13 T.C. 8 (1949)

A real estate dealer can also be an investor, and gains from the sale of rental properties held primarily for investment purposes, rather than primarily for sale to customers in the ordinary course of business, are taxable as capital gains.

Summary

Nelson Farry, a real estate and insurance businessman, developed subdivisions and constructed residences, selling them at a profit, which he reported as ordinary income. He also acquired rental properties for investment, collecting rents and later selling these properties, reporting the profits as long-term capital gains. The Commissioner of Internal Revenue determined these gains should be taxed as ordinary income. The Tax Court held that Farry held the rental properties primarily for investment, not for sale in his ordinary course of business, and thus the gains were taxable as capital gains under Section 117(j) of the Internal Revenue Code.

Facts

Nelson Farry was involved in real estate, insurance, and investments in Dallas, Texas. He developed subdivisions (Cedar Crest and Clarendon Heights), building houses for sale. Separately, he acquired rental properties, including negro rentals and duplex apartments, considering them more desirable for revenue. He financed these rental properties with long-term loans, expecting rental income to liquidate the loans and increase his estate. In 1944 and 1945, due to changes in the housing market and advice from his banker, he sold several rental properties.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies against Nelson and Velma Farry for 1944 and 1945, arguing that gains from the sales of rental properties should be taxed as ordinary income, not capital gains. The Farrys contested this determination, leading to consolidated proceedings before the Tax Court.

Issue(s)

1. Whether the rental properties sold by Farry were held “primarily for sale to customers in the ordinary course of his trade or business.”
2. Whether the gains from the sale of said rental properties are taxable as ordinary income or as capital gains under Section 117(j) of the Internal Revenue Code.

Holding

1. No, because the evidence demonstrated that Farry acquired and held the rental properties primarily for investment purposes.

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2. Capital gains, because Farry held the properties primarily for investment, not for sale to customers in the ordinary course of his business.

Court’s Reasoning

The Tax Court applied Section 117(j) of the Internal Revenue Code, which provides that gains from the sale of property used in a trade or business are treated as capital gains if the property is not held primarily for sale to customers in the ordinary course of business. The court emphasized that a real estate dealer can also be an investor. “[W]here the facts show clearly that the investment property is owned and held primarily as an investment for revenue and speculation, it is classed as a capital asset and not property held ‘primarily for sale to customers in the ordinary course of trade or business.'” The court found that Farry’s rental properties were acquired and held primarily for investment, with the sales occurring due to changing market conditions and financial advice. The court noted that Farry accounted for rental income separately from income derived from developing and selling houses. Therefore, the gains from the sales of the rental properties were taxable as capital gains, not ordinary income.

Practical Implications

This case clarifies the distinction between a real estate dealer and an investor for tax purposes. It illustrates that the intent for which a property is held is crucial in determining whether gains from its sale are treated as ordinary income or capital gains. Taxpayers who actively engage in real estate sales can still hold separate properties for investment purposes. This decision provides guidance on how to distinguish between properties held for sale in the ordinary course of business and those held for long-term investment. Later cases cite Farry for the principle that a taxpayer can be both a dealer and an investor in real estate, and the characterization of gains depends on the primary purpose for holding the specific property sold.

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