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Distinguishing Between Dealer and Investor Sales of Real Estate

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DISTINGUISHING BETWEEN DEALER AND INVESTOR SALES OF REAL ESTATE

INTRODUCTION

The tax treatment accorded by the Internal Revenue Code to capital gains or losses as contrasted with ordinary gains or losses makes it imperative that taxpayers give timely consideration to the tax consequences of the gain or loss incident to a sale of real property. The determination of this controversy is dependent upon whether the *res* sold was a capital asset as defined in the Internal Revenue Code. There, capital assets are broadly defined as "property held by the taxpayer (whether or not connected with his trade or business)" with a number of important exclusions.[1] Herein we are concerned with one of these exclusions which has proved a fertile source of litigation, and which provides that an asset is not a capital asset if it is "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[2]

The purpose of this statutory exclusion is to afford treatment as ordinary income to the gain or loss on sales of real estate held by a "dealer" for sale to customers, or a treatment parallel to that accorded the stock-in-trade of a merchant. On the other hand an "investor", who would usually hold real property for the income which it produces or for long term appreciation in value, is accorded such restricted tax effects as are appropriate to capital gains or losses.

TAX CONSEQUENCES OF CAPITAL GAINS AND LOSSES

The most significant aspect of the treatment of long-term capital gains[3] in the case of a taxpayer other than a corporation is the fact that only 50 per cent[4] of the recognized gain or loss[5] is taken into account in computing taxable net income. Further, the law embodies an alternative tax computation which, by limiting the tax rate to 50 per cent of any excess of net long-term capital gain over net short-term capital

1. I. R. C. § 117 (a) (1).
2. I. R. C. § 117 (a) (1) (A).
3. Defined in I. R. C. § 117 (a) (4) as meaning "gain from the sale or exchange of a capital asset held for more than six months."
4. I. R. C. § 117 (b).
5. I. R. C. § 112.

loss results in a maximum total effective income tax rate of 25 per cent of such excess.[6]

While a corporate taxpayer is required to take the entire amount of a capital gain into account regardless of the holding period,[7] it is favored with an alternative tax provision limiting the rate on long-term capital gains to 25 per cent.[8]

A similar principle embodying a restricted or lesser tax effect is accorded to *losses* resulting from the sale of capital assets. Corporations are allowed no deduction against ordinary income for capital losses in excess of capital gains.[9] In the case of taxpayers other than corporations net capital losses allowed for a single year are limited to the amount of ordinary income or $1,000.00, whichever is the lesser.[10] Taxpayers other than corporations are also favored with a five year capital loss carry-over provision.[11]

These statutory provisions, by placing a premium on inconsistency, encourage recurrent litigation concerning essentially similar sales transactions. It is clear that it is generally profitable to a taxpayer to assert a dealer status when he has suffered losses, so that they may be deducted in full as ordinary losses, and on the other hand, to assert an investor status when he has realized gains in order to enjoy favorable capital gains provisions. Conversely the interest of the Government requires the assertion of opposite contentions.

A critical appraisal of the relevant statutory language reveals that only indefinite and broad indicia as to the distinction between dealer and investor sales are there embodied. This issue has been productive of much litigation because the question presented is essentially one of fact, and no one factor or element in the cases has appeared to be invariably decisive. However, the facts in the numerous decisions tend to fall in a logical pattern. The most important criteria which the courts have established and reiterated are:

(1) Occupation of the Seller
(2) Extent of Sales and Developmental Activity
(3) Frequency and Continuity of Transactions
(4) Motive or Purpose

6. I. R. C. § 117 (c) (2).
7. I. R. C. § 117 (b).
8. I. R. C. § 117 (c) (1).
9. I. R. C. § 117 (d) (1).
10. I. R. C. § 117 (d) (2).
11. I. R. C. § 117 (e).

OCCUPATION OF THE SELLER

The frequency with which the occupation of the seller is mentioned in the cases makes it a factor to be considered even though no case has been decided in reliance on this point exclusively.

From the outset it must be noted that a taxpayer may be considered a dealer in real estate even if that is not his only or principal business.[12] Although it is not necessary that he devote a great deal of time to this activity,[13] or that the business be extensive,[14] carrying on a "business" has been held to imply an occupational undertaking to which one habitually devotes time, attention, or effort with substantial regularity.[15]

The taxpayer who wishes to be characterized as an "investor" in respect to his dealings in realty should avoid the use of any term connoting a real estate business. The style in which he holds himself out to the public in advertisements, letterheads, and telephone listings, as well as holding membership in dealers' associations[16] may be considered significant. The Government, as evidence that the taxpayer is a real estate dealer, sometimes offers a statement in the tax return to that effect.[17] Indeed, the Tax Court in holding profits taxable as ordinary income has characterized the "admission" on the tax return as the "highest and best evidence" that the taxpayer was a dealer, saying that surely an astute business man with a legal education "knew in what business his firm was engaged."[17a]

Lawyers who have been involved in real estate transactions have generally been rather successful in persuading the court

12. G. C. M 8787, C. B. 1930-2, p. 189; Oliver v. Comm'r., 138 F. (2d) 910 (C. C. A. 4, 1943); George J. Wibbelsman, 12 T. C. 1022 (1949).

13. Ethel S. White, 6 T. C. M. 1038 (1947), affirmed 172 F. 2d 629 (C. C. A. 5, 1949).

14. Amelie M. Staff, 3 T. C. M. 1149 (1944).

15. Fahs v. Crawford, 161 F. 2d 315 (C. C. A. 5, 1947).

16. Replogle v. United States, 33 AFTR 1664 (D. C. T. S. D. Fla., 1944); Snell v. Comm'r., 97 F. 2d 891 (C. C. A. 5, 1938); but *cf.* Gruver v. Comm'r., 142 F. (2d) 363, 367 (C. C. A. 4, 1944), where the finding that taxpayer had never had a real estate broker or agent's license, did not advertise, and had never been a member of any organization of real estate men was without avail, the court nevertheless characterizing him a dealer.

17. Oliver v. Comm'r., 138 F. (2d) 910 (C. C. A. 4, 1943); S. E. Boozer, 6 T. C. M. 1021, 1027 (1947).

17a. Ethel S. White, 6 T. C. M. 1038 (1947), affirmed 172 F. (2d) 629 (C. C. A. 5, 1949).

that they were not dealers.[18] There have been decisions both ways in respect to contractors.[19] Two licensed real estate salesmen, employed full time by a real estate firm, successfully contended they were investors and entitled to capital gains treatment.[20] It appears that a taxpayer may actually be deemed an investor as to some transactions in real estate and at the same time a dealer as to others, *provided* he establishes and maintains adequate accounting classifications.[21]

Extent of Sales and Developmental Activity

It is in regard to the nature and amount of sales and developmental effort that the taxpayer can do most to assure himself of the desired tax treatment. Although this factor appears not to have been mentioned as often in the cases as frequency and continuity, a consideration of it is usually necessary to reconcile the cases, and has not infrequently been persuasive in the courts' decisions.

Obviously the more active the taxpayer is in erecting "for sale" signs, listing with real estate agents, advertising, flying flags, establishing tract offices, sub-dividing and making improvements, the greater is the likelihood that he will be labeled a dealer.[22] It seems that real property may be fairly extensively improved by one contending for an investor status only if the work takes the form of "preliminary activity" calculated to make the property more readily saleable.[23]

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18. Fahs v. Crawford, 161 F. 2d 315 (C. C. A. 5, 1947); Sparks v. United States, 55 F. Supp. 941 (D. C. Ga., 1944); Boomhower v. United States, 74 F. Supp. 997 (D. C. Iowa, 1947); Peter A. Miller, 20 B. T. A. 230 (1930); Estate of Douglas S. Mackall, Sr., 3 T. C. M. 701 (1944).

19. Ben L. Carroll, 21 B. T. A. 724 (1930); Marsch v. Comm'r., 110 F. (2d) 423 (C. C. A. 7, 1940).

20. Ashton C. Jones, 1 T. C. M. 816 (1943).

21. Nelson A. Farry, 13 T. C., 8 (1949), following the doctrines set out in Van Tuyl, 12 T. C., 900 (1949).

(A) 1949-20-13191, and Carl Marks & Co., 12 T. C., 1196 (1949), allowing securities dealers to hold securities for investment purposes, even though of the same type as others held for resale, provided they were sufficiently segregated and separate books were kept.

22. Oliver v. Comm'r. 138 F. (2d) 910 (C. C. A. 4, 1943); Ehrman v. Comm'r., 120 F. (2d) 607, 610 (C. C. A. 9, 1941); Replogle v. United States, 33 AFTR 1664 (D. C. S. D. Fla., 1944).

23. Fahs v. Crawford, 161 F. 2d 315 (C. C. A. 5, 1947); Phipps v. Comm'r., 54 F. (2d) 469 (C. C. A. 2, 1931); Sparks v. United States, 55 F. Supp. 941 (D. C. Ga. 1944); Boomhower v. United States, 74 F. Supp. 997 (D. C. Iowa, 1947) wherein taxpayer subdivided his tracts, installed untilities, advertised for thirty-five weeks in the local paper, but was nevertheless held not to have lost his status as an investor.

Conversely if taxpayer largely or entirely refrains from such active conduct and passively allows himself to be sought out by prospective buyers, there is a distinct likelihood that he will be held to be an investor.[24] In one case wherein the facts indicated that the sales in question were essentially in the nature of a gradual and passive liquidation without "extensive development" and "sales activity" the Tax Court said ". . . Nor did petitioner engage in any activities whatsoever to promote sales. He did no advertising, hired no agents, did not list the property, and erected no signs. Petitioner, in our opinion, merely accepted satisfactory offers from unsolicited purchasers. It would seem that petitioner could have maintained a more passive role only by refusing to sell at all."[25]

Ordinarily it is implied that one's own attention and effort are involved, but here as elsewhere the maxim *qui facit per alium facit per se* applies, and one may carry on a business through agents whom he supervises,[26] by a developer who is an independent contractor,[27] or by a trust created by the owner.[28]

FREQUENCY AND CONTINUITY

In considering the frequency and continuity of transactions the courts have often held profits to be capital gains despite a substantial volume and frequency of sales.[29] When these decisions are contrasted with those upholding a dealer status[30] it appears clear that this criterion is not alone determinative but can be intelligently evaluated only in view of the other facts in the case.

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24. Three States Lumber Co. v. Comm'r., 158 F. (2d) 61 (C. C. A. 7, 1946); Dagmar Gruy, 8 T. C. M. 787 (1949); Ethel M. Hauk,....T. C. M....., Docket No. 23931 (T. C. Memo. Sept. 28, 1951).

25. Frieda E. J. Farley, 7 T. C. 198 (1946).

26. Brown v. Comm'r., 143 F. (2d) 468 (C. C. A. 5, 1944); Snell v. Comm'r., 97 F. (2d) 891 (C. C. A. 5, 1938); John E. Sadler, 3 T. C. M. 1285 (1944).

27. Comm'r. v. Boeing, 106 F. 2d 305 (C. C. A. 9, 1939); but *cf*, Fahs v. Crawford, 161 F. 2d 315 (C. C. A. 5, 1947).

28. Richards v. Comm'r., 81 F. (2d) 369 (C. C. A. 9, 1936); Welch v. Solomon, 99 F. (2d) 41 (C. C. A. 9, 1938).

29. In Fahs v. Crawford, 161 F. 2d 315 (C. C. A. 5, 1947), 36 lots plus 95% of the lots in the remaining large acreage were sold in 1940-41; in Sparks v. United States, 55 F. Supp. 941 (D. C. Ga., 1944), 15½ lots were sold in 1940 and 13 in 1941; in Guthrie v. Jones, 72 F. Supp. 784 (D. C. Okla, 1947), 100 transactions in 1940-41, 24 in 1942, and 53 in 1943; in Boomhower v. United States, 74 F. Supp. 997 (D. C. Iowa, 1947), 7 lots in 1941 and 1 in 1943.

30. In Oliver v. Comm'r., 138 F. (2d) 910 (C. C. A. 4, 1943), 24 lots were sold in 1938, 16 lots in 1939, and 40 lots in 1940, or in all 80 lots

It has been held[31] where taxpayer acquired property previously subdivided by the vendor, assumed further improvement obligations of the vendor, made continual sales of lots and thereafter continually added land to the project, that such sustained operations constitute a business for tax purposes. In reaching this result, consideration of the circumstances of acquisition or purpose of sale were swept aside.

Conversely the cases indicate the rule that lack of continuity in sales of land, either by inactivity toward the land itself or by infrequency of sales will give the transactions which do take place the color of "isolated conveyances", and take the taxpayer out of the character of one transferring title to real estate in the "ordinary course of business."[32]

The courts may look to taxpayer's sales in years other than those in question, insofar as they relate to the frequency and continuity of sales of realty,[33] and where taxpayer has acquired a dealer status in earlier years, he is not deprived of it by a later cut in volume due to a depression or business slump.[34] The court's review of frequency and volume of transactions is not limited to the specific type of property sold in the taxable year,[35] but must be confined to a review of sales and not extended to rentals of real property.[36]

MOTIVE OR PURPOSE

The Board of Tax Appeals has indicated that the question of whether property is a capital asset is dependent upon taxpayer's "purpose or intention in its acquisition and during his term of ownership. This is to be ascertained from his testi-

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from a 175 acre tract; in White v. Comm'r., 172 F. (2d) 629 (C. C. A. 5, 1949), sales of over 250 lots were made in 1942, 87 in 1943 and 3 in 1944; in Ehrman v. Comm'r., 120 F. 2d 607 (C. C. A. 9, 1941), 120 lots were sold in 1934 and 186 lots sold in 1935; in Brown v. Comm'r., 143 F. (2d) 468 (C. C. A. 5, 1944), 32 lots were sold in 1937, 29 in 1938 and 19 in 1939.

31. Ehrman v. Comm'r., 120 F. (2d) 607 (C. C. A. 9, 1941).

32. Goldberg v. Comm'r., 36 F. (2d) 551 (1929); Accord: Atkins v. United States, 14 F. Supp. 288, 83 Ct. Cl. 56 (1936); 512 W. Fifty-Sixth St. Corp. v. Comm'r., 151 F. (2d) 942 (C. C. A. 2, 1945).

33. Phipps v. Comm'r., 54 F. (2d) 469 (C. C. A. 2, 1931); Ehrman v. Comm'r., 120 F. 2d 607, 610 (C. C. A. 9, 1941); Eddy D. Field, 8 T. C. M. 170 (1949), affirmed per curriam, 180 F. (2d) 170 (C. C. A. 9, 1950).

34. Walter G. Morley, 8 T. C. 904, 916 (1947); Replogle v. United States, 33 AFTR 1664 (D. Ct. S. D. Fla., 1944).

35 Charles H. Black, Sr., 45 B. T. A. 204 (1941), where the sale was of a business building, though taxpayer usually dealt in residential property.

36. Wineman Realty Co., 1 T. C. M. 791 (1943).

mony as to such intention, the circumstances surrounding the acquisition, use and disposal of the property, the nature of his business, and the character of the property."[37] It appears clear that if a taxpayer may be shown to have obtained real property with the intention of making prompt sales at a profit he will be held to be a dealer,[38] though a vague hope of ultimately realizing a profit will not serve to divorce him from his otherwise deserved status as an investor.[39]

Status as an investor has been granted in cases wherein the mode of acquisition was involuntary, as where real property was received upon liquidation of a corporation,[40] on the foreclosure of a mortgage,[41] or in payment of trade obligations.[42] However, such capital gain or loss treatment has been denied in some cases of involuntary acquisition by inheritance,[43] receipt as compensation for services,[44] to protect an existing business,[45] and in payment of a debt.[46] The Tax Court quite properly rejected the contention advanced in one case that an acquisition was involuntary, where taxpayers asserted they were forced to take the parcels in question in order to get another tract they desired.[47]

Consideration of the factors and circumstances of acquisition must naturally be modified where it is made to appear that there has been a deviation from the original purpose,[48]

37. Ben L. Carroll, 21 B. T. A. 724, 727 (1939) (A); Accord: W. D. Haden, 2 T. C. M. 1029 (1943).

38. Gruver v. Comm'r., 142 F. (2d) 363 (C. C. A. 4, 1944); Collin v. United States, 57 F. Supp. 217 (N. D. Ohio, 1944); Factoria Land Company, 6 T. C. M. 234 (1947). See: George J. Wibbelsman, 12 T. C. 1022 (1949), where the court relied on language of a syndicate agreement to carry this theory to an extreme otherwise difficult to justify.

39. Harriss v. Comm'r., 143 F. (2d) 279 (C. C. A. 2, 1944); Phipps v. Comm'r., 54 F. 2d 469, 471 (C. C. A. 2, 1931); Albert F. Keeney, 17 B. T. A. 560 (1929).

40. Estate of Douglas S. Mackall, Sr., 3 T. C. M. 701 (1944).

41. Guthrie v. Jones, 72 F. Supp. 784 (D. C. Okla., 1947); Kanawha Valley Bank, 4 T. C. 252 (1944) (A); but see White v. Comm'r., 172 F. (2d) 629 (C. C. A. 5, 1949), where a paving contractor had a dealer status realizing ordinary income on the sale of lots from property acquired by foreclosure of paving liens.

42. Thompson Lumber Co., 43 B. T. A. 726 (1941); Thompson Yards, Inc., 1 T. C. M. 822 (1943).

43. Ehrman v. Comm'r., 120 F. 2d 607, 610 (C. C. A. 9, 1941); see also Comm'r. v. Boeing, 106 F. (2d) 305, 309, 310 (C. C. A. 9, 1939).

44. William Foster, 2 T. C. M. 595 (1943).

45. J. O. Chapman, 3 T. C. M. 604 (1944).

46. Alex Weil, 3 T. C. M. 528 (1944).

47. George J. Wibbelsman, 12 T. C. 1022 (1949).

48. Richards v. Comm'r., 81 F. (2d) 369 where a farmer who originally acquired property for raising produce subsequently subdivided into lots, installed utilities, and solicited purchasers. See also Brown

as the decisive question is the purpose for which the property was held when sold.[49] In one such case, unimproved real estate was purchased with the intention of erecting a business building, but upon later abandonment of the plan the building was sold. The property was held "used in the trade or business" and the loss was not a capital loss, hence, was deductible in full.[50] But in a somewhat similar case in which taxpayer was prevented by a belatedly discovered zoning restriction from furthering his intention of using the property for an automobile paint shop, his contention of a business purpose in acquiring the property was without avail. The court in denying this claim stated that timely investigation would have revealed this restriction and pointed to the fact that the property had never been devoted to an actual business use.[51]

At times the courts have given weight to the motive or purpose which prompted the taxpayer to make the sales in question.[52] Although in the absence of active sales effort the Tax Court[53] and some circuits[54] have given credence to an avowed purpose in disposing of realty to liquidate the investment, this oft repeated argument has generally been rejected by the courts.[55] The Government contention that a sale ipso facto, shows a dealer status has been brushed aside almost as frequently as advanced.[56]

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v. Comm'r., 143 F. 2d 468 (C. C. A. 5, 1944); *cf.* Frieda E. J. Farley, 7 T. C. 198 (1946) (A); but see George J. Wibbelsman, 12 T. C. 1022 (1949).

49. Oliver v. Comm'r., 138 F. (2d) 910 (C. C. A. 4, 1943), where taxpayer, who subdivided and sold off his home place formerly operated as a dairy, was held a dealer.

50. Carter-Colton Cigar Co., 9 T. C. 219 (1947).

51. Montell Davis, 11 T. C. 538 (1948) (A).

52. See Estate of Douglas S. Mackall, Sr., 3 T. C. M. 701 (1944), where taxpayer was sick during the period in question, undergoing three major operations involving amputation of his legs, and he was successful in contending that the motive or purpose in selling real estate was to liquidate the holdings to obtain needed cash, and was held to have realized capital gains.

53. Frieda E. J. Farley, 7 T. C. 198 (1946) (A).

54. Three States Lumber Co. v. Comm'r., 158 F. (2d) 61, 64 (C. C. A. 7, 1946); Phipps v. Comm'r., 54 F. (2d) 469 (C. C. A. 2, 1931); and see: White v. Comm'r., 172 F. (2d) 629 (C. C. A. 5, 1949), where this view is given sympathetic treatment on principle.

55. Marsch v. Comm'r., 110 F. (2d) 423 (C. C. A. 7, 1940); Ehrman v. Comm'r., 120 F. (2d) 607 (C. C. A. 9, 1941); Spanish Trail Land Co., 10 T. C. 430, 435 (1948).

56. Phipps v. Comm'r., 54 F. (2d) 469 (C. C. A. 2, 1931); Ashton C. Jones, Jr., 1 T. C. M. 816 (1943); Guthrie v. Jones, 72 F. Supp. 784 (D. C. Okla., 1947).

CONCLUSION

Although the proposition has been expounded that complete passivity is the only reliable means of avoiding treatment of gains from the sale of realty as ordinary income, the congeries of litigated cases indicate that there is at least some hope of carrying on even a substantial number of sales and still being classified as an investor.

It is unlikely that one will maintain his desired status as an investor if his activities exceed these bounds:

(1) Make every effort to avoid the appearance of being a real estate dealer.
(2) Avoid participation in sales and promotional endeavors.
(3) Abstain from subdividing and making improvements unless absolutely necessary, and then only if they may be characterized as "preliminary activity."
(4) Endeavor to give transactions the color of "isolated conveyances."
(5) In the event of the necessity for numerous sales, seek to relate with a legitimate business need for liquidation, and do not make reacquisitions forthwith.
(6) Hold the property for a long period to avoid the appearance of purchasing for prompt sale at a profit.

It is imperative that these limits be viewed at best as unreliable. As indicated at the outset, the distinction between dealer and investor sales presents an issue which is essentially one of fact and no one criterion or indicium is invariably decisive.

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