Brown v. Commissioner, 54 T. C. 1475 (1970)

Property held primarily for sale to customers in the ordinary course of a taxpayer's trade or business is not a capital asset, even if sold to a controlled corporation.

Summary

Royce W. Brown, engaged in the real estate business, purchased two tracts of land (Emmons and Anderson) with the intent to subdivide and sell them. He later assigned his interests in these properties to a controlled corporation, Royce Brown Development Co. , receiving payments in 1963. The IRS classified these gains as ordinary income, arguing the properties were held primarily for sale in Brown's trade or business. The Tax Court agreed, finding that Brown's activities, including subdividing and developing land, were part of his ongoing real estate business, and thus the gains were ordinary income under IRC § 1221, not capital gains.

Facts

In 1958, Royce W. Brown entered into contracts to purchase the Emmons and Anderson properties, both undeveloped tracts of land. The contracts specified that the land would be conveyed to a trustee, subdivided, and developed into building sites. Brown intended to subdivide these properties for sale, as evidenced by the trust agreements and his actions, such as ordering the platting of the land and securing financing for development. In 1959, Brown assigned his interests in these properties to Royce Brown Development Co. , a corporation he controlled, receiving promissory notes in return. In 1963, Brown received payments from the corporation totaling $71,636. 31, which he reported as long-term capital gains on his tax return.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Brown's 1963 income tax, reclassifying the gains from the property assignments as ordinary income rather than capital gains. Brown petitioned the United States Tax Court to challenge this classification. The Tax Court upheld the Commissioner's determination, finding that the properties were held primarily for sale to customers in the ordinary course of Brown's trade or business.

Issue(s)

1. Whether the gains realized by Royce W. Brown from the assignment of his interests in the Emmons and Anderson properties to Royce Brown Development Co. were ordinary income under IRC § 1221 because the properties were held primarily for sale to customers in the ordinary course of his trade or business.

Holding

1. Yes, because the court found that Brown held the Emmons and Anderson

properties primarily for sale to customers in the ordinary course of his real estate business, as evidenced by his actions and the nature of the contracts and trust agreements involved.

Court's Reasoning

The court applied IRC § 1221, which excludes property held primarily for sale to customers in the ordinary course of a taxpayer's trade or business from being classified as a capital asset. The court emphasized that the capital gains provision is an exception to the normal tax requirements and must be narrowly applied. The court considered Brown's background in real estate development, the language in the contracts and trust agreements indicating intent to subdivide and sell, and Brown's active role in the development process. The court rejected Brown's claim that the properties were held for investment, finding his testimony and that of his lawyer unconvincing. The court noted that Brown's use of a controlled corporation did not change the nature of the transactions, citing cases where similar transactions with controlled corporations were treated as part of the taxpayer's business. The court concluded that the gains were ordinary income because the properties were held primarily for sale in Brown's trade or business.

Practical Implications

This decision clarifies that property held for subdivision and sale, even if sold to a controlled corporation, can be classified as ordinary income if it is part of the taxpayer's ongoing trade or business. Taxpayers engaged in real estate development must carefully consider the tax implications of property transactions, especially when involving controlled entities. The ruling underscores the importance of documenting the purpose of property acquisitions and the need for clear evidence distinguishing investment properties from those held for sale in a business context. Subsequent cases have applied this principle, emphasizing the factual nature of the inquiry into whether property is held primarily for sale in a taxpayer's business.

