Alstores Realty Corp. v. Commissioner

46 T.C. 363 (1966)

Facts

- Alstores ("Buyer") paid $750,000 to Steinway ("Seller") for the right to take possession of a warehouse two and a half years after payment. The fair market value of the warehouse is $1,000,000 and the fair market value of the warehouse with possession deferred for 2.5 years is $750,000.
- Buyer is the taxpayer in the case.

Arguments

- Taxpayer's Argument: Buyer claims the transaction should be treated as the purchase of a remainder in the warehouse for $750,000. The remainder becomes possessory after the 2.5 year term reserved by the seller. As a result, Buyer should take a $750,000 basis in the warehouse.
- Government's Argument: Buyer should be treated as paying $1,000,000 for the warehouse. Buyer should then be treated as renting the warehouse back to Seller for a term of 2.5 years in exchange for prepaid rent of $250,000. As a result, Buyer has a cost basis in the warehouse of $1,000,000 and $250,000 of income.

Court’s Analysis

- The Court looked at the various factors that follow ownership of a building such as: (1) responsibility for property taxes; (2) responsibility for utilities; and (3) the right to condemnation and insurance proceeds in case of condemnation or destruction.
- Of course, by far the most important right of ownership is the right to possess, and there was no dispute how that right was divided.
- Since the parties can easily shift the burden of taxes and utilities by adjusting the contract price, and the parties always allocate condemnation and insurance proceeds, is the Court’s analysis meaningful?

Consequences of the Approaches

- Taxpayer’s Approach: Cost basis of $750,000 and the warehouse ownership shifts in 2.5 years. But should the annual increase in value of the remainder be taxable as a reverse form of depreciation? That is, isn’t the growth in value from cost of $750,000 to $1,000,000 simply a function of the passage of time? Is it relevant that the warehouse might be worth more or less than $1,000,000 in 2.5 years?
- Government’s Approach: The prepaid rent is income, but when? For an accrual taxpayer, should it be accrued over time (i.e., as it accrues) or includible in full immediately? Recall the prepaid income cases such as *AAA* and *AA of Southern California*.

Summary

- If the remainder is taxed as it increases in value (if we treat this as the purchase of a remainder) and if the rent is includible over the term of the lease (if we treat this as a sale and leaseback), the outcomes are the same. Since the two characterizations seem equally valid, shouldn't they produce the same outcome?

Problem P-4

- Let's look at the Seller's side of the transaction, and assume the Seller's adjusted basis was $600,000 (a number I made up).
- If we treat the transaction as a sale and leaseback, then Seller has gain from the sale of $400,000 (amount realized of $1,000,000 less adjusted basis of $600,000) followed by a deduction of $250,000 over 2.5 years (amortization of the prepaid rent). Thus, net income over 2.5 years of $150,000.
- If we treat the transaction as a sale of a remainder, what consequences follow?

Problem 4 Answer

- The sale of the remainder for $750,000 produces a gain under section 1001(a) based on the amount realized of $750,000 and Seller's adjusted basis *in the thing sold*. We're assuming Seller's basis in the warehouse was $600,000, but Seller sold *only a portion* of the warehouse. How much? $750,000/$1,000,000 equals 75%, so seller should be allowed to use only 75% of $600,000 – that is, $450,000 – against the amount realized. Accordingly, Seller realizes and recognizes a gain of $300,000. Seller's $150,000 remaining basis in the warehouse should be amortized over the 2.5 year term, so that there is net income of $400,000 less $250,00, or $150,000.