31 T.C. 431 (1958)

Whether profits from real estate sales are taxed as ordinary income or capital gains depends on factors such as the taxpayer's purpose for acquiring the property, the frequency and continuity of sales, and the level of sales activity.

Summary

The United States Tax Court addressed whether a lawyer's profits from selling real estate were taxable as ordinary income or capital gains. The court considered factors like the number of properties bought and sold, the continuity of sales activity, and the lack of substantial improvements. The court held that the taxpayer was a real estate dealer and therefore the profits were taxable as ordinary income. The court also addressed other issues, including the deductibility of estimated abstract expenses, the liability for self-employment tax, and the imposition of an additional tax for underpayment. The case emphasizes the importance of examining the overall nature of a taxpayer's activities to determine the appropriate tax treatment for gains from property sales.

Facts

Solly K. Frankenstein, a lawyer, inherited and purchased numerous lots in Fort Wayne, Indiana. He acquired 981 parcels between 1941 and 1954. During the years in question (1949-1954), he consistently bought and sold real estate. He placed "For Sale" signs on some lots and advertised in a local newspaper for a period. His gains from real estate sales far exceeded his income from the practice of law. He reported sales of lots on his income tax returns, often as separate transactions. Some lots were sold via conditional sale contracts. He estimated the cost of abstracts for some sales and included it in the cost of sale, even when the abstracts were not yet paid for.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Frankensteins' income tax for the years 1949-1954. The Commissioner also assessed an addition to tax under Section 294(d)(2) of the 1939 Internal Revenue Code for the year 1954. The Frankensteins contested these determinations in the United States Tax Court.

Issue(s)

1. Whether profits from the sale of real estate were taxable as long-term capital gains or ordinary income.

2. Whether the taxpayers could add estimated expenses for acquiring abstracts to the cost of property sold under conditional sale contracts.

3. Whether the taxpayers were subject to self-employment tax for the years 1951 through 1954.

4. Whether the Commissioner correctly determined an addition to tax under Section 294(d)(2) of the 1939 Internal Revenue Code against the taxpayers for the year 1954.

Holding

1. Yes, because the Frankensteins held the lots for sale to customers in the ordinary course of business.

2. No, because the abstract expenses that were not paid or incurred could not be included in the cost of sale to compute gross profit.

3. Yes, because the Frankensteins were also in the business of selling real estate, in addition to their law practice.

4. Yes, because the issue was not raised at the hearing or supported by any evidence.

Court's Reasoning

The court considered the key issue of whether the real estate sales generated ordinary income or capital gains. The court applied the tests developed to determine whether a taxpayer is a dealer in property or an investor. The court looked at Frankenstein's purpose, the continuity of sales, the number and frequency of sales, and the extent of his efforts to sell. The court found Frankenstein purchased and sold real estate frequently, lending continuity to his activities. Although he did not advertise extensively or actively improve the lots, his sales were significant, and his income from real estate sales greatly exceeded his legal income. "After careful consideration of all the evidence we are of the opinion that petitioner held the lots for sale to customers in the ordinary course of business." The court noted the taxpayer "made substantial sales over a period of years," further solidifying his status as a real estate dealer.

The court also addressed whether the Frankensteins could include estimated abstract costs in the cost of the property sold. The court noted that the Frankensteins were cash basis taxpayers, meaning they could not deduct the costs of the abstracts until they were actually paid. Since they were real estate dealers, the costs of the abstracts were to be treated as expenses, as opposed to being spread out over the term of the installment payments. Since the costs had not been paid, the Frankensteins could not deduct them. The court also held that the Frankensteins were subject to self-employment tax on their income from real estate sales. Because the issue of the additional tax under Section 294(d)(2) had not been supported, the court affirmed the Commissioner's determination, subject to modifications based on concessions made at the hearing.

Practical Implications

This case illustrates the importance of how a taxpayer's business activities are characterized for tax purposes. Lawyers who buy and sell real estate, for example, need to be especially careful about structuring their activities to ensure that their gains from such sales are treated as capital gains rather than ordinary income if that is their intent. The court's emphasis on the frequency and continuity of sales, along with the proportion of income derived from those sales, should be considered when advising clients. The decision further underscores the importance of proper accounting methods when reporting real estate sales, including the timing of deductions for expenses and the use of the installment method, if appropriate.

The decision clarifies the rule for taxpayers classified as real estate dealers versus those who are not. Furthermore, it highlights how failure to present evidence in support of claims before the Tax Court will lead to a ruling in favor of the Commissioner.

