10 T.C. 919 (1948)

A mortgagee in possession, who receives rents from a property to cover taxes and expenses, does not receive taxable income when the conveyance of the property was not intended as an absolute transfer of ownership but as additional security under the mortgage.

Summary

The Penn Athletic Club Building case addresses whether a mortgagee-trustee, receiving rents after a conveyance of property in default, must include those rents in its gross income. After the Penn Athletic Club defaulted on its mortgage, the trustee (Girard Trust) received a deed to the property but explicitly maintained the mortgage's effect. The trustee then leased the property and applied the rental income to cover taxes and expenses. The Tax Court held that because the deed was intended as additional security under the mortgage, not an absolute conveyance, Girard Trust was acting as a mortgagee in possession and the rents were not taxable income. This case clarifies how to determine if a conveyance constitutes a true transfer of ownership versus a continuation of a mortgage arrangement for tax purposes.

Facts

The Penn Athletic Club secured a mortgage through Girard Trust. Upon default, Girard Trust, acting under a clause in the mortgage allowing for conveyance of the property, requested and received a deed from the Club. The deed stipulated that the mortgage would remain in effect, with no intention of merging the title and mortgage interests. Girard Trust leased the property to the Securities and Exchange Commission (SEC). The rental income was used to pay real estate taxes (mostly for prior years) and operating expenses.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Girard Trust's income tax for 1942 and 1943, asserting that the rents received should be included in its gross income. Girard Trust petitioned the Tax Court. The Tax Court reviewed the terms of the mortgage, the deed, and the circumstances surrounding the conveyance, ultimately ruling in favor of Girard Trust, finding that the rents were not taxable income.

Issue(s)

1. Whether the rents received by the petitioner from the Penn Athletic Club Building during the taxable years are required to be included in its gross income.

2. If the rent is includible in petitioner's gross income, whether petitioner is entitled to deductions for items such as payments on a loan used for prior real estate taxes,

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depreciation, trustee's commissions, and attorneys' fees.

Holding

1. No, because the petitioner received the rents as a mortgagee in possession, not as an absolute owner. Therefore, the rents are considered collections on the mortgage debt and not taxable income.

Court's Reasoning

The Court reasoned that the crucial point was whether Girard Trust was acting as a mortgagee in possession. A mortgagee in possession is one who lawfully acquires possession of mortgaged premises to enforce the security or use the income to pay the debt. The Court emphasized that the deed explicitly stated the mortgage remained in effect, indicating an intent to maintain the mortgagee status. The Court noted the inclusion of "all the estate, right, title and interest" in the granting clause, but emphasized that "it is expressly stipulated that it is not intended hereby to merge the interests of Girard Trust Company, as Trustee...but that the said mortgage shall be, remain and continue in full force and effect for all purposes as though the present conveyance had not been made." The Court also pointed to external evidence, such as the prevailing court practice of limiting leases by mortgagees in possession to one year, as a reason for structuring the transaction in this way. The Court cited Peugh v. Davis, 113 U.S. 542, stating that one holding under an absolute deed given as security is a mortgagee in possession. The court also cited Macon, Dublin & Savannah Railroad Co., supra. and Helvering v. Lazarus & Co., 308 U.S. 252, affirming 32 B. T. A. 633, and holding that a deed in fee simple, with lease back, was in fact a mortgage and did not deprive the grantor of its right to deduct depreciation. The Court stated that, "In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." Judge Harlan dissented, arguing that the conveyance was an outright sale for adequate consideration, extinguishing the debtor-creditor relationship and thus requiring the rental income to be included in gross income.

Practical Implications

This case provides critical guidance on distinguishing between a true sale of property and a conveyance for security purposes in mortgage default scenarios. The explicit language in the deed preserving the mortgage's effect was paramount. Attorneys should carefully document the intent of parties in similar transactions to ensure the tax consequences align with the economic reality. For tax purposes, the substance of the transaction, as evidenced by the parties' intent and actions, prevails over the form of the transfer. Later cases would likely cite this case for its emphasis on the economic substance of a transaction over its formal structure in determining tax liabilities for mortgagees in possession.

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