

AMENDING SECTION 1237 OF THE INTERNAL REVENUE CODE OF 1954

MARCH 22 (legislative day, MARCH 19) 1956.—Ordered to be printed

Mr. LONG, from the Committee on Finance, submitted the following

R E P O R T

[To accompany H. R. 6712]

The Committee on Finance, to whom was referred the bill (H. R. 6712) to amend section 1237 of the Internal Revenue Code of 1954, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are as follows:

Page 1, line 7, strike out "business" and insert "business and only in the case of property described in the last sentence of subsection (b) (3)".

Page 1, strike out subsection (a) of section 2 and insert:

(a) In subparagraph (A) strike out "water or sewer facilities" and insert: "water, sewer, or drainage facilities".

PURPOSE OF BILL

This bill amends section 1237 of the Internal Revenue Code of 1954 relating to real property subdivided for sale. Under this bill the capital-gains treatment generally granted by section 1237 is extended to certain corporations and other taxpayers in the case of land acquired directly (or indirectly in the manner provided) through foreclosure and held for more than 10 years although the taxpayer may have installed water, sewer, or drainage facilities or roads.

GENERAL STATEMENT

Prior to the enactment of the 1954 Code when a taxpayer subdivided real property for sale, he was likely to be considered as holding the property for sale to customers in the ordinary course of a trade or business and subjected to ordinary income treatment. Section 1237 provided relief in a limited area by providing special rules for the taxation of gain from the sale of real property coming within

the scope of the section. The section provides that the taxpayer is not to be considered as holding property primarily for sale to customers in the ordinary course of trade or business "solely" because he subdivided the tract for purposes of sale or because of any activity incident to the subdivision or sale if the property came within the scope of the section. If the taxpayer could be considered a dealer in real property because of his transactions involving other property, the property would still be considered as held for sale to customers in the ordinary course of trade or business. However, a determination that a taxpayer is a dealer in real estate must be predicated upon all the facts and circumstances surrounding the transaction or transactions in question and the fact that a corporate taxpayer's charter permits or prohibits trading in real estate would not of itself be controlling. For purposes of section 1237, property will not be regarded as held for sale to customers solely because of real-estate development and sales activity, relating to the tract, that is within the scope of section 1237. This bill enlarges the scope of section 1237 primarily with regard to property that is acquired through foreclosure.

EXPLANATION OF BILL

This bill allows certain property to come within the scope of section 1237 although the taxpayer has made improvements on the property. Under section 1237 (a) (2) of present law, property is not to qualify if the taxpayer (as defined in sec. 1237 (a)) has made a substantial improvement on the tract of land that substantially enhances the value of the lot or parcel sold. The subparagraphs of subsection (b) (3) of present law provide that no improvement is to be deemed a substantial improvement for purposes of subsection (a) if the lot or parcel is held by the taxpayer for a period of 10 years and the taxpayer satisfies certain conditions. Subparagraph (A) provides that the improvement must constitute the building or installation of water or sewer facilities or roads. Subparagraph (B) provides that it must be shown to the satisfaction of the Secretary or his delegate that the lot or parcel, the value of which was substantially enhanced by such improvement, would not have been marketable at the prevailing local price for similar building sites without such improvement. Subparagraph (C) provides that the taxpayer must elect in accordance with regulations prescribed by the Secretary or his delegate to make no adjustment to the lot or parcel, or of any other property owned by the taxpayer, on account of the expenditures of such improvements.

This bill amends subsection (b) (3) to provide that the taxpayer may install "drainage facilities" as well as those listed in the present paragraph (3) (A). The bill also provides that in determining whether or not an improvement is to be considered a substantial improvement, the requirements of subparagraphs (B) and (C) described above are not to apply in the case of property acquired through the foreclosure of certain liens and property adjacent to such property if 80 percent of the real property owned by the taxpayer is property acquired through foreclosure as described in paragraph (3). The lien must have secured the payment of an indebtedness to the taxpayer or (in the case of a corporation) to a creditor who has transferred the foreclosure bid to the taxpayer in exchange for all of its stock and other consideration.

Under the 1954 Code, section 1237 is limited to real property "in the hands of a taxpayer other than a corporation." This bill extends the scope of the section to include corporations in the case of land acquired through foreclosure and adjacent property (as described in the last sentence of subsection (b) (3)).

Your committee has made two amendments in the bill as passed by the House of Representatives. Under the House bill, the benefits of section 1237 would have been extended to corporations on the same basis as individuals in all cases if no shareholder of the corporation was a real-estate dealer. It was pointed out that this provision would be difficult to administer, and your committee has amended the bill to permit corporations to qualify only if the corporation is holding property originally acquired through foreclosure of a lien thereon. This would include a corporation to which was transferred the foreclosure bid in exchange for all of its stock and other consideration or a corporation was itself the creditor.

The second amendment made by your committee removes a reference in the bill to "other public utilities" and substitutes "drainage facilities." This will narrow the scope of the House bill by limiting the types of improvements that the taxpayer may make and remain within the scope of section 1237.

This bill is applicable to all taxable years beginning after December 31, 1954.

CHANGES IN EXISTING LAW

In compliance with subsection (4) of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets; new matter is printed in italics; existing law in which no change is proposed is shown in roman):

SECTION 1237 OF THE INTERNAL REVENUE CODE OF 1954

SEC. 1237. REAL PROPERTY SUBDIVIDED FOR SALE.

(a) GENERAL.—Any lot or parcel which is part of a tract of real property in the hands of a taxpayer [other than a corporation] (*including corporations only if no shareholder directly or indirectly holds real property for sale to customers in the ordinary course of trade or business and only in the case of property described in the last sentence of subsection (b) (3)*) shall not be deemed to be held primarily for sale to customers in the ordinary course of trade or business at the time of sale solely because of the taxpayer having subdivided such tract for purposes of sale or because of any activity incident to such subdivision or sale, if—

(1) such tract, or any lot or parcel thereof, had not previously been held by such taxpayer primarily for sale to customers in the ordinary course of trade or business (unless such tract at such previous time would have been covered by this section) or, in the same taxable year in which the sale occurs, such taxpayer does not so hold any other real property; and

(2) no substantial improvement that substantially enhances the value of the lot or parcel sold is made by the taxpayer on such tract while held by the taxpayer

or is made pursuant to a contract of sale entered into between the taxpayer and the buyer. For purposes of this paragraph, an improvement shall be deemed to be made by the taxpayer if such improvement was made by—

(A) the taxpayer or members of his family (as defined in section 267 (c) (4)), by a corporation controlled by the taxpayer, or by a partnership which included the taxpayer as a partner; or

(B) a lessee, but only if the improvement constitutes income to the taxpayer; or

(C) Federal, State, or local government, or political subdivision thereof, but only if the improvement constitutes an addition to basis for the taxpayer; and

(3) such lot or parcel, except in the case of real property acquired by inheritance or devise, is held by the taxpayer for a period of 5 years.

(b) SPECIAL RULES FOR APPLICATION OF SECTION.—

(1) GAINS.—If more than 5 lots or parcels contained in the same tract of real property are sold or exchanged, gain from any sale or exchange (which occurs in or after the taxable year in which the sixth lot or parcel is sold or exchanged) of any lot or parcel which comes within the provisions of paragraphs (1), (2), and (3) of subsection (a) of this section shall be deemed to be gain from the sale of property held primarily for sale to customers in the ordinary course of the trade or business to the extent of 5 percent of the selling price.

(2) EXPENDITURES OF SALE.—For the purpose of computing gain under paragraph (1) of this subsection, expenditures incurred in connection with the sale or exchange of any lot or parcel shall neither be allowed as a deduction in computing taxable income, nor treated as reducing the amount realized on such sale or exchange; but so much of such expenditures as does not exceed the portion of gain deemed under paragraph (1) of this subsection to be gain from the sale of property held primarily for sale to customers in the ordinary course of trade or business shall be so allowed as a deduction, and the remainder, if any, shall be treated as reducing the amount realized on such sale or exchange.

(3) NECESSARY IMPROVEMENTS.—No improvement shall be deemed a substantial improvement for purposes of subsection (a) if the lot or parcel is held by the taxpayer for a period of 10 years and if—

(A) such improvement is the building or installation of [water or sewer facilities] *water, sewer, or drainage facilities* or roads (if such improvement would except for this paragraph constitute a substantial improvement);

(B) it is shown to the satisfaction of the Secretary or his delegate that the lot or parcel, the value of which was substantially enhanced by such improve-

ment, would not have been marketable at the prevailing local price for similar building sites without such improvement; and

(C) the taxpayer elects, in accordance with regulations prescribed by the Secretary or his delegate, to make no adjustment to basis of the lot or parcel, or of any other property owned by the taxpayer, on account of the expenditures for such improvements. Such election shall not make any item deductible which would not otherwise be deductible.

The requirements of subparagraphs (B) and (C) shall not apply in the case of property acquired through the foreclosure of a lien thereon which secured the payment of an indebtedness to the taxpayer or (in the case of a corporation) to a creditor who has transferred the foreclosure bid to the taxpayer in exchange for all of its stock and other consideration and in the case of property adjacent to such property if 80 percent of the real property owned by the taxpayer is property described in the first part of this sentence.

(c) TRACT DEFINED.—For purposes of this section, the term “tract of real property” means a single piece of real property, except that 2 or more pieces of real property shall be considered a tract if at any time they were contiguous in the hands of the taxpayer or if they would be contiguous except for the interposition of a road, street, railroad, stream, or similar property. If, following the sale or exchange of any lot or parcel from a tract of real property, no further sales or exchanges of any other lots or parcels from the remainder of such tract are made for a period of 5 years, such remainder shall be deemed a tract.

(d) EFFECTIVE DATE.—This section shall apply only with respect to sales of property occurring after December 31, 1953, except that, for purposes of subsection (c) (defining tract of real property) and for determining the number of sales under paragraph (1) of subsection (b), all sales of lots and parcels from any tract of real property during the period of 5 years before December 31, 1953, shall be taken into account, except as provided in subsection (c).

