October 22, 2003

Timing Is Everything
(Can Property Sale Occur Before Delivery of Deed?)

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The detailed arrangements and provisions surrounding real estate transactions, ranging from the dates on the documents to who gets the interest on an escrowed deposit, often have an impact on the tax results of the transaction. The Internal Revenue Code imposes federal income tax on "gains derived from dealings in property" and then defines such gains as the excess of the amount realized from "the sale or other disposition of property" over the adjusted basis thereof. Thus, tax is not due until property is considered sold or otherwise disposed of for federal income tax purposes. The Tax Court recently addressed the question of whether a sale of real property had taken place for tax purposes even before the deed was delivered.

In *Robert K. and Dawn E. Lowry,* 2003 RIA TC Memo ¶ 2003-225 (2003), Robert Lowry was a 50-percent partner in Lowry Wells Investments (the partnership), which owned a property in Irvine, California. The property was encumbered by a $3.5 million mortgage, which was personally guaranteed by the partners.

As of June 29, 1993, the loan was in default, and the mortgage lender began the process of foreclosure. The lender and the partnership negotiated a settlement agreement in lieu of foreclosure whereby the partnership would convey the property to the lender in full settlement of the outstanding indebtedness.

On December 15, 1993, the partners executed a deed to convey the property to the lender and the lender executed a "Covenant Not to Sue" the partnership and its general and limited partners as to any matter arising from the loan made by the lender to the partnership. The Covenant was conditioned upon a release by the partnership to the lender and the conveyance of the property to the lender.

The deed was placed in escrow with a title insurance company. Among the conditions to the release of the escrow was the satisfaction of prerequisites to the issuance of title insurance. By May 27, 1994, the title insurance company had determined that it could issue the title policy, so the escrow closed and the deed was recorded on that date.

The taxpayer (Robert Lowry) did not report the gain on his 1994 tax return, contending that the partnership conveyance of the property to the lender occurred on December 15, 1993. The taxpayer based his argument on the fact that the deed and the Covenant Not to Sue were dated Dec. 15, 1993, and the fact that the lender issued a 1993 Form 1099-A, showing the "date of the lender's acquisition" of the property to be "12-15-93." The taxpayer argued that once the deed went into escrow, the Partnership took no further action and the subsequent actions of the lender in obtaining a title policy and recording the deed were not relevant to determining time of sale for tax purposes.

The court disagreed.

> The escrow instructions, dated December 9, 1993, recite that they were being issued to the Title Company on behalf of the lender and the Partnership. Also, the Grant Deed recited that the Grantor and Grantee intend that the lien created by the Deed of Trust would not merge into the fee title being acquired by the Grantee. The Grant Deed further recites that no merger will occur until the Grantee executes and records a separate instrument specifically effecting such merger. These facts alone repudiate petitioners' contention that "The subsequent actions by the lender in obtaining a title policy and recording the deed through 'their' escrow agent are not relevant to the question of the date when transfer of ownership was complete." In fact, subsequent steps taken by all concerned in 1993 and 1994, and not by the lender alone, are very relevant to that question.

Thus, the court found that the 1994 activity of the escrow agent did relate to the partnership because, as evidenced

by the escrow instructions, the escrow agent was acting on behalf of the partnership as well as the lender.

Moreover, since the documents explicitly provided that the mortgage would not merge with the deed until recordation, the court concluded that the parties did not intend the transfer to occur before release of the escrow. It is unclear why the court emphasized that the deed and mortgage did not merge until recordation. Had the deed recited that merger would occur upon delivery of the deed, that would have been a clear indication that the deed was intended to take effect only when it came out of escrow. However, the deed recited that "no merger will occur until the grantee executes and records a separate instrument specifically effecting such merger."

This would seem to permit the deed to be released from escrow and still not merge with the mortgage until some later time. If so, why does this provision establish a later time of sale?

Focus on Form

Then the court focused on the form of the transaction: "although other factors may be considered, passage of title is usually conclusive" and "it seems beyond dispute that title to the [property] passed on May 27, 1994."

The court then examined the role the transfer of title played in the economic arrangement between the parties. At the time the lender agreed to accept a deed to the property in lieu of foreclosure, the balance due on the secured note substantially exceeded the fair market value of the property, so that if foreclosure had proceeded, the lender could have pursued a substantial deficiency judgment against the partners, who were personally liable on the mortgage note.

To protect themselves against this possibility, the partners required the Covenant Not to Sue, which was conditioned upon, among other things, the conveyance of the property to the lender, which could only take place upon satisfaction of the terms of the escrow. Thus, the release of the escrow and recording of the deed had a real economic effect upon the partnership and were not merely internal, ministerial actions taken by the lender.

The taxpayer relied on *Keith v. Commissioner,* 115 T.C. 605 (2000), to demonstrate that a title closing is not necessary to establish a closed transaction. In *Keith,* the taxpayer had entered into contracts requiring deed transfers at later dates and the Tax Court held that sales had taken place at the time the contracts were executed.

The court, however, distinguished *Keith* as follows:

> The facts of Keith, however, are specifically relevant to a form of transaction under Georgia law known as a "contract for deed." Georgia law normally construes a contract for deed as a device for passing equitable ownership, leaving the seller with essentially a security interest.

As the court explained, under a contract for deed in Georgia, the buyer obtains a right to possession; an obligation to pay taxes, assessments, and charges against the property; responsibility for insuring the property; the duty to maintain the property; the right to improve the property without the seller's consent; and a right to obtain legal title at any time by paying the balance of the full purchase price.

All of these elements, short of transfer of title, were held in *Keith* to be sufficient for obtaining "equitable" ownership. The facts in *Lowry,* however, did not establish that the lender obtained equitable ownership before title to the property passed in 1994 by virtue of the recordation of the deed upon satisfaction of escrow instructions.

Thus, while in *Keith,* the court found that the economic reality was sufficiently compelling to establish that "ownership" had passed despite the absence of a deed, there was nothing in this case to indicate that the benefits and burdens of ownership had shifted at the time the deed was placed in escrow.

While normally a "time of sale" case would be determined by a benefits and burdens analysis similar to that employed in *Keith,* the *Lowry* case presented the court with greater difficulty, since, in the case of a deed in lieu of foreclosure, by its very nature the debtor's economic participation is limited.

When the value of the property falls below the amount of the mortgage, it can be said that, for all practical purposes, the mortgage lender owns the property both before and after the conveyance; it is therefore difficult to identify a moment in time when the benefits and burdens of ownership pass.

The court seemed to reach the right result by looking to 1994 when the taxpayer formally transferred the property and when the Covenant Not to Sue, the only real economic consequence of the transaction to the debtor, became effective.

One might speculate, however, as to how much the court was influenced by the fact that the taxpayer, while claiming the gain was realized for tax purposes in 1993, failed to report the gain on his 1993 income tax return.

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