Loan proceeds are generally not income because of the offsetting obligation to repay the loan (there has been no accession to wealth). Also, repayment of the loan principal is not deductible because the loan proceeds were not included in income (exclusion when borrowed and deduction when repaid would result in a double tax benefit). The exclusion for loan proceeds assumes that the borrower will repay the loan. If that assumption turns out to be false, the borrower will have cancellation of indebtedness income.

But loan proceeds, even though not included in income, can create basis. If you buy property for 10K of cash, your basis will be 10K. If you borrow 5K from the bank and use 5K of your own money to buy property, your basis will still be 10K. This is also the result if you borrow from the seller (aka "seller financed sale"). Thus, if you give the seller 5K and the seller takes back a mortgage of 5K on the property, your basis will also be 10K.

Finally, suppose the property has a FMV of 10K and is subject to a mortgage of 5K. If you were to purchase the property "subject to" the mortgage, you would pay the seller only 5K in cash, but your basis would include the debt, so your basis would be 10K. This scenario is economically equivalent to the previous two and the debt is thus included in basis. These results are the same whether the debt is recourse or nonrecourse and were confirmed in Crane v. CIR, 331 US 1 (1947).

Remember, however, that after-acquired debt (for example, you take out a second mortgage on your house and buy a car) does not increase the basis of property securing the debt because the dollars the borrower receive have their own basis and will create basis in the property purchased with those dollars. (Obviously if you use the debt to improve the property, the property's basis will also increase.)

Now, let's look at the effects of debt on the seller. Assume that the property you purchased has increased in value from 10K to 12K but is still subject to a 5K mortgage. Buyer comes along and offers to pay you 7K and take the property subject to the 5K mortgage. The property has increased in value by 2K, so your gain should only be 2K. To get this result, debt relief (the buyer promising to become liable on the mortgage) is considered to be part of amount realized: your amount realized is the 7K of cash plus 5K of relief of debt benefit thereby resulting in a gain of 2K. In essence, a purchase for 7K in cash and assumption of the 5K of mortgage can be thought of as a purchase for 12K in cash and the seller using 5K to repay the mortgage. You are relieved from the obligation to repay the debt so you have received an economic benefit of that amount.

The Crane case held that this was the result whether the debt was recourse or nonrecourse (if the NR debt didn't exceed the value of the property). The Crane court said that as long the NR debt was less than the value of the property, both buyer and seller would treat it as recourse, that is, it would be paid off in order protect any equity in the property.

CIR v. Tufts, 461 US 300 (1983), held that when a person transfers property subject to a NR mortgage, amount realized includes the entire amount of the NR mortgage, regardless whether it exceeds the value of the property (and wouldn't be paid off by a rationale seller). If the debt is recourse and exceeds the value of the property, and the property is transferred to a creditor in satisfaction of the liability (e.g., property FMV = 5K and recourse debt = 7K and property transferred to creditor in satisfaction of debt), the amount realized is only the FMV of the property (producing capital G/L depending on the property's basis) and the excess is cancellation of indebtedness income (producing ordinary income). See Reg. 1.1001-2(c), Ex. 8.