BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
CARL W. AND SYLVIA L.)
(LAUGHLIN) OLSON)

Appearances:

For Appellants: Larry Siegel
Certified Public Accountant

For Respondent: James C. Stewart
Counsel

OPINION

This appeal is made pursuant to section 19057, subdivision (a), of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Carl W. and Sylvia L. (Laughlin) Olson for refund of personal income tax in the amount of $44,220 for the year 1975.

For purposes of convenience, only Sylvia L. Olson shall herein be referred to as "appellant."

The sole issue presented by this appeal is whether, in determining if appellant received payments in the year of sale in excess of 30 percent of the selling price of mortgaged real property within the meaning 'of the installment sale provisions, the excess of the mortgage over appellant's adjusted basis in the property is to be included in the payments.

In 1975, appellant sold two pieces of real property for $1,050,000.00 utilizing a "wraparound" mortgage. The purchasers made a down payment of $175,000.00; two all-inclusive deeds of trust were received totaling $875,000.00, thus accounting for the full sales price. The gain from this transaction was reported on appellant's 1975 California personal income tax return. Upon audit, respondent increased the reported gain by reducing the basis of the property; appellant has not disputed this adjustment. After the adjustment, the existing mortgage exceeded appellant's basis in the property. Respondent determined that this excess, $178,776.00 was to be added to the down payment for purposes of computing the total payments made by the purchasers in the year of sale. When the excess was added to the down payment, the sale no longer qualified for reporting under the installment sale provisions because more than 30 percent of the purchase price was deemed to have been received in the year of sale. Respondent subsequently issued a proposed assessment in the amount of $45,882.66 reflecting the aforementioned adjustments; appellant paid this amount and filed an amended return claiming a refund in the amount in issue. When respondent failed to act upon appellant's refund claim within six months, appellant considered her claim denied pursuant to Revenue and Taxation Code section 19058,[1/] and this appeal followed.

In recent years there has been a resurgence in the use of a real estate financing device known as the "wraparound" mortgage. A wraparound mortgage, also referred to as an "all-inclusive deed of trust," is a second mortgage securing a promissory note, the face amount of which is the sum of the existing mortgage liability plus the cash or equity advanced by the lender. The wraparound borrower must make payments on the first mortgage debt to the wraparound lender, who, as required by the wraparound mortgage agreement, must in turn make payments on the first mortgage debt to the third party,, the first mortgagee. (Schrader, The Wrap-Around Mortgage: A Critical Inquiry, 21 UCLA L.Rev. 1529 (1974).)

1/ Hereinafter, all references are to the Revenue and Taxation Code unless otherwise noted.

As previously noted, appellant sold real property in 1975 under a contract providing for payment to be made in installments over a period of years. Appellant elected to report the gain realized from this sale under the installment method provided by section 17578 which, during the appeal year, was the California counterpart to section 453(b) of the Internal Revenue Code of 1954.2/ The controversy here arises from the fact that, at the time of the sale, the property was encumbered by a mortgage the unpaid balance of which exceeded appellant's adjusted basis in the property.

During the appeal year, section 17577 provided that certain sellers of personal property on the installment plan could return as income from the sale of such property in any year the proportion of the payments actually received in that year that the gross profit on the sale bore to the total contract price. This treatment was extended to sales of real property by section 17578 if the payments in the year of sale did not exceed 30 percent of the selling price. The parties here disagree over whether appellant received payments in the year of sale exceeding this 30 percent limitation. Appellant asserts that the only payment received in 1975 consisted of the $175,000.00 down payment. Respondent maintains, however, that in addition to this cash payment, appellants received a payment in the year of sale equal to the excess of the mortgage over the adjusted basis of the property, a total amount in excess of 30 percent of the total selling price.

Although section 17578 did not expressly provide any special treatment for sales of mortgaged property, respondent's regulations provided, in relevant part, as follows:

> 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

2/ During the year in issue, section 17578 was substantively identical to section 453(b) of the Internal Revenue Code of 1954. Accordingly, federal case law is highly persuasive in interpreting the former California statute. (Rihn v. Franchise Tax Board, 131 Cal.App.2d 356, 360 [280 P.2d 893] (1955).) AB 380 (Stats. 1981, ch. 336), operative January 1, 1981, repealed sections 17577 and 17578 of the Revenue and Taxation Code as they existed in 1975, and added current sections 17577 and 17578, operative for taxable years beginning on or after January 1, 1981. Former section 453(b) of the Internal Revenue Code was repealed by the Installment Sales Revision Act of 1980 (Public Law 96-471, 1980 U.S. Code Cong. & Ad News (94 Stat.) 2247) which also added current section 453(b).

> the purpose of determining the payments and the total contract price ..., the amount of such mortgage shall be included only to the extent that it exceeds the basis of the property.

(Former Cal. Admin. Code, tit. 18, reg. 17577-17580 (d), subd. (3).3/)

While the regulation first refers broadly to "the sale of mortgaged property," the provisions following this general reference describe the two types of sales of mortgaged property to which the regulation applies: (1) where a buyer takes property subject to a mortgage, and (2) where a buyer assumes the mortgage. (Stonecrest Corporation, 24 T.C. 659, 666 (1955); see also United Pacific Corporation, 39 T.C. 721 (1963); Estate of E. P. Lamberth, 31 T.C. 302, 314 (1958).)

In Stonecrest Corporation, supra, the tax court held that the expressions used in the former federal regulation 4/ which was the predecessor to the regulation in issue, i.e.; "property is merely taken subject to the mortgage" and "mortgage is assumed by the purchaser," have the meanings customarily attributed to them in transactions involving transfers of mortgaged property:

> While in a sense every sale of mortgaged property is subject to a mortgage since the property remains liable to have the mortgage debt satisfied from it, we think the expression was used in the regulation in its customary meaning, to define the obligations of the parties to a sale of property with respect to the mortgage debt,

(Stonecrest Corporation, supra, 24 T.C. at p. 668.)

The tax court stated its understanding of the customary meanings of the expressions in the following language:

> 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

3/ Respondent's former regulation was repealed by Register 81, No. 26 effective July 25, 1981.

4/ Treasury Regulation § 29.44-Z was promulgated pursuant to section 44 of the Internal Revenue Code of 1939, the predecessor to section 453(b) of the Internal Revenue Code of 1954, as the latter existed in 1975.

> 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. Where 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.

(Stonecrest, supra, 24 T.C. at p. 666.)

In Stonecrest, as here, the taxpayer sold its property under an installment sales contract. Under the facts presented by that case, the tax court held that the sale did not fall within the meaning of the regulation. Specifically, there was no assumption of the mortgage because the buyer had no obligation to the mortgagor to pay the mortgage. The fact that the ultimate use of the buyer's payments was to pay off the mortgage was not deemed a determining factor. Also, the property was not taken subject to the mortgage because the seller was obligated to the buyer to make payments on the mortgage.

While respondent has not disputed the correctness of Stonecrest, it has noted that the Internal Revenue Service has not acquiesced in that decision and that two private letter rulings of the latter agency set forth the position that a wraparound mortgage involves a taking "subject to" the senior mortgage even though the seller has retained the obligation to meet the senior mortgage payments. The position of the Internal Revenue Service is that with the conveyance of title to the purchaser, he becomes the owner of all the property rights and takes the property "subject to" any mortgage. Moreover, respondent apparently seeks to distinguish the factual situation presented by this appeal from that present in Stonecrest by noting that this case involves an immediate transfer of title whereas Stonecrest involved a contract for sale or contract for deed where title did not pass immediately.

The agreement executed by appellant and the purchasers of her property makes clear that there was no assumption of the senior mortgage. As it clearly provided, appellant was solely responsible to make the payments of principal and interest on the pre-existing mortgage. The fact that she may have used the installment payments received from the purchasers of her property to pay off the senior mortgage debt is irrelevant. (Stonecrest Corporation, supra; Estate of E. P. Lamberth, supra.) As noted above, the assumption of a mortgage means that the buyer takes over the seller's obligation to the mortgagee and incurs an obligation generally enforceable by the mortgagee; the buyers here were under no such obligation.

Moreover, the sale made by appellant was not "subject to" the pre-existing mortgage. In Stonecrest Corporation, supra, it was emphasized that property is taken subject to a mortgage within the meaning of respondent's former regulation only where the payments on the senior mortgage are to be made to the mortgagee and not the seller. (See also Estate of E. P. Lamberth, supra.) In such a circumstance, the total purchase price should be reduced by the amount of the mortgage debt to arrive at the selling price. In this case there was no reduction in the purchase price because of the senior mortgage and, as previously noted, appellant was responsible for paying the mortgage debt.

We find the factual situation presented by this appeal to be indistinguishable from that of Stonecrest; the fact that Stonecrest involved a contract for deed and not a wraparound mortgage with immediate transfer of title is a distinction without a difference. In Estate of E. P. Lamberth, supra, the tax court specifically held that a sale may qualify for section 453 treatment whether or not title has passed. William J. Goodman, 74 T.C. 684 (1980), is not to the contrary; in that case the tax court held that the purchaser of the taxpayer's property had taken that property subject to the senior mortgage and did not address the question of whether a wraparound mortgage with immediate transfer of title should be treated differently from a contract for deed. Finally, the position of the Internal Revenue Service as expressed in private letter rulings, as well as that agency's non-acquiescense to the decision in Stonecrest, merely indicate the Internal Revenue Service's interpretation of the law and are not binding upon this board. (See Appeal of Verne D. and Joanne O. Freeman, Cal. St. Bd. of Equal., June 23, 1981.)

For the reasons set forth above, respondent's action in this matter must be reversed.

Appeal of Carl W. and Sylvia L. (Laughlin) Olson

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS **HEREBY ORDERED, ADJUDGED** AND DECREED, **pursuant to section 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Carl W. and Sylvia L. (Laughlin) Olson for refund of personal income tax in the amount of $44,220 for the year 1975, be and the same is hereby reversed.**

Done at Sacramento, California, this day 17th of August **, 1983, by the State Board of Equalization, with Board Members** Mr. Bennett, Mr. **Collis, Mr.** Dronenburg, Mr. Nevins and Mr. Harvey present.

William M. Bennett **, Chairman**

Conway H. Collis **, Member**

Ernest J. Dronenburg, Jr. **, Member**

Richard Nevins **, Member**

Walter Harvey* **, Member**

*For Kenneth Cory, per Government Code section 7.9