S & H, Inc. v. Commissioner, 77 T. C. 1265 (1981)

Property constructed with a specific intent to sell to a particular buyer pursuant to a pre-existing arrangement is considered held primarily for sale to customers in the ordinary course of a trade or business, resulting in ordinary income treatment rather than capital gains.

Summary

S & H, Inc. , an Arkansas corporation, constructed a warehouse for Griffin Grocery Co. under a pre-existing agreement that stipulated Griffin would lease and ultimately purchase the property. The Tax Court held that the income from the sale of the warehouse should be treated as ordinary income, not capital gain, because the property was held primarily for sale to Griffin in the ordinary course of S & H's business. The court reasoned that the warehouse was constructed with the specific intent to sell to Griffin, which constituted a trade or business under the Internal Revenue Code sections 1221 and 1231. This decision emphasizes the importance of the intent behind property acquisition and the nature of the transaction in determining tax treatment.

Facts

S & H, Inc. , an Arkansas corporation primarily engaged in acquiring and leasing or operating Holiday Inn Motels and other improved real properties, entered into an agreement with Griffin Grocery Co. (Griffin) in 1974. Under this agreement, S & H was to construct a warehouse on land it owned, known as the Whiteside Farm, according to Griffin's specifications. Griffin would then lease the warehouse upon completion and had an option to purchase it after 15 years. The construction was financed through an industrial development revenue bond issue, requiring the city of Van Burén to hold title to the land temporarily. The warehouse was completed in July 1975, and Griffin began paying rent. S & H reported the income from Griffin as rental income for 1976 and as long-term capital gain for 1977. The IRS, however, treated the income as ordinary income, leading to the dispute.

Procedural History

The IRS determined deficiencies in S & H's federal income tax for the fiscal years ending June 30, 1975, 1976, and 1977. After concessions, the sole issue was whether the income from the sale of the warehouse should be treated as capital gain or ordinary income. The case was heard by the United States Tax Court, which issued its opinion in 1981.

Issue(s)

1. Whether the income realized from the sale of the warehouse to Griffin should be treated as capital gain or ordinary income.

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Holding

1. No, because the warehouse was held primarily for sale to customers in the ordinary course of S & H's trade or business, the income from its sale is taxable as ordinary income, not capital gain.

Court's Reasoning

The Tax Court applied sections 1221 and 1231 of the Internal Revenue Code, which exclude property held primarily for sale to customers in the ordinary course of a trade or business from capital gains treatment. The court found that S & H constructed the warehouse specifically for Griffin under a pre-existing arrangement, indicating that the property was held primarily for sale. The court rejected S & H's argument that the warehouse was held for lease, noting that the intent to sell to Griffin was clear from the outset. The court also considered that S & H's business activities expanded to include constructing and selling property, which constituted a trade or business under the tax code. The court cited Malat v. Riddell, defining "primarily" as "of first importance" or "principally," and concluded that the profit from the sale was not due to market appreciation but to S & H's activities in constructing the warehouse. The court distinguished this case from Commissioner v. Williams, where no pre-existing arrangement existed, and held that the transaction here was not a speculative venture but a definite plan to sell to Griffin.

Practical Implications

This decision impacts how similar transactions involving the construction and sale of property should be analyzed for tax purposes. It emphasizes that if property is constructed with the specific intent to sell to a particular buyer under a pre-existing agreement, it will likely be treated as held primarily for sale, resulting in ordinary income treatment. Legal practitioners must carefully evaluate the intent behind property acquisitions and the nature of agreements to determine the appropriate tax treatment. This ruling may affect business planning, particularly in real estate development, where such arrangements are common. Subsequent cases, such as DeMars v. United States, have applied this principle, reinforcing the importance of pre-existing arrangements in determining tax treatment.

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