II. DEALER VERSUS INVESTOR

One of the most often litigated, and difficult to predict, areas of the tax law is whether real property (generally raw land) is held for investment as a capital asset or whether the taxpayer is a dealer, i.e., whether taxpayer is holding the property primarily for sale to customers in the ordinary course of his trade or business. In Malat v. Riddel, 383 U.S. 569 (1966) the Supreme Court (in its only consideration of the phrase) held that where both the business and investment motive exist in the holding of a particular parcel of real estate, the taxpayer's principal motivation controls in determining whether the property was held primarily for sale to customers.

A. **Factors Considered.** Because the inquiry into the taxpayer's motivation for owning a particular piece of real property is a factual one, the courts have developed sets of factors to determine whether the asset was capital or not. The following list set forth in United States v. Winthrop, 417 F.2d 905 (5th Cir. 1969) is representative and often cited:

1. The nature and purpose of the acquisition of the property and the duration of the ownership;
2. The extent and nature of the taxpayer's efforts to sell the property;
3. The number, extent, continuity and substantiality of the sales;
4. The extent of subdividing, developing and improving the property that was done to increase sales;
5. The use of a business office and advertising for the sale of the property;
6. The character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and
7. The time and effort the taxpayer actually devotes to the sale of the property.

B. **Methodology For Analysis.**

1. No One Factor Controls. The Fifth Circuit summed up the application of the factors to each situation in Biedenharn Realty Co. v. U.S., 526 F.2d 409 (5th Cir. 1976) as follows: " No one set of criteria is applicable to all economic structures. Moreover, within a collection of tests, individual factors have varying weights and magnitudes, depending on the facts of the case. The relationship among the factors and their mutual interaction is altered as each criteria increases or diminishes in strength, sometimes changing the controversy's outcome." However, the court noted (and other courts have agreed) that the single most important factor is the frequency and substantiality of the sales of real property.

2. Suburban Realty Inquiry. To avoid becoming mired in the analysis of the factors only, the 5th Circuit in Suburban Realty Co. v. United States, 615 F.2d 171 (5th Cir. 1980), cert. denied 449 U.S. 920 (1980), set forth the three relevant questions which must be answered under the statutory framework by the application of the factors. These inquiries are:

   a. Was the taxpayer engaged in a trade or business, and, if so, what business?

   b. Was the taxpayer holding the property primarily for sale in that business?

   c. Were the sales contemplated by the taxpayer "ordinary" in the course of that business?

C. Trade or Business Inquiry.

1. Frequency and Substantiality of Sales. The court in Suburban Realty stated that a taxpayer who engages in frequent and substantial sales of real property is almost inevitably engaged in the real estate business.

   a. Frequency. There is no bright line test with respect to frequency or continuity of sales. The taxpayer in Suburban Realty had engaged in at least 244 individual sales in prior years. In Biedenharn Realty, the taxpayer (held to be a "dealer") had engaged in at least 477 lots sales from the basic subdivision in question. In Sanders v. United States, 740 F.2d 886 (11th Cir. 1984), the taxpayer (held to be a "dealer") had averaged 15 sales of lots per year during a five year period with the number of sales ranging from zero to 21 in each of the years.

      (1) However, in Reese v. Commissioner, 615 F.2d 226 (5th Cir. 1980), the Fifth Circuit upheld the Tax Court's determination that an executive was not engaged in the trade or business of developing real property. The executive had purchased a tract of land and arranged for the construction of a new plant on the land. The completed building was leased to the corporation that the executive owned. Following foreclosure, the taxpayer attempted to claim an ordinary loss, arguing that he acted as the general contractor on the construction project and thereby had begun to engage in the trade or business of real estate development. The court rejected that argument, holding that the project was clearly an isolated, nonrecurring venture.

(2) Compare Morely v. Commissioner, 87 T.C. 1206 (1986) with Reese. In Morely, the taxpayer, who was engaged in the trade or business of selling real estate for commission as a broker, purchased a large tract of land and immediately began attempting to resell the property. The court determined that the taxpayer in Morely was engaged in the trade or business of selling real estate and, consequently, was not subject to the investment interest limitations of Section 163(d). In contrast, in Fraley v. Commissioner, 66 T.C.M. (CCH) 100 (1993), the taxpayer built homes on finished lots that he purchased. In 1979, the taxpayer purchased the lot in question, in 1981 he removed the house on the lot and in 1987 he sold the lot. During this period, he did nothing to improve the property and his sole marketing effort was to place a sign thereon indicating his willingness to build to suit. The court held that the sale generated a capital gain notwithstanding the taxpayer's long involvement in buying and selling real estate.

(3) In Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1992), the taxpayer was a partner in a joint venture that purchased unimproved property. The partners of the venture also formed a corporation shortly thereafter to perform all development activities on the property. Prior to the sale in dispute, the joint venture had made four sales, three of which were to the corporation. The remainder of the property was sold to the corporation which developed the property. The Fifth Circuit held that the Tax Court's determination that the selling joint venture was directly in the business of selling land was clearly erroneous because the joint venture did not sell land "frequently" and the only "substantial" sale was the one at issue. The Fifth Circuit also rejected the Internal Revenue Service arguments that the corporation was acting as an agent for the joint venture and that the corporation's development activities should be attributed to the joint venture.

b. Substantiality. The courts are also influenced by the substantiality of the amount and percentage of income derived from the sale of real property by a taxpayer. For instance, in Suburban Realty, the court noted that 83 percent of the taxpayer's gross cash proceeds from all sources were derived from real estate sales. The court in Biedenharn Realty was likewise impressed with the sheer dollars generated by the sale of real property even though the taxpayer in question also had significant income from other sources, thus rejecting the taxpayer's contention that it was not engaged in the trade or business of real estate development separate and apart from its other trades and businesses.

c. The courts have also emphasized the substantiality of sales, comparing the amount of income derived from real estate activities with income from other activities of the taxpayer. See e.g., Guardian Industries Corp. V. Commissioner, 97 T.C. 308 (1991). However, it should be noted that a taxpayer who holds property for long term appreciation may have a very large amount of income derived from the sale of that property in a particular year which may dwarf his other sources of income. This factor by itself should certainly not be determinative because it can also be an indication that the property has appreciated significantly over a long period of time, the hallmark of an investor.

2. Activities. Typically, an investor will merely wait for the value of property to appreciate with time, as opposed to seeking to increase the value of the property through improvements. Consequently, improvements are usually made by taxpayers engaged in the trade or business of developing the property. In Biedenharn Realty, the extensive development and improvement activities convinced the Fifth Circuit that a real estate company was not merely liquidating a former investment in farming property, but was selling property in its active conduct of a real estate business. Similar results were reached in Gault v. Commissioner, 332 F.2d 94 (2nd Cir. 1964) and Sanders v. United States, 740 F.2d 886 (11th Cir. 1984). Minor improvements may not rise to the level of causing a taxpayer to be engaged in trade or business. In Gartrell v. United States, 619 F.2d 1150 (6th Cir. 1980), the taxpayer was employed full time in a non-real estate position. The taxpayer purchased real property, subdivided it and added gravel roads and then sold the lots over a twenty year period. The court determined that the sales generated capital gains. In Buono v. Commissioner, 74 T.C. 187 (1980), acq. 1981-2 C.B. 1, an S corporation purchased a tract of land with a view to obtaining residential zoning approval on the tract and then selling it in bulk to a developer. It was anticipated that the property would be held for only 1-1/2 years. After a protracted and expensive process, zoning approval was obtained and the property was sold in three transactions. The Tax Court noted that even though the property had always been held for sale to customers, the taxpayer had never engaged in a trade or business because of the infrequency of the sales of property by the taxpayer.

3. Platting properties (for a subdivision) coupled with clearing, grading, construction of entryways, streets, sewers, etc., are considered by the courts to be indicia of dealer activity. See, e.g., Bush v. Commissioner, 610 F.2d 4206 (6th Cir. 1979); Jersey Land & Development Co. v. United

States, 539 F.2d 311 (3rd Cir. 1976); United States v. Winthrop, supra; and Bynum v. Commissioner, 46 T.C. 295 (1966). However, the improvements are not too extensive and the taxpayer can prove that they added very little to the gain which was ultimately realized by the taxpayer on the disposition, the taxpayer may still obtain capital gains status. See Huey v. United States, 504 F.2d 1388 (Ct.Cl. 1974); Barrios Estate v. Commissioner, 265 F.2d 517 (5th Cir. 1959) and Brodnax v. Commissioner, 29 T.C.M. 733 (1970). In Gartrell v. United States, 619 F.2d 1150 (6th Cir. 1980), the taxpayer was employed full time in a non-real estate position. The taxpayer purchased real property, subdivided it and added gravel roads and then sold the lots over a 20-year period. The court determined that the sales generated capital gains.

a. Use of a Business Office For Sale of Property. The use of a business office to conduct and coordinate sales activities for real estate together with obtaining the necessary licenses and permits to conduct the sales activities are considered indicia of deal status. See Segal Est. v. Commissioner, 370 F.2d 107 (2nd Cir. 1966).

b. Supervision or Control Exercised by Taxpayer Over Selling Efforts. The devotion of a significant amount of time by the taxpayer with regard to the sale of properties, together with hands-on supervision and control of any agents who are involved in such efforts, were found by the courts to support dealer status. See, e.g., Biedenharn Realty Co., Inc. v. United States, supra. However, in Fahs v. Crawford, 161 F.2d 315 (5th Cir. 1947) and Smith v. Dunn, 224 F.2d 353 (5th Cir. 1955), the taxpayer turned the entire property over to brokers who were granted total responsibility with respect to the sale of properties including decisions regarding the setting of sales prices. The court in both Fahs and Smith found that the taxpayer was an investor rather than a dealer. Under normal circumstances, however, any activities undertaken by a broker will be attributed to the taxpayer because they will be regarded as the taxpayer's agent. Biedenharn, Supra.

c. Time and Effort Devoted by Taxpayer to Sales Activities. The devotion of a significant amount of time by the taxpayer to the types of activities that imbue the property with dealer characteristics will increase the likelihood that the taxpayer will be deemed to be a dealer with respect to the property in question.

D. **Holding Property Primarily for Sale.** As stated above, the Supreme Court in Malat v. Ridell held that the word "primarily" as used in Section 1221(1) means of first importance or principally.

1. Purpose of Investment and Holding. The relevant inquiry is the taxpayer's motivation in holding the property prior to sale, not immediately before the sale, because at that point obviously the taxpayer's motivation is to sell the property. Generally, the taxpayer's original purpose for acquiring the property will continue unless such purpose is altered by evidence of a subsequent change. For instance, in Suburban Realty, the court assumed that the property was originally acquired as an investment. However, subsequent development activity stemming from the construction of an interstate highway through the property, changed this original purpose to that of holding primarily for sale to customers. A subsequent withdrawal of all development plats was not enough of an action to change the purpose from holding the property primarily for sale to customers back to an investment holding purpose.

2. Changed Purpose. An original investment purpose is typically overridden with evidence of a changed purpose unless the taxpayer can show "unanticipated externally induced factors which make impossible the continued preexisting use of the realty." Biedenharn Realty. Examples of such events include events which render the property unfit for their intended use, acts of God, illness and threat of foreclosure. See, for example, Estate of Barrios v. Commissioner, 265 F.2d 517 (5th Cir. 1959) (construction of a government canal rendered land infeasible for continued farming and the taxpayer commenced to liquidate her investment by selling subdivided lots over a 14-year period), Herndon v. Commissioner, 27 T.C.M. (CCH) 662 (1968) (a real estate dealer was allowed to report the sale of subdivided farm property as capital gain because he was merely liquidating an investment following the illness of his wife), and Erfurth v. Commissioner, 53 T.C.M. (CCH) 767 (1987) (gain from the taxpayer's sale of converted apartment units into condominiums was allowed to be reported as capital gain to the extent the sales were made to remove the property from the threat of foreclosure because the sales were not in the ordinary course of business; additional sales were required to be reported as ordinary income). The courts have utilized the extensive sales activities as evidence of a change in the purpose for holding the property from that of an investment intent to that of being held primarily for sale to customers in the ordinary course of business. Thompson v. Commissioner, 322 F.2d 122 (5th Cir. 1963).

3. Solicitation, Advertising and Brokerage Efforts. Solicitation and advertising tend to indicate that the taxpayer is searching for customers and not holding the land for appreciation over time. The courts may infer inherent advertising. For instance, in Biedenharn Realty, the court inferred an advertising and solicitation intent by the fact that the taxpayer made physical improvements to the property that would be noticed by customers who would inquire as to its availability for sale.

E. **Sales in the Ordinary Course.** Under Suburban Really, the relevant inquiry of what is "ordinary" is whether the sale was usual as opposed to an abnormal or unexpected event. Consequently, if the taxpayer's purpose in holding the property was primarily for sale to customers and the sale occurred without the occurrence of an event which rendered its original use changed, an ordinary course sale will most likely be implied.

1. Special Treatment for Property Acquired by Gift or Inheritance. Property which is received by a taxpayer through inheritance or through a lifetime gift is generally viewed in a more favorable light by the courts (this relates to the first factor in Winthrop - the nature and purpose of the acquisition of the property). The courts have even exhibited a willingness to permit a taxpayer to engage in a certain amount of development and sales activities in order to dispose of inherited or gifted property. For example, in Yunker v. Commissioner, 256 F.2d 130 (6th Cir. 1958), the taxpayer inherited farmland. The taxpayer was unable to sell the inherited property as a whole. However, with the aid of a real estate broker, the taxpayer improved the land by building roads and providing utilities. The taxpayer then sold the land and subdivided lots over a two-year period. The court allowed capital gains treatment for the income from the sale of the property, and stated "Where a taxpayer liquidates his real estate holdings in an orderly and businesslike manner, he is not by that circumstance held to have entered into the conduct of a business." Id. at 134. See also Reidel v. Commissioner, 261 F.2d 371 (5th Cir. 1958), and Fahs v. Taylor 239 F.2d 224 (5th Cir. 1956), cert. Denied, 355 U.S. 936 (1957). On the other land, if the liquidation process extends over a considerable period of time and is coupled with development and sales activities, the courts may not hesitate to classify the property as a dealer property. Thus, in Winthrop, supra, inherited land was subdivided and sold during the period commencing 1932 and ending 1960. The taxpayer engaged in platting, clearing and creating the property; he introduced utilities, provided an entryway and roads and ran sewer lines in through the property. The taxpayer also participated in building five houses on the lots which were held for sale. During this period of time over 456 lots were sold. Despite the fact that the property had been inherited by Mr. Winthrop, the court determined that he had developed a clear intent to sell off the property in the regular course of his trade or business. Thus, it is fair to say that, while the courts are more tolerant with respect to development and sales activities in the case of property that is either received by gift or inheritance, there is a limit to this tolerance, particularly if the development and sales activities are extended over more than a few short years.

2. Liquidation of Investment. There are several cases which permit a taxpayer with a large tract of land and who can demonstrate that it is very difficult or impractical to bulk sell the property at a fair price, to engage in a certain amount of development and sales activities in order to "liquidate

his investment." For example, in Heller Trust v. Commissioner, 382 F.2d 675 (9th Cir. 1967), a partnership built duplexes which were held for rent. The partnership ultimately experienced problems in keeping the duplexes rented and was only able to do so at a very low rental rate. A disagreement among the partners ensued with respect to whether it would be prudent to make further improvements to increase tenant occupancy. The partners could not resolve their dispute and it was ultimately decided that the duplexes would be liquidated. They were advertised for sale using extensive newspaper and radio advertising; a sales office was opened; one of the duplexes was utilized as a model and a staff of salesmen was employed to sell them. The duplexes were also completely reconditioned and redecorated in order to make them salable. The duplexes were ultimately sold off during a four-year period. The Ninth Circuit Court of Appeals found that the property was originally held for investment purposes and was ultimately sold off on a unit-by-unit basis simply because this was the most efficient and expedient manner of liquidating the partnership's investment. Thus, the court found that the partnership was entitled to capital gain treatment on the sales. The Tax Court reached a similar conclusion in Charles R. Gangi in which the taxpayer converted a 36-unit rental apartment building into condominiums and proceeded to sell the condominiums as a means of liquidating his investment. The Tax Court found that the taxpayers were entitled to treat the gains as long term capital gains. On the other hand, even if a taxpayer has clearly held property for investment purposes for an extended period of time, he engages in subdivision activities, undertakes significant sales activities, and continues this process over an extended period of time, the previous investment intent will not be sufficient to warrant capital gain treatment. Thus, in Biedenharn Realty Co., v. United States, 526 F.2d 409 (5th Cir. 1976), cert. Denied 429 U.S. 819 (1976), the Fifth Circuit Court of Appeals upheld the Service's treatment of sales by the taxpayer as ordinary income despite the fact that the taxpayer had operated the property in question as farm land for a period of over five years. The taxpayer later improved the land, adding streets, drainage and water lines, sewers and electricity. The cost of the improvements was substantial. Although the subdivided lots were sold over a period of approximately 30 years. In holding for the Service, the court made the following observation which is pertinent to the issue at hand:

a. "Undoubtedly, in most subdivided-improvement situations, an investment purpose of antecedent origin will not survive into a present era of intense retail selling. The antiquated purpose, when overborne by later, but substantial and frequent selling activity, will not prevent ordinary income from being visited upon the taxpayer. Generally investment purpose has no built-in perpetuity nor a guaranty of capital gains forever more." Id, at 421.

b. The court went on to offer the following observation which may be useful in determining, when the liquidation theory may prove useful to a taxpayer.

c. "There will be instances where an initial investment purpose endures in controlling fashion notwithstanding continuing sales activity. We doubt that this aperture, where an active subdivider and improver receives capital gains, is very wide; yet we believe it exists. We would most generally find such an opening where the change from investment holding to sales activity results from unanticipated, externally induced factors which make impossible the continuing pre-existing use of the reality."

3. <u>Suggested Techniques and Planning to Use the Special Exceptions for Inherited or Gifted Properties and the Limited "Liquidation" Exception</u>. If a taxpayer has received property by gift or inheritance or if a taxpayer has property that has clearly been held for investment purposes and has determined that it is not feasible to sell the property in bulk but must resort instead to the subdivision and/or sale of the property in multiple parcels, consider the use of some or all of the following:

a. If the property is held by an entity, such as a corporation, limited liability company or partnership, include clear statements of intent in the articles of incorporation, minutes, partnership agreements, etc., which clearly set forth that the principal objective of the entity is to liquidate the properties and distribute the proceeds thereof in an expedient fashion. The language can be appropriately embellished to tract the history of the property; the desire of the owners to dispose of the property and to divide the proceeds; and the use of the entity as a vehicle to liquidate its remaining real estate investments. In this regard, it may also be useful to select an appropriate name for the entity such as the "XYZ Liquidating Partnership, Ltd." (Of course, the actions taken by the entity must be consistent with these statements of intent or they will be regarded as meaningless, self-serving declarations).

b. Segregate clear investment parcels from development parcels. If certain portions of the property will be sold in bulk and others are to be subdivided and sold in a piecemeal fashion, it would probably be prudent, as a hedge against possible classification of the entire property as a dealer property, for the entity to adopt a written plan which designates a portion of its properties that are to be segregated from the balance of the property and sold in bulk. The remaining properties would be placed in a second category as properties which will be "developed if necessary in order to liquidate." Since it is possible even for a dealer to obtain capital gains treatment on certain properties that are held for investment, the division of properties in this manner from dealer status if it is later determined that the developed property is dealer property.

c. A liquidation plan generally means that once properties are sold the proceeds will be distributed to the owners as quickly as possible. Although it may be necessary to retain a portion of the proceeds to cover the cost of holding the remaining properties, the balance of the sales proceeds should be distributed as promptly as possible. Any reinvestment of proceeds in additional real property would clearly be inconsistent with the liquidation purposes.

d. Although stating the obvious, the taxpayer should carefully review the seven Winthrop factors and make every effort to minimize those activities which the court equates to dealer activities. This might include some or all of the following:

(1) If it is necessary to put streets, sewers, and utilities into a specific parcel of property, and if the taxpayer is dealing with one or more builders who will buy all or a substantial number of the lots in the new subdivision, consider working a deal with the builders to have them install these improvements in exchange for a reduced cost of the lots.

(2) If a builder is going to acquire substantially all of the lots in a particular phase or subdivision, consider granting the builder an option to acquire the property and allow him to interface with governmental authorities to obtain permits and approvals, as well as to perform improvements as described above. This will remove the taxpayer from this process.

(3) Bulk sell as many properties as possible, consistent with obtaining a reasonable after-tax return thereon.

e. Any dealings with the local press with regard to the development should be minimized but, to the extent required, should emphasize that the purpose of the entity is to liquidate the taxpayer's real estate holdings. You should keep in mind that anything that is said to the press can and will be found and used against the taxpayer by an IRS agent if it supports the Service's case.

F. **Section 1237.** Section 1237 may provide statutory relief to certain noncorporate taxpayers that engage in limited subdivision activities.

1. Statutory Requirements. Under Section 1237, a noncorporate taxpayer will not be treated as a dealer merely because of the subdivision of a tract of land and promotional sales activities relating to it so long as:

   a. the taxpayer was not a dealer in real estate with respect to the lot or parcel (or tract of which it is a part) in any year prior to sale and in the year of sale is not a dealer with respect to any other real property;

   b. the lot or parcel has been held by the taxpayer for five years, except where acquired by inheritance or devise; and

   c. the seller did not make substantial improvements which substantially enhanced the value of the lot or parcel sold.

2. Dealer Status. Basically, the inquiry as to whether or not the taxpayer is a dealer in real property is the same as the common law inquiry discussed above, except the inquiry will not take into account any subdivisions of the tract of land and promotional sales activity relating to it, so long as there is no substantial other evidence that the taxpayer is a dealer. Under the Regulations, the relevant inquiry seems to be the taxpayer's intent and the existence of substantial other evidence. Substantial evidence to the contrary does not exist if one of the following is true and may not exist if more than one of the following is true:

   a. holding a real estate dealer's license;

   b. selling other real property which was clearly investment property;

   c. acting as a salesman for a real estate dealer, but without any financial interest in the business; or

   d. mere ownership of other vacant property without engaging in any selling activity whatsoever with respect to it.

   e. Treas. Reg. § 1.1237-1(a)(3). For purposes of determining the taxpayer's dealer status, the taxpayer is considered as holding property which he owns individually, jointly, or as a member of a partnership. He is not generally considered as holding property owned by members of his family, an estate or trust, or a corporation. Treas. Reg. § 1.1237-1(b)(3).

3. Substantial Improvements. As stated above, a taxpayer will not be eligible for the special provisions of Section 1237 if the taxpayer or certain others make improvements on the tract which are substantial and which substantially increase the value of the lot or parcel of real property sold.

a. Improvements That Are Not Substantial. Temporary structures used as a field office in surveying, filling, draining, leveling and clearing operations, and the construction of minimum all-weather access roads, including gravel roads where required by the climate, are not substantial improvements. Treas. Reg. Section 1.1237-1(c)(4).

b. Improvements That Are Substantial. Shopping centers, other commercial or residential buildings, and the installation of hard surface roads or utilities such as sewers, water, gas or electric lines are considered substantial. Because these improvements entail minimal activity, further relief provisions to the substantial improvement rule exist. An improvement will not be considered a substantial improvement if the lot or parcel is held by the taxpayer for ten years or more (regardless of whether acquired by inheritance) and (i)the improvement consists of the building or installation of water, sewer, or drainage facilities or roads, including hard surface roads, curbs and gutters; (ii) the District Director with whom the taxpayer must file his return is satisfied that without such improvement, the lot sold would not have brought the prevailing local price for similar building sites, and (iii) the taxpayer elects not to adjust the basis of the lot sold or any other property held by him for any part of the cost of such improvement attributable to such lot and not to deduct any part of such cost as an expense. Decisions finding substantial improvements increase value are Pointer v. Commissioner, 419 F.2d 213 (9th Cir. 1969); and Kelly v. Commissioner, 281 F.2d 527 (9th Cir. 1968).

c. Improvements By Others. Improvements to the taxpayer's property by others are imputed to the taxpayer for purposes of determining whether or not the improvements are substantial for purposes of Section 1237. Improvements by the following are imputed to the taxpayer:

    (1) the taxpayer's whole or half brothers and sisters, spouse, ancestors and lineal descendants;

    (2) a corporation controlled by the taxpayer (50% or more direct or constructive ownership of the corporation's voting stock);

    (3) a partnership of which the taxpayer was a member at the time the improvements were made;

    (4) a lessee if the improvement takes the place of a payment of rental income;

(5) a federal, state or local government or political subdivision thereof, if the improvement results in an increase in the taxpayer's basis for the property, as it would, for example, from a special tax assessment for paving streets;

(6) any improvements made by the buyer pursuant to a contract of sale entered into between the taxpayer and the buyer.

(7) Treas. Reg. Section 11.1237-11(c)(2).

(8) See Rev. Rul. 77-338, 1978-2 C.B. 312, which permitted capital gain treatment under Section 1237 where land was leased on a long term basis to developers who improved and subdivided the land, constructed houses on the land, and sold the houses subject to a lease. A testamentary trust created under the will of the lessor subsequently sold the land to tenant/homeowners. The Service held that, since the taxpayer had not improved the land (developers, who are unrelated to the lessor, made all improvements), the sales qualified under Section 1237.

4. Substantial Increase in Value. To remove the taxpayer from the benefits of Section 1237, a substantial improvement must substantially increase the value of the lot sold. If the improvements increase the value of a lot by ten percent or less, such increase will not be considered as substantial, but if the value of the lot is increased by more than ten percent; then all relevant factors must be considered to determine whether, under such circumstances, the increase is substantial. Additionally, the increase in value to be considered is only the increase attributable to the improvement or improvements. Changes in the market price of the lots not attributable to the improvements are to be disregarded. Treas. Reg. Section 1.1237-1(c)(4).

5. Special Rule for Sales of More Than Five Lots. A taxpayer selling less than six lots in any taxable year will treat the entire gain as capital. In later years, five percent of the selling price, to the extent of its gain, on the sixth and all further lots is recognized as ordinary income with the remainder as capital gain. Expenses of the sale reduce the ordinary income portion of the gain first. However, if the sixth lot is sold in the same taxable year as the first five lots, five percent of the selling price on all of the lots, including the first five lots, is ordinary income. Treas. Reg. Section 1.1237-1(e).