***16 T.C. 960 (1951)***

When a taxpayer acquires property from a mortgagor via deed in lieu of foreclosure, the basis for calculating gain or loss upon a subsequent sale of the property is the fair market value of the property at the time it was acquired, adjusted for depreciation.

**Summary**

Achilles Kohn received a mortgage as a gift in 1930. In 1935, the mortgagor deeded the property to Kohn in exchange for his agreement to pay the property's back taxes. The original mortgagor remained personally liable on the mortgage. When Kohn sold the property in 1944, he claimed a loss using his donor's original mortgage loan amount as his basis. The Tax Court held that Kohn's basis was the fair market value of the property when he acquired it in 1935, adjusted for depreciation. This case clarifies how to determine the basis of property acquired through a mortgage agreement when the original debt is not fully extinguished.

**Facts**

On December 12, 1930, Achilles Kohn received a bond and mortgage as a gift from his mother. The mortgage secured a $12,000 loan she had made to Beilin Service Corporation for property located at 2240 Cedar Avenue, Bronx, New York.
On June 12, 1935, Beilin Service Corporation deeded the property to Kohn. In exchange, Kohn agreed to pay the $1,303.94 in back taxes owed on the property. The mortgagor was allowed to continue occupying the premises at a rental of $35 per month.
The conveyance of the property to Kohn did not release Beilin Service Corporation from its obligation on the original bond and mortgage. The deed specifically stated that the mortgage was not intended to merge with the fee.
The parties stipulated that the bond and mortgage had a value of $12,000 when acquired by Kohn and that the property had a net value of $10,000 when deeded to Kohn in 1935.
On November 9, 1944, Kohn sold the property for $7,000 ($2,500 cash and $4,500 by reducing the existing mortgage). Kohn incurred $552.75 in broker's commissions and other expenses, resulting in net proceeds of $6,447.25.

**Procedural History**

The Commissioner of Internal Revenue determined a deficiency in Kohn's 1944 income tax. Kohn petitioned the Tax Court contesting the deficiency. The Tax Court addressed the basis for calculating gain or loss on the sale of the real estate, an issue not resolved by stipulation. The Tax Court ruled in favor of the Commissioner.

**Issue(s)**

Whether the basis for computing loss on the sale of property acquired from a

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mortgagor via deed, where the original mortgage obligation was not extinguished, is the fair market value of the property at the time of acquisition, adjusted for depreciation; or the donor's original loan amount plus taxes and expenses.

**Holding**

No, because when a taxpayer acquires property securing a mortgage loan, the basis for computing gain or loss upon a subsequent sale of the property is its fair market value when so acquired, adjusted to the date of sale.

**Court's Reasoning**

The court reasoned that when a taxpayer acquires property via mortgage foreclosure or voluntary conveyance, they reduce the indebtedness by the property's fair market value. The balance of the mortgage indebtedness can be charged off as a bad debt if uncollectible. The basis for computing gain or loss on a later sale is the fair market value when acquired, adjusted for depreciation. The court cited *Bingham v. Commissioner*, 105 F.2d 971, *Commissioner v. Spreckels*, 120 F.2d 517, and *John H. Wood Co.*, 46 B.T.A. 895.
Kohn argued that this rule doesn't apply because the mortgage obligation wasn't satisfied when he acquired the property. The court rejected this argument, stating that the unsatisfied portion of the mortgage remains an unsecured debt of the mortgagor, deductible as a bad debt only when it becomes worthless under Section 23(k)(1) of the Internal Revenue Code. The court found no evidence showing when the debt became worthless, and Kohn didn't claim a bad debt deduction. The court sustained the Commissioner's adjustment.

**Practical Implications**

This case provides clarity on determining the basis of property acquired through mortgage-related transactions. It reinforces that the fair market value at the time of acquisition, not the original mortgage amount, is the relevant basis for calculating gain or loss upon subsequent sale. Legal professionals must understand that even if the original debt isn't fully extinguished, the taxpayer's basis is still the fair market value at the time of acquisition. The unsatisfied debt may be treated as a bad debt, deductible only when proven worthless, and requires adherence to the specific rules for bad debt deductions under the Internal Revenue Code. This ruling impacts how tax advisors counsel clients in similar situations, influencing tax planning and reporting strategies.

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