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Mieg v. Commissioner

32 T.C. 1314 (T.C. 1959).

Eugene T. Garrett, Esq., for the petitioners.

Donald P. Chehock, Esq., for the respondent.

The Commissioner determined the following deficiencies in income tax for the year 1954:
Additions to tax. I.R.C. 1939 Charles E. and Lillian W. Mieg, Docket Deficiency Sec. 294(d)(2)
Sec.294(d)(1)(A) 65904 \$5,693.57 James P. and Laurretta G. Fallis, Docket 65905 4,730.34
\$356.44 \$734.52 William J. and Floy Ladyman, Jr., Docket 65906 369.30 Harrison M. and
Alphonsine C. Howard, Docket 65907 149.19 43,58 67.19

The sole issue is whether certain parcels of real estate sold by a joint venture, in which petitioners were participants, were held "for sale to customers in the ordinary course of business," thereby subjecting the gains realized upon such sales to tax as ordinary income rather than as capital gains.

FINDINGS OF FACT.

A stipulation of facts filed by the parties is incorporated herein by reference.

The petitioners in each case, husband and wife, filed a joint return for the calendar year 1954 with the district director of internal revenue, Phoenix, Arizona.

The sales in issue were made by a joint venture known as Trust Venture 1186 (more fully described hereinafter), which filed its Federal income tax returns and kept its books on the basis of a fiscal year ending May 31.

Charles E. Mieg formerly lived in New York. From 1924 to 1929, while living in New York, he was a real estate salesman, mostly for subdividers. In 1932 he moved to Arizona and from then until 1945 he worked at a number of different jobs. In 1945 he moved to Phoenix and worked for 2 years as a salesman for real estate brokers in that city. In 1947 he obtained a real estate broker's license and started his own business at Scottsdale, a suburb of Phoenix. In 1950 he formed a real estate brokerage partnership with James P. Fallis, known as Mieg & Fallis. Both men are now about 60 years of age. The partnership is an entity separate from Trust Venture 1186. By 1953 the partnership was well known and buyers came to it without the necessity of advertising.

Prior to and during the transactions here under review, the partnership was in the business of selling properties of others for commissions; it did not buy or sell properties for its own account. Prior to the formation of Trust Venture 1186 neither Mieg nor Fallis ever bought or sold land for his own account other than as an occasional investment.

Mummy Mountain is a mountain located in an area generally known as Paradise Valley; it is about 3½ miles from Scottsdale and about 10 miles from downtown Phoenix. Mummy Mountain is shaped roughly like a horseshoe; it is approximately 2,300 feet above sea level at its highest elevation, the surrounding area being about 1,000 to 1,150 feet above sea level. The parties have used the term "front side" of the mountain to refer to that portion of the property bounded by the ridge and included within the so-called horseshoe. Most of the rise of some 1,000 feet is concentrated in a distance of about one-quarter of a mile from the base; but on the front side of the mountain there is in addition about one-half mile of gently sloping land. The back side of the mountain consists of steep mountain land. The mountain is almost solid rock, and there is relatively little dirt or loose pellets at the base.

The Mummy Mountain property, consisting of some 747 acres, was owned by members of the Van Benschoten family which had a home on the front side of the mountain. Apart from that home (and possibly some related structures), there were no other buildings of consequence on the property.

In early December 1952 Mieg approached the Van Benschoten interests and attempted to purchase approximately 80 acres on the front side of the mountain for subdivision purposes. The owners refused to sell 80 acres, but subsequently agreed to sell the entire property as a unit, excepting about 20 acres surrounding the residence. The sale was made on March 31, 1953, through the medium of a trust, in which the sellers (the Van Benschotens) were designated "First Beneficiaries," and the buyers (Mieg and Fallis and their respective wives) were designated as "Second Beneficiaries." The trust has been identified and referred to as Trust Venture 1186, and the purchasers thereby acquired a beneficial interest in approximately 727 acres. In 1953, Fallis sold portions of his interest in Trust Venture 1186 to Harrison Howard, a retired businessman, and to William J. Ladyman, Jr., an employee of the Phoenix Title and Trust Company, the trustee for Trust Venture 1186. Thereafter, the proportionate share of each petitioner and his wife was as follows: Mieg, 50 per cent; Fallis, 43 per cent; Ladyman, 5 per cent; Howard, 2 per cent.

Prior to entering into the purchase agreement, petitioners Mieg and Fallis made a careful study of the entire acreage, and determined that on the front side of Mummy Mountain 280 acres were suitable for immediate subdivision and another 200 acres were possibly suitable for subdivision. The rest of the property, including all of the property on the back side of Mummy Mountain, was determined not to be suitable for subdivision.

The trust agreement provided for a basic purchase price of \$96,000, of which \$10,000 was to be paid at the time of execution of the trust agreement (March 31, 1953), and the remaining \$86,000 in specified amounts at various times prior to May 1, 1957. In addition, the First Beneficiaries (the Van Benschotens), were to receive 20 per cent of the net profits to be realized by the Second Beneficiaries (the purchasers) from their subsequent sale of the properties over and above the first \$86,000 of net profits. The Second Beneficiaries were under no obligation to subdivide the property, and they had the right to cause any part of it to be sold without subdivision for minimum sales prices set forth. Various portions of the Mummy Mountain property were separately identified in the trust agreement, and any of them could be sold to third parties for specified "Minimum Sales Prices," from which the First Beneficiaries would receive the "Release Price," and, upon payment of the "Minimum Sales Price" record title to the property could be transferred to third party purchasers free and clear of any liens to the First Beneficiaries. The "Minimum Sales Price" for the land that was readily suitable for subdivision on the front

side of the mountain was \$1,100 per acre, and the "Release Price" for such land was \$700 per acre. For other specified parcels (on both the front and back sides), the "Minimum Sales Price" was \$50 per acre, and the "Release Price," \$20 per acre. The amounts paid over to the Van Benschotens as "Release Prices" were to be applied against that portion of the purchase price owed by petitioners which was then unpaid.

Mieg and Fallis together had insufficient funds to purchase the Mummy Mountain property from the Van Benschotens for cash. Mieg raised \$10,000 for the downpayment by using \$2,000 of his wife's money and by borrowing \$8,000 from his mother-in-law. Fallis, in all, advanced \$8,986.18 for development costs and was reimbursed this same amount by the trust on April 23, 1954.

At the time Mieg and Fallis entered into the trust venture, they knew substantial capital would be needed to raise the basic sale price of \$96,000 in the 4 years allowed for the payments, to pay for newly constructed roads, extension of water mains, to provide other utilities and other development costs needed in the planned subdivision project. It was contemplated capital would come from the sale of lots, but initially it was known also immediate capital would be needed. Mieg and Fallis, upon inquiry soon after the project started, learned that they could borrow \$15,000 from the Phoenix Title and Trust Company, which they did. During the first year's operation of the trust, aside from the \$10,000 downpayment, approximately \$94,278.75 was expended by the trust in making payments to the Van Benschotens under the trust and for development costs. This amount, in turn, was raised by the \$15,000 borrowed from the Phoenix Title and Trust Company, by approximately \$14,000 from the sale of "subdivided" lots, and \$65,000 from sale of land on the back side of the mountain here in controversy. However, of the \$94,278.75 expended during the first year's operations, more than half could have been deferred and made in subsequent years. Exclusive of the land costs, approximately \$178,000 was spent by the trust on development costs on the subdivided properties up to May 31, 1958.

Shortly after the Mummy Mountain property was acquired, petitioners hired Western Engineering Company to make a survey and help prepare a subdivision plan. The survey showed that Camelback Inn, a third party, had made minor improvements on a small portion of the total land purchased, on the back side of the mountain, contiguous to its own property, thinking that it owned the small area in question. The matter was settled amicably by sale of 40 acres to Camelback Inn on June 5, 1953, for \$5,000. Forty acres were sold, instead of only the portion covered by the Camelback Inn improvements, for otherwise a parcel of land would have been left up the mountain side without any practical means of access. The sale of these 40 acres was occasioned solely by the title mixup.

Acting in accordance with subdivision plats prepared by licensed civil engineers, petitioners proceeded to subdivide the lands suitable for subdivision on the front side of Mummy Mountain. The subdivision, which was named "Mummy Mountain Park," was developed in three units; plats for Units I, II, and III were approved by the Planning and Zoning Commission on June 3, 1953, December 12, 1956, and December 19, 1956, respectively.

The subdivision properties on the front side of Mummy Mountain known as Mummy Mountain Park were improved with paved roads, water mains, telephone lines, electricity, and natural gas. An aggressive selling program for the sale of the subdivision properties was entered into, which included newspaper advertisements, the employment of two salesmen, and listings with many brokers.

From the beginning of the venture until May 31, 1958, total sales of the subdivided lots were \$595,970; and at that time there remained a number of unsold lots in Units II and III. No question is presented with respect to sales of the subdivided lands; the gains upon such sales have been reported as ordinary income.

As previously noted, substantially all of the properties acquired by the venture on the back side of Mummy Mountain are mountain side lands. The sides are steep and the canyons rugged. Although there was a road and legal right of access for entry to the properties on the front side of Mummy Mountain when they were purchased, there was no road leading to the back side, and the only legal right of entry by petitioners to any of the properties on the back side was over the mountain.

The land on the back side of the mountain has been treated as consisting of 6 parcels, identified respectively as Parcel 1 through Parcel 6. Parcel 1 consists of the 40 acres sold to Camelback Inn, set forth above. Parcels 1, 2, 4, 5, and 6 were not contiguous to Parcel 3, and the only legal access between Parcel 3 and Parcels 1, 2, 4, 5, and 6 would be a road which would have to follow a course to the top of the mountain and down again. It was not possible to build a road to the top of the mountain that would be approved by the county engineer. Even if access to the lands on the back side of the mountain had been available, the topography was such that only a portion of those lands might have been subdivided. Moreover, the cost of building roads, making utilities available, and other necessary development costs would have required a total outlay in respect of such lands that could not have been recovered by the sale of building sites. Subdivision of lands on the back side of the mountain would not have been economically feasible.

No improvements were placed by Trust Venture 1186 on any of the properties on the back side of Mummy Mountain. Nor were the properties on the back side of Mummy Mountain ever advertised for sale, listed with any broker, nor any other sales efforts ever made.

As of the date of the hearing, approximately 6 years after the acquisition of Mummy Mountain by the venture, none of the properties on the back side has been subdivided, and the only improvements which have been placed on the back side by the present owners consists of a water tank on Parcel 1 and two houses which have recently been built on Parcel 5.

At the time the venture acquired the Mummy Mountain property, the land on the back side was considered to have only a relatively small value. The purchasers contemplated holding such land for a period of time with the expectation that eventually there would be an appreciation in value, at which time the land might be profitably disposed of.

Commencing in 1952 and extending into 1953, an effort was made by outside parties to organize a country club in Paradise Valley. Prior to and up to the time of the actual acquisition of land by the Paradise Valley Country Club, a number of sites were under consideration. One of those sites was where the club was eventually located, and was in the immediate vicinity of the back side of Mummy Mountain. Other sites ranged from a distance of a mile and one-half to 5 miles from Mummy Mountain. The Paradise Valley Country Club was incorporated March 17, 1953, acquired its first interest in real estate on March 30, 1953, and commenced operations with the opening of a golf course on February 8, 1954. Construction of a clubhouse was started in February 1955.

The lands acquired by the joint venture on the back side of Mummy Mountain enjoyed rapid appreciation over a short period of time. The formation and building of a country club was primarily responsible for such rapid appreciation.

All 6 parcels on the back side of the mountain were sold as follows:

Acreage	Price	Total Parcel	Date sold	Purchasers	per acre	selling price
1	June 5, 1953					
Camelback Inn	40	\$125.00	\$5,000	2 Dec. 7 1953	E. Jacobson	20 500.00 10.000
3	Apr. 19, 1954					
E.J. Casman	87	574.71	50,000	4 May 19, 1954	E. Jacobson and Melczer	20 600.00 12,000
5	June 14, 1954					
W. Linton	40	500.00	20,000	6. Dec. 14, 1954	Anchor Realty	40 700.00 28,000

Only the first four of the foregoing sales are involved herein, having been made during the venture's fiscal year ending May 31, 1954. The gain on the parcel sold to Camelback Inn was reported as short-term capital gain and the gains on the other 3 parcels were reported as long-term capital gains. The Commissioner determined that the gains on all 4 parcels constituted ordinary income.

The venture was in continual need of additional capital during its first year of operation, and the pressure generated by such need was substantially relieved by the proceeds from the sales of Parcels 1, 2, and 3.

Mieg & Fallis, by agreement, received a 5 per cent commission as real estate brokers for all parcels or lots sold by them of the Mummy Mountain property. During the first year's operation of the trust they received \$3,850 in commissions from sales on the back side of the mountain, and they earned \$1,550 in commissions from sales of subdivided lots on the front side, of which \$1,410 was paid by May 31, 1954.

The sale of each of the parcels on the back side of the mountain was made as a result of an unsolicited offer by the purchaser, and each such offer was the first bona fide cash offer made on the respective parcel.

None of the parcels on the back side of Mummy Mountain was held by Trust Venture 1186 at the time of sale as property primarily for sale to customers in the ordinary course of business.

OPINION.

RAUM, Judge:

There is no doubt that the Mummy Mountain property was purchased in order that land on the front side of the mountain might be subdivided and sold as lots. Nor is there any question that such land on the front side was held for sale to customers in the ordinary course of business. The gains realized upon sale of such lots were reported as ordinary income, and are not in controversy herein. The lands here involved are on the back side of the mountain which could not be economically subdivided for resale. When Mieg sought to buy only a portion of the front of the mountain from the Van Benschotens for subdivision purposes, he was unsuccessful. The owners insisted upon selling the entire mountain property (except 20 acres around their house), and the joint venture thus acquired land readily suitable for subdivision on the front side as well as mountain land on the back side.

The issue before us relates exclusively to 4 of the 6 parcels constituting that portion of the Mummy Mountain property located on the back of the mountain.

It is plain that a taxpayer may be both a dealer and an investor in real estate. Cf. *W. Linton Atkinson*, 31 T.C. 1241, 1247; *D. L. Phillips*, 24 T.C. 435, 445; *Walter R. Crabtree*, 20 T.C. 841, 846; *Nelson A. Farry*, 13 T.C. 8, 14; *Rev. Rul. 57-565*, 57-2 C. B. 546. And it is our judgment on the record before us that the petitioners had such a dual status. As we view the evidence, the property on the back of the mountain was not held for sale to customers in the ordinary course of business. The situation in relation to such land is to be sharply contrasted with the extensive subdivision activities on the front side involving the building of roads, installation of utilities and other improvements, accompanied by widespread advertising and a vigorous selling campaign. No improvements were made on the lands here involved and they were never advertised or offered for sale; each of the parcels was in fact sold to the maker of the first bona fide offer for such parcel. The evidence persuades us that the rapid increase in value of such parcels was attributable to the location of a country club nearby, and that the original intention accompanying the venture's acquisition of such mountain land was to hold it for an extended period as an investment with the hope that an ultimate enhancement in value would provide the opportunity for profitable disposition. Although there is other evidence in the record, stressed by respondent, which could lead to the conclusion that petitioners anticipated the very rapid increase in value that actually occurred, we think, on the whole, that the balance tips in favor of the petitioners in this respect. Respondent points, among other things, to the continual need for capital that was pressing upon the joint venture during its first year of operation, and contends that petitioners intended from the outset to sell the contested parcels promptly to relieve such pressure. True, such pressure existed, and the sales of the parcels in fact furnished much needed cash. However, we think that a substantial portion of the needed cash could have been obtained from other sources, and we are not persuaded that the prompt sale of the parcels was in fact contemplated at the outset as the means for providing capital for the enterprise.

The issue is primarily one of fact, and we are satisfied on weighing all the evidence that the parcels on the back of the mountain were not held primarily for sale to customers in the ordinary course of business. We have made a finding to that effect.

In the *Fallis* and *Howard* cases, the Commissioner made certain adjustments that were not contested. Accordingly,

Decisions will be entered for the petitioners in Docket Nos. 65904 and 65906, and decisions will be entered under Rule 50 in Docket Nos. 65905 and 65907.