Reinhardt v. Commissioner, 75 T. C. 47 (1980)

Only the statutory redemption penalty portion of a payment to redeem property from a tax lien can be deducted as interest, while other components must be capitalized.

Summary

In Reinhardt v. Commissioner, the taxpayers purchased property unaware of existing delinquent real estate taxes. Upon attempting to refinance, they discovered a tax lien and paid $8,462. 27 to redeem the property, which included taxes, penalties, and fees. The issue was whether any part of this payment was deductible as taxes or interest. The U. S. Tax Court held that only the redemption penalty could be deducted as interest, as it was compensation for the use of money during the redemption period. The delinquent taxes, delinquency penalty, and other fees had to be capitalized as part of the property's cost, as they were not imposed on the taxpayers.

Facts

Al S. Reinhardt and Miriam Reinhardt purchased the Woodman Apartments at a foreclosure sale on December 30, 1971. Unbeknownst to them, the property was subject to a lien for delinquent real property taxes from prior to their purchase. In 1973, while attempting to refinance, they discovered the lien and paid $8,462. 27 on December 31, 1973, to redeem the property. This payment comprised $6,218. 59 in taxes for 1970-71, a $373. 11 delinquency penalty, $3. 00 in costs, a $1,865. 57 redemption penalty, and a $2. 00 redemption fee. They claimed this entire amount as a deduction on their 1973 federal income tax return.

Procedural History

The Commissioner of Internal Revenue disallowed the entire deduction and determined a deficiency in the Reinhardts' 1973 federal income tax. The taxpayers petitioned the U. S. Tax Court, which heard the case and issued its decision on October 8, 1980.

Issue(s)

1. Whether the taxpayers may deduct the entire $8,462. 27 payment as real estate taxes under section 164 of the Internal Revenue Code.
2. Whether any portion of the payment attributable to penalties and costs can be deducted as interest under section 163(a) of the Internal Revenue Code.

Holding

1. No, because the taxes were not imposed on the taxpayers and must be capitalized as part of the property's cost.
2. Yes, but only the $1,865. 57 redemption penalty can be deducted as interest

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because it represents compensation for the use of money during the redemption period; the other components must be capitalized.

Court’s Reasoning

The court applied the rule that taxes are deductible only by the person upon whom they are imposed, which in this case was the previous owner. The court found that the delinquent taxes, delinquency penalty, and associated costs were not deductible but had to be capitalized as part of the purchase price of the property. The court distinguished the redemption penalty, which accrued over time and was for the forbearance of the State during the redemption period, as interest under section 163(a). The court cited Deputy v. du Pont and other cases to define interest as compensation for the use or forbearance of money. The court noted that the state’s characterization of the redemption penalty as a penalty did not bind the court’s determination of its deductibility as interest. The court expressed sympathy for the taxpayers but stated it must apply the law as it found it.

Practical Implications

This decision clarifies that when redeeming property from a tax lien, only the redemption penalty portion of the payment can be deducted as interest. Taxpayers must capitalize other components such as delinquent taxes, delinquency penalties, and fees. This ruling impacts how real estate investors and attorneys should approach the tax treatment of payments made to clear tax liens on purchased properties. It also highlights the importance of due diligence in real estate transactions to identify any existing liens. Subsequent cases and IRS rulings have continued to apply this distinction between deductible redemption penalties and non-deductible other components of redemption payments.

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