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CAPITAL GAINS FOR REAL ESTATE OPERATORS

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The current rising market in real estate, coupled with the present high rates of income taxation, places a premium upon the realization of capital gain when real property is sold. Without the assurance that the sale or exchange of property will result in long-term capital gain, many landowners choose to forego a sale in preference to the often disastrous effects of paying tax on the gain at ordinary income rates. The Commissioner of Internal Revenue,[1] in his enforcement of the revenue laws, has been hard put to distinguish between the bona fide investor in real estate and the "fast buck" artist seeking a quick turnover at capital gains rates. The Commissioner's attempts to draw a line which would conserve the revenue have resulted in his application of two rules to the effect that (1) an individual who engages in real estate operations to even a moderate degree is, per se, a "dealer" in real estate, and (2) a "dealer" is not entitled to realize capital gain on the sale of land.

It is an economic postulate that capital gains are the principal return for risk taking and that risk taking is of greatest strategic importance to a dynamic economy.[2] It follows therefore that a policy of taxation which discourages the taking of capital gains has an adverse effect upon the economy and, by limiting profit taking, on the revenue as well. The uncertainty which surrounds the tax consequences of a land sale[3] has dissuaded many otherwise willing sellers from parting with their property and, as a direct result, has deprived the Treasury of substantial revenues.

As is usually the case in taxation, the principal problems arise not at the extreme ends of the transaction spectrum but in the penumbral twilight between. It is clear that an individual who under-

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[1]"In most cases, a euphemistic term employed to describe a functionary in the field, or a coterie of them, struggling for advancement by producing income for the exchequer." Cameron, J., in Brinson v. Tomlinson, 264 F.2d 30, 37 (5th Cir. 1959).

[2]GROVES, FINANCING GOVERNMENT 181 (1945).

[3]This uncertainty is compounded by the Commissioner's reluctance to issue advance rulings in this area.

takes a casual sale of his residence is engaging in a capital transaction, while a person engaged in the business of subdividing, developing, and promoting the sale of land should realize ordinary income or loss on its sale. But what of the householder who subdivides and sells surplus land acquired when he bought his home? Is a dealer in real estate, unlike a dealer in securities, precluded from realizing capital gain on the sale of land? When, for that matter, does a person become a "dealer"? It is to these and other related questions that this article will address itself.

THE DEALER CONCEPT

The concept of a dealer in real estate is one that has evolved from case law[4] and the Commissioner's search for a rule of thumb. It finds only oblique support in the statutes themselves. The principal statutes controlling the realization of capital gain on the sale of real estate are section 1221, which defines a "capital asset," and section 1231, which provides that real estate used in a taxpayer's trade or business may produce either capital gain or ordinary loss when sold. Both of these sections contain provisions which deny capital gain treatment to "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." The language of both of these statutes places fundamental emphasis on the property itself and the manner and purpose for which it is held. The dealer concept, on the other hand, tends to focus principal attention on the owner of the property and his business activities.

For practical purposes, therefore, a dealer may be defined as a person[5] who holds property primarily for sale to customers in the ordinary course of his trade or business.[6] The Internal Revenue Service has uniformly applied the rule that a dealer in real estate is presumed to hold all of his real property as inventory or stock in trade and cannot, therefore, realize capital gain on its sale. The

[4]Boomhower v. United States, 74 F. Supp. 997 (D.C. Iowa 1947); D. G. Bradley, 26 T.C. 970 (1956), *acq.*, 1957-1 CUM. BULL. 5; D. L. Phillips, 24 T.C. 435 (1955); Walter R. Crabtree, 20 T.C. 841 (1953), *acq.*, 1954-1 CUM. BULL. 4; Nelson A. Farry, 13 T.C. 8 (1949).

[5]A corporation, an estate, or a trust may also be a dealer.

[6]It is well established that persons engaged in other businesses and professions may also be dealers in real estate. Gilford v. Commissioner, 201 F.2d 735 (2d Cir. 1953); Harvey v. Commissioner, 171 F.2d 952 (9th Cir. 1949); Reynolds v. Commissioner, 155 F.2d 620 (1st Cir. 1946); A. L. Carter Co. v. Commissioner, 143 F.2d 296 (5th Cir. 1944); Fackler v. Commissioner, 133 F.2d 509 (6th Cir. 1943).

cases indicate that this presumption can be rebutted with relative ease in a situation involving income-producing property such as an apartment or office building, but when unimproved land is in issue the presumption cannot be so easily overcome. The practical result is that, at the revenue agent level at least, an established dealer in real estate is almost invariably denied capital gains treatment on the sale of unimproved land.

The simple answer to the entire rationale of the dealer concept is that it is contrary to the language of the statute. Whether land constitutes a capital asset in the hands of a given taxpayer depends not on *who* owns the land but on *how* it is held. Land is either held for investment and is a capital asset or it is held for sale to customers in the ordinary course of a taxpayer's trade or business. It is unimportant to what extent the taxpayer may have been in the real estate business; the sole question is whether the property from which the gain was derived was within the statutory definition of a capital asset.[7]

DEALER OR INVESTOR?

Since 1951 the Internal Revenue Code has permitted dealers in securities to earmark certain of their securities as property held for investment and thus derive capital gain upon its subsequent sale.[8] This may be done by clearly identifying the securities on the dealer's records as property held for investment and never thereafter holding them for sale to customers in the ordinary course of trade or business.[9]

Although the law does not contain a similar provision with regard to real estate dealers, it is recognized that a dealer in land may also hold real estate for investment and treat gain on its sale as capital gain. While this basic proposition has been accepted by the courts[10]

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[7]Rubino v. Commissioner, 186 F.2d 304 (9th Cir. 1951), *affirming* 8 CCH Tax Ct. Mem. 1095 (1949), *cert. denied,* 342 U.S. 814 (1951).

[8]INT. REV. CODE OF 1954, §1236.

[9]The regulations require an accounting separation of investment securities from other securities. This is satisfied by an entry on the books of account identifying the security and distinguishing it from inventory securities. Treas. Reg. §1.1236-1.

[10]Lobello v. Dunlap, 210 F.2d 465 (5th Cir. 1954); Hardin v. Tomlinson, 59-1 U.S. Tax Cas. ¶9320 (D.C. Fla. 1958); Ryman v. Tomlinson, 56-2 U.S. Tax Cas. §9741 (D.C. Fla. 1956); Ryman v. Tomlinson, 56-1 U.S. Tax Cas. ¶9519 (D.C. Fla. 1956); D. G. Bradley, 26 T.C. 970 (1956), *acq.,* 1957-1 CUM. BULL. 5; Walter R. Crabtree, 20 T.C. 841 (1953), *acq.,* 1954-1 CUM. BULL. 4; Nelson A. Farry, 13 T.C. 8 (1949).

and the Commissioner,[11] neither has suggested a clear-cut method by means of which capital gains will be guaranteed. Until such a procedure is written into the Code and real estate dealers are placed on the same footing with dealers in securities, no certainty can exist in this area. There are, however, many well-defined guide posts which will point the way as the facts of a given situation direct. The courts, in determining whether property is held primarily for investment or for sale, apply a number of objective tests. Generally grouped, these are (1) type of property, (2) method and purpose of acquisition, (3) activities while holding the property, (4) activities in selling the property, (5) reasons for selling the property, (6) frequency and continuity of sales.

Historically, the Tax Court has given the most weight to frequency and continuity of sales in its approach to the problem. This emphasis has perhaps been the leading factor in fostering the dealer concept, because it places first importance on the owner's other activities in the real estate field. The courts of appeals and the district courts, on the other hand, have taken the view that if the property was originally acquired for investment and circumstances changed so as to make the sale of the property "involuntary" or in the nature of a liquidation, the frequency and continuity test should not be applied to transform investment property into property held primarily for sale.

This difference in approach is well illustrated in the course taken by a case involving the sale of fourteen houses originally built as rental property. The Tax Court, apparently relying on the continuity and frequency test, held that at the time of sale the houses were held primarily for sale to customers, regardless of the purpose for which they had originally been built.[12] The Court of Appeals for the Ninth Circuit reversed and remanded, with the direction that the Tax Court make findings as to whether the property was held primarily for sale to customers prior to its sale and if so for how long.[13] The Tax Court concluded, on remand, that the property had been so held for some time.[14] The Circuit Court again reversed upon grounds that the Tax Court's conclusion was not supported by the evidence and that the houses had not been sold voluntarily

[11]Rev. Rul. 57-565, 1957-2 CUM. BULL. 546.

[12]Lucille McGah, 15 T.C. 69 (1950).

[13]McGah v. Commissioner, 193 F.2d 662 (9th Cir. 1952).

[14]Lucille McGah, 17 T.C. 1458 (1952).

but had been disposed of because a creditor was demanding payment.[15]

In analyzing the cases which pass upon a landowner's right to return his profit as capital gain, it is interesting to note the court in which the litigation took place and to speculate as to its influence on the final result. An analysis of the cases indicates that here, as in few other areas in tax law, the choice of a forum for litigation is of critical importance.

Type of Property

In establishing that real estate is held for investment, the nature of the property itself is often determinative of the purpose for which it is held. The classic definition of an investment contemplates the realization of income or profit. It follows, therefore, that improved income-producing property is more readily associated with an investment purpose than property which produces no income and upon which the realization of profit will be postponed until some time in the future.

The courts have had little trouble holding that apartment buildings,[16] rental housing,[17] and hotels[18] are held for investment and are entitled to capital gain treatment upon sale. In the case of smaller dwelling units, however, the fact that they were originally constructed as income property has often been overriden by too large a volume of sales, resulting in the gain from their disposition being treated as ordinary income.[19]

The fact that real estate was held in good faith as rental property seems to be one of the touchstones which produces capital gain. In situations in which a taxpayer has been engaged in several facets

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[15]McGah v. Commissioner, 210 F.2d 769 (9th Cir. 1954).

[16]Jones v. Commissioner, 209 F.2d 415 (9th Cir. 1954); Cole v. United States, 141 F. Supp. 558 (D.C. Wyo. 1956); Peter A. Miller, 20 B.T.A. 230 (1930), *acq.*, X-1 CUM. BULL. 44 (1931).

[17]Delsing v. United States, 186 F.2d 59 (5th Cir. 1951); King v. Phinney, 58-1 U.S. Tax Cas. ¶9486 (D.C. Tex. 1958); King v. Jackson, 56-2 U.S. Tax Cas. ¶9881 (D.C. Tex. 1956); Carl E. Metz, 14 CCH Tax Ct. Mem. 1166 (1955).

[18]Clark v. United States, 143 F. Supp. 165 (D.C. Cal. 1956); Harry Simberg, 13 CCH Tax Ct. Mem. 477 (1954).

[19]Anderson v. Commissioner, 250 F.2d 242 (5th Cir. 1957), *cert. denied*, 356 U.S. 950 (1958); Pacific Homes, Inc. v. United States, 230 F.2d 755 (9th Cir. 1956); Cohn v. Commissioner, 226 F.2d 22 (9th Cir. 1955); Galena Oaks Corp. v. Commissioner, 218 F.2d 217 (5th Cir. 1954); Palm Homes, Inc., 11 CCH Tax Ct. Mem. 28 (1952); Cletus H. J. Jollie, 10 CCH Tax Ct. Mem. 985 (1951).

of the real estate business and has sold both productive and nonproductive properties, the Tax Court has held that he is an investor as to the income-producing property but that the nonincome-producing property was held primarily for sale to customers in the ordinary course of his real estate business.[20] Likewise, a corporation which disposed of its units of defense housing was allowed capital gain on the houses which had been rented but was held to realize ordinary income on those which had not.[21]

In the case of unimproved, vacant land, the larger the tract held the greater the likelihood that capital gain will be realized. This is true even though a number of sales may be required to dispose of the entire tract.[22] As the tract becomes smaller, the size of the unit sold becomes more important. Acreage sold by government survey description or by metes and bounds is usually permitted capital gains treatment provided the volume of sales is not too great.[23] When lots have been subdivided and platted prior to their acquisition, the occasional sale of a lot or two does not preclude the realization of capital gain, although in this area frequency and volume of sales become critical.[24]

Method and Purpose of Acquisition

Although the method and purpose of acquiring a particular piece of realty may not in any way be conclusive as to how it was later held, the courts have frequently examined the circumstances of a taxpayer's acquisition of property in search of clues. If, for example, a taxpayer bestirred himself to considerable effort in order to become the owner of a property, it would appear that this factor would tend to reduce his chances of being allowed capital gain on its sale. Conversely, if the property was thrust upon the taxpayer and he accepted it reluctantly, he is less likely to be adjudged as holding

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[20]D. G. Bradley, 26 T.C. 970 (1956), *acq.*, 1957-1 CUM. BULL. 3; D. L. Phillips, 24 T.C. 435 (1955), *acq.*, 1956-1 CUM. BULL. 5. *But cf.* Carl E. Metz, *supra* note 17.

[21]Elgin Building Corp., 8 CCH Tax Ct. Mem. 114 (1949).

[22]Alabama Mineral Land Co. v. Commissioner, 250 F.2d 870 (5th Cir. 1957); Consolidated Naval Stores Co. v. Fahs, 227 F.2d 923 (5th Cir. 1955); Chandler v. United States, 226 F.2d 403 (7th Cir. 1955); Goldstein v. United States, 59-1 U.S. Tax Cas. ¶9365 (D.C. Wash. 1958).

[23]Houston Deepwater Land Co. v. Scofield, 110 F. Supp. 394 (D.C. Tex. 1952); W. B. Malouf, 14 CCH Tax Ct. Mem. 746 (1955); *cf.* Lewis Culley, 29 T.C. 1076 (1958), *acq.*, 1958-2 CUM. BULL. 4.

[24]South Texas Properties Co., 16 T.C. 1003 (1951), *acq.*, 1951-2 CUM. BULL. 4.

it primarily for sale to customers in the ordinary course of business. While this rationale may not be completely logical — for example, why should a person hold property for investment when he was not anxious to acquire it in the first place? — it would seem to be an accurate distillation of the cases.

When lawyers purchased vacant lots at tax sales and later cleared titles and removed liens, their subsequent disposition of the property was held to result in ordinary income.[25] On the other hand, when a bank was forced to foreclose on real estate pledged as security for a loan,[26] or when building materials companies were required to take over property to minimize a loss on accounts receivable,[27] the courts ruled that the property had not been held primarily for sale to customers. Generally, the foreclosure and sale of real estate will result in capital gain.[28] Similarly, real estate received by shareholders when a corporation is liquidated is usually held to result in capital gain or loss when sold,[29] as does property received as a gift[30] or by inheritance.[31]

A somewhat novel approach was made in a recent case decided by the Court of Appeals for the Fifth Circuit. The taxpayer, who was a real estate broker, together with others, put together a block of phosphate-bearing land large enough to interest one of the major phosphate companies. The blocking together of the land took place over a three-year period and was the taxpayer's first attempt at that

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[25]J. M. Philbin, 26 T.C. 1159 (1956); Vincent Johnson, 14 CCH Tax Ct. Mem. 981 (1955).

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

[27]Scarsdale Supply Co. v. United States, 42-1 U.S. Tax Cas. ¶9290 (D.C.N.Y. 1942); Thompson Lumber Co., 43 B.T.A. 726 (1941); Thompson Yards, Inc., 1 CCH Tax Ct. Mem. 822 (1943).

[28]Alabama Mineral Land Co. v. Commissioner, 250 F.2d 870 (5th Cir. 1957); Guthrie v. Jones, 72 F. Supp. 784 (D.C. Okla. 1947); Nathan Schwartz, 10 CCH Tax Ct. Mem. 400 (1951). *But cf.* White v. Commissioner, 172 F.2d 629 (5th Cir. 1949); Louis E. Whitham, 10 CCH Tax Ct. Mem. 250 (1951).

[29]Powers v. United States, 58-2 U.S. Tax Cas. ¶9597 (D.C. Ill. 1958); King v. Jackson, 56-2 U.S. Tax Cas. ¶9881 (D.C. Tex. 1956); Rylander v. United States, 56-2 U.S. Tax Cas. ¶9863 (D.C. Cal. 1956).

[30]Sparks v. United States, 55 F. Supp. 941 (D.C. Ga. 1944); Allen Moore, 30 T.C. 1306 (1958), *acq.*, 1959 INT. REV. BULL. No. 12, at 8.

[31]Smith v. Dunn, 224 F.2d 353 (5th Cir. 1955); Beck v. Commissioner, 179 F.2d 688 (7th Cir. 1950); Scott v. McCrory, 162 F. Supp. 535 (D.C. Neb. 1957); Potter v. United States, 162 F. Supp. 591 (D.C. Ga. 1957); Green v. United States, 56-1 U.S. Tax Cas. ¶9537 (D.C. Colo. 1956); John Randolph Hopkins, 15 T.C. 160 (1950); Estate of Mackall, 3 CCH Tax Ct. Mem. 701 (1944).

type of land transaction. After some negotiation, the entire tract was sold and the gain was reported as capital gain. The Tax Court agreed with the Commissioner that the land had been acquired and held primarily for sale to customers in the ordinary course of trade or business.[32] The Court of Appeals reversed, holding that the acquisition and sale was a nonrecurring transaction and, though the property was obviously held primarily for sale, it was not in the ordinary course of trade or business, since a single transaction, not expected to occur again, could not be considered a business.[33]

Activities While Holding the Property

A landowner who desires to avoid the risk of having his holdings classified as held primarily for sale to customers in the course of business would be well advised to limit his activities to a minimum with respect to the property. The best approach in this regard is the absolutely passive holding of the land without improvement or activity. This, however, is often not practical if the best use of a given piece of land is to be achieved. It may become necessary to provide access roads to the property, drainage, irrigation, or other facilities. In some cases the platting of roads and public areas is required by governmental authority.

By far the most significant activity which can be pursued with regard to raw land is that of breaking it up into uniform small tracts in the nature of lots. This is usually done by subdividing and recording a plat which lays out streets, parks, and public, commercial, and residential areas. Subdivision of a tract is regarded by most courts, in the absence of other compelling factors, as significant of an intent to merchandise the property. The Internal Revenue Service goes even further and treats subdivision activity as conclusive evidence that the land is held primarily for sale as stock in trade. The Commissioner has ruled, however, that if land which is a capital asset in a taxpayer's hands is subdivided in part, sale of the unsubdivided portion may be treated as the sale of a capital asset.[34]

A relief provision granting capital gains on subdivided land made its appearance in the Internal Revenue Code of 1954, but it is of limited benefit to the average real estate investor and does not apply

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[32]Robert Thomas, 28 T.C. 1 (1957).
[33]Thomas v. Commissioner, 254 F.2d 233 (5th Cir. 1958).
[34]Rev. Rul. 57-565, 1957-2 CUM. BULL. 546.

at all to dealers or corporations which have a dealer as a stockholder.[35]

In the absence of other factors which might be controlling, the Tax Court requires a taxpayer to hold the land more or less inactively in order to qualify as an investor.[36] It has allowed a trust capital gain on the sale of sixteen lots and an eighty-acre tract when the land had been passively held without being improved, advertised for sale, or listed with brokers,[37] but denied such treatment in the case of a farm which had been inherited and held for thirty years before being subdivided and sold off in lots.[38]

When circumstances have dictated a change in the use of land the Tax Court appears to be less inclined to permit subdividing as part of a plan to facilitate disposition of the land. For example, when a taxpayer who owned mined-out sand and gravel land platted and improved it to make it more salable and then sold it for building sites, the Tax Court ruled that it had been held for sale to customers in the ordinary course of trade or business.[39] Other land owned by the same taxpayer but outside the platted area was held to be a capital asset.[40]

In this connection, the Tax Court's approach seems to be a bit more rigid than that of the district courts and courts of appeals. The district courts, sitting with or without juries, are more willing to permit subdivision of land without loss of its status as a capital asset.[41] This was done when a taxpayer, after selling off part of his farm to local governmental agencies, found it impractical to continue his farming operation and subdivided and sold the land.[42] A similar result obtained when the owners of farm property hired a broker to subdivide and sell the land,[43] and again when a doctor bought a

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35 INT. REV. CODE OF 1954, §1237. For a discussion of this provision see Emmanuel, *Tax Problems in Real Estate Transactions,* 8 U. FLA. L. REV. 411, 415 (1955).

36 W. T. Thrift, Sr., 15 T.C. 366 (1950).

37 Helen Jane Martina Schwerin Trust, 13 CCH Tax Ct. Mem. 202 (1954).

38 Alfred J. Riedel, 16 CCH Tax Ct. Mem. 946 (1957).

39 Charles E. Reithmeyer, 26 T.C. 804 (1956), *acq.,* 1956-2 CUM. BULL. 8.

40 *Ibid.*

41 Scott v. McCrory, 162 F. Supp. 535 (D.C. Neb. 1957); Mackall v. United States, 162 F. Supp. 522 (D.C. Va. 1957); Potter v. United States, 162 F. Supp. 591 (D.C. Ga. 1957); Martin v. United States, 56-2 U.S. Tax Cas. ¶10,074 (D.C. Tex. 1956); Green v. United States, 56-1 U.S. Tax Cas. ¶9537 (D.C. Colo. 1956).

42 Green v. United States, 56-1 U.S. Tax Cas. ¶9538 (D.C. Colo. 1956).

43 Schuhmacher v. United States, 59-1 U.S. Tax Cas. ¶9408 (D.C. Tex. 1958).

160-acre farm intending to go into the dairy business, changed his mind, subdivided, and sold out.[44]

When it can be convincingly shown that improvements are necessary to make the land valuable as an investment,[45] or that subdividing is a prerequisite to liquidating a land investment which has been held for a considerable length of time,[46] the district and circuit courts smile on the capital gains treatment of sales proceeds. The reverse is usually the case in the Tax Court.[47]

Activities in Selling the Property

In determining if an owner is actively pushing the sale of his real estate, an analysis of his sales activities is of first importance. The usual methods of promoting the sale of real property are the posting of "for sale" signs, listing with brokers, advertising, maintaining a sales office, and employing sales agents. Any one or a combination of these methods may be indicative of the fact that the owner is holding the property primarily for sale so as to negate its treatment as a capital asset.[48] The owner is not relieved of the onus of sales activity by relying entirely on agents, since the acts of the agent are usually imputable to the owner of the property.[49]

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[44]Berberovich v. Menninger, 147 F. Supp. 890 (D.C. Mich. 1957); *accord*, White v. Scofield, 56-2 U.S. Tax Cas. ¶9703 (D.C. Tex. 1956); Nelson v. Tomlinson, 54-1 U.S. Tax Cas. ¶9336 (D.C. Fla. 1954).

[45]Fahs v. Crawford, 161 F.2d 315 (5th Cir. 1947).

[46]Yunker v. Commissioner, 256 F.2d 130 (6th Cir. 1958); Smith v. Dunn, 224 F.2d 353 (5th Cir. 1955); Sage v. United States, 58-2 U.S. Tax Cas. ¶9659 (D.C. Fla. 1958); Mackall v. United States, 162 F. Supp. 522 (D.C. Va. 1957); Potter v. United States, 162 F. Supp. 591 (D.C. Ga. 1957); Scott v. McCrory, 162 F. Supp. 535 (D.C. Neb. 1957); Martin v. United States, 56-2 U.S. Tax Cas. ¶10,074 (D.C. Tex. 1956); Green v. United States, 56-1 U.S. Tax Cas. ¶9537 (D.C. Colo. 1956); Hebenstreit v. United States, 55-2 U.S. Tax Cas. ¶9571 (D.C.N.M. 1955); Collin v. United States, 57 F. Supp. 217 (D.C. Ohio 1944).

[47]Walter G. Morley, 8 T.C. 904 (1947), *acq.*, 1947-2 CUM. BULL. 3; Julius Goodman, 40 B.T.A. 22 (1939), *acq.*, 1942-1 CUM. BULL. 8; R. G. Elbert, 16 CCH Tax Ct. Mem. 449 (1957); Factoria Land Co., 6 CCH Tax Ct. Mem. 234 (1947). *But cf.* Wellesley A. Ayling, 32 T.C. ____ No. 59, in which the taxpayers subdivided land adjoining their residence to protect the value of their home property and realized capital gain on its subsequent sale.

[48]Oliver v. Commissioner, 138 F.2d 910 (4th Cir. 1943) (signs); Snell v. Commissioner, 97 F.2d 891 (5th Cir. 1938) (agents); Richards v. Commissioner, 81 F.2d 369 (9th Cir. 1936) (minimum price list).

[49]Brown v. Commissioner, 143 F.2d 468 (5th Cir. 1944); Fowler v. United States, 154 F. Supp. 859 (D.C. Ohio 1957); Cosby v. Phinney, 57-2 U.S. Tax Cas.

In cases in which there has been no sales activity, its absence becomes a negative factor, the effectiveness of which is hard to evaluate. Sometimes it can cancel out the ill effects of a large number of sales transactions, as was the case when a district court held a taxpayer entitled to capital gains on profits from continuing periodic sales of real estate held for more than twenty years, during which time he employed no salesmen, posted no "for sale" signs, engaged in no advertising or sales program, made no improvements, and added no new land.[50] In another case in which the taxpayers sold twenty-five lots in one year principally through the unsolicited activities of their friends, without erecting signs, advertising, or listing the property, the Tax Court was impressed by the almost complete absence of sales activity and held the profit taxable as capital gain.[51]

Reasons for Selling the Property

In trying to establish, ex post facto, whether property was held with investment intent or otherwise, the courts have delved deeply into the taxpayer's motives for selling the property and the pressures to which he was subjected which resulted in its disposition. An analysis of the cases which hinge on this point leaves little doubt that the magic word is "liquidation." The liquidation may be for probate purposes or to dispose of a very large tract of land. It may be due to a change in circumstances, in order to reinvest in another type of property, as a prelude to the dissolution of a corporation or because of the pressure of creditors.

It is generally true that sales made for the purpose of liquidating real estate held by an estate[52] or acquired by gift[53] or inheritance[54]

¶9814 (D.C. Tex. 1957). *But cf.* Martin v. United States, 230 F.2d 106 (7th Cir. 1956).

[50]Austin v. United States, 116 F. Supp. 283 (D.C. Tex. 1953); *accord,* James G. Hoover, 32 T.C. ——, No. 55 (1959); Thomas E. Wood, 16 T.C. 213 (1951).

[51]Frieda E. J. Farley, 7 T.C. 198 (1946), *acq.,* 1946-2 CUM. BULL. 2.

[52]McConkey v. United States, 130 F. Supp. 621 (Ct. Cl. 1955); Garrett v. United States, 120 F. Supp. 193 (Ct. Cl. 1954); Daniel W. Ellis, 13 CCH Tax Ct. Mem. 15 (1954); Estate of W. D. Haden, 12 CCH Tax Ct. Mem. 825 (1953).

[53]Sparks v. United States, 55 F. Supp. 941 (D.C. Ga. 1944); Allen Moore, 30 T.C. 1306 (1958), *acq.,* 1959 INT. REV. BULL. No. 12, at 8. *But cf.* Bistline v. United States, 260 F.2d 77 (9th Cir. 1958).

[54]Yunker v. Commissioner, 256 F.2d 130 (6th Cir. 1958); Smith v. Dunn, 224 F.2d 353 (5th Cir. 1955); Beck v. Commissioner, 179 F.2d 688 (7th Cir. 1950); Scott v. McCrory, 162 F. Supp. 535 (D.C. Neb. 1957); John Randolph Hopkins, 15 T.C.

will be treated as the disposition of a capital asset. This result has been reached even though the lots sold by the estate were held primarily for sale during the lifetime of the decedent.[55]

Although the Tax Court has not permitted capital gains treatment merely because the taxpayer desired to liquidate his investment in land,[56] it has ruled that real estate sold to pay creditors was the liquidation of a capital asset.[57] The court of appeals and the district courts have liberally allowed large scale liquidations of land at capital gains rates when the purpose was to dispose of a large tract which was not readily salable in one piece.[58] An outstanding example of this involved a naval stores company which owned hundreds of thousands of acres of Florida land. When the naval stores industry declined, the character of the land changed, and it was used for producing citrus and raising cattle. It was also leased to others for various purposes. During the years 1932 through 1952, the company sold over 1,300,000 acres of its land in a large number of transactions, reporting the sales as capital gain. The Court of Appeals for the Fifth Circuit agreed that this was proper upon the ground that it would have been impossible to sell 1,300,000 acres in a single transaction and that the liquidation which took place over a period of twenty years was the sale of property held for investment.[59]

In situations in which taxpayers have acquired real estate with the intention of improving it as rental property, only to have their purposes frustrated by zoning changes or building restrictions, the courts have approved dispositions of the property as the liquidation of a capital asset.[60] Similar results have been obtained when housing

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160 (1950); Estate of Mackall, 3 CCH Tax Ct. Mem. 701 (1944).

[55]Garrett v. United States, 120 F. Supp. 193 (Ct. Cl. 1954).

[56]See, *e.g.*, Arthur E. Wood, 25 T.C. 468 (1955); Boyd Gudgel, 17 CCH Tax Ct. Mem. 414 (1958); W. J. Lewis, Jr., 13 CCH Tax Ct. Mem. 1161 (1954). *But cf.* Altizer Coal Land Co., 31 T.C. 70 (1959).

[57]Charles L. Meyer, 14 CCH Tax Ct. Mem. 160 (1955); Thomas E. Reese, 13 CCH Tax Ct. Mem. 823 (1954). *But cf.* W. J. Lewis, Jr., 13 CCH Tax Ct. Mem. 1161 (1954).

[58]Estate of Barrios v. Commissioner, 265 F.2d 517 (5th Cir. 1959); Alabama Mineral Land Co. v. Commissioner, 250 F.2d 870 (5th Cir. 1957); Consolidated Naval Stores Co. v. Fahs, *infra* note 59; Chandler v. United States, 226 F.2d 403 (7th Cir. 1955); Penman v. Tomlinson, 57-1 U.S. Tax Cas. ¶9671 (D.C. Fla. 1957); Berberovich v. Minninger, 147 F. Supp. 890 (D. C. Mich. 1957); Doss v. United States, 54-1 U.S. Tax Cas. ¶9413 (D.C. Tex. 1953); Steinegger v. Stewart, 52-1 U.S. Tax Cas. ¶9182 (D.C. Ariz. 1952).

[59]Consolidated Naval Stores Co. v. Fahs, 227 F.2d 755 (5th Cir. 1956).

[60]Ross v. Commissioner, 227 F.2d 265 (5th Cir. 1955); Lobello v. Dunlap, 210

projects were liquidated as unprofitable,[61] or when the owners desired to reinvest in shopping centers.[62]

The sale of real estate by a real estate corporation in the course of a program for the liquidation of its assets preliminary to dissolution has been held by the Court of Claims to be the disposition of a capital asset.[63]

Frequency and Continuity of Sales

Just as a merchant's gross sales are his best measure of the volume of business done, so are the number and dollar volume of sales an accurate indication of the extent to which a land owner is engaged in the real estate business. True, the courts are pretty well agreed that a well-established purpose to liquidate large land holdings may mitigate the effect of frequent and substantial sales, so that capital gains can be realized;[64] but in most other situations frequent, continuous sales give a quietus to the establishment of investment intent.

As an example, a lawyer who sold thirty-seven vacant lots in one year and 198 the next was permitted to report the gain on them at capital gains rates upon a showing that he had originally bought the lots for the construction of rental housing but a change in the zoning laws made the land undesirable for that purpose. The court held that frequency and continuity of sales had to bow to purpose of acquisition (investment) and reason for sale (liquidation).[65] In comparison, a district court jury returned a verdict against capital gains for a taxpayer who sold 214 lots in 122 transactions over a four-year period.[66]

Gain on the sale of rental property can go either way, largely depending on the frequency and continuity of sales. Sales of homes rented to war workers because of governmental restrictions and which were sold right after the restrictions were removed were found to

F.2d 465 (5th Cir. 1954).

61Goldberg v. Commissioner, 223 F.2d 709 (5th Cir. 1955); Schwartzberg v. Sauber, 56-1 U.S. Tax Cas. ¶9234 (D.C. Ill. 1955).

62Curtis Co. v. Commissioner, 232 F.2d 167 (3d Cir. 1956).

63Western & So. Life Ins. Co. v. United States, 163 F. Supp. 827 (Ct. Cl. 1958); *cf.* Powers v. United States, 58-2 U.S. Tax Cas. ¶9597 (D.C. Ill. 1958).

64See cases cited note 58 *supra.*

65Ross v. Commissioner, *supra* note 60; *cf.* King v. Jackson, 56-2 U.S. Tax. Cas. ¶9881 (D.C. Tex. 1956). *But cf.* Gamble v. Commissioner, 242 F.2d 586 (5th Cir. 1957).

66Emery v. United States, 58-2 U.S. Tax Cas. ¶9757 (D.C. Fla. 1958).

have been the liquidation of capital assets,[67] while other sales of rental housing resulted in ordinary income because of the continuity and frequency of sales.[68]

REAL ESTATE BROKERS AS INVESTORS

The Commissioner and the courts have been hard on the real estate broker — the Commissioner usually taking the position that a broker should not be allowed capital gain on the sale of real estate, and the courts holding brokers to a more strict burden of proof as to their investment intent. As a matter of fact, a broker need not be a dealer in real estate at all. He is in most cases merely a middleman or agent who brings the buyer and the seller together.[69] There are cases, however, when a broker is both a dealer and an investor, and it is in these arenas that battle lines are tightly drawn.[70] The broker must wage an uphill fight against the natural suspicion of both the Internal Revenue Service and the courts, and in order to prevail he must have most of the guideposts of investment intent pointing in the right direction.

In recent years real estate brokers have been more than occasionally successful in establishing their rights to capital gains before district court juries. One of the principal keys to their success has been the proper segregation of investment property from dealer property, coupled with clear and convincing evidence as to investment intent. In one case the taxpayer-brokers had the particularly

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[67]Smith v. Commissioner, 232 F.2d 142 (5th Cir. 1956); Dillon v. Commissioner, 213 F.2d 218 (8th Cir. 1954); Victory Housing No. 2, Inc. v. Commissioner, 205 F.2d 371 (10th Cir. 1953); Coe v. United States, 146 F. Supp. 481 (D. C. Fla. 1956); *cf.* Barber v. Edwards, 130 F. Supp. 83 (D.C. Ga. 1955).

[68]Anderson v. Commissioner, 250 F.2d 242 (5th Cir. 1957), *cert. denied,* 356 U.S. 950 (1958); Pacific Homes, Inc. v. United States, 230 F.2d 755 (9th Cir. 1956); Galena Oaks Corp. v. Scofield, 218 F.2d 217 (5th Cir. 1954); Russ Prater, Inc., 11 CCH Tax Ct. Mem. 538 (1952); Palm Homes, Inc., 11 CCH Tax Ct. Mem. 28 (1952); Cletus H. J. Jollie, 10 CCH Tax Ct. Mem. 985 (1951).

[69]Thomas v. Commissioner, 254 F.2d 233 (5th Cir. 1958).

[70]See, *e.g.,* Jones v. Commissioner, 209 F.2d 415 (9th Cir. 1954); Lobello v. Dunlap, 210 F.2d 465 (5th Cir. 1954); Hardin v. Tomlinson, *infra* note 73; Sage v. United States, 58-2 U.S. Tax Cas. ¶9659 (D.C. Fla. 1958); Durr v. Usry, 163 F. Supp. 355 (D.C. La. 1958); Mackall v. United States, 162 F. Supp. 522 (D.C. Va. 1957); Scott v. McCrory, 162 F. Supp. 535 (D.C. Neb. 1957); Ryman v. Tomlinson, *infra* note 71; Malouf v. Riddell, *infra* note 72; W. Linton Atkinson, 31 T.C. ___ No. 126 (1959). J. M. Philbin, 26 T.C. 1159 (1956); Weyman Willingham, 12 CCH Tax Ct. Mem. 584 (1953).

difficult task of convincing a jury that land once held primarily for sale to customers in the ordinary course of trade or business had changed in character with the passage of time and had become investment property. This they did to the jury's satisfaction. The court instructed the jury that the mere fact that the taxpayers were real estate brokers did not mean that they could not hold land for investment and, further, that the taxpayers' records earmarking the property involved as being held for investment were entitled to some weight.[71] In another district court case tried before a jury, similar instructions were given by the court and the real estate broker involved received a favorable verdict.[72]

Perhaps the classic case having to do with a broker's efforts to establish his right to capital gains involved the sale of twelve sizable parcels of land over a three-year period. The taxpayer had been a registered real estate broker for thirty-five years and had engaged in hundreds of land transactions for his own account. Shortly after World War II he began picking up promising pieces of land in good locations and setting them apart for long-term investment. These properties were listed in detail in a special ledger entitled "Investment Real Estate," which had been kept by his bookkeeper for many years. The properties had never been listed with other brokers or even in his own office, and the salesmen employed by him did not show the land to prospective customers. No signs were placed on the properties except in one instance by mistake. There was no advertising of the property or other promotion, and each sale resulted from an unsolicited offer that was too good to refuse. During the years involved the taxpayer had bought, subdivided, developed, and sold many other pieces of property, reporting the gain as ordinary income. The jury found that ten of the twelve parcels had been held for investment but that the one on which the sign had been posted and one that had been held a comparatively short time were held primarily for sale to customers.[73]

These cases clearly demonstrate that upon a proper showing of investment intent a real estate broker or a broker-dealer can justify treating the sale of land as the disposition of a capital asset.

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[71]Ryman v. Tomlinson, 56-1 U.S. Tax Cas. ¶9519 (D.C. Fla. 1956).

[72]Malouf v. Riddell, 52-1 U.S. Tax Cas. ¶9296 (D.C. Cal. 1952).

[73]Hardin v. Tomlinson, 59-1 U.S. Tax Cas. ¶9320 (D.C. Fla. 1958). *But cf.* Durr v. Usry, *supra* note 70, in which the taxpayer broker used signs and newspaper advertisements to sell his "investment" real estate, all of which resulted in a large volume of sales.

Conclusion

With the upsurge of land activity throughout the nation, a flooding stream of real estate capital gains cases has hit the courts, and the crest is yet to pass. The bulk of this litigation has occurred in the wide-open spaces of the South, Southwest, and West, with a modicum of cases sprinkled through the rest of the country. Since each piece of land is unique and there are infinite variations in real estate transactions, each case must stand on its own bottom and be decided on its own particular facts. The applicable law is simple and easy to understand, and no real landmark cases are to be found in the area. It is truly a section of the law ideally tailored to a jury's measure.

It should be evident to even the casual observer that the greatest degree of success enjoyed by taxpayers in these cases is achieved before the United States district courts as compared to the Tax Court and the Court of Claims. The principal reason for this is the unmatched local knowledge of the area, people, customs, and land-selling techniques possessed by the district court judges and juries. Then, too, juries have a way of getting down to basic fundamentals. On the other hand, the Tax Court approaches most factual situations with a certain degree of cynicism, which stems naturally from years of listening to taxpayers' schemes for tax avoidance. The third forum available to litigants, the Court of Claims, has had so little traffic in tax cases generally and real estate cases in particular that its precedents are minimal and of little significance.

A careful examination of the Tax Court's more recent decisions indicates the beginning of what may develop into a trend away from its comparatively rigid attitude with respect to land sales. It may well be that the decisions of the district courts and their frequent reversals by the courts of appeals are nudging the Tax Court into receding from its adherence to the dealer concept. Additionally, the regular and memorandum opinions by its sixteen judges are developing a degree of consistency in this field that has been lacking in the past.

From the foregoing analysis of the ground rules which are observed by trial and appellate courts as principal points of reference, it is possible to synthesize formulas which, taken in context with the total fact situation, will distinguish a speculative investment from a commercial enterprise and a bona fide liquidation of a capital asset from a sale in the ordinary course of business.

Giving proper effect to the case law as it has developed, a dealer, or even a real estate broker who is not a dealer, must hold himself to a closer tolerance in his land dealings than a person who is clearly not a dealer. Upon his acquisition of land for investment, a broker or dealer should carefully and clearly segregate it as investment real estate, making appropriate entries on his books of account. The property should be retained for as long as possible without any improvements, subdivision, or development. It should not be posted with "for sale" signs, advertised for sale, listed with brokers, or shown to prospective customers. While offers may be received, no prices should be quoted. If the land is raw acreage, it should be sold as the largest possible tract; if it has been previously subdivided, the greatest possible number of lots should be sold in a single transaction. Above all, the number of transactions which take place in each taxable year should be carefully limited. One is best; certainly there should be no more than three or four. If land is actually bought and held as a long-term investment, the reason for its sale will take care of itself. Eventually an offer will be received that will be too good to refuse.

A nondealer should also earmark his investment land if his holdings are at all extensive. He should not subdivide large tracts except as a last resort to dispose of them; and of course he should not list the land with brokers, advertise it for sale, or post signs on it. Most important, his frequency of sales and income from land transactions should be kept at a reasonable investor level lest he be declared a dealer in land. A nondealer investor in land would be well advised to stay away from lots in platted subdivisions and confine himself to the purchase of acreage.

Finally, good faith is the best insurance available that transactions will be accepted as they are intended. No amount of rigging to comply with court-made rules will give a case the sparkle of honest investment intent if that intent was not present.