1991

Tax Consequences of Restructuring Debt on Troubled Real Estate

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TAX CONSEQUENCES OF RESTRUCTURING DEBT
ON TROUBLED REAL ESTATE

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a professional
corporation
Washington, D.C.
October 28, 1991
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I. OVERVIEW.

A. Inclusion of Mortgage in Basis.

1. Generally, the original basis of property purchased is its cost. Sec. 1012, I.R.C.

   a. The cost of property is the amount paid for such property in cash or other property (at its fair market value). Reg. §1.1012-1(a).

   b. Therefore, where a purchaser acquires property by personally assuming an existing mortgage liability, or taking subject to such mortgage debt, the purchaser’s basis for such property generally includes the amount of the mortgage debt. See Crane v. Comm’r, 331 U.S. 1 (1947); Denver & Rio Grande Western R.R. Co. v. U.S., 505 F.2d 1266 (Ct. Cl. 1974); and Parker v. Delaney, 186 F.2d 455 (CA1 1950). See also U.S. v. Hendler, 303 U.S. 564 (1938); and Stollberg Hardware v. Comm’r, 46 B.T.A. 788 (1942).

   c. EXAMPLE: If a purchaser acquires real property encumbered by a $300,000 mortgage by personally assuming such mortgage and paying the seller $100,000 cash, the purchaser’s basis for the property is $400,000.

2. This general rule also applies to taxpayers who acquire encumbered property by inheritance. In Crane v. Comm’r, 331 U.S. 1 (1947), the Supreme Court held that, where the taxpayer acquired property subject to a mortgage by inheritance from her husband, the taxpayer’s basis for such property was its fair market value at the decedent’s date of death (including the mortgage), not just the fair market value of decedent’s equity in the property.

3. While the basis of property purchased with mortgage financing includes valid liabilities incurred (which term "incurred" includes assumed or taken subject to) in acquiring the property, cost basis does not include any liability if the payment thereof is speculative, contingent or indefinite in nature. See Mayerson v. Comm’r, 47 T.C. 340 (1966); and Waddell v. Comm’r, 86 T.C. 848 (1986).

   a. For example, a note is contingent and indefinite, and not includible in basis, if repayment can be accomplished only from future profits, which are speculative in nature. Rev. Rul. 80-235, 1980-2 C.B. 229.

   b. Waddell v. Comm’r, 86 T.C. 848 (1986), is illustrative of this point. In that case, the taxpayer purchased four medical equipment franchises. Each franchise included one of the seller/franchisor’s computerized electrocardiogram
terminals. The taxpayer paid $6,000 cash and executed a $25,000 promissory note for each franchise and terminal. The note was for a 7-year term and was labeled "recourse"; however, the taxpayer's only obligation during the initial 7-year term was to make a minimum payment of $1,500 per year, which was denominated as interest at the stated rate of 6% of the stated principal amount of $25,000. Any payments of principal prior to maturity would come only from the seller/franchisor's right to 50% of the taxpayer's net profits from each franchise. The notes could be renewed for an additional 7-year period, so long as the taxpayer renewed the franchise. In addition, for the payment of $1,000 during the extended term, the taxpayer could convert each note to a "nonrecourse" status.

(1) The Court held, among other things, that the $25,000 notes could not be treated as true indebtedness for tax purposes, and thus were not includible in the taxpayer's basis for the franchises, because the likelihood that the notes would be paid was (based on their own terms) too speculative.

(2) The Court indicated that adequate security at the inception of the transaction alone does not guarantee that the loans will be recognized for Federal income tax purposes. Rather, the proper focus in determining the likelihood of payment is "to look at the transaction based on the facts and circumstances at its inception -- including reasonable revenue projections based on objective criteria and the value of the security at the time the lender has a right to proceed against the security for payment -- and determine whether it is likely that the note will be paid."

(3) Because the Court could not conclude at the outset of the transaction that payment of any note was likely, it held that the notes were too speculative to be recognized for Federal income tax purposes, and so could not be included in basis. Apparently, although the taxpayer paid $27,500 for each ECG terminal, the value of each was only $6,500, and, given the relevant market for such franchises, no reasonable projection of revenue and expense could indicate that the taxpayer's franchises would generate enough cash so that the notes were likely to be paid.

B. Effect of Mortgage on Income and Basis.

1. When an owner of real property places a mortgage on that property in order to secure borrowed funds, he realizes no immediate tax consequences.

a. This is so even though the mortgage is in excess of his basis in the property. See, e.g., Woodsam Associates v. Comm'r, 198 F.2d 357 (CA2 1952).
b. EXAMPLE: Assume that a taxpayer owns real property worth $200,000 and places a new mortgage thereon of $130,000 in order to pay off a prior loan of $50,000. Subject to the rules on interest tracing under Sec. 163, I.R.C., the mere placement of the new debt has no tax consequences, even though the taxpayer pockets $80,000.

2. The foregoing is not an evasion or avoidance of any income tax, but is merely a deferral, for when a taxpayer sells or otherwise disposes of real property, the amount realized is equal to the cash or other property (at its fair market value) received plus the amount of any outstanding unpaid principal mortgage liability that the purchaser assumes or to which he takes subject. Regs. §§1.1001-1(a) and 1.1001-2(a)(1). See also Chilingirian v. Comm’r, 918 F.2d 1251 (CA6 1990).

a. In determining gain or loss, the seller offsets against the amount realized his adjusted basis for the property, which, as discussed above, included the amount of any mortgage liability on the property when it was acquired. See Crane v. Comm’r, 331 U.S. 1 (1947); and Comm’r v. Tufts, 461 U.S. 300 (1983).

b. EXAMPLE: Assume a taxpayer purchases real property for $100,000 cash and agrees personally to assume an existing $300,000 mortgage. If the taxpayer later sells the property for $200,000 cash and the buyer either assumes, or takes the property subject to, the same, unreduced mortgage, then the taxpayer’s amount realized is $500,000 ($200,000 cash plus $300,000 mortgage liability). Assuming that the property is not depreciable and that there were no other basis adjustments, the taxpayer would have a $100,000 gain (amount realized, $500,000, less adjusted basis, $400,000, equals $100,000).

3. Any payments made by the mortgagor on the principal amount of the mortgage are treated only as debt reduction payments. Such payments have no effect upon basis (see Blackstone Theater Co. v. Comm’r, 12 T.C. 801 (1949)), and, further, are not deductible.

4. The transferor of property to another entity must be wary of adverse tax consequences, which often are a pothole for the unvigilant.

a. For example, a subsequent transfer of real property with a mortgage in excess of adjusted basis to a corporation will cause the taxpayer to recognize gain at least equal to the amount of such excess. Sec. 357(c), I.R.C. If the placement of the mortgage and subsequent transfer to the corporation were for a principal purpose of avoiding Federal
income tax or, if not, were not for a bona fide business purpose, the entire principal amount of the liability and any other liabilities transferred at that time (and not just the excess over adjusted basis) would be considered gain recognized. Sec. 357(b), I.R.C.

b. As another example, while the contribution of real property with a mortgage in excess of basis generally does not cause a contributing partner directly to recognize gain (Sec. 721, I.R.C.), the contributing partner may be required to recognize gain if the amount of the contributing partner's liabilities deemed to be assumed or taken subject to by the remaining partners is in excess of the contributing partner's basis in his partnership interest. Secs. 752(b) and 731(a)(1), I.R.C. See Stackhouse v. Comm'r, 441 F.2d 465 (CA5 1971). See also Newman Estate v. Comm'r, 934 F.2d 426 (CA2 1991), rev'g 59 TCM 543 (1990); but see Gershkowitz v. Comm'r, 88 T.C. 984 (1987).

c. Not only may the unwary contributing partner be required to recognize gain, but, under certain circumstances, the existing partners of the same partnership will recognize gain as well. For example, the Service has ruled that, where a new partner joins an existing partnership that has outstanding liabilities and unrealized receivables, the existing partners are treated as having received distributions for which ordinary income must be recognized to the extent that such partners' shares of the partnership's unrealized receivables are reduced. See Rev. Rul. 84-102, 1984-2 C.B. 119.

5. A mortgage placed on property after it has been acquired does not increase the owner's basis in the property. See, e.g., Woodsam Associates, Inc. v. Comm'r, 198 F.2d 357 (CA2 1952).

a. If the mortgage proceeds are used to improve the property, the basis of the property is increased by the cost of the improvements. Blake v. Comm'r, 8 T.C. 546 (1947).

b. This is because the cost of the improvements is a capitalized expenditure which increases basis, and the fact that borrowed funds were used is immaterial.

6. As noted, the practical effect that a subsequent real property mortgage has on income and basis is to postpone the recognition of any economic gain or loss realized from the property at the time the property becomes encumbered by the mortgage (that is, the mortgage proceeds) to the time when the property is sold or otherwise disposed of.
a. EXAMPLE: Assume that a taxpayer bought real property in early 1987 for $400,000 cash. Also assume that the property is now worth $600,000, and that the taxpayer places a $500,000 mortgage on the property. Although the taxpayer has immediate use of the full amount of the mortgage proceeds, the taxpayer has also incurred an obligation to repay the $500,000; therefore, the taxpayer has realized no gain on the borrowing. If the taxpayer later sells the property for $600,000, payable $100,000 in cash and the assumption of the mortgage, the taxpayer will have a total gain of $200,000. See, e.g., Allan v. Comm'r, 86 T.C. 655 (1986); Mendham Corp. v. Comm'r, 9 T.C. 320 (1947); and Lutz & Schram Co. v. Comm'r, 1 T.C. 682 (1943).

b. Thus, the placing of the mortgage allowed the taxpayer to receive part of the property's appreciation without tax consequence until the later sale.

II. CANCELLATION OR REDUCTION OF PRINCIPAL AMOUNT OF MORTGAGE.

A. Impact on Mortgagor.

1. In general, any reduction in the principal amount of the mortgage by compromise or negotiation, or other benefit of debt relief by modification of the mortgage terms -- in the absence of a mortgage foreclosure, voluntary conveyance of a deed in lieu of such foreclosure or abandonment -- will cause the mortgagor to recognize cancellation of indebtedness income, taxable at ordinary rates, to the extent of the cancellation. Sec. 61(a)(12), I.R.C. See U.S. v. Kirby Lumber, 284 U.S. 1 (1931); and B. F. Avery & Sons, Inc. v. Comm'r, 26 B.T.A. 1393 (1932). See also Republic Supply Co. v. Comm'r, 66 T.C. 446 (1976). See, generally, Tucker, The Real Property Owner in Default: The Income Tax Consequences, 3 J. Real Est. Tax. 5 (1975); and Axelrod and Fetter, Amount and Type of Taxable Gain on Real Estate Foreclosures Can Be Controlled by the Parties, 18 Tax. for Law. 146 (1989).

a. The forgiveness of a debt is considered to occur when it becomes reasonable to assume that the debt will probably never be paid. See Bear Manufacturing Co. v. U.S., 430 F.2d 152 (CA7 1970); and Fidelity-Philadelphia Trust Co. v. Comm'r, 23 T.C. 527 (1954).

b. In fact, the Tax Court has held that cancellation of indebtedness income was not recognized by a taxpayer who would not accept forgiveness from his debts while he was living. Estate of Marcus v. Comm'r, 34 TCM 38 (1975).

2. There are a number of exceptions to this general rule.
a. One significant exception to the general rule provides that no cancellation of indebtedness income results where the debt is discharged in a title 11 case. Sec. 108(a)(1)(A), I.R.C. (A "title 11 case" is a case under title 11 of the United States Code, but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court. Sec. 108(d)(2), I.R.C.)


(2) By legislatively determining that a debtor coming out of bankruptcy is not burdened with an immediate tax liability, Congress preserved the bankruptcy law's policy of giving such a debtor a fresh start.

(3) Upon the filing of a title 11 case (chapter 7 or chapter 11), the individual debtor is deemed to transfer all of his or her assets to the bankruptcy estate. Such transfer is generally nontaxable, and the bankruptcy estate assumes the tax attributes of the debtor. See Sec. 1398, I.R.C.

(a) Transfers between the individual debtor and the bankruptcy estate are both treated in the same manner. Sec. 1398(f), I.R.C.

(i) A transfer of an asset by the debtor to the estate -- other than by sale or exchange -- is not treated as a disposition of the asset, and the estate is treated as the debtor would be treated as to such asset. Sec. 1398(f)(1), I.R.C.

(ii) On termination of the estate, any transfer of an asset by the estate to the debtor -- other than by sale or exchange -- is not treated as a disposition of the asset, and the debtor is treated as the estate would be treated as to such asset. Sec. 1398(f)(2), I.R.C.

(b) A partnership is not treated as an individual; however, the interest in a partnership of an individual debtor is treated the same as any other asset of the debtor. Sec. 1398(b)(2), I.R.C.

(c) The taxable income of the estate is computed in the same manner as for an individual, with the tax thereon due from the trustee. Sec. 1398(c)(1), I.R.C.
(i) The tax table used is that under Sec. 1(d), I.R.C. -- married individuals filing separate returns. Sec. 1398(c)(2), I.R.C.

(ii) If the estate does not itemize deductions, the basic standard deduction for the estate is the same as for a married individual filing a separate return. Sec. 1398(c)(3), I.R.C.

(d) The taxable year of the debtor is determined without regard to the title 11 case, except that the debtor may elect to treat his taxable year as two separate taxable years, the first of which ends on the day before the date of the title 11 case, and the second of which begins on the commencement date of the title 11 case. Secs. 1398(d)(1) and (2)(A), I.R.C. See also Temp. Reg. §7a.2. (issued May 1, 1981).

(i) This election must be made on or before the due date for the earlier of the two returns; and, once made, the election is irrevocable. Sec. 1398(d)(2)(D), I.R.C.

(ii) The debtor cannot make this election if the debtor has no assets other than exempt property under sec. 522 of title 11. Sec. 1398(d)(2)(C), I.R.C.

(e) The gross income of the estate for each taxable year includes the gross income of the debtor to which the estate is entitled under title 11, except where the gross income is received or accrued by the debtor prior to the commencement date of the title 11 case. Sec. 1398(e)(1), I.R.C.

(i) Any item included in the gross income of the estate is not included in the gross income of the debtor. Sec. 1398(e)(2), I.R.C.

(ii) The determination of whether or not any amount paid or incurred by the estate is allowable as a deduction or credit for income tax purposes or is wages for employment tax purposes is made as if the amount were paid or incurred by the debtor and as if the debtor were still engaged in the trades or businesses, and in the activities, the debtor was engaged in before the commencement of the title 11 case. Sec. 1398(e)(3), I.R.C.

(f) As set forth in Sec. 1398(g), I.R.C., the estate succeeds to and takes into account the following items of the debtor (determined as of the first day of the debtor's taxable year in which the title 11 case commences):
(i) The net operating loss carryovers determined under Sec. 172, I.R.C.

(ii) The carryover of excess charitable contributions determined under Sec. 170(d)(1), I.R.C.

(iii) Any recovery of tax benefit items to which the debtor would be entitled under Sec. 111, I.R.C.

(iv) The carryovers of any credit and all other items which, but for the commencement of the case, would be required to be taken into account by the debtor with respect to any credit.

(v) The capital loss carryover determined under Sec. 1212, I.R.C.

(vi) As to any asset acquired by the estate from the debtor, other than by sale or exchange, the basis, holding period and character such asset had in the hands of the debtor.

(vii) The method of accounting used by the debtor.

(viii) Other tax attributes of the debtor, as provided in Regulations (that are not yet issued).

(g) On termination of the estate, the debtor, in turn, succeeds to and takes into account the same items referred to immediately above. Sec. 1398(i), I.R.C.

(h) Administration expenses of the estate and fees and charges assessed against the estate are allowed as deductions, to the extent not otherwise disallowed by the Code. Sec. 1398(h)(1), I.R.C.

(i) These items may be carried forward or carried back by the estate. Sec. 1398(h)(2), I.R.C.

(ii) On termination of the estate, the debtor cannot pick up these deductions to the extent not utilized by the estate. Sec. 1398(h)(2)(D), I.R.C.

(i) Sec. 1398 does not apply if the chapter 7 or chapter 11 proceeding is dismissed. Sec. 1398(b)(1), I.R.C.

b. A debtor also need not recognize discharge of indebtedness income where such debtor is insolvent both before
and after cancellation of the debt. Sec. 108(a)(1)(B), I.R.C. See also Dallas Transfer & Terminal Warehouse Co. v. Comm'\r, 70 F.2d 95 (CA5 1934); Danenberg v. Comm'\r, 73 T.C. 370 (1979); and Lakeland Grocery Co. v. Comm'\r, 36 B.T.A. 289 (1937).

(1) "Insolvency" is defined as the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, is determined on the basis of the taxpayer’s assets and liabilities immediately before the discharge. Sec. 108(d)(3), I.R.C. See also Estate of Marcus v. Comm'\r, 34 TCM 38 (1975).

(a) Thus, whether a taxpayer is insolvent for purposes of this exception is determined according to the taxpayer’s balance sheet, and the mere ability of a taxpayer to pay his debts when they become due does not disqualify him from being deemed insolvent. See, e.g., Brutsche v. Comm'\r, 65 T.C. 1034 (1976) (holding that a corporation was solvent after a forgiveness of indebtedness because cash proceeds received in a settlement of a suit for damages resulting from lost profits were to be treated as an asset of the corporation in determining its solvency).

(b) In Estate of Marcus, supra, the Court held that assets exempt from the claims of creditors under state law are not to be included among the taxpayer’s assets in determining whether assets exceed liabilities. See also Priv. Ltr. Rul. 9125010 (March 19, 1984) (under which the Service found that the taxpayer’s personal residence and other property exempt from creditors under state law should be disregarded in the determination of the extent to which the taxpayer was insolvent); and Hunt v. Comm'\r, 57 TCM 919 (1989).

(2) The amount excluded from income for purposes of the "insolvency exception" is limited to the amount by which taxpayer is insolvent. Sec. 108(a)(3), I.R.C.

3. Taxpayers having debts discharged pursuant to either the title 11 bankruptcy exception or the insolvency exception, though not required to recognize discharge of indebtedness income, are required to reflect such discharge in their overall tax status through a reduction in overall tax attributes. See Sec. 108(b), I.R.C.

a. Unless the taxpayer elects first to reduce the basis of his depreciable assets by the amount excluded from gross income, the taxpayer is required to reduce, by the amount of the discharged debt, net operating losses and net operating loss carryovers, general business credit carryovers under Sec. 38, I.R.C., capital losses and capital loss carryovers under Sec.
1212, I.R.C., asset bases and foreign tax credit carryovers under Sec. 27, I.R.C., in that order. Secs. 108(b)(1) and (2)(A) through (E), I.R.C.

b. While most tax attributes are generally reduced on a dollar-for-dollar basis, the necessary reductions in a taxpayer’s credit carryovers (that is, general business credit carryovers under Sec. 38 and foreign tax credit carryovers under Sec. 27) are only reduced by 33-1/3 cents for each dollar of the discharged debt. Secs. 108(b)(3)(A) and (B), I.R.C.

4. Rather than have certain tax attributes reduced by the amount of the discharged debt, a taxpayer who is seeking a discharge in bankruptcy or due to insolvency may instead elect to reduce the adjusted bases of certain depreciable property. Secs. 108(b)(5) and 1017, I.R.C.

a. The amount of the reduction in basis is limited to the aggregate adjusted bases of the taxpayer’s depreciable property as of the beginning of the taxable year following the taxable year in which the discharge occurs. Sec. 108(b)(5)(B), I.R.C.

b. For purposes of basis reduction, the Service has ruled that a partnership is an individual for purposes of Sections 108 and 1017. Rev. Rul. 72-205, 1972-1 C.B. 37.

(1) For a detailed discussion of the statutory rules of Secs. 108(b)(5) and 1017, see Pollack, How Section 108 Permits Debt Cancellation Income to Be Minimized, 62 J. Tax. 276 (1985).

(2) As to the rules for a timely election and consent, see Reg. § 1.108(a)-2, noting that the consent must be made on IRS Form 982.

c. Furthermore, the basis reduction election only applies to income from the discharge of indebtedness, not income from a sale or exchange of property, such as that which may occur in a repossession or foreclosure. See Estate of Delman v. Comm’r, 73 T.C. 15 (1979).

d. Moreover, where the taxpayer attempts to vary the general basis reduction rules (Reg. §1.1017-1), the Service’s Regulations (Reg. §1.1017-2) and Revenue Procedures (see Rev. Proc. 78-15, 1978-2 C.B. 488 (as to stock), and Rev. Proc. 85-44, 1985-2 C.B. 504 (as to depreciable property)) should be referred to and closely followed.

e. Finally, where the basis reduction election is made, the rules regarding the reduction of the taxpayer’s tax
attributes will only be applied after the bases of the taxpayer's depreciable assets have been reduced to zero and some discharge income remains. Sec. 108(b)(5)(C), I.R.C. For a detailed discussion, see Asofsky and Tatlock, Bankruptcy Tax Act Radically Alters Treatment of Bankruptcy and Discharging Debts, 54 J. Tax. 106 (1981).

5. Prior to December 31, 1986 taxpayers need not have recognized cancellation of indebtedness income if the indebtedness discharged was a "qualified business indebtedness". Former Sec. 108(a)(1)(C), I.R.C.

a. An indebtedness for these purposes was only a "qualified business indebtedness" if the indebtedness was incurred or assumed by a corporation or by an individual, where such debt was incurred or assumed in connection with property used in the individual's trade or business, and the corporate or individual taxpayer made an election with respect to such indebtedness. Former Sec. 108(d)(4), I.R.C.

b. Where the "qualified business indebtedness" exception applied, the adjusted bases of the taxpayer's depreciable property were reduced by the amount of the debt discharged. Former Sec. 108(c), I.R.C. The bases of the taxpayer's assets were reduced according to Sec. 1017, I.R.C., and the amount of such reduction was limited to the aggregate adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the debt was discharged. Former Sec. 108(c), I.R.C.

c. Effective with respect to discharges of indebtedness occurring after December 31, 1986, the "qualified business indebtedness" exception was revoked by the Tax Reform Act of 1986.

6. There is no cancellation of indebtedness income where the forgiveness is intended as a gift. See Helvering v. American Dental Co., 318 U.S. 322 (1943), as modified by Comm'r v. Jacobson, 336 U.S. 28 (1949). See also Sutphin v. U.S., 14 Cl. Ct. 545, 88-1 U.S.T.C. ¶9,269 (Cl. Ct. 1988), which held that a discounted prepayment of a mortgage was considered discharge of indebtedness income, rather than a gift, because it resulted from a creditor's business judgment.

a. This exception is usually applicable only in the family gift situation. But see Hartland Associates v. Comm'r, 54 T.C. 1580 (1970), and Sec. 118, I.R.C. and Reg. §1.61-12(a) (dealing with the cancellation of a corporate debt by a shareholder as a contribution to the capital of a corporation).
b. While a cancellation of indebtedness intended as a gift will not result in income to the mortgagor, the cancellation will cause the mortgagee to recognize income where the indebtedness cancelled is an installment obligation. Sec. 453B(f), I.R.C.

(1) In this situation, the mortgagee must recognize gain to the extent that the fair market value of the obligation exceeds the mortgagor's basis for the installment note, which is usually the remaining basis of the property. Sec. 453B(a), I.R.C.

(2) This provision generally forces the mortgagee to recognize the previously deferred gain, such deferral being permitted by use of the installment method.

7. Where the mortgage debt is a purchase money mortgage and there is a reduction in the purchaser's obligation, such reduction does not result in discharge of indebtedness income; rather, such reduction is treated as a purchase price reduction and a corresponding reduction in the basis of the property. Sec. 108(e)(5), I.R.C. See Priv. Ltr. Rul. 8429001 (March 12, 1984).

a. For this provision to apply, the purchase money debt must be owed to the seller/creditor of the property and the debtor can be neither insolvent nor in bankruptcy under title 11. Secs. 108(e)(5)(A) and (B), I.R.C.

(1) While not currently supported by the Code or case law, it would be logical for this provision to apply to the estate or beneficiary of a deceased seller.

(2) See Sec. 1038(g), I.R.C., which made Sec. 1038, I.R.C. applicable to the estate or beneficiary of a deceased seller because Congress felt that an estate or beneficiary should be entitled to the same treatment as if the decedent seller had survived. Installment Sales Revision Act of 1980, Pub. L. No. 96-471, Sec. 4.

b. Interestingly enough, prior to the enactment of Sec. 108(e)(5), courts held that, where there was a reduction in the unpaid principal amount of the mortgage, which adjustment was an adjustment in the purchase price of the property to reflect a revaluation of the property, or a loss in value, the debt cancellation could be treated as a reduction in basis to the purchaser, and not as taxable income, regardless of whether the purchase money debt was:

(1) Owed directly to the seller (see Helvering v. A. L. Killian Co., 128 F.2d 433 (CA8 1942)), or
(2) Owed to a third-party creditor who financed the purchase. See Hirsch v. Comm'r, 115 F.2d 656 (CA7 1940). But see Fifth Avenue Fourteenth Street Corp. v. Comm'r, 147 F.2d 453 (CA2 1944) (limiting Hirsch to direct negotiations regarding purchase price with the seller); and Rev. Rul. 82-202, 1982-2 C.B. 35.

c. In Rev. Rul. 91-31, 1991-20 I.R.B. 4, the Service held that a reduction in principal of a nonrecourse debt by a holder who was not the original seller of the property results in the realization of discharge of indebtedness income by the debtor, irrespective of whether the fair market value of the property is greater than or less than the balance of the debt at the time of the principal reduction.

(1) The holding in Rev. Rul. 91-31 amplified Rev. Rul. 82-202, 1982-2 C.B 35, in which the Service ruled that a reduction in debt, whether recourse or nonrecourse, results in the realization of income by the debtor under Sec. 61(a)(12), I.R.C., if, at the time of the reduction, the fair market value of the property is greater than the principal balance of the debt.

(2) The Service expressly rejected the holding in Fulton Gold Corp. v. Comm'r, 31 B.T.A. 519 (1934), in which the Board of Tax Appeals held that the satisfaction of a nonrecourse mortgage for an amount less than its face amount results in a reduction of the mortgagor's basis in the underlying property rather than the realization of income. See also Comm'r v. Tufts, 461 U.S. 300 (1983); and Gershkowitz v. Comm'r, 88 T.C. 984 (1987). But see, for a variation of Gershkowitz, Newman Estate v. Comm'r, 934 F.2d 426 (CA2 1991), rev'g 59 TCM 543 (1990).

8. A taxpayer who issues new debt in satisfaction of old indebtedness will be treated as having satisfied such old indebtedness with an amount of money equal to the "issue price" of the new debt. Sec. 108(e)(11), I.R.C.

a. Under Sec. 108(e)(11)(B), the issue price is determined under Secs. 1273 and 1274, I.R.C., relating to original issue discount.

(1) If either the new debt or the old debt is publicly traded, the "issue price" of the new debt is equal to its fair market value. Sec. 1273(b)(3), I.R.C.

(2) If neither debt instrument is publicly traded, the issue price of the new debt is equal to its stated principal amount or, where it does not provide "adequate"
interest, a lower imputed principal amount, as determined under Sec. 1274(b), I.R.C. Sec. 1274(a), I.R.C.

   a. A debt instrument will be deemed to provide for adequate interest if interest accrues at a rate at least equal to the applicable Federal rate, as defined under Sec. 1274(d), I.R.C.

   b. The imputed principal amount is equal to the sum of the present values of all payments due under the debt instruments, except in the case of "potentially abusive situations" (as defined under Sec. 1274(b)(3)(B), I.R.C.), under which the imputed principal amount is equal to the fair market value of the property for which the debt instrument was issued, adjusted to take into account other considerations involved in the transaction. Sec. 1274(b), I.R.C.

(3) The corporate reorganization exception of Sec. 1275(a)(4) has been repealed and, as a result, a taxpayer which issues new debt instruments in connection with a Sec. 368(a)(1)(E) recapitalization may incur cancellation of indebtedness income and/or original issue discount income. Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, Sec. 11325.

   b. A debt instrument is viewed as being exchanged for a new debt instrument if the new debt instrument differs "materially either in kind or in extent" from the old debt instrument. Reg. §1.1001-1(a). See also Burstein, Federal Taxation of Debt Swaps and Modifications, 17 J. Corp. Tax. 3 (Spring 1990).

   (1) A change or substitution of obligors generally constitutes a material modification. Rev. Rul. 78-408, 1978-2 C.B. 203; and Priv. Ltr. Rul. 8848051 (September 7, 1988). But see Rev. Rul. 82-122, 1982-1 C.B. 80 (substitution and release of the original obligor of an installment note and a change in interest rate did not constitute an exchange because the noteholder's right to payments were neither eliminated nor materially altered); see also Rev. Rul. 68-419, 1968-2 C.B. 196 (payment deferrals for 5 years and interest rate increase did not cause disposition of installment note); Rev. Rul. 74-157, 1974-1 C.B. 115; and Rev. Rul. 75-457, 1795-2 C.B. 196.

   (2) A change in the interest rate, unless minimal, will generally constitute a material modification of the debt instrument. Rev. Rul. 89-122, 1989-2 C.B. 200 (holding that a United States commercial bank was, as a result, entitled to recognize a loss on a debt modification by a foreign country); and Rev. Rul. 87-19, 1987-1 C.B. 249 (ruling that a waiver of the right to receive a higher interest rate under an interest rate
adjustment clause was a material change). See also Prop. Reg. §1.1274-1(c)(2), Example. But see Rev. Rul. 82-122, supra (increased interest rate on installment note assumed by new obligor not considered exchange of old installment note for new note); and Newberry v. Comm’r, 4 TCM 576 (1945) (change in the interest rate, maturity date and collateral not deemed exchange of debt instruments).

(3) The deferral of accrued interest likely would not constitute a material modification of the debt instrument. See West Missouri Power Co. v. Comm’r, 18 T.C. 105 (1952).

(4) A modification of the collateral securing the indebtedness may be considered material, depending on other facts and circumstances of the lending transaction. The following held that the change in the security arrangement was a material modification: Federal National Mortgage Association v. Comm’r, 90 T.C. 405 (1990), aff’d 896 F.2d 580 (D.C. Cir. 1990); Rev. Rul. 81-169, 1981-1 C.B. 429 (the elimination of a sinking fund); Priv. Ltr. Rul. 9037009 (June 12, 1990); and Priv. Ltr. Rul. 8907049 (November 23, 1989). But see Rev. Rul. 77-416, 1977-2 C.B. 34; and Priv. Ltr. Rul. 8346104 (August 18, 1983).

(5) A reduction or other adjustment of the principal balance of the indebtedness is generally considered a material modification, but may be treated as a purchase price reduction under Sec. 108(e), as discussed above. See Rev. Rul. 89-122, supra.

(6) A change in the maturity date of a debt obligation is generally not considered a material modification of the underlying instrument. See Priv. Ltr. Rul. 9037009 (June 12, 1990); Priv. Ltr. Rul. 8928049 (April 18, 1989); and Rev. Rul. 73-160, 1973-1 C.B. 365 (change in the maturity date, together with the modification of the security arrangement, did not constitute a material modification). But see Rev. Rul. 81-169, supra (a change in maturity date together with a change in the collateral security constituted a material modification).

(7) A modification of the type of instrument may be considered material. See Johnson v. U.S., 78-2 U.S.T.C. ¶9,609 (M.D. Tenn. 1978), aff’d 81-1 U.S.T.C. ¶9,298 (CA6 1980) (exchange of demand note for fixed longer term debenture was mere substitution for equal value). But see Watson v. Comm’r, 8 T.C. 569 (1947) (exchange of note for bond with same interest rate but different maturity date).

9. There is no cancellation of indebtedness income where the debtor performs services in full or partial
satisfaction of the debt, which services have a fair market value equal to the debt satisfied.

a. The rationale for this exception appears to be that the mortgagor does not realize any economic benefit on a release of previously encumbered assets because the mortgagor has in reality paid for the debt with human capital.

b. In any event, while the mortgagor has no income from the cancellation of the debt, the mortgagor has realized compensation income in the amount of the debt satisfied, which is included in the mortgagor’s gross income. Reg. §1.61-12(a).

10. A cash-basis taxpayer is not required to recognize discharge of indebtedness income where the payment of the debt would have been deductible by the payor. Sec. 108(e)(2), I.R.C.

a. For example, the forgiveness of a trade payable by a creditor or the forgiveness of accrued wages by an employee of the debtor would not give rise to income upon discharge of such liabilities.

b. In contrast, an accrual-basis taxpayer is required to recognize discharge of indebtedness income when the debt is forgiven to offset the tax effect of previously accrued deductions.

11. The release of collateral securing an obligation does not, in and of itself, create income in the absence of a reduction or cancellation of the underlying debt. See Estate of Whitthorne v. Comm’r, 44 B.T.A. 1234 (1941).

a. The release of a contingent liability to contribute capital to a partnership does not give rise to cancellation of indebtedness income. Hunt v. Comm’r, 59 TCM 635 (1990).

b. Similarly, the release of guarantors of a loan, who are secondarily liable thereon, does not generate cancellation of indebtedness income to such guarantors. Priv. Ltr. Rul. 7953004 (September 7, 1979). But see Tennessee Securities v. Comm’r, 37 TCM 1803 (1978), aff’d 674 F.2d 570 (CA6 1982), in which guarantors who were called upon to pay the guarantee obligation which was ultimately paid by the guarantors’ closely-held corporation realized dividend income.

12. The general rule of cancellation of indebtedness income and the exceptions thereto apply only to a cancellation of indebtedness, or a satisfaction of a mortgage at less than its face amount. The tax consequences to a mortgagor or debtor which
result from foreclosure, voluntary conveyance in lieu thereof or abandonment are governed by different rules.

B. Impact on Mortgagee.

1. Where there is a cancellation of indebtedness or a satisfaction of a mortgage debt at less than its face amount, and there is no mortgage foreclosure, deed in lieu thereof or abandonment, the mortgagee will realize a loss to the extent that its tax basis for the debt exceeds the amount actually paid by the mortgagor.

   a. This loss is deductible whether or not the mortgagor is able to repay the mortgage debt in full and whether or not the value of the mortgaged property has increased or decreased. See Smith v. Comm’r, 48 T.C. 872 (1967), aff’d in part and rev’d in part on other issues 424 F.2d 219 (CA9 1970).

   b. Note, however, that, if the mortgage note were issued, taken or acquired at a discount, the mortgagee could have a gain, rather than a loss, on the debt settlement. This would occur if the settlement were for an amount more than the tax basis for the note, although less than the face amount.

   c. EXAMPLE: Assume that a taxpayer purchases a $100,000 face value mortgage note at a time when the market rate of interest is greater than the mortgage note’s stated rate of interest. Also assume that, because of this differential in interest rates, the taxpayer is able to purchase the note for $90,000. If the taxpayer later agrees to accept $95,000 from the mortgagor as a final settlement for the mortgage debt, the taxpayer would have a $5,000 gain. The character of this gain is determined under Sec. 1276, I.R.C. In general, to the extent that such gain reflects that the debt was issued at an interest rate below the market interest rate, such income is ordinary in character. Sec. 1276(a), I.R.C. See, generally, Auster, Market Discount Elections with Respect to Bonds after the Tax Reform Act of 1984, 63 Taxes 111 (1985).

2. A corporate mortgagee always has a business bad debt, resulting in ordinary loss treatment. Secs. 166(a) and 166(d), I.R.C. See, e.g., West Coast Securities Co. v. Comm’r, 14 T.C. 947 (1950). But see, with regard to the loss deduction under Sec. 165, I.R.C., International Trading Co. v. Comm’r, 484 F.2d 707 (CA7 1973), rev’g 57 T.C. 455 (1971) (holding that a corporation could not take a loss deduction under Sec. 165(a), I.R.C. as to property neither used in a trade or business nor held for production of income). See also Schautz Co. v. U.S., 567 F.2d 373 (Ct. Cl. 1977) (denying a loss deduction on the sale of residential vacation property on the theory that Sec. 274
overrides Sec. 165, I.R.C.); and Blake Construction Co., Inc. v. U.S., 572 F.2d 823 (Ct. Cl. 1978).

3. A non-corporate mortgagee may receive ordinary loss treatment, but only if the debt was a business debt. Sec. 166(d)(1), I.R.C.

a. A business debt is either a debt created or acquired in connection with a trade or business of the taxpayer or a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business. Sec. 166(d)(2), I.R.C.

b. The characterization of a worthless debt as business or nonbusiness is a question of fact which depends on the relationship between the debt and the creditor's trade or business. The test for determining what constitutes a "trade or business" for purposes of applying Sec. 166 is the same as that used for ascertaining the deductibility of a loss under Sec. 165 -- that is, whether the loss is proximately related to the conduct of the trade or business of the taxpayer. Reg. §1.166-5(b).

c. The issue of whether an individual has incurred a business bad debt or a non-business bad debt has frequently been litigated. In 1963, the Supreme Court attempted, although inarticulately, to distinguish an investor from a person engaged in a trade or business. Whipple v. Comm'r, 373 U.S. 193 (1963).

(1) The Court's decision did not, unfortunately, provide much guidance. Therefore, the various cases since that time, along with the range of fact patterns on which these cases have arisen, leaves the area in some doubt. See, generally, Ohl, The Deduction for Bad Debts: A Study in Flexibility and Inflexibility, 22 Tax Law 579 (1969); and Tucker, The Warren Court: Its Impact on the Capital vs. Ordinary Concept Under the Internal Revenue Code, 17 Kansas L. Rev. 53 (1968).

(2) For example, the Claims Court, on the third time around for the same case, found that advances by a taxpayer engaged in the business of rendering financial services constituted business loans made for the dominant purpose of advancing the consulting business, so that the subsequent bad debts were business bad debts. Adelson v. Comm'r, 6 Cl. Ct. 102 (1984). Note that, although the Court of Appeals for the Federal Circuit affirmed the Claims Court's findings that the taxpayer's advances were bona fide business debts, the case was remanded back to the Claims Court for additional factual findings to support the objective analysis required under U.S. v. Generes, 405 U.S. 93 (1972). Adelson v. Comm'r, 782 F.2d 1010 (CA Fed Cir 1986).
4. The generally accepted belief that the mere holding of rental real property constitutes a trade or business may not be wholly valid, under certain circumstances. See Lee, "Active Conduct" Distinguished from Conduct of a Rental Real Estate Business, 25 Tax Lawyer 317 (1972).

   a. In contrast, the making of mortgage loans may constitute an individual’s trade or business. If such loans are made on a frequent and continual basis, then such money lending may in and of itself constitute a business, so that bad debts therefrom will constitute ordinary losses. See, e.g., Sales v. Comm’r, 37 T.C. 576 (1961); and Barish v. Comm’r, 31 T.C. 1280 (1959).

   b. As to a partner in a partnership, the type of business carried on by the partnership, and the ability to cause attribution of such business to the partner, may be determinant as to whether a loss on a loan to the partnership is an ordinary loss or capital loss. See, e.g., Butler v. Comm’r, 36 T.C. 1097 (1961); Kasdin v. Comm’r, 28 TCM 432 (1969); and Hambuechen v. Comm’r, 43 T.C. 80 (1964).

   c. See Cary v. Comm’r, 32 TCM 913 (1973), as to the separation of the individual’s activities from those of his controlled entities in the "dealer" area.

5. Treatment of Bad Debts.

   a. Wholly Worthless Bad Debts.

      (1) Generally, a bad debt which is wholly worthless must be deducted in full in the year in which such worthlessness occurs. Sec. 166(a)(1), I.R.C.; Reg. §1.166-3(b).

      (2) The burden of proving worthlessness is on the taxpayer, and the Service may examine all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor. Reg. §1.166-2(a).

      (3) While the Service is entitled to scrutinize closely the taxpayer’s documents regarding the debt in question, the creditor-mortgagor need not be an "incorrigible optimist", and so legal action to enforce payment is not necessary where the facts indicate that such action would be futile. Reg. §1.166-2(b).

      (4) The factors considered by the courts or the Service have included: receivership or bankruptcy of the debtor; the termination of, or decline in, the debtor’s business;
the debtor’s disappearance or departure from the country; and the
debtor’s death. See, e.g., Lunsford v. Comm’r, 212 F.2d 878 (CA5
1954); Keller v. Comm’r, 29 TCM 369 (1970); Portland
71-37, 1971-1 C.B. 78.

b. Partially Worthless Bad Debts.

(1) It is also possible to obtain a
deduction for a partially worthless bad debt. As a general rule,
a partially worthless debt is deductible in the taxable year in
which it is determined that only a portion of the debt is
recoverable; the worthless portion is deductible to the extent
that it is charged off for financial accounting purposes in such
year. Sec. 166(a)(2), I.R.C.; Regs. §§1.166-3(a)(1) and (2).

(2) The worthlessness of the portion
charged off must be established to the satisfaction of the
Service. Reg. §1.166-3(a)(1). See, e.g., Harrington v. Comm’r,
31 TCM 888 (1972); and Bullock v. Comm’r, 26 T.C. 276 (1956),
aff’d per curiam 253 F.2d 215 (CA2 1958).

(3) In this connection, the courts have
held that the determination of the Service, if reasonably based
on the facts, will not be overturned by the courts unless
arbitrary or unreasonable. See, e.g., American Processing and
Sales Co. v. U.S., 371 F.2d 842 (Ct. Cl. 1967); and Stranahan v.
Comm’r, 42 F.2d 729 (CA6 1930).

(4) Furthermore, where the uncollectible
portion of the debt cannot be clearly ascertained with a high
degree of certainty, the deduction for the partially worthless
debt will be disallowed, even though it can be shown that debt is
truly partially worthless. Reg. §1.166-3(a)(2)(ii). See, e.g.,
First National Bank of Los Angeles v. Comm’r, 6 B.T.A. 850
(1927).

(5) Lack of charge-off is not fatal to the
deduction, but only to the year of deductibility. The bad debt
may be deducted in the year of charge-off, irrespective of
whether the partial worthlessness was ascertained in the year of
charge-off or an earlier year. Reg. §1.166-3(a).

(a) The Regulations note that a
disallowance of a bad debt deduction in one year does not prevent
an allowance of such deduction in a subsequent year, and the
charge-off, although erroneous in the earlier year, will be
deemed to suffice, as to the portion charged off in the earlier
year, in the later year. Reg. §1.166-3(a)(2)(ii).
(b) The Tax Court has indicated that partial worthlessness need not be deducted on a year-to-year basis, but can be deducted through a charge-off in a later year. See E. Richard Mieniq Co. v. Comm'r, 9 T.C. 976 (1947). See also Estate of Denton v. Comm'r, 11 TCM 802 (1952).

(c) The burden is on the taxpayer to prove that a proper charge-off was made. See, e.g., Findley v. Comm'r, 25 T.C. 311 (1955), aff'd per curiam 236 F.2d 959 (CA3 1956); and Klegberg v. Comm'r, 43 B.T.A. 277 (1941).

(d) The entries actually charging off the partially worthless debt need not be made in the taxable year for which the deduction is taken, as where the taxpayer's accountants do not make the charge-off until they close the books for the year, so long as they are made prior to the filing of the income tax return for that year. See, e.g., Brandtien & Kluge, Inc. v. Comm'r, 34 T.C. 416 (1960); Kentucky Rock and Asphalt Co. v. Helburn, 108 F.2d 779 (CA6 1940); and Colorado County Federal Savings & Loan Ass'n v. Comm'r, 36 T.C. 1167 (1961), aff'd 309 F.2d 751 (CA5 1962).

III. MORTGAGOGER'S TAX CONSEQUENCES ON FORECLOSURE

A. Sale or Exchange Treatment. A foreclosure (or deed in lieu of foreclosure or other transfer to lender in full satisfaction of the debt) is treated, for Federal income tax purposes, as a sale of property which may give rise to gain or loss to the mortgagor. See Regs. §§1.1001-2(a)(1) and (2). See also Helvering v. Hamel, 311 U.S. 504 (1941); and Rev. Rul. 78-164, 1978-1 C.B. 264.

B. Recourse Debt.

1. Upon the foreclosure of property encumbered by recourse debt (that is, debt for which the mortgagor is personally liable), the property is deemed to be sold for its fair market value.

2. The realized gain is bifurcated between that portion allocable to the "sale element" of the transaction and the portion allocable to the "debt cancellation element". See Michaels v. Comm'r, 87 T.C. 1412 (1986); and Rev. Rul. 90-16, 1990-1 C.B 12.

   a. With respect to the "sale element", the mortgagor will, on foreclosure, recognize taxable gain to the extent that the fair market value of the property on the date of foreclosure exceeds the mortgagor's adjusted basis in such property. See Sec. 61(a)(3), I.R.C.
b. With respect to the "debt cancellation element", the mortgagor will, on foreclosure, recognize discharge of indebtedness income to the extent that the outstanding debt exceeds the fair market value of the property (assuming the mortgagee releases the mortgagor from liability). Sec. 61(a)(12), I.R.C. See also Reg. §1.1001-2(c), Example (8).

(1) The rule requiring the recognition of discharge income is subject to the bankruptcy exception under Sec. 108(a)(1)(A), I.R.C., and the insolvency exception under Sec. 108(a)(1)(B), I.R.C.

(2) For example, in Rev. Rul. 90-16, 1990-1 C.B. 12, an insolvent mortgagor who transferred real property with an adjusted basis of $8,000 and a fair market value of $10,000 to the mortgagee in satisfaction of a $12,000 recourse debt recognized capital gain of $2,000 (that is, the difference between the property's fair market value of $10,000 and the mortgagor's basis of $8,000). However, although the mortgagor realized $2,000 of discharge of indebtedness income (that is, the difference between the $12,000 debt and the property's $10,000 fair market value), such amount was nontaxable under the insolvency exception of Sec. 108(a)(1)(B), I.R.C.

3. The taxpayer will recognize a loss (capital, Sec. 1231 or Sec. 1221 loss, depending on the nature of the asset in the taxpayer's hands) if the adjusted basis of the transferred property is greater than the debt encumbering such property at the time of disposition. See, generally, Fogel and Allison, Planning to Allow Both Parties to Control Tax Consequences of a Real Estate Foreclosure, 12 Tax. for Law. 48 (1983).

a. While Sec. 1231 losses are ordinary losses, such losses must first be netted against Sec. 1231 gains.

(1) Sec. 1231(c), I.R.C. was added to the Code to prevent manipulation by taxpayers who could bunch sales of appreciated trade or business assets in one taxable year and sales of similar but decreased value property in a different taxable year, thus maximizing the capital gains and ordinary losses. See General Explanation of the Tax Reform Act of 1984, prepared by the Staff of the Joint Committee on Taxation, at 547. See, generally, Harmelink and Copeland, Section 1231 Transaction Planning: The Impact of the Tax Reform Act of 1984, 63 Taxes 489 (1985); and Cash, The Erosion of Section 1231, 62 Taxes 789 (1984).

(2) The 1984 Tax Reform Act significantly impacted this netting process. For taxable years beginning after December 31, 1984, a taxpayer's net Sec. 1231 gain is treated as ordinary income to the extent that such gain does not exceed the
taxpayer’s aggregate amount of net Sec. 1231 losses for the five most recent preceding taxable years. Sec. 1231(c), I.R.C. Thus, if a taxpayer had net Sec. 1231 losses during the five preceding years, Sec. 1231(c) effectively requires the taxpayer to net such past losses with the current net Sec. 1231 gain by recapturing such losses to the extent of the current gain.

b. A taxpayer who is personally liable under recourse debt is generally held not to have sustained a deductible loss merely by abandoning the property.

(1) There must be either a subsequent foreclosure or a voluntary conveyance because these events cut off the taxpayer’s interest in the property.

(2) When one of these events has occurred, a sale or exchange has taken place; therefore, the taxpayer has experienced the necessary taxable event which gives rise to the loss. See Comm’r v. Green, 126 F.2d 70 (CA3 1942) (holding that the subsequent foreclosure sale, rather than the abandonment, of real property encumbered by a recourse mortgage was the event which cut off the mortgagor’s interest in the property; accordingly, such sale was the appropriate event upon which the taxpayer could recognize a loss). See also Priv. Ltr. Rul. 8649051 (September 10, 1986) (where the Service noted that, in the case of recourse debt, a recognition event occurs only at the time of the foreclosure sale or other event which formally evidences the mortgagee’s intent not to pursue collection of the debt; however, in the case of nonrecourse debt, a recognition event could arise upon the mortgagor’s abandonment of the mortgaged property).

C. Nonrecourse Debt.

1. Upon the foreclosure of property encumbered by nonrecourse debt (that is, debt for which the taxpayer is not personally liable), the property is deemed to be sold for the outstanding balance of the nonrecourse debt, irrespective of the fair market value of such property. Reg. §1.1001-2(b). See also Woodson Associates, Inc. v. Comm’r, 16 T.C. 649 (1951), aff’d 198 F.2d 357 (CA2 1952); and Lutz & Schram Co. v. Comm’r, 1 T.C. 682 (1943).

2. Although historical at this time, it is interesting to note that some commentators thought (or at least contended) that footnote 37 of the Crane case (Crane v. Comm’r, 331 U.S. 1, 14 (1947), which reads as follows:

"Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the
mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case."

justified limiting the maximum amount of the taxpayer’s gain to the fair market value of the property over the taxpayer’s basis in the property, regardless of the face amount of the mortgage debt, since such amount represented the unrecognized gain actually inherent in the property. See, e.g., Adams, Exploring the Outer Boundaries of the Crane Doctrine: An Imaginary Supreme Court Opinion, 21 Tax L. Rev. 159 (1966). Unfortunately for the taxpayers, as discussed below, this theory did not prevail (and, indeed, never should have prevailed).

a. In Rev. Rul. 76-111, 1976-1 C.B. 214, the Service first attempted squarely to face the issue reserved in footnote 37 of Crane. In that Ruling, the taxpayer purchased a herd of cattle for breeding purposes by paying the seller a small amount of cash and giving the seller a nonrecourse note for the balance of the purchase price. The taxpayer also pledged the herd as collateral for the unpaid mortgage debt. The taxpayer transferred the herd to the seller three years later in satisfaction of the unpaid nonrecourse note. At the time of this transfer, the fair market value of the herd was less than the mortgage liability. The Service held that the taxpayer had to recognize gain equal to the amount of the unpaid mortgage debt in excess of the taxpayer’s adjusted basis for the property, even though the value of the property was less than the mortgage debt.

b. Soon thereafter, the Tax Court followed the Service’s lead and held that, where a taxpayer voluntarily conveyed property subject to a nonrecourse mortgage debt in satisfaction of such debt, the fair market value of the property at the time of such disposition was irrelevant in determining the gain on the disposition. Millar v. Comm’r, 67 T.C. 656 (1977), aff’d on this issue 577 F.2d 212 (CA6 1978). See, generally, Halpern, Footnote 37 and the Crane Case: The Problem That Never Really Was, 6 J. Real Est. Tax. 197 (1979).

c. Finally, the issue was resolved in Comm’r v. Tufts, 461 U.S. 300 (1983), where the Supreme Court held that the amount of gain attributable to liabilities forgiven was not limited to the fair market value of the property.

(1) The Court pointed out that a taxpayer does not have income upon the receipt of the proceeds of a nonrecourse loan, and that the taxpayer is allowed to include such proceeds in basis because the taxpayer has undertaken an obligation to repay; as a consequence, the taxpayer, when relieved of the obligation to repay such loan, must include the
full amount of such debt relief in its amount realized regardless of the fair market value of the underlying property, because the extinguishment of the obligation produced value to the taxpayer.

(2) The Court went on to determine that the only difference between recourse and nonrecourse financing is to shift the risk of a decline in the property’s value to the mortgagee; therefore, the use of nonrecourse financing should not affect the mortgagor’s tax consequences. Comm’r v. Tufts, 461 U.S. 300, 311-312 (1983). See also Cunningham, Payment of Debt with Property -- The Two-Step Analysis after Commissioner v. Tufts, 38 Tax Lawyer 575 (1985) (arguing that the Supreme Court should have accepted Justice O’Connor’s bifurcation theory, which breaks a Tufts-like transaction into its two separate components -- a taxable disposition of property and a separately taxable discharge of debt); Dorr and Lacy, Crane After Tufts: Still Some Unanswered Questions, 62 Taxes 162 (1984); and Young, Tufts: pursuant to a foreclosure. Footnote to Crane, 62 Taxes 118 (1984).

d. The rule established in Tufts requiring the realization of indebtedness income in the full amount of the nonrecourse debt forgiven or eliminated upon the disposition of the underlying property applies equally to cash settlements or other negotiated agreements in which the mortgagor does not surrender the collateral. See Gershkowitz v. Comm’r, 88 T.C. 984 (1987); but see, for a variation, Newman Estate v. Comm’r, 934 F.2d 426 (CA2 1991), rev’g 59 TCM 543 (1990).

3. If the adjusted basis of the transferred property is greater than the balance of the nonrecourse debt encumbering such property, the taxpayer will recognize a loss (either capital, Sec. 1221 or Sec. 1231 loss). See Russo v. Comm’r, 68 T.C. 135 (1977).

a. If the property is transferred to the mortgagee voluntarily in lieu of foreclosure, and the adjusted basis is in excess of the amount of the mortgage debt, at one time the courts held that the taxpayer had incurred an ordinary loss rather than a capital loss, on the theory that no sale or exchange had occurred. See Stokes v. Comm’r, 124 F.2d 335 (CA3 1941); Polin v. Comm’r, 114 F.2d 174 (CA3 1940); and Commonwealth, Inc. v. Comm’r, 36 B.T.A. 850 (1937). However, where the taxpayer received some (even de minimis) consideration for conveying the property, then the taxpayer had a capital loss because a sale or exchange was considered to have occurred. See Blum v. Comm’r, 133 F.2d 447 (CA2 1943) (where a nominal payment by the transferee to the transferor’s lawyer resulted in a "sale", so that capital loss was recognized).
b. The Service began to contend that the difference between a foreclosure and a voluntary conveyance of a deed in lieu thereof was "too tenuous" to warrant any substantive difference in tax treatment. Priv. Ltr. Rul. 7744006 (July 5, 1977).

(1) Soon thereafter, the Service ruled that a loss on a voluntary conveyance in lieu of foreclosure was a capital loss. Rev. Rul. 78-164, 1978-1 C.B. 264.

(2) The Tax Court followed the Service's lead and held that a voluntary conveyance in lieu of foreclosure, where the debt was nonrecourse, was a "sale", so that any loss was a capital loss. Freeland v. Comm'r, 74 T.C. 970 (1980). In Freeland, the Court also stated that, to the extent prior opinions such as Commonwealth, Inc. v. Comm'r, 36 B.T.A. 850 (1937), were inconsistent with its holding in Freeland, it would "no longer adhere" to its prior opinions. See also Laport v. Comm'r, 671 F.2d 1628 (CA7 1982); and Hope v. Comm'r, 42 TCM 224 (1981).

(3) Recently, the Tax Court stated that, "[i]t is now well settled that the transfer of property by deed in lieu of foreclosure constitutes a 'sale or exchange'." Allan v. Comm'r, 86 T.C. 655 (1986). See Ebben v. Comm'r, 783 F.2d 906 (CA9 1986) (holding that a transfer of encumbered property to charity constituted a "sale or exchange" for purposes of Sec. 1011(b), I.R.C."

c. Generally, when property subject to a nonrecourse mortgage is abandoned, such abandonment will be treated as a sale or exchange. See Schmudde, Real Estate Investments: Foreclosure and Abandonment of Mortgaged Property, 3 J. Tax. Invests. 245 (1986).

(1) Under earlier law, if the taxpayer had an adjusted basis in the property exceeding the mortgage debt, then the taxpayer could recognize an ordinary loss, provided he could prove both worthlessness of equity and, by some clearly identifiable event, abandonment in the year for which the deduction was claimed. See Hoffman v. Comm'r, 40 B.T.A. 459 (1939), aff'd 117 F.2d 987 (CA2 1941); and Daily v. Comm'r, 81 T.C. 161 (1983) (where, at footnote 4, the Court noted that there would be ordinary loss on abandonment because the property was trade or business property, so that Sec. 1231, I.R.C. was applicable). See also Regs. §§1.165-2(a) and 1.167(a)-8(a)(4) (dealing with the issue of when abandonment occurs). See, generally, Cook, Abandonment of Property Can Convert Capital Loss into Ordinary Loss, 7 Tax. for Law. 168 (1978).
(2) However, current law, based on the Freeland decision, treats an abandonment as a "sale or exchange".

(a) Thus, abandonment losses will generally be capital losses. See Middleton v. Comm'r, 77 T.C. 310 (1981), aff'd 693 F.2d 124 (CAll 1982). See also Yarbrough v. Comm'r, 45 TCM 170 (1982), aff'd 732 F.2d 479 (CA5 1984) (holding that, on abandonment by a joint venture of its property, capital loss was recognized under Sec. 165(f), I.R.C.); and Arkin v. Comm'r, 76 T.C. 1048 (1981) (capital loss recognized under Sec. 165(f), I.R.C. on abandonment constitutes a "sale or exchange" for purposes of Sec. 1011(b), I.R.C.). But see Citron v. Comm'r, 97 T.C. __, No. 12 (1991) (abandonment loss resulting from a partner's renunciation of his interest in a partnership in which no liabilities existed was an ordinary loss in the year of the partnership's dissolution).

(b) Note that, as a general matter, an abandonment may be difficult to prove, in the absence of an easily ascertainable event. As an illustration, see Equity Planning Corp. and Subsidiaries v. Comm'r, 45 TCM 610 (1983) (where abandonment was found not to have occurred because the partnership continued its efforts, which eventually were successful, to retrieve value from its investment).

(c) On the other hand, see Echols v. Comm'r, 953 F.2d 703 (CA5 1991), rev'g 93 T.C. 553 (1989) (taxpayer's statement to other partner that he would make no additional capital contributions to the partnership was a "clear and unequivocal indication to [the other partner] and the world" that the taxpayer was "walking from his ownership interest").

(3) If the abandoned property is encumbered by a nonrecourse mortgage debt and the taxpayer's basis in the real property is less than the outstanding mortgage debt, the taxpayer will have gain to the extent of such difference. Because an abandonment has been held to be a "sale or exchange", such gain will be capital gain, subject, again, to the recapture rules, unless the property fails to constitute a capital asset with respect to the taxpayer.

D. **Timing of Mortgagor's Tax Consequences.**

1. A loss on foreclosure is deductible in the year in which, under state law, the taxpayer's right of redemption expires. See Derby Realty Corp. v. Comm'r, 35 B.T.A. 335 (1937).

   a. If there is no right of redemption, the deduction is taken in the year of the foreclosure sale, rather than in the year of the final decree. See Belcher v. Comm'r, 24
TCM 1 (1965). See also Priv. Ltr. Rul. 8649051 (September 10, 1986) (ruling that the foreclosure sale itself, not the decree of foreclosure that precedes the sale, fixes the time when the taxpayer recognizes gain or loss under Sec. 1001, I.R.C.).

b. In addition, if the debtor wants a deduction in the year of foreclosure and has a right of redemption, he may voluntarily quitclaim his right to the same in order to obtain the deduction. See Hill v. Comm’r, 40 B.T.A. 376 (1939).

2. If there is a voluntary conveyance in lieu of foreclosure or abandonment, the loss is taken in the year such voluntary conveyance or abandonment occurs. See Hoffman v. Comm’r, 117 F.2d 982 (CA2 1941).

IV. MORTGAGEE’S TAX CONSEQUENCES ON ACQUISITION OF THE PROPERTY.

A. Deed in Lieu of Foreclosure.

1. A mortgagee to whom property is conveyed voluntarily will recognize gain (or loss) to the extent that the transferred property’s fair market value is greater (or less) than the mortgagee’s basis for the cancelled mortgage debt. See, e.g., Henry v. U.S., 180 F. Supp. 597 (Ct. Cl. 1960).

2. The character of such gain or loss depends upon whether the mortgage debt is a capital asset in the mortgagee’s hands.

   a. Originally, the courts held that such gain or loss was ordinary in character because it was believed that no sale or exchange had occurred in the deed in lieu of foreclosure context. See Humphrey v. Comm’r, 162 F.2d 853 (CA5 1947).

   b. However, it is now clear that the transfer of property by a deed in lieu of foreclosure constitutes a sale or exchange with respect to the mortgagor. See Freeland v. Comm’r, 74 T.C. 970 (1980). See also Allan v. Comm’r, 86 T.C. 655, 659 (1986).

   c. It would certainly be incongruous, with respect to the same transaction, to treat the mortgagor as if a sale or exchange had occurred and yet treat the mortgagee as if no sale or exchange had occurred. Since it is proper to view the mortgagee as having cancelled the mortgage debt in exchange for conveyance of the property, the character of any gain or loss recognized by the mortgagee will depend upon whether the mortgage debt is a capital asset in the mortgagee’s hands. See Sec. 1221, I.R.C. See also Rev. Rul. 80-57, 1980-1 C.B. 157 (holding that a real estate investment trust had ordinary income upon the cancellation of a mortgage debt in exchange for the mortgaged
property because the mortgage debt was not a capital asset in the hands of the real estate investment trust).

B. Foreclosure.

1. If the mortgagee forecloses, and the property is sold for less than the amount of the debt, and there is an uncollectible deficiency, the mortgagee has a bad debt deduction to the extent that the basis for the debt exceeds the bid price. Reg. §1.166-6(a).

   a. There should be capital gain or loss equal to the difference between (1) the mortgagee's basis for so much of the debtor's obligations as are applied to the purchase price and (2) the fair market value of the property. Reg. §1.166-6(b). See Nichols v. Comm'r, 141 F.2d 870 (CA6 1944).

   b. But see Community Bank v. Comm'r, 62 T.C. 503 (1974) (where the Service argued that such gain was ordinary income); and Rev. Rul. 80-56, 1980-1 C.B. 154 (where the Service ruled that any gain which offsets a bad debt deduction under Reg. §1.166-6(a)(1) is taxable as ordinary income even if the mortgage note is a capital asset).

2. The fair market value for purposes of this determination is, in the absence of clear and convincing proof to the contrary, presumed to be the amount for which the property is bid in by the mortgagee. Reg. §1.166-6(b)(2).

   a. Illustrative of this point is Community Bank v. Comm'r, 62 T.C. 503 (1974), where the mortgagee foreclosed on properties on which the aggregate balance due was approximately $861,000. At the foreclosure sales, the mortgagee acquired such properties for an aggregate cost of $371,000. The mortgagee claimed a bad debt deduction of $490,000, the difference between the basis for the debt and the bid price.

      (1) The Service argued that the mortgagee had gain to the extent of the differential between the fair market value and the bid price.

      (2) The Court held, however, that there was no gain realized by the mortgagee because the bid price was presumed equal to the fair market value, inasmuch as the Service presented "no evidence to indicate that the presumption does not apply." Community Bank v. Comm'r, 62 T.C. 503, 507-8 (1974). But see Rev. Rul. 72-238, 1972-1 C.B. 65 (where the fair market value was held to be in excess of the bid price where so determined by qualified appraisers). See also Community Bank v. Comm'r, 79 T.C. 789 (1982) (holding that the Service may seek to
rebut the presumption that fair market value is equal to the bid price).

3. Where the mortgagee forecloses, but a third party purchases the property at the foreclosure sale, the difference between the purchase price and the basis may be allowable as an ordinary loss deduction, rather than as a capital loss. See Havemeyer v. Comm'r, 45 B.T.A. 329 (1941). See also Reg. §1.166-6(a)(1).

4. If the mortgagee is entitled to a bad debt deduction, such deduction is allowable in the year of worthlessness. Regs. §§1.166-6, 1.166-3.

   a. Accordingly, such debt becomes worthless in the year of the foreclosure sale.

   b. However, if there is a right of redemption, the bad debt is not deductible until the year in which the sale becomes absolute and indefeasible. But see Securities Mortgage Co. v. Comm'r, 58 T.C. 667 (1972) (where the bad debt was held deductible in the year of foreclosure even though there was a right of redemption because in economic reality there was no chance that the redemption rights could be exercised by anyone holding an interest adverse to the mortgagee).

   c. If the property is transferred voluntarily to the mortgagee, then the loss is deductible in the year of the transfer.

C. Exception for Seller Reacquisitions under Sec. 1038.

1. Generally, when a purchaser under a purchase money mortgage defaults, the seller, either by foreclosure or by voluntary conveyance of a deed in lieu of foreclosure, reacquires the property formerly owned. In situations where the value of the real property at the time of the reacquisition is greater than the seller's adjusted basis for the mortgage debt in default, Sec. 1038, I.R.C. determines the tax consequences.

2. Sec. 1038 was spurred by the belief that it was inequitable to tax the seller when he was really in no better position to pay tax after the foreclosure than before. S. Rep. No. 1361, 88th Cong., 2d Sess. (1964), found at 1964-2 C.B. 828-835.

   a. Instead of the repossession of the property being treated as a second sale of the property back to its original holder, it was viewed by Congress as more desirable to consider instead that the first sale had been nullified and to limit the gain upon reacquisition to the payments actually

b. The rationale behind Sec. 1038 is that to tax the seller at reacquisition would have undesirable results. For example, if the property has increased in value, any tax imposed would be a tax on a gain not yet realized; on the other hand, if the property has decreased in value, any tax imposed would be a tax on a gain which might never be realized.

3. In general, Sec. 1038 applies where a sale of real property results in seller acceptance of a promissory note from the buyer which is secured by the real property sold, and the seller subsequently reacquires such real property in partial or full satisfaction of such indebtedness. Sec. 1038(a), I.R.C.; Reg. §1.1038-1(a). In such cases, generally no gain or loss (which, but for Sec. 1038, would be measured, in accordance with Sec. 1001, I.R.C., by the difference between the fair market value of the property and the seller's basis in the indebtedness) will result to the seller on such reacquisition. Sec. 1038(a), I.R.C.; Reg. §1.1038-1(a).

4. Several overriding concepts are to be found under the umbrella of this general rule.

a. Sec. 1038 applies only to real property, and not to personal property. Sec. 1038(a), I.R.C.; Reg. §1.1038-1(a)(1). See Held v. U.S., 75-2 U.S.T.C. ¶9,678 (D. Ala. 1975), where the Court found that Sec. 1038 was not applicable because corporate stock rather than real property had been sold. See also Rev. Rul. 86-120, 1986-2 C.B. 145, holding that Sec. 1038 did not apply to a shareholder who received an installment obligation from a corporation in a Sec. 337 liquidation when that shareholder, upon buyer's default, subsequently received the real property used to secure the obligation, because the liquidated corporation, not the former shareholder, was the seller of the real property for purposes of Sec. 1038.

b. Thus, if the property sold included elements of both real property and personal property, it would be necessary, upon reacquisition, to separate both the basis of the personal property sold and the value of the personal property reacquired, for there would be gain or loss resulting, under the general income tax rules noted above, with respect to such personalty.

c. A sale may occur even though title to the property has not passed to the purchaser.

(1) A sale will be considered to have occurred if the purchaser has contractual rights to retain pos-
session of the property, so long as it performs its obligations under the contract, and to obtain title upon completion of such obligations. Reg. §1.1038-1(a)(2)(i).

(2) Moreover, a sale may have occurred even if the purchaser does not have the right to possession until he partially or fully satisfies the terms of the contract. For example, if the seller contracts to sell property to the purchaser, and under the contract the purchaser is to take possession of the property when 10 percent of the purchase price is paid, but is not to receive legal title until the full purchase price is paid, a sale is considered to have occurred on the date of the contract. Reg. §1.1038-1(a)(2)(i).

(3) While a "sale" may be deemed to have occurred for purposes of Sec. 1038, I.R.C., the date of the contract may not be the date that the holding period of the property is considered to have commenced for capital gains purposes, if the purchaser did not take on the burdens and benefits with respect to the property on that date. See Rev. Rul. 54-607, 1954-1 C.B. 177. See also Hoven v. Comm’r, 56 T.C. 50 (1971); and Borrelli v. Comm’r, 31 TCM 876 (1972).

d. A disposition of real property which constitutes an exchange of property will not be considered a sale. Reg. §1.1038-1(a)(2)(i).

(1) Sec. 1038, I.R.C. does not apply to a transaction treated as a sale under Sec. 121(d)(4) or 1034(i), I.R.C.

(2) Nor does Sec. 1038 apply to a sale of stock in a cooperative housing corporation described in Sec. 121 (d)(3) or 1034(f), I.R.C.

e. There must have been debt secured by the property sold.

(1) This means that the seller must have the right to take title or possession of the property, or both, if there is a default with respect to the debt. Reg. §1.1038-1(a)(2)(ii).

(2) However, there is no requirement that the purchaser have any personal liability on the debt; rather, the seller may be "limited in his recourse to the property for payment of the indebtedness in the case of default." Reg. §1.1038-1(a)(2)(ii).

5. Originally, the Service interpreted the word "seller" as used in Sec. 1038(a)(2) to mean that the original
seller would be the only party who could reacquire the property and receive the favorable treatment of Sec. 1038. See Rev. Rul. 69-83, 1969-1 C.B. 202, where the Service rejected the applicability of Sec. 1038, I.R.C. to a decedent’s estate because the original seller died between the time of the sale and the time of voluntary reconveyance of the property in lieu of foreclosure.

a. In 1980 Congress, by enacting Sec. 1038(g), extended the availability of Sec. 1038 to the estate or beneficiary of a deceased seller.

b. Under Sec. 1038(g), I.R.C., this is only the case where there is an installment obligation to which Sec. 691(a)(4)(B), I.R.C. applies.

c. The basis of the reacquired property is increased by an amount equal to the Sec. 691(c) deduction that would have been allowable with respect to the gain on the exchange of the obligation for the real property. Sec. 1038(g)(2), I.R.C.

6. The reacquisition must be in partial or full satisfaction of the debt. "That is, the reacquisition must be in furtherance of the seller’s security rights in the property with respect to indebtedness to him that arose at the time of the sale." Reg. §1.1038-1(a)(3)(i).

7. The manner in which the seller reacquires the real property is generally immaterial. Reg. §1.1038-1(a)(3)(ii). The property may be acquired either by agreement or by process of law. Reg. §1.1038-1(a)(3)(ii).

8. There is no requirement that the property be reacquired from the original purchaser, inasmuch as no mention is made in Sec. 1038(a) of the "purchaser". Therefore, the property may be reacquired from the purchaser’s assignee or transferee or from a trustee holding title to the property pending the purchaser’s satisfaction of the terms of the sales contract or purchase money indebtedness, so long as, in any such event, the debt partially or completely satisfied in the reacquisition arose in the original sale and was secured by the property reacquired. Reg. §1.1038-1(a)(4).

9. Sec. 1038 is mandatory. Reg. §1.1038-1(a)(1).

a. As to the election to apply Sec. 1038, I.R.C. to certain taxable years beginning after December 31, 1957, but before September 3, 1964, see Reg. §1.1038-3.
b. If the requirements of Sec. 1038(a) are met, then Sec. 1038 will automatically be applicable to the reacquisition of the security property by the seller on the cancellation of the debt. It is irrelevant whether the seller realized a gain or a loss on the sale, or even whether it could be ascertained at the time of the sale if gain or loss would result from the sale.

10. While Secs. 1038(b) and 1038(d), I.R.C. set forth the rules as to the recognition of gain in certain situations, Sec. 1038(a), I.R.C. specifically provides that under no circumstances will any loss be recognized where Sec. 1038 is applicable. Thus, if it is desirable for the seller to recognize a loss, one or more of the requirements of Sec. 1038 must be broken. See Hassan v. Comm’r, 63 T.C. 175 (1974).

11. An exception is made to the general rule of nonrecognition, based on the fact that when a reacquiring seller has received payments prior to his reacquisition of the property, requiring the seller to recognize gain would not result in hardship since he is in a better position, both economically and to pay tax, than he was before the reacquisition.

a. Thus, if the seller received part payment on the selling price prior to the reacquisition, which was in excess of the gain reported, tax is imposed at the time of reacquisition. Reg. §1.1038-1(a)(1).

b. This would occur if the sale were reported on the installment method or on the deferred-payment method.

c. Sec. 1038(b)(2) places a ceiling on the amount of taxable gain as a result of reacquisition.

(1) In no event is the gain attributable to payments received before repossession to exceed:

(a) The potential gain attributable to the initial sale (that is, the amount by which the selling price of the real property exceeded its adjusted basis in the hands of the seller), reduced by

(b) The sum of (i) any amounts received before repossession already reported as income (payments by the buyer on a mortgage or other debt to which the property was subject when acquired by the buyer are considered received by the reacquiring seller before repossession pursuant to Reg. §1.1038-1(b)(2)(i)) and (ii) the amount of money and the fair market value of other property (except purchase money obligations of the purchaser) paid or transferred by the seller in connection with the reacquisition. Regs. §§1.1038-1(b) and (c).
d. In determining the potential gain attributable to the initial sale, the gross selling price is reduced by selling commissions, legal fees and other expenses incident to the sale. Sec. 1038(b)(2), I.R.C.; and Reg. §1.1038-1(c)(3). See also Cramer v. Comm'’r, 55 T.C. 1125 (1971). But see Greene v. Comm’r, 76 T.C. 1018 (1981) (taxpayer not entitled to reduce capital gain by unpaid sales commissions and selling expenses incurred at the time of the original sale).

e. EXAMPLE: Assume that the seller sold for $300,000 an unencumbered property with an adjusted basis of $200,000. Also assume that the purchaser paid for the property by giving the seller $30,000 cash and executing a note in the seller’s favor for $270,000. The note was payable in nine equal annual installments, together with interest on the unpaid principal balance at 10%. Furthermore, assume that the installment method of reporting applies; the purchaser defaults on the note after making two annual payments; the seller reacquires the property by voluntary conveyance in lieu of foreclosure; and the seller pays $20,000 in connection with the reacquisition. Upon sale, the seller has a realized, but not recognized, gain of $100,000 ($300,000 selling price less $200,000 adjusted basis). Also prior to the reacquisition the seller has, excluding interest on the installment note, received $90,000 in cash (the initial $30,000 and two annual payments of $30,000 each) from the purchaser and recognized $30,000 of income ($90,000 received times one-third, the percentage of gain inherent in each installment receipt). Upon reacquisition, the seller’s gain is limited to $50,000 (initial sales price, $300,000, less initial adjusted basis, $200,000, previously reported gain, $30,000, and money paid in connection with reacquisition, $20,000). Thus, this limitation of gain rule takes into account both the original gain realized upon the sale and the costs associated with the reacquisition.

12. In many situations, the purchase money mortgage debt will not be the only encumbrance on the property. For example, at the time of the sale the purchase money mortgage may have been subordinated to a newly placed first mortgage debt to an institutional lender. When the property is reacquired, and such first mortgage is assumed or taken subject to by the seller, the unpaid balance of the first mortgage, so long as the first mortgage did not arise when the seller owned the property, will be treated as money paid by the seller on the reacquisition, thereby increasing basis. Reg. §1.1038-1(c)(4)(ii). See, generally, Keatinge and Roche, The Silver Lining in the Wraparound Mortgage Rule -- Free Basis on Foreclosure under Section 1038, 64 Taxes 505 (1986).
13. The rules governing the basis to the seller of the reacquired property are designed to provide the symmetry typical of nonrecognition provisions.

a. The basis is adjusted so that gain or loss not currently recognized on the disposition of the purchase obligation is recognized on later disposition of the reacquired property.

b. This is accomplished by requiring that the reacquired property take a substitute basis — namely, the basis for the purchase money obligation. See Anderson v. Comm’r, 64 T.C. 560 (1975).

c. To prevent double taxation, this substituted basis is then increased to reflect the gain reported on the reacquisition and any money or other property, at its fair market value, paid by the reacquiring seller. Sec. 1038(c), I.R.C.; Reg. §1.1038-1(g)(1).

14. The Regulations, pointing out that the reacquisition is "in a sense considered a nullification of the original sale of the real property" (Reg. §1.1038-1(g)(3)), provide for the tacking of holding periods.

a. The holding period for the reacquired property is therefore deemed to include the period during which the seller held it prior to the original sale.

b. However, the holding period does not include the period between the date of the original sale and the date of the reacquisition. Reg. §1.1038-1(g)(3).

c. If the purchaser made improvements to the property, the reacquisition produces two holding periods for the seller.

(1) Tacking is permitted for the portion of the property not improved by the purchaser; however, the holding period of the improved portion is not tacked but is limited to the period beginning with the date of reacquisition. See Smith v. Comm’r, 58 T.C. 874 (1972).

(2) See also Conners v. Comm’r, 88 T.C. 541 (1987), where the Service permitted improvements to be reacquired by the taxpayers without gain by reason of Sec. 1038, I.R.C., but noted that the improvements would have a zero basis in their hands, as well as a separate and new holding period.
(3) A separate holding period for improvements would also be required if they were constructed by the seller after the reacquisition.

15. The Code does not specify whether gain resulting from a reacquisition is capital gain or ordinary income. The Regulations fill this gap with complex and somewhat illogical rules, as follows:

a. If the original sale was reported under the installment method, then the character of the gain is capital if the property is a capital asset or used in the taxpayer's trade or business. Reg. §1.1038-1(d).

b. If the original sale was reported as a deferred-payment sale, the character of the gain is artificially made to depend on whether title was transferred.

(1) On the one hand, if the seller retained title, the gain is capital gain.

(2) On the other hand, if title was transferred to the purchaser and there is a voluntary reconveyance, the gain is taxed as ordinary income if the purchaser was an individual, but as capital gain if the purchaser was a corporation whose obligations are satisfied by the reacquisition of corporate securities. Reg. §1.1038-1(d).

16. No bad debt deduction is allowed as a result of the reacquisition. Reg. §1.1038-1(f)(1).

a. Moreover, if the seller claimed a deduction for the complete or partial worthlessness of the purchaser's obligation prior to the reacquisition, the deduction must be "reversed" upon the reacquisition.

b. Under Sec. 1038(d), I.R.C. the seller realizes income on the reacquisition equal to the amount of the prior bad debt deduction, and the adjusted basis of the indebtedness is increased, as of the date of reacquisition, by a like amount. Reg. §1.1038-1(f)(2).

c. However, the taxability of the restored income is limited by the "tax benefit" rule of Sec. 111, I.R.C. Reg. §1.1038-1(f)(2).

17. Finally, if the property sold was the seller's principal residence, gain on the sale may have been avoided by a timely replacement (Sec. 1038(e)(1)(A), I.R.C.; Reg. §1.1038-2) or gain may have been excluded, even without a replacement, if
the seller was 55 years of age or older. Sec. 1038(e)(1)(B), I.R.C.

a. The relief provisions providing for such nonrecognition will be overridden under Sec. 1038(e), I.R.C. unless the seller resells the property within one year after the reacquisition. Reg. §1.1038-2(a)(1). See, generally, Burke and Friel, Reacquisitions of Seller-Financed Real Property: Evaluating Section 1038, 13 Rev. Tax. Indivs. 107 (1989).

b. If the residence is resold within the one-year period, the resale basically receives the same treatment as the original sale, with corresponding adjustments to the adjusted sales price and basis to account for the effect of the prior sale and reacquisition. Reg. §1.1038-2. See also Lohman v. Comm'r, 56 TCM 1600 (1989), wherein a taxpayer who sold a ground lease to a subtenant was required to add rental payments made on behalf of the subtenant to his adjusted basis for purposes of calculating potential gain on the resale of the lease. The court rejected the taxpayer's position that such lease payments were deductible under Sec. 212, I.R.C. as an ordinary and necessary expense incurred for the conservation of an income-producing property.

D. Exception for Rescission of the Transaction.

1. If the reacquisition is in the same year as the sale, and no consideration is paid by the purchaser, it may be possible to treat the reacquisition as a rescission of the prior sale. The Service has ruled that the rescission of a prior sale during the same taxable year negates the original sale, so that no gain or loss is realized. See Priv. Ltr. Rul. 7802003 (September 28, 1977). See also Rev. Rul. 80-58, 1980-1 C.B. 181; and Branum v. Campbell, 211 F.2d 147 (CA5 1954), holding that a sale of a partnership interest was taxable, even though the interest was repurchased in the year of sale (however, note that the taxpayer did not argue that the transaction had been rescinded).

2. The Service has also ruled that a rescission in a later year is a realization transaction. See Priv. Ltr. Rul. 8210015 (November 23, 1981).

E. Reporting Requirements upon Reacquisition by Mortgagee.

1. A mortgagor which reacquires property in satisfaction of any indebtedness thereon is required to file IRS Form 1099-A in the year the transfer takes place. Sec. 6050J, I.R.C. The information contained on Form 1099-A includes the classification of the debt as recourse or nonrecourse and, if recourse, the portion that is allocable to the "sale element" of
the transaction and the portion allocable to the "debt cancellation element".

2. The penalty for failure to file Form 1099-A is $50 for each return. See Sec. 6721, I.R.C.

V. SPECIAL TAX ISSUES IN RESTRUCTURING REAL ESTATE PARTNERSHIPS.

A. Reduction or Other Modification of Partnership Indebtedness.

1. Unless otherwise excepted, a partnership will recognize cancellation of indebtedness income upon the reduction or other material modification of partnership indebtedness. Sec. 61(a)(12), I.R.C.

2. As with other partnership items, discharge of indebtedness income is generally allocated to the partners in accordance with the allocation provisions set forth in the partnership agreement, provided such allocation has "substantial economic effect". Sec. 704(b), I.R.C.; Reg. §1.704-1(b).

   a. If the cancellation of indebtedness income is allocated to the partners in the same ratio as the discharged debt is shared under Sec. 752, I.R.C., any increase in a partner’s basis from the allocation of such income would be offset by a corresponding deemed distribution under Sec. 752(b), I.R.C. Secs. 705(a)(1) and 752(b), I.R.C. See S. Rep. No. 1035, 96th Cong., 2d Sess., at 21 (1980).

   b. However, in the case of partnership recourse debt, differences may arise if the partnership cancellation of indebtedness income is allocated under Sec. 704(b), I.R.C. in a manner different from the percentages in which partners share debt. [Note, partnership recourse debt is allocated to the partners who bear "economic risk of loss", as set forth in Prop. Reg. §1.752-2(a).]

   (1) As a result of any such allocation, a partner without economic risk of loss with respect to the debt, and therefore lacking basis therein, may recognize phantom income.

   (2) Simultaneously, a partner bearing economic risk of loss on discharged debt may recognize gain under Sec. 731(a)(1), I.R.C. to the extent that the Sec. 752 deemed distribution exceeds his share of partnership discharge of indebtedness income.
3. The provisions of Secs. 108(a), (b) and (g), I.R.C. regarding cancellation of indebtedness income are applied at the partner level rather than at the partnership level. Sec. 108(d)(6), I.R.C., overruling Stackhouse v. Comm'r, 441 F.2d 465 (CA5 1971) (which held that the discharge of partnership indebtedness resulted in a decrease in partnership liabilities under Sec. 752(b), I.R.C., rather than partnership income). (See Newman Estate v. Comm'r, 934 F.2d 426 (CA2 1991), rev'g 59 TCM 543 (1990), under which the Court applied the insolvency exception at the partnership level with respect to partnership cancellation of indebtedness income which arose prior to the enactment of the Bankruptcy Tax Act of 1980.)

a. Income from the discharge of partnership indebtedness is allocated to the partners as a separate item under Sec. 702(a), I.R.C. to allow each partner to apply the provisions of Sec. 108, I.R.C. separately at the partner level.

b. The bankruptcy or insolvency of the partnership does not allow a partner which is both solvent and outside Title 11 to exclude its pro rata share of the partnership's discharge of indebtedness income.

c. It is unclear whether certain exceptions to the recognition of discharge of indebtedness income under Sec. 108, I.R.C. should be applied at the partnership or partner level, including the purchase money debt exception (Sec. 108(e)(5), I.R.C.) and the lost deduction exception (Sec. 108(e)(2), I.R.C.). See, generally, Mason, Resnick & Smith, Restructuring of Partnership Debt Need Not Result in Income Recognition, 74 J. Tax. 312 (May 1991); and Sheffield & Maynes, Selected Tax Issues in Partnership Debt Restructurings, 68 Taxes 861 (December 1990).

(1) If the exceptions are applied at the partnership level, the partnership would recognize no discharge of indebtedness income. However, the decrease in each partner's share of partnership liabilities would produce a deemed Sec. 752(b) distribution which could ultimately create phantom income for the partners. See Priv. Ltr. Rul. 8429001 (March 12, 1984) (the Service applied the purchase money debt exception at the partnership level).

(2) If the exceptions are applied at the partner level, the partnership's discharge of indebtedness income would be allocated to the partners, who would then apply the exception individually. This treatment would allow each partner to increase his basis to the extent of the income allocated and thereby avoid phantom income. See Newman Estate v. Comm'r, 934 F.2d 426 (CA2 1991), rev'g 59 TCM 543 (1990).
B. Admission of New Money Partner.

1. The admission of a new partner with fresh capital to pay down or eliminate existing partnership debt typically requires an adjustment of profit and loss percentages and other partnership items through an amendment to the partnership agreement.

2. The tax implications of admitting a new money partner depend on a number of factors, including whether the new capital will be used to repay existing partnership debt rather than for another partnership purpose and whether such debt is recourse or nonrecourse.

   a. If the existing partnership debt is nonrecourse and all or any portion thereof is repaid, the existing partners may be required to recognize gain to the extent of any deemed distributions in excess of their basis. Secs. 731(a)(1) and 752(b), I.R.C.; and Prop. Reg. §1.752-2(f). See also Rev. Rul. 84-102, 1984-2 C.B. 119.

   b. In addition to the Sec. 752 deemed distribution, the reduction of the partnership nonrecourse debt may cause a "minimum gain chargeback" to the existing partners.

      (1) Generally, a "minimum gain chargeback" is an allocation of income or gain to a partner to the extent of the greater of his share of any net decrease in "partnership minimum gain" or the deficit balance in such partner’s capital account. Reg. §1.704-1T(b)(iv)(e).

      (2) For this purpose, "partnership minimum gain" is defined, with respect to each nonrecourse liability, as the amount of gain which would be realized by the partnership if it disposed of partnership property encumbered by the nonrecourse liability. Reg. §1.704-1T(b)(iv)(c).

   c. In order to avoid the allocation of partnership minimum gain to the existing partners, the partnership may elect to revalue the partnership assets to account for any differences between tax basis and book value of such property. Sec. 704(c), I.R.C.

      (1) The "book-up" treats the book basis of the partnership assets as being at least equal to the nonrecourse indebtedness securing such property and, therefore, any partnership minimum gain prior to the revaluation would be reduced to zero. Reg. §1.704-1(b)(2)(iv)(f).
(2) Furthermore, by restating the capital accounts of the existing partners to zero, any minimum gain chargeback to them can be avoided.

d. If the partnership elects not to book-up its assets upon admitting a new partner and does not reduce the partnership debt, the tax consequences would be beneficial to the existing partners and detrimental to the new money partner.

(1) With respect to the existing partners, any minimum gain attributable thereto would remain intact and thereby avoid any minimum gain chargeback. Also, the existing partners may avoid the recognition of gain under Sec. 731(a)(1), I.R.C.

(2) With respect to the new money partner, allocations of partnership taxable income (loss) may be greater (less) than if the partnership had revalued its assets.

C. Admission of Lender as Partner.

1. Generally, the exchange of partnership debt for an interest in the partnership appears to be nontaxable to both the creditor partner and the partnership.


   b. The creditor partner would receive a basis in his partnership interest equal to his basis in the debt contributed. Sec. 722, I.R.C.

2. The exchange or contribution of a nonrecourse loan by a partnership creditor may have an adverse impact on the existing partners.

   a. Upon the admission of a new partner, the profit and loss allocation percentages would require adjustment, which could result in deemed distributions to the existing partners in excess of basis and the recognition of taxable gain. Secs. 731(a)(1) and 752(b), I.R.C.

   b. Based on the nonrecourse nature of the loan, minimum gain would be decreased, thereby triggering minimum gain chargeback and the existing partners would be allocated income to
eliminate their negative capital accounts. Reg. §1.704-1T(b)(4)(iv)(e)(2).

c. A nonrecourse debt contributed by the lender in exchange for a partnership interest would be recharacterized as "partner nonrecourse debt" for which only the lender would bear economic risk of loss. See Reg. §1.704-1T(b)(4)(iv)(k)(4)

(1) All deductions and other tax incidents attributable to the partner nonrecourse debt would be allocated to the lender partner, which could result in deemed distributions to the existing partners. Sec. 752(b), I.R.C.; and Reg. §1.704-1T(b)(4)(iv)(h).

(2) As an exception, under Prop. Regs. §§1-752-2(d)(1) and (2), the nonrecourse debt contributed by the lender partner would retain its nonrecourse character if the lender partner’s interest in each item of income, gain, loss or deduction is ten percent (10%) or less and the loan constitutes qualified nonrecourse financing under Sec. 465(b)(6), I.R.C. See Prop. Reg. §1.752-2(f), Example 5.