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TAX CONSEQUENCES TO A MORTGAGEE OF REPOSSESSING REAL PROPERTY: A LOOK BACK AND A LOOK FORWARD

HERBERT L. LEVY *

WHEN an owner of real property sells the property, he can be paid the purchase price in cash, cash and other property, or part cash and/or other property and notes of the buyer. If part of the payment is in notes of the buyer, not only may the seller hold the buyer personally liable for the purchase price, but he may also either retain title to the property until full payment is made, or take a purchase money mortgage in which case the property becomes security for the debt. If the buyer does not pay all the notes and the property is security for the debt, the seller can foreclose or accept a voluntary reconveyance of the property. This article will examine the tax consequences to the seller of a foreclosure or an acceptance of a voluntary reconveyance.

The article is separated into two parts: pre-section 1038 and section 1038. Such a division is necessitated by the complexity of the law existing prior to the enactment of section 1038 in 1964. Although section 1038 must be followed today, the pre-section 1038 rules can still present problems to a mortgagee who repossessed real property prior to the enactment of section 1038. These problems involving pre-section 1038 law arise if the Commissioner

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1 Section 1038 was added to the Internal Revenue Code of 1954 by Pub. L. No. 88-570, § 2(a) (1964). It is effective for all taxable years beginning after September 2, 1964.

2 The pre-section 1038 rules only present problems to the taxpayer if he has not made an election to have § 1038 apply to repossessions in any taxable years beginning after December 31, 1957. The election was permitted under 78 Stat. 856 (1964), and had to be made within one year after September 2, 1964. See also Treas. Reg. § 1.1038-3 (1967).
can assess a deficiency with respect to the mortgagee's treatment of the repossession because: (1) the six year statute of limitations applies;\(^3\) (2) an extension of the statute of limitations was filed;\(^4\) (3) the statute of limitations has never run because of fraud by the taxpayer;\(^5\) or (4) an adjustment can be made under section 1311. Thus, to a limited extent, one must still be aware of the pre-section 1038 rules.

A second reason for presenting the pre-section 1038 rules is that to appreciate what section 1038 does, it is best to see what it was like without it. When viewed from this perspective it is very interesting to note that it took Congress until 1964 to make a change in the law. Prior to that time all changes were made by the courts, and almost always they were followed by the Treasury with amendments to the regulations.

**PRE-SECTION 1038**

Prior to the enactment of section 1038, whether gain or loss would be recognized on the repossession of real property depended upon how the mortgagee had treated the gain realized from the sale of the property to the vendee-mortgagor. The vendor could report the gain using any one of three methods:

1. the installment method,\(^6\)
2. the deferred payment method,\(^7\) or
3. the accrual method of accounting.

In each of the three subdivisions which make up this part of the article, first the tax consequences of the sale of the property will be briefly stated, and second the tax consequences of the repossession will be discussed.

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1. INSTALLMENT METHOD

The problem presented is best illustrated by a simple fact situation:

S sells land and a building to B. The contract price is $400, payable as follows: $100 at the closing which takes place on January 1, 1960, and thirty negotiable notes of B, each having a face value of $10 and payable in thirty annual installments starting January 1, 1961, the property being security for the notes. All the notes provide for annual interest payable at the rate of five percent. S held the building as a capital asset. The adjusted basis of the land and building, as an aggregate figure, is $200. The building has been depreciated using the straight line method of depreciation and was held for more than one year before being sold by S. S is on the cash basis method of accounting.

In the situation presented S can elect to report the gain on the sale using the installment method because the payments in the year of sale do not exceed thirty percent of the selling price.\(^8\)

\(^8\) By having a provision in the notes for at least four percent simple interest § 483 will apply and thus the problem is not complicated. For a brief discussion on the problems presented by § 483 when adequate interest is not provided for in the notes, see note 10 infra.

\(^9\) Straight line depreciation is used in the hypothetical situation and thus § 1250 will not operate and turn a part of the capital gain into ordinary income.

\(^{10}\) INT. REV. CODE of 1954, § 453(b) (2)(A)(ii). Determining the selling price is complicated in two situations: (1) where the property sold is mortgaged property and the buyer either assumes or takes subject to the mortgage; and (2) where adequate interest has not been provided for in the notes.

Where the property sold is mortgaged property, the amount of the mortgage is part of the selling price for the purpose of determining whether the sale qualifies for the installment method of reporting the gain. If the test of § 453(b) (2)(A) is met so that the installment method can be used, the mortgage is only a part of the contract price (the contract price is the denominator of the inclusion percentage; the realized gain is the numerator) to the extent that it exceeds the basis of the property. Treas. Reg. § 1.453-4(c) (1958).

Where the property sold is a capital asset or a § 1231 asset, if at least four percent simple interest is not provided for in the notes, then § 483 provides that part of each payment is interest and not purchase price. Thus, § 483 reduces both the selling price, which is the denominator in the fraction used to see whether § 453 can be applied, and the contract price, which is the denominator in the inclusion percent formula under § 453. By having the denominator reduced in the § 453(b) (2)(A) formula, the
As S's amount realized is $400 and his adjusted basis $200, he has a realized gain of $200. The contract price is $400. The realized gain over the contract price is the inclusion percent. Therefore, one half or fifty percent of each payment made by B is profit and income to S in the year the payment is received. That portion (fifty percent) of each payment made by B which will be includible in S's income is treated by S as long term capital gains.

At the end of the twenty-fifth year B cannot meet the twenty-fifth note and no further payments are made. S either forecloses or accepts a voluntary reconveyance of the property at which time the fair market value of the property is $100. S takes the property in full satisfaction of the outstanding notes of B. S's gain or loss is the difference between the fair market value of the property and the basis of B's obligations. The basis of an obligation is the face value minus that portion of the obligation which would be included in income under section 453(b) if the obligation were paid. In this case the basis of the obligations which are unsatisfied is $50 face value (5 notes times $10 per note) minus $25 (50 percent of each of the five notes unsatisfied) or $25. The gain on the repossession is $75 ($100 minus $25).

An interesting and somewhat puzzling result occurs if the fair market value of the property repossessed is less than the basis of the unpaid obligations. Assuming that the fair market value of the property repossessed is $5 and thirty percent test may not be met. If it is met, by having the denominator reduced in the inclusion percentage formula, the inclusion percentage will be greater, thus making a greater part of each payment includible in gross income.

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14 Section 453(d)(1)(A) uses the term "amount realized" as part of the formula for determining gain or loss. Section 1.453-5(b) of the regulations in the same formula, uses the term "fair market value." There is no conflict between the two terms and for all purposes, they have the identical meaning. The only problem that arises is what is the fair market value. The regulations provide no help except to say that if the property is acquired in a foreclosure, the bid price is presumed to be the fair market value. In T. Eugene Piper, 45 B.T.A. 280 (1941), the taxpayer foreclosed and at the foreclosure sale, he purchased the property. The court
the basis of the unsatisfied notes is $25, the repossession can be reported in either of two ways. First, the seller can treat the repossession as a satisfaction of only one of the five notes. The other four notes can be deducted as a bad debt if the seller can establish that the four notes are uncollectible. The deduction would be the basis of the four notes that are uncollectible, the basis being the face value, $40, minus that portion which would have been income to S, $20, if it had been paid. No gain or loss would be recognized with respect to the satisfaction of the one note because the fair market value of the property is equal to the basis of the obligation satisfied. Second, the seller can treat the repossession as a satisfaction of all the notes. In this case there would be a $20 loss on the repossession, the difference between the $5 fair market value of the property and the $25 basis of the obligations satisfied. In all cases the basis of the repossessed property is the fair market value of the property. There are no cases or rulings requiring the taxpayer to use one method instead of the other. The regulations under sections 166 and 453 permit either method so the taxpayer can choose the method which is better for him. If he chooses to take a loss, the loss is a capital loss if the asset sold was a capital asset. Thus the deductibility of the loss is limited by section 1211(b). If he chooses to take the bad debt deduction, the item is fully deductible if the bad debt is a business bad debt. If the bad debt is a non-business bad

held that the part of the bid price which was for the unpaid interest is not part of the bid price for purposes of determining fair market value. Accord, Hadley Falls Trust Co. v. United States, 110 F.2d 887 (1st Cir. 1940). However, according to Helvering v. Midland Mutual Life Ins. Co., 300 U.S. 216 (1937), the amount of the bid price which represents the unpaid interest is considered interest income to the taxpayer. For a further discussion of the interest problem, see note 47 infra. In all probability what usually happens when the fair market value of the property received is in dispute is that a settlement is reached before the case goes to court.


17 Id.

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debt, it is fully deductible but only if the taxpayer itemizes his deductions. 9

This method for determining gain or loss on the repossession of real property, when the gain on the sale was reported on the installment method, has had an interesting evolution. It is important to devote some time to it because it is relevant in considering and understanding section 1038. The original method for determining the gain or loss on a repossession treated the sale as never having occurred. Thus, the entire amount of cash and property received, except the buyer's notes, minus (1) that portion of the cash and property received which was reported as income under the installment method, and (2) an amount which would equal the depreciation, depletion or amortization of the property during the time that the property was held by the buyer was the amount of the gain or loss on the repossession. 20

In Jacob Dickinson, Jr., 21 the court refused to follow this formula. The court reasoned that since the seller transferred title to the buyer on the sale of the property, when the original seller re-purchased the property at a foreclosure sale, the purchase was a separate transaction which gave rise to gain or loss without looking to the original sale. The court applied a method which gave the taxpayer the identical result as the rule found in the regulations under section 453 today, 22 but which no longer applies where section 1038 is applicable.

In an effort to avoid the Dickinson 23 decision, the Treasury 24 established two separate formulas depending upon whether or not the seller transferred title of the property to the buyer at the time of the sale. If he did not transfer title, the Treasury refused to follow Jacob Dickinson, Jr.; thus the seller had to treat the repossession as though a sale never took place. If the seller did transfer title, the rule of the Dickinson case prevailed, that is, the

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9 INT. REV. CODE of 1954, § 63(a).
20 Revenue Act of 1928, Article 353 of Regulations 74.
21 18 B.T.A. 790 (1930).
22 Note 15 supra.
23 Jacob Dickinson, Jr., 18 B.T.A. 790 (1930).
24 T.D. 4360, XII-1 CUM. BULL. 116 (1932).
repossession was considered a purchase by the original seller. This amendment in the case where title was not transferred was declared invalid and contrary to the predecessor of section 453(d)(1)\textsuperscript{25} by the court in \textit{Boca Ratone Co. v. Commissioner}.\textsuperscript{28} The court said a satisfaction of the installment notes took place on a repossession—a satisfaction within the meaning of section 44(d).\textsuperscript{27} The court said the regulations had a rule which was contrary to the statute because the statute made no distinction between retaining or transferring title. Many cases followed this holding\textsuperscript{29} and in 1938 the Treasury changed its position and established the same formula for cases in which title was retained by the seller and those in which title was transferred to the buyer.\textsuperscript{29} Since 1938, the regulations have remained substantially unchanged until the enactment of section 1038.\textsuperscript{30}

When gain or loss does occur on the repossession, the character of the gain or loss—capital gain or ordinary income—depends upon the character of the gain which resulted from the original sale.\textsuperscript{31} At one time the Com-

\textsuperscript{25}Revenue Act of 1928, § 44(d), 45 Stat. 806 (1928).
\textsuperscript{26}86 F.2d 9 (3d Cir. 1936).
\textsuperscript{27}Section 44(d) of the Revenue Act of 1928 is the predecessor of Int. Rev. Code of 1954, § 453(d)(1).
\textsuperscript{28}United States v. Eversman, 133 F.2d 261 (6th Cir. 1943); Edward Barron Estate Co. v. United States, 38 F. Supp. 1016 (N.D. Cal. 1941) (where the court held that the measure of gain is the fair market value of the property and not the amount of improvements the buyer made or the bonds the buyer paid); Lucille L. Morrison, 12 T.C. 1178 (1949) (The court rejected the taxpayer's contention that the Commissioner under § 44(d) is taking the gain on the \textit{acquisition} of property in a repossession whereas when the property is sold a tax is imposed on the profit from the disposition. The court stated that the taxpayer elected to use the installment method of reporting gain and the gain recognized is derived from satisfying the notes and not the acquiring of the property).
\textsuperscript{29}T.D. 4832, 1938-2 Cum. Bull. 155. This amendment was made retroactive to Article 351 of Regulations 74.
\textsuperscript{31}An interesting problem is presented as to when recognition of the realized gain or loss must occur. The rule is that recognition occurs in the year of repossession, but when the seller gets repossession by way of foreclosure, it has been held that recognition does not occur until the vendee-mortgagor's statutory right of redemption either expires or is relinquished by a quitclaim deed. William Albert Belcher, Jr., 24 CCH Tax Ct. Mem. 1 (1965); Abernathy, Jr. v. Patterson, 63-2 U.S. Tax Cas. 9678 (N.D. Ala. 1963); Miles Realty Co., 31 B.T.A. 443 (1934) (where the gain was not recognized for two years after the seller repossessed the property
missioner argued that the obligations themselves give rise to the gain when they are satisfied by a repossession, but his argument was rejected in Provident Trust Co. of Philadelphia.\textsuperscript{32} The holding of the court in that case became part of the statute in the Revenue Act of 1934,\textsuperscript{33} and it is part of the Code today.\textsuperscript{34} In effect, the taxpayer must go back to the original sale and, if it gave rise to a capital gain,\textsuperscript{35} the satisfaction of the notes by repossession will also give rise to a capital gain.

2. DEFERRED PAYMENT METHOD

If, instead of $100 being the cash paid, the buyer gave $150 in cash and only $250 in notes, then the threshold question is whether the installment method can be used to report the gain. The installment method can only be used if the payments received in the year of sale do not exceed thirty percent of the amount realized.\textsuperscript{36} To determine whether the thirty percent test is met, the face value of the notes is included in the amount realized; hence the seller has an amount realized of $400 ($150 cash and $250 notes). Thirty percent of the amount realized is $120 and the cash received in the year of sale exceeds it by $30; therefore, the installment method of reporting the gain cannot be used.

When the installment method cannot be used, the taxpayer must then use his normal method of accounting, i.e., cash or accrual. If he is a cash basis taxpayer the method of reporting the gain is the deferred payment method. This method uses the same rules that a cash basis taxpayer

\textsuperscript{32} 29 B.T.A. 374 (1933).
\textsuperscript{33} Revenue Act of 1934, §44(d), 48 Stat. 695 (1934).
\textsuperscript{34} INT. REV. Code of 1954, §453(d)(1).
\textsuperscript{35} Briefly, to have a capital gain there must be: (1) a sale or exchange, (2) of a capital asset within the meaning of section 1221 and section 1231, (3) the sale must not be an assignment of income, and (4) the asset sold must not be a "future" where the taxpayer's dealings in "futures" are an integral part of his manufacturing business. Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955).
uses for any sale of property, i.e., the taxpayer must value the obligations of the purchaser to find the cash equivalent of the obligations.\textsuperscript{37}

An interesting problem arises in trying to value the obligations. The notes could be negotiable and either have some cash equivalent or be worthless; or the notes could be non-negotiable and either have a cash equivalent or be worthless. If the notes have a cash equivalent, the seller has income in the year of sale to the extent of the cash equivalent and any cash and/or other property received. If the cash equivalent is less than the face value of the notes, two possibilities exist when payment of any note occurs in a year subsequent to the year of sale: (1) each payment of a note is part return of capital (that is, part is allocated to the basis of the note) and the balance of the payment, if any, is ordinary income and not capital gain because no sale or exchange took place by merely paying an obligation; or (2) if the obligation has a very low cash equivalent in relation to the face value of the notes, then as each note is paid the entire payment is applied against the basis of all the notes and once the basis has been recovered, then each payment is, to the full extent of the payment, ordinary income.\textsuperscript{38}

If the obligations have no cash equivalent, this situation can be called a true deferral. The reason is that in the year of sale no income is reported and any cash or other property received is used as a recovery of the basis of the property sold. Each subsequent payment received is accorded the same treatment until the full basis has been recovered. Once this occurs, each subsequent payment is capital gain if the item sold is a capital asset because the transaction is treated as an "open transaction."\textsuperscript{39}

This problem of being able to value or not being able to value the obligations is a very difficult one. There are

\textsuperscript{37} Treas. Reg. § 1.453-6(a) (1958).
\textsuperscript{38} Wingate E. Underhill, 45 T.C. 489 (1966).
\textsuperscript{39} Burnett v. Logan, 283 U.S. 404 (1931); Wingate E. Underhill, 45 T.C. 489 (1966); Fidelity Savings & Loan Co., 44 B.T.A. 471 (1941).
no guidelines telling when a note or a contractual promise cannot be valued. Many factors must be considered. The test adopted by the Fifth Circuit in Cowden v. Commissioner is:

if a promise to pay of a solvent obligor is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable in like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation.40

Unlike the installment method, when the buyer fails to make one or more payments and the seller decides to foreclose, the tax consequences are dependent upon whether he initially transferred title to the buyer or retained the title to the property.

A. Title Transferred

When the seller has transferred the title to the buyer and there is a default in payment, the seller can reacquire the property either by a voluntary reconveyance from the buyer or by purchase at a foreclosure sale.

(1) Voluntary reconveyance

When a voluntary reconveyance takes place the fair market value of the property and the fixed improvements placed on the property by the buyer is considered the amount realized by the seller.41 If this amount exceeds the basis of the obligations satisfied, gain results; if it does not exceed the basis of the obligations, there is a loss. The basis of the obligations of the buyer held by the seller is the cash equivalent of the obligations which we determined for purposes of computing the amount realized when the seller sold the property.

Before this rule came into effect in 1942,42 the voluntary reconveyance was treated as an exchange, thus enabling

40 299 F.2d 20, 24 (5th Cir. 1961).
41 Treas. Reg. § 1.453-6(c) (1958).
the taxpayer to get capital gain or capital loss on the reconveyance. The change made in 1942, which remained in effect until superseded by section 1038, stated that the excess of the fair market value of the property over the basis of the obligations is ordinary income. An exception to this rule was made for situations where the notes of the buyer constitute securities within the meaning of section 165(g)(2)(C); here the reconveyance will give rise to capital gain. The change also stated that if the basis exceeds the fair market value of the property received, the excess may be deducted as a bad debt, unless the notes are securities as above; then the excess will be a capital loss. If the vendor should subsequently sell the property, the basis of the property is the fair market value of the property and the improvements placed on it by the prior buyer.

(2) Reacquisition in a foreclosure proceeding

When the vendor brings foreclosure and a judicial sale occurs, the vendor can bid for the property. Assuming he does, and that he purchases the property, two computations must be made to determine his tax consequences. First, the fair market value of the property repossessed minus the basis of the obligations of the purchaser applied to the bid price results in either capital gain or capital gain or capital loss. 

43 Article 46 of Regulations 69 (1926).
44 Id.
45 In Commissioner v. Spreckles, 120 F.2d 517 (9th Cir. 1941), the court allowed a taxpayer who accepted a voluntary reconveyance by the buyer to take a bad debt deduction. The statute said a bad debt deduction could be had on a foreclosure and the court said no distinction should be made between foreclosure and voluntary reconveyance. Accord, Bingham v. Commissioner, 105 F.2d 971 (2d Cir. 1939); I.T. 3548, 1924-1 Cum. Bull. 74. These cases prompted the Treasury to provide in the regulations for a bad debt deduction when property was voluntarily reconveyed.
46 Treas. Reg. § 1.453-6(c) (1958).
47 Normally when a sale is made and notes of the buyer are accepted in whole or in part, the notes will provide for interest. The interest is the means by which the buyer pays the seller for the privilege of not having to pay the purchase price at the time the contract of sale is consummated. Some notes do not provide for interest to be paid: as to those notes which were executed pursuant to a binding contract made after June 30, 1963, § 483 applies and requires that a part of each payment of the note (with certain limitations found in § 483(c)(1)) must be interest. (See § 483(f) for rules when § 483 does not apply, especially § 483(f)(3)
loss; second, if the bid price is less than the basis of the debt satisfied, the balance is deductible as a bad debt. From these two computations it is possible for a taxpayer on a foreclosure to have both capital gain and a bad debt deduction.

B. Title Not Transferred

When the vendor has sold property, but has not transferred the title to the buyer, and if there is a repossession for

which provides that § 483 will not apply unless the property sold is a capital asset.)

When either the notes provide for interest, or § 483 imputes interest, a problem occurs on foreclosure of the property which is the security for the notes. Foreclosure is usually instituted because there has been a default in payment of one or more notes and this would also normally mean a nonpayment of the interest. As seen in the text, when the bid price is less than the basis of the outstanding notes, the mortgagee will have a bad debt. If the bid price includes the unpaid interest, then the mortgagee will, along with having a bad debt, also have interest income. Helvering v. Midland Mutual Life Insurance Co., 300 U.S. 216 (1937). The situation is made considerably more complex when the fair market value of the property recovered on the foreclosure is worth less than the bid price which included the unpaid interest. Under ordinary circumstances the mortgagee would have a capital loss (I.T. 3121, 1937-2 Cum. Bull. 138). Would that loss be precluded because according to Helvering v. Midland Mutual Life Insurance Co., supra, the mortgagee has interest income? Probably not, because the court only said the interest was includible in income. The court did not consider the loss question since it was not raised. The court in Nichols v. Commissioner, 141 F.2d 870 (6th Cir. 1944), refused to follow Midland Mutual, supra, when the mortgagee would realize and recognize a capital loss on the foreclosure, and stated that, in this particular case, the interest should not be income to the mortgagee. Accord, Hadley Falls Trust Co. v. United States, 110 F.2d 887 (1st Cir. 1940).

The importance of this interest problem persists today even though § 1038 establishes a uniform rule concerning repossessions no matter how the initial sale of the property was reported. This problem persists because Treas. Reg. §1.1039-1(b)(2)(ii) (1967) states “any amounts received by the seller as interest, stated or unstated, are excluded from the computation of gain on the sale of the property and are not considered amounts of money or other property received with respect to the sale.”

Four examples of this phenomenon are as follows:

| Basis of the debt | 10 | 5 | 3 | 10 |
| Bid price | 5 | 5 | 5 | 5 |
| Amount of the bad debt deduction | 5 | 0 | 0 | 5 |
| Fair Market Value of the property repossessed | 8 | 8 | 8 | 1 |
| Obligation of the purchaser applied to the bid price | 5 | 5 | 3 | 5 |
| Capital gain or (capital loss) | 3 | 3 | 5 | (4) |

50
failure to pay (or any other reason such as breach of a covenant in the contract), the formula for determining gain or loss is different from a situation in which he transferred title. In this case, the vendor must add (1) the amount of cash and property received from the buyer, except the notes of the buyer, and (2) the value of any improvements placed on the property by the buyer; then subtract from that result (1) the amount of profit on the sale which was reported as income, plus (2) an amount representing depreciation, amortization or depletion for the period the property was held by the buyer. If the figure representing the amount received from the buyer plus the value of the improvements is larger than the figure representing the profit reported plus depreciation, amortization or depletion, the seller realizes a gain on the repossession; if not, he realizes a loss. The basis of the property repossessed is the original basis the property had at the time of the sale; however, if the repossession occurred after September 18, 1958, the basis is reduced by an amount which represents depreciation, amortization or depletion during the time the buyer had possession.

Once gain or loss is determined, is it capital gain (or loss) or ordinary income (or loss)? No clear answer exists; however, since the repossession is treated as nullifying the original sale, no sale or exchange has taken place. Without a sale or exchange there cannot be a capital gain (or loss). On the other hand, one could possibly look to the Arrowsmith doctrine and say that since the original sale gave rise to a capital gain, the repossession likewise gives rise to a capital gain.

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51 Treas. Reg. § 1.453-6(b)(1) (1958). In Joseph Frost, 37 B.T.A. 190 (1938), the taxpayer sold real property and reported the gain on the deferred payment method. The taxpayer repossessed the property and argued that the gain or loss should be determined under §44(d) of the Revenue Act of 1928 (predecessor of Int. Rev. Code of 1954, § 453(d)(1)). The court disagreed, saying that Article 354 of Regulations 74 (which was substantially the same as Treas. Reg. § 1.453-6(b)(1) (1958)) applies because the taxpayer did not use the installment method.


3. **Accrual Method**

If an accrual method taxpayer qualifies to report gain on the installment sales method but does not elect to do so, or fails to qualify for the use of that method, he must report the gain on the sale making use of the normal accrual method rules. Thus, the buyer's obligations are valued at their face in determining the amount realized, even though they might not be worth that much in the market. When a repossession does occur, whether or not the seller transferred title, the taxpayer realizes gain or loss based on the difference between the fair market value of the property repossessed and the face value of the unpaid notes.

**SECTION 1038**

In the preceding part of the article the pre-section 1038 rules were presented. Two unsatisfactory characteristics were quite evident: lack of a single rule, and some of the rules did not take cognizance of economic reality. In an installment sale, or a deferred payment sale where title was transferred, when a repossession occurred the vendor was forced to recognize a gain or loss on the theory that a taxable exchange took place, although after repossession he was in substantially the same position as before the sale took place. If the applicable rule made the vendor recognize a gain, he may have been placed in a difficult position because, though he now has the property, he may not have enough money to pay the tax generated by the repossession.

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54 Under certain circumstances, a taxpayer may not want to be an accrued basis taxpayer because distortions between income and expenses will exist. See Schlude v. Commissioner, 372 U.S. 128 (1963). However, Treas. Reg. § 1.446-1(c)(2)(i) (1957) requires any taxpayer who maintains an inventory to use the accrual method with respect to sales and purchases. (See Chester Farrara, 44 T.C. 189 (1965), where advance payments given for clothing which would be selected and delivered at a later date were held to be current income to an accrual basis taxpayer.) Section 453, if its requirements are met, is a blessing to accrual basis taxpayers because it reduces the amount of inclusion in the year of sale where the taxpayer has not been fully paid. Thus it really puts the taxpayer on a modified cash method.

55 See Table A, p. 352 infra.
Section 1038 is designed to do three things: simplify the rules concerning repossession of real property; eliminate the possibility of taking loss deductions on a repossession of real property where no real economic loss has occurred; and eliminate the necessity for, and the difficulty in, determining the fair market value of the property.

A. Prerequisites for Using Section 1038

Section 1038 will apply to a repossession of real property if two tests are met. First, the original sale of the real property has to give rise to an indebtedness to the seller which was secured by the real property sold.\(^5^5\) In effect, the seller must have a security interest in the real property. The property is considered security for the debt when the seller has the right to reacquire the title or possession or both if the buyer does not perform.\(^5^7\) It is immaterial that the seller did not transfer title of the property to the buyer so long as the buyer has a right by the contract to remain on the property during the time he performs his contractual obligations.\(^5^8\) Thus, a purchase money mortgage held by the seller is sufficient security whether or not the seller transferred title. If the sale was in the form of an installment land contract where the seller kept title until the buyer who took possession made all the payments, the security interest requirement is met because the seller has the right to reacquire possession upon the buyer's failure to meet the installment payments.\(^5^9\) If the sale was in the form of an escrow agreement where the seller delivered the deed to a third party under irrevocable instructions to deliver the deed only if the buyer pays all the notes and, if not, then to give it back to the seller, the security interest requirement is met because the seller can reacquire title to the property sold.\(^6^0\)

\(^6^0\) Id.
Second, the repossession must be in partial or full satisfaction of the indebtedness that is secured by the real property. The manner of repossessing the property is wholly immaterial so that, for example, repossession can occur by abandonment to the seller, voluntary reconveyance, or bid and purchase at a foreclosure sale.

Assume that a sale was made and a purchase money mortgage was given by the buyer so that the property sold was security for the debt. Several years later the seller decides he wants the property back but the buyer is not in default. The seller agrees that he will cancel the remaining notes and give the buyer X dollars in cash in return for a reconveyance of the property. The buyer agrees. Does this repossession come within section 1038? The first requirement is met; that is, the property is security for the debt. The second requirement is literally met because there was a full satisfaction of the indebtedness. Literally meeting the statute is not sufficient because the committee reports and the regulations indicate that a repossession must be in furtherance of the seller's security rights in the property; that is, for the purpose of protecting his security rights in the property. When the buyer is not in default the seller is not protecting his security rights by paying cash and/or other property in addition to cancelling the notes so that he can reacquire the property. Section 1038 can be used when the seller reacquires the property and the buyer is not in default if the original contract of sale has a provision permitting this reacquisition, or if the seller reacquires and only cancels the notes, that is, he does not give the buyer cash and/or other property. It is interesting to note that this latter provision was not in either the committee reports or the proposed regulations, but does appear in the final regulations.

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61 Int. Rev. Code of 1954, § 1038(a) (2).
63 Treas. Reg. § 1.1038-1(a) (3)(i) (1967); S. Rep. No. 1361, 88th Cong., 2d Sess. 8 (1964). If the seller reacquires the property and assumes or takes subject to a debt on the property which arose after he sold the property to the buyer, this amount of debt assumed or taken subject to is considered additional consideration paid by the seller.
64 Treas. Reg. § 1.1038-1(a) (3)(i) (1967).
Once the two tests have been met, section 1038 applies, notwithstanding any other provision in the Code. It is irrelevant whether the original sale gave rise to a gain or a loss; also irrelevant is the accounting method used by the seller to report the gain or loss. As a consequence of this overriding provision, the installment method under section 453, the deferred payment method in the regulations, and the accrual method can still be used to report the initial gain. However, when a repossession occurs, section 1038 will apply if its prerequisites are met. The fact that section 1038 applies can, in some instances, be very beneficial because it will remedy the economic reality problem presented under the old methods. Unfortunately, in some instances, the taxpayer may wish that the old law was still in effect because of the tax consequences generated by section 1038.

B. Determination of Gain

A realized gain results from the repossession of real property (if the prerequisite tests in subdivision A, above, are met) to the extent that (1) the cash plus the fair market value of all property (other than the buyer's obligation) received prior to the repossession exceeds (2) that part of the realized gain on the initial sale which was reported as income depending upon the accounting method the taxpayer used to report the gain. In effect the rule of section 1038 treats the original sale as never having taken place. Thus, the true economic reality of the transaction is considered by using this formula. It is interesting to note that this formula is substantially iden-
rical to the formula which the court in *Jacob Dickinson, Jr.* declared to be contrary to the installment method.

What would happen if in any year prior to the year the repossession occurred, the seller treated part or all of the buyer's notes as worthless and took a bad debt deduction? Section 1038 does not permit a loss deduction or a bad debt deduction in the year of the repossession, but here the seller took the bad debt deduction in an earlier year. By doing this he is considered as receiving on the repossession an amount equal to the amount he deducted as a bad debt. This amount is excluded from gross income only to the extent of the "recovery exclusion" with respect to such item as provided in section 111.

Therefore, on the repossession, if there were a prior bad debt deduction the seller can have ordinary income to the extent of the prior bad debt deduction. However, this generation of income by section 1038(d)(1) is not considered a part of the amount of the gain which was reported as income for purposes of the section 1038(b) formula.

If the seller receives payment of any note, he has income in the year it is received, unless the notes were so speculative that he is permitted to first recover the basis of the property sold. Should he repossess the property in the same year he received a payment, he still has income from receipt of the payment. This income also becomes part of the amount of the gain which was reported as income for the purposes of the section 1038(b) formula.

The first part of the section 1038(b) formula speaks of the "amount of money and fair market value of other property" (except the buyer's notes). Included in this part are not only direct payments made to the seller, but also any payments made by the purchaser for the benefit of the seller, such as the payment of a mortgage to which the property was subject at the time of the sale, or the pay-

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63 18 B.T.A. 750 (1930).
73 Id.
ment of any property taxes. However, any amounts which were received by the seller as interest either by an express provision in the notes requiring interest or by interest being imputed under section 483 are excluded as an amount received with respect to the sale. Thus, interest received is not part of the formula for determining the gain on the repossession. 76

The amount of the gain realized, determined under section 1038(b)(1), is limited by section 1038(b)(2). The limitation provides that the gain realized cannot exceed the selling price of the property in the original sale minus the adjusted basis of the property reduced by (1) that portion of the realized gain that was recognized by the seller under his method of accounting, and (2) the amount of money and the fair market value of other property given by the seller to the buyer (not counting the buyer’s notes) in connection with the reacquisition. 78 The gain that is realized on the repossession must be recognized, notwithstanding any other provision of the Code. 77

Section 1038, though requiring recognition of gain, does not characterize the gain recognized. 78 The character of the recognized gain is determined by the method used by the seller for reporting the gain on the initial sale. Hence, if the item was a capital asset in the hands of the seller, and the seller used the installment method for reporting the gain, the gain on the repossession gives rise to capital gains. If the original sale was reported on the deferred payment method the character of the gain is determined by the rules under the regulations. 79

76 Treas. Reg. § 1.1038-1(b) (2) (iii) (1967).
77 The selling price is the gross sales price minus any commissions, legal fees and any other expenses in connection with the sale. Int. Rev. Code of 1954, § 1038(b) (2) (1964); Treas. Reg. § 1.1038-1(c) (3) (1967). Note, however, that this limitation does not apply when as of the time of the sale, the selling price cannot be determined such as in Burnet v. Logan, 283 U.S. 404 (1931). For the rules which must be used in determining the amounts paid in connection with the reacquisition see Treas. Reg. § 1.1038-1(c) (4) (1967).
70 For the rules that determine the basis of the repossessed property see Int. Rev. Code of 1954, § 1038(c) (1964) and Treas. Reg. § 1.1038-1(g) (1967).
C. Is Section 1038 Beneficial?

Since section 1038 is mandatory, if the prerequisites for its applicability exist, will it be beneficial to the taxpayer? In most instances the answer will be yes. There are instances, however, where the taxpayer would be better off if section 1038 did not exist.

Table A (following) compares the treatment of a repossession under the installment method, the deferred payment method, and section 1038. It is quite evident that the taxpayer will prefer to have section 1038 apply whenever the fair market value of the property exceeds the gain realized on the original sale of the property, because section 1038 produces a lower gain in the year of repossession due to the limitation provision in section 1038(b)(2). The taxpayer who used the installment method has a very high gain in the year of repossession, but he also gets a high basis in comparison to the taxpayer who uses section 1038. The taxpayer using section 1038 ends up in a better tax position because he has a small gain in the year of repossession, and, though he has a low basis for resale purposes, the gain he will realize on the resale does not exceed the gain recognized by a taxpayer who was able to calculate the gain on the repossession using section 453. The taxpayer using section 1038 recognizes gain twice: once on the repossession and once on the resale.\(^8\) If the fair market value of the property on the repossession date is the same as on the date of resale, the taxpayer using section 1038 has, in two figures (the gain on the repossession and the gain on the resale), the same total gain as the taxpayer using section 453. The major difference is that if the resale does not occur in the year of the repossession, the taxpayer using section 1038 has the advantage of having the total gain taxed at lower rates; that is, the gain is taxed over a two-year period.

Section 1038 loses some of its appeal when the fair market value of the property falls below the gain realized.

\(^8\) The repossession when § 1038 is applicable is really a nullification of the original sale. Therefore, the holding period of the property later resold includes the period of time the seller held the property prior to the original sale. Treas. Reg. § 1.1038-1(g)(3) (1937).
on the original sale. The lower the fair market value, the less desirable section 1038 appears to be. This result occurs because when the fair market value is low, if section 453 is used, a loss will usually result on the repossession. If the loss is ordinary and not capital, the taxpayer gets the immediate benefit of having the loss reduce his taxable income. If section 1038 is used, the taxpayer still has a gain on the repossession, even if the fair market value is zero because fair market value is irrelevant for any of the section 1038 computations. This was purposely done in order to prevent the ever present problem under prior law of trying to determine the fair market value of a piece of property. However, even though the taxpayer using section 1038 has a recognized gain when the fair market value is very low, he gets a basis higher than the fair market value, so that when he resells he has a loss which is greater than the loss recognized by a taxpayer who is using section 453. This big loss plus the gain recognized equals the amount of loss that the taxpayer using section 453 would recognize.

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81 Taxpayers usually do not like capital losses because they are used to offset preferential capital gains. Also a capital loss if it exceeds capital gains is only deductible to the extent of taxable income or $1,000, whichever is lower. Int. Rev. Code of 1954, § 1211(b).
CONCLUSION

Section 1038 appears to be a major improvement over the prior rules because it eliminates the need for determining the fair market value of the property repossessed, it takes cognizance of the economic reality of the transaction and it does not discriminate against any particular accounting method for reporting the gain on the original sale. The only area left untouched by section 1038 is repossession of personal property where gain or loss is measured by the difference between the fair market value of the property repossessed and the basis of the obligations. By far, there are more sales and repossessions of personal property than of real property and it is probably more difficult to determine the fair market value of personal property. Section 1038 would be a blessing in this area, but before any change takes place, a study should be made of the operation of section 1038 for a period of time to make sure that it does what it was designed to do.
<table>
<thead>
<tr>
<th>Year of Repossession</th>
<th>Fair Market Value of Property Repossessed</th>
<th>Gain on Repossession Using (1) Section 453 or (2) Vol. Reconveyance Where Title Was Transferred in a Deferred Payment Sale, Fair Market Value—Basis of Obligations</th>
<th>Basis of Property Repossessed</th>
<th>Gain on Repossession Using (1) Section 1038 or (2) Deferred Payment Sale Where Title Not Transferred,* Cash and Fair Market Value of Other Property—Realized Gain Which Was Recognized</th>
<th>Section 1038 Limitation (§ 1038(b)(2)) (Selling Price—Basis)—(Realized Gain That Was Recognized—Cash—Fair Market Value of Other Property)</th>
<th>Section 1038 Recognized Gain</th>
<th>Basis of Property Repossessed Using Section 1038 (Basis of Obligations and Gain Recognized Under 1038 and Cash and Fair Market Value of Property Paid by the Seller in the Repossession)</th>
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<td>25 + 25 = 50</td>
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</table>

* Reporting gain where title was not transferred in a deferred payment sale was the same formula with the slight modification that the seller is entitled to a depreciation deduction for the period of time the property was held by the buyer.

SELLING PRICE $400 ($100 cash; $300 notes)

BASIS OF PROPERTY SOLD $200