Joe Kelly Butler, Inc. v. Commissioner, 87 T. C. 734, 1986 U. S. Tax Ct. LEXIS 44, 87 T. C. No. 44 (1986)

In a bulk sale of assets, the mortgage assumed in excess of the aggregate basis of all assets sold is considered a payment in the year of sale for installment reporting purposes.

Summary

Joe Kelly Butler, Inc. sold various assets, including encumbered real property, to Mitchell Energy Corp. for a total consideration including cash, a promissory note, and the assumption of a mortgage exceeding the basis of the real property alone. The issue before the U. S. Tax Court was whether the excess of the mortgage over the real property's basis constituted a payment in the year of sale, potentially disqualifying the sale from installment reporting. The Court held that the mortgage assumption should be compared against the aggregate basis of all assets sold, not just the real property, allowing the taxpayer to use the installment method as the mortgage did not exceed the total basis.

Facts

Joe Kelly Butler, Inc. sold its operating assets to Mitchell Energy Corp. for $6,401,345 on October 1, 1974. The consideration included $246,900 in cash, a promissory note of $5,357,538, and the assumption of a $796,907 mortgage on the real property sold. The real property had a basis of $14,676, and total assets sold had an aggregate basis of $831,183. The taxpayer elected to report the gain on the sale using the installment method, treating only the cash received as income in the year of sale.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the taxpayer's federal income tax for the years 1974, 1975, 1977, and 1978, arguing that the mortgage assumption in excess of the real property's basis was a payment in the year of sale, disqualifying the sale from installment reporting. The taxpayer challenged this determination in the U. S. Tax Court, which ultimately ruled in favor of the taxpayer, allowing the use of the installment method based on the comparison of the mortgage to the total basis of all assets sold.

Issue(s)

1. Whether, in a bulk sale of assets, the mortgage assumed by the buyer, when it exceeds the basis of the real property alone, should be treated as a payment in the year of sale for the purpose of determining eligibility for the installment method of reporting gain.

Holding

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1. No, because the mortgage should be compared to the aggregate basis of all the assets sold, not just the real property. The Court determined that since the mortgage did not exceed the total basis of all assets sold, there was no payment in the year of sale in excess of basis, allowing the taxpayer to use the installment method.

Court's Reasoning

The Court's decision was based on the purpose of the installment method, which is to relieve taxpayers from paying the full tax on anticipated profits in the year of sale when they have received only a small portion of the sales price. The Court rejected the Commissioner's argument to segregate assets for installment sale purposes, reasoning that the relevant percentage of initial payments to selling price remains the same whether analyzed as a whole or by component. The Court also considered the history and purpose of the relevant regulation, concluding that it should be applied narrowly to avoid unintended disqualification of transactions under the 30% test. The Court's approach was consistent with the Fifth Circuit's reasoning in *Irwin v. Commissioner*, which compared assumed liabilities against the basis of all assets sold in a bulk sale.

Practical Implications

This decision clarifies that for bulk sales of assets, the entire transaction should be considered when determining eligibility for the installment method, rather than segregating assets into classes. This allows taxpayers to potentially qualify for installment reporting even when a mortgage assumed exceeds the basis of the real property alone. Legal practitioners advising on asset sales should consider the aggregate basis of all assets when structuring transactions to maximize tax benefits. This ruling may impact business planning and tax strategies for companies disposing of multiple asset types in a single transaction. Subsequent cases applying this ruling have reinforced the importance of a holistic approach to bulk sales in tax analysis.

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