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Publisher/Editor
Robert P. Achenbach, Jr.
Contributing Editor
Dr. Neil E. Harl, Esq.

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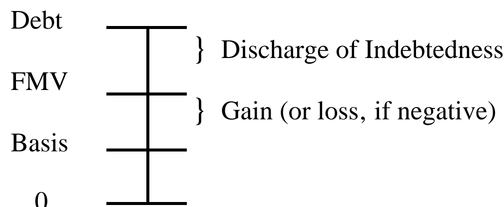
GAIN ON FORECLOSURE OF PROPERTY

— by Neil E. Harl*

A 1998 Tax Court case has focused attention once again on the income tax consequences of mortgage foreclosure transactions.[1] Although the courts have not been entirely consistent in handling the calculation of gain or loss and any discharge of indebtedness income,[2] the rules governing recourse debt have been interpreted fairly consistently in recent years.[3]

Rules governing recourse debt

For recourse debt, the rules governing foreclosure transactions or conveyance of property to the creditor in satisfaction of the debt are fairly straightforward—(1) the difference between the fair market value (or foreclosure sale price) and the adjusted income tax basis is gain or loss, taxable as capital gain or ordinary income, as the case may be,[4] and (2) the difference between the fair market value of the property and the amount of indebtedness discharged is discharge of indebtedness income.[5] Thus, the transaction can be portrayed as follows—



Emmons v. Comm'r

In the 1998 Tax Court case of *Emmons v. Commissioner*,[6] the taxpayers lost two tracts of rental real property through foreclosure—the "Honore" property and the "Campbell" property. The Honore property had an adjusted basis of $32,963 and a mortgage of $43,356 and was sold at the foreclosure sale for $54,435.[7] The Campbell property had an adjusted basis of $84,459 and a mortgage of $88,491 and was foreclosed and sold for $106,620.[8] Thus, the relevant information on the properties may be portrayed as follows—

Honore		Campbell	
FMV	54,435	FMV	106,620
Debt	43,356	Debt	88,491
Basis	32,963	Basis	84,459

Ordinarily, it would be expected that, for the Honore property, the difference between the basis and fair market value ($54,435—$32,963) or $21,472 would be

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* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

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taxed as gain to the taxpayer. The debt ($43,356) would be paid off and the difference between the debt and fair market value or $11,079 would be paid to the debtor less any expenses involved. For the Campbell property, the usual outcome would be for the difference between the basis and fair market value ($106,620—$84,459) or $22,161 to be taxed as gain to the taxpayer. The debt ($88,491) would be paid off and the difference between the debt and fair market value or $18,129 would be paid to the debtor, again less any expenses involved.

The opinion in *Emmons v. Commissioner*[9] recites that indeed the mortgages were paid off on the respective properties but that the debtor did not receive the excess of fair market value over the mortgage on either property. The opinion states that "petitioners did not receive any other amounts from the sale" on either the Honore property or the Campbell property.

It is not clear from the opinion why the debtor did not receive the overplus from the foreclosure sale. Presumably, it was because other creditors laid claim to the proceeds although other explanations are possible.

The Commissioner, properly, determined that the taxpayers had long-term capital gains in the amount of $43,633, computed as the difference between the total sale price of both sales ($161,055) and the taxpayers' total adjusted basis in both properties ($117,422).[10] At the trial, the Commissioner "…conceded $29,208 of the $43,633 adjustment for capital gains, and now contends that petitioners only had gain of $14,425, which is the difference between their total adjusted basis in the two properties ($117,422) and the combined mortgage liabilities from which they were relieved ($131,847)."[11] The taxpayers continued to claim they had no gain because they did not receive any proceeds from the foreclosure sales.[12]

The Tax Court held that the taxpayers had gain of $14,425, the extent to which the mortgages exceeded their basis in the properties.[13]

Was the case correctly decided?

There is no doubt that the taxpayers had gain to the extent the mortgages exceeded their bases in the two properties. The question is why the taxpayers did not have gain of $43,633, the difference between the foreclosure sale price and the adjusted basis on each of the two properties.

• If the taxpayers' other creditors laid claim to the balance of the foreclosure proceeds, that should not affect the gain to the taxpayers of $43,633. The other debt was simply paid off with the foreclosure sale proceeds in a manner similar to the mortgages on the two rental properties.

• If the taxpayers, through inattention or otherwise, did not collect the overplus, that arguably should not affect the amount of gain, either. Depending upon the circumstances, the taxpayers might have a deduction for the amount reported into income yet not received.

The case may have been correctly decided but the decision raises questions for which answers are not provided. Most importantly, why did the Commissioner concede the gain of $29,208?

FOOTNOTES

1 Emmons v. Comm'r, T.C. Memo. 1998-173. See generally 4 Harl, *Agricultural Law* § 39.02 (1997); Harl, *Agricultural Law Manual* § 4.02[13] (1998). See also Harl, "Gain From Insolvent Taxpayers," 6 *Agric. L. Dig.* 97 (1995); Harl, "Turn Over of Assets to Creditors," 1 *Agric. L. Dig.* 69 (1990).

2 See Rev. Rul. 73-36, 1973-1 C.B. 372 (capital loss measured by difference between basis and amount of cancelled obligation).

3 See, e.g., Gehl v. Comm'r, 102 T.C. 784 (1984), *aff'd*, 95-1 U.S. Tax Cas. (CCH) ¶ 50,191 (8th Cir. 1995) (excess of fair market value of property over basis was gain for insolvent taxpayer).

4 Treas. Reg. § 1.1001-2 (c), Ex. 8. See, e.g., Bressi v. Comm'r, T.C. Memo. 1991-651.

5 *Id.* See I.R.C. § 108.

6 T.C. Memo. 1998-173.

7 *Id.*

8 *Id.*

9 T.C. Memo. 1998-173.

10 *Id.*

11 *Id.*

12 *Id.*

13 *Id.*

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ANIMALS

DOGS. The plaintiff's cattle were killed by a dog belonging to the defendant who admitted liability for the loss of the cattle. The issue was whether the plaintiff could be awarded double damages (limited to double the value of the livestock) under Or. Rev. Stat. § 609.140(1), since the action was brought more than three years after the loss of the cattle. The plaintiff argued that the double damage provision was compensatory and not subject to the three year statute of limitations applied to penalty damages under Or. Rev. Stat. § 12.100(2). The court examined the legislative history of the double damages provision and held that the legislature intended the double damages to be only compensatory; therefore, the plaintiff could be awarded double the value of the livestock in an action brought more than three years after the loss involved. **Diaz v. Coyle, 953 P.2d 773 (Or. Ct. App. 1998)**.