16 T.C. 1003 (1951)

The sale of real estate is considered a capital gain, not ordinary income, when the property is not held primarily for sale to customers in the ordinary course of business, even if the company charter permits real estate subdivision.

Summary

South Texas Properties Co., primarily a rental property business, sold several unimproved land parcels in 1945 and 1946. The IRS determined these gains to be ordinary income, arguing the company was in the business of selling real estate. The Tax Court disagreed, holding the sales qualified for capital gains treatment because the company's primary business was rentals, sales were infrequent, unsolicited, and the company did not actively market or develop the land. The court emphasized that the presence of a clause in the company charter allowing real estate subdivision was not determinative.

Facts

South Texas Properties Co. was incorporated in 1930 and engaged primarily in owning and leasing real estate in San Antonio, Texas. The company's charter included a purpose clause allowing it to subdivide real property. From 1938 to 1950, the company made infrequent sales of real estate, often consisting of small strips of land sold to the State Highway Department for road widening. In 1945, the company made one unsolicited sale of a 4-acre tract. In 1946, it sold six parcels, including an undesirable 31.13-acre tract and several adjoining lots to a group of friends. The company maintained no real estate office, employed no sales personnel, did not advertise its properties, and each sale required board approval.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies against South Texas Properties Co. for the years 1945 and 1946, determining that gains from the sale of unimproved real estate constituted ordinary income, not capital gains. The Tax Court reviewed the Commissioner's determination.

Issue(s)

Whether the gains from the sales of unimproved real estate by South Texas Properties Co. in 1945 and 1946 are taxable as ordinary income or as capital gains under sections 117 (a) (1) and 117 (j) (1) of the Internal Revenue Code?

Holding

No, because the unimproved real estate was not held by the company primarily for sale to customers in the ordinary course of its trade or business.

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Court’s Reasoning

The Court reasoned that the key factor is whether the company intended to hold the property for sale to customers in the ordinary course of its business. The court emphasized that possessing the power to subdivide real estate in the corporate charter isn’t controlling. The court considered the following factors: the company maintained no price list, employed no salesmen, had no established office for sales, and each sale required board approval. Furthermore, only a few sales of unimproved real estate were made during the taxable years. The Court stated, “Such facts strongly indicate that the real estate was not held by petitioner for sale to its customers in the ordinary course of its trade or business.” Because the Tax Court found that South Texas Properties Co. was not in the business of selling real estate, the selling expenses could only be deducted from the selling price of the real estate in the computation of petitioner’s capital gain, section 111 of the Code.

Practical Implications

This case clarifies that a company’s stated purpose (e.g., in its corporate charter) is not the sole determinant of whether real estate sales constitute ordinary business income or capital gains. Courts will examine the actual business practices of the company, including the frequency and nature of sales activities, marketing efforts, and the overall proportion of income derived from sales versus other activities like rentals. This case is often cited when determining whether gains from real estate sales should be treated as ordinary income or capital gains, particularly for businesses with diverse activities. The case emphasizes a “facts and circumstances” approach. Subsequent cases distinguish South Texas Properties by emphasizing more frequent sales, active marketing, or development activities as indicators of holding property for sale in the ordinary course of business.

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