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Income Taxation - Property Held "Primarily for Sale" - Effect of Malat v. Riddell

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NOTES

INCOME TAXATION—PROPERTY HELD "PRIMARILY FOR SALE"—EFFECT OF MALAT V. RIDDELL

The distinction between capital gains and ordinary income has spawned constant litigation and comment. Due to the considerable benefit of capital gains treatment,[1] taxpayers frame their transactions to qualify for these savings. Capital gains are derived from the sale of *capital assets* which are defined by exclusion in section 1221 of the Internal Revenue Code of 1954.[2] Clause one of section 1221 excludes from the category of capital assets "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[3] The application of this standard[4] to real estate transactions is the topic of this Note.

The determination of whether property is held primarily for sale to customers is considered a question of fact.[5] Factors recognized by the courts to bear on its resolution include: (1) the purpose for which the property was acquired;[6] (2) the frequency and continuity of sales;[7] (3) the activity of the seller in improving and selling the property,[8] including the extent of advertising;[9] (4) the holding period;[10] and (5) other factors

1. The Internal Revenue Code provides for a deduction from gross income of fifty percent of the excess of net long-term capital gains over net short-term capital losses. However, in no case may the tax exceed 25 percent of the excess. INT. REV. CODE of 1954, §§ 1201, 1202.

2. 26 U.S.C. §§ 1-8023 (1954).

3. *Id.* § 1221: "For purposes of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

"(1) . . . property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

4. The standard also appears in other sections of the Internal Revenue Code. See *id.* §§ 337(b)(1)(A), 341(b)(3)(B), 1031(a), 1231(b)(1)(B).

5. Lakin v. Commissioner, 249 F.2d 781, 783 (4th Cir. 1957); Rollingwood Corp. v. Commissioner, 190 F.2d 263, 265 (9th Cir. 1951); George V. Sottong, 25 CCH Tax Ct. Mem. 1366, 1371 (1966); Wellesley A. Ayling, 32 T.C. 704, 708 (1959).

6. Friend v. Commissioner, 198 F.2d 285, 287 (10th Cir. 1952); George V. Sottong, 25 CCH Tax Ct. Mem. 1366, 1371 (1966).

7. Frank v. Commissioner, 321 F.2d 143, 149 (8th Cir. 1963); Rollingwood Corp. v. Commissioner, 190 F.2d 263, 266 (9th Cir. 1951); George V. Sottong, 25 CCH Tax Ct. Mem. 1366, 1371 (1966).

8. King v. Commissioner, 189 F.2d 122, 123 (5th Cir. 1951); George V. Sottong, 25 CCH Tax Ct. Mem. 1366, 1371 (1966).

9. Scheuber v. Commissioner, 371 F.2d 996, 998 (7th Cir. 1967); Delsing v. United States, 186 F.2d 59, 61 (5th Cir. 1951).

10. Scheuber v. Commissioner, 371 F.2d 996, 998 (7th Cir. 1967).

indicating that the sale was in the ordinary course of business.[11] No one of these tests is considered determinative[12] and each case must be decided in the light of its own facts.[13]

The interpretation of "primarily" has received recent clarification by the United States Supreme Court in *Malat v. Riddell*.[14] The Court granted certiorari[15] because of a conflict among the courts of appeal. The Second[16] and Ninth[17] Circuits adopted the position of the Commissioner of Internal Revenue[18] and the Tax Court[19] in finding that "primarily" indicated only a "substantial" or "essential" purpose to hold for sale; while the Fifth[20] and Eighth[21] Circuits restricted the meaning to "of first importance" or "principally."

In *Malat*, the taxpayer was a member of a joint venture which purchased a 45-acre tract and subdivided the interior portion. The gain from the subdivision sales was taxed as ordinary income. Confronted with mortgage and zoning problems which prevented development of two frontage parcels, the taxpayer sold out his interest in this acreage, claiming the favorable capital gains treatment. The Commissioner assessed and collected a deficiency claiming the property was held with a "dual purpose" of developing for rental purposes or selling, whichever proved more profitable. Therefore, the purpose to sell was a "substantial" one. Mr. Malat contended the property was held as an investment; sale not being contemplated until the difficulties were encountered. The district court and the court of appeal[22] found one of the "substantial" purposes was that of sale, and upheld the Commissioner in denying capital

11. Delsing v. United States, 186 F.2d 59, 61 (5th Cir. 1951) (licensed real estate agent); S. O. Bynum, 46 T.C. 295, 300 (1966) (significance of time spent and income from real estate transactions).

12. Scheuber v. Commissioner, 371 F.2d 996, 998 (7th Cir. 1967); Recordak Corp. v. United States, 325 F.2d 460, 461 (Ct. Cl. 1963); Frankenstein v. Commissioner, 272 F.2d 135 (7th Cir. 1959).

13. Scheuber v. Commissioner, 371 F.2d 996, 998 (7th Cir. 1967); Mauldin v. Commissioner, 195 F.2d 714 (10th Cir. 1952).

14. 383 U.S. 569 (1966).

15. Malat v. Riddell, 382 U.S. 900 (1965).

16. American Can Co. v. Commissioner, 317 F.2d 604, 605 (2d Cir. 1963).

17. Malat v. Riddell, 347 F.2d 23 (9th Cir. 1965); Rollingwood Corp. v. Commissioner, 190 F.2d 263, 266 (9th Cir. 1951).

18. See Rollingwood Corp. v. Commissioner, 190 F.2d 263, 266 (9th Cir. 1951).

19. Municipal Bond Corp., 41 T.C. 20, 29 (1963); American Can Co., 37 T.C. 198, 210 (1961); Joseph A. Harrah, 30 T.C. 1236, 1241 (1958).

20. United States v. Bennett, 186 F.2d 407, 410 (5th Cir. 1951).

21. Municipal Bond Corp. v. Commissioner, 341 F.2d 683, 688 (8th Cir. 1965).

22. Malat v. Riddell, 347 F.2d 23 (9th Cir. 1965).

gains treatment. The Supreme Court redefined "primarily" to mean "of first importance" or "principally." It vacated[23] and remanded the case for disposition under the new definition.[24]

To understand the significance of this decision and the cases which have interpreted it, the requirements of the statute must be divided into the following elements:[25] (1) held "primarily" for sale, and (2) to customers in the ordinary course of business. In other words, the court must find the taxpayer in the real estate business before it can turn to *Malat* for the definition of "primarily held for sale."[26]

It is here that *Malat* can be of service to the real estate dealer. As noted above,[27] the Commissioner has in the past been able to succeed if he could prove a "dual purpose," the intention to hold for sale being at least a "substantial" one.[28] The dealer can now qualify for capital gains treatment by showing that the primary purpose for owning the asset was not that of sale.[29]

The Tax Court was confronted with a post-*Malat* case involving "dual purpose" in *Emilio Olivieri*.[30] It found the taxpayer and his partner, real estate developers, were undecided with respect to the use to be made of the particular tract and were holding it without taking any action which would commit them to its development or to retaining it as an investment. The court held, relying on *Malat*, that when the property was sold neither of these purposes had become a principal purpose or one of first importance; therefore, the property was not being held "primarily for sale."[31]

23. It must be remembered that the Supreme Court made no decision on the facts. Therefore, deciding future cases by comparison of facts as in Scheuber v. Commissioner, 371 F.2d 996 (7th Cir. 1967) is improper.

24. Malat v. Riddell, 383 U.S. 569 (1966).

25. The Tax Court has divided the second element into "for sale to customers" and "in the ordinary course of business," but considers the former insignificant because all sales are made to customers. S. O. Bynum, 46 T.C. 295, 302 (1966) (concurring opinion); Eugene L. Freeland, 25 CCH Tax Ct. Mem. 1473, 1479 (1966).

26. See Rollingwood Corp. v. Commissioner, 190 F.2d 263, 266 (9th Cir. 1951).

27. See notes 16 and 17 *supra* and accompanying text.

28. Malat v. Riddell, 347 F.2d 23 (9th Cir. 1965); American Can Co. v. Commissioner, 317 F.2d 604 (2d Cir. 1963); Rollingwood Corp. v. Commissioner, 190 F.2d 263 (9th Cir. 1951).

29. Comment, *Dual Purpose Assets and Capital Gains*, 12 S.D. L. REV. 408 (1967); *Supreme Court to clarify dealer's right to capital gain; will rule in Malat case*, 24 J. TAXATION 22 (1966).

30. 25 CCH Tax Ct. Mem. 920 (1966).

31. The court gave a more liberal interpretation of *Malat* than necessary to decide the case. The purposes of holding for sale and holding for invest-

In two other cases, where a "dual purpose" was involved, the Tax Court originally determined the taxpayer's purpose met the test of holding with sale as a "substantial" purpose. After *Malat*, the court reconsidered these cases and affirmed their previous decision finding that they could meet the more exacting test of "principally" laid down by the Supreme Court.[32]

With respect to the second element, sale "to customers in the ordinary course of business," the Supreme Court decision has had negligible effect.[33] It is here that equity calls for a change in the requirements of the Code. With regard to section 1221(1), the Supreme Court has said:

> "The purpose of the statutory provision with which we deal is to differentiate between the 'profits and losses arising from the everyday operation of a business' on the one hand . . . and the 'realization of appreciation in value accrued over a substantial period of time' on the other."[34]

However, in many cases, the statutory standard is unequipped to make this distinction. In *S. O. Bynum*[35] the taxpayer purchased a farm in 1942 for use in the nursery business. Due to financial reversals, he was forced to subdivide a part of it in 1959 to meet his obligations. The Tax Court correctly held under the statute that at the time of sale the property was held "primarily for sale" and subjected the gain to treatment as ordinary income. However, the gain resulted from both realized appreciation and everyday profits, and provision should be made to divide it between ordinary income and capital gain.[36]

The Code provides the means for making the necessary distinction between capital gains and ordinary income in dealing

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ment are alternative. The lack of a finding that the property was held as an investment connotes that the taxpayer has failed to shoulder the burden of proof in convincing the court that the property was not held primarily for sale. See TAX CT. R. 32.

32. Municipal Bond Corp., 46 T.C. 219 (1966); Joan E. Heller Trust, 25 CCH Tax Ct. Mem. 634 (1966). However, both of these cases were reversed on appeal because of a seeming reluctance on the part of the Tax Court to accept the full import of *Malat*. Municipal Bond Corp. v. Commissioner, 67-2 U.S. Tax Cas. ¶ 9633 (8th Cir. 1967); Joan E. Heller Trust v. Commissioner, 67-2 U.S. Tax Cas. ¶ 9626 (9th Cir. 1967).

33. Compare Lakin v. Commissioner, 249 F.2d 781 (4th Cir. 1957), with L. P. Barney, 26 CCH Tax Ct. Mem. 109 (1967).

34. Malat v. Riddell, 383 U.S. 569, 572 (1966).

35. 46 T.C. 295 (1966).

36. The Internal Revenue Code provides limited relief when the subdivision development is on a small scale and certain requirements are met. However, this relief has very limited application. INT. REV. CODE OF 1954 § 1237.

with cut timber.[37] This principle could be easily adapted to the real property area by treating the appreciation in value of the property while held as an investment as capital gain, and the profits made in developing and selling as ordinary income.[38] Such a scheme would surely restore equity and certainty in this much-litigated area.

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"OTHER INSURANCE" CLAUSES IN UNINSURED MOTORIST PROVISIONS

Plaintiff and Courville were guest passengers in a vehicle when it collided with an uninsured automobile. The uninsured motorist's negligence was the sole cause of the accident. The host's insurer deposited $10,000.00, the policy limit, of which Courville[1] was awarded $5,000.00, the host $2,000.00, and plaintiff $3,000.00. Each claimant would have been entitled to a larger recovery but for the size of the policy limit. Plaintiff then brought suit against his own insurer, under his policy's uninsured motorist provisions. Defendant insurer argued that under the "other insurance" clause in plaintiff's policy[2] its liability was extinguished by the host's insurer's payment of $3,000.00, since the uninsured motorist limits of both plaintiff's and the host's policies were identical. The district court allowed plaintiff full recovery ($5,000.00) under his policy. *Held*, amended and

37. The Internal Revenue Code treats the application in value of the standing timber as capital gain to be considered realized when the timber is cut, and the profits made in selling the cut timber as ordinary income. *Id.* § 631(a).

38. SURREY & WARREN, FEDERAL INCOME TAXATION, CASES AND MATERIALS 695 (1960); Dakin, *The Capital Gains Treasure Chest: Rational Extension or Expedient Distortion?*, 14 LA. L. REV. 505, 522 (1954). A similar effect could be created by the taxpayer by the establishment of another entity to acquire the property for development if he already holds the land for investment purposes. Berge, *Special Tax Problems of Participants in Real Estate Developments*, 45 TAXES 161, 163 (1967).

1. Courville was denied recovery under his own policy's uninsured motorist coverage in the companion case of Courville v. State Farm Mut. Auto. Ins. Co., 194 So.2d 797 (La. App. 3d Cir. 1967), *writs refused*, 197 So.2d 79 (1967).

2. The clause contained the following language: "Other Insurance. With respect to bodily injury to an insured while occupying an automobile now (sic) owned by the named insured, the insurance under Part IV shall apply only as excess insurance over any other similar insurance available to such insured and applicable to such automobile as primary insurance, and this insurance shall then apply only in the amount by which the limit of liability for this coverage exceeds the applicable limit of liability of such other insurance." LeBlanc v. Allstate Ins. Co., 194 So.2d 791, 792 (La. App. 3d Cir. 1967).