Morley v. Commissioner, 87 T. C. 1206 (1986)

Interest on property held for resale is not 'investment interest' if the taxpayer intended to promptly resell the property and engaged in bona fide negotiations to do so.

Summary

In Morley v. Commissioner, the Tax Court held that interest paid by the Morleys on a loan used to purchase real estate was not 'investment interest' under IRC § 163(d)(3)(D). The court found that Morley, a real estate broker, intended to promptly resell the property (Elm Farm) and engaged in genuine negotiations with a potential buyer. Despite the failure to sell due to market conditions, the court determined that Morley was engaged in the trade or business of selling the property, thus the interest was deductible as ordinary business expense, not subject to investment interest limitations.

Facts

E. Dean Morley, a real estate broker since 1961, entered into a contingent contract to purchase Elm Farm in September 1973. He intended to resell the property immediately and engaged in negotiations with John Pflug, sending him a sales contract in September 1973. Morley closed the purchase in December 1973 using a loan from United Virginia Bank. Despite ongoing negotiations, the deal with Pflug fell through in early 1974 due to a severe real estate market downturn. Morley was unable to find another buyer, and Elm Farm was eventually foreclosed upon, leaving him with 14 undeveloped acres. Morley paid interest on the loan in 1980 and 1981, which he deducted as business expense.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Morleys' federal income tax for 1980 and 1981, arguing the interest paid was 'investment interest' under IRC § 163(d)(3)(D). The Morleys petitioned the U. S. Tax Court, which held a trial and subsequently issued its opinion in 1986.

Issue(s)

1. Whether interest paid by the Morleys on the loan used to purchase Elm Farm constituted 'investment interest' under IRC § 163(d)(3)(D).

Holding

1. No, because the court found that Morley intended to promptly resell Elm Farm and engaged in bona fide negotiations to do so, indicating he was engaged in the trade or business of selling the property, thus the interest was not 'investment interest'.

Court’s Reasoning

The court rejected the Commissioner’s argument that a prior binding commitment to sell was necessary for the property not to be considered held for investment. Instead, it applied the rationale from S & H, Inc. v. Commissioner, extending it to situations where the taxpayer intended to promptly resell and engaged in good faith efforts to do so. The court found Morley’s actions met this standard, noting the negotiations with Pflug began before Morley finalized the purchase and continued earnestly until external market forces intervened. The court emphasized Morley’s intent and actions were genuine, not merely a tax avoidance scheme, and his financial situation did not allow him to hold the property long-term. The court also distinguished Morley’s situation from other cases cited by the Commissioner, focusing on the specific facts of Morley’s case.

Practical Implications

This decision clarifies that for tax purposes, property can be considered held for resale, rather than investment, even without a prior binding commitment to sell, provided the taxpayer’s intent to resell is clear and supported by objective evidence of genuine efforts to do so. This ruling impacts how real estate professionals and investors should structure their transactions and report interest expenses, particularly in volatile markets where sales may not materialize. It also influences how the IRS and courts will evaluate similar cases, focusing on the taxpayer’s intent and actions at the time of purchase. Subsequent cases have cited Morley in discussions about the nature of property held for resale versus investment, and it remains a key precedent in this area of tax law.

