***Hilpert v. Commissioner, 4 T.C. 583 (1945)***

When property is sold subject to a mortgage, even if the mortgage's validity was previously disputed and later affirmed by a court, the amount of the mortgage must be included in the total consideration received for the purpose of calculating capital gain.

**Summary**

The Hilperts sold property in 1940 after successfully litigating in state court to have a prior deed declared a mortgage. The Tax Court addressed how to calculate the gain from this sale for federal income tax purposes. The court held that the sale price included both the cash received by the Hilperts and the amount of the mortgage lien discharged by the buyer. The court reasoned that the state court's determination that the original transaction was a mortgage was binding for tax purposes, and the discharge of the mortgage was part of the consideration received by the Hilperts. Additionally, the net rentals credited against the mortgage were considered ordinary income.

**Facts**

In 1931, the Hilperts executed a deed for their property to Frank Markell for $65,000, simultaneously receiving an option to reacquire it for $86,000. They reported a profit on the sale for the 1931 tax year. Failing to exercise the option, the Hilperts sued in 1937 to have the deed declared a mortgage. In 1939, the Florida Supreme Court ruled in their favor, determining the transaction was a loan secured by a mortgage. In January 1940, the Hilperts sold the property to Lawrence and Lena Lawton, with the buyers paying off the mortgage ($54,364.67 to Markell's grantees) and the Hilperts receiving $17,067.67. The adjusted value of the property as of March 1, 1913, was $15,668.25.

**Procedural History**

The Commissioner of Internal Revenue assessed deficiencies against the Hilperts for the 1940 tax year, treating the net rentals credited against the mortgage as ordinary income and calculating the gain from the sale of the property based on a sale price that included the mortgage amount. The Hilperts petitioned the Tax Court for a redetermination of these deficiencies.

**Issue(s)**

1. Whether the amount of the mortgage, discharged by the buyer, should be included in the total consideration received by the Hilperts when calculating the capital gain from the sale of the property.
2. Whether the net rentals credited against the mortgage should be treated as ordinary income to the Hilperts.

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## Holding

1. Yes, because the state court's decree established that the transaction was a mortgage from its inception, and the discharge of the mortgage by the buyer was a necessary component of the cost of acquiring clear title to the property from the Hilperts.
2. Yes, because the net rentals represent postponed or delayed income from the rental of the property, and are therefore taxable as ordinary income when received.

## Court's Reasoning

The court relied on the Florida Supreme Court's determination that the 1931 transaction was a mortgage, which is binding for tax purposes per *Blair v. Commissioner*, 300 U.S. 5. The court reasoned that when the Hilperts sold the property in 1940, they were acting as any vendor selling property subject to a mortgage. The sale price must include the amount of the mortgage because its discharge was necessary for the buyers to obtain clear title. The court cited *Fulton Gold Corporation, 31 B.T.A. 519*, emphasizing that the payment made to discharge the lien was part of the cost of the property to the purchasers. The court stated, "It is the property which is sold, not the unencumbered fragment alone." Regarding the net rentals, the court cited *Hort v. Commissioner, 313 U.S. 28*, stating, "Where, as in this case, the disputed amount was essentially a substitute for rental payments which §22 (a) expressly characterizes as gross income, it must be regarded as ordinary income." The court concluded that the Hilperts effectively received these rental payments and then used them to reduce the principal on the mortgage, thus selling the property subject to a reduced lien.

## Practical Implications

This case clarifies how to calculate gain or loss on the sale of property when a mortgage is involved, particularly when the nature of the transaction has been subject to prior legal disputes. The key takeaway is that the sale price includes any mortgage discharged by the buyer, regardless of whether the seller directly receives that amount. This ruling emphasizes the importance of considering the economic substance of a transaction, rather than just its form. It also demonstrates that a state court's determination regarding property rights will be binding for federal tax purposes. Later cases will apply Hilpert to ensure that taxpayers cannot avoid capital gains taxes by structuring sales to exclude the mortgage component of the sale price. It also reinforces the principle that income, even if received in a delayed or accumulated form, is taxable as ordinary income when it represents a substitute for what would otherwise be ordinary income (like rental payments).

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