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Louis A. Del Cotto  
*University at Buffalo School of Law*

Kenneth F. Joyce  
*University at Buffalo School of Law*

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Inherited Excess Mortgage Property: Death and the Inherited Tax Shelter

LOUIS A. DEL COTTO AND KENNETH F. JOYCE *

Introduction

This article is concerned with the federal tax effect of a decedent dying holding property which is subject to a mortgage in excess of its adjusted basis. The enactment of the carryover basis provisions of section 1023 and the related provisions of section 1040 as part of the 1976 Tax Reform Act 1 has caused speculation on whether gain will be recognized to the decedent, or to his estate, or to the ultimate beneficiary of the property, in the amount of the difference between basis and liability. 2 It is our position that this speculation somewhat misconstrues the function of section 1023. More specifically, we will attempt to demonstrate that the underlying issues which arise at the death of an owner of mortgaged property are basically the same as they were before section 1023 was enacted and are, for the most part, governed by settled principles.

Our basic position can be stated:

(1) The underlying principle is that transfers effected at death should not be taxed any differently so far as the decedent-transferor is concerned than are inter vivos transfers. Any gain or loss recognized on a transfer at death should be reported on the decedent's final return.

(2) In determining whether a decedent has recognized gain or loss at death, the debts of the decedent and encumbrances on his property should be considered amounts realized, but an offset against those amounts realized should be allowed, not only for the decedent's basis in encumbered property, but also for his basis in other assets which pass at death.

(3) If a decedent does not recognize gain at death, the question

* LOUIS A. DEL COTTO and KENNETH F. JOYCE are Professors of Law, Faculty of Law and Jurisprudence, State University of New York at Buffalo.


whether the decedent’s estate or a beneficiary will be taxed depends largely upon the basis at death provisions. If the basis at death is a combination of cost under section 1012 (for encumbrances on the decedent’s property) together with carryover from the decedent, then some transferee from the decedent (estate or beneficiary) will ultimately pay the tax on any gain inherent in the decedent’s property. If, on the other hand, the basis at death is stepped up under section 1014 (or the partial step-up provisions of section 1023) then the step-up wipes out the potential gain in the decedent’s property pro tanto, so that it may completely avoid the income tax.

The overall problem of the transfer of mortgaged property at death is better seen if it is restated as a number of different problems, depending on such variations as whether the decedent consumed the mortgage benefits during his life, whether the property is the subject of a specific or residuary bequest or whether the beneficiary of the mortgaged property acquires additional property from the decedent. Before we discuss these variations, however, we will summarize our basic position on the underlying issues.

Basic Theory: Essential Identity of Lifetime Transfers and Transfers at Death

Established Law: Rules for Lifetime Transfers

Under Crane v. Commissioner, the settled general principle is that the conveyance of encumbered property is a sale, and the encumbrance is included in the transferor’s amount realized under section 1001. This principle has been extended to the part sale-part gift situation by a number of cases and rulings, including Joseph W. Johnson, which held that

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3 331 U.S. 1 (1947).

Compare with Crane and Johnson, Blumenthal v. Commissioner, 76 F.2d 507 (2d Cir.), rev’d per curiam, 296 U.S. 552 (1935), reinstating 30 B.T.A. 591 (1934), suggesting that transferor’s personal liability for the encumbrance prevents a sale unless the transferee assumes the debt. This result is contrary to what appears to be the better reasoned position of the Second Circuit Court of Appeals (the transferor lost primary liability for the debt, becoming only a surety) which was reversed by the Court on the authority of Douglas v. Willecuts, 296 U.S. 1 (1935). For a discussion of Blumenthal, see Comment, Tax Consequences of
there was a taxable sale to the extent of the encumbrance and only the equity (i.e., the excess of the value of the property over the encumbrance) was transferred by gift. One of the purposes of this principle of Crane is to recapture as gain from the sale the amount of past depreciation deductions which were taken because of inclusion of the mortgage debt in the basis for depreciation, but which were not supported by true economic cost. Unless the past depreciation is so recaptured, the conveyance of the property will shift the liability from the transferor to the transferee, and the transferor would never pay either the economic or tax cost of the benefit he received from past depreciation deductions. The second purpose of the recapture principle is similar. It taxes as gain any past borrowing on the appreciation in the property. This gain does not represent past depreciation so it will not be taxed because of prior deductions; it does, however, represent previously borrowed, and untaxed, dollars which will not be repaid by the transferor after conveyance of the property. The tax on the gain represents a delayed tax on this past borrowing.5

The effect of the Crane-Johnson rule is to create a deferred tax on past gain attributable either to tax-saving deductions without economic cost, or to tax-free borrowing on the value of property. Both types of tax benefit are given on condition that the owner of the property eventually pays the related debt. When the property is transferred subject to the debt and it becomes clear that the transferor will not pay it, he must account for his past gain.6 It should be emphasized at this point that this does not involve the taxation of unrealized appreciation, but rather the deferred taxation (i.e., recognition) of clearly realized gain (i.e., past rents or other income previously offset by depreciation deductions, or loan proceeds of a now effectively extinguished debt).

Before analyzing the operation of this rule on death transfers, let us illustrate how it operates for a lifetime transfer. Assume T owns Blackacre which has a value of $100,000, is encumbered by a mortgage of $80,000 due to T's having borrowed $80,000 on the appreciation in the property and that T's basis in Blackacre is $10,000. On a lifetime transfer by "gift," T would be taxed on $70,000 of gain because Johnson would treat the transfer as a part sale for $80,000 and a part gift of $20,000. The regulations do not use an allocated basis approach in

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5 For a discussion of the two purposes, see Del Cotto at 294–98.
computing the gain from the part sale, and so the amount realized, $80,000, is offset by the full $10,000 basis. Johnson also allowed full basis rather than allocated basis offset.

The tax on the $70,000 gain is said to be upon the gain from the sale; as noted above, it is really a deferred tax on the gain from the past borrowing, the benefit of which the transferor retains while shifting the liability to the transferee. The result to the transferor would be identical, and the reasoning would be similar, if the mortgage represented the cost of the property and $T$ had taken $70,000 of depreciation deductions. Turning to the transferee, his basis under the regulations is the higher of his cost (the amount of the mortgage) or the carryover basis from the transferor, here, $80,000. This result is in accord with sections 1012 and 1015 applied independently: The transferee has a cost of $80,000, and a carryover basis of zero, because the transferor fully utilized his basis on the part sale.

This example illustrates two basic ideas: (1) A transfer of property by gift is not a taxable event to the transferor, and so, the $20,000 of equity value is not taxed as gain. (2) No matter that the label "gift" is placed on the entire transaction, there is a sale up to the amount of the mortgage, and there is a gift only to the extent of the equity, that is, to the extent the value of the property exceeds the mortgage. Thus, the amount of the mortgage is an amount realized to the transferor under section 1001, and is cost to the transferee under section 1012. The carryover basis provisions of section 1015 apply only to the equity.

This last statement, which is crucial to our later analysis of death transfers, deserves elaboration. Suppose there were no equity in the property. Suppose, for example, the property had a fair market value of $80,000, the mortgage still being $80,000 and the transferor's basis still being $10,000. In such a case, any transfer, even an intrafamily transfer in a gift setting, would not involve a gift for tax purposes, to any extent, because there was no equity. Nothing of economic value passed gratuitously to the transferee. Such an intrafamily transfer would be

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7 Reg. § 1.1001-1(e), discussed in Del Cotto at 301–05.
8 495 F.2d at 1084–85.
9 The mortgage is allowed as basis under another aspect of Crane. Del Cotto at 294–98.
10 See, e.g., Teofilo Evangelista, 71 T.C. 1057 (1979).
11 Reg. § 1.1015–4(a). Some part of the gift tax is also added to basis under section 1015(d) and this regulation, but that addition will be ignored since it is not pertinent to our discussion.
12 Del Cotto at 301–05.
13 See, e.g., Grove v. Comm'r, 490 F.2d 241 (2d Cir. 1973). See generally Del Cotto at 299.
identical with a sale in a commercial setting, or an abandonment to the mortgagee, or a "contribution" to charity. In all cases, since the entire value of the property was subject to the lien, the transferee's basis would be a cost basis under section 1012. Notions of carryover basis under section 1015 would be completely irrelevant.

Applicability of Principles of Lifetime Transfers to Transfers at Death

Let us now turn to the case of a taxpayer who dies owning the property described in our principal example: property which is worth $100,000, subject to a mortgage of $80,000 and in which he has a basis of $10,000. For purposes of this discussion of basic theory, we will assume that the decedent has no other property in his estate (probate or non-probate), that his will leaves all of his estate to one beneficiary and that the title to the mortgaged property passes directly and immediately to the beneficiary on the decedent's death. Variations on these assumptions will be discussed in detail later.

First, we know that the transfer of property by bequest, devise or inheritance is not a taxable event to the decedent; nor is its receipt taxable to the estate. But, just as in the case of property passing by gift in a lifetime transfer, the only portion of the property passing by "bequest, devise or inheritance" at death is the equity value of $20,000, because, no matter that a label like "inheritance" is placed on the entire transaction, up to the amount of the mortgage there is a sale, and the amount of the mortgage should therefore be an amount realized to the decedent who received the fruits of the mortgage. Only in this manner can anyone be made to account for the benefit the decedent received during his life from the borrowing. The beneficiary will not (and should not) account for such benefit because, by a parity of reasoning, the amount of the mortgage is included as cost basis to the beneficiary since to the extent of the mortgage the acquisition is by purchase rather than by inheritance. Thus, the decedent would recognize $70,000 of gain at death and the beneficiary's basis would include the $80,000 mortgage. (The beneficiary's basis in the equity of $20,000 would depend on whether section 1014 or the carryover basis provisions of section 1023 applied.)

It has been suggested that these results are precluded because Con-

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15 I.R.C. § 102.
16 Crane contains the contrary implication that all of the property was acquired by inheritance. For a discussion of this point, see Del Cotto at 294–95.
gress, by enacting the carryover basis provisions of section 1023, decided against recognition of gain at death.\textsuperscript{17} The suggestion appears to be that the presence of carryover basis for the transferee indicates a congressional intent not to tax the decedent-transferor. This, of course, is the law for lifetime gifts of unencumbered property: The transferor does not recognize any appreciation in the property as gain; the transferee steps into the transferor's basis shoes by way of section 1015(a), and could eventually recognize the gain which was not taxed to the transferor. This, basically, is also the law for transfers at death of unencumbered property where section 1023 applies. This is not the law, however, for lifetime gifts of encumbered property because Crane and Johnson view the transferor as receiving consideration in the form of relief from the debt, \textit{i.e.}, as selling the property for the debt; and, to the extent of the debt, the transferee is viewed as acquiring not by gift (with a carryover basis), but by purchase (with a cost basis). Indeed, a cornerstone of the Crane rationale is that for the purposes of basis, the transferee must be treated in advance as if he paid the mortgage debt.\textsuperscript{18} Thus, the transferee is entitled to a cost basis and is prevented from being in the (carryover) basis shoes of the transferor and, since the transferee will not be taxed on the transferor's gain due to lack of a carryover basis, the transferor should be taxed, and is under Crane and Johnson. Otherwise, the gain will escape tax altogether.

So it is for lifetime transfers; so it should be for transfers at death. Whether the basis provision governing property acquired by bequest, devise or inheritance is section 1023 or section 1014, to the extent the transferee gets a cost basis for debt encumbering the transferred property, the basis will be determined under section 1012, and section 1023 or section 1014 will only apply to the equity. Hence, the tax conse-


\textsuperscript{18} The reason for giving advance credit to the transferee of mortgaged property is the unacceptability of the alternative, which would be to await actual payment before giving the transferee a cost basis. Such an alternative would, with respect to depreciable property, distort depreciation deductions by requiring a continual readjustment of basis, and, even more important, with respect to both depreciable and nondepreciable property, it would be inconsistent with the accepted rule that the proceeds of a typical loan transaction do not constitute income, it being presumed that the borrower will repay the loan. In this respect, from the point of view of a transferee, there is no economic difference between taking subject to an existing mortgage and obtaining a cost basis by discharging an existing mortgage with borrowed money. This is true, moreover, regardless of whether the transferee acquires by a lifetime transfer or a transfer at death.
quences for the decedent should be the same whether the basis provision
governing the transferee's equity is section 1014 or section 1023.

It is true that prior to the enactment of section 1023 it was generally
assumed that a transfer at death was not a taxable sale or disposition
even where the liabilities exceeded the basis of property transferred. The result of such an assumption in a case such as our hypothetical
(but, as we will see, not in all cases) was that $70,000 of gain, deferred
in the hands of the decedent, completely escaped taxation. Perhaps this
result was tolerated in view of section 1014 which permitted unrealized
gain to escape taxation. It has been suggested, in fact, that Congress—by failing to enact proposals of the Treasury in 1963 and in 1969 to undo section 1014 by taxing appreciation at death—has rejected altogether the notion of death as a taxable event for income tax purposes. As we have pointed out, however, the question we are dealing with does not involve the taxation of unrealized gain, but rather the deferred taxation of realized gain. Since the Treasury's proposals to repeal section 1014 were directed at taxing unrealized appreciation at death, the fact that Congress balked at so general a levy should not be interpreted as congressional disapproval of a tax upon a much more limited category of transactions involving gain realized by a decedent during his life. Moreover, after the enactment of the carryover basis provisions of section 1023 in 1976, there is no longer any wholesale escape of unrealized appreciation at a decedent's death. There is thus no longer even this specious argument for allowing the deferred tax on realized gain to result in complete escape at the decedent's death.

Again, the point that is critical to understand is that when mortgaged property is transferred at death, the transferee is as much entitled as a lifetime transferee to a cost basis to the extent of the mortgage. The transferee at death and the lifetime transferee are in identical economic positions vis-à-vis the mortgaged property. In terms of our hypothetical case, each has received property worth $100,000, subject to a mort-

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19 Roth at 782.
gage of $80,000, and has thus gratuitously received an equity of
$20,000. The factors which have led the courts and the Treasury to
give the transferee advance credit for payment of the mortgage debt
without differentiation to the transferee at death as well as to the life-
time transferee. They are, in fact, the same factors which apply when
there is no gratuitous transfer of the equity, either because there is no
equity or separate consideration has been given by the transferee for the
equity (for instance, a down payment).

And if, as we contend, the transferee at death must be given this cost
basis as advance credit for the payment of the mortgage, in a case like
the one in our example, the conclusion is inescapable that if the gain is
not recognized at death it will escape recognition altogether. Such an
escape would truly violate the purpose for the enactment of section 1023
and would render transfers at death more advantageous than lifetime
transfers—the very phenomenon section 1023 was designed to elimi-
nate.25

To reiterate, our basic position is twofold:

(1) The provisions for basis of property acquired from a decedent,
sections 1014 and 1023, do not speak to, or in any way affect, the
income tax consequences to a decedent who dies with excess mort-
gaged property. These income tax consequences are the same as those
upon a transfer of property during life, and are governed by the rules
of Crane and Johnson.

(2) Sections 1014 and 1023 have no application to the transferee

25 The belief has been expressed that "Congress' failure to treat excess mort-
gaged property differently from other types of appreciated property can[not] be
attributed to mere oversight. The House . . . Report . . . describes the application
of section 1023 to property subject to a non-recourse mortgage of $80,000, having
a basis of only $10,000, a classic example of excess mortgaged property." Lawyers
Association at 165–66 n.86. The example discussed in the House report, however,
merely illustrates what section 1023(g)(4) was intended to provide, i.e., that to
the extent of the mortgage the property does not bear any estate taxes and there-
fore should not share in any estate tax adjustments. H.R. REP. No. 1380, 94th
Cong., 2d Sess. 39-40 (1976). The example does not speak to the question of
whether the decedent is required to recognize any gain at death or whether the
basis of the transferee includes the amount of the mortgage. The $10,000 basis
referred to in the example discussed in the report is not the basis of the estate
or other transferee, but is rather the basis used to determine "net appreciation" which
is defined in section 1023(f)(2) as "the amount by which the fair market value
of such property exceeds the adjusted basis of such property immediately before
the death of the decedent." In short, nothing in the discussion of this example
in the House report is inconsistent with the notion that the decedent would be re-
quired to recognize gain at death, and more importantly, that the basis of the
transferee includes the amount of the mortgage under section 1012. Section 1023
(g)(4) which is the source of the House report's example, has since been repealed.
of the property, whether it is the decedent's estate or the ultimate beneficiary, to the extent such transferee takes subject to the mortgage. To this extent, the transferee acquires by purchase and not by bequest, devise or inheritance, and thus takes a cost basis in the amount of the mortgage under section 1012.

All of this is not to say, however, that a decedent who dies owning property mortgaged in excess of basis should recognize gain to the extent of such excess, or to any extent. As we trust our prior discussion has demonstrated, the death of the decedent is the appropriate time to treat him as recapturing the mortgage amount as an amount realized under section 1001. As the following discussion will demonstrate, whether the decedent recognizes any gain at death will depend upon the amount of offsetting basis he may have in both the mortgaged property and in assets other than the mortgaged property. This discussion will show that gain can be recognized by the decedent, or, where section 1023 is in effect, by the decedent's beneficiaries and, in some situations, by the decedent's estate. Finally, we shall see that a significant role can be played by the decedent's will and other estate planning instruments, and that there are planning possibilities, both pre-mortem and post-mortem.

Analysis in Detail

Lifetime Transfers

Assume that A owns Blackacre, which has a fair market value of $100,000 and a basis to A of, for the sake of simplicity, zero.

Example 1: A makes a gift of Blackacre to B. The accepted tax results of this transaction are:

1. No gain is recognized to A.
2. B's basis is zero, the carryover basis under section 1015(a), disregarding the gift tax adjustments of section 1015(d). Thus, when B sells the property, he will recognize the gain attributable to the appreciation in the hands of A, together with any appreciation taking place thereafter.

Example 2: Prior to the transfer to B, A borrows $80,000 with personal liability, giving no mortgage. A gives Blackacre to B and keeps the $80,000. The tax results are the same as for Example 1. A's borrowing has no effect on A's basis in Blackacre, which remains at zero; nor does A's borrowing affect B's basis since A's debt does not become attached to Blackacre; thus, it does not become a liability of B. With
respect to Blackacre, B's basis is a carryover basis and he stands in the shoes of A.

Example 3: On borrowing the $80,000, A gives back a mortgage on Blackacre and then transfers Blackacre to B subject to the mortgage, A keeping the $80,000. This is the Johnson situation (part sale for $80,000 and part gift of $20,000) and the tax results are:

(1) A's amount realized is $80,000 (the amount of the mortgage); his basis offset is zero and his gain is $80,000.
(2) B's basis is $80,000 (cost under section 1012) 0 (under section 1015(a)) $80,000 (total).

These tax results view A as selling the property for the amount of the mortgage in order to make him account for his past tax-free borrowing of $80,000 on the value of Blackacre, the benefit of which he will keep while shifting the liability to B. Thus, it is a deferred tax on a past economic benefit. B will not receive a carryover basis of zero, but a cost basis of $80,000 due to the presence of the mortgage on Blackacre, which it is assumed B will pay.\footnote{Del Cotto at 294–98. Compare Bittker, Tax Shelters, Nonrecourse Debt, and the Crane Case, 33 Tax L. Rev. 277 (1978).} A is treated as being relieved from the debt and pays the deferred tax on his past borrowing; B is given an advance cost basis of $80,000 and will not pay tax on A's gain when he sells Blackacre.\footnote{B's basis would also include the step up for the gift tax paid, i.e., the portion of the gift tax allocable to the appreciation in value of the gift. The value of the gift here is $20,000 and no basis should be allocated to it because A used all the basis on the sale. So the entire gift tax is allocable to appreciation in value. See I.R.C. § 1015(d); Del Cotto at 317 n.487.}

Example 4: The facts are the same as in example 3, except that A transfers to B both Blackacre (mortgaged by $80,000) and the $80,000 proceeds of the borrowing.\footnote{We assume here that the $80,000 is in the form of cash and thus clearly has a basis of $80,000. Any other property with an $80,000 basis would serve the same function as the cash in this example. It does not matter that the value of the property is less than its basis if any inherent loss in the property is deductible upon realization. For example, if A bought Whiteacre with the $80,000 cash and the value of Whiteacre fell to $70,000, the mortgage could be paid off with Whiteacre to the extent of $70,000, and the remaining $10,000 of gain from the mortgage would be offset by the $10,000 loss in the sale of Whiteacre. Of course, if the $10,000 loss is nondeductible, then $10,000 of basis in Whiteacre should be disregarded. See, e.g., Rev. Rul. 74–347, 1974–2 C.B. 26. The different consequences which would arise if the $80,000 was comprised of...} This is an uncommon transaction to take...
place during A’s lifetime. It is quite common, however, for such a transfer to take place at A’s death. Therefore, we deal with it first as a lifetime transfer to see how it is treated under established principles.

The factor differentiating this example from example 3 is that, while A has shifted the mortgage liability to B by transferring Blackacre subject to the mortgage, A has also transferred to B the “fruits” of the mortgage, the borrowed proceeds of $80,000. Unlike Crane and Johnson, where the transferor kept the fruits while shifting the liability, here A has not kept any mortgage related benefits such as cash throw-off from depreciation, or borrowed dollars. Therefore, A has no gain arising from the transaction, because he has passed to B both the liability of $80,000 plus the benefits relating to the liability, the borrowed proceeds of $80,000. There is no tax benefit to A upon which a deferred tax should be imposed.

Who then will account for A’s past tax-free borrowing? Under these facts the logical candidate is B, who stands with respect to Blackacre, the mortgage and the $80,000 of borrowed funds, exactly as did A, that is, B stands squarely in the shoes of A with respect both to the mortgage and the mortgage proceeds. Arguably, therefore, B should also stand in A’s income tax shoes and have a zero basis in Blackacre and a basis of $80,000 in the borrowed cash. Now it is B who must repay the borrowing or treat the mortgage as an amount realized on the disposition of Blackacre.29

This is exactly the result we contend for, and the mechanism used to arrive at the result is the accepted approach of Crane and Johnson. A has transferred $100,000 of overall value by gift ($80,000 cash and $20,000 equity in Blackacre) and has sold $80,000 by B assuming or taking subject to the mortgage on Blackacre.

\[
\begin{align*}
A's \ amount & \ realized \quad $80,000 \ (mortgage) \\
A's \ basis & \ offset \quad $80,000 \ (cash) \\
A's \ gain & \quad 0
\end{align*}
\]

B’s basis is $80,000, cost under section 1012 and zero carryover under section 1015(a), since A has used up his entire basis in the sale portion of the transaction.30 B’s basis of $80,000 is allocated among property with less than $80,000 of basis in A’s hands will be discussed in the analysis of transfers at death.

29 Economically, the transaction is also the same as A transferring Blackacre to B unencumbered, prior to any borrowing, and B himself borrowing the $80,000 and giving the mortgage. In that case, B would clearly have a carryover basis of zero under section 1015(a), and the mortgage would be his amount realized on any disposition of Blackacre while it was encumbered.

30 Reg. § 1.1001–1(e), discussed in Del Cotto at 301–05.
the assets received, Blackacre and the $80,000 cash. Since in this example the cash must have a full basis, the entire $80,000 is allocated to the money, and B has a zero basis in Blackacre. This is not the traditional part sale-part gift, but we see no reason why it should not be viewed in the same way as if Blackacre had a value of $180,000 and was subject to a mortgage of $80,000 and had a basis of $80,000 to A. Under Johnson, a transfer of Blackacre would be a part sale for $80,000 with a basis offset of $80,000, and a part gift of $100,000. In our example there is also a transfer of a total value of $180,000, having an overall basis of $80,000 and subject to a mortgage of $80,000. A should have gain only to the extent that the amount of the mortgage exceeds the total adjusted basis of all properties transferred.

As an economic matter, the transaction could also be viewed as a no sale-all gift transfer of an unencumbered Blackacre with no additional cash. Stated another way, this transaction is economically the same as if A paid off the mortgage with the $80,000 of cash and then transferred Blackacre unencumbered to B, who thereafter proceeded himself to borrow $80,000 giving back a mortgage on the property. If the transaction were recast in the form of these additional steps which lead to the same economic result giving the tax consequences to both A and B would be clear: A would have no gain, B's basis in Blackacre would be a carryover of zero from A and, after B borrowed $80,000, his basis in Black-

32 Therefore, on a sale by B of Blackacre, B will recognize the gain of $80,000 attributable to the mortgage proceeds. This may appear to contradict the result to B for the lifetime transfer and for example 3, where we noted that because B acquired a cost basis in the amount of the mortgage, it was necessary to tax A on the disposition of Blackacre, or no one would be taxed. In example 4, we do not tax A because of his basis offset (attributable to the cash), and we do tax B when he sells Blackacre despite his acquisition of a cost basis of $80,000. This result is entirely proper since the basis is allocated away from Blackacre, to the cash, thus, B does get the benefit of his "cost" for Blackacre, albeit it is shifted to a different asset.

To clarify this point, instead of cash, assume A transferred Whiteacre, value $80,000, basis $80,000, and unencumbered. The results are the same for A; B again has $80,000 of cost due to the mortgage on Blackacre; we could attribute that entirely to Blackacre, leaving Whiteacre with a carryover basis of zero. Now B would recognize the $80,000 gain on the sale of Whiteacre. Or, we could allocate the $80,000 basis between Blackacre and Whiteacre according to their respective values. Then the gain would be wholly recognized only when both assets were sold. The point is that however B's cost for Blackacre is allocated, he does receive the benefit of that cost in some asset. In our example, it is reflected in the cash due to the necessity for the cash to have a full basis.

33 The statutory analog for this result is section 357(c); Reg. § 1.357-2(a). Section 357(c) is merely an application of section 1001 (and section 61) in limitation of the anti-Hendler and anti-Crane principle of section 357(a). In other
acre would remain at zero and his basis in the borrowed cash would be $80,000. These should also be the results if in one step A transfers to B both the cash that he borrowed plus the encumbered property.\textsuperscript{34}

Transfers at Death

Again, let us assume that \( A \) owns Blackacre which has a fair market value of $100,000 and a basis to \( A \) of zero.

Example 5: \( A \) dies owning only Blackacre unencumbered. The tax results on the transfer of Blackacre at \( A \)'s death are:

1. No gain is recognized to \( A \) or to \( A \)'s transferee.\textsuperscript{35}
2. The basis of \( A \)'s transferee in Blackacre will be $100,000 under section 1014, or zero under section 1023 (disregarding adjustments).\textsuperscript{36}

words, section 357(a) is the exception to the Crane-Hendler rule that the amount realized on transfer of encumbered property is treated as the receipt of so much cash. Section 357(c) reinstates that rule for encumbrances in excess of aggregated basis.

\textsuperscript{34} This approach also eliminates problems in computing the step-up in basis in Blackacre for any gift tax paid by \( A \). Under section 1015(d)(6), \( B \) is entitled to a step up for the gift tax paid which is attributable to the net appreciation in value of the gift, \( i.e. \), the excess of the value of the gift, here, $100,000 over the transferor's allocable basis immediately before the gift. I.R.C. § 1015(d)(6)(B). Viewing all the property as a single unit, value $180,000, basis $80,000, the gift portion of $100,000 could be argued to have an allocable basis of $45,000 (100/180 \times $80,000), thus, a net appreciation in value of $55,000. But this statutory formula fails to take into account that in a part gift-part sale transaction the regulations and cases allocate the entire basis of $80,000 to the portion of the property sold, and none to the gift portion of $100,000. Consistently, therefore, the gift portion should have a basis of zero for the purpose of determining the net appreciation under section 1015(d)(6)(B). Thus, the net appreciation would be $100,000 and \( B \) would receive a step-up in basis for the entire gift tax paid. If, for example, we assume that the gift tax paid by \( A \) was $10,000, then \( B \) would have an overall basis of $90,000, allocable $80,000 to the cash and $10,000 to Blackacre. This desired consistency would be achieved if, as we have stated in the text, the one-step transaction where \( A \) transfers $80,000 of cash plus an encumbered Blackacre is seen as being the economic equivalent of, and therefore demanding the same tax consequences as, the multistep transaction where \( A \) first pays off the mortgage with $80,000 of cash and then transfers an unencumbered Blackacre to \( B \) who thereafter himself borrows $80,000 giving a mortgage on Blackacre.

\textsuperscript{35} It is unnecessary at this point to discuss whether \( A \)'s transferee is \( A \)'s estate, or some other ultimate beneficiary such as a beneficiary under \( A \)'s will or an intestate distributee. All transferees would be entitled to exclude any gain as a "bequest, devise or inheritance" under section 102(a).

\textsuperscript{36} Again, it is unnecessary at this point to identify the transferee of Blackacre as being the estate or the ultimate testate or intestate beneficiary, because the concept of "uniform basis" renders the basis the same in the hands of any transferee who acquires property from a decedent under section 1014 or section 1023. Reg. § 1.1014–4(a). Any adjustments made under section 1023, such as for "fresh
Example 6: Prior to his death, A borrows $80,000 and gives back a mortgage on Blackacre. At his death, A's only assets and liabilities consist of Blackacre, value of $100,000, encumbered by the $80,000 mortgage. The tax consequences at A's death should be similar to those for example 3, where A deeded Blackacre to B during life and retained the $80,000 mortgage proceeds. A's amount realized at the time of his death is $80,000, the amount of the mortgage; his basis is zero, thus, his gain recognized is $80,000.

The basis of the transferee is

\[
\begin{align*}
&\text{\$80,000 (cost under section 1012)} \\
&\text{\$20,000 (step-up under section 1014)} \\
&\text{\$100,000 (total)} \\
&\text{or} \\
&\text{\$80,000 (cost)} \\
&\text{0 (carryover under section 1023)} \\
&\text{\$80,000 (total)}.
\end{align*}
\]

This view of the tax consequences treats A at death exactly as Johnson treats him when he makes the part sale-part gift transfer during life, as in example 3. Once he is relieved of the debt by the transfer, there is a sale in the amount of the debt and he must account for the $80,000 of gain he consumed during his lifetime. There is thus imposed a deferred tax on A's past economic benefit. The lifetime part sale-part gift translates to a part sale-part bequest and Crane and Johnson should apply to A.

By a parity of reasoning, the transferee at death acquires a cost basis of $80,000 by receiving advance credit for payment of the mortgage. As previously discussed, there is no reason for the treatment of the transferee at death to be different, with respect to the liability, from the treatment of the lifetime transferee under Johnson. Although the Supreme Court, in interpreting the predecessor to section 1014, said in Crane that the transferee's basis was the fair market value of the property undiminished by the mortgage, the rest of the Court's reasoning belies this conclusion and points to section 1012 as giving a cost basis for

start,” or estate taxes paid, will eliminate part of the appreciation in Blackacre and, to the extent of the adjustments, will have the same step-up effect as section 1014.

Again, there is no necessity at this point to identify the particular transferee as being the estate of A, or the testamentary or intestate beneficiary of A, since the basis effects of sections 1012, 1014 and 1023 will apply equally to any transferee who takes subject to the mortgage and acquires the property by “bequest, devise or inheritance.”
the mortgage. Later cases construing Crane support this conclusion.

Returning to A, why should we consider a transfer at death a taxable event? And, assuming it is, why tax the decedent on his final return rather than his estate or someone else, such as the ultimate beneficiary?

On the question of whether a transfer at death is a taxable event, we are faced with what appears to be a general understanding of the law prior to the Tax Reform Act of 1976, that the presence of a section 1014 step up prevented the decedent (and his transferee) from ever being taxed on decedent’s lifetime gain; there is also the belief that the enactment of section 1023 may allow taxation of the gain to the transferee, assuming its provisions will become effective in the future. Let us just stress again our position that the presence of a basis at death provision, whether it be section 1014 or section 1023, affects the basis of decedent's transferee only for the equity portion of the transfer, i.e., the portion received by bequest, devise or inheritance; but such provisions have no application to the encumbered portion of the transferred property, either for the decedent or the transferee.

As for taxing the decedent on his final return, we contend he is a transferor within Johnson, and that he (in his final return) is the one who must account for the gain arising from the debt from which he is effectively discharged on transfer of the property, since he is the one who realized and benefitted from the gain during his life—his death being the only occasion for a deferred tax on his lifetime gain. The presence of the carryover basis provision of section 1023 is irrelevant because the transferee will take the encumbrance as cost, and carryover basis applies

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38 Del Cotto at 294–95.
39 Ibid. See also Del Cotto, Basis and Amount Realized under Crane: A Current View of Some Tax Effects in Mortgage Financing, 118 U. Pa. L. Rev. 69, 72–75 (1969). This result at death is specifically allowed by section 1.742–1 of the regulations, which provides that the basis of a partnership interest acquired from a decedent is its fair market value, increased by the estate’s share of partnership liabilities. Example 2 of section 1.743–1 (b) of the regulations makes it clear that “net” fair market value is intended. The same analysis should apply to encumbered property which is not a partnership interest.
40 Compare text accompanying Ns. 16–19 supra.
41 Compare Revenue Ruling 77–402, 1977–2 C.B. 222, where release of taxable powers in a grantor trust was held to be a sale by the grantor of the partnership interest held by the trust, and his share of partnership liabilities was part of his amount realized. The ruling states, “[w]hen a transfer of an interest in a partnership occurs and the transferor's share of partnership liabilities is reduced or eliminated, the transferor is treated as having sold the partnership interest for an amount equal to the share of liabilities reduced or eliminated.” See also Revenue Ruling 75–194, 1975–1 C.B. 80, which describes the income tax consequences of a transfer to a charity of a limited partnership interest. The limited partners' share of the liabilities was an amount realized on a sale and only the equity value was a gift. Accord, Rev. Rul. 70–626, 1970–2 C.B. 158.
only to the equity in the property. Similarly, the section 1014 step up does not apply to the decedent; nor should it apply to the full value of the property in the hands of the transferee since payment of the mortgage gives cost basis in that amount, with only the equity value being subject to section 1014. Indeed, it is important again to stress this: Unless we treat the mortgage as an amount realized in a taxable exchange at death, no one will pay the tax on decedent's past gain of $80,000 because his transferee will get a cost basis for the $80,000 mortgage.

It has been suggested that even if gain is recognized at the decedent's death, it might be taxed to the estate as section 691 income in respect of the decedent. See generally Brode, Tax Shelter Problem Areas, 54 Taxes 306 (1976); Ginsburg, The Leaky Tax Shelter, 53 Taxes 719, 737-39 (1975) (herein cited as Ginsburg); Ferguson, Freeland & Stephens, Federal Income Taxation of Estates and Beneficiaries 231-40 (1970). Receivables owned by a decedent which arise from his performance of services or sale of goods would clearly be subject to section 691 treatment at his death, so it is not surprising that the portion of a partnership interest attributable to such receivables of a partnership receive a section 691 taint under the above provisions. Panel Discussion, Handling the Problems of the Tax Shelter That Has Crossed the Line, 34 N.Y.U. Inst. 397, 424-28 (1976), and authorities cited therein. The same treatment for partnership recapture gain would be somewhat surprising in view of the fact that recapture property of nonpartner decedents is eligible for basis step up under section 1014, or upward basis adjustments under section 1023, because neither section 1014(c) nor section 1023(b)(2)(A) invokes section 691 treatment. I.R.C. §§ 1245(b)(2), 1250(d)(2); Reg. §§ 1.1245-2(c)(1)(iv), 1.1245-4(b), 1.1250-3(b)(2). Indeed, in light of these regulations, it is arguable that the partnership provisions on recapture property were intended to apply only to lifetime transfers in order to prevent capital gain for such recapture on the disposition of a partnership interest, and were not intended to negative the general rule for death transfers which allows the basis at death provisions of the Code to
debt, there would be no reason to defer the tax on the loan and the tax would be imposed on the loan proceeds despite a legal obligation to repay.\textsuperscript{44}

An analogy from section 1033 may be helpful. Suppose a decedent who has received the proceeds of an involuntary conversion determines to replace the converted property but dies before actually purchasing the replacement property. If the decedent's plan is carried out by his executor within the permissible section 1033 period, no gain is recognized.\textsuperscript{45} If the replacement does not take place within the permissible period, however, the gain must be reported, and it must be reported on the decedent's return, since it is the decedent who realized the gain during his life.\textsuperscript{46} So also in our case, the decedent is allowed (by virtue of administrative and judicial decision) to exclude a receipt from income on the supposition that the receipt will be repaid and that the receipt


The more important point to be made here is that any such recapture gain can be taxed to the recipient under section 691 only if it is the gain of the recipient. If the property is unencumbered and is sold for cash by the recipient, then he is simply placed in decedent's shoes with respect to the gain. But if the property is encumbered and the related proceeds flowing from the encumbrance are not received by the transferee, as in our example 6, then it is decedent who consumed the gain during his lifetime and his death should be a taxable event. Indeed, in such a case, up to the amount of the mortgage there is simply no gain to the transferee upon which he could be taxed. In that amount, he will receive nothing of value which would be gain; and in any event he has a cost basis in that amount were the mortgage to be treated as an amount realized to him, so he cannot be taxed on decedent's gain. This conclusion that the decedent is taxed is supported by the regulations on depreciation recapture which state that the section 1245 (b)(2) (and section 1250(d)(2)) exemption from recapture for "transfers at death" does not apply where the transferee takes a cost basis under section 1012, as distinguished from a date of death basis under section 1014 (or section 1023). Reg. §§ 1.1245-4(b), 1.1250-3(b).

\textsuperscript{44} See, e.g., Fairchild v. Comm'r, 462 F.2d 462 (3d Cir. 1972).
\textsuperscript{45} In re Goodman's Estate, 199 F.2d 895 (3d Cir. 1952); Estate of Morris, 55 T.C. 636 (1971), aff'd per curiam, 454 F.2d 208 (4th Cir. 1972); Estate of Gregg, 69 T.C. 468 (1977); Chichester v. United States, 78–1 U.S.T.C. ¶ 9458 (D. Ala. 1978).
\textsuperscript{46} The return on which the gain must be reported is for the year during the decedent's life when the gain was realized, i.e., the year when the proceeds of the conversion were received. Reg. § 1.1033(a)–2(c)(2). In our case, it would be more accurate to open up the decedent's previous return or returns, but there is no statutory authority for this, and without statutory authority an analogy to the tax benefit cases supports the decedent's final return as the proper one. Compare Perry v. United States, 160 F. Supp. 270 (Ct. Cl. 1958), with Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967).
and repayment considered together will give rise to no gain. If the repayment does not take place, however, the receipt is what is being taxed and that receipt took place during the decedent's lifetime.

Revenue Ruling 78–292 presents an interesting contrast. There, the decedent's estate received reimbursement for medical expenses paid by the decedent. These expenses had been deducted on the decedent's return and, although reimbursement was due to the decedent under the policy, the decedent died before receiving the proceeds. The ruling held that the amount of the reimbursement should be included to the estate as income in respect of the decedent under section 691. This ruling seems proper, since it was the estate, and not the decedent, that received reimbursement. The decedent, to be sure, received a tax benefit in the form of a lifetime deduction, which offset income, but to be entitled to that deduction, of course, the decedent had to make an actual expenditure. Although our hypothetical case, like Revenue Ruling 78–292, also involves the principle of tax benefit, in our case it is the decedent who received a benefit, by way of an exclusion from income, without ever having made an expenditure. The estate received no benefit in the form of either an exclusion or a deduction.

**Example 7:** The facts are the same as in example 6 except that A leaves at his death Blackacre, encumbered by the $80,000 mortgage, and also $80,000 of cash. At first blush, this example seems identical with example 4 where A, during his lifetime, transferred the mortgaged property plus $80,000 of cash to B, since in both cases A has passed both the liability and the proceeds of the liability. In the lifetime example 4, however, A transferred both the mortgaged property and the cash proceeds to the same person. Thus, in example 4, the transaction could be recast as a transfer by A to B of Blackacre, which had a value of $180,000, was subject to a mortgage of $80,000 and had a basis of $80,000 to A. We saw also that the transaction was the economic equivalent of A paying off the mortgage with $80,000 of cash, then transferring Blackacre unencumbered to B who thereafter himself borrowed $80,000 giving back a mortgage on the property.

(1) Assume A's will leaves both Blackacre and the cash to B. If, in the death transfer example we are now considering, A's will leaves Blackacre and the $80,000 of cash specifically to B, i.e., to one beneficiary, we would then have a case identical with example 4. As in the lifetime transfer in example 4, A has passed on the liability to B, but he has also disgorged the fruits of the mortgage to the same person, therefore, there is no past gain to A which should be subject to a deferred tax.

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The practical effect of $A$ shifting the liability to $B$ together with the money with which to pay the debt is that $A$ has transferred Blackacre unencumbered and $B$ has borrowed the $80,000 himself.\footnote{This alternative view of the transaction would leave any potential depreciation recapture gain intact if section 1014(c) prevented step up due to such gain being a section 691 item under the partnership provisions discussed in N. 43 \textit{supra}. Our main view of the transaction, however, would eliminate up to $80,000 of such gain because of the presence of $80,000 of cost in Blackacre to the transferee.}

Again using the part sale-part gift mechanism:

\begin{tabular}{l l}
\textit{A's amount realized} & $80,000$ (mortgage) \\
\textit{A's basis offset} & $80,000$ (cash) \\
\textit{A's gain} & $0$
\end{tabular}

The basis to $B$ is:

\begin{align*}
&$80,000$ ("cost" under section 1012) \\
&$100,000$ (step-up under section 1014) \\
&$180,000$ (total) \\
&or \\
&$80,000$ (cost) \\
&$0$ (carryover under section 1023(a)) \\
&$80,000$ (total which is allocated to the cash so that Blackacre has a basis of zero)
\end{align*}

Where section 1014 is the basis provision which operates on property acquired from a decedent, the resulting step-up in basis for the unencumbered portion ($100,000$) of the total property passing at death ($180,000$) has the effect of wiping out the unrealized appreciation in Blackacre. Thus, section 1014 would supply to $B$ a basis of $100,000$ and section 1012 would supply a cost basis of $80,000 due to the mortgage on Blackacre. $B$ would have an overall basis of $180,000$, $80,000$ in the cash and $100,000$ in Blackacre. Note again that this is the same result which would occur if the transaction took the form of $A$ paying off the mortgage and then dying with Blackacre unencumbered, and no cash. Section 1014 would give a basis of $100,000$ to Blackacre and $B$ could borrow $80,000$, give back a mortgage on Blackacre and have total assets of $180,000$, basis of $180,000$, which assets would be burdened by an $80,000$ mortgage. Thus, due to the application of section 1014, the unrealized appreciation of $100,000$ in Blackacre is wiped out whether the loan proceeds are obtained by $A$ while alive and passed on to $B$ at $A$'s death, or there is no loan during $A$'s life, but $B$ incurs the loan after $A$'s death.
Where section 1023 is the operative basis at death provision, and assuming there are no adjustments to basis, $B$ will have a carryover basis of zero and an overall basis of $80,000$ supplied solely by section 1012 as cost due to the presence of the mortgage, with the cost being allocated entirely to the cash. Again, these results accord entirely with our alternative view of the transaction—$A$ dying with only Blackacre, unencumbered, and $B$ borrowing $80,000$ and giving the mortgage. Under either view, $B$ has a basis of zero in Blackacre and $80,000$ in the cash. The potential for $80,000$ of gain to be recognized on a disposition of Blackacre now remains with $B$, the transferee, as it did in the lifetime transfer in example 4.

(2) Assume $A$’s will leaves Blackacre to $B$ and the cash to $C$.

(a) The effect of such a transfer by $A$ during life. Note that if $A$ during his lifetime had transferred outright the mortgaged property to $B$ and the $80,000$ cash to $C$, it is clear that $A$ would be taxed on $80,000$ (the mortgage on Blackacre) under Crane and Johnson. In such a case, $A$’s transfer of $80,000$ cash to $C$ is the same as his retention or previous consumption of the cash. $B$ takes subject to the mortgage and his cost basis of $80,000$ prevents $B$ from recognizing the $80,000$ of gain. If $A$ doesn’t recognize the gain, it will escape altogether.

(b) The effect of a lifetime transfer to a trust for $B$ and $C$. Note that a different result would probably occur if $A$ made the lifetime transfer to $B$ and $C$ via a trust, i.e., if $A$ transferred the mortgaged property plus the $80,000$ cash to $T$ as trustee and directed the trust to transfer the mortgaged property to $B$ and the cash to $C$. The immediate reaction to such a hypothetical would probably be that the interposition of a trust should not change the situation since the trustee is merely being used to pass title to $B$ and $C$, and doctrines such as step-transaction and business purpose would be invoked to tax $A$. But this misses the point that the issue in such a case is really one of assignment of income. If $A$ is not taxed, the gain will be taxed to the trust; it will not escape as it would if $A$ were not taxed where $A$ transferred Blackacre to $B$ and the cash to $C$ without a trust.

Of course, seeing the issue as one of assignment of income does not solve it. It does, however, make relevant the notion that Congress has seen fit to treat a trust as an entity separate from the grantor (where the grantor trust provisions do not apply) and thus has sanctioned the trust as an income splitting device. If, for example, a taxpayer, $G$, desires personally to accumulate income from property and give it to a relative, $S$, at a later time (say, after 15 years), the income would be taxed to $G$ while it was being accumulated. But if $G$ transferred the property to a
trust and directed the trustee to accumulate the income for 15 years, and then pay it to \( S \), the income would be taxed to the trust and not to \( G \). The point is that the congressional recognition of a trust as a separate taxable entity permits assignment of income, even though that may be the only purpose of the arrangement and even though the grantor, solely for tax purposes, is doing in two steps what he could have done in one. The question is whether conveyance of Blackacre subject to a mortgage, with directions to distribute Blackacre to \( B \) and the $80,000 cash to \( C \), will allow \( A \) to shift the tax on the gain arising from his past borrowing. Turning to our alternate view of the transaction, the issue appears to be the same as would arise if \( A \) transferred Blackacre to a trust, unencumbered, and directed the trustee to borrow $80,000 cash, convey Blackacre to \( B \) (subject to the mortgage) and the cash to \( C \). Absent application of any grantor trust provision,\(^{40}\) could \( A \) shift the tax arising from the borrowing to the trustee? The same issue would also appear to arise if \( A \) directed the trustee to sell Blackacre (which is unencumbered) and pay the proceeds $20,000 to \( B \) and $80,000 to \( C \). Would the realized gain be that of \( A \) or of the trust? In these situations, we suggest that \( A \) should be allowed to shift the tax to the trust.\(^{50}\) Essentially, these situations are not different from one where \( A \) transfers Blackacre to a trust and directs the trustee to rent Blackacre, accumulate the income for 15

\(^{40}\) If, for example, \( A \) retained a power of revocation, section 676 would apply and \( A \), not the trust, would be taxed on any gain.

\(^{50}\) Section 644 of the Code, enacted as part of the Tax Reform Act of 1976, lends support to this proposition. That section provides that on any sale by a trust within two years of the initial transfer of the property in trust, the trust is taxed albeit, as though the grantor sold the property, i.e., at the grantor's rates. This section presupposes that the grantor himself is not taxed unless the grantor trust provisions apply.

On the other hand, Revenue Ruling 60–370, 1960–2 C.B. 203, holds that where a trustee is under an express or implied obligation to sell the property transferred in trust, "the transferor [grantor] realizes gain, includible in his gross income in the taxable year of the sale or exchange." That ruling, however, should be distinguished since it did not involve an attempt to shift the tax to a trustee but rather an attempt by the grantor to receive and retain the gain (or a substantial part of it) but without any tax. Under the scheme (the so-called "Pomona Plan"), the grantor retained the life income and the trustee, a charity, was required to sell the property and acquire tax-exempt securities. There was also a secondary life beneficiary who also was to receive tax-exempt income; thus, the grantor was attempting to transform capital gain through a tax-exempt organization into tax-exempt income to be received by himself and his secondary beneficiary. In such a context, the step transaction and business purpose doctrines support the ruling's result of taxing the grantor on the gain realized by the trust. In our situation, however, the trust is not being used to transmute taxable income into nontaxable income retained by the grantor (a function not intended for the trust by Congress), but to shift income to another taxpayer, a role that a trust traditionally has been permitted to play.
years and then pay it to B. This is common and accepted practice, and it is clear that the trust pays the tax on the rents, not A. This is so despite the fact that A’s direction to the trustee to lease is the same as a direction to sell, since all leases are, pro tanto, sales of interests in the “leased” property.

Since, under the assignment of income principles, a direction to sell, lease or borrow, and to pay the proceeds to a beneficiary, would not prevent A from shifting the tax on the gain realized, it should follow that A could shift the tax where A does the borrowing himself prior to the transfer to the trust directing conveyance of Blackacre to B and the cash to C. Economically, this transaction does not differ in substance from a conveyance of Blackacre unencumbered, and a direction for the trustee to borrow and so distribute.

(c) **The effect of such a transfer by will.** In terms of a transfer effected by death, the above analysis would result in treating a sale by the estate pursuant to a decedent’s directions as a taxable event to the estate and not the decedent.\(^{51}\) The transfer of mortgaged property together with the proceeds of the mortgage with directions to distribute the property to B and the proceeds to C is the equivalent of transferring unencumbered property to an estate with directions to sell it and pay $20,000 of the proceeds to B and $80,000 to C. In net sum, a decedent should not be taxed whenever he dies with mortgaged property as long as he also owns (and thus also transfers) property with a basis sufficient to offset the amount of the mortgage.

This, of course, is precisely the approach taken by the regulations for a lifetime part gift-part sale under section 1001. It is true that the regulations speak of a part gift-part sale of a single piece of property, whereas typically at death we have an aggregate of assets and liabilities. As we have stated previously, however, where, *e.g.*, Blackacre (value $100,000, mortgage $80,000, basis zero) is transferred simultaneously with $80,000 of cash, there is no reason to treat the transferor as having done anything other than transfer Blackacre (value $180,000, mortgage $80,000, basis $80,000).

From the estate’s point of view, if the estate receives Blackacre (value $100,000, mortgage $80,000, basis zero) plus $80,000 of cash its basis

\(^{51}\) Where a will has directed an executor to sell property and distribute the proceeds, no attempt is made to tax the decedent. The question has arisen whether the estate or the beneficiaries should be taxed on the gain from the sale, but since the cases arose under section 1014, the gain involved was post-death appreciation and not the pre-death appreciation we deal with here. See, *e.g.*, Commissioner v. Brinckerhoff, 168 F.2d 436 (2d Cir. 1948), holding that such gain is taxed to the estate. For the view that the gain in such a case should be taxed to the beneficiary, see *Del Cotto* at 237–38.
in the aggregate will be $180,000 under sections 1012 and 1014 or $80,000 under sections 1012 and 1023. Thus, the pre-death appreciation in Blackacre will be wiped out if the sections 1012 and 1014 combination is operative, but not if sections 1012 and 1023 are operative. As we shall see, in the latter situation the pre-death gain may be recognized by either the estate or the beneficiaries.

**Post-Death Transfers (Distributions From Estate to Beneficiary)**

The examples we use here are numbered 5(A), 6(A) and 7(A) to correlate with examples 5, 6 and 7. In analyzing these examples, we will assume, for the present, that there is no distributable net income of the estate applicable to the distribution.

**Unencumbered Property**

**Example 5(A):** In example 5, A dies owing Blackacre unencumbered, with a basis to A of zero and a fair market value of $100,000. As we saw, on A's death,

(1) No gain is recognized to A, or his estate; and
(2) The basis of the estate in Blackacre becomes $100,000 under section 1014 and zero under section 1023 (disregarding adjustments).

**Distribution to a Specific or Residuary Devisee.** When the estate distributes Blackacre in kind to a specific or residuary devisee, neither the estate nor the beneficiary will have engaged in a sale. Thus, the estate will not realize any gain on the distribution and the beneficiary will step into the estate's shoes and will have a section 1014 basis of $100,000 or a section 1023 basis of zero.

**Distributions in Satisfaction of a Fixed Dollar Amount.** When the estate distributes Blackacre in satisfaction of a fixed pecuniary amount

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52 These basic results to the estate are also consistent with the part gift-part sale regulations under section 1015. Those regulations state that a transferee's basis is the higher of his cost or the transferor's basis. Thus, they would have the same result as we have proposed where sections 1012 and 1023 operate. The regulations, however, were written only for lifetime situations, since carryover basis operates in such a case under section 1015. They simply do not speak to death transfers where sections 1012 and 1014 operate because the principle of section 1014 is not carryover basis, but value at death.


54 Any section 1023 adjustments will have the same effect, *pro tanto*, as a section 1014 step up to fair market value.
($100,000), the distribution constitutes a sale by the estate and a purchase by the beneficiary, with the following results:

**Under Section 1014.** Since the estate's basis is $100,000 under section 1014, no gain would be realized. The beneficiary has a basis in his claim equal to the amount of the claim, since that is its fair market value at death. Thus, the beneficiary of a $100,000 legacy who receives Blackacre, worth $100,000, in satisfaction of that legacy, has no gain and his basis in Blackacre would now be his cost under section 1012, i.e., $100,000.

**Under Section 1023.** If the estate's basis is zero under section 1023, $100,000 of gain would be realized to the estate. However, section 1040 (a), enacted at the same time as section 1023, provides that if the executor of an estate satisfies a pecuniary bequest with carryover basis property the realized gain of the estate shall be recognized only to the extent of post-death appreciation. Thus, in our case, none of the $100,000 realized gain would be recognized.

Section 1040(c) speaks to the situation of the beneficiary, providing that the basis of the beneficiary shall be carried over from the estate but increased by any gain recognized by the estate. The basis of the beneficiary here would be zero since no gain was recognized by the estate. Thus, under the specific provisions of sections 1040(a) and (c), the pre-death appreciation in unencumbered property which is used to satisfy a pecuniary legacy is not taxed to the estate but is carried over to the legatee. The implication, of course, is that the legatee will not be taxed at the time he receives the property in satisfaction of his legacy, but rather only upon a taxable disposition of the property itself.

**Encumbered Property**

*The transfer of mortgaged property without accompanying transfer of other property with basis offset.*

**Example 6(A):** In example 6, A, prior to his death, had borrowed $80,000 and given back a mortgage on Blackacre. When he died, only Blackacre, encumbered by the $80,000 mortgage, was in A's estate. Under our analysis, the results at A's death were:

1. A recognized $80,000 of gain which should be reported on A's final return.
2. The estate's basis in Blackacre became $100,000 under sections 1012 and 1014 or $80,000 under sections 1012 and 1023.

Let us now examine the effect of a distribution of Blackacre in such a case, under the same variations which we discussed in example 5(A).

**Distribution to a Specific or Residuary Devisee.** The transfer by the
estate and receipt by the beneficiary in this situation should be viewed as a bifurcated event. To the extent of the mortgage of $80,000, the estate has sold the property and the beneficiary has purchased it. To the extent of the equity, here $20,000, there has been a nonsale distribution.

**Results Under Sections 1012 and 1014.** Where the estate’s basis has been determined to be $100,000 under sections 1012 and 1014, the estate will recognize no gain or loss since its amount realized on the sale (the $80,000 mortgage) will be offset by a properly allocable basis of $80,000.

The beneficiary will have a basis of $100,000 in Blackacre, $80,000 derived from section 1012 and $20,000 derived from section 1014 as the fair market value of property (equity) acquired from the decedent.

**Results Under Sections 1012 and 1023.** The estate should also be treated as having no gain or loss where the estate’s basis is determined to be $80,000 under sections 1012 and 1023. In this situation, it could be argued that only 80 percent of the basis of $80,000 ($64,000) should be allocated to the sale, which would give rise to a gain of $14,000. Such a result, however, would be inconsistent with the part gift-part sale regulations for lifetime transfers, which allow a full basis offset. Moreover, it would ignore the fact that any gain in this situation would be derived only by considering the mortgage an amount realized, and all of such gain has already been recognized by the decedent. Taxing $14,000 of gain here to the estate would thus be taxing $14,000 of the unrealized appreciation which inheres in the $20,000 of equity.

In this section 1012 and 1023 situation, the beneficiary’s basis will be $80,000, being totally derived from section 1012 since there is a zero basis carryover in the equity under section 1023. There is thus preserved in the beneficiary’s hands the potential for the recognition of the $20,000 of unrealized pre-death appreciation which was not recognized by the decedent on his final return.

**Distribution in Satisfaction of a Fixed Dollar Amount.** The assumption here is that the specific dollar amount legacy, in satisfaction of which Blackacre is distributed, is $20,000. This is because the equity in Blackacre is only $20,000 and is thus the only amount for which Blackacre could be distributed to a specific dollar legatee. What we have, then, is really a dual sale. To the extent of the mortgage of $80,000, the estate has engaged in a sale, but without regard to the satisfaction of any specific dollar legacy. To the extent of the equity of $20,000, there has also been a sale since that equity has been distributed in satisfaction of a specific dollar legacy. The beneficiary of the $20,000 legacy has purchased all of Blackacre, partly ($80,000) by taking subject to the $80,
000 mortgage and partly ($20,000) by exchanging his $20,000 claim for the $20,000 equity in the property.

Results Under Sections 1012 and 1014. The estate has no gain or loss realized because its basis of $100,000 fully offsets the $100,000 amount realized ($80,000 realized because of the mortgage, $20,000 realized from the satisfaction of the $20,000 legacy).

The beneficiary has exchanged his $20,000 claim for the $20,000 equity in the property. This exchange, however, gives rise to no inclusion in the beneficiary’s income, since the beneficiary exchanged a claim with a basis under section 1014 of $20,000 in return for an equity worth $20,000. The beneficiary’s basis in Blackacre will be $100,000, totally derived from section 1012. Again, $80,000 of the $100,000 will be due to Crane principles giving $80,000 of cost because of the mortgage. The other $20,000 is exchange cost since the beneficiary has exchanged his claim for $20,000 (in which he had a section 1014 basis of $20,000) for a fair market value of $20,000 (the equity in Blackacre).55

Results Under Sections 1012 and 1023. Since the estate has a zero basis in the equity which it uses to satisfy the $20,000 legacy, the estate has realized $20,000 of gain. Since, however, this gain is not due to post-death appreciation, it is given nonrecognition treatment to the estate under the policy of section 1040.

The beneficiary of the $20,000 legacy, who receives Blackacre in a section 1012 and 1023 situation, will have a basis of $80,000, solely derived from section 1012 due to the mortgage. Although the beneficiary has engaged in an exchange of his $20,000 claim for the $20,000 of equity, he acquires no exchange cost basis thereby, because of the specific provisions of section 1040(c), requiring that a beneficiary of a pecuniary legacy take as a basis in the property distributed in satisfaction thereof the basis of the estate plus any gain recognized to the estate as a result of the distribution. Again, the clear implication of section 1040(c) is that the receipt by the beneficiary of the equity in satisfaction of his $20,000 claim gives rise to no includable income to the beneficiary.

Summary of Example 6(A). As appears from the analysis immediately above, combined with our previous analysis of example 6: (1) Regardless of whether sections 1012 and 1014 or sections 1012 and 1023 apply to the estate and beneficiary, the decedent’s personal representative must report $80,000 of gain on decedent’s final return. In this manner, $80,000 of the $100,000 gain inherent in Blackacre is considered to be realized because of nonpayment of the mortgage.

(2) Where sections 1012 and 1014 apply to the estate and beneficiary, the remaining $20,000 of that gain escapes because of the policy of section 1014.

(3) Where sections 1012 and 1023 apply, this remaining gain does not escape, but continues to be deferred under the policy of sections 1023 and 1040 through the estate into the hands of the beneficiary. This is so even where the estate satisfies a fixed dollar legacy because of the policy of section 1040.

**Encumbered Property**

The transfer of mortgaged property accompanied by a transfer of additional property with sufficient basis to offset the mortgage.

Example 7(A): In example 7, the decedent, A, prior to his death, had borrowed $80,000 and given back a mortgage on Blackacre. When he died, his estate included Blackacre, encumbered by the $80,000 mortgage, plus $80,000 of cash. Our conclusion was that A had no gain at his death and that the basis of his estate in Blackacre would be $100,000 under section 1014, but would be zero under section 1023.

**Distribution to a Specific or Residuary Devisee. Results Under Sections 1012 and 1014.** Since the estate has a basis of $100,000 in Blackacre, where sections 1012 and 1014 apply the results to both the estate and the devisees of a specific or residuary devise will be the same as they were in example 6(A), i.e., the estate will have no gain and the beneficiary will have a basis of $100,000. This is true even though the decedent, A, did not recognize gain on his final return since where A's estate also includes $80,000 of cash, the situation is the same as if A paid off the mortgage and transferred Blackacre unencumbered, with a basis of zero and a fair market value of $100,000, in which case the basis of Blackacre steps up to $100,000.

**Results Under Sections 1012 and 1023.** Where section 1023 applies, the basis of the estate in Blackacre is zero because the unrealized appreciation is carried over to the estate under the policy of section 1023. If, therefore, the estate distributes Blackacre to any beneficiary, including a specific or residuary devisee, the mortgage will be an amount realized of $80,000 to the estate and the estate will be required to recognize $80,000 of gain on the transfer unless the executor also transfers to such beneficiary, under the mandate or permission of the decedent, additional property with basis sufficient to offset the mortgage. If, for example, A's will left all of his property to B, a transfer of Blackacre and the $80,000 of cash to B would result in no gain to the estate. In such a case B would step into the shoes of the estate and would have a basis of zero in Blackacre and $80,000 in the cash.
If, on the other hand, A's will left Blackacre to B and the residue of his estate to C, the transfer of Blackacre to B would result in $80,000 of gain to the estate under Crane and Johnson and B's basis in Blackacre would be a cost basis of $80,000 and a zero carryover in the equity, for a total of $80,000. There would be a similar result if A's will required that the executor distribute $80,000 of cash to B and the rest of his estate to C. Gain of $80,000 would again result to the estate on the transfer of Blackacre to C under the residuary clause and C would have a cost basis of $80,000.

Suppose A's will leaves 80 percent of his estate to B and 20 percent of his estate to C and permits the executor, in his discretion, to determine which assets shall be distributed to B and which to C. If, in such a case, the executor distributed Blackacre to C and $80,000 of cash to B, the estate would be required to recognize $80,000 of gain, and C would have a basis of $80,000 in Blackacre. If, on the other hand, the executor distributed $20,000 of cash to C and $60,000 of cash plus Blackacre to B, the estate would be required to recognize only $20,000 of the gain, and B's basis in Blackacre would be $20,000 (his basis in the cash being $60,000), leaving B with the $60,000 of gain potential in Blackacre which is as yet unrecognized.

Distribution in Satisfaction of a Fixed Dollar Amount. Suppose that A's will left a fixed dollar legacy of $20,000 to B and the residue of his estate to C, and permitted the executor to satisfy the dollar legacy in cash or in kind. If the executor distributed Blackacre in satisfaction of the fixed dollar legacy, we would again have (as in example 6(A)) a dual sale. To the extent of the mortgage of $80,000, the estate has engaged in a sale, but without regard to the satisfaction of any specific dollar legacy. To the extent of the equity of $20,000, there has also been a sale, since that equity has been distributed in satisfaction of a specific dollar legacy.

Results Under Sections 1012 and 1014. The step-up of section 1014 would prevent the estate from recognizing gain on either sale, and B's basis in Blackacre would be $100,000.

Results Under Sections 1012 and 1023. If we assume that the executor did not transfer additional property to B, the estate would realize $100,000 of gain, $80,000 under Crane (since the mortgage would be an amount realized and there would be no offsetting basis) and $20,000 because of the transfer of the equity in Blackacre in satisfaction of the legacy of $20,000. Because of the policy of section 1040, however, the estate would recognize only $80,000 of the $100,000 gain, i.e., the gain attributable to the mortgage; not the gain arising from transfer of the equity in discharge of the pecuniary bequest since that is within section 1040(a). B would have a basis of $80,000 in the property, derived
solely from section 1012, since B took subject to the mortgage of $80,000; under section 1040(c), B would have a carryover basis of zero in the equity.

Summary of Example 7(A). Where a decedent transfers at death property encumbered by a mortgage and also property with a basis sufficient to offset the amount of the mortgage, the decedent should be treated as though he paid off the mortgage and transferred the property unencumbered. The estate, in turn, should be treated as having received the property unencumbered and then to have encumbered it. In such a case, if section 1014, rather than section 1023, applies to property acquired from a decedent, the unrealized appreciation in the encumbered property will escape taxation, and the estate and beneficiaries will have a basis of $100,000 in the property.

If section 1023 is applicable, however, the estate is in the same position as the decedent immediately before his death. Thus, if the estate disposes of the property without paying off the mortgage, or without passing on to the transferee of the mortgaged property additional property of sufficient basis to offset the mortgage, the estate will be required to recognize gain under Crane. If the estate, on the other hand, passes on additional property with basis sufficient to offset the mortgage, the beneficiary then will step into the estate’s shoes and will take the mortgaged property with a basis of zero, and the potential gain will continue in the beneficiary’s hands.

Effect of State Law

Our analysis of death transfers and post-death transfers has proceeded on the assumption that the property of a decedent passes from the decedent to his estate, and then from his estate to the beneficiaries of his estate, by way of distribution. Under the laws of some states, however, it is said that title to property of a decedent passes directly from the decedent to the decedent’s beneficiaries.56 For certain portions of our analysis, this concept of state law would have negligible effect. For example, where the decedent dies with encumbered property, and there is insufficient basis in the encumbered property and his other property to offset the amount of the encumbrance (example 6), our analysis indicates that the decedent should recognize the gain on his final return. Thus, the gain cannot be shifted to the estate beneficiaries. There is, thus, no reason to

56 This notion is normally applicable to real property (Arrott v. Heiner, 92 F.2d 773 (3d Cir. 1937) (Pennsylvania law)), although in some states it is applied to personalty as well (Jones v. Whittington, 194 F.2d 812 (10th Cir. 1952) (Texas law)).
determine whether the property bypasses the estate and passes directly to the beneficiaries.

On the other hand, where the decedent dies with encumbered property and there is sufficient basis in the encumbered and other property to offset the amount of the encumbrance, our analysis indicates that the decedent should not be taxed on his final return, because he is essentially in the same position as if he paid off the mortgage and transferred the property unencumbered. In such a case, moreover, if section 1014 is the operative basis section regarding property acquired from a decedent, any gain inherent in the difference between the value and the basis of the encumbered property will be wiped away. If section 1023 operates, however, there is still the potential for recognition of this gain, and it is at this point that the concept of the estate as a separate taxpayer becomes crucial. Suppose that a decedent who dies owning property with basis sufficient to offset the amount of debt on encumbered property has directed that the encumbered property be distributed to one beneficiary, but has not also directed that that property with sufficient basis offset be distributed to the same beneficiary. In such a case, if the decedent is not to recognize gain on his final return, any gain inherent in the encumbered property must be recognized by the estate or else it will escape altogether, contrary to section 1023. Put another way, the question is whether this situation should be treated as though during lifetime an owner transferred encumbered property to one transferee and other property to another transferee, in which case the transferor is required to recognize the gain in the encumbered property under Crane and Johnson, or whether the situation should be rather treated as though the transferor made the transfer to the separate transferee by way of a trust, in which case, under our prior analysis the gain would be recognized by the trust, but not by the transferor. The problem is that if, for tax purposes, the decedent's property is considered to pass at death directly to the beneficiaries, the decedent will not be able to use the death counterpart of the lifetime trust, i.e., the estate, as a separate entity to which to shift the tax. In such a case, the only alternative to allowing the gain to escape altogether would be to require the decedent to recognize the gain on his final return, just as a lifetime transferor would be required to recognize the gain at the time of the transfer. In both situations, the ultimate transferee of the encumbered property will not be required to recognize the gain because he takes a cost basis equal to the amount of the encumbrance.\textsuperscript{57}

\textsuperscript{57}If the ultimate beneficiary receives both the encumbered property and property (including the encumbered property) with basis sufficient to offset the encumbrance, as our analysis indicates, it would be unnecessary and improper to tax
What then should be the relevance of the state law property concept that certain property passes directly from the decedent to the decedent’s beneficiaries? This concept of state law has already been the subject of sporadic litigation in the federal tax area and, although the cases and rulings are not entirely clear, the rule that seems to have emerged is: If the income, including capital gains, of the property, is subject to administration, or more accurately, subject to the payment of claims against the estate and expenses of the estate, such income, during the normal period of administration, is income of the estate even if under state law title to the property vests immediately in the intestate distributees or testamentary beneficiaries.  

Given this rule, there would seem to be no reason why we should not analyze the problem as we have, that is, by treating the property of the decedent as passing from the decedent to his estate and from the estate to his beneficiaries. The transfer of encumbered property is a sale under Crane and should not be differentiated from any other sale for the purposes of considering the estate as a separate entity which is required to report gains on the sale of property during the period of administration. Were this not the case, moreover, the decedent could easily make it the case merely by transferring the title to all of his property to his personal representative, in which case, despite any state law concept that property passes immediately from the decedent to his beneficiaries, the personal representative would take title to the property and the form of the transaction would comport with our analysis.  

A question which would still remain, however, would be one of timing. If, for tax purposes, we are going to consider property as passing from the decedent to the estate of the decedent and then from the estate of the decedent to the beneficiaries, when shall the title be considered to pass from the estate to the beneficiaries in those states which, for state law purposes, consider the title to pass immediately from the decedent to the beneficiaries, thus bypassing the estate? The proper time, consistent with the decedent or the estate on the gain preserved by section 1023 since the transaction is essentially a transfer of unencumbered property to the beneficiary who thereafter encumbers the property. Thus, the potential gain is deferred into the beneficiary’s hands and will not escape if not taxed to the decedent or his estate.

58 The cases are reviewed in Jones v. Whittington, 194 F.2d 812 (10th Cir. 1952). See also FERGUSON, FREELAND & STEPHENS, FEDERAL INCOME TAXATION OF ESTATES AND BENEFICIARIES 12-14 (1970). The limitation of the rule to the normal period of administration arises from the possibility that an estate may be open for state law purposes but closed for income tax purposes. Reg. § 1.641(b)-3(a). If the tasks of administration are complete, a sale of property by named executors may be attributed to estate beneficiaries (Arrott v. Heiner, 92 F.2d 773 (3d Cir. 1937)) or to a trust established by the decedent’s will (Anderson v. Wilson, 289 U.S. 20 (1933)).  

with the rule that has emerged for taxing the recognized gains to the estate during administration, would seem to be the time when the property is no longer subject to administration. This principle has recently been applied in connection with section 2032 of the Code where the question has arisen whether property has been "distributed" prior to the six month alternate valuation date, since, under that provision, if property is "distributed, sold, exchanged, or otherwise disposed of" before the six month period, it must be valued as of the date of "distribution, sale, exchange, or other disposition." In Revenue Ruling 78–378, a decedent died leaving all of his real property to A and all of his personal property to B. Under the applicable state law, legal title to both real and personal property passed immediately to the decedent's heirs, legatees and devisees, subject to the right of the executor to use the property to satisfy claims and expenses. The state law required the executor to take possession of all personal property but with respect to real property, the executor had no right of possession unless the realty had to be sold to satisfy claims or unless it was necessary for the executor to preserve the property for the devisees. The real property could be sold before payment of all claims against the estate upon a finding that the other assets would be sufficient to pay the claims. The ruling held that although title and possession to the realty immediately passed to the devisee, such passing did not constitute a distribution within the meaning of section 2032 because the property was subject to the executor's right of possession until final settlement of the estate. Transfer of full control was not effected "until the probate court entered an order specifically releasing the realty from the executor's right of possession, or until entry of a final order approving payment of all claims." 61

Returning to the relevant variation of our basic example, and applying the above-outlined principles, if a decedent devised Blackacre (basis zero, value $100,000, mortgage $80,000) to A and the rest of his estate ($80,000 cash) to B, there would be no gain recognized to the decedent. On the decedent's death, the estate would have a basis of zero in Blackacre and $80,000 in cash under sections 1012 and 1023 and, when Blackacre was no longer subject to administration, the estate would recognize a gain of $80,000. These would be the results even if the state law considered title had passed directly to A and B.

61 Id. at 54. Our analysis could also be applied to property that passes outside of a decedent's probate estate, e.g., by way of a revocable inter vivos trust or even as jointly held property since in some states such property is available for the payment of claims against the estate. See Matter of Granwell, 20 N.Y.2d 91, 228 N.E.2d 779 (1967). But cf. Rev. Rul. 78–431, 1978–2 C.B. 230.
Planning Considerations

In our discussion, three taxpayers were identified: the decedent, his estate and the decedent's beneficiary (or beneficiaries).

The decedent will be the taxpayer who recognizes gain on his final return, when he does not have sufficient basis in the property transferred at death to offset liabilities.1 If this is the situation at death, no post-death actions can be taken to avoid recognition since death is the time at which the taxable transfer takes place. For the same reason, no amount of pre-death planning with respect to the at-death disposition by will or will substitute (for instance, revocable trust, jointly held property) of the decedent's encumbered or unencumbered property will be of any avail since such planning cannot change the gain producing excess of liabilities over basis at death. Indeed, the only real planning available to prevent the decedent's recognition of gain is the pre-death avoidance of the at-death excess of liabilities over basis. If we posit such an excess at a point prior to death, this gain causing excess cannot be avoided by transferring the property together with the related debt, since that will be a lifetime taxable event.0 It can thus be avoided only by acquiring sufficient offsetting basis, which is tantamount to saying that it can be avoided only by paying off the debt. And this is as it should be, since the rationale for gain, when it is required to be recognized by the decedent, is the certainty that the debt from which the decedent derived tax benefit will not be repaid by him.

On the other hand, where the decedent transfers at death property with basis sufficient to offset liabilities, and he thus escapes tax himself (properly), planning possibilities, both pre-death and post-death, are present. First, however, it should be noted that in such a case, no planning is necessary to prevent gain recognition where section 1014 is the basis section applicable to property acquired from a decedent, since all gain inherent in the decedent's property, whether specifically encumbered or not, is wiped away by a step-up in basis to fair market value at death.

It is thus only where section 1023 operates that planning is necessary

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1 Although all of our hypothetical cases have involved specific encumbrances, the analysis which leads to recognition of gain by a decedent where specific encumbrances exceed basis leads equally to such gain recognition where the liabilities are general, e.g., personal debts of the decedent; for the principle involved calls for a comparison at death between a taxpayer's aggregate basis and aggregate liabilities.

0 Pre-death transfers of unencumbered property might leave the decedent's estate without property to pay the tax. Such transfers, however, in order to be successful avoidance mechanisms would have to pass muster under transfer in fraud of creditor doctrine.
and possible, and essentially the planning is for continued deferral. The policy of section 1023, like section 1015 during life, is to prevent the escape of gain which existed in the property in the hands of the gratuitous transferor and to carry it over into the hands of the transferee. Where the property is unencumbered, that carryover and continued deferral is accomplished merely by the transfer of the property—from decedent to the decedent's estate, and from the decedent's estate to the beneficiary, or beneficiaries. Where the property is specifically encumbered, however, gain will be recognized to the estate upon distribution and deferral will not continue, unless the beneficiary of the encumbered property also receives property, including the encumbered property, with a sufficient basis (to the estate) to offset the encumbrance. If, e.g., a decedent dies owning (1) Blackacre (value $100,000, mortgage $80,000, basis zero), (2) cash of $80,000 and (3) Whiteacre (value $80,000, basis zero), and the decedent's will leaves Blackacre and Whiteacre to X and the residue to Y, the estate will recognize $80,000 of gain when it distributes Blackacre and Whiteacre to X. But if the will had left Blackacre and the cash to X and the residue to Y, the estate would recognize no gain and the gain in Blackacre would be deferred into X's hands. Thus, by pre-death planning, basis can be directed to follow liability and gain can be deferred indefinitely.

If the match up of basis and liability is not directed in pre-death instruments, it may be permitted to the executor. Suppose, for example, that the decedent's will in the above example gave an $80,000 legacy to X, residue to Y and gave discretion to the executor with respect to the assets used to satisfy legacies. If, in that situation, the executor distributed $80,000 of cash to X, the estate would be required to recognize $80,000 of gain when the residue (Blackacre and Whiteacre) was distributed to Y. Such gain inherent in Blackacre could be avoided by the executor and the deferral continued into Y's hands if the executor distributed Whiteacre to X and cash and Blackacre to Y.

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64 It bears repeating that this is tantamount to the estate satisfying the mortgage debt with the cash and transferring Blackacre unencumbered. In such a case, the gain in Blackacre is avoided by the estate and is deferred into the hands of the beneficiary.

65 Where the decedent does not recognize gain because his aggregate basis in transferred property equals or exceeds the liabilities, if particular property is not specifically encumbered but is subject to general encumbrances, such as personal debts of the decedent, it will have the same basis to the transferee as unencumbered property. If, e.g., decedent died owning Blackacre, value $100,000, and basis of $90,000 and subject to decedent's personal debt of $80,000, the decedent would recognize no gain and the estate's basis would be $90,000 under sections 1012 and 1023 (higher of cost or carryover under the theory of section 1.1015-4 of the regulations).

66 The opportunity for post-death planning is not limited to situations involving
Finally, even where basis and liability are misdirected in the decedent's will and no discretion is left to the executor, recognition to the estate can be avoided and deferral continued by the proper use of disclaimer. Suppose, e.g., the decedent's will in our hypothetical left Blackacre specifically to X and the residue to Y. If distribution were in accordance with these will provisions, the estate would recognize gain of $80,000. If, however, X disclaimed his devise of Blackacre, it would fall into the residue and the distribution of all the property (Blackacre, Whiteacre and $80,000 cash) to Y would prevent recognition by the estate and continue deferral of the gain in Blackacre into Y's hands.

To repeat, however, all these planning possibilities in section 1023 situations are limited to avoiding gain to the estate and continuing deferral. They are not designed to eliminate recognition of gain (except to the extent that continued deferral approximates such elimination). Of course tax on the gain could be eliminated if the encumbered property and property with offsetting basis (including the encumbered property) were distributed to a tax-exempt organization, just as the distribution could eliminate tax on unencumbered property despite section 1023. With respect to encumbered property, however, the elimination of tax can only be accomplished by an accompanying disposition of property (including the encumbered property) with sufficient offsetting basis.

Conclusion

The subject of this article has been the tax consequences to a decedent, an estate and estate beneficiaries of the passage of encumbered property at death. Our major concerns have been the questions of the realization and recognition of gain to each of these separate tax entities and the effect on such questions of varied circumstances, including the decedent's estate plan and postmortem events. In light of these major concerns, and in order to avoid undue complexities, we have determined not to delineate the effect of the depreciation recapture provisions of the Code, or of the presence of distributable net income in an estate. We would only note that although these factors are undoubtedly important, their application to the situations and transactions we have discussed do not raise any major novel issues or affect our analysis and conclusions.

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*fixed amount legacies. If, for example, the decedent’s will in our example left 4/9 (80/180) of his estate (value $80,000) to X and the residue to Y, the executor is in the same position with respect to deferring the gain in Blackacre as he is when the will leaves a cash legacy of $80,000 to X and the residue to Y. An executor with the proper discretion could satisfy X’s fractional share with Whiteacre (value $80,000) and thereby avoid recognition of the gain in Blackacre.*
Illustrative examples for both depreciation recapture \(^{67}\) and distributable net income \(^{68}\) are noted below.

\(^{67}\) Take the situation in example 3: A owns Blackacre, value $100,000, basis zero, encumbered by a mortgage of $80,000. On a transfer to B subject to the mortgage, A's gain is $80,000. As we have seen, up to the amount of the encumbrance there has been a sale. The gift exclusion of the recapture sections (I.R.C. §§ 1245(b)(1), 1250(d)(1)) has no application except to the portion of the transfer in which the transferee takes a section 1015 basis. Reg. §§ 1.1245-4(a)(1), 1.1250-3(a)(1). Therefore, the gift exclusion applies only to the $20,000 equity in the property transferred, and not to the encumbered portion.

So, the portion of the gain which is depreciation recapture under either section 1245(a)(1) or section 1250(a)(1) will be ordinary income. Reg. §§ 1.1245-4(a)(3), (4), 1.1250-3(a)(2), (4) Ex. 1.

B, the transferee, takes the property with an $80,000 cost basis under section 1012, and a sections 1015(a) and (d) basis for the equity. To the extent B has cost, the property is no longer subject to the recapture sections. Reg. §§ 1.1245-2(e)(1), 1.1250-2(e)(1). B holds the equity value, however, subject to the recapture provisions in the amount not recaptured by A. Reg. §§ 1.1245-4(a)(4), 1.1250-3(a)(3), (4) Ex. 1.

Where the identical transfer is effected at A's death, as in example 6, the results for the decedent-transferor and the estate-transferee are similar to those for example 3. There is a sale up to the amount of the encumbrance, which sale is not within the transfer at death exception of sections 1245(b)(2) and 1250(d)(2). Reg. §§ 1.1245-4(b)(1), 1.1250-3(b). Hence, any depreciation recapture in the $80,000 gain is taxable as ordinary income on the decedent's final return.

The estate-transferee takes the property with an $80,000 cost basis under section 1012, and a date of death basis for the equity. If section 1014 is the operative date of death provision, then any further recapture gain is eliminated by the basis step up. If section 1023 is operative, then, by a parity of reasoning with the example 3 discussion, the estate holds the property subject to recapture in the amount not recaptured by the decedent. Although this result is not explicit in the statute, the legislative history makes it clear that a section 1023 basis carries with it depreciation recapture under sections 1245 and 1250. H.R. REP. No. 94–1380, 94th Cong., 2d Sess. 39 (1976).

In examples 5(A), 6(A) and 7(A), when the estate distributes Blackacre, to the extent there is gain arising from the presence of the mortgage, the recapture provisions will apply in the usual manner. Thus, if Blackacre goes to the estate unencumbered (example 5(A)), it is fully subject to the transfer at death exceptions of the recapture statutes, and the estate takes subject to full recapture when it makes a disposition of the property in a taxable transfer. A transfer by the estate to a specific legatee would not be such a transfer because of the property keeping its date of death basis in the hands of the legatee. Reg. §§ 1.1245-4(b)(1), 1.1250-3(b).

But, to the extent of any encumbrance (examples 6(A) and 7(A)), the property would pass by sale and any gain to the estate would be subject to the recapture provisions to the extent the recapture was not taxed to the decedent.

Most important, any gain attributable to the value of the equity and which, but for sections 1245 and 1250, is protected by section 1040 (i.e., gain arising from satisfaction of a pecuniary bequest), would seem to lose such protection when the estate transfers the property. There is full recapture of the section 1040 gain under the general provisions of sections 1245(a) and 1250(a) because Congress has failed to extend the carryover basis exception of sections 1245(b)(3) and 1250(d)(3) to the basis acquired by the estate's transferee under section 1040(e).
Take one of the variations in example 7(A) assuming section 1023 rather than section 1014 applies: A dies owning Blackacre, value $100,000, basis zero, encumbered by a mortgage of $80,000. His estate also includes $80,000 of cash. His will leaves all of his property to B. On A’s death, he has no gain and the basis of the estate in Blackacre under section 1023 would be zero.

Suppose now that the estate distributes Blackacre and the $80,000 cash to B during a taxable year when it has distributable net income of $10,000. In such a case the estate would have no gain on the distribution since its amount realized ($80,000 mortgage) is offset by the $80,000 cash. B, however, would have to include $10,000 in his gross income under section 662 since the distribution of the equity of $20,000 in Blackacre plus the $80,000 of cash carries out all of the distributable net income of $10,000 to B. B’s basis would then be derived from three sources: $80,000 under Crane because of the mortgage on Blackacre, $10,000 because of his inclusion of $10,000 distributable net income in his income (Reg. § 1.662(a)(1)(f)), and a zero carryover basis under section 1023 for A’s zero basis in Blackacre. This total of $90,000 would then be allocated $80,000 to the cash leaving B with $10,000 of basis in Blackacre.