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PRINCIPAL TAX CONSIDERATIONS IN THE SALE OF REAL ESTATE†

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There is probably nothing more commonplace in the general practice of law than the handling of a real estate transaction. It is also doubtful whether any transaction is more replete with tax pitfalls. By anticipating the tax potentialities of a real estate transaction, the attorney may preserve a substantial portion of the profit on the sale or turn an unprofitable sale into a welcome tax-saving. It is the scope of this article to outline some of the income tax factors to be considered by an attorney in advising a client in the sale of real estate.

CONTROLLING THE YEAR OF TAX-CLOSING

In the first instance, it is within the power of the vendor to control the taxable year in which the transaction is closed. In this manner, the vendor may allocate a taxable gain or a deductible loss to the period which will produce a minimum tax cost or a maximum tax-saving. He may desire to off-set gains and losses in the same year; he may wish to carry-over an advantageous tax deduction; he may wish to shift taxable gain to a period of lesser income or lower tax rates; or he may desire to extend the holding period of the property to obtain the benefit of a long term capital gain.

This power is inherent in the rule established by *Lucas v. North Texas Lumber Co.*,¹ namely, that a real estate transaction is not closed for tax

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†This article is taken for the most part from a paper delivered before the Real Property Division, Section of Real Property, Probate and Trust Law, at the annual meeting of the American Bar Association, September 26, 1951, New York, N. Y. Proceedings, Section of Real Property, Probate and Trust Law, American Bar Association 4 (1951). In both that paper and this article, the author has leaned heavily upon an earlier excursion into this area. See: Young, *Tax Problems in Real Estate Transactions*, 1949 U. OF ILL. LAW FORUM 473.

1. 281 U.S. 11 (1930). On December 27, 1916, the taxpayer granted a ten day option to purchase its timber lands. The option was exercised on December 30, but a deed was not tendered and possession was not relinquished until January 5,

purposes until there has been either a transfer of title or a relinquishment of possession to the purchaser. If neither of these events have occurred, there is no gain to be reported or loss to be deducted.² Conversely, the occurrence of either event will have the effect of concluding the transaction tax-wise. Thus, the retention of title³ or possession⁴ after the occurrence of the other event does not serve to delay the tax closing.

The rule is a sound one and is solidly premised on the principle that no gain or loss should be recognized for tax purposes until there is reasonable certainty that the transaction will be fully executed.⁵ Even though there is a binding contract, until delivery of a deed or relinquishment of possession, there is a possibility that the transaction might be rescinded by mutual agreement or fail of execution by reason of a defect in title. By holding the transaction open for tax purposes until there is an unequivocal event in the execution of the contract, unrealistic tax consequences are avoided.⁶

The requirement of delivery of a deed or transfer of possession as a condition precedent to the tax-closing of a real estate transaction is applicable to both cash and accrual basis taxpayers. The receipt of a down payment prior to the occurrence of either of the requisite events does not alter the general rule. It enables the vendor currently to consummate a binding contract and accept a substantial part of the consideration without incurring tax liability.⁷

Where the vendor wishes to carry a gain or loss over to the following year, he may execute a contract, accept a down payment and provide for relinquishment of possession and transfer of title during the subsequent year. Both parties can be amply protected by placing the vendor's deed

1917. The taxpayer, being on the accrual basis, reported the gain on the transaction in its return for 1916. It was held that the gain should have been reported in 1917 since that was the year in which the vendee became unconditionally liable for the purchase price.

2. *Bourne v. Comm'r*, 62 F. 2d 648 (4th Cir. 1933).

3. *Comm'r v. Union Pac. R. R.*, 86 F. 2d 637 (2d Cir. 1936).

4. *Ohio Brass Co.*, 17 B. T. A. 1199 (1929) (personal property).

5. It has been suggested that a binding contract is a sufficient basis for accrual of the gain on the sale of real estate. MAGILL, *TAXABLE INCOME* 212 (Rev. ed. 1945).

6. If a binding contract standing alone closed the transaction tax-wise, the gain would be reportable in the year of contract subject to the applicable accounting method. It would follow that if the transaction fell through in the following year, when title and possession were scheduled for delivery, the vendor would suffer a deductible loss. *United States v. Lewis*, 340 U. S. 590 (1951).

7. *Bourne v. Comm'r*, *supra* note 2.

and the balance of the vendee's consideration in escrow to be released concurrently on a specified possession date scheduled in the subsequent taxable period.⁸ If the vendor wishes to accelerate the tax closing and report the transaction in the contract year he has two alternatives. He may immediately transfer possession and place his deed in escrow to be delivered upon full payment of the purchase price.⁹ If possession cannot be conveniently relinquished, he can conclude the transaction by currently delivering a deed to the purchaser with possession to follow in a subsequent period.¹⁰

In some transactions, circumstances render it impossible to finally determine the contract price in the contract year. This is likely to occur in the sale of a large tract of land where the price per acre is agreed upon, but final computation of the total price is deferred pending completion of a survey to establish the exact acreage. Unless a subsequent adjustment substantially alters the estimated contract price, relinquishment of possession or delivery of a deed will serve to close the transaction in the year of contract.¹¹

Finally, there are instances where the transaction is closed except that a portion of the contract price is placed in escrow to protect the purchaser against additional expenses or costs such as defects in title. In that case, none of the proceeds placed in escrow constitute income until released to the vendor.¹²

SELECTING THE METHOD OF REPORTING GAIN

The closing of a profitable transaction often presents the taxpayer with a choice of accounting methods for reporting the gain thereon. This is true, however, only where payment of part of the purchase price is deferred to subsequent periods. If the entire consideration is paid in the year of closing, the entire gain is reportable in that year. Where payments on the purchase price are deferred, both the cash and accrual basis vendor may

8. C. S. Chapman, 7 T. C. M. 88 (1948).

9. *Comm'r v. Union Pac. R.R.*, *supra* note 3; *Harris Trust and Savings Bank, Ex'r.*, 24 B. T. A. 498 (1931)

10. *Ohio Brass Co.*, *supra* note 4.

11. *Frost Lumber Industries v. Comm'r*, 128 F. 2d 693 (5th Cir. 1942); *Helvering v. Nibley-Mimnaugh Lumber Co.*, 70 F. 2d 843 (D. C. Cir. 1934); *Comm'r v. R. J. Darnell, Inc.*, 60 F. 2d 82 (6th Cir. 1932). In the last case, the subsequent adjustment reduced the gain by approximately fifty per cent. It was held that the transaction was not closed until the contract price was finally determined.

12. *Stoner v. Comm'r*, 79 F. 2d 75 (3rd Cir. 1935), *cert. denied sub nom. Helvering v. Stoner*, 296 U. S. 650 (1935).

wish to bring the transaction within the provisions governing the installment method. If the transaction does not qualify for installment treatment, the cash method is the only method left for the cash basis taxpayer, but it provides a possible third alternative for the accrual basis taxpayer. Where the cash method is followed, consideration should be given to the tax consequences of accepting the purchaser's notes and mortgage as security for the balance of the purchase price.

Cash method. If the vendor is on a cash basis, the general rule is that he reports no gain until he has fully recovered, in cash or other property, the basis or tax cost of the property sold. But in applying this rule, it should be remembered that the purchaser's notes, bonds, or mortgages taken as security for the deferred payments under the contract, are treated as the equivalent of cash to the extent of their present market value.¹³ Thus, even though the down payment is small, if the balance of the purchase price is secured by any of the foregoing instruments, substantially all the gain on the transaction may fall in the year of closing rather than subsequent years as desired by the taxpayer.

There is an additional risk of increasing the tax cost in this situation. It arises where the original transaction results in capital gain and the discountable value of the vendee's obligations is substantially less than face value. The purchaser's obligations are treated as property acquired by the vendor with a basis equal to their discountable value at the time of closing. Upon collection at maturity, the difference between the face value and the discountable value will be taxed as ordinary income.¹⁴ This is true since the collection of a debt does not constitute the sale or exchange of a capital asset. The foregoing tax consequences can be obviated by requiring the vendee, under the terms of the contract, to make his notes and mortgage payable to a trustee with the provision that the proceeds be distributed to the vendor upon collection. Since the vendor would not have power to dispose of the purchaser's obligations, this would preclude inclusion of the value of the notes and mortgage in determining gain on the transaction in

13. U. S. Treas. Reg. 111, § 29.44-4 (1943). If the purchaser's obligations have no market value, no portion thereof will be included in determining gain realized in the year of closing. Fidelity Savings & Loan Co., 44 B. T. A. 471 (1941).

14. A. B. Culbertson, 14 T. C. 1421 (1950); Victor B. Gilbert, 6 T. C. 10 (1946). If the purchaser's obligations had no market value at the time received, this risk does not exist. In that case, the character of the gain upon collection will be the same as if full payment had been received at the time of closing. A. B. Culbertson, *supra* at 1423.

the year of closing and would avoid realization of ordinary income upon subsequent collection. This procedure may be desirable in those transactions which do not qualify for the installment method.

The same tax result can be obtained if the vendor is willing to accept the vendee's mere contractual obligation without the security of notes, bonds, or mortgages. A mere contractual obligation standing alone is not treated as the equivalent of cash or as property having a present market value regardless of the strength of the purchaser's credit.¹⁵ This principle was re-affirmed in a recent Tax Court decision.¹⁶ In 1945, the taxpayer sold an "inn," as a going concern, consisting of real estate, equipment, furnishings and fixtures. The sale price was \$70,000 and the taxpayer's basis, in round figures, was \$26,500. The purchaser made a down payment of \$8,000. By the terms of the contract, which was the only evidence of the purchaser's obligation, the balance was payable over a period of several years. The vendor was on a cash basis and reported no gain on the sale until 1947, the year in which he had fully recovered his basis. The Commissioner assessed a deficiency for the year 1945 on the ground that the purchaser's obligation was property (other than money) received by the taxpayer which had a fair market value equivalent to cash. In holding for the taxpayer, the court stated:¹⁷

"In determining what obligations are the 'equivalent of cash' the requirement has always been that the obligation, like money, be freely and easily negotiable so that it readily passes from hand to hand in commerce. . . . In the case before us the promise to pay was merely contractual; it was not embodied in a note or other evidence of indebtedness possessing the element of negotiability and freely transferable. It is true that the contract possessed many elements of a mortgage . . . but this characteristic does not lend to the contract the necessary element of negotiability."

Accrual method. In accordance with sound principles of accrual accounting, an accrual basis taxpayer reports the entire gain on a transaction in the year of closing.^{17a} This is so whether the consideration is received in the year of closing or is deferred to subsequent periods. But in the *Titus*

15. *Bedell v. Comm'r*, 30 F. 2d 622 (2d Cir. 1929).

16. *Nina J. Ennis*, 17 T. C. 465 (1951).

17. *Id.* at 470.

17a. For the accrual basis taxpayer, "it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income." *Spring City Foundry Co. v. Comm'r*, 292 U.S. 182, 184 (1934).

case,¹⁸ the Tax Court held that an accrual basis taxpayer may elect the cash (or deferred payment) method of reporting gain on sale of an interest in real estate. The decision is a questionable one in that it is contrary to generally accepted concepts of accrual accounting. Furthermore, the Commissioner has entered his non-acquiescence. Nevertheless, the case is highly significant. At first the court held that since the taxpayer was on the accrual basis and since the transaction did not qualify as an installment sale, the entire gain should be reported in the year of closing.¹⁹

Later the court granted a rehearing in which it reversed its original position and allowed the taxpayer to follow the cash method. Its final position was premised on the conclusion that the regulations, by long standing provision, have authorized the deferred payment method of reporting gain on the sale of real estate without regard to the method of accounting regularly employed by the taxpayer.²⁰ This decision has been cited with approval in several recent cases.²¹ It should not be overlooked where an accrual basis taxpayer can use the cash method to advantage.

Installment method. The installment method of reporting gain on the sale of real estate is an alternative method expressly authorized by Internal Revenue Code Section 44. By this method, the gain is allocated proportionately to the payments made by the vendee and is spread over the entire period of the contract. It is available to both cash and accrual basis taxpayers, whether dealers or non-dealers, and is applicable to all real estate transactions regardless of amount. Where the taxpayer has consummated several qualifying transactions in the same taxable period, he is free to elect the installment method with respect to any one, several, or all of his sales. He is not bound, by an election as to one or more sales, to apply the installment method to all transactions.²² Election of the installment method must be made in the return for the year of sale.²³ Failure to elect at that time constitutes a waiver of the right to utilize the installment method.²⁴

To qualify for the installment method, the "initial payments" must not

18. 33 B. T. A. 928 (1936), *Non-Acq.*, XV-1 CUM. BULL. 46 (1936).

19. 32 B. T. A. 1222 (1935).

20. 33 B. T. A. 928, 930 (1935).

21. The most recent is Nina J. Ennis, *supra* note 16.

22. U. S. Treas. Reg. 111, § 29.22(a)(11) 1943; G.C.M. 3350, VIII- CUM. BULL. 62 (1928).

23. Cedar Valley Distillery, Inc., 16 T.C. 870 (1951); Sylvia S. Strauss, 33 B. T. A. 855 (1935).

24. *Pac. Nat. Co. v. Welch*, 304 U S. 191 (1938).

exceed thirty percent of the total selling price.²⁵ As defined by statute, the term "initial payments" means "payments received [in the year of closing] in cash or property other than evidences of indebtedness" executed by the purchaser.²⁶ Consequently, the vendor may accept a purchaser's installment notes, bonds, or mortgage without jeopardizing his right to apply the installment method.

Furthermore, he can immediately discount the purchaser's obligations which are due in future periods. The proceeds will not be includable in the initial payments since they do not constitute "payments received" from the vendee.²⁷ Any unliquidated encumbrances upon the property, whether assumed by the vendee, are not included in the initial payments except to the extent that the indebtedness exceeds the vendor's basis.²⁸

As an additional qualifying factor, there must be two payments, one in the year of closing and one in a subsequent period. If there is no payment in the year of closing, the transaction will not qualify for the installment method even though subsequent payments extend over more than one taxable period.²⁹ But a down payment received in a prior period carries over to the year of closing for purposes of the foregoing requirement and also in applying the thirty percent rule.³⁰ Assume, for example, that the vendor contracted in December, 1951 to sell certain real estate for a consideration of \$20,000. He accepted a down payment of \$1,000 and it was agreed that title and possession would be transferred on February 1, 1952. If the balance of the purchase price were paid on the closing date, the entire gain would be reported in 1952. Nothing would be reportable in 1951, regardless of the taxpayer's method of accounting, since the transaction was not closed in that year. But assume that the balance of the purchase price were paid as follows: \$3,000 on the closing date in 1952, and \$4,000 in each of the following four years. In that event, the down payment made in December, 1951 would carry over and the vendor would be deemed to have received a total initial payment of \$4,000 in 1952, the year of closing. Since this amount is less than

25. INT. REV. CODE § 44(b).

26. *Ibid.*

27. *Duram Bldg. Corporation v. Comm'r*, 66 F. 2d 253 (2d Cir. 1933); U. S. Treas. Reg. 111, § 29.44-2 (1943).

28. U. S. Treas. Reg. 111, § 29.44-2 (1943); *Burnett v. S & L Building Corporation*, 288 U. S. 406 (1933).

29. U. S. Treas. Reg. 111, § 29.44-2 (1943); G. C. M. 12148, XII-2 Cum. BULL. 57 (1933).

30. *Newaygo Portland Cement Co.*, 27 B. T. A. 1097 (1933); *Warren National Bank*, 22 B.T.A. 759 (1931), *aff'd*, 61 F. 2d 325 (3rd Cir. 1932).

30% of the total selling price, the transaction would qualify for the installment method.

REPORTING LOSSES

There are no alternative methods of reporting losses and both cash and accrual basis taxpayers must take deductions for losses in the year in which the sale is closed.³¹ At this point, special consideration should be given to losses on the sale of real property used in a trade or business and held for more than six months which qualify under Section 117(j). By the terms of Section 117(j), a loss on the sale of such property may be fully deductible from ordinary income. But there is a limitation upon the operation of this rule. Any loss incurred must first be off-set against (a) gains on the sale or exchange of other business property and (b) gains on the involuntary conversion of both business property and capital assets. But these off-setting gains are capital gains. Therefore, to obtain the maximum benefit of Section 117(j) losses, which are deductible in full from ordinary income, it is desirable to shift these losses to a taxable period in which there are no off-setting capital gains. This is a situation where the vendor may wish to resort to his power to control the year of closing.

Another problem, closely related to Section 117(j) losses, involves the net operating loss deduction provided in Section 122. The question arises where the loss on the sale of real estate qualifies as an ordinary loss and exceeds the income for the taxable period. For an individual taxpayer to enjoy the benefits of the carry-back and carry-over provisions, the loss must arise in the ordinary course of his business. Consequently, for losses on the sale of real estate to qualify, the vendor must be a dealer. Thus it has been held that losses on the sale of a farm,³² a citrus fruit grove,³³ and real estate held for rental purposes³⁴ do not constitute net operating losses under the statute.

CHARACTER OF THE GAIN OR LOSS

Reference has been made to profitable real estate transactions without attempting to classify the gain as ordinary income or capital gain. It is not within the scope of this article to attempt to resolve the difficult prob-

31. U. S. Treas. Reg. 111, § 29.23(e)-1 (1943).

32. *Baruch v. Comm'r*, 178 F. 2d 204 (2d Cir. 1949); *Lazier v. United States*, 170 F. 2d 521 (8th Cir. 1948).

33. *Pettit v. Comm'r*, 175 F. 2d 195 (5th Cir. 1949).

34. *Claudia N. S. Schamberg*, 8 T. C. M. 609 (1949).

lems in this area. That topic deserves separate treatment. But the following summary of applicable rules may provide a bit of perspective.

(1) If real property is held for sale to customers in the ordinary course of business, the gain thereon will be taxed as ordinary income and any loss will constitute an ordinary business loss. The critical issue is whether the vendor is to be considered a "dealer" in consummating the particular transaction.

The factors to be considered have been summarized by one writer³⁵ to include: (a) the frequency and continuity of the taxpayer's real estate transactions; (b) the purpose of the original acquisition of the property; (c) proximity of sale to purchase; and (d) the activity (participation) of the vendor in the development, promotion, and sale of the property. It should be noted, however, that the vendor cannot avoid classification as a dealer by selling through agents, for such sales will be attributed to him.³⁶ On the other hand, one who is regularly engaged in the real estate business may hold investment property which will qualify under Section 117(j).³⁷

(2) If the property is real property used in a trade or business and has been held for more than six months it falls within Section 117(j). Gain thereon is taxable as capital gain and a loss is fully deductible as an ordinary loss subject to the limitations stated in the statute. This classification includes property acquired for business use³⁸ and also investment real estate held for the production of income.³⁹

(3) If the property falls in neither of the foregoing classifications, it will constitute a capital asset and a gain or loss will be reported as capital gain or loss.

EXCHANGE OF REAL ESTATE

There is one real estate transaction to be noted which will produce neither taxable gain nor deductible loss. Section 112(b)(1) provides that if real estate "held for productive use in trade or business or for investment"

35. FINK, *Dealing in Real Estate*, 2 TAX L. REV. 111 (1946).

36. *Ehrman v. Comm'r*, 120 F. 2d 607 (9th Cir. 1941), *cert. denied*, 314 U. S. 668 (1941).

37. *Nelson A. Farry*, 13 T. C. 8 (1949).

38. *Alamo Broadcasting Company, Inc.*, 15 T. C. 534 (1950) (property originally purchased for use in business but sold when subsequent circumstances prevented such use).

39. *Mary E. Crawford*, 16 T. C. 678 (1951); *George W. Carnrick*, 9 T. C. 756 (1947), *Acq.*, 1948-1 CUM. BULL. 1. *Contra: Keneipp v. United States*, 184 F. 2d 263 (D. C. Cir. 1950).

is exchanged for real estate "of a like kind" to be held for either of the same purposes, no gain or loss shall be recognized. This may prove advantageous to the taxpayer who wishes to liquidate one real estate investment and reinvest in other real estate. He may find a buyer who is in a position to make a direct exchange. However, an indirect exchange is equally effective for the statute has been applied where the vendor deeded his property to the buyer and received in exchange a deed to other real estate from a third party pursuant to arrangements made by the buyer.⁴⁰

One word of caution is appropriate in this transaction. The basis of the original investment carries over as the basis of the property acquired in the exchange.⁴¹ Thus, in avoiding the realization of gain, the taxpayer loses an opportunity to acquire a stepped-up basis for depreciation purposes. The advantage on the one hand should be weighed against the disadvantage on the other in deciding upon the exchange method of disposition.

FORM IN WHICH THE TRANSACTION IS CONSUMMATED

Lease With Option to Purchase. Most real estate transactions are consummated as immediate sales. But this is not always the case. There are instances where the parties choose to cast the transaction in the form of a lease with an option to purchase.⁴² The lease, in this event, provides that upon exercise of the option to purchase the interim rental payments shall be applied to the purchase price. From a tax standpoint, these transactions should not be encouraged. As a sale, the transaction may not be considered closed until the lessee-purchaser has exercised his option.⁴³ In the meantime, the rental payments which are to apply on the purchase price will be taxed as ordinary income to the vendor-lessor.⁴⁴ If the transaction were an outright sale, in the first instance, the vendor would be entitled to recover his basis, at least in part, before realization of any taxable gain. Furthermore, the gain might well be capital gain and not ordinary income. The lessee-purchaser is also at a disadvantage for he may have planned to deduct the interim rental payments as ordinary business expenses. These rental pay-

40. *W. D. Haden Co.*, 5 T. C. M. 251 (1946), *aff'd*, 165 F. 2d 588 (5th Cir. 1948).

41. INT. REV. CODE § 113(a)(6).

42. *E.g.*, *Robert A. Taft*, 27 B.T.A. 808 (1933).

43. *Compare Truman Bowen*, 12 T.C. 446 (1949) (holding the transaction an immediate sale), *with Estate of Clarence B. Eaton*, 10 T. C. 869 (1948) (holding the transaction a lease until exercise of the option to purchase).

44. *Estate of Clarence B. Eaton*, *supra* note 43.

ments, however, generally prove to be capital expenditures by operation of Section 23(a)(1)(A) which limits rental deductions to property "to which the taxpayer has not taken or is not taking title or in which he has no equity."⁴⁵

The risk incurred by the vendor in consummating a lease with option to purchase is aptly illustrated by a recent case.⁴⁶ There the vendor entered into a lease-purchase agreement which provided for a total consideration of \$125,000 of which \$25,000 was paid on the effective date of the lease. The lessee-purchaser was granted an option to purchase the property, exercisable within a period ending six months after the death of the lessor. The sum of \$100,000 was payable upon exercise of the option. The agreement further provided for quarterly payments of \$1,125 which represented interest at the rate of 4½% per annum upon the unpaid balance. The lessee did not exercise the option within the period provided by the agreement. The taxpayer contended that the \$25,000 was consideration for the option and was not taxable until the option was exercised or forfeited.⁴⁷ But the Tax Court held that the sum was taxable in the year of receipt as ordinary income (apparently in the nature of rent) since it had been received by the taxpayer under claim of right and without restriction upon its disposition. From the language of the decision it appears that the same result would have been reached even if the option had been subsequently exercised by the lessee.

Sale and Lease-back. Another transaction which has received considerable attention in recent years is the sale and lease-back.⁴⁸ It has been utilized for both financial and tax benefits and raises some interesting problems which have not been finally resolved. The usual arrangement consists of a sale to an insurance company or charitable corporation which simultaneously leases the property to the vendor under a long-term lease. At first blush it might seem that the gain or loss on the sale portion of the transaction should be handled in the same manner as any other sale. But recent

45. Judson Mills, 11 T. C. 25 (1948).

46. Estate of Mary G. Gordon, 17 T. C. 427 (1951), *appeal pending* 6th Cir.

47. If the taxpayer had been successful in this contention, the payment would have been taxable in the year of forfeiture as a short-term capital gain under INT. REV. CODE § 117(g)(2). See discussion *infra* page 136.

48. For a complete analysis, see Cary, *Corporate Financing Through the Sale and Leaseback of Property; Business, Tax and Policy Considerations*, 62 HARV. L. REV. 1 (1948); also, Cary, *Current Tax Problems in Sale, or Gift, and Leaseback Transactions*, N.Y.U. 9th ANNUAL INSTITUTE ON FEDERAL TAXATION 959 (1951), reprinted in 29 TAXES 662 (1951).

decisions involving losses incurred in sale and lease-back transactions indicate that this hasty conclusion does not follow. In two cases, the court found that the sales were bona fide and held the losses deductible.⁴⁹ It should be noted that the leases were for periods of 20 and 25 years, respectively, without renewal options. The duration of these leases was a determining factor in the court's decisions. In two other cases the losses were disallowed—one on the ground that the sale was not bona fide;⁵⁰ the other on the ground that the transaction constituted an exchange of property of like kind within Section 112(b)(1).⁵¹

The latter, the *Century Electric Co.* case, is the most significant. There the taxpayer sold its property to an educational institution in 1943 at a loss in excess of \$380,000 and took back a 95-year lease. The transaction was prompted by both financial and tax considerations, the latter being particularly obvious since it was an excess profits tax year. In holding that the transaction constituted an exchange with respect to which no loss could be recognized, the court stressed the 95-year term of the lease-back. Reliance was placed upon a long standing provision in the Regulations that "no gain or loss is recognized if . . . a taxpayer who is not a dealer in real estate exchanges a lease-hold of a fee with 30 years or more to run for real estate."⁵² By this provision, a lease-hold of 30 years or more is considered the equivalent of a fee in applying the "like kind" test. On this basis it was concluded that there was an exchange of the fee interest in the property for an equivalent 95-year lease plus cash. The consideration received was applied in reduction of the basis which was held amortizable over the entire 95-year term of the lease.

The present status of the decisions leads to the conclusion that a sale and lease-back transaction involving a lease of 30 years or more will be classed as a Section 112(b)(1) exchange. No loss will be allowed and a gain will be taxable in an amount not to exceed the cash (or other property) received as boot. Furthermore, the adjusted basis will be amortizable over the term of the lease irrespective of the useful life of the property. And

49. *May Department Stores Co.*, 16 T. C. 547 (1951); *Standard Envelope Mfg. Co.*, 15 T. C. 41 (1950).

50. *H. E. Harman Coal Corporation*, 16 T. C. 787 (1951) (sidetracks having a basis of \$21,637.58 sold to railroad company for consideration of \$1 and an agreement for maintenance).

51. *Century Electric Co.*, 15 T. C. 581 (1950), *aff'd* 192 F. 2d 155 (8th Cir. 1951), *cert. denied* March 10, 1952, 5 CCH 1952 Fed. Tax Rep. p. 44, 102.

52. U. S. Treas. Reg. 111, § 29.112(b)(1)-1 (1943).

finally, there is the question of rental deductions yet to be settled. Future litigation in this area will warrant careful attention.

Borrowing on the Security of Real Estate Without Personal Liability.

It is generally conceded that one does not realize income as a result of borrowing. But a particular type of mortgage transaction, which has been prevalent in recent years, has given rise to speculation, if not argument, as to its proper tax consequences. It involves the situation where the owner obtains a loan solely upon the security of the property in an amount in excess of his basis. Recent inflationary trends have made this type of transaction financially acceptable to lenders. It has been proposed that since the owner is under no obligation to repay the loan, he should be deemed to have realized gain on the transaction to the extent that the proceeds exceed his basis.⁵³ The suggested corollary to this result is that the basis of the property should be increased by the amount of gain realized upon the transaction.

In a recent decision,⁵⁴ the Tax Court refused to accept this proposition, and concluded that mortgaging property does not constitute a disposition within Section 111(a). It was the court's position that there could be no gain realized solely as a consequence of the loan and mortgage unless and until the mortgage was foreclosed and the property taken in satisfaction of the debt. The immediate response, of course, is that from the standpoint of neither the Government nor the taxpayer is the foreclosure of a mortgage and loss of the property an advantageous time at which to assess a substantial income tax upon the owner. But it is submitted that the Tax Court's view is eminently sound. The possible disruptive economic consequences of imposing an income tax upon a large volume of borrowing transactions would seem to overshadow the risk of loss of revenue in the relatively few hardship cases which arise where the loans cannot be repaid at maturity.

FAMILY TRANSACTIONS

The rapidly increasing dollar value of real estate during the past several years has brought an increased consciousness of the impact of death taxes upon real estate holdings. As a consequence, inter vivos transfers

53. Lurie, *Mortgagor's Gain on Mortgaging Property for More Than Cost Without Personal Liability (Contentions of Taxpayer's Counsel in a Pending Case)*, 6 TAX L. REV. 319 (1951).

54. Woodsam Associates, Inc., 16 T. C. 649 (1951), *appeal pending* 2nd Cir. Here the taxpayer argued for application of the rule in order to establish a stepped-up basis for purpose of determining gain upon foreclosure of the mortgage.

have become more and more popular within family groups. However, many of these transactions are consummated as sales, rather than as gifts, with tax consequences which warrant careful consideration.

Bargain Sales. Perhaps you have had an optimistic client enthusiastically confront you with the *perfect* tax transaction. He owns certain real estate which has a basis of \$100,000 and a fair market value of \$200,000. It is his plan to sell the property to his son at a bargain price of \$40,000. This transaction, he happily announces, will shift the title of valuable property to one who is the object of his bounty and at the same time provide him with an income tax deduction of \$60,000. His proposal is, of course, a fanciful dream. In the first place, Section 24(b) prohibits the deduction of losses incurred on sales between related taxpayers.⁵⁵ Secondly, the transaction involves a taxable gift of \$160,000, that being the excess of the fair market value of the property over the stipulated consideration.⁵⁶ And lastly, the basis of the property in the hands of the son will be \$40,000, the actual cash consideration paid for the property. Although the transaction constitutes a gift for gift tax purposes, it is deemed strictly a purchase and sale under the income tax and no part of the father's basis would be carried over to the son.⁵⁷ Thus, the net result of the suggested transaction would be a taxable gift of \$160,000 and a reduction of \$60,000 in the basis of the property.

Sale in Consideration of an Agreement to Pay an Annuity. A device frequently employed in family circles is a transfer of real estate in consideration of the transferee's agreement to pay an annuity to the transferor.⁵⁸ If the value of the annuity is less than the fair market value of the property transferred, there is a bargain sale with substantially the same tax consequences as indicated above.⁵⁹

55. "Related taxpayers" are defined with particularity in the statute and include a husband, wife, brother, sister ancestor, lineal descendant, and a controlled corporation.

56. INT. REV. CODE § 1002.

57. *Farid-Es-Sultaneh v. Comm'r*, 160 F. 2d 812 (2d Cir. 1947), reversing 6 T. C. 652 (1946) (acquisition by inter vivos transfer under antenuptial contract); cf. *Mack v. Comm'r*, 148 F. 2d 62 (3rd Cir. 1945), affirming 3 T. C. 390 (1944) (acquisition by bargain purchase under provisions of a will). *Contra*: *May Rogers*, 31 B. T. A. 994 (1935), *rev'd on other grounds*, 107 F. 2d 394 (2d Cir. 1939).

58. It should be noted that an estate tax will not be avoided if the transferor retains an interest in the property. *Estate of Cornelia B. Schwartz*, 9 T. C. 229 (1947).

59. For gift tax purposes, the value of the gift would be measured by the difference between the actuarial value of the annuity and the fair market value of the property transferred. *Estate of Koert Bartman*, 10 T. C. 1073 (1948).

But the transaction may be bona fide and for an adequate and full consideration. In that event, there is no taxable gift. The gain, if any, will be recognized only after the transferor has fully recovered his basis.⁶⁰ Consistent with the principles discussed under accounting methods, the mere promise of the obligor has no fair market value for purpose of determining gain on the sale.⁶¹ After basis has been recovered, the payments will be taxable in full as ordinary income since the transaction is one involving the purchase of an annuity by the transferor.⁶² This result is, of course, at variance with that which follows the purchase of a commercial annuity.⁶³

The basis (tax cost) of the property in the hands of the transferee-purchaser presents an interesting problem which has not been fully resolved. Treating the transaction as a purchase of property by the transferee,⁶⁴ the original basis will be the discounted value of the annuity payments computed actuarially as of the date of the transfer.⁶⁵ Original basis will be determined in this manner regardless of whether the transfer is for an adequate and full consideration in money or money's worth. This rule is consistent with the requirement that cost generally determines the basis of property and cost includes the purchaser's deferred payment obligations. The transferor-annuitant's life span, however, will not square exactly with his life expectancy. Consequently, subsequent adjustments to basis will be necessary. Where the transferor dies prior to the expiration of his life expectancy, the transferee's basis becomes the actual cost of the property to him rather than the actuarial value of the annuity obligation.⁶⁶ Where the transferor

60. *Ware v. Comm'r*, 159 F. 2d 542 (5th Cir. 1947).

61. *Comm'r v. Kann's Estate*, 174 F. 2d 357 (3rd Cir. 1949).

62. *Ware v. Comm'r*, *supra* note 60; *Bella Hommel*, 7 T. C. 992 (1946). There is one case, however, in which the court treated a transfer in consideration of an agreement to pay an annuity as two separate transactions: one as a sale of property at a recognized gain reportable after recovery of basis; the other as the purchase of an annuity at a cost measured by the value of the property transferred. *Hill's Estate v. Maloney*, 58 F. Supp. 164 (D. C. N. J. 1944).

63. For an analysis of the problem, see Note, *Taxing Deferred Return Upon Transfer of a Capital Asset*, 63 HARV. L. REV. 853 (1950).

64. In a few early decisions the transferee was considered to have entered into an annuity venture. Thus payments made to the transferor pursuant to the agreement were considered partly a return of capital and partly the payment of interest on the unpaid balance. *E.g.*, *Comm'r v. John C. Moore Corp.*, 42 F. 2d 186 (2d Cir. 1930). But this theory has been discarded in the more recent decisions which have adopted the view that the transaction is strictly a purchase of property by the transferee. *Gillespie & Sons Co. v. Comm'r*, 154 F. 2d 913 (10th Cir. 1946), *cert. denied*, 329 U. S. 781 (1946) and cases note 67 *infra*.

65. *Nelson Trotman*, 3 T. C. M. 316 (1944).

66. *D. Bruce Forrester*, 4 T. C. 907 (1945).

lives beyond his life expectancy, there is a question as to whether the payments made thereafter by the transferee constitute deductible losses. For the most part, it has been consistently held that these additional payments are capital expenditures which are to be added to the transferee's basis.⁶⁷ These adjustments, of course, present complications where there are depreciable improvements upon the real estate or where the transferee disposes of the property prior to the annuitant's death.

RESIDENTIAL PROPERTY

Sale at a Gain. Section 112(n) was added to the Code by the Revenue Act of 1951 to govern the gain on the sale of one's residence. Prior to this admendment, gain on the sale of a residence was taxable as capital gain even though the proceeds were immediately applied to the purchase of a new home. Under the new provisions, which are mandatory in application, no gain will be recognized if the proceeds are fully reinvested in a new home. If the entire proceeds are not reinvested in a new home, gain on the sale of the old home will be recognized to the extent that the sale price of the old home exceeds the cost of the new home.⁶⁸ The new rule is applicable only to the sale and purchase of the taxpayer's "principal residence." It does not apply, for example, to the sale and purchase of a summer home. But it is applicable to that portion of business property which is occupied as the taxpayer's residence, such as a residence on a farm or an apartment in a store building. As a corollary to the rule regarding non-recognition of gain, the basis of the old residence carries over as the basis of the new residence.⁶⁹ Similarly, the holding period of the old residence is tacked to the holding period of the new residence.⁷⁰

The statute prescribes certain time limitations upon the operation of the new rule. Where the taxpayer purchases a new residence, the purchase must be made within a year prior or subsequent to the sale of the old home.⁷¹ Furthermore, the new home must be used as the taxpayer's residence not later than a year following the sale. Where the taxpayer constructs a new residence, construction must begin within a year and the pro-

67. *Citizens Nat. Bank v. Comm'r*, 122 F. 2d 1011 (8th Cir. 1941), *cert. denied*, 315 U. S. 822 (1942); *Steinbach Kresge Co. v. Sturgess*, 33 F. Supp. 897 (D. N. J. 1940); *A. H. Black Co.*, 3 T. C. C. M. 14 (1944).

68. INT. REV. CODE § 112(n)(1).

69. *Id.* § 112(n)(4).

70. *Id.* § 117(h)(7).

71. *Id.* § 112(n)(1).

perty must be used as his residence within eighteen months following the sale.⁷² If the taxpayer reconstructs another home as his new residence, the reconstructed home must be occupied not later than a year following the sale of the old home.⁷³

In applying these rules, the date of closing is very important.⁷⁴ If the taxpayer sells his old home and purchases a new home, the sale and purchase must both be closed tax-wise within a one year period. Assume that the taxpayer sold his old home and delivered possession and title on February 1, 1951. On January 15, 1952 he contracted to purchase a new home. He received title and possession of his new home on February 15, 1952. The transaction would not qualify under the statute since more than a year would have elapsed between the sale of the old home and purchase of the new home.

Certain rules are applicable in determining reinvestment of the proceeds of the sale of the old home. The sale price of the old home and purchase price of the new home include, of course, any deferred payments and other obligations or encumbrances assumed, respectively, by the purchaser and the taxpayer. Commissions on the sale of the old residence are not deducted in determining the sale price of the old residence, but expenses incurred in the acquisition of the new home are added to the cost of purchase.⁷⁵ Capital expenditures made upon the new home within the above mentioned time limits are also included as a part of the purchase price.⁷⁶ Capital expenditures beyond the statutory period are excluded. The value of inherited or gift property is also excluded from the cost of purchasing the new home since acquisition in this manner does not actually involve a reinvestment of proceeds from the sale of the old home. But excluded capital expenditures and the basis of inherited and gift property are included in determining the basis of the new home.

The new statutory provisions apply to exchanges and involuntary conversions as well as sales and purchases.⁷⁷ In the case of a direct exchange of residences, boot paid by the taxpayer would increase the basis of the new

72. *Id.* § 112(n)(G).

73. *Id.* § 112(n)(2)(D).

74. The statute does not define the meaning of "sale" and "purchase" as used in § 112(n). It would follow therefore, that these terms are to have the same meaning as in other sale transactions. See discussion *supra* pages 117-118.

75. SEN. REP. No. 781, Pt. 2, 82d Cong., 1st Sess. 33 (1951).

76. INT. REV. CODE § 112(n)(2)(D).

77. *Id.* § 112(n)(2)(A) and (B).

home and boot received would result in taxable gain. The rule for non-recognition of gain is applicable only to one sale in a given twelve month period with an exception allowed in the case of involuntary conversion.⁷⁸ The rule does not apply where the taxpayer purchases a new residence and sells it prior to the sale of his old residence.⁷⁹ Similarly, if the taxpayer purchases and uses more than one new residence within a year following the sale of his old residence, only the residence last purchased will constitute a new residence under the statute.⁸⁰ To take advantage of the new rule it is not necessary in the case of husband and wife that title to the new residence be held in the same form as title to the old residence.⁸¹

Sale at a Loss. The new statutory provision does not alter the rule that a loss on the sale of one's residence is in the nature of a personal expense and is not deductible.⁸² But this restriction upon the deduction of losses does not apply where the taxpayer has converted his residence into rental property. In that event the property will be classed as used in a trade or business within the provisions of Section 117(j) and a loss on a subsequent sale will be fully deductible.⁸³ In determining the loss, the basis is the lesser of cost or fair market value at the date of conversion, less depreciation during the rental period.⁸⁴ To convert one's residence to rental property, the decisions generally require actual renting. Merely vacating one's residence and listing it for sale or rent is insufficient. A loss in these circumstances will be disallowed.⁸⁵

A different rule applies to an inherited residence not occupied by the taxpayer. In that case actual renting is not a condition precedent to the deduction of a loss on a subsequent sale. Merely holding the property for sale or rent will serve to convert the residence into property used in a trade

78. *Id.* 112(n)(3).

79. *Id.* § 112(n)(2)(E).

80. *Id.* § 112(n)(2)(F).

81. *Id.* § 112(n)(6).

82. This rule was strictly applied in a recent case where the taxpayer sold two residences during the taxable year—the first at a gain, the second at a loss. The taxpayer contended that he should be permitted to off-set the loss against the gain and report only the net gain from the two sales. The Tax Court rejected this contention on the ground that each transaction must be considered separately and that the loss on the second sale constituted a non-deductible personal, living expense. Richard P. Koehn, 16 T. C. 1378 (1951).

83. Heiner v. Tindle, 276 U. S. 582 (1928); U. S. Treas. Reg. 111, § 29.23(e)-1 (1943).

84. Quincy A. Shaw McKean, 6 T. C. 757 (1946).

85. Morgan v. Comm'r, 76 F. 2d 390 (5th Cir. 1935), *cert. denied*, 296 U.S. 601 (1935).

or business.⁸⁶ But it has recently been held that listing only "for sale," as contrasted with a listing "for sale or rent," does not convert an inherited residence into real property used in a trade or business.⁸⁷ The loss, in the former instance, was restricted to a capital loss.

When the taxpayer's residence is in a cooperative apartment, no deduction will be allowed for a loss incurred upon the sale of his interest therein.⁸⁸ The loss does not arise out of a transaction entered into for profit and is also considered a personal, living expense. But if the taxpayer has subleased his apartment and converted it to rental property, a loss on a subsequent sale will be allowed. In that case, however, the loss may be attributed solely to the stock in the corporation and treated as a long-term capital loss.⁸⁹

PROPERTY TAXES AND THE SALE OF REAL ESTATE

A problem, which has caused some difficulty relates to current property taxes which have become a lien or personal obligation of the vendor prior to sale. It is customary for the parties to allocate these taxes on the basis of their respective periods of possession during the year of closing or in some comparable manner. As held in *Magruder v. Supplee*,⁹⁰ the portion assumed by the vendee constitutes an additional capital expenditure or cost of the property and is not deductible by the purchaser in determining taxable income. It follows, as a corollary to this rule, that the payment made by the purchaser must be treated by the vendor as additional consideration received for the property and reported as part of the selling price. However, the vendor is entitled to take a deduction for the total amount of the taxes including the portion assumed and paid by the vendee.⁹¹ This may provide a substantial tax benefit where the gain on the sale is a capital gain, for the property taxes may be deductible in full from ordinary income.

86. N. Stuart Campbell, 5 T. C. 272 (1945).

87. Maria Assman Estate, 16 T. C. 632 (1951) (listed "for sale"; loss a capital loss); Mary E. Crawford, 16 T.C. 678 (1951) (listed "for sale or rent"; loss an ordinary loss).

88. John H. Amen, 7 T. C. M. 577 (1948).

89. Junius B. Peake, 10 T. C. M. 579 (1951). Court, in effect, found the lease to be worthless at the time of conversion to rental property; loss was, therefore, limited to the stock in the cooperative corporation.

90. 316 U. S. 394 (1942). The rule adopted by this decision is wholly unrealistic. Both the vendor and vendee look upon current property taxes as current operating expenses applicable to their respective periods of possession. An amendment of Internal Revenue Code § 23(c) to authorize deduction of current property taxes on the basis of a reasonable allocation by the parties is warranted.

91. Norman Cooledge, 40 B. T. A. 1325 (1939), *Acq.*, 1940-1 CUM. BULL. 2.

BREACH OF CONTRACT AND FORFEITURES

Real estate transactions which have been duly and fully executed have been the principal subject of this discussion. But those transactions which fail to bear fruit as originally anticipated also warrant comment. A typical situation involves the option contract. Many real estate transactions are initiated under option agreements which provide that the consideration for the option shall apply on the purchase price in the event the option is exercised. For the vendor, the transaction is not closed tax-wise until the option has either expired or has been exercised. If it is exercised, the closing does not occur until delivery of a deed or transfer of possession.⁹² But if allowed to expire, the consideration received therefor is reportable as income in the period of expiration.⁹³ The reason for the delay in taking up the consideration for the option as income is the fact that the true nature of the payment cannot be determined until expiration or exercise as the case might be.⁹⁴ By specific statutory provision, the gain upon forfeiture is treated as a short-term capital-gain and, conversely, the optionee is allowed a short-term capital loss.⁹⁵

A similar problem arises where the vendee executes a binding contract to purchase and makes a down payment, but subsequently fails to perform. If the down payment is forfeited as liquidated damages without litigation, the gain will be reportable in the year of forfeiture.⁹⁶ But the vendor may tender merchantable title and bring suit for specific performance. That raises another interesting question. If the taxpayer is on a cash basis, no gain will be reportable until successful conclusion of the suit and receipt of the purchase price. If the taxpayer is on an accrual basis, there is a conflict of authority as to whether the transaction is closed in the year in which the vendor tenders a deed⁹⁷ or in a subsequent period when a decree of specific performance is rendered.⁹⁸ The latter would seem to be the better view since there can be no certainty that the transaction will be consummated until the litigation has been concluded.

92. *Lucas v. North Texas Lumber Co.*, 281 U. S. 11 (1930).

93. *Hunter v. Comm'r*, 140 F. 2d 954 (5th Cir. 1944).

94. *Virginia Iron Coal & Coke Co. v. Comm'r*, 99 F. 2d 919 (4th Cir. 1938); *C. V. L. Corporation*, 17 T. C.—No. 95 (1951).

95. INT. REV. CODE § 117(g)(2).

96. *Doyle v. Comm'r*, 110 F. 2d 157 (2d Cir. 1940), *cert. denied*, 311 U. S. 658 (1940).

97. *Comm'r v. Northern Jersey Title Ins. Co.*, 79 F. 2d 492 (3rd Cir. 1935).

98. *Doyle v. Comm'r*, *supra* note 96.

In this connection another point should be noted. By contrast with forfeitures under option agreements, there is no statute governing forfeitures by default under contracts for the sale of real estate. Consequently it has been held that the amount forfeited is taxable to the vendor as ordinary income since the gain did not arise from a "sale or exchange."⁹⁹

It would apparently follow that the loss to a defaulting purchaser should be deductible as an ordinary loss where the transaction arose in the operation of a trade or business or was entered into for profit. But in a recent case the Tax Court refused to adopt this view.¹⁰⁰ There the taxpayer entered into a contract to purchase a lot which required a down payment of \$2,000. It was provided that in the event of the purchaser's default on the date set for closing, the vendor could elect between a forfeiture of the down payment and a suit for specific performance. The purchaser defaulted and the vendor, by letter, threatened to institute a suit for specific performance. But an action did not materialize and the taxpayer deducted his forfeited down payment as an ordinary loss. The Tax Court sustained the Commissioner in limiting the deduction to a short-term capital loss. The court reasoned that the taxpayer had acquired an equitable interest in the property under a binding contract. If this interest was transferred to the vendor in consideration of a termination of his obligation under the contract, there was a sale or exchange. In the instant case, it was concluded that the taxpayer's evidence had not negated the existence of a subsequent agreement by which he relinquished his interest in the property to the vendor. As authority for its position the court erroneously relied on cases where the vendee in possession under a closed contract of sale transferred the property to the vendor in satisfaction of the unpaid balance of the purchase price.¹⁰¹ Those decisions are sound in treating the vendee's loss in the particular circumstances as one arising from a "sale or exchange." There had been an original closed transaction (sale) in those cases. But where a forfeiture occurs in a transaction which does not constitute a "sale or exchange" by the vendor, it is difficult to justify a conclusion that, nevertheless, a "sale or exchange" has been consummated by the purchaser. At

99. *United States v. National City Bank of New York*, 21 Fed. Supp. 791 (S. D. N. Y. 1937).

100. *Fred A. Bihlmaier*, 17 T. C. 620 (1951).

101. *C. L. Gransden & Co.*, 39 B. T. A. 985 (1939), *aff'd*, 117 F. 2d 80 (6th Cir. 1941); *Harold R. Smith*, 39 B. T. A. 892 (1939); *Betty Rogers*, 37 B. T. A. 897 (1938), *aff'd*, 103 F. 2d 790 (9th Cir. 1939).

no time, in the established tax sense of the term, is there a sale (closed transaction) by the vendor to the vendee. Consequently, the purchaser's forfeited payment should be classified as ordinary income to the vendor and as an ordinary loss to the vendee.