Federal Income Taxation: The Effect of Condemnation on Property Held Primarily for Sale to Customers in the Ordinary Course of the Taxpayer's Business

Nancy Kane Hall

Follow this and additional works at: http://lawecommons.luc.edu/luclj

Part of the Taxation-Federal Commons

Recommended Citation

Available at: http://lawecommons.luc.edu/luclj/vol6/iss3/6
Federal Income Taxation: The Effect of Condemnation on Property Held Primarily for Sale to Customers in the Ordinary Course of the Taxpayer’s Business

Sales of real estate by a real estate dealer qualify for capital gain treatment only in unusual circumstances. While other taxpayers need only demonstrate that their activities in regard to the sale of the property in question were inadequate to constitute a business as a dealer in real estate, the acknowledged dealer must establish that the property sold had been held for investment purposes and not for sale in the ordinary course of his business. Where property held by a real estate dealer is sold under an actual or threatened condemnation, the courts appear to have been confused in their efforts to determine whether capital gain treatment is to be allowed.

INTRODUCTION

The Internal Revenue Code of 1954 provides preferential capital gain treatment for the sale of a capital asset as defined in section 1221, which reads in part:

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 . . . included in the inventory of the taxpayer . . . , or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. . . .

The above-quoted paragraph (1) language was enacted by Congress specifically to bring real estate dealers within the exclusion. As fur-

1. Although a similar problem arises in determining whether a loss is to be deducted as a capital or ordinary loss, this article assumes sales at a profit.
3. INT. REV. CODE OF 1954 § 1221(1).
4. The Revenue Act of 1921, ch. 136, § 206(a)(6), 42 Stat. 227, the precursor of section 1221, referred only to “inventory” which, according to conventional accounting practices, had never included real estate. See, e.g., AMERICAN INSTITUTE OF CERTIFIED
ther proof of this, the Income Tax Regulations give as an example "the case of a dealer in real estate."5 But neither the Code nor the regulations offer any further guidelines as to the circumstances under which property is held primarily for sale to customers in the ordinary course of business. The task of dealing with this problem has fallen upon the courts.

Any discussion of the judicial approach to capital gains must begin with the landmark decision of the United States Supreme Court in Corn Products Refining Co. v. Commissioner.6 The taxpayer, a manufacturer of products made from grain corn, bought and sold corn futures on the commodity market to protect its manufacturing operation against a rise in the cost of its principal raw material. Futures trading would normally have been accorded capital gain treatment, and the Court acknowledged that the corn futures did not come within the literal language of any of the exclusions to the definition of a capital asset. It reasoned, however, that:

Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss . . . .7

Where, as here, the trading was an "integral part"8 of the taxpayer's business, the gain realized was ordinary income. Moreover, the Court stated that:

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.9

Thus, in determining whether a sale of property produces capital gain or ordinary income, a court is to consider whether the sale is an integral part of the everyday operation of the taxpayer's business.

In an attempt to formulate criteria which would make possible a determination of the purpose for which the property was held, i.e., whether it was held primarily for sale to customers in the ordinary

---

7. Id. at 52.
8. Id. at 51.
9. Id. at 52.
course of the taxpayer's business, the courts have developed a list of factors which are to be considered: (1) the purpose for which the property was acquired; (2) the purpose for which the property was held; (3) the length of time the property was held; (4) the presence of improvement and development activities; (5) the number, frequency and continuity of sales; (6) the extent and substantiality of the transactions involved; (7) the extent of the efforts of the seller or those acting in his behalf to solicit buyers and sell the property; and (8) the nature and extent of the taxpayer's principal business.\textsuperscript{10} This list, or a modified version, has invariably been set forth by the courts with the accompanying statement that no single factor is determinative, and that each case must be decided upon its own facts.\textsuperscript{11}

The first four of these factors tend to reveal the character of the taxpayer and, therefore, help define the ordinary course of his trade or business. The last four factors aid in determining the nature of the property, thereby indicating whether the sale was in the ordinary course of the taxpayer's business.

The typical section 1221(1) condemnation case is based upon the following facts: The taxpayer is an acknowledged developer of real estate.\textsuperscript{12} He has never sold raw land, \textit{i.e.}, land which he has not developed and improved. The property in question was bought with the intention of developing and reselling it, but after an actual or threatened condemnation, was sold to the condemning party.\textsuperscript{13} At the time of the threatened or actual condemnation, either no development or very minimal development had occurred. No effort had been made by the taxpayer to sell the property prior to condemnation, and the condemnation sale was made reluctantly.

These facts, together with others which are unique to the particular case, are used by the court in determining two issues. The first is whether prior to the threatened or actual condemnation, the property was held primarily for sale to customers in the ordinary course of the taxpayer's business. If it was not, it was a capital asset and will receive

\textsuperscript{10} See, \textit{e.g.}, J. MERTENS, 3B LAW OF FEDERAL INCOME TAXATION § 22.138(1)-(6) (1966); Broughton v. Commissioner, 333 F.2d 492 (6th Cir. 1964); Kaltreider v. Commissioner, 255 F.2d 833 (3d Cir. 1958); George W. Mitchell, 47 T.C. 120 (1966); Raymond Bauschard, 31 T.C. 910 (1959), aff'd, 279 F.2d 115 (6th Cir. 1960).

\textsuperscript{11} Bauschard v. Commissioner, 279 F.2d 115 (6th Cir. 1960); W.T. Thrift, Sr., 15 T.C. 366 (1950).

\textsuperscript{12} In most cases the taxpayer develops and improves tracts of land for resale as residential lots.

\textsuperscript{13} The sale may also be made to a third party so long as the impetus of the sale is the condemnation. \textit{See, e.g.}, Ridgewood Land Co., Inc., 31 CCH Tax Ct. Mem. 39 (1972), aff'd, 477 F.2d 135 (5th Cir. 1973).
capital gain treatment. If, however, the property was so held, it falls within the section 1221(1) exclusion, and the gain from its sale will be treated as ordinary income unless the taxpayer can demonstrate that his purpose in holding the property was changed prior to the sale.

The second issue, then, is whether the threatened or actual condemnation caused the taxpayer to change his purpose in holding the property, thereby rendering the real estate a capital asset. The concept of a change in purpose by the taxpayer has long been accepted in capital gain cases. This is a reflection of the fact that, although the purpose for which the taxpayer acquired the property will be considered, the ultimate question is the purpose for which the property was held at the time of sale. This concept is sometimes used in regard to property originally held as an investment, but eventually sold under conditions which suggest that the taxpayer has entered into the business of selling real estate and has sold the property in the ordinary course of that business. In section 1221(1) condemnation cases the reverse situation may occur: it is possible for the taxpayer to have ceased to hold the property in question primarily for sale to customers and to have commenced holding it as investment property. The fact that he is a recognized dealer in real estate and commonly holds property primarily for sale to customers in the ordinary course of his business does not in itself prevent the taxpayer from also holding property for investment purposes. Even where he acquired and/or originally held real estate for development and resale, he will be found to have held the property as an investment at the time of sale if the evidence is adequate to show that his original purpose has been either abandoned or else rendered impossible by events beyond his control.

The determination of either issue can result in a finding that the taxpayer is entitled to capital gain treatment. Theoretically, the issues are separate and distinct; in actual practice, however, they have been treated together. Thus it sometimes becomes difficult to ascertain

---

15. See, e.g., Rollingwood Corp. v. Commissioner, 190 F.2d 263 (9th Cir. 1951); Maudlin v. Commissioner, 195 F.2d 714 (10th Cir. 1952).
17. This is to be differentiated from a similar situation in which the real estate was originally held for investment purposes, and evidence of a change in conditions is offered to show that the taxpayer sold the property only because he was forced to liquidate his investment. See, e.g., Heller Trust v. Commissioner, 382 F.2d 675 (9th Cir. 1967).
which factors were found to be determinative of which issue, and at times there is even some confusion as to which issue was found to be determinative of the case.\textsuperscript{20} An understanding of how these factors have operated and what patterns have emerged in section 1221(1) situations requires an analysis of the major cases in which they have been discussed.

**Condemnation: The Unmentioned Factor in the Early Cases**

The early 1221(1) condemnation cases, while recognizing and discussing a multitude of evidentiary factors, failed to recognize the condemnation itself as a possible cause of the taxpayer's alleged change in purpose.

In *Stockton Harbor Industrial Co.*,\textsuperscript{21} the United States Tax Court\textsuperscript{22} applied the usual tests\textsuperscript{23} and found that property sold to the United States Navy after condemnation had been held primarily for sale to customers in the ordinary course of the taxpayer's business. The court considered statements made by the taxpayer in its articles of incorporation and in a letter to the Internal Revenue Service,\textsuperscript{24} as well as in advertising and on its corporate stationery, in determining that the property had been acquired and held for the purpose of developing and selling it as industrial sites. Although only five sales totalling approximately 34 acres (of the original 902-acre tract) had been made in the seven years preceding the condemnation, the court refused to consider them as casual or isolated sales, finding instead that development and sale of industrial sites in the area would normally have been expected to be slow. The fact that no subdividing or other development had been done was found to be in accordance with the taxpayer's purpose of offering property suitable for the varying needs of different industries. The court acknowledged that an established business purpose could be changed, but held that here no such change had occurred.\textsuperscript{25} The court made no distinction between a possible change of intent prior to the time the taxpayer learned of the Navy's interest in the real estate and one made as a result of either the threatened or actual condemnation; in fact, the court never discussed the effect of

\textsuperscript{20} Commissioner v. Tri-S Corp., 400 F.2d 862 (10th Cir. 1968).
\textsuperscript{21} 11 CCH Tax Ct. Mem. 364 (1952), aff'd, 216 F.2d 638 (9th Cir. 1954).
\textsuperscript{22} Hereinafter referred to as the Tax Court.
\textsuperscript{23} See text accompanying note 10 supra.
\textsuperscript{24} Hereinafter referred to as the IRS.
\textsuperscript{25} 11 CCH Tax Ct. Mem. at 375.
the condemnation on the intentions of the taxpayer. The facts, however, strongly suggest that the property was not only offered for sale prior to receipt of the condemnation notice, but also continued to be held for sale to customers after the taxpayer learned of the possibility of condemnation. Significantly, the sixth and largest sale (of 214 acres) occurred after talks with the Navy had begun. The court also considered the fact that the corporate stationery, with its reference to wharf, warehouse, and manufacturing sites, was used even after the condemnation award.

Perhaps the most important factor, cited by the Tax Court in its statement of facts but not discussed in its opinion, was that the taxpayer had "welcomed and encouraged the Navy to acquire its property." This fact indicates that rather than forcing a change in the purpose for which the property was held, the condemnation and acquisition by the Navy was actually an event which fulfilled that purpose. The taxpayer had held this property not for sale as improved lots (which purpose would have been defeated by the condemnation) but rather for sale as unimproved real estate available in parcels as small or as large as the buyer wished. Consequently, the sale to the Navy could well be considered a sale in the ordinary course of the taxpayer's business.

Unfortunately, this aspect of the sale was discussed neither by the Tax Court nor by the Court of Appeals for the Ninth Circuit which heard the case on review. The Ninth Circuit, declaring that the findings of the Tax Court could be upset only if there was no substantial evidence to support them, upheld the decision. Judge Chambers concurred on this issue but maintained that the Tax Court would have been equally justified in finding that the property had not been held primarily for sale to customers in the ordinary course of the taxpayer's business, failing, however, to specify what evidentiary facts would have supported this conclusion.

The Tax Court again failed to discuss directly the effect of a threatened condemnation 11 years later when it decided *Pontchartrain Park Homes, Inc.* The taxpayer was a corporation engaged in the business of developing raw land for sale to individuals in the form

---

26. Id. at 371.
27. 216 F.2d 638 (9th Cir. 1954), aff'g 11 CCH Tax Ct. Mem. 364 (1952).
28. The courts of appeals are required to accept the factual findings of the Tax Court unless such findings are clearly erroneous. FED. R. CIV. P. 52(a); INT. REV. CODE OF 1954 § 7482(a).
29. 216 F.2d at 656.
30. 22 CCH Tax Ct. Mem. 437 (1963), aff'd, 349 F.2d 416 (5th Cir. 1965).
of improved lots either with or without houses. When the taxpayer had developed approximately half of its 211-acre tract and had at least temporarily ceased development of the remaining portion because of adverse physical and economic conditions, a 17-acre tract of raw land was sold to the State Board of Education. In a remarkably self-contradictory opinion, the court first declared:

[W]e are convinced that [the taxpayer], at the date of sale of the 17-acre tract, had not abandoned its purpose of ultimately developing Section 4 [the undeveloped land from which the 17 acre tract was sold] and selling the lots thus made available for sale.\textsuperscript{31}

Later in the opinion, however, while again discussing the taxpayer's purpose at the time of sale, the court stated:

We are convinced that . . . [the taxpayer] had in fact decided to forego further development and to liquidate its remaining unimproved acreage.\textsuperscript{32}

Both the character of the taxpayer and the nature of the property in question were discussed. In considering the taxpayer, the court found first that the ordinary course of its business was the development and sale of improved lots as home sites, and that the sale of the 17-acre tract was the taxpayer's only sale of undeveloped land. Secondly, the court found that the customers to whom the taxpayer sold real estate in the ordinary course of its business were individuals seeking homes, whereas the State Board of Education was specifically interested in land unprepared for the erection of a home.\textsuperscript{33}

In considering the nature of the property, the Tax Court grappled with the problem of unimproved or undeveloped land in the hands of a taxpayer whose business is that of improving and developing raw land and thereafter selling it. Citing cases which had held such undeveloped real estate to be a capital asset\textsuperscript{34} and also cases which had found the sale to produce ordinary income,\textsuperscript{35} the court held that in this instance the raw land had been held as an investment at the time it was acquired and had continued to be so held until it was developed to the point where it could be sold to customers. At this point it became inventory property, the sale of which would produce ordinary

\textsuperscript{31} Id. at 443.
\textsuperscript{32} Id.
\textsuperscript{33} Id.
\textsuperscript{34} Id. at 442, citing Nelson A. Farry, 13 T.C. 8 (1949); Charles E. Mieg, 32 T.C. 1314 (1959); Eline Realty Co., 35 T.C. 1 (1960).
\textsuperscript{35} 22 CCH Tax Ct. Mem. at 442, citing Donald J. Lawrie, 36 T.C. 1117 (1961); August Engasser, 28 T.C. 1173 (1957). A more recent case on the same point is Estate of Freeland v. Commissioner, 393 F.2d 573 (9th Cir. 1968), aff'd 25 CCH Tax Ct. Mem. 1475 (1966).
income. The court reasoned that since the 17-acre tract had never been developed, it remained an investment and its sale produced a capital gain.\(^{36}\)

While this reasoning produces the pleasing result of having arrived at the same conclusion by traveling two different routes, it does leave some unanswered questions. The court, for example, gives no hint as to the basis for its decision that the undeveloped land in this case was held as an investment rather than as inventory. Furthermore, the court fails to reconcile its statement that the taxpayer had acquired and, at the time of the sale, still held the property for the purpose of ultimately developing it,\(^{37}\) with the seemingly incongruous conclusion that the property was held as an investment.

These problems received no clarification when the Fifth Circuit Court of Appeals considered the case on review.\(^{38}\) In an extremely brief per curiam opinion, that court affirmed, holding that on the record it was clear that "by the time of the sale, the Taxpayer's purposes with regard to this property had been so altered"\(^{39}\) that the 17-acre tract could no longer be considered property held primarily for sale to customers in the ordinary course of business. That the Fifth Circuit would have upheld the decision on the basis of an alteration in the taxpayer's purpose is rather surprising, especially as the Tax Court had made no reference (except in one statement, contradicted elsewhere in the opinion,\(^{40}\) that the taxpayer had decided to forego further development) to a change in the taxpayer's purpose in holding the property.

Thus, the early *Stockton Harbor* and *Pontchartrain Park Homes* cases failed to clearly enunciate the criteria which determined whether property held by a dealer for development and sale, but sold instead under threatened or actual condemnation, was to be accorded capital gain treatment. More specifically, these cases completely failed to deal with the condemnation itself and with any effect it might have on the purpose for which the property was held. In addition, *Pontchartrain Park Homes* raised but left unsolved the difficult problem concerning the point at which raw land held by a developer for eventual improvement and resale becomes a part of the taxpayer's inventory. Although later cases have occasionally turned a similarly deaf ear upon both the

---

36. 22 CCH Tax Ct. Mem. at 443.
37. See note 16 supra.
38. 349 F.2d 416 (5th Cir. 1965), aff'g 22 CCH Tax Ct. Mem. 437 (1963).
39. Id. at 416.
40. See text accompanying notes 31 through 32 supra.
condemnation and its effect, the attention of the courts was specifically directed toward this element by the Eighth Circuit in Municipal Bond Corporation v. Commissioner, a landmark decision in the interpretation of section 1221(1).

THE EFFECT OF CONDEMNATION ON PURPOSE:
RELUCTANCY OF SALE

The first consideration of condemnation as a relevant factor arose in Municipal Bond Corporation v. Commissioner. The Tax Court had found that the taxpayer had acquired various properties, many of them through the purchase of tax certificates and tax deeds. The improved properties were usually rented for several years and sold only when the houses could no longer be rented without extensive repairs or when the sale values exceeded the rental values. Two of the tracts in question had been sold to purchasers having the power to condemn. The Tax Court had found that the taxpayer had acquired and held all of the properties for the dual purpose of investment and sale. Relying on the common construction of “primarily” to mean “substantial,” the Tax Court had found that the sales purpose had indeed been substantial throughout the period during which the property was held. Therefore, the court concluded that the properties had been held primarily for sale to customers in the ordinary course of the taxpayer’s business. No mention was made of the fact that two of the properties had been sold to purchasers having condemnation powers.

The Eighth Circuit reversed and remanded, holding that the Tax Court had erred in its interpretation of the word “primarily.” Declaring that the word should be given its “plain, usual and well-understood” meaning, the court found that meaning to be “of first im-

41. See, e.g., Koch v. United States, 457 F.2d 230 (7th Cir. 1972); Scheuber v. Commissioner, 371 F.2d 996 (7th Cir. 1967); Ackerman v. United States, 335 F.2d 521 (5th Cir. 1964); Nadalin v. United States, 364 F.2d 431 (Ct. Cl. 1966).
42. 341 F.2d 683 (8th Cir. 1965), revg and rem’g 41 T.C. 20 (1963).
43. 41 T.C. 20, 29 (1963).
44. The question involving the interpretation of “primarily” had developed from the fact that taxpayers rarely buy property with a single purpose in mind. Almost anyone who buys land as an investment does so with the expectation of selling it when and if that course of action becomes more profitable than continuing to hold it. In an attempt to bring all of these dual-purpose (or undecided-purpose) taxpayers under the section 1221(1) exclusion, the IRS had argued that “primarily” meant “substantially” or “essentially.” The courts found this interpretation especially attractive in cases where the taxpayer had offered property for optional rent or sale, so that resulting sales were quite obviously in the ordinary course of the taxpayer's business. An example of such a dual-purpose case is Rollingwood Corp. v. Commissioner, 190 F.2d 263 (9th Cir. 1951). By 1965, the Tax Court, several district courts, and the Ninth Circuit had adopted this view.
45. 41 T.C. at 29-31.
46. 341 F.2d at 689.
portance or principally." The court also found that for capital gain purposes, intent must be determined with respect to each tract in question, and that the taxpayer's intention might vary with respect to different tracts. While this idea was certainly not without precedent, it marked a new emphasis on the nature of the property in question as opposed to the character of the taxpayer, and made it clear that an individual might be a dealer with respect to certain properties and yet be eligible for capital gain treatment in regard to other real estate sales.

In citing examples of instances in which the Tax Court's findings had been affected by the erroneous interpretation of "primarily," the court of appeals specifically named the two condemnation-related sales. The court noted that both sales had been initiated by the purchaser and that at least one of them had been made reluctantly.

In a lengthy property-by-property analysis on remand, the Tax Court found that the taxpayer had neither sought to sell these two properties nor held them primarily for sale, but instead had sold them reluctantly, knowing that the purchasers had the power of condemnation. As authority for this position, the court cited Pontchartrain Park Homes, a case in which neither the Tax Court nor the court of appeals had discussed the pertinence of either the party initiating the sale or the reluctancy with which the sale was made. The Tax Court's opinion on remand is significant, then, in two respects: (1) its emphasis on the reluctancy of the sale and on the initiating party; and (2) its property-by-property approach.

The position taken by the Eighth Circuit in Municipal Bond concerning the interpretation of "primarily" was adopted by the United States Supreme Court a year later in Malat v. Riddell. In a brief, per curiam opinion, the Court held that:

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 (Corn Products Co. v. Commissioner, 350 U.S. 46, 52) and "the realization of appreciation in value accrued over a substantial period of time" on the other. (Commissioner v. Gillette Motor Co., 364 U.S. 130, 134.) A literal reading of the statute is consistent with this legislative

47. Id. at 688.
48. Id.
49. Municipal Bond Corp., 46 T.C. 219 (1966), on remand from 341 F.2d 683 (8th Cir. 1965).
purpose. We hold that, as used in §1221(1), "primarily" means "of first importance" or "principally."51

This suggests a limitation on the holding in Corn Products in which the Court stated that where the sale of property is an integral part of the taxpayer's business, ordinary income will be generated.52 The Court now imposes the further requirement that the sale be the principle reason for holding the property in order for it to fall within the section 1221(1) exclusion. The implication, of course, is that different properties can be held for different reasons and, therefore, their sales can have different relationships with the operation of the taxpayer's business.53

Conspicuously absent from the Malat opinion, however, is any guidance as to how this statutory interpretation is to be applied to various fact situations. This problem has continued to plague the courts in their examinations of condemnation sales.

Tri-S: THE DEVELOPMENT OF A COHESIVE CONDEMNATION THEORY AND THE PLANTING OF THE SEED OF CONFUSION

Tri-S Corp.54 marks the first recognition by the Tax Court that a condemnation notice might cause the taxpayer to change the purpose for which the property was held, and might result in a sale which is outside of and unrelated to the ordinary course of the taxpayer's business. In one of the most clearly reasoned of its opinions on condemnation sales, the Tax Court found that the property had been acquired as raw land with the intention of developing and improving it for ultimate sale as lots with houses. Until the date of the notice that a 20-acre tract was to be condemned, the property was held primarily for sale to customers in the ordinary course of the taxpayer's business. When the condemnation notice was received, however, this purpose had to be abandoned, as the property would necessarily be acquired by the state; therefore, the property was no longer held for sale to customers in the ordinary course of the taxpayer's business.55

The Tax Court also noted that the taxpayer had not sought the sale, and that no improvements other than platting had been made either at

51. Id. at 572.
52. See text accompanying notes 6 through 9 supra.
54. 48 T.C. 316 (1967), aff'd, 400 F.2d 862 (10th Cir. 1968).
55. Id. at 318.
the time of the notice or at the time of the sale. Unfortunately, the opinion was unclear as to the importance of the fact that no improvements had been made, and it is possible to infer that a different result might have been reached had improvements been initiated.\(^5\)

The Tenth Circuit upheld the decision on review\(^5\) in a somewhat ambiguous opinion that perhaps unintentionally created a question as to the basis of its decision. The court declared first that the taxpayer had:

\begin{quote}
never at any time held such 20-acre tract for sale in its raw state to customers in the ordinary course of its trade or business. It intended to sell such 20-acre tract at some time in the future, only after it had improved the same . . . .\(^5\)
\end{quote}

The court then stated that the property clearly had not been held for sale to customers in the ordinary course of the taxpayer's business during the period between the condemnation notice and the final sale. While prior to the date of the notice the taxpayer:

\begin{quote}
had intended at some time in the future to improve the 20-acre tract . . . , from and after that date it would have been futile for it to have undertaken to carry out such future plans.\(^5\)
\end{quote}

The court found that the taxpayer's intentions regarding the property changed when it received the notice of condemnation. But its statement that the taxpayer "never at any time" held the property for sale in its raw state raised several questions. Was the court implying that a taxpayer's intentions regarding real estate and its purpose in holding that real estate are separate concepts, so that one might change while the other remained the same? Was the court implying that it might have decided the case differently had the property, prior to the condemnation notice, ever been held for sale to customers in either its raw state or in an improved state? Finally, was the court saying (as the Tax Court did in Pontchartrain Park Homes)\(^6\) that raw land in the hands of a developer is held as an investment until it is developed to the point where it is ready for immediate sale to customers?\(^6\) If so, the appellate court overruled the Tax Court's finding that the raw land became part of the taxpayer's inventory immediately

\(^{56}\) For further discussion, see p. 37 infra.

\(^{57}\) Commissioner v. Tri-S Corp., 400 F.2d 862 (10th Cir. 1968), aff'g 48 T.C. 316 (1967).

\(^{58}\) Id. at 864.

\(^{59}\) Id.

\(^{60}\) 22 CCH Tax Ct. Mem. at 443. See text accompanying notes 34 through 36 supra.

\(^{61}\) It is unlikely that the Third Circuit would intentionally overrule the Tax Court on this point without any discussion whatsoever.
upon acquisition without any steps being taken toward development. Certainly neither the words nor the tone of the opinion advise the reader that the Tax Court’s reasoning, if not its decision, is being rejected. The ambiguity of the opinion, however, creates new areas of uncertainty which are especially unfortunate in an opinion affirming a relatively straightforward decision of the Tax Court.

THE PROBLEM OF RAW LAND IN THE POSSESSION OF A DEVELOPER

The Tax Court next dealt with condemnation in Juleo, Inc. and Ridgewood Land Co., Inc. The two cases are similar only in their concern over the point at which the raw land became part of the developer’s inventory, i.e., the point at which it first became property held primarily for sale to customers. In Juleo the taxpayer was found to have acquired and held a 100-acre tract of land for the purpose of development and sale. Approximately one year after acquisition, the taxpayer had obtained preliminary approval for a subdivision from the township. The court held that this action rendered the property salable and caused it to become part of the taxpayer’s inventory, or property held by the taxpayer for sale to customers in the ordinary course of its business. Although subdivision maps were filed and engineering work was done, these were not the factors which changed the status of the property in the eyes of the Tax Court.

A year later, in Ridgewood, the Tax Court again made a special effort to define the point at which the undeveloped property became part of the taxpayer’s inventory. This time the court found that the raw property—which could not be immediately developed or sold because it was not officially platted, was not zoned, lacked utilities, and was outside the city limits—had nevertheless been “suitable for development within a reasonable period of time” and had been included in the taxpayer’s inventory from the date of acquisition. Relying on Estate of Freeland v. Commissioner, a case it had not considered in the Juleo decision, the court held that:

[O]rdinarily, purchasing and holding raw acreage is an integral part of the subdivision development business, and in the absence of special circumstances, such acreage is not a capital asset.
Land which is held by a developer principally for development and sale, even when undeveloped for an extended period of time, is “property held primarily for sale to customers in the ordinary course of his trade or business” within the ambit of section 1221...67

This holding indicates that the Tax Court had taken a firm stand on the question of whether raw land passes immediately into the developer's inventory, or whether it remains a capital asset until some point of development is reached. In light of this decision, the reasoning in Pontchartrain Park Homes, in which the Tax Court had found raw land to be held as an investment until fully developed and ready for sale, is no longer accepted. Although the opinion may suggest that property, in order to be considered inventory, must be suitable for development “within a reasonable period of time,”68 the impediments which were present in Ridgewood make it obvious that the test is not a stringent one, and the court specifically stated that property could meet the test even when undeveloped “for an extended period of time.”69 Indeed, the leniency of the Ridgewood test is in sharp contrast to the severity of that used in Juleo, where the property was found not to become inventory until the single impediment—the lack of township approval of a subdivision—was removed.

The declaration that virtually any property acquired by a developer for eventual development and resale will be considered a part of the taxpayer's inventory rather than a capital asset has important consequences for the taxpayer-developer who is seeking capital gain treatment. It effectively eliminates any possibility that he will be successful in arguing that the raw property had not yet become part of his inventory and was not being held primarily for sale to his customers. It forces him to prove, instead, either that the property had not been bought for purposes of development70 and resale or that the purpose for which he was holding the property had changed at some point between acquisition and resale. Fortunately for the taxpayer, the Tri-S decision has made it clear that the Tax Court will find a notice of impending condemnation to cause exactly such a change of purpose in at least some factual situations.

67. 31 CCH Tax Ct. Mem. at 45 (emphasis added).
68. Id.
69. Id.
70. This will be extremely difficult to prove in cases where the taxpayer is an acknowledged developer, has never sold undeveloped land, and is able to produce no specific evidence that the acquisition of this property had been separate and distinct from his usual land acquisitions. See, e.g., Pomeroy, Dispositions of Real Estate, 12 W. RES. L. REV. 364 (1961).
FOLLOWING Tri-S: TWO APPROACHES BY THE TAX COURT

In discussing the effect of the condemnation notice, the Tax Court in Juleo and Ridgewood followed its Tri-S decision and found that the taxpayers no longer held their property for sale to customers after they had received notice of the impending condemnations. The two opinions, however, differ radically in both approach and effect. The Juleo opinion purported to adopt the Tri-S court's conclusions but did not adopt its reasoning and managed, in fact, to distort even the conclusions. The distortion arose when the Juleo court phrased the issue as being:

whether the notice of condemnation . . . removed [the property in question] from inventory or from classification as property held by the [taxpayer] primarily for sale to customers in the ordinary course of his trade or business . . . . 71

As authority on this issue, the court stated that the Tri-S opinion had found the property to be held as inventory before the notice of condemnation and as a capital asset afterward. 72 Unfortunately, the Juleo opinion failed to mention that the Tri-S court had also reasoned that the taxpayer's "plan [to develop the property] had to be abandoned when the condemnation notice was received." 73

This sentence plays a crucial role in the Tri-S opinion, making it clear that the condemnation notice changed the status of the property by forcing the taxpayer to change his purpose in holding the real estate. By omitting reference to this sentence, the Juleo court created the impression that the notice of condemnation automatically removed property from the taxpayer's inventory. No opinion, either by the Tax Court or by any of the courts of appeals, had ever made this claim; on the contrary, the Stockton Harbor case had presented a fact situation in which no change of purpose was found to have occurred, and which almost certainly would call for the same result under the Tri-S reasoning. 74 Therefore, the Juleo opinion implied a drastically new theory on the effect of a condemnation notice, a theory which must be viewed with some alarm since its propagation by the Tax Court appears to be entirely accidental. 75

The Ridgewood opinion also declared Tri-S to be determinative of

71. 30 CCH Tax Ct. Mem. at 286 (emphasis added).
72. Id. at 286.
73. 48 T.C. at 318.
74. See text accompanying notes 25 through 26 supra.
75. The Juleo court specifically stated: "We regard the holding of the Tri-S Corp. case as determinative of the issue now before us." 30 CCH Tax Ct. Mem. at 286.
the condemnation issue, but accompanied that statement with a careful application of the *Tri-S* reasoning to the facts before it. Analyzing the effect of the threatened condemnation, the court held that the taxpayer:

realized that it would be futile to hold the land any longer for eventual residential development; [its] original objective in holding [the property] had to be abandoned and thereafter the land was held primarily for speculation and investment. [Citations omitted.] By the time of the disposition of the land in question . . . [taxpayer's] purpose with regard to [it] had been so altered by circumstances beyond its control that the character of the land could no longer be considered within section 1221(1).76

Two points are to be noted in this passage. The first is that the condemnation was a circumstance "beyond the taxpayer's control." Other cases have declared similar sales to be "involuntary."77 Both phrases emphasize the lack of control by the taxpayer over the fact that the property will eventually be sold. The second point is that the threat of condemnation rendered the taxpayer's original plans impossible to complete. These two factors, the lack of control over the fact of the sale and the futility of persisting in the original purpose, are discussed not as issues in themselves, but as evidence that the taxpayer's purpose was indeed changed.

*Juleo on Appeal: A New Interpretation of Tri-S*

Both the *Juleo* and the *Ridgewood* decisions were appealed, the *Ridgewood* case reaching its respective court of appeals first.78 The Fifth Circuit followed the Tax Court's reasoning in *Ridgewood* and found no difficulty in affirming.79 The Third Circuit, however, was faced with the scanty and distorted reasoning of the *Juleo* opinion.80 Perhaps in a search for elucidation, the court went back to the *Tri-S* case, where it encountered the equally ambiguous Tenth Circuit opin-

---

76. 31 CCH Tax Ct. Mem. at 46.
77. See, e.g., *Juleo, Inc.*, 30 CCH Tax Ct. Mem. 284, 285 (1971). The use of the "circumstances beyond the taxpayer's control" language, rather than the more common "involuntary sale," is probably due to the fact that the sale in *Ridgewood* was not to the condemning party, and thus not strictly involuntary. The sale was made to the taxpayer's neighbor, who believed that the purchase of taxpayer's property would put him in a better bargaining position in regard to the impending condemnation of his own property. The court took pains to show that the sale was made only after the taxpayer had become convinced that his property would eventually be condemned.
78. The *Ridgewood* appeal was decided in April, 1973; the *Juleo* appeal was decided in June, 1973.
79. 477 F.2d 135 (5th Cir. 1973), aff'g 31 CCH Tax Ct. Mem. 39 (1972).
A divided court reversed the Tax Court decision, declaring that reliance on *Tri-S* was erroneous. 81

The Third Circuit began by agreeing that the *Tri-S* Tax Court opinion had held that "a condemnation notice converted land held primarily for sale to customers in the ordinary course of business into a capital asset." 82 The Third Circuit declared, however, that the *Tri-S* court of appeals had not affirmed on that ground, but instead had found that the property had never been held for sale in its raw state. The court of appeals in *Tri-S* had not commented on the Tax Court's finding that prior to condemnation the property had been held as inventory.

The Third Circuit went on to hold that "a condemnation notice does not change land held primarily for sale to customers in the ordinary course of business into a capital asset," citing *Stockton Harbor*. The court made no attempt to differentiate between the condemnation notice's inability to automatically change the character of the property, and the possibility that it might cause a change in the purpose for which the property was held. The Third Circuit then turned to an entirely new consideration and declared it inequitable that a taxpayer should receive capital gain treatment on property which, but for the condemnation, would have generated ordinary income. 84 The court refused to interpret the law in so inequitable a manner where the statute did not mandate such a result and where the court had found no case authority for doing so.

The dissenting opinion, 85 noting that the purpose for which the property is held is a factual question, brought the focus of attention back to the usual considerations in a case of this type. In a factor-by-factor analysis, the dissent emphasized: (1) that the taxpayer had never solicited the sale of the property in question; (2) that the original resale purpose had been terminated by force of necessity when condemnation became inevitable; (3) that no improvements were made on the property in question and even the subdivision approval had expired; and (4) that holding real estate for 8 years was incon-

---

81. *Id.* at 49.
82. *Id.* (emphasis added).
83. *Id.*
84. This theory seems to be based on the fact that the taxpayer had sought to establish a value for purposes of the condemnation award that reflected the amount he would have received had the land been sold after development. At least one other court has viewed a large profit as being indicative that the property was a capital asset. Scheuber v. Commissioner, 371 F.2d 996 (7th Cir. 1967).
85. 483 F.2d at 50 (Gibbons, J., dissenting).
sistent with the nature of this taxpayer's business. In a statement that directly rejects the majority's concern with the equity of the tax in this situation, the dissent concluded: "There is no reason for this court to be so zealous of guarding the revenue that we should arrogate to ourselves the task of fact finding which Congress entrusted to the Tax Court." 86

**THE Juleo INTERPRETATION: HOW MUCH WEIGHT WILL IT CARRY?**

The Tenth Circuit opinion in *Tri-S* was undeniably ambiguous, but it permitted only two reasonable interpretations. The first is that the court intended to affirm on the grounds cited in the Tax Court opinion. Under this analysis, the appellate court's assertion that the taxpayer had never held the property for sale in its raw state to customers in the ordinary course of its business becomes nothing more than a rather poorly worded conclusion that, due to the nature of the taxpayer's business, it had never intended to sell raw land and had never offered raw land for sale. The important point is that the notice of condemnation rendered the taxpayer's original intentions futile and that thereafter the property was held as a capital asset. This, of course, was the view adopted by the Tax Court in *Juleo* and *Ridgewood* and by the Fifth Circuit in *Ridgewood*.

The second possible interpretation is that the Tenth Circuit found the property to have been acquired and held as a capital asset without ever having become a part of the taxpayer's inventory, or property held primarily for sale to customers in the ordinary course of the taxpayer's business. Under this interpretation, the court's discussion of the effect of the condemnation notice on the taxpayer's intention to eventually develop the property is actually superfluous. As the property had never ceased to be a capital asset, there was no need to determine whether the condemnation notice caused a change in the purpose for which it was held. Under this analysis, it was unnecessary for the Tenth Circuit to either adopt or reject the reasoning of the Tax Court regarding the effect of the condemnation notice, and any comments by the court must be regarded as mere dicta. In any case, these comments are certainly approving of the Tax Court's reasoning.

Under either interpretation, the Tenth Circuit stands with the Tax Court 87 and the Fifth Circuit 88 in reasoning that a notice of condemnation...
nation can force a taxpayer-developer to change his purpose in holding real estate and thus indirectly convert the property into a capital asset. The only area of real uncertainty is whether the Tenth Circuit, like the Fifth Circuit\textsuperscript{89} and the Tax Court,\textsuperscript{90} considers undeveloped property in the hands of a real estate developer to be property held primarily for sale to customers in the ordinary course of the taxpayer's business. If, as the Third Circuit opinion in \textit{Juleo} states, the Tenth Circuit considers such undeveloped property to be a capital asset, then the only question to be decided is whether the property was indeed undeveloped or whether it had been improved to a point where it was held primarily for sale to customers in the ordinary course of the taxpayer's business. Even if the property is found to have been developed to this point, the taxpayer will avoid ordinary income treatment if he can demonstrate that the condemnation notice forced him to change his purpose in holding the property. In other words, under the interpretation which the Third Circuit has adopted, the taxpayer can prove that his property was a capital asset either by showing that it was undeveloped and had therefore never ceased to be a capital asset, or else by showing that the condemnation notice had forced a change of purpose which converted the real estate back to a capital asset.

Rather than clarifying the theories available to the taxpayer, the \textit{Juleo} opinion only created confusion in regard to section 1221(1). It completely ignored the Fifth Circuit's holdings in \textit{Ridgewood}, where that court had found the threat of condemnation to have forced the taxpayer to change his purpose in holding the real estate. More importantly, after having analyzed the \textit{Tri-S} opinion, it failed to apply the implication of that analysis. The \textit{Juleo} court interpreted \textit{Tri-S} as having been decided, not on the basis that the condemnation notice had forced a change in the taxpayer's purpose in holding the real estate, but rather on the basis that the real estate had never become part of the taxpayer's inventory. That is to say, the \textit{Juleo} court interpreted the \textit{Tri-S} decision as holding that where raw land is purchased by a developer who intends to develop and improve it, but who takes no steps toward such development other than the preparation of a plat of the real estate, the property is held as a capital asset and not for sale to customers in the ordinary course of the developer's business. The idea that some degree of development is necessary before real estate becomes inventory in the hands of one whose intention is to develop and

\textsuperscript{89} Id.
improve it has been discussed in numerous cases.\textsuperscript{91} However, even among courts who have required some degree of development, the amount required has varied greatly and has generally been discussed at some length.\textsuperscript{92}

The major weakness in the Third Circuit \textit{Juleo} opinion lies in its failure, after rejecting the Tax Court's holding on the effect of condemnation, to examine what then becomes the basis of its decision— the question of whether the real estate had in fact ever become part of the taxpayer's inventory. If, as the \textit{Juleo} court asserts, the \textit{Tri-S} decision is not authority for the proposition that a condemnation can force the taxpayer to change his purpose in holding the condemned real estate, then it must be authority for the proposition that raw land in the hands of a real estate developer requires more than mere platting before it becomes inventory, or property held primarily for sale to customers in the ordinary course of the taxpayer's business. Certainly, then, some discussion is called for regarding the Tax Court's holding that the property in \textit{Juleo} had become part of the taxpayer's inventory, especially in light of the extremely minimal steps which had been taken toward development in \textit{Juleo}. In the absence of any such discussion, it is necessary to conclude that the Third Circuit, in effect, reversed the Tax Court's decision without considering that portion of the opinion which it found to be determinative of the case.

Under these circumstances the Third Circuit opinion certainly stands as authority for the proposition that a condemnation notice does not automatically remove the condemned property from the inventory of a real estate developer. To view it as authority for the proposition that a condemnation notice can not change the purpose for which property is held by a developer is to give it credit for reasoning which it neither develops nor borrows. It may stand as authority for the proposition that an extremely minimal step toward development (here, the procurement of township approval of a subdivision) is adequate as well as necessary to convert real estate into part of a developer's inventory, although this is a point which the court never discussed and only impliedly affirmed. And it is certainly available as authority for the argument that capital gain treatment will be denied where it is inequitable.


\textsuperscript{92} See cases cited note 91 supra.
THE TAX COURT IN THE POST-JULEO ERA

The Tax Court has attempted to avoid a direct confrontation with the conflicting *Juleo* and *Ridgewood* decisions. In *Maurice Fabiani*93 the court narrowly distinguished the Third Circuit decision in *Juleo* and declined to reconsider its own decisions in *Tri-S, Ridgewood*, and *Juleo*. Taking advantage of a rather unique factual situation in which the possibility of condemnation had existed even before the date of acquisition, the court found sufficient evidence to indicate that at least 3 years prior to the actual notice, the taxpayers became convinced that the land was unsuitable for development because of the threatened condemnation and were holding the property as a capital asset.

The Tax Court apparently believed that by using this reasoning it had avoided the controversial question of whether receipt of a condemnation notice could change the taxpayer's purpose in holding property.94 The actual basis of the decision, however, is that even the possibility of an eventual condemnation can cause the taxpayer to change his purpose in holding the real estate. It is difficult to view *Fabiani* as anything other than an affirmation of the principles developed by the Tax Court in *Tri-S, Juleo*, and *Ridgewood*, and adopted by the Fifth Circuit and, probably, the Tenth Circuit.95 *Fabiani* strongly suggests that the Tax Court is unimpressed by the Third Circuit opinion in *Juleo* and will continue to find that a threatened or actual condemnation can force the taxpayer-developer to change his purpose in holding real estate, thus converting the property to a capital asset.

CONCLUSION

Under the present case law, two alternatives are available to the taxpayer-developer who purchased real estate with the intention of improving and reselling it, but who ultimately sold it, under threatened or actual condemnation. One is to show that the property was never developed to the extent that it could be classified as property held primarily for sale to the taxpayer's customers in the ordinary course of his business. The crucial question here is the degree of development necessary to so classify the property. The other alternative

94. Id. at 947.
95. *Ridgewood Land Co., Inc. v. Commissioner*, 477 F.2d 135 (5th Cir. 1973); *Commissioner v. Tri-S Corp.*, 400 F.2d 862 (10th Cir. 1968).
is to demonstrate that the threatened or actual condemnation caused the taxpayer to change the purpose for which he held the property, thereby converting the property from inventory to a capital asset. In determining whether such a change of purpose has occurred, the courts give greatest consideration to the extent to which the condemnation rendered the taxpayer's original purpose impossible and to the degree of reluctance with which the taxpayer made the sale. Unfortunately, the courts have been far from unanimous in their handling of these issues. The United States Supreme Court has indicated that it has no inclination to resolve these uncertainties, and neither Congress nor the IRS has taken any measure to clarify section 1221(1). In spite of indications by the Tax Court that it will continue to recognize a change of purpose in at least some factual situations, the taxpayer seeking to avoid section 1221(1) can hardly be assured of success.

NANCY KANE HALL