21 T.C. 1029 (1954)

When properties are constructed primarily for sale in the ordinary course of business, profits from those sales are considered ordinary income and are not eligible for capital gains treatment, even if subject to restrictions on sale and used for rental purposes.

Summary

The Winnicks, builders of residential properties during World War II, sought to treat profits from the sale of houses as long-term capital gains rather than ordinary income. The Commissioner of Internal Revenue determined the gains were ordinary income because the houses were constructed primarily for sale. After an initial Tax Court decision and a remand from the Sixth Circuit Court of Appeals, the court reaffirmed that the primary intention of the Winnicks was to sell the houses, even though wartime regulations required them to be rented to defense workers initially. The court emphasized the overall pattern of the Winnicks' business, including their pre-war, contemporaneous, and post-war activities as builders primarily for sale, in reaching its decision. The court also determined the Winnicks were entitled to an adjusted cost basis in determining the gain from the sales of houses received in a corporate liquidation and to an additional deduction for depreciation.

Facts

Albert Winnick began building houses for sale in 1938. During World War II, the government allocated priorities and provided financing for constructing defense housing. These houses were subject to rental restrictions. Between 1943 and 1944, the Winnicks, either directly or through corporations they controlled, built 66 houses. During the period from 1943-1946, the Winnicks built 99 houses. 33 were built for sale, and 66 were built under government programs to provide defense housing. Of the 66 houses, 50 were at issue in this case. Of these 50, 22 were sold in 1945 before removal of the restrictions. Winnick also built houses for sale on completion in the years 1947 and 1948 and built 5 duplex houses which he still held and rented at the time of the reopened hearing. After the initial rental period required by the wartime regulations, the Winnicks sold these houses. They also reported gains from these sales as long-term capital gains. The IRS determined the gains were ordinary income.

Procedural History

The Commissioner determined tax deficiencies for the Winnicks for 1945 and 1946, treating gains from the house sales as ordinary income. The Tax Court upheld the Commissioner's decision (17 T.C. 538). The Winnicks appealed to the Sixth Circuit Court of Appeals, which set aside the Tax Court's decision and remanded the case for additional findings of fact regarding the Winnicks' intentions. The Tax Court reopened the record, received additional evidence, and issued supplemental findings

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and opinion, which reaffirmed its original decision.

Issue(s)

1. Whether the primary intention of the petitioners in building and acquiring the 50 houses was to hold them for sale to customers in the ordinary course of their business.

2. Whether the petitioners are entitled to an adjusted cost basis in determining their gain from the sales of the 21 houses received in the liquidation of Alwin, Inc., and to an additional deduction for depreciation.

Holding

1. Yes, because the court found that the Winnicks' primary intention was to sell the houses.

2. Yes, because the court determined they were entitled to an adjusted cost basis and an additional depreciation deduction.

Court's Reasoning

The court followed the directive from the Court of Appeals and examined the primary intention of the Winnicks when they constructed the 50 houses. The court analyzed whether the Winnicks' initial intent was to hold the properties for investment or for sale in the ordinary course of their business. The Court noted that the regulations did not completely restrict sales, as permitted sales of units to eligible war workers after a four-month occupancy. The court considered that the pattern of sales, including sales before the restrictions were lifted, indicated an intention to sell as quickly as circumstances permitted. Furthermore, the court looked at the overall pattern of the Winnicks' business, including their pre-war, contemporaneous, and post-war activities. They concluded that the Winnicks were builders of houses primarily for sale. The court quoted, "the crucial criterion was the purpose for which the properties were held at the time they were sold." The Court also traced the funds used by the Winnicks to finance the construction of the apartment building to see if the funds used were from the sale of the properties at issue in the case.

Practical Implications

This case highlights the importance of demonstrating the primary purpose for holding property, especially in the context of real estate sales. For attorneys, it's crucial to gather evidence of intent (e.g., contemporaneous documents, business patterns, marketing efforts, time of sale) to support whether a property was held for investment or for sale to determine if the gains will be treated as capital gains or ordinary income. This case also suggests that even when external factors (such as wartime regulations) influence the use of property, the underlying intent of the

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property owner is critical. Furthermore, this case reinforces the significance of considering the taxpayer’s entire business history to assess the character of income received.

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