***Michaels v. Commissioner, 87 T. C. 1412 (1986)***

A discount received on the prepayment of a recourse mortgage in connection with the sale of a residence must be reported as discharge of indebtedness income, not as part of the gain on the sale of the residence.

**Summary**

In Michaels v. Commissioner, the Tax Court ruled that a discount received by homeowners on the prepayment of their recourse mortgage, as part of selling their home, must be treated as discharge of indebtedness income under IRC Sec. 61(a)(12), rather than part of the gain from the sale deferred under IRC Sec. 1034. The court emphasized that such discounts are not included in the 'amount realized' from the sale for tax purposes, despite being part of the sale transaction. This decision underscores the importance of distinguishing between different types of income in real estate transactions and impacts how taxpayers report income from mortgage prepayments.

**Facts**

John and Rebecca Michaels sold their residence in 1982 for $40,000, with the sale contingent upon receiving a 25% discount on the prepayment of their recourse mortgage with Perpetual Federal Building & Loan. They subsequently purchased a new residence for $65,000. The Michaels included the discount in the gain from the sale of their old residence but deferred recognition of this gain under IRC Sec. 1034. The Commissioner of Internal Revenue argued that the discount should be taxed separately as income from discharge of indebtedness under IRC Sec. 61(a)(12).

**Procedural History**

The case was initiated in the United States Tax Court with the Michaels filing a petition against the Commissioner's determination of a tax deficiency. Both parties filed cross-motions for summary judgment, which were assigned to a Special Trial Judge. The court adopted the Special Trial Judge's opinion, leading to the final decision in favor of the Commissioner.

**Issue(s)**

1. Whether a discount received on the prepayment of a recourse mortgage made in connection with the sale of a residence must be recognized as income.
2. If so, whether the discount should be taxed as ordinary income or as long-term capital gain.

**Holding**

1. Yes, because the discount is not included in the 'amount realized' for purposes of computing gain on the sale under IRC Sec. 1001 and related regulations, and thus

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must be reported separately as discharge of indebtedness income under IRC Sec. 61(a)(12).
2. Yes, because the prepayment of the mortgage, which resulted in the discount, is not considered a 'sale or exchange' for tax purposes, and thus the discount cannot be taxed as capital gain but must be treated as ordinary income.

**Court's Reasoning**

The court relied on IRC Sec. 1001 and the accompanying regulations to determine that the 'amount realized' from the sale of the residence did not include the mortgage prepayment discount. Specifically, the court cited IRC Sec. 1001(b) and Treas. Reg. Sec. 1. 1001-2(a)(2), which exclude discharge of indebtedness income from the 'amount realized' in sales involving recourse liabilities. The court also referenced the 'bifurcated approach' to transactions involving discharge of indebtedness income, as discussed in Vukasovitch, Inc. v. Commissioner. The court rejected the taxpayers' argument that the discount should reduce their basis in the residence, finding no statutory or judicial support for this position. Furthermore, the court determined that the prepayment was not a 'sale or exchange' and thus could not result in capital gain, citing Fairbanks v. United States and Osenbach v. Commissioner.

**Practical Implications**

This decision requires taxpayers to report discounts received on the prepayment of recourse mortgages as ordinary income from discharge of indebtedness, rather than as part of the gain from the sale of their residence. This ruling affects how similar transactions are structured and reported for tax purposes, emphasizing the need to distinguish between different types of income in real estate sales. It also influences legal and tax planning strategies, as practitioners must advise clients on the tax consequences of mortgage prepayment discounts. The decision has been followed in subsequent cases and remains relevant in the analysis of home sale transactions involving mortgage prepayments.

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