Gateway Motor Inn, Inc. v. Commissioner, 53 T. C. 30 (1969)

When a corporation acquires property subject to debt, the basis for depreciation includes the amount of the debt up to the fair market value of the property.

Summary

Gateway Motor Inn, Inc. purchased a motel from a bankrupt estate for $25,000, subject to secured debts. The key issue was determining Gateway's basis for depreciation. The court held that the basis included the purchase price plus the amount of the first lien debt up to the property's fair market value of $333,800. The second lien debt, deemed worthless, was excluded from the basis. This ruling clarified how secured debts affect the basis for depreciation in property acquisitions from bankruptcy estates.

Facts

Lincoln Enterprises, Inc. constructed a motel but faced financial difficulties. Palpar, Inc. , and Mike-Pol Construction Co. , Inc. held first and second lien notes, respectively, on the motel. Lincoln filed for bankruptcy, and Gateway Motor Inn, Inc. , controlled by Sidney Cohn, purchased the motel from the bankruptcy trustee for $25,000, subject to the existing secured debts. The first lien notes amounted to $333,800, and the second lien notes to $173,962. Gateway claimed a depreciation basis equal to the purchase price plus the full amount of both sets of notes.

Procedural History

The Tax Court consolidated cases involving Gateway's tax liabilities for the years 1961-1964 and Palpar's tax liabilities for the years 1959-1961. The IRS challenged Gateway's depreciation basis and Palpar's treatment of payments received on the notes as returns of capital. The court's decision focused on determining the proper basis for depreciation and the tax treatment of the payments received by Palpar.

Issue(s)

1. Whether Gateway's basis for depreciation of the motel should include the amount of the secured debts held by Palpar and Mike-Pol.
2. Whether payments received by Palpar on the notes from Lincoln should be treated as returns of capital or as income.

Holding

1. Yes, because the basis for depreciation includes the purchase price plus the amount of the first lien debt up to the fair market value of the property, but excludes the second lien debt deemed worthless.
2. No, because the payments received by Palpar on the notes were partly interest income, not solely returns of capital.

Court’s Reasoning

The court applied the Crane v. Commissioner rule, which states that the basis for depreciation includes the amount of secured debt up to the fair market value of the property. The court determined that the fair market value of the motel was $333,800, equal to the first lien notes held by Palpar. The second lien notes held by Mike-Pol were deemed worthless and excluded from the basis. The court reasoned that including worthless debt would inflate the basis for tax purposes, citing Burr Oaks Corporation v. Commissioner. Regarding Palpar’s tax treatment, the court found that the payments received on the notes included interest income, as the security for the notes was adequate, distinguishing this case from Wingate E. Underhill and Morton Liftin. The court rejected the IRS’s argument that Palpar should be treated as having foreclosed on the property, as this was inconsistent with the facts.

Practical Implications

This decision clarifies that when acquiring property subject to debt, the basis for depreciation includes the debt up to the property’s fair market value. Attorneys should carefully assess the value of secured debts when determining a client’s depreciation basis. The ruling also emphasizes the importance of properly characterizing payments received on notes as either returns of capital or income, based on the adequacy of the underlying security. This case may impact how businesses structure acquisitions from bankruptcy estates and how they report income from debt instruments. Subsequent cases, such as Imperial Car Distributors, Inc. v. Commissioner, have applied similar principles in determining basis when a corporate purchaser takes property subject to debt.

