***Cottle v. Commissioner, 89 T. C. 467 (1987)***

Real property used in a rental business is not considered held primarily for sale to customers, even if it is later sold, if the primary purpose was rental and not resale.

**Summary**

In Cottle v. Commissioner, Donald Cottle purchased three four-plex units as part of a larger apartment complex with the intention of renting them out. After a year of managing and improving the units, Cottle sold them at a gain, which he reported as long-term capital gain. The IRS argued that the gain should be treated as ordinary income because the property was held primarily for sale. The Tax Court disagreed, ruling that Cottle's primary purpose was to rent the properties and that the sale was a liquidation of a failed rental venture. Additionally, the court addressed the allocation of income from a subsequent condominium conversion project, ruling that the income should be allocated to Cottle's corporation, not to him personally, based on the timing of the transfer of his partnership interest.

**Facts**

In June 1976, Donald Cottle purchased three four-plex units within the Gambetta Park apartment complex in Daly City, California, as part of a larger plan to acquire and manage the entire complex. Cottle, who had no prior real estate experience, invested significant time and money in renovating the units to improve their rentability. Despite initial rental losses, Cottle expected future positive cash flow. By April 1977, other owners began selling their units, leading Cottle to sell his units in June 1977 at a substantial gain. Cottle then engaged in other real estate ventures, including a condominium conversion project where he transferred his partnership interest to his corporation, DRC Enterprises, Inc. , before the project's income was realized.

**Procedural History**

The IRS issued a deficiency notice for 1977, asserting that Cottle's gain from selling the four-plex units should be treated as ordinary income and that income from the condominium conversion should be taxed to Cottle personally rather than his corporation. Cottle and his wife, Julia, filed a petition with the U. S. Tax Court, which heard the case and ruled in favor of the Cottles on both issues.

**Issue(s)**

1. Whether the gain from the sale of the four-plex units should be treated as long-term capital gain or ordinary income, depending on whether the properties were held primarily for sale to customers in the ordinary course of Cottle's trade or business.
2. Whether the income from the condominium conversion project should be allocated to Cottle personally or to his corporation, DRC Enterprises, Inc. , based on

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the timing of the transfer of his partnership interest.

**Holding**

1. Yes, because Cottle held the four-plex units primarily for rental in his trade or business, not for sale to customers. The sale was a liquidation of a failed rental venture, and thus the gain was correctly treated as long-term capital gain.
2. No, because under the interim closing of the books method, no income from the condominium sales was earned by the partnership on the date Cottle transferred his interest to DRC. Therefore, the entire 25% distributive share of the income was properly allocated to DRC, not Cottle.

**Court's Reasoning**

The court focused on Cottle's intent at the time of purchase and sale of the four-plex units. It determined that Cottle's primary purpose was to rent the properties, not to sell them, based on his actions and the fact that he sold only after losing control over the project. The court applied factors from prior cases to conclude that Cottle did not hold the properties primarily for sale. For the condominium conversion income, the court applied Section 706(c) and the interim closing of the books method, determining that no income was earned by the partnership until after Cottle's transfer of his interest to DRC. The court rejected the IRS's argument that Cottle should be taxed on the income based on the assignment of income doctrine, emphasizing that the timing of income recognition is determined at the partnership level.

**Practical Implications**

This case clarifies that real property used in a rental business is not automatically considered held for sale, even if it is later sold at a gain. It emphasizes the importance of the taxpayer's primary intent at the time of holding the property. For similar cases, attorneys should closely examine the facts surrounding the acquisition, use, and sale of the property to determine the appropriate tax treatment. The decision also impacts how partnership income is allocated when a partner transfers an interest during the year, reinforcing the use of the interim closing of the books method. Subsequent cases have cited Cottle for these principles, particularly in distinguishing between holding for rental and holding for sale.

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