9 T.C. 320 (1947)

A taxpayer can realize a taxable gain when property acquired in a tax-free exchange, subject to a mortgage, is foreclosed, even if the taxpayer is not personally liable on the mortgage, to the extent the mortgage exceeds the adjusted basis.

Summary

Mendham Corporation acquired property from its parent corporation, River Park, in a tax-free exchange, subject to a mortgage. River Park had previously taken out the mortgage and received the proceeds. When the mortgage was foreclosed, the Tax Court held that Mendham realized a taxable gain to the extent the mortgage exceeded the adjusted basis of the property, even though Mendham was not personally liable on the mortgage. The court reasoned that because the original transaction was tax-free, the gain from the mortgage needed to be accounted for at some point, and the foreclosure was the event that triggered the recognition of that gain.

Facts

River Park Corporation purchased property in 1927 for $231,502.16. In 1928, River Park borrowed $325,000, secured by a mortgage on the property, and used the funds for various purposes, including paying off an old mortgage, making improvements, and holding cash. In 1932, River Park transferred the property to Mendham Corporation in a tax-free exchange, with Mendham taking the property subject to the mortgage but not assuming personal liability. Mendham took depreciation deductions on the property. In 1939, the mortgagee foreclosed on the property.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Mendham’s income tax and declared value excess profits tax for the taxable year ended December 31, 1939. Mendham petitioned the Tax Court, contesting the Commissioner’s determination that it realized a taxable gain upon the foreclosure of the property.

Issue(s)

Whether the amount due on a mortgage constitutes “property (other than money)” received by the taxpayer in computing the “amount realized” under Internal Revenue Code section 111 when the taxpayer acquired the realty in a tax-free exchange subject to the mortgage, and the mortgagee foreclosed the mortgage and bought in at the foreclosure sale.

Holding

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Yes, because the court reasoned that the foreclosure of the mortgage resulted in the elimination of a debt, which ultimately resulted in a taxable gain to the taxpayer, to the extent that proceeds of the mortgage received by the transferor-mortgagor exceeded adjusted basis for the property, even though petitioner was not itself liable on the mortgage.

Court's Reasoning

The Tax Court relied on the principles established in *Lutz & Schramm Co.* and *R. O'Dell & Sons Co.*, which held that the disposition of property subject to a mortgage can result in a taxable gain, even if the taxpayer is not personally liable on the mortgage. The court reasoned that because the initial transfer of the property from River Park to Mendham was a tax-free exchange, the tax consequences of the mortgage were not triggered at that time. However, when the property was foreclosed upon, the mortgage debt was eliminated, and the taxpayer realized the benefit of the original mortgage proceeds received by River Park. The court stated that "it is petitioner's disposition of the property, and its elimination of the mortgage debt, which concludes the operation instituted by its predecessor and furnishes the occasion for a survey of the results of the entire transaction." The court also noted that the depreciation deductions taken by Mendham (based on River Park's original basis) reduced the adjusted basis of the property, further increasing the gain realized on the foreclosure. The court distinguished *Charles L. Nutter*, noting that unlike *Nutter*, the mortgage was not a purchase money mortgage and resulted in an ultimate cash benefit to the mortgagor.

Practical Implications

This case illustrates that a taxpayer can realize a taxable gain on the disposition of property subject to a mortgage, even if the taxpayer is not personally liable for the debt. This is particularly relevant in situations involving tax-free exchanges or corporate reorganizations where liabilities are transferred along with assets. Attorneys should advise clients who are acquiring property subject to debt to consider the potential tax implications of a future disposition of the property, especially if the debt exceeds the adjusted basis. This case also highlights the importance of tracking depreciation deductions, as they can significantly impact the amount of gain realized on a disposition. Later cases have cited *Mendham* to support the principle that liabilities assumed or taken subject to in a transaction can be treated as part of the amount realized for tax purposes.

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