William J. and Marjorie L. Howell v. Commissioner, 28 T.C. 1193 (1957)

Whether the gain from the sale of real estate is taxable as ordinary income or capital gain depends on whether the taxpayer held the property primarily for sale to customers in the ordinary course of their trade or business.

Summary

The Howells, a married couple, sought to have the Tax Court reverse the Commissioner’s determination that profits from the sale of land were ordinary income rather than capital gains. The Howells purchased a 27-acre tract, subdivided it into lots, and had a family corporation build houses on some of the lots. The Howells argued they were merely investors and the corporation was independently selling the houses. The Tax Court disagreed, finding the Howells were engaged in the real estate business through an agency relationship with the corporation and thus, the profits were taxable as ordinary income. The court also upheld penalties for failure to file a declaration of estimated tax.

Facts

- William J. and Marjorie L. Howell purchased a 27-acre tract of land.
- They subdivided the land into approximately 28 lots for residential purposes.
- A closely held family corporation built houses on 18 of the lots.
- During the tax years in question, 12 of these houses were sold to individual purchasers.
- The Howells reported the income from land and house sales on their tax returns, although later, amended returns were filed to indicate the corporation earned the income from house sales.
- The IRS determined the profits from the land sales were ordinary income.

Procedural History

The Commissioner determined deficiencies in the Howells’ income tax, treating the profits from the land sales as ordinary income. The Howells challenged this determination in the United States Tax Court.

Issue(s)

1. Whether the Howells were engaged in a trade or business of selling real estate, thereby making the profits from the sale of land ordinary income.
2. Whether the additions to tax for failure to file a declaration of estimated tax and substantial underestimation of tax were proper.

Holding

1. Yes, because the Howells, through their family corporation acting as their

agent, were engaged in the business of subdividing and selling real estate.
2. Yes, because the Howells failed to demonstrate that their failure to file a declaration of estimated tax was due to reasonable cause.

Court's Reasoning

The court applied a factual analysis to determine whether the Howells were engaged in a trade or business. The court noted that the Howells' activities, including subdividing the land and using the corporation to build and sell houses, constituted a business. The court found the corporation acted as an agent for the Howells. The court stated "one may conduct a business through agents, and that because others may bear the burdens of management, the business is nonetheless his." The court considered the continuity and frequency of sales and the activities related to those sales. The court emphasized that the Howells' involvement in the development, construction, and sales program placed them in the status of "dealers" in real estate. The court dismissed the amended returns as self-serving declarations. The court also held that the Howells did not have a reasonable cause for failing to file a declaration of estimated tax and upheld the penalties because they failed to prove their accountant was qualified to advise them on tax matters and that they had reasonably relied on his advice. The court stated that "For such fact to be a defense against the consequences of the failure to file a return, certain prerequisites must appear. It must appear that the intervening person was qualified to advise or represent the taxpayer in the premises and that petitioner relied on such qualifications."

Practical Implications

This case emphasizes the importance of analyzing the nature and extent of a taxpayer's activities when determining whether profits from real estate sales are ordinary income or capital gains. Lawyers advising clients who buy, develop, and sell real estate must carefully evaluate the client's level of involvement in the process, looking at factors such as the subdivision of the land, the construction of improvements, the frequency and continuity of sales, and whether the sales are conducted directly or through an agent. This case suggests the IRS and courts will look behind the formal structure (e.g., use of a corporation) to see the true nature of the transaction. Failing to file estimated tax declarations can trigger penalties if the taxpayer cannot prove that the failure was based on reasonable cause, and the taxpayer relied on a qualified advisor. The case illustrates that amendments to tax returns made after a tax audit has commenced will be viewed with skepticism by the Tax Court.

