Realty Loan Corp. v. Commissioner, 54 T. C. 1083 (1970)

The sale of a business can be allocated between the sale of capital assets, resulting in capital gain, and the sale of future income, resulting in ordinary income, with both parts eligible for installment reporting.

Summary

Realty Loan Corporation sold its mortgage-servicing business to Sherwood & Roberts, Inc. for $86,500. The Tax Court determined that this price should be allocated between the sale of capital assets ($10,000) and the right to future income from servicing fees ($76,500). The gain from the capital assets was taxable as long-term capital gain, while the gain from future income was taxable as ordinary income. Both portions of the gain were eligible for installment reporting under Section 453 of the Internal Revenue Code, as the sale was casual and the future income rights were considered property. This ruling impacts how businesses selling both tangible and intangible assets should allocate and report their gains.

Facts

Realty Loan Corporation (RLC) was engaged in the mortgage banking business in Portland, Oregon. In 1962, RLC sold its mortgage-servicing business to Sherwood & Roberts, Inc. (S&R) for $86,500, as part of a larger package deal. RLC's business involved servicing mortgages it had originated and sold to insurance companies like Mutual Trust Life and Bankers Life, for which it received servicing fees. The sale included RLC's mortgage portfolio, contracts with the insurance companies, and other intangible assets like goodwill. RLC reported the sale as an installment sale of a capital asset on its tax return.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in RLC's 1962 income tax, arguing that the entire gain from the sale should be taxed as ordinary income and not reported on the installment method. RLC challenged this determination in the U. S. Tax Court, which heard the case and issued its decision on May 25, 1970.

Issue(s)

1. Whether the $86,500 sales price of RLC's mortgage-servicing business should be allocated between the sale of capital assets and the sale of future income from servicing fees?
2. If part of the sales price is allocated to future income, can this portion be reported on the installment method under Section 453 of the Internal Revenue Code?

Holding

1. Yes, because the sale price should be allocated between capital assets ($10,000) and future income rights ($76,500), as both types of assets were sold.
2. Yes, because the future income rights were considered property, and the sale was casual, meeting the requirements of Section 453(b) for installment reporting.

Court's Reasoning

The court applied the principle that the sale of a business can involve both capital assets and rights to future income. It cited prior cases like *Bisbee-Baldwin Corp. v. Tomlinson* to support the allocation of the sales price between goodwill and future income. The court reasoned that S&R was primarily interested in the future income from servicing fees but also valued RLC's connections with insurance companies and goodwill with builders and realtors. The allocation was based on evidence that S&R expected to receive about $40,000 annually in gross servicing fees, with a net income of approximately $16,000. The court considered the future income rights as property, not merely compensation for services, thus eligible for installment reporting under Section 453(b). This decision was influenced by policy considerations to allow taxpayers to report income as it is realized, rather than in a lump sum.

Practical Implications

This decision establishes that businesses selling both tangible and intangible assets must carefully allocate the sales price between capital assets and future income rights. This allocation affects the tax treatment of the gain, with capital assets taxed at potentially lower rates and future income taxed as ordinary income. The ruling also clarifies that both types of gains can be reported on the installment method if the sale is casual and the future income rights are considered property. This impacts how similar transactions should be analyzed and reported, potentially affecting business sale strategies and tax planning. Subsequent cases have applied this ruling in various contexts, including sales of insurance agencies and other businesses with future income streams.