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MINIMIZING TAX CONSEQUENCES OF DEFERRED PAYMENT SALES OF REAL PROPERTY SOLD ON CONTRACT BY CASH-BASIS TAXPAYERS

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For various reasons it is commonplace to sell interests in real estate by using some form of land sale contract whereby the seller retains legal title to the property until all or most of the selling price has been paid and the buyer goes into possession promising to make stipulated payments over a period of time. These contracts are denominated by various names such as "land contract," "contract of sale," "receipt and option," "lease and option to purchase," etc., but the general intention of the parties is to consummate a sale of the property.

When a taxpayer contemplates a sale of real property to be effected by such a contract and a large taxable gain is involved, he is usually concerned with the following questions:

(1) How much will be the over-all tax on the sale?

(2) When and in what amounts will the tax payments have to be made?

(3) Who is entitled to the depreciation deduction?

(4) What will be the tax consequences in the event of default by the purchaser?

The scope of this article deals with sales of real property involving deferred payment contracts by cash-basis taxpayers only; it would seem (although there is some conflict in the decisions) that accrual-basis taxpayers would have to report the entire gain in the year of the transaction unless the total sales price is contingent or unknown, or the installment method of reporting gain is available under the circumstances.

HOW MUCH WILL BE THE OVER-ALL TAX ON THE SALE, AND WHEN AND IN WHAT AMOUNTS WILL THE TAX PAYMENTS HAVE TO BE MADE?

The answer to these questions will depend on whether the gain is reported as a deferred payment sale or as an installment sale under Section 453 of the Internal Revenue Code of 1954. In many instances the use of the installment method will result in a lesser over-all tax by reporting the gain proportionately over the years as the payments are received instead of reporting the entire gain in the year of transaction. This is so because the lower percentages of the graduated tax rates are applied to only a fraction of the gain on the sale each year instead of the higher percentage rates that would apply if the entire gain was reported in the year of the transaction. However, the installment method of reporting gain is only available if the initial payments received in the taxable year of the transaction do not exceed 30 per cent of the selling price.

In this article, we wish to deal with the problem of a cash-basis taxpayer who has made a deferred payment sale to which the installment sale provisions of the Code are not applicable or for some reason he has not elected to so report the sale on his tax return.

A specific illustration will show the tax consequences of a sale of real estate using a deferred payment contract for which the installment method of reporting gain is not available and yet similar tax savings are possible for a cash-basis taxpayer.

John Brown, a farmer, wishes to sell a tract of land and farm buildings thereon for a price of $50,000. His adjusted basis for the property is $25,000 and he has owned the property for a number of years. Tom Smith, the buyer, is willing to pay the $50,000 for the property but is not certain of his future success as a farmer and feels that $50,000 is a somewhat inflated price. However, he is anxious to have the property and is willing to risk a $16,000 down payment and some hard work. Brown and Smith execute a contract whereby title to the property is to remain in the seller until the entire purchase price is paid, and the buyer is to get immediate possession, pay $16,000 down and $3,400 annually thereafter for 10 years plus interest. The contract merely requires future payments and *no* notes, mortgages or other evidence of indebtedness such as commonly change hands in commerce are given as a part of the purchase price. If Smith defaults on his payments, he forfeits his interest in the property but is not personally obligated for any un-

paid balance on the contract. Since Brown received a down payment in excess of 30 per cent of the selling price, the installment method of reporting the gain of $25,000 is not available. However, if the current position of the United States Tax Court is followed in subsequent cases, Brown can use a cost-recovery method and report no gain on the sale until the down-payment plus annual payments exceed his cost basis of $25,000. After recovering his cost, Brown will report the remaining installments as gain annually as he receives them. Thus, there would be no tax on the money received in the year of the sale and for 2 years thereafter, $1,200 of the $3,400 payment in the third year would be subject to tax, and all of the remaining payments of $3,400 each would be reportable as gain annually when received. Since these latter annual payments would be afforded favorable capital gains treatment and would be taxed over a period of years, much the same advantages are gained by this method of reporting gain as are available under the installment method.

In analyzing this problem, the following sections of the Internal Revenue Code of 1954 and supporting regulations are applicable:

Sec. 451 (a) "General Rule—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period."

Sec. 1001 "Determination of Amount of and Recognition of Gain or Loss.

"(a) Computation of Gain or Loss—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

"(b) Amount Realized—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

Regulations 118, Sec. 39.44-4 "Deferred-payment sale of real property not on installment plan:

"(a) . . . the obligations of the purchaser received by the vendor to be considered as the equivalent of cash to the amount of their fair market value in ascertaining the profit or loss from the transaction.

"(c) If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold, and, if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount being the difference between the reduced basis as provided above and the amount realized therefor. Only in rare and extraordinary cases does property have no fair market value."

In construing the language of the above sections and regulations

the courts have developed a doctrine applicable to cash-basis taxpayers selling property under deferred payment contracts that is not entirely in accord with the Commissioner's views.

Recent decisions continue to be influenced by Judge Learned Hand's opinion in *Bedell v. Commissioner*[1] written in 1929. The question resolved in that case was the year in which income was realized. Taxpayer sought to include income in the year of entering into the contract which was 1919, whereas the Commissioner determined that income was realized in 1920, because performance was uncertain and the closing date of the agreement was February 29, 1920. The Commissioner was upheld by United States Board of Tax Appeals which was affirmed in Judge Learned Hand's opinion in which he said, "To speak of the profit as resulting because its amount can be presently ascertained, though performance remains uncertain, seems to us a perversion of language." Later in the opinion Judge Hand said, "But if land or a chattel is sold, and title passes merely upon a promise to pay money at some future date, to speak of the promise as property exchanged for the title appears to us a strained use of language, when calculating profits under the income tax. Section 202 (b) of the Act of 1918 provided for an exchange of property and made the profit depend upon "the amount of its (the property received) fair market value, if any"—a phrase which was amended in the law of 1921 (42 Stat. 227) to "readily realizeable market value." There is a difference between the two, but it is absurd to speak of a promise to pay a sum in the future as having a "market value," fair or unfair. Such rights are sold, if at all, only by seeking out a purchaser and haggling with him on the basis of the particular transaction. Even if we could treat the case as an exchange of property, the profit would be realized only when the promise was performed."

A leading decision on the question was promulgated by the Tax Court, April 5, 1950, in the case of *Johnston v. Commissioner*.[2]

In this case a stockholder who employed the cash receipts method of reporting income joined with other stockholders on December 28, 1942, to sell all of the stock of a corporation. Purchasers deposited one-half of the estimated price of the stock with an escrow agent. Balance of the purchase price was to be paid in 1943, after certain events in 1943 determined the total purchase price by a method prescribed in the contract. It was expressly provided that

1. 30 F. 2nd 622 (2nd Cir., 1929).
2. 14 TC 560 (1950).

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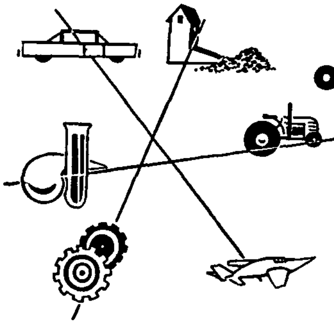
purchasers were not obligated to purchase any of the stock unless all shares were sold to the purchasers in accordance with the contract. Petitioners here owned 5,588 shares out of a total of 224,806. Petitioners sought to report their share of funds deposited with escrow agent as realized in 1942, and the balance as realized in 1943. The Commissioner determined that none of the gain was realized in 1942, but all of the gain was realized in 1943, since petitioners' share of the cash in escrow was not actually or constructively received by him in 1942, and the contract itself was not "property (other than money)" or part of an "amount realized" in 1942, within the meaning of Section 111 (b). The Court said "the petitioner is on a cash basis and to realize gain must receive during the taxable year *cash or its equivalent in excess of his basis* before he can have any taxable gain." (Emphasis added) . . . the cash was not unqualified subject to the demand of the sellers in 1942 and, therefore, was under no circumstances income in 1942 to the petitioner on the cash basis. The Commissioner would not hold a taxpayer to constructive receipt of income under such circumstances, Regulations 111, Sec. 29.44-2, and the reverse is also true. Furthermore, even if petitioner were right about his share of the cash, that alone would do him no good, since his share of the $214,913.90 was less than his basis for gain on his stock and he, on a cash basis, realized no gain until the "amount realized" by receipt exceeds that basis. In conformity with this case, it seems clear that a cash basis taxpayer who receives a deposit of over thirty per cent on a contract of sale, when



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such deposit does not exceed the taxpayer's basis of the property being sold, has no income to report, until the installment or deferred payments received exceed his basis of the property which is the subject of the contract.

Further decisions in the Tax Court involving this question were promulgated, in 1951, in the *Nina J. Ennis* case[3] and in 1955 in the *Clarence W. Ennis* case.[4] Facts in these two cases were the same. Nina J. Ennis and Clarence W. Ennis were cash basis taxpayers who sold real estate known as the Deer Head Inn in 1945 for a down payment of $8,000, and a contractual obligation for monthly payments over a period of years for the balance of the selling price, the total price being $70,000. Sellers kept title to the property, and agreed to deliver good and sufficient abstract and Warranty Deed and a Bill of Sale, upon full performance by purchaser. The only security of seller was a right to declare a forfeiture of purchaser, of all amounts paid, in the event that purchaser did not keep up with payments as provided in the contract. Purchaser received immediate possession of the premises upon entering the agreement, but was to relinquish possssion in event of default.

In the *Nina J. Ennis* case there was apparently no evidence introduced to show that such real estate contracts were marketable in Michigan. The Court held that section 111(a) of the Internal Revenue Code provides that "amount realized" shall be "any money received plus the fair market value of the property, (other than money) received." "This contractual obligation cannot be considered as "amount realized" unless equivalent to cash . . . To be equivalent of cash, the requirement has always been that the obligation, like money, be *freely and readily negotiable* (emphasis added) so that it readily passes from hand to hand in commerce." The Court held that the only "amount realized" by Nina J. Ennis was cash received as down payment and monthly installments.

The *Clarence W. Ennis* case involved the estate of the deceased husband of Nina J. Ennis. Facts were here stipulated by the parties that land contracts such as the one herein involved, were commonly used in the State of Michigan in virtually every land transaction in which deferred payments are involved and had been so used for over fifty years, and that such contracts are regularly sold, traded and assigned in the State, and numerous persons are engaged in buying and selling them. Respondent here contended that the contract had a fair market value in 1945 of 75% of its fair value and since it was of a type which was freely assignable, bought and sold, it should be included in 1945 as amount realized to the extent of 75% of its face value. A prominent realtor who had been engaged in real estate business for many years and who was also a director of two banks in Lansing testified that he frequently bought and sold such contracts, but that he had never known a contract as large as this one to be sold. He further indicated that this contract might have been salable in 1945 if it were discounted as much as 50%. It was his opinion that this contract was not a salable contract, and he esti-

3 17 TC 465 (1951).
4 23 TC 799 (1955).

mated the value of the property without a liquor license to be not in excess of $20,000. The court held in this case that "even though this contract was of a type which was regularly assigned in Michigan and passed from hand to hand in commerce, we are satisfied, on the whole record, and have so found as a fact, that this particular contract had no ascertainable fair market value in 1945." The court concluded that the only amount realized by decedent in 1945 on sale of the property was the amount of actual cash received in that year.

In the case of *Hurlburt v. Comm.*[5] filed March 21, 1956, taxpayers sold on "receipt and option" forms three tracts of farm lands in 1947. Each of these forms provided for a down payment upon signing of the forms by both vendor and vendee. It was further provided that installment payments be made on these "receipt and opinions" for periods ranging from 10 years to 18 years. Two of the agreements provided that one copy of the contract together with abstract of title and warranty deed would be deposited with Citizens National Bank, Akron, Colorado, and held until payments had been made as agreed. The other form did not contain this provision, but it was deposited in the same bank with abstract and warranty deed. Purchasers all took immediate possession and there were no defaults in payment. The only security of sellers were the receipt and option forms and a provision that buyers would in each case forfeit payments made if purchaser defaulted in payments provided for by the receipt and option. Taxpayer reported no gain in 1947. Commissioner assessed a deficiency and included as "amounts realized" the face value of unpaid installments in 1947, supporting his contention that the "receipts and options" had a fair market value in 1947 with the fact stipulated that the unpaid balances of these sales were included in the Colorado Inheritance Tax return of deceased husband as part of his estate as of date of death on October 22, 1948. The Court said, "That evidence is without significance in determining whether the contracts had possessed a fair market value in the hands of a cash basis taxpayer. Admittedly the contract rights were assets in the deceased vendor's estate. As such, they should be valued as of the date of death and this would be true even though they were not the type of asset as would be includible in the income

[5] CCH Dec. 21, 637.

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of a cash basis taxpayer." The court also said, "When the contract merely requires future payments and no notes, mortgages, or other evidences of indebtedness such as commonly change hands in commerce, which would be recognized as the equivalent of cash to some extent, are given and accepted as a part of the purchase price—it creates accounts payable by purchasers and accounts receivable by the sellers which those two taxpayers would accrue if using an accrual method.—But such an agreement to pay the balance of the purchase price in the future has no tax significance to either purchaser or seller if he is using a cash system."

The decision in *Haimovitz v. Commissioner*[6] was promulgated on January 20, 1956. The Court there found "Agreement for Deed" and "Lease with Option to Purchase" forms both were" freely and easily negotiable and readily passed from hand to hand in commerce." Therefore, the value of these documents was includible in the year of sale as "amount realized." In this case petitioner had dealt extensively in real estate and frequently used one of the forms indicated above. There was uncontradicted and affirmative testimony that such instruments were readily transferable, and in ordinary course of commercial dealings these instruments were freely dealt in at a discount of 10%. Therefore, the fair market value of 90% should have been included as amount realized in the year of sale. The Tax Court distinguished this case from the *Ennis* cases in that the Ennis contract was not "freely and easily negotiable so that it readily passes from hand to hand in commerce."

In the case of *Wood v. Commissioner*[7], which was filed December 14, 1955, the question of profit realized on collection of deferred payment contracts purchased was involved. Petitioner purchased deferred land contracts at discount; he later collected installments and reported the discount gain as long term capital gain on the theory of sale of a capital asset. None of the profits resulted from sale of contracts. It was held that collection of installments was not a "sale or exchange" and therefore the gain was not a capital gain.

The net result of these cases appears to be that a cash basis taxpayer can recover his cost before reporting gain where the prop-

6 T. C. Memo 1956-15; CCH Dec. 21, 529(M).
7 25 TC........., CCH Dec. 21, 377 (1956).

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erty is exchanged for a cash down payment and a contractual promise to pay the balance in installments, where the contractual promise is embodied in an instrument that is not freely and readily negotiable so that it readily passes from hand to hand in commerce. This seems to be true even if the promisor has adequate financial resources and there seems to be no question as to ultimate payment of the contract, if there is no readily realized market for the contract. This result appears to be entirely in accord with the concept of permitting taxpayers to elect to report their income on a cash-basis method of accounting under which no consideration is given to amounts earned until they are actually received.

Income is not reportable until *received* under the cash-basis method of accounting, and a taxpayer does not realize income unless he recovers an amount over and above the cost of the property sold. Thus *income* to a cash-basis taxpayer would not be *received* until after the recovery of his cost.

Any other conclusion would require the taxpayer to speculate as to the value of the contract and report as present income money he hopes to receive in the future, a concept in direct conflict with the principles of cash-basis accounting. It seems to the writers that the Tax Court has adopted a sound and practical view and one that is fair to both the taxpayer and the government.

WHO IS ENTITLED TO THE DEPRECIATION DEDUCTION?

An additional question where the purchaser goes into possession of the property but title remains in the seller by the terms of the sales contract is which party is entitled to deduct depreciation on buildings and improvements on the property that are used for business or income-producing purposes. Since the economic loss through depreciation falls on the purchaser, he is the one entitled to depreciate the property; an equitable interest is sufficient to entitle a person to the statutory deduction. *Helvering v. Lazarus & Co.*, 308 U. S. 252 (1939). An Internal Revenue Service ruling, I.T. 2275, V-1 C B 62, provides in substance that the vendee of real estate under a forfeitable executory contract of purchase is entitled to depreciation from the time possession and the burdens of ownership are transferred to him, or when the deed passes, whichever occurs first. But no depreciation is allowed the vendee prior to the transfer

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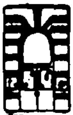

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of possessions and the burdens of ownership. S.M. 1723, III-1 C B 163.

WHAT WILL BE THE TAX CONSEQUENCES IN THE EVENT OF DEFAULT BY THE PURCHASER?

The final consideration when making a deferred payment sale under an executory sales contract is the tax consequences of a default by purchaser and a repossession of the property by the seller. Regulations 118, Sec. 39-44-4 (b) set forth the measures of gain or loss when the vendor has retained title to the property as follows: ". . . . The difference between (1) the entire amount of the payments actually received on the contract and retained by the vendor plus the fair market value at the time of repossession of fixed improvements placed on the property by the purchaser and (2) the sum of the profits previously returned as income in connection therewith and an amount representing what would have been a proper adjustment for exhaustion, wear and tear, obsolescense, amortization, and depletion of the property during the period the property was in the hands of the purchaser had the sale not been made will constitute gain or loss, as the case may be, to the vendor for the year in which the property is repossessed." This regulation was approved and followed in the case of *Joseph Frost*[8] in 1938.

Alluding to the previous illustration of the sale of the farm from John Brown to Tom Smith, assume that Smith decided after having made the second payment of $3,400 that he couldn't successfully operate the farm or continue the payments so he notified Brown he was not going to make further payments on the contract and that Brown could retake possession of the property. Assume further that Smith had made improvements to the farm of the value of $2,000 as of the date of repossession and that Brown would have been entitled to deduct $1,000 depreciation during the period had the sale not been made to Smith. The gain on repossession would be determined as follows:

Payments received on the contract		
Down payment		$16,000
Installment payments (2 at $3,400)		6,800
Fair value of improvements placed on the property by Smith		2,000
Total		$24,800
Less:		
Profits previously returned as income	Nil	
Depreciation allowable had the sale not been made	$1,000	1,000
Gain on repossession		$23,800

A word of warning should be interjected here as to the character of this gain on repossession, i.e. whether this gain is to be treated as capital gain or ordinary income. The regulations use the term "gain or loss" implying that capital gain or loss treatment is

[8] 37 BTA 190 (1938).

to be afforded items of this nature. The reasoning behind this language in the regulations could logically be that the purchaser's equitable interest is given up "in exchange" for a release from further obligation to the seller under the contract therefore subjecting the transaction to capital gain and loss limitations. The contract obligation in the hands of the seller is a capital asset and he acquires the equitable interest of the purchaser in exchange therefor. However, the regulations also provide that where title has previously been transferred to the purchaser under a deferred payment sale of real estate and the purchaser defaults in his payment and the seller accepts a voluntary reconveyance of the property in part or full satisfaction of the unpaid balance of the contract, any excess of the fair market value of the property over the unpaid balance of the contract is ordinary income, not capital gain. The difference in the treatment by the regulations of the gain on repossession when legal title has passed and when title has not passed to the purchaser has been criticized by the courts and textwriters and it is doubtful that the treatment afforded by the regulations can be considered settled. The gain or loss realized is in fact the same.

The basis of the property to Brown, after repossession, will be his adjusted basis at the time of the original sale of $25,000 plus the value of improvements made by Smith of $2,000 minus depreciation allowable had the sale not been made of $1,000 or a new basis of $26,000. The regulations do not specifically provide for the depreciation adjustment in the above computation, but it would seem that it could not properly be omitted.

CONCLUSION

The use of the cost-recovery method by cash-basis taxpayers selling property on contract as sanctioned by the courts is in conflict with the Commissioner's position stated in the regulations that "Only in rare and extraordinary cases does property have no fair market value."[9] The issue seems to have resolved itself into a question of fact as to when is the contract of sale on the deferred payment plan "freely and readily negotiable so that it readily passes from hand to hand in commerce." If the contract is not freely and readily negotiable the courts will permit a cash-basis taxpayer to recover his cost before reporting any gain on the sale.

9 Section 39.44-4 of Regulations 118.

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