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Recommended Citation

Liquerman, Robert and Di Franco, Diane (1987) "The Tax Consequences of Wraparound Mortgages," *Journal of Civil Rights and Economic Development*: Vol. 2 : Iss. 2 , Article 4.

Available at: <https://scholarship.law.stjohns.edu/jcred/vol2/iss2/4>

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THE TAX CONSEQUENCES OF WRAPAROUND MORTGAGES

Often in a sale of real property, the seller may elect to receive payment in installments, thereby providing the buyer with convenient financing while securing for himself desirable tax advantages.¹ The installment method of reporting allows a taxpayer who is to receive at least one payment after the year of a disposi-

¹ See I.R.C. § 453 (1982 & Supp. 1984). This section, which contains rules for reporting income under the installment method, provides in pertinent part:

(b) Installment sale defined. - For purposes of this section-

(1) In general. -

The term "installment sale" means a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs.

(c) Installment method defined. -

For purposes of this section, the term "installment method" means a method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

Id.

The Senate Committee in reporting on the installment method of reporting income stated that:

The function of the installment method of reporting income is to permit the spreading of the income tax over the period during which payments of the sales price are received. Thus, the installment method alleviates possible liquidity problems which might arise from the bunching of gain in the year of sale when a portion of the selling price has not been actually received.

S. REP. NO. 1000, 96th Cong., 2d Sess. 7, reprinted in 1980 U.S. CODE CONG. & ADMIN. NEWS 4696, 4701 [hereinafter SENATE REPORT].

A wraparound mortgage allows the seller to benefit from the lower than market rate of the original mortgage. See Messinger, *Wrap-Around Mortgages: Valuations and Interest Accruals*, 42 N.Y.U. ANN. INST. ON FED. TAX'N § 22.01 [2] (1984). In addition, because he collects the payments from the buyer and then services the underlying mortgage, the seller has control of the property and is well aware of any potential default. *Id.* Finally, by using a wraparound mortgage the seller can avoid large prepayment penalties. See Guerin, *Selected Problems in Wrap-Around Financing: Suggested Approaches to Due-on-Sale Clauses and Purchaser's Depreciable Basis*, 14 U. MICH. J.L. REF. 401, 401-02 (1981).

Alternatively, the buyer may be able to negotiate favorable terms since the seller is not constrained by the statutory restraints placed on banks. *Id.* at 402. In addition, the buyer can avoid "points" and other loan origination fees. *Id.* Finally, the wraparound mortgage's smaller debt service will demand less of the property's income than a new mortgage at prevailing interest rates. Davies, Zumpano & Mansfield, *The IRS Approach to the Wraparound Mortgage: A Contradiction of Tax Fundamentals*, 12 TAX ADVISER 260, 261 n.1 (1981). For a general discussion on use of the installment method in real property transactions, see G. OSBORNE, G. NELSON & D. WHITMAN, *REAL ESTATE FINANCING LAW* § 1.7 (1973).

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tion of real property to recognize income as the proceeds are actually received.² Use of an installment sale permits a seller to spread income over time and thereby avoid liquidity problems that could arise if the entire gain is recognized before full payment is received.³ The benefits afforded the seller by installment reporting may be lost if the purchaser "assumes"⁴ or takes the

² See Fed. Tax. Coordinator 2d (Res. Inst. Am.) ¶ G-6201. The installment method of reporting is a relief provision which enables a taxpayer to receive in cash the profit arising out of each installment before tax on it must be paid. *Id.*

Under the installment method of reporting, the income reportable during any year equals the payment(s) received in that year multiplied by the gross profit ratio (Gross Profit / Total Contract Price). See Bronner, *The Wraparound Mortgage: Its Structure, Uses and Limitations*, 12 J. REAL EST. TAX'N 315, 326 (1985). See also I.R.C. § 453(c) (1982 & Supp. 1984).

³ See SENATE REPORT, *supra* note 1, at 4701. In an installment sale payments are annually divided into portions representing a return on capital and profit. See *Stonecrest Corp. v. Commissioner*, 24 T.C. 659, 665 (1955).

For purposes of computing the amount of tax to be paid, "gross profit" equals the selling price minus the seller's adjusted basis in the property. See Temp. Treas. Reg. § 15a.453-1(b) (1981). The selling price equals the gross selling price without reduction to reflect any existing mortgages or encumbrances. *Id.* Adjusted Basis is defined in § 1011 of the Internal Revenue Code and the regulations thereunder. See I.R.C. § 1011 (1986).

The total contract price (the denominator of the gross profit ratio) is equal to the selling price minus that portion of certain qualifying indebtedness assumed or taken subject to by the buyer that is not in excess of the seller's basis in the property. See Temp. Treas. Reg. § 15a.453-1(b) (1981). Qualifying indebtedness is a mortgage or other indebtedness encumbering the property or other indebtedness not secured by the property but incurred or assumed by the purchaser incident to the purchaser's acquisition, holding or operation of the property, but does not include an obligation incident to the disposition of the property or any obligation unrelated to the acquisition, holding or operating of the property. *Id.*

⁴ See *Stonecrest Corp. v. Commissioner*, 24 T.C. 659, 666-67 (1955). An assumption of a mortgage occurs when the buyer takes over the seller's obligation on the mortgage and incurs an obligation generally enforceable by the mortgagee. *Id.* When a buyer assumes a mortgage he pays the seller for his equity interests. *Id.* In addition, the buyer promises the seller to pay off his mortgage debt and such promise can usually be enforced by the mortgagee. See Dickens & Orbach, *Installment Reporting: Wraparound Mortgages After the IRS's Temporary Regulations and Hunt*, 12 J. REAL EST. TAX'N 137, 143 (1985).

Under the installment method, if the purchaser assumed the existing mortgage, this method of "[taxing] income in the year received did not reach all of the seller's profit, since the total amount of the selling price was not paid over by the buyer to the seller; that portion of the selling price represented by the mortgage was paid by the buyer directly to the mortgagee." *Stonecrest*, 24 T.C. at 665. This gap was originally filled by a treasury regulation, promulgated August 28, 1926 and amended by T.D. 4255, 8-1 C.B. 165 (1929), whereby it was resolved that:

the amount of the mortgage . . . shall be included as a part of the 'selling price,' but . . . to the extent it does not exceed the basis to the vendor of the property sold, shall not be considered as a part of the 'initial payments' or of the 'total contract price'.

Id. See *Stonecrest*, 24 T.C. at 665. This regulation increased the percentage of each installment which would be treated as income and thereby allowed the I.R.S. to reach the entire

property "subject to"⁶ an existing underlying mortgage.⁶ However, the Federal Tax Court has held that where the seller's mode of financing does not constitute an assumption or taking subject to the underlying mortgage, negative tax ramifications can be avoided.⁷ One way to achieve tax benefits is through the use of a wraparound mortgage.⁸ However, the Internal Revenue Service

profit from the sale. *Id.*

⁶ See *Stonecrest*, 24 T.C. at 666. In *Stonecrest*, the Tax Court noted:

Taking property subject to a mortgage means that the buyer pays the seller for the latter's redemption interest, i.e., the difference between the amount of the mortgage debt and the total amount for which the property is being sold, but the buyer does not assume a personal obligation to pay the mortgage debt. The buyer agrees that as between him and the seller, the latter has no obligation to satisfy the mortgage debt, and that the debt is to be satisfied out of the property. Although he is not obliged to, the buyer will ordinarily make the payments on the mortgage debt in order to protect his interest in the property.

Id.

It has recently been affirmed that "[u]nder both terms (i.e., assumed and taken subject to), 'a common element is that the vendor-mortgagor retains his liability, if only secondarily.'" *Sallies v. Commissioner*, 83 T.C. 44, 55 (1984) (quoting *Maddox v. Commissioner*, 69 T.C. 854, 858 (1978)).

⁷ *Hunt v. Commissioner*, 80 T.C. 1126, 1134 (1983). The court in *Hunt* explained that if purchased property is taken subject to a mortgage or the mortgage is assumed by the purchaser:

[T]he amount by which the mortgage liability exceeds the seller's basis is to be treated as a payment received in the year of sale. Also, the mortgage liability is to be excluded from the total contract price, except to the extent of this excess. The latter rule has the effect of reducing the denominator (in the fraction - gross profit divided by total contract price [hereinafter gross profit ratio]), and thereby increasing the portion of each installment payment that is treated as profit.

Id. See also Friedman, *Tax Treatment of Wrap-Around Debt Received in Installment Sales Under Temporary Installment Sale Regulations*, 60 TAXES 439 (1982). "[D]ebt which is assumed or taken 'subject to' [which is not in excess of basis] is not included in the installment sale contract price." *Id.* at 441. When a buyer assumes or takes subject to an existing mortgage, that exceeds the basis of the property being sold, such excess is treated as a payment in the year of sale, resulting in an acceleration of taxpayer's recognized gain. *Levingston, Wrap-around Mortgages Revisited: Temp. Regs. Sec. 15a.453-1(b)(3)(ii)*, 12 TAX ADVISER 452, 453 (1981).

⁸ *Stonecrest*, 24 T.C. at 659 (1955).

⁹ See *Davies, Zumpano & Mansfield, supra* note 1, at 260-65. A wraparound mortgage is a secondary mortgage subordinate to an existing one. 4 P. ROHAN, *REAL ESTATE FINANCING - FORMS* pt. 2, § 3A.04; Kraus, *Tax Advantages of Wraparound Mortgages*, 8 J. REAL EST. TAX'N 264 (1981); Ominsky, *Creative Mortgaging: PMMs, Wraps and Various Participations*, 14 REAL EST. REV. 74, 77 (1984). By merely using a wraparound mortgage the purchaser neither assumes the existing mortgage liability nor takes the property subject to the existing liability. *Hunt*, 80 T.C. at 1145; Williford, *Treatment of Wraparound Mortgage with an Installment Sale*, 17 TAX ADVISER 97, 98 (1986); Friedman, *supra* note 6, at 444. As the purchaser makes payments to the seller on the wraparound, the seller satisfies the original debt. See *Messinger, supra* note 1, § 22.01; *Bronner, supra* note 2, at 319.

The Federal Tax Court has held that when a wraparound mortgage is utilized, the

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("I.R.S.") has consistently rejected the Federal Tax Court's position on wraparound mortgages⁹ and has repeatedly reasserted its argument, based on Temporary Treasury Regulation section 15a.453-1(b)(3)(ii), that the wraparound mortgage is deemed to be a "subject to" mortgage for tax purposes.¹⁰ Recently, in *Professional Equities, Inc. v. Commissioner*,¹¹ the Federal Tax Court declared Temporary Treasury Regulation section 15a.453-1(b)(3)(ii) invalid as inconsistent with section 453 of the Internal Revenue Code ("Code") and well established case law.¹²

In *Professional Equities*, the petitioner was a corporation primarily engaged in the purchase of undeveloped real estate for future resale.¹³ The petitioner customarily resold the land using conditional sales contracts in which the buyer gave petitioner a wraparound mortgage in addition to a down payment.¹⁴ The petitioner would continue to service the underlying mortgage on the parcel with installment payments received from the purchaser.¹⁵ In the sales transactions at issue, the wraparound indebtedness was payable to Professional Equities, Inc. in monthly installments over a period of ten to fifteen years, and included a rate of interest which was higher than that on the underlying mortgage.¹⁶ At the

amount of the mortgage is not to be subtracted from the contract price and that the excess of mortgage over the seller's adjusted basis is not considered a payment in the year of sale. *Stonecrest v. Commissioner*, 24 T.C. 659, 669 (1955). This would reduce both the amount recognized as an initial payment and the gross profit ratio. See *infra* note 20 and accompanying text. The net effect would be to decelerate the recognition of income. Compare note 6 and accompanying text.

⁹ See Temp. Treas. Reg. § 15a.453-1(b)(3)(ii) (1981). This regulation states that a wrapped debt is deemed to be taken subject to. *Id.* See *infra* notes 70-71 and accompanying text.

¹⁰ See Temp. Treas. Reg. § 15a.453-1(b)(3)(ii) (1981).

¹¹ 89 T.C. No. 15, slip op. at ____ (July 23, 1987).

¹² *Id.* at ____.

¹³ See *id.* at _____. When Professional Equities, Inc. purchases real property it either assumes an existing mortgage or it gives the seller a purchase money note and executes a trust deed to secure the note. *Id.* Upon resale of the land these obligations are referred to as the "underlying" or "wrapped indebtedness." *Id.* at ____.

¹⁴ See *id.* at ____.

¹⁵ See *id.* Professional Equities, Inc. was liable for payments on the wrapped indebtedness while the buyer was liable for making the payments on the wraparound indebtedness (i.e. the installment obligation). *Id.* Moreover, Professional Equities, Inc.'s obligation to make payments on the underlying mortgage was not dependent on whether the buyer made payments on the wraparound mortgage. *Id.*

¹⁶ See *id.* at _____. Documents submitted at the trial revealed that Professional Equities, Inc. received payments on its installment obligations from which its obligation on the un-

center of the controversy was the proper amount of gain to be recognized on the petitioner's 1981 income tax return with respect to its installment sales of land on which wraparound mortgages were taken as part of the payment price.¹⁷ The Commissioner determined that petitioner incorrectly computed the proportion of the payments received on installment sales in that year to be recognized as gain.¹⁸ Relying upon Temporary Treasury Regulation section 15a.453-1(b)(3)(ii), the Commissioner contended that the amount of recognizable gain should be calculated by reducing the total contract price by the underlying mortgage,¹⁹ which resulted in acceleration of gain to be recognized in the first year regardless of the rate at which payments were actually received.²⁰ Conversely, the taxpayer argued that the contract price was synonymous with the sales price used in figuring the amount of gross profit.²¹ The petitioner maintained that the temporary regulation was invalid because it was unsupported by section 453 of the Code²² and because it was in conflict with case law.²³

In an opinion by Judge Raum, the Federal Tax Court held Temporary Treasury Regulation section 15a.453-1(b)(3)(ii) invalid due to its "tortuously complex"²⁴ nature and inconsistency with the language of Code section 453 and the goals of the Installment

derlying mortgage could easily be discharged. *Id.* The court stated that:

[p]ayments received on the installment sales were greater than the payments petitioner owed on the underlying mortgages both because the principal amount of the \$104,000 obligation due petitioner (the so-called wraparound mortgage) was larger than that of the \$44,080 underlying mortgages, and because the interest rate on the obligation due petitioner (8% percent) was higher than that on the underlying mortgages (7 and 8 percent).

Id. at ____.

¹⁷ See *id.* at _____. The Commissioner contended that there was a \$28,540 deficiency in Professional Equities, Inc.'s fiscal 1981 income tax return. *Id.*

¹⁸ See *id.* at ____.

¹⁹ See Temp. Treas. Reg. § 15a.453-1(b)(3)(ii) (1981). For the exact language of this regulation, see *infra* note 70.

²⁰ See *Professional Equities*, 89 T.C. No. 15, slip op. at ____ (July 23, 1987). The court noted that the treasury regulation requires gain to be artificially accelerated "solely because in the 'subject to' and 'assumed' situations such a pattern of gain recognition would occur." *Id.* See also Levingston, *supra* note 6, at 453.

²¹ *Professional Equities*, 89 T.C. No. 15, slip op. at ____.

²² See *id.* at _____. See also *infra* note 70.

²³ See *Professional Equities*, 89 T.C. No. 15, slip op. at _____. For a discussion of the case law that is in direct conflict with the regulation, see *infra* note 29 and accompanying text.

²⁴ *Professional Equities*, 89 T.C. No. 15, slip op. at ____.

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Sales Revision Act of 1980.²⁵ The court determined that it could find no justification for the I.R.S.'s radically different treatment of wraparound installment sales.²⁶ The court noted that despite numerous modifications made to Code section 453(c) since *Stonecrest Corp. v. Commissioner*,²⁷ there had been no changes made to the critical governing language of these provisions that would indicate a change in policy regarding the treatment of gain recognized on installment wraparound sales.²⁸ Contrary to the I.R.S.'s position, the court determined that the language of Code section 453(c) speaks of using only a single constant proportion, determined by a fixed ratio of gross profit to total contract price.²⁹ Moreover, the court criticized the I.R.S.'s attempt to justify the change in the treatment of wraparound mortgages through the use of the Installment Revision Sales Act of 1980.³⁰

It is submitted that the analysis in *Professional Equities* was well reasoned and the Federal Tax Court adequately supported its conclusion to invalidate the temporary regulation. Further, it is suggested that the decision in *Professional Equities* evinces the

²⁵ See *id.* at _____. The purpose of the Installment Revision Sales Act of 1980 was to simplify the taxation of installment sales by making structural improvements to the existing law and to remove those limitations on the use of the installment method, such as the 30% requirement, that "operated as a trap for the unwary." *Id.* Further, the court asserted: "the tortuously complex Temporary Regulations promulgated under the 1980 Act can in no way be considered compatible with the goals of that Act." *Id.* at _____.

²⁶ See, e.g., SENATE REPORT, *supra* note 1, at 4701.

²⁷ 24 T.C. 659 (1955).

²⁸ See *Professional Equities*, 89 T.C. No. 15, slip op. at ____ (July 23, 1987). The court stated that the conclusion in *Stonecrest*, that Treasury Regulation § 1.453-4(c) did not apply, was based on the premise that these provisions, by their own terms, were limited to sales in which "the property is merely taken subject to the mortgage or . . . the mortgage is assumed by the purchaser." *Id.* See also *United Pac. Corp. v. Commissioner*, 39 T.C. 721 (1963); *Estate of Lamberth v. Commissioner*, 31 T.C. 302 (1958); *Stonecrest*, 24 T.C. at 667. In a later case, the Tax Court stated that "[t]he *Stonecrest* line of cases provides an appropriate analysis of [the I.R.S.'s] regulations in wraparound mortgage cases. . . . [A]ccordingly, so long as [the I.R.S.'s] regulations remain unchanged, we will not exclude wraparound mortgages per se from our *Stonecrest*-line analysis." *Hunt v. Commissioner*, 80 T.C. 1126, 1143 (1983) (footnote omitted). In a footnote the court noted that the temporary regulations were inapplicable to the case at bar. *Id.* at 1143 n.14. However, the *Hunt* court alluded to the possibility that the same conclusion would have been reached had the regulations been applicable. See *id.* at 1142-43.

²⁹ See *Professional Equities*, 89 T.C. No. 15, slip op. at _____.

³⁰ See *id.* at _____. The court noted that in the Installment Sales Revision Act of 1980, § 453 was repealed and replaced by a new § 453 containing the same proportion for taxing gain. *Id.* See also *supra* note 1 and accompanying text; *infra* notes 99-100 and accompanying text.

court's continuous support for its past position, that a well structured wraparound mortgage is not a "subject to" mortgage despite the I.R.S.'s argument that wraparound indebtedness should, for tax purposes, be deemed equivalent to "subject to" mortgages.³¹ The long term implications of *Professional Equities* are unclear, yet one conclusion is inescapable: the Tax Court is expanding its prior position and is showing no signs of retreat. This comment will first examine the court's reliance on prior precedent and will trace the development of the *Stonecrest* doctrine. It will then discuss the I.R.S.'s attempt to codify its position in disregard of *Stonecrest*. Finally, this comment will discuss the effect the Tax Reform Act of 1986 may have on sales which utilize a wraparound mortgage.

I. THE *Stonecrest* DOCTRINE

In reaching its conclusion in *Professional Equities*, the Tax Court adhered to its long-standing line of decisions beginning with *Stonecrest Corp. v. Commissioner*,³² which established that if a wrap-around mortgage was utilized in a conditional sales contract, the purchaser neither assumes the original indebtedness nor takes the property subject to the underlying mortgage.³³ The sales transactions in *Stonecrest* were essentially like those in *Professional Equities*.³⁴ In *Stonecrest*, the taxpayer sold mortgaged homes under an arrangement in which the buyer agreed to make all payments on the purchase price directly to the seller, who would in turn service the original mortgage.³⁵ The agreement stipulated that title to the

³¹ *Professional Equities*, 89 T.C. No. 15, slip op. at — (July 23, 1987). See Installment Sales Revision Act of 1980, Pub. L. No. 96-471 § 2(a), 94 Stat. 2247 (1980) (codified as amended at I.R.C. §§ 453, 453A, 453B (1982 & Supp. 1984) [hereinafter Installment Sales Revision Act.] For a discussion of the Installment Sales Revision Act, see *infra* notes 90, 94, 99-100 and accompanying text.

³² 24 T.C. 659 (1955).

³³ *Id.* at —.

³⁴ See *Professional Equities, Inc. v. Commissioner*, 89 T.C. No. 15, slip op. — (July 23, 1987).

³⁵ *Stonecrest*, 24 T.C. at 662-63. Compare *id.* at 666-67 (court noted that the purchaser was required to make installment payments to the seller as provided in the promissory note and the seller was required to apply these installment payments against the original mortgage) with *Professional Equities*, 89 T.C. No. 15, slip op. at — (seller's obligation to a senior mortgagee to make payments on the underlying mortgage was not dependent on whether he received payment from buyer; furthermore, the seller was not required to apply these

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property need not be conveyed for several years³⁶ and upon such conveyance the buyer would assume the mortgage.³⁷ The Tax Court held that there was no assumption under the facts of the case since the contract specifically stipulated that the buyer was under no present obligation to the mortgagee.³⁸ It could not be said that the purchaser took property subject to the original mortgage because there was no understanding that the debt was to be satisfied out of the property.³⁹ Rather, the seller agreed to make payments on the mortgage until conveyance of the title.⁴⁰ The court held that since there was no assumption nor taking subject to the previous mortgage,⁴¹ the I.R.S. erred in subtracting the

installment payments to the underlying obligation).

³⁶ *Stonecrest*, 24 T.C. at 666-67. The court found that the seller was required to deliver and that the buyer was required to accept conveyance of the property within five to twelve years after the first payment was made. *Id.* at 662, 667. Although the agreement stated that there was to be an "assumption," the buyer, in essence, signed a guaranty of the seller's original mortgage loan. *See id.* The court further explained that "[e]ven if title had passed before complete performance by the purchaser, the [seller] would have remained primarily liable to the bank for the unpaid amount of the mortgage." *Id.* at 662.

³⁷ *Id.* The court noted from the agreement that upon conveyance the buyer was to assume payment of the promissory note secured by a deed of trust. *Id.* Compare *Professional Equities*, 89 T.C. No. 15, slip op. at ____ (July 23, 1987). The seller did not convey title to the property until the purchaser had paid the entire balance together with interest. *Id.*

³⁸ *Stonecrest*, 24 T.C. at 667. In *Stonecrest*, the buyer agreed to assume the mortgage upon conveyance and under such stipulation the buyer was under no present obligation to the mortgagee. *Id.* The court took a strict view of what would constitute an assumption of indebtedness; the court refused to infer an assumption unless it actually occurred. *Id.* at 662-63. The court further noted that the fact that the seller was to utilize the installment payments to pay off the mortgage did not constitute an assumption by the buyer. *Id.* But see *Republic Petroleum Corp. v. United States*, 613 F.2d 518, 522 (5th Cir. 1980) (deemed assumption); *Goodman v. Commissioner*, 74 T.C. 684, 686-87 (1980), *aff'd*, 673 F.2d 1332 (7th Cir. 1981) (same); *Voight v. Commissioner*, 68 T.C. 99, 114 (1977), *aff'd*, 614 F.2d 94 (5th Cir. 1980) (same).

³⁹ *Stonecrest*, 24 T.C. at 667. The expression "subject to" a mortgage means that the buyer has no personal obligation to pay the mortgage indebtedness; as between the buyer and seller, the seller has no obligation to pay the debt and the debt is to be satisfied from the property itself. *Id.* See *supra* note 5 and accompanying text. The *Stonecrest* court specifically noted that "there was no understanding that the debt was to be satisfied out of the property" *Stonecrest*, 24 T.C. at 667.

⁴⁰ *Id.*

⁴¹ *Id.* at 668-69. In discussing the terms "assumption" and "subject to", the court clarified its position: "These expressions we take to have the meaning customarily attributed to them in transactions concerned with the transfer of mortgaged property." *Id.* at 666. See *Professional Equities*, 89 T.C. No. 15, slip op. at ____ In *Professional Equities*, the court asserted that "[s]ince 1955, when this Court found in *Stonecrest* that the installment sales regulations did not cover the wrap-around variation, we have been allowing the recognition of gain in such wrap-around sales according to our understanding of the statutory mandate." *Id.* at ____ Further, the court noted that their conclusion that wraparound sales

mortgage from the total contract price and including the excess of the mortgage over the basis in the initial payment.⁴² The net effect of the holding was to reduce both the gross profit ratio, i.e., the percentage of each installment payment to be reported as income, and the amount recognized as the initial payment in the year of sale.⁴³

A. *United Pacific Corp. v. Commissioner*

The first case decided pursuant to the 1954 Code⁴⁴ was *United Pacific Corp. v. Commissioner*.⁴⁵ In *United Pacific*, an agreement between the purchaser and seller of a building stipulated that the purchaser would make payments directly to the seller and that the seller would continue to service the underlying mortgage.⁴⁶ When the agreed-to purchase price was paid in full, excluding the amount of the mortgage, the seller was to transfer title to the pur-

are to be taxed under their own distinct method is generally accepted by those courts which have been faced with the issue. *See id.* at _____. For further illustration of this distinction, see *supra* notes 15-17 and accompanying text.

⁴² *Stoncrest*, 24 T.C. at 668-69. The court found that the I.R.S. wrongfully subtracted the amount of the mortgage from the total contract price in determining the gross profit ratio. *Id.* at 669. The court also found that the I.R.S. was not permitted to include the original mortgage in excess of the seller's basis in computing the initial payment received by the seller. *Id.*

⁴³ Friedman, *supra* note 6, at 441. Under the rationale of *Stoncrest*, the underlying indebtedness is ignored in computing the amount of payments received in the year of sale and in calculating the gross profit ratio. *Id.* "This treatment has the effect of (i) reducing the amount of payment in the year of sale by the amount of the debt in excess of basis and (ii) lowering the gross profit ratio." *Id.* Based on *Stoncrest*, "taxpayers have ignored the underlying indebtedness . . . in computing the amount of their payments in the year of sale and in calculating the contract price and the gross profit ratio." *Id.* See *supra* notes 1-3 and accompanying text (explaining gross profit ratio).

Estate of Lamberth v. Commissioner, 31 T.C. 302 (1958), involved facts similar to those of *Stoncrest*. Compare *Stoncrest*, 24 T.C. at 666-67 (purchaser of property agreed to make all payments on purchase price directly to seller who then paid off original mortgage) and *Estate of Lamberth*, 31 T.C. at 303-09 (purchaser paid seller who in turn serviced original mortgage). In *Lamberth*, the court held that when a seller services the original mortgage liability the amount of such mortgage is not excluded from the contract price. *Lamberth*, 31 T.C. at 318. If the amount of the wrapped mortgage was subtracted from the contract price, the ratio of gross profit to contract price would be one-to-one and the gross profit on the sale would be taxed during the first five years, even though payments were to continue for another five years. *Id.* The court held that this would be inconsistent with the use of the installment method of reporting income, which purports to consistently tax gain over the entire contract period. *Id.*

⁴⁴ I.R.C. § 453(c) (1954); Treas. Reg. § 1.453-4 (1958).

⁴⁵ 39 T.C. 721 (1963).

⁴⁶ *Id.* at 723-24.

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chaser,⁴⁷ with the purchaser assuming the remaining payments on the underlying mortgage.⁴⁸ The Tax Court applied the *Stonecrest* doctrine, holding that the excess of the underlying mortgage over the seller's basis was not to be considered a payment in the year of sale.⁴⁹ While the Tax Court continues to apply the *Stonecrest* doctrine it will not sustain apparent "wraparounds" that do not include every element required by *Stonecrest*.⁵⁰

⁴⁷ *Id.* at 724.

⁴⁸ *Id.* The court noted that unless there was a present assumption of a mortgage or taking of property subject to a mortgage, the indebtedness attributable to the wrapped mortgage was not to be excluded from the contract price. *Id.* at 726. See *supra* notes 28-43 and accompanying text.

⁴⁹ *United Pac.*, 39 T.C. at 727. For a discussion of the *Stonecrest* doctrine, see *supra* notes 28-43 and accompanying text.

⁵⁰ See *Professional Equities, Inc. v. Commissioner*, 89 T.C. No. 15, slip op. at — (July 23, 1987); *Stonecrest Corp. v. Commissioner*, 24 T.C. 659 (1955). In the thirty years since *Stonecrest*, the Tax Court's focus has been to determine whether the sales transaction at issue is a true wraparound mortgage. *Id.* *Professional Equities*, 89 T.C. No. 15, slip op. at — n. 8; *Webb v. Commissioner*, T.C.M. 1987-451 slip op. at — (September 9, 1987). In those cases where the Tax Court has refused to apply § 1.453-4(c), "the transaction was found to be, in substance, different from those transactions this regulation was designed to address." *Id.* In *Stonecrest* the court outlined the elements a mortgage must possess in order to avoid the I.R.S.'s classification of "subject to" or "assumed" status. *Stonecrest*, 24 T.C. at 667. The intent of the parties must be that the seller satisfy the senior debt. *Id.* at 668. The selling price must not have been reduced because of the senior debt. *Id.* The buyer's payments must relate only to his obligation to the seller and should not relate to the latter's obligation to the senior mortgagee. *Id.* In the following cases the parties lacked one of the essential elements and the buyer was held to have either assumed the underlying mortgage or taken the property subject to the original debt. See, e.g., *Republic Petroleum Corp. v. Commissioner* 613 F.2d 518 (5th Cir. 1980); *Goodman v. Commissioner*, 74 T.C. 684 (1980), *aff'd without published opinion*, 673 F.2d 1332 (7th Cir. 1981); *Voight v. Commissioner*, 68 T.C. 99 (1977), *aff'd*, 614 F.2d 94 (5th Cir. 1980); *Waldrep v. Commissioner*, 52 T.C. 640 (1969), *aff'd*, 428 F.2d 1216 (5th Cir. 1970).

In *Waldrep*, the buyer executed a note, secured by a mortgage, to both the seller of the property and to the holder of the underlying mortgage. *Id.* at 642. The seller then endorsed the note over to the mortgagee. *Id.* The court held that there was "no substantive distinction between a formal agreement to assume an existing mortgage and the creation of a new mortgage on the same property to secure a newly created personal liability of the transferee [purchaser] to the mortgage in the same amount [as the underlying mortgage]." *Id.* at 646. Thus, the transaction was, in essence, nothing more than the assumption of a mortgage. *Id.*

Another illustration of a deemed assumption is the *Goodman* case. *Goodman*, 74 T.C. 684 (1980). In *Goodman*, the taxpayer made payments to a banking institution, which in turn, serviced the original mortgage. *Id.* at 691. The purchasers were treated as if they had taken the property subject to the underlying debt because the banking institution was viewed as a mere conduit for payments due on the first mortgage. *Id.* at 714.

Finally, in *Republic Petroleum*, the language of the sales agreement and the minutes of a meeting of the buyer/corporation's board of directors specified that the corporation had assumed the mortgage. *Republic Petroleum*, 613 F.2d at 523. The buyer made some payments directly to the seller and sent other checks directly to the mortgagee bank. *Id.* The

B. *Hunt v. Commissioner*

The dilemma of determining the proper tax treatment of a wraparound mortgage was again before the Tax Court in *Hunt v. Commissioner*.⁶¹ Once again, the Commissioner argued that the purchaser acquired the property subject to the mortgage, relying on Treasury Regulation section 1.453-4(c).⁶² After reviewing the relevant case law and Treasury Regulation section 1.453-4(c),⁶³ the Tax Court held that the purchaser did not assume or take the property subject to the underlying mortgage.⁶⁴ Therefore, the amount by which the mortgage debt exceeded basis was not treated as a payment received by the seller in the year of sale⁶⁵ and no part of the underlying mortgage was to be excluded from the contract price for the purpose of determining the gross profit ratio.⁶⁶ This allows the seller to more effectively delay the recognition of income over the period in which installment payments are received.⁶⁷

The Tax Court upheld the *Stonecrest* doctrine⁶⁸ and explicitly extended its rationale to include situations in which title to the subject property was in fact conveyed.⁶⁹ However, the court ac-

United States Court of Appeals for the Fifth Circuit held that, based on the intent of the parties and the substance of the transactions, the buyer had assumed the mortgage. *Id.*

⁶¹ 80 T.C. 1126 (1983). During 1973, Hunt contracted to sell an apartment complex which had an outstanding mortgage debt of about \$2 million, with a basis of approximately \$1.6 million, for a price of \$2.7 million. *Id.* at 1128-30. Pursuant to the sales contract, the seller was obligated to service the underlying mortgage indebtedness. *Id.* at 1129. The buyer executed a wraparound note for \$2.5 million and gave a purchase money note and cash for the remaining \$200,000. *Id.* at 1130.

⁶² *Id.* at ____ See also *Webb v. Commissioner*, T.C.M. 1987-451 slip op. at ____ (September 9, 1987) (court noted Commissioner repeatedly advanced this position since 1955 and Tax Court consistently rejected his argument).

⁶³ See *Hunt v. Commissioner*, 80 T.C. 1126, 1134-35 (1983).

⁶⁴ *Id.* at 1145.

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ See *supra* notes 2 and 6 and accompanying text. If the excess of mortgage liability over basis is considered a payment in the year of sale and the amount of liability (except to the extent of such excess) is excluded from the contract price, the recognition of gain is accelerated. *Id.*

⁶⁸ *Hunt v. Commissioner*, 80 T.C. 1126, 1143 (1983). The court held that the *Stonecrest* line of cases provided a proper analysis of the applicable treasury regulation in cases of wraparound mortgages. *Id.* For an in depth discussion and analysis of the *Stonecrest* doctrine see *supra* notes 28-43 and accompanying text.

⁶⁹ *Hunt*, 80 T.C. at 1141-42. The Tax Court concluded that the conveyance of title to the property did not cause the case "to fall outside the analysis of the *Stonecrest* line . . ."

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knownedged that eight years after the sale of the property,⁶⁰ temporary treasury regulations relating to issues set forth in *Hunt* were enacted.⁶¹ Since these regulations did not apply to the case at bar, the Tax Court made no comment on the outcome of a case decided with reference to the temporary regulations.⁶² It is submitted that the position adopted by Temporary Treasury Regulation section 15a.453-1(b) is contrary to the intent of Congress and therefore invalid.

The *Professional Equities* court noted that the *Stonecrest* method of recognizing gain as applied to wraparound sales has been consistently followed by those courts faced with the issue⁶³ and that this method has the tacit approval of Congress.⁶⁴ In each case where the Federal Tax Court has refused to apply section 1.453-4(c) the transaction was found to be in substance, different from those transactions that the regulation was designed to address.⁶⁵ Nevertheless, the I.R.S. promulgated temporary regulations which called for treatment of wraparound mortgages that is radically different⁶⁶ from what was set out in *Stonecrest* and its progeny.⁶⁷

and rejected the I.R.S.'s contention that the fact of conveyance was a "fundamental distinction." *Id.* See Dickens & Orbach, *supra* note 4, at 138. These authors noted that, in *Hunt*, the Tax Court extended prior case law on wraparounds to include a sale with an immediate transfer of title. *Id.* Another commentator has suggested that the *Hunt* court held that the rationale of the *Stonecrest* line of cases applied to a sale involving a wraparound mortgage when title is immediately transferred to the buyer. Kaster, *Wrap-Around Mortgage Not Payment Says TC*, 59 J. Tax'n 188, 188 (1983).

⁶⁰ See *Hunt*, 80 T.C. at 1128. The property at issue was sold in 1973. *Id.*

⁶¹ See Temp. Treas. Reg. § 15a.453-1 (1981).

⁶² See *Hunt*, 80 T.C. at 1143 n.14. The court stated "[t]hese temporary regulations do not purport to apply to the years before the Court and so we make no comment on what the result would be under these temporary regulations in the factual setting of the instant cases." *Id.*

⁶³ See *Professional Equities, Inc. v. Commissioner*, 89 T.C. No. 15, slip op. at ____ (July 23, 1987). See, e.g., *Stonecrest Corp. v. Commissioner*, 24 T.C. 659 (1959); *Estate of Lamberth v. Commissioner*, 31 T.C. 302 (1958); *Hunt v. Commissioner*, 80 T.C. 1126 (1983).

⁶⁴ See *Professional Equities*, 89 T.C. at _____. See also *infra* note 90, and accompanying text. (Prior to enactment of Installment Sales Revision Act, congressional committees indicated their awareness of *Stonecrest*, yet no changes were made in critical language of § 453 with respect to method of computing gain included in each installment as approved in *Stonecrest*).

⁶⁵ See *Professional Equities*, 89 T.C. at _____. To see where the Tax Court has applied form over substance, see *supra* note 50.

⁶⁶ See *Professional Equities*, 89 T.C. at _____. See generally *infra* notes 70-86, and accompanying text.

⁶⁷ See Dickens & Orbach, *supra* note 4.

II. TEMPORARY TREASURY REGULATION SECTION 15a.453-1(b)(3)(ii)

Pursuant to the Installment Sales Revision Act of 1980,⁶⁸ the I.R.S. attempted to undercut the authority of the *Stonecrest* doctrine⁶⁹ by issuing Temporary Treasury Regulation section 15a.453-1(b)(3)(ii).⁷⁰ The *Professional Equities* court sharply criticized the I.R.S.'s attempt to use the Installment Sales Revision Act to justify the changes made by the temporary treasury regulation.⁷¹ The regulation states that a wrapped debt is deemed to be taken "subject to" regardless of whether title has passed in the year of sale or whether the seller remains liable on the underlying obligation.⁷²

⁶⁸ Installment Sales Revision Act of 1980, Pub. L. No. 96-471, § 2(a), 94 Stat. 2247 (1980) (codified as amended at I.R.C. §§ 453, 453A, 453B (1982 & Supp. 1984)) [hereinafter *Installment Sales Revision Act*].

⁶⁹ See *supra* notes 28-43 and accompanying text.

⁷⁰ Temp. Treas. Reg. § 15a.453-1(b)(3)(ii) (1981) provides:

(ii) *Wrap-around mortgage* A "wrap-around mortgage" means an agreement in which the buyer initially does not assume and purportedly does not take subject to part or all of the mortgage or other indebtedness encumbering the property ("wrapped indebtedness") and, instead, the buyer issues to the seller an installment obligation the principal amount of which reflects such wrapped indebtedness. Ordinarily, the seller will use payments received on the installment obligation to service the wrapped indebtedness. The wrapped indebtedness shall be deemed to be taken subject to even though title to the property has not passed in the year of sale and even though the seller remains liable for payments on the wrapped indebtedness. In the hands of the seller, the wrap-around installment obligation shall have a basis equal to the seller's basis in the property which was the subject of the installment sale, increased by the amount of gain recognized in the year of sale, and decreased by the amount of cash . . . received in the year of sale . . . the amount of any indebtedness assumed or taken subject to by the buyer (other than wrapped indebtedness) is to be treated as cash received by the seller in the year of sale.

Therefore . . . the gross profit ratio with respect to the wrap-around installment obligation is a fraction, the numerator of which is the face value of the obligation less the taxpayer's basis in the obligation and the denominator of which is the face value of the obligation.

Id.

It has been suggested that the I.R.S. has attempted to use the Installment Sales Revision Act "to attempt to accomplish through the regulatory process what it abjectly failed to do in court." Dickens & Orbach, *supra* note 4, at 148-49. Other commentators have voiced similar concerns. See, e.g., Friedman, *supra* note 6, at 442. (I.R.S. has attempted to undercut the "precedential basis" of *Stonecrest*); Levingston, *supra* note 6, at 452, 454 (temporary regulation represents "legislation by regulation").

⁷¹ *Professional Equities, Inc. v. Commissioner*, 89 T.C. No. 15, slip op. at ___ (July 23, 1987). See also Davies, Zumpano & Mansfield, *supra* note 1, at 264 ("to now allow the I.R.S. to do administratively that which Congress refused to do by statute would introduce a new, volatile and dangerous element into the taxing system").

⁷² Temp. Treas. Reg. § 15a.453-1(b)(3)(ii) (1981). For the exact language of this regula-

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This regulation attempted to create a new method of determining recognized gain in transactions financed by a wraparound mortgage.⁷³ The *Professional Equities* court characterized this method of determining gain as “virtually incomprehensible”⁷⁴ from the language of the regulation.⁷⁵ The regulation established two gross profit ratios, one in the year of sale and the other in subsequent years.⁷⁶ The gross profit ratio in the year of sale is computed in a similar manner as prior to the enactment of the temporary regulation, except that now the wraparound indebtedness is ignored and the underlying wrapped mortgage is considered indebtedness subject to which the property was purchased.⁷⁷ When a wraparound mortgage is utilized and the original mort-

tion, see *supra* note 70.

⁷³ See *Professional Equities*, 89 T.C. at _____. The court stated that Temp. Treas. Reg. § 15a.453-1(b)(3)(ii) introduced a new concept: “the basis of the installment obligation as distinguished from the seller’s basis in the property itself—resulting in two different proportions required to be applied to payments made, neither of which is clearly set out in the regulation.” *Id.* at _____. Moreover, the court noted:

the highly complex regulations attempt to tax the gain on wrap-around sales at the rate such gain would be recognized if the adjusted proportion were used but applied only to that part of the sales price that would be paid to the seller (i.e., that in excess of the underlying mortgage) if the sales were made ‘subject to’ a mortgage or involved an ‘assumed’ mortgage.

Id. See also Bronner, *supra* note 2, at 338 (temporary regulation creates new method of computing seller’s recognized gain in a wraparound mortgage situation). See, e.g., Temp. Treas. Reg. § 15a.453-1(b)(5) (1981) (Examples 5 and 6).

⁷⁴ *Professional Equities*, 89 T.C. at _____.

⁷⁵ See Temp. Treas. Reg. § 15a.453-1(b)(3)(ii) (1981).

⁷⁶ *Id.* “[I]t was the purpose of . . . [section 453] that a constant proportion, determined by a fixed ratio of gross profit to total contract price of each installment payment be returned as income.” *Estate of Lamberth v. Commissioner*, 31 T.C. 302, 318 (1958). See also Bronner, *supra* note 2, at 338 (temporary regulations require calculation of two gross profit percentages: one for year of sale and one for subsequent years); Friedman, *supra* note 6, at 442 (same); Levingston, *supra* note 6, at 455 (same). See, e.g., Temp. Treas. Reg. § 15a.453-1(b)(5) (Examples 5 and 6). Examples 5 and 6 reveal the goal of the regulation to reach the gain on payments received through the use of two ratios. *Professional Equities, Inc. v. Commissioner*, 89 T.C. No. 15, slip op. at ____ (July 23, 1987). The I.R.S. maintains that the use of these two proportions will result in taxing the gain on an installment sale financed by a wraparound at the same rate as an installment sale financed by a “subject to” or “assuming” an existing mortgage. *Id.* at _____. However, there is no support for the I.R.S.’s position in § 453 of the Code to indicate that Congress approved the use of the two ratio method. *Id.* The *Professional Equities* court stated that the language of this provision “clearly speaks in terms of only a single proportion.” *Id.*

⁷⁷ See Temp. Treas. Reg. § 15a.453-1(b)(3)(ii) (1981). See, e.g., Temp. Treas. Reg. § 15a.453-1(b)(5) (1981) (Examples 5 and 6). For an explanation of the ramifications of taking property subject to an underlying mortgage, see *supra* notes 5 and 6 and accompanying text.

gage exceeds the seller's basis in the property, this method of computation will increase both the gross profit ratio in the year of sale (gross profit over contract price)⁷⁸ to 100%⁷⁹ and further increase the payment recognized in the year of the sale to the extent the underlying obligation exceeds the seller's basis.⁸⁰ The net effect of applying this increased gross profit ratio to the increased recognized payment in the year of sale is to accelerate the recog-

⁷⁸ Temp. Treas. Reg. § 15a.453-1(b)(3)(ii) (1981). The amount of any payment which is income is that portion of the installment payment received in that year which gross profit realized or to be realized bears to the total contract price. Temp. Treas. Reg. § 15a.453(b)(2) (1981). See also Friedman, *supra* note 6, at 442 ("The gross profit ratio in the year of sale is a fraction, the numerator of which is gross profit and the denominator of which is the contract price"). For discussion of the components of the gross profit ratio, see *supra* notes 1-3 and accompanying text.

⁷⁹ Bronner, *supra* note 2, at 339. Bronner noted that the gross profit ratio in the year of sale will be 100% whenever the mortgage is in excess of the seller's basis in the property. *Id.* This is true because:

whenever the underlying mortgage is greater than the seller's basis in the property, gross profit will equal the total contract price. Recall that the total contract price = [equals] selling price - [minus] mortgage assumed or taken subject to (limited to seller's basis in the property); and that gross profit = [equals] selling price - [minus] seller's basis in the property.

Id. at 339 n.97. To illustrate this concept numerically:

A sells realty encumbered by a first mortgage with a principal amount of \$500,000 and a second mortgage with a principal amount of \$400,000 to Z for a selling price of \$2,000,000. A's basis in the property is \$700,000. Under the sales agreement, passage of title is deferred . . . Z pays A \$200,000 in cash and issues a wraparound mortgage note with a principal amount of \$1,800,000 . . . Z is treated as having acquired the realty subject to the first and second mortgage (wrapped indebtedness) totaling \$900,000. The total contract price is \$1,300,000 (\$2,000,000 minus \$700,000 mortgages not in excess of basis). The gross profit is also \$1,300,000 (\$2,000,000 minus \$700,000 basis). The gross profit ratio is 100% (\$1,300,000 divided by \$1,300,000).

Fed. Tax Guide Rep. (CCH) ¶ 4138 at 1411 (1986).

In his article, Livingston noted that when the amount of the underlying mortgage indebtedness is in excess of the seller's basis and a wraparound mortgage is used the gross profit percentage in the year of sale will always be 100% because the contract price will always equal the gross profit. See Livingston, *supra* note 6, at 455.

⁸⁰ Temp. Treas. Reg. § 15a.453-1(b)(3) (1981). This section makes it clear that "[f]or purposes of determining the amount of payment received in the taxable year the amount of qualifying indebtedness . . . assumed or taken subject to by the person acquiring the property shall be included only to the extent it exceeds the basis of the property." *Id.* For an explanation of "qualifying indebtedness," see *supra* note 3.

To illustrate its position on payment to be recognized in the year of sale the I.R.S. has set forth this example:

H has a basis in Blackacre of \$700,000 and sells Blackacre for \$200,000 cash and a wraparound note of \$1,800,000. The land is encumbered by a senior mortgage of \$900,000. Payment in the year of sale is \$400,000 (\$200,000 cash plus \$200,000 mortgage in excess of basis (\$900,000 - \$700,000)).

See Temp. Treas. Reg. § 15a.453-1(b)(5) (Example 5) (1981).

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niton of income.⁸¹

The gross profit ratio of the wraparound installment obligation,⁸² which is to be used subsequent to the year of sale,⁸³ is the face amount of the obligation minus the seller's basis in the obligation over the face value of the obligation.⁸⁴ For purposes of computing this ratio, the seller's basis in the obligation is equal to the seller's basis in the subject property adjusted accordingly to reflect the seller's gain recognized and property received.⁸⁵ Furthermore, the amount of indebtedness assumed or taken subject to, excluding the wrapped indebtedness, is to be treated as cash received in the year of sale.⁸⁶

In *Professional Equities*, the petitioner directly challenged the method of taxing gain that the I.R.S. codified in the new regulations arguing that the utilization of two gross profit ratios was not supported by Code section 453, its legislative history or by case law.⁸⁷ Congress has defined the income recognized in any taxable

⁸¹ See *Professional Equities, Inc. v. Commissioner*, 89 T.C. No. 15, slip op. at ___ (July 23, 1987). The court asserted that the regulations require gain to be artificially accelerated "regardless of the rate at which payments are received solely because in the 'subject to' and 'assumed' situations, such a pattern of gain recognition would occur." *Id.* at ___. The court further noted that in "assumed" and "subject to" transactions any disproportionate gain resulting in the year of sale does so because a disproportionate amount of payments have been received in that year. *Id.* at ___. See, e.g., Temp. Treas. Reg. § 15a.453-1(b)(5) (Examples 5 and 6). See also *supra* notes 5 and 6 and accompanying text (seller's recognized gain accelerated when purchaser takes property subject to a mortgage in excess of seller's basis).

⁸² Temp. Treas. Reg. § 15a.453-1(b)(3)(ii) (1981). The regulation provides in pertinent part: "the gross profit ratio with respect to the wrap-around installment obligation is a fraction the numerator of which is the face value of the obligation less the taxpayer's basis in the obligation and the denominator of which is the face value of the obligation." *Id.*

⁸³ See *id.* See also *Dickens & Orbach*, *supra* note 4, at 150 (temporary regulation prescribes a separate gross profit ratio to be applied to wraparound installment obligation, upon which subsequent payments are received); *Friedman*, *supra* note 6, at 442 (the payments received subsequent to the year of sale are multiplied by the gross profit ratio of the installment obligation).

⁸⁴ Temp. Treas. Reg. § 15a.453-1(b)(3)(ii) (1981).

⁸⁵ *Id.* See *supra* note 70 for full text of the regulation.

⁸⁶ Temp. Treas. Reg. § 15a.453-1(b)(3)(ii) provides in pertinent part: "the amount of any indebtedness assumed or taken subject to by the buyer (other than wrapped indebtedness) is to be treated as cash received by the seller in the year of sale." *Id.* See *supra* note 70.

⁸⁷ See *Professional Equities, Inc. v. Commissioner*, 89 T.C. No. 15, slip op. at ___ (July 23, 1987). See also *Webb v. Commissioner*, T.C.M. 1987-451, slip op. at ___ (September 9, 1987).

Petitioner, relying on section 453 and numerous opinions of this court regarding the installment sale of encumbered real property to compute its gain, argues that section 15a.453-1(b)(3)(ii), Temporary Income Tax Regs . . . is in direct conflict with estab-

year from a qualifying installment sale as the "proportion of the payments received in that year which the gross profit . . . bears to the total contract price."⁸⁸ Thus, Congress recognized that "payments" will be received but elected to use the words "proportion," "gross profit" and "contract price" in the singular form, implying that a single gross profit ratio should be employed.⁸⁹ Furthermore, there is no evidence that Congress considered the use of two gross profit ratios.⁹⁰ Since the basic purpose of the installment method of reporting income is to consistently tax gain over the entire contract period,⁹¹ the court concluded that the use of two gross profit ratios was inconsistent with legislative intent.⁹²

Although the Treasury Department has been granted the general authority to enact rules and regulations to enforce the Code⁹³ the court suggested that the promulgation of Temporary Treasury Regulation section 15a.453-1(b)(3)(ii) totally ignored the purpose of the Installment Sales Revision Act.⁹⁴ It should be noted that Congress specifically empowered the Secretary of the Treasury to prescribe necessary and appropriate regulations to carry

lished case law, and is wholly inconsistent with the language, legislative history and purpose of section 453, therefore, it is invalid.

Id.

⁸⁸ I.R.C. § 453(c) (1982).

⁸⁹ See I.R.C. § 453(c) (1982 and Supp. 1984). See also Dickens & Orbach, *supra* note 4, at 150 (§ 453 refers to "gross profit" [singular] and "contract price" [singular]).

⁹⁰ See SENATE REPORT, *supra* note 1, at 4725. The legislative history of the Installment Sales Revision Act shows that the Committee was aware of the *Stonecrest* decision and that the I.R.S. had published its non-acquiescence to that decision. See *id.* at 4703. Since the Committee only changed the treatment of a wraparound mortgage to the extent of eliminating the 30% rule, it is submitted that at least the Senate either maintained the status quo in this area or tacitly approved current Tax Court decisions. *Id.* at 4703-04 & n.2. For a discussion of the 30% rule, see *infra* note 101.

⁹¹ SENATE REPORT, *supra* note 1, at 4701.

⁹² See Dickens & Orbach, *supra* note 4, at 150 ("[T]he concept of two gross profit ratios of the temporary regulations is dissonant with the enabling legislation").

⁹³ See I.R.C. § 453(j)(1) (1982) ("the Secretary shall prescribe such regulations as may be necessary or appropriate in carrying out the provisions of this section").

⁹⁴ See *Professional Equities, Inc. v. Commissioner*, 89 T.C. No. 15, slip op. at ____ (July 23, 1987). The court stated that the I.R.S.'s attempt to support the temporary regulations was made "more egregious by its use of the Installment Sales Revision Act of 1980 to justify the changes made by the temporary regulations." *Id.* at ____ . Moreover, the court noted that the Act's purpose was not to revise the tax treatment of wraparound sales but to simplify it by "making structural improvements to existing law." *Id.* Thus, "[t]he tortuously complex treasury regulations promulgated under the pretext of interpreting the changes made in the 1980 Act can in no way be considered compatible with the goals of that Act." *Id.* at ____ .

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out the provisions of the Code relating to the installment method of reporting income.⁹⁵ Treasury regulations are generally upheld by the courts unless they are clearly inconsistent with the enabling revenue statute.⁹⁶ However, if a regulation does not reasonably relate to the purpose of the underlying legislation, the courts will not uphold the regulation's validity.⁹⁷

Subsequent to the passage of the Installment Sales Revision Act of 1980, the I.R.S. codified its position that a purchaser utilizing a wraparound mortgage takes the purchased property subject to the underlying indebtedness.⁹⁸ However, nothing in the Installment Sales Revision Act⁹⁹ nor its legislative history manifest a congressional intent to adopt such a position.¹⁰⁰ Interestingly, the only mention of wraparound mortgages appeared when the Senate Committee analyzed the inadequacies inherent in the 30% rule.¹⁰¹

⁹⁵ See I.R.C. § 453 (j)(1) (1982). For the exact language of this section, see *supra* note 93.

⁹⁶ See *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948). In *South Texas*, the Supreme Court noted that treasury regulations will be sustained unless "unreasonable and plainly inconsistent" with the revenue statutes. *Id.*

⁹⁷ See *United States v. Cartwright*, 411 U.S. 546, 550 (1973); *Mourning v. Family Publications Serv. Inc.*, 411 U.S. 356, 369 (1973); *Washington v. Commissioner*, 77 T.C. 656, 675 (1981), *aff'd*, 692 F.2d 128 (D.C. Cir. 1982). Courts will sustain the validity of regulations so long as they "implement the congressional mandate in some reasonable manner." *Cartwright*, 411 U.S. at 550 (quoting *United States v. Correll*, 389 U.S. 299, 307 (1967)). See also *Mourning*, 411 U.S. at 369 (regulation must be sustained if it reasonably relates to purpose of enabling legislation).

⁹⁸ Temp. Treas. Reg. § 15a.453-1(b)(3)(ii) (1981). See *supra* notes 70-89 and accompanying text.

⁹⁹ See Installment Sales Revision Act *supra* note 68. See also SENATE REPORT, *supra* note 1 at 4703. The Senate Finance Committee Report stated that the Installment Sales Revision Act was enacted to simplify present law under § 453. *Id.* at 4701. This suggests the fact that Congress, by enacting this legislation, sought to make the installment method of reporting income more widely available. See, e.g., *Webb v. Commissioner*, T.C.M. 1987-451, slip op. at —, (September 9, 1987). The court noted that "[C]ongress, by enacting the Installment Sales Revision Act, intended to liberalize the eligibility requirements of section 453, thereby making the installment method of reporting more widely available." *Id.*

¹⁰⁰ See SENATE REPORT, *supra* note 1, at 4696-725. See also *Levingston*, *supra* note 6, at 454 (nothing in Committee Report or legislation displayed congressional intent to equate wraparound mortgages with assuming or taking property subject to a mortgage). See also Tax Reform Bill of 1986, 73 Stand. Fed. Tax Rep. (CCH) II - 293-301 (Sept. 21, 1986) (H.R. 3838 Statement of the Managers) (no congressional intent in Tax Reform Act of 1986 to accelerate gain in installment sales merely by using wraparound mortgage).

¹⁰¹ SENATE REPORT, *supra* note 1, at 4702-03. Under the 30% rule, gain from the sale of realty may not be reported under the installment method if the payments received in the taxable year of sale exceed 30% of the selling price. *Id.* at 4702. The Committee noted that when a mortgage in excess of the seller's basis is assumed, such excess is considered a payment in the year of sale. *Id.* at 4703. If such excess caused the deemed payment in the year of sale to exceed 30% of the selling price the transaction was disqualified from installment

Thus, the fact that Congress recognized the existence of wrap-around mortgages¹⁰³ but did not comment on their proper tax treatment¹⁰³ should be construed as indicating that Congress intended to let existing law remain in effect.¹⁰⁴

III. WRAPAROUND MORTGAGES UNDER THE TAX REFORM ACT OF 1986

It should be noted that the proportionate disallowance rule, as promulgated in section 453C¹⁰⁵ of the Tax Reform Act of 1986,¹⁰⁶ will accelerate the recognition of income in selected transactions in which an installment obligation (i.e., a wraparound mortgage) is undertaken.¹⁰⁷ Under Code section 453C, utilization of the installment method as applied to certain sales of business, rental, personal, or real property is limited based upon the taxpayer's outstanding indebtedness.¹⁰⁸ This limitation is administered by calculating the taxpayer's "allocable installment indebtedness"¹⁰⁹ for each tax year.¹¹⁰ This figure is then treated as a

reporting. *Id.* The Committee recognized that if a well planned wraparound mortgage is utilized the seller is more likely to qualify for installment reporting. *Id.* Because of such inconsistencies the Installment Sales Revision Act eliminated the 30% rule. *Id.* at 4704.

¹⁰³ See *supra* note 101 and accompanying text.

¹⁰⁴ See *supra* notes 100 and 101 and accompanying text.

¹⁰⁵ See *Cammarano v. United States*, 358 U.S. 498, 510-11 (1959); *Fishgold v. Sullivan Drydock and Repair Corp.*, 154 F.2d 785, 790-91, *aff'd*, 328 U.S. 275 (1946). The *Fishgold* court noted that reenactment of legislation by Congress with knowledge of current interpretations of the law implies tacit congressional approval of that existing law. *Id.*

¹⁰⁶ I.R.C. § 453C (1986).

¹⁰⁷ Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

¹⁰⁸ *Committee Report on Pub. L. 99-514*, Fed. Tax Guide Rep. (CCH) ¶ 2888U (April 9, 1987). The Committee stated that § 453C "disallows the use of the installment method with respect to a portion of certain installment receivables based on the amount of the outstanding indebtedness of the taxpayer." *Id.* at 35,677.

¹⁰⁹ *Id.* The Committee noted that under § 453C "use of the installment method for certain sales by persons who regularly sell real or personal property described in section 1221(1), and for certain sales of business or rental property, is limited based on the amount of the outstanding indebtedness of the taxpayer." *Id.* It is significant that § 453C does not affect installment sales of real property so long as (1) the seller does not sell real property in his ordinary course of business (2) such property is not used in the taxpayer's trade or business or (3) the property was not held for the production of rental income. *Id.* at 35,678. See also note 111 and accompanying text.

¹¹⁰ I.R.C. § 453C(b)(1) (1986). Code section 453C(b)(1) provides in pertinent part:

(b) Allocable Installment Indebtedness - For purposes of this section -

(1) In General. - The term "allocable installment indebtedness" means with respect to any taxable year, the excess (if any) of -

(A) the installment percentage of the taxpayer's average quarterly indebtedness for

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payment on the taxpayer's "applicable installment obligations"¹¹¹ that arose in the taxable year and are still outstanding at the close of such taxable year.¹¹² Since the taxpayer has been deemed to have received payment before actual receipt of the proceeds, the recognition of gain is accelerated.¹¹³

such taxable year, over

(B) the aggregate amount treated as allocable installment indebtedness with respect to applicable installment obligations which -

(i) are outstanding as of the close of such taxable year, but

(ii) did not arise during such taxable year.

Id. See I.R.C. § 453C(b)(2) (1986) for an explanation of the term "installment percentage."

For an explanation of "applicable installment obligation," see *infra* note 111.

¹¹⁰ I.R.C. § 453C (1986). See *Committee Report on Pub. L. 99-514*, Fed. Tax Guide Rep. (CCH) ¶ 2888U (April 9, 1987). The committee stated that use of the installment method of reporting is limited by:

determining the amount of the taxpayer's 'allocable installment indebtedness' for each taxable year and treating such amount as a payment immediately before the close of the taxable year on 'applicable installment obligations' of the taxpayer that arose in that taxable year and are still outstanding as of the end of that year.

Id. at 35,678.

¹¹¹ I.R.C. § 453C(e)(1)(A) (1986). Code § 453C(e)(1)(A) provides that an "applicable installment obligation" is any obligation which arises from the disposition (1) of personal property under the installment method by a party who regularly sells such property, (2) of real property under the installment method by a party who regularly sells such property, or (3) of real property under the installment method which is property used in the taxpayer's trade or business or property held for the production of rental income if the sale price of such property exceeds \$150,000. *Id.*

¹¹² See I.R.C. § 453C(a) (1986). Code § 453C(a) states that:

(a) General Rule - For purposes of sections 453 and 453A, if a taxpayer has allocable installment indebtedness for any taxable year, such indebtedness -

(1) shall be allocated on a pro rata basis to any applicable installment obligation of the taxpayer which -

(A) arises in such taxable year, and

(B) is outstanding as of the close of such taxable year, and

(2) shall be treated as a payment received on such obligation as of the close of such taxable year.

Id.

¹¹³ See *supra* note 2 and accompanying text. Under the installment method of reporting the amount of gain recognizable for each tax year is determined by multiplying a gross profit ratio against the payments received in such taxable year. *Id.*

Michael Hirschfeld, Esq. has observed that if a wraparound mortgage is utilized and I.R.C. § 453C is applicable, several factors would even further accelerate the recognition of income in an installment sale. M. Hirschfeld, *Installment Sales of Real Property After the Tax Reform Act of 1986 Presentation* at NEW YORK UNIVERSITY 9TH ANNUAL CONFERENCE ON FEDERAL TAXATION OF REAL ESTATE TRANSACTIONS (May 4 - 5, 1987) (manuscript available at St. John's Journal of Legal Commentary). Mr. Hirschfeld noted that:

If a taxpayer sells property and takes back a wraparound mortgage, the taxpayer's balance sheet will show the installment note receivable (that is, the wrap) as an asset, but the debt upon which the installment note is wrapped will still appear as a liability on that balance sheet, which liability would presumably enter into the computation of the taxpayer's AII. By contrast, if the purchaser assumed the existing indebted-

It is submitted that the gross profit ratio, as set forth by the Tax Court, should be applied to the deemed payment of "allocable installment indebtedness." Congress enacted section 453C because taxpayers were able to receive cash from borrowings related to their holding of installment obligations.¹¹⁴ This opportunity to receive cash is inconsistent with the general purpose of the installment method of reporting; that of recognizing income as payments are received.¹¹⁵ However, nowhere in the Tax Reform Act of 1986 did Congress further accelerate the recognition of income by altering the gross profit ratio as Temporary Treasury Regulation section 15a.453-1(b)(3)(ii) purports to do.¹¹⁶ This indicates that Congress focused on the abuses inherent in the installment method of reporting, made the necessary adjustments and allowed the Tax Court's computation of the gross profit ratio to remain in effect.¹¹⁷

CONCLUSION

In Temporary Treasury Regulation section 15a.453-1(b)(3)(ii), the I.R.S. attempted to achieve through the regulatory process what it had consistently failed to accomplish in court. The Tax Court has repeatedly held that when a well-planned wraparound mortgage is utilized in an installment sale, the purchaser does not assume or take property subject to an existing underlying mortgage. Under both the Tax Reform Act of 1986 and the Installment Sales Revision Act of 1980, there is neither evidence of congressional support for the position adopted by the I.R.S. nor of congressional dissatisfaction with the Tax Court holdings concern-

ness but gave a second lien mortgage to the seller for any principal mark-up that otherwise existed in the wrap, then the underlying debt would not appear on the seller's balance sheet.

Id. at 9.

¹¹⁴ S. REP. NO. 313, 99th Cong., 2d Sess. 123 (1986). The Senate Finance Committee noted that under certain circumstances the installment method of reporting should not be available "to the extent that the taxpayer has been able to receive cash from borrowings related to its installment obligations." *Id.* at ____.

¹¹⁵ See *supra* note 2 and accompanying text. The installment method allows taxpayers to recognize income as proceeds are received. Fed. Tax. Coordinator 2d (Res. Inst. Am.) ¶ G-6201 (1987).

¹¹⁶ See I.R.C. § 453C (1986).

¹¹⁷ See *supra* note 104 and accompanying text.

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ing the wraparound issue. Therefore, it is submitted that the Tax Court's decision invalidating Temporary Treasury Regulation section 15a.453-1(b)(3)(ii) is adequately supported by prior judicial interpretation as well as the legislative history, intent and purpose of those provisions of the Code at issue.

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