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Tax Problems Incident To the Acquisition of Real Estate

II

DETERMINING AND ALLOCATING "COST" AND PRORATING PROPERTY TAXES

Warren E. Hacker

DETERMINATION OF THE "COST" OF THE ACQUIRED PROPERTY

Generally, where property is acquired in a transaction upon which either gain or loss is not recognized, its basis is determined in the first instance by its basis in the hands of the other party to the transaction,¹ or by the basis to the taxpayer of the property given up in exchange therefor.² Such acquisitions are here put to one side and only

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the basis of property acquired in transactions upon which gain or loss is recognized in full are considered. In such cases, "basis" is "cost" to the taxpayer.³ Curiously, however, the term "cost" is not

defined by the statute and is defined with no particularity by the regulations. Here examined are the kind of items which are included in the cost of property; the kind of items which do not add to cost but which are currently deductible; and the circumstances under which certain items of the latter kind may, at the taxpayer's election, be added to cost.

Items Adding to Cost

Cost, of course, includes the consideration to the seller paid or incurred by the purchaser. It thus includes the amount of money paid and the property (usually at fair market value⁴) transferred to the

1. See, e.g., INT. REV. CODE OF 1954, §§ 334(b) (1), 362(a), (b).

2. See, e.g., INT. REV. CODE OF 1954, §§ 358(a), 1031(d), 1033(c).

3. INT. REV. CODE OF 1954, § 1012.

4. Treas. Reg. § 1.1012-1 (1957), as amended, T.D. 6311, 1958-2 CUM. BULL. 394, states merely that "cost is the amount paid . . . in cash or other property." Under § 1001(b) of the code, gain or loss on the property transferred by each party is measured by the money plus the "fair market value" of the property received. It will usually be presumed that the value of the consideration transferred equals the value of that received in an arm's-length transaction. Therefore, generally each party's cost for the property received will exactly correspond with the value of that property at that time. It may seriously be questioned whether by agreement the parties can avoid this by assigning fictitiously high or low prices to the property involved where property is acquired for property or for cash and property. See discussion, pp. 166-67.

seller for the property. In cases where the consideration includes the purchasing corporation's own stock, the fair market value⁵ of such shares is included in the cost of the property, whether or not the stock represents an original issue or treasury shares.⁶ Cost includes the principal amount of any indebtedness to the seller incurred by the purchaser on the acquisition. It also includes indebtedness which antedates the purchase and which is assumed by the purchaser, or subject to which the property is acquired.⁷ In addition to the familiar example of principal mortgage indebtedness, this category includes such items as property taxes for years prior to the year of purchase,⁸ special assessments which accrued prior to purchase, and interest or penalties on any of the foregoing accrued prior to the purchase.⁹ Such indebtedness and pre-existing liabilities add to cost, even though the purchaser uses the cash rather than accrual method of accounting, whether or not the purchaser is personally liable therefor, and whether or not it represents a lien on the property.

In addition, cost of the property includes commissions and finders' fees, if any, paid or incurred by the purchaser, together with other costs of obtaining, perfecting, and assuring title or quiet possession of the property, which are paid or incurred by the purchaser. Thus, attorneys' fees, the costs of surveying the property, title search and title insurance, and recording fees all add to the property's cost and are hence not currently deductible.¹⁰

Generally, a loss is sustained upon removal or demolition of buildings which is measured by their adjusted basis. Where, however, land and buildings are acquired with the intention of removing the buildings, no loss is sustained thereby. Moreover, no deduction is allowed for the expense of removal, and the entire purchase price for both land and buildings, together with the costs of removal, is treated as cost of the land only.¹¹ This is a realistic approach where the intention to remove existed at the time of purchase. In such

5. 3A MERTENS, LAW OF FEDERAL INCOME TAXATION, § 21.25, n. 38 (2d ed. 1954).

6. This assumes, as stated at the outset, that the transaction is taxable, e.g., not within §§ 351 or 362. See Treas. Reg. § 1.1032-1(d) (1956). The corporation realizes neither gain nor loss on the disposition of its own shares. INT. REV. CODE OF 1954, § 1032(a).

7. United States v. Hendler, 303 U.S. 564 (1938), *rehearing denied*, 304 U.S. 588 (1938) (debt assumed); Crane v. Commissioner, 331 U.S. 1 (1947) (property acquired subject to debt).

8. Taxes for the year of purchase must be prorated. See discussion of § 164(d), pp. 171-75.

9. A later compromise or reduction in such pre-existing liabilities does not reduce the cost (Blackstone Theatre Co., 12 T.C. 801 (1949)), but may give rise to taxable income. See INT. REV. CODE OF 1954 §§ 61(a)(12), 108; Treas. Reg. § 1.61-12 (1957).

10. E.g., Millinery Center Bldg. Corp., 21 T.C. 817 (1954), *rev'd on other grounds*, 221 F.2d 322 (2d Cir. 1955), *aff'd*, 350 U.S. 456 (1956) (attorneys' fees); Warner Mountains Lumber Co., 9 T.C. 1171 (1947), *acq.*, 1948-2 CUM. BULL. 4 (title examination); Vincent Johnson, 24 P-H Tax Ct. Mem. 819 (1955) (survey costs). See generally 4 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 25.25 (2d ed. 1954).

11. Treas. Reg. § 1.165-3 (1960). Bekins Moving & Storage Co., 10 P-H B.T.A. Mem. 1344 (1941).

cases, the purchaser's intention is to obtain the land; the buildings are acquired only because they were located on the land.¹² Clearing the land of the unwanted buildings is no different from clearing the land of other obstructions to its intended use. Where, however, the purchaser's immediate purpose is to acquire and hold both land and buildings, a later change in that intention does not bring this principle into play.¹³

One other peculiar rule having particular application in this area should be mentioned. Such recurring items as painting, and roof, floor, plumbing, and electrical maintenance and repairs, are usually treated as currently deductible expenses.¹⁴ However, such expenditures, if undertaken as part of a general rehabilitation program, may be held to be additions to the cost of the property and not currently deductible.¹⁵ The risk of this principle's being applied is greatly increased where the rehabilitation program occurs shortly after purchase because it then may be regarded as, in effect, maintenance which the seller neglected or deferred, a matter presumably reflected in the property's having been purchased at a price lower than it otherwise would have been.¹⁶

Certain local benefit assessments also add to the cost of the property and are nondeductible.¹⁷ Street paving and lighting, sewer, sidewalk, and other taxes assessed against local benefits, imposed because of, and measured by, some benefit accruing directly to the property, are not deductible as taxes.¹⁸ The theory is that such items are as much a cost of improving the property as if the owner himself had made

12. Another instance of where the purchaser's intention prevails over the form of the transaction is where he purchases stock of a corporation in order to obtain its assets through liquidation (*Georgia Properties Co. v. Henslee*, 138 F. Supp. 587 (M.D. Tenn. 1955); *Montana-Dakota Utilities Co.*, 25 T.C. 408 (1955); *Kimbell-Diamond Milling Co.*, 14 T.C. 74 (1950), *aff'd*, 187 F.2d 718 (5th Cir. 1951), *cert. denied*, 342 U.S. 847 (1951)), or other distribution (*Hogg v. Allen*, 214 F.2d 640 (5th Cir. 1954); *Charles A. Clark*, 19 T.C. 48 (1952); *Western Wine & Liquor Co.*, 18 T.C. 1090 (1952)), or to accomplish other purposes (*Pressed Steel Car Co.*, 20 T.C. 198 (1953), *acq.*, 1956-2 CUM. BULL. 8). *Cf. Gulftext Drug Co.*, 29 T.C. 118 (1957), *aff'd*, 261 F.2d 238 (5th Cir. 1958).

13. *Ingle v. Gage*, 52 F.2d 738 (W.D.N.Y. 1931); I.T. 3311, 1939-2 CUM. BULL. 206; *O. Maples*, 25 P-H Tax Ct. Mem. 921 (1956); *Parma Co.*, 18 B.T.A. 429 (1929), *acq.*, IX-1 CUM. BULL. 42 (1930). However, where the buildings are later razed to permit construction of a new building, the remaining cost of the old building may be treated as part of the cost of the new building. *Commissioner v. Appleby*, 123 F.2d 700 (2d Cir. 1941). *Treas. Reg. § 1.165-3(b)(1)* (1960) allow a loss even in such a case.

14. See *Treas. Reg. § 1.162-4* (1958).

15. *Ethyl M. Cox*, 17 T.C. 1287 (1952); *Home News Publishing Co.*, 18 B.T.A. 1008 (1930).

16. The fairness of the principle can be questioned where the expenditures merely represent deferred maintenance of the same taxpayer. The principle makes considerably more sense where the items represent lack of ordinary maintenance by the predecessor owner.

17. INT. REV. CODE OF 1954, § 164(b)(5).

18. *Treas. Reg. § 1.164-4(a)* (1957). The tax is considered assessed against local benefits when the property taxed is limited to the property benefited. *Ibid.*

the improvement. Accordingly, they are a proper addition to the cost of the property.¹⁹

Items Currently Deductible

On the other hand, local benefit assessments, to the extent they can be shown to represent maintenance and repair of the improvements or interest charges with respect to such improvements, are deductible currently as taxes.²⁰ As usual, the burden is on the taxpayer and if the proper allocation cannot be shown, no part of the assessment is deductible.²¹ In addition, special assessments levied by special taxing districts are deductible if: (a) the district covers at least all of one county, (b) at least 1,000 persons are subject to the assessment, and (c) the tax is assessed annually at a uniform rate on the same assessed values as are used for the real property tax generally.²² None of the assessments of special taxing districts in Ohio presently meet these tests.²³

A special problem arises with respect to federal and state taxes incident to the acquisition, development, and construction of property. The code²⁴ specifically denies deduction — as a tax — for all federal excise taxes, but permits them to be deducted as ordinary and necessary expenses. The wages paid in connection with the construction of an improvement are treated as part of the cost of the property, not as ordinary and necessary expense. Still, the social security and other federal employment taxes, imposed upon the employer and measured by such wages, are allowed as current deductions and are not required to be capitalized.²⁵

Similarly, the Ohio sales and use taxes paid or incurred on the purchase of tangible personal property, including construction materials for improvements to real estate, are deductible as taxes and do not add to the cost of capital items.²⁶ These taxes are imposed upon and, hence, are deductible only by the "consumer" as defined by

19. INT. REV. CODE OF 1954, § 1016(a) (1); Treas. Reg. § 1.1016-2(a) (1957).

20. INT. REV. CODE OF 1954, § 164(b) (5) (A).

21. Treas. Reg. § 1.164-4(b) (1) (1957).

22. INT. REV. CODE OF 1954, § 164(b) (5) (B); Treas. Reg. § 1.164-4(b) (2) (1957).

23. Such multi-county taxing districts (*e.g.*, conservancy and flood control districts) in Ohio assess the tax in accordance with formulae which attempt to vary the burden according to the benefit conferred and, hence, not "at a uniform rate" on the assessed values. See generally A.R.R. 3111, II-2 CUM. BULL. 111 (1923); Champion Coated Paper Co., 10 B.T.A. 433 (1928).

24. INT. REV. CODE OF 1954, § 164(b) (3).

25. R. A. Bryan, 32 T.C. No. 10 (Apr. 16, 1959); Joe W. Stout, 31 T.C. No. 124 (Mar. 25, 1959). Treas. Reg. § 1.266-1(b) (2) (1958), as originally adopted, contained a provision indicating that the Commissioner would treat such taxes as capital items, not expenses, where incurred in connection with construction or development of property. This regulation has recently been amended to eliminate that provision by T.D. 6380, 1959 INT. REV. BULL. NO. 12, at 25. Cf. Treas. Reg. § 1.164-3 (1957).

26. Rev. Rul. 267, 1955-1 CUM. BULL. 23 (Ohio sales tax).

the local statute.²⁷ Thus, if a landowner purchases materials to be used in construction of improvements to real estate, he thereby incurs the tax and may deduct it. If, on the other hand, the land owner contracts for the improvements, his contractor will be the consumer of such materials. In such cases it is not a tax of the land owner and may not be deducted by him, even though he will undoubtedly bear the economic burden of the tax in the price paid for the improvements.²⁸ Prior to the 1959 amendments to the Ohio sales and use tax,²⁹ this result could be avoided and the landowner assured of the deduction simply by a separate statement of the cost of materials entering into the real estate improvement, either in the contract or in the billing. Under the present law, this is no longer possible.³⁰ The Ohio sales and use tax on materials purchased by the contractor will now be part of the cost of the structure or improvement. The Ohio General Assembly has thus unwittingly deprived Ohio landowners of a federal income tax deduction for Ohio sales and use taxes incident to the construction of land improvements, except in instances where the landowner himself makes the purchases of the necessary materials.³¹

Election to Capitalize Taxes and Carrying Charges

In some instances, *e.g.*, where current deduction would not be of benefit, the taxpayer may prefer not to deduct some or all of his currently deductible items, but to add them to his cost of the property. This is permitted, to a limited extent, at the election of the taxpayer.³² The type of items as to which this election is permitted and the effect of the election vary depending upon the class of property involved.

27. I.T. 2882, XIV-1 CUM. BULL. 64 (1935) (Ohio sales tax); I.T. 3938, 1949-1 CUM. BULL. 59 (Ohio use tax).

28. See I.T. 3909, 1948-1 CUM. BULL. 34. Taxes generally are deductible only by the person upon whom imposed. Treas. Reg. § 1.164.1 (1957). See also *Biddle v. Commissioner*, 302 U.S. 573 (1938).

29. Amended Sub. S.B. No. 376, 103d General Assembly of Ohio (1959).

30. OHIO REV. CODE § 5739.01(B) now provides that a construction contract pursuant to which tangible personal property is, or is to be, incorporated into a structure, or improvements on and becoming a part of real property is *not* a sale of such personalty and the construction contractor is the consumer thereof.

31. It is possible that the landowner may obtain the Ohio sales and use tax deduction by authorizing the contractor in advance to purchase the necessary materials for, and on behalf of, the landowner, thus, in effect, making the contractor his purchasing agent. A similar procedure was used by the Defense Plant Corporation and similar governmental agencies during World War II and was recognized by the Ohio Department of Taxation as effective to make the governmental agency the "consumer," thus exempting the purchases from Ohio sales and use tax. Cf. *Midwest Hauler's Inc. v. Glander*, 150 Ohio St. 402, 83 N.E.2d 53 (1948). However, in such cases, the landowner, as principal, must be willing to accept the risk of being bound by the commitments made by his agent beyond his actual, but within his apparent, authority. RESTATEMENT (SECOND), AGENCY § 159 (1958).

32. INT. REV. CODE OF 1954, § 266. Section 1016(a) (1) requires adjustment to basis for items properly chargeable to capital account. See Treas. Reg. § 1.1016-2(c) (1957).

(a) If it is unimproved and unproductive real property, the election may cover only annual taxes, interest, and other carrying charges.³³

(b) If it is real property, whether improved or unimproved, productive or unproductive, the election may cover interest, taxes, and otherwise deductible expenses of any kind paid or incurred in development, construction, or additions to construction prior to completion of the project.³⁴

(c) If it is personal property, the election may include employer taxes on compensation paid or incurred for transporting and installing; interest on loans incurred to purchase, transport, or install; and sales and use taxes.³⁵

In the case of unimproved and unproductive real estate, a new election may be made annually; but in the other two, the election, once made, is binding upon the taxpayer until the project or installation is completed.³⁶

The taxpayer is given considerable latitude in making this election. He may elect to capitalize items relating to one project and not to others.³⁷ And even as to a single project, he may elect to capitalize certain of the items but deduct currently other items as to which the election is permitted.³⁸ Here again, no particular form is prescribed for the election. It is simply made by attaching a statement to the return indicating the item or items and project or projects covered by the election.³⁹

ALLOCATING COST

Having determined the cost, the problem then arises as to how it should be allocated among the several assets acquired. Where the assets are purchased in separate transactions, *i.e.*, from different persons or at different times, the problems here considered do not arise. Cost can, and must, be separately determined for each separate property in such cases. But where several assets are purchased from the same person at the same time, it frequently becomes necessary to determine the separate cost of each.

The most common examples are (1) the allocation of cost between depreciable and nondepreciable assets after a lump-sum pur-

33. Treas. Reg. § 1.266-1(a)(1)(i) (1958).

34. Treas. Reg. § 1.266-1(b)(1)(ii) (1958).

35. Treas. Reg. § 1.266-1(b)(1)(iii) (1958).

36. Treas. Reg. § 1.266-1(c)(2) (1958).

37. Treas. Reg. § 1.266-1(c)(1) (1958).

38. *Ibid.* Where an item (*e.g.*, salary of a corporate officer during the construction of a building) relates in part to such project and in part to ordinary activities, the item must be allocated between them in some equitable fashion and only that allocated to the former is subject to the election. Treas. Reg. § 1.266-1(e) (1958).

39. Treas. Reg. § 1.266-1(c)(3) (1958).

chase of land, buildings, and appurtenant personal property, and (2) the allocation of cost between the portion of land disposed of and that retained where purchased as a single tract. The problem of allocating cost among the several assets or segments should be distinguished from that of resolving a lump sum into several elements — *e.g.*, determining whether an amount paid or received includes interest as well as principal in absence of designation.⁴⁰ In the latter case, the question is whether such an element exists in the absence of express agreement or designation. In the type of cases herein considered, the several elements (*i.e.*, the several kinds of property acquired) clearly exist and the problem is to determine the proper amount included for each in the lump-sum price paid.

From the purchaser's point of view, it is generally desirable that as much of the cost as possible be allocated to ordinary deduction items (such as buildings and equipment) as contrasted with the land and other nondepreciable items; and that as much of the cost as possible be allocated to depreciable assets having relatively short lives as contrasted with the building proper. From the viewpoint of the seller, the optimum tax result may or may not coincide with these desires of the purchaser.⁴¹ Thus, the allocation made, whether negotiated as part of the agreement or made in the absence of an agreed allocation, may involve a delicate balance of tax considerations between the seller and the purchaser.

Where Price Is Not Allocated by Agreement

In the absence of an agreed allocation of the price among the several assets or classes of assets involved in the transaction, some equitable allocation must be made. Where, as sometimes occurs, an allocation which is beneficial in a tax sense to the purchaser involves a tax detriment to the seller,⁴² the allocation must, in the absence of

40. See *Estate of Jacob Resler*, 17 T.C. 1085 (1952), *acq.*, 1952-1 CUM. BULL. 3. Prior to 1954, the taxpayers who purchased property on the installment plan were denied interest deductions even though the "time price" clearly included an interest element. See, *e.g.*, *Henrietta Mills, Inc. v. Commissioner*, 52 F.2d 931 (4th Cir. 1931); *Daniel Bros. v. Commissioner*, 28 F.2d 761 (5th Cir. 1928). This is now remedied in certain instances by § 163(b), which presumes that such arrangements include interest at 6 per cent per annum.

41. In many instances, the allocation will be of no concern to the seller. If not a dealer, he is entitled to capital gain treatment for gain and ordinary loss treatment for loss on sale of both depreciable assets and real property used in trade or business which has been held for more than 6 months. INT. REV. CODE OF 1954, § 1231. If he is a dealer, he has ordinary gain or ordinary loss on both land and buildings. See discussion p. 255.

42. When the purchase agreement includes not only property, but also the seller's covenant not to compete for a limited period, the amount allocated to that covenant is ordinary income to the seller (*Hamlin's Trust v. Commissioner*, 209 F.2d 761 (10th Cir. 1954)), but may be amortized by the purchaser ratably over the period (*Commissioner v. Gazette Telegraph*, 209 F.2d 526 (10th Cir. 1954)). To the extent that the lump-sum price is allocated to the property instead of the covenant, the seller could have capital gain and the purchaser simply an increased capital cost. See note 41 *supra*.

agreed allocation, yield even-handed justice to both sides of the transaction. Generally, therefore, the price in such cases is allocated in the ratio which the fair market value of each asset or class of assets bears to the total fair market value of all the assets purchased.⁴³ In view of the frequency with which this problem arises, and the almost universal use by the Internal Revenue Service of this allocation method, it is curious that it has not long since been incorporated into the regulations as a rule of general application.⁴⁴

The rule is deceptively simple. Determining "fair market value" is more frequently difficult than easy. There is a hard core of truth in Judge Learned Hand's observation that "fair market value is not nearly so universal a phenomenon" as the Internal Revenue Service would have us believe.⁴⁵ Yet, the application of an equally elusive concept, as it relates to real property, is required and accepted as a matter of course in the assessment of real property taxes. Thus, in the absence of better evidence, the relative assessed values for real estate tax purposes are used as the basis of allocating cost between land and buildings.⁴⁶ In the absence of better evidence, the original cost may be allocated among the several properties in the ratio of their selling prices⁴⁷ where the properties are later sold. The best evidence is, of course, the price at which the property has been sold in an arm's-length transaction. It is the lack of such evidence which gives rise to the problem here discussed. In such instances, therefore, the best evidence is an appraisal of the several assets made by qualified independent experts at or about the time of the purchase. In any case which involves substantial sums or the likelihood of later dispute with the Internal Revenue Service, it would appear advisable for the taxpayer to cause such appraisals to be made as the basis for allocating his cost among the several assets or classes of assets.⁴⁸

43. *Watson v. Commissioner*, 345 U.S. 544 (1953); *Williams v. McGowan*, 152 F.2d 570, 572 (2d Cir. 1945); *C. D. Johnson Lumber Corp.*, 12 T.C. 348 (1949). See also excellent Note, *Considerations in Applying the Rule of Williams versus McGowan*, 13 TAX L. REV. 369 (1958).

44. See, e.g., particular applications of this allocation method in Treas. Reg. § 1.61-6(a) (1957) *Example 2* (sale of part of a larger property); Treas. Reg. § 1.307-1(a) (1955) (allocation of basis between old and new shares after stock dividend); Treas. Reg. § 1.358-2 (1955) (allocation of basis among stock or securities received in nontaxable exchanges); Treas. Reg. § 1-1031(d)-1(c) (1956) and *Example* (allocation of basis among properties received on a nontaxable "like kind" exchange). Cf. Treas. Reg. § 1.1033(c)-1(B) (1957) (allocation of basis among replacement property after involuntary conversion).

45. This learned comment was made in *Helvering v. Walbridge*, 70 F.2d 683, 684-88 (2d Cir. 1934), in rejecting the dictum of the regulations that "only in rare and extraordinary cases will property be considered to have no fair market value." Treas. Reg. § 1.1001-1(a) (1957).

46. E.g., *Joseph F. Cullman, Jr.*, 16 B.T.A. 991 (1929); *Barbara Konold*, 9 B.T.A. 1194 (1928).

47. See, e.g., *L. M. Graves*, 21 P-H Tax Ct. Mem. 425 (1952).

48. Appraisals made at the time of the purchase, but in any event shortly after purchase and before the matter becomes an issue, obviously will carry more weight with the Service and the courts than one made some years later or after the Service has questioned the taxpayer's alloca-

Where the Price Is Allocated by Agreement

Where the parties negotiate and agree upon the price for each asset or class of assets involved in the transaction, there is, in contrast to the type of case described above, no problem of equitable allocation. The seller and purchaser, dealing at arm's length, are free to make their bargain and have made it. The question then is the extent to which that agreed allocation forecloses the Internal Revenue Service.

In some cases, the parties may be able to establish the prices for the respective assets agreed upon by them, even though that allocation was not carried into the written contract.⁴⁹ Obviously, however, it is far better to include this part of the understanding in the written contract, if for no other reason than that it may avoid the expenditure of time and money involved in possible dispute and litigation. It is equally obvious that if the prices assigned bear some reasonable relationship to relative fair market values, the chances of dispute are greatly minimized. The touchy problems arise when, for whatever reason, the allocation appears to be unrealistic in the eyes of the Internal Revenue Service. This can occur either because the contract allocation disregards certain valuable assets acquired by the purchaser in the transaction, or because certain of the assets appear to have been overpriced at the expense of others.

The first of these cases usually involves such intangibles as goodwill, trade name, or the like. Where such a nondepreciable intangible exists and has value,⁵⁰ the purchaser will, of course, wish to have the contract provide for its transfer to him, but may insist that little or none of the price be allocated to it. If the contract requires its transfer to the purchaser but assigns no part of the price to it, the Internal Revenue Service may require allocation of part of the price to it. Frequently the result is more burdensome to the purchaser than if a reasonable allocation had been made in the contract at the outset. This leads to two practical suggestions: *First*, if the purchaser believes in good faith that there is no such intangible value, or in any event does not want it (*e.g.*, because he is going to change the character of the operation or the name under which it is carried on), the contract should make clear the intention of the parties that the purchaser is not acquiring any such intangibles. Equally important, the purchaser should not use the trade name, customer lists, and the like after the purchase since here, as elsewhere in life, actions speak

tion. In contrast, the appraisals made by the Service are, of necessity, almost invariably retrospective.

49. *Bryant Heater Co. v. Commissioner*, 231 F.2d 938 (6th Cir. 1956); *Lorenzo Zerillo*, 25 P-H Tax Ct. Mem. 758 (1956).

50. It is, of course, entirely possible for such real property as a hotel, motel, or office building to have goodwill apart from its physical attributes such as desirable location and arrangement of space.

louder than words. *Secondly*, if the purchaser does wish to acquire such intangible assets, then the contract, in addition to covering their transfer, should specify a portion of the price for them.⁵¹ In either case, the purchaser should be prepared to show, if later inquiry is made, that the price assigned to the physical assets purchased is reasonable in all of the circumstances, leaving nothing additional to be assigned to the intangibles.⁵²

As noted above, allocation of price among the assets purchased in relation to their respective fair market values is less likely to attract difficulties. But it is not essential that the allocation by the parties be strictly in relation to fair market values for the allocation to be reasonable. Some latitude is allowed. However, where the prices assigned to the several assets have been obviously distorted to suit the purchaser's tax situation, the Internal Revenue Service may well be sustained in reallocating the purchaser's cost on a more realistic basis. Generally, such an obvious distortion arises only where the allocation of price in the agreement is a matter of relative indifference to the seller and, accordingly, where it cannot be said that this portion of the agreement was really the result of arm's-length bargaining. On the other hand, where the allocation agreed upon resulted in a tax advantage to the purchaser with a correlative tax disadvantage to the seller, the Commissioner should not be at liberty to remake the transaction and thereby deprive the purchaser of the benefit for which he bargained and possibly paid.

Unfortunately, the law to date is not that clear — even where the allocation of price resulted from arm's-length bargaining.⁵³ If the allocation made in the contract appears to be unrealistic, there is no certainty of its being sustained against an attack by the Commissioner.⁵⁴

51. In *Fraser v. Nauts*, 8 F.2d 106 (N.D. Ohio 1925), the purchaser, interested in acquiring lumber and warehouse space, purchased a lumber business for \$525,000 under a contract which allocated \$250,000 to the lumber and \$100,000 to goodwill for which the seller had a basis of \$102,000. The Commissioner allocated the whole amount to lumber, but the court held the seller had the right to fix values, high or low, on the lumber and other assets "as an inducement to obtain a market for his less salable goodwill." Assuming that there was in fact goodwill having some substantial value at the time of the sale, and that the allocation was a matter of arms-length bargaining, this decision seems correct. The purchaser's intention is not of significance in determining the seller's tax consequences. Compare *Armored Tank Corp.*, 11 T.C. 644 (1948), *acq.*, 1949-1 CUM. BULL. 1 (seller held to have sold stock) with *Pressed Steel Car Co.*, 20 T.C. 198 (1953), *acq.*, 1956-2 CUM. BULL. 198 (cost of same stock held deductible by purchaser where acquired for the purpose of settling litigation). But see suggestion to the contrary in Note, *Considerations in Applying the Rule of Williams versus McGowan*, 13 TAX L. REV. 369, 378 n.41 (1958).

52. See note 47 *supra*.

53. Compare *Lorenzo Zerillo*, 25 P-H Tax Ct. Mem. 758 (1956) with *Particelli v. Commissioner*, 212 F.2d 498 (9th Cir. 1954); and see cases discussed, note 42 *supra*.

54. See *Semmel & Stern, Tax Effect of Form in the Acquisition of Assets*, 63 YALE L.J. 765 775 (1954).

PRORATION OF PROPERTY TAXES

For simplicity's sake, this discussion will be limited to the application of federal income tax principles to transactions involving Ohio taxes.

Ohio Real Property Taxes

The standard conveyancing practice in Ohio is for the real estate taxes for the year of sale to be prorated to the date of transfer and the economic burden of the taxes to be borne by the seller and purchaser, respectively, in those proportions. Since 1954, a similar proration is required in determining, as between the parties, the deductibility of such taxes for the year of sale⁵⁵ as well as the effect, for federal income tax purposes, upon the amount of sale proceeds realized by the seller⁵⁶ and the purchaser's cost of the property.⁵⁷ These provisions cure in part — but only in part — certain inequities which existed under the prior law.

Deductibility for the Year of Purchase

As applied to Ohio transactions, there were two inequities. The *first* arose from the general principle that a taxpayer may deduct only such taxes as are imposed upon him or his property, and not those of another.⁵⁸ In Ohio, the real estate tax year is the calendar year;⁵⁹ the owner has no personal liability for the tax,⁶⁰ but it becomes a lien on the property on January 1st of that year;⁶¹ the tax valuation and rate are not fixed and, therefore, the amount of tax for the year cannot be known until after August 1st;⁶² and the tax is payable in full between October 1st and December 20th, or may be paid half then and the balance on or before June 20th of the following year.⁶³ In actual practice, there is no county in which the tax can be paid as early as October 1st. Thus, the tax always becomes a lien while the property is in the hands of the seller; it frequently is undetermined and undeterminable at the time of sale; and almost invariably it is payable after the property has passed to the purchaser. Since in these circumstances the tax is regarded as imposed upon the seller, the purchaser could never deduct any part of the tax for the year of purchase.⁶⁴

55. Under INT. REV. CODE OF 1954, § 164(d).

56. Under INT. REV. CODE OF 1954, § 1001(b).

57. Under INT. REV. CODE OF 1954, § 1012.

58. See authorities cited, note 28 *supra*.

59. See 2 C. C. H. Ohio Tax Cas. 11, 861 (B. T. A. 1958).

60. OHIO REV. CODE § 5719.01.

61. 1943 OPS. ATT'Y GEN. NO. 5841 at 89 (Ohio).

62. OHIO REV. CODE §§ 319.28, .30.

63. OHIO REV. CODE §§ 323.12, .17.

64. *Magruder v. Supplee*, 316 U.S. 394 (1942).

The *second* inequity was that whether, and the extent to which, even the seller could deduct the tax varied depending upon the facts. If the seller used an accrual method of accounting, the entire amount of the tax accrued and was deductible for the taxable year during which the lien date fell,⁶⁵ even though he never paid the tax and was reimbursed for part of it in the price received by him from the purchaser. On the other hand, if the seller used the cash method of accounting, he obtained no deduction unless he paid the tax; it was not payable until after the sale; and it was somewhat doubtful whether an allowance by him to the purchaser of an equivalent amount against the purchase price was properly to be treated as payment of the tax.⁶⁶ Beginning with 1954, the code attempts to remedy both of these inequities.

Mandatory Proration of the Tax

The code now provides that the real property tax for the real property tax year during which the property is sold must be prorated between the seller and the purchaser to the date of sale and shall be treated as though the tax were imposed upon them in those proportions.⁶⁷ This proration is required regardless of whose tax it is under local law and whether or not there is a proration of the economic burden of the tax by agreement between the parties.⁶⁸ It is limited to the real property taxes for the year of sale. It does not apply to taxes for prior real property tax years, whether or not they are delinquent at the time of the sale.⁶⁹ Nor does it make deductible taxes which are otherwise nondeductible.⁷⁰ But it would seem that local benefit assessments which are otherwise deductible for the year of sale should be treated as real property taxes for this purpose. Unfortunately, this is not made clear by the regulations.

Another matter left in doubt by the code and regulations is whether its application is limited to transactions which are strictly "sales." The code, by its terms, applies only "if real property is sold during any real property tax year" This, it would appear,

65. *Walsh-McGuire Co. v. Commissioner*, 97 F.2d 983 (6th Cir. 1938); Rev. Rul. 152, 1955-1 CUM. BULL. 67. Cf. election since 1954 to accrue real estate taxes ratably over the real estate tax year under § 461(c).

66. However, deduction was allowed a cash basis vendor for taxes paid by the vendee in *Van Dyke v. United States*, 156 F. Supp. 155 (E.D. Wis. 1957); *Norman Coolege* 40 B.T.A. 1325 (1939), *acq.*, 1940-1 CUM. BULL. 2. In both cases, the purchase price reflected the fact that vendee would pay the taxes and the taxes were in fact paid. Deduction by vendor was sustained on the theory that vendee had acted as an "agent" for payment of the taxes.

67. INT. REV. CODE OF 1954, § 164(d)(1). INT. REV. CODE OF 1954, § 164(b)(7) denies deduction to one party to the extent that the tax is thus treated as imposed upon the other.

68. Treas. Reg. § 1.164-6(c) (1959).

69. Treas. Reg. § 1.164-6(b)(2) (1959).

70. *E.g.*, local benefit assessments made nondeductible by INT. REV. CODE OF 1954, § 164(b)(5).

clearly excludes transfers without consideration, such as gifts and contributions.⁷¹ It is a closer question whether it also excludes "exchanges" of property.⁷² Certainly where the transaction involves a *taxable* transfer of real property for money and other property,⁷³ it should be treated as "sold" for this purpose. It can hardly be believed that Congress intended the principle to operate only where the sole consideration for the real property is money.⁷⁴ Where the transaction is an involuntary sale,⁷⁵ it is within the literal terms of the code and, it would appear, the result does not depend upon whether or not the taxpayer chooses to replace the property, or, having done so, chooses to elect nonrecognition of gain.⁷⁶ Thus, the principle applies in at least some nontaxable transactions. This, then, leads to conjecture as to whether it applies to exchanges of real property solely for other property, whether nontaxable⁷⁷ or taxable.

Some argument can be made of the fact that at the same time Congress enacted these rules governing deductibility of the tax for the year "sold," it also enacted provisions governing the effect of this tax proration upon the computation of the seller's proceeds of sale and the purchaser's cost for the property. The first of these⁷⁸ expressly deals with realization of gain or loss upon "sale or other disposition of property" and the other⁷⁹ does so indirectly. This is certainly some indication that at least exchanges and other dispositions upon which gain or loss is recognized are within the term "sold." There is already one case which states by way of *dictum* that this is true for a transaction which, by statutory fiat, is treated as an "ex-

71. However, there appears to be no reason why the statute should not be amended to extend the same principle to such transfers since, even in case of sale, there is no requirement that the parties agree to share the economic burden of the tax. The same inequities exist where the real property is transferred by gift or contribution, as where it is sold or exchanged.

72. Throughout the law, there appears to have been a careful and deliberate effort made to distinguish between "sale," "exchange," and "other disposition." See *e.g.*, INT. REV. CODE OF 1954, §§ 1001, 1011 ("sale or other disposition"); INT. REV. CODE OF 1954, § 1002 ("sale or exchange"); and INT. REV. CODE OF 1954, §§ 331, 351, 1031 ("exchange" only). "Sale" has generally been regarded as a disposition for cash or its equivalent (*e.g.*, *Hale v. Helvering*, 85 F.2d 819 (D.C. Cir. 1936)), while "exchange" has been regarded as implying "reciprocal transfers of capital assets" (*Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247, 249 (1941)).

73. Liabilities assumed or subject to which the property is taken are regarded as "other property" for other purposes. See *Crane v. Commissioner*, 331 U.S. 1 (1947); *United States v. Hendler*, 303 U.S. 564 (1938).

74. But the Committee Reports are silent. S. REP. NO. 1622, 83d Cong., 2d Sess. 22-23, 196-98. This hardly justifies the silence of the regulations.

75. *E.g.*, by mortgage foreclosure, sale for money under threat or imminence of condemnation, or receipt of money awarded for property condemned.

76. Under INT. REV. CODE OF 1954, § 1033(a). See discussion, pp. 215-21.

77. Under INT. REV. CODE OF 1954, § 1031. See discussion, p. 209.

78. INT. REV. CODE OF 1954, § 1001(b).

79. INT. REV. CODE OF 1954, § 1012. This defines basis as "cost" and is thus limited to acquisition in transactions upon which gain or loss was recognized.

change.”⁸⁰ It is doubtful whether the property is “sold” in other transactions on which gain or loss is not recognized. If applied to such transactions, the result under the provisions herein discussed would, in some instances, actually be contrary to the result required elsewhere in the code.⁸¹

It seems certain that Congress, in attempting to remedy the inequities which existed under prior law, did not foresee these various questions. It is to be hoped that the Internal Revenue Service is prepared to recommend legislation to clarify these matters promptly. In the meantime, and lacking guidance by appropriate regulations, taxpayers are justified in requesting rulings from the Internal Revenue Service whenever these questions arise.⁸²

Constructive Payment of the Tax

In addition to requiring proration of the tax between the seller and purchaser, the code provides the time when a cash basis purchaser or seller is deemed to have paid the tax.⁸³ Here, in sharp contrast, the regulations do not hesitate to fill gaps left in the statute. A cash basis purchaser in Ohio is permitted to deduct the portion of the real property tax prorated to, and treated as imposed upon him (1) as though he had paid it on the date of sale, (2) on the date when he thereafter actually pays the taxes, or (3) on the date when he pays an “amount representing such tax . . . to the seller, mortgagee, trustee or other person having an interest in the property as security.”⁸⁴ The same options are permitted by regulation to the

80. *Simon J. Murphy Co. v. Commissioner*, 231 F.2d 639, 643 (6th Cir. 1956) (real estate distributed in a taxable corporate liquidation under the 1939 Code). See INT. REV. CODE OF 1954, § 331(a) which treats such liquidations as an “exchange.” *Rewrite Bulletin*, 6 CCH 1959 STAND. FED. TAX REP. ¶ 8769.

81. After certain types of intercorporate transactions upon which gain or loss is not recognized, § 381(c) (16) permits the acquiring corporation to deduct items of its predecessor the obligation for which it has assumed, provided that the obligation was not “reflected in the amount of stock, securities or property” given up by it in acquiring the property. Thus, assuming this proviso is satisfied, a cash basis taxpayer (e.g., a bank) which acquires another such taxpayer by merger, or on a tax-free intercorporate liquidation of its subsidiary, would be entitled to the entire real property tax deduction both for the current year and any prior years when it later pays the taxes on the real property so acquired. Section 381 was enacted at the same time as § 164(d). In contrast, § 164(d) would, if applied to the successor corporation, allow deduction only for the current year’s tax, and then only a pro rata portion thereof. This rather clearly indicates that the term “sold” in § 164(d) was not intended to apply to such non-taxable transactions as are expressly dealt with by § 381.

82. From time to time, there have been complaints about the volume of matters upon which the Internal Revenue Service is requested to issue private rulings. It seems clear that to a large extent such requests are prompted by the Service’s failure to resolve in the regulations ambiguities which may exist in the code. Failure of Treas. Reg. § 1.164-6(a) to mention “exchanges” could hardly have been oversight since the regulations were promulgated in final form on October 7, 1957, some eighteen months after the decision in *Simon J. Murphy v. Commissioner*, 231 F.2d 639 (6th Cir. 1956). See also discussion in note 80 *supra*.

83. INT. REV. CODE OF 1954, § 164(d).

84. Treas. Reg. §§ 1.164-6(b) (2), (3) (1959), *Example 2*. By permitting the purchaser this option, the Service takes the view that the rule of § 164(d) (2) was not intended to be

cash basis *seller* in Ohio when "the tax is not payable until after the date of sale."⁸⁵ No similar provision exists for cases where the sale occurs during or after the time the tax is payable. In such cases, it would appear necessary for the cash basis seller actually to pay the tax if it is payable at the date of sale.⁸⁶

There is a still more basic question involved from the viewpoint of the cash basis seller in Ohio. The code specifically provides for constructive payment by one party, where the other party to the sale was either personally liable for the tax or was the owner when the tax became a lien on the property. Where, as in Ohio, there is no personal liability for the tax and it becomes a lien on January 1st, the first day of the real property tax year, the purchaser (the "other party" to the sale) is never liable and never the owner on lien day.⁸⁷ Literally, therefore, the code does not provide for constructive payment by a cash basis seller in Ohio. As noted, the regulations wisely remedy this omission. No reason appears why, pending an appropriate amendment to the statute, taxpayers may not rely upon these regulations.

Constructive Accrual of the Tax

Where the seller uses an accrual method of accounting, no particular problem arises in regard to the Ohio real property tax. Even under prior law he was assured of a deduction, since the tax accrued on January 1st.⁸⁸ That rule remains in effect, but the code limits the amount deductible by him to the prorated amount.⁸⁹ However, the accrual basis purchaser in Ohio requires, and is afforded, relief. If he has not elected to accrue real property taxes ratably over the real property tax year, then his pro rata portion of the Ohio real property tax for the year of purchase is deemed to accrue on the date of the sale.⁹⁰ If he has elected to accrue real property taxes ratably, then the portion of the Ohio real property tax for the year of pur-

exclusive. The latter section, by its terms, requires that the taxpayer be treated as having paid his portion of the tax "on the date of sale" and gives no option. The option to claim it either in the year of sale or in a later taxable year permits the purchaser to claim the deduction in whichever year will afford him the greater tax benefit.

85. Treas. Reg. §§ 1.164-6(d) (1), (4), *Example 1*. Presumably, "payable" contemplates that time when the seller can actually make payment of the tax, *i.e.*, when the County Treasurer's books are actually open for collection in Ohio, rather than the collection periods contemplated by the Ohio Revised Code. Accordingly, the regulation giving the option to the cash basis seller will cover the vast majority of cases in Ohio.

86. It is theoretically possible for the sale to occur between December 21st, after the first half collection has closed, and December 31st.

87. This will be true except when the sale occurs on New Year's Day. In that case, the question is moot because proration is not required under INT. REV. CODE OF 1954, § 164(d).

88. *Magruder v. Supplee*, 316 U.S. 394 (1942).

89. This is true under INT. REV. CODE OF 1954, § 164(d) (1), whether he treats the tax as accruing in full on January 1st or has elected under § 461(c) to accrue it ratably over the real property tax year.

90. Under INT. REV. CODE OF 1954, § 164(d) (2) (D).

chase prorated to, and treated as imposed upon him presumably is allowable as a deduction ratably over the portion of the real property tax year during which he owned the property.⁹¹

Effect of Proration Upon the Seller's Income or Loss

As noted above, the code⁹² provides that in computing gain or loss on the transaction, the seller's proceeds of sale shall exclude any amounts received as reimbursement from the purchaser for the portion of real property taxes treated as imposed upon the purchaser. If "reimbursement" is given its commonly accepted meaning, this will rarely apply to Ohio transactions.⁹³ The statute also provides that the seller's proceeds shall include the portion of real property taxes treated as imposed upon the seller, if such taxes are to be paid by the purchaser. As shown below, this must be interpreted as providing by implication that the purchaser's portion of the tax shall not be included in the seller's proceeds. Where the sale and the January 1st accrual date fall within the same taxable year of the seller (either because he uses the calendar year or because the sale occurs within the same fiscal year of the seller during which the entire tax accrued), no income arises for the seller because of the proration of part of the tax to the purchaser. In such cases, the reduction in the seller's accrual because of the sale occurs within the same taxable year of the seller and is simply a wash. However, where the seller's fiscal year ends after the January 1st accrual date for the tax and before the date of sale, a problem for the seller arises from the fact that the entire tax accrued in one of his fiscal years and the sale of the property (with its consequent reduction in the amount deductible by him) occurs in the seller's subsequent fiscal year. In the latter case, the seller has ordinary income in the later year equal to the amount of tax treated as imposed on the purchaser,⁹⁴ unless the deduction for real property taxes in the prior fiscal year gave him no income tax benefit.⁹⁵

Effect of Proration Upon the Purchaser's Cost

The purchaser's tax situation is fairly well correlated with that of the seller. Any portion of the real property tax deemed imposed

91. Neither the regulations under § 164(d) nor under § 461(c) are explicit on this point, but it would seem necessarily to follow. The election under § 461(c) will actually make a difference only where the taxpayer uses a fiscal year which ends after the date of purchase. In such cases, the whole of the tax deemed imposed upon the purchaser would accrue in the prior fiscal year in the absence of election under § 461(c). But where there is such an election, the deduction is split between the two fiscal years which the real property tax year overlaps.

92. INT. REV. CODE OF 1954, § 1001(b).

93. It will apply only in those cases where the sale occurs during or after the collection period for Ohio real property taxes and where the seller has paid the full amount of the tax for the year of sale.

94. Treas. Reg. § 1.164-6(d) (5) (1959).

95. Under INT. REV. CODE OF 1954, § 111.

upon the purchaser cannot be added to his cost of the property.⁹⁶ But he is entitled to add to his cost the portion of the real property tax deemed imposed upon the seller.⁹⁷ For example, assume that the property is purchased on March 31, 1959, and the Ohio real property tax for the year is \$1,200. Under the principles explained above, 25% of that amount (\$300) is deemed to be imposed upon the seller and 75% (\$900) upon the purchaser. Under Ohio law, the tax for 1959 was not payable on March 31st. Assume that the purchaser uses the cash method and files his return on the calendar year basis. If he pays the entire \$1,200 tax on December 20, 1959, he is entitled to deduct only \$900 for 1959.⁹⁸ If the purchaser assumed the entire tax and the parties made no proration by contract, the seller would still be entitled to deduct \$300 of the tax. If the selling price of the property without proration of the real property tax for 1959 was \$30,000, the purchaser would add the \$300 (the seller's portion of the tax) to the \$30,000 which he pays to the seller, and the seller would include that amount in his proceeds of sale in addition to the \$30,000 actually received from the purchaser.⁹⁹ Thus, the seller would be regarded as having sold for \$30,300 and the purchaser's cost basis would be \$30,300.

In actual practice, the parties usually will prorate the tax by contract. Since this is frequently made at a time when the amount of the tax for the year of sale is unknown and unknowable, the agreed proration is commonly based upon the prior year's valuation and rates as a matter of necessity. This may, but frequently will not, be the same as the actual amount of the tax for the year of sale, and more likely will, in these times of increased rates and assessed valuations, be less than the actual tax. At the same time, the federal income tax consequences to the parties are based upon the actual tax for the year of sale, regardless of whether, or how, the contract of the parties requires the economic burden of the tax to be shared. The difference between the agreed proration and that made for federal income tax purposes is reflected in the proceeds to the seller and the purchaser's cost. Thus, in the example above, assume that the parties prorate the real property tax for 1959 based upon 1958 taxes of \$1,000. In this case, the seller would receive, and the purchaser would pay, \$29,750 (*i.e.*, \$30,000 less 25% of \$1,000 tax prorated to the seller) upon the purchaser's assuming the 1959 taxes. For income tax purposes, the seller would be regarded as having received on the sale \$30,050 (*i.e.*, the \$29,750 actually received plus the \$300

96. INT. REV. CODE OF 1954, § 1012 expressly so provides.

97. Under the general principle that cost includes pre-existing liens subject to which the property is acquired, the entire tax would be added to the cost.

98. Assuming he so elects. See discussion, p. 171.

99. Under INT. REV. CODE OF 1954, § 1001(b)(2). If it were not so interpreted, the seller would be regarded as having sold for a price higher than that for which the purchaser is regarded as having bought it.

of the 1959 tax prorated to him), and he will be able to take a \$300 deduction for 1959 real property taxes; the purchaser would have a cost basis of \$30,050 for the property. Thus, the net result is that the economic benefit of \$50, which the seller reaped as a result of the agreed proration's being less than that required for income tax purposes, is reflected in both the seller's proceeds of sale and the purchaser's cost of the property. Where (hasten the day) the Ohio real property taxes decline, so that the proration by contract is based upon higher taxes than actually obtain for the year of sale, the economic benefit to the purchaser will be reflected in diminished proceeds of sale to the seller and a reduction in the purchaser's cost basis.¹⁰⁰

There is one additional problem which may pose difficulty for the purchaser of Ohio real property. When a cash basis purchaser elects under Ohio law to pay the tax in installments, it will sometimes occur that one installment is paid within one taxable year (whether calendar or fiscal) and the other installment is paid in the subsequent taxable year of the purchaser. Under the principles herein discussed, the purchaser is not entitled to deduct more than his pro rata share and the question arises as to how that share should be reflected in the installments. To illustrate, take the same example as assumed above, but assume further that the purchaser decides to pay the tax in installments, one-half (\$600) on December 20, 1959, and the other half during 1960. Should he treat only \$300 of the first installment and all of the second installment as payment of his tax; or all of the first installment and only \$300 of the second installment as payment of his tax; or \$450 (75%) of each installment as payment of his tax? Since two of his taxable years are affected, the tax result could depend upon which of these three possibilities is the proper one. As noted above, the code would require the cash basis purchaser to deduct the \$900 in 1959, the year of purchase, regardless of when actually paid. The regulations, giving the purchaser the option to deduct it when it is later paid, are completely silent as to what the purchaser should do in the type of case assumed. It seems probable that the Service will allow the purchaser to treat the installment payments as he wishes.¹⁰¹

Ohio Tangible Personal Property Taxes

Many purchases of real property also involve purchase of appurtenant or related items which are classified as personal property

100. Unfortunately, the regulations do not make these matters clear by examples showing the result where the parties prorate the tax by contract on a basis different from that required by § 164(d) of the code.

101. It would appear inconsistent for the Service to allow the cash basis purchaser the flexibility permitted by Treas. Reg. § 1.164-6(d)(a) (1959) as to time of the deduction, but to deny him this additional flexibility.

for Ohio tax purposes.¹⁰² There is no provision in the federal income tax law requiring proration of personal property taxes similar to those discussed above relating to real property taxes.¹⁰³ While proration by contract is the almost invariable practice for real property taxes, similar proration of Ohio personal property taxes is rare, even though the purchaser in some cases receives a benefit from the personal property taxes paid or incurred by the seller.

The Ohio tangible personal property tax is, like the Ohio real property tax, imposed for the calendar year.¹⁰⁴ The person who owns tangible personal property used in trade or business on tax-listing day is personally liable for the tax.¹⁰⁵ For calendar year taxpayers, tax-listing day is December 31st of the year preceding that for which the tax is imposed;¹⁰⁶ for taxpayers using a fiscal year ending April 30th or before, tax-listing day is the last day of the fiscal year ending within the year for which the tax is imposed;¹⁰⁷ and for taxpayers using a fiscal year ending after April 30th, tax-listing day is the last day of the fiscal year ending during the year preceding that for which the tax is imposed.¹⁰⁸ For a taxpayer who engages in business in Ohio for the first time, tangible personal property must be listed as of the date he first engages in business in Ohio. But he is not required to list such property if he establishes that the same has already been listed or assessed in Ohio for the same calendar year.¹⁰⁹ It is in the latter case where proration by agreement may be proper, since the purchaser may obtain a benefit from the tax paid by the seller for the same year.

That benefit, however, may not be obtainable in all cases. Where the seller and the purchaser use different accounting years, the property may or may not be exempt as to the purchaser, depending upon whether the property has been listed or assessed for that same personal property tax year.¹¹⁰ Where the seller and the purchaser use the same accounting year, calendar or fiscal, the purchaser may be benefited by reason of the seller's liability for the tax.

In cases where the purchaser is benefited, the seller should give

102. See, *e.g.*, *Zangerle v. Standard Oil Co.*, 144 Ohio St. 506, 60 N.E.2d 52 (1945); *National Tube Co.*, 45 Ohio Op. 358 (B.T.A. 1950). See also Ohio Tax Commissioner's Rule 19-26, as amended July 8, 1958.

103. It would appear that § 164 (d) of the code will apply where, as in Pennsylvania, personal property is in some circumstances taxed as part of the real property. See PA. STAT. ANN. Tit. 72 §§ 5020-201 (Supp. 1958).

104. *Chicago Pneumatic Tool Co. v. Peck*, 1 C.C.H. Ohio Tax Cas. 10,741 (B.T.A. 1953).

105. OHIO REV. CODE § 5711.08.

106. OHIO REV. CODE § 5711.03.

107. OHIO REV. CODE § 5711.10; Ohio Tax Commissioner's Rule No. 202.

108. *Ibid.*

109. OHIO REV. CODE § 5711.03.

110. *David J. Joseph Co. v. Evatt*, 32 Ohio Op. 55 (B.T.A. 1945) (calendar year purchaser not entitled to the benefit of taxes paid by a seller using a May 31st fiscal year where purchased after May 31st).

consideration to including in the contract of sale a proration of the Ohio tangible personal property taxes for the year during which the property is sold. The seller will invariably obtain an income tax deduction for such taxes whether the seller uses an accrual method of accounting (since he incurred personal liability therefor on listing day¹¹¹) or uses the cash method and later pays the taxes. Disposition of the property after listing day does not vitiate his liability for the tax.¹¹² Any increase in price for the property which he charges the purchaser on account of this benefit merely increases his realization on the sale¹¹³ and correspondingly increases the purchaser's depreciable cost basis for the property.

In short, in those cases where Ohio tangible personal property taxes are prorated by agreement of the parties, the federal income tax consequences are generally the same as those which resulted upon proration of Ohio real property taxes prior to 1954. It would appear that Ohio practitioners have seriously neglected this area where proration by contract can yield a substantial tax benefit to the seller.

111. I.T. 2632, XI-2 CUM. BULL. 74 (1932); G.C.M. 8218, IX-2 CUM. BULL. 106 (1930); Rev. Rul. 616, 1957-2 CUM. BULL. 305; Faultless Rubber Co., 5 P-H Tax. Ct. Mem. 212 (1936).

112. OHIO REV. CODE § 5711.03.

113. Generally taxable to the seller as capital gain under INT. REV. CODE OF 1954, § 1231.