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## The Accountant and the Real-estate Developer

BY WALTER MUCKLOW

During the recent past, business in Florida real estate has been so active that the ribald and the profane regard it and speak of it as a "boom," rather than as the natural and proper reward of undoubted merit. Whichever it may be, it has drawn the accountant and the developer into closer contact—a contact which in some cases has been similar to that of oil on a heated bearing, resulting in smooth running; while, in other cases, the contact has been more like that of flint on steel and resultant sparks have been made to fly. It is proposed briefly to discuss some of the more important points of contact and some of the difficulties which have been encountered in what is generally known as subdivision or development accounting.

Let us first consider the functions of an accountant, the character of his reports and the nature of his budgets.

The first function of an accountant is to cooperate.

Inasmuch as profits are dependent upon sales and sales upon the sales manager, that officer frequently temporarily obtains an undue influence and is allowed to dictate procedure, a course often resulting in the adoption of records which do not record—or do not fully and accurately record—the transactions which have occurred. They miss the mark as widely as might the efforts of an accountant to conduct a sales campaign.

As a matter of fact, final success can only be secured by cooperation among, and by preliminary discussion between, the various interests which are involved and which may be described as the owner, the lawyer, the engineer, the sales manager, the accountant and the collector.

These persons should bring all their plans to a series of meetings and a fixed routine should be sketched, discussed and, when finally approved, written in the form of a manual dealing with each department, but especially with the engineer's costs, the salesman's routine, the accountant's methods and the plans for collection.

The abilities and the functions of a salesman differ so widely from those of an accountant that they are seldom combined in one person. The salesman is likely to grumble at the red tape of the accountant, who retaliates by complaining of the inac-

curacies and inadequacies of the sales reports and the frequency with which salesmen violate the rules which have been laid down. Much of this can be avoided by explaining the reason for those rules and by helping salesmen to understand them. Such assistance has been given with such success that a sales manager, instead of regarding the accountant as a hindrance, has advertised him to be a "life saver."

The accountant should aim for simplicity. It is important that the accounts should be as simple as is possible. This means that the rules as to terms of sale, commissions, forms of security and so forth should be as uniform as circumstances will allow. Selling is of primary importance, for without sales there will be no profits to account for, and the accountant must be careful not to tie the hands of the salesman. However, it must also be remembered that the sale is only the initial movement and that final success depends upon collections which are conducted by a branch of the accounting department and which call for abilities differing from, but fully equal to, those required for selling. Therefore, the entire subject should be thoroughly discussed in advance by all departments, and the resulting rules should be as simple as the requirements will permit and deviated from as seldom as possible.

#### ACCOUNTANTS' REPORTS

The contents and preparation of accountants' reports are matters beyond the scope of this article, but it is desired to emphasize the importance of making them human documents. Some reports consist merely of a collection of statements without comment or explanation, while some contain elaborate technical discussions which can only be fully understood by one trained in accounts. It should be remembered that many of the most able of those engaged in the development business have no such training and that the average layman is as much bewildered by such technicalities as is a patient who hears his disease described in medical terms by a consultant to his colleague.

Whatever the report may contain, it should include a comparatively brief story setting forth the main facts and requirements in such language as may be understood by the man on the street. This subject has recently been well treated in *THE JOURNAL OF ACCOUNTANCY* by George Armistead.\* Perhaps the

\* *Auditing Counties in Texas*, by George Armistead, *THE JOURNAL OF ACCOUNTANCY*, July and August, 1926.

main difficulty with reports in these days when examinations call for considerable technical knowledge is the fact that so little attention is given to literary training and that many accountants have no knowledge of any language but their own; they suffer from the hallucination that long words are better than short ones; they prefer "parvum in multo" to "multum in parvo." Strength and clarity are usually obtained by the use of short paragraphs, short sentences and short words.

#### BUDGETS

In no business is there a greater need for carefully prepared monthly budgets, showing the requirements for the current month and for the succeeding months, than in real-estate development. In large work this must be prepared jointly by the financial manager, the engineers or the contractors, and the accountant.

Usually the principal receipts consist of collections on sales already made and on new sales. The disbursements should include:

Administrative expenses  
Selling expenses  
Engineering expenses  
Construction expenses  
Miscellaneous expenses  
Borrowed money payable  
Purchase money payable

We now come to some of the difficulties peculiar to this work, which may be divided into three classes and, if arranged in the inverse order of their frequency, may be described as problems related to:

- I. The theory of accountancy
- II. The enormous mass of detail which frequently occurs, and
- III. The laws and regulations related to the income tax.

These may also be described, respectively, as intellectual, mechanical and promiscuous.

#### I. DIFFICULTIES RELATED TO THE THEORY OF ACCOUNTANCY

The difficulties in the first class are the least in number and, perhaps, are the easiest to deal with, as the complications which

sometimes arise should not be found difficult to cope with by one who is familiar with the recognized principles of accounting.

Formerly, one of the commonest difficulties arose from the desire of officers to anticipate unrealized profits in order to render an attractive annual report. However, this was curbed by the desire of stockholders to realize immediately these profits in the shape of dividends and it has now been scotched by the imposition of an income tax which leads officers and stockholders alike to defer profits and the resultant payment of tax for as long as possible.

The principles laid down in the federal reserve bulletin on approved methods for the preparation of balance-sheet statements—originally drawn by members of the Institute—are applicable to any business involving real estate, and there are only a few items which are not dealt with therein. Some of the chief of these are:

1. The price at which land is to be shown on the balance-sheet.
2. The establishment of reserves for profits not yet realized.
3. The treatment of prepaid expenses and deferred charges.
4. Contingent liabilities.
5. The method of dealing with sales which have been canceled.

1. *Cost of property.* It is axiomatic to say that land and buildings should be shown separately and at cost, although, in the case of a corporation, the cost may be represented by capital stock to an amount far in excess of the actual cost to the vendors, a condition which may result in two sets of profits, one to the corporation on the sale of the land and a second to the original vendor on the sale of his capital stock. In any event, this cost may properly include the price paid for the property, legal expenses incurred by the purchase and all expenditures for improvements.

Frequently, the improvements to the property are not completed when the corporation is organized—perhaps they are not even commenced. In such cases there should be obtained the most careful estimates possible, setting forth in detail—in great detail—the improvements to be made and the cost of each item thereof. The total may be added to the other items of cost and the sum set up as a credit account, such as reserve for improve-

ments, to which all expenditures on account of these improvements may be charged.

If for any reason the real estate be shown at an appraised valuation in excess of the cost, the difference between the cost and the appraisal should be carried to a special account, such as surplus from re-appraisal, and not into a profit-and-loss or surplus account from which dividends may be declared. This particular surplus account is charged from time to time as sales are made with its proportion of the sales prices obtained. This point is further discussed later in this article with relation to the income tax.

2. *Reserves for unrealized profits.* Now that everything from motor cars to memory systems and millinery can be bought on the instalment plan, there are comparatively few real-estate offices which have escaped the infection. As a result, it is essential that the paper or book profits be divided into those actually received and those which it is hoped may be received in the future.

This entails the establishment of some account in the nature of a reserve for unrealized profits to which may be credited those profits which have not been received in cash or its equivalent, but are represented merely by some form of promise to pay—a matter considered later in the discussion of income-tax requirements.

It is essential that the bookkeeper have a clear idea of what is meant by realized profits and unrealized profits, and it has been found that this can be effected by regarding the profits from all sales other than sales for cash as involving some unrealized profit. Let us consider a sale of \$10,000, yielding a profit of \$6,000: we credit unrealized profits with \$6,000. If the sale be on the instalment plan, we shall then transfer periodically to realized profits 60 per cent. of the amount by which the principal has been reduced.

If the sale be on the deferred-payment plan, no profit exists until the cost of the property to the vendor has been received in some form; once that amount is received, all subsequent receipts (or in the case of instalment sales, portions thereof) are debited to unrealized profits and credited to realized profits. Difficulties occur with relation to the value of securities received by a vendor, as appraised by the treasury department, and will be discussed at some length.

3. *Prepaid expenses and deferred charges.* One is frequently asked about the two accounts, prepaid expenses and deferred

charges, although the treatment is identical with that followed in other businesses. The chief items of prepaid expenses are improvements (which have already been touched on), taxes, insurance, interest, improvements on leasehold property and the like.

These all represent expenditures which have already been made but which have some cash value, or for which the concern has yet to receive the full benefit. A clear distinction should be drawn between this class of item and those which are deferred charges, such as unamortized bond discount, for which the benefits have already been received but the expense of which it is desired to spread over a period of years.

4. *Contingent liabilities.* The difficulty arising with respect to contingent liabilities is not to cook the hare, but to catch it. In times of phenomenal activity property may change hands many times between the date of the agreement to sell, made with the original owner, and the time of delivery of a deed to the purchaser who intends to develop or improve the property. Each of these transfers is at an advanced price and many of them involve the assumption by the purchaser of existing mortgages. For example, property owned by A is sold to B, who assumes a mortgage and sells to C, and these operations are repeated until F buys it. In such circumstances, A, B, C, D and E consider themselves free of the liability under the mortgage, yet if F fails to meet the obligation it falls on E and may, quite conceivably, finally come back on A.

The situation is further complicated when one of the purchasers is a syndicate, or partnership, the members of which are jointly and severally liable. In such circumstances, it is sometimes impossible to make a definite statement as to the amount of the contingent liabilities, but this affords no excuse for disregarding them or for failing to make mention of them in a report.

In times of feverish activity the desire to purchase becomes so strong as almost to justify the statement that mere mortgages are not seriously considered and that, provided the cash payment be small enough, a purchaser will assume any mortgage rather than miss the opportunity to buy land which he is confident he can quickly sell at a profit. If, as has happened in thousands of cases, the purchaser has not time even to look at the land, how can he be expected to pay much attention to the existence of mere mortgages?

In such circumstances, the liabilities encountered with relation to real estate may be divided into three classes: (a) legal, (b) moral and (c) immoral. The first consists of those liabilities, either actual or contingent, for which the owner is liable and which appear on his books. The second class consists of items which are included in (a) but in which the liability is shared by others—where the liability is assumed jointly and severally by partners—and on which, if things go well, the owner will be called upon to pay his share only. The third class appertains to the ultra-optimistic salesman who makes unwarranted or unauthorized representations; the records of these can be found only in the books of the recording angel.

5. *Cancellations.* Even in the best regulated offices cancellations are bound to occur which result in the owner repossessing the property. In such cases good accounting demands that the property be taken back on the books of the concern at its cost to that concern, unless there has been undoubted enhancement or depreciation in the value. Very frequently it involves an adjustment of the unrealized profits, so that a usual form of journal entry is as follows:

1. Real estate (for original cost of the property).
2. Unrealized profits (for the profit unrealized still on the books).
  3. To contracts or mortgages (for the amount remaining unpaid).
  4. To realized profit (the difference of  $(1+2)-3$ ).

Modifications of this are considered later in a discussion of the income-tax requirements.

## II. DIFFICULTIES ARISING FROM THE MASS OF DETAIL

It is of common occurrence that the disposal of a large subdivision results in many thousands of individual sales, for each one of which an individual record must be maintained to show:

1. A detailed account with each purchaser.
  2. The profit on each lot realized in any given period.
  3. The commissions paid and to be paid on each sale.
- Also, proper provision must be made for:
4. The care of securities.
  5. Collection of instalment payments as they mature.



1. *Individual accounts with purchasers.* The general practice is to keep individual accounts with purchasers on loose-leaf or card ledgers or on loose sheets kept on a bookkeeping machine, in all cases full particulars of the sale being entered on each account. The selection of the method depends somewhat upon individual taste, but the writer has found that loose-leaf ledgers, especially those of the "visible" variety, give the most satisfactory results where the accounts run into the thousands. They afford ease in posting, very quick reference and facilities for collection and follow-up systems which are unequaled.

The bookkeeping machine is invaluable in many offices, notably in banks and in houses where much detailed billing is required, involving many additions and extensions. In the opinion of the writer these conditions do not fully apply to subdivision work, where one debit entry and one credit entry are required sometimes monthly but more frequently quarterly, semi-annually or annually.

2. *Ascertaining realized profits.* It is doubtful if the profits derived during a given period from a group of sales can ever be accurately determined by any method based on the average results. In the case of instalment sales or of other deferred-payment sales, there is involved the determination of that portion of the amount received on each sale which shall be considered as realized profit.

In normal times it has been customary to regard the security received by the vendor, whether it be a mortgage note or a contract, as being worth par and to have value as collateral security. The recent rhapsodic realization of realtors' reveries in Florida has shown that under abnormal conditions such values do not exist and that as a matter of fact such securities sometimes are of a value so doubtful as to be unsaleable and to be unacceptable as collateral security.

If the number of individual accounts be comparatively small, the record of realized profits can well be kept in loose-leaf ledgers, and the form introduced by the writer some fifteen years since will greatly facilitate the calculation of the realized profit for any given period. Where the number of accounts runs into the thousands, the most convenient form of record available is a columnar record arranged to show all the details pertaining to each lot, including the cost, the list price, the actual sales price, commissions, total gross profit, periodic collections and periodic



values. For example, if the land includes lots which front on the water, those lots are usually worth more than the back lots and the value gradually declines as the land recedes from the water.

There is no general rule for determining the respective values of the front and the back lots, and one must use the best means available, which may consist of a statement from the vendor showing how the gross price was determined; it may be indicated by different amounts named as the price for releasing specific lots from underlying mortgages, or it may be by an appraisal of the whole.

It must be remembered, when dealing with instalment sales, that the course usually followed is merely a convention, for there is grave doubt as to the correctness of the assumption that each instalment is composed of two parts, one being a portion of the cost and the other a portion of the profits.

It may be argued—and with force—that no profit can exist until the vendor has received cash, or its equivalent, equal to the cost of the property sold. If the securities received have no market value and no borrowing value, there can be no profit realized until the vendor has collected in cash the cost of the property sold. However, this view is not generally held by vendors or by the treasury department in considering sales known as instalment sales.

3. *Commissions.* In days of yore, the treatment of commissions was a simple matter, but they have now become the subject of development to an extent equal to that of real estate itself. Today, commissions vary in rate, in terms of payment, in the basis on which they are calculated and in the extent to which they are liabilities of the vendor.

Experience shows that they frequently vary from  $\frac{1}{2}$  per cent. to 35 per cent. and upwards; sometimes they are payable out of the first payments; often a portion only is taken from each instalment until the whole is paid; sometimes they are payable at a fixed date from the time of a sale, and sometimes they are contingent upon the sale being completed.

Many corporations use all the above variations, and as each must be provided for separately much detail is unavoidable.

One concern has been known to pay the following commissions:

	Per cent.
1. Salesmen having their own cars . . . . .	10
2. Salesmen not owning a car . . . . .	7

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3. "Bird dogs" . . . . .	3
4. Crew managers . . . . .	5
5. Assistant sales manager . . . . .	1
6. Sales manager . . . . .	2
7. Publicity or advertising manager . . . . .	1½
8. Treasurer . . . . .	1½

The first four are usually paid on individual sales, while commissions of the others are generally calculated on monthly totals. The "bird dog," by the way, is the person who scents the victim and leads the salesman to him.

Obviously, there must be an individual account with each person earning commissions and such an account must be arranged to show:

- Commissions earned and payable.
- Commissions earned, but not yet payable.
- Contingent commissions.
- Cash paid.

Often it is convenient to keep a portion of the record on the account of the purchaser, especially when commissions are contingent.

It is impossible to describe here the best method of recording commissions, partly because of the space at command, partly because there is no one best way. The selection should be governed by the method of accounting and by the form of ledger used, for a method which would be suitable for a ledger kept on a machine might be entirely unsuitable in the case of a loose-leaf ledger.

Probably, in any event, the basis of the work is a minute examination of all receipts from purchasers each month, in order to be sure that the account of each salesman is credited with each item to which he is entitled as it becomes payable.

The best way to avoid the difficulties associated with commissions is to prevent them, and this can usually be done through the coöperation which is spoken of in the beginning of this article, and by striving for simplicity and uniformity.

4. *Care of securities.* With sales running into the thousands and each one secured by a mortgage or contract, often accompanied by notes falling due at periods varying from a month to a year, special provision must be made for safe keeping as well as for quick reference.

It is convenient, if not essential, that as sales are made they should be numbered consecutively immediately when the first payment is completed, and the number then given to a sale should apply throughout all the records. It should be placed on the mortgage or contract and on each of the notes which relate thereto; it should also appear on all receipts given and on all entries in the books relating to that sale. Where a series of notes is given for a sale, each should bear, in addition to the sale number, its own serial number, from 1 up.

While purchasers' ledgers are usually arranged alphabetically, as the name of the purchaser is the principal means of identification, it is convenient to file the securities numerically. Any purchaser's notes can readily be found through the usual indexes and numerical filing greatly facilitates the checking of missing papers.

All notes relating to any one sale should be clipped together, filed numerically or alphabetically and kept in a vault. Toward the end of a month, those notes falling due in the succeeding month should be taken out and placed in a current file for quick reference.

Notes remaining unpaid should not be returned to the main file, but should be kept by themselves so that the amount of overdue notes may be readily verified, care being taken to see that payments made on account are endorsed on the notes. Such matters may seem elementary—and this may be said of most of the mechanical difficulties—yet failure to observe such elementary rules has led to as much trouble as has the non-observance of sound theory.

5. *Collections.* In not a few cases, the management has been dependent upon collections for the funds with which to carry out the improvements which have been undertaken; in all cases they rely on them to some extent. Therefore the prompt collection of payments due is a matter of the first importance.

In some offices a small army is employed in this work, in others a few clerks under intelligent direction achieve equally good results. It has been found that the use of visible ledgers, with a complete set of colored signals, obviates the preparation of many lists, and if such a ledger be compared monthly with the notes held out for payment a double and valuable check is readily secured.

### III. DIFFICULTIES ASSOCIATED WITH THE FEDERAL INCOME TAX

The imposition of an equitable income tax always has been, is now and always will be a matter of difficulty; the man on the

street calls it a "teaser", while he of more classical attainments might describe it as a Herculean task—and thus afford another example of the elasticity of our language.

The practitioner in income-tax work finds himself involved in a labyrinth of memoranda, laws, rulings, decisions and opinions, but unfortunately the tax is not as yet of sufficient age to furnish such a set of precedents as exists in other branches of the law and no Ariadne has appeared to provide him with the thread without which it is impossible to find his way with certainty.

It is not safe to carry the metaphor further, or we might be charged with a desire to compare the authorities presiding over these regulations to the Minotaur whose best known characteristics are his undoubted bull-headedness and his desire to devour his victims. Nothing could be further from our intent than such a comparison; on the contrary, before discussing the difficulties related to the income-tax, we can not help speaking of those officers who are associated therewith. It is not desired to pay them a compliment, but merely to render to them a tribute which is due.

No one can practise in income-tax work without coming into somewhat close contact by correspondence and in person with many members, in various grades, of the treasury department. The flock is an enormous one, the pasturage is not rich and, as in all other flocks, a black sheep occasionally finds entrance. If his color be due to absence of light, he does not rise; if it be due to mud-groveling, he is separated from the sheep and turned over to the goats.

In the course of considerable correspondence and many interviews, I have yet to find one of the higher officers or employees who has declined to give a sympathetic hearing or who has failed to render to a taxpayer all the assistance which he believes the law allows.

In all businesses the basic difficulty is to determine the taxable income, as defined by the law and regulations, which has been received during a given period; in the present instance this difficulty is increased by the fact that the consideration received by the taxpayer—on which profits are necessarily based—is frequently represented by a value which can best be indicated by "x."

This emphasizes the fact that balance-sheets and statements of profit and loss are, after all, expressions of opinion rather than statements of fact. The certificate of an accountant indicates

that in his opinion the statement to which it is attached correctly represents the condition, or the operations, of the business. A bookkeeper may prepare a statement similar in all respects, but a client desires and pays for the opinion of his accountant in the same manner as he wishes for the opinion of his doctor or his lawyer. Striking examples of the truth of this have occurred recently where some of the leading accountants in the world have positively declined to state their opinion regarding the accounts of some of the largest developments which they have audited: in other words, they have declined to express an opinion as to the final results which will accrue.

A brief history of the legislation concerned with instalment sales of real estate will help to a clear understanding of the matter.

No mention of such sales is made in any of the acts prior to 1921, but sec. 202 (c) of that act contains the negative provision that

“Nothing in this section shall be construed to prevent . . . the taxation of that portion of any instalment payment representing gain or profit in the year in which such payment is received.”

The same clause appears in the act of 1924, and the act of 1926 is the first one to contain any positive recognition of instalment sales. In sec. 212 (d) of this act, it is provided that

“Under regulations prescribed by the commissioner, with the approval of the secretary . . . in the case of a sale or other disposition of real estate, if in either case the initial payments do not exceed one-fourth of the purchase price, the income may . . . be returned on the instalment plan.”

That is, the taxpayer may report as income in any taxable year that proportion of the instalment payments received in that year which the total profit to be realized bears to the total contract price, e.g., if the total profit be 20 per cent. of the purchase price, he may report as taxable income 20 per cent. of the actual receipts.

There is added a rider to the effect that “initial payment” means all the cash, or its equivalent, received during the first taxable period.

When dealing with this question, there must also be considered the definition found in the law of what is meant by receipts. This is stated in sec. 202 (c) of the act of 1926, which reads:

“The amount realized from the sale or other disposition of property shall be the sum of money received plus the fair market value of the property (other than money) received.”

We now come to the regulations, and it appears from them that the commissioner has treated the taxpayer more liberally than had the legislators.

In *Regulations 33*, under the acts of 1916 and 1917, article 116 provides that instalment sales of real estate, where title passes to the purchaser, shall be regarded as closed transactions in which the entire profit is taxable in the year of sale.

However, article 117 provides that if the vendor retain title the profits may be treated on the instalment plan, as is now allowed under the act of 1926.

In *Regulations 45*, under the act of 1918, a fresh departure is made and the distinction made in *Regulations 33* between sales in which title passes to the purchaser and those in which it is retained by the vendor is abolished, and another classification is made, as follows:

(a) "Instalment sales" in which the initial payment is generally less than one-fourth of the purchase price and subsequent payments are numerous and of small amount (article 45).

(b) "Deferred-payment sales not on the instalment plan" in which there is a substantial initial payment and, as compared with (a), a small number of subsequent payments each for a substantial portion of the price (article 46).

Sales made under (a) may be reported on the instalment plan, but sales under (b) are regarded as closed transactions and the entire profit is taxable in the year in which the initial payment is made.

It is to be noted that in *Regulations 45* it is stated that the instalment payments are not ordinarily to be regarded as the "equivalent of cash" but sales under (b) are so regarded, and therefore such sales are to be regarded as closed transactions.

*Regulations 62*, under the act of 1921, in articles 45 and 46 follow the wording of *Regulations 45*, except that in both cases (a) and (b) the words "readily realizable market value" are substituted for "equivalent of cash."

*Regulations 65*, articles 45 and 46, are similar to *Regulations 45* and *62*, except that the expression "fair market value" is substituted for "readily realizable market value."

Throughout the regulations, "fair market value" is defined as "that amount which would induce a willing seller to sell and a willing buyer to purchase."

In the case of normal sales, made under normal conditions, there is little difficulty in determining the amount of profit, and in the case of instalment sales the convenience of the convention, or figment, that each instalment consists of cost and profit may outweigh the theoretical objections.



It is not necessarily so under abnormal conditions, such as exist during a boom, for then the majority of purchasers are speculators and the demand for cash is so great that purchasers willingly assume mortgages rather than pay cash, in the hope of reselling and passing the mortgages on to succeeding purchasers. So-called values, actual selling prices, pyramid so rapidly that anything like productive or commercial value is never thought of. Some years since a friend bought land for three dollars an acre; he was recently offered six thousand dollars an acre for it. Such increases naturally intoxicated dealers, who spent money like drunken sailors and, in many cases, like them, ended in the gutter.

When there were offered on the market mortgage notes assumed by those whose names are powers in the financial world for 80 cents on the dollar; when other good mortgages made by less well known people were offered at discounts ranging up to 60 per cent. and higher, it is ridiculous to speak of a fair market value. Such mortgages are an indication of strong faith rather than of visible value; they are indeed the substance of things hoped for and the evidence of things not seen.

In determining the fair market value of a note, that note should be valued as if endorsed without recourse; if it can be sold only when endorsed, the price paid represents, in part at least, the value of the endorsement and not that of the note.

#### THE REMEDY

All these difficulties would vanish if the basis of calculation were changed, if fact were allowed to replace figment and if such phrases as "fair market value" and "readily realizable market value," which may have originated in the good intention of helping the taxpayer, were consigned to that place for which they would make suitable paving material.

In normal times it is often difficult to state the fair market value of contracts and mortgages received by a vendor, for even then cancellations do occur and are often difficult to estimate in advance.

If it be true that a vendor can not realize profit until he has received his cost of the property sold—which seems to be fairly obvious—then it is an arbitrary convention to say that each payment on an instalment sale contains the two elements of cost and profit. In many cases such a figment is convenient; in others it is a calamity.

The solution is to be found in some such provision as the following:

In all sales of real estate, no taxable profit shall arise until the vendor has received in cash, or in obligations assumed by the purchaser, the cost of the property; after which all receipts shall constitute taxable income.

Such a law would remove all doubt, would not be unfair to the government, would obviate the necessity for such expressions as "initial payment," "fair market value," "readily realizable market value," and would simplify the rules dealing with repossession. In other words, it would remove the cause of most of the arguments in this connection which have arisen between the government and the taxpayer; it would save both sides labor and expense; would greatly reduce the number of amended returns, and would lessen the labors of the board of tax appeals.

It would also prevent the growth of an erroneous idea which appears to be gaining strength, that there is some mysterious basic difference between various sales, such as instalment sales, sales on the deferred-payment plan and closed transactions. No doubt, the birth of this idea is largely due to the effort made in the regulations to facilitate the preparation of returns in accordance with the rules which have been laid down.

The department has done much to simplify this matter in T. D. 3921 which has just been issued, for it brings out the fact that a sale on the deferred plan is not an instalment sale, but is a completed transaction in which the vendor has received some securities, the face value of which does not indicate their market value.

Perhaps the matter is expressed most clearly in the form of a formula:

Let  $p$  = the gross taxable profit.

$c$  = the cost of the property.

$r$  = the cash received, i.e., the initial payment.

$m$  = the fair market value of the securities received.

Then, in every case  $p = (r + m) - c$ .

Obviously, this is true in the case of a normal sale where the mortgage is worth its face; equally obviously, it is true in the other extreme where the mortgage received by the vendor has no market value and  $m = \text{zero}$ .

The suggested rule also removes another inequality which is now of frequent occurrence with relation to instalment sales and is due to the definition of an "initial payment." A concrete

example offers the clearest explanation. Take the case of a taxpayer whose fiscal year is the calendar year and who sells real estate on an instalment plan under which purchasers pay 25 per cent. in cash and the balance in quarterly payments. If such a sale be made between October 1st and December 31st, it is an instalment sale, for only 25 per cent. is collected in the first taxable period. If a similar sale be made between January 1st and September 30th, it is no longer an instalment sale because the vendor will receive the cash payment and one or more quarterly payments, or more than 25 per cent., in the first taxable period. In such cases compliance with the regulations would force a taxpayer to divide his sales, all of which are made on identical terms, into two classes and to calculate his taxable income for any year from this one class of sale under two methods widely differing from each other. Unless memory is at fault, when I was studying logic I was instructed to apply to such a conclusion the phrase "reductio ad absurdum".

The suggested law has been tested by applying it to many cases which have occurred in the course of practice in a territory which has thoroughly proved its fertility in producing such instances as well as the finest grapefruit in the world.

It is not necessary to offer any apology for dwelling at length on this matter of simplifying the law regarding sales of real estate; the defect is basic. The fact that the difficulties are not imaginary but are very real appears to be amply proved by the fact that at the end of August the treasury department had not been able to issue regulations applying to the act which was approved on February 26th, although they had the basis of former regulations to work on. It is currently reported that the chief cause of this delay and a similar delay in publishing certain long-promised treasury decisions relating to real-estate sales, is the difficulty experienced by those who are expert in such matters in construing the law relating to these particular sales. If this be true, what chance has the inexpert taxpayer to place a correct construction thereon?

It is believed that a simple solution is afforded, and it is hoped that this may lead to a crystallization of ideas and may assist in the formation of a public opinion, which will lead to a greatly improved condition.

#### SYNDICATES

In the present discussion the term "syndicates" is applied to a group of interests, individual persons or corporations, which unite

their forces, consisting of wealth, penury, knowledge, sales ability, assurance or what not, for the purpose of handling specified property for the benefit of the group. Such an arrangement, in itself, is entirely proper and it is always a purchaser's business to remember the caution, "caveat emptor."

While these syndicates assume various forms to meet varying requirements, they are usually regarded by the participants as partnerships or joint ventures, regardless of the fact that the regulations contain special rules applying thereto. Under these rules, and speaking generally, syndicates are usually regarded as falling in one of two classes:

1. Joint ventures or
2. Associations.

If the syndicate be merely a loosely formed alliance for the purpose of arranging a sale or making collections, it is regarded as a joint venture and the share of each partner in any resulting profit or loss is returned by each individual member, no return being required of the syndicate. On the other hand, such syndicates frequently prepare elaborate deeds of trust conferring on some one in the nature of a trustee powers as broad as, or even broader than, those possessed by the board of directors of a corporation: in such cases the treasury department regards a syndicate as an association and requires that a return be filed by the syndicate itself in the same manner as is prescribed for corporations.

It is likely that this requirement has frequently been overlooked or disregarded and that many trustees may find themselves faced with charges of delinquency and resulting penalties.

The dividing line between joint ventures and associations is a fine one and is affected so greatly by the details of each case that no general rule can be given in an article such as this.

#### COMMISSIONS

The principal difficulties with regard to commissions are of a mechanical nature and have already been touched upon. However, numerous and conflicting decisions have been rendered by the treasury department and doubt sometimes exists as to the period in which commissions are to be regarded as income.

With regard to commissions receivable which have been earned by a taxpayer, it seems to be fairly well established that they do not constitute taxable income until they are received by, or are available to, a taxpayer. For example, the mere fact that a cor-

poration has credited a salesman with commissions does not in itself constitute income to that salesman in this amount. If the corporation has at its command cash which is immediately available and which can be turned over to the salesman, the amount may constitute income to him; on the other hand, if it be merely a credit to him which the company does not or can not make immediately available to him it does not constitute taxable income to him until such a condition exists.

In the case of commissions payable, somewhat different conditions sometimes apply, and if in such a case as the above a corporation habitually keeps its accounts on the accrual plan, it may be allowed to treat such commissions as an allowable deduction in the period during which the entry is made.

It seems to be well established that estimated contingent commissions are not a deductible item and that a reserve set up for any liability which is in fact contingent is not deductible.

#### REPOSSESSION

So far as the requirements of accountancy are concerned, there is no difficulty in dealing with mortgages or contracts which have been foreclosed, canceled or surrendered, by law or by agreement, so that the property covered thereby is repossessed by the vendor. It is clear that such property should be brought back on the books at the same price at which it was taken out from the property account, subject to any deductions for depreciation, obsolescence, etc. which have been suffered, or to any addition for material improvements or, possibly, for expenses incurred in regaining the property.

Such a practice has been consistently prescribed by the regulations, and *Regulations 65*, article 46, require that in such circumstances the vendor "must include such real estate in his inventory at its original cost to himself, less any depreciation," etc.

However, the United States board of tax appeals has rendered several decisions which are directly opposed to this in the case of land the title to which has been conveyed by a vendor to a purchaser who has given a purchase-money mortgage as a part of the consideration.

One of the clearest of such decisions is the appeal of Manomet Cranberry Company (B. T. A. 1, 706).

In 1916 this company sold property for \$139,500 and as this was the value in 1913, no profit arose from the sale. A mortgage

was given and cash paid by the purchaser so that in 1918 there remained \$94,400 due on the mortgage. Default was made and the company bought in the property for \$94,400 in addition to which it paid the costs of foreclosure and some arrears of taxes.

The company contended that while in possession of the purchaser the property had depreciated in value to the extent of \$45,100 and, therefore, the \$94,400 represented the true value of the property at the time of its re-acquisition, and the company had made its return accordingly.

The commissioner claimed that under *Regulations 65*, article 46, quoted above, the taxpayer should have taken the property on its books at the original value of \$139,500 and in this case the \$45,100 which had been received in cash would constitute taxable profit.

The taxpayer claimed that if such were the case it was entitled to a deduction for depreciation amounting to the same amount, and offered evidence as to the value.

The board decided that neither was correct, although it agreed with the taxpayer in the statement that it had not realized any taxable profit. The board decided that there were two separate and distinct transactions; first, a completed sale and, second, the foreclosure, and that the commissioner could not treat these several transactions as one where the effect of so doing was to the disadvantage of the taxpayer. Therefore, it ruled that the taxpayer should bring the re-acquired property back on its books at the cost of \$94,400 and not of \$139,500, and that no realized gain existed until the property was disposed of.

Possibly, an accountant would have brought the property back at \$139,500 showing a profit of the \$45,100 received, but would have offset this by writing off the same amount to depreciation. There are several ways of killing any cat.

It is not clear whether or not a similar rule would apply to sales under which the vendor retained title to the land and gave the purchaser a contract. Be that as it may, and granting that it resulted in justice to the Cranberry Company, the decision affords ground for apprehension as it appears to lead to another case of *reductio ad absurdum*.

On reading the Manomet Cranberry Company decision one may conclude that foreclosure is an essential requirement and that at a public sale it may be assumed that property will bring approximately its market value. However, in a later case (*I. M. Davis*,

B. T. A. 2,359) there was no foreclosure but the property was voluntarily surrendered by the purchaser. Unfortunately in each of the cases the facts do not bring out clearly the principle upon which the decisions rest. In the Cranberry case the amount due and costs appear to be identical with the bid in price. In the case of I. M. Davis the amount paid by the purchaser, the amount of depreciation allowed and the actual value of the property are the same, namely \$15,000, and the decision is silent as to which of these three factors determine the "cost" of \$15,000.

The similarity of the two cases shows clearly that the principle does not depend on foreclosure but upon re-acquirement by any process.

Under abnormal conditions, such as still exist in Florida, it is quite possible that no bidders would appear at a foreclosure sale of unimproved property, and in such a case the decisions quoted might be taken to indicate that the amount remaining due would be the measure of the cost of the property in re-acquirement, and if several similar pieces of property were re-acquired and if varying amounts had been received on them, the results would be varying costs for properties of equal value. If this be true, ridiculous "costs" might result in extreme cases, such as re-acquirement after only the initial payment had been made, as compared with a case where all payments but the final one had been made.

This leaves the matter cloudy and we pray for further decisions to throw a clearer light upon the subject.\*

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\* AUTHOR'S NOTE.—Just about the time when the above article was placed in the hands of the printer, there were published the new regulations, No. 69, applying to the revenue act of 1926. The fact that about nine months have passed since the passage of the act indicates that the difficulties above described are not confined to accountants, for it has been reported that the unusual delay which has occurred in publishing the regulations has been due chiefly to difficulties related to transactions involving real estate.

The new rules do not differ greatly from those formerly in force as modified in T. D. 3921; and the most important changes to be noted are related to the repossession of lands sold on the instalment or deferred-payment plan.

As formerly, sales of real estate involving deferred payments are divided into two classes, (1) instalment sales and (2) deferred-payment sales not on the instalment plan. In dealing with the latter we still have to meet the difficulties mentioned above with reference to determining the "fair market value".

In calculating profits, no distinction is drawn between those cases where the vendor gives the purchaser a contract and those in which the vendor conveys title and receives back a mortgage.

However, in the case of repossession, a distinction is observed; in the former case the property is taken back on the vendor's books at the original basis (less any depreciation, etc.) while in the latter case a new transaction is considered to have occurred and the "fair market value" becomes the basic value on which the cost on repossession is to be calculated.

"The fair market value of the property shall be presumed to be the amount for which the property is bid in by the vendor in the absence of clear and convincing proof to the contrary".

At the annual meeting of the American Institute of Accountants held at Atlantic City in September, 1926, an amendment to the existing law, as suggested in this article, was unanimously approved, and the executive committee was desired to do its utmost to effect its enactment.