Debough v. Commissioner, 142 T. C. 297 (2014)

In *Debough v. Commissioner*, the U. S. Tax Court ruled that a taxpayer who reacquired his principal residence after a defaulted installment sale must recognize previously excluded gain under Section 121 upon reacquisition, as mandated by Section 1038 of the Internal Revenue Code. Marvin E. Debough sold his home in 2006, excluding $500,000 of gain, but had to repossess it in 2009 after the buyers defaulted. The court clarified that without resale within one year, as stipulated in Section 1038(e), the general rule of Section 1038(b) applies, requiring recognition of gain received before reacquisition. This decision underscores the interaction between these sections and their impact on homeowners facing similar circumstances.

Parties

Marvin E. Debough, the petitioner, sought a redetermination of a deficiency in federal income tax assessed by the respondent, the Commissioner of Internal Revenue. Throughout the litigation, Debough was represented by Matthew L. Fling, while the Commissioner was represented by John Schmittdiel and Randall L. Eager.

Facts

In 1966, Marvin E. Debough purchased his primary residence and surrounding land for $25,000. On July 11, 2006, he sold this property to Stonehawk Corp. and Catherine Constantine Properties, Inc. (collectively, the buyers) under a contract for deed, with a total purchase price of $1,400,000. The sale included a down payment of $250,000, with the remaining $1,150,000 to be paid over time with interest at 5% per annum. Debough reported an adjusted basis of $742,204 in the property, which included half of the original cost, capital improvements, a stepped-up basis from his deceased spouse, and sale expenses. However, the parties later stipulated a basis of $779,704. Debough and his deceased spouse excluded $500,000 of gain from their 2006 tax return under Section 121 and reported the remaining gain on an installment basis. Debough received payments totaling $505,000 before the buyers defaulted in 2009. After serving a notice of cancellation, Debough reacquired the property on or about July 29, 2009, incurring $3,723 in repossession costs. He reported $97,153 in long-term capital gains for 2009 but later amended his return to exclude this amount. The Commissioner assessed a deficiency, determining Debough should recognize $448,080 in long-term capital gains for 2009, including the previously excluded $500,000.

Procedural History

The Commissioner issued a notice of deficiency to Debough on June 18, 2012, asserting a deficiency of $58,893 in federal income tax for the 2009 taxable year. Debough timely filed a petition with the United States Tax Court seeking redetermination of the deficiency. The parties stipulated facts under Tax Court Rule

122. The Tax Court, with Judge Negah presiding, considered the case and ruled in favor of the Commissioner, ordering that a decision be entered for the respondent.

Issue(s)

Whether a taxpayer who reacquires his principal residence after an installment sale where gain was previously excluded under Section 121 must recognize that previously excluded gain upon reacquisition under Section 1038?

Rule(s) of Law

Section 1038 of the Internal Revenue Code provides that no gain or loss results from the reacquisition of real property sold on an installment basis and later reacquired in satisfaction of the debt secured by the property, except to the extent of money and other property received before reacquisition. Section 1038(b) mandates recognition of gain to the extent that the amount of money and the fair market value of other property received before reacquisition exceeds the gain on the sale reported as income before reacquisition. Section 1038(e) provides an exception for reacquisition of a principal residence, allowing nonrecognition of gain if the property is resold within one year of reacquisition. Section 121 permits taxpayers to exclude up to $500,000 of gain from the sale of a principal residence if certain conditions are met.

Holding

The Tax Court held that Marvin E. Debough was required to recognize long-term capital gain upon the reacquisition of his property under Section 1038, including the $500,000 previously excluded under Section 121, because he did not resell the property within one year of reacquisition as required by Section 1038(e).

Reasoning

The court reasoned that Section 1038 applies to the reacquisition of real property sold on an installment basis and later reacquired in satisfaction of the debt secured by the property. The court noted that Congress intended for Section 1038 to prevent recognition of gain or loss based on fluctuations in the fair market value of the property upon reacquisition, but not to the extent of cash or other property received by the seller before reacquisition. The court interpreted the specific exception in Section 1038(e) for principal residences as evidence that Congress intended for the general rule of Section 1038(b) to apply in cases like Debough's, where the property was not resold within one year of reacquisition. The court rejected Debough's argument that the absence of a specific provision mandating the recognition of previously excluded Section 121 gain meant that Section 1038 did not apply to recapture such gain. Instead, the court found that the mandatory language of Section 1038(b) required recognition of gain to the extent of money received before reacquisition, which in Debough's case included the $505,000 received before the buyers defaulted. The court also noted that this interpretation was consistent with the basic principles of federal income tax law, which include any accession to wealth in gross income unless specifically excluded by statute.

Disposition

The Tax Court entered a decision for the respondent, the Commissioner of Internal Revenue, affirming the deficiency in federal income tax for the 2009 taxable year.

Significance/Impact

The decision in *Debough v. Commissioner* has significant implications for taxpayers who sell their principal residences on an installment basis and later reacquire them due to buyer default. It clarifies that the exclusion of gain under Section 121 is not permanent if the property is reacquired and not resold within one year, as provided by Section 1038(e). This ruling emphasizes the importance of understanding the interplay between Sections 1038 and 121 and may affect the financial planning of homeowners considering installment sales of their residences. The case also reinforces the principle that statutory exclusions and deductions must be explicitly provided by Congress and cannot be inferred from silence in the tax code.

