7 T.C. 465 (1946)

When a lessor repossesses property and gains possession of a building constructed by a lessee, the lessor's cost basis for calculating gain upon a later sale does not include the fair market value of the building at the time of repossession, because the lessor had no cost in the building.

Summary

Therese Johnson repossessed real estate in 1929 after her lessee defaulted, gaining possession of a building the lessee had constructed. Johnson didn't report the building's value as income. When she sold the land and building in 1938, the IRS determined a deficiency, arguing her gain should include the building's 1929 fair market value in her basis. The Tax Court held Johnson's cost basis should not include the building's 1929 value because she had no cost in its construction. The court also addressed adjustments to the cost basis related to taxes, attorney fees, and improvements, and whether Johnson could report the gain on the installment basis.

Facts

Johnson acquired lots in Palm Beach in 1920. She divided the lots into three tracts. She leased tract No. 3 in 1924, with the lessee obligated to build a commercial building. The lessee constructed the Royal Palm Way Building in 1925. The lessee defaulted, and Johnson repossessed the property in 1929. In March 1938, Johnson sold the Royal Palm Way Building and tract No. 3 for $114,710, receiving cash, the assumption of a first mortgage, and a second mortgage.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Johnson's 1938 income tax. Johnson petitioned the Tax Court for redetermination. The Tax Court addressed several issues related to the calculation of Johnson's gain from the sale. The decision was entered under Rule 50, indicating further calculation was needed to determine the final deficiency or overpayment.

Issue(s)

1. Whether Johnson's gain on the sale should include the fair market value of the building when she acquired it in 1929 in her cost basis.
2. What was the correct cost basis of the land sold?
3. Whether attorney fees and other expenditures related to the property were allowable adjustments to the cost basis.
4. Whether Johnson could deduct attorney fees and other costs as selling expenses.
5. Whether Johnson could report her profit on the installment basis.

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Holding

1. No, because the building cost Johnson nothing; her cost basis should not include the fair market value of the building when acquired in 1929.
2. The cost basis of the land was $10,000.
3. Some expenditures, like special assessments, were includible in the cost basis, but others, like taxes and attorney fees, were not.
4. Yes, Johnson was entitled to deduct $2,000 in attorney fees and $25 for a quitclaim deed as selling expenses.
5. Yes, Johnson could report her profit on the installment basis.

Court's Reasoning

Regarding the building's cost basis, the court relied on Section 113 (a) of the Revenue Act of 1938, stating the basis of property is its cost. Citing Detroit Edison Co. v. Commissioner, <span normalizedcite="319 U.S. 98“>319 U.S. 98, the court emphasized that "'basis of property shall be the cost of such property' (§ 113 (a)) normally means...cost to the taxpayer." Because Johnson had no cost in the building's construction, its value was excluded from her basis. The court found the land's cost basis to be $10,000, based on the evidence presented. Special assessments were added to the cost basis as they increased the property's value. Attorney fees and taxes were not added. The court allowed deductions for selling expenses and permitted Johnson to report her gain on the installment basis since initial payments were below 30% of the selling price.

Practical Implications

This case reinforces the principle that

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