***McManus v. Commissioner, 65 T. C. 197 (1975)***

Real property held by a partnership primarily for sale to customers in the ordinary course of its business results in gains taxed as ordinary income, not capital gains.

**Summary**

Thomas McManus, John Gutleben, and Nelson Chick, experienced in construction engineering, acquired and subdivided a 36. 5-acre tract in Oakland, California, for potential leasing and sale. They held themselves out as a partnership and engaged in substantial sales of the property. The key issue was whether the gains from these sales should be treated as ordinary income or capital gains. The U. S. Tax Court held that the property was held primarily for sale to customers in the ordinary course of business, thus the gains were ordinary income. Additionally, the court ruled that an individual partner's election to defer gain under Section 1033 was ineffective as it should have been made by the partnership itself.

**Facts**

In 1961, Thomas McManus, John Gutleben, and Nelson Chick, all experienced in construction engineering, purchased a 36. 5-acre tract of land in Oakland, California, for $926,000. They subdivided the property, made improvements, and sold portions of it, including two sales due to condemnation. They held themselves out as a partnership, filed partnership tax returns, and shared profits equally. The property was marketed for industrial or commercial development and was the subject of negotiations for leasing and sales. The partnership's activities included sales to various entities, including the State of California under condemnation.

**Procedural History**

The Commissioner of Internal Revenue determined deficiencies in the petitioners' federal income taxes for the years 1968 through 1971, reclassifying their reported long-term capital gains from the property sales as ordinary income. The petitioners filed a consolidated case challenging these determinations in the U. S. Tax Court. The court upheld the Commissioner's reclassification and found that the partnership's election under Section 1033 was necessary for any deferral of gain.

**Issue(s)**

1. Whether the entity created by McManus, Gutleben, and Chick constitutes a partnership.
2. Whether the partnership acquired and held the property primarily for sale to customers in the ordinary course of its trade or business.
3. Whether the condemnation activity changes the purpose for which the property was held by the partnership.
4. Whether an individual partner's election under Section 1033 to defer gain from a condemnation sale is effective.

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## Holding

1. Yes, because the taxpayers intended to carry on their business as a partnership, held themselves out as such, and managed their affairs accordingly.
2. Yes, because the property was acquired and managed for eventual resale at a profit, and the partnership engaged in activities indicative of a real estate business.
3. No, because the condemnation did not change the partnership's primary purpose of holding the property for sale to customers.
4. No, because the election to defer gain under Section 1033 must be made by the partnership, not individually by a partner.

## Court's Reasoning

The court applied the definition of a partnership under Section 761(a), which includes any unincorporated organization through which a business is carried on. The taxpayers' actions, including filing partnership tax returns and holding themselves out as partners, indicated their intent to operate as a partnership. Regarding the property's purpose, the court considered factors such as the nature of acquisition, extent of sales efforts, and improvements made, concluding that the property was primarily held for sale. The court distinguished this case from others where condemnation changed the purpose of holding the property, noting that here, the government was a potential customer in the ordinary course of business. The court cited *Mihran Demirjian* to support the ruling that an individual partner's Section 1033 election was ineffective.

## Practical Implications

This decision clarifies that real property held by a partnership primarily for sale to customers is subject to ordinary income tax on gains. Partnerships must carefully consider their activities and holdings to avoid unintended tax consequences. The ruling also reinforces that Section 1033 elections must be made at the partnership level, impacting how partnerships manage condemnation sales and reinvestment. Future cases involving similar issues will need to assess the primary purpose of holding property and the nature of the partnership's business activities. This case may influence how partnerships structure their operations and report income from real property transactions.

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