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 $750,000. 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.