Howell v. Commissioner, 57 T. C. 546 (1972)

A corporation's sole activity of acquiring and selling real property can qualify as an investment, entitling shareholders to capital gains treatment if the property is not held primarily for sale in the ordinary course of the corporation's business.

Summary

In Howell v. Commissioner, the Tax Court held that Hectare, Inc. , which was formed to purchase and sell a single tract of land, was entitled to treat the proceeds from the sale as capital gains rather than ordinary income. The court determined that the property was held for investment, not for sale in the ordinary course of business, despite being the corporation's only asset and activity. Additionally, Hectare's election to be taxed as a small business corporation under Subchapter S was upheld, allowing the gains to pass through to shareholders as capital gains. The decision highlights the distinction between investment and business activities in the context of corporate taxation and sets a precedent for similar cases involving corporations with singular investment activities.

Facts

Three individuals formed Hectare, Inc. , in 1961 to purchase a 42. 86-acre tract of land in Georgia known as the Montgomery property. The corporation had no other assets and did not receive income from the property during its ownership. Hectare filed an election in 1964 to be taxed as a small business corporation under Subchapter S. The property was sold in three transactions between 1964 and 1966, with the final sale disposing of over 90% of the tract. Hectare did not subdivide or improve the land, nor did it advertise it for sale. The shareholders reported the gains from the sales as long-term capital gains on their tax returns.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the taxpayers' income taxes for 1965 and 1966, asserting that the proceeds from the land sales should be treated as ordinary income and that Hectare was not entitled to the Subchapter S election. The taxpayers petitioned the Tax Court for a redetermination of the deficiencies. The Tax Court consolidated the cases of the shareholders and Hectare, Inc. , and issued a decision in favor of the petitioners.

Issue(s)

1. Whether the Montgomery property was a capital asset within the meaning of section 1221, I. R. C. 1954, or whether it was held primarily for sale to customers in the ordinary course of Hectare's trade or business.
2. Whether Hectare, Inc. , was entitled to the small business corporation election under section 1372.
3. Whether the distributions received by Hectare's shareholders from the

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corporation were taxable as long-term capital gain or ordinary income.

Holding

1. Yes, because the property was held for investment and not primarily for sale in the ordinary course of Hectare's business, despite being its only asset and activity.
2. Yes, because Hectare met the requirements for a small business corporation under section 1371 and had no passive investment income as defined by section 1372.
3. Yes, because the gains from the sale of the property were properly treated as long-term capital gains by the shareholders due to Hectare's valid Subchapter S election.

Court's Reasoning

The Tax Court analyzed the legal distinction between holding property for investment versus holding it for sale in the ordinary course of business. The court applied the tests established in prior cases to determine the nature of Hectare's activities, focusing on the purpose of acquisition, frequency and continuity of sales, improvements made to the property, and the duration of ownership. The court emphasized that the property was held for four years before being sold, with no improvements or subdivision, indicating an investment intent rather than a business of selling real estate. The court also noted that the legislative intent behind section 1221 was to differentiate between profits from everyday business operations and the realization of long-term appreciation. The court rejected the Commissioner's argument that a corporation's sole activity cannot qualify as an investment, citing cases like 512 W. Fifty-sixth St. Corp. v. Commissioner and Morris Cohen, where similar corporate activities were deemed investments. The court upheld Hectare's Subchapter S election, finding that the corporation met the statutory requirements and had no passive investment income. A dissenting opinion argued that Hectare was engaged in the business of selling real estate, but the majority opinion prevailed.

Practical Implications

This decision clarifies that a corporation can hold a single asset for investment purposes, even if it is the corporation's sole activity, and still qualify for capital gains treatment upon sale. Practitioners should analyze the nature of the property's holding and the corporation's activities to determine whether the property is an investment or part of a business operation. The ruling also reinforces the validity of Subchapter S elections for corporations with investment activities, as long as they meet the statutory requirements. Subsequent cases have cited Howell in distinguishing between investment and business activities, particularly in the context of real estate transactions. Businesses and investors should consider this case when structuring their operations to achieve favorable tax treatment on the sale of assets.

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