

Appeal of Roger and Harriet Cunningham

In March 1954, after continued unsuccessful operation appellants transferred the property by delivery of a quit claim deed, to the original seller and consequently were relieved of the total \$1, 500,000 liability.

Appellants have submitted a statement of financial condition as of the transfer date in 1954, showing assets of \$101,759. Among the assets listed was "Land in Coal Creek Drainage & Levy Dist. Cost \$15,000." The Coal Creek property was sold in 1956 for \$101,120. Liabilities listed totaled \$123,400, including an item listed as "Delinquent taxes claimed \$78,000."

Depreciation of \$377,692 was deducted by appellants while they had the property. The amount of appellants' income and deductions other than depreciation was such that only \$191,091 of the claimed depreciation resulted *in* reduction of taxes.

Respondent concluded that the reconveyance was a taxable transfer, that the amount realized was the cancelled indebtedness of \$1,500,000 and that the adjusted cost basis was \$1,005,215 (\$1,382,907, less depreciation claimed, \$377,692), resulting in a gain of \$494,785.

The issues are whether the reconveyance was a taxable transfer and if so, whether the amount computed as taxable gain was excessive.

Appellants contend (1) that they were, in effect, merely given an option to purchase which was not exercised; (2) that, if they are regarded as purchasers, they derived no gain because their quit claim of the property constituted an abandonment and the cancellation of their indebtedness constituted a reduction of the purchase price; (3) that there was no consideration for the \$250,000 note and therefore no taxable income from its cancellation; (4) that even if taxable income would have otherwise resulted, none resulted here because appellants were insolvent before and after the cancellation; and (5) that, in any event, the basis of the property for the purpose of computing gain should have been reduced only to the extent of depreciation deductions which resulted in a tax benefit.

While appellants assert they were merely given an option to purchase which was not exercised, the record in this appeal does not support their assertion. The facts disclose a purchase pursuant to a down payment and the execution of a promissory note secured by a trust deed. Appellants treated the property as *their own* on their books, depreciated it on the basis of their cost and negotiated a loan secured by the property. All these facts clearly support the existence of a purchase.

Appeal of Roger and Harriet Cunningham

During the year in question, section 17651 (now 18031) of the Revenue and Taxation Code provided that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis. Whether or not the quit claim conveyance back to the original seller was a sale, it was nevertheless a disposition within the meaning of section 17651, (Parker v. Delaney, 186 F.2d 45 cert. denied, 341 U.S. 926 [95 L.Ed. 1357].) Furthermore, the amount realized from the disposition included the amount of the encumbrance for the balance of the purchase price, at least if the property's fair market value equalled or exceeded that encumbrance at the time of the disposition. (Parker v. Delaney, supra.)

Appellants rely upon a principle established in Hirsch v. Commissioner, 115 F.2d 656. In that case it was held that where the market value of property fell below the amount of the obligation for the balance of the purchase price the cancellation of part of the obligation was a nontaxable reduction of the purchase price of the property which was retained by the purchaser. This principle was applied in Charles L. Witter, 7 T. C. 480, to a situation where the debtor conveyed encumbered property to his creditor in discharge of his obligation secured by the property. Without raising all of the possible distinctions from the facts before us, it is sufficient to note that each of those cases, and others which have followed the same principle, is marked by the fact that the market value of the property had fallen below the obligation for the purchase price.

Although appellants maintain that at the time of their reconveyance the fair market value of the property was less than the balance due on the purchase price, they have not established that fact. It is true that the relatively small down payment lends some credence to their view, but on the other hand, the fact that appellants were able to use the property as security for a substantial loan is some indication that the fair market value exceeded the obligation for the balance of the purchase price. Respondent's finding of fair market value is entitled to a presumption of correctness and appellants have not overcome the presumption.

In addition to the obligation for the balance of the purchase price, the obligation to repay the loan of \$250,000 was also cancelled upon the reconveyance of the property. Contrary to appellants' contention, they did receive consideration for that loan. They directly received \$20,000 and the remainder was used to pay liabilities incurred in operating the Club Del Mar, thus preventing the closing of the club and a threatened foreclosure on the first trust deed. These elements lead to the conclusion that valuable and bargained for consideration was received. The sum of \$250,000

Appeal of Roger and Harriet Cunningham

constituted realized gain upon the reconveyance, irrespective of the fair market value of the property. (Jantz & Schramm Co. 1 T.C. 682; Woodsam Associates v. Commissioner, 198 F.2d

Citing cases such as Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F.2d 95, appellants also contend that even if taxable income would have otherwise resulted, it did not result here because appellants were insolvent before and after the cancellation of indebtedness. Assuming, without deciding, that appellants' solvency or insolvency is relevant here, the statement of financial condition submitted by them does not establish that they were insolvent. The asset figures submitted were apparently based on cost. The figure given for one asset, for example, was \$15,000, but the asset was sold two years later for \$101,120. Since fair market value, not cost, is determinative in establishing insolvency, the submitted asset figures cannot be relied upon. It is also questionable whether a liability listed for "delinquent taxes claimed" represented a fixed liability of appellants. We must conclude that insufficient evidence has been presented to show insolvency.

Finally, appellants argue that the basis of the property for the purpose of computing gain on the reconveyance should have been reduced only to the extent of depreciation deductions that resulted in a tax benefit. During the period in question, section 17783 (now 18052) of the Revenue and Taxation Code provided that:

Proper adjustment in **respect** of the property shall in all cases be made for exhaustion, wear and tear, obsolescence, amortization and depletion, to the extent sustained prior to January 1, 1935, and for periods thereafter to the extent allowed (but not less than the amount allowable) under this part .

There is no contention or evidence that the depreciation allowed was less than the amount allowable. The basis of property must be reduced by depreciation allowable, regardless of whether the allowable depreciation results in a tax benefit (William R. Collins, 18 T.C. 99 ; Mae E. Townsend, 27 T.C. 99 .)

Upon the record before us, therefore, appellants' argument is not supported.

Having carefully examined all of appellants' contentions, we find no ground for reversing or modifying respondent's action.

