14 T.C. 1421 (1950)

When a note received as part of the consideration in a property sale has a fair market value less than its face value, the taxpayer realizes ordinary income, not capital gain, to the extent the amount collected on the note exceeds its fair market value at the time of receipt.

Summary

The Culbertsons sold property in 1944, receiving cash and a $10,000 note. They reported the sale but not the note, believing it had no value. In 1945, they collected the full $10,000 and reported it as long-term capital gain. The Tax Court determined the note had a $3,000 fair market value in 1944. The court held that the $7,000 difference between the note’s face value and its fair market value constituted ordinary income in 1945, following the precedent set in *Victor B. Gilbert, 6 T.C. 10*. The court reasoned that only the return of the note’s fair market value was non-taxable, while the excess was taxable as ordinary income because it wasn’t derived from the sale or exchange of a capital asset.

Facts

- The Culbertsons acquired the Mayo Courts for $42,858.55 in 1943.
- They sold the property on November 1, 1944, for $70,000 cash and a $10,000 second lien note.
- The note was payable in monthly installments, subordinate to a $70,000 first lien.
- The note was fully paid on March 1, 1945.
- The Culbertson’s accountant knew the makers of the note to be solvent at the time the note was given.

Procedural History

- The Commissioner of Internal Revenue determined deficiencies in the Culbertsons’ income tax for 1945.
- The Culbertsons petitioned the Tax Court, arguing the $10,000 was long-term capital gain.
- The Tax Court consolidated the proceedings for husband and wife petitioners.

Issue(s)

1. Whether the collection of the $10,000 note in 1945 constituted ordinary income or long-term capital gain?
2. In what amount should the collection be taxed?

Holding

1. The collection of the note resulted in ordinary income, not capital gain, to the

extent it exceeded the note's fair market value at the time of receipt.
2. The amount of $7,000 constituted ordinary income in 1945.

Court's Reasoning

The court relied on Internal Revenue Code section 111(b), which states that the amount realized from a sale is the sum of money received plus the fair market value of other property received. The court found the note had a fair market value of $3,000 in 1944. Quoting Regulations 111, sections 29.44-2 and 29.44-4, the court noted that deferred-payment sales are sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made exceed 30 percent of the selling price.

Following *Victor B. Gilbert, 6 T.C. 10*, the court reasoned that when a taxpayer collects on a note that was initially valued at less than its face value, the difference between the fair market value at receipt and the amount collected is taxed as ordinary income. The court distinguished capital gain from ordinary income noting, "It is, of course, well settled that where a note is paid by the maker in satisfaction of the maker's liability thereon, capital gain does not result."

The court rejected the Culbertsons' argument that the Commissioner's acceptance of their 1944 return (which didn't mention the note) was an admission that the note had no value. The court emphasized the taxpayer has the burden to prove the note had no fair market value. The court found that the taxpayer did not meet that burden and, furthermore, that the omission of the note from the 1944 return was a taxpayer error in a year not before the court.

Practical Implications

Culbertson clarifies how to treat payments received on notes in property sales when the notes were initially valued at less than face value. This case is important for tax planning and reporting in situations involving deferred payments. Legal professionals must consider the fair market value of any non-cash consideration received in a sale to accurately determine the tax implications. Taxpayers must accurately report the fair market value of notes received in property sales in the year of the sale, or risk having subsequent payments taxed as ordinary income, even if the initial omission was an error.

