M. A. Paul, Petitioner, v. Commissioner of Internal Revenue, Respondent, 18 T.C. 601 (1952)

For tax purposes, the holding period of a newly constructed building, relevant for capital gains treatment, commences upon the completion of the building, not at the earlier stage of entering into construction contracts.

Summary

In 1944, Petitioner Paul purchased land to construct an apartment building, which began in 1945 and was partially completed by May 1946. Paul started renting apartments in August 1946 and sold the building in November 1946. The Commissioner of Internal Revenue determined that the gain from the sale of the building should be taxed as ordinary income, not capital gain, because Paul did not hold the building for more than 6 months. The Tax Court agreed, holding that the holding period for a newly constructed building begins upon its completion, not from the start of construction contracts. Since the building was sold within 6 months of completion, it did not meet the long-term holding period requirement for capital gains treatment under Section 117 of the Internal Revenue Code.

Facts

Petitioner, M.A. Paul, a lumber and building supply company owner, purchased land in Pittsburgh in February 1944 to build an apartment building.

Architectural plans were drawn by May 1944.

Construction commenced in October 1945.

By May 11, 1946, the building was partially complete, with plastering, plumbing, and tiling finished between May 8 and June 20, 1946.

Prior to May 15, 1946, the building was not ready for occupancy.

Paul began renting apartments in August 1946, before the building's completion.

The building was inspected and deemed complete by the City of Pittsburgh on November 1, 1946.

Paul acted as his own general contractor, hiring craftsmen and contracting for various work types.

By May 12, 1946, construction contracts totaled approximately $59,000, with $28,000 paid.

By November 6, 1946, an additional $45,000 was paid on contracts.

Paul intended to rent the building for income but was offered approximately

$183,000 by a real estate broker's client.

On November 11, 1946, Paul sold the building for $183,539.75, realizing a gain of $77,021.62, of which $66,329.91 was attributed to the building.

Paul reported rental income and expenses for 1946 from the apartment building.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Paul's 1946 income tax, arguing that the gain from the building sale was ordinary income, not capital gain.

Paul contested this determination in the United States Tax Court.

Issue(s)

1. Whether the apartment building constituted depreciable property used in the petitioner's trade or business under Section 117(a)(1)(B) of the Internal Revenue Code.

2. Whether the holding period for the newly constructed apartment building, for purposes of Section 117(j)(1) of the Internal Revenue Code, began when construction contracts were signed or upon completion of the building.

3. Whether the gain from the sale of the apartment building should be taxed as ordinary income or capital gain.

Holding

1. Yes, because the petitioner constructed the apartment building with the intention of renting apartments and did in fact rent apartments, thus using it in his trade or business.

2. No, because for newly constructed buildings, the holding period commences upon completion of the building, not when construction contracts are signed.

3. Ordinary income, because the building was a depreciable noncapital asset used in the petitioner's trade or business and was not held for more than 6 months prior to the sale, failing to meet the requirements for capital gains treatment under Section 117(j).

Court's Reasoning

The court reasoned that the apartment building was clearly depreciable property used in Paul's trade or business, as evidenced by his intention to rent and actual rental activity. The court cited *Fackler v. Commissioner*, 133 F.2d 509, and other cases to support that a taxpayer can be engaged in more than one trade or business, and rental activity constitutes a trade or business.

Regarding the holding period, the court rejected Paul's argument that it began when construction contracts were signed. The court relied on *Helen M. Dunigan, Administratrix*, 23 B.T.A. 418, which established that land and buildings are treated separately for federal taxation, diverging from the common law merger rule. The court stated, "We think the rule of the *Dunigan* case is a sound one for the purpose of determining the holding period of newly-constructed buildings. Under that rule, the holding period does not necessarily begin from the time the taxpayer acquired the land. Therefore, to mark the beginning of the holding period, we must look to another event, namely, the date the building was completed. Until that event occurs, the taxpayer has not 'acquired' the building."

Referencing *McFeely v. Commissioner*, 296 U.S. 102, the court emphasized that "to hold property is to own it. In order to own or hold one must acquire. The date of acquisition is, then, that from which to compute the duration of ownership or the length of holding." The court found Paul's analogy to securities holding periods (starting when an unconditional right to shares is acquired) inapplicable because the construction contracts were executory and the building was not in existence when contracts were signed.

Because the building was sold within 6 months of its completion, it did not meet the holding period requirement for capital gains treatment under Section 117(j). Therefore, the gain was taxable as ordinary income under Sections 117(a)(1)(B) and 22(a) of the Internal Revenue Code.

Practical Implications

Paul v. Commissioner provides a clear rule for determining the holding period of newly constructed property for tax purposes. It establishes that the holding period for such property begins only upon completion of the construction. This is crucial for developers and taxpayers who construct property with the intent to sell shortly after completion, as it directly impacts whether the gain from such sales qualifies for favorable capital gains tax rates or is taxed as ordinary income.

This case clarifies that entering into construction contracts or commencing construction does not equate to holding the completed building. Legal practitioners advising clients on real estate development and sales must consider the completion date as the starting point for the holding period calculation. This ruling prevents taxpayers from claiming capital gains treatment on quick sales of newly built properties by attempting to backdate the holding period to pre-completion activities.

Subsequent cases and IRS guidance have consistently followed the principle established in *Paul*, reinforcing the completion date as the critical event for determining the holding period of newly constructed real property.