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Tax Problems Incident To the Disposition of Real Estate

II

PROBLEMS OF TAXABLE DISPOSITIONS

Richard Katcher

In general, whether the gain or loss resulting from the taxable disposition of real estate will be capital or ordinary depends upon the nature of the seller's holding of the property and the length of time it has been held by him. If the seller is not a dealer in real estate, the gain or loss will probably be capital. The amount of the gain or loss is computed in the same manner as that from the sale or exchange of any other property. For example, the gain is the excess of the amount realized over the adjusted basis of the property, and the amount realized is the money received plus the fair market value of any other property received.

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Usually, the taxing of the gain or loss occurs in the year in which title and possession pass. However, it is common for real estate to be sold under an arrangement whereby part of the purchase price is paid immediately in cash and the balance is deferred. While it is true that twenty-five per cent, rather than a progressive figure, may be the maximum tax rate on that gain, there are tax reasons for deferring the balance over a number of years:

a. An opportunity is provided to offset the gain against a loss that might be incurred in a year subsequent to the sale.
b. The seller may be in a lower tax bracket than twenty-five per cent in later years.
c. The deferral may facilitate the making of the sale and permit the obtaining of a larger selling price.

METHODS OF DEFERRING GAIN

The Installment Method

Basically, there are two methods of deferring the gain on the sale — the installment method and the deferred payment method. Under the installment method, the only profit reported in any year is that proportion of the payments actually received in that year which the gross profit on the transaction bears to the total contract price.[1] In other words, the seller is permitted to pay the tax on his

1. INT. REV. CODE OF 1954, § 453(b)(1).

gain in the years in which he actually receives it, rather than paying all the tax in the year of sale. The character of the gain as ordinary income or capital gain does not, of course, change. The installment method is available in any sale of real estate, whether by a dealer or an investor.[2]

In the case of sales of real estate, "gross profit" means the selling price less the adjusted basis of the property. Gross profit, in the case of a sale of real estate by a person other than a dealer, is reduced by commissions and other selling expenses;[3] thus, these expenses are recouped only over the period of the installment payments. A dealer, however, may deduct these expenses at one time, in either the year paid or accrued.[4]

The installment method may be used only if in the taxable year of the sale there are either no payments or the payments do not exceed thirty per cent of the selling price.[5] Evidences of indebtedness of the purchaser are not considered to be payments, and, therefore, the receipt of a less than thirty per cent cash down payment and of the purchaser's note and mortgage for the balance will not negate the use of the installment method. If the purchaser assumes a mortgage or takes subject to a mortgage on the property, the full amount of the mortgage is considered a part of the "selling price" in determining whether the payments in the year of sale exceed thirty per cent of the "selling price."[6] However, for the purpose of determining the amount of the payments in the year of sale and the total contract price, the amount of such a mortgage is included only to the extent, if any, that it exceeds the basis of the property.[7]

Although, as noted above, commissions and other selling expenses paid by the seller reduce the gross profit, they do not reduce the amount of the payments in the year of sale, the total contract price, or the selling price.[8]

There is no requirement, in order to qualify for the installment method, that there be an immediate transfer of title to the property sold.[9] However, there must be an affirmative election to use the method, and this election must be made on the income tax return filed for the year of the sale.[10]

It is obvious that an accrual basis taxpayer will obtain the great-

2. INT. REV. CODE OF 1954, § 453(b)(1)(A).

3. E. A. Giffin, 19 B.T.A. 1243 (1930); Treas. Reg. § 1.453-1(b) (1958).

4. I.T. 2305, V-2 CUM. BULL. 108 (1924).

5. INT. REV. CODE OF 1954, § 453(b)(2)(A).

6. Fifty-Three West Seventy-Second Street, Inc., 23 B.T.A. 164 (1931); Treas. Reg. § 1.453-4(c) (1958).

7. Burner v. S. & L. Bldg. Corp., 288 U.S. 406 (1933); Treas. Reg. § 1.453-4(c) (1958); *cf.* Stonecrest Corp., 24 T.C. 659 (1955).

8. Treas. Reg. § 1.453-4(c) (1958).

9. Therefore, a sale of the property on a "land contract" may qualify.

10. W. A. Ireland, 32 T.C. No. 89 (July 31, 1959); Treas. Reg. § 1.453-8(b)(1) (1958).

est benefit from fitting the sale into the installment method, since it permits him to spread the tax over the period of payments. Without the benefit of the installment method, the entire tax would be due in the year of sale. This could create a hardship where only a portion of the sale proceeds is received in the year in which the sale is made. For example, in the case of a sale of greatly appreciated property, the tax might exceed the down payment.

The Deferred Payment Method

The other manner, of more limited application, in deferring the gain on a sale is through the use of the deferred payment method. This method is available where part of the price is payable in the future, but the payments received in the year of sale exceed thirty per cent of the selling price. In that event, the entire gain or loss is normally reportable in the year of sale. Any obligations of the purchaser are taken into account at their fair market value in determining the amount realized on the sale. However, if these obligations, which may be evidenced by a promissory note or merely by a bare contractual promise, have no ascertainable market value (which is a rare situation), then the transaction is not closed and the taxable gain on the sale is deferred until the seller recovers his entire basis in the property, after which the amounts received are fully taxable. The courts have held rather consistently that a land contract, for example, has no fair market value.[11] Nevertheless, the Internal Revenue Service continues to litigate the issue of whether a bare contractual obligation received by a taxpayer, *i.e.*, an obligation not evidenced by a note or other form of indebtedness, has any fair market value.[12] The ascription to a note of a value less than its face value means that the transaction is closed and the subsequent receipt of amounts in excess of that value results in the excess amounts being taxable as ordinary income, since there is no sale or exchange but only the collection of an account.[13] These rules with respect to deferred payment reporting do not apply to an accrual basis taxpayer, who must report his entire gain in the year of sale.[14]

Methods of Disposition

Disposition of Mortgaged Property

Abandonment

The time may come when the owners of mortgaged property are unwilling or unable to meet the mortgage payments. If that be the

11. *E.g.*, Nina J. Ennis, 17 T.C. 465 (1951); Harold W. Johnston, 14 T.C. 560 (1950).
12. Rev. Rul. 402, 1958-2 Cum. Bull. 15. See Frank Cowden, 32 T.C. No. 73 (June 30, 1959).
13. A. B. Culbertson, 14 T. C. 1421 (1950).
14. George L. Castner Co., 30 T.C. 1061 (1958).

case, the property may be lost by abandonment, foreclosure, or voluntary conveyance. Although legal title to real estate cannot be abandoned under state law, for tax purposes it is possible to abandon property even though title remains in the mortgagor. Actual physical abandonment must be proved, *i.e.*, a clearly identifiable event showing permanent abandonment. The worthlessness of the mortgagor's interest must also be proved, as by showing that the amount of the outstanding indebtedness against the property exceeds its value.[15] If these conditions exist, the loss is deductible in its entirety as an ordinary loss.[16] The loss is not capital because there is no sale or exchange on abandonment. The loss is deductible in the year of abandonment even if foreclosure occurs in a subsequent year,[17] but a mortgagor personally liable on the debt takes his loss in the year of foreclosure.[18]

Mortgage Foreclosures

If a mortgagee should foreclose upon his mortgage, any resulting loss to the mortgagor is considered a loss resulting from a sale even though it is an involuntary disposition.[19] The loss is capital whether or not the mortgagor is personally liable on the mortgage. The amount of the loss is the difference between the adjusted basis of the property and the amount realized from the foreclosure. Any amount paid by the mortgagor on a deficiency judgment in the foreclosure increases his basis and therefore his loss.[20] Included in the amount realized from the foreclosure is the unpaid balance of the mortgage, even when there is no personal liability.[21] Therefore, it is possible for a mortgagor to have a gain on foreclosure where the adjusted basis of the property is less (because of depreciation deductions) than the amount of the mortgage debt. Normally, the loss or gain on foreclosure occurs in the year the foreclosure becomes final.

Voluntary Conveyance to Mortgagee

A third possibility whereby a mortgagor can avoid his mortgage indebtedness is to convey the property voluntarily to the mortgagee in lieu of foreclosure. If the mortgagor receives any consideration for the deed (for example, if the mortgagee assumes real estate taxes for which the mortgagor is personally liable or the mortgagor's personal liability on the mortgage debt is discharged), the transaction

15. Denman v. Brumback, 58 F.2d 128 (6th Cir. 1932); Stanley Burke, 32 T.C. No. 66 (June 29, 1959); *cf.* Commissioner v. McCarthy, 129 F.2d 84 (7th Cir. 1942).
16. William H. Jamison, 8 T.C. 173 (1947).
17. W. W. Hoffman, 40 B.T.A. 459 (1939).
18. Commissioner v. Green, 126 F.2d 70 (3d Cir. 1942).
19. Helvering v. Hammel, 311 U.S. 504 (1941).
20. Harry H. Diamond, 43 B.T.A. 809 (1941).
21. Crane v. Commissioner, 331 U.S. 1 (1947).

qualifies as a sale, creating capital gain or loss.[22] However, if no consideration passes to the mortgagor, there is no sale and any resulting loss is an ordinary loss.[23]

From these rules it is clear that the best tax position for a mortgagor who is giving up his real estate which is a capital asset in his hands is either to abandon it or to give a deed to the mortgagee in lieu of foreclosure (making certain that he receives no consideration for the conveyance). In this manner, the mortgagor will obtain an ordinary loss deduction. However, even if he receives consideration, if the property is used in the mortgagor's trade or business, the loss will be ordinary.[24]

Disposition by Option

The use of an option in the disposition of real estate often gives rise to special tax consequences. Sometimes, a seller who has not held the real estate for more than six months, but who wishes his gain on the sale to be long-term, may grant the purchaser an option to purchase after the expiration of the six months. If the seller obtains a large price for the option which is forfeitable if the option is not exercised, he can be economically certain that the transaction will be completed. Furthermore, he will have attained his objective — that the sale result in long-term gain.

The payment which the grantor of an option receives therefor is not taxable to him at the time he receives it.[25] If the option is exercised, then the seller adds the amount received therefor to the additional price to be paid for the property in determining his gain or loss.[26] If the holder of the option fails to exercise it, then the seller is treated as having received ordinary income on the day of the expiration of the option.[27]

This treatment accorded the grantor of the option is not necessarily consistent with that accorded the holder of the option. If the holder sells or exchanges the option, or if he suffers a loss attributable to his failure to exercise it, his gain or loss is considered as capital or ordinary depending upon whether the real estate, if he had

22. Blum v. Commissioner, 133 F.2d 447 (2d Cir. 1943); Harry C. Aberle, 41 B.T.A. 863 (1940).

23. Stokes v. Commissioner, 124 F.2d 335 (3d Cir. 1941); Commonwealth, Inc., 36 B.T.A 850 (1937).

24. INT. REV. CODE OF 1954, § 1231.

25. Mary P. Hunter, 12 P-H Tax Ct. Mem. 698 (1943).

26. *Quaere:* if a seller receives $2,000 in 1959 for an option to purchase the property in 1960 for $8,000, and if the option is exercised in 1960 and an additional payment of $2,000 is then made with the balance payable in subsequent years, does the sale qualify for the installment method?

27. Virginia Iron, Coal & Coke Co. v. Commissioner, 99 F.2d 919 (4th Cir. 1938); Dill Co., 33 T.C. No. 21 (Oct. 30, 1959); Treas. Reg. § 1.1234-1(b) (1959).

acquired it, would have been a capital asset in his hands.[28] If the holder of an option suffers a loss attributable to his failure to exercise it, the loss is deemed to have been incurred on the day the option expired.[29] Any such gain or loss is subject to the provisions of section 1231 if the sale or exchange of the property subject to the option, if acquired by the holder of the option, would have been within section 1231.[30] These rules apply also to an option to buy or sell a lease, but not to an option to lease property.[31]

If the grantor of the option changes his mind and pays the holder of the option to release or surrender the option at a gain to the holder, the tax treatment of this gain is not specifically covered by statute. However, such gain would probably be treated the same as the gain from the sale of the option to a third person.[32]

Effect of Disposition to Related Persons

In disposing of real estate it is also important to consider any relationship between the seller and purchaser. If an individual, even though he is not a dealer, disposes of depreciable property to his spouse or to a corporation of which more than eighty per cent in value of the outstanding stock is owned by him, his wife, his minor children, or minor grandchildren, any gain to him on the transaction is taxed as ordinary income.[33] However, to the extent that the gain can be attributed to the sale of land — a nondepreciable asset — the gain may be capital.[34] The purpose of this provision is to prevent a step up in basis (resulting in an increased deduction for depreciation against ordinary income) at the cost of a capital gains tax when there has been no real loss of control over the property.

It is interesting to note that the rule is more stringent in the case of a disposition between a partnership and its partners. Where the sale is between a partnership and a partner owning more than an eighty per cent interest in the capital or profits of the partnership, or between two partnerships in which the same persons own more than an eighty per cent interest in the capital or profits of each, any gain will be taxed as ordinary income if the property is not a capital asset in the hands of the purchaser.[35] Accordingly, the gain on the sale, not only of depreciable property, but also of *land* used in a trade or business, would be converted into ordinary income in the partner-

28. Int. Rev. Code of 1954, § 1234(a).

29. Int. Rev. Code of 1954, § 1234(b).

30. Treas. Reg. § 1.1234-1(a)(2) (1959).

31. Treas. Reg. § 1.1234-1(f) (1959).

32. *Cf.* H. R. Rep. No. 1337, 83d Cong., 2d Sess. 83 (1954); see Milliken v. Commissioner, 196 F.2d 135 (2d Cir. 1952) (dealing with 1939 code provision). But *cf.* Hale v. Helvering, 85 F.2d 819 (D.C. Cir. 1936).

33. Int. Rev. Code of 1954, § 1239.

34. Int. Rev. Code of 1954, § 1239(b); W. H. Weaver, 32 T.C. No. 40 (May 29, 1959).

35. Int. Rev. Code of 1954, § 707(b)(2).

partnership situation. Furthermore, the rules for determining the persons who own more than an eighty per cent interest in the partnership are more strict than the comparable rules in other areas.[36]

If a sale is at a loss, the loss will be disallowed if the sale is to a controlled corporation, between a controlled partnership and a partner or another controlled partnership, or between related persons or organizations.[37] "Related persons" is considerably broader in the case of sales at a loss than in the case of sales at a gain,[38] the purpose being to prevent obtaining the benefit of a loss deduction where effective control over the property has not been surrendered.

SIGNIFICANCE OF THE HOLDING PERIOD

Effective Date of Acquisition

Equally important as the problem of determining whether the gain or loss on a taxable disposition is capital or ordinary is the problem of determining whether the gain is long-term or short-term. If property is held for more than six months, the gain or loss on its disposition is long-term;[39] if property is held for six months or less, the gain or loss on its disposition is short-term.[40] In computing how long real estate has been held (the holding period), it obviously is necessary to determine the date of acquisition and the date of disposition. The usual date of acquisition is the date when the deed is delivered from escrow, and not the date of the contract.[41] If the real estate is acquired pursuant to the exercise of an option, the holding period begins when the real estate itself is acquired, and not when the option was acquired.[42]

It is important to note that there may be different holding periods for land and the building on it,[43] which could result in part of the gain or loss being treated as long-term, while the rest is short-term. Similarly, if part of a building was constructed within six months of its sale, holding periods must be determined both for the part completed prior to the beginning of the six-month period terminating with the sale, and for the part completed within the six

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36. See INT. REV. CODE OF 1954, § 707(b)(3).

37. INT. REV. CODE OF 1954, §§ 267, 707(b)(1).

38. *Compare* INT. REV. CODE OF 1954, § 267(b) *with* § 1239(a).

39. INT. REV. CODE OF 1954, §§ 1222(3), (4).

40. INT. REV. CODE OF 1954, §§ 1222(1), (2).

41. Howell v. Commissioner, 140 F.2d 765 (5th Cir. 1944).

42. Helvering v. San Joaquin Fruit & Inv. Co., 297 U.S. 496 (1936). But see Rev. Rul. 607, 1954-2 CUM. BULL. 177, providing that the holding period of the seller cannot end prior to the exercise of an option to purchase, even though possession has been delivered to the holder of the option prior to such time.

43. Dunigan v. Burnet, 66 F.2d 201 (D.C. Cir. 1933); I.T. 2469, VIII-1 CUM. BULL. 158 (1926).

months, and the purchase price must be allocated between the two parts.[44]

If real estate is acquired from a decedent by reason of his death, the beneficiary's holding period begins on the date of death rather than on the date of distribution from the estate to the beneficiary.[45] The donee of a gift generally adds the donor's holding period to his own, *i.e.*, "tacking" is permitted.[46]

Effective Date of Sale

The holding period generally terminates on the date the seller's deed and possession are delivered to the purchaser.[47] If the contract between the parties is executory and dependent upon the fulfillment of conditions, then the transaction is not closed until the conditions are satisfied.[48] Conversely, if the purchaser takes possession under an unconditional contract of sale and assumes the benefits and burdens of ownership, the holding period terminates on the date the purchaser takes possession, and not when legal title passes later.[49] Where the sale is pursuant to the exercise of an option, the holding period terminates when the deed and possession are delivered.[50]

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44. Paul v. Commissioner, 206 F.2d 763 (3d Cir. 1953); Fred Draper, 32 T.C. No. 49 (May 29, 1959).

45. Brewster v. Gage, 280 U.S. 327 (1930). This is true even if the optional valuation date is used for federal estate tax purposes. The rule may be different if the property is distributed in satisfaction of a pecuniary legacy.

46. INT. REV. CODE OF 1954, § 1223(2). However, if the property is sold at a loss by the donee and the fair market value of the property at the date of the gift was less than the donor's basis, then the donee's holding period begins at the date of the gift. I.T. 3453, 1941-1 CUM. BULL. 254.

47. *Cf.* Williams v. United States, 219 F.2d 523 (5th Cir. 1955), wherein the sale was considered closed on the date the purchaser delivered his funds into escrow where the seller delayed the closing for his own purposes.

48. Bedell v. Commissioner, 30 F.2d 622 (2d Cir. 1929).

49. Commissioner v. Union Pac. R.R., 86 F.2d 637 (2d Cir. 1936).

50. Lucas v. North Texas Lumber Co., 281 U.S. 11 (1930); Rev. Rul. 607, 1954-2 CUM. BULL. 177.