved lots.[24]

The court in the *Achong* case noted but gave little consideration to the nature of the improvements which the taxpayer represented would be made.[25] These improvements were not made while the taxpayer held the lots and were not made pursuant to a contract of sale.[26] The taxpayer had held the property for more than ten years and under the 1954 Code could have made substantial improvements and still not have been considered in the real estate business, if he could show that the improvements were the type enumerated in section 1237, if they were needed to make the lots marketable at prevailing prices, and if he did not elect to adjust the basis in this or other property. There seems to be little doubt that under section 1237 this taxpayer would have been able to control the activities of his agent and to make substantial improvements and still be able to treat his gain as long-term capital gain.

The Committee on Finance, referring to section 1237, stated: "It is a new section which permits an individual who is not otherwise a real estate dealer (as the result of his engaging in the business of selling other real property to customers) to dispose of a tract of real property, held for investment purposes, by sub-dividing it without necessarily being treated as a real estate dealer with respect to all of his long term

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[24]S. Rep. No. 1622, 83d Cong., 2d Sess. 441, 442 (1954). However, ,a substantial improvement of a portion of a tract may be made which does not substantially increase the value of the remainder of the lots in the tract, although it may enhance their salability, such as would probably be the case where the taxpayer simply erects his personal residence on one of the lots in the tract.

[25]246 F.2d at 446.

[26]Ibid.