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Editor: Robert P. Achenbach, Jr. esq. Contributing Editor Dr. Neil E. Harl, esq.

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REPOSSESSING LAND

— by Neil E. Harl*

Before enactment of I.R.C. § 1038 in 1964, repossession of real property following default under an installment sale transaction generally resulted in substantial gain or loss, usually to the extent of the difference between the fair market value of the property at the time of repossession and the income tax basis of the installment obligation.¹ Repossession was essentially treated as a disposition of the obligation.

Scope of I.R.C. § 1038. With enactment of I.R.C. § 1038 in 1964, neither gain nor loss is recognized on repossession except to the extent of money and the fair market value of any property other than the debt of the purchaser received as payments before repossession and not reported as income.² For this purpose, a repossession includes voluntary conveyances, abandonments, judicial and strict foreclosures, forfeitures, transfers under a power of sale and foreclosure by entry and possession or publication or notice.³

The provisions of Section 1038 governing the calculation and reporting of gain on repossession of real property are mandatory if the transaction comes within the statute.⁴ Several important conditions are imposed for transactions to come within Section 1038 —

- It is immaterial whether the seller realized a gain or sustained a loss on the sale of the real property or whether it can be ascertained at the time of sale whether a gain or loss occurred.

- It is also immaterial what method of accounting the seller used in reporting gain or loss from the sale or whether at the time of reacquisition the property had increased or decreased in value since the time of the original sale.⁵

- Section 1038 does not apply if the disposition essentially constitutes an exchange of the property.⁶ Thus, if a buyer overburdened with debt gives up one tract of land in return for a smaller tract with a lighter debt load, Section 1038 may not apply.

- Section 1038 does not apply except where the indebtedness is secured by the real property.⁷ Thus, reconveyance of property by the obligor under a private annuity to the annuitant would appear not to come within Section 1038. Under a private annuity, if the obligation to pay is secured

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

by the real property, the transaction is likely to be treated as a sale rather than as a private annuity with deferral of gain until payments are received.⁸ This feature complicates the dismantling of a private annuity following default by the obligor in making payments.

- Because Section 1038 is applicable only if the seller reacquires the property to satisfy the purchaser's debt, it is generally inapplicable if the seller repurchases the property by paying the buyer an extra sum in addition to cancellation of the debt.⁹ Section 1038 is applicable, however, if the seller reacquires the property when the purchaser has defaulted or when default is imminent even if the seller pays additional amounts.¹⁰

- Section 1038 applies to voluntary cancellations of installment obligations, even to those involving related parties.¹¹

- Amounts of interest received, stated or unstated, are excluded from the computation of gain.¹²

Calculating gain on repossession. On repossession, the amount of gain recognized is *the lesser of* — (1) the amount of cash and the fair market value of other property received prior to the reacquisition (but only to the extent the money or other property exceeds the amount of gain reported prior to the reacquisition) or (2) the amount of gain realized on the original sale (adjusted sales price less adjusted income tax basis) in excess of the gain previously recognized before the reacquisition and the money or other property transferred by the seller in connection with the reacquisition.¹³

Example: Farmland acquired in 1950 was sold under installment contract for \$150,000 calling for \$15,000 down and payments of \$15,000 per year for nine years. The property had an adjusted income tax basis at the time of sale of \$30,000. The seller received the downpayment and the first regular payment for the following year. The buyer then defaulted and the seller proceeded to forfeit the buyer's interest in the property. The four step computational procedure would produce the following results —

Step 1: Calculate the amount of cash and the fair market value of the property received prior to the reacquisition

Year of sale	\$15,000
Following year	<u>15,000</u>
Total	30,000

Step 2: Subtract the gain returned as income for the period prior to acquisition —

Determine the gross profit —
 = 150,000 – 30,000
 = 120,000

Determine the total contract price —
 = 150,000 – 0
 = 150,000

Determine gross profit percentage —

$$= \frac{\text{Gross profit}}{\text{Total contract price}}$$

$$= \frac{120,000}{150,000}$$

 = 0.8

Gain reported —
 = 30,000 x 0.8
 = 24,000

Gain before application of second limitation —
 Money and other property received \$30,000
 Less gain reported 24,000
 "First limitation" on gain 6,000

Step 3: Determine the second limitation of gain—
 Sales price of property 150,000
 Less: adjusted basis at time of sale 30,000
 plus gain returned as income
 before acquisition 24,000
 54,000 54,000
 Second limitation on amount of gain 96,000

Step 4: Determine the lesser figure from Step 2
 or Step 3 as the amount of gain resulting
 from acquisition \$6,000

Character of the gain. The character of the gain from reacquisition is determined by the character of the gain from the original sale. For an original sale reported on the installment method, the character of the reacquisition gain is determined as though there had been a disposition of the

installment obligation.¹⁴ In the above example, the \$6,000 of gain would be treated as capital gain.

Basis of the property. The adjusted income tax basis for the property is the sum of three amounts — (1) the adjusted income tax basis to the seller of the indebtedness, determined as of the date of repossession, (2) the taxable gain resulting from reacquisition and (3) the money and other property (at fair market value) paid by the seller as reacquisition costs.¹⁵

Holding period for the property. The holding period of the reacquired property, for purposes of subsequent disposition, includes the period during which the seller held the property prior to the original sale plus the period after reacquisition.¹⁶ However, the holding period does not include the time between the original sale and the date of reacquisition.

Application to residence. The provisions on reacquisition of property generally apply to residences or to the residence part of a farm. However, the repossession rules do not apply if — (1) an election is in effect for an over age 55 sale¹⁷ or sale and reinvestment¹⁸ and (2) the property is resold within one year after the date of reacquisition.¹⁹ The subsequent resale is treated as part of the original sale of the property. In general, the resale is treated as having occurred on the date of the original sale. An adjustment is made to the sales price of the old residence and the basis of the new residence.

If not resold within one year, gain is recognized under Section 1038.²⁰

Reacquisition by estates. In 1969, the Internal Revenue Service ruled that Section 38 did not apply to a reacquisition by an estate of a deceased taxpayer.²¹ A decedent's estate was not permitted to succeed to the income tax treatment that would have been accorded a reacquisition by the decedent.

That result was changed legislatively in 1980 as part of the Installment Sales Revision Act of 1980.²²

FOOTNOTES

¹ Treas. Reg. § 1.453-5(b)(2). See generally 6 Harl, **Agricultural Law** § 48.03[11] (1991).
² I.R.C. § 1038.
³ Treas. Reg. § 1.1038-1(a)(3)(ii).
⁴ Treas. Reg. § 1.1038-1(a)(1).
⁵ *Id.*
⁶ Treas. Reg. § 1.1038-1(a)(2).
⁷ Treas. Reg. § 1.1038-1(a)(1).
⁸ *Est. of Bell v. Comm'r*, 60 T.C. 469 (1973); *212 Corp. v. Comm'r*, 70 T.C. 788 (1978).
⁹ See *Scallen v. Comm'r*, T.C. Memo. 1987-412 (Section 1038 did not apply where property sold by one of taxpayer's controlled corporation that

paid additional consideration but sales contract did not provide for payment of additional consideration on reacquisition).

¹⁰ Treas. Reg. § 1.1038-1(a)(3)(i).

¹¹ Ltr. Rul. 8402006, Sept. 22, 1983.

¹² Treas. Reg. § 1.1038-1(b)(2)(iii).

¹³ I.R.C. § 1038(b)(2). See Ltr. Rul. 8736026, June 5, 1987 (Section 1038 applies to repossession of farmland by seller through forfeiture of installment sales contract after several modifications of payment terms). See *Connors v. Comm'r*, 88 T.C. 541 (1987) (gain on repossession of improved real property limited to amount of downpayment

received and amount of seller's indebtedness discharged by buyer and did not include increase in fair market value from improvements made by buyer).

¹⁴ See Treas. Reg. §§ 1.1038-1(d), 1.453-9(a).

¹⁵ See Treas. Reg. §§ 1.1038-1(g), 1.1038-1(h).

¹⁶ Treas. Reg. § 1.1038-1(g)(3).

¹⁷ See I.R.C. § 121.

¹⁸ See I.R.C. § 1034.

¹⁹ I.R.C. § 1038(e).

²⁰ See I.R.C. § 1038(e).

²¹ Rev. Rul. 69-83, 1969-1 C.B. 202.

²² I.R.C. § 1038(g).