Burbage v. Commissioner, 82 T. C. 546 (1984)

A Maryland redeemable ground rent lease is treated as a mortgage for tax purposes, resulting in the lessor recognizing gain at the time of the lease.

Summary

John Howard Burbage leased property under a 99-year Maryland ground rent lease, which the court treated as a mortgage under IRC section 1055. The court held that Burbage realized taxable gain in 1972 upon entering the lease, not upon its redemption, extending the statute of limitations for assessment due to the unreported gain. The 1974 exchange of ground rents was not taxable, but payments received were to be reported as interest income. Additionally, Jamaica Industries, Inc. , a subchapter S corporation in which Burbage held a stake, was found to have received excessive passive income, terminating its S corporation status.

Facts

In 1972, John Howard Burbage leased oceanfront lots to Larmar Corp. for 99 years under a redeemable ground rent agreement, receiving annual rent payments and retaining a right of reentry. In 1974, Burbage exchanged his rights under this lease for 18 unit ground rents from a condominium project. Burbage reported payments received from Larmar as capital gains, while Jamaica Industries, Inc. , where Burbage was a 50% shareholder, received interest payments on loans to James B. Caine.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Burbage's 1972, 1974, and 1975 taxes. Burbage petitioned the U. S. Tax Court, which upheld the deficiency for 1972 due to unreported gain from the ground rent lease, treated as a mortgage. The court found no taxable event in the 1974 exchange but required interest income reporting. Additionally, the court terminated Jamaica Industries, Inc. 's subchapter S status due to excessive passive income.

Issue(s)

1. Whether the assessment of the deficiency for Burbage's 1972 taxable year is barred by the statute of limitations?
2. Whether Burbage's 1972 transfer of real property under a 99-year redeemable ground rent lease constituted a taxable sale or exchange?
3. Whether Burbage's 1974 transfer of one ground rent for 18 was a taxable event?
4. Whether payments received from Larmar in 1974 and 1975 should be reported as interest income?
5. Whether Jamaica Industries, Inc. received excessive passive income in 1974, terminating its subchapter S election?

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Holding

1. No, because Burbage omitted more than 25% of gross income in 1972, extending the statute of limitations to six years under IRC section 6501(e)(1).
2. Yes, because the ground rent lease was treated as a mortgage under IRC section 1055, and Burbage realized gain in 1972.
3. No, because the 1974 exchange of ground rents did not result in a taxable gain or loss.
4. Yes, because payments received from Larmar were interest on the mortgage-equivalent ground rents.
5. Yes, because more than 20% of Jamaica Industries, Inc. ‘s income was from passive investments, terminating its subchapter S status.

Court’s Reasoning

The court applied IRC section 1055, which treats Maryland ground rents as mortgages, to Burbage’s 1972 lease. This resulted in Burbage realizing gain upon leasing the property, not upon its redemption, aligning with the legislative intent to treat ground rents like mortgages. The court rejected Burbage’s argument that the statute should not apply to business property, emphasizing the broad intent of section 1055. For the 1974 exchange, the court found no gain or loss as the exchanged ground rents were valued equally. The payments from Larmar were deemed interest on the mortgage-equivalents. Jamaica’s termination of subchapter S status was upheld due to the clear classification of payments as interest, not compensation for services.

Practical Implications

This decision clarifies that Maryland ground rent leases are to be treated as mortgages for tax purposes, requiring gain recognition upon lease execution. Practitioners should ensure clients report such transactions accurately to avoid statute of limitations issues. The ruling also affects how similar exchanges and payments are treated for tax purposes, requiring careful classification as interest income. For S corporations, this case underscores the need to monitor passive income levels to maintain S status. Subsequent cases, such as those involving real estate transactions, often reference Burbage for its interpretation of ground rent leases and passive income rules.

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