7 T.C. 198 (1946)

A taxpayer who passively sells subdivided real estate originally acquired for a different business purpose is not necessarily engaged in the trade or business of selling real estate, and the profits may be taxed as capital gains rather than ordinary income.

Summary

The Farleys, husband and wife, owned land used for their nursery business. The city built streets through the property, increasing its value for residential purposes but decreasing its value for nursery use. The Farleys sold lots, making a profit. They didn't actively solicit sales. The Tax Court had to determine whether the profit from these sales was taxable as ordinary income (because the property was held primarily for sale to customers) or as a capital gain. The court held it was a capital gain because the Farleys were passively liquidating an asset, not actively engaging in the real estate business.

Facts

The Farleys acquired several tracts of land between 1909 and 1927, using them for their nursery, florist, and landscaping business. The key parcels, known as the Gentilly Squares, had been platted into lots and streets by the city in 1909, but these streets existed only on paper. In 1937, the city built the platted streets, which increased the land's residential value but hurt its nursery use. Due to restrictions, the Farleys couldn't build fences to protect nursery stock. During the tax year, the Farleys sold 25 1/2 lots. They didn't advertise, hire agents, or improve the lots, but accepted offers from unsolicited purchasers.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Farleys' income tax, arguing the profits from the lot sales were ordinary income, not capital gains. The Farleys petitioned the Tax Court, arguing the property was not held primarily for sale in the ordinary course of their business.

Issue(s)

Whether the profit from the sale of the Gentilly lots is taxable as ordinary income because the property was "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" under Section 117(a)(1) of the Internal Revenue Code, or as a capital gain?

Holding

No, the profit is taxable as a capital gain because the Farleys were passively liquidating an asset and not actively engaged in the trade or business of selling real

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estate.

Court’s Reasoning

The court emphasized that the frequency and continuity of sales aren’t the only determinants of whether an activity constitutes a business. The court distinguished the case from others where frequent sales led to ordinary income treatment, noting that those cases involved significant development and sales activities, which were absent here. The court noted, “Not only are there absent here the elements of development and sales activities… but there are also other circumstances which, in our opinion, explain the frequency and continuity of sales here involved in terms other than those connotating business activity.” The city, not the Farleys, improved the property. The Farleys didn’t solicit sales. The court considered the fact that the land had been platted before the Farleys acquired it and that the sales were driven by unsolicited purchasers. The court also considered the Farleys’ passive role as a gradual liquidation of an asset which had become less useful to their existing business, stating, “It would seem that petitioner could have maintained a more passive role only by refusing to sell at all.” Finally, the court noted the purpose of the capital gains provisions is “to relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.” The court concluded that taxing the profits as ordinary income would distort the facts and avoid the purpose of the capital gains provisions.

Practical Implications

This case illustrates that merely selling subdivided real estate does not automatically mean a taxpayer is in the business of selling real estate for tax purposes. The key is the level of activity. Taxpayers who passively respond to unsolicited offers and do not actively develop or market the property are more likely to receive capital gains treatment. The case also underscores the importance of considering the original purpose for which the property was acquired and whether a change in circumstances forced the sale. Later cases have distinguished *Farley* by focusing on the level of sales activity and development undertaken by the taxpayer.

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