31 T.C. 238 (1958)

The cost of improvements, such as a sewage disposal system, constructed to make subdivision lots salable can be included in the cost basis of the lots for tax purposes, provided the developer substantially parts with ownership and control of the improvements for the benefit of the lot owners.

Summary

The Estate of Collins (taxpayers) developed real estate subdivisions and sold lots to builders. To induce sales, they constructed a sewage disposal system. They arranged for a corporation they owned to operate the system at a loss, and lot owners were given an equitable interest. The court addressed whether the profits from the lot sales constituted ordinary income or capital gains, and if the cost of the sewage system could be included in the cost basis of the lots. The court held that the profits were ordinary income because the lots were held for sale in the ordinary course of business, and that the cost of the sewage disposal system was properly included in the cost basis of the lots. The key to the decision was that the developers had, in substance, given up ownership of the sewage system for the benefit of the lot owners.

Facts

M.A. Collins and his wife developed two contiguous subdivisions, Rodney Units 1 and 2. The soil conditions required a private sewage disposal system. The Federal Housing Administration (FHA) required such systems for mortgage insurance approval, stipulating that the system be owned by a corporation and that lot owners have an interest. Collins formed Rodney Sanitary Company, which constructed the sewage system. Collins, acting as trustee, received a trust deed conveying the sewage system's assets. The company was obligated to operate the system, charging lot owners low fees, resulting in operating losses. The system was unsatisfactory, generating many complaints. Collins later formed Independent Utility Company to service his properties. The Collinses sold lots in 1951, claiming a basis that included a proportionate cost of the sewage system.

Procedural History

The Commissioner of Internal Revenue determined tax deficiencies, disallowing the inclusion of the sewage system's cost in the lot basis and treating profits as ordinary income. The Tax Court reviewed the case, finding that the profits from lot sales constituted ordinary income and that the cost of the sewage disposal system was includable in the cost basis of the lots sold. Judge Kern delivered the opinion of the court, with two judges dissenting.

Issue(s)

1. Whether the profits from the sale of subdivision lots constituted ordinary

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income or capital gains.
2. Whether the cost of the sewage disposal system was properly includible in the cost basis of the lots sold.

Holding

1. Yes, the profits from the sale of subdivision lots were ordinary income.
2. Yes, the cost of the sewage disposal system was properly includible in the cost basis of the lots.

Court’s Reasoning

The court first determined that the sale of the lots was part of the Collins’ ordinary business. The court then analyzed whether the cost of the sewage system could be added to the basis of the lots. The court distinguished this case from prior cases, such as *Colony, Inc.*, where the developer retained

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