Securities Mortgage Co. v. Commissioner, T.C. Memo. 1976-2

A mortgagee's loss from a foreclosure sale is deductible in the year of the foreclosure sale, not when redemption rights expire, and the fair market value of property acquired at foreclosure, especially incomplete projects, is determined by subtracting completion costs and a developer's profit from the estimated value of the completed project.

Summary

Securities Mortgage Co. (Petitioner) foreclosed on two uncompleted apartment complexes, Tacoma Mall and Terri Ann Apartments, and sought to deduct losses from these foreclosures in the 1966 tax year. The IRS (Respondent) argued the losses were not deductible in 1966 due to outstanding redemption rights and disputed the Petitioner's valuation of the properties. The Tax Court held that the foreclosure loss is deductible in the year of sale, and established a method for valuing incomplete properties based on the estimated value upon completion, less the costs to complete and a reasonable developer's profit. The court found in favor of the Petitioner regarding the year of deductibility and provided guidance on proving fair market value in foreclosure scenarios.

Facts

Petitioner, a mortgage loan company, made construction loans for Tacoma Mall and Terri Ann Apartments, receiving notes and mortgages as security. Both projects defaulted and were foreclosed in 1966. Petitioner bid on and acquired both properties at sheriff's sales. Tacoma Mall was approximately 25% complete when advances stopped in 1963 and was later weatherproofed. Terri Ann was about 65% complete when construction halted in 1963 and suffered vandalism and weather damage. After foreclosure, Petitioner completed both projects and later sold them. On its 1966 tax return, Petitioner claimed bad debt deductions related to these foreclosures, which the IRS challenged.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the Petitioner's federal income tax for 1966. The Petitioner contested this deficiency in the Tax Court. The Tax Court heard evidence and arguments to determine the deductibility of the foreclosure losses and the valuation of the foreclosed properties.

Issue(s)

1. Whether a mortgagee may deduct a loss on foreclosure in the year of the foreclosure sale or in the year redemption rights expire?
2. What burden of proof is placed on a mortgagee to demonstrate the fair market value of property acquired at a foreclosure sale is less than the bid price?
3. What is the proper formula for determining the fair market value of an

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incomplete apartment project acquired through foreclosure?

Holding

1. Yes, a mortgagee may deduct the loss in the year of the foreclosure sale because the sale is the taxable event that determines gain or loss, and in this case, redemption was unlikely and effectively controlled by the Petitioner.
2. The mortgagee must initially show, by clear and convincing evidence, that the bid price does not represent fair market value. Once this is shown, the mortgagee must then prove the actual fair market value by a preponderance of the evidence.
3. The fair market value of an incomplete apartment project is determined by estimating the value of the completed project and subtracting the estimated costs of completion and a reasonable developer's profit.

Court's Reasoning

The court relied on Treasury Regulation § 1.166-6(b)(1), which states that when a mortgagee buys mortgaged property at foreclosure, gain or loss is realized, measured by the difference between the debt applied to the bid price and the property's fair market value. The court cited *Hadley Falls Trust Co. v. United States*, supporting the foreclosure sale as the taxable event. The court distinguished cases cited by the Respondent that suggested loss recognition should be deferred until redemption rights expire, noting those cases were either not applicable to mortgagees or were obsolete. The court emphasized the economic reality that redemption was highly improbable in this case, further supporting deductibility in 1966.

Regarding valuation, the court upheld the validity of Treasury Regulation § 1.166-6(b)(2), which presumes the bid price is the fair market value unless "clear and convincing proof to the contrary" is presented. Once this initial burden is met, the standard of proof for establishing actual fair market value becomes preponderance of the evidence. The court defined fair market value as the price a willing buyer and seller would agree upon without compulsion, referencing *Williams Estate v. Commissioner*. For incomplete properties, the court rejected the reproduction cost approach and endorsed the Petitioner's valuation method: estimating the completed value and subtracting completion costs and a developer's profit. The court accepted the expert witness's completed value estimates but adjusted the developer's profit from a percentage of costs to 10% of the buyer's investment to arrive at the fair market values of Tacoma Mall and Terri Ann at the time of foreclosure.

Practical Implications

This case provides crucial guidance for mortgagees dealing with foreclosure losses for tax purposes. It clarifies that the loss is deductible in the year of the foreclosure

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sale, even with redemption rights, especially when redemption is economically unrealistic. The case establishes a practical methodology for valuing incomplete construction projects acquired through foreclosure, moving away from potentially misleading reproduction costs and towards a market-based approach. This method, subtracting completion costs and developer's profit from the completed value, is now a recognized standard for valuing such assets in foreclosure scenarios. The case also underscores the burden of proof on the mortgagee to overcome the presumption that the bid price equals fair market value, initially requiring clear and convincing evidence, then a preponderance for the actual value.

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