Lockwood v. Commissioner, 90 T. C. 323 (1988)

Abandonment of depreciable property encumbered by nonrecourse debt constitutes an exchange, and the loss is calculated by subtracting the remaining principal of the extinguished debt from the adjusted basis of the property.

Summary

In Lockwood v. Commissioner, the Tax Court addressed the tax implications of abandoning depreciable property (master recordings) encumbered by nonrecourse debt. The taxpayer, Lockwood, purchased five master recordings and later abandoned them, storing them in a closet where they were damaged. The court held that this abandonment constituted an exchange, allowing Lockwood to recognize a loss equal to the adjusted basis of the recordings minus the extinguished nonrecourse debt. This case clarified that abandonment of property subject to nonrecourse debt should be treated as an exchange, impacting how losses are calculated for tax purposes.

Facts

Frank S. Lockwood, operating as FSL Enterprises, purchased five master recordings from HNH Records Inc. for $175,000, financed partly by nonrecourse promissory notes totaling $146,848. These notes were payable solely from the proceeds of the recordings' exploitation. After unsuccessful attempts to market the recordings, Lockwood abandoned them in 1979 by storing them in a closet without climate control, leading to their physical deterioration. Lockwood then claimed a retirement deduction for the full adjusted basis of the recordings, which included the nonrecourse debt.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Lockwood's income tax for 1979 and 1980, contesting the deduction for the retirement of the master recordings. Lockwood petitioned the Tax Court, where the parties stipulated that the initial basis included the nonrecourse debt and that the notes represented bona fide debt. The court focused on whether the abandonment of the recordings constituted a retirement and how to calculate the resulting loss.

Issue(s)

1. Whether Lockwood's abandonment of the master recordings in 1979 constituted a retirement by physical abandonment under section 1. 167(a)-8(a)(4), Income Tax Regs.
2. If so, whether the loss from this retirement should be calculated by subtracting the remaining principal of the nonrecourse debt from the adjusted basis of the recordings.

Holding

1. Yes, because Lockwood's act of storing the recordings in a closet without proper care constituted physical abandonment, effectively discarding the recordings.
2. Yes, because the abandonment of property subject to nonrecourse debt is treated as an exchange, and the loss is calculated as the adjusted basis minus the extinguished debt, resulting in a recognizable loss of $11,819.

Court's Reasoning

The court applied the rules of section 1. 167(a)-8, Income Tax Regs. , which govern losses from the retirement of depreciable property. It determined that Lockwood's abandonment of the recordings in a manner that assured their destruction qualified as "actual physical abandonment" under section 1. 167(a)-8(a)(4). The court further reasoned that the abandonment of property encumbered by nonrecourse debt should be treated as an exchange, relying on precedent from Middleton v. Commissioner and Yarbro v. Commissioner. This treatment was justified because Lockwood relinquished legal title to the recordings and was relieved of the nonrecourse debt obligation. The court calculated the loss by subtracting the remaining principal of the nonrecourse debt ($105,431) from the adjusted basis of the recordings ($117,250), resulting in a recognizable loss of $11,819. The court rejected the Commissioner's argument that the abandonment canceled the notes, as there was no agreed reduction in the purchase price.

Practical Implications

This decision has significant implications for how losses are calculated when depreciable property subject to nonrecourse debt is abandoned. Taxpayers must recognize that such abandonment is treated as an exchange, and the loss calculation must account for the extinguished debt. This ruling affects tax planning for businesses dealing with depreciable assets financed through nonrecourse loans, as it clarifies the tax treatment of abandoning such assets. Subsequent cases have followed this precedent, ensuring consistent application of the exchange treatment for abandoned property with nonrecourse debt. Attorneys should advise clients to carefully consider the storage and treatment of depreciable assets to avoid unintended tax consequences.

