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ARTICLE

REAL PROPERTY: FOR CONNOISSEURS OF THE PREPOSTEROUS — WHEN IS IT A CAPITAL ASSET?¹

MICHAEL S. WEINER

THE TAX APPROACH TO PROFIT REALIZED from the sale or exchange of real property involves a complex determination of whether it is to be treated as ordinary income or a capital gain. This problem has plagued the practitioner for more than fifty years, and has produced a voluminous body of case law. Developments in recent years have resulted in some clarification, yet to a certain extent, decisions have merely complicated what was already complex.

I. DEFINING THE PROBLEM

To oversimplify for the purpose of introduction, a capsulized outline of the problem will be helpful. If the taxpayer is a dealer in real estate, he holds land in the same manner as a grocer holds groceries on his shelves. Accordingly, like the grocer, the real estate dealer should report his profits on the realty sales as ordinary income. On the other hand, if the taxpayer holds land in the same manner that an investor holds stocks and bonds, the profit on the disposition of those assets has a different character, the taxpayer deserving capital gains treatment. Congress has long recognized that the profits on the sale of an investment are significantly different from the income produced by the sale of goods. Since 1921 capital gains have been taxed at a considerably lower rate than ordinary income.²

The above phrasing of the issue is technically misleading. The treatment of the gain does not depend upon the status of the taxpayer/seller as a dealer or an investor, but upon the character of the real property sold.³ If the real property sold is a “capital asset,” the profit is a

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‡ To obtain capital gains treatment, one must make a great show of having been thinking of something else . . . .

§ This branch of the income tax laws . . . should be of great interest to those whom H.L. Mencken used to call “connoisseurs of the preposterous.”


² A number of rationales have been offered to explain the differing treatment. Some authorities argue that such profit is not truly income. Others have stated that it would be inequitable to tax in one year the appreciation in value that had occurred over a period of time. Lastly, there may be economic benefits in maximizing the turnover of capital investments. See MERTENS, LAW OF FEDERAL INCOME TAXATION: CODE COMMENTARY [1955-1973 Transfer Binder] §§ 1201-1241:1 at 3, 4 (1969).

³ A number of commentators have viewed the issue in terms of the dealer/investor dichotomy. Beck, Berkowitz, Kohl & Schlesinger, The Situation of the Investor-Dealer,
capital gain; if the real property sold is something other than a capital asset (e.g., inventory), the profit is ordinary income. The issue is more appropriately labeled the capital/non-capital asset problem as opposed to the dealer/investor problem.

Section 1221 of the Internal Revenue Code of 1954 defines the term capital asset by exception; all property held by a taxpayer is a capital asset except those items specifically listed. The majority of the exceptions, however, do not concern the classification of real property as a capital asset. A second term related to the definition of capital asset is “property used in the trade or business” of the taxpayer contained in Section 1231(b). Such property combines the best of both worlds:


For purposes of this subtitle, the term “capital asset” means property held by the taxpayer (whether or not connected with his trade or business), but does not include —

(1) 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;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by —

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

CODE, § 1231(b).

(1) General Rule —— The term “property used in the trade or business” means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not ——

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or

(C) a copyright, a literary, musical or artistic composition, a letter or memorandum, or similar property, held by a taxpayer described in paragraph (3) of section 1221.

(2) Timber, Coal, or Domestic Iron Ore —— Such term includes timber, coal, and iron ore with respect to which section 631 applies.

(3) Livestock —— Such term includes ——

(A) cattle and horses, regardless of age, held by the taxpayer for draft,
if the property is sold at a profit, the profit is treated as a capital gain; if the sale results in a loss, the loss is an ordinary loss fully deductible in the year of sale. This term, like capital asset, is also defined by negation. Exceptions common to both capital assets and property used in a taxpayer’s trade or business include a certain type of copyright; literary, musical or artistic composition; inventory; and property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer’s trade or business.6

As a result of this statutory scheme, (i.e., definition by exception), it is necessary to study what is not a capital asset to determine the appropriate classification of a given item.7 Obviously, of the exceptions common to Sections 1221 and 1231, the two which may exclude real estate from being defined as a capital asset or property used in a taxpayer’s trade or business are the exceptions of inventory and property held primarily for sale to customers in the ordinary course of one’s trade or business. An historical review of these exceptions will focus the study.

A. Historical Review

A preferential rate for profit derived from the sale of capital assets was first enacted by Congress in 1921 allowing “profits earned over a series of years”8 relief from the graduated rates applied to ordinary in-breeding, dairy, or sporting purposes, and held by him for 24 months or more from the date of acquisition, and

(B) other livestock, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

(4) Unharvested Crop —— In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted) at the same time and to the same person, the crop shall be considered as “property used in the trade or business.”

6 A third provision, section 1237, offers a safe harbor whereby a taxpayer engaged in the sale of subdivided property may attain capital gains treatment. The criteria set forth in that section are highly restrictive and technical. Only in rare circumstances will each of the required conditions be met. Code, § 1237.

The statute was originally enacted to decrease the volume of litigation which arose as a result of subdivision sales of real estate. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 84 (1954). The mechanical rules and the limitation on the number of lots which may be sold in any one year have restricted its use. Thus, few are able to avail themselves of the statute’s benefit with the result that the litigation in this area has continued. (In the last ten years more than fifty published cases have been reported dealing with the question of the treatment of gain from realty transactions.) The question of whether a gain qualifies for section 1237 treatment, however, is beyond the scope of this article. For further discussion of this issue see Primmer, Sales of Subdivided Realty —— Capital Gains v. Ordinary Income, 19 S.W.L.J. 118, 136 n.113 (1965).

7 Hereinafter, reference to the term capital asset will include the term property used in a trade or business. This does not distort the issue since the two types of property have a significant common exception —— property held primarily for sale in the ordinary course of the taxpayer’s trade or business. If an item falls into that category it cannot be either a capital asset or property used in a trade or business of the taxpayer.

This article is confined to an examination of real estate as a capital asset. For recent general discussions of the character of capital assets outside this ambit see International Shoe Mach. Corp. v. United States, 369 F. Supp. 588 (D. Mass. 1973), aff’d, 491 F.2d 157 (1st Cir.), cert. denied, 419 U.S. 834 (1974); Charles A. Sykes, 57 T.C. 618 (1972).

come. Section 206(a)(6) of the 1921 Code excluded from the definition of the term capital asset, "stock in trade of a taxpayer or 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." Those items which were properly includible as items of inventory were listed in regulations promulgated by the Commissioner of Internal Revenue, real property not being listed. In harmony with the Commissioner, the Board of Tax Appeals on various occasions held that the inventory exception did not exclude land from treatment as a capital asset. In 1924, however, the exception broadened "to remove any doubt as to whether property which is held primarily for resale constitutes a capital asset, whether or not it is the type of property which under good accounting practice would be includible in the inventory." Excluded now was "property held by the taxpayer primarily for sale in the course of his trade or business." The emphasis was placed upon the taxpayer's intent to resell the property instead of upon accounting practices.

In 1934 that phrase was once again modified to read: "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." The purpose of this modification was to nullify the contention that a stock speculator trading on his own account was in the trade or business of selling stocks, making his stock market losses fully deductible in the year of the sale. Accordingly, the sale must be to a customer, in the ordinary course of business and not a mere trading activity. The intent of the taxpayer to resell, while of continued importance, would not be determinative unless these conditions of sale to a customer and sale within the ordinary course of business were initially met.

By the middle of the Depression, the scenario was set. If the taxpayer sold parcels of land at a profit, the Commissioner would assert that the land sold by the taxpayer was property held primarily for sale to customers in the ordinary course of his trade or business excluding it from the definition of capital asset, the consequence being treatment of the profit as ordinary income. The taxpayer would retort that the land was a capital asset with attendant capital gains on its sale, making the exclusion inapplicable.

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10 Loughborough Dev. Corp., 29 B.T.A. 95 (1933); John Welch, 19 B.T.A. 394 (1930), modified, 59 F.2d 1085 (6th Cir. 1932); Albert F. Kinney, 17 B.T.A. 560 (1929); Atlantic Coast Realty Co., 11 B.T.A. 416 (1928).
14 H.R. REP. No. 385, 73d Cong., 2d Sess. 22 (1934).
II. THE INITIAL APPROACH

Fledgling case law turned on the issue of whether one was selling real estate "in the ordinary course of his trade or business."15 The other part of the exclusionary phrase dealing with the requirement that it be held "primarily for sale to customers" was ignored. Typical in this respect is the case of Richards v. Commissioner16 where the Ninth Circuit affirmed a Tax Court decision holding that a farmer's gain on the subdivision and sale of his vegetable farm was ordinary income. The court, in concluding that "business" was a very comprehensive term, adopted a definition approved in a 1916 Supreme Court case — business is that which "occupies the time, attention and labor of men for the purpose of a livelihood or profit."17 On the basis of the foregoing analysis, the court held that the taxpayer engaged in the business of selling real estate within the broad definition that had been set by the Supreme Court.18 It was found most significant that improvements to the farm in promotion of the subdivision plan were financed by a bank. The argument that the subdivision and sale was a liquidation of a capital asset was, therefore, unpersuasive.

A. The "Tests" Approach

As the litigation in this area began to multiply, the courts considered a number of different factors and developed "tests" whereby it could be objectively determined whether the taxpayer was in the business of selling real estate. Frequency of sales and continuity of involvement were the premier factors.19 One of the more ingenious "tests" to emerge was the "busyness" test devised by Circuit Judge Sibley in Snell v. Commissioner.20 While examining the phrase "in the ordinary course of his trade or business" the Judge focused on the word "business."

The word, notwithstanding disguise in spelling and pronunciation, means busyness; it implies that one is kept more or less busy; that the activity is an occupation. It need not be one's sole occupation, nor take all his time. It may be only seasonal, and not active the year round. It ordinarily is implied that one's own attention and effort are involved, but the maxim qui facit per alium facit per se applies, and one may carry on a business through agents whom he supervises.21

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15 Ehrman v. Commissioner, 120 F.2d 607 (9th Cir.), cert. denied, 314 U.S. 668 (1941); Welch v. Solomon, 99 F.2d 41 (9th Cir. 1938); Wineman Realty Co., 12 P-H Tax Ct. Mem. 424 (1943).
16 81 F.2d 369 (9th Cir. 1936).
18 Id. at 374.
19 Brown v. Commissioner, 143 F.2d 468 (5th Cir. 1944); Commissioner v. Boeing, 106 F.2d 305 (9th Cir.), cert. denied, 308 U.S. 619 (1939); Snell v. Commissioner, 97 F.2d 891 (5th Cir. 1938).
20 97 F.2d 891 (5th Cir. 1938).
21 Id. at 892-93.
By the late nineteen-forties, the courts had utilized numerous well recognized tests in deciding the many cases presenting this question. Among the tests were continuity of sales or sales related activity over a period of time; frequency of sales, as opposed to isolated transactions; the activity of the seller or those acting under his instructions; the extent or substantiality of the transactions; and the reasons, purpose, or nature of the acquisition of the subject matter.

The listing of the above tests culled from other cases and the collection of the facts with those tests was the methodology first employed in Boomhower v. United States. Boomhower, a lawyer, had purchased farm land, which had not been a profitable investment, from a trust for which he was trustee. In later years as the town of Mason City, Iowa began to expand, the lawyer was approached by a lumber company that had a plan to subdivide the property supplying its products to builders who would construct homes on it. A city ordinance required that the land be platted before it could be sold. The lawyer complied with this requirement before sale and also improved the property for home sites. A portion of the subdivision was sold through the lumber company. The court found that the taxpayer did not hold the land primarily for sale to customers in the ordinary course of his business. The asset was acquired to save the trust from suffering further loss. "The extent of the taxpayer's activities with or concerning the subject matter" was found to be minimal, the court believing this to be the most important test. Additionally, the activities of the lumber company could not be attributed to him. Although improvements were extensive, they were necessary to make the capital asset saleable. The property had been held for five years before resale during which Boomhower's other real estate activities lacked continuity. Richards was distinguished on the basis that the management activities of the taxpayer and his agents, that is, the bank that financed Richards, supplied "the continuity requisite for a business."

The greatest difficulty with the Boomhower approach was that it required a voluminous factual record often bringing in the extraneous and the trivial. The courts most often characterized the issues as being entirely factual to be examined in the light of all surrounding circumstances. Each test was said to hold no greater weight than any other.  

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24 Id. at 1004.
25 See text accompanying note 16 supra.
26 74 F. Supp. at 1003.
27 For examples of this approach (independently aligning facts to tests) and some variations see Thompson v. Commissioner, 322 F.2d 122 (5th Cir. 1963); Camp v. Murray, 226 F.2d 931 (4th Cir. 1955); Smith v. Dunn, 224 F.2d 353 (5th Cir. 1955); Sylvester A. Lowery, 33 P-H Tax Ct. Mem. 169 (1964); Eline Realty Co., 35 T.C. 1 (1960); James G. Hoover, 32 T.C. 618 (1959); W. Linton Atkinson, 31 T.C. 1241 (1959); Charles E. Reithmeyer, 26 T.C. 804 (1956); Carl E. Metz, 24 P-H Tax Ct. Mem. 976 (1955); Thomas E. Wood, 16 T.C. 213 (1951); W.T. Thrift, 15 T.C. 366 (1950).
28 E.g., Tibbals v. United States, 362 F.2d 266 (Ct. Cl. 1966); Browne v. United States, 356 F.2d 546 (Ct. Cl. 1966); Ralph L. Quay, 39 T.C. 743 (1963).
Distillation of any guidelines from these cases which would allow one to reasonably predict the status of his profit on a real property sale became impossible, resulting in increased litigation. Congress attempted to reduce the uncertainty by enacting Section 1237 as part of the Internal Revenue Code of 1954, but this addition did little to relieve the pressure. Some courts found the analysis so burdensome that they resorted to purely ad hoc determinations.

While most courts believed that the Boomhower approach was the axe to cleave the Gordian knot of defining the term capital asset when confronted with a real estate fact situation, a fresh look was taken in Municipal Bond Corp. v. Commissioner.

B. Increased Focus on Statutory Language

Charles F. Curry was a successful Kansas City developer who built, owned, and sold apartment buildings while also advising others on real estate dealings. To house his varied investments he formed nine corporations including Municipal Bond Corporation of which he was president, director and controlling shareholder. Between 1954 and 1958 Municipal Bond sold nineteen tracts of land from which the profits amounted to more than $120,000. The properties, mostly vacant lots, had been held an average of four and one-half years. The corporation's other source of income was a lease with a railroad. The Commissioner determined that the gains on the nineteen sales were ordinary income and assessed a deficiency in excess of $38,000.00. The Tax Court decided that the Commissioner did not err in his determination. Despite initial reference to the tests approach, the court focused on the word "primarily" which it interpreted to mean substantial.


30 See Cole v. Usry, 294 F.2d 426, 427 n.3 (5th Cir. 1961); see also Surrey, Definitional Problems in Capital Gains Taxation, 69 Harv. L. Rev. 985, 991 (1956) and Weithorn, supra note 3, at 160.

31 The Tax Court observed that this question appeared to be one of the most frequently litigated issues under the Internal Revenue Code. Charles E. Reithmeyer, 26 T.C. 804, 806 (1956).

32 See note 6, supra.

33 Finding ourselves engulfed in a fog of decisions with gossamer like distinctions, and a quagmire of unworkable, unreliable, and often irrelevant tests, we take the route of ad hoc exploration . . . .


When the Fifth Circuit was once again required to meet the question, Judge Brown depicted the issue as "the old, familiar, recurring, vexing and oft-times elusive problem . . . ." Thompson v. Commissioner, 322 F.2d 122, 123 (5th Cir. 1963).


35 Id. at 28, citing, inter alia, Rollingwood Corp. v. Commissioner, 190 F.2d 263 (9th Cir. 1951).
This construction permits recognition of the dual purpose concept inherent in some types of business operations. In petitioner’s real estate operations, its dual purpose is obvious. Petitioner acquired and held real estate for the dual purpose of both investment and sale to the public. And while the sales purpose, in some instances, may not have been predominant over the investment purpose, it was, nevertheless, substantial throughout the entire period under review. Petitioner’s gains from the sale of properties in some years exceeded its gains from all other sources. They were substantial in each of the years involved. On an overall basis the gains from real estate sales and from rentals, petitioner’s two principal sources of income, were about equal. 36

The Court of Appeals for the Eighth Circuit reversed, 37 concluding that the word “primarily” had a plain and usual meaning:

The word “primarily” is unambiguous and has a well-recognized and understood meaning. It has been construed in various types of cases of federal and state courts as meaning “of first importance or principally.” 38

The court went on to criticize the Tax Court for failing to make a determination on a tract-by-tract basis. As a final point, it observed that Municipal Bond Corporation was a distinct and separate entity. Consequently, the operations of the other corporations “would have no probative force in establishing the taxpayer’s purpose of holding real estate except to the extent that it might be shown that the other corporations were acting as [agents] for the taxpayer.” 39 On remand the Tax Court found that six of the nineteen sales were of capital assets. 40

The Tax Court had relied upon Rollingwood Corp. v. Commissioner 41 for the proposition that “primarily” meant “essential” or “substantial.” Rollingwood Corporation had been formed for the specific purpose of building low-rent housing for workers brought to the Richmond, Virginia area during World War II, providing each occupant with a rent-option agreement. Seven hundred houses were built and disposed of pursuant to such agreements. The Ninth Circuit unequivocally accepted the Commissioner’s definition of primarily, reasoning that if a person held property with the dual intentions of rental (if the rental market were good) and sale (if the sales market were more profitable), one of the essential purposes for holding the property was sale. 42 (It may have been an as-

37 Municipal Bond Corp. v. Commissioner, 341 F.2d 683 (8th Cir. 1965).
38 Id. at 688 (citations omitted).
39 Id. at 691.
40 Municipal Bond Corp., 46 T.C. 219 (1966), aff’d in part, rev’d in part, 382 F.2d 184 (8th Cir. 1967). For discussion of the second opinion of the Eighth Circuit see text accompanying notes 161-69 infra.
41 190 F.2d 263 (9th Cir. 1951).
42 The court determined that the legislative purpose of Int. Rev. Code of 1939, § 117(j) was to treat proceeds of a sale of an asset held by a taxpayer with these motivations as
sumption, considering the extensive activities of the taxpayer, but the court never made an explicit finding that these homes were sold in the ordinary course of the taxpayer's "trade or business."

The Municipal Bond decision created a classic split in circuits, making necessary Supreme Court resolution of the conflict.

III. MALAT v. RIDDELL

Malat is the only comment which the Supreme Court has ever made on the subject of the classification of real property as a capital or non-capital asset. Although there have been a great number of cases construing the capital gains provisions contained in Subchapter P of the Internal Revenue Code, only Malat arose from a dispute involving real property.

William Malat was a general partner in Louis Lesser Enterprises, Ltd. which formed a joint venture in the summer of 1953 with four individuals, acquiring acreage in Inglewood, California. According to the district court's findings, the members of the joint venture "as of the date the 44,901 acres were acquired, intended either to sell the property or develop it for rental, depending upon which course appeared to be most profitable."

The interior of the tract was subdivided into 105 lots, distributed to the joint venturers as equal tenants in common, and ultimately transferred to a second joint venture. Gain from the sale of this subdivided tract was reported as ordinary income. As to the remaining property which fronted on intersecting boulevards, a rift arose among the joint venturers which resulted in acrimony making continued business relations as partners unpleasant. Consequently, nine acres were sold to ordinary income. This section is substantially similar to Code § 1231. See note 13 supra.

The capital gains provisions are remedial provisions. Congress intended to alleviate the burden on a taxpayer whose property has increased in value over a long period of time from having the profits from sales taxed at graduated tax rates designed for a single year's income. The purpose is to protect "investment property" as distinguished from "stock in trade," or property bought and sold for profit. It is our view that this policy was not meant to apply to a situation where one of the essential purposes in holding the property is sale. Rollingwood Corp. v. Commissioner, 190 F.2d 263, 266-67 (9th Cir. 1951) (footnotes omitted).

The word "primarily" as used in Code § 1231 and Int. Rev. Code of 1939 § 117(j) had been construed with varied results by other circuits in settings not involving real estate. See Recordak Corp. v. United States, 325 F.2d 460 (Ct. Cl. 1964); American Can Co. v. Commissioner, 317 F.2d 604 (2d Cir. 1963); United States v. Bennett, 186 F.2d 407 (5th Cir. 1951).


See, e.g., Corn Prod. Ref. Co. v. Commissioner, 350 U.S. 46 (1955). Corn Product Refining Company had speculated in commodity futures and declared its profits to be capital gains. The Supreme Court held that such hedging transactions were excluded from treatment as capital gains. The case is most often cited for the proposition that the capital gains provisions are "relief provisions" which "must be narrowly applied and its exclusions interpreted broadly." Id. at 52. See also Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958).

one faction of the joint venture and slightly less than eleven acres were conveyed to an unrelated real estate developer. These last two sales were reported as sales of capital assets by the joint venture with Louis Lesser Enterprises, Ltd. and its general partner, Malat, in turn treating their portion of the profit as a capital gain. Malat was assessed a deficiency on the classification of the profits of the two sales as capital gain. Malat paid the deficiency and filed his complaint for a refund in the district court for Southern California.

Judge E. Avery Crary rendered the opinion of the district court finding that the members of the joint venture held the property for the dual purposes of either selling or developing it depending upon which was more profitable. The judge considered *Rollingwood* to be most applicable, stating:

> Plaintiffs have failed to establish by a preponderance of the evidence that the subject real properties were not held by Plaza [the joint venture] primarily for sale to customers in the ordinary course of trade or business. *Rollingwood Corp. v. Commissioner*, 190 F. 2d 263 (9th Cir. 1951).

The subject real property was held for development or sale, depending upon which course appeared to be most profitable. *Rollingwood Corp. v. Commissioner*, supra. Any rift among the partners may have expedited the sale but did not affect any essential primary purpose for which the property was held.48

In affirming, the Ninth Circuit Court of Appeals explored the nether reaches of the joint venturers’ minds to determine their purposes for holding the property.49 The court said first that “an investor’s prospective recognition of the fact that he may ultimately wish to realize a profit on his investment is not enough to constitute sale [as being one of the] dual purpose[s]” for holding the property.50 At the time they purchased the property, the joint venturers were aware of many possibilities for gain. The avenues included sale, commercial development, or subdivision. Each plan was explored; when one plan (commercial development) became impossible because of the inimical relationship between the partners, they pursued an alternate course (sale).51

Before the Supreme Court,52 the government’s position was that a taxpayer who purchases an asset for either rental or sale in the ordinary

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49 Malat v. Riddell, 347 F.2d 23 (9th Cir. 1965).
50 Id. at 26.
51 *Sale*, then, was not the liquidation of an investment. It was the final alternative in taxpayer’s continuing efforts to realize gain from his acquisition. It was *part* of his plan rather than the abandonment of it.
52 Id. at 27 (first emphasis added).
53 The Supreme Court granted certiorari and dealt with the case in a per curiam opinion concurred in by seven Justices. Justice White took no part in the opinion; Justice Black would have affirmed the opinion of the Court of Appeals.
course of his business, whichever is more profitable, is not entitled to have his regular business profits from such sale taxed as capital gains. This proposition would have covered most "dual purpose" holding situations. It was argued that this general proposition did not depend upon an examination of the word "primarily" as contained in the exception "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." Rather, the government claimed, the definition of a capital asset must first be read narrowly. In this instance, the property held for the dual purpose was not initially a capital asset, creating no need to even consider the exceptions. Since the word "primarily" is contained in the exception, not the definition, it was not necessary to examine it.

The government brief went on to explain an alternate ground for the result: the exception should be read broadly, and "primarily" should be interpreted to mean "substantial." The major argument of the taxpayer's brief, in contrast, was simply that "primarily" does not mean "substantial." The Supreme Court looked to the narrow issue as presented by Malat, engaging in none of the psychology of the court of appeals. Choosing restraint in its approach, the Court's opinion solely addressed the construction of the word "primarily" as used in section 1221(1) of the Code. It observed that words in statutes should be interpreted where possible in their ordinary everyday sense. The ordinary everyday meaning of the word "primarily" was held to be "of first importance" or "principally." This interpretation, it was thought, did not do violence to the legislative purpose of the capital gains provisions which sought to differentiate between "the profits and losses arising from the everyday operation of a business" and "the realization of appreciation in value accrued over a substantial period of time." Since an incorrect legal standard had been applied by interpreting "primarily" to mean "substantial," the case was vacated; upon remand it was found that the purpose of first importance to the members of the joint venture was to hold the property for development or rental. It was concluded as a matter of law that the taxpayer had established by a preponderance of the evidence that the real properties sold were not held by the joint ven-

54 Id. at 17.
56 Malat v. Riddell, 383 U.S. 569, 571 (1966). It is significant that the Supreme Court ignored the Government's contention that the definition of capital asset is something apart from the exceptions contained in the sections 1221 and 1231. It is not a principal of law that a taxpayer has two burdens — first, proof that the property in question is a capital asset and second, proof that it is not covered by one of the exceptions.
57 Id. at 572.
58 Id. In light of this statement the holding period in Malat should be noted. The joint venture opened an escrow account for purchase of the Century and Crenshaw Boulevards property on August 12, 1953 and closed the sale February 15, 1954. The two sales of the property which were the subject of the suit occurred October 15, 1954 (eight months later), and November 5, 1954 (less than nine months later). Query: should it not be inferred that eight months is a "substantial period of time"?
ture primarily for sale to customers in the ordinary course of its trade or business.\footnote{59}

Since \textit{Malat} was the first expression by the Supreme Court on this specific issue, the lower courts were forced to reexamine their approaches to the subject. Importantly, the opinion did not mention the tests which had become a crutch for a majority of courts. The opinion looked directly to the statutory phrase and focused on a single word within it. \textit{Malat} did not halt the flood of litigation but it did channel the floodwaters.\footnote{60}

IV. The Post-Malat Pulse

Although \textit{Malat} appeared to have resolved much of the controversy in the area, a number of questions still merited examination. The courts were left with the problem of how to apply the dictates of the decision. Procedural questions remained unanswered as well as the question of what position, if any, the tests formulae (or at least their underlying principles) were to occupy in the new order.

A. Procedural and Preliminary Features

Although \textit{Malat} was a blow for the taxpayer against the government it has not meant the wholesale classification of real property as a capital asset. There remain concrete obstacles to proving the subject of a realty sale to be a capital asset, many of which are procedural. First, the determinations of the Commissioner of Internal Revenue are prima facie correct. Once he has determined that the proceeds from a particular realty sale are ordinary income, the burden of proof shifts to the taxpayer.\footnote{61} Thus, in what is mainly a contest of marshalling facts, the taxpayer must be the active force in assembling them in order to meet this presumption with a preponderance of evidence.

The question of whether those findings must be made as to each separate parcel sold or merely as to the taxpayer's dealings as a whole presents another procedural problem. Previously when the issue was merely whether the taxpayer was selling real estate in the ordinary course of his business, it was unimportant to examine each individual piece of property. Important were the overall real estate activities of the taxpayer. Since \textit{Malat}, however, a determination must be made as to whether the taxpayer held any particular tract \textit{primarily} for sale to customers in the ordinary course of his business.\footnote{62} Thus, some land may be held primar-
ily for sale to customers while other acreage may not. The Municipal Bond case which correctly forecast the position of the Supreme Court as to the definition of the word "primarily" stated that purpose or intention must be determined for each individual tract since the purpose of holding property may vary.63

Despite this, some courts have failed to make separate findings,64 claiming that it would serve no useful purpose.65 Since the issue of classifying real property as a capital or non-capital asset has been continuously viewed as basically a factual issue,66 it is difficult to understand why no useful purpose would be served by such a detailed analysis. The preferrable procedure is to make a finding on a tract-by-tract basis and if necessary, a sale-by-sale basis unless, of course, the circumstances surrounding the sales are so similar as to make the analyses redundant. The subdivision of a tract, for example, would not require a separate conclusion as to each and every sublot sold.67

The conclusions of the finder of fact are especially important in these types of cases since the scope of review on appeal is limited. The underlying issue being basically one of fact,68 certain courts of appeals have limited their review solely to the question of whether the trial court was clearly erroneous in reaching its result.69 It is reasoned that Rule 52(a) of the Federal Rules of Civil Procedure demands this limitation.70

This position is not without dissenters; the Third and Fifth Circuits allow a more liberal scope of review.71 These circuits argue that the

65 See text accompanying note 68 infra.
67 See, e.g., Koch v. United States, 457 F.2d 230 (7th Cir. 1972); Huxford v. United States, 441 F.2d 1371 (5th Cir. 1971); United States v. Burket, 402 F.2d 426 (5th Cir. 1968); Commissioner v. Tri-S Corp., 400 F.2d 862 (10th Cir. 1968); Goodman v. United States, 390 F.2d 915 (Ct. Cl. 1968).
68 See Brown v. Commissioner, 448 F.2d 514 (10th Cir. 1971); Estate of Freeland v. Commissioner, 393 F.2d 573 (9th Cir. 1968); Joan E. Heller Trust v. Commissioner, 382 F.2d 675 (9th Cir. 1967); Municipal Bond Corp. v. Commissioner, 382 F.2d 184 (8th Cir. 1967).
69 Fed. R. Civ. P. 52(a). That Rule states that findings of fact "shall not be set aside unless clearly erroneous and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses." (Emphasis added.)
70 See Juleo, Inc. v. Commissioner, 483 F.2d 47 (3d Cir.), cert. denied, 414 U.S. 1103 (1973); United States v. Winthrop, 417 F.2d 905 (5th Cir. 1969); see also Baum v. United States, 409 F.2d 829 (5th Cir. 1969), where the lower court's jury verdict was affirmed because a review
finder of fact concludes as to an ultimate fact, that is, whether the property was held by the taxpayer primarily for sale in the ordinary course of his trade or business. Ultimate facts are not subject to the "clearly erroneous" limitation since they call for reasoning and interpretation more akin to conclusions of law than findings of fact. Malat is silent on this particular aspect. The Supreme Court's reversal in that case was due to "the courts below applying an incorrect legal standard."\(^{72}\) It might be implied from that statement that the Justices recognized the "clearly erroneous" doctrine as the appropriate scope of review for a court of appeals. This is, at best, merely an inference and not the holding of the Court. As a result of this inconclusive language in addition to the different views among the circuits, this procedural issue remains unresolved.

Another hurdle confronting the taxpayer concerns the holding in Corn Products Refining Co. v. Commissioner\(^{73}\) that the capital gains provisions must be construed narrowly since they are relief provisions.\(^ {74}\) This is a mandate to broadly interpret the exclusions from the definition of capital asset thereby narrowly interpreting the definition. The Malat Court, however, made clear that a broad construction may be given to the exclusions only to the extent it does not do violence to the plain language of the statute. A court should not be so overzealous in pursuing a broad interpretation of the exclusion as to give the phrase a meaning contrary to the intent of Congress.

B. The New Approach: Analysis of the Statutory Language

Malat v. Riddell returned the attention of the courts to the language of sections 1221(1) and 1231(b)(1)(B).\(^{75}\) The reexamination of the statutory language in Malat led to a new pattern of close dissection of the exclusionary phrase "held primarily for sale to customers in the ordinary course of the taxpayer's trade or business."

In the first case concerning the treatment of profits from the sale of real property to be reviewed by the Tax Court after Malat,\(^{76}\) Judge Tannenwald, in a concurring opinion, advocated this approach. The facts of the record revealed "ample and substantial evidence" to support it. The Seventh Circuit remains uncommitted. See Hansche v. Commissioner, 457 F.2d 429, 433 (7th Cir. 1972).

\(^{72}\) 383 U.S. at 572.

\(^{73}\) 350 U.S. 46 (1955).

\(^{74}\) Id.; see note 45 supra. This proposition has been cited in a number of cases involving reality sales. See Hansche v. Commissioner, 457 F.2d 429 (7th Cir. 1972); Cairo Developers, Inc. v. United States, 381 F. Supp. 431, 440 (M.D. Ga. 1974); S.O. Bynum, 46 T.C. 295, 298 (1966); Climate Control, Inc., 43 P-H Tax Ct. Mem. 852, 856 (1974); Estate of Sam E. Broadhead, 41 P-H Tax Ct. Mem. 993, 1108 (1972); Ridgewood Land Co., 41 P-H Tax Ct. Mem. 40, 45 (1972), aff'd per curiam, 477 F.2d 135 (5th Cir. 1973).

\(^{75}\) Yet even prior to the decision there was a warning: Essential as they are in the adjudication of cases, we must take guard lest we be so carried away by the proliferation of tests that we forget that the statute excludes from capital assets "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

Thompson v. Commissioner, 322 F.2d 122, 127 (5th Cir. 1963).

of the case involved a husband and wife who were engaged in the landscape business on a farm of 113 acres. The business did not prosper and they were forced to procure loans from a bank. Late in 1959, it was decided that subdivision of their farm would be financially beneficial. An arrangement with a bank to which they were indebted was negotiated allowing a partial release of the mortgage on the property securing their loans. The subdivision was advertised and listed with local realtors and by September of 1960, thirty-eight lots had been subdivided and sold. Unconvinced by petitioners' argument that they were trying to sell just enough land to satisfy the debt to the bank, the Tax Court found the proceeds to be ordinary income. The majority gave faint recognition to the holding of *Malat* by commenting that "this purpose [holding the property for sale to customers in the ordinary course of a trade or business] had become of first importance" as evidenced by the extensive improvement activities made by the taxpayers.

Except for this comment, the Tax Court's opinion was a mere amalgamation of undistinguished authorities, lacking analysis. Judge Tannenwald's concurrence admonished that since this was the first case after *Malat* it was "extremely important [that the basis of the decision] be crystal clear. . . . Otherwise we will simply provide more fuel for the fires of further litigation in this area." Judge Tannenwald continued by breaking the exclusionary phrase into three elements:

1. "Primarily" which, as the Supreme Court has mandated, means of "first importance." The element of substantiality is no longer enough. By the same token, the proscribed purpose does not, I believe, have to be capable of a quantitative measurement of more than 50 percent. It should be sufficient if such purpose is *primus inter pares*.

2. "For sale to customers." This is the least significant element. Unquestionably, any person who proposes to sell his property has "for sale" as his purpose. Equally clearly, anyone who buys the property is a "customer."

3. "In the ordinary course of business." This phrase is crucial. Thus, the taxpayer must be in a business of which the sale is a part. In addition, even though a sale is usually the "ordinary" way of disposing of property, it must also be in the "ordinary course" of the business. Thus, a decision by a manufacturer to sell an outmoded plant would not be within the proscribed purpose.

This approach was applied by certain other courts. The first two elements were usually united by making a finding whether the taxpayer held the property at the time of sale "primarily for sale to customers." Then, if established, an additional finding would be made to decide if

77 *Id.* (emphasis added).
78 *Id.* (Tannenwald, J., concurring).
79 *Id.* at 302.
the sale was made “in the ordinary course of the taxpayer’s trade or business.”\(^{80}\) The tests were most often relegated to a lesser status, with the observation that they “in and of themselves . . . have no independent significance, but only form part of a situation which in the individual case must be considered in its entirety. . . .”\(^{81}\)

1. Primarily for Sale to Customers

In accordance with this analytical approach, a textual examination of sections 1221(1) and 1231(b)(1)(B) is illuminating. The first element of the exclusionary phrase — primarily for sale to customers — was scrutinized in part by the Supreme Court in Malat. It has now become settled that “primarily” means of first importance or principally. This definition has had a significant impact on lower court decisions.\(^{82}\)

The remainder of this element — for sale to customers — has not been the subject of much comment. Judge Tannenwald called it the least important part of the exclusion since there was obviously at least one sale on which the treatment of the profits would be in dispute, and a sale is by definition to a customer.\(^{83}\) This is not necessarily true, however, since the word “customer” was inserted for the purpose of denying stock market investors the advantage of declaring market losses to be ordinary losses by claiming that they were in the trade or business of speculating in stocks. Stock market investors selling through brokers did not sell to customers.\(^{84}\) Although most courts fail to give the word “customer” any consideration,\(^{85}\) Judge Nichols’ dissent in Goodman v. United States presents this forceful logic:

The majority considers the meaning of the word “primarily”, but they pass the word “customers” over in silence. I presume some sales are other than to customers, else the word is surplusage. In my semantics, the word fits the buyers of subdivision lots perfectly and the purchasers here involved not at all. However, we may assume arguendo that if a person is in a “trade or business” the persons he sells to in the ordinary course of his business are “customers”.\(^{86}\)


\(^{82}\) See, e.g., Malat v. Riddell, 66-2 U.S. Tax Cas. 86, 800 (S.D. Cal. 1966) (applying this standard upon remand from Supreme Court, both realty sales found to be capital assets); Municipal Bond Corp., 46 T.C. 219 (1966), aff'd in part, rev'd in part, 382 F.2d 184 (8th Cir. 1967) (found 11 of 19 sales to yield capital gains).

\(^{83}\) S.O. Bynum, 46 T.C. 305, 302 (1966).

\(^{84}\) See text accompanying notes 13, 14 supra.


\(^{86}\) 390 F.2d 915, 925 (Ct. Cl.) (Nichols, J., dissenting), cert. denied, 393 U.S. 824 (1969).
The word "customer" needs greater consideration and cannot be treated as mere excess. It connotes something other than a buyer. A class of people who frequent an establishment for the purpose of purchasing what is being offered for sale would be a reasonable description. A shopper at a grocery store is a customer, but a syndicate purchasing a multimillion dollar corporation directly from its shareholders is not a customer within the plain meaning of the word (and in Judge Nichols' eyes, probably not buying in the ordinary course). These are undoubtedly the ends of the spectrum.

2. In the Ordinary Course of Trade or Business

This element has been the subject of varied interpretations. The threshold question is: What is a "trade or business"? In response, some courts have returned to the "busyness" test devised in Snell. In Robert L. Adam the taxpayer sold twelve unimproved waterfront lots over a three year period. He was a certified public accountant earning almost $100,000.00 annually as a managing partner in a large firm. His profits from the real estate sales for the three years at issue totaled more than $75,000.00. The Tax Court categorized the profits as capital gains. The taxpayer was not in the trade or business of selling unimproved land because he did not meet the "busyness" test of Snell. His activities were infrequent and he performed no service which enhanced the value of the properties. The court further relied upon Boomhower, in that there was no continuity or sustained activity in the real estate field; the majority of his time was spent as an accountant. In contrast, an individual who improved and platted certain property and sold the subdivided lots informally from his home without advertising showed "the singleness of purpose" which characterizes a trade or business.

[T]he taxpayer here devoted a substantial amount of his time, skill and financial resources to developing and selling the property. He thereby became engaged in the business of subdividing real estate for sale. One need not be a static holder to qualify for capital gains treatment, but the flexing of commercial muscles with frequency and continuity, design and effect does result in disqualification because it indicates one has entered the business of real estate sales.

In addition to "busyness," the relative amounts of real estate income as compared to one's occupational income may demonstrate that one is in the trade or business of selling real estate. Hence, one is in the trade

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87 The key to the definition seems to be regularity. WEBSTER'S NEW TWENTIETH CENTURY DICTIONARY 450 (2d ed. 1970).
88 See text accompanying notes 19-21 supra.
89 60 T.C. 996 (1973).
90 See text accompanying notes 23, 24 supra.
91 United States v. Winthrop, 417 F.2d 905, 912 (5th Cir. 1969).
92 Id. at 911 (emphasis added).
93 It has been noted that when more than one-half of the taxpayer's income is from realty sales,
or business of selling realty if he does it frequently, with some degree of continuity, devoting a substantial amount of his time and effort to the activity, while making expenditures in furtherance of it and deriving a good portion of his income therefrom.

Using these factors as the means to define "trade or business" forces some speculation. First, can one be in the trade or business of selling capital assets and receive capital gains treatment on the income derived therefrom? If this is the sole activity of a taxpayer does that taint whatever opportunity he may have to reap capital gains from the sales? Although there is some contrary authority, there exists the cautionary note that such activity must not be continuous.

Another uncertainty is whether one can be in multiple trades or businesses if to be in a trade or business requires singleness of purpose. The Snell case stated that a trade or business "need not be one's sole occupation, nor take all his time." If, however, one has a regular occupation it may tend to show that the realty sales were merely a sideline. Of course, when one's regular business is adjunct to realty sales there should be no such inference. The rental of apartment buildings, for example, merely for the purpose of establishing their value so that they might command a higher sale price did not prevent the taxpayer from being in the business of selling those various buildings.

Lastly, it is open to question whether an admitted real estate dealer may set aside certain property for investment purposes in a fashion similar to a stockbroker who establishes a personal investment account. The definition of "trade or business" may seem on the surface to preclude such a segregation but, as shall be later explained more fully, such segregation might be possible.

If the threshold question of being in the trade or business of selling realty is answered affirmatively, the exclusionary phrase requires the additional element that the sale be in the ordinary course of that business. This intimates a "concept of normalcy" in the sales. Thus,

94 There is nothing unique or improper about a corporation engaging in exclusively investment activity. We can find no basis in the Code, the regulations thereunder, the decided cases, or the general [sic] accepted concepts of tax law for requiring that every corporation must have some "ordinary income" activity.

95 A taxpayer was not in the trade or business of selling real estate when he was in the business of constructing homes. Maddux Constr. Co., 54 T.C. 1278 (1970). A taxpayer whose principal business was outdoor advertising and the management of numerous investments was held not to be engaged in the business of selling real estate. C. Frederick Frick, 41 P-H Tax Ct. Mem. 301 (1972). Apartment houses held for rent were not part of a subsequent real estate sales business. Peter R. Shibley, 40 P-H Tax Ct. Mem. (1971).

96 See text accompanying notes 139-44 infra.


when a company whose income, derived from stocks, bonds, farming operations, rentals, and royalties, sold subdivided lots through independent contractors, the company neither advertising nor controlling the independent contractors, any sublots sold were not classified as sold in the ordinary course of the company's trade or business.\textsuperscript{101} Similarly, if one is forced to abandon a disappointing investment by means of a series of sales, it is not in the ordinary course of his business.\textsuperscript{102} Liquidations, however, may eventually become so extensive that the taxpayer enters into a new trade or business with sales thereafter being in its ordinary course.\textsuperscript{103}

Accordingly, proper analysis of the exclusionary phrase contained in section 1221(1) and 1231(b)(1)(B) requires close examination of each word. For the exclusionary phrase to apply, the land must be held primarily for sale to customers and the eventual sale for profit must be in the ordinary course of the taxpayer's realty sales business.

\section{V. The "Tests" Formula Survives}

Cases which utilize a textual analysis of the exclusionary phrase represent the minority. The majority of post-Malat decisions continue to follow a variation of the Boomhower tests.\textsuperscript{104} Their popularity remains despite the criticism which can rightfully be leveled against their use.\textsuperscript{105} The tests bring in extraneous and marginally probative facts.

\begin{itemize}
  \item \textsuperscript{101} Biedenham Realty Co. v. United States, 356 F. Supp. 1331 (1973), aff'd, 509 F.2d 171 (5th Cir. 1975), rev'd, 526 F.2d 409 (5th Cir. 1976).
  \item \textsuperscript{102} Joan E. Heller Trust v. Commissioner, 382 F.2d 675 (9th Cir. 1967).
  \item \textsuperscript{103} Huxford v. United States, 441 F.2d 1371 (5th Cir. 1971) (court of appeals affirmed jury verdict finding a taxpayer who had sold off his timber holdings which had once been used for the production of turpentines, but which had been rendered obsolete by synthetics, was in a new trade or business of timber selling thus requiring treatment of the profits as ordinary income).
  \item \textsuperscript{105} United States v. Winthrop, 417 F.2d 905, 909 (5th Cir. 1969); Thompson v. Commissioner, 322 F.2d 122 (5th Cir. 1963); Cole v. Ury, 294 F.2d 426, 427 (5th Cir. 1961); Biedenham Realty Co., 356 F. Supp. 1331 (W.D. La. 1973), aff'd, 509 F.2d 171 (5th Cir. 1975), rev'd, 526 F.2d 409 (5th Cir. 1976). See also S. O. Bynum, 46 T.C. 295, 299 (1966) where the Tax Court (without noticing the implication of its statement) stated: Without any notable exceptions the many, many cases in this particular field have noted that each individual case must be considered and evaluated on its peculiar and particular facts, e.g., Kelley v. Commissioner, supra; Pool v. Commissioner, supra. Lazarus v. United States, 172 F. Supp. 421 (Ct. Cl. 1959).

As stated in Lazarus, "Perhaps the only guiding principle of general application that can be gleaned from the judicial decisions dealing with the problem is that every case of the type mentioned must be decided on the basis of its own
becoming a quest in and of themselves so that the congressional intent of the Code sections is lost. They are often applied mechanically but are unreliable since an integral axiom of the tests requires that in applying them they be given differing weights in each factual setting. The use of these tests have left this branch of income tax law to ad hoc decision-making thwarting any effort to engage in tax planning.

Nonetheless the tests remain precedent and must be reckoned with in order to fully consider the issues in a controversy involving the classification of real property as a capital asset. The tests are usually broken down into six, seven, eight, or nine categories, accompanied by a caveat that no single test is conclusive in and of itself, and each may be given varying weight. Lastly, some opinions explain that the tests must be viewed in light of the totality of the circumstances.

The tests may be grouped into three broad categories: those concerning the intent of the taxpayer during the period he held the land; those concerning the activities of the taxpayer in the realty business; and those concerning the circumstances surrounding the purchase and sale of the land in question.

\[\text{facts, there being no single test that can be applied to all such cases with decisive results.}^{106}\] For this reason we have endeavored to make our findings of fact in the instant case full and comprehensive. (Emphasis added.)

See also authorities listed at notes 30, 31 supra.

The six "tests" are: (1) the purpose for which the asset was acquired; (2) the frequency, continuity, and size of the sales; (3) the activities of the seller in the improvement and disposition of the property; (4) the extent of improvements made to the property; (5) the proximity of sale to purchase; and (6) the purpose for which the property was held during the taxable years. William B. Howell, 57 T.C. 546, 554 (1972). This approach is most popular.

The seven "tests" are: (1) the nature and purpose of the acquisition of the property and the duration of the ownership; (2) the extent and nature of the taxpayer's efforts to sell the property; (3) the number, extent, continuity, and substantiality of the sales; (4) the extent of subdividing, developing, and advertising to increase sales; (5) the use of a business office for the sale of the property; (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and (7) the time and effort the taxpayer habitually devoted to the sales. United States v. Winthrop, 417 F.2d 905, 910 (5th Cir. 1969).

The eight "tests" are: (1) the purpose for which the property was acquired; (2) the purpose for which it was held; (3) improvements, and their extent, made to the property by taxpayer; (4) frequency, number, and continuity of sales; (5) the extent and substantiality of the transactions; (6) the nature and extent of taxpayer's business; (7) the extent of advertising to promote sales, or the lack of such advertising; and (8) listing of the property for sale directly or through brokers. Jersey Land & Dev. Corp. v. United States, CCH 1975 STAND. FED. TAX REP., U.S. TAX CAS. (75-1, at 86,935) ¶ 9386 (D.N.J. Mar. 20, 1975).

The nine "tests" are: (1) the purpose for which the property was initially acquired; (2) the purpose for which the property was subsequently held; (3) the extent to which improvements, if any, were made to the property by the taxpayer; (4) the frequency, number, and continuity of sales; (5) the extent and nature of the transactions involved; (6) the ordinary business of the taxpayer; (7) the extent of advertising, promotion, or other active efforts used in soliciting buyers for the sale of the property; (8) the listing of property with brokers; and (9) the purpose for which the property was held at the time of sale. Maddux Constr. Co., 54 T.C. 1278, 1284 (1970).


\[\text{United States v. Winthrop, 417 F.2d 905 (5th Cir. 1969); Cairo Developers, Inc. v. United States, 381 F. Supp. 431 (M.D. Ga. 1974).}^{108}\]
A. Intent of the Taxpayer

This area includes the purpose for which the asset was acquired, the purpose for which the property was held during the taxable year, and the purpose for which the property was held at the time of sale. This analysis is superficial in that it merely separates the question of intent into three time periods. Certainly, the purpose for which the property was originally acquired is sometimes relevant.109 (There is a distinction between a person who originally buys the land to farm and a person who buys the land contemplating development as a subdivision.) Much greater emphasis, however, must be given to the time surrounding sale. “A taxpayer's purpose can change during the course of his holding of property, and in such cases it is the dominant purpose of his holding during the period prior to the sale which is critical.”110 Past intent should not be controlling when present activity indicates a different purpose. The farmer may become a real estate developer and conversely the real estate developer may find his subdivision floundering and sell off his holdings in bulk. Neither individual’s case should be prejudiced by his former plans.

This measure of intent also fails to take into account the word "primarily." No matter what point in time intent is assessed it must always involve an assessment of the primary purpose of the taxpayer. Since the tests formula was constructed long before Malat, its perspective has been appended to but not incorporated into the equation. Consequently, the focus is on three time periods, whereas the statute is not as concerned with the moment in time at which intent is determined, but whether that intent was of first importance in the taxpayer’s mind.

B. Activities of the Taxpayer

This area includes the extent and nature of the taxpayer's efforts to sell the property, the use of a business office for the sale of the property, the extent and nature of the taxpayer's business, and the frequency, number, and continuity of sales. These tests essentially address the question of whether the taxpayer was in the trade or business of selling real property."111

Illustrative of the weakness in the tests formula is the uneven application of the frequency and continuity factors. A single sale may not be enough to demonstrate the continuity and frequency of sales


111 See text accompanying notes 88-93 supra.
associated with a trade or business. Beyond that little is clear however.

The decided cases are of little aid in establishing the "frequency and continuity" of sales sufficient to constitute a regular course of business. A total of 7 sales during the tax year was held sufficient in George J. Wibbelsman, 12 T.C. 1022 (1949), while the sale of 95 subdivided lots in 2 tax years was held insufficient in Fahs v. Crawford, 161 F.2d 315 (C.A. 5. 1947).

Rather than apply a mechanical test, one approach is to determine whether the taxpayers were engaged in activity commonly associated with a particular business.

Undoubtedly the question of whether one is in the trade or business of selling realty is important in deciding whether a capital asset was sold. But the issue would be better framed by addressing the statutory language, placing emphasis on the question of whether the gain arose from the everyday operation of a business as opposed to profit realized upon appreciation of the asset. Additionally, it highlights the issue of whether the businesses of third-parties related to the taxpayer are attributable to the taxpayer as his trade or business.

Advertising, promoting, and individual effort are significant, but they must be considered as having been done in consummation of a sale in the ordinary course of the taxpayer's business and not another's.

C. Purchase and Sale of Land

Lastly, there are tests relating to the circumstances surrounding the particular tract in question such as the proximity of sale to purchase, the extent of improvements, and the listing of the property with brokers. Once again, the tests seem reasonable but their application is uneven. Holding periods of less than a year have not prejudiced capital gains treatment from profits reaped on sales of real property; in contrast, a holding period of seventeen years has been held insufficient.

Advertising is also an unreliable factor since some properties may sell favorably without it in a seller's market whereas individuals merely trying to rid themselves of a bad investment might have to make an active effort to promote what is obviously an unattractive piece of property.

In relation to the improvements factor there is some authority that, absent unusual circumstances, land held for subdivision cannot be a capital asset. Moreover, there are contradictory statements: Improve...
ment alone will not render property a capital asset; there must be improvement plus promotion and sales. Thus, the dispositive significance of improvements remains uncertain.

The tests never adequately take into account certain basic elements, namely that the primary purpose must be sale to customers. Even if the taxpayer is in the realty business, the sales must be in the ordinary course of his business. Therefore, taken as a whole, the tests focus on a phrase that is interpreted to read "property held by the taxpayer for sale connected with a trade or business," whereas the phrase actually reads: property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. When this is added to the unpredictable application of the tests, it seems obvious that the Supreme Court was wise to return to the text of the phrase and not engage in this type of peripheral analysis. Merely identifying a few of the important factors is not a satisfactory method for solving this complex problem.

VI. Common Problems

Three recurring problems have surfaced in the last ten years since the decision in Malat v. Riddell. These problems demonstrate the need for a close textual reading of the Code sections. The first concerns the "change of circumstance cases" where the realty sale was prompted by an unexpected event. A second involves the "attribution cases" where the activities of a separate entity or individual were attributed to the taxpayer, with the result that the taxpayer was found to be in the same trade or business as that entity or individual. Lastly, there are the "dealer and developer cases" where a developer, subdivider, or real estate broker desired to segregate property for purposes of investment apart from his regular trade or business.

A. The Changed Circumstances Cases

As far back as 1936, taxpayers were advancing the contention that the

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120 The recent case of Biedenharn Realty Co. v. United States, 526 F.2d 409 (5th Cir. 1976), reversing, 509 F.2d 171 (5th Cir. 1975), strenuously defended the conventional lines of reasoning by applying the seven factors. Judge Goldberg stated in the reversing opinion that the task must begin with an evaluation of the main Winthrop factors. The opinion continued by discussing prior investment intent and the Malat decision. The court held that the taxpayer had held the property in question primarily for sale and any profit therefrom was ordinary income.

The decision misconstrued both the opinion below and Winthrop. Winthrop began by admitting its outright hostility to the tests formula finding themselves "engulfed in ... a quagmire of unworkable, unreliable, and often irrelevant tests." 417 F.2d at 906. Winthrop did list the seven factors but gave them short shrift. The thrust of Winthrop was an analysis of the direct statutory language of section 1221(1) breaking it down into component parts as suggested in this article. The same is true of the district court opinion in the case. Biedenharn Realty Co. v. United States, 356 F. Supp. 1331 (W.D. La. 1973). In the reversing circuit court opinion, Judge Rooney, in a specially concurring opinion, incisively remarked that "the various indicia which the courts have delineated are useful in applying the § 1221(1) test to the facts of a case, but should not be regarded as a substitute for the statutory test." 526 F.2d at 424.
sale of realty must yield capital gains when that sale was prompted solely
by a desire to liquidate an investment made unprofitable by a change in
circumstances. 121 By recounting the changed circumstances, the tax-
payer had the advantage of objectively establishing the purpose for which
he held the land during the decisive period prior to sale. With Malat
holding that the purpose of sale to customers in the ordinary course of
business must be the primary purpose, this argument has new meaning.

A bare allegation that one is liquidating an unprofitable venture is
insufficient to overcome the presumption of correctness in the Commis-
sioner's determination. 122 Moreover, if the liquidation is accompanied
by "extensive development and sales activity, the mere fact of liquidation
does not preclude the existence of a trade or business. . . ." 123 This
does not mean that the fact of sale in itself will jeopardize a liquidation; if
that were the case no one could ever liquidate a capital asset. 124 When
the liquidation sale or sales are accompanied by such extensive efforts
that it is actually the launching of a new enterprise, it will be found to
produce ordinary income.

The condemnation or threat of condemnation by eminent domain pro-
ceedings may also present changed circumstances which prompt the sale
of a capital asset. In two similar cases portions of land held by developers
were subject to eminent domain proceedings. In one case the land was
sold to the State Highway Department; 125 in the other it was sold to a
private party. 126 The same conclusion was reached in both instances;
the subject of the sale was considered a capital asset. As explained by
the Tax Court, "under the circumstances, we do not believe that the profit
realized by petitioner on this one isolated transaction [under threat of
condemnation] represents profits . . . arising from the everyday opera-
tion of a business." 127 In contrast, the case of Juleo, Inc. v. Commis-
sioner 128 held a sale to state authorities by a developer to be taxable as
ordinary income because the condemnation award reflected what would
have been received had the land been sold as developed property. This
opinion is clearly incorrect. There was never an attempt to grapple with
the issue of whether the sale was in the ordinary course of the taxpayer's
trade or business. That the taxpayer made the same amount of profit
as he would have made had he developed the land is not a fact crucial to
the classification of property as a capital asset. Rather, the circum-
stances surrounding the sale are more important.

121 Richards v. Commissioner, 81 F.2d 369 (9th Cir. 1936); see also Ehrman v. Commissioner,
120 F.2d 607 (9th Cir. 1941), cert. denied, 314 U.S. 668 (1941).
123 Huxford v. United States, 441 F.2d 1371, 1375 n.4 (5th Cir. 1971), citing White v. Commis-
sioner, 172 F.2d 629, 630 (5th Cir. 1949); see also Melvin R. Hansche, 39 P-H Tax Ct. Mem.
1809 (1970), aff'd mem., 457 F.2d 429 (7th Cir. 1972).
124 Heller Trust v. Commissioner, 382 F.2d 675 (9th Cir. 1967).
125 Tri-S Corp., 48 T.C. 316 (1967), aff'd, 400 F.2d 862 (10th Cir. 1968).
126 Ridgewood Land Co., 41 P-H Tax Ct. Mem. 40 (1972), aff'd per curiam, 477 F.2d 135 (5th Cir.
1973).
127 Id. at 47.
At times, profits from a realty sale prompted by the reversal of a business decision will produce capital gains treatment. Illustrative is Climate Control, Inc. A predecessor of Climate Control, Inc. had been in the business of buying unimproved land, developing it, and selling the land for residential purposes. One piece of property purchased had been set aside for the purpose of building an apartment complex for rental. Application for zoning changes and other efforts were made to complete the project. An alert real estate broker and acquaintance of the principal stockholder of the company which owned the property inquired if the property was for sale. In a jocular manner, the stockholder affirmed that it was. A sale was consummated with profit in excess of $100,000.00. The Tax Court held the profit to be capital gain. Until the moment of sale it had always been the business decision of the company to hold this land for investment. Such was the primary purpose, objectively proven by enumerating the steps taken to accomplish it. In another situation, however, a taxpayer remained in the business of selling real estate despite a change in his method of conducting business, namely, by disposing of the property in a single transaction to a developer. The circumstances revealed that after he changed his business method, he entered (albeit through the developer as agent) a new business.

Factors other than those enshrined in the tests formula have a great bearing on the outcome of such cases. Liquidation motives, condemnation proceedings, and changes in business decisions are highly probative with regard to defining the subject of sale as a capital or a non-capital asset. If a list is desirable, it would be inappropriate not to give these factors an enumerated status.

B. The Attribution Cases

A second common problem concerns attributing activities of third parties to the taxpayer to prove that he engaged in a trade or business. The Fifth Circuit in Snell v. Commissioner first expressed the idea that it is possible to conduct a realty sales business through others. This concept is central to the issue of classifying real property as a capital asset since a tax avoidance scheme could easily be devised by which the taxpayer is isolated from those activities normally associated with a trade or business by conducting such activities through multiple corporations.

The activities of a third party will be attributed to the taxpayer where the third party is acting as agent for, or participating in a joint venture with, the taxpayer. Attribution of business activities is not made

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129 43 P-H Tax Ct. Mem. 852 (1974). See also Tibbals v. United States, 362 F.2d 266 (Ct. Cl. 1966) (taxpayer who had first sold or developed approximately 100 lots in a subdivision and sold the remaining 333 in a single sale received capital gains treatment on the proceeds).

130 Nadalin v. United States, 364 F.2d 431 (Ct. Cl. 1966); see also S.O. Bynum, 46 T.C. 295 (1966).

131 97 F.2d 891 (5th Cir. 1938). See text accompanying notes 20, 21 supra.

132 The "agency" theory was applied in H-H Ranch, Inc. v. Commissioner, 357 F.2d 885 (7th Cir. 1966); Robert A. Boye, 58 T.C. 316 (1972) and C & A Land Co., 40 P-H Tax Ct.
merely because the taxpayer has an interest in a corporation which engages in real estate promotion or development. The corporation must have acted on behalf of the taxpayer for the express purpose of advancing the particular sale in question. 133

Illustratively, if the taxpayer sells the property but retains a stake in the business venture, the activities of the development corporation to which he sold may be imputed to him. 134 A sale at an inflated price, siphoning off profits prior to development, is also indicative of a hand-in-glove operation in which the activities of one entity should be imputed to another. 135

Good business reasons must be furnished to justify conveyance to a related third party. In Thomas A. Cary, 136 a corporation conveyed property to a syndicate which included the sole shareholder of that corporation. It was reacquired by the corporation at a substantial gain to the syndicate. The syndicate’s profits were treated as capital gain despite the later development of the tract by the corporation. The Tax Court was convinced that the original sale was consummated because of the financial difficulties of the corporation and that the profit to the syndicate was warranted since conditions had changed during the holding period, making repurchase attractive to the corporation. Hence, adequate business reasons precipitated both transactions.

Another variation of the attribution issue involves the interrelationship between partners. It is unsettled whether all partners of a partnership must be treated the same. One court arrived at the conclusion that it is the partnership’s purpose for holding the land which must be considered and not the purpose of any one particular partner. 137 This would mean that all partners either receive capital gains or ordinary income treatment without distinction. Other courts have reasoned that the individual partner’s intent is the controlling factor and each partner may be a participant for diverse reasons. 138

133 Mem. 1245 (1971). The “joint venture” theory was employed in Tibbals v. United States, 362 F.2d 266 (Ct. Cl. 1966) and Royce W. Brown, 54 T.C. 1475 (1970), aff'd, 448 F.2d 514 (10th Cir. 1971).

134 It is established that, in determining the trade or business of an individual taxpayer, the business activities of his closely-held corporation will not be attributed to him, but it is also true that a taxpayer may be individually in the same business as his corporation, may make that business his own, or may utilize the company in his own business. It is therefore appropriate, in circumstances such as these, to see whether the taxpayer uses his controlled company — for instance, as agent, co-participant, or joint venturer — to implement or further his own personal business, as he easily can. That type of inquiry has often been made by the courts, including this one, in cases testing (under § 117(a) of the 1939 Code or § 1221 of the 1954 Code) whether profit from a sale of property was ordinary income or capital gain. Tibbals v. United States, 362 F.2d 266, 272 (Ct. Cl. 1966) (citations omitted).


137 Robert A. Boyer, 58 T.C. 316 (1972).

138 Riddell v. States, 106 F.2d 218, 219 (9th Cir. 1940), citing United States v. Rosebrooks, 318
The attribution question is not specifically listed among the tests formula except to the extent that the employment of a real estate broker will be considered. Again, a significant aspect of the capital/non-capital asset dispute is inadequately formulated in the tests approach.

C. The Dealer and Developer Cases

The last common situation is the segregation of investment properties by a real estate dealer or developer from his inventory of properties held for sale to customers. The Commissioner has argued that a real estate broker has a greater burden of proof when confronting this situation. The reasoning is that since a real estate broker or developer is engaged in the trade or business of selling realty, he should be compelled to submit a greater quantity of evidence as to the investment nature of his dealings. This argument has been rejected by some courts. A person engaged in the business of holding real estate need not supply more than the normal quantity of evidence to prove that a particular property was not held for sale in the ordinary course of his business. Accordingly, a real estate broker or developer may simultaneously hold some property for sale in the ordinary course of his business and some for investment.

Whatever the burden of proof, the difficulty remains to evince the investment intent. Mere self-serving statements are not satisfactory; the intent should be demonstrable through objective facts. The recent case of Richard H. Pritchett presented such a situation. Pritchett was a real estate broker who occasionally purchased real estate in his own name for his own account. The gain from sale of these properties contributed significantly to his annual income. Over a four year period he had completed more than twenty-five sales for his own account. The Commissioner challenged the gain realized on four of those sales, considering it to be ordinary income. The Tax Court found in all four instances that the taxpayer had correctly characterized the gains. All were less-than-anxious sales. Three of the four involved no solicitation of buyers through advertising, or through Pritchett as a broker. In one instance, Pritchett had plans to develop one tract as a trailer park but was unable to obtain financing, forcing abandonment of the plans. A very close factual question involved a sale to an individual who had first approached Pritchett for his services as a real estate broker. The court found, however, that the sale was not made by Pritchett in his capacity as

139 See Municipal Bond Corp. v. Commissioner, 382 F.2d 184, 188 (8th Cir. 1967); Scheuber v. Commissioner, 371 F.2d 996 (7th Cir. 1967), cited in Municipal Bond Corp. v. Commissioner, supra.
140 Municipal Bond Corp. v. Commissioner, 382 F.2d 184 (8th Cir. 1967).
142 See Myers v. United States, 345 F. Supp. 197, 211 (N.D. Miss. 1972), aff'd per curiam, 469 F.2d 1393 (5th Cir. 1973).
143 63 T.C. 149 (1974).
a dealer. The taxpayer had always scrupulously segregated his activities as dealer and investor, the latter being conducted through a partnership and corporation, while the former activity was conducted in an individual capacity.

The tests formula does not properly conceptualize the problem. The listed tests concentrate on the "trade or business" aspect as devised when the sole question considered by courts was whether the taxpayer engaged in the trade or business of selling real estate. The "ordinary course" concept which allows a broker to separate sales into two categories — investment and inventory — is secondary. Since "the fundamental objective of the capital gains provisions [is to grant] preferential treatment to gains realized from those transactions which are not the normal source of business income," the two-step process of first, finding if the taxpayer is in the realty business and second, determining whether the particular sale was in the ordinary course of that business more accurately reflects the statutory scheme.

VII. SUMMARY AND CONCLUSION

This branch of income tax law has had a checkered history. Since the Depression the issue has been whether the property sold is excluded from the definition of capital asset by the phrase "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." If so excluded, any resulting profit is ordinary income. Originally, the sole question was whether the taxpayer was in the trade or business of selling real estate. With time, the courts recognized a host of factors which might influence the outcome. Certain of those factors became entrenched in a formalistic approach to the problem which proved unreliable, spawning contradictory results. Litigation was legion, yet the case law failed to produce workable guidelines.

The Supreme Court in Malat v. Riddell made its sole comment on the issue concluding that the word "primarily" as used in the statute meant "of first importance." Significant was the methodology which the Court employed, eschewing the tests formula and using a textual analysis of the identical phrase contained in sections 1221(1) and 1231(b)(1)(B). Some courts have followed this lead but remain in the minority. Reliance is still placed in substantial part upon the tests formula.

A close scrutiny of that exclusionary phrase identifies some important concepts which are not adequately considered in the tests formula. First, proper emphasis must be given to the word "primarily." Second, the oft-forgotten word "customers" is revived as part of the phrase. Third, the concept of selling in the ordinary course of the taxpayer's business is given importance equal to the concept of engaging in such a "trade or business." Lastly, there is recognition of the fact that the business must be his (that is, the taxpayer's) trade or business.

There can be little doubt that the tests identify some significant and highly relevant factors. Other factors, however, are of equal importance
and there is little reason for not including them in a list of probative factors. A review of the cases since the *Malat* decision illustrates the problems arising from their absence. In some instances an unusual change in circumstances must be taken into account. Factors of liquidation, condemnation of the property, or a reversal of business plans are equal to any of the enumerated tests in reaching a result. At other times, the attribution of the activities of any entity related to the taxpayer becomes determinative. Lastly, when a real estate developer or broker desires to segregate land for investment purposes, the tests formula does not properly consider the concept of sales in the ordinary course of business.

This article does not suggest that the tests should be abolished. The tests contain indispensable elements which must be considered by a court deciding the capital/non-capital assets issue in relation to a realty sale. Listing the factors, however, is not enough; there must be an attempt to fulfill the objectives of the statutory scheme, relating the enumerated factors to the concepts embodied in the language of the statute. Moreover, the tests must not be employed as primary indicators to the exclusion of other relevant points. Relating all factors to the interpretation of the plain meaning of the phrase "property held by the taxpayer for sale to customers in the ordinary course of his trade or business" will give substance to the congressional intent embodied in that language.