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"Dealer" Property Issue is Subject to Recent Tax Court Rulings

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The United States Tax Court has recently issued two memorandum decisions regarding the issue of whether property was held by a taxpayer "primarily for sale to customers in the ordinary course of his trade or business" within the meaning of Internal Revenue Code ("IRC") section 1221(1). Property so held—sometimes referred to as "dealer" property—is not a capital asset, and therefore gain or loss from the sale of such property will not be capital gain or loss.

The more recent decision, *Margaret Hancock v. Commissioner* (T.C. Memo 1999-336), is remarkable mostly because of the unusual position of the government, which asserted that the petitioner was not a dealer in circumstances strongly suggesting that she was. In *Harry Olstein v. Commissioner* (T.C. Memo 1999-290), which presented the more common situation of a taxpayer arguing that the property was not dealer property and therefore that the income realized was capital gain, the Tax Court reached a conclusion that will strike many practitioners as surprisingly favorable.

Hancock

The petitioner, Margaret Hancock, began working in the real estate business in 1957 or 1958. She managed the day-to-day operations of a publicly traded company formed and controlled by Hancock and her husband that subdivided and developed land for residential and commercial construction. The Hancocks surrendered their stock of the company during a decline in the real estate market in the 1960's.

The Hancocks then formed J.W. Hancock Enterprises, Inc. in 1973. From that year through 1986, Hancock Enterprises engaged in development activities managed by Hancock and her husband which included the purchase and subdivision of tracts of land and the construction and sale of houses on the subdivided lots. In 1976, a trust of which Hancock's husband was the trustee acquired the stock of Hancock Enterprises. Although not stated in the opinion, it appears likely that the trust was a grantor trust for income tax purposes.

Hancock Enterprises stopped building in 1982 or 1983, at a time when high interest rates made further development activity difficult, and began selling its remaining land (about 115 lots). The Hancocks then explored other development activities but, so far as is indicated in the opinion, did not undertake any further purchases of raw land or construction activity.

Hancock's husband died in 1985. Hancock and the Commissioner agreed that her cost basis in the stock of Hancock Enterprises was increased to the date-of-death value under IRC section 1014 (taking into account the special rule for community property under section 1014(b)(6)); that value was not at issue in the proceedings before the court.

Hancock Enterprises made a bulk sale of six lots in 1986 and then, on December 31, 1986, adopted a plan of liquidation and distributed its remaining 48 lots to the trust.

The opinion states that, from 1987 to 1994, Hancock's primary activity was selling lots, and that she sold 44 of the 48 lots during this eight-year period (and three additional lots in 1995 and 1996). Three of the lots were sold to a son of Hancock who was a real estate developer.

The sales of the lots during the years 1987 to 1996 resulted in an overall economic gain of $1.3 million, computed by reference to cost, and in tax losses aggregating $1.6 million, taking into account the step-up in basis upon the death of Hancock's husband. Hancock's selling activities included meetings with potential buyers, putting up "for sale" signs, attending homebuilders' meetings, and using her contacts in the real estate industry to sell the lots. She paid brokers' commissions of about $40,000 in the aggregate to sell certain lots, and used an office in one broker's place of business to do her work.

Hancock also met regularly with her accountant to discuss whether to buy additional property, and bought one lot in 1986 and four lots in 1990. All of these lots were sold within two years after purchase.

The lots distributed to the trust in liquidation of Hancock Enterprises were reflected on the liquidating corporation's books as inventory, and Hancock reported the sales of lots thereafter as sales of property held for sale in the ordinary course of her business—which was described in her tax returns, on Schedule C, as a real estate development business.

The government determined income tax deficiencies for Hancock for the years 1993 and 1994, and contended, in the Tax Court proceedings, that the eight lots sold in those years were not held for sale to customers in the ordinary course of a trade or business. Thus, in the government's view, the sales caused Hancock to realize capital losses, rather than the ordinary losses she reported.

The court applied five factors typically evaluated in resolving the "dealer" issue, namely: the frequency of sales; the nature of the taxpayer's business; the purpose for which the property was acquired and held before sale; the time and effort devoted to selling activities; the extent of improvements made by the taxpayer; and the length of time the properties were held. Unsurprisingly, the court concluded that, even if Hancock was not in the real estate development business during the years at issue, she was in the business of selling lots to customers, and held the lots for sale to customers pursuant to that business rather than for investment.

Given the apparent preponderance of factors favoring a "dealer" characterization, one may speculate that the government's pursuit of this case might have been attributable more to a sense that Hancock was emerging with an overly favorable result (taking into account the basis step-up at death) than to a careful analysis of the prevailing law in this area.

A factor that may have contributed to the government's persistence, however, were statements made during the IRS audit by Hancock's representatives, who were employed by or affiliated with her long-time accounting firm but not fully familiar with her operations. Those representatives told the IRS agent that Hancock Enterprises had "held back" some lots *for investment*, which may of course have suggested to the government that Hancock had an investment purpose when her trust acquired the lots at the end of 1986. Those statements were then cited by the government in the Tax Court proceedings as evidence that Hancock held the lots for investment rather than as a dealer.

Olstein

Harry Olstein, a real estate developer for more than 30 years, operated his business through several entities, including Hamptons Joint Venture ("HJV") and Whitehouse Partners ("Whitehouse"). HJV acquired a tract of land in Marlboro Township, New Jersey in 1983, and subdivided the land into 133 lots. HJV constructed houses on 77 of the lots and sold those lots in 1986.

Because of litigation with homeowners and the township beginning in 1986, HJV ceased development of the remaining lots and began seeking a developer to purchase the lots. In 1988, HJV contracted to sell those lots to Eli and Sol Kramer in three transactions to close in 1988, 1989, and 1991. Under that contract, 37 lots were sold to the Kramers in 1988 and 1989 for cash and purchase money debt.

The Kramers, who were real estate developers, encountered financial difficulties and sought, unsuccessfully, to renegotiate their contract. In settlement of ensuing litigation between the Kramers and HJV, (i) the Kramers conveyed 9 undeveloped lots acquired by them in 1989 and (ii) HJV conveyed 19 lots that were to have been sold to the Kramers in 1991, to Whitehouse, a partnership comprised of Olstein and entities apparently controlled by him.

In accordance with the settlement, the Kramers performed all of the activities necessary to develop, market, and sell the 28 lots, and received 4% of the net proceeds from the sale of the developed lots to home buyers in 1993 and 1994.

The government asserted that adjustments were required with respect to the partnership returns of Whitehouse to reflect the sales as resulting in ordinary income. Olstein and the other petitioners contended that the sales resulted in capital gains.

The court's opinion briefly states the issue and then concludes that Whitehouse did not hold the lots primarily for sale to customers in the ordinary course of business. The court first reasoned that, although HJV acquired and initially held the land for development, the litigation that commenced in 1986 forced HJV to abandon development plans and instead to seek to sell the 56 undeveloped lots to a single buyer. That objective was apparently viewed by the court as being inconsistent with a purpose of holding lots for sale to customers—a view that has some support in the case law.

The court then characterized the transfers of the lots thereafter (1) by the Kramers and HJV to Whitehouse, and (2) by Whitehouse to individual buyers, as being in furtherance of the original objective of HJV at the time it agreed to sell the lots to the Kramers, stating: "Whitehouse held the lots to facilitate the completion of the sale to, and resolve the dispute with, the Kramers." Accordingly, it seems, the purpose of Whitehouse in holding the lots was the same as that of HJV at the time it agreed to sell the lots to the Kramers.

Considering that the activities of Whitehouse itself were similar to that of many partnerships engaged in real estate development—that is, it acquired undeveloped property, engaged others (the Kramers) to build and market homes on the lots, and sold the improved lots within a two-year interval—the court's decision seems generous to the taxpayers. The overall fact pattern is unusual, however, and the court's analysis that the purpose for holding the lots changed from a dealer to a non-dealer purpose, and that Whitehouse inherited that nondealer purpose from HJV, may well be justified on these facts.