22 T.C. 533 (1954)

In determining whether profits from real estate sales are taxed as ordinary income or capital gains, the court considers factors such as the taxpayer's initial purpose, the nature and extent of sales activity, and the frequency and substantiality of sales.

Summary

The United States Tax Court addressed whether profits from the sale of 90 houses by Pinecrest Housing, Inc., in 1946 should be taxed as ordinary income or capital gains. The corporation, initially building the houses for rental, shifted to selling them. The court held that the profits were taxable as ordinary income because the houses were held primarily for sale to customers in the ordinary course of its business. The decision emphasized the substantiality and frequency of sales, the shift in the corporation's business purpose, and the easing of restrictions on sales, indicating a change from a rental to a sales operation.

Facts

Pinecrest Housing, Inc., was formed in 1943 to build houses for rental near Marshall, Texas, to accommodate war workers. The corporation obtained a loan with FHA guarantees and was subject to restrictions on sales. By 1946, Pinecrest had changed its business model and was in the business of selling houses. In 1946, Pinecrest sold 90 houses, and the corporation was then dissolved. Despite initial operating losses from rentals, the corporation made profits from the sale of properties. The sales were handled by one of the owners, though not actively advertised.

Procedural History

The Commissioner of Internal Revenue asserted deficiencies in income tax against the petitioners as transferees of Pinecrest Housing, Inc. The cases were consolidated for hearing and disposition. The Tax Court considered whether the profits from the house sales constituted ordinary income or capital gains.

Issue(s)

1. Whether the 90 properties sold by Pinecrest Housing, Inc. in 1946 were held primarily for sale to customers in the ordinary course of its business.

Holding

1. Yes, because the corporation's activities put it in the business of selling real estate.

Court's Reasoning

The court applied the principles of Section 117(a) of the Internal Revenue Code, defining capital assets and exclusions, and Section 117(j) to determine the tax treatment of the gains from the sale of the houses. The court considered factors, including the initial purpose of the taxpayer, and the nature of the sales activity. The court found that Pinecrest initially built the properties for rental. However, by the beginning of 1946, the corporation had shifted to selling houses. The court emphasized the substantiality and frequency of sales and cited the number of sales made in a one-year period, which met the frequency test. The court also considered that the petitioners admitted there was a demand to buy houses in Marshall, Texas, in 1946, and that one petitioner could have sold more houses than they had available. The court distinguished this case from others where sales were incidental to a rental business or made under creditor pressure.

The court stated, “We have found that from October 1943 until the beginning of 1946, Pinecrest held its properties for rental… We think it is also true that by the beginning of 1946 Pinecrest had changed the nature of its business activity and was then holding its houses for sale.” and “…the making of 90 sales of realty over a 1-year period meets the test of frequency, continuity, and substantiality and puts the corporation in the business of selling real estate.”

Practical Implications

This case provides guidance on distinguishing between ordinary income and capital gains from real estate sales. Lawyers should consider:

1. The initial purpose for acquiring the property
2. The frequency and substantiality of sales.
3. Changes in business purpose over time.
4. Market conditions at the time of sale.

This decision may influence the structuring of real estate transactions to potentially qualify for capital gains treatment. Later cases dealing with the sale of real estate will likely consider the same factors: initial purpose, sales activity, frequency, and market conditions.