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Suburban Realty Co. v. United States: Capital Gain Treatment Denied on Profits from the Sale of Undeveloped and Highly Appreciated Real Property

Pursuant to its organization in 1937, Suburban Realty Company received an undivided one-fourth interest in a tract of real estate located in Harris County, Texas.1 Between 1939 and 1971 Suburban made at least 244 sales of portions of the property suitable for commercial and residential development.2 The majority of Suburban's sales were of subdivided lots located near the center of the property. Much of the rest of the land remained undeveloped and was never put to any substantial use.3 In 1957 the Texas Highway Department proposed that Houston's North Loop be constructed across Suburban's undeveloped property,4 and as a result of the location of the freeway the value of the property more than doubled.5 By 1959 all development activities had been discontinued and the officers, directors, and stockholders of Suburban had begun discussing the liquidation of the corporation.6 In 1961 Suburban withdrew and cancelled the plats for two remaining undeveloped residential additions. In 1966 Suburban instituted a program of purchasing securities from which the company began receiving a significant income. Between 1968 and 1971 Suburban sold six tracts out of the remaining unimproved property and reported the profits from those sales as ordinary income. Suburban subsequently filed a claim for refund with the Internal Revenue Service, asserting that it was entitled to preferred capital gains treatment of its profits because the tracts sold were capital assets within the meaning of section 1221 of the Internal Revenue Code.

1. The property consisted of 1746.2 acres. In exchange for all of its stock Suburban received its interest in the property from four individuals. Other parties, and eventually their successors, held the remaining interest. As stated in its charter, Suburban's corporate purposes were to erect or repair buildings or improvements; to purchase, sell, and subdivide realty; and to accumulate and lend money to accomplish such purposes.
2. Real estate sales represented 83% of Suburban's income for the period between 1939 and 1971. The number of sales per year varied considerably, from one sale in each of four years, to 52 sales in 1950. Suburban made less than 10% of the total number of its sales after 1965.
3. In 1938 Suburban and the owners of the other undivided interest formed a separate corporation that platted and sold a parcel of land located in the northeastern quadrant of the property. Without advertising or otherwise soliciting buyers, this corporation sold most of its subdivided lots by 1961 and was thereafter liquidated.
4. In 1959 and 1960 Suburban sold parcels from the property to the Texas Highway Department for the purpose of constructing the freeway.
5. Real estate in the area that had sold for $3,000 to $5,000 per acre prior to the announcement of the proposed freeway location jumped in value to $7,000 to $12,000 per acre.
6. Suburban contended that the liquidation discussions concerned the winding up of its corporate affairs and the conversion of assets into cash, as well as the possibility of the passive liquidation of investment property suggested by Biedenharn Realty Co. v. United States, 526 F.2d 409, 417 (5th Cir.), cert. denied, 429 U.S. 819 (1976); see notes 47-57 infra and accompanying text. These discussions became common after Rice University became a stockholder of Suburban in 1961 because the university desired income-producing assets rather than raw land.
NOTES

Revenue Code of 1954. The Commissioner disallowed the claim, and Suburban then brought a refund suit for an amount equal to the alleged overpayment of taxes. After the district court dismissed the complaint, Suburban appealed to the Fifth Circuit. Held, affirmed: Capital gain treatment will be denied on profits from the sale of undeveloped, highly appreciated portions of a large tract of land when the taxpayer is engaged in the business of selling real estate from the tract, the property is held primarily for sale in that business, and the sales are "ordinary" in the course of that business. Suburban Realty Co. v. United States, 615 F.2d 171 (5th Cir.), cert. denied, 101 S. Ct. 318 (1980).

I. REAL ESTATE AS SECTION 1221(1) PROPERTY

Because there was no provision for the favorable treatment of capital gains in the first United States income tax law, gain from the sale of investment property received the same tax treatment as ordinary income. Recognizing the inequity of taxing at progressive ordinary income rates in a single year gains resulting from appreciation in value accrued over a substantial period of time, Congress enacted in 1921 the first capital gains relief measure. Although the original capital gains provisions have undergone numerous and sometimes inconsistent changes, capital gains have continued to receive preferential tax treatment.

Under the Internal Revenue Code of 1954 a capital gain usually results from the profitable sale or exchange of a capital asset. Section 1221 defines the term "capital asset" as all property held by a taxpayer not falling within one of the exceptions to that section. Subsection 1221(1) excludes from the definition of capital assets stock in trade or certain inventory items or, "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

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8. Suburban sought a refund of $102,754.50.
10. 38 Stat. 166.
18. I.R.C. § 1221(1).
fore, real estate will be considered a capital asset, the sale or exchange of which will result in a capital gain or loss, if the taxpayer holds the property primarily for investment rather than primarily for sale to customers in the ordinary course of its trade or business. Although this standard appears straightforward, section 1221(1) has been the subject of frequent litigation, and the reported decisions have at times been ad hoc and discordant.

19. A discussion of the different tax consequences of capital losses and ordinary losses is beyond the scope of this Note. For a recent Fifth Circuit discussion of the criteria for classifying losses from real estate sales as capital or ordinary, see Reese v. Commissioner, 615 F.2d 226, 230-31 (5th Cir. 1980).

20. Commentators have suggested that an “investor” in real estate will receive capital gain treatment on gains arising from the sale of his property whereas a “dealer” will be denied this privilege. See Brown, Individual Investment in Real Estate: Capital Gains vs. Ordinary Income; Attaining Nondealer Status; Structuring Disposition of Investment; Dealer as Investor: Implications of Investor-Dealer Partnership, 34 N.Y.U. Inst. Fed. Tax. 189, 190 (1976); Hooton, Permanent Tax Savings Provided by Properly Structured Real Estate Transactions, 58 Taxes 643, 644 (1980); Levin, Capital Gains or Income Tax on Real Estate Sales, 37 B.U.L. Rev. 165, 165 (1957). Other commentators assert that this distinction in terms can only lead to confusion since merely because a taxpayer is a “dealer” with respect to some of his property, a court’s opinion should not therefore be automatically prejudiced with respect to the question of whether the taxpayer holds other property as an “investor.” See Friedman & Solomon, Tax Consequences on the Sale of Real Property—A New Approach, 19 S. Cal. Tax. Inst. 281, 315 (1967).


Although not at issue in Suburban, § 1237 of the Internal Revenue Code provides that in certain limited circumstances sales of subdivided realty can qualify for capital gains treatment. Id. § 1237(a). For discussions on the availability of such treatment, see Houston Endowment, Inc. v. United States, 606 F.2d 77, 83-84 (5th Cir. 1979). See also Libin, “Transactions Entered Into for Profit,” “Regular Trade or Business”, and/or “Investment”: Some Distinctions and Differences, 27 N.Y.U. Inst. Fed. Tax. 1209, 1216-17 (1969); Repetti, What Constitutes a Dealer under Section 1237, 17 N.Y.U. Inst. Fed. Tax. 651, 651-56 (1959).

22. The Second Circuit described the number of § 1221(1) real estate cases as “legion.” Gault v. Commissioner, 332 F.2d 94, 95 (2d Cir. 1964).


The confusion has resulted in part from the combination of both subjective and objective elements in § 1221(1). For example, the determination of whether a taxpayer’s real estate has been held primarily for sale requires a subjective examination of the taxpayer’s purpose or intent for holding such property. Objective determinations are required in order to resolve whether the taxpayer’s activities constitute a trade or business and whether the sales in question were made in the ordinary course of that business. See Comment, Sales of Subdivided Realty—Capital Gains v. Ordinary Income, 19 Sw. L.J. 116, 121-22 (1965). See also Note, Taxation of Sales of Subdivided Land: Ordinary Income or Capital Gain?, 14 Hous. L. Rev. 500, 504 (1977). The outcome of a given case may depend on whether a court stresses the objective or the subjective determinations that must be made with regard to § 1221(1).

Compare Snell v. Commissioner, 97 F.2d 891 (5th Cir. 1938), in which the court based its decision on the objective determination that the nature and extent of the taxpayer’s activities constituted a real estate business, with Ross v. Commissioner, 227 F.2d 265 (5th Cir. 1955), in which the court held that the taxpayer was entitled to capital gain treatment despite his numerous purchases and sales of property, based on the taxpayer’s testimony that he did not intend to hold the property at issue for sale except through liquidation of a capital asset. For
The United States Supreme Court in *Malat v. Riddell*\(^{24}\) resolved an early conflict among the circuit courts of appeals regarding the meaning of the term "primarily" in section 1221(1).\(^{25}\) The taxpayer in *Malat* was a dealer in real estate and joined with others to purchase a tract of farmland not for resale but to hold for the purpose of developing the entire property into a garden apartment complex. The joint venturers realized at the outset that they had made a good purchase and that if rezoning and financing were unavailable the whole property could be sold in bulk at a profit.\(^{26}\) Financing in fact proved unavailable, and the venturers subdivided and sold the interior portion of the tract, reporting the profits as ordinary income.\(^{27}\) Subsequently Malat sold out his remaining interest in the undeveloped frontage areas of the tract and reported his profits as capital gains.\(^{28}\) The Internal Revenue Service assessed a deficiency, asserting that because of the taxpayer's flexible plans for the property, his substantial purpose for holding the property had been primarily for sale. In Malat's refund suit the district court agreed, finding that from the time the property was acquired, and throughout its ownership, Malat had held the property for the dual purposes of development or sale, whichever course of action proved more profitable.\(^{29}\) In denying Malat capital gains treatment, the court concluded that resale was the essential primary purpose for which the property was held.\(^{30}\) The Ninth Circuit affirmed the judgment of the district court and rejected the taxpayer's argument that he had merely liquidated a disappointing investment.\(^{31}\) The court agreed with Malat that an investor's prospective awareness that he might resell property in the future at a profit does not cause him to have a dual purpose for holding property.\(^{32}\) The court found, however, that Malat had alternative

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\(^{24}\) 383 U.S. 569 (1966) (per curiam).

\(^{25}\) The Second and Ninth Circuits had held that as used in § 1221(1), "primarily" referred to the taxpayer's "substantial" or "essential" purpose for holding property. E.g., American Can Co. v. Commissioner, 317 F.2d 604, 605 (2d Cir. 1963), cert. denied, 375 U.S. 993 (1964); Rollingwood Corp. v. Commissioner, 190 F.2d 263, 266 (9th Cir. 1951); accord, Harrah v. Commissioner, 30 T.C. 1236, 1241 (1958). The Eighth and Fifth Circuits had employed a literal interpretation of the term "primarily." See, e.g., Municipal Bond Corp. v. Commissioner, 341 F.2d 683, 688-89 (8th Cir. 1965); United States v. Bennett, 186 F.2d 407, 410-11 (5th Cir. 1951).


\(^{27}\) *Malat v. Riddell*, 64-1 U.S. Tax Cas. ¶ 9432, at 92,154 (S.D. Cal. 1964) (mem.).

\(^{28}\) *Id.*

\(^{29}\) *Id.*

\(^{30}\) *Id.*

\(^{31}\) 347 F.2d 23, 27 (9th Cir. 1965), vacated per curiam, 383 U.S. 569 (1966).

\(^{32}\) 347 F.2d at 26.
essential holding purposes from the time he acquired his interest in the property.\textsuperscript{33} When he opted to sell the property, that became his primary holding purpose within the meaning of section 1221(1).\textsuperscript{34}

Reversing the court of appeals and remanding to the district court, the Supreme Court held that the term "primarily" as used in section 1221(1) means "principally" or "of first importance."\textsuperscript{35} The Court stated that a literal interpretation of "primarily" was in keeping with the legislative purpose of section 1221 to differentiate between those profits and losses arising from the everyday operation of a business\textsuperscript{36} and appreciation in value that has accrued over a substantial period of time.\textsuperscript{37} The Supreme Court, however, expressly declined to address the facts of the case\textsuperscript{38} and did not express an opinion regarding the Ninth Circuit's theory that when Malat resolved to sell, that became his primary purpose for holding the property.\textsuperscript{39} The Court's opinion, therefore, left unclear the issue of whether the Court's interpretation of the term "primarily" includes situations in which the taxpayer's purpose for holding the property in question changes over time.\textsuperscript{40}

\textsuperscript{33} Id. at 27.

\textsuperscript{34} Id.

\textsuperscript{35} 383 U.S. 569, 572 (1966) (per curiam).

\textsuperscript{36} Id. (citing Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46, 52 (1955)). In Corn Products the Court denied capital gain treatment to a taxpayer engaged in selling unused commodities futures. The Court held that the futures were § 1221(1) property and stated that "the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly." 350 U.S. at 52.

\textsuperscript{37} 383 U.S. at 572 (citing Commissioner v. Gillette Motor Transp., Inc., 364 U.S. 130, 134 (1960)). In Gillette Motor Transport the Court held that proceeds received by the taxpayer from the United States as consideration for the government's takeover of the taxpayer's business during World War II were properly characterized as ordinary income because Congress intended to "afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year." 364 U.S. at 134. See also note 12 supra and accompanying text.

\textsuperscript{38} 383 U.S. at 572.

\textsuperscript{39} One commentator has suggested that the Court's statement of congressional policy was inapplicable to the facts of the case since Malat had owned his interest in the property for only eight or nine months. Rubin, Capital Gain Treatment of Real Estate Sales: Implications of the Malat Case, 16 Tul. Tax Inst. 421, 424 (1966). The same author concludes however that because of the factual setting of Malat, the Court probably meant to remove from the classification of ordinary real estate income those gains arising from the sale of property that the taxpayer intends to hold for long-term appreciation. Id. at 425. This logic seems persuasive because although Malat's purpose for holding his interest in the subdivided tracts may have changed from investment to sale, there was no showing that with respect to the residual frontage areas his investment purpose had changed. On remand the district court ultimately concluded that the tracts in question were not § 1221(1) property. 66-2 U.S. Tax Cas. ¶ 9564 (S.D. Cal. 1966).

\textsuperscript{40} See Suburban Realty Co. v. Commissioner, 615 F.2d at 183 n.36. The Suburban court expressed confusion about whether the Malat definition of "primarily" means, "'predominates at a certain point of time' or 'predominates over the life of taxpayer's ownership of the asset,'" but found that Suburban's holding purpose was primarily for sale under either interpretation. Id.

In Scheuber v. Commissioner, 371 F.2d 996 (7th Cir. 1967), the Commissioner argued that the Malat decision only applied to situations in which the taxpayer has a dual holding purpose and that Scheuber was not entitled to capital gains because he had always intended to sell the property in question. The Seventh Circuit disagreed, finding this argument a harsh
With the exception of the Ninth Circuit, the Fifth Circuit has decided more section 1221(1) real estate cases than any other circuit court. Older decisions in the circuit under section 1221(1) had suggested that certain primary factors concerning a taxpayer's activities with respect to his property were relevant in analyzing the ultimate issue of whether or not the property was held by the taxpayer in the ordinary course of his business. In *United States v. Winthrop* the court cataloged seven factors commonly found in the court's earlier decisions, but cautioned that none had an independent significance and that every case must be considered in its entirety. The taxpayer was denied capital gain treatment of certain profits

interpretation of *Malat* and its principles. The court found that the real estate dealer was entitled to capital gain treatment on the sale of certain unimproved real estate because "returns on the amounts initially invested were unrealistically high for items held for resale in day to day operation of a business." *Id.* at 999.

In contrast to the *Scheuber* decision, the Tax Court in *Bynum v. Commissioner*, 46 T.C. 295 (1966), denied capital gains to a taxpayer who owned a farm for use in connection with his nursery and landscaping business but who subsequently subdivided and sold part of the active farm. The court noted at the outset that it was not dealing with a case like *Malat* in which the taxpayers had a dual holding purpose, but rather a case in which the taxpayer's purpose for holding the property in dispute had changed over time. *Id.* at 298-99. The Tax Court held that the gains from the sales of the subdivided lots were ordinary income because at the time of such sales the taxpayers held the property primarily for sale to customers in the ordinary course of business. *Id.* at 299, 301. The court indicated that the inquiry into a taxpayer's holding purpose should be directed toward the time of the sale or sales. *Id.* at 299; accord, *Maddux Constr. Co. v. Commissioner*, 54 T.C. 1278, 1286 (1970); *Eline Realty Co. v. Commissioner*, 35 T.C. 1, 5 (1960). Some commentators agree with the *Bynum* decision and suggest that the *Malat* interpretation of the term "primarily" has no significance when a taxpayer's holding purpose for particular property has changed over time, since in this situation no dual purpose exists at any one time. See Freedman & Solomon, *supra* note 20, at 346.

41. Comment, *supra* note 23, at 121 n.35. This fact can be attributed to the large number of land transactions that take place within the court's jurisdiction. *Id.* See also Note, *Biedenharn Realty Co. v. United States: A Restatement of the Tax Treatment of Subdivided Real Estate Sales*, 29 BAYLOR L. REV. 389, 401 (1977).

42. *United States v. U.S. Steel*, 294 F.2d 426 (5th Cir. 1961); *Estate of Barrios v. Commissioner*, 265 F.2d 517 (5th Cir. 1959); *Consolidated Naval Stores Co. v. Fahs*, 227 F.2d 923 (5th Cir. 1955); *Ross v. Commissioner*, 227 F.2d 265 (5th Cir. 1955); *Smith v. Dunn*, 224 F.2d 353 (5th Cir. 1955); *Goldberg v. Commissioner*, 223 F.2d 709 (5th Cir. 1955).

43. 417 F.2d 905 (5th Cir. 1969). See also *Smith v. Dunn*, 224 F.2d 353, 356 (5th Cir. 1955).

44. The court in *Winthrop* concluded that the relevant factors in determining whether profits from the sale of real estate should be classified as either capital gains or ordinary income were the following:

(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.

417 F.2d at 910 (citing *Smith v. Dunn*, 224 F.2d 353, 356 (5th Cir. 1955)). For similar criteria in other circuits, see, e.g., *Gault v. Commissioner*, 332 F.2d 94, 95 (2d Cir. 1964); *Bauschard v. Commissioner*, 279 F.2d 115, 118 (6th Cir. 1960); *Kaltreider v. Commissioner*, 255 F.2d 833, 838 (3d Cir. 1958); *Boomhower v. United States*, 74 F. Supp. 997, 1002 (N.D. Iowa 1947).

45. 417 F.2d at 911. The district court apparently had relied on these factors as it had
from subdivided and improved lots carved out of a tract held for over twenty-five years even though the taxpayer's activities did not include all of the traditional indicia of a real estate business.\footnote{46}

In \textit{Biedenharn Realty Co. v. United States} the Fifth Circuit sought to define more clearly the \textit{Winthrop} factors and to suggest those that should be emphasized.\footnote{48} The court concluded that the "main" factors to be considered in section 1221(1) real estate cases were the substantiality and frequency of sales, the addition of improvements to the real estate, solicitation and advertising efforts, and broker activities.\footnote{49} In \textit{Biedenharn} the taxpayer had purchased a large tract of land for farming and investment purposes. Subsequently, the company subdivided and improved portions of the tract. Between 1964 and 1966 Biedenharn reported part of its profits from sales of the subdivided lots as capital gains. The Internal Revenue Service assessed a deficiency, concluding that the gains should be characterized as ordinary income. In its suit for refund Biedenharn argued that it was entitled to capital gain treatment because it had originally acquired the property as a capital asset for farming and investment and had subsequently merely "liquidated" a part of its investment by selling the tracts in issue. The district court determined on the basis of the \textit{Winthrop} factors that Biedenharn had not been engaged in a real estate business apart from its farming and other business activities, and held that Biedenharn was entitled to capital gain treatment.\footnote{50} A three-judge panel of the Fifth Circuit affirmed the district court, finding that Biedenharn had engaged in reasonable efforts to liquidate a large tract originally acquired for

\footnote{46} \textit{Id.} at 909-12. In holding against the taxpayer, the court determined that the magnitude and continuity of the taxpayer's development and sales activities established that the taxpayer had held the property primarily for sale. \textit{Id.} Because of \textit{Winthrop}'s planned program of subdividing and selling, the court found the sales to have been made in the course of \textit{Winthrop}'s business. \textit{Id.} The court rejected, however, the government's argument that capital gain treatment should be limited to situations in which gain is solely attributable to market forces and should be denied if the profits were generated by the taxpayer's efforts. \textit{Id.} at 908-09. The court cited several cases in which it had previously found capital gain treatment to be proper when taxpayer efforts had contributed to the value of the real estate in issue. \textit{Id.} at 909 (citing United States v. Temple, 355 F.2d 67 (5th Cir. 1966); Commissioner v. Pontchartrain Park Homes, Inc., 349 F.2d 416 (5th Cir. 1965); Cole v. Usry, 294 F.2d 426 (5th Cir. 1961); Estate of Barrios v. Commissioner, 265 F.2d 517 (5th Cir. 1959); Smith v. Dunn, 224 F.2d 353 (5th Cir. 1955); Goldberg v. Commissioner, 223 F.2d 709 (5th Cir. 1955)).

\footnote{47} 526 F.2d 409 (5th Cir.), \textit{cert. denied}, 429 U.S. 819 (1976).

\footnote{48} 526 F.2d at 415.

\footnote{49} \textit{Id.} See also \textit{Houston Endowment, Inc. v. United States}, 606 F.2d 77, 81 (5th Cir. 1979).

\footnote{50} \textit{Biedenharn Realty Co. v. United States}, 356 F. Supp. 1331, 1336 (W.D. La. 1973), \textit{rev'd on rehearing en banc}, 526 F.2d 409 (5th Cir.), \textit{cert. denied}, 429 U.S. 819 (1976). The district court likened Biedenharn's sales to those in \textit{Estate of Barrios v. Commissioner}, 265 F.2d 517 (5th Cir. 1959), in which the court allowed capital gain treatment because the taxpayer had been forced to liquidate a tract of land by subdividing it into lots after the tract had been rendered useless for farming purposes. \textit{Id.} at 520.
farming and investment. The panel cautioned, however, that due to Bie-
denharn's development and sales activities its profits were on the border-
line between capital gains and ordinary income.

Sitting en banc the Fifth Circuit reversed the district court and the three-
judge panel and held that the profits from the lot sales were ordinary in-
come. The court rejected Biedenharn's liquidation argument and, apply-
ing its revised Winthrop analysis, determined that Biedenharn's original
investment intent had been overborne by intense sales and development
activity. Deemphasizing the importance of Biedenharn's continued
farming activities on the undeveloped and unsold portions of the tract, the
court determined that a Malat v. Riddell dual holding purpose analysis
was inapplicable because over a period of time Biedenharn had thoroughly
abandoned its investment intent and was primarily engaged in selling sub-
divided and developed property at the time the lots in controversy were
sold. Significantly, however, the court left open the possibility that under
certain circumstances an investor could receive capital gain treatment of
profits from the liquidation of a large tract without making a bulk sale.

II. SUBURBAN REALTY CO. v. UNITED STATES

In Suburban Realty Co. v. United States the Fifth Circuit undertook to
reduce further the uncertainty in section 1221(1) real estate cases and to
address the "false dichotomy" created by the United States Supreme
Court in Malat v. Riddell. Affirming the dismissal of Suburban's com-
plaint, the court noted that the disputed profits in the case before it had
arisen from both the ordinary operation of a business and long-term mar-
ket appreciation. The court attributed the substantial confusion sur-
rounding the proper characterization of gains from the sale of real estate in
part to religious adherence to the traditional "factor" tests. The court
expressly declined to overrule Winthrop's first factor concerning the nature and purpose of
the acquisition and duration of the taxpayer's ownership of the property. Id. at 174.

51. Biedenharn Realty Co. v. United States, 509 F.2d 171 (5th Cir. 1975). The panel
expressly declined to overrule Winthrop's first factor concerning the nature and purpose of
the acquisition and duration of the taxpayer's ownership of the property. Id. at 174.

52. Id. at 175.

53. Biedenharn Realty Co. v. United States, 526 F.2d 409, 423-24 (5th Cir.), cert. de-

54. 526 F.2d at 423; cf. Yunker v. Commissioner, 256 F.2d 130 (6th Cir. 1958), in which
the taxpayer was held entitled to capital gains on profits derived from the liquidation of an
inherited investment tract despite substantial development and sales activity.

55. The majority of the court noted that some testimony in the record "may" have indi-
cated that some farming on the tract was extant. 526 F.2d at 418. The district court had
determined explicitly that farming of the remainder of the tract was active. 356 F. Supp. at
1336. See also 526 F.2d at 425 (Gee, J., dissenting).

56. 526 F.2d at 422-23.

57. Id. at 420 n.39.

58. 615 F.2d at 187.


60. 615 F.2d at 187.

61. Id. at 173. Suburban's profits from the sales in question approximated 95%; Subur-
ban demonstrated that the average net profit on sales made by a real estate developer is 33%.
Id. at 186 n.43.

62. Id. at 177-78. For listings of the factors used in the traditional factor tests, see note
44 supra and text accompanying note 49 supra.
stated that these factors had often attained a significance independent of
the language of the statute because courts had applied them to the single
question of whether gain is ordinary or capital. The court concluded that
three separate inquiries are demanded by the exclusionary language of sec-
tion 1221(1):

(1) [W]as taxpayer engaged in a trade or business, and, if so, what
business?

(2) [W]as taxpayer holding the property primarily for sale in that
business?

(3) [W]ere the sales contemplated by taxpayer "ordinary" in the
course of that business?

After formulating these inquiries, the court stated that it was not rejecting
the use of the Biedenharn-Winthrop factors. Rather, the court noted, the
factors are useful in varying degrees to the resolution of each inquiry.

For example, the court concluded that the frequency and substantiality of
sales remains the most important factor in section 1221(1) real estate cases
because it is relevant to each of the three statutory inquiries. Moreover,
even a taxpayer who has made only a few sales and has realized only a
modest profit might be considered to be in the real estate business if a high
percentage of his total annual income results from the sales. On the
other hand, the court determined that the extent of development activity
may be relevant to the first inquiry, but implied that it is only peripher-
ally related to the second inquiry. Additionally, the court observed that

63. 615 F.2d at 178. The district court had stated, "A single issue is presented by this
lawsuit: Whether six properties sold by the plaintiff . . . qualify for capital gains treatment,
i.e., are to be taxed at one-half the normal corporate rate of taxation." 77-2 U.S. Tax Cas. ¶
9547, at 87,835 (S.D. Tex. 1977). The Fifth Circuit in Suburban rejected the district court's
single issue approach insofar as it glossed over the inquiries demanded by the statute. 615
F.2d at 178. Addressing the single issue approach, two commentators stated that "it would
not be a gross exaggeration to declare that [under the traditional factor approach] courts
could use the same opinion in all their cases and merely insert their conclusion—capital gain
or ordinary income." Freedman & Solomon, supra note 20, at 299.

64. 615 F.2d at 178.
65. Id.
66. Id.
67. Id. The court concluded that frequency and substantiality of sales are relevant to
the first inquiry because a taxpayer who has engaged in frequent and substantial real estate
sales activity is almost always in the real estate business; they are relevant to the second
inquiry because frequent and substantial sales activity ordinarily belies a taxpayer's conten-
tion that he was holding the property for investment purposes; and they are relevant to the
third inquiry because they may support a finding that the sales were ordinary in the course
of the taxpayer's business.

68. Id. at 179-80 n.24. The court declined to define the quantum of sales activity re-
quired to establish conclusively the existence of a real estate trade or business. Id. at 181. If
a taxpayer is extensively involved in other activities, his real estate activities might not con-
stitute another business unless his real estate activity is frequent and substantial in dollar
amount. Id.

69. Id. at 178-79. The court drew a distinction between the business of developing and
the business of selling real estate, stating that development activity may be relevant to a
determination of the existence of a development business, but that it is irrelevant to a deter-
mination of the existence of a real estate sales business. Id.

70. Id. at 179. The court stated that some degree of development activity, standing
alone, is not conclusive evidence that a taxpayer held property primarily for sale. Id. at 178-
solicitation and advertising efforts are "quite" relevant to the first and second factors and in turn can strengthen the case for ordinary income treatment, but that their absence is not conclusive, especially if a strong seller's market exists. Although the court chose not to discuss the remaining Biedenharn-Winthrop factors, it stated that each factor was relevant to some extent to one or more of the three inquiries.

After explaining that the section 1221(1) issue is a mixed question of law and fact, the court applied the Biedenharn-Winthrop factors to each of the three statutory inquiries in the context of Suburban's real estate activities. The court first examined the issue of whether Suburban was in the real estate business. Suburban argued that when the sales in issue were made it carried on no trade or business and that if it had ever been in the real estate business it had exited that business long before 1968. In support of these contentions Suburban relied on the insignificance of its past development activities, the complete absence of advertising or sales solicitation, the absence of additional land purchases to replenish the lots sold, and its commencement of a securities investment program in 1966. Relying solely on Suburban's history of real estate sales, the court concluded that Suburban was engaged in the business of selling real estate. As if defensive of

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79. For example, the court suggested that a taxpayer might engage in clearing, grading, and filling land in connection with farming activities. Id. at 179 n.22. The court concluded that development activity is less conclusive of the taxpayer's holding purpose than is the frequency and substantiality of its sales. Id. at 179.

71. Id. at 179.

72. Id. The court cautioned that its discussion of the relevancy of factors to particular inquiries may not be applicable to all situations. Id. at 179 n.23.

73. Id. at 180-81. The court concluded that the practice of applying factors to the single question of whether the gain was ordinary had created confusion concerning the appropriate standard of appellate review in § 1221(1) real estate cases. Id. at 180; see note 63 supra and accompanying text. Two lines of cases had emerged in the Fifth Circuit as a result of the single issue approach. One line held that the issue of whether property had been held by a taxpayer primarily for sale to customers in the ordinary course of his business was a question of law, for which the standard of review on appeal is plenary. See Houston Endowment, Inc. v. United States, 606 F.2d 77, 83 (5th Cir. 1979); United States v. Winthrop, 417 F.2d 905, 910 (5th Cir. 1969); Galena Oaks Corp. v. Scofield, 218 F.2d 217, 219 (5th Cir. 1954). The other line of cases held that the question was essentially one of fact. Under this analysis, the factfinder's conclusion may not be overturned unless it is found to be clearly erroneous. See, e.g., Huxford v. United States, 441 F.2d 1371, 1375 (5th Cir. 1971); United States v. Burkett, 402 F.2d 426, 429 (5th Cir. 1968); United States v. Temple, 355 F.2d 67, 68 (5th Cir. 1966); Thompson v. Commissioner, 322 F.2d 122, 127 (5th Cir. 1963). The court determined that the inquiries concerning the taxpayer's purpose for holding the property and the "ordinariness" of sales are essentially factual questions, while the question of whether the taxpayer was engaged in a trade or business is a mixed question of law and fact. 615 F.2d at 181. The ultimate question of whether property has been held by a taxpayer primarily for sale to customers in the ordinary course of business is a legal conclusion, and the trial court's ultimate conclusion based on the answers to the three inquiries is subject to plenary appellate review. Id. at 181 n.28.

74. 615 F.2d at 181. At the outset the court observed that the description of Suburban's principal business activity in its income tax returns for the period was "development and sales of real estate." Id. Although admitting that such statements were not conclusive of the issue, the court found that the statements showed that if Suburban was engaged in a trade or business, that business was real estate. Id. See also Thomas v. Commissioner, 254 F.2d 233, 236-37 (5th Cir. 1958). The court rejected each of Suburban's arguments. The court indicated that the absence of development activity was irrelevant to a determination of whether
its position the court stated that section 1221(1) does not require that property be sold while a taxpayer is still actively engaged in the real estate business, only that the property have been held for sale in that business.\textsuperscript{75}

The court next examined Suburban's purpose for holding the particular tracts for sale. Suburban argued that at the time of the sales it did not hold the property at issue, or, alternatively, that it had originally purchased the property for investment, and its holding purpose with respect to the particular parcels sold had not changed.\textsuperscript{76} The court rejected Suburban's argument that the inquiry into a taxpayer's holding purpose should be directed to the time of the sale of the property and concluded that the proper approach is to trace the taxpayer's holding purpose over the entire course of his ownership of the property.\textsuperscript{77} Without differentiating between the parcels in question and the entire tract, the court concluded that even if Suburban originally had purchased the land for investment, its holding purpose by the 1950s had become primarily one of sale.\textsuperscript{78} The court stated, however, that Suburban was entitled to show that its holding purpose had changed since that time from one of sales to one of investment.\textsuperscript{79} In this regard Suburban argued that by the three years when the six tracts in controversy were sold, its overall sales had decreased, its officers and directors had conducted several discussions concerning the liquidation of the company, and it had withdrawn and cancelled the plats for two residential additions. The court found no significance in Suburban's first two contentions,\textsuperscript{80} but indicated that in certain circumstances a withdrawal of

\textsuperscript{75} Suburban was in the real estate sales business. 615 F.2d at 181; see note 69 supra. Because Suburban had enjoyed a strong seller's market, the court rejected Suburban's reliance on the absence of advertising and solicitation. 615 F.2d at 182; see text accompanying note 71 supra. Although withholding judgment on the issue, the court determined that Suburban's investments in securities could evidence a second business distinct from its real estate sales business. 615 F.2d at 182. The court attached no significance to the fact that Suburban had never purchased land to replenish the parcels sold, since Suburban had an ample supply with which to carry on its sales business. Id.

\textsuperscript{76} For a discussion of the change of intent and liquidation theories implicit in Suburban's alternate arguments, see Hooton, supra note 20, at 645-49. Apparently by its latter argument Suburban intended to analogize itself to the taxpayer in Malat v. Ridell, 383 U.S. 569 (1966) (per curiam). See notes 39 & 40 supra and accompanying text.

\textsuperscript{77} Both Suburban and the Commissioner argued that the taxpayer's holding purpose under § 1221(1) should be determined at the time of the sales in question. Id. The court rejected those cases indicating that a taxpayer's holding purpose at the time of sale is determinative of the capital gains issue, noting that "[a]t the very moment of sale, the property is certainly being held 'for sale.'" Id. at 182. The court decided that Malat was inapplicable to the issue of the time at which a taxpayer's holding purpose should be ascertained because it did not address the issue. Id. at 183. In apparent contradiction, the court cited Malat as authority for its holding that the proper approach begins with establishing the taxpayer's holding purpose on the date of acquisition followed by a determination of whether the taxpayer changed that purpose during his ownership of the property. Id.

\textsuperscript{78} Id. at 184. The court apparently relied on Suburban's numerous sales during the 1940s and 1950s of developed lots from additions carved out of the larger tract of land. Id. at 184-85.

\textsuperscript{79} Id. at 184.

\textsuperscript{80} Id. The court indicated that a clearly demarcated exit from the real estate business could be strong evidence that a taxpayer has changed his holding purpose. Id. at 182 n.33. Because Suburban had continued to make some sales, however, the court attached little
plats could reflect a significant change in holding purpose. The district court, however, had found that Suburban withdrew the plats so that more profitable industrial and commercial sales could be made from the property. The court accepted that finding as further evidence that Suburban had held the tracts in question primarily for sale and concluded that Suburban had failed to sustain its burden of proving that the specific tracts sold were held separately from those held for sale in its business. Addressing the third and final statutory question, the court concluded summarily that Suburban's history of continuous and frequent sales activity was conclusive evidence that the sales were completed in the ordinary course of Suburban's business.

Despite its conclusion that under the plain language of section 1221(1) the parcels sold were not capital assets, the court considered whether the

81. 615 F.2d at 184-85.
82. 77-2 U.S. Tax Cas. at 87,834.
83. 615 F.2d at 185. The court implied that if the withdrawal of the plats had been motivated by investment reasons rather than for the purpose of maximizing profits by selling to commercial users, Suburban might have successfully established that its holding purpose had changed.
84. The court noted that although there could be cases in which a taxpayer in the real estate business may hold specific tracts of a larger property for investment purposes, the taxpayer has the burden of establishing that "the parcels held primarily for investment were segregated from other properties held primarily for sale." Id. For example, the court stated earlier in its opinion that "if a taxpayer who engaged in a high volume [real estate] business sold one clearly segregated tract in bulk, he might well prevail in his claim to capital gain treatment on the segregated tract." Id. at 180 n.24. The court found, however, that Suburban had not established that its primary purpose for holding the parcels at issue was different from its purpose for holding the entire tract and concluded that mere lack of development activity is insufficient to establish that investment tracts were separated from tracts held for sale. Id. The court did not address Suburban's proof that the platted and unplatted parts of the tract were recorded in separate accounts on its books and records. Brief for Appellant at 36. In its brief Suburban stated that "the separate, undeveloped real estate was always held for investment purposes." Id. For an interesting although not precedential ruling that the unsubdivided balance of a large tract of real estate was not § 1221(1) property, see Rev. Rul. 565, 1957-2 C.B. 546.
85. 615 F.2d at 185-86 (citing United States v. Winthrop, 417 F.2d 905, 912 (5th Cir. 1969)); accord, Houston Endowment, Inc. v. United States, 606 F.2d 77 (5th Cir. 1979), in which the court stated that "the question whether [the taxpayer] was selling property in the ordinary course of business may be answered only by focusing on the sales pattern relative to the entire tract of land . . . ." Id. at 81. But see Commissioner v. Ponchartrain Park Homes, Inc., 349 F.2d 416 (5th Cir. 1965), in which the Fifth Circuit affirmed in a brief per curiam opinion the result reached by the Tax Court in Ponchartrain Park Homes, Inc. v. Commissioner, 22 T.C.M. (CCH) 437 (1963). The Fifth Circuit cautioned without explanation that it was not adopting the broad standards set forth by the Tax Court. 349 F.2d at 416. The Tax Court held that the taxpayers were entitled to capital gain treatment of profits that resulted from the sale of certain portions of a larger tract that had proved infeasible for development, reasoning that these tracts were not sold in the ordinary course of the taxpayer's business. 22 T.C.M. (CCH) at 442.
congressional purpose of capital gains relief taxation expressed in earlier precedents mandated a decision in favor of Suburban. The court recognized that Suburban's profits had arisen from market forces and Suburban's patience, rather than from any merchandising or development efforts. The court noted that in the circuit's principal section 1221(1) real estate cases in which capital gain treatment had been denied, subdivision or development activity had always existed in conjunction with frequent and substantial sales. In Suburban, however, it was undisputed that the taxpayer undertook no development or subdivision activity with respect to the particular parcels in issue. The court stated that Malat v. Riddell provided no guidance because the Supreme Court's statement of congressional purpose suggested that profits "could not arise" from both the ordinary operation of a business and appreciation accrued over a substantial period of time. The court next examined Commissioner v. Gillette Motor Transport, Inc. and Corn Products Refining Co. v. Commissioner, upon which the Malat Court based its statement of legislative purpose. The court observed that the Gillette Court had explained that capital gain treatment is allowed only in those situations in which appreciation has accrued over a substantial period of time, but did not hold that capital gains must be allowed in all situations involving accrued appreciation. Moreover, the court found that Corn Products stood for the proposition that Congress intended that profits arising from the everyday operation of a business be considered ordinary income. The court found that Suburban's profits were definitely of this type. The Suburban court concluded that, provided section 1221(1)’s requirements are met, "when [the taxpayer’s] ordinary business . . . is to make profits from appreciation in value caused by market forces, those profits [will be taxed] as ordinary income." The Fifth Circuit in Suburban purported to ease the confusion in section 1221(1) real estate cases by rejecting the practice of employing factors such as development and merchandising activities to resolve the sole issue of whether gain is ordinary or capital. In the guise of formulating a more thorough method of analysis, however, the court has effectively directed attention to the single question of whether the taxpayer has engaged in frequent and substantial sales activity. The court declined to suggest the quantum of real estate sales activity that will constitute a real estate sales

86. 615 F.2d at 186.
87. Id. at 186-87.
88. Id. at 176 (citing Houston Endowment, Inc. v. United States, 606 F.2d 77, 82 (5th Cir. 1979); Biedenharn Realty Co. v. United States, 526 F.2d 409, 417 (5th Cir.), cert. denied, 429 U.S. 819 (1976); United States v. Winthrop, 417 F.2d 905, 911 (5th Cir. 1969)).
89. 615 F.2d at 177.
90. Id. at 186; see text accompanying notes 36-37 supra.
91. 364 U.S. 130 (1960).
93. 615 F.2d at 186.
94. Id. at 187.
95. Id. Although its holding caused a bunching of accrued income, the court noted that any hardship imposed on the company was minimized because the taxation of overall sales from the entire tract had been spread over time. Id.
“business” but indicated that the issue could be resolved against the taxpayer if real estate profits constitute a large proportion of his annual income. This approach has ominous implications for real estate investors and belittles the legislative purpose of capital gains relief taxation.

III. Conclusion

In Suburban Realty Co. v. Commissioner the taxpayer was denied capital gain treatment of profits from the sale of parts of a tract of real estate that had appreciated for over thirty years. With respect to the tracts in issue the taxpayer engaged in no development or merchandising activities. Based on the taxpayer’s history of frequent and substantial sales from the tract, the court determined that within the language of section 1221(1) the taxpayer was in the real estate sales business, the property was held primarily for sale in that business, and the sales were ordinary in the course of that business. To avoid a direct confrontation with Suburban, a taxpayer who in the past has been involved in the business of selling real estate should consider maintaining a lengthy and absolute hiatus in his real estate activities before making further sales. Although the Fifth Circuit was cavalier in its analysis of Malat v. Riddell, the Supreme Court’s decision may still be viable. A taxpayer who owns a large tract perhaps can convincingly establish that parcels always held primarily for investment were segregated from those held for sale.

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