

Malat v. Ridell
64-1 USTC ¶ 9432, 13 AFTR2d 1348 (S.D. Cal. 1964)

[1954 Code Sec. 1221]

Sales and exchanges: Sales in the course of business: Capital gain v. ordinary income.--Gain on the sale of two parcels of land in 1954 was taxable as ordinary income, rather than capital gain, since the parcels were held primarily for sale in the ordinary course of business rather than for investment. The failure to obtain rezoning and satisfactory financing was the primary cause of the sale, which was the step intended by the parties to be taken at the time the property was acquired and while it was held, if the rezoning and financing failed. BACK REFERENCES: 64FED ¶4729.62.

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Memorandum Opinion for Use in Preparing Proposed Findings of Fact, Conclusions of Law, and Judgment

CRARY, District Judge:

The plaintiffs, partners in Louis Lesser Enterprises, Ltd., a partnership, hereafter referred to as "Lesser", seek refund of income taxes, plus interest, paid for the year 1956. The court here adopts the admitted facts as set forth in the amended Pre-Trial Order.

[Sales in Course of Business]

The principal issue is whether 20 + acres, sold in two parcels in October and November, 1954, were held by Century-Crenshaw Plaza, hereafter referred to as "Plaza", a joint venture, with "Lesser" as one of the partners, primarily for sale to customers in the ordinary course of trade or business.

One of the parcels (10 + acres) of the 20 acres involved fronted on Crenshaw Boulevard and the other (9 + acres) on Century Boulevard. The said two parcels were a part of 44.90 acres which were acquired in February, 1954, by "Plaza", of which "Lesser" was a partner. "Plaza" was organized in August, 1953, for the purpose of purchasing the said 44 + acres. It is the position of the plaintiffs that the purpose of acquisition was to develop the two frontage parcels for commercial use and the remaining 24 + acres as multiple residence property also to be held by "Plaza" for rental purposes. Efforts to have the two parcels zoned for commercial use and to develop the 24 acres as planned failed. The Planning Commission refused to rezone the two parcels, and the mortgage market was so weak, plaintiffs assert, that a loan could not be obtained to build apartments on the 24 acres from a practical business standpoint. The inside 24 + acres were distributed by "Plaza", in April, 1954, to its members as equal tenants in common. On May 26, 1954, the distributees transferred the property to a joint venture under the name of Century Crenshaw Properties Company, which consisted of "Lesser", Sidney Rogan, Herman Millman, Espada Properties, Inc., and Hicks Properties, Inc. Fenmore was a controlling stockholder of

Espada and Hicks was the controlling stockholder of Hicks Properties. This group subdivided the 24 + acres and the resulting lots were sold during the period from two to nine months after acquisition. Gains from the sale of lots were reported as ordinary income. It appears from the testimony of plaintiff William Malat that if the zoning of the two front parcels for commercial use could not be obtained that "Plaza" intended to build apartments on them for rental but was prevented by the "rough" mortgage market.

After failure to obtain the rezoning of the front parcels, a rift arose among the partners of "Plaza" with "Lesser", Millman and Rogan on one side and Hicks and Fenmore on the other. The rift resulted in acrimony between the said partners that made further business relations as partners unpleasant, and about October 15, 1954, "Plaza" sold the said 9 + acres fronting on Century Boulevard to Hicks-Fenmore Development Company, a partnership, and about November 5, 1954, "Plaza" sold the 10 + acres and Crenshaw to George Ponty, and gains from said sales were reported by the partners as long term capital gains. From the testimony of plaintiff William Malat during the trial, it appears to the court that it is the position of plaintiffs that the sale of the two parcels involved was for a three-fold reason:

1. Inability to get the property rezoned for commercial uses.
2. Inability to get mortgage money to build apartments on terms which would make such construction practical.
3. The acrimonious rift between the partners which, plaintiffs state, precipitated the sale.

The Government, for the purpose of evidencing the intent on the part of the plaintiffs insofar as concerns the acquiring and *holding* by "Plaza" of the frontage properties, points to testimony of the plaintiff, William Malat, given in his deposition taken in the case, commencing at page 11, line 24, thereof, where the plaintiff observes that the possibility of failure of rezoning or refinancing is always a possibility in real estate development and that if this could not be accomplished re the parcels involved "* * * we would sell the whole thing off in bulk. We wouldn't get hurt," and at page 13, line 4, "If you don't get the zoning, then you do the next best thing. You either develop it at some lesser zoning or sell it off in bulk." At page 24, line 13, of his deposition, plaintiff, in referring to the parcel on Century sold to Hicks-Fenmore Development Company, states, "Their property was still R-3 when we sold it and as far as we knew it was one of the reasons we sold it. We couldn't get it zoned commercially * * *."

Now to the question as to whether the partners, including plaintiffs, held the said two frontage parcels primarily for sale to customers in the ordinary course of trade or business. The statute involved, to wit, §1221(1) of the Internal Revenue Code of 1954, being one containing relief provisions, is to be strictly construed. The Supreme Court of the United States has held that statutory provisions granting favorable tax treatment to gains on the sale of capital assets held for more than six months are such relief provisions. *Commissioner v. P. G. Lake, Inc.* [58-1 USTC ¶9428], 356 U. S. 260, at page 265 (1958). See also *Corn Products Co. v. Commissioner* [55-2 USTC ¶9746], 350 U. S. 46 at page 52, where the court states, referring to Section 117a of the Internal Revenue Code of 1939, provisions of which are similar to the Section here involved:

“It was intended ‘to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.’ *Burnet v. Harmel* [3 USTC ¶990], 287 U. S., at 106. Since this section is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly.”

The Court of Appeals, 9th Circuit, in the case of *Rollingwood Corp. v. Commissioner* [51-2 USTC ¶9374], 190 F. 2d 263 at 266 (1951), states that the reason for acquisition is not controlling unless it is found to be the same as the reason for which the property is *held*. Although the purpose for which acquired is of some weight, the court says:

“The ultimate question is the purpose for which the property is held.”

Plaintiffs, in the case at bar, have, for a number of years, been engaged in the purchase of property for development as an investment. They have frequently held interests as partners and stockholders in businesses holding properties for development and income where, in isolated cases, a portion of the unimproved real estate was sold as lots or raw land. The evidence shows that such sales were infrequent. The court recalls only three being referred to by plaintiff.

A test applied in determining the purpose for which the property was held is “the frequency and continuity of the transactions claimed to result in a trade or business.” Pg. 266, *Rollingwood Corp.*, *supra*. Applying the test in the case at bar, it does not follow that it supports the contention that the plaintiffs were in the business of selling real property. It appears from the testimony of plaintiff read into evidence from his deposition, referred to above, that the property here in question was purchased with the thought in mind that if the rezoning or appropriate financing could not be accomplished that the parties “would sell the whole thing off in bulk. We wouldn’t get hurt.” It is also noted that the idea of building apartments or multiple dwellings on the inside 24 + acres was abandoned within a *few weeks* after acquisition (February 15, 1954). The date of distribution of said acres (April 26, 1954) to the individual partners was promptly followed by subdivision.

In *Lowery v. Commissioner* [CCH Dec. 26,645(M)], 23 T. C. M. 152 (1964), cited by plaintiffs, the taxpayer, a real estate broker, occasionally bought and sold real estate. In determining the three properties there involved were not held primarily for sale to customers in the ordinary course of business but for investment, the court observed, at page 156:

“In making this determination the courts have relied upon various factors including the following: (1) The intent of the taxpayer with respect to the particular asset in question; (2) the purpose for the acquisition and disposition of the property; (3) the period the property was held; (4) the number, frequency and substantiality of sales; and (5) the extent of development, improvement, and sales activity.”

Later, on the same page, the court says:

“* * * we give particular weight to the fact that Lowery had held the 21st Street and Church

Lane property for five years, the Gates Street and Ridge Avenue property for three years, and the Rhawn Street tract for two years. We also considered the facts that Lowery made no overt efforts to list or advertise the properties and he had made no improvements on any of the properties nor did he replace them by further purchases. In 1953 he held the properties for investment.”

The taxpayers in *Leeb v. Commissioner* [CCH Dec. 19,516(M)], 12 T. C. M. 256, also relied on by plaintiffs, were members of a partnership formed for the purpose of buying 42 acres of unimproved real estate purchased in June, 1945. The property was acquired for subdivision. Block A, a 6 acre portion of the tract, after preliminary study by architects, was not included in the site plan nor in a map prepared in May, 1947, as not being economically practical for use in the subdivision planned. The remaining 36 acres were subdivided and sold to the public. Block A was never improved or subdivided nor mapped for subdivision. The plat of the subdivision was recorded in May, 1947. Block A was sold on January 30, 1948. In holding that the sale of Block A was properly taxed as capital gains, the court observed at page 261 of its opinion, re the intention of the parties in holding Block A:

“But the initial purpose for which property is acquired and held is not conclusive. The determining factor is the purpose for which such property is held at the time a sale thereof is consummated. Thus, property originally purchased and held for sale to customers in the ordinary course of a taxpayer’s business as a dealer may subsequently be converted into a capital asset as property held for investment and/or speculation purposes of the taxpayer. See *Pacific Affiliate, Inc., supra*; *Carl Marks & Co., supra*. In determining whether such conversion actually in fact was effected, consideration must be given to all material facts, the inferences and conclusions fairly to be drawn therefrom.”

The court also notes that no effort was made to sell Block A, no sales solicited, it was not advertised for sale, no “For Sale” signs were ever displayed thereon and it was never listed for sale with any broker. The evidence showed that Block A was held “for future use as a site for an apartment development later to be erected by them * * * to be held by them as a rental income producing investment.”

The Commissioner’s determination that Block A was held by taxpayers primarily for sale to customers in the ordinary course of trade or business, was reversed.

In another case cited by plaintiffs, *Edwards v. Commissioner* [CCH Dec. 19,886(M)], 12 T. C. M. 1045 (1953), the real estate involved was purchased in 1945 for construction of a hotel, garage, and so forth. These plans failed because of a city zoning ordinance passed in 1946 prohibiting such building on the property. The taxpayers had been actively engaged in the field of construction and building materials. After attempts to have the property rezoned had failed, the tract was listed for sale. A unit sale failed and the property was subdivided into twelve lots and these lots sold during the period from 1947 to 1948, some two to three years after the property was acquired. The Tax Court found that “the purchase and sale of the property was an isolated transaction and was not part of their business (pg. 1047). All of the authorities comment on the point that the question involved is one of fact to be determined with regard to the particular facts in each case.

Again referring to the *Rollingwood Corporation* case (9th Cir.), *supra*, we find that the petitioners, Rollingwood Corporation (hereafter referred to as R Corp.), and Bohannon, unsuccessfully contended that the sale of property there concerned resulted in a capital gain. Bohannon, before December, 1941, was engaged in the real estate business, to wit, the subdividing and selling of real property and the construction of homes. R. Corp. was incorporated in January, 1943, to construct and manage a project involving 700 homes in Richmond, Virginia. Bohannon owned 26 shares of the 50 shares of outstanding stock of R Corp. and in May, 1945, R Corp. acquired the other 24 shares. The 700 houses were completed in August, 1943, and rented to war workers on a rent-option agreement in form required by the United States. By May, 1947, R Corp. had sold 801 houses, which included re-sale of several houses reacquired by R. Corp. The houses, constructed primarily for rental, were advertised for rent and were rented for an average of 21 months under the said agreement which restricted the possibility of sale (pg. 265). About May 31, 1947, R Corp. was dissolved.

With respect to the meaning of “primarily”, see the court’s comments on page 266, as urged by defendant, but also see on this point *Philber Equipment Corp. v. Commissioner* [56-2 USTC ¶9934], 237 F. 2d 129 at 131 (9th Cir. 1956).

As noted on page 266 of the opinion, the question in the case was whether “the houses were held primarily for sale or primarily for rent.” Still on page 266, the court poses and answers a question re the propriety of the imposition of tax as follows:

“Suppose the taxpayer in the instant case intended to rent the houses for as long as he was required to do so under existing regulations and then to sell them. Or suppose his intention was to pursue whichever of these activities proved to be the most profitable, that is, if the *rental market* were good he would continue to rent but if the *sales market* were high he would sell. In either of these suppositions we think it is fair to say that one of the essential purposes (in acquiring or holding the houses) is the purpose of sale. Under such circumstances, if the taxpayer does dispose of the houses by sale, is it within the legislative *purpose* to allow him to treat the proceeds of these sales as a capital gain? *We think not.*” (Last italics ours.)

Applying the rule to the case at bar, if the taxpayers acquired and were holding the frontage properties with the purpose in mind of developing them for investment or to sell them for profit, depending on which would be most advantageous, and that by reason of the rezoning and financing problems it was more profitable to sell the properties, then it appears the profits from the sale should not be treated as capital gain under the rule stated by the Court of Appeals, 9th Circuit, in the R. Corp. case. This court notes the observation of the Court of Appeals in *Philber Equipment Corp.*, *supra*, at page 131 of its opinion, which it says, referring to the R Corp. case, that it was one of the numerous war time housing operation cases,

“* * * where individuals normally in the business of selling houses were required to turn to rental activities due to war time restrictions. Anticipation of selling activities with respect to the rental housing is an important consideration in many of these cases, so that the dual purpose of rental and sale is quite an inseparable factor in determining for what purpose the property is ‘primarily’ held.”

[Intent]

This comment should be considered in interpreting the effect of the R Corp. case on the case at bar but it does not appear that the rule in the R Corp. case with respect to the intent to follow the avenue of greatest profit is not binding on this court.

By reason of

1. The narrow construction rule to be applied in interpreting the statute involved,
2. The declared intent of plaintiffs as to the purpose of acquiring and holding the property, that is, if rezoning and financing could not be satisfactorily accomplished, “we would sell the whole thing off in bulk,” and
3. The rule as announced by the Court of Appeals, 9th Circuit, in the *R Corp. case*, *supra*, quoted hereinabove,

the court concludes that plaintiffs have failed to establish by a preponderance of the evidence that the profits here involved were held primarily for investment and not for sale in the ordinary course of trade or business. The rift between the partners may have expedited the sale but it appears that the failure to obtain rezoning and satisfactory financing was the primary cause of the sale which was the step intended by the parties to be taken at the time the property was acquired and while it was held, if the rezoning and financing failed. In other words, the property was purchased and held for development *or sale* depending on which course appeared to be most profitable, having in mind the need for rezoning and the availability of proper financing on reasonable terms.

[Conclusions of Court]

For the foregoing reasons and circumstances, the court concludes that the plaintiffs are entitled to take nothing by their complaint and the defendant is entitled to Judgment for costs.

Counsel for defendant is requested to prepare, serve and lodge proposed Findings of Fact, Conclusions of Law, and Judgment, in accordance with Local Rule 7, as amended. The Judgment shall be a separate document.

This Memorandum Opinion is not to be deemed a final Judgment.