BASIS AND AMOUNT REALIZED UNDER *CRANE*: A CURRENT VIEW OF SOME TAX EFFECTS IN MORTGAGE FINANCING

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I. INTRODUCTION

All tax students should be familiar with the general principle that indebtedness to which property is subject is included for income tax purposes in its "cost,"¹ even though the purchaser does not incur or assume personal liability for the debt. That the United States Supreme Court approves this principle is evident from the reasoning in *Crane v. Commissioner*,² and decisions affirming it can be found in both the federal courts of appeals and the Tax Court of the United States.³ *Crane* and the lower court decisions following it also hold that upon sale of the property, the indebtedness must be included in amount realized for purposes of computing the seller's gain or loss, whether or not he is personally liable on the debt, and whether the debt is part of the basis of the property⁴ or is excluded therefrom because it was incurred on a borrowing subsequent to the acquisition of the property.⁵

One new to the area must wonder how there can be "cost" without investment of some form of economic wealth, or at least commitment of one's personal credit, and must question how one can "realize"⁶ a debt for which he has no personal obligation.⁷ If a cost basis can be acquired without economic investment, it becomes possible to obtain a tax-free cash flow from depreciation deductions based on "cost" without ever having to account for all or any of the tax benefits pro-

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¹ "Cost" as referred to in this Article is "cost" as defined by INT. REV. CODE OF 1954, § 1012.

² 331 U.S. 1 (1946).

³ See *Parker v. Delaney*, 186 F.2d 455 (1st Cir. 1950), *cert. denied*, 341 U.S. 926 (1951); *Manuel D. Mayerson*, 47 T.C. 340 (1966); *Blackstone Theatre Co.*, 12 T.C. 801 (1949).

⁴ See, e.g., *Parker v. Delaney*, 186 F.2d 455 (1st Cir. 1950), *cert. denied*, 341 U.S. 926 (1951).

⁵ See, e.g., *R. O'Dell & Sons Co. v. Commissioner*, 169 F.2d 247 (3d Cir. 1948); *Woodsam Associates v. Commissioner*, 198 F.2d 357 (2d Cir. 1952); *Mendham Corp. v. Commissioner*, 9 T.C. 320 (1947).

⁶ See INT. REV. CODE OF 1954, § 1001(b).

⁷ See *Parker v. Delaney*, 186 F.2d 455, 459-60 (1st Cir. 1950) (Magruder, J., concurring), *cert. denied*, 341 U.S. 926 (1951), where Judge Magruder attempted to explain "realization," through the concept of a negative basis. The Supreme Court looked with disfavor on the concept in *Crane v. Commissioner*, 331 U.S. 1, 10 (1946).

duced by such deductions on disposition of the property. Whether the result will differ if the disposition is by means of a transfer other than a sale (such as by gift, testamentary disposition, or abandonment), is also unclear.⁸

The Commissioner of Internal Revenue⁹ recently voiced his concern with these problems in *Manuel D. Mayerson*,¹⁰ where he tried unsuccessfully to prevent a taxpayer from including an unassumed mortgage in the basis of his property. On the authority of *Crane* the Tax Court held that the full amount of the mortgage was the "cost" of the property. Although the Commissioner later acquiesced in *Mayerson*,¹¹ nevertheless he warned that the Treasury "will continue to review transactions . . . designed to improperly create or inflate depreciation deductions . . ." and "will disallow unwarranted depreciation deductions."¹²

The cause of the Commissioner's alarm is that the investor can acquire a very large depreciable basis for a comparatively small amount of money, without incurring personal liability on the mortgage. In *Mayerson*, for example, the taxpayer obtained a depreciable basis of \$200,000 for his building for only \$10,000 cash and a mortgage note which did not require periodic amortization of the mortgage or involve personal liability on the note.¹³ Thus, depreciation deductions taken on an extremely high basis, often at accelerated rates, not only can offset income from the property, but may result in losses which can be applied against other income.¹⁴ Furthermore, although *Crane* also requires that the amount of the unamortized mortgage be included in the amount realized when the property is sold, any gain will generally be capital gain,¹⁵ whereas past depreciation deductions will have offset ordinary income.¹⁶

This Article reexamines the *Crane* decision and the cases following it, analyzes the implications of those decisions, and recommends alternatives to correct the resulting deficiencies and the confused dogma attributable to them.

⁸ See Adams, *Exploring the Outer Boundaries of the Crane Doctrine: An Imaginary Supreme Court Opinion*, 21 TAX L. REV. 159 (1966).

⁹ The Commissioner of Internal Revenue will hereinafter be referred to as Commissioner.

¹⁰ 47 T.C. 340 (1966).

¹¹ 1969 INT. REV. BULL. No. 8, at 6.

¹² Rev. Rul. 69-77, 1969 INT. REV. BULL. No. 8, at 10.

¹³ Text accompanying notes 18-20 *infra*.

¹⁴ See Adams, *supra* note 8.

¹⁵ INT. REV. CODE OF 1954, § 1231.

¹⁶ Text accompanying notes 125-26 *infra*.

II. *Crane* RE-EXAMINED: SHOULD UNASSUMED DEBT BE INCLUDED IN "COST"?

Section 1001(a) of the Internal Revenue Code provides that the gain from any sale or other disposition of property "shall be the excess of the amount realized therefrom over the adjusted basis." To make analysis easier, adjusted basis (as defined by sections 1011 and 1016) for purposes of this discussion will simply be the "cost" basis provided for in section 1012 minus any allowable deductions¹⁷ for exhaustion, wear and tear, amortization, or depletion.

When property is acquired in exchange for cash or other property free of encumbrances, the basis of the new property in general is the cash expended or the value of the property surrendered. These amounts are relatively simple to compute. Similarly, when property is acquired in exchange for a promise to pay or a note enforceable against the maker, the face amount of the promise or note is treated in the same manner as if a cash payment had been made. However, if there is no personal liability on the part of the maker of a note, it is questionable whether the debt is part of the cost of acquisition, and hence part of basis. For example, in *Mayerson*,¹⁸ the taxpayer financed a real estate purchase by executing a purchase money note in the face amount of \$332,500, secured by a mortgage. The note provided that, except for \$10,000 payable immediately, the obligation was not due for ninety-nine years, and that in case of default the mortgagee's sole recourse was against the property. Although the Commissioner contended that the taxpayer acquired only a ninety-nine year leasehold interest in the property, and therefore should only be entitled to depreciate the \$10,000 "cost" of this interest,¹⁹ the Tax Court held that the taxpayer had purchased, rather than leased, the property, and could depreciate it on a "cost" basis of \$332,500 (the face amount of the mortgage). Since the court cited *Crane*²⁰ as authority, it is necessary to examine the principles which the Supreme Court established in that case for determining basis under the relevant sections of the Internal Revenue Code.

The taxpayer in *Crane* received as part of her inheritance under her husband's will real estate valued at \$262,042.50, which was the exact amount of the mortgage and interest in default encumbering the property.²¹ Later, she sold the property (still subject to the mortgage) for \$25,000 net, and reported a taxable gain of only \$1,250, on the

¹⁷ INT. REV. CODE OF 1954, § 1016, provides that basis must be adjusted for "allowable" depreciation, even though the taxpayer may not have taken the deduction.

¹⁸ 47 T.C. 340 (1966).

¹⁹ *Id.* at 349.

²⁰ *Id.* at 351.

²¹ 331 U.S. at 3-4.

theory that the "property" which she had acquired by devise was only the equity which her husband possessed in the property, or the excess of the value of the lot and building over the mortgage, which was zero.²² The Commissioner maintained that the property acquired and sold was not the equity, but was the physical property itself. Because the Court thought the property had not been acquired by purchase, it did not deal with section 1012, as the *Mayerson* court did. It dealt with what is now section 1014,²³ which defines the basis of property acquired from a decedent. This section provides that the basis of inherited property is the fair market value at the time of the decedent's death. Holding that this meant the fair market value of the property undiminished by the mortgage, and not merely the taxpayer's equity in the property, the Court expressed three policy reasons for its decision.

First, it relied on the dictionary definition of property and administrative construction of the statute, commenting that revenue acts should be interpreted in their ordinary, everyday sense.²⁴ Since the dictionary had no difficulty in distinguishing "property" from "equity," and since neither Congress nor the Treasury used the terms interchangeably,²⁵ the Court concluded that "equity" was not synonymous with "property," and that the dictionary definition of "property" was controlling.

Next, the Court reasoned that if "property" were construed to mean "equity," the construction would wreak havoc with the statutory provision for depreciation,²⁶ because depreciation would have to be computed on the basis of a shifting equity, that is, on the taxpayer's original economic investment plus any amounts that he later paid to amortize the mortgage.²⁷ This would distort income, because in the early years of the property's life the depreciation allowance would be only a fraction of the amount of the physical exhaustion of the property, and in later years the allowance would presumably exceed the actual amount of exhaustion.²⁸ Furthermore, the shifting equity basis would not only allow the mortgagor to control the timing of his depreciation allowances, but would also create an intolerable accounting burden.

Finally, the Court expressed a concern that avoiding the problems of a shifting equity basis by allowing depreciation on the full value of the property and deducting this from an equity basis would result in

²² *Id.* at 3.

²³ Section 113(a)(5), Int. Rev. Code of 1939, ch. 289, 52 Stat. 490, remains substantially unchanged as INT. REV. CODE OF 1954, § 1014.

²⁴ 331 U.S. at 6.

²⁵ *Id.* at 8.

²⁶ See INT. REV. CODE OF 1954, § 167; text accompanying note 135 *infra*.

²⁷ 331 U.S. at 9-10.

²⁸ *Id.* at 9.

loss of the deduction on a sub-zero basis. The Court hinted that it found a negative basis objectionable.²⁹

In light of the rationale of the Court in *Crane*, the Tax Court was clearly correct in *Mayerson*,³⁰ holding that the face amount of the mortgage was part of the basis, since Congress presumably intended the same definition of property to apply throughout the Internal Revenue Code, and since the same problems of a shifting basis that worried the Court in *Crane* would also exist in the *Mayerson* situation if only equity were included in basis. Therefore, the authority for *Mayerson* is unassailable. But the rationale—the *Crane* doctrine—underlying that authority is subject to attack.

Resort to the dictionary could perhaps be forgiven, since the problem, if it does not boggle the mind, at least on first exposure appears somewhat unmanageable. Yet, careful consideration of the precise issue in *Crane* exposes the inadequacy of the dictionary definition of property. The precise question was not the meaning of the word “property” alone, but of all the relevant statutory language: “property acquired by . . . devise.” The value of the real estate as appraised for estate tax purposes was identical to the sum of the mortgage plus the interest in default on the date of death. Because the taxpayer could not acquire free of the mortgage lien any part of the property value without first paying off a portion of the mortgage, the value of the property acquired by devise necessarily was zero. It is a strange inheritance that must be purchased! Even an everyday construction of the statute would lead one to conclude that the taxpayer inherited no property interest, and that no such interest could be acquired except by payments amortizing the mortgage. Payments would then provide a “cost” basis for the property.

The rationale of *Crane* leads to the same result as including the mortgage in cost, but results would vary in other situations. Thus, suppose that in *Crane* the value of the property had been somewhat less than the amount of the mortgage debt. The Court apparently would disregard the mortgage and give a fair market value basis, even though to acquire a clear title to the property the devisee would have to pay an amount larger than the value of the property in order to discharge the mortgage. In such a case there is no reason to deny a “cost” basis in the amount of the mortgage.

A further example of the unfortunate results that the *Crane* definition of property produces is the situation in which a taxpayer acquires property worth \$150,000 and subject to a \$50,000 mortgage, in ex-

²⁹ *Id.* at 10.

³⁰ Other cases have reached an identical result. See *Parker v. Delaney*, 186 F.2d 455 (1st Cir. 1950), *cert. denied*, 341 U.S. 926 (1951); *Blackstone Theatre Co.*, 12 T.C. 801 (1949). See also Rev. Rul. 55-675, 1955-2 CUM. BULL. 567.

change for his unmortgaged property worth \$100,000 in which his basis is \$40,000. His gain should be only \$60,000, the difference between the net value of the property received and his basis in the property which he exchanged for it. But, under the rationale of *Crane*, the word "property" in section 1001(b) connotes the property itself and not merely the equity therein, so that the amount realized is \$150,000, rather than \$100,000 as it should be, and the gain is \$110,000, a patently ridiculous result.³¹

The controlling force behind the Court's decision in *Crane* was probably its concern for depreciation policy. Section 167(g) of the Internal Revenue Code provides that the basis for purposes of depreciation is the same as provided in section 1011 for determining gain or loss on a sale or other disposition of property. Therefore, if the debt were not included in the "cost" basis, the basis for depreciation would be limited to the mortgagor's equity, a result the Court found unacceptable.³² On the other hand, the Court could not bring itself to allow depreciation on the full amount of the mortgage, which depreciation would be subtracted from the equity basis, resulting in many cases in a negative basis.³³

If the owner of mortgaged property is to be allowed depreciation representing the true value of the physical exhaustion of his property, the rule of *Crane* appears to be as good as or better than any other. It is questionable however, whether such depreciation allowances should be allowed to all mortgagors. In *Crane* the taxpayer argued that she was not entitled to depreciation deductions, whatever the basis of the property, because in the case of an unassumed mortgage, it is the mort-

³¹ Surrey and Warren suggest that this result can be avoided by adding the mortgage to the basis in the property exchanged by the taxpayer. This is undoubtedly wrong, since the mortgage will be part of the cost only of the property received, not of that exchanged. See S. SURREY & W. WARREN, *FEDERAL INCOME TAXATION* 646 (1960 ed.).

³² 331 U.S. at 9.

³³ The Tax Court had also rejected the concept of a negative basis. Beulah B. Crane, 3 T.C. 585, 591 (1944). Its position was apparently shared by the Treasury. See Surrey, *Assumption of Indebtedness in Tax-Free Exchanges*, 50 YALE L.J. 1, 19 (1940); Cooper, *Negative Basis*, 75 HARV. L. REV. 1352, 1353 n.4 (1962). However, a negative basis was supported by the concurring opinion of Judge Magruder in *Parker v. Delaney*, 186 F.2d 455, 459-60 (1st Cir. 1950), *cert. denied*, 341 U.S. 926 (1951), and the position of the Tax Court was eventually reversed and a negative basis allowed in *Easson v. Commissioner*, 294 F.2d 653 (9th Cir. 1961), *reversing* 33 T.C. 963 (1960). In *Easson* the Tax Court held that a taxpayer who transferred real estate subject to a mortgage in excess of his basis to a newly formed corporation in exchange for all its stock was taxable on the excess in order to avoid a basis adjustment below zero under what are now §§ 358(a) & 358(d) of the INT. REV. CODE OF 1954. 33 T.C. at 970. But the Ninth Circuit reversed and approved the negative basis. 294 F.2d at 658. When it enacted the 1954 Code, Congress disapproved the negative basis by introducing § 357(c) which resolves the *Easson* problem in accord with the Tax Court's solution. For further evidence of Congressional disapproval of negative basis see INT. REV. CODE OF 1954, § 362(c)(2); Treas. Reg. § 1.362-2(b) (1955); INT. REV. CODE OF 1954, §§ 301(c), 1021. See generally, Cooper, *Negative Basis*, 75 HARV. L. REV. 1352 (1962).

gagee, not the mortgagor, who will bear any economic loss. She reasoned that the one who bears the risk of economic loss should be the person who is entitled to take depreciation deductions. The Court disposed of this argument by noting that the value of the property never fell below the amount of the mortgage lien³⁴ (suggesting that the mortgagor could reasonably be expected to pay off the mortgage and bear any loss that might result). It concluded that so long as the mortgagor remains in possession, the mortgagee cannot take depreciation deductions since the property is not being used in the mortgagee's trade or business.³⁵ The Court could have added that the scheme of the Code was to allow the mortgagee to deduct his economic loss either as a bad debt under section 166, or as a loss under section 165.

Thus, the crux of the decision is the reasoning that where the value of the property exceeds the amount of the mortgage lien, the mortgagor could be expected to amortize the mortgage in order to retain the land:

[A]n owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations.³⁶

Indeed, the discussion of the problems in determining a proper depreciation allowance that a shifting equity would create is superfluous unless the Court had in fact made the judgment that economic cost would actually be incurred by the mortgagor.

When the Tax Court was faced with *Mayerson*, it could find no reason to treat a taxpayer purchasing by mortgage differently from one who had acquired property by devise, or from one who had paid cash for the property. The Tax Court, untroubled about the lack of personal liability (like the Supreme Court in *Crane*), stated:

The element of the lack of personal liability has little real significance due to common business practices. As we have indicated in our findings it is not at all unusual in current mortgage financing of income-producing properties to limit liability to the property involved. Taxpayers who are not personally liable for encumbrances on property should be allowed depreciation deductions affording competitive equality with taxpayers who are personally liable for encumbrances or taxpayers who own unencumbered property. The effect of such a policy is to give the taxpayer an advance credit for the amount of the mortgage. This appears to be reasonable since

³⁴ 331 U.S. at 11-12.

³⁵ *Id.* at 10 n.28. See INT. REV. CODE OF 1954, § 167(a).

³⁶ 331 U.S. at 14 (footnote omitted).

it can be assumed that a capital investment in the amount of the mortgage will eventually occur despite the absence of personal liability. The respondent has not suggested any rationale that would reasonably require a contrary conclusion. The lien created by the purchase-money mortgage, like the tax liens in the *Blackstone Theatre* case, should be included in basis for the purpose of computing depreciation.³⁷

In the usual case where a mortgage calls for amortization payments, an assumption that an investment in the amount of the mortgage will eventually occur may be warranted. The language of the court in *Mayerson* might be correct in such a case. But the *Mayerson* court was so concerned with the general rule that it failed to recognize the crucial difference between *Mayerson* and *Crane*. In *Mayerson*, no payments beyond the initial \$10,000 were due for ninety-nine years; therefore there was a much greater doubt than in *Crane* that the mortgage would be paid. To give advance credit for the amount of the mortgage when there is such uncertainty that the mortgage would be paid can only be viewed as an extreme application of the *Crane* doctrine. Nevertheless, perhaps it is proper for reasons of depreciation policy—the point stressed by the Tax Court. In any event, the Commissioner acquiesced in the decision,³⁸ although he stressed the “bona fides” of the transaction³⁹ and noted that the fair market value of the property was not in issue, warning that depreciation allowances will be disallowed when “unwarranted.”⁴⁰ In the business motivated transaction, the *Crane* rule—requiring inclusion of the mortgage in basis—should be continued to prevent a distortion of annual depreciation allowances.

A. Cancellation of Indebtedness Aspects of the Crane Rule: Settlement of the Mortgage Debt at Less Than Face Amount

When a debtor negotiates with his creditor for settlement of the debt at a discount, a question arises whether the debtor realizes income due to the cancellation of indebtedness. In *United States v. Kirby Lumber Co.*⁴¹ the taxpayer issued bonds at par and later purchased them back in the open market at a discount. The amount of the discount was held to be income, because the taxpayer received economic gain since its assets were freed of the offset of the debt in the amount of the cancellation.

³⁷ 47 T.C. at 351-52.

³⁸ 1969 INT. REV. BULL. No. 8, at 6.

³⁹ Text accompanying note 8 *supra*.

⁴⁰ Rev. Rul. 69-77, 1969 INT. REV. BULL. No. 8, at 10.

⁴¹ 284 U.S. 1 (1931).

Kirby Lumber Co. has been followed by the Court in similar cases.⁴² It has not been followed, however, where the taxpayer is not personally liable on the debt.⁴³ For example, in *Fulton Gold Corp.*,⁴⁴ in which the taxpayer satisfied a real estate mortgage at a discount, the Tax Court held that because there was no personal liability on the mortgage debt, the discount did not free any assets of the taxpayer. The Court reasoned that the use of the assets had not been restricted before the discount, and therefore the cancellation of indebtedness was not such an economic benefit that produced income under *Kirby Lumber*. The proper tax treatment of the discount was to treat it as a downward adjustment to the cost of the mortgaged property.⁴⁵

Even when the debtor is personally liable, some courts have held that there is no income if the debtor negotiates with his creditor to obtain a reduction of an asset's purchase price where the value of the asset has declined by at least the amount of debt cancelled. Instead, the transaction is treated as an adjustment of the purchase price, and the basis of the asset is reduced by the amount of debt cancelled.⁴⁶ But where there is no shrinkage in the value of the asset, the Treasury has ruled that a reduction in indebtedness produces income.⁴⁷

This distinction is erroneous. To allow a reduction of the purchase price in lieu of finding income is improper if the taxpayer is personally liable, even though the asset has shrunk in value. Freeing otherwise committed assets produces income. When liability is cancelled, whether by purchase of notes at a discount in the open market, or by a reduction in the purchase price of an asset, assets are freed and income is therefore produced. Indeed, income was found in *Fifth Avenue-Fourteenth Street Corp. v. Commissioner*,⁴⁸ where a mortgagor personally liable on the mortgage was able to buy mortgage certificates at a discount and use them at face value to discharge its mortgage debt. Although the case is distinguishable because negotiations for the discount did not relate to the purchase price, nonetheless

⁴² See, e.g., *Commissioner v. Jacobson*, 336 U.S. 28 (1949); *Helvering v. American Chicle Co.*, 291 U.S. 426 (1934).

⁴³ See, e.g., *Fulton Gold Corp.*, 31 B.T.A. 519 (1934); *P. J. Hiatt*, 35 B.T.A. 292 (1937); *Hotel Astoria, Inc.*, 42 B.T.A. 759 (1940); *Brighton Recreations, Inc.*, 30 P-H Tax Ct. Mem. 135 (1961).

⁴⁴ 31 B.T.A. 519 (1934).

⁴⁵ *Id.* at 520.

⁴⁶ *Hirsch v. Commissioner*, 115 F.2d 656, 658 (7th Cir. 1940); *Helvering v. A. L. Killian Co.*, 128 F.2d 433, 434-35 (8th Cir. 1942); *Commissioner v. Sherman*, 135 F.2d 68, 70 (6th Cir. 1943); *Ahrens Publishing Co., Inc.*, 1 T.C. 345, 354 (1942); *Charles L. Nutter*, 7 T.C. 480, 483 (1946). But see *L. D. Codden & Bros.*, 37 B.T.A. 393, 397-99 (1938).

⁴⁷ I.T. 4018, 1950-2 CUM. BULL. 20.

⁴⁸ 147 F.2d 453 (2d Cir. 1944).

Judge Frank termed "irrational" the reduction of purchase price distinction.⁴⁹

Allowing a reduction of the purchase price creates a serious problem when cancellation occurs after the taxpayer has already benefited from deductions based upon the unreduced cost of the property. In *Blackstone Theatre Co.*,⁵⁰ for example, the taxpayer acquired real estate subject to tax liens of approximately \$120,000 and was able to discharge the liens five years later for about \$50,000. The Commissioner contended that the taxpayer's basis for depreciation was limited to the amount eventually paid on the liens, not the total amount of the encumbrances (\$50,000 rather than \$120,000). He argued that this adjustment to basis should be made retroactively in order to disallow depreciation deductions on a basis of more than \$50,000. The Tax Court held that under *Crane* the basis for depreciation included the full amount of the liens (\$120,000) and this basis could not be retroactively reduced. The result is consistent with *Mayerson*⁵¹ where the court held that the taxpayer's basis for depreciation in the years prior to the discharge included the full mortgage debt unaffected by a subsequent settlement at less than the face amount.⁵²

Although it may appear that taxpayers are given a windfall when they are allowed to reduce the amount of outstanding debt by a reduction in the purchase price without realizing income, after depreciating the property on the face amount of the debt, the windfall may be illusory. For instance, in *B. F. Avery & Sons, Inc.*,⁵³ the taxpayer purchased merchandise and manufacturing equipment partially on credit. When the merchandise was sold, its cost was deducted as part of the cost of goods; while the machinery was used, depreciation deductions were made. Ten years later the taxpayer obtained a cancellation of part of the debt remaining. Because the cost of merchandise and depreciation expense had already been deducted, the taxpayer had to treat the amount of the notes cancelled as income. The court noted that if cancellation of the debt had taken place in the same year as the purchase

[t]he adjustment necessitated by the note cancellation probably would have been accomplished by eliminating the basis for depreciation and loss on the manufacturing machinery and reducing inventory and cost of goods sold.⁵⁴

⁴⁹ *Id.* at 457. The distinction was also rejected in *Commissioner v. Coastwise Transp. Corp.*, 71 F.2d 104, 106 (1st Cir.), *cert. denied* 293 U.S. 595 (1934).

⁵⁰ 12 T.C. 801 (1949).

⁵¹ 47 T.C. 340 (1966). See text accompanying notes 18-21 *supra* for a discussion of the relevant facts.

⁵² *Id.* at 354.

⁵³ 26 B.T.A. 1393 (1932).

⁵⁴ *Id.* at 1399.

However, the court noted that the transactions did not take place in a single year but were spread over ten years. Therefore, relying on *Kirby Lumber* and "tax benefit" principles the court held that in the tenth year it was necessary to include the amount of the cancellation as income in order to offset prior deductions.⁵⁵ Thus, although the prior depreciation taken on the inflated price of the property cannot be re-computed, the excess amounts of the depreciation are taken into income in the year the debt is cancelled. Except for changes in yearly tax rates or vicissitudes in the profits of the taxpayer, the result is substantially the same.

B. *Contingent Obligations as Part of Cost*

An obligation cannot be included as part of the basis of property if it is contingent or indefinite in nature.⁵⁶ In *Lloyd H. Redford*,⁵⁷ for example, a note given as part payment on the purchase of property was excluded from the basis of the property since it was payable from future profits only. Whether or not there would be any future profits was uncertain. Actually, by the time of the litigation, the uncertainty had been considerably reduced since profits had been returned, but had not yet been applied against the note. Nevertheless, the court held that the obligation could not be included in basis. Retrospective analysis did not change the fact that uncertainty existed at the time of acquisition.

An identical result was reached in *Albany Car Wheel Co.*⁵⁸ The taxpayer purchased certain business assets with \$15,000 in notes and assumed specified liabilities of about \$75,000, plus an obligation for severance pay to the seller's employees under a union contract. The Commissioner and the taxpayer agreed that the notes and \$75,000 liability were part of basis, but the Commissioner rejected the taxpayer's claim that \$50,000 (the alleged severance pay liability) was also includable.

The court upheld the Commissioner on two grounds. First, no fixed sum of \$50,000 could be set, because the liability was dependent upon the number of employees at the time of closing the plant. There would be no liability to those who died or left the taxpayer's employ in the meantime. More important, the court emphasized that the taxpayer had obtained a release from the obligations of the union contract and had negotiated a new agreement with the union under which he was relieved of liability for severance pay if the employees were given notice

⁵⁵ *Id.* at 1400.

⁵⁶ *Albany Car Wheel Co.*, 40 T.C. 831 (1963), *aff'd per curiam*, 333 F.2d 653 (2d Cir. 1964); *Columbus Greenville Ry. Co.*, 42 T.C. 834 (1964); *Lloyd H. Redford*, 28 T.C. 773 (1957); Rev. Rul. 55-675, 1955-2 CUM. BULL. 567.

⁵⁷ 28 T.C. 773 (1957).

⁵⁸ 40 T.C. 831 (1963), *aff'd per curiam*, 333 F.2d 653 (2d Cir. 1964).

for specified periods (six to twelve weeks depending upon the length of prior service) before the plant was closed.

The court recognized that there could have been liability for severance pay, if, for example, the plant had burned, leaving the employees without work before they received the required notice. But the court reasoned that the taxpayer was protected against this contingency by fire insurance, the premiums of which were a deductible business expense, and it concluded:

We think that petitioner's liability for severance pay . . . was so speculative that its obligations under the union contract cannot fairly be regarded as part of the "cost" of the assets acquired. . . . To the extent that any liability might accrue in a later year as a result of that contract, payments thereunder may properly be taken into account at such later time; they may not be used to increase the cost of goods sold in an earlier year or to increase the amount of the depreciation allowance for such earlier year.⁵⁹

In *Mayerson* the face amount of the mortgage (\$332,500) was to be reduced if it were paid off in either the first or second year following purchase, to \$275,000 or \$298,750, respectively.⁶⁰ No prepayment occurred, but the purchase money obligation was in fact settled some years later for \$200,000. Rejecting the Commissioner's argument that the entire obligation was too indefinite to be included in basis,⁶¹ the court held that the taxpayers' basis was the full \$332,500. No reasons were given for the decision, but the court characterized the price reduction terms as a "bonus discount,"⁶² which "merely provided an incentive for very early retirement of the mortgage which did not occur."⁶³

"Bonus discount" is a label signifying nothing. Satisfied with verbal distinctions, the court chose not to grapple with the concept of contingency. A discount for prepayment by its very nature makes the price indefinite and to some extent contingent on future events. The Commissioner may have gone too far in excluding even the reduced price from basis, but it is clear that any obligation in excess of the reduced price is contingent. Although the decision pays lip service to it, this case disregards the "contingent and indefinite" rule and is inconsistent with *Redford* and *Albany Car Wheel*. The *Mayerson* court did

⁵⁹ *Id.* at 841. The court did not state whether future payments were to be expended or capitalized.

⁶⁰ This reduction did not represent any interest since the mortgage required annual payments of interest at the market rate. 47 T.C. at 342.

⁶¹ *Id.* at 353-54. The Commissioner used the argument that the obligation was excessively indefinite to bolster the claim that there was in reality no debt but only the establishment of a leasehold. *Id.* at 349-50. Text accompanying notes 6-11 *supra*.

⁶² *Id.* at 354.

⁶³ *Id.*

note, however, that prepayment had not in fact occurred. In both *Redford*⁶⁴ and *Albany Car Wheel*⁶⁵ the courts also mentioned that the taxpayer never paid the contingent amount. Emerging from these cases is a rule of retrospective analysis rather than a reasoned approach to the problem of contingent obligations.

Whether to include a contingent obligation in basis is a problem different only in degree from the general problem of whether noncontingent liability should be included in cost. The rationale for inclusion of the latter is premised on the notion that eventually it will be paid, either because the taxpayer is personally liable or because he must discharge the obligation in order to keep the property.⁶⁶ If the obligation consists of a long-term mortgage, the possibility is often remote that the debt will be entirely discharged before the property is sold. In this sense the mortgage obligation is contingent, but it is nevertheless included in basis. An adjustment is made for the unamortized portion of the mortgage by adding it to the amount realized on sale. No explanation has been given for the distinction drawn between these cases and *Redford*, where the possibility of an increase in cost based on future profits was excluded from basis. In both situations inclusion of the liability in basis can be offset by inclusion of the unamortized portion in the amount realized on sale. Although the adjustment to amount realized may alone be inadequate to prevent an unwarranted tax benefit,⁶⁷ the solution is just as appropriate in *Redford* as in *Crane* and *Parker v. Delaney*.⁶⁸ In *Crane*, no part of the mortgage was amortized during the six years the property was held by the taxpayer, and in *Parker v. Delaney*, only \$14,000 of a \$273,000 mortgage was amortized over the approximately ten-year period before the property was conveyed to the mortgagee. In both cases allowable depreciation exceeded amortization payments. If proper depreciation policy requires inclusion in basis of the mortgage obligations in *Crane* and *Parker v. Delaney*, it must require as much of the contingent note in *Redford*, since its payment is no more contingent than full payment of the mortgage in

⁶⁴ 28 T.C. at 778.

⁶⁵ 40 T.C. at 840.

⁶⁶

Taxpayers who are not personally liable for encumbrances on property should be allowed depreciation deductions affording competitive equality with taxpayers who are personally liable for encumbrances or taxpayers who own unencumbered property. The effect of such a policy is to give the taxpayer an advance credit for the amount of the mortgage. This appears to be reasonable since it can be assumed that a capital investment in the amount of the mortgage will eventually occur despite the absence of personal liability.

Manuel D. Mayerson, 47 T.C. 340, 352 (1966) (emphasis added).

⁶⁷ Text accompanying note 125 *infra*.

⁶⁸ 186 F.2d 455 (1st Cir. 1950). For further remarks on *Parker v. Delaney* see text accompanying note 107 *infra*.

the former cases. Such treatment would also make *Redford* consistent with *Mayerson*.⁶⁹ However, such consistency may in some cases be improper.

Judicial opinions on the subject normally begin in the same manner as did this section of the Article—with the postulate that contingent obligations are not included in basis. Gradually, courts avoided application of the rule in cases where there were obvious contingencies.⁷⁰ If exceptions are not to swallow the rule, remote contingent obligations must be excluded from basis. In *Mayerson* the taxpayers had all the benefits of absolute ownership without assuming personal liability on the mortgage. Exempt from required payments for ninety-nine years, the taxpayer could obtain nothing through amortization that he did not already possess. Therefore, amortization was not only contingent; it was highly unlikely. Once the court concluded that the mortgage was part of basis, it decided, probably correctly, that the possibility of prepayment in the first two years was so remote that the basis could not be reduced below the face amount of the mortgage. Similarly, if the court finds, as it did in *Redford* and *Albany Car Wheel*, that there is only a remote chance of expenditure, basis should not be expanded to include this contingency.

III. *Crane* REEXAMINED: SHOULD UNASSUMED DEBT BE INCLUDED IN AMOUNT REALIZED?

Section 1002 of the Internal Revenue Code provides that on the sale or exchange of property the entire amount of the gain shall be recognized. Gain is defined in section 1001 as the excess of the amount realized over the adjusted basis;⁷¹ amount realized includes the fair market value of property received. *Eisner v. Macomber*⁷² established the concept that "realization" of the gain is a prerequisite to imposition of the income tax, although later cases indicate that the court is zealous in finding realization has occurred.⁷³ Since *United States v. Hendler*⁷⁴ it is clear that the assumption of a debt is treated just as if money were actually paid to the person whose obligation is assumed. The taxpayer whose debt is assumed therefore realizes a gain to the extent that the debt exceeds basis. *Hendler* involved a reorganization in which a corporate taxpayer transferred its assets in return for consideration that

⁶⁹ See note 66 *supra*.

⁷⁰ E.g., *Parker v. Delaney*, 186 F.2d 455 (1st Cir. 1950), *cert. denied*, 341 U.S. 926 (1951); *Crane v. Commissioner*, 331 U.S. 1 (1946).

⁷¹ INT. REV. CODE OF 1954, § 1001. Text accompanying note 17 *supra*.

⁷² 252 U.S. 189 (1920). Whether or not the doctrine of realization is constitutionally required or is simply part of the congressional scheme has been the subject of much debate. See Lowndes, *Current Conceptions of Taxable Income*, 25 OHIO ST. L.J. 151, 171-72 (1964).

⁷³ See, e.g., *Helvering v. Bruun*, 309 U.S. 461 (1940).

⁷⁴ 303 U.S. 564 (1938).

included assumption of its bonded indebtedness by the transferee. Therefore, the gain realized was taxable to the extent of the debt. Although there is some ambiguity in the court's reasoning that the transaction was identical to the transferor receiving money and then paying creditors, nevertheless *Hendler* is generally read as establishing that the assumption of the debt, rather than the payment, is equivalent to receipt of money by the debtor.⁷⁵ This principle is now embodied in the Code.⁷⁶

In *Crane*, the Court faced the question whether the taxpayer realized a gain when she sold property for cash subject to a mortgage on which neither she nor the buyer was personally liable. The seller conceded that if she were personally liable on the mortgage, and the purchaser assumed her liability, the amount of the mortgage would have been part of her amount realized. In spite of the lack of personal liability of either the vendor or vendee, the Court held on two separate grounds that the amount of the mortgage was realized by the seller.

First, the Court noted that the word "property" in section 1001(b)⁷⁷ must be construed in the same way as in the basis provisions of the Code.⁷⁸ This is necessary, said the Court, because "the functional relation of the two sections requires that the word mean the same in one section that it does in the other."⁷⁹ In other words the Court believed that the inclusion of a mortgage in basis for depreciation purposes required an offsetting inclusion in amount realized to prevent the taxpayer from receiving depreciation tax benefits without economic cost. The Court did not express the idea quite so succinctly, but later in its opinion when it dealt with the taxpayer's contention that she was being taxed on something other than income as defined by the sixteenth amendment, the Court noted that the taxpayer had taken the depreciation deductions to which she was entitled, and concluded, "The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain."⁸⁰ By holding that the taxpayer must include the unamortized mortgage in the amount realized, the Court prevented the taxpayer from obtaining any benefit from the absence of personal liability, since any depreciation allowable

⁷⁵ See *Surrey, Assumption of Indebtedness in Tax-Free Exchanges*, 50 YALE L.J. 1 (1940).

⁷⁶ See, e.g., INT. REV. CODE OF 1954, §§ 1031(d), 357(c), 358(d).

⁷⁷ INT. REV. CODE OF 1954, § 1001(b) is identical in all pertinent respects with Int. Rev. Code of 1939, ch. 289, § 111(b), 52 Stat. 447 (1938), which was the applicable section when *Crane* was decided.

⁷⁸ Text accompanying notes 24-27 *supra*.

⁷⁹ 331 U.S. at 12.

⁸⁰ *Id.* at 15.

during the period in which the taxpayer holds the property reduces the basis of the property below the amount of the unamortized mortgage, resulting in inclusion of the amount of this depreciation in income when the property is sold.⁸¹

The second line of reasoning used by the Court is more troublesome, especially since it was not essential to the decision. As the rationale for applying *Hendler*, the Court stated that a sale of property subject to a mortgage for which there is no personal liability gives the seller a "benefit" in the amount of the mortgage which is "as real and substantial as if the mortgage was discharged, or as if a personal debt in an equal amount had been assumed by another."⁸² To support this statement, the Court noted that "[A]n owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage as if they were his personal obligations."⁸³

To state this concept more clearly, one can say that as long as the property value is not less than the face amount of the mortgage securing it, the lien of the mortgagee on the property is tantamount to the imposition of personal liability on the mortgagor, because his property can be taken to satisfy the lien. In effect, the mortgagee is simply a preferred creditor of the mortgagor. When the debt follows the property into the hands of a buyer, the mortgagor is relieved of a liability and realizes a benefit in the amount of the mortgage.

Persuasive though this theory may be in the context of *Crane*, it creates a problem in treating a sale by the mortgagor when the value of the property is less than the amount of the mortgage debt at the time of the sale. The Court was aware of the problem:

⁸¹ Underlying this rationale is the principle of tax benefit; that is, in the year in which he disposes of property, a taxpayer must include in income any deductions made in a prior year that later prove to have been unwarranted. *Perry v. United States*, 160 F. Supp. 270 (Ct. Cl. 1958), *overruled*, *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct. Cl. 1967). INT. REV. CODE OF 1954, § 111, and Treas. Reg. § 1.111-1(a) incorporate the tax benefit principle into current tax law. Under § 111, bad debts, prior taxes, or delinquency amounts written off in prior years must be included in income when recovered, unless the prior deduction did not reduce the tax.

When depreciation is involved, a more stringent rule is applied. Section 1016 requires that the basis of property be reduced by the amount of depreciation allowable, whether or not it is taken. Whereas the tax benefit rule is designed to prevent the taxpayer from making a personal gain through unwarranted deductions, § 1016 is more than a protective device, since it operates regardless of whether there has been a tax benefit via a deduction. *See, e.g., Virginia Hotel Corp. v. Helvering*, 319 U.S. 523 (1943). Therefore, in *Crane* the taxpayer's basis would have been reduced by the amount allowable even if she had made no depreciation deduction. However, this is not a problem unique to *Crane*. It is a derivative of the fundamental principle that depreciation deductions should not be manipulated by the taxpayer. *See Commissioner v. Kennedy Laundry Co.*, 133 F.2d 660 (7th Cir.), *cert. denied*, 319 U.S. 770 (1943).

⁸² 331 U.S. at 14.

⁸³ *Id.*

Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.⁸⁴

To the extent that the amount of the mortgage exceeds the value of the property, no property of a mortgagor not personally liable could be used to satisfy the mortgage. Thus the taxpayer would get no "benefit" to this extent from disposition of the property subject to the mortgage. If the "economic benefit" theory is to be applied consistently, no gain is realized in this amount.

This is the dilemma of *Crane*. Consistent application of a theory of "economic benefit" limits the amount of the mortgage that is realized, while the other discernible rationale of *Crane*—based on a theory of "tax benefit"—requires inclusion in amount realized of the full amount of the mortgage irrespective of the property's value. To resolve the dilemma, one must reconsider the Court's preoccupation with depreciation policy. Because the mortgage is included in basis, under the theory of economic benefit, a decline in the value of the property at a rate faster than the amortization of the mortgage could result in tax-free income to the taxpayer by way of the depreciation deductions that were taken on that portion of the property value equivalent to the difference between the value of the property at the time of its sale, and the amount of the unamortized mortgage. Therefore, the amount realized on the sale of the property should not be reduced by this amount. Admittedly, there is no relief from liability on this amount where there is no personal liability on the mortgage. In this sense, there is no economic benefit. But the amount must nevertheless be included in the amount realized under the principle of tax benefit. In this manner the taxpayer is made to account for depreciation allowable without economic investment.

That the amount realized on a sale includes any mortgage to which the property is subject, irrespective of personal liability, is a rule uniformly followed—sometimes on the theory of economic benefit,⁸⁵ and sometimes on the tax benefit theory.⁸⁶ Although taxpayers have tried to avoid the result suggested above in cases where the value of the property at the time of sale is exceeded by the amount of the mortgage,

⁸⁴ *Id.* at 14 n.37. See also *id.* at 15 n.42.

⁸⁵ *E.g.*, *Titelbaum v. Commissioner*, 346 F.2d 266 (7th Cir. 1965); *Commissioner v. Fortree Properties, Inc.*, 211 F.2d 915 (2d Cir. 1954).

⁸⁶ *E.g.*, *Mendham Corp.* 9 T.C. 320 (1947).

no court has yet accepted the argument that consistent application of the economic benefit principle requires that case to be treated differently.⁸⁷

In many cases the mortgage on the property is the result of a borrowing made some time after the property is acquired. When such property is sold, the amount of the mortgage is still included in the amount realized even though it was not part of the cost of the property⁸⁸ but rather is the cost only of the money borrowed subsequent to the acquisition of the property. Here, it is a variant of the economic benefit theory that supports inclusion of such a mortgage in the amount realized. Excluded from cost, the mortgage debt does not give rise to depreciation deductions and cannot be included in amount realized on tax benefit grounds. But the mortgage must be included in amount realized to make the taxpayer account for the past borrowing represented by the mortgage for which the taxpayer is no longer effectively liable. Otherwise, the borrowing, followed by a sale of the property subject to the mortgage, to the extent it is not offset by basis would give tax-free gain to the taxpayer in the sum of the cash received on the borrowing and not repaid at the time of sale. And since the economic benefit is represented by that cash, a court should not allow a decline in property value to reduce the amount realized below the amount of the mortgage.⁸⁹

From a slightly different angle, borrowing on the value of property after acquiring ownership can be viewed as returning to the taxpayer pro tanto his original economic investment. Looked at this way, the taxpayer has an investment of zero dollars. He therefore would have a depreciable basis without economic investment. Thus, when he sells the property, he must recognize the amount of the mortgage under the tax benefit theory.⁹⁰ However, this theory is inapplicable when the borrowing represents appreciation on the property for which there was no prior investment. In such case, the economic benefit theory provides the only rationale for including the mortgage in amount realized.

⁸⁷ In *Parker v. Delaney*, 186 F.2d 455 (1st Cir. 1950), *cert. denied*, 341 U.S. 926 (1951), the court rejected this argument by the taxpayer, presumably because it was bound by the district Tax Court's finding that the value of the property was at least equal to the mortgages. *Id.* at 458. A similar argument was made by the taxpayer in *Woodsam Associates, Inc. v. Commissioner*, 198 F.2d 357 (2d Cir. 1952). But the court said, "However, the petitioner has disclaimed reliance upon that and, we think, advisedly so. Cf. *Parker v. Delaney*" *Id.* at 358 n.1.

Prior to *Crane*, the Tax Court had held in *Lutz & Schramm Co.*, 1 T.C. 682 (1943) that the full amount of a mortgage on which there was no personal liability was realized despite the fact that the value of the property was exceeded greatly by the amount of the mortgage. Compare INT. REV. CODE OF 1954, § 311(c) with *id.*, § 358(d).

⁸⁸ *Woodsam Associates, Inc. v. Commissioner*, 198 F.2d 357 (2d Cir. 1952); *R. O'Dell & Sons Co. v. Commissioner*, 169 F.2d 247 (3d Cir. 1948); *Mendham Corp.*, 9 T.C. 320 (1947); *Lutz & Schramm Co.*, 1 T.C. 682 (1943).

⁸⁹ See *Lutz & Schramm Co.*, 1 T.C. 682 (1943).

⁹⁰ The theory is discussed at text accompanying notes 77-81 *supra*. See also *Mendham Corp.*, 9 T.C. 320 (1947).

A. *The Influence Upon Amount Realized of the Cancellation of Indebtedness Doctrine*

When mortgaged property is transferred in return for a cancellation of the debt, the courts, as illustrated above, may tax as income the difference between the indebtedness and the taxpayer's basis. Once having found that there is income, the courts do not bother to divide this income into classes. It makes no difference that one portion may represent gain or loss from the disposition of the property and another segment gain from cancellation of indebtedness.⁹¹ To illustrate, suppose a taxpayer who is personally liable on a mortgage of \$100 has a basis of \$80 in property worth \$90 when transferred in discharge of the mortgage. A court would treat the transaction as a sale and would tax him on \$20 gain from the sale of the property.⁹² Properly treated, however, the transaction should be broken down into two separate components of gain. The gain from the sale is only \$10, the difference between basis and value of the property. The remaining \$10 is income from cancellation of the debt,⁹³ under *Kirby Lumber*. If the property were worth \$80 and taxpayer's basis were \$90, a conveyance in discharge of a mortgage of \$100 gives rise to a loss from the sale of \$10, and debt cancellation income of \$20.

Suppose, however, that the same taxpayer were insolvent after transfer of the property. There is authority for the proposition that no income arises from cancellation of the indebtedness when a continuing state of insolvency prevents the debt cancellation from freeing any of the taxpayer's assets from the burden of all obligations.⁹⁴ Yet, this exception to *Kirby Lumber* should not affect the segment of the gain which is due to the sale of the property.

In the first example above, cancellation of the debt segment of the gain is only \$10, the difference between the \$90 value and \$100 debt. The other \$10, the difference between the basis in the property and its value, is gain from the sale of the property. This gain is probably not exempt from taxation under the insolvency rule. In *Parkford v. Commissioner*⁹⁵ the court held that a salary received by an individual ad-

⁹¹ See Lurie, *Mortgagors with "Negative Equities" and "Negative Bases"*, N.Y.U. 10th INST. ON FED. TAX. 71, 84 (1952); S. SURREY & W. WARREN, *FEDERAL INCOME TAXATION* 843 (1960 ed.).

⁹² See, e.g., *R. O'Dell & Sons Co. v. Commissioner*, 169 F.2d 247 (3d Cir. 1948); *Lutz & Schramm Co.*, 1 T.C. 682 (1943); cf. *Parker v. Delaney*, 186 F.2d 455 (1st Cir. 1950), *cert. denied*, 341 U.S. 926 (1951).

⁹³ Treas. Reg. § 1.1017-1(b) (5) (1956) properly identifies the cancellation of debt segment.

⁹⁴ *Towers & Sullivan Mfg. Co.*, 25 B.T.A. 922 (1932); *Eastside Mfg. Co.*, 18 B.T.A. 461 (1929); *Simmons Gin Co.*, 16 B.T.A. 793 (1929), *aff'd*, 43 F.2d 327 (1930). But see *Lakeland Grocery Co.*, 36 B.T.A. 289 (1937), in which the taxpayer was insolvent prior to forgiveness of the debt and solvent thereafter.

⁹⁵ 133 F.2d 249 (9th Cir.), *cert. denied*, 319 U.S. 741 (1943).

judged bankrupt is taxable income. Similarly in *Home Builders Lumber Co. v. Commissioner*,⁹⁶ where an insolvent debtor realized gain from the sale of certain installment contracts pledged as security for its debts, the court held that the insolvency rule did not exempt from taxation any gain from the sale.

Both the solvent and the insolvent may receive profits and be liable for the tax thereon. It stands out clearly that when the contracts were sold a profit . . . was realized, and it is immaterial whether or not the proceeds of the sale were sufficient to pay the indebtedness of the taxpayer in full. The tax was not on that part of its indebtedness which it may not have been able to pay by reason of its alleged insolvency. No debt was forgiven nor cancelled.⁹⁷

In both of these cases, the court distinguished gain arising from the cancellation of a debt from gain attributable to a source unrelated to debt cancellation. But in *Main Properties, Inc.*⁹⁸ the Tax Court failed to make this distinction. There, the taxpayer conveyed real estate which had an adjusted basis of approximately \$212,000 and a value of approximately \$260,000⁹⁹ in exchange for its own bonds with a face value of \$640,000. The court held that the entire gain was exempt from tax under the insolvency exception to the *Kirby Lumber* rule.¹⁰⁰ Neither the Commissioner nor the court thought of treating separately from the cancellation of indebtedness that portion of the gain arising from the real estate sale (\$48,000).¹⁰¹ Although *Main Properties* did not involve mortgaged property, the situation was quite similar to one involving property burdened by debt, since the taxpayer's debt was discharged by conveyance of the property even though the debt was not a specific lien thereon. If the taxpayer had sold the building for \$260,000 and used this money to retire its debt, it would have been compelled to take \$48,000 into income under *Home Builders Lumber Co.* Elimination of the middle step should not change the result. If *Home Builders* is correct, then only the gain due to debt cancellation should be exempt under the insolvency exception to *Kirby Lumber*.¹⁰²

⁹⁶ 165 F.2d 1009 (5th Cir. 1948).

⁹⁷ *Id.* at 1011.

⁹⁸ 4 T.C. 364 (1944).

⁹⁹ *Id.* at 382.

¹⁰⁰ *Id.* at 385.

¹⁰¹ *Id.* at 383.

¹⁰² Of course, if the taxpayer is at all times solvent, there is still a possibility that he may not realize income from the cancellation of the debt, due to the reduction of purchase price doctrine. See text accompanying notes 46-47 *supra*.

IV. APPLICATION OF *Crane* TO TRANSFERS OF PROPERTY BY GIFT, AT DEATH, AND ON ABANDONMENT

Commentators have been fearful that the *Crane* rule could be exploited either by the taxpayer or the Commissioner when the property is disposed of other than through a sale. One writer feared that a gift of the mortgaged property would not be a taxable event, with the result that the taxpayer would never recognize the gain attributable to his depreciation deductions, even though he could deduct the value of the equity if the gift were to a charity.¹⁰³ Others have thought that abandonment of mortgaged property to the mortgagee would not be a taxable event.¹⁰⁴ On the other hand, at least one writer found it "difficult to justify charging a gain to one who has merely surrendered property that is worthless to him," even though he received depreciation deductions without economic investment.¹⁰⁵ In the same vein, it has been said that the idea of income resulting from abandonment "is like saying that a casualty, such as a storm, which wipes out a taxpayer's investment, may be productive of income."¹⁰⁶

The point that is being missed by those who criticize the application of *Crane* to dispositions by abandonment is that there can be no investment in the property to the extent that the mortgage exceeds basis. Where, under *Crane*, the mortgage is part of basis, the excess will represent past deductions for depreciation in excess of taxpayer's own investment. Where the mortgage is not part of basis, the excess will represent money (or other property) received by borrowing on the appreciation of the property. With this established, the discussion below will show that the rule of *Crane* finding an amount realized in the amount of the mortgage is properly applied to every disposition of property, whether by way of abandonment, gift, or even transfer at death.

A. *Disposition by Abandonment*

The agonizing and persistent debate over whether *Crane* applies to dispositions by abandonment was ended by *Parker v. Delaney*.¹⁰⁷ That case held that *Crane* was applicable when the mortgagor abandoned property to the mortgagee:

¹⁰³ Lurie, *Mortgagor's Gain on Mortgaging Property for More Than Cost Without Personal Liability*, 6 TAX. L. REV. 319, 320 (1951).

¹⁰⁴ This was the view that Judge Learned Hand expressed when *Crane* was in the circuit court. *Commissioner v. Crane*, 153 F.2d 504, 506 (2d Cir. 1945), *aff'd* 331 U.S. 1 (1947).

¹⁰⁵ Note, *Taxation of Gain Resulting From Sales of Mortgaged Property*, 60 HARV. L. REV. 1324, 1329 n.29 (1947).

¹⁰⁶ Lurie, *Mortgagors With "Negative Equities" and "Negative Bases,"* N.Y.U. 10TH INST. ON FED. TAX. 71, 80 (1952).

¹⁰⁷ 186 F.2d 455 (1st Cir. 1950).

[I]t does not help appellant [taxpayer] to term the transaction an abandonment if it was nevertheless a disposition within the meaning of § 111 [§ 1001] upon which a gain was realized In these circumstances, the unpaid amount of the liens is carried forward, as it were, from the time of acquisition to the time of disposition. They are treated as cost at the earlier time and so must be treated as value at the later time. The result in the end is that the taxpayer accounts to the taxing authorities for the gain realized by his deductions for depreciation in excess of his own investment.¹⁰⁸

B. Disposition by Gift

Once it is decided that the mortgage is part of the amount realized when property is abandoned, the rationale applies with equal force to a gift of mortgaged property, since a gift, at least in this context, is also a disposition within section 1001. In a recent article,¹⁰⁹ Nelson Adams analyzes this problem by presenting the imaginary case of *Blank v. Commissioner*, in which a taxpayer acquired an office building for \$100,000, subject to a \$2,000,000 mortgage. He held the property for 5 years during which time he amortized \$125,000 of the mortgage. During this same period, he had net rental income of \$100,000 before depreciation, and took depreciation deductions of \$525,000,¹¹⁰ \$425,000 of which he applied against income from other sources. When he disposed of the property by donating it to a tax exempt organization, which took it subject to the unamortized mortgage of \$1,875,000, the taxpayer reported no income from the gift, but claimed a charitable deduction of \$100,000 (the value of the equity).

The Tax Court sustained the Commissioner's disallowance of the charitable deduction on the ground that the property had no value in excess of the mortgage. This point was not appealed by the taxpayer. The Commissioner also contended that at the time of the gift the taxpayer realized income in the amount of the excess of the mortgage, \$1,875,000, over his adjusted basis, \$1,575,000. This \$300,000 disparity represented the difference between the taxpayer's investment of \$225,000 and the allowable depreciation of \$525,000. Eventually, an imaginary Supreme Court granted certiorari to review the lower courts' holding that the taxpayer realized no income on the gift.

In the Supreme Court, the Commissioner argued that if basis included the mortgage, then *Crane* required that the gift be treated as a

¹⁰⁸ *Id.* at 459.

¹⁰⁹ Adams, *Exploring the Outer Boundaries of the Crane Doctrine; An Imaginary Supreme Court Opinion*, 21 TAX L. REV. 159 (1966).

¹¹⁰ The imaginary taxpayer used the straightline method of depreciation. Five per cent of his basis of \$2,100,000 for each of 5 years gave him a total depreciation deduction of \$525,000.

disposition upon which the amount of the mortgage is realized. Taxpayer responded that *Crane* could not apply since "from time immemorial it has been the rule that income is not realized from a gift to charity of property which has a value in excess of its adjusted basis."¹¹¹ The Court accepted the taxpayer's statement of the law in regard to charitable contributions, but refused to apply it to him because he had no equity in the transferred property. Absent some equity in the property, the Court could not find any contribution. But even if an equity were present, the rule preventing realization would not control because it has been applied only to situations where the transferred property was not encumbered by debt.¹¹² Authority is abundant for the proposition that absent a mortgage, a gift is not an event which causes realization of gain.¹¹³ The value of property in excess of its basis, whether due to market appreciation or to the reduction of basis by past deductions, is therefore not realized by a donor of the property.¹¹⁴

¹¹¹ Adams, *supra* note 109, at 167.

¹¹² See L.O. 1118, II-2 CUM. BULL. 148 (1923); Rev. Rul. 55-410, 1955-1 CUM. BULL. 297; Rev. Rul. 57-328, 1957-2 CUM. BULL. 229; Estate of Farrer, 15 T.C. 277 (1950); White v. Brodrick, 104 F. Supp. 213 (D. Kan. 1952); Campbell v. Prothro, 209 F.2d 331 (5th Cir. 1954); Elsie SoRelle, 22 T.C. 459 (1954).

¹¹³ See, e.g., Campbell v. Prothro, 209 F.2d 331, 336 (5th Cir. 1954).

¹¹⁴ The Commissioner acquiesced in Rev. Rul. 55-138, 1955-1 CUM. BULL. 223, 225-26 and Rev. Rul. 55-531, 1955-2 CUM. BULL. 520. He ruled that the fair market value of inventory property contributed to a charity is not includable in the donor's income, and that such value is an allowable charitable deduction. Similarly, INT. REV. CODE OF 1954, §§ 1245(b)(1), 1250(d)(1) exempt gifts from the recapture provisions of those sections so that past depreciation will not be taxed on a gift of depreciable property. However, on a gift of inventory there must be an adjustment to remove the cost of the property from opening inventory in the year of the gift. Similarly, current cost items applicable to the property are not deductible, and such cost items deducted in past years must reduce the charitable contribution to avoid a double deduction. See also Treas. Reg. § 1.170-1(c)(1) (1958), and INT. REV. CODE OF 1954, § 170(e).

The cost and expense adjustments required by the Commissioner's rulings are inconsistent with their underlying principle (and part of L.O. 1118, II-2 CUM. BULL. 148 (1923)) that a gain is not realized on a gift even though the full value of the property, including the untaxed excess of value over basis, qualifies for the charitable deduction. Under this principle, the exclusion from income of market appreciation allows a charitable deduction without a corresponding cost basis. Where the excess of value over basis is caused by past deductions rather than market appreciation, a symmetrical system would also allow the charitable deduction albeit there is no cost basis.

For example, if real estate valued at \$100 with a basis of \$80 is donated to a charity, the amount of the charitable contribution must be adjusted downward to \$80 if the \$20 by which value exceeds basis represents "additional depreciation" which would have been taxed as ordinary income under § 1250(a) had the property been sold. See INT. REV. CODE OF 1954, § 170(e). (This is essentially the same as the adjustments required by the above rulings, but here the adjustment is for past depreciation deductions rather than inventory and related costs.) It is clear that reduction of the charitable deduction by \$20 will increase taxable income by \$20, which, in essence is a recognition of the gain on the gift, a result thought to be prohibited by the authorities. See note 112 *supra*.

It is true that in the language of the above rulings there is a "double deduction." But the depreciation deduction for cost is simply a recovery of investment and puts the donor of the property in the position of owning an asset in which, for tax purposes, he has only a partial investment—the same as a donor who owns an asset with unrealized market appreciation.

In *Blank*, however, it was not the gift alone which caused realization. The gain occurred because depreciation deductions were taken on a basis which, because it included a mortgage, was in excess of the taxpayer's investment in the property. The gift merely made the gain due to such deductions sufficiently fixed and definite to impose a tax. If realization did not occur at the time of the gift, it never would occur.

Viewed slightly differently, the transfer might not be called a "gift" at all. It could be characterized as a sale (to which *Crane* clearly applies) since there is no actual difference to the charity between accepting the property subject to the mortgage and buying the property by taking title subject to the mortgage. Whether the mortgage is treated as consideration for the sale of property or as a condition to a gift, the result is identical. Under the analysis of *Crane* discussed earlier, the amount of the mortgage can only be acquired by purchase regardless of the form of the transaction. Thus, *Crane* should apply at least up to the amount of the mortgage. The analysis would then be clear: the transferor would "realize" the amount of the mortgage and the transferee would have a basis of "cost" in such amount.

Nevertheless, the Court in the hypothetical *Blank* case stated that the amount of the mortgage was realized only if the property was worth not less than the amount of the mortgage.¹¹⁵ Caught on the horns of the dilemma of either giving the taxpayer a tax windfall where the property is worth less than the amount of the mortgage, or repudiating the reasoning in *Crane* that one who sells subject to a mortgage for which he is not personally liable receives the benefit thereof, the Court rejected *Crane* and held:

The same analysis applies to a charitable gift of inventory property. Deductions attributable to the property should be disregarded on a gift to charity. If this seems improper it is not because of the "double deduction" but because of a principle which allows a deduction for market value without recognition of gain for appreciation in the property. Although this principle has been modified by enactment of § 170(e), that modification does not reach gifts of inventory property.

¹¹⁵ See Adams, *supra*, note 108, at 169. The Court read *Crane* to mean that when the value of the property fell below the amount of the mortgage, no amount would be realized. This conclusion apparently follows from the *Crane* language that "an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations." 331 U.S. at 14. In such case, the *Blank* court reasons that relief from the mortgage on conveyance of the property gives a sense of personal relief from the debt. Conversely, if the property falls in value to an amount less than the mortgage, the owner will not feel "personally" obligated, and relief from the mortgage or conveyance of the property results in no benefit whatsoever. This view of *Crane* places undue stress on the presence or absence of psychological relief to the owner on being rid of the debt. *Crane* can be read, in a less extreme manner, to mean that personal liability is simply a function of asset liability. Since the owner's asset is subject to the mortgage, to that extent the owner is, in effect, personally liable. On conveyance of the property subject to the mortgage, he is relieved of liability to that extent, even when the mortgage exceeds the value of the property.

[T]he taxpayer's economic benefit stems from the deductions which we have allowed him to take on the unassumed mortgage. These deductions arose by reason of the tax law and not because of what the taxpayer paid for the property. Hence, when the property is disposed of—whether by sale, abandonment, charitable gift, or otherwise—the tax law must be interpreted as requiring the taxpayer to account for these deductions.¹¹⁶

Implicit in this reasoning is a principle that gain due to past depreciation deductions is realized on any disposition of property, and should therefore be taxed. Where the mortgage results from subsequent borrowing on the value of the property, gain on any disposition of the property must also be realized, since the borrowing will represent a recovery either of past investment or of market appreciation.¹¹⁷

It should be noted that sections 1245(b)(1) and 1250(d)(1) provide explicitly that a gift is not a taxable event under sections 1245(a) and 1250(a), thus preventing recognition of ordinary income attributable to prior depreciation deductions, which might otherwise be required by those sections. But, as already discussed, to the extent of any mortgage on the property, the transferee is a purchaser, not a donee. Any transfer of section 1245 or section 1250 property should therefore result in the same tax treatment as was given the property in *Blank*. The reach of the "gift" exemption in these sections is no greater than that in the cases relied upon by the taxpayer in *Blank*.

C. Mortgaged Property Passing at Death

The transfer of unencumbered property at death is not a taxable event. The beneficiary of the property obtains a "stepped-up basis"¹¹⁸ (the value of the property at the time of the grantor's death), in spite of the fact that neither he nor the grantor has ever paid or will ever pay tax on the property's appreciation while in the hands of the grantor.¹¹⁹ Although there appears to be no constitutional prohibition on taxing these transactions, Congress has chosen not to do so.¹²⁰ If

¹¹⁶ Adams, *supra* note 109, at 169-70.

¹¹⁷ See, e.g., letter ruling from National Office, November 26, 1954, and letter ruling from St. Paul District Director, December 1955 (RIA Fed. Tax Coordinator ¶ K3110); cf. *Magnolia Dev. Corp.*, 19 CCH TAX CT. MEM. 934 (1960); *Simon v. Commissioner*, 285 F.2d 422 (3d Cir. 1960).

¹¹⁸ INT. REV. CODE OF 1954, §1014.

¹¹⁹ INT. REV. CODE OF 1954, §102(a). But see, e.g., Tax Reform Studies and Proposals of U.S. Treasury Department, 91st Cong., 1st Sess., pt. 1, at 28 (1969).

¹²⁰ See *Hearings on the President's 1963 Tax Message Before the House Committee on Ways and Means*, 88th Cong., 1st Sess., pt. 1, at 598; *Campbell v. Prothro*, 209 F.2d 331, 336 (5th Cir 1954).

the property is section 1245 or section 1250 property, a transfer thereof by gift or at death does not invoke these sections.¹²¹

Thus, when unencumbered property is transferred at death, the excess of the value of the property over decedent's basis therein escapes income tax entirely, whether the excess is due to market appreciation, or to decedent's depreciation deductions in excess of economic wear and tear. The benefit accrues to the transferee of the property who can recover the excess value free of tax, although no one ever had an economic investment therein.

A different result is required, however, when the property is encumbered with mortgage liability. Assume, for example, that when the decedent died his property was subject to a mortgage of \$500,000, which was either the original "cost" of the property to the decedent, or the product of subsequent borrowing. Further assume that the decedent took the allowable depreciation deductions of \$100,000 on an original basis of \$500,000, and the property was worth \$500,000 at his death. Under *Crane*, the basis to the beneficiary of the property is \$500,000, its full value undiminished by the mortgage. This is the basis acquired under section 1014(a). But, as we have seen, the only true value acquired by inheritance is the equity, here zero. The remainder of the value of the physical property can only be acquired by amortizing the mortgage, which has the effect of an installment purchase and gives a cost basis.¹²²

Because the mortgage in this example is equal to the full value of the property, no value passes to the beneficiary from the decedent. All the beneficiary really inherits is a valueless option to buy the property by amortizing the mortgage in the full amount of the property value. Thus, the beneficiary's entire basis will be acquired by purchase—it is the normal "cost" basis. This is important because it means that no tax-free step-up in basis is given under sections 1014 and 102. The presence of the mortgage requires the beneficiary to pay for the value of the property. He does not acquire it free of cost or tax. Indeed, the roles of the decedent and the beneficiary are somewhat reversed. Instead of the beneficiary obtaining the value of any appreciation which accrued to decedent, the decedent himself has "realized" the

¹²¹ See INT. REV. CODE OF 1954, § 1245(b)(1), (2); *id.*, § 1250(d)(1), (2).

But if the basis determined under § 1014(a) is required to be reduced under § 1014(b)(9) for the past depreciation taken by the beneficiary (*e.g.*, where property was held by the beneficiary as a tenant by the entirety with the decedent), the regulations provide that the amount of the reduction is "additional depreciation" under INT. REV. CODE OF 1954, § 1245(a)(2), and all or part of the reduction may be "additional depreciation" under § 1250(a), (b). Treas. Reg. § 1.1245-2(c)(3) (1965). Proposed Treas. Reg. § 1.1250-3(b), 31 Fed. Reg. 6974 (1966).

¹²² Note that the beneficiary of encumbered property generally bears the burden of the encumbrance. See, *e.g.*, N.Y. ESTATE, POWERS AND TRUSTS LAW § 3-3.6 (McKinney 1967); N.Y. Surr. Ct. Proc. Act, § 1811 (McKinney 1967).

benefit of depreciation deductions without cost, or of borrowing on the appreciation of the property. It is the beneficiary who must repay the "cost" of these benefits by amortizing the mortgage. Therefore, the decedent's gain should be taxed to his estate since the gain becomes fixed when the property is disposed of at his death, and his interest will no longer exist following the transfer.

To restate the proposition from an economic point of view, no part of the property passes by inheritance. To the extent of the mortgage, the transaction is properly viewed as a sale to the beneficiary. There is no difference between inheriting fully mortgaged property, and purchasing it subject to the mortgage.

It is, of course, logical that sections 1245(b)(2) and 1250(d)(2) should no more exempt an inheritance of property subject to a mortgage that exceeds the decedent's basis¹²³ than they did a transfer of similar property by gift.¹²⁴

V. CONCLUSION: SOME COMMENTS ABOUT TAX AVOIDANCE

Largely because of the rule established in *Crane*, depreciable real estate offers an attractive "tax shelter." At the risk of a comparatively small cash investment, the investor receives any profit or other benefits that are the result of an increase in property value. In the interim between investment and appreciation not only can he use depreciation and mortgage interest deductions to wipe out taxable rental income, but he may also apply excess deductions against other income. If the property appreciates, he may borrow on the appreciation by means of a mortgage without personal liability. On any disposition of the property, he must account (as income) for depreciation deductions in excess of investment and for any cash received for which he has no personal obligation to repay. Although this requirement may compel him to include in income the same number of tax-free dollars which he obtained by taking the deductions or borrowing, the overall transaction may still give him an unwarranted tax advantage.

His most important advantage is that the gain on the disposition will generally be capital gain,¹²⁵ whereas past depreciation deductions reduced ordinary income. This is true in spite of section 1250, which taxes as ordinary income some part of the lower of gain or past depreciation deductions, since under that section no depreciation is taken

¹²³ Note that §§ 1245(b)(2) and 1250(d)(2) exempt "a transfer at death," rather than "property acquired by bequest, devise, or inheritance," as in § 1014(b)(1), or "property acquired . . . by reason of death" in § 1014(b)(9). However, the meaning appears to be the same. See Treas. Reg. § 1.1245-2(c)(3) (1965); Proposed Treas. Reg. § 1.1250-3(b), 31 Fed. Reg. 6974 (1966).

¹²⁴ Text following note 117 *supra*.

¹²⁵ See INT. REV. CODE OF 1954, § 1231.

into account for property held more than one year, except for depreciation deductions in excess of those allowable under the straight line method.¹²⁶ There is an obvious need for legislative tax reform in this area. However, consideration should nevertheless be given to a number of methods whereby this tax avoidance result can be mitigated.

A. Woodsam Associates, Inc.

As we have seen, *Crane* requires that the amount realized on a disposition of property include the amount of any mortgage on the property, irrespective of whether there is personal liability thereon. When the mortgage is due to borrowing on the appreciation of the property subsequent to its purchase, the taxpayer is accountable for the cash obtained by borrowing. The effect is to allow a taxpayer to liquidate his investment, thereby assuring himself of any gain from property appreciation which would increase the amount of cash received by borrowing. When there is no personal liability should such gain be recognized and taxed on the borrowing, rather than on a subsequent disposition?

This issue arose in *Woodsam Associates, Inc. v. Commissioner*.¹²⁷ Mrs. Wood acquired certain real property for \$300,000, depreciated it down to \$250,000, and then obtained a loan of \$400,000 without personal liability, secured by a mortgage on the property. The property was later transferred to the taxpayer corporation in exchange for its stock in a tax-free exchange under the predecessor of section 351 of the Code. At this time, the provisions of section 357(c),¹²⁸ which would have taxed her on the excess of the mortgage over her basis at the time of the transfer to the corporation, had not been enacted. Mrs. Wood therefore recognized no gain on the transfer to the corporation. The corporation argued, however, that she should have recognized the gain when she borrowed the \$400,000 since at that time she had obtained \$150,000 without any liability to repay it. If the corporation had prevailed, her basis in the property would have been increased by \$150,000, and this stepped-up basis would have become the basis for the corporation under the provisions of what is now section 362(a). But the court rejected the corporation's argument and held that under the predecessor of section 1001(a) the borrowing was not a taxable disposition of property. To support its decision the court explained that Mrs. Wood did not close the transaction since she had not finally relinquished the property. She could collect the rents and borrow more

¹²⁶ See INT. REV. CODE OF 1954, § 1250(b)(1).

¹²⁷ 198 F.2d 357 (2d Cir. 1952).

¹²⁸ This section was new to the Internal Revenue Code of 1954.

on the property, if this was possible.¹²⁹ In other words, the court emphasized that she still had an economic interest in the property.

The court also noted that a mortgagee is a creditor of the borrower even in the absence of personal liability on the mortgage, albeit nothing more than a preferred creditor.¹³⁰ Here the court seems to be saying that the only real effect of personal liability is to subject all of one's assets to the claim of the creditor. When there is no personal liability, but the creditor's claim is a lien on an asset of the taxpayer which is of sufficient value to satisfy the claim, this is tantamount to personal liability. Thus, "mortgaging out" was not a final disposition of the property. No gain was realized because of Mrs. Wood's continuing economic interest in the property, and also because any gain was offset by the obligation to repay the loan.¹³¹

It has been argued that a mortgage in excess of cost without personal liability should be treated as a sale of a lien upon the property, and that it should be a taxable event because the mortgagor can keep all profit without restriction. The absence of liability guarantees that the profit made will not be lost.¹³² Although the taxpayer has a continuing economic interest in the property, his interest is relinquished in the amount of the mortgage, and to this extent, there is a "disposition" of the property.

This argument is a persuasive refutation of *Woodsam*. Its primary advantage lies in the fact that there is no deferral of the tax. Current collection is favored for many reasons, not the least of which is the assurance of a solvent taxpayer. If the gain is taxed currently the amount of gain recognized is added to the basis of the property so that upon a later sale of the property that amount would offset inclusion of the mortgage in the amount realized and the same gain will not be taxed again. This gain also becomes part of the basis for depreciation.¹³³

Not only is this argument intriguing, it also embraces a justifiable notion of realization, since the gain is sufficiently fixed and definite to be taxed, in light of the taxpayer's ability to prevent a loss. However, the practical consequences of this treatment should not be overlooked. In many, if not most cases, the taxpayer will repay the loan.

¹²⁹ 198 F.2d at 359.

¹³⁰ *Id.*

¹³¹ *See, e.g., James v. United States*, 366 U.S. 313 (1961); *Commissioner v. Wilcox*, 327 U.S. 404, 408 (1946); *Resthaven Mem. Cemetery, Inc.*, 43 B.T.A. 683 (1941) (repurchase option defeated by occurrence of an event outside of the seller's control). *See also* Marion A. Blake, 8 T.C. 546 (1947) (conveyance with retained option to repurchase held not to be a sale).

¹³² Lurie, *Mortgagor's Gain on Mortgaging Property For More Than Cost Without Personal Liability* (*Contentions of Taxpayer's Counsel in A Pending Case*), 6 TAX. L. REV. 319, 322, 325 (1951).

¹³³ *Id.* 326-27.

Do we then "unwind" the transaction and give the taxpayer a deduction for the repayment, and a corresponding reduction in the basis of the property? How to treat this transaction is the converse problem of how to treat a tax benefit—perhaps we should call it a "tax detriment." It includes subsidiary problems of bunching, tax rate differentials, and depreciation adjustments. For example, any deduction for repayment may have to be reduced by the amount of depreciation already taken.

Alternatively, the repayment could be viewed as a reinvestment in the property. If the borrowing is treated as a sale of the property, then the repayment can be treated as a repurchase. The property would keep its stepped-up basis, and past depreciation thereon would cause no problem. But under this approach, the taxpayer will have acquired, in effect, a stepped-up basis for gain which, if viewed with hindsight, is unrealized in any but the most legalistic sense.

Moreover, although deferral of tax is avoided, the major objection to *Crane*—the capacity to obtain depreciation deductions in excess of investment, at capital gains cost—is not removed. Even more important, if borrowing on appreciation is treated as a taxable disposition, how will the taxpayer who simply buys property subject to a mortgage without personal liability be treated? For example, suppose a taxpayer buys property subject to a mortgage of \$100 without personal liability and depreciates the property on a basis of \$100 down to zero. He is in exactly the same position as another taxpayer who buys for \$100 cash, depreciates on a basis of \$100 down to zero, and later borrows \$100 on the property without personal liability. If the latter has recognized gain on the borrowing, so has the former, who recognizes it as he depreciates. The real gain for each of them is the depreciation allowed without economic investment in the property. Thus the effect of a rule treating mortgaging out as a disposition is denial of depreciation entirely to one who buys property on credit.

B. *Depreciation Adjustment Limited to Investment*

Another suggestion for preventing tax avoidance through depreciation deductions is limiting the depreciation allowance to the owner's net investment in the property (investment less depreciation). At the same time, the amount of the deduction could be calculated on the sum of the original investment and the amount of the mortgage.¹³⁴

¹³⁴ See, e.g., Rusoff, *The Federal Income Tax Consequences of Transactions Relating to Mortgages on Land*, 4 BUFFALO L. REV. 181, 196 (1955); Note, *Tax Consequences of the Disposition of Property Subject to An Unassumed Mortgage*, 49 COLUM. L. REV. 845, 851 (1949); Comment, *Depreciation of Property Subject To an Unassumed Mortgage: Implications of The Crane Decision*, 26 TEXAS L. REV. 796, 799-800 (1948).

Following any initial deductions, depreciation allowances would cease unless the down payment, together with amortization payments on the mortgage, kept pace with depreciation deductions. Of course, the mortgage would be included in neither basis nor amount realized on disposition of the property.¹³⁵

The advantage of this proposal is that it avoids the problem of computing depreciation on a shifting equity, a concept which would cause substantial inconvenience for both the taxpayer and the Commissioner, and which would tend to distort income by bunching depreciation deductions toward the end of the property's useful life. But this proposal is dependent on the initial investment plus amortization payments always being at least equal to the sum of past depreciation allowed and the current depreciation deduction. In cases where there is a small down payment and current payments in large part represent interest, even this proposal may involve problems of shifting equity, especially if the depreciation is accelerated.¹³⁶

C. Tax Avoidance Motive

A third solution to the problem is exclusion from basis of the amount of the unassumed mortgage when it is in excess of the value of the property.¹³⁷ This exclusion is based on the presumption that where the amount of the mortgage exceeds the value of the property—contrary to the reasoning of *Crane*—the taxpayer will not amortize the mortgage. This presumption is reasonable, since amortization payments in the difference between the value of the property and the mortgage will be wasted unless the property increases in value to make up the difference. A related ground for denial of depreciation is the “purposeless activity” rationale of *Goldstein v. Commissioner*,¹³⁸ which denies a deduction where the taxpayer has no reason to engage in a transaction except to secure the deduction.¹³⁹

The difficulty with both of these approaches is proof of the operative facts. Problems of valuation are susceptible to proof, but are nevertheless difficult. The difficulty is compounded if the value of the property fluctuates during the time it is owned by the mortgagor. In a close case, a taxpayer who makes the initial determination in a self-assessment system will have little difficulty finding an expert to resolve

¹³⁵ Note, *Tax Consequences of the Disposition of Property Subject to an Unassumed Mortgage*, 49 COLUM. L. REV. 845, 851 n.46 (1949).

¹³⁶ See INT. REV. CODE OF 1954, § 167(c).

¹³⁷ See, e.g., Adams, *Exploring the Outer Boundaries of the Crane Doctrine; An Imaginary Supreme Court Opinion*, 21 TAX L. REV. 159, 165 (1966).

¹³⁸ 364 F.2d 734 (2d Cir. 1966).

¹³⁹ See also, e.g., *Knetsch v. United States*, 364 U.S. 361 (1960); cases discussed in Adams, *supra* note 137, at 166 n.10.

any doubts about value in his favor. The *Goldstein* test—whether an activity is “purposive” or “purposeless”—is not designed to calm the waters of tax controversy, and may raise as many questions as it answers. This is especially true when the purchaser of real estate attempts to salvage the property and restore its market value—an attempt which he would not make if he had to assume personal liability on the mortgage. Surely, this activity has a purpose beyond acquiring tax deductions. *Mayerson*¹⁴⁰ was such a case. There the taxpayer acquired an older piece of property with the intent to remodel it and enhance its profit potential.¹⁴¹ Because of the building’s age, poor condition, and municipal orders outstanding against it, conventional financing was unavailable. The taxpayer purchased the building by giving a purchase money note without personal liability, no portion of which (except for \$10,000) was due for 99 years. Within a few years, he had so improved the property’s earning power that he was able to retire the 99 year mortgage and obtain conventional financing at a much reduced price.¹⁴² It may have appeared to the Commissioner that the taxpayer was doing no more than buying huge depreciation deductions for only \$10,000. But it turned out after all that he had a legitimate economic purpose. Such activity should not be discouraged.

Nevertheless, the Internal Revenue Service, in announcing acquiescence in *Mayerson* stressed that there was present “a bona fide sale . . . consummated at arm’s length between knowledgeable strangers, for valid business purposes, and that a bona fide debt obligation for most of the purchase price had been created.”¹⁴³ The Service also “noted that the fair market value of the property was not put in issue in the case . . .” and that it would “continue to review transactions . . . designed to improperly create or inflate depreciation deductions . . .” and would “disallow unwarranted depreciation deductions.”¹⁴⁴

The fair market value of the property was not in issue, but a substantial price reduction was provided if the mortgage was paid within the first two succeeding years. Five years after the purchase, when the taxpayer had so improved the property that he could get conventional financing, he settled the \$332,500 mortgage note for \$200,000.¹⁴⁵ The discount did not seem to represent the interest element since the mortgage bore interest at 6 per cent.¹⁴⁶ Thus, fair

¹⁴⁰ 47 T.C. 340 (1966).

¹⁴¹ *Id.* at 341.

¹⁴² *Id.* at 345-46.

¹⁴³ Rev. Rul. 69-77, 1969 INT. REV. BULL. No. 8, at 10.

¹⁴⁴ *Id.*

¹⁴⁵ 47 T.C. at 346.

¹⁴⁶ *Id.* at 342.

market value perhaps should have been an issue in *Mayerson*. In any case, the taxpayer had a business purpose for the purchase, and was not merely buying depreciation deductions.

D. Taxing Gain as Ordinary Income

A final solution to the problems posed in *Crane* is to disallow as part of basis any mortgage for which there is no personal liability, regardless of the value of the property. Such a blanket approach would guarantee that depreciation deductions would not exceed investment, but serious objections to this solution are easily discernible. First, the problem of depreciation deductions in excess of investment can arise even when there is personal liability on the mortgage, especially where accelerated depreciation is present or where the mortgage does not require amortization for a long period, as in *Mayerson*. Although the presence of personal liability is some evidence that tax avoidance is not the motive of the transaction, it does not prevent depreciation deductions in excess of investment, which are taken against ordinary income and repaid at capital gains rates. This problem is broader than that raised by *Crane*, and Congress has attempted a solution of it on a broader level.¹⁴⁷

A second objection is derived from the language of the Court in *Crane*—a shifting equity would be created and income distorted as a result of depreciation deductions which increase, inversely to the usual rate of exhaustion,¹⁴⁸ in the later years of a property's useful life. One who takes property subject to a mortgage may be placed at a disadvantage as compared to one who assumes personal liability, a result that may be inappropriate if an investment will eventually be made in the property. As already noted, amortization could be allowed on a basis including only that part of the mortgage equal to the actual investment. This is probably the best solution, but its adoption is unlikely in light of *Crane*.

However, there is a solution that both accommodates the principle of *Crane* regarding basis, and still treats the gain realized on the disposition of the property as ordinary income. This solution is to ignore the *Crane* doctrine that the mortgage is realized on a disposition. Instead, gain resulting from depreciation in excess of investment would be viewed as arising from the depreciation rather than from the disposition. This was the basic approach of the imaginary Supreme Court in the nonexistent case of *Blank v. Commissioner*.¹⁴⁹ Underlying this approach is the concept that the gain actually occurs when the taxpayer

¹⁴⁷ See, e.g., INT. REV. CODE OF 1954, §§ 1239, 1245, 1250.

¹⁴⁸ See Adams, *supra* note 137, at 174.

¹⁴⁹ *Id.* 169.

deducts more than his investment, thereby removing from taxable income the income which would otherwise be taxed at ordinary rates. The disposition of the property, whether it be by sale or otherwise, simply marks a definite time (the last feasible time) for the deferred taxation of this income. Any possibility of treating the transaction as a sale or exchange to invoke capital gains treatment is destroyed.¹⁵⁰ Conceptually, this may be treated as an application of the tax benefit principle of section 111 which requires inclusion in a taxpayer's income of a "recovery" of a past deduction which has given him a tax benefit. Such a result is similar to that in *West Seattle National Bank v. Commissioner*,¹⁵¹ where the amount of a bad debt reserve was held to be ordinary income when the taxpayer sold its accounts receivable at face value pursuant to section 337. The bad debt reserve, the court held, "represents income earned in the past which has escaped taxation."¹⁵² Thus when the liquidating corporation sold its assets, the gain due to the reserve was not entitled to the exemption from tax given by section 337. In other words, the court treated the gain not as arising from the sale of accounts receivable, but as resulting from a prior deduction which gave tax benefit.¹⁵³

There is no inconsistency between this analysis and *Crane*. The *Crane* court itself noted that the "crux of this case, really, is whether the law permits her [the taxpayer] to exclude allowable deductions from consideration in computing gain."¹⁵⁴ Upon reconsideration, the *Crane* requirement that the mortgage be included in amount realized appears to be a clumsy application of the tax benefit principle—clumsy, because it looks not to the deductions which gave the tax benefit, but (because of section 1016) to allowable deductions for depreciation, whether or not they were of tax benefit. Furthermore, in its failure to distinguish the various elements of gain, the *Crane* doctrine treats the entire gain as realized on a sale, rather than as a recovery of prior deductions, resulting in possible capital gains treatment for the entire amount.

¹⁵⁰ See, INT. REV. CODE OF 1954, §§ 1201, 1202, 1221, 1222. There are certain dispositions of property which may not be treated as a sale or exchange anyway, such as abandonment of the property. See, e.g., *Parker v. Delaney*, 186 F.2d 455 (1st Cir. 1950), cert. denied, 341 U.S. 926 (1951); cases discussed in Rusoff, *The Federal Income Tax Consequences of Transactions Relating to Mortgages on Land*, 4 BUFFALO L. REV. 181, 209-214 (1955). But see *Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir. 1962); *Commissioner v. Dresser Indus., Inc.*, 324 F.2d 56 (5th Cir. 1963).

¹⁵¹ 288 F.2d 47 (9th Cir. 1961).

¹⁵² *Id.* at 49.

¹⁵³ Accord Rev. Rul. 62-128, 1962-2 CUM. BULL. 139; cf. *Estate of Schmidt v. Commissioner*, 355 F.2d 111 (9th Cir. 1966). See also INT. REV. CODE OF 1954, §§ 1245, 1250, which treat amounts deducted in the past for depreciation as income at disposition, although the disposition does not involve a sale, and is not otherwise a taxable event (e.g., a corporate liquidation under INT. REV. CODE OF 1954, § 336).

¹⁵⁴ 331 U.S. at 15 (footnotes omitted).

Although the proposed solution is not inconsistent with *Crane*, it is apparently precluded by the provisions of section 1231. This section normally treats gain from the sale of depreciable property used in the trade or business as capital gain. Its effect is to remove "recovery" of past depreciation deductions from the tax benefit principles of section 111¹⁵⁵ (under which such a recovery would presumably get ordinary income treatment) and to treat the recovery as gain from the sale of a capital asset.

Disposition may be by other means than by sale—by abandonment or by gift, for example—but, as already noted, to the extent the property is subject to a mortgage, any disposition is really a sale. In any event, tax consequences should not be dependent upon a strict construction of the term "sale," if there has been a disposition of the property with concomitant termination of the taxpayer's interest.¹⁵⁶ A taxpayer bent on exploiting *Crane* will have no trouble achieving a sale.

The problems raised by *Crane* cannot be solved in a vacuum. In order to resolve some of the questions presented herein, section 1231 (as well as the sections relating to basis, gain, and amount realized) will have to be reexamined. Congressional attempts to modify its effect, evidenced by sections 1239, 1245, and 1250, have been largely ineffective. If we are to achieve a consistent, fair tax policy for inclusion of unassumed mortgage liability in basis, depreciation of the excess of unassumed liability over investment, and taxation of depreciation recovery, legislative reform is needed. Congress must reconsider the problems in light of past abuses, with the knowledge that taxpayers will do everything possible to transform ordinary income into capital gains.

¹⁵⁵ See Treas. Reg. § 1.111-1(a) (1956), which removes depreciation from the coverage of § 111.

¹⁵⁶ See, e.g., *Commissioner v. Dresser Indus., Inc.*, 324 F.2d 56 (5th Cir. 1963); *Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir. 1962).