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SALES OF SUBDIVIDED REALTY—
capital gains v. ordinary income

John L. Primmer

I. INTRODUCTION

One of the most litigated areas in the tax law, arising in a multitude of ways, concerns the treatment given to gains and losses resulting from sales of realty. Suppose an investor in real estate takes advantage of the rapid growth around his property and the attendant rise in fair market value by selling. Suppose a dealer in real estate sells a parcel of land which has been segregated from his stock in trade. Suppose the owner of the rental houses or apartments begins to dispose of them. The question presented, of course, is whether profits from these and similar transactions should be taxed at ordinary or capital gains rates. The problem is not new, but it remains important so long as an active market in real estate is maintained through the growth of urban communities.

This Comment is not intended to deal generally with the area of capital gains and ordinary income, but rather with a specific statutory exclusion from capital gains. Nevertheless, a brief general discussion of the equitable considerations which led to the present preferential treatment given the sale of capital assets is necessary. Capital gains treatment was first allowed after it was recognized that taxation at ordinary rates for gains from the sale of property held over a long period of time was an unjust burden on the taxpayer. Many were paying taxes completely disproportionate to the taxes they ordinarily paid because they were taxed in one year for an increment in value which had taken place over a period of several years. In addition, the profits realized were taxed at much higher rates, due to the graduated tax, than they would have been had the income been spread over a number of years. Because it was impractical to tax the gains at rates equivalent to what would have been paid for the increase in value

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¹ For further references in this area see generally: Groh, Tax Problems in Real Estate, 36 Taxes 267 (1958); Heitberg, Dealer or Investor? 37 Taxes 155 (1959); Levin, Capital Gains or Income Tax on Real Estate Sales, 37 B.U.L. Rev. 161 (1917); Repetti, What Constitutes a Dealer under Section 1237, N.Y.U. 17th Inst. on Fed. Tax 651 (1959); Rubenstein, A Few Federal Income Tax Aspects of Selling Land—Ordinary Income vs. Long-Term Capital Gains, 22 Brooklyn L. Rev. 56 (1955); Spandorf & Tonelson, Capital Gains Provisions for Real Estate Investors in Section 1237—More Promise Than Fact, 8 J. Taxation 201 (1958); Weithorn, Subdivision of Real Estate—Dealer v. Investor Problem, 8 Tax L. Rev. 177 (1953).

² S. Rep. No. 275, 67th Cong., 1st Sess. 10 (1921); H.R. Rep. No. 350, 67th Cong., 1st Sess. 11 (1921). Both reports also claimed that the prohibitive tax rates were stifling the turnover of the property.
for each year the property was held, an arbitrary rate lower than the ordinary rates was applied to these sales. As with any remedial legislation aimed at relieving the burdens of a few, everyone attempts to take advantage of the capital gains provisions. Often, preferential treatment is sought when the equitable considerations which originally brought about capital gains treatment are absent. Even though use of the provision may have been abused, these considerations are still present in many cases and should not be ignored.

The Internal Revenue Code contains three sections which are applicable to realty sales. The first, section 1221, is a general capital gains provision. It defines a capital asset broadly as “property held by the taxpayer (whether or not connected with his trade or business).” This section lists a number of specific exclusions from this definition, two of which may be applicable to realty sales. The first is “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.” Another exclusion is depreciable property or realty used in the taxpayer’s trade or business. If the property is found to be within the first exclusion, capital gains treatment is denied. If the property fits within the second category, it is covered by section 1231, which allows capital gains treatment in the event of a gain and an ordinary loss deduction in the case of a loss. Section 1231 is the second statute applicable to sales of realty and it, like section 1221, denies capital gains treatment to sales of property held primarily for sale. A third statute, section 1237, deals specifically with subdivided realty. The primary purpose of section 1237 is to provide some relief to the taxpayer who sells subdivided lots and who, under the other statutes as applied by the courts, might be found to be a dealer in real estate. Supposedly, the standards in section 1237 for determining whether property is held

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8 The original rate at which capital gains were taxed was 12 1/2%. Revenue Act of 1921, ch. 136, § 206(b), 42 Stat. 233.
4 Ibid.
6 Int. Rev. Code of 1954, § 1221(1). This exclusion was originally placed in § 1221 as an amendment to the then-existing exclusion which only applied to inventory. Revenue Act of 1924, ch. 234, § 208(a)(8), 43 Stat. 262. The purpose of the amendment was to take recognition of the fact that property might be held for sale without being included in inventory. H.R. Rep. No. 179, 68th Cong., 1st Sess. 19 (1924). Land is not required to be and it usually is not included in inventory.
7 Int. Rev. Code of 1954, § 1221(2).
10 Int. Rev. Code of 1954, § 1231(b)(1)(B). The result of cases dealing with the question whether the property is held primarily for sale is substantially the same whether the taxpayer attempts to qualify under § 1221 or § 1231. Differences in the computation of the tax are sometimes present in the two sections, but they are not material here.
primarily for sale are easier for the taxpayer to meet than those applied under sections 1221 and 1231.\footnote{Int. Rev. Code of 1954, § 1237(a) states that property will not be found to be held primarily for sale merely by reason of the taxpayer's subdividing and carrying on sales activities in selling it.}

The cases dealing with realty sales involving capital gains problems revolve almost entirely around the question of whether the property was held for sale. Generally, if the property is sold as the taxpayer acquired it, it will be given capital gains treatment.\footnote{Yunker v. Commissioner, 256 F.2d 130, 136 (6th Cir. 1958).} It is when the taxpayer subdivides, improves the property and devotes a substantial amount of time and energy to his sales that the problems arise. By so doing, he acts much as would a dealer in real estate, thus presenting the question whether the property is held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

\section*{II. Scope of Review by Appellate Courts}

An introductory factor, separate from the substantive aspects of this area but important to the taxpayer, is whether the court hearing his case considers the property held for sale test to be one of fact, law, ultimate fact or mixed law and fact. In a large percentage of these cases the facts are stipulated, the only remaining question being whether or not the taxpayer falls under the statutory exclusion from capital gains. Thus, the willingness of the reviewing court to re-evaluate the facts on appeal from the tax court or district courts and its attitudes toward capital gains are substantial considerations. Those courts which consider it a fact question usually restrict themselves to use of the "clearly erroneous"\footnote{See, e.g., Bauschard v. Commissioner, 279 F.2d 115 (6th Cir. 1960).} or substantial evidence\footnote{Stockton Harbor Industrial Co. v. Commissioner, 216 F.2d 638 (9th Cir. 1954), cert. denied, 349 U.S. 904 (1954); Gruver v. Commissioner, 142 F.2d 363 (4th Cir. 1944).} rule of review. Those courts which consider it a question of law may freely determine the question anew; the result is much the same in the courts which call it a question of ultimate fact.\footnote{Compare Voss v. United States, 329 F.2d 164 (7th Cir. 1964), \textit{with} Yunker v. Commissioner, 256 F.2d 130 (6th Cir. 1958). But see Tidwell v. Commissioner, 298 F.2d 864 (4th Cir. 1962), in which the question was labeled one of ultimate fact, but the "clearly erroneous" rule was applied.}

Apparently the characterization of the question is used more as a means of obtaining what the court considers the proper outcome than as a logical standard of review. The greatest number of tax cases in the circuit courts are appeals from decisions adverse to the taxpayer, and if the reviewing court agrees with the decision, the simplest way to dispose of a case is to hold that the issues presented
are fact issues which the trial court correctly decided. Other courts, more willing to find for the taxpayer, have answered by characterizing the test as one necessitating legal reasoning, thus reserving power to reverse the lower court. The Ninth Circuit, which usually sides with the Commissioner, has repeatedly held that the question is one of fact. In *Bistline v. United States*, the court strongly reiterated this position. The district court had ruled against the taxpayer when she sold property received as a gift from her father, a dealer in real estate. Though the property was partially improved when she received it, she made no further improvements. The Ninth Circuit upheld the district court and stated: "This is obviously a question of fact, which ordinarily is governed by the findings of the trial court, unless these are clearly erroneous or unless an appellate court is convinced by an examination of the entire record that a mistake has been made. Much of the criticism directed at the appellate opinions in this field has a sophomoric ring because of the failure of the writers to regard this principle." The court, however, was less reluctant in *United States v. Beard*, decided the same month as *Bistline*, to overturn a district court decision in favor of the taxpayer. *Beard* repeated that the determination was one of fact and subject to the clearly erroneous rule, but it added that a number of earlier decisions in the circuit were persuasive of a decision that this particular finding was wrong. Thus, the court substituted its judgment for that of the trial court, not on the basis of an erroneous fact finding, but rather on what it considered to be the inference, in accord with previous cases, to be drawn from the evidence. Thus, the scope of review given in *Beard*, although termed a fact test, was at least as broad as that given by courts which adhere to the "ultimate fact" classification.

Some of the circuits characterize the question as one of ultimate fact, thereby freeing themselves from the clearly erroneous rule, in cases in which the only issue to be determined is whether or not the property is held for sale. These cases generally state that the question

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17 An example of the Ninth Circuit's attitude toward capital gains is found in *Pacific Homes, Inc. v. United States*, 230 F.2d 755 (9th Cir. 1956). There the taxpayer was seeking capital gains on the sales of rental homes which had been regulated by the National Housing Agency during World War II as defense worker's housing. The opinion began, "The sovereign is not to be frustrated in the replenishment of its fist by the fine-spun arguments advanced by the appellant." Id. at 756. The opinion later refers to the taxpayers' sales methods as "Machiavellian subtlety." Id. at 760.

18 260 F.2d 77 (9th Cir. 1958).
19 Id. at 78.
20 260 F.2d 81 (9th Cir. 1958).
21 Id. at 81.
22 *Gudgel v. Commissioner*, 273 F.2d 206 (6th Cir. 1959); *Curtis Co. v. Commissioner*,
is resolved through a process of legal inference and reasoning, and thus it is for the reviewing court to determine whether the result reached stems from a correct view of the law. Nevertheless, it is not possible to dig very deeply into the cases within each circuit without discovering contradictions. For example, the Fifth Circuit, which subscribes to the “ultimate fact” label, has apparently also treated it as a question of law and a question of ultimate fact subject to the clearly erroneous rule. Likewise, the cases in this circuit which have emphasized the taxpayer’s statement that he was not holding the property primarily for sale in the course of the business actually are based entirely on a single fact determination. The Sixth Circuit has adhered to the “ultimate fact” classification in the past, but two recent cases, holding that the ultimate question is one of fact, indicate that that circuit no longer intends to substitute its judgment unless the lower court’s determination is clearly erroneous.

The Seventh Circuit stands alone in consistently holding that the held for sale question is one of law. That court has left the door open to broad review even if subsidiary fact issues are in dispute. In Voss v. United States, the court stated that although the jury is to determine disputed questions of fact, the court is to determine whether the evidence warrants submission of the ultimate question to the jury.

232 F.2d 167 (3d Cir. 1956); Consolidated Naval Stores v. Fahs, 227 F.2d 923 (5th Cir. 1955).

2 The courts which have thus characterized the question seem to have done so on the basis of a statement by Mr. Justice Frankfurter in Baumgartner v. United States, 322 U.S. 665, 670-71 (1944):

The conclusiveness of a “finding of fact” depends on the nature of the materials on which the finding is based. The finding even of a “subsidiary” fact may be a more or less difficult problem varying according to the simplicity or subtlety of the type of “fact” in controversy. Finding so-called ultimate “facts” more clearly implies the application of standards of law... Though labeled “finding of fact,” it may involve the very basis on which judgment of fallible evidence is to be made. Thus, the conclusion that may appropriately be drawn from the whole mass of evidence is not always the ascertainment of the kind of “fact” that precludes consideration by [the reviewing] court.

Gamble v. Commissioner, 242 F.2d 186 (5th Cir. 1957); Consolidated Naval Stores v. Fahs, 227 F.2d 923 (5th Cir. 1955); Goldberg v. Commissioner, 223 F.2d 709 (3rd Cir. 1951); Galena Oaks Corp. v. Scofield, 218 F.2d 217 (5th Cir. 1954).

Ross v. Commissioner, 227 F.2d 265 (5th Cir. 1955).

Lobello v. Dunlop, 210 F.2d 465 (5th Cir. 1954).

Ross v. Commissioner, 227 F.2d 263 (5th Cir. 1955); Foran v. Commissioner, 165 F.2d 705 (5th Cir. 1948). See text accompanying notes 42 and 43 infra.

Gudgel v. Commissioner, 271 F.2d 206 (6th Cir. 1959); Yunker v. Commissioner, 236 F.2d 130 (6th Cir. 1956).

Mathews v. Commissioner, 315 F.2d 101 (6th Cir. 1963); Bauschard v. Commissioner, 279 F.2d 115 (6th Cir. 1960).

Chandler v. United States, 226 F.2d 403 (7th Cir. 1955); Three States Lumber Co. v. Commissioner, 118 F.2d 61 (7th Cir. 1941).

329 F.2d 164 (7th Cir. 1964).

The district court had submitted to the jury only the question of whether the prop-
The courts would have less difficulty in finding a common standard of review if it were not used as a method of reaching a result with which each court agrees. Indeed, the willingness of the Ninth Circuit to substitute its judgment more readily when the trial court's decision is in favor of the taxpayer,33 and the willingness, in the same situation, of the Fifth Circuit to abide by the clearly erroneous rule,34 seem to be strong indications that the standard for scope of review is no more than an accommodation for those circuits' attitudes toward capital gains.

III. HELD PRIMARILY FOR SALE IN ORDINARY COURSE OF TRADE OR BUSINESS35

A. "Busyness" Or "Intent"

It would be difficult to find statutory language which has been subjected to so diverse an interpretation and application as has been the phrase "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."36 What constitutes property held for sale has received discordant analysis. The conflicts which have arisen may be partially explained by the differing emphasis placed on the respective components of the statutory exclusion. This exclusion, as applied to realty transactions, logically embodies two major elements. The first, "property held . . . primarily for sale . . .," is a subjective concept which looks to the purpose for which the property was held—i.e., the taxpayer's intent in relation to the transactions. This intent, however, is not meant to mean merely a scienter or state of mind on the part of the taxpayer which is present when he sells his lots. Rarely does one stop to think of whether he is a dealer or an investor as he disposes of his property. Rather, the intent element should include a number of components, both objective and subjective, which pertain to the entire transaction from the time the land is acquired until the lots are sold. What components will make up this factor depends, of course, on each particular case.

33 See e.g. notes 20 & 21 and accompanying text.
34 U.S. v. Kalmutz, 309 F.2d 437 (5th Cir. 1962).
35 The Fifth and Ninth Circuits have contributed more cases in this area than have the other circuits, primarily because there are a good deal more land transactions within the states which lie in the jurisdiction of those courts. The other circuits have for the most part followed the Fifth and Ninth Circuits. Also, there is more divergence between the Fifth and Ninth Circuits' views than between any of the others. For these reasons, this Comment will focus mainly upon the Fifth and Ninth. At the same time, a circuit by circuit breakdown is not intended except when there are striking conflicts.
36 This exclusion will hereinafter be referred to in a shortened form, i.e., "property held primarily for sale."
The second element, "in the ordinary course of [a] trade or business," connotes an objective standard, viz., whether the activities carried on by the taxpayer contemporaneous to his realty sales amount in fact to his carrying on a business. The factors which make up this objective consideration, as well as the intent factors, will be discussed in more detail in a later section. Throughout this Comment, reference will be made to the varying emphases placed by the courts on the intent or "busyness" elements. A statement that the court examined or emphasized the taxpayer's intent will generally mean (excepting the Ross and Foran cases) that the court considered all of the factors surrounding the entire transaction, from acquisition to sale. Likewise, when the court is said to emphasize "busyness" it will usually mean that the court's consideration was limited to the factors present at the time the sales were made.

A substantial number of earlier cases, in effect, disregarded all of the statutory language except the objective (trade or business) standard. In Snell v. Commissioner, the court stated that the word "business" was merely a disguised spelling of "busyness" and held that the taxpayer was in the business of selling real estate when he was kept "more or less busy" with his sales. Several cases adopted this approach by limiting their examination to the circumstances contemporaneous to the sales. In those decisions, once the external indicia of a business were found to exist at the time of the sale, the other requirements of the exclusion seemed to fall in place.

It is paradoxical that the same court which placed the word "busyness" in the capital gains vocabulary went to the other extreme in emphasizing, in effect, the "held . . . primarily," or purpose held, criterion. In Ross v. Commissioner and Foran v. Commissioner, the court elevated this element to sole importance in reversing lower court decisions which had held that taxpayers were in the real estate business when there was substantial evidence of activity on their part. The court's basis in reversing was the taxpayers' testimony that they did not intend to hold the property for sale in the course of a business. Evidence of prior dealings in real estate and "busyness" with respect to the sales in question was not sufficient to override these statements.

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37 See notes 42-44 infra and accompanying text.
38 97 F.2d 891 (5th Cir. 1938).
39 Id. at 892.
40 Ibid.
41 See, e.g., 512 West Fifty-Sixth St. Corp. v. Commissioner, 151 F.2d 942, 944 (2d Cir. 1945); Ehrman v. Commissioner, 120 F.2d 607 (9th Cir. 1941).
42 227 F.2d 261 (5th Cir. 1955).
43 165 F.2d 701 (5th Cir. 1948).
44 Both decisions held that evidence of prior dealings was competent, but that in these
The language of the exclusion in sections 1221 and 1231 indicates that both of the extreme approaches above are inadequate means of effectuating Congressional intent. A taxpayer who acts in such a way that it appears he is in the business of selling real estate may actually intend to hold the property primarily for sale in the course of that business. Nevertheless, there are instances in which the taxpayer becomes quite active in disposing of what he believes to be a capital asset without intending to become a dealer in real estate. Many considerations may influence the taxpayer in the manner he adopts in selling his investment, and these considerations should be taken into account. Nonetheless, a bald statement that it is not the intent of the taxpayer to hold the property primarily for sale to customers in the ordinary course of business should not be allowed to negate strong objective evidence to the contrary.

The majority of the cases seem to take both of these major elements into account in determining how the property was held. Generally, these considerations are broken down into a number of smaller factors. The labels ascribed to these factors and the weight given to each again are subject to the diverse views of the courts hearing the cases. For purposes of this Comment each factor has been grouped cases it should not have the weight of an uncontested statement by the taxpayer that the property was not held primarily for sale.

Although not dealing with the sale of realty, Greenspoon v. Commissioner discussed the conflict in the cases in this area. The court said:

The apparent conflict in the lines of cases . . . can perhaps in some instances be explained on the basis of factual differences. There also appear to be differences in the law applied. It would be impossible to reconcile all the conflicting decisions and, since the factual situation presented by the particular case is the important and controlling factor, little would be accomplished by discussing the cases in detail. On the whole, the cases denying the capital gains treatment appear to do so on the basis of finding a few similarities between the way in which liquidation was conducted and the manner in which business is ordinarily conducted. . . . On the other hand, it would seem that in general, the cases permitting capital gains treatment reached that result after a more thorough and complete survey of the entire factual situation. 229 F.2d 947, 952 (8th Cir. 1956).

See, e.g., Mathews v. Commissioner, 315 F.2d 101 (6th Cir. 1963); Tidwell v. Commissioner, 299 F.2d 864 (4th Cir. 1962); Yunker v. Commissioner, 251 F.2d 130 (6th Cir. 1958); Curtis Co. v. Commissioner, 232 F.2d 167 (3d Cir. 1956); Camp v. Murray, 226 F.2d 931 (4th Cir. 1955); Chandler v. United States, 226 F.2d 403 (7th Cir. 1955); Smith v. Dunn, 224 F.2d 313 (5th Cir. 1955); Galena Oaks Corp. v. Scofield, 218 F.2d 217 (7th Cir. 1954); McGah v. Commissioner, 210 F.2d 769 (9th Cir. 1954); King v. Commissioner, 189 F.2d 122 (5th Cir. 1951); Beck v. Commissioner, 177 F.2d 688 (7th Cir. 1950).

These factors are sometimes called the "Boomhower tests," because they apparently were compiled first in Boomhower v. United States, 74 F. Supp. 997 (N.D. Iowa 1947). The tests as set out in Boomhower 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 or in his behalf, or the time and labor given to effect the transactions, such as by improvements or advertisement to attract purchasers; the extent or substantiality of the transactions; the reasons for, purpose, or nature of the acquisition of the subject matter." Id. at 1002.
under one of three categories: (1) those which have a signal effect—
i.e., to bring the transaction to the attention of the Commissioner;
(2) those which relate to the taxpayer's intent with respect to his
sales; and (3) those which look to the "busyness" of the taxpayer
in carrying on his sales.

B. Signal Factors

1. Subdivision  The presence of subdivision usually is not considered
a factor in itself. Rather, the act of subdividing rather than selling
in large tracts seems to raise an inference that the taxpayer is a dealer
in real estate. In most cases capital gains treatment is readily available
if the property is sold just as the taxpayer acquired it, but the act
of subdivision has a signal effect in bringing the taxpayer's sales
under closer scrutiny by the Commissioner. At times the mere fact
of subdivision has acted almost as a prima facie case in favor of the
Commissioner. The better approach, however, is to consider this fact
as merely calling for an examination of additional circumstances sur-
rounding the sales. If the taxpayer acquires property which is
already subdivided it is possible that he purchases it to sell in the
course of a business. Nevertheless, this is not necessarily true, and
again the other factors should be consulted.

2. Improvements  To an extent, the presence of improvements, just
as subdivision, acts as a signal. This factor takes on greater im-
portance, however, if the improvements are substantial.

Improving to an extent greater than is necessary to bring about a
profitable disposition of the lots may imply a business operation. There
is no clear line as to what improvements may cause a loss of investor
status, and of course other factors present have a bearing on what
is allowed. At times, weight is placed on the necessity of the im-
provements made. Thus, levelling land and grading dirt roads have
been held not to defeat capital gains treatment when they were
necessary to make the property accessible to prospective purchasers.
On the other hand, some improvements are almost always considered
to be inconsistent with a contention that the taxpayer is liquidating
a capital asset. For example, the construction for sale of homes on

48 Yunker v. Commissioner, 276 F.2d 130, 136 (6th Cir. 1958). But where it appears
that the land is more valuable if left in large tracts, the fact that it is not subdivided
does not necessarily operate in the taxpayer's favor. Pennroad Corp. v. Commissioner, 261
F.2d 325 (3d Cir. 1958).
49 See Palos Verdes Corp. v. United States, 201 F.2d 256 (9th Cir. 1952).
50 See note 46 supra and accompanying text.
51 King v. Commissioner, 189 F.2d 122 (1st Cir. 1951).
52 See, e.g., Fahs v. Crawford, 161 F.2d 311 (5th Cir. 1948).
53 Gudgel v. Commissioner, 273 F.2d 206 (6th Cir. 1959); Barrios' Estate v. Commis-
  sioner, 261 F.2d 517 (5th Cir. 1959).
the lots will nearly always place the taxpayer in the real estate business. Between these two extremes, nothing is certain. Advertising rental property for sale "as is" has been a factor in obtaining capital gains treatment. Those courts which allow a close approximation of normal business methods when the taxpayer is liquidating are more likely to allow fairly substantial improvements which embellish the property or make it more saleable than those court which do not. This result is apparently reached because of the courts' reluctance to penalize the taxpayer who earnestly intends to liquidate an investment merely because he chooses means calculated to make the property sell faster at a better price.

C. Intent Factors—Purpose For Which Property Is Held

By far the most important factor, and in turn the most difficult to ascertain, is the purpose for which the property is held at the time of sale. Obviously, if the lots are sold, the taxpayer intended to sell them; but this fact alone will not establish that the taxpayer's primary purpose at the time of sale was to hold the property for sale to customers in the ordinary course of business. Likewise, the fact that a purchaser often intends, at the time he acquires the property, to sell it at some indefinite time in the future, should not place it within the exclusion. To find the purpose for which the property is held, a number of factors must be considered.

1. Intent to Liquidate

It is usually contended by the taxpayer that he is primarily liquidating a capital asset and only incidentally holding property for sale. The usual effect of such a finding is to remove the sales from the held for sale exclusion. Although this is often the result, the courts have demonstrated clearly that the word "liquidation" will not work as a shibboleth in bringing about capital gains treatment. Preoccupation with the "busyness" criteria led the courts in several earlier cases to disregard the fact that the taxpayer was liquidating, or to hold that the taxpayer was in the business of

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44 See Kaltreider v. Commissioner, 255 F.2d 833 (3d Cir. 1958), in which the taxpayer built homes on farmland and reported ordinary income on the sales of the houses while claiming capital gains on the lots. The court held that the entire gain was ordinary income.
45 Curtis Co. v. Commissioner, 232 F.2d 167 (3d Cir. 1956).
46 E.g., Voss v. United States, 329 F.2d 164 (7th Cir. 1964); Fahs v. Crawford, 161 F.2d 315 (7th Cir. 1947).
47 See, e.g., Bauschard v. Commissioner, 279 F.2d 111, 118 (6th Cir. 1960); Gamble v. Commissioner, 242 F.2d 586, 590 (5th Cir. 1957); Rollingwood Corp. v. Commissioner, 190 F.2d 263, 266 (9th Cir. 1951).
48 Palos Verdes Corp. v. United States, 201 F.2d 256 (9th Cir. 1952).
49 Yunker v. Commissioner, 256 F.2d 110 (6th Cir. 1958); Alabama Mineral Land Co. v. Commissioner, 210 F.2d 870 (5th Cir. 1957); Curtis Co. v. Commissioner, 232 F.2d 167 (3d Cir. 1956); Smith v. Dunn, 224 F.2d 313 (4th Cir. 1955); McGah v. Commissioner, 210 F.2d 769 (9th Cir. 1954). See also Elmer Farley, 7 T.C. 198 (1946).
liquidating when the objective elements of a business were present. In *Snell v. Commissioner*, the taxpayer, who had been in the real estate business for a number of years, decided to get out of that business and began selling his property without acquiring more. The court held that "the fact that he bought no additional lands during this period does not prevent his activities being a business. He merely had enough land to do a large business without buying any more." Once the court began to look to the taxpayer's intent, however, the fact of liquidation became more important. In *White v. Commissioner*, the court upheld a Tax Court finding that the taxpayer who subdivided and sold property he had acquired through foreclosure of paving liens was in the business of selling property, repeating that the mere fact of liquidation does not preclude the existence of a business. Nevertheless, the court went on to say that liquidation should not be disregarded completely.

2. Mode of Acquisition and Use of Property Whenever the court examines the taxpayer's intent, a good deal of weight is given to a subsidiary factor, the purpose for which the property was acquired. For example, in *Goldberg v. Commissioner*, the taxpayer sold a number of houses which he had originally built as rental homes. The court stated that a significant factor was whether he intended to operate a rental business in the first place. Having found that intent, the court allowed capital gains treatment and went on to say, "the original purpose is important, for to counterbalance it there must be significant objective evidence of a change in that purpose." Thus, the likelihood of having the transaction treated as a liquidation, thereby receiving capital gains treatment, is greater if the taxpayer originally acquires the property through inheritance, gift or foreclosure—i.e., if his role in obtaining the property is passive—or if the property is purchased to be held in a trade or business. This was

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60 See, e.g., Palos Verdes Corp. v. United States, 201 F.2d 256 (9th Cir. 1952); Brown v. Commissioner, 143 F.2d 468 (5th Cir. 1944); Ehrman v. Commissioner, 120 F.2d 607 (9th Cir. 1941); Snell v. Commissioner, 97 F.2d 891 (5th Cir. 1938); Richards v. Commissioner, 81 F.2d 369 (9th Cir. 1936).

61 97 F.2d 891 (5th Cir. 1938).

62 Id. at 893.

63 172 F.2d 629 (5th Cir. 1949).

64 Id. at 630.

65 223 F.2d 709 (5th Cir. 1955).

66 Id. at 712. See also Thomas v. Commissioner, 214 F.2d 233 (5th Cir. 1955).

67 Starke v. Commissioner, 312 F.2d 608 (9th Cir. 1963) (vacant lots acquired when bonds which they secured were defaulted); Yunker v. Commissioner, 216 F.2d 130 (6th Cir. 1953) (property acquired through inheritance); Camp v. Murray, 226 F.2d 931 (4th Cir. 1955) (inherited property); Western & So. Life Ins. Co., 163 F. Supp. 827 (Ct. Cl. 1958) (property acquired through foreclosure).

68 Barrios' Estate v. Commissioner, 265 F.2d 517 (5th Cir. 1959); Curtis Co. v. Commissioner, 232 F.2d 167 (3d Cir. 1956); McGah v. Commissioner, 210 F.2d 769 (9th Cir.
the result reached, for example, in *Smith v. Dunn*, 9 in which the property sold was inherited, and in *Delsing v. United States*, 10 in which it was used in the trade or business. In these and similar situations, there can be no inference that the taxpayer set out to acquire property to sell as there might be if the property were purchased as an investment. Nevertheless, the same result has been reached in cases in which the property was acquired merely for investment purposes. 11

3. Factors Influencing Mode of Sale  It frequently happens that there are external circumstances which persuade or compel the taxpayer to sell his property. A common victim of such compulsion is a taxpayer who owns property which has been used in an unprofitable business. For example, in *Barrios' Estate v. Commissioner*, 12 the taxpayer subdivided and sold land which she had farmed until it became unsuitable for that purpose. The court afforded capital gains treatment on the theory that once the taxpayer was compelled to sell, she should be allowed to adopt the method most likely to bring about the best profit. Other factors which have been held to be of sufficient persuasive force are: pressure from the taxpayer's employer to make property available to other employees during a housing shortage, 13 directions from settlor to trustee to convert all realty into securities, 14 pressure from bank-creditor 15 and need for money. 16 As in *Barrios' Estate*, the courts in the above situations apparently felt that once the need to sell was established, the mode adopted was up to the taxpayer. On the other hand, it has been held that preservation of property values is not a sufficient motive to justify subdivision of adjacent property into restricted lots. 17

In addition to forces which induce the taxpayer to decide to sell the property, there may also be others which influence the mode of sale which he adopts. At times the taxpayer may find that he is unable to make a profit upon sale of his land without subdivision and improvements. In this situation the courts have usually allowed capital

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10 224 F.2d 353 (5th Cir. 1955).
11 386 F.2d 59 (1st Cir. 1961).
12 See, e.g., *Austin v. Commissioner*, 263 F.2d 460 (9th Cir. 1959); *Thomas v. Commissioner*, 214 F.2d 233 (5th Cir. 1958). But see *Thompson v. Commissioner*, 322 F.2d 122 (5th Cir. 1963).
13 261 F.2d 517 (5th Cir. 1959).
14 226 F.2d 931 (4th Cir. 1955).
15 226 F.2d 403 (5th Cir. 1955).
16 210 F.2d 769 (9th Cir. 1954).
17 226 F.2d 115 (6th Cir. 1960).
gains treatment.' It would appear, however, that the mere fact that
the taxpayer may expect larger profits by selling subdivided property
than he could by selling large tracts is not in itself a compelling
factor. In almost all cases, in fact, sale by lots is more profitable than
sale of the property intact. This factor, however, coupled with a
compelling reason to sell probably is sufficient to bring about capital
gains treatment."

An interesting line of cases arose from the sale of rental homes
built during World War II to provide low-cost housing for defense
workers. These homes were built, in most instances, at the behest of
the National Housing Agency and were subject to regulation by that
authority. The regulations limited the amount of rent which could
be charged and forbade sales of the homes except those made pursuant
to purchase options exercisable by the tenant. In many cases the
options were required, in others they were voluntary, but in all cases
no sales were allowed except to the option holders. The rental and
sale of the homes, under the NHA restrictions, was less profitable
than would have been the case on the open market. The courts in
looking to these similar facts reached conflicting results. Several cases
allowed capital gains treatment by emphasizing the coercive nature of
the regulations and apparently concluded that had the taxpayer in-
tended to be in the business of selling homes, he would have chosen
more profitable methods. Others looked primarily to the "busyness"
surrounding the sales, ignored the regulations, and found that the
property was held primarily for sale. The wartime rental cases are,
of course, unique, and it is unlikely that such circumstances are found
in the present cases. It is significant, however, to note the diversity
that resulted from the courts’ consideration of these cases which were
so strikingly similar in their fact situations.

D. Busyness Factors

1. Sales Activity No factor will place the taxpayer within the held
for sale proscription as readily as substantial sales activity. By be-
coming greatly involved, the taxpayer satisfies not only the "busyness"

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8 Voss v. United States, 329 F.2d 164 (7th Cir. 1964); Riedel v. Commissioner, 261
F.2d 371 (5th Cir. 1958); Yunker v. Commissioner, 256 F.2d 130 (6th Cir. 1958). But
ef. Kelley v. Commissioner, 281 F.2d 527 (9th Cir. 1960); Maudlin v. Commissioner, 195
F.2d 714 (10th Cir. 1952).
8 Dillon v. Commissioner, 213 F.2d 218 (8th Cir. 1954); McGah v. Commissioner,
210 F.2d 169 (9th Cir. 1954); Victory Housing No. 2, Inc. v. Commissioner, 205 F.2d
371 (10th Cir. 1953); Delsing v. United States, 186 F.2d 19 (5th Cir. 1951).
8 Achong v. Commissioner, 246 F.2d 443 (9th Cir. 1957); Galena Oaks Corp. v.
Scofield, 218 F.2d 217 (5th Cir. 1954); Rollingwood Corp. v. Commissioner, 190 F.2d 263
(9th Cir. 1951); King v. Commissioner, 189 F.2d 122 (5th Cir. 1951); cert. denied, 342
U.S. 829 (1951).
element, but he also shows considerable evidence of an intent to sell property in the course of a business. The degree of activity allowed before one loses capital gains treatment is, of course, subject to the other facts present in each case. The taxpayer, however, treads on dangerous ground if he does much more than merely sit back and wait for prospective purchasers to come to him. Extensive advertising, listing and solicitation of buyers unfamiliar to the taxpayer often will result in ordinary income treatment in the event of a sale. The placing of for-sale signs on the property may also work the same result. In fact, the absence of for-sale signs has been held not to remove the element of sales activity when the taxpayer was selling on a seller’s market and a lack of signs created an appearance of scarcity. Setting an inflexible price on each lot, rather than negotiating with the individual buyer, may be considered to be evidence that the property is held primarily for sale.

When the taxpayer sells the lots himself, it is difficult to avoid adopting methods similar to those used by a dealer in real estate. Nevertheless, the courts apparently are more willing to overlook subdivision, improvements and frequency and continuity of sales than they are sales activity. Several cases which have allowed capital gains where the number of sales were massive have pointed out that the taxpayer was not himself carrying on the sales, or if he was, that his role was passive.

Indirect methods of selling may offer substantial advantages. Hiring a real estate broker may be one method of avoiding involvement on the part of the taxpayer, but the courts often apply agency principles and impute the broker’s acts to the taxpayer. The amount of supervision and control exercised by the taxpayer over the agent must be considered. If control is great, the agent’s acts probably will be imputed to the taxpayer. Conversely, if the taxpayer is acquiescent and does not supervise the agent’s activity, the courts may classify

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82 See Elmer Farley, 7 T.C. 198 (1946), in which the taxpayer engaged in practically no sales activities.
83 It is often said that the lack of sales activity—e.g., listing, promoting or advertising—does not show that the taxpayer did not hold property primarily for sale if, due to general business conditions, these activities were not necessary. Thompson v. Commissioner, 322 F.2d 122 (5th Cir. 1963); William H. Miller, 31 P-H Tax Ct. Mem. 198 (1962).
84 Pacific Homes, Inc. v. United States, 230 F.2d 735 (9th Cir. 1956).
85 Thompson v. Commissioner, 322 F.2d 122 (5th Cir. 1961).
87 Brauschard v. Commissioner, 279 F.2d 115 (6th Cir. 1960); Wood v. Commissioner, 276 F.2d 586 (5th Cir. 1960); Ehrman v. Commissioner, 120 F.2d 607 (9th Cir. 1941).
the agent as an independent contractor and refuse to attribute his acts to the taxpayer.88

Various business forms have been adopted to bypass the held for sale exclusion, but it appears that the courts will not allow the form to obscure the substance of the transaction. In *Jacobs v. Commissioner*,9 the taxpayer, a dealer in real estate, attempted to isolate himself from the sales transactions by forming a corporation. He sold the property to the corporation in exchange for its stock and later sold the stock to another party who intended to develop and sell the real estate. The court found that the property had at all times been held for sale in the course of his business and taxed him at ordinary rates on the sale of stock. If the taxpayer has no control over the entity selling the property for his benefit, he is more likely to receive capital gains treatment. Thus, in *United States v. Rosebrook*,90 the court refused to impute the activities of the trustees, real estate dealers, to a taxpayer who was a partial beneficiary under a trust set up to sell real estate holdings.

2. Frequency and Continuity of Sales

It is difficult to determine from the cases what is considered frequent and continuous and what is casual. The sale of twenty-nine lots in three years has been held to be too many sales to qualify for capital gains treatment,9 although the sale of ninety rental houses in one year has not been considered excessive.91 The cases are too numerous, with factual situations too diverse, for any line to be drawn. Nonetheless, one will more easily appear to be in the business of selling real estate if he sells many lots over a short period of time than if he sells only a few in isolated transactions. Therefore, the "busyness"-intent dichotomy again becomes important. The Ninth Circuit has refused capital gains in cases in which frequency and continuity of sales have stood almost alone as evidence that the taxpayer was holding the property primarily for sale in the ordinary course of business.92 The Fifth Circuit, on the other hand, has questioned the validity of the frequency and continuity test by

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88 Boomhower v. United States, 74 F. Supp. 997 (N.D. Iowa 1947). Apparently it is the exercise of control, not the mere right, which is important. Voss v. United States, 329 F.2d 164 (7th Cir. 1964).
89 244 F.2d 412 (9th Cir. 1955).
90 In Ackerman v. United States, 335 F.2d 521 (5th Cir. 1964), both a trust set up to hold title to the property to be sold and a corporation which sold the property were disregarded where the taxpayer and his brothers had substantial control over both entities.
91 316 F.2d 316 (9th Cir. 1963).
92 Kelley v. Commissioner, 281 F.2d 527 (9th Cir. 1960).
93 Goldberg v. Commissioner, 223 F.2d 709 (5th Cir. 1955).
94 Palos Verdes Corp. v. Commissioner, 190 F.2d 263 (9th Cir. 1951). The Tenth Circuit has also stressed frequency and continuity. See Mauldin v. Commissioner, 195 F.2d 714 (10th Cir. 1952).
reasoning that if the taxpayer actually intends to liquidate a large amount of property, it is only reasonable to expect that there will be a great number of sales over a short period of time. It would seem that this factor should be ignored only if there is not sufficient evidence of sales activity and of an intent of the taxpayer to hold the property primarily for sale.

3. **Substantiality of Realty Sales to Principal Business** If the income from realty sales is large in proportion to the taxpayer's normal business income, it might be seen as strong evidence that he is engaged in the real estate business. There is no formula for determining at just what point sales income becomes too substantial for capital gains treatment. Once again, a court that rejects liquidation intent emphasizes substantiality, usually in conjunction with frequency and continuity.

The factor of substantiality is actually based on two relationships, viz., the time spent in selling realty compared to the time spent in taxpayer's primary business, and the proportion of sales income resulting from realty sales to that from his principal source. The former presents few problems. It is clear that a taxpayer may be in more than one business at a time, and if he spends a large portion of his time dealing in real estate he may expect to be classified as a dealer. It is the second factor which may create hardship. When liquidation of a large capital asset is intended, just as it is natural to expect frequency and continuity, it is almost inevitable that the income from that liquidation will be lumped over a short time and in many cases will exceed the taxpayer's regular income. When this factor is considered significant, the very considerations which originally precipitated capital gains relief are the ones which will cause the taxpayer to lose capital gains treatment. In cases in which the taxpayer

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**Notes:**

85 Smith v. Commissioner, 232 F.2d 142 (5th Cir. 1956); Goldberg v. Commissioner, 223 F.2d 709 (5th Cir. 1955). But cf. Dunlap v. Oldham Lumber Co., 178 F.2d 781 (5th Cir. 1950), in which the court placed emphasis on the lack of frequency and continuity of the taxpayer's sales in finding that the property was held primarily for sale, thereby limiting him to a capital loss deduction.

86 The rationale behind discounting the validity of frequency and continuity of sales is that, if the property is liquidated on a seller's market, the element of substantial sales may be present without a corresponding excess of sales activity. Goldberg v. Commissioner, 22 F.2d 709 (5th Cir. 1935). If this is indeed the reason, then there should be an examination of whether the sales were frequent only because of the seller's market, or because of the taxpayer's promotion. If the latter is true, then frequency and continuity would seem to be further valid evidence of an intent to hold the property primarily for sale in the course of a business.

87 Thompson v. Commissioner, 322 F.2d 122 (5th Cir. 1963); Welch v. Solomon, 99 F.2d 41 (9th Cir. 1938).

88 Mauldin v. Commissioner, 195 F.2d 714 (10th Cir. 1952); Fahn v. Crawford, 161 F.2d 315 (5th Cir. 1947); Snell v. Commissioner, 97 F.2d 714 (5th Cir. 1938).

89 See notes 2 and 3 supra, and accompanying text.
actually is involved in the business of selling realty this is justifiable. But the cases in which this factor will create the greatest hardship are those in which the taxpayer attempts to rid himself of property which has been held or used in an unprofitable business. In such an instance, the same element which caused him to liquidate—i.e., insufficient income from his business—is compared to the income resulting from the sales. One need not be selling property used in an unprofitable business to experience the harshness of this paradox. The same result is reached in all cases in which the taxpayer’s activity and purposes in selling would not be sufficient to classify him as a dealer without a consideration of the substantiality of his sales. The example of the sale of business property demonstrates the error in the substantiality test if carried to its logical end. If in fact the taxpayer is in the real estate business, payment of ordinary income rates on lumped income is a correct result; but the question of substantiality of realty income to other income should not be raised in the determination of whether he is in that business. Some cases have recognized that substantiality of income is important only if it shows that there was also a substantial amount of time and activity expended by the taxpayer in making his sales. This seems to be the more valid approach.

4. Other Dealings in Realty The same factors which are examined when an investor sells realty are considered when a dealer claims capital gains on a portion of his transactions, but the degree of difficulty in establishing that the property was not held for sale in the realtor’s business is greater. His burden is increased twofold: first, the fact that he is a dealer with respect to other property makes it difficult to segregate any realty to be held as a capital asset; second, the major portion of his time usually is spent in realty transactions, thus cloaking his investment activity with the element of “busyness.” It has been possible to separate his investment holdings from activities in his business, but only by keeping accurate records and accounts which clearly show his intent not to hold the property for sale to customers in the ordinary course of business. Capital gains treatment has also been allowed when evidence showed that he was liquidating his realty business.

Just as the dealer is placed under a greater burden, the risk of...
losing capital gains treatment is greater for the investor who has a history of real estate dealings and who holds other investment property at the time the questioned sales were made. And, like the dealer, it is possible for him to receive capital gains treatment on part of his sales while being taxed at ordinary rates on others. Some factors which may work against the taxpayer are evidence of sales activity with respect to other property, continuous purchases and sales of realty, holding a dealer's license, maintaining an office from which to handle realty sales, and declaring himself as a dealer on his income tax return. The taxpayer who avoids all unnecessary indicia common to dealers is more likely to retain his investor status.

E. Summary

Because of the uncertainty in the cases, there is no formula for the taxpayer to follow to avoid dealer classification while disposing of his lots. Nevertheless, certain minimum standards may be suggested which, if practical, the taxpayer would be prudent to observe. It is difficult for the taxpayer to control the factors which evidence his intent unless he has them in mind prior to his acquisition of the property. The "busyness" factor, on the other hand, may be controlled if observed immediately before and during the sales. Of course, the easiest way to escape suddenly finding oneself in the real estate business is to avoid subdivision and improvement. Difficulties are rarely encountered if the taxpayer disposes of his property in the same market as that in which he acquired it. If reasons compel development of the property, however, or if the opportunities for profit on subdivided property substantially exceed those available for the sale of large tracts, there is still a good chance that the sales will be given capital gains treatment.

Once the decision to subdivide has been made, the taxpayer must be careful to avoid the disqualifying tests which the courts will consider. The most promising way to avoid becoming an unwitting real estate dealer is to insulate oneself from the entire transaction by contracting with a real estate agent or broker to develop and sell the property. It

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107 Wood v. Commissioner, 276 F.2d 586 (5th Cir. 1960).
109 Gruver v. Commissioner, 142 F.2d 363 (4th Cir. 1944).
110 Friend v. Commissioner, 198 F.2d 281 (10th Cir. 1952). But if a license is required by law in order to participate in certain transactions, that should not work against the taxpayer. Carruth v. United States 167 F. Supp. 294 (S.D. Fla. 1958).
111 Friend v. Commissioner, 198 F.2d 281 (10th Cir. 1952) (taxpayer apportioned office expense between law practice and realty sales).
112 Pacific Homes, Inc. v. Commissioner, 230 F.2d 755 (9th Cir. 1956); Friend v. Commissioner, supra note 111; Oliver v. Commissioner, 138 F.2d 910 (4th Cir. 1943).
should be kept in mind, however, that, if too much control and supervision is exercised over the agent, there is a good possibility that his activities will be imputed to the taxpayer. Another method which may be helpful is to establish a separate business entity to dispose of the property, but here again control over that entity may bring about attribution of that entity’s activities to the taxpayer. This form carries the additional disadvantage of raising the inference that the taxpayer is using the back door to gain capital gains treatment.

If the transactions are to be carried on solely by the taxpayer, he should avoid excesses. If at all practical, he should attempt to limit himself to the following procedures in disposing of his lots. The safest means of advertising is by word of mouth; if impractical, the advertising employed should be minimal. Any appearance of attempting to appeal to the public should be avoided. Listing with a broker may be advisable; but, on the other hand, it might be considered excessive sales activity. For-sale signs should not be used. Prices should not be fixed and inflexible, but should be open to negotiation. Using an office from which to conduct sales may result in a land office business, but it will probably also result in paying ordinary rates on any profits. A dealer’s or broker’s license should not be obtained unless it is required by law, and one should not list his occupation on his tax return as a dealer in real estate if in fact he is not. If possible, sales should be made in large blocks rather than by individual lots, and the transactions should be spread out over a long period of time. Also, the taxpayer should avoid reinvesting the proceeds from his sales in more realty to be developed and sold. In short, all methods characteristic of those used by real estate dealers should be avoided if possible.

It is possible that the taxpayer could become more than minimally involved in his sales without losing capital gains treatment. This depends upon the court which hears the case and upon the many other factors present, e.g., the prior holding of the land and the relationship of realty sales to the normal occupation of the taxpayer. However, in this chaotic area of tax law one should not hope for the best unless he has taken maximum precautions against a finding that the property was held primarily for sale to customers in the ordinary course of his business.

IV. Conclusion

The courts are confronted with countervailing policies each time a taxpayer claims capital gains treatment for profits received from the sale of subdivided realty. On the one hand is the desirability of allowing an investor to liquidate his investment in the manner most
likely to result in a profitable return. On the other hand is the undesirability of giving preferential tax treatment to one who is actually in the business of selling real estate. The divergent results in the cases can, for the most part, be explained by the adherence of the different courts to one or the other of these dichotomous considerations. Many courts have reasoned that one who is liquidating his realty should be allowed to employ whatever methods are advantageous in bringing about the highest possible yield or, in many cases, the only methods which will insure a profit. As a result, many taxpayers are afforded capital gains treatment on great portions of their incomes when in fact their business activities differ little from those of the dealer who pays taxes at ordinary rates. Apparently, it is precisely this result which has prompted the courts coming to an opposite conclusion on similar facts to reject the liquidation argument except in the clearest situations. Under these circumstances, the taxpayer will receive capital gains treatment only at the expense of rejecting the business methods of a dealer which, in most cases, are the most profitable. Due to this conflict in basic approach to capital gains in this area, it is unlikely that uniformity ever will be achieved. One cannot say that either approach is more valid than the other; each has basis both in the statutes and in the case law. It is only when one approach is emphasized totally without regard for the other that the basic principles of capital gains treatment are frustrated. A court should not come to a decision without a thorough examination of both the “busyness” and intent factors present throughout the entire history of the taxpayer’s activities relating to the realty sold. The purpose for and mode of acquisition of the property should be an important consideration, as should the use of the property during the time it was held and the circumstances surrounding the decision to sell. These factors, if supporting the taxpayer’s contention that he merely is liquidating a capital asset, should be weighed heavily against purely objective evidence, contemporaneous with his sales, which might imply the existence of a real estate business. On the other hand, these subjective factors might often show that the taxpayer is indeed intending to carry on a real estate business when in fact his sales are handled carefully so as to avoid dealership classification.

The objective factors should be important insofar as they negative the taxpayer’s contention that he is liquidating a capital asset. Thus, sales activities, if they involve a great deal of the taxpayer’s time and are employed to an unnecessary extent; frequency and continuity; and even substantiality of sales income to the rest of the taxpayer’s income should be good evidence of a dealer’s status in spite of contra
subjective evidence. A short holding period before subdivision and sale may raise a strong inference that sale for profit was intended when the property originally was acquired; the same is true with evidence that the taxpayer is reinvesting the sales proceeds in additional realty in order to carry on a continuing pattern of subdivision and sale. All of these factors are consonant with the idea that the property is held primarily for sale, and it should take a great deal of evidence to the contrary for the taxpayer to overturn a presumption that he is in the real estate business.

Even if the discord in the basic approaches were resolved, conflict in the decisions would persist. The nature of the held for sale exclusion is such that it may only be determined by an ad hoc approach to each case. In this situation and in view of the number of cases which have arisen, it is inevitable that the eleven circuit courts will disagree extensively. The Supreme Court has not decided a case in this immediate area, but if it does it will not be able to help a great deal, as it will be confronted with only one of many possible fact situations. Perhaps a statement from that Court indicating the factors upon which the greatest emphasis should be placed in determining whether property is held for sale would add a certain amount of clarity, but it is doubtful whether this would be of much help. Furthermore, it is doubtful that legislation could be drafted which would alleviate the problem. Section 1237 was enacted to deal with this specific area, but it has proven to be of little use. The most obvious shortcomings of section 1237 are its sharply limited applicability and the artificial restrictions and penalties, not found elsewhere in the law of capital gains, placed on those to whom it does apply.

The taxpayer is probably in a better position in the courts than he would be under any new, workable legislation. The fault of the case law which has developed is not so much the direction it has taken as it is the lack of uniformity and predictability. If the present capital gains structure and the held for sale exclusion are to be retained, an
ad hoc approach to the sale of realty is a must. It is difficult to conceive of legislation which would bring about uniformity and yet preserve this approach.

property. Int. Rev. Code of 1954, § 1237(a)(2). This requirement is twofold. Not only must the improvements be substantial, but such improvements must also enhance the value of the property. The value of the property is considered enhanced if the fair market value increases by 10% or more. Treas. Reg. § 1.1237-1(c) (3)(ii) (1957). The taxpayer is allowed to make necessary improvements. Int. Rev. Code of 1954, § 1237(b)(3), but these may not be used to adjust his basis, nor may they be deducted as an expense. Int. Rev. Code of 1954, § 1237(b)(3)(C). If improvements are made the taxpayer must hold the property for an additional five years after the last sale. Int. Rev. Code of 1954, § 1237(b)(3). If the property has previously been held for sale, or if the taxpayer holds other property for sale, § 1237 does not apply. Int. Rev. Code of 1954, § 1237(a)(1).

If the qualifications of § 1237 are met, the first five sales are taxed at capital gains rates. Int. Rev. Code of 1954, § 1237(b)(1). The sixth lot and all lots sold subsequent thereto are taxed at ordinary rates to the extent of 5% of the selling price less selling expenses, with capital gains realized on the balance of the gain. Int. Rev. Code of 1954, § 1237(b)(1). If the sixth lot is sold in the same year as any of the first five, all sales are subject to the 5% rate. Int. Rev. Code of 1954, § 1237(b)(1). After the tract from which the lots have been sold is held an additional five years from the last sale, it becomes a new tract for purposes of § 1237. Int. Rev. Code of 1954, § 1237(c). In other words, the qualifying taxpayer may subdivide, sell five lots, wait five more years from the last sale to sell five more lots, repeat this process, and never pay more than capital gains rates on his sales. If § 1237 appears to be of limited application, the regulations passed pursuant to it restrict it even more. It has been said that § 1237 is "noble in purpose, nebulous in language and practically nullified by regulation." Spandorf & Tonelson, Capital Gains Provision for Real Estate Investors in Section 1237—More Promise than Fact, 8 J. Taxation 201 (1958). It serves little purpose to go deeply into the regulations. Nevertheless, one or two of the restrictive regulations should be examined, as there might otherwise be some value in § 1237 without them.

Although the statute provides that evidence of sales activity is to be disregarded in determining whether § 1237 applies, the regulations provide for the examination of other evidence which will likely have the same effect as an examination of sales activity. In determining whether the property has been held primarily for sale, evidence of the following is to be considered: (1) holding a dealer's license, (2) the sale of clearly investment property, (3) merely holding investment property without engaging in sales activity and (4) acting as a salesman of property in which the taxpayer has no financial interest. Treas. Reg. § 1.1237-1(a)(3) (1957). None of these factors is to have any weight by itself, but a combination of any two is strong evidence that the property which the taxpayer is attempting to bring under § 1237 has been held primarily for sale. Treas. Reg. § 1.1237-1(a)(3) (1957). Another restrictive regulation embodies the prior ownership test, in which the purpose of a prior owner to hold the property primarily for sale in the course of his business may be imputed to the taxpayer unless the taxpayer shows evidence to the contrary. Treas. Reg. § 1.1237-1(b)(3) (1957). The effect of these regulations is to further restrict the application of an already preclusive code section.

Section 1237 does not foreclose seeking capital gains treatment on all of the taxpayer's sales under §§ 1221 and 1231. Treas. Reg. § 1.1237-1(a)(4) (1957). Even if the taxpayer seeks § 1237 treatment, it does not apply if it is found that capital gains would be afforded under those sections. Treas. Reg. § 1.1237-1(a)(4) (1957). Because it is not exclusive and because almost no one can qualify under it, § 1237 has been virtually ignored. It appears that when it is used it is used only as an alternative. See, for example, Gault v. Commissioner, 332 F. 2d 94 (2d Cir. 1964), and Kelley v. Commissioner, 281 F. 2d 127 (9th Cir. 1960).

Section 1237 was intended to alter the importance of subdivision and sales activity by prohibiting their consideration and to alter the importance of frequency and continuity of sales through an allowance of a limited number of sales with capital gains consequences. Under the "common law" of realty sales, these factors are equally as important as before; and by seeking capital gains treatment under the old statutes, the taxpayer is exposed to them. Nevertheless, only in rare circumstances, when all of the stipulating requirements have been met, would it be advisable to attempt § 1237 treatment.