

July 1960

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Recommended Citation

Lester R. Rusoff, *The Income Tax Basis of Land Acquired by Homestead*, 22 Mont. L. Rev. 60 (1960).
Available at: <https://scholarworks.umt.edu/mlr/vol22/iss1/9>

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Rusoff: The Income Tax Basis of Land Acquired

The Income Tax Basis of Land Acquired by Homestead

By LESTER R. RUSOFF*

The owner of land which he homesteaded, or received by gift from the homesteader, may someday face the problem whether to keep that land or sell it. His decision should depend at least in part on the amount of gain he will realize for federal income tax purposes if he sells. The gain will be the difference between the amount he receives for the property and his adjusted basis. Adjusted basis is basis that has been increased for capital additions and decreased for such items as depreciation.¹

How, then, is basis computed? The basis of purchased property is cost.² The basis of property acquired by gift before January 1, 1921, is the fair market value of the property at the time of the gift.³ The basis of property acquired by gift on or after that date, for the purpose of computing gain, is the basis in the hands of the donor or the last preceding owner by whom it was not acquired by gift.⁴

The decision of the owner of homestead property whether to sell must be made with the aforementioned rules in mind. Under those rules, the important question is whether the homesteader should be treated as having acquired his title by gift or by purchase.

The Treasury Department at one time held that homestead property is acquired by gift. It ruled that the basis of such property was fair market value as of the time of entry or March 1, 1913, whichever was later. The taxpayer was not allowed to add to his basis any amounts spent to clear Land Office records or any fees paid to the government, in order to arrive at the adjusted basis; he was allowed to add the cost of improvements.⁵ This was consistent with the early view of the Department as to the basis generally of property acquired by gift.⁶

There is some slight judicial authority to support this view. In 1894, the right of a discharged soldier or sailor, his widow or orphaned child, to enter land additional to a homestead was held assignable before entry.⁷ The court said, "It [the homestead right] was an unfettered gift in the nature

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¹INT. REV. CODE OF 1954, §§ 1001(a), 1011, and 1016.

²INT. REV. CODE OF 1954, § 1012.

³INT. REV. CODE OF 1954, § 1015(c).

⁴INT. REV. CODE OF 1954, § 1015(a).

⁵O.D. 601, 3 CUM. BULL. 50 (1920); O.D. 386, 2 CUM. BULL. 33 (1920); O. 880, 1 CUM. BULL. 31 (1919).

⁶Originally this view was adopted without express statutory authority. H.R. REP. No. 350, 67th Cong. 1st Sess. 9 (1921). The 1921 Revenue Act preserved this view as to gifts made on or before December 31, 1920, but adopted the present rule requiring the donee to carry over the basis of the donor, for purposes of gain, as to gifts made after that date. Revenue Act of 1921, ch. 136, § 202(a)(2), 42 Stat. 229 (Now INT. REV. CODE OF 1954, § 1015(a), (c)).

⁷Barnes v. Poirier, 64 Fed. 14 (8th Cir. 1894).

of compensation for past services.⁸ A 1924 district court case, citing this decision, held that a possessory mineral right on federal land was acquired by gift and had a basis equal to its value at the time of discovery.⁹

If this position stood, it would raise a problem as to the basis of homestead land entered after December 31, 1920. Under the statute,¹⁰ the basis to the government should carry over to the homesteader, who acquired by "gift." Presumably, the government has no basis and the homesteader would thus have a basis of zero.

The Treasury has, however, changed its stand. It has ruled that mineral rights are not acquired by gift, because the grantee must perform certain acts to receive a grant of them.¹¹ This ruling seems applicable by analogy to homestead rights,¹² and the government has informally so ruled.¹³

The present position of the Treasury seems correct. For analogy, there are the decisions concerning the distinction between income, taxable under section 61(a) of the Internal Revenue Code, and gifts, exempt under section 102(a). If one makes a payment to another with intent to compensate him for services already rendered, the recipient is taxed.¹⁴ A similar result is reached if the government pays a subsidy to a taxpayer to encourage him to erect improvements conducive to conservation.¹⁵ Under these analogies, the acquisition of title to homestead land is by purchase, not gift, whether title was obtained through occupation and improvement or by virtue of status as a discharged member of the armed forces.

If title to homestead land is obtained by purchase, the basis of the land is its cost, which probably would be the expenses incurred in obtaining the homestead, plus the adjusted basis of improvements.¹⁶ It should be kept in mind, however, that when property is transferred to a taxpayer as compensation for services, the excess of the value of the property over any

⁸*Id.* at 18.

⁹United States v. Hurst, 2 F.2d 73 (D. Wyo. 1924).

¹⁰INT. REV. CODE OF 1954, § 1015(a).

¹¹A.R.R. 2516, II-1 CUM. BULL. 65 (1923), modifying A.R.R. 759, I-1, CUM. BULL. 94 (1922).

¹²42 AM JUR. 801, Public Lands § 22 (1942).

¹³2 P-H 1960 FED. TAX SERV. ¶ 10,271.

¹⁴Commissioner v. Duberstein, 80 Sup. Ct. 1190 (1960); Fisher v. Commissioner, 59 F.2d 192 (2d Cir. 1932).

¹⁵Baboquivari Cattle Co. v. Commissioner, 135 F.2d 114 (9th Cir. 1943); 1 MERTENS, FEDERAL INCOME TAXATION § 7.12 n. 67 (Zimet, Stanley, & Kilcullen rev. 1956).

It might have been argued that one who occupies and improves homestead land, as a condition to getting title, is merely fulfilling the conditions of a gift and contributing to the general prosperity rather than furnishing consideration to the government for the transfer of title. Cf. United States v. Hurst, 2 F.2d 73, 78 (D. Wyo. 1924). The tendency to treat subsidies as income to the recipient casts this argument aside. The relatively recent *Duberstein*, *Fisher*, and *Baboquivari Cattle Co.* cases seem far more significant for our present purpose than the *Barnes* and *Hurst* cases. The *Barnes* case is old and deals with a non-tax problem; under the *Duberstein* and *Fisher* cases, the statement quoted from the opinion in the *Barnes* case is internally inconsistent. The *Barnes* case is discussed here principally because a popular tax service cites it, under section 102, as holding that a grant of a homestead is a gift from the Government. 1 CCH 1960 STAND. FED. TAX REP. ¶ 932.35. The *Hurst* case is an income tax case but dates from another era in taxation; also it is only a district court case.

amount paid for it by the taxpayer is includible in the taxpayer's gross income.¹⁷ Thus it is arguable that the value of homestead land, in excess of any amounts paid by the homesteader to get title to it, was includible in his income for the year when he got title. If he included that excess in his gross income, that amount should become part of his basis.¹⁸ The government might argue that if he omitted such amount from his gross income he is estopped from including it in his basis. Although the regulations indicate that principles of estoppel apply in determining basis,¹⁹ there is authority that an innocent mistake of law is not ground for an estoppel.²⁰ Presumably, the omission in question would in most cases have resulted from such an innocent mistake. Thus, it is possible that the amount erroneously excluded from gross income is includible in basis.

Consideration should also be given to the possibility that, if a taxpayer now claims as part of the basis of the property an amount which he erroneously excluded from gross income of a prior year, his gross income for that prior year may now be adjusted, despite the running of the statute of limitations.²¹ This may still be preferable, however, to recognizing income in the present year if the decision is made to sell.

Assuming that the application of the principles discussed above indicates that a taxpayer's homestead property has an adjusted basis which is low in respect to its present fair market value, the taxpayer should consider keeping that property until he dies. The basis of property which has passed by inheritance or devise is the fair market value of the property as of the date of the decedent's death, or as of one year after his death if his executor elects to value the estate for estate tax purposes at the later date.²² Thus, if the taxpayer keeps his homestead property until his death, the legal questions discussed above will not need to be answered and the appreciation in value of the property, to the date of his death, can permanently escape income taxation.²³

¹⁷Treas. Reg. § 1.61-2(d)(2) (1957).

¹⁸*Ibid.*

¹⁹Treas. Reg. § 1.1016-6(b) (1957).

²⁰See *Helvering v. Salvage*, 297 U.S. 106, 109 (1936); 10 MERTEN, LAW OF FEDERAL INCOME TAXATION §§ 60.03 nn. 40, 41 & 42, and 60.12 n. 53 (Zimet rev. 1958).

²¹INT. REV. CODE OF 1954, §§ 1311-1315.

²²INT. REV. CODE OF 1954, §§ 1014(a), 2032.

²³If the landowner does not wish to liquidate his investment but merely to exchange his land for other land, the possibility of a tax-free exchange should be considered.

INT. REV. CODE OF 1954, § 1031(a)

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MONTANA LAW REVIEW

Member, National Conference of Law Reviews

Volume 22

Fall 1960

Number 1

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Published semi-annually, Spring and Fall, by students of the School of Law,
Montana State University, Missoula, Montana