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"Primarily for Sale" in I.R.C Sections 1221 and 1231 Held To Mean "Principally for Sale" Rather Than "Substantially for Sale" --*Malat v. Riddell* (U.S. 1966)

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RECENT DEVELOPMENTS

"Primarily for Sale" in I.R.C. Sections 1221 and 1231 Held To Mean "Principally for Sale" Rather than "Substantially for Sale"— *Malat v. Riddell**

Sections 1221 and 1231 of the Internal Revenue Code disqualify from capital gains treatment profits derived from the sale or exchange of property "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[1] In deciding whether these sections deny capital gains treatment to profits realized by real estate dealers from the sale or exchange of land,[2] the circuit courts, while examining similar facts in relation to the same criteria,[3] have reached divergent conclusions.[4] Two recent decisions, *Municipal Bond Corp. v. Commissioner*[5] and *Malat v. Riddell*,[6] illustrate these

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* 383 U.S. 569 (1966).

1. INT. REV. CODE OF 1954, § 1221 states in pertinent part:

> For purposes of this subtitle, the term "capital asset" means property held by the taxpayer . . . , but does not include—
>
> (1) . . . property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business . . . .

INT. REV. CODE OF 1954, § 1231 provides generally that gains realized on the sale of "property used in the trade or business" may be treated as capital gains in some instances. Section 1231(b) defines "property used in the trade or business" as:

> (1) . . . property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than six months, and real property used in the trade or business, held for more than six months, which is not—. . .
>
> (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business . . . .

2. While this note analyzes capital gains treatment for dealers who sell or exchange the property in which they customarily deal in the context of real estate dealers who sell land, the same problems arise with dealers of other property. The same criteria must be used for all dealers. See note 23 *infra*.

3. These criteria, first enumerated in Boomhower v. United States, 74 F. Supp. 997, 1002 (N.D. Iowa 1947), are: continuity of sales or related activity over a period of time; frequency of sales, as opposed to isolated transactions; business or activity of seller and his agents; effort put forth in sales (improvements or sales campaigns); the extent and substantiality of transactions; the reasons and purposes for, or nature of, the acquisition of the asset. These criteria have been applied in Mathews v. Commissioner, 315 F.2d 101 (6th Cir. 1963); Tidwell v. Commissioner, 298 F.2d 864 (4th Cir. 1962); Yunker v. Commissioner, 256 F.2d 130 (6th Cir. 1958); Curtis Co. v. Commissioner, 232 F.2d 167 (3d Cir. 1956); Chandler v. United States, 226 F.2d 403 (7th Cir. 1955); Galena Oaks Corp. v. Scofield, 218 F.2d 217 (5th Cir. 1954); McGah v. Commissioner, 210 F.2d 769 (9th Cir. 1954).

4. *Compare* Carlson v. Commissioner, 288 F.2d 228 (7th Cir. 1961), *and* Dillon v. Commissioner, 213 F.2d 218 (8th Cir. 1954), *with* Rollingwood Corp. v. Commissioner, 190 F.2d 263 (9th Cir. 1951), *and* S.E.C. Corp. v. United States, 140 F. Supp. 717 (S.D.N.Y. 1956), *aff'd per curiam*, 241 F.2d 416 (2d Cir.), *cert. denied*, 354 U.S. 909 (1957).

5. 341 F.2d 683 (8th Cir. 1965). The Solicitor General chose not to file a petition for certiorari. See P-H 1965 FED. TAX. SERV. ¶ 56404 (June 3, 1965).

6. 347 F.2d 23 (9th Cir. 1965).

discordant results. In *Municipal Bond* the Eighth Circuit ruled that a real estate dealer holds land "primarily for sale" only if his *principal* intention in holding the property is to sell it for gain. In contrast, the Ninth Circuit in *Malat* held that a real estate dealer holds land "primarily for sale" if, when he originally purchases the property he has as part of his overall plan, a *substantial* intention to sell the property for gain. In an attempt to resolve this controversy the United States Supreme Court granted certiorari in *Malat*,[7] and in a per curiam opinion determined that "primarily for sale" means "principally for sale" rather than "substantially for sale."[8]

In spite of a preponderance of authority to the contrary in the lower federal courts,[9] the Supreme Court's preference for a dictionary definition appears sound. It is a well established rule of statutory construction that words should be interpreted in their ordinary, everyday meaning.[10] Furthermore, the Supreme Court's reading of the statutory language is consistent with one of the primary purposes of the capital gains provisions—the stimulation of investment.[11] To the extent that real estate dealers hold land for purposes other than sale in the ordinary course of trade or business, they should be entitled to capital gains treatment just as is any other investor.[12] Capital gains treatment is even more justifiable for investors who are not real estate dealers in the sense that real estate sales constitute their major vocation, but are nevertheless classified as dealers for

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7. 382 U.S. 900 (1965).

8. 383 U.S. 569 (1966).

9. American Can Co. v. Commissioner, 317 F.2d 604 (2d Cir. 1963), *cert. denied*, 375 U.S. 993 (1964); Rollingwood Corp. v. Commissioner, 190 F.2d 263 (9th Cir. 1951); S.E.C. Corp. v. United States, 140 F. Supp. 717 (S.D.N.Y. 1956), *aff'd per curiam*, 241 F.2d 416 (2d Cir.), *cert. denied*, 354 U.S. 909 (1957); Desilu Productions Inc., P-H TAX CT. REP. & MEM. DEC. ¶ 65307 (1965).

10. Crane v. Commissioner, 331 U.S. 1, 6 (1947). See also Hanover Bank v. Commisisoner, 369 U.S. 672, 687-88 (1962); Commissioner v. Korell, 339 U.S. 619, 627-28 (1950).

11. It has been said that the capital gains provisions not only facilitate economic growth by encouraging investment (Presidential Message on Tax Reduction and Reform, 109 CONG. REC. 962 (daily ed. Jan. 24, 1963); see generally BUTTERS, THOMPSON & BOLLINGER, EFFECTS OF TAXATION: INVESTMENTS BY INDIVIDUALS (1953)), but also increase the mobility of investment funds. H.R. REP. NO. 2333, 77th Cong., 1st Sess. (1942).

12. The importance of the taxpayer's being a dealer arises from the code provisions denying capital gains treatment to profits from the sale of property held primarily for sale to customers "in the ordinary course of his trade or business." See INT. REV. CODE OF 1954, §§ 1231(a), (b)(1)(B). To be in the real estate "business" for purposes of these provisions, however, the taxpayer need not be a broker or sell real estate as an occupation. It is sufficient that he carry on a significant number of sales activities. Thus, an investor who buys land and later carries on an extensive sales program may qualify as being in the real estate business. See, *e.g.*, Smith v. Commissioner, 338 F.2d 627 (5th Cir. 1964), *affirming* 40 T.C. 1067 (1963); Gault v. Commissioner, 332 F.2d 94 (2d Cir. 1964); Thompson v. Commissioner, 322 F.2d 122 (5th Cir. 1963); Mathews v. Commissioner, 315 F.2d 101 (6th Cir.), *rehearing denied*, 317 F.2d 360 (1963); Frankenstein v. Commissioner, 272 F.2d 135 (7th Cir. 1959); Bistline v. United States, 260 F.2d 80 (9th Cir. 1958); Marx v. United States, CCH U.S.T.C. ¶ 9369 (S.D. Cal., Dec. 3, 1965).

the purposes of sections 1221 and 1231.[13] While the impact on these investors who occasionally deal in real estate has been mitigated to some degree by section 1237, the limitations of this section prohibit its broad application.[14]

However salutary the result, the Supreme Court's abbreviated analysis in its per curiam opinion is subject to criticism. Initially, the Court gave little consideration to the key question whether a sale of land held, as the district court found, by a real estate dealer for sale or rent, whichever becomes more profitable, is an integral part of a real estate dealer's business and thus subject to ordinary income treatment.[15] This question would seem to merit some consideration, since it is a question by which the courts of appeals have been troubled.[16] The Court could have been of more assistance to the lower courts by bolstering its opinion with an analysis of congressional intent. There are indications in the legislative history of the pertinent revenue acts that Congress intended that the sale of land held by a real estate dealer for sale or rent, whichever becomes more profitable, be treated as part of his ordinary business. Attempts were made to draft a section for the Internal Revenue Code of 1954 permitting real estate dealers to obtain capital gains treatment on profits from personal investments in land if the property was properly earmarked.[17] The House recommended a bill with a provision allowing a limited access to capital gains treatment by real estate dealers on profits from the sale of land,[18] but the provision was

13. See note 12 *supra*.

14. Section 1237 allows capital gains treatment of profits from the sale of subdivided real estate provided that a number of conditions are met. Among the conditions are (1) the property must not have been previously held primarily for sale; (2) no substantial improvement can have been made; (3) the taxpayer cannot hold any other real property primarily for sale during the year the sale is made; and (4) no more than five lots can have been sold that year.

15. Rather, the Court merely 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 over a substantial period of time' on the other." The Court evidently regards the two categories as mutually exclusive, a conclusion which seems fallacious in light of Corn Products Ref. Co. v. Commissioner, 350 U.S. 46 (1955). In that case the taxpayer had bought and sold grain futures. Even though the gain had appreciated over a substantial period of time, capital gains treatment was disallowed because the dealings were deemed to have constituted an integral part of the taxpayer's business. The Court's cursory treatment of this issue may not only confound lower courts, but may also enable them to circumvent the actual holding of the case. See note 26 *infra*.

16. See Malat v. Riddell, 347 F.2d 23 (9th Cir. 1965); Municipal Bond Corp. v. Commissioner, 341 F.2d 683 (8th Cir. 1965); Rollingwood Corp. v. Commissioner, 190 F.2d 263 (9th Cir. 1951); *cf.* American Can Co. v. Commissioner, 317 F.2d 604 (2d Cir. 1963), *cert. denied*, 375 U.S. 993 (1964); Gotfredson v. United States, 303 F.2d 464 (6th Cir. 1962).

17. *Hearings on Internal Revenue Code of 1954 Before the House Committee on Ways and Means*, 83d Cong., 1st Sess. 1013-14, 1164-67 (1953).

18. H.R. 8300, 83d Cong., 2d Sess. § 1237 (1954). The proposed bill was similar to § 1236, which allows capital gains treatment to securities dealers who properly earmark the securities they trade for their own accounts.

deleted by the Senate, in part because of a fear that loopholes in the bill would allow capital gains treatment for sums which should be classified as ordinary income.[19] The same congressional intent was manifested by the inclusion of certain limitations on real estate trusts for the specific purpose of precluding real estate dealers who buy and sell land for gain from obtaining capital gains treatment on the resulting profits.[20]

A second basic criticism of the Supreme Court's analysis stems from the fact that the Court, in relying on the rule of statutory construction that words should be interpreted in their ordinary, everyday sense, did not discuss its refusal in the past to adhere to the rule in interpreting the definition of a capital asset. Although the term "capital asset" is broadly defined in the Code,[21] the Court has consistently stated that the definition is to be restrictively interpreted.[22] This traditional departure from a literal interpretation seems more drastic than the departure by courts which adopted the "substantially for sale" test, for while there is a striking semantic difference between "substantially" and "principally" or "primarily," the practical difference in the interpretation of sections 1221 and 1231 seems minimal. The courts which adopted the "substantially for sale" test generally did so to deny capital gains treatment where the intent to sell was equal to the intent to rent.[23] That test, there-

19. S. REP. No. 1622, 83d Cong., 2d Sess. 114 (1954).

20. *Hearings on Internal Revenue Code of 1954 Before the Senate Finance Committee*, 83d Cong., 2d Sess. 1275 (1954).

21. INT. REV. CODE OF 1954, § 1221.

22. Corn Products Ref. Co. v. Commissioner, 350 U.S. 46 (1955); Kieselbach v. Commissioner, 317 U.S. 399, 403 (1943); Hort v. Commissioner, 313 U.S. 28, 31 (1941); Burnet v. Harmel, 287 U.S. 103, 108 (1931).

23. See, *e.g.*, American Can Co. v. Commissioner, 317 F.2d 604 (2d Cir. 1963), *cert. denied*, 375 U.S. 993 (1964). The "substantially for sale" test was used to deny capital gains treatment where there was a specific finding that the assets had been held with an equal intent to sell or to rent.

In *Malat*, the district court denied capital gains treatment after finding that the intent to sell was equal to the intent to rent. The Ninth Circuit in affirming relied on its prior decision in Rollingwood Corp. v. Commissioner, 190 F.2d 263 (9th Cir. 1951), in which capital gains treatment was disallowed to a real estate dealer who intended to sell or rent, whichever became more profitable. In reaching its conclusion, however, the Ninth Circuit gave two hypothetical situations to illustrate what purposes do and do not constitute a primary intention to sell:

> (1) If the purpose for which the property was acquired and held was solely and specifically to develop for rental; if it excluded the realization of gain other than in that fashion; and if such purpose was accompanied by an intent to liquidate (irrespective of consequent gain or loss) if this purpose failed, then a sale pursuant to such a program might well be regarded as nothing more than liquidation of a disappointing investment.
>
> (2) If, however, the property was acquired and held with the purpose of realizing gain from it in any feasible manner which might present itself; if the owner stood ready to adapt his program to such changes as failing prospects might require and to realize gain wherever and however he could; then surely the realization of gain by sale is pursuant to the purpose of the holding. The taxpayer in such a case could be said throughout the course of his holding to have had several alternative purposes (all of which were substantial reasons for his holding within

fore, must be taken as meaning that capital gains treatment would be *denied* to gains from the sale of an asset held with an intent to sell which is substantially equal to the intent to rent. Thus, the only case where the result reached using the "principally for sale" test would differ from the result reached using the "substantially for sale" test is that in which an asset is held equally for rent or sale: where there is equality of intent, capital gains treatment must be allowed under the "principally for sale" test, since the asset cannot be said to be held "principally" for either purpose.[24]

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the Rollingwood definition of "primary"), each of which in turn actually became the primary purpose as efforts were concentrated in its direction.

If considered as general criteria for establishing the eligibility for capital gains treatment of profits from the sale of land by real estate dealers, these hypotheticals bristle with difficulty. The language appears to exclude from capital gains treatment profits realized on the sale of property by a real estate dealer who has *any* intent to sell for gain, even though that intent is clearly subordinate to his dominant intent to rent. However, it seems clear that the Ninth Circuit did not intend these hypotheticals to establish general criteria. Language preceding the hypotheticals indicates that the court intended them to apply only where an investment program had been frustrated at the outset. This interpretation is substantiated by the opinion in a contemporaneous Ninth Circuit case. In Margolis v. Commissioner, 337 F.2d 1001 (9th Cir. 1964), the taxpayer had acquired and subdivided a number of pieces of property, retaining some land from each subdivision for commercial purposes. Thereafter the taxpayer made several exchanges of this property over a period of more than two years. The gains from these exchanges were treated as capital gains, even though the intent to exchange the property near the end of the two years was clearly greater than the minimum which would be required by the hypotheticals.

24. The practical insignificance of the test used can be seen not only in real estate cases, but also in a number of other areas.

Machinery. In Philber Equip. Corp. v. Commissioner, 237 F.2d 129 (3d Cir. 1956), the court held that since the dominant intention of the company was the leasing of equipment, the intent to sell the equipment when it could no longer be leased was subordinate, and that profits from the sale could thus qualify for capital gains treatment. The result reached would be the same no matter which of the tests is used. In American Can Co. v. Commissioner, 317 F.2d 604 (2d Cir. 1963), *cert. denied*, 375 U.S. 993 (1964), the court employed the "substantially for sale" test with respect to machinery held with equal intent to sell or to rent. Had the court used the "principally for sale" test, capital gains treatment would have been denied. In S.E.C. Corp. v. United States, 140 F. Supp. 717 (S.D.N.Y. 1956), *aff'd per curiam*, 241 F.2d 416 (2d Cir.), *cert. denied*, 354 U.S. 909 (1957), the court used the "substantial" test to deny capital gains treatment where the sale was an integral part of the taxpayer's business. (The result which would be reached under the "principally for sale" test cannot be determined from the findings of fact in this case.)

Automobiles. In Hillard v. Commissioner, 281 F.2d 279 (5th Cir. 1960), it was held that a rental agency selling cars no longer useful could obtain capital gains treatment on the profits, since the sales were only an incident of the business; the result would have been the same no matter which test was used. In Greene-Haldeman v. Commissioner, 282 F.2d 884 (9th Cir. 1960), the court disallowed capital gains treatment on profits from the sales of cars where leases contained options to buy, with previous payments being applied against the purchase price, and evidence showed that the dealer leased cars only because he could obtain more cars from the manufacturer by doing so. It would appear that capital gains treatment would have been disallowed even if the "principally for sale" test had been used. See also Rev. Rul. 108, 1953-1 CUM. BULL. 185 (denying capital gains treatment to taxpayers who customarily buy automobiles at wholesale prices or fleet discounts and, after leasing them for a period substantially shorter than their normal useful life, sell them at wholesale or retail

A third criticism of the Supreme Court's per curiam opinion in *Malat* can be directed to the manner in which the Supreme Court instructed the district court to dispose of the case on remand. The district court had made a specific finding that the property was held with an equal intent to rent or to sell.[25] Using the "principally for sale" test adopted by the Supreme Court, it would appear that on these facts the Court could have directed the district court to hold for the taxpayer on remand, since the property was not held with a "principal" intention to sell. However, the Supreme Court instructed the district court to make a new finding of fact based on the correct legal test. In so doing the Supreme Court has intimated that it would be possible in *Malat* for the district court to find that the property was held "principally for sale." It would thus appear that the factual determination may vary with the test used. This apparent oversight on the part of the Court emphasizes the minimal distinction between the two tests. Under the "principally for sale" test a court must find as a matter of fact that the taxpayer's intent to sell was greater than his intent to invest before it may deny capital gains treatment. The difference between a finding of an equal intent to invest and to sell and a finding that the intent to sell is infinitesimally greater than the intent to invest may prove to be so minute that courts will reach the same result no matter which test is used.[26] Never-

prices, provided that the taxpayer is in the business of dealing in automobiles as well as leasing them); Rev. Rul. 229, 1954-1 CUM. BULL. 124 (excepting from the above ruling taxpayers who: (1) are primarily engaged in the business of renting and leasing motor vehicles to others, (2) sell their vehicles at wholesale prices to dealers, wholesalers, or jobbers, and (3) do not maintain facilities for the retail sale of such vehicles). These rulings seem consistent with either test.

Motion Pictures. In Desilu Productions, Inc., P-H TAX CT. REP. & MEM. DEC. ¶ 65307 (1965), the Tax Court held that profits on the sale of motion pictures which had previously been rented qualified as capital gains, since the main reason for holding the films was for rental. Although the Tax Court adopted the "substantially for sale" test, the same result would be reached using the "principally for sale" test.

Livestock. In United States v. Bennett, 186 F.2d 407 (5th Cir. 1951), and Albright v. United States, 173 F.2d 339 (8th Cir. 1949), it was held that the taxpayers were entitled to capital gains treatment on the sale of livestock where the sale was merely an incident of the taxpayers' business. This result is consistent with either test. See also Gotfredson v. United States, 303 F.2d 464 (6th Cir. 1962), which rejected the proposition that capital gains treatment must be denied if the taxpayer holds cattle with an equal intent to sell or to market their milk.

25. See Malat v. Riddell, 347 F.2d 23, 27 n.3 (9th Cir. 1965).

26. A number of cases since *Malat* support this argument. On the remand of Municipal Bond, 46 T.C. # 19 (May 16, 1966), the Tax Court all but emasculated the Supreme Court's decision in *Malat.* Despite a finding that the property had been held "with the principal objective of realizing the best profit available therefrom, whether it be from rental or sale, whichever seemed best at the time," it disallowed capital gains treatment stating:

> Petitioner is a corporation whose sole business activity over a number of years has apparently been buying, holding, renting and selling real estate. While we recognize that a corporation may be an investor in real estate and entitled to capital gain on the profits realized on the sale of such investment property . . . , we find it difficult to understand how the profits realized on the sales of property by a corporation engaged solely in the above business can be considered other

theless, the semantic difference in the tests will undoubtedly be sufficient to encourage real estate dealers to seek capital gains treatment in transactions where such treatment would previously have been precluded.[27]

than the "profits . . . arising from the everyday operation" of that business, unless the corporation can show by convincing evidence that its primary purpose for acquiring all of its properties . . . [was to derive income rather than hold for sale].

Thus, with a fact finding identical to that in *Malat*, the Tax Court used the language employed by the Supreme Court in *Malat* to reach a result contrary to the spirit of the Court's mandate.

The efficiacy of the Supreme Court's holding that "primarily" means "principally" was further diluted by Judge Tannewald's concurring opinion in S.C. Bynum, 46 T.C. # 28 (June 3, 1966). In trying to clarify the Tax Court's position he said that "primarily," as utilized by the Supreme Court, means of "first importance." He continued: "The element of substantiality is no longer enough. By the same token, the proscribed purpose does not, I believe, have to be capable of a quantitive measurement of more than 50 per cent. It should be sufficient if such purpose is *primus inter pares*." He went on to emphasize the increased significance of the phrase "in the ordinary course of business," a point which was also emphasized in Joan E. Heller Trust, P-H TAX CT. REP. & MEM. DEC. ¶ 66-121 (June 6, 1966). In the latter case the Tax Court disallowed capital gains treatment on the profits from the sale of certain duplex houses with another semantic sleight of hand:

> When we say in our opinion that petitioner intended at the outset to either rent or sell these houses, whichever proved more profitable, we are talking of a taxpayer whose primary business was developing and selling houses and who was about to try renting some of its houses, and if renting proved unprofitable, then it would be abandoned as a business endeavor and the houses, like the other 500 houses it built and sold to customers, would be held primarily for sale to customers in the ordinary course of its business.

Thus, in a situation in which property is held for rental or sale, whichever becomes more profitable, the court will look beyond the finding of the actual intention of the taxpayer to the nature of the taxpayer's business in order to circumvent the liberal interpretation of "primarily for sale."

27. The decision in *Malat* on remand can be found in P-H 1966 FED. TAX SERV. (18 Am. Fed. Tax R.2d 5015) ¶ 66-5003 (S.D. Cal. May 6, 1966) (capital gain).