

Dealings in Encumbered Property

Facts: T purchases property for \$1,000,000, paying \$100,000 in cash and signing a note for \$900,000. While T holds the property, T claims \$400,000 of depreciation and makes a principal payment of \$150,000.

Case 1A: T transfers the property to Buyer in exchange for a cash payment of \$350,000, and the loan is fully recourse to T. T's amount realized on the transfer equals \$1,100,000, consisting of cash actually received of \$350,000 plus the transfer of the \$750,000 debt to Buyer (see *Old Colony*). T's adjusted basis at the time of the transfer equals \$600,000 (initial basis of \$1,000,000 less depreciation of \$400,000). As a result, T's gain on the transfer equals \$1,100,000 less \$600,000, or \$500,000. Thus gain represents T's cash-flow economic gain of \$100,000 (total cash invested of \$250,000 as compared with cash received of \$350,000) plus a pay-back of the depreciation claimed while T held the property (because the property in fact did not decline in value).

Case 1B: Same facts as case 1A except the note signed by T is nonrecourse. The outcome is the same although the authority for T's amount realized including the outstanding debt is *Tufts* rather than *Old Colony*.

Case 2A: The holder of T's note forecloses on the property, paying T nothing, and the note was nonrecourse. T's amount realized equals \$750,000 under *Tufts* while T's adjusted basis equals \$600,000, so T recognizes a gain on the foreclosure of **\$150,000**. T's economic loss equals \$250,000 (down payment plus principal payment), but T deducted \$400,000 while holding the property, so a dispositional gain of \$150,000 causes T's net tax loss of \$250,000 (depreciation deductions of \$400,000 less dispositional gain of \$150,000) to equal T's actual economic loss. Note that the value of the property at the time of the foreclosure plays no role in the calculation.

Case 2B: Same facts as case 2A except the note signed by T is fully recourse, the property is worth \$680,000 when the foreclosure takes place, and the lender does not seek a deficiency judgment against T for sound business reasons. Because the lender had a right to be paid the full \$750,000 remaining on the debt but instead received only collateral worth \$680,000, \$70,000 of the debt was discharged and so T has **\$70,000 income** from discharge of indebtedness (*Kirby Lumber* income), subject to possible exclusion under section 108. In addition, because T is credited with satisfying \$680,000 of the debt with the property, T's amount realized on the foreclosure equals \$680,000 while T's adjusted basis in the property equals \$600,000, so there is a gain on the foreclosure (under section 1001(a)) of **\$80,000**. Note that the total income realized by T on the disposition is the same in case 2A and in case 2B (\$150,000; see the amounts in bold), with the difference being all gain in case 2A while there is a mix of gain and *Kirby Lumber* income in case 2B. The concurrence in *Tufts* argues that case 2A should be taxed the same as case 2B.

Case 2C: Same facts as case 2A except that the lender does not foreclose but instead agrees to write the loan down from the existing amount due of \$750,000 to \$680,000 (that being the value of the

collateral). Sometime thereafter, the lender forecloses on the property in complete satisfaction of the (modified) loan. On the loan modification, T has *Kirby Lumber* income of **\$70,000**. When the foreclosure occurs, T's amount realized equals \$680,000 (under *Tufts*) and T's adjusted basis equals \$600,000 (cost of \$1,000,000 less depreciation of \$400,000), for a gain under section 1001(a) of \$80,000. Case 2A has in effect been turned into Case 2B.