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The Federal Income Tax Consequences of Transactions Relating to Mortgages on Land

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This article deals with the federal income tax liabilities incurred by the owner of mortgaged land and by the holder of the mortgage in respect to various transactions relating to the land or the debt. One of the most interesting aspects of the problems arising in this field is the extent to which the debt has been treated as that of the owner of the land, even though he was not personally liable for it. The cases following that approach are often startling at first glance, but appear on further study to be consistent with the body of tax law.

A related facet of this study is the conflict between the tendency at times to treat a mortgagor as the owner of a physical object and at times to recognize that he has only part of the interests related to it. The outcome of that conflict seems to depend more on practical considerations than on jurisprudential distinctions between things and legal interests. To the extent that the mortgagor is treated as the owner of a physical object, he is considered as "owing" debts secured by liens upon it.

In this article, the term, "mortgagor", is used to refer to the owner of land which is subject to a mortgage, whether or not he is personally liable for the debt. Where his tax liability is affected by his having assumed or not assumed the debt, that fact is indicated.

The Execution of a Mortgage

If a person gives a mortgage on land as security for a loan, no immediate tax consequences arise for either the borrower or the lender. Such a transaction has two aspects. First, the mortgagor receives a loan from the mortgagee. Second, he transfers to the mortgagee an interest in the property used as security.¹

Receipt of the loan does not effect realization of taxable income, since the borrower is legally obliged to repay it.² He has increased his assets to the extent of the loan but has also made a corresponding increase in his liabilities.

Nor does the giving of the mortgage result in taxable gain or deductible loss for either party. In the older common law, a mort-

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² A contrary result would undoubtedly be reached in the case of a sale disguised as a loan.
gage was considered to be a conveyance of legal title, subject only to a condition subsequent which gave the mortgagor a power to re-enter if he paid a certain sum by a stated day. So interpreted, the giving of a mortgage might be held to be a sufficient disposition of property for the realization of taxable gain or deductible loss. The tendency of our courts has been, however, to hold that a mortgagee has merely a lien, without any right to possession. As Judge Learned Hand said in *Commissioner v. Crane*,

the mortgagor is the owner for all purposes; . . . He has all the income from the property; he manages it; he may sell it; any increase in its value goes to him; any decrease falls on him until the value goes below the amount of the lien. The mortgagee is a creditor, and in effect nothing more than a preferred creditor, even though the mortgagor is not liable for the debt.

For tax purposes too we treat the execution of a mortgage as the mere giving of security for a loan, not as a disposition of the property. Therefore, the execution of a mortgage does not give rise to taxable gain or deductible loss.

A taxpayer has argued that when the owner of property subjects it to a mortgage securing a loan in an amount greater than his investment in the property he realizes taxable gain. The taxpayer was a corporation which had received the property in a tax-free exchange and hence had taken over the basis of its transferor. The issue was the extent of the gain realized by the taxpayer on a foreclosure sale. The taxpayer argued that, when its transferor had given a mortgage securing a loan greater than her investment in the property, she had realized a taxable gain, the amount of which should have been added to her basis, thus increasing the basis of the taxpayer and reducing the amount of the gain realized on foreclosure.

The Court of Appeals rejected the taxpayer's argument, however, on the ground that execution of a mortgage did not constitute "disposition" of the property under Section 111(a) of the 1939 Internal Revenue Code and hence did not lead to the realization of taxable gain. Quoting its language in the *Crane* case, the court said that the mortgagee is a creditor and the mortgagor remains the owner of the property.

4. Id. at 939.
5. 153 F. 2d 504, 506, (2d Cir. 1945).
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THE PARTY ENTITLED TO DEDUCT DEPRECIATION

Since the mortgagor remains substantially the owner of the mortgaged property, he is ordinarily the person entitled to deduct depreciation on it. The general principle is that the person who will bear the economic loss resulting from the physical deterioration of the property may take the deduction. Usually the mortgagor bears that economic loss, because the value of the mortgaged property exceeds the amount of the debt. Normally, he will repay the debt and own the property unencumbered.

In *Crane v. Commissioner*, however, the taxpayer, who had inherited mortgaged property and had not assumed the debt, argued that she had not borne the economic loss occasioned by depreciation. The value of the property had been reported for estate tax purposes as equal to the total of the principal of the debt and the interest in default. The taxpayer had used that value as her basis for calculating deductions for depreciation. She later sold the property and received a small amount of cash. The Commissioner contended that she had realized a gain, computed by adding the amount of the debt to the net cash received by the

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7. The basis of the assets of a public utility company has been reduced to eliminate amounts which its customers had paid toward the erection of its facilities. *Detroit Edison Co. v. Commissioner*, 319 U. S. 98 (1943). The Court said in respect to depreciation:

"The end and purpose of it all is to approximate and reflect the financial consequences to the taxpayer of the subtle effects of time and use on the value of his capital assets. For this purpose it is sound accounting practice annually to accrue as to each classification of depreciable property an amount which at the time it is retired will with its salvage value replace the original investment therein." [Italics added.]

Contrast *Brown Shoe Co. v. Commissioner*, 339 U. S. 583 (1950), where the taxpayer was allowed to depreciate buildings given to encourage it to conduct manufacturing operations in particular towns and to depreciate the full cost of property purchased with contributions made by local people for such purposes. The Supreme Court there held that the amounts received had been contributions to capital; it distinguished *Detroit Edison Co.*, as involving payments made by customers for services. 339 U. S. 583, 591 (1950). Section 362(c) of the 1954 Code now provides in effect, that property contributed to a corporation, not by a shareholder as such, or property acquired for money so contributed shall have a basis of zero. Congress thus has denied any deduction for depreciation of such property. A transaction purporting to effect a transfer in trust with a lease back to the transferor was construed as a loan on the security of the property transferred; depreciation deductions were allowed to the transferor. *Helvering v. F. & R. Lazarus & Co.*, 308 U. S. 252 (1939). The owner of condemned property has been denied the right to deduct depreciation for the period between the condemnation judgment and the transfer of possession. *Edith Henry Barbour*, 44 B. T. A. 1117 (1941), reversed on other grounds, 136 F. 2d 486 (6th Cir. 1943).


10. Apparently the taxpayer received little tax benefit from those deductions but did not argue that point in the Supreme Court. According to a Note, 49 Col. L. Rev. 845, 848 n. 24, (1949), the taxpayer realized a tax benefit of roughly $150 from the depreciation deductions but had to pay a tax, on disposition of the property, of about $1900.
taxpayer and subtracting therefrom the basis of the taxpayer, which he determined to be the value at which the property had been returned for estate tax purposes, minus the depreciation which the taxpayer had deducted. The taxpayer argued that she should calculate her taxable gain by subtracting a basis of zero, the value of her equity, from the amount of the net cash received. The Commissioner argued that using the value of an equity as a basis for depreciation was impractical. The taxpayer replied that the problem of depreciation was irrelevant, because her equity had no value and consequently not she but the mortgagee bore the economic loss resulting from depreciation and should have been allowed the deductions. In support of the taxpayer’s position, it could be argued that generally depreciation is allowed only to replace the actual investment of the taxpayer, not to recover the value of the physical object.\(^1\) The difficulties with the taxpayer’s position were first, that depreciation had in fact been “allowed” to her and, second, that she had not proved that the value of the property was less than the amount of the mortgage.\(^2\) The Supreme Court adopted the view of the Commissioner as to the taxpayer’s basis. It did not directly decide that the taxpayer had been entitled to deduct depreciation, but such a conclusion probably follows from the decision that was made.

Normally, no one will make a loan on property worth less than the amount of the loan. If, however, the value of the property drops below the amount of the debt, does the right to deduct depreciation shift to the mortgagee? This problem may not be important if in fact mortgagors usually suffer foreclosure or transfer their interests to the mortgagees when the value of the property falls below the amount of the debt.\(^3\) Perhaps, however, during times of depression mortgagees prefer to let mortgagors retain possession if they will at least make some payments of interest rather than foreclose and be burdened with management of the property. That appears to have been for some years the situation involved in \textit{Crane v. Commissioner}. Even if the mortgagor does default and suffer foreclosure relatively soon after the decline of the value of the property below the amount of the debt, a problem may arise as to the person entitled to deduct depreciation.

\(^{12}\) See also note 7, \textit{supra}.
\(^{13}\) As executrix of the estate of her husband, the taxpayer claimed deductions for depreciation for the estate for the years 1932 through 1936; she claimed such deductions in her own returns for 1937 and 1938. 3 T. C. 585, 587 (1944). The Supreme Court apparently assumed that the taxpayer had claimed the deductions in her individual returns for the years 1932 through 1938. 331 U. S. 1, 3, n. 2, 15 (1947). The matter may be inconsequential, since the taxpayer was the sole beneficiary of her husband’s estate.

tion for the period between that decline and the foreclosure sale. There appear, however, to be no decisions permitting a mortgagee to deduct depreciation on the mortgaged property, and the Supreme Court, in the *Crane* case, indicated that a mortgagee could not deduct depreciation while the mortgagor was in possession, since the deduction was then allowed only as to property "used in the trade or business."14

If the mortgagor is solvent and personally liable on the debt he should be able to deduct depreciation regardless of the relative amounts of the debt and the value of the property, since further decline in value of the property may increase his liability on a deficiency judgment. Even in other cases, shifting the right to the deduction may be undesirable because of the difficulty of determining the fair market value of property. Such value may have to be determined as of the time of the foreclosure sale so that the mortgagee’s gain or loss can be ascertained;15 but shifting the right to deduct depreciation would require determining just when the fair market value of the property fell below the amount of the debt. That burden would overbalance the theoretical advantage of shifting the deduction to the party who will bear the loss. See the more feasible suggestion, discussed below, that the mortgagor deduct depreciation until he has exhausted a basis equal to his original equity and that no further depreciation be allowed to either party, with any loss suffered by the mortgagee being deductible as a bad debt.

**The Mortgagor’s Basis for Purposes of Depreciation**

Since the mortgagor normally may deduct depreciation on the property, what is his basis? If he owned the property before he executed the mortgage, he continues to use his original basis. If, when he bought the property, he gave a purchase money mortgage to secure his obligation to pay part of the price and became personally liable for the debt, he uses the total price as his basis.

A more difficult problem arises if the mortgagor is not personally liable for the debt. The leading case dealing with that problem is *Crane v. Commissioner,*16 which held that a taxpayer

14. 331 U. S. 1, 10, n. 28 (1947). Int. Rev. Code § 23(1) (1939), prior to its amendment by § 121(c) of the 1942 Revenue Act. The addition of the phrase, "of property held for the production of income", probably did not change the result, if "property" means "physical property", since the "property" would then seem to be "held" by the mortgagor. Query as to whether this line of argument can be squared with the cases, such as *Terminal Realty Corporation*, 32 B. T. A. 623 (1935), which have allowed a lessor to deduct depreciation in respect to leased property.


who had inherited property from her husband subject to a mortgage should use as her basis for depreciation the fair market value of the physical property as of the time of his death, undiminished by the debt. The Court based its conclusion on long-established administrative interpretation and practice, on the interpretation of the word, "property", in Section 113(a)(5) of the 1939 Internal Revenue Code, as referring to a physical thing rather than to a particular legal interest in a thing, and on the impracticality of computing depreciation deductions on the basis of changing equities.

Under Crane v. Commissioner, what is the effect on the mortgagor's basis of payments by him on the principal amount of the debt? That problem was later dealt with in Parker v. Delaney. The taxpayer had acquired property subject to liens totalling $273,000. While he owned the property, he paid $13,989.38 on the mortgages and deducted depreciation of $45,280.48. The taxpayer then transferred the property to the mortgagees. The First Circuit held that he realized taxable gain in the amount of $31,291.10. That amount apparently was computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unadjusted basis</td>
<td>$273,000.00</td>
</tr>
<tr>
<td>Less depreciation</td>
<td>45,280.48</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>$227,719.52</td>
</tr>
<tr>
<td>Original debt</td>
<td>273,000.00</td>
</tr>
<tr>
<td>Less payments</td>
<td>13,989.38</td>
</tr>
<tr>
<td>Amount realized</td>
<td>$259,010.62</td>
</tr>
<tr>
<td>Amount realized</td>
<td>259,010.62</td>
</tr>
<tr>
<td>Less adjusted basis</td>
<td>227,719.52</td>
</tr>
<tr>
<td>Gain</td>
<td>$31,291.10</td>
</tr>
</tbody>
</table>

The payments on the debt then had no effect on the taxpayer's basis. It would seem at first thought that such payments should be added to the taxpayer's basis, but the effect would be to permit depreciation on an amount exceeding the fair market value and hence the deduction would be without relation to the physical exhaustion of the property. That alone might not be fatal, since depreciation of property does not necessarily correspond to the economic loss caused by physical deterioration. The basis of the

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17. Now § 1014(a) of the 1954 Code.
18. 186 F. 2d 455, 457, n. 2 (lst Cir. 1950).
19. Legal title was held by a strawman for the taxpayer, but that fact may be ignored for present purposes.
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property may be considerably different from its fair market value, because the price paid, in the case of purchased property, may be different from the market value and because the market value of the property may fluctuate after its acquisition. A second effect, however, would be to give the taxpayer an undeserved loss on disposition of the property. Assuming that the amount of the debt, reduced by the payments, would be includible in the amount realized by the taxpayer, he would recover such payments twice, once through their addition to his basis and the second time through their deduction from the amount realized. Thus, it seems preferable to ignore such payments in determining the mortgagor's basis. An alternative approach would be to add the payments but subtract the corresponding reduction of the debt; that approach offers no substantial advantage.

In a concurring opinion, Judge Magruder proposed another approach. Noting the strain exerted on Section 111(b) of the 1939 Code by inclusion of the amount of an unassumed debt in the "amount realized", he suggested that the original out-of-pocket cost of the taxpayer, zero, be taken as his unadjusted basis, that payments on the debt be added to that basis, and that depreciation that had been allowed be subtracted from it. The adjusted basis at the time of disposition of the mortgagor's interest would then be negative. The "amount realized" would be only the amount of cash received, zero. The gain so computed would be the same as that arrived at by the majority.

Judge Magruder's approach had the theoretical advantage of permitting a less strained construction of the phrase, "amount realized", and using it retroactively in Parker v. Delaney would have done no harm, since the result would have been the same. Used prospectively, however, it would add complexity to the calculation of deductions for depreciation without preventing the tax avoidance and hardship which may result from the Crane case.

A question can also be raised as to whether the Crane case would have reached a different decision as to the taxpayer's basis if it had been proved that the estate from which she had received the property had not been liable for the amount of the debt. Section 81.38 of Regs. 105 provides that in such an event only the value of the equity need be included in the gross estate. Would that have affected the basis calculated under Section 113(a)(5) of the 1939 Code? Probably there should be no difference since the practical result, for estate tax purposes, of including the fair market

20. See the discussion below under the heading, Transfer to a Third Party of the Interest of the Mortgagor or Mortgor, and under subsequent headings.
value of the physical object and deducting the amount of the debt is the same as that of including only the value of the equity. Section 81.38 does, however, show that the word "property" has sometimes been interpreted to mean "equity" and that consequently such an interpretation of "property" in Sections 111 and 113(a)(5) of the 1939 Code was not necessarily excluded.\(^2\)

The *Crane* case dealt with a taxpayer who had received the property in question by devise. There is also authority which supports the position that one who buys property subject to a mortgage but without assuming liability thereunder may include the amount of the mortgage in his basis. In *Parker v. Delaney*, discussed above, the parties apparently agreed upon such treatment of a mortgage. *Blackstone Theatre Co. v. Commissioner* so held as to tax liens.\(^2\) The Tax Court there relied chiefly on *Crane v. Commissioner*.

The position of the *Crane* case need not have been carried over to the case of a taxpayer who purchased property subject to liens, as in *Blackstone Theatre Co.* The decision in *Crane* was based at least partly on the fact that it dealt with inherited property, subject to Section 113(a)(5) of the 1939 Code. There the problem was the meaning of the word "property". The Regulations seemed to require that the word be interpreted to refer to the physical object and that its value be taken as the fair market value returned for estate tax purposes, undiminished by liens.\(^2\) Here, however, Section 113(a) of the 1939 Code was applicable, and the question, at least in part, was the meaning of "cost".\(^2\) Exclusion of the debt from "cost" for this purpose would have been consistent with the cases on cancellation of indebtedness, which have found that the owner of mortgaged property not personally liable for the debt did not realize taxable income.\(^2\) The result here does show the increasing tendency of the courts to treat an unassumed debt as a liability of the owner of the security.

**The Mortgagor’s Basis as Affected by Reduction of the Debt**

Reduction of a debt often results in the realization of taxable income by the debtor.\(^2\) Such tax treatment may be harsh, however, because the transaction does not give the debtor any cash

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22. 12 T. C. 801 (1949).
24. The same question is raised under Section 1012 of the 1954 Code.
25. See below at page 192.
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with which to pay the tax. Consequently, judicial and legislative devices for avoiding that hardship have been evolved. The courts have sometimes interpreted the transaction as a reduction of the purchase price of property held by the debtor. His basis for such property has then been reduced, thus, in effect, delaying any tax until the disposition of the property.\(^\text{27}\)

The real difficulty has been determining whether the transaction should be treated as a reduction of the purchase price of the mortgaged property. Except where special facts were present, a mortgagee's settlement of the debt or part of it for less than the face amount has been treated not as such a reduction but as a realization of taxable income.\(^\text{28}\) That was the usual result where the mortgagor repurchased its bonds at a discount.\(^\text{29}\) That result could be avoided if the mortgagor could prove that he dealt with the mortgagee in terms of reduction of the purchase price, as where the value of the property had fallen and the debt was settled for an amount not less than the then value of the property. This doctrine is consistent with the usual principle that no taxable income is realized on the purchase of property." It may conflict, however, with the rule that tax liability is computed on the basis of annual accounting periods.\(^\text{30}\) The doctrine has, in fact, been rejected in part on that ground\(^\text{32}\) by cases which tend to limit the purchase price doctrine to cases in which the debt was incurred and reduced in the same year.\(^\text{33}\) The purchase price doctrine has

\(^{27}\) For a full analysis of this problem under the 1939 Code, see L. Hart Wright, Realization of Income Through Cancellations, Modifications, and Bargain Purchases of Indebtedness: II, 49 Mich. L. Rev. 667, 674-684 (1951).

\(^{28}\) Commissioner v. Jacobson, 336 U.S. 28 (1949); Helvering v. American Chicle Co., 291 U.S. 426 (1934); Frank v. Utah, 44 F. Supp. 729 (D. Utah 1942); cert. denied, 293 U.S. 595 (1934); Commissioner v. Coastwise Transportation Corp., 71 F. 2d 104 (1st Cir. 1934); aff'd, 131 F. 2d 864 (3rd Cir. 1942); Marion A. Blake, 8 T. C. 546 (1947); L. D. Coddon & Bros., 37 B. T. A. 393 (1938); Consolidated Gas Co. of the City of Pittsburgh, 24 B. T. A. 901 (1931).

\(^{29}\) Helvering v. A. L. Killian Co., 128 F. 2d 433 (8th Cir. 1942), affirming 44 B. T. A. 169 (1941); Hirsch v. Commissioner, 115 F. 2d 655 (7th Cir. 1940), reversing 41 B. T. A. 890 (1940). In the Hirsch case, the court based its decision on the ground that a loss in value of the property offset any income realized from the reduction of indebtedness. On its facts, however, the case seems to fall with those relying on the doctrine of reduction in purchase price. Hextell v. Huston, 28 F. Supp. 521 (D. Iowa 1939), appeal dismissed without opinion, 107 F. 2d 1016 (8th Cir. 1939); Gehring Publishing Co., Inc., et al., 1 T. C. 345 (1942); Ralph W. Gwinn, P-H 1944 T. C. Mem. Dec. Par. 44,208; Mark W. Allen & Co., P-H 1943 T. C. Mem. Dec. Par. 43, 168.


\(^{32}\) Commissioner v. Coastwise Transportation Corp., 71 F. 2d 104, 106 (1st Cir. 1934); cert. denied, 293 U. S. 595 (1934); L. D. Coddon & Bros., Inc., 37 B. T. A. 393, 397-8 (1938); B. F. Avery & Sons, Inc., 26 B. T. A. 1393, 1399-1400 (1932).

\(^{33}\) Des Moines Improvement Co., 7 B. T. A. 279 (1927).
been criticized on several other grounds. It ignores the fact that reduction of the debt to an amount not exceeding the value of the security frees other assets of the mortgagor from liability to be taken in satisfaction of the debt. Such freeing of assets from an offset by a debt was the basis of the decision in U. S. v. Kirby Lumber Co., the leading case holding that taxable income resulted from cancellation of indebtedness. The purchase price doctrine tends to cause administrative inconvenience since the reduction of basis should lead to re-computation of depreciation on returns previously filed and still open to adjustment. It has also been argued that the doctrine would delay final determination of gain or loss on the sale of mortgaged property subject to a mortgage until settlement of the debt. This seems to be wrong since a settlement of the debt which led to a reduction of the basis of the mortgagor would result in a similar reduction of the amount realized by him.

The purchase price doctrine has also been criticized on the ground that it involves a recognition of a loss in respect to property which the taxpayer still owns. Some cases have been decided in part upon that ground. It is submitted, however, that that argument is not conclusive. The taxpayer in such a case is not attempting to deduct a loss from income received from other transactions. He seeks merely to avoid being treated as having realized a taxable gain at the time of the settlement of the debt. If no such gain is realized, the taxpayer's basis will be reduced, so that if he sells the property during a later inflationary period, he may realize a gain at that time.

In effect, Congress appears to have adopted and extended the purchase price doctrine. Under Sections 22(b)(9) and 113(b)(3) of the 1939 Code, a corporation which realized income through the discharge of indebtedness evidence by a security might elect to exclude that income and instead to reduce the basis of its assets. The 1954 Code has broadened that privilege. Under Sections 108(a) and 1017, either a corporation or an individual has such an election, if in the case of the individual the indebtedness was incurred or assumed in connection with property used in his trade or business. Also, the debt need not have been evidenced by a security.

The purchase price doctrine developed by the courts relates only to a debt incurred in connection with the acquisition of spe-

35. 284 U. S. 1 (1931).
36. See, A Statutory Approach to the Tax Problems of the Mortgagor Consequent upon Reduction of the Mortgage Debt, 21 FORDHAM L. REV. 42, 47 (1952)
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cific property. Sections 108(a) and 1017 seem to apply not only to such debts but also to debts incurred subsequently to the purchase of the property given as security and to debts not secured by any specific property of the taxpayer. This result is clear in the case of corporate debtors. It is less certain in the case of individuals. The statute refers to a debt "incurred or assumed . . . in connection with property used in his trade or business." The Senate Committee Report, however, states that the provision is applicable "to the indebtedness of an individual if the indebtedness was incurred or assumed by the individual in connection with the acquisition of property used in his trade or business." The words "the acquisition of" do not appear in the statute. Do they nevertheless constitute a limitation on the applicability of the statute?

Whether the election is permitted in respect to debts secured by previously acquired property seems to depend on the answers to the following questions:

1. Does the language of Section 108(a) clearly bar the election? Are such debts incurred or assumed in connection with the property? The connection is not so great as in the case of a purchase-money debt, but is it sufficient for the purpose of Section 108(a)?

2. If Section 108(a) does not clearly bar the election, is it ambiguous, so that a committee report may be used to determine its meaning?

3. If Section 108(a) taken literally clearly does permit the election, may a committee report be used to limit the applicability of that section?

4. Did the Committee in fact mean to limit the application of Section 108(a) to purchase-money debts or merely to state an instance in which the statute does apply?

The writer submits that Section 108(a) should be interpreted to permit the election as to debts secured by previously acquired property. The ground for this position is that Section 108(a) does not clearly bar the election, and that even if it does not clearly permit it, the Committee Report does not show an intention of Congress to limit the election to the case of a purchase-money debt. Had Congress intended such a limitation, it could easily have inserted the words "the acquisition of" into the statute. Furthermore, there seems to be no reason to place such a limitation upon an individual when it does not apply to a corporation.

Probably the purpose of the limiting language in clause (1)(B) of Section 108(a) is merely to bar the use of the election in respect to non-business debts which would generally not be incurred by a corporation.

Thus it appears that the effect of Section 108(a) and 1017 is broader than that of the purchase-price doctrine, in that those sections permit the reduction of the basis of property not purchased in connection with the incurrence of the debt. Also those sections confer an election, thus giving the taxpayer a greater choice than the judicial decisions could.

Before the adoption of the 1954 Code the owner of property subject to a mortgage could also avoid a finding that a reduction of the debt constituted a realization of taxable income if he was not personally liable on the debt. Note, however, the discussion of *Lutz & Schramm Co.*, below. The tendency to treat a secured debt as the debt of the owner of the security even though he has not assumed the debt may lead to a change in this rule. We have already seen that pre-existing liens have been treated as part of the "cost" of one who purchased property without assuming the debts secured thereby.

It is arguable that the exception of the taxpayer who was not personally liable on the debt has been abrogated by the 1954 Code. Section 108(a) extends the privilege of excluding income realized by the discharge of indebtedness not only to a taxpayer who was personally liable for the debt but also to a taxpayer who merely took property subject to a debt. This seems to be the effect of Section 108(a), despite some ambiguity which appears in Section 108(a)(1) because of the use of the phrase, "incurred or assumed". Was a debt "incurred" by a taxpayer who bought property subject to it? Probably Congress meant that it was.

There seems to be no reason to state expressly that a taxpayer who merely takes subject to a debt may exercise the election granted by Section 108 unless in the absence of that provision he would realize gross income. Such a result will not damage a taxpayer who may exercise the election granted by Section 108, since he would normally reduce the basis of his property in this

39. *Ernst Kern Co.*, 1 T. C. 249 (1942), appeal dismissed (6th Cir. 1944); *P. J. Hiatt*, 35 B. T. A. 292 (1937); *Fulton Gold Corp.*, 31 B. T. A. 519 (1934); *American Seating Co.*, 14 B. T. A. 328 (1928), modified without discussion of this point, 50 F. 2d 681 (7th Cir. 1931).


41. It may be noted also that Section 108(a) does not indicate whether the taxpayer must be the corporation or the individual who incurred or assumed the debt within Section 108(a)(1). Congress probably meant that he must.
situation, but it will work to the detriment of a taxpayer who does not have that privilege because of the limitations stated in Section 108(a)(1)(B).

Probably the mortgagor would not be considered to have realized taxable income but to have reduced his basis for the mortgaged property if he was insolvent before and after the reduction of the debt. It has been held that no income is realized in such a situation.\textsuperscript{42} That result has been criticized on the ground that it is inconsistent with the treatment of other types of income, such as dividends or interest, as taxable to an insolvent taxpayer.\textsuperscript{43} The reason for the result seems to be the converse of the notion of \textit{Kirby Lumber Co.}: that a taxpayer realizes taxable income on the cancellation of indebtedness because it frees his assets from the liability. No such freedom is gained by the taxpayer who remains insolvent.

Similar results have also been reached in less common situations: where the debtor and creditor reduced the contemplated amount of the debt before the transaction giving rise to it was complete;\textsuperscript{44} where the original agreement contemplated a reduction of the debt if paid in cash;\textsuperscript{45} or where the mortgagor paid the debt with certificates of the mortgagee purchased at a discount, pursuant to the terms of the original agreement.\textsuperscript{46}

\textbf{Payments of Interest by the Mortgagor}

The treatment of such payments reflects the tendency to treat the owner of an equity as liable on the debt, even though it could not be enforced against his other assets. If the mortgagor is personally liable on the debt, he can of course deduct payments of interest.\textsuperscript{47} This is the case even if the equity has since been transferred to a third party.\textsuperscript{48} Although not personally liable on the debt, he can deduct payments of interest.\textsuperscript{49} This is an exception to the general rule that one may deduct interest payments only on his own debts.\textsuperscript{50} The explanation can only be our tendency to treat the owner of the equity as liable on the debt regardless of whether he has assumed it.

\textsuperscript{42} Dallas Transfer & Terminal Warehouse Co., v. Commissioner, 70 F. 2d 95 (5th Cir. 1934).
\textsuperscript{43} 1 Rabkin & Johnson, \textit{Federal Taxation}, § 36.02(1).
\textsuperscript{44} Des Moines Improvement Co., 7 B. T. A. 279 (1927).
\textsuperscript{45} Pinckney Packing Co., 42 B. T. A. 823 (1940).
\textsuperscript{46} Cherokee Co., 41 B. T. A. 1212 (1940).
\textsuperscript{47} Int. Rev. Code § 163(a) (1954).
\textsuperscript{49} U. S. Treas. Reg. 118, § 39.23(b) (1953).
\textsuperscript{50} Colson v. Burnet, 59 F. 2d 867 (D. C. Cir. 1932), cert. denied, 287 U. S. 640 (1932).
Interest on a mortgage debt is, of course, includible in the gross income of the mortgagee.\(^{51}\) The time of inclusion depends on the time of payment and on whether the mortgagor uses the cash or accrual system of accounting.\(^{52}\) The problem of whether a mortgagor should be treated as having received interest on foreclosure of a mortgage will be dealt with below.

**TRANSFER TO A THIRD PARTY OF THE INTEREST OF THE MORTGAGEE OR MORTGAGOR**

Our most interesting questions lie in this area, the field of the leading and controversial *Crane* case.

The tax consequences of a transfer of the interest of the mortgagor are relatively easy to develop. If he sells his interest at a loss, he has a deduction under Section 165. If the mortgage and the debt constituted a capital asset in his hands, his treatment of the loss will be subject to the limitations of Sections 1211 and 1212.\(^{53}\) Similarly, any gain will be includible in gross income under Section 61, subject to the provisions relating to capital gains and losses.

The problems relating to a mortgagor's disposition of his interest are more difficult. The easiest situation to dispose of is that in which the mortgagor was personally liable for the debt and sold his equity to a purchaser who assumed liability for the debt. In that case, the amount of the mortgage is property other than money received by the mortgagor and hence is part of the amount realized by him. That follows because the promise of the purchaser to pay the debt is an asset of the mortgagor.\(^{54}\)

The more difficult rule to accept is that applicable to the mortgagor who was not personally liable for the debt: the amount of the debt is still treated as part of the amount realized.\(^{55}\) The difficulty lies in seeing how in such a case the seller can be said to have received anything in respect of the mortgage. The result, though, is probably sound being compelled by the holding discussed above, that the basis of property acquired subject to a mortgage, but without its assumption, includes the amount of the mortgage.

The result of excluding the debt from the amount realized would have been undesirable. Justice Vinson said that it would

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51. *Int. Rev. Code § 61(a)(4) (1954).*
52. *Int. Rev. Code §§ 441, 446, and 451 (1954).*
53. *Int. Rev. Code § 165(f) (1954).*
55. *Crane v. Commissioner,* 331 U. S. 1 (1947). Regulation 118 § 39.44-2(c) treated the amount of the debt as part of the selling price, for the purposes of Section 44 of the 1939 Internal Revenue Code, which dealt with installment sales. On that matter see also Fritz L. Braunfeld, *Subject to a Mortgage,* 24 *Taxes* 424, 434 (1946).
have meant, in effect, giving the taxpayer a double deduction for depreciation. In what sense is that true? A contrary holding would have given the taxpayer a deductible loss to the extent of the difference between her adjusted basis and the amount of cash realized. Such a result would have been undesirable since the taxpayer had not invested anything in the property and had never had a substantial equity in it. That result would not, however, by itself have involved a double deduction of depreciation, since the amount of the loss would have been determined by reference to adjusted basis, taking into account the depreciation which the taxpayer had deducted.

Justice Vinson assumed, however, that since the taxpayer received some cash the property must have been worth the amount of the debt plus the cash. He thought that the taxpayer's position then, in becoming free of the debt-ridden property was the same as if she had received the cash plus other money in the amount of the debt, subject to an obligation to use that other money to pay the debt. Had that occurred she would have received cash totalling more than her adjusted basis so that she would not only have realized no loss but also would have realized a gain to the extent that her adjusted basis was exceeded, to the extent that she had deducted depreciation. Compared with such a result, the result of a holding that the amount realized did not include the amount of the debt thus would have been an allowance to the taxpayer of a double deduction for depreciation. Since the taxpayer had deducted depreciation from a basis which represented neither any outlay by her nor the actual value of her interest in the property, it was desirable that she be treated as having realized a taxable gain to compensate the government for the taxes lost through that deduction. That result was achieved by holding that the debt was included in the amount realized.

The government does not recover, through the result in *Crane v. Commissioner*, precisely the amount of taxes saved by a mortgagor through the allowance of deductions for depreciation. The deductions are allowed against ordinary income whereas the gain on the sale is capital. Thus the *Crane* decision as to basis affords a simple method of tax avoidance for taxpayers in high brackets. That assumes that the *Crane* rule, which includes the amount of the debt in the mortgagor's basis, is applied to purchasers as well.

56. 331 U. S. 1, 15-16 (1947).
57. Note, 49 Col. L. Rev. 843, 847 n. 19 (1949). The taxpayer did not contend for such a result but argued that her unadjusted basis was only the value of her equity and that she had realized only the net cash which she had received.
as to devisees and heirs, or that thoughtful fathers will buy heavily mortgaged property to be inherited by their wealthy children. The Tax Court has applied the Crane rule to purchasers.\textsuperscript{60}

On the other hand the government may on the sale more than recover the taxes lost through depreciation deductions. That will be the case if the mortgagor had so little income that his effective rate of tax in the years before the sale was less than the rate applicable to capital gains or if he had insufficient income to benefit from the whole of the deductions.\textsuperscript{60} The basis of a taxpayer who is entitled to deduct depreciation is reduced in the amount of the depreciation deduction taken, even though that deduction does not give him any tax benefit, to the extent that the deduction is allowable.\textsuperscript{61} The Crane case itself involved such a hardship for the taxpayer.\textsuperscript{63}

To end these possibilities of tax avoidance by some taxpayers and hardship to others, the suggestion has been made that if the owner of property subject to a mortgage is not personally liable on the debt, the debt should be included in his basis for the purpose of computing the amount of his deductions for depreciation, but excluded from the basis from which those amounts are deducted as well as from the amount realized on the sale of the property. The amount of the deduction then would be calculated as a percentage of the sum of the equity and the debt, but the deduction would be applied against only the equity.\textsuperscript{63} After adjustment of the equity to zero no further depreciation deductions would be allowed.\textsuperscript{63} The equity would, of course, include not merely the original investment of the mortgagor but also any payments by him of the debt.\textsuperscript{65}

Limiting depreciation to the book equity would cause no hardship to the mortgagor since only the property concerned is liable for the debt. The real loss would fall on the mortgagee who would be permitted a deduction of a loss or a bad debt on foreclosure or settlement with the mortgagor.

Such procedure would prevent both the tax avoidance and the hardship made possible by the Crane case. The taxpayer in the

\begin{itemize}
\item 59. \textit{Blackstone Theatre Co.}, 12 T. C. 801 (1949).
\item 60. Note, 49 \textit{Col. L. Rev.} 845, 849-50 (1949).
\item 63. Note, 49 \textit{Col. L. Rev.} 845, 851 (1949).
\item 64. An alternative suggestion is that the basis and the amount realized should include the amount of the debt but that depreciation should be allowed only to the extent of the book equity; the result would be the same. Note, 13 \textit{U. Chi. L. Rev.} 510, 514 (1946).
\end{itemize}
high brackets would not get depreciation deductions calculated on and deducted from a basis exceeding his actual investment. The taxpayer in a low bracket would not need to be charged with the realization of the debt on disposition of the property merely to balance depreciation deductions which he did not need and to prevent him from deducting a loss which did not represent an investment by him.

Would the treatment just described involve difficulties if the mortgagor's equity fluctuated? Fluctuations due to increases in the market value of the realty should be disregarded for purposes of depreciation, as they generally are. Here we sacrifice economic theory for administrative convenience. Such fluctuations would simply result in the realization of gain on disposition of the property if, for example, a third party paid a substantial sum for it. A more difficult problem is that of an increase in the equity or the re-creation of an equity through payments of principal by the mortgagor. As a practical matter a mortgagor not personally liable may rarely make payments of principal on a debt which is greater than the fair market value of the mortgaged property. If he did make such payments, they could be added to his adjusted basis and depreciation allowed until their exhaustion. Some additional computation by the taxpayer and the revenue officials would be required, but no problem of guessing at fair market value would arise. Thus the difficulties that might arise from fluctuation of the equity seem soluble.

The adoption of a rule providing for the deduction of depreciation only to the extent of the mortgagor's book equity, and for the exclusion of the amount of the debt from the "amount realized" could best be effected through legislation. The course of decision now shows a tendency to apply generally the rules of *Crane v. Commissioner* as to basis and amount realized. It seems doubtful that that tendency will be reversed; and complete settlement of the matter by the Supreme Court may be long delayed.

Assuming, however, that the result of the *Crane* case is allowed to stand, what is a satisfactory rationalization for it? The difficulty arises partly from the ambiguity of the word "property". In determining the taxpayer's basis the court interpreted that word to mean the physical thing, not the taxpayer's interest in it. Then in ascertaining the amount realized the court

68. For specific suggestions as to the sections of the Internal Revenue Code to be amended, see Note, 33 Iowa L. Rev. 143, 149-150 (1947).
asserted that she must have sold the same "property", that no one sells a "property" worth several hundred thousand dollars for a few thousand, and that, therefore, she must have received the amount of the mortgage debt. The difficulty is that the taxpayer never had nor disposed of the totality of interests in the physical thing. Admittedly, it is not correct to treat the taxpayer's interest as only the excess of the value of the property over the amount of the debt. In addition to that interest she had the right to possession of the property and to the income from it so that she was more like an "owner" of "the property" than anyone else. Yet she never had, nor disposed, of the totality of interests in the physical thing. The answer seems to be that having abused the word "property" to arrive at a practicable basis for depreciation we kick it again to avoid giving the taxpayer undeserved deductions of depreciation and a loss.

There has been some discussion of the significance of the receipt of cash by the taxpayer in the Crane case. The court used that fact as a basis for arguing that the property was worth more than the amount of the debt, that the taxpayer before the sale had to treat the debt as its own, and that therefore, the sale of the property subject to the debt amounted to a release of the taxpayer from a debt. The difficulty with that argument is that the purchaser may have paid that cash merely for the privileges of receiving income from the property until foreclosure and of negotiating with the mortgagee for a reduction in the debt. Hence the equity may have had some market value, but not such value as to cause the taxpayer to pay principal or interest from her other funds. It does not follow, then, that the taxpayer was under serious economic pressure to treat the debt as her own while she owned the equity.

This discussion of the effect of the receipt of cash for the equity leads to the question of what result would occur if no cash were received, especially if there were evidence that the property was worth less than the amount of the debt, or if cash were received but the sum of that cash and the value of the property was less than the amount of the debt. In the latter case, should the "amount realized" be limited to that sum? Such a limitation would lessen the hardship to the taxpayer who has to pay a tax on his gain without having received anything with which to pay it except the small amount of cash. For the government such a limitation would be better than a rule that only the cash was realized since the taxpayer would not realize so great an undeserved loss deduction.

69. As seems to be implied in a note, 13 U. Chi. L. Rev. 510, 513, n. 15 (1946).”
70. 1 Rabkin and Johnson, Federal Taxation § 43.02(4).
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If the problem arises often enough to be important it might be dealt with by amending Section 1001(b) of the Internal Revenue Code to include a provision like the following:

"The amount realized from the sale or other disposition of property subject to an indebtedness for which the taxpayer shall not have been personally liable shall be the sum of any money received, plus the fair market value of any property (other than money) received, plus either the amount of the debt or the fair market value of the property sold or disposed of, whichever shall be less. For the purpose of this subsection, the amount of the debt secured by the property shall not be considered property received by the taxpayer.""

Such a statute would effect a compromise between the result of Crane v. Commissioner as to the amount realized and the result which would have followed from a contrary decision. If the property had been worth the amount of the debt when it was acquired by the taxpayer and if the decline in value had been due to physical deterioration, the statute should prevent the taxpayer from realizing any substantial gain that would result from including the full debt in the amount realized or the loss that would result from excluding the debt entirely. Thus the taxpayer would avoid the hardship of the Crane rule, without getting the "free" loss deduction which a contrary conclusion in the Crane case would have permitted.

Could such a statute be justified theoretically? It would be met with the objection which is available against the Crane case itself: the taxpayer has not in fact received anything. Also, taxable gain is usually measured by the value of what the taxpayer has received, not by the value of what he has given. The answer to those objections would be that a mortgagor who is not personally liable realizes the amount of the debt when he transfers the property subject to the debt since he is thereby freed from a liability. That liability is only to surrender the property and hence does not exceed the value of the property. There would still be left unanswered, however, the argument that a taxpayer who has deducted depreciation from a basis which did not represent an actual expenditure by him should be required to include the amount of that depreciation in the "amount realized". That is the "double deduction" argument of Crane v. Commissioner. Thus such a statute would leave open the tax avoidance possibilities of the Crane rule. A preferable approach, therefore, would seem to be that suggested above: including only the equity in the mortgagor's basis and only any cash or property (apart from the debt) received in the amount realized.
Is there any way that a mortgagor whose equity is worth little or nothing can avoid the result of the *Crane* case? The opinion in *Crane v. Commissioner* suggested that a taxpayer may avoid that result by abandoning the property or transferring it subject to the mortgage without receiving boot, at least if the amount of the debt exceeds the value of the property. Those possibilities will be dealt with in another section.

It has also been suggested that a mortgagor may avoid the result of the *Crane* case by transferring realty in which his equity is worthless to a new corporation which has no other assets. The transfer should be made before the mortgagor has deducted such depreciation as to adjust the basis of the transferred property to an amount less than that of the debt, so that the tax-free character of the exchange will not be important. Then on foreclosure the corporation may realize a capital gain, but will lack any assets from which a tax could be collected. The stockholder will not be liable for the tax as a transferee because it will have received no valuable assets from the corporation.

The danger of this corporate device, as was admitted by those suggesting it, is that the Commissioner may ignore the corporation and treat the gains as that of the stockholder. That result seems highly probable if the corporation is used merely to hold title to the realty. The cases have divided on whether a taxpayer may for his own tax benefit disregard the entity of a corporation which he had created primarily to hold title to property. The

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71. 331 U. S. 1, 14 n. 37 (1947).
73. Under Section 351, a person may transfer property to a corporation without recognition of gain if he makes the transfer solely for stock or securities of the corporation and immediately thereafter controls the corporation. If, however, the transfer is not made for a bona fide business purpose, the taking of the property by the corporation subject to a liability of the transferor is treated as money received by the transferor and any gain realized by him is recognized to the extent of the money received. Sections 351 (b) and 357 (b). Query, whether Section 357 (b) is applicable if the transferor had held the property only subject to the debt, without personal liability. It should be noted also that if the adjusted basis of the property transferred is less than the liabilities to which the property was subject, the excess is treated as a gain from the sale or exchange of the property, so that the gain will be capital gain if the asset was a capital asset. Section 357 (c).
74. The following cases permitted the taxpayer to disregard the corporate entity: U. S. v. Brager Bldg. & Land Corp., 124 F. 2d 349 (4th Cir. 1941); *North Jersey Title Ins. Co. v. Commissioner*, 84 F. 2d 898 (3d Cir. 1936); *112 West 59th St. Corp. v. Helvering*, 63 F. 2d 397 (D. C. Cir. 1933); *Carling Holding Co.*, 41 B. T. A. 493 (1940);
The following cases reached a contrary result: *Palcar Real Estate Co. v. Commissioner*, 131 F. 2d 210 (8th Cir. 1942); *Salmon v. Commissioner*, 126 F. 2d 203 (2d Cir. 1942); *Sheldon Bldg. Corp. v. Commissioner*, 118 F. 2d 835 (7th Cir. 1941).
matter is complicated by the fact that in some of the cases a showing could be made that the corporation had some business purpose other than merely holding title. It seems highly probable, in any case, that the Commissioner could successfully disregard a corporate entity created only for the purpose of avoiding taxes. The Supreme Court in *Higgins v. Smith*,76 said:

... [T]he Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute. To hold otherwise would permit the schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation. It is command of income and its benefits which marks the real owner of property.

In *Moline Properties, Inc. v. Commissioner*,78 the Supreme Court refused to permit a taxpayer to disregard a corporation but said: “In general, in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction.”

Perhaps the suggested device would be upheld if the corporation actively managed the property. The problem then would be whether the Commissioner could successfully penetrate the disguise by using the argument, based on *Gregory v. Helvering*,77 that the arrangement had no business purpose. The doctrine of that case has been referred to in situations far afield from its origin in a question of whether there had been a re-organization.78 In short, this corporate device seems unlikely to succeed.

A question may also arise as to whether the corporate device would be successful in the face of Section 269. Probably that section would not be relevant, since the purpose of the corporation would be not to secure the benefit of a "deduction, credit, or other allowance" but to avoid taxation on a gain.

Another possibility would be giving the property to a charity.79 On such a transfer the mortgagor would probably not be held to realize any taxable gain. Cases like *Helvering v. Horst*80 are distinguishable on the ground that they involve transfers just of a

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75. 308 U. S. 473, at 477 (1940).
76. 319 U. S. 436 (1943).
77. 293 U. S. 465 (1935).
80. 311 U. S. 112 (1940).
segment of the periodic income arising from particular property and separated from that property, whereas here the mortgagor would be transferring the basic property itself, the tree as well as any fruit concealed in its branches. On the other hand, it might be argued that although unrealized appreciation of the market value of donated assets is not taxable to the donor, he should not be able to avoid the taxation of a gain attributable to depreciation deducted by him.

If successful this device not only should enable the mortgagor to avoid being taxed on a gain but also should give him a deduction for the charitable gift. Normally that deduction would be of the fair market value of the property, subject to the percentage limitations imposed on deduction of charitable gifts by Section 170(b).

The suggestion has been made that here the deduction should be of only the donor's equity. Such an idea appeals to our sense of justice, since the value of the property in excess of the equity reflects no investment by the donor. On the other hand, we normally let a donor deduct the fair market value of the property, although that may include appreciation due to outside factors. Perhaps then the donor in the suggested case should be permitted a deduction of the full value of the property, since such a procedure would be not much less rational than our usual rules for deduction of charitable gifts.

Effect of Foreclosure on the Tax Liability of a Mortgagor

If the mortgagor does not transfer its interest when paying the debt appears hopeless or unwise but instead suffers foreclosure, the sale is treated as a sale for the purpose of determining its tax liability. More specifically, the transaction is a “sale or exchange” under Section 1222, dealing with capital gains and losses.

There was some theoretical difficulty in reaching this result, because it was not consistent with the traditional concept of a sale. The argument was that the mortgagor was not a party to the transaction, did not assent to it and did not receive any consideration if he was not personally liable on the debt and the bid price did not exceed the total interest of the mortgagee. It was also

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82. Helvering v. Hammel, 311 U. S. 504 (1941). That conclusion was reached after considerable litigation. Among the earlier cases reaching a contrary result were: Sol Greister, 102 F. 2d 787 (3d Cir. 1939) affirming 37 B. T. A. 542 (1938); Lloyd Jones, 39 B. T. A. 531 (1939); H. L. Rust, Jr., 38 B. T. A. 910 (1938), appeal dismissed without opinion 105 F. 2d 1017 (4th Cir. 1939); C. Griffith Warfield, 38 B. T. A. 907 (1938).
argued that the transaction effected merely a partial payment of a debt of the mortgagor, and that payment of a debt does not constitute a sale or exchange. Taxpayers contended that Congress had sought, by limiting the deductibility of capital losses, only to prevent fluctuations in revenue caused by voluntary sales of capital assets. In Helvering v. Hammel, however, the Supreme Court took the position that the statutory language relating to sales should not be restricted to voluntary sales unless the lack of such a restriction would lead to an absurd result or thwart the purpose of the statute. The court also argued that Congress must have intended to treat foreclosure sales as "sales" since it had not adopted a specific statement to the effect that they should be treated as sales, as it had done for other involuntary transactions, such as the retirement of bonds.

It was held then that a foreclosure is a sale, for the purposes of determining the tax liabilities of the mortgagor, regardless of whether he had been personally liable on the debt. The result is probably sound and not such a departure from traditional ideas of property law as might at first be supposed. A foreclosure sale deprives the mortgagor of all his interest in the property, if he does not redeem. The difficult theoretical question is whether the mortgagor can be said to have received any consideration, which is thought to be an essential element of a sale. The answer seems to be that release from a debt which is enforceable only against the mortgaged property is consideration. That would follow from the holding of Crane v. Commissioner that the debt

84. Sol Greisler, 102 F. 2d 787, 790 (3rd Cir. 1939).
85. 311 U. S. 504 (1941).
86. Int. Rev. Code §117(f) (1939). These are striking reversals of the old interpretative maxims of expressio unius and of the interpretation of ambiguous tax statutes in favor of the taxpayer. For a classic statement of the latter maxim, see Gould v. Gould, 245 U. S. 151, 153 (1917). There seems today to be little hope for the taxpayer whose case rests largely on the latter maxim. Note the following language from White v. U. S., 305 U. S. 281, 292 (1938):

We are not impressed by the argument that, as the question here decided is doubtful, all doubts should be resolved in favor of the taxpayer. It is the function and duty of courts to resolve doubts. We know of no reason why that function should be abdicated in a tax case more than in any other where the rights of suitors turn on the construction of a statute and it is our duty to decide what that construction fairly should be.


88. Note, 54 Harv. L. Rev. 880 (1941).
89. Fritz L. Braunfeld, Subject to a Mortgage, 24 Taxes 424, 438-9 (1946). Mr. Braunfeld puts this in terms of release from liability to yield the property.
is part of the amount realized by a mortgagor who sells property subject to a mortgage. As a practical matter reaching the same tax result in the case of a foreclosure sale as in a voluntary sale by the mortgagor to a third person is desirable. The form of the transaction by which a taxpayer disposes of his property should affect the amount of his taxes as little as possible.

Before the 1942 Revenue Act revised Section 117 of the 1939 Code so as to treat most deductible losses on the sale of realty as ordinary, mortgagors were concerned to establish that they had not sold or exchanged their property. Helvering v. Hammel and the related cases defeated that effort in respect of foreclosure sales. Since the adoption of the 1942 Act, the mortgagor has been more often concerned with the problems of whether he would be treated as having realized a taxable gain on foreclosure and whether that gain was capital or ordinary. Mendham Corporation, is interesting as an illustration of the pressure that the calculation of basis for purposes of depreciation without subtraction of liens, creates toward a holding that the mortgagor realizes taxable gain on any non-donative disposition of the property. The mortgagor had received the property in a tax-free exchange, so that it used the basis of the transferor. It was not personally liable on the debt, but the Tax Court held that the amount of the debt was includible in the "amount realized", and that the mortgagor had realized taxable gain on the foreclosure on the ground that a contrary result would fail to take account of depreciation deducted by the transferor and so facilitate avoidance of the tax.

A mortgagor may still be concerned with the problem of whether his property is a capital asset. It is now desirable for him to have it considered as used in his trade or business so that any gain will be capital and any loss ordinary. Thus he will contend that rental property was used in his trade or business. There is authority to that effect. A problem has arisen as to whether property is used in the taxpayer’s trade or business if it considers putting the property to use but decides not to do so and sells it. The Tax Court has held that when a taxpayer bought vacant land for the erection of a warehouse to be used in conjunction with its tobacco business but later changed its plans and sold the land,

90. Now Section 1231 of the 1954 Code.
91. 9 T. C. 320 (1947).
92. The following cases also held that mortgagors realized taxable gains on foreclosure sales: R. O'Dell & Sons Co. Inc. v. Commissioner, 169 F. 2d 247 (3d Cir. 1948), affirming 8 T. C. 1165 (1947); Woodsam Associates, Inc. v. Commissioner, 198 F. 2d 357 (2d Cir. 1952), affirming 16 T. C. No. 80 (1951); 1180 E. 63rd St. Bldg. Corp. 12 T. C. 437 (1949).
93. John E. Good, 16 T. C. 906 (1951); Wm. H. Jamison, 8 T. C. 173 (1947).
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the land had been used in the trade or business and the loss on its sale was ordinary. In the case, however, of property held primarily for sale to customers in the ordinary course of trade or business both gains and losses still are ordinary. Whether such a classification will be undesirable then will depend on whether a gain or a loss is realized on foreclosure. The cases holding that the amount of the debt is part of the basis and of the amount realized should be kept in mind in the determination of whether there is a gain or a loss.

WHEN THE TAX CONSEQUENCES OF A FORECLOSURE ARE FIXED—THE MORTGAGOR

The next problem relates to the time when the mortgagor shall be held to have realized gain or loss in connection with a foreclosure sale. The applicable principle is that stated by the regulations dealing with losses generally:

"In general losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained during the taxable period for which allowed."

When is a foreclosure a sufficiently closed and completed transaction for this purpose? Tax consequences do not arise upon the issuance of a decree of foreclosure but upon some later event. One of the few cases dealing with realization of gain by a mortgagor on foreclosure held that a gain, measured by the excess of the obligation discharged over the mortgagor’s adjusted basis, was realized in the year in which an action for a deficiency judgment became barred and the right of redemption cut off. More commonly the cases have dealt with the time of realization of loss. The cases have held generally that if there is a period after the foreclosure sale during which the mortgagor can redeem the property, he does not realize a loss until the expiration of that period. It has been held, however, that a mortgagor could de-

95. See Charles H. Black, 45 B. T. A. 204 (1941), which held that the mortgagor had held land primarily for sale to customers in the ordinary course of his trade or business and had realized an ordinary loss on foreclosure.
duct his loss in the year of the foreclosure sale, when it appeared that the value of the property was substantially less than the redemption price and the mortgagors decided not to redeem the property.\textsuperscript{100} The reason for the general rule seems to be that while the mortgagor has a right to redeem there has been no completed transaction giving rise to a loss. Also, the mortgagor may under local statutes have possession and legal title until the redemption period has expired.

**Effect of Foreclosure on the Tax Liability of a Mortgagee**

The mortgagee too may realize a deductible loss on foreclosure. If the property is bid in for less than the amount of the debt and the excess is uncollectible, the mortgagee may treat the excess as a bad debt deductible under Section 166.\textsuperscript{101} The excess may be treated as uncollectible at the time of the foreclosure sale, if the mortgagor then has no other assets from which it can be collected.\textsuperscript{102} Otherwise the excess may not be deducted as of that time because the foreclosure alone does not conclusively establish the uncollectibility of the debt.\textsuperscript{103} The excess does, however, become uncollectible for this purpose when the period for getting a deficiency judgment has expired.\textsuperscript{104}

When the period for redemption has expired a mortgagee who bid in the property may also deduct a loss to the extent that the fair market value of the property is less than the amount of the obligations of the debtor representing capital or interest taxed to the mortgagee, bid in on the property.\textsuperscript{105} Several difficulties lie in the way of allowance of the loss. Usually no loss is realized on the purchase of property.\textsuperscript{106} Here, however, the mortgagee may be said not merely to have purchased property but to have exchanged obligations of the debtor for the property. An ex-

\textsuperscript{100} Jacob Abelson, 44 B. T. A. 98 (1941).
\textsuperscript{102} William C. Heinemann & Co., 40 B. T. A. 1090 (1939).
\textsuperscript{103} Arthur Berenson, 39 B. T. A. 77 (1939), affirmed without opinion, 113 F. 2d 113 (2d Cir. 1940).
\textsuperscript{105} The older cases also raised questions as to when the mortgagee had sufficiently ascertained the debt and charged it off. Malden Trust Co. v. Commissioner, 110 F. 2d 751 (1st Cir. 1940), affirning 39 B. T. A. 190 (1939); Brown v. U. S., 95 F. 2d 487 (3d Cir. 1938), reversing 19 F. Supp. 825 (E. D. Penn. 1937); since the revision of § 23(k) by the 1942 Revenue Act, such questions have not arisen. U. S. Treas. Reg. 118, § 39.23(k)-1 (1953).
change may give rise to a deductible loss. Also, under the holding in *Helvering v. Midland Mutual Life Insurance Co.*, it was awkward to acknowledge for tax purposes the fact that the fair market value of the property might be less than the face amount of the obligations bid for it. That case was distinguished on the ground that it had not dealt with Section 29.23(k)-3 of Regulations 111. Repeated re-enactment of the statute was held to give that regulation the force of law. Perhaps another factor was simple antagonism for the result of the *Midland Mutual* case.

The *Midland Mutual* case held that if a mortgagee who is on the cash basis buys the mortgaged property at the foreclosure sale, on a bid equal to the sum of the principal debt and the accrued interest, it realizes taxable income to the extent of the accrued interest. The taxpayer had offered evidence to the effect that the fair market value of the property was less than the amount of the debt, but the Board of Tax Appeals considered that point immaterial and therefore made no finding of fact in respect to it. The arguments adopted by the Supreme Court were as follows:

1. The statute taxing "interest" received by insurance companies spoke broadly and should be so construed. Or we might say that ambiguous tax statutes are to be construed against taxpayers contrary to the earlier approach of *Gould v. Gould*.  
2. Theoretically the purchase at a bid equalling principal and interest paid and discharged the debt giving the mortgagor a deduction for interest paid and resulting in taxable income to the mortgagee.

Assuming that the purchase discharged the debt, it did not necessarily follow that the debtor should be treated for tax purposes as having paid the debt or the creditor as having received it. The problem is really one of policy.

3. The taxpayer considered the protection of a high redemption price worth the discharge of the interest debt.

4. Administration of the tax law would be burdened unduly by taking account of the fair market value of the property.

This argument was weakened, if not defeated, by the fact that the Treasury Department itself in Section 29.23(k)-3 of Regulations 111 had provided for consideration of fair market value in

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108. Now § 39.23(k)-3 of Regulations 118.
110. 245 U. S. 151, 153 (1917).
the determination of the tax liabilities of a mortgagee who bid in property at a foreclosure sale.\textsuperscript{111}

5. The taxpayer itself voluntarily made its bid and by its practice of bidding principal and interest may have deterred others from making bids which would have paid at least part of the interest.

As Justice McReynolds said in his dissenting opinion in the Midland Mutual case, "Like imaginary 'receipts' of interest often repeated and similarly burdened would hasten bankruptcy."\textsuperscript{112} Although there is no conclusive subsequent case, Justice McReynolds' view seems likely to prevail in the future. The Eighth Circuit had earlier adopted the approach of the Midland Mutual case.\textsuperscript{113}

The Midland Mutual case was followed by the Board of Tax Appeals.\textsuperscript{114} The Sixth Circuit, however, refused to follow the Midland Mutual case where the taxpayer was not an insurance company.\textsuperscript{115} It distinguished that case chiefly on the ground that it had dealt with an insurance company, to the transactions of which Section 29.23(k)-3 of Regulations 111 was inapplicable. The Nichols case indicates that at least in the Sixth Circuit a mortgagee other than an insurance company need not fear the result of the Midland Mutual case. The difficulty is that insurance companies invest heavily in mortgages. If we have another depression and widespread foreclosure of mortgages, the Midland Mutual case may cause headaches. The writer's understanding is, however, that in periods of depression when redemption is unlikely to occur insurance companies do not include unpaid interest in the bid price.

Even if the Midland Mutual case is not followed, a mortgagee bidding in property at a foreclosure sale may realize taxable income if the fair market value of the property exceeds the mortgagee's basis for the obligations credited against his bid.\textsuperscript{116}

\textsuperscript{111} Hadley Falls Trust Co. v. U. S., 110 F. 2d 887, 892 (1st Cir. 1940).
\textsuperscript{112} At page 227.
\textsuperscript{113} Helvering v. Missouri State Life Insurance Co., 78 F. 2d 778 (8th Cir. 1934), reversing 29 B. T. A. 401 (1933).
\textsuperscript{114} Clarkson Coal Co., 46 B. T. A. 688 (1942); T. Eugene Piper, 45 B. T. A. 280 (1941).
\textsuperscript{115} Nichols v. Commissioner, 141 F. 2d 870 (6th Cir. 1944), reversing 1 T. C. 328 (1942).
\textsuperscript{116} Humphrey v. Commissioner, 162 F. 2d 853 (5th Cir. 1947), cert. denied 332 U. S. 817 (1947); Commissioner v. West Production Co., 121 F. 2d 9 (5th Cir. 1941), cert. denied 314 U. S. 682 (1941); Aaron W. Hardwick, P-H 1947 T. C. Mem. Dec. Par. 47,060.
FEDERAL INCOME TAX CONSEQUENCES

If the Midland Mutual case stands, a cash basis mortgagor may deduct the interest which under that case is taxed to the mortgagor. Thus the unreality of that case is further demonstrated.

PAYMENTS BY A MORTGAGOR AFTER FORECLOSURE

Even after foreclosure of a mortgage and expiration of the right of redemption, transactions relating to the debt may have tax consequences for the mortgagor or mortgagee. If the mortgagor pays additional amounts to discharge his liability on the debt, he may deduct those amounts as losses, capital or ordinary, according to whether the mortgaged property had been a capital asset in his hands since such payments are treated as additional payments toward the price of the mortgaged property. Such payments would reduce the loss or bad debt deduction of the mortgagor, or constitute income to him if he had already deducted such a loss.

POSSIBILITY OF ABANDONMENT AND ITS ADVANTAGES

We have seen above that a mortgagor may suffer only a capital loss, if any, on a foreclosure sale of the mortgaged property. Worse yet, he is held to realize the amount of the debt if he transfers the property to a third person for a small cash consideration subject to the mortgage. Can the mortgagor avoid those results by claiming a loss in the year when his equity becomes worthless, without any transfer, voluntary or involuntary? Such a loss would be ordinary for lack of the "sale or exchange" requisite for realization of a capital gain or loss under Section 1222.

The mortgagor has a chance of success if he was not personally liable on the debt and can prove that his interest was worthless, and that he did abandon control over the land and its rents. The argument supporting the result of the cases so holding is that

118. Charles H. Black, 45 B. T. A. 204 (1941); Harry H. Diamond, 43 B. T. A. 809 (1941).
119. If the property was neither held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business nor used in his trade or business. Int. Rev. Code §§ 1221 and 1231 (1954).
120. Crane v. Commissioner, 331 U. S. 1 (1947).
121. Bickerstaff v. Commissioner, 128 F. 2d 366 (5th Cir. 1942), reversing 44 B. T. A. 457 (1941); Commissioner v. Hoffman, 117 F. 2d 987 (2d Cir. 1941), affrming 40 B. T. A. 459 (1939); Rhodes v. Commissioner, 100 F. 2d 966 (6th Cir. 1939), reversing 34 B. T. A. 212 (1936); Denman v. Brumback, 58 F. 2d 128 (6th Cir. 1932), affirming 48 F. 2d 255 (N. D. Ohio 1930); Morton L. Kahn, 44 B. T. A. 84 (1941); Realty Operators, Inc., 40 B. T. A. 1051 (1939), petition for review dismissed, 118 F. 2d 286 (5th Cir. 1941).
the test of when a loss has been sustained is practical rather than legal.\textsuperscript{122} That argument was opposed by the view that title to real property cannot be lost by abandonment, unlike title to personal property, and that therefore, there is no transaction sufficiently closed for the ascertainment of a loss until the mortgagor has formally conveyed his interest to another.\textsuperscript{123} 

It has also been held that the mortgagor could not claim an ordinary loss on abandonment of the mortgaged property if he was personally liable on the debt, on the ground that the property continued to have some value until a foreclosure sale cut off the mortgagor’s interest and determined his liability for a deficiency judgment.\textsuperscript{124} That argument apparently is not that the mortgagor’s interest continued to have a fair market value but that the extent of his loss could not be ascertained at least until after the foreclosure sale since a deficiency judgment might be obtained against him. A similar result has been reached in the case of a mortgagee who was not personally liable but who had failed to prove the value of the property or his abandonment of control over it.\textsuperscript{125} 

As against the reasoning of the \textit{Green} case that the amount of the loss of a mortgagor who was personally liable cannot be ascertained until the foreclosure sale and entry of a deficiency judgment or passing of the time for obtaining such a judgment, it has been argued that the loss can be ascertained by comparing the basis of the mortgagor with the fair market value of the property at the time of the purported abandonment.\textsuperscript{126} It has been contended that the determination of fair market value for that purpose is not administratively wasteful since it must be determined for the purpose of ascertaining the bad debt deduction of the mortgagee and his subsequent basis. That contention appears to be based on the assumption that the tax liability of the mortgagee will be fixed as of the time of the purported abandonment. That would be the case if the abandonment was effected by a formal conveyance from the mortgagor to the mortgagee. It might be the case if the abandonment amounted only to a relinquishment by the mortgagor of control over the property, with foreclosure occurring later, if the abandonment were treated as the event which substantially changed the positions of both parties. If, however,

\textsuperscript{123} *Greenleaf Textile Corp.*, 26 B. T. A. 737 (1932), affirmed mem., 65 F. 2d 1017 (2d Cir. 1933); *H. M. N. Muhle*, 19 B. T. A. 1247 (1930); *Consolidated Brick Co.*, 17 B. T. A. 831 (1929); *A. J. Schwaelder Co.*, 3 B. T. A. 535 (1926); this argument seems to be supported by 4 TIFFANY, REAL PROPERTY, 28 (3d edition, 1939).
\textsuperscript{124} *Commissioner v. Green*, 126 F. 2d 70 (3d Cir. 1941).
\textsuperscript{125} *Commissioner v. Abramson*, 124 F. 2d 416 (2d Cir., 1942).
\textsuperscript{126} Fritz L. Braunfeld, \textit{Subject to a Mortgage}, 24 TAXES 424, at 440 (1946).
the foreclosure were treated as the event fixing the tax liabilities of the mortgagee, the fair market value of the property might change between the time of the abandonment and the time of the foreclosure. Also in that case, fair market value would be relevant in determining whether the mortgagee realized a gain or a loss if he became the purchaser, but not relevant to the determination of whether he had a bad debt deduction.  

Voluntary Conveyance by the Mortgagor to the Mortgagee

Can the mortgagor achieve favorable tax results by voluntarily conveying the mortgaged property to the mortgagee? In the cases of roughly fifteen years back, mortgagors argued that their transfers to mortgagees were not sales or exchanges and that therefore they had realized ordinary losses thereon. A number of cases held that such a transaction effected by a mortgagor who was not personally liable on the debt was not a sale or exchange and therefore resulted in an ordinary loss if any. The suggestion has been made that the explanation of these cases lies in a desire to reach the same result as in the cases of foreclosure, which was before Helvering v. Hammel, generally thought not to involve a sale or exchange of property of the mortgagor.

A number of other cases dealing with such transfers by mortgagors who were personally liable either for the mortgage debt or for taxes, in consideration of release from the debt or payment of the taxes, have held that the mortgagor realized only a capital loss. The release from liability or payment of taxes is the con-
sideration which enables the transaction to be treated as a sale or exchange.

A problem has arisen where the mortgagor was not personally liable on the debt and therefore did not receive any release from liability which could be treated as consideration but the mortgagor paid or promised some relatively small pecuniary consideration for the transfer. Nominal consideration recited in the deed but not paid has been ignored. A similar result was reached when a mortgagor quitclaimed his interest to his co-mortgagor by a deed reciting consideration of one dollar which was neither paid nor meant to be paid. On the other hand, payment of a fee of $250 to the mortgagor’s lawyer by the mortgagee has been held to make the transfer a sale, although the mortgagor had been willing to give the property away.

The nature of the argument seems to be shifting. In the earlier cases, a mortgagor who had transferred the property to the mortgagee was thought to realize a loss of his equity; hence he was concerned to argue that the transaction was not a sale or exchange and that, therefore, his loss was ordinary. Now that losses on the sale or exchange of land used in the trade or business are ordinary, mortgagors are less often eager to establish that a voluntary transfer to the mortgagee was not a sale. Furthermore, the tendency now seems to be to hold that on such a transfer the mortgagor realizes the amount of the debt; hence it is to the interest of the mortgagor to argue that the transaction was a sale or exchange and that he realized only a capital gain. The First Circuit has held that if a mortgagor, not personally liable for the debt, conveys the property to the mortgagee, he thereupon realizes the amount of the debt. The result was based largely on the Crane case with reference to the fact that the mortgagor had deducted depreciation calculated on a basis which included the amount of the debt. As in the Crane case, the court left open the possibility that the result would be different if the value of the property were proved to be less than the amount of the debt and the mortgagor received no boot. The court based its decision

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134. Park Chamberlain, 41 B. T. A. 10 (1940).
135. Blum v. Commissioner, 133 F. 2d 447 (2d Cir. 1943).
136. Parker v. Delaney, 186 F. 2d 455 (1st Cir. 1950).
137. Crane v. Commissioner, 331 U. S. 1, 14 (footnote 37) (1947); Parker v. Delaney, 186 F. 2d 455, 458 (1st Cir. 1950).
on the ground that the transfer was a "disposition" for purposes of Section 111 of the 1939 Code, so that gain or loss might be realized. Whether it was also a "sale or exchange" for purposes of Section 117 of the 1939 Code was not in issue.

A tax result somewhat similar to that just discussed was arrived at in *Lutz & Schramm Co.* on a different basis. The taxpayer-mortgagor had apparently borrowed money and given a mortgage on real property as security. It became free of personal liability on the debt in 1934. Then in 1937 it transferred the property to the creditor in discharge of the debt which was greater in amount than the adjusted basis of the property. The Tax Court held that the taxpayer had realized gain in 1937 from the disposition of the property since it had received the benefit of the loan and had discharged it for less than the full amount.

Starting with *Crane* and *Parker v. Delaney* as a basis for prediction, it appears probable that a mortgagor who is not personally liable for the debt and who transfers the mortgaged property to the mortgagee will ultimately be held not only to have realized the amount of the debt but to have made a sale or exchange, so that he will not realize a deductible loss if the amount of the debt exceeds his basis but will realize a capital gain. If under *Crane* the mortgagor realizes the amount of the debt, because he has become free from the practical necessity of treating the debt as his own or losing the property, when he transfers the property to a third party, the same result should apply when he transfers it to the mortgagee. *Parker v. Delaney* so holds. Further, if he realizes the amount of the debt for the purpose of determining the amount of his gain or loss, he must also realize it for the purpose of deciding whether he has received consideration for the transfer and hence has made a sale or exchange, so that his gain or loss is capital. His basis for the determination of the amount of his gain or loss presumably will include the amount of the debt if it is to be treated as part of the amount realized.

The results suggested here are desirable also so that the tax consequences of a voluntary conveyance to the mortgagee will be

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138. 1 T. C. 682 (1943).
139. Apparently the Tax Court has refused to follow *Lutz & Schramm*, where the debt was incurred in connection with the purchase of the property pledged as security. *Charles L. Nutter*, 7 T. C. 480 (1946).
140. This assumes that the property is a capital asset or that § 1231 applies.
142. *Blackstone Theatre Co.*, 12 T. C. 801 (1949). Before the decision of the *Crane* case and the tendency to include the amount of the debt in the amount realized, it was thought that the basis of a mortgagor who was not personally liable on the debt was merely the cost of his equity. *Note*, 46 Col. L. Rev. 485, 487 (1946).
the same as those of a foreclosure. Then the choice between suf-
ferring foreclosure or making a voluntary transfer will be moti-
vated by business reasons, such as a judgment as to whether a
foreclosure sale might result in a realization of more than the
amount of the debt, rather than a desire to minimize taxes.143

Mortgagee's Acceptance of Voluntary Transfer From
Mortgagor

The problem then arises as to the tax consequences to a mort-
gagor of his acceptance of a voluntary conveyance of the mortgaged
property in satisfaction of the debt. If the property is worth less
than the mortgagee's basis for the obligation discharged, the mort-
gagor is generally held to realize a deductible bad debt to the ex-
tent of the difference.144 There is some authority that the loss is
not a bad debt but a loss.145 Presumably the deduction of such a
loss is subject to the limitations relating to capital losses.

The arguments for allowing the deduction as a bad debt are:
1. If the mortgagor had sold the property to a third party and
paid the proceeds to the mortgagee, the transaction would have
been a payment of a debt as far as the mortgagee was concerned,
rather than a sale.

2. The average business man would interpret the transaction as
resulting in a bad debt.

The contrary argument is that there is not a bad debt deduc-
tion because the transaction extinguishes the debt. This latter ar-
gument is overly theoretical.

Instead of a loss, the transaction may result in the realiza-
tion of a gain to the mortgagee.146 If the value of the property ex-
ceeds the principal of the debt, the excess is treated as interest if
the mortgagee is an insurance company, not taxable on gains gen-
erally.147

143. Fritz L. Braunfeld, Subject to a Mortgage, 24 Taxes 424, 435 (1946).
144. Commissioner v. Spreckels, 120 F. 2d 517 (9th Cir. 1941); Commissioner v.
Nat'l. Bank of Commerce of San Antonio, Texas, 112 F. 2d 946 (5th Cir. 1940), affirm-
ing 40 B. T. A. 471 (1939); Bingham v. Commissioner, 105 F. 2d 971 (2d Cir. 1939);
147. See Helvering v. Missouri State Life Ins. Co., 78 F. 2d 778 (8th Cir. 1934),
reversing 29 B. T. A. 401 (1933); Manufacturers Life Ins. Co., 4 T. C. 811 (1945);
Manufacturers Life Ins. Co., 43 B. T. A. 867 (1941); See Manhattan Mutual Life Ins.
Co.; 37 B. T. A. 1041 (1938); The Midland Mutual case has been distinguished here
because of the lack of a bid; Manufacturers Life Ins. Co., 4 T. C. 811, 819 (1945).
FEDERAL INCOME TAX CONSEQUENCES

If a mortgagee acquires full title to the mortgaged property from the mortgagor it must determine its basis for the future calculation of depreciation and gain or loss. If for example, it buys the property at a foreclosure sale, the fair market value of the property as of the time of the sale becomes its basis. A similar rule applies as to basis if the mortgagee accepts a voluntary conveyance from the mortgagor in settlement of the debt.

SETTLEMENT OF DEBT AT DISCOUNT BY TRANSFER OF PROPERTY OTHER THAN MORTGAGED REALTY

If a mortgagor satisfies the debt by transferring to the creditor property other than the mortgaged property, he thereby realizes taxable income if he is solvent and the basis of the property is less than the amount of the debt, assuming that the doctrine relating to the reduction of the purchase price is not applied. This is now subject to the election, offered by Section 108, to exclude the income realized and to reduce the basis of the taxpayer’s property. If, however, the mortgagor was insolvent, he would have realized no income. The theory is that by discharge of a debt such a taxpayer realizes no change in his economic position.

A related problem arose when a mortgagor paid a sum to the mortgagee for release from personal liability without satisfaction of the debt. The Board of Tax Appeals held that the amount of the payments was a deductible loss, not part of the cost of the property, since the mortgagor acquired no further interest in the property through his making the payment.

Settlement of a mortgage debt without transfer of the mortgaged property raises tax problems for the mortgagee too. The transaction has been held not to be a sale or exchange on the part of the mortgagee. Therefore, any loss suffered by the mortgagee is not capital. Whether it is an ordinary loss or a bad debt

150. Dr. John Huberman, P-H 1943 T. C. Mem. Dec. Par. 43, 323. The following cases do not relate to mortgages but would be applicable authority, since the problem is merely part of the general problem of satisfaction of a debt with property having a basis less than the amount of the debt: J. L. McAlpine Land & Development Co., Ltd., 126 F. 2d 163 (9th Cir. 1942), affirming 43 B. T. A. 520 (1941); Peninsula Properties Co., Ltd., 47 B. T. A. 84 (1942); Carlisle Packing Co., 29 B. T. A. 514 (1933); E. F. Simms, 28 B. T. A. 986 (1933); Twin Ports Bridge Co., 27 B. T. A. 346 (1932); Hagan Corp., 21 B. T. A. 41 (1930).
151. Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F. 2d 95 (5th Cir. 1934); Main Properties, Inc., 4 T. C. 364 (1944).
deduction is not clear. The Stewart case held it to be a bad debt rather than a capital loss. I. T. 4018 held it an ordinary loss rather than a capital loss. The better answer seems to be that the loss is a bad debt, since the mortgagee has not sold his interest to a third party but has settled the debt with the mortgagor.\textsuperscript{154}

Sometimes a mortgagee has accepted Home Owner's Loan Corporation bonds in exchange for his release of the liability of the mortgagor. The Board of Tax Appeals held first that the mortgagee had exchanged one obligation for another and therefore had suffered only a capital loss.\textsuperscript{155} Later, without discussion of the Bowen case, the Board held that the loss gave rise to a bad debt deduction.\textsuperscript{156} Theoretically, the earlier result seems to be correct. As a practical matter, however, the HOLC bonds seem to have been treated as the equivalent of cash. Hence the transaction might well be treated as a refunding of the debt by the mortgagor and payment of the original debt by him to the mortgagee.

**CONCLUSION**

This study demonstrates principally the great extent to which the owner of mortgaged property is treated as owing the debt secured by the property, regardless of whether he is technically liable for its payment. That appears in respect to the treatment of interest payments, in the determination of the basis of such a taxpayer and of the amount realized by him on disposition of the property, and probably will appear in the determination of whether his disposition of the property is a sale or exchange. If further evidence of the wisdom of looking to the tax consequences of business transactions were needed, the fact of such treatment should supply it.

\textsuperscript{154} Accord, Harold S. Denniston, 37 B. T. A. 834 (1938). If however the mortgagee is not a bank and the mortgage debt is evidenced by "securities", within the meaning of Section 165(g), the loss on the worthlessness of those securities is capital: Charles A. Morehead, How to Handle Foreclosures, Settlements between Mortgagor and Mortgagee and Other Mortgage Disposition, 6 N. Y. U. Institute on Federal Taxation 399, 401 (1948).

\textsuperscript{155} Josephine C. Bowen, 37 B. T. A. 412 (1938).

\textsuperscript{156} Mary E. Wenger, 42 B. T. A. 225 (1940), affirmed on other issues, 127 F. 2d 523 (6th Cir. 1942), cert. denied, 317 U. S. 646 (1942):