26 T.C. 1213 (1956)

Real property used for rental purposes is considered property used in a trade or business, and thus is not a capital asset for the purpose of determining capital gains or losses.

Summary

The Henry L. Stern Trust sought to classify losses from the sale of rental properties in 1945 and 1946 as capital losses, allowing for a capital loss carry-forward. The Tax Court ruled against the trust, determining that the properties, used for rental purposes and subject to depreciation, were not capital assets under Section 117(a)(1) of the Internal Revenue Code of 1939. The court reasoned that since the properties were used in a trade or business, as evidenced by the trust's rental activities, and were subject to depreciation, they were excluded from the definition of capital assets, thus denying the capital loss treatment.

Facts

The Henry L. Stern Trust was created in 1928. The trust invested in various first mortgages on improved real estate. After mortgage defaults, the trust acquired 20 properties through foreclosure and subsequent purchase. The trust rented these properties for residential or commercial use, claiming deductions for depreciation and related expenses. The trust sold several of these properties in 1945 and 1946, resulting in losses. The key factual element is the consistent rental of the foreclosed properties for a substantial period before their sale.

Procedural History

The case originated in the United States Tax Court. The Commissioner of Internal Revenue determined deficiencies in the trust's income tax for 1950 and 1951. The trust challenged these determinations, asserting that losses from the property sales in 1945 and 1946 should be treated as capital losses, entitling them to capital loss carry-forwards for the later years. The Tax Court ruled in favor of the Commissioner.

Issue(s)

Whether the losses realized by the Henry L. Stern Trust from the sale of improved rental properties in 1945 and 1946 were capital losses.

Holding

No, because the properties were used in the trust's trade or business (rental), and subject to depreciation, thus explicitly excluded from the definition of capital assets under the Internal Revenue Code.

Court's Reasoning

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The court relied on Section 117(a)(1) of the Internal Revenue Code of 1939, which defines “capital assets” and explicitly excludes “property used in the trade or business, of a character which is subject to the allowance for depreciation.” The court determined that the rental of the properties constituted a trade or business. It cited precedent, including *Rosalie W. Post, 26 T.C. 1055*, to support the contention that real estate used for rental purposes is used in a trade or business. Since the properties were rented for residential or commercial use, depreciation was claimed on the buildings, thereby fulfilling the exclusionary criteria of Section 117(a)(1), the losses were not capital losses.

Practical Implications

This case underscores the importance of classifying property correctly for tax purposes. Attorneys should consider the nature of the property and its use when advising clients on the tax implications of sales or other dispositions of real estate. If property is used in a trade or business and subject to depreciation, losses are likely to be treated as ordinary losses, not capital losses. The case also highlights the relevance of depreciation deductions in determining the character of a loss. Later cases regarding real estate sales follow this precedent in determining whether a loss is ordinary or capital.

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