31 T.C. 1028 (1959)

In installment sales of real property, the method of calculating taxable gain depends on whether the property is sold “subject to” the mortgage, and the total contract price should be adjusted accordingly.

Summary

The case involves a tax dispute over the proper method of reporting income from installment sales of real property. The partnership of Lamberth and Lewis sold duplexes subject to existing mortgages, reporting the sales on the installment basis. The IRS recomputed the gain by including the mortgage amounts exceeding the property’s basis in the initial payments. The Tax Court held that the installment method was correctly applied but disagreed with the IRS’s specific calculation of the “total contract price.” The court found that the partnership, while using the installment method correctly, should not have the entire mortgage amount factored into the initial payments because the purchasers only took properties subject to the mortgages’ remaining balance at the time of deed transfer, not for the duration of the contract. The court also addressed other issues like depreciation of vehicles and a house used for storage, and the deductibility of entertainment expenses.

Facts

The partnership constructed and rented duplexes. In 1951, it sold 26 duplexes using installment sales contracts. The contracts required small down payments, and the buyers made monthly payments with the remaining balance of the purchase price, plus interest. Each duplex had an existing mortgage that exceeded the partnership’s basis in the property. The partnership reported these sales on the installment basis, using the total sales price, without subtracting mortgage amounts, to calculate gains. The IRS recomputed the gain, including the mortgage amounts exceeding basis in the “initial payments.” Other issues were related to depreciation of automobiles and a house used for storage and entertainment expenses.

Procedural History

The Commissioner determined deficiencies in the income taxes of the petitioners. The petitioners challenged the Commissioner’s determination in the Tax Court.

Issue(s)

1. Whether the sales of the duplexes were properly reported on the installment basis, or should be determined to be reportable only on a deferred payment recovery-of-cost basis.
2. If properly reported on the installment sales basis, should the amounts by which each mortgage exceeded the partnership’s basis in each respective duplex be included in the “initial payments” received and the “total contract prices” at which the duplexes were sold.

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3. Whether the partnership can deduct depreciation for 1950 and 1951 on a house in Dallas, Texas, which was used by the partnership for storage purposes in those years.
4. Whether the partnership is entitled to deduct in entertainment expenses for 1950 and 1951 greater amounts than those allowed by the respondent in his deficiency notices.

Holding

1. No, because the partnership's election to use the installment method was binding.
2. No, because, the total contract price should be reduced only by the mortgage amounts that would not be paid before the transfer of title, and the "initial payments" should be calculated accordingly.
3. Yes, a portion of the depreciation for the house should be allowed.
4. Yes, the partnership is entitled to deduct greater entertainment expenses than those allowed by the respondent.

Court's Reasoning

The court held that the partnership was bound by its election to report the sales on the installment method. The court referenced *Pacific National Co. v. Welch*, which established that once a taxpayer elects an accounting method, they are bound to that method unless the application of the method fails to clearly reflect income. Here, the court found that the partnership's chosen installment method clearly reflected its income. However, the court disagreed with the Commissioner's calculation of the "total contract price" concerning the mortgages. The court analyzed the sales contracts, noting that purchasers did not assume the mortgages; they were obligated to pay a portion of the mortgage through monthly installments. The court reasoned that the property was only taken subject to the mortgage's unpaid balance when title was transferred. Therefore, the Commissioner incorrectly reduced the total contract price by the entire mortgage amount.

Regarding the depreciation of automobiles, the court acknowledged the vehicles' use in the business and estimated reasonable annual allowances. As for the house, the court found it was used for storage. The court stated, "the principle of the Cohan case, supra, is applicable; the partnership is entitled to some deduction for depreciation." Finally, it allowed increased entertainment expense deductions, based on evidence that the bookkeeper made the allocations without partners' authority.

Practical Implications

This case is critical for understanding how to correctly account for mortgages when using the installment method for real estate sales. It clarifies that the tax treatment depends on the specific terms of the sale contract. When advising clients, attorneys

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must carefully examine the contract's language to determine when the property becomes subject to the mortgage. If the purchaser assumes the mortgage or takes the property subject to the entire mortgage immediately, then regulations for tax purposes as set forth by the IRS apply. If, however, the buyer takes the property subject to the mortgage at the end of the payment term, the calculation of gain is affected. This case underscores the importance of precision when drafting sales contracts and calculating tax liabilities. Tax practitioners must also consider the practical realities of the transaction, such as whether the purchaser is likely to default. The court also emphasizes the importance of documentation to support deductions for depreciation and business expenses.

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