Longfellow v. Commissioner, 31 T.C. 11 (1958)</p>

<p class="key-principle">The profit from the sale of subdivided lots is taxable as ordinary income, not capital gains, if the taxpayer's activities in improving and selling the lots constitute a business, and the lots are held primarily for sale to customers in the ordinary course of that business.</p>

<p>Summary</p>
<p>In Longfellow v. Commissioner, the U.S. Tax Court addressed whether profits from the sale of subdivided lots should be taxed as capital gains or ordinary income. The taxpayer purchased raw land, subdivided it into lots, and made substantial improvements. They hired a real estate agent to market the lots, and the court concluded that the taxpayer's activities in grading, subdividing, and selling the lots constituted a business. Therefore, the profits from these sales were treated as ordinary income because the lots were held primarily for sale to customers in the ordinary course of that business. This case emphasizes that taxpayers cannot convert ordinary income into capital gains by subdividing and selling land if those activities rise to the level of a business.</p>

<p>Facts</p>
<p>George Longfellow purchased a 21-acre tract of unimproved land in 1943. The land was located in a residential zone. In 1951, George decided to subdivide and sell the land, after rejecting a prior offer to sell the entire tract, and after consulting with a real estate agent, Maurice Wickenhauser. George graded the property, subdivided it into 88 lots, and installed streets. George and his wife paid for substantial improvements. Maurice Wickenhauser, acting as a real estate agent, marketed the lots. Over the years, George sold lots, and his expenses for the improvements were considerably higher than the original land cost. George’s corporation performed the grading and related work. George retained the right to approve house plans to protect the value of remaining lots.</p>

<p>Procedural History</p>
<p>The Commissioner of Internal Revenue determined deficiencies in George Longfellow’s income tax. The Commissioner determined that profits from the sale of the lots were taxable as ordinary income, not capital gains, as reported by Longfellow. The Tax Court agreed with the Commissioner.</p>

<p>Issue(s)</p>
<p>Whether the profit from the sale of lots is taxable at capital gain rates or as ordinary income.</p>

<p>Holding</p>
<p>Yes, the profit from the sale of lots is taxable as ordinary income because the activities undertaken by George in grading, subdividing, improving, and selling the lots constituted a business.</p>

<p>Court's Reasoning</p>
<p>The court's reasoning focused on whether George's activities constituted a business. The court applied the rule that the character of income (capital gains vs. ordinary income) depends on whether the asset was held for investment or as inventory in a business. The court analyzed whether the taxpayer was involved in a business: (1) improvement: George undertook extensive improvements to the land, significantly increasing its value; (2) selling: George engaged a real estate agent to market lots, and (3) frequency and substantiality: The sales were continuous over several years, and the income was a substantial part of George's total income. The court cited George's own testimony, "I needed space to keep my equipment," to establish his business activity. The court concluded that George had, in fact, established a business by creating a product and selling that product for a profit rather than simply liquidating an investment in the land. The court also noted that George bore the entire risk of the costly venture and made all of the important decisions.</p>
<p>The court emphasized that "Each case of this kind must be decided on its own facts." The court also noted that, "George's activities in grading, subdividing, improving with streets, curbs and gutters, and selling lots from the 21-acre tract constituted a business."</p>

<p>Practical Implications</p>
<p>Longfellow is an important case for practitioners advising clients on real estate transactions and tax planning. The decision emphasizes the need for careful planning when a taxpayer intends to subdivide and sell land. Substantial improvements to the land, coupled with regular sales, will likely be treated as a business. This means that profit will be treated as ordinary income. If, however, a taxpayer simply sells land without significant improvement and with limited sales, they are more likely to receive capital gains treatment. The case highlights the importance of documenting the taxpayer's intent and demonstrating that sales were not part of a regular business activity. Later cases often cite Longfellow as a key case regarding the definition of "business" in the context of land sales, which should therefore inform the legal reasoning of any similar case.</p>

<p>It can also have significant business implications: decisions about the level of investment in land improvement, the frequency of sales, and the role of brokers should be made with tax consequences in mind.</p>