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Installment Method Treatment of a Sale of Real Property with Mortgage in Excess of Basis: Will the Correct View Please Stand Up?

MICHAEL H. BERKENS*

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I. INTRODUCTION

The tax consequences to a seller of encumbered real property under the installment sales method, where the preexisting mortgage on the property exceeds the seller's basis in the property, have long been the subject of dispute and uncertainty.¹ In an effort to resolve this uncertainty, the Internal Revenue Service (hereinafter "the Service") has promulgated several temporary regulations.² This attempt has met with opposition, however, as critics have questioned the new regulations' validity.³ This article traces the origins of the controversy and compares the effects of the temporary regulations with the effects of the prior regulation and case law. The goal of this analysis is to identify a method that properly reflects the economic consequences to the seller of encumbered real property under the installment sales method, where the mortgage on the property exceeds the seller's basis.

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² Id. at 66-68.
³ See Rosenkranz, infra note 55, at 23-42.
II. Background: The Battlelines Are Drawn

The installment sales method permits a seller of property to recognize his realized gain ratably over the period in which he receives payments under the installment obligation. Under the installment sales method, the seller attributes a portion of each payment he receives to his realized gain, and a portion to return of capital. The installment sales method achieves this objective by applying a gross profit ratio to each payment the seller receives. The gross profit ratio is the proportion that the gross profit on the sale bears to the total contract price. Gross profit is the selling price reduced by the seller’s adjusted basis in the real property. The selling price is the price the property sells for without reduction for any existing mortgage. The total contract price is the selling price reduced by the amount of any mortgage, whether the purchaser takes the property subject to the mortgage or assumes the mortgage, that does not exceed the seller’s basis in the property.

Pursuant to Treasury Regulation section 1.453-4(c), when a

4. The installment sales method is codified at Section 453 of the Internal Revenue Code, which provides in part:
   (a) General Rule
      Except as otherwise provided in this section, income from an installment sale shall be taken into account for purposes of this title under the installment method.

   (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.


5. Id. § 453(c) (1982).

6. Id.


10. Treasury Regulation § 1.453-4(c) provides in part:
   (c) Determination of “selling price.” In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall, for the purpose of determining whether a sale is on the installment plan, be included as a part of the “selling price”; and for the purpose of determining the payments and the total contract price... the amount of such mortgage shall be included
person sells mortgaged real property on the installment method and the purchaser either assumes the mortgage or takes the property subject to the mortgage, the Service treats the seller as having received a constructive payment in the year of sale in the amount that the mortgage exceeds his basis. Additionally, the total contract price component of the gross profit ratio includes the amount of the mortgage only to the extent that the mortgage exceeds the seller’s basis. The remainder of the mortgage is excluded from the total contract price, thereby increasing the percentage of gain the seller must realize on each payment. Where the mortgage exceeds the seller’s basis, the gross profit ratio is always one hundred percent; accordingly, the seller must recognize gain on every dollar he receives on the installment obligation.

Taxpayers have attempted to avoid the operation of Treasury Regulation section 1.453-4(c) by structuring the sale of encumbered real property so that the purchaser neither assumes nor takes the property subject to the preexisting mortgage. As a result, the Treasury Regulation section 1.453-4(c) meaning of “taken

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only to the extent that it exceeds the basis of the property. The term “payments” does not include amounts received by the vendor in the year of sale from the disposition to a third person of notes given by the vendee as part of the purchase price which are due and payable in subsequent years. Treas. Reg. § 1.453-4(c) (1960) (emphasis added).

11. Id.
12. Id.

13. For example, assume a taxpayer sells Whiteacre for $160,000. Whiteacre is encumbered by a mortgage in the amount of $60,000 and the seller’s basis in Whiteacre is $90,000. Assume the purchaser agrees to either assume or take the property subject to the $60,000 mortgage and pay the remaining $100,000 in ten equal annual installments. The gross profit ratio is 70% computed as follows: the gross profit of $70,000 ($160,000 selling price less the seller’s basis of $90,000) divided by $100,000 (the contract price which is the total selling price of $160,000 reduced by the $60,000 mortgage). On the other hand, if the purchaser neither assumed nor took the property subject to the mortgage the gross profit ratio would be only 43%, computed as follows: The gross profit of $70,000 ($160,000 selling price less the seller’s basis of $90,000) divided by $160,000 (selling price without reduction for the amount of the mortgage). See Temp. Treas. Reg. § 15a.453-(1)(b)(5), ex. (2), T.D. 7768, 1981-1 C.B. 296, amended by T.D. 7788, 1981-2 C.B. 109. For a definition of selling price, see supra text accompanying note 8. For a definition of gross profit, see supra note 7. For a definition of total contract price, see supra note 9 and accompanying text.

14. Hunt v. Commissioner, 80 T.C. 1126, 1134 (1983). For example, assume a taxpayer sells property encumbered by a $70,000 mortgage for $100,000. Assume further that the taxpayer’s basis in the property is $50,000. The gross profit ratio would be 100%, as computed in the following manner: The $100,000 selling price reduced by $50,000, the amount of the mortgage that does not exceed the seller’s basis, and divided by the seller’s gross profit, $50,000 ($100,000 selling price less the seller’s basis of $50,000).

subject to,” and “assumed,” with respect to sales of encumbered real property, has been the subject of frequent litigation.\textsuperscript{16} Initially, taxpayers structured the sale of encumbered real property under the installment sales method as a conditional sale.\textsuperscript{17} A conditional sale is a transaction in which the purchaser agrees to make payments to the seller for a fixed number of years during which time the seller remains legally obligated to make payments to the mortgagee on the preexisting mortgage.\textsuperscript{18} At the end of such period, the buyer acquires title to the property, and becomes obligated to make any remaining mortgage payments.\textsuperscript{19}

In \textit{Stonecrest Corp. v. Commissioner},\textsuperscript{20} the Tax Court held that a person neither assumes nor takes property subject to a mortgage when he purchases mortgaged real property under a conditional sale arrangement. The \textit{Stonecrest Corp.} court discussed the factors which determine whether a purchaser takes property subject to a mortgage:

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. . . .

. . . "A circumstance which is usually of controlling importance [in determining if property is taken subject to a mortgage] is whether the mortgage was considered in adjusting the purchase price. If the price was reduced by reason of the mortgage, it is a reasonable conclusion that it was intended that the debt . . . should be imposed on the land in the hands of the transferee rather than on the transferor, while if the full agreed value of the land was paid, it may be concluded that the parties intended the grantor to pay the mortgage debt out of the proceeds of the sale."\textsuperscript{21}

\textsuperscript{16} See id. at 50-66.
\textsuperscript{17} See Schacht, Mortgages: Leveraging Real Estate Investments, 38 Inst. on Fed. Tax'n §§ 14.01, 14.04[4], at 14-20 (1980).
\textsuperscript{18} Id.
\textsuperscript{19} Id.
\textsuperscript{20} 24 T.C. 659 (1955), nonacq. 1956-1 C.B. 6.
\textsuperscript{21} Id. at 666-68 (quoting 5 H. Tiffany, The Law of Real Property § 1435, at 365 (3d
The court found that the purchaser of property sold pursuant to a conditional sale contract did not take the property "subject to" the preexisting mortgage because the contract obligated the seller to make payments on the mortgage until he conveyed the property to the purchaser. The court noted that the selling price was not reduced by the amount of the mortgage, and found this to be a further indication that the purchaser did not take the property subject to the mortgage.

The court also identified factors that indicate whether a purchaser assumes a mortgage. The court stated, "[w]here a buyer assumes a mortgage on property, he pays the seller for the latter's redemption interest, and in addition promises the seller to pay off the mortgage debt. This promise of the buyer can ordinarily be enforced by the mortgagee." The court stated that the seller's contractual obligation to utilize the installment payments received from the purchaser to make payments to the mortgagee did not constitute an assumption of the mortgage by the purchaser. The court also stated that for an assumption to occur, the purchaser must take over the seller's obligation on the mortgage and incur personal liability. In conclusion, the Stonecrest Corp. court held that an assumption had not occurred because the purchaser did not have any initial obligation to make payments on the mortgage.

The Stonecrest Corp. decision indicates that the parties can avoid the effect of Treasury Regulation section 1.453-4(c) by structuring a transaction as a conditional sale whereby the seller continues to make payments on the mortgage until he conveys title to the purchaser at some point after the year of sale. The court reached a similar result in Estate of Lamberth v. Commissioner, where the seller transferred real property with a preexisting mortgage pursuant to a conditional sale agreement. The purchaser made payments to the seller, and the seller made payments to the mortgagee for a period of ten years. At the end of the ten-year period, the

22. Id. at 667.
23. Id. at 668.
24. Id. at 666 (citing 5 H. Tiffany, The Law of Real Property §§ 1435, 1436 (3d ed. 1939)).
25. Id. at 667.
26. Id.
28. See supra notes 17-19 and accompanying text.
29. 31 T.C. at 316.
seller conveyed title to the purchaser who then became obligated to pay the remaining mortgage debt.\(^{30}\) The court held that because the purchaser would take the property subject to the mortgage only upon the expiration of the ten-year period, the Service should treat him as having taken the property subject to that portion of the mortgage that would be outstanding at the end of ten years.\(^{31}\)

Similarly, in \textit{United Pacific Corp. v. Commissioner},\(^{32}\) a taxpayer used a conditional sale agreement to sell a mortgaged commercial building.\(^{33}\) The seller conveyed title to the purchaser five years after the sale.\(^{34}\) During this five-year period, the agreement obligated the seller to continue to make payments to the mortgagee.\(^{35}\) After this period had expired, the purchaser made payments directly to the mortgagee.\(^{36}\) Rejecting the Service's contention that Treasury Regulation section 1.453-4(c) applied to "every sale of mortgaged property,"\(^{37}\) the court concluded that the purchaser had not assumed the mortgage until five years after the sale.\(^{38}\)

Notwithstanding the court's holdings in \textit{Stonecrest Corp., Estate of Lamberth}, and \textit{United Pacific Corp.} (hereinafter \textit{Stonecrest} line of cases), the Service continues to assert, with much success, that when a person sells encumbered property, the purchaser takes the property subject to the mortgage. In \textit{Voight v. Commissioner},\(^{39}\) the taxpayer sold mortgaged real property pursuant to a conditional sale agreement. The purchaser agreed to make monthly payments to the seller for a period of several years, at

\begin{itemize}
\item[30.] Id.
\item[31.] Id. at 318.
\item[32.] 39 T.C. 721 (1963).
\item[33.] See supra notes 17-19 and accompanying text.
\item[34.] 39 T.C. at 724.
\item[35.] Id.
\item[36.] Id.
\item[37.] Id. at 726 (emphasis omitted). The Service contended that the regulation applied to every sale of real property with a mortgage that exceeded the seller's basis "regardless of whether the purchaser technically [took] the property subject to or assume[d] the obligation to pay the mortgage." \textit{Id.} (quoting the Service's brief).
\item[38.] Id. at 727. Prior to the Installment Sales Revision Act of 1980, if the seller received actual or constructive payments in the year of sale that exceeded 30% of the sales price, the entire transaction was ineligible for installment sales treatment. Installment Sales Revision Act of 1980, Pub. L. No. 96-471, 94 Stat. 2247. Thereby, if the purchaser assumed or took the property subject to the mortgage causing the seller to recognize a constructive payment in the year of sale in the amount that the mortgage exceeded his basis, the transaction could have violated the 30% restriction and failed to qualify for installment sales treatment. The court in \textit{United Pacific Corp.} allowed the seller to qualify for installment sales treatment by finding that the purchaser neither assumed nor took the property subject to the mortgage and that Treasury Regulation \textsection{} 1.453-4(c) was therefore inapplicable. 39 T.C. 721 (1963).
\item[39.] 68 T.C. 99 (1977), \textit{aff'd per curiam}, 614 F.2d 94 (5th Cir. 1980).
\end{itemize}
which time the seller would convey title to the purchaser. Unlike the agreements in the Stonecrest line of cases, the agreement in Voight permitted the purchaser to make payments directly to the mortgagee, and then deduct such payments from amounts due the seller. In actuality, the purchaser remitted all payments due on the mortgage directly to the mortgagee. The court concluded that the purchaser had assumed the mortgage within the meaning of Treasury Regulation section 1.453-4(c). The court reasoned that the absence of a formal promise to assume the mortgage was not fatal to a finding that an assumption had in fact occurred where all the facts and circumstances surrounding the transaction indicated that the parties intended for the purchaser to assume the mortgage.

In Waldrep v. Commissioner, the court held that the sale of real property with a preexisting mortgage amounted to an unexpressed assumption. As part of the consideration, the purchasers executed notes payable to the seller and the preexisting mortgagee, and a mortgage in favor of both parties. In holding that this transaction constituted an assumption of the mortgage, the court stated that a purchaser assumes a mortgage "when he agrees, expressly or impliedly, to become personally liable for the amount of the underlying debt." The court noted that even where the agreement does not contain a formal promise to assume, the court may imply intent to assume by examining the entire instrument of conveyance. The court found no substantive distinction between a formal agreement to assume an existing mortgage and the creation of a new mortgage in the same amount as the preexisting mortgage on which the purchaser, and not the seller, was personally liable.

The Service distinguished Voight from the Stonecrest line of cases in two letter rulings. In Letter Rulings 7814010 and

40. 68 T.C. at 108.
41. Id. at 102.
42. Id. at 114.
43. Id.
44. Id. at 112 (citing Waldrep v. Comm'r, 52 T.C. 640, 646 (1969), aff'd per curiam, 428 F.2d 1216 (5th Cir. 1970)).
45. 52 T.C. 640 (1969), aff'd per curiam, 428 F.2d 1216 (5th Cir. 1970).
46. 52 T.C. at 642. The note given to the preexisting mortgagee was for $76,838.68, the amount of the seller's preexisting mortgage. Id.
47. Id. at 645 (citing 5 H. TIFFANY, THE LAW OF REAL PROPERTY § 1436 (3d ed. 1939)).
48. Id. at 646.
49. Id.
50. Id.
51. Pvt. Ltrs. 7814010 & 7814011, [1978] 52 IRS LETTER RUL. REP. (CCH) (Mar. 3,
7814011, the taxpayers sold encumbered real property in accordance with agreements that obligated the taxpayers to continue to make payments to the mortgagee after the sale. The purchasers possessed the right to make payments directly to the mortgagee if the sellers failed to do so, and to deduct such payments from the amount due to the sellers. Relying on Voight, the Service concluded in both letter rulings that the purchaser had taken the property subject to the mortgage. The Service distinguished the Stonecrest line of cases by noting that the purchasers in the letter rulings had the right to cure the seller's default by making payments directly to the mortgagee, while the purchasers in the Stonecrest line of cases had no such right. Moreover, the sellers conveyed title to the properties in the letter rulings in the year of sale, while in the Stonecrest line of cases, the sellers did not convey title until after the year of sale. Finally, the Service found that upon fulfillment of the conditions of sale, the taxpayer would receive his redemption interest in the property; thus, the transaction met one part of the Stonecrest court's definition of property taken subject to a mortgage.

Commentators have criticized both letter rulings. One commentator concluded that the position of the Service is that in every instance where there is a sale of property and the mortgage lien continues, the sale is made subject to the mortgage within the meaning of Treasury Regulation section 1.453-4(c).

III. WRAPAROUND MORTGAGES AND INSTALLMENT SALES

In recent years taxpayers have attempted to avoid the operation of Treasury Regulation section 1.453-4(c) by structuring sales of encumbered real property to include a wraparound mortgage.

1978). For further analysis of these two letter rulings, see Levinton, Use of Wrap-Around Mortgages Can Expand Installment Sale Despite IRS Opposition, 51 J. Tax’n 166, 168-70 (1979).
52. Pvt. Ltr. 7814010 at 2; Pvt. Ltr. 7814011 at 2.
53. Levinton, supra note 51, at 168.
54. Id. at 170.
55. Although outside the scope of this article, there are many nontax reasons for using a wraparound mortgage. Sellers use a wraparound mortgage to avoid the effect of a due-on-sale clause contained in the preexisting mortgage and as a refinancing device that permits the seller to take advantage of a low interest rate in the preexisting mortgage. See generally Barnett, Use of the Wrap-Around Mortgage in Realty Sales: The Tax Advantages and Problems, 40 J. Tax’n 274 (1974); Lane, The “Wraparound” Mortgage: Tax Problems Related to its Use in Connection with the Refinancing or Sale of Real Estate, 33 Inst. on Fed. Tax’n 1235 (1975); Rosenkranz, Voluntary Disposition of Real Estate: Sale of Principal Residence; Dealer v. Investor, Current Considerations; Installment Sales, Including Wrap-
A wraparound mortgage transaction occurs when a person sells real property that is encumbered by a preexisting mortgage, yet remains legally obligated to remit payments on the preexisting mortgage to the mortgagee. The seller conveys title to the purchaser in the year of sale. The purchaser then executes a second mortgage in favor of the seller. This mortgage secures a note the amount of which is the sum of the preexisting mortgage and the new indebtedness. The purchaser becomes obligated to make payments to the seller in an amount that is usually equal to or greater than the preexisting mortgage payments. If the seller fails to make payments on the preexisting mortgage to the mortgagee, the mortgagee may foreclose the mortgage on the property and proceed against the seller for any deficiency. Since the purchaser is not liable on the preexisting mortgage, the mortgagee has no recourse against him.\(^6\)

Initially, the Service successfully prevented taxpayers, who structured sales of encumbered real property to include a wraparound mortgage, from avoiding the effect of Treasury Regulation section 1.453-4(c). In *Goodman v. Commissioner*,\(^5\) taxpayers used a wraparound mortgage to sell encumbered real property. The purchasers remitted payments to a banking institution\(^6\) that forwarded the payments to the preexisting mortgagee. The court held that the purchasers acquired the property subject to the mortgage.\(^9\) The court reasoned that the financial institution served as a mere conduit for the purchasers' direct payments to the mortgagee.\(^9\) The court reserved decision on whether a wraparound mortgage was within the scope of Treasury Regulation section 1.453-4(c).\(^6\)

In *Hutchison v. Commissioner*,\(^6\) the taxpayer sold a mortgaged apartment complex pursuant to an agreement that included a wraparound mortgage.\(^3\) The agreement required the purchaser to make monthly payments to the taxpayer, who then applied a

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\(^6\) 74 T.C. 684 (1980), aff'd, 673 F.2d 1332 (7th Cir. 1981).

\(^9\) *Goodman*, 74 T.C. at 693.

\(^9\) *Id.* at 714.

\(^6\) *Id.* at 712 n.16.

\(^6\) 42 T.C.M. (CCH) 1089 (1981).

\(^6\) *Id.* at 1090.
portion of the payments to the preexisting mortgage. Although the taxpayer remained personally liable on the mortgage, he believed that in the event of default the sale of the property would satisfy the mortgage debt. When the purchaser subsequently failed to make payments to the taxpayer as the contract required, the parties modified the agreement to require the purchaser to make mortgage payments directly to the mortgagee.

The court held that after the parties modified the agreement, the purchaser held the property subject to the mortgage. The court stated that, "the major characteristic of a taking of property subject to a mortgage, is that . . . the buyer concedes that the debt is to be satisfied out of the land." The fact that the seller remains liable on the mortgage after the sale "does not preclude a finding that a sale to a third party is subject to an outstanding mortgage."

Despite the court's holdings in Goodman and Hutchison, the Tax Court did not address the issue of whether a wraparound mortgage was within the scope of Treasury Regulation section 1.453-4(c) until recently. In Hunt v. Commissioner, the Tax Court followed the Stonecrest line of cases and distinguished Voight and Goodman. The court held that a purchaser of mortgaged real property neither assumed nor took the property subject to the mortgage when he structured the purchase of the property to include a wraparound mortgage. In Hunt, the purchasers' contract required them to make monthly payments to the seller, and required the seller to apply a portion of such payments to the preexisting mortgage. The seller conveyed title to the purchaser in the year of sale.

The Tax Court stated that the holdings in the Stonecrest line of cases governed the treatment of wraparound mortgages. Relying heavily on Stonecrest, the court concluded that a wraparound

64. Id.
65. Id. at 1091.
66. Id at 1090. The court stated that "where there is no express reference to the mortgage in the transactional documents," the intention of the parties must be determined by reference to all the facts and circumstances. Id. at 1093. The court further noted that the mortgagee changed his loan records to reflect that the payments were due from the purchaser and that the "seller no longer deducted interest on his debt to the mortgagee since he did not make payments on his debt." Id. at 1094. Moreover, after the parties amended the agreement, the seller rarely dealt with the mortgagee. Id.
67. Id.
68. Id.
69. 80 T.C. 1126 (1983).
70. Id. at 1145.
71. Id. at 1143.
mortgage is not tantamount to assuming or taking property subject to a mortgage. Applying the reasoning in Stonecrest, the court noted that for a purchaser to take property subject to a mortgage, the purchaser must pay the seller for his equity interest in the property, and the parties must understand that the mortgagee is to satisfy the mortgage debt out of the property.\textsuperscript{72}

In Hunt, the court found that the contract price was not reduced by the amount of the mortgage. Moreover, the court determined that the parties did not intend for the mortgagee to satisfy the mortgage debt out of the property.\textsuperscript{75} The court noted that the contract obligated the purchaser to pay the entire contract price, without reduction for the mortgage, directly to the seller. The seller would apply the payments received from the purchaser to the preexisting mortgage. The court concluded that the transaction failed to meet both parts of the Stonecrest test; consequently, the purchaser did not take the property subject to the mortgage.\textsuperscript{74}

The court dismissed the Service’s argument that Hunt was distinguishable from the Stonecrest line of cases, because the seller in Hunt conveyed title in the year of sale. Citing Estate of Lambert v. Commissioner,\textsuperscript{76} the court stated that “application of the regulation . . . was not dependent directly on whether title was conveyed.”\textsuperscript{76} The court noted that conveyance of title in the year of sale neither discharged the seller from liability on the mortgage, nor resulted in the purchaser making mortgage payments directly to the mortgagee. The court concluded that the conveyance of title to the purchaser in the year of sale did not cause “the instant cases to fall outside the analysis of the Stonecrest line of cases.”\textsuperscript{77}

Therefore, the court held that the taxpayer could include the full amount of the mortgage in the calculation of the total contract

\textsuperscript{72} Id. at 1137-38. When property is sold subject to a mortgage, the selling price of the property is reduced by the amount of the mortgage. Id.  

\textsuperscript{73} Hunt, 80 T.C. at 1140.  

\textsuperscript{74} Id.  

\textsuperscript{75} 31 T.C. 302 (1958).  

\textsuperscript{76} Hunt, 80 T.C. at 1141.  

\textsuperscript{77} Id.
price resulting in a reduced gross profit ratio.\textsuperscript{78} The court further noted that the taxpayer need not treat the amount by which the mortgage exceeded his basis as a payment in the year of sale.\textsuperscript{79}

The Hunt decision was based on Treasury Regulation section 1.453-4(c). In February 1981, the Service issued temporary regulations that codified its position that a purchaser of encumbered real property takes the property subject to the mortgage regardless of when the seller conveys title to the purchaser, or whether the seller remains personally liable on the mortgage.\textsuperscript{80} Under the temporary regulations, the Service treats a seller of encumbered real property as having received a constructive payment in the year of sale in the amount that the mortgage exceeds his basis.\textsuperscript{81} In addition, the seller must exclude the amount of the mortgage, except for the portion that exceeds his basis, from the total contract price for purposes of computing the gross profit ratio. Thus, the temporary regulations require the seller to recognize a greater percentage of gain on each installment payment.

The Hunt court declined to rule on any effect the temporary

\textsuperscript{78} Id. at 1135.
\textsuperscript{79} Id.

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. \ldots The wrapped indebtedness shall be deemed to have been 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.


\textsuperscript{81} Temporary Treasury Regulation § 15a.453-1(b)(3)(i) provides in part:

Payments include amounts actually or constructively received in the taxable year under an installment obligation. \ldots Payment includes receipt of an evidence of indebtedness of a person other than the person acquiring the property from the taxpayer. For purposes of determining the amount of payment received in the taxable year, the amount of qualifying indebtedness \ldots assumed or taken subject to by the person acquiring the property shall be included only to the extent that it exceeds the basis of the property \ldots. For purposes of the preceding sentence, an arrangement under which the taxpayer's liability on qualifying indebtedness is eliminated incident to the disposition (e.g., a novation) shall be treated as an assumption of the qualifying indebtedness.

MORTGAGE IN EXCESS OF BASIS

regulations might have on a sale of mortgaged property under a wraparound mortgage. Commentators have criticized the Service for issuing these temporary regulations. Critics contend that the temporary regulations are invalid because the Service enacted them without authority in an attempt to legitimize a position that the courts have rejected several times. Supporters of the temporary regulations contend, however, that the Service merely has corrected a flaw that existed in the previous regulations.

If the Service's position is fundamentally unsound, courts should not give credence to it solely because it is now codified in regulations. On the other hand, if the Service's position results in the correct tax treatment of a sale of mortgaged real property under the installment method, courts should refuse to follow the Stonecrest line of cases and should give full effect to the temporary regulations. The question, then, is not whether the temporary regulations mandate a change from the Hunt result, but rather, whose position is correct.

IV. THE CORRECT POSITION?

A. Case for the Service

The effect of classifying a wraparound mortgage as outside the scope of Treasury Regulation section 1.453-4(c) is to permit form

82. Hunt, 80 T.C. at 1143 n.14. The significant events in Hunt arose in 1973, whereas the temporary regulations did not become effective until March 4, 1981. See supra note 80.

83. See generally Cuff, Avoiding the Tax Impact of the Temporary Installment Sale Regs. on Wraparound Debt, 55 J.Tax'n 144 (1981) (temporary regulations do not address the problems of accommodation indebtedness, blanket indebtedness, or contingent indebtedness); Rosenkranz, supra note 55.

84. See Rosenkranz, supra note 55, at 23-42. The Stonecrest line of cases and Hunt reject the Service's position.

85. Ginsburg, Taxing the Sale for Future Payment, 30 Tax L. Rev. 471, 489 (1975). These temporary regulations, promulgated under the Installment Sales Revision Act of 1980, are legislative regulations. The Service issues legislative regulations pursuant to specific statutory authorization. M. Saltzman, IRS Practice and Procedure ¶ 3.02[4][a] (1981). In the instant case, § 453(j)(1) of the Internal Revenue Code provides: "The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the provisions of this section." I.R.C. § 453(j)(1) (West Supp. 1985). Since the Service promulgated the temporary regulations pursuant to this statutory authority, they have full force and effect of law unless they are contrary to the statute, exceed the scope of the delegated power, or are "otherwise unreasonable." Rogovin, The Four R's: Regulation, Rulings, Reliance and Retroactivity—A View from Within, 9 Stand. Fed. Tax Rep. (CCH) ¶ 5980A.0152, 0157 (1984). Therefore, a "reviewing court has no authority to substitute its judgment as to the content of the regulation, because Congress has placed maximum discretion in the agency and not in the court." M. Saltzman, supra, at 3-8, 9. Temporary regulations are effective until superseded by permanent regulations.
to prevail over substance. In accordance with real property law, there is no difference between property sold subject to a mortgage and that sold pursuant to a wraparound mortgage. Thus, there are no grounds to justify different treatment for the two types of mortgage transactions.

When a purchaser assumes a mortgage, he accepts liability to the extent of the value of the property, and in the event of foreclosure, he agrees that the mortgagee may hold him personally liable for any deficiency. When a purchaser takes property subject to a mortgage, he accepts liability on the property to the extent of the value of the property; however, he does not accept personal liability for a deficiency in the event of foreclosure. When a purchaser acquires property pursuant to a wraparound mortgage, he accepts liability to the extent of the value of the property, but he does not accept personal liability for a deficiency in the event of foreclosure of the preexisting mortgage. The effects of a foreclosure by the pre-existing mortgagee on the purchaser are identical whether he takes the property subject to the mortgage or under a wraparound mortgage. If the purchaser uses a wraparound mortgage, although he is not subject to any personal liability, the property remains encumbered by the preexisting mortgage. Under a wraparound mortgage, if the seller does not remit payments to the preexisting mortgagee, the mortgagee will foreclose the mortgage on the property. Likewise, in a subject to a mortgage transaction, if the purchaser does not remit payments to the mortgagee, then the mortgagee will foreclose the mortgage on the property. In either transaction, the mortgagee cannot hold the purchaser personally liable for a deficiency. This analysis has led one commentator to state: "[T]here is no substantive difference whatsoever between a subject to mortgage and the situation in a land contract involving a wraparound mortgage . . . ."

Other commentators assert that a person who uses a wrap-

86. See Comment, supra note 55, at 1552.
88. See Comment, supra note 55, at 1552.
89. This scenario could occur in various situations. Under a wraparound mortgage, the purchaser might fail to pay the seller, and the seller might refuse to pay the mortgagee thereby causing the mortgagee to foreclose the mortgage on the property. A second possibility is that the purchaser would pay the seller, but the seller might fail to pay the mortgagee thereby causing the mortgagee to foreclose the mortgage on the property.
90. R. Levine, supra note 56, at 542. "The wraparound mortgage device should not achieve a tax result for the seller different from that which obtains when the buyer merely takes subject to the existing encumbrance." Ginsburg, supra note 85, at 489.
around mortgage to purchase property indirectly relieves the seller of the responsibility to make payments on the mortgage. This should result in the Service treating a sale secured by a wraparound mortgage and a sale made subject to the mortgage in the same manner. The seller of encumbered real property who uses a wraparound mortgage realizes the same economic benefit as the seller in Crane v. Commissioner, where the Court held that a seller of mortgaged real property realizes an economic benefit when a purchaser takes the property subject to the mortgage, thereby relieving the seller of the primary obligation to make payments on the mortgage. Commentators contend that a wraparound mortgage is within the Crane rationale because the purchaser who uses a wraparound mortgage, like the purchaser in Crane, treats the "mortgage as his own obligation notwithstanding the fact he pays it through the seller or a trustee." The Crane rule does not require that the seller remain personally liable on the mortgage. Additionally, it is immaterial whether the seller remains personally liable on a wraparound mortgage in charging him with gain in the year of sale in the amount that the mortgage exceeds his basis.

The seller should recognize the amount by which the mortgage exceeds his basis as payment in the year of sale because this difference represents tax benefits he has realized by taking depreciation deductions. Because the seller previously has received an economic benefit, it would be improper to allow him to defer reporting of this gain to future years. Nonetheless, the wraparound tech-

91. This is because the payments the seller receives on a wraparound mortgage note are usually sufficient to meet the debt service obligations on the underlying mortgage.
92. 331 U.S. 1 (1947). In Crane, the taxpayer sold mortgaged real property for $3,000 cash, subject to a mortgage of $255,000. The taxpayer claimed a taxable gain of $1,250, the amount by which the value of the property exceeded the amount of the mortgage. The taxpayer claimed that she could only be taxed on the appreciation of her equity in the property. The court held that the taxpayer should include the full amount of the mortgage in the amount that she realized on the sale. Therefore, the court found that the taxpayer realized her equity and the $255,000 mortgage upon sale of the property.
93. Comment, supra note 55, at 1555 (citing Crane v. Comm'r, 331 U.S. 1, 14 (1947)).
94. Id. at 1556. This is because if the mortgagor does not receive payments, then it will foreclose the mortgage on the property in either situation.
95. Id; see Schacht, supra note 17, at 14-17. The excess might also be attributable to the seller having refinanced the property thereby increasing the mortgage note without increasing the basis. The seller should also recognize this excess in the year of the sale. Id.
96. See id. Section 112 of the Tax Reform Act of 1984 amended § 453 of the Internal Revenue Code to provide that when property subject to depreciation recapture is sold pursuant to the installment sales method, the seller must recognize the entire amount of depreciation recapture in the year of sale regardless of the amount received in the year of sale. Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 635 (to be codified at 26 U.S.C. § 453(i)).
nique allows the seller to defer this gain beyond the year of sale. There is no justification for permitting the wraparound seller to avoid this gain in the year of sale while saddling the seller who takes subject to the mortgage with this burden.\textsuperscript{97}

By requiring the seller to recognize the amount by which the mortgage exceeds his basis, the temporary regulations are consistent with other code provisions that provide for a seller to recognize gain in the year of sale where he sells property and provides the buyer with a mortgage that exceeds his basis. Section 357\textsuperscript{98} provides that when a party to a tax-free incorporation or specified reorganization transfers encumbered property to a corporation and the amount of the liability exceeds his basis, the transferor must recognize this difference as gain. Likewise, section 311(c)\textsuperscript{99} provides that when a corporation distributes encumbered property to a shareholder and the amount of the liability exceeds the corporation’s basis in the property, the corporation must recognize gain in an amount equal to the excess. The rationale behind these code provisions, similar to the rationale in \textit{Crane}, is that the seller-transferor realizes a benefit when he disposes of property to the extent that the sale relieves him of an obligation that exceeds his basis in the property. This same benefit is present where a sale relieves a seller of real property of a liability that exceeds his basis in that property. Thus, the temporary regulations treat this benefit in a manner that is consistent with other code sections.

\textbf{B. Case for the Taxpayer}

The rights and liabilities of a seller of encumbered property vary depending on whether the purchaser assumes the mortgage, takes the property subject to the mortgage, or agrees to be bound by a wraparound mortgage.\textsuperscript{100} When a purchaser assumes a mortgage, he agrees to make payments on the mortgage directly to the mortgagee, thereby relieving the seller of the primary obligation to make the payments. Similarly, if a purchaser takes the property subject to the mortgage, he will make payments to the mortgagee to prevent foreclosure of the mortgage on the property. The seller again is relieved of his primary obligation to make payments to the mortgagee. Under a wraparound mortgage, however, the seller con-

\begin{itemize}
\item \textsuperscript{97} Comment, \textit{supra} note 55, at 1556.
\item \textsuperscript{98} I.R.C. § 357 (1982).
\item \textsuperscript{99} I.R.C. § 311(c) (1982).
\item \textsuperscript{100} See Levinton, \textit{supra} note 51, at 166-68, 170.
\end{itemize}
continues to be primarily obligated to make payments to the mortgagor, and in the event of foreclosure, he will be liable for any deficiency. Because of this primary liability, the seller will not realize an economic benefit that would require him to recognize gain in the year of sale under the Crane rationale.

The seller's rights and liabilities depend upon the form of the transaction; thus, the tax consequences of the sale of mortgaged property should reflect the different effects on rights and liabilities among the types of transactions. The wraparound transaction results in greater primary liability for the seller than either a mortgage assumption or a transaction where the purchaser takes the property subject to the mortgage; accordingly, the wraparound mortgage transaction should receive different tax treatment.

Further, by requiring a seller to recognize gain in the year of sale in the amount by which the mortgage exceeds his basis, the Service arguably has ignored the intent of Congress. If Congress had intended this result, it could have provided a subsection in section 453 similar to those within sections 357 and 311 that require the seller to recognize the gain. Congress was certainly aware of the litigation and uncertainty surrounding this area when it passed the Installment Sales Revision Act of 1980. That Congress declined to take this opportunity to legislate in the area is a strong indication that Congress's intent was not to require sellers to recognize this gain in the year of sale.

Finally, an examination of the practical effect of Treasury Regulation section 1.453-4(c) upon a wraparound mortgage reveals that the regulation results in a seller's disproportionate recognition of the gain realized on the transaction. This impact is contrary to the original purpose of the installment sales provision.

V. THE NUMBERS GAME

The correct tax treatment of a wraparound mortgage is the

101. Schacht, supra note 17, at 14-35.
102. 331 U.S. at 14. The court stated that "a mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and for additional consideration, realizes a benefit in the amount of the mortgage as well as the boot." Id.
103. See Cuff, supra note 83, at 144.
106. Congress enacted the installment sales provision to relieve sellers from paying an income tax in the year of sale based on the full amount of anticipated profits when the seller actually received only a portion of the sales price in the year of sale. Guerin, supra note 1, at 68; Schacht, supra note 17, at 14-14.
method that best achieves the objectives of the installment sales method. The installment sales method allows a taxpayer to recognize gain realized in a transaction ratably over the period during which he receives payments on the installment note. Each payment should represent, in part, the gain the seller realized on the sale, and in part, the return of his capital. The Hunt court, mindful of this objective, concluded that the Service should not treat a wraparound mortgage like a subject to mortgage under Treasury Regulation section 1.453-4(c).

The Hunt court illustrated the effect of treating a wraparound mortgage like a subject to mortgage transaction. The result was that the first few installment payments represented only gain and later payments represented only return of capital. The court found this to be a "perverse result." It is also contrary to the objectives of the installment sales method. To illustrate this principle, assume that a person sells mortgaged real property for $1,000. The seller's basis in the property is $400 and the mortgage is $500. The agreement provides for annual payments of $200 to the seller for five years beginning in the year of sale. The purchaser neither assumes nor takes the property subject to the mortgage but rather gives the seller a wraparound mortgage. The table compares the amount of profit recognized each year by the seller under the Service's approach where the transaction is treated as within the scope of Treasury Regulation section 1.453-4(c), to the amount of profit recognized each year under the Hunt court's position where the transaction is not treated as within Treasury Regulation section 1.453-4(c).

108. Id.
110. Id. at 1144.
111. I have varied the Hunt court's example slightly to emphasize the distortion that results under the Service's position. This distortion is implicit in the Hunt court's example.
Profit to Be Recognized

<table>
<thead>
<tr>
<th>Year</th>
<th>Service's Position</th>
<th>Hunt Position</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Excess of mortgage</td>
<td>Payment to seller</td>
</tr>
<tr>
<td>1</td>
<td>over basis</td>
<td>$100</td>
</tr>
<tr>
<td></td>
<td>Payment to seller</td>
<td>$200</td>
</tr>
<tr>
<td></td>
<td>TOTAL year 1</td>
<td>$300</td>
</tr>
<tr>
<td>2</td>
<td>$200</td>
<td>$120</td>
</tr>
<tr>
<td>3</td>
<td>$100</td>
<td>$120</td>
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<tr>
<td>4</td>
<td>-0-</td>
<td>$120</td>
</tr>
<tr>
<td>5</td>
<td>-0-</td>
<td>$120</td>
</tr>
</tbody>
</table>

If the wraparound mortgage is treated as within the scope of Treasury Regulation section 1.453-4(c), the gross profit ratio becomes one hundred percent, and the seller must attribute the entire amount of each installment payment to gross income until he has realized the full gain of $600. In addition, Treasury Regulation section 1.453-4(c) requires that the seller recognize as gain the amount by which the mortgage exceeds his basis. Applying the Hunt court's rationale, Treasury Regulation section 1.453-4(c) is inapplicable and only sixty percent of each payment is attributable to gain, and includable in the seller's income, while forty percent constitutes return of capital. The Service does not deem the seller to have received any additional payment in the year of sale because the mortgage exceeds his basis. Instead, the seller will receive five equal payments of $200, and recognize $120 per year as gain. Under the Service's method, although the seller will still receive payments of $200 per year for five years, he will recognize the


113. Pursuant to Treasury Regulation § 1.453-4(c), the gross profit ratio is the gross profit the seller realizes on the transaction ($1,000 selling price less $400 basis), divided by the contract price, less the amount of the mortgage that does not exceed the seller's basis ($600 divided by $600, or 100%).

114. The Hunt court held Treasury Regulation § 1.453-4(c) to be inapplicable; therefore, the seller was not charged with a constructive payment in the year of sale in the amount that the mortgage exceeded his basis. The full amount of the mortgage was included in the contract price resulting, under this example, in a gross profit ratio of 60%. The gross profit ratio is the seller's $600 gross profit divided by the $1,000 total contract price ($600 divided by $1,000 or 60%). Therefore, 60% of each payment the seller received constituted gain, while 40% constituted return of capital. See Treas. Reg. §§ 1.453-1(b)(2), 1.453-5(a), 1.453-4(c) (1960).
full amount of gain from the sale by the middle of the third year. Thus, under the Service's method, the seller does not recognize gain ratably over the entire payment period as envisioned by the installment sales method, but recognizes it in an accelerated fashion.

Faced with choosing between these two methods, the Hunt court correctly held that a wraparound mortgage was not within the scope of Treasury Regulation section 1.453-4(c).\textsuperscript{115} If the temporary regulations had been in effect at the time of the Hunt transaction and the court would have had to choose between treating the wraparound mortgage as within or outside the scope of the temporary regulations, then the court's decision may have been different.

VI. THE CHOICE UNDER THE TEMPORARY REGULATIONS

Under the temporary regulations, the computation of the gross profit ratio on a wraparound mortgage transaction is significantly different from that prescribed under Treasury Regulation section 1.453-4(c). Whereas under Treasury Regulation section 1.453-4(c) the gross profit ratio is one hundred percent whenever a mortgage exceeds the seller's basis, under the temporary regulations the fact that the wrapped indebtedness exceeds the seller's basis does not automatically render the gross profit ratio one hundred percent.\textsuperscript{116} The temporary regulations result in more favorable tax consequences to the taxpayer than Treasury Regulation section 1.453-4(c). The table below illustrates the Hunt court's example\textsuperscript{117} of the tax consequences of a sale of real property with a mortgage in excess of basis as computed under the temporary regulations, Treasury Regulation section 1.453-4(c), and the Hunt court's method. A comparison of the results of these computations reveals that the temporary regulations best achieve the objectives of the installment sales method.

\begin{footnotesize}
\textsuperscript{115} Hunt, 80 T.C. at 1144-45.

\textsuperscript{116} This results because the temporary regulations provide for two gross profit computations. See infra note 118.

\textsuperscript{117} I have slightly varied and expanded the Hunt court's example to emphasize the distortion that results under Treasury Regulation § 1.453-4(c). This distortion is implicit in the Hunt court's example.
\end{footnotesize}
118. Under Temporary Treasury Regulation § 15a.453-1(b)(3)(ii), the gross profit ratio is computed twice. Temp. Treas. Reg. § 15a.453-1(b)(3)(ii), T.D. 7768, 1981-1 C.B. 296, amended by T.D. 7788, 1981-2 C.B. 109. The first computation affects payments actually or constructively received in the year of sale. Under the first computation, the gross profit ratio is a fraction, the numerator of which is the gross profit the seller realizes on the transaction (selling price less adjusted basis; see Temp. Treas. Reg. § 15a.453-1(b)(2)(v)), and the denominator of which is the contract price (selling price less the amount of any preexisting mortgage that does not exceed the seller's basis; see Temp. Treas. Reg. § 15a.453-1(b)(2)(iii)). In the instant case, the gross profit of $600 ($1,000 selling price less $400 basis) divided by the $600 contract price ($1,000 selling price less the mortgage not in excess of the $400 seller's basis), results in a gross profit ratio of 100%. This gross profit ratio applies to all payments the seller receives in the year of sale. In the instant case, the seller actually received $200 in cash and constructively received $100 (mortgage in excess of basis) in the year of sale. Applying the gross profit ratio, the seller must recognize as gain the full amount of both payments he received in the year of sale.

The second gross profit ratio computation affects all payments the seller receives subsequent to the year of sale on the wraparound mortgage note. Under the second gross profit ratio computation, the numerator of the ratio is the face-value of the wraparound mortgage note less the seller's basis in the obligation. The denominator of the ratio is the face-value of the obligation. The seller's basis in the wraparound note is equal to the seller's basis in the property increased by the amount of gain recognized in the year of sale, and reduced by the amount of cash and the fair market value of other nonqualifying property the seller receives in the year of sale. Temp. Treas. Reg. § 15a.453-1(b)(3)(i), T.D. 7768, 1981-1 C.B. 296, amended by T.D. 7788, 1981-2 C.B. 109. In this example, the second gross profit ratio is 50%, computed as follows: $1,000 face-value of the wraparound mortgage note less the seller's $500 basis in the wraparound note ($400 basis in the real property, increased by $300 gain realized in the year of sale, and reduced by $200 cash he received in the year of sale), and divided by the $1,000 face-value of the wraparound note. This results in $500 divided by $1,000, or 50%. Of each payment the seller receives in years subsequent to the year of sale, he must attribute 50% to gain and 50% to return of capital until he has realized all gain due under the transaction.

119. Treasury Regulation § 1.453-4(c) requires the computation of only one gross profit ratio. In this example, the gross profit ratio is 100%, computed as follows: $600 gross profit divided by $600 ($1,000 total contract price less the mortgage not in excess of the seller's $400 basis). This results in $600 divided by $600, or 100%. See Treas. Reg. § 1.453-4(c) (1982).

120. See supra note 114.
As this comparison illustrates, the temporary regulations allow the seller to recognize gain ratably over the period during which he receives payments under the installment obligation, whereas Treasury Regulation section 1.453-4(c) requires the seller to recognize all gain before treating any payment as return of capital. This disparity would be even more profound in situations where the seller did not receive any cash payment in the year of sale, as illustrated in the table below.

<table>
<thead>
<tr>
<th>Year</th>
<th>Temporary Regulations</th>
<th>Regulation 1.453-4(c)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Gain</td>
<td>Gain</td>
</tr>
<tr>
<td></td>
<td>Return of capital</td>
<td>Return of capital</td>
</tr>
<tr>
<td>1</td>
<td>Excess of mortgage over basis</td>
<td>100</td>
</tr>
<tr>
<td>2</td>
<td>Payment</td>
<td>100</td>
</tr>
<tr>
<td>3</td>
<td>Payment</td>
<td>100</td>
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<tr>
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<td>5</td>
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<tr>
<td>6</td>
<td>Payment</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>TOTALS</td>
<td>600</td>
</tr>
</tbody>
</table>

As the preceding example demonstrates, the temporary regulations allow the seller to recognize gain ratably over six years, whereas Treasury Regulation section 1.453-4(c) requires the seller to recognize his entire gain over the first four payments received on the note. Thus, the temporary regulations more effectively achieve the objectives of the installment sales method; they allow the seller to recognize gain ratably over the period during which he receives payments on the note. The temporary regulations are more favorable to the taxpayer than Treasury Regulation section 1.453-4(c), and become even more so as the amount the seller receives in the year of sale diminishes.

Although the Hunt court's method arguably allocates the seller's realized gain more evenly over the payment period than ei-

121. The results under the Hunt court's approach are not illustrated because they would be the same as in the previous example, except that the seller would recognize gain in years two through six.
122. The two gross profit ratios remain the same as in the previous example. See supra note 118.
123. The gross profit ratio, as in the previous example, is 100%. See supra note 119.
ther the temporary regulations or Treasury Regulation section 1.453-4(c), it fails to account for the gain the Crane court held that the seller realizes in the year of sale in the amount that the mortgage exceeds his basis. The temporary regulations accurately and fairly reflect the seller's realized gain ratably over the period during which the seller receives payments under the installment obligation, and also meet the Crane requirement that the seller recognize gain in the amount that the mortgage exceeds his basis in the year of sale.

Although apparently according proper treatment to the sale of encumbered real property under a wraparound mortgage, the temporary regulations, Treasury Regulation section 1.453-4(c), and the Service's position suffer from a faulty assumption. All three methods are based on the assumption that when a seller uses a wraparound mortgage he will be receiving payments from the purchaser in amounts sufficient to enable him to meet the debt service due on the preexisting mortgage without having to resort to his own funds. This assumption led the Service to argue in Hunt that, as to the seller, a sale utilizing a wraparound mortgage is indistinguishable from a sale of property subject to the mortgage.

Although the seller who uses a wraparound mortgage will usually receive payments from the purchaser in amounts sufficient to allow him to service the preexisting mortgage, in some situations the payments the seller receives may be inadequate to meet the debt service obligation on the preexisting mortgage. In such cases, the inadequate payments will force the seller to make the payments due to the mortgagee, to some extent, from his own funds. In this situation, the Service cannot equate the seller of encumbered property who accepts a wraparound mortgage with a person who sells property subject to the mortgage.

This situation could occur where the purchaser executes a note in favor of the seller with a duration longer than the note that the preexisting mortgagee holds. For example, assume the seller's preexisting mortgage note has a remaining term of five years while the purchaser's note is for ten years. Assuming the seller's remaining liability on the preexisting mortgage is $500, payable one hundred dollars per year for five years, he would receive only $50 per year from the purchaser under the wraparound mortgage note towards the preexisting mortgage obligation. The seller would then have to

124. For a discussion of the rationale behind requiring the seller to recognize such gain, see supra text accompanying note 92.
supply an additional $50 out of his own funds to meet his obligation on the preexisting mortgage. The temporary regulations and Treasury Regulation section 1.453-4(c) fail to envision this situation; consequently, they are ill-equipped to treat it properly. Taxpayers need a regulation that specifically provides for these circumstances.

VII. CONCLUSION

Commentators have criticized the Service for promulgating the temporary regulations that deal with wraparound mortgages. As the examples illustrate, however, the temporary regulations dictate results that are markedly different from those that the Service advocated in the Stonecrest line of cases. Had the Tax Court adopted the Service’s position that Treasury Regulation section 1.453-4(c) governs wraparound transactions, a perverse result would have occurred. If the Tax Court decides to give effect to the temporary regulations, however, such is not the case.

The temporary regulations require the seller to recognize as gain in the year of sale the amount by which the mortgage exceeds his basis without unduly accelerating the recognition of his remaining realized gain. Some commentators seek to distinguish the wraparound transaction from a subject to transaction on the basis of the seller’s continuing primary liability under the wraparound mortgage. On this basis, these commentators contend that the seller who uses a wraparound mortgage should not recognize as gain in the year of sale the amount by which the mortgage exceeds his basis. The distinction is largely illusory. In a wraparound transaction, if the purchaser defaults on his obligation to the seller, the seller will undoubtedly allow the preexisting mortgagee to foreclose the mortgage on the property. Theoretically, the preexisting mortgagee could recover any foreclosure sale deficiency from the seller. This, however, rarely occurs. Practically speaking, the seller rarely, if ever, incurs any detriment by remaining primarily obligated to the mortgagee. In fact, a seller may structure a transaction to include a wraparound mortgage for many nontax reasons such as to avoid a due-on-sale clause, or to increase his profit on the transaction by taking advantage of a low interest rate on the preexisting mortgage. Unless a seller believes that significant benefits outweigh his potential liabilities, he will not enter into a

125. See supra text accompanying note 102.
126. See supra note 55.
wraparound transaction. Thus, there is no reason to distinguish a subject to transaction from a wraparound transaction. Accordingly, no justification exists in either situation for allowing the seller to escape recognition of gain in the year of sale in the amount by which the mortgage exceeds his basis.

By computing the gross profit ratio twice, the temporary regulations effectively allocate the recognition of gain over the period in which the seller receives payments. They avoid the accelerated recognition of gain that resulted when applying Treasury Regulation section 1.453-4(c); therefore, critics and courts should not summarily dismiss them as an attempt by the Service to circumvent the Stonecrest line of cases. Instead, the courts should give the temporary regulations full effect because they best reflect the tax consequences of the transaction and achieve the objectives of the installment sales method.