CAPITAL ASSETS: REAL PROPERTY "USED IN A TRADE OR BUSINESS."

Whether or not real property is "used in a trade or business" so as to be excluded from the definition of Capital Asset as such is defined in Section 143.-100 (2) Cum. Supp. 1955, RSMo 1949, is a factual determination to be made in each case. Gains and losses from capital assets treated differently under Missouri and Federal law.

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October 28, 1957

Honorable Jack C. Jones
Senator Sixteenth District
Carrollton, Missouri

Dear Senator Jones:

In your recent inquiry you submitted several hypothetical situations upon which you desired to have an opinion, as to whether or not the property concerned in each situation constituted a capital asset under the provisions of Section 143.-100 (2) Cumulative Supplement 1955.

You submitted the following situations:

> "Situation A: Taxpayer A was engaged in the practice of law. He purchased a dwelling house which he intended to hold as a rental property investment. He held the property for more than six months and sold it.
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> "Situation B: Taxpayer B was engaged in the insurance business. He purchased a dwelling house which he intended to hold as rental property investment. He held the property for more than six months and sold it.
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> "Situation C: Taxpayer C was a farmer. He purchased some additional farming land and did not operate it but rented it to others. He held the land for more than six months and sold it.
>
> "Situation D: Taxpayer D was a farmer. Held the farm which he operated for more than six months and sold it."

It is not stated in your letter, but it is presumed that your questions arise because of a lack of understanding of the effect of the changes made in our statute in 1953.

Section 143.100, 1 (2) is as follows:

> "1. * * * The term 'capital assets', as used in this subsection, means property held by the taxpayer (whether or not connected with his trade or business), but does not include * * *.
>
> "(2) Property used in his trade or business, of a character which is subject to the regular allowance for depreciation, or real property used in his trade or business;"

Prior to 1953, our statute permitted capital gains treatment "* * * in any case * * *" where property was held for more than six months. (See prior provisions of Section 143.100-1, RSMo 1949.) Such is not the case now.

It becomes apparent, immediately, that the question of whether or not something is a capital asset requires two or three determinations in the course of arriving at any answer to the question. The first of which seems to be: Is there a "trade or business" involved? Once that is determined it is not difficult, ordinarily, to tell whether or not real property is "used" in it.

We can find no help from precedents of Missouri cases. Because Section 143.200 of our present code provides that the director of revenue may prescribe rules and regulations for the administration of the income tax laws, and because the section also provides that "* * * Such rules and regulations shall follow as nearly as practicable the rules and regulations prescribed by the United States government on income tax assessments and collections," and because the director has prescribed such rules we find some help from a study of the federal cases.

It must be remembered, however, that the federal code, Section 1231 of Title 26 in the 1954 version, contains provisions for throwing "non-capital asset business property" (other than stock in trade, inventories, or property held for sale to customers) with "non-sale or exchange inventory conversions" (other than stock in trade, inventories, or property held for sale to customers) into a hodge-podge, under which any plus figure becomes a capital gain rather than ordinary income. Under that section a loss from the sale of land, buildings, or machinery used in the business, remains the ordinary loss that the other provisions of the chapter on Capital Gains and Losses prescribe, but the gain that would otherwise be ordinary becomes a capital gain. Missouri has no such provision. It certainly is not possible for this state's director of revenue to follow

the federal regulations in toto just because he must follow them as far as practicable. We need, here in Missouri, to determine only whether or not there was a trade or business, and then determine whether or not the property was used in it. If the property in question was used in it, we cannot treat it as a capital asset.

It is recognized by both federal and state codes (for the State, see Section 143.100-1 which says a capital asset includes property "whether or not connected with a trade or business") and regulations, and by various federal cases, that there can be and is a difference between property "used in a trade or business" and property "held as an investment," or property "held for investment purposes." The 1956 rules and regulations covering the filing of Missouri individual tax returns, on page 13, in speaking of depreciation and depreciable property, states: "This allowance is confined to business or investment property * * *."

Further, under (A), we find the heading "Business Property And Investor's Property. The deduction is allowed on property used in the taxpayer's trade or business and on property held for the production of income, whether or not used in the taxpayer's business. The test relates to the use to which the property is put in the tax year."

The regulations make still other allusions to property which might be used either for business or investment purposes.

Thus, it is evident that the State Department of Revenue recognizes that not all income-bearing property, and not all depreciable property, is necessarily classed as "property used in a trade or business."

In the case of Fackler v. Commissioner, 133 Fed. 2d 509, a 1943 case from the Sixth Circuit Court of Appeals, it was said, l.c. 511:

> "The difficulty centers around the problem that petitioner here was engaged in a profession which admittedly occupied all of his business hours, but there is such a thing as carrying on a business through agents which is in fact a common practice. The question is one of degree or 'where to draw the line'."

In Commissioner v. Boeing, 106 Fed. 2d 305, the taxpayer had contracts with a logging company to cut, ship and sell logs from the taxpayer's timber land. The taxpayer received one-third, the logging company two-thirds of the gross sale price. The logs were sold to various purchasers; the title to the logs remained in the taxpayer (owner) until sold by the logging company. The contractor who was engaged to cut, remove and sell the logs was an independent contractor. It was held that the taxpayer was engaged in a "trade or business." The court said:

> "* * * The facts necessary to create the status of one engaged in a 'trade or business' revolve largely around the frequency or continuity of the transactions claimed to result in a business status."

There was, of course, involved in the Boeing case the question of "property held for sale in the ordinary course of a trade or business." Involved there, too, was the question of an agency relationship, notwithstanding the fact that the contractor was an independent contractor.

The opposite was held, however, in 1955 in the Court of Appeals, Georgia, in the case of Smith v. Dunn, 224 Fed. 2d 353. There, under facts similar in many respects, the taxpayer, a practicing architect, turned the problem of liquidating inherited real estate over to a broker. The broker carried out the sale and liquidation as a part of the broker's own business and independently of the taxpayer. The degree of supervision and control retained by the taxpayer could be one main point in distinguishing the cases.

In the case of Ehrman v. Commissioner of Internal Revenue, 120 Fed. 2d 607, the heirs of an estate sold land to a corporation which proposed to subdivide and sell the land by lots. For financial reasons, the corporation could not continue. The heirs were forced to re-acquire the land which had been subdivided into lots. Some lots had been deeded to purchasers; some were under contracts of sale. The decision was made to carry on the plans and to sell by lots. That was done. It was held, applying the test of frequency and continuity of actions, as that test was laid down in the case of Commissioner v. Boeing, the heirs were engaged in carrying on a trade or business thus the gain was not a capital gain.

In another case, Kemp v. Murray, Court of Appeals, Virginia, 1955, 226 Fed. 2d 941, the taxpayer was not in the real estate business and devoted most of his time to his duties as a

corporation officer. He sold inherited land primarily to provide residential sites for workers in his plant at prices below those obtainable on the market. The profits on the sales were held taxable as capital gains rather than ordinary income.

In the case of Commissioner v. Smith, 203 Fed. 2d 310, Court of Appeals, Second Circuit, Smith claimed as bad debts (business) losses sustained by loans made to a corporation in which he was a twenty per cent stockholder, treasurer and general manager. He had an interest in several other corporations, lent money to them or left dividends or salaries as loans to the corporation. It was held:

> "Whether a particular loss or expense is incurred in a taxpayer's trade or business is a question of fact in each particular case."

It was said further:

> "The full time management of one's investments does not constitute a trade or business."

Here the case was similar to Bennett v. Clark, 287 U. S. 410, 53 S. Ct. 207, 88 L. Ed. 397, where it was held that an officer and stockholder was not engaged in a trade or business merely because he endorsed corporation notes to protect his investment. It was stated (in the form of dictum):

> "If he had been regularly engaged in lending money to business enterprises, bad debt losses resulting therefrom would have been incurred in business."

In Foss v. C.I.R., 75 Fed. 2d 326, the court considered the question of whether lawyers' fees were normal and necessary deductions incurred in carrying on a "trade or business." The court said:

> "A person of property who devotes his time to active management of it, and also to active participation in the management of the companies in which his property is invested and who maintains an office for that purpose, where he spends a substantial part of his time, is carrying on business within the meaning of the statute * * *. The line comes between those who take the position of passive investors doing only what is necessary from an

> investor's point of view, and those who associate themselves actively in the enterprise in which they are financially interested and devote a substantial part of their time to that work as a matter of business."

Later, in Marsch v. C.I.R., 110 Fed. 2d 423, 425, it was stated:

> "In Miller v. Commissioner, 9th Circuit, 102 Fed. 2d 476, 479, it is said:
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> "'The courts have held that where a man takes an active part in the management of an enterprise in which he has investments, his activities amount to the carrying on of a trade or business, but they have drawn a line between such cases and those where the activities are merely looking after investments and doing only what is necessary from an investment point of view. Bedell v. Commissioner, 2d Cir. 1929, 30 Fed. 2d 622; Washburn v. Commissioner, 8th Cir. 1921, 51 Fed. 2d 949; Foss v. Commissioner, 1st Cir. 1935, 75 Fed. 2d 326 * * *'."

The court then further quoted from the Foss case the last part of the quotation from the Foss case above, "The line comes between * * * etc."

In February of 1956, in the Second Circuit, in the case of Folker v. Johnson, 230 Fed. 2d 906, the court said that the term "trade or business" as used in the different sections of the Internal Revenue Code should be given the same meaning as far as possible. At l.c. 907, the court stated:

> "The phrase 'trade or business', has a common and well understood connotation as referring to the activity or activities in which a person engages for the purpose of earning a livelihood."

In this case the court stated that absent any controlling precedents requiring the contrary conclusion that they would feel constrained to give "trade or business" its more usual broadly inclusive meaning.

In May of 1956, in the Eastern District of Pennsylvania, in First National Bank of Lansdale v. Smith, 141 Fed. Supp. 722, at 728, the court said:

> "A reading of the cases which involve the construction of the term 'trade or business' discloses a general proposition of law that it is a question of fact to be determined by the surrounding circumstances of each case as to whether the taxpayer involved is engaged in a trade or business * * *. The general rule is the term 'trade or business,' as used in the I.R.C. in the section involved in this case as well as other sections, bears a restricted meaning which does not include every activity of an individual engaged in for livelihood or profit. * * * Isolated or occasional transactions do not constitute a business, but varied, continuous and regular activities by a taxpayer in a business venture in which he is not only financially interested but to which he devotes a substantial part of his time may make such a venture a business. * * * Kuhn v. Thompson, D.C.E.D. Ark., decided November 13, 1953 (1954 Prentice Hall, par. 72, 358)."

Whether or not the term is given a broad or a restricted meaning, one can certainly see that the answer as to whether or not a trade or business exists depends upon the factual situation in each case.

In Gilford v. C.I.R., 201 Fed. 2d 735, Second Circuit, February 5, 1953, a taxpayer who had an interest in apartments and other rental properties was held to be engaged in "trade or business," through agents, because the court determined that an appreciable amount of time and work was necessarily required on the part of the managing agent, and if such management was a trade or business the taxpayer was so engaged although she acted only through an agent. There the court held that such necessary, regular and continuous activity as maintenance of the rental property in rental condition, the supplying of services for the tenants as were needed to rent them to good advantage, amounted to carrying on a trade or business.

In 1946, the tax court, in 7 T. C. 372, in Hazard v. Commissioner, allowed Leland Hazard, a Kansas City practicing attorney, to deduct the entire loss occasioned by the sale of his Kansas City residence as an ordinary loss on the theory that after he left Kansas City and moved to Pittsburgh and rented his old Kansas City residence, that property was "used in the trade or business of the taxpayer."

Prior to 1942 depreciation was allowable only when property was "used in the trade or business" of the taxpayer. In the case of income-bearing property the commissioner and the courts tended toward allowing depreciation to be taken. Therefore, to do so, they had to hold that income-bearing property is property used in a "trade or business." This case, though decided four years after a change in the federal law, followed that old concept.

Depreciation is now allowed "whether or not" the property is business or investment property. (See the codes and state regulations cited supra.) As can be seen the later federal cases cited herein, do not use so elementary a yard stick as the tax court did in this case. Under what was then 23e of the I.R.C. (now Sec. 165), there was allowed as a deduction, losses sustained during a taxable year and not compensated for by insurance. For individuals this was limited to "losses incurred in a trade or business."

This case might also be explained on a factual basis. Here the factual situation regarding the taxpayer's activities in connection with the rental property, was not reported in detail.

In a 1954 case, N. D. Georgia, Martin v. United States, 119 Fed. Supp. 468, in discussing whether or not property was held primarily for sale, the court went into the question of whether or not a business existed. In its "conclusions of Law" in that case it said, l.c. 473:

> "* * * the word 'business' as used in the statute means 'busyness'--- it implies that one is kept more or less busy, that the activity is an occupation."

It then cited Snell v. C.I.R., Fifth Circuit, 97 Fed. 2d 891, 892.

See also Curtis Co. v. Commissioner of Internal Revenue, 232 Fed. 2d 167, decided in Third Circuit, U. S. Court of Appeals, March 30, 1956, for a comprehensive discussion in both the majority and dissenting opinions on the same point as in the Martin case.

It is an obvious conclusion, from the above cited cases, that there is always a considerable questions as to where the line is drawn between the mere managerial attention to investments and activity so regular and continuous and varied as to amount to engagement in a "trade or business." A study of the cases determined only by the tax court indicates that that court

until quite recently, at least, tended toward the conclusion that any income-producing property is property "used in a trade or business," but the federal appellate courts seem to imply that the property owner must engage, either personally or through agents in the management of his property, and such management must consist of more than the mere attention to his investments before he can be held to be engaging in a "trade or business."

If we apply the test of frequency or continuity and the test of the degree of participation by the taxpayer, as those tests seem to emerge from the majority of the federal court cases, to the situations about which you ask, we must come to the following conclusions in each of the situations you submit.

Situation A. "Taxpayer A was engaged in the practice of law. He purchased a dwelling house which he intended to hold as a rental property investment. He held the property for more than six months and sold it."

It would seem that more facts would be necessary before one could make a determination. It is obvious that one could purchase a dwelling and the lot on which it stands and hold it as investment property only and not take such a part in the management, the care and upkeep of it, with such frequent and continuous and varied activities as to make it amount to a trade or business. But, as seems obvious from the Gilford and Hazard cases cited above, so could he, under a given set of facts, be engaged in a trade or business of renting his investment property, in addition to his profession or in addition to another trade or business.

Situation B. "Taxpayer B was engaged in the insurance business. He purchased a dwelling house which he intended to hold as rental property investment. He held the property for more than six months and sold it."

Situation B is identical to A. See the discussion above.

Situation C. "Taxpayer C was a farmer. He purchased some additional farming land and did not operate it but rented it to others. He held the land for more than six months and sold it."

The situation here is identical to A and B, with the exception of the additional question as to whether the mere fact that property owned by some taxpayer is of the same kind or character as other property used in his trade or business, is enough to require that all such property so held by the taxpayer be included in the category of "real property used in a trade or business."

We see in the cases of Burkhard v. U. S., 22 Fed. Supp. 23, affirmed in 102 Fed. 2d 643, D.C. California 1938, and Smith v. C.I.R., Court of Appeals, Fifth Circuit, 1956, 233 Fed. 2d 142, that answer to this question is No.

In the Burkhard case it was said that a taxpayer may be both a dealer and an investor in real estate at the same time as respects his rights to deduct a loss on an exchange of real property.

In the Smith case it was held that one's usual trade or business does not freeze all of his dealings inevitably within the framework of that calling, and he may hold some property primarily for sale to customers in the ordinary course of his trade or business, while holding similar property for other purposes. It would follow that if one can hold property "for sale in the ordinary course of a trade or business" and hold the same kind of property for investment, he could likewise hold property that he "uses" in his trade or business and some of the same kind for investment only. It would likewise follow that if a dealer and an investor in real estate may do so, so may a farmer.

Situation D. "Taxpayer D was a farmer. He held the farm which he operated for more than six months and sold it."

The answer to the question as to whether the land which a farmer is actually farming is "used in a trade or business" certainly seems obvious and clear and above dispute. Such farm is certainly "used in the trade or business" of a farmer.

CONCLUSION

From the above discussion we come to the conclusion that whether or not real property is "used in a trade or business" so as to be excluded from the Missouri statutory definition of Capital Asset is a factual determination to be made in each case; and that because of the differences between federal and state statutory provisions, the state may not by regulation treat gains and losses from the sale of capital assets the same as they are treated under federal law and regulation.

Honorable Jack C. Jones

The foregoing opinion, which I hereby approve, was prepared by my Assistant, Russell S. Noblet.

Yours very truly,

John M. Dalton
Attorney General

RSN/lc/bi