

IN THE OREGON TAX COURT  
MAGISTRATE DIVISION  
Income Tax

STEVEN M. HAUGEN and ELIZABETH HAUGEN,	)	
	)	
	)	
Plaintiffs,	)	TC-MD 021102F
	)	
v.	)	
	)	
DEPARTMENT OF REVENUE, STATE OF OREGON,	)	
	)	
Defendant.	)	<b>DECISION</b>

Plaintiffs appeal from Notices of Deficiency issued by Defendant for tax years 1998, 1999, and 2000. Oral argument was held on January 15, 2003.

**STATEMENT OF FACTS**

Plaintiffs, Steven Haugen and Elizabeth Haugen, purchased real property from Elizabeth Haugen's mother, Cecelia Lux, in May 1997 via a land sale contract. The property consists of a 60-acre farm and their personal residence. Plaintiffs lived at the property in excess of 15 years prior to their purchase. The land sale contract required interest-only payments for 15 years. A warranty deed was prepared in March 1998. Lux's attorney stores the warranty in his office safe; he has been directed to record the deed upon satisfaction on the contract. The land sale contract was recorded at the Washington County Assessor's Office in July 2001. For the tax years 1998, 1999, and 2000, Plaintiffs, on Schedule A, claimed a deduction for the home mortgage interest paid to Lux pursuant to the terms of the land sale contract. Defendant disallowed the claimed mortgage interest deduction because the land sale contract was not recorded during the relevant tax years. The parties agree that Plaintiffs hold equitable title to the property.

**ANALYSIS**

Generally, personal interest is not allowed as a deduction on a taxpayer's income tax return. IRC § 163(h)(1) (1994). However, qualified residence interest is an exception to the general rule. IRC § 163(h)(2)(D) (1994). Qualified residence interest is defined as:

“any interest which is paid or accrued during the taxable year on -

“(i) acquisition indebtedness with respect to any qualified residence of the taxpayer \* \* \* .

“\* \* \* \* \*

“For purposes of the preceding sentence, the determination of whether any property is a qualified residence of the taxpayer shall be made as of the time the interest is accrued.”

IRC § 163(h)(3)(A) (1994). Acquisition indebtedness is defined as “any indebtedness which - (I) is incurred in acquiring \* \* \* any qualified residence of the taxpayer, and (II) is secured by such residence.” IRC § 163(h)(3)(B)(i) (1994). The parties disagree on whether the moneys paid to Lux represent acquisition indebtedness within the meaning of the Internal Revenue Code and its attendant regulations.

For purposes of qualified residence interest, secured debt is defined as:

“a debt that is on the security of any instrument (such as a mortgage, deed of trust, or land contract)--

“(i) That makes the interest of the debtor in the qualified residence specific security for the payment of the debt,

“(ii) Under which, in the event of default, the residence could be subjected to the satisfaction of the debt with the same priority as a mortgage or deed of trust in the jurisdiction in which the property is situated, and

“(iii) That is recorded, where permitted, or is otherwise perfected in accordance with applicable State law.”

Temp Treas Reg § 1.163-10T(o)(1) (1987).

A debt is considered secured:

“as of the date on which each of the requirements of paragraph (o)(1) of this section are satisfied, regardless of when amounts are actually borrowed with respect to the debt. For purposes of this paragraph (o)(3), if the instrument is recorded within a commercially reasonable time after the security interest is granted, the instrument will be treated as recorded on the date that the security interest was granted.”<sup>1</sup>

Temp Treas Reg § 1.163-10T(o)(3) (1987).

Plaintiffs first argue that Temporary Treasury Regulation section 1.163-10T(o) (1987) does not apply to the case at bar because Plaintiffs do not hold legal title. They suggest that a land sale contract could be within the purview of the regulation “but only if the taxpayer is placed in legal title.” (Ptf’s Statement of Points and Authorities in Support of Ptf’s Appeal at 9.) The court disagrees. The regulation specifically names land sale contracts. Additionally, the purpose of a land sale contract is so the seller can retain legal title as security for performance of the contract. See *Newman v. Randall*, 90 Or App 629, 633, 753 P2d 435 (1988). To argue a taxpayer buying property using a land sale contract could also hold legal title to the property would render the land sale contract nugatory. Plaintiffs’ argument is not persuasive.

As noted earlier, one of the criteria for secured debt is that the instrument, in this case a land sale contract, “is recorded, where permitted, or is otherwise perfected in accordance with applicable State law.” Temp Treas Reg § 1.163-10T(o)(1)(iii) (1987). The parties agree that the land sale contract was not recorded at any time during the tax years at issue. Thus, in order to be qualified residence interest, the land sale contract must be “otherwise perfected in accordance with [Oregon] law.” *Id.*

With certain exceptions, not relevant here:

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<sup>1</sup> Neither party argued that the instrument was recorded within a commercially reasonable time after the security interest was granted.

“All instruments contracting to convey fee title to any real property, at a time more than 12 months from the date that the instrument is executed and the parties are bound, shall be acknowledged, in the manner provided for acknowledgment of deeds, by the conveyor of the title to be conveyed. Except for those instruments listed in subsection (2) of this section, **all such instruments**, or a memorandum thereof, **shall be recorded** by the conveyor not later than 15 days after the instrument is executed and the parties are bound thereby.”

ORS 93.635(1).<sup>2</sup> Land sale contracts are among those instruments included within the reach of the statute. *Braunstein v. Trottier*, 54 Or App 687, 690 n2, 635 P2d 1379 (1981).

Further, without recordation the land sale contract would be “void as against any subsequent purchaser in good faith and for a valuable consideration of the same real property \* \* \* whose conveyance \* \* \* is first filed for record \* \* \*.” ORS 93.640.

The question becomes whether a land sale contract may be “otherwise perfected in accordance with [Oregon] law” even though not recorded as required by ORS 93.635. See Temp Treas Reg § 1.163-10T(o)(1)(iii) (1987). Plaintiffs argue that in Oregon perfection can be achieved by three types of notice: actual notice, record notice, and inquiry notice. (Ptf’s Statement of Points and Authorities in Support of Ptf’s Appeal at 9.) Inquiry notice is when the existence of a claimed interest in real property may be determined through investigation based on facts available to the claimant that would cause a reasonable person to make such inquiry. *Akins v. Vermast*, 150 Or App 236, 242, 945 P2d 640 (1997). Plaintiffs contend that they achieved inquiry notice by having actual and open possession of the property. Plaintiffs also contend that in this case inquiry notice is encompassed by constructive notice under ORS 93.643. Thus, they claim that the debt is secured through a land sale contract perfected by inquiry notice. Plaintiffs are in error. Constructive notice is defined as “documentation of the interest [in real property] recorded

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<sup>2</sup> All references to the Oregon Revised Statutes (ORS) are to 1995.

in the indices \* \* \* in the county where the property is located. Such recordation, **and no other record** [with certain exceptions not relevant here], constitutes constructive notice \* \* \*.” ORS 93.643(1) (emphasis added).<sup>3</sup>

Plaintiffs might have a valid point if ORS 93.635 **permitted** rather than **required** land sale contracts to be recorded. However, the requirement that land sale contracts be recorded implicitly excludes other means of perfecting those instruments under Oregon law. This analysis is further buttressed by looking at Temporary Treasury Regulation section 1.163-10T(o)(1)(ii) (1987) which defines secured debt as, among other requirements, “a debt that is on the security of any instrument \* \* \* (ii) [u]nder which, in the event of default, the residence could be subjected to the satisfaction of the debt with the same priority as a mortgage or deed of trust in the jurisdiction in which the property is situated \* \* \*.” A land sale contract that has not been recorded will not have the same priority as a mortgage or deed of trust. This is consistent with ORS 93.640 where an unrecorded land sale contract is void against a subsequent purchaser in good faith whose conveyance is recorded first in time.

## CONCLUSION

Plaintiffs and Lux accepted the benefits and burdens of their decision when, for whatever reason, they chose not to record the land sale contract. Unfortunately for Plaintiffs, one consequence of that decision was that the unrecorded land sale contract was not perfected under Oregon law. As a result, the moneys paid by Plaintiffs to Lux on

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<sup>3</sup> The court notes that under common law, Plaintiffs' view of inquiry notice would be correct. *High v. Davis*, 283 Or 315, 333 584 P2d 725 (1978) (“Constructive notice encompasses both notice chargeable under the recording statute, ORS 93.710, and ‘inquiry notice.’ See *Belt et ux v. Matson et al*, 120 Or 313, 321, 252 P 80 (1927).). None of the cases cited above dealt with a statutory definition of constructive notice. In the present case, ORS 93.643(1) precludes the use of the common law definition of constructive notice.

that contract are not qualified residence interest within the meaning of IRC section 163(h)(2)(D) (1994). Defendant acted appropriately in disallowing the claimed mortgage interest deductions. Now, therefore,

IT IS THE DECISION OF THIS COURT that Plaintiffs' appeal is denied

Dated this \_\_\_\_\_ day of July, 2003.

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SALLY L. KIMSEY  
MAGISTRATE

**IF YOU WANT TO APPEAL THIS DECISION, FILE A COMPLAINT IN THE REGULAR DIVISION OF THE OREGON TAX COURT, FOURTH FLOOR, 1241 STATE ST., SALEM, OR 97301-2563. YOUR COMPLAINT MUST BE SUBMITTED WITHIN 60 DAYS AFTER THE DATE OF THE DECISION OR THIS DECISION BECOMES FINAL AND CANNOT BE CHANGED.**

**THIS DOCUMENT WAS SIGNED BY MAGISTRATE SALLY L. KIMSEY ON JULY 17, 2003. THE COURT FILED THIS DOCUMENT ON JULY 17, 2003.**