Ayling v. Commissioner, 32 T.C. 707 (1959)

When a taxpayer sells real estate, the profits are considered capital gains, not ordinary income, if the property was not held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

Summary

The Aylings purchased a property that included a house and additional acreage, intending to sell the excess land. They subdivided the land and sold it in lots. The IRS determined the profits were ordinary income, not capital gains. The Tax Court disagreed, ruling that the Aylings were not in the real estate business, as their primary intent was to secure a residence and their sales activity was limited. The court considered factors such as the intent in acquiring the property, the frequency and continuity of sales, and the level of activity in developing and selling the land.

Facts

Wellesley and Mary Ayling purchased a property for $25,565.18, including a house and approximately 6 acres. They wanted the house, but the seller insisted on including the surrounding land. The Aylings initially considered selling the excess land in one piece but opted to subdivide it into 14 lots to protect the value of their home. They spent $7,531.90 on improvements (roads, waterlines, etc.) and sold 13 lots over four years, realizing $39,850. The Aylings were not real estate professionals; Mr. Ayling was a full-time employee-salesman and Mrs. Ayling was a housewife. They advertised the lots with only a few classified ads.

Procedural History

The Aylings reported the profits from the lot sales as capital gains. The IRS disagreed, determining the profits were ordinary income and assessed tax deficiencies, which were contested by the Aylings in Tax Court.

Issue(s)

1. Whether the lots sold by the Aylings were held primarily for sale to customers in the ordinary course of a trade or business, thus taxable as ordinary income.
2. Whether the allocation of the purchase price and basis among the individual lots was properly determined.

Holding

1. No, because the Aylings were not engaged in the real estate business.
2. Yes, the basis should be allocated on a square foot basis.

Court's Reasoning

The court found that the Aylings purchased the property primarily to obtain a home, with the intent to sell the excess land. However, this intent alone did not constitute a real estate business. The court considered several factors: the Aylings were not real estate professionals, they had limited sales activity and advertising, and their primary goal was to protect the value of their home. The court emphasized that for the Aylings to be considered in the real estate business, they must be engaged in that business "in the sense that term usually implies". The court also rejected the IRS's allocation of the purchase price and ordered a square-foot allocation.

Practical Implications

This case highlights the importance of distinguishing between investment and business activity in real estate. To achieve capital gains treatment, taxpayers should avoid actions that indicate a real estate business, such as frequent sales, significant development, or professional marketing. Courts examine the taxpayer's intent, the frequency of sales, and the level of activity to determine whether the taxpayer is a "dealer" in real estate. A single transaction, or limited activity to protect an existing asset, is less likely to be considered a business. The court's method of allocating basis on a square foot basis provides a practical approach for similar situations. This case continues to inform how tax courts view the distinction between capital gains and ordinary income in cases involving real estate sales, particularly for those who are not regularly involved in the real estate business.

