TAXING TRANSFERS OF MORTGAGED PROPERTY†

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One of the more troubled corners of the tax law is reserved for transfers of mortgaged property. Taxable dispositions of property result in gain or loss depending on whether the "amount realized" from the disposition of the property is greater or less than the adjusted cost basis.¹ It is a simple thing to determine the "amount realized" where the transferor receives cash or other property of readily determinable value in full consideration for his own property. The problem occasioned by a sale of encumbered property is that the cash or equivalent consideration will reflect the encumbrance in that it will be reduced by the amount of the encumbrance on the property.

The question then arises whether the amount of the mortgage is added to the cash or equivalent consideration in fixing the "amount realized" for tax purposes. This question has been considered elementary where the buyer assumes the mortgage: courts readily include the amount of the mortgage on the theory that debt assumption is a good form of consideration.² This apparently obvious reasoning has, in fact, been responsible for all the difficulties; for it has seemed to preclude an acceptable rationale for "realization" where the buyer does not assume the mortgage, or where the seller himself is not personally responsible for the mortgage.

Actually, realization is not occasioned by assumption of the debt encumbering the property, but by disposition of the property itself. However, because the separateness of these two elements is not always perceived, there has been a tendency to mistake the tax consequences of the one for the other, so that the tax results of the sale are rationalized in terms of mortgage debt assumption or discharge. Finally, in making debt assumption or its equivalent the touchstone of decision, the tax cases have made inadequate analysis of the nature of the adjustments of debtor-creditor relationships occasioned by the transfer of mortgaged property.

What has been needed was a correct analysis of such adjustments of

† Portions of the material in this article will appear in a chapter of the forthcoming revised edition of the "Handbook of Tax Techniques" (Prentice-Hall, Inc.), entitled "Causes and Effects of a Negative Basis in Mortgage Transactions".

* See Contributors' Section, Masthead, p. 690 infra, for biographical data.

¹ Int. Rev. Code § 111.

² See Brons Hotel, Inc., 34 B.T.A. 376 (1936); Walter Haass, 37 B.T.A. 948 (1938).
liability, and a reassessment of the tax consequences. The former has been provided in a penetrating article by Professors Storke and Sears in the *Cornell Law Quarterly.* This article is offered to provide the latter.

**SAMPLINGS OF TROUBLED TAX LAW**

No better documentation of the unsatisfactory state of the tax law is needed than the leading case of *Crane v. Commissioner,* where the Supreme Court professed to find the same benefit for the grantor in transferring property subject to a mortgage, for which he was not personally liable, as would be realized by a personally indebted mortgagor whose transferee assumed the mortgage. The value of this benefit for tax purposes was said to equal the unpaid balance of the mortgage. The Court allowed that where the property was worth less than the mortgage, an unindebted transferor's benefit could not equal the full amount of the mortgage; but the Court skirted this problem by letting itself believe that the buyer's cash payment of $3,000 over a $250,000 mortgage showed the value of the property to be greater than the mortgage.

The opinion leaves one groping, as perhaps the Court was itself, for the basis of the decision. We shall see that the result in the *Crane* case appears correct; whereas the problem that plagued the Court in that case, of finding an equivalent of debt assumption in transfers of encumbered property by unindebted vendors, has led many other courts into error, if not absurdity. Witness the holdings that a voluntary conveyance of encumbered property to the mortgagee in lieu of foreclosure gives the transferor ordinary loss if he receives no "boot" from the mortgagee, while the receipt of even the most nominal cash consideration—$250 in one case—turns the transaction into one productive of capital loss. Similarly, a mortgagor has been allowed an ordinary loss if his personal liability had been extinguished prior to his conveyance of the property to the mortgagee, but the mortgagor has been limited to a capital loss if the personal liability is extinguished as an incident of and in consideration for the conveyance.

The reason for finding ordinary loss is said to be that unless the unindebted transferor of mortgaged property also receives on the transfer

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4 331 U.S. 1 (1947).
5 Compare Polin v. Comm'r, 114 F.2d 174 (3d Cir. 1940), and Stokes v. Comm'r, 124 F.2d 335 (3d Cir. 1941), with Blum v. Comm'r, 133 F.2d 447 (2d Cir. 1943).
6 Compare Bert B. Burnquist, 44 B.T.A. 484 (1941), with Richter v. Comm'r, 124 F.2d 412 (2d Cir. 1942).
some cash or other form of "boot," the transaction is without consideration for him, the extinguishment of a lien for which he was not personally liable not being adequate consideration to produce a "sale or exchange" under the capital gain and loss provisions.\(^7\)

Yet, a foreclosure sale is in every instance held to be productive of capital loss (or gain), because foreclosure is said to involve a "sale" per se and thus, the reasoning goes, it is not necessary to show consideration passing to the transferor.\(^8\) On the other hand, abandonment in anticipation of foreclosure results in ordinary loss—\(^9\) and in one recent case,\(^10\) it was suggested that abandonment might result in ordinary gain under appropriate facts! In another opinion, it was intimated that this gain might go wholly untaxed in case of an abandonment.\(^11\)

**NEW TERMINOLOGY FOR SALE TRANSACTIONS**

The disparate results in cases with slight factual differences might have led to the suspicion that the underlying rules were erroneously premised. That they did not arouse such suspicion is probably due, at least in part, to the lack of a uniform, concise, and precise terminology by which the elements in different kinds of transfers might be readily identified and recognized.

The field of transfers of mortgaged property abounds with ambiguous phrases like "assumption of the mortgage," and phrases with definitely false or misleading connotations such as "subject to the mortgage." There is a total absence of generally accepted, short, descriptive phrases for certain recurring transactions, resulting in the need to employ cumbersome circumlocutions, viz., "the transfer of mortgaged property by an owner not personally obligated for the mortgage debt."

Professors Storke and Sears have felt the great handicap imposed by this language barrier, and their remedy has been to coin inventive new terminology to describe the different kinds of arrangements covering

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\(^7\) See Int. Rev. Code §§ 112(a), 117(b) and (c).
\(^8\) Helvering v. Hammel, 311 U.S. 504 (1941).
\(^10\) Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950), cert. denied, 341 U.S. 926 (1951).
\(^11\) The intermediate court in the Crane case stated that if an owner of property who is not personally liable for the mortgage surrenders the property to the mortgagee or abandons it without receiving "boot," he cannot be charged with having "realized" the amount of the mortgage. Comm’r v. Crane, 153 F.2d 504 (2d Cir. 1945), aff’d, 331 U.S. 1 (1947). The Supreme Court, in affirming, did not go this far, but left it in doubt what the result would be in such a case. The effect of the Circuit Court’s statement would be to allow a taxpayer in an appropriate case to get the benefit of excessive depreciation, as pointed out in the discussion of the Crane case at page 614 infra.
the transfers of encumbered property. Crane v. Commissioner was a
case of "Grantee's Option," in the new language of Professors Storke
and Sears—in other words, a case where the buyer takes the property
subject to the mortgage, but does not assume a personal obligation to
pay the mortgage, rather leaving it at his option to "pay off the mortgage
and keep the land, or simply let the land go upon foreclosure." Actually, if additional coining is permissible, the Crane transaction might
be described as Extended Grantee's Option, because the grantor also
had not been personally obligated to pay the mortgage and so, by the
transfer in issue, merely extended the same option to the grantee. In
the typical Grantee's Option case the grantor is personally indebted on
the mortgage.

Grantee's Option is to be distinguished from what the authors call
"Grantor-to-Discharge," and "Grantee-to-Discharge" transactions. These
phrases describe, respectively, transactions where, as one of the terms
of the sale, either the grantor or the grantee personally obligates himself
to pay the mortgage. "Grantee-to-Discharge" is, of course, the familiar
transaction of the buyer assuming the mortgage and getting credit in
the purchase price for the amount of the mortgage. "Grantor-to-
Discharge" is employed most frequently in subdivision sales, where an
entire tract is covered by a single mortgage, and each buyer of a plot
pays the developer the full purchase price without offset for the mortgage;
the developer then may secure a release of lien as to the particular plot
on payment of a portion of the mortgage debt.

For precision of reference Storke and Sears suggest that the amount
of cash paid by the buyer in Grantee's Option and Grantee-to-Discharge
cases be termed the "equity price," which they define as the "basic
cash price," or agreed sales price, reduced by the amount of the
mortgage. "Basic bargain price" and "equity price" are in turn dis-
tinguished from "basic value," which is assumed fair market value
(but not necessarily the sale price), and from "equity value," which is
this "basic value" less the amount of the mortgage.

THE CRANE CASE

The professors state that the Grantee's Option transaction is most
often employed in the sale of a "thin" equity, i.e., where the property
is mortgaged for all it is worth and the buyer is willing to take over

12 Storke and Sears, supra note 3, at 186.
13 Id. at 190.
14 Id. at 211.
15 Id. at 186.
the property for a small cash outlay, representing substantially an
option price, but is not willing to incur any great liability.\textsuperscript{16} Property
in such an over-mortgaged condition can generally only be released to
the mortgagee or dropped on foreclosure; but there is the occasional
trader who will take such a property for a nominal sum, either to run
away with the first rents or to gamble on a rising market.

Such was the transaction in the \textit{Crane} case. Mrs. Crane inherited a
piece of property worth approximately $255,000, which was then-encumbered by a mortgage exactly equal to its value. She proceeded to
operate the property under an arrangement with the mortgagee, whereby
she collected the rents, paid the taxes and the expenses of repairs and
maintenance, and turned the net rentals over to the mortgagee to be
applied against interest charges. After several years, and with foreclosure
imminent, she succeeded in interesting a buyer in the property, and
sold it to him for $2,500 net cash. The buyer took subject to the
mortgage but did not assume it (exactly as she had herself done). During the period of her ownership, she had been allowed depreciation
deductions aggregating approximately $25,000, and the full amount of
depreciation “allowable” was $28,000.\textsuperscript{17}

With some simplification of the figures, Mrs. Crane reported a profit
of $2,500 (actually only $1,250, as long-term capital gain). The Commissioner claimed that her profit was $30,500, arguing that she realized
not only the amount of the “boot,” but also the full amount of the
mortgage (which still was $255,000), or a total “amount realized” of
$257,500, which had to be compared with an adjusted basis of $227,000
(arrived at by subtracting the “allowable” depreciation from the original
basis of $255,000). The taxpayer conceded that under principles pre-
viously laid down, had she been personally liable for the mortgage and
had her buyer assumed the mortgage, the assumption would have con-
stituted a taxable benefit to her, and the amount of the mortgage would

\textsuperscript{16} Id. at 190.

\textsuperscript{17} Int. Rev. Code § 113(b)(1)(B) required, during the years in issue in the Crane
case, an adjustment of basis for depreciation “to the extent allowed (but not less than
the amount allowable).” This statute now subjects the basis adjustment rule to the in-
fuence of the “tax benefit” rule, so that to the extent that depreciation deductions have
been “allowed” in an amount in excess of what is “allowable,” but without tax benefit,
the basis need not be adjusted by the amount of this excess. Int. Rev. Code § 113(b)(1)(B),

Mrs. Crane is reported to have enjoyed tax savings of only $150 from the $25,000 of de-
preciation deductions she claimed; but the new statute would not have helped her, because
her “allowable” depreciation expense exceeded what was “allowed”; and the new statute
requires adjustment of basis at least by the amount of depreciation “allowable,” even
though this may have been without tax benefit.
then have been includible in the "amount realized." But she could not see the benefit to her in the buyer's taking over her property subject to a mortgage for which she was not liable.

As noted above, the Supreme Court agreed with the Commissioner, saying that the benefit to the mortgagor not personally indebted is as real as if a personal debt had been assumed by the buyer. The principal reason it offered for this conclusion was 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."

The Court's identification of the benefits accruing to the unindebted transferor with those of the transferor in a Grantee-to-Discharge sale was unfortunate. The practical problem before the Court was how to make the taxpayer pay tax for the $25,000 of depreciation deductions she had been allowed (as well as the additional $3,000 "allowable") notwithstanding the absence of any real cost to her of the property. (That is, since a mortgage represents either debt incurred in lieu of cash payments of purchase price or subsequent borrowing by way of recovery of cash payments previously made on the purchase price, where the mortgage fully equals the cost basis for the property, it signifies the absence of any cash expenditure, or at least the absence of an expenditure that has not been restored to the owner.) The problem of excessive depreciation is normally self-adjusting, because the basis of the property is correspondingly reduced; so on disposing of the property the owner accounts for excessive depreciation in the realization of a smaller loss or greater gain than otherwise. This adjustment is not possible in the case of encumbered property unless the mortgage is included in the "amount realized" on disposition.

The soundness of the result in the Crane case may be conceded. But it will be demonstrated that to reach this result the Court did not have to show something in the nature of a release from mortgage indebtedness; and, moreover, that the Court's showing in this regard was unconvincing.

18 For discussion of the rule governing depreciation of encumbered property advocated by the Court in the Crane case, see infra pp. 630-2. Commentators have speculated that Mrs. Crane might have been able to avoid accounting for her depreciation entirely, had she assigned the property without receiving "boot". Compare Braunfeld, "Subject to a Mortgage (Part I)," 24 Taxes 424, 442, n. 55 (1946), with Note, 60 Harv. L. Rev. 1324 (1947); and see opinion of lower court in Crane case, 153 F.2d 504 (2d Cir. 1945). This speculation accepts the erroneous thesis that an unindebted mortgagor realizes no consideration, and hence does not engage in a "sale", if he receives no "boot". See infra pp. 621-623.
The sale of mortgaged property invariably results in an adjustment of the transferor's position in relation to the mortgage debt. Where the person buying from the transferor-mortgagor assumes the mortgage debt in the common Grantee-to-Discharge type of transaction, it has been a cornerstone of the tax law that the transferor has a taxable benefit. With no little difficulty it also has been established that in the Grantee's Option case, the personally indebted transferor-mortgagor has a taxable benefit notwithstanding the failure of the grantee to assume. 19

In fact there is no reason for a different tax treatment of transferors in Grantee-to-Discharge cases and Grantee's Option cases, because the effect of the transaction on the transferor's personal liability is almost identical in each case. The transferor reduces his personal liability from that of principal to surety. If he is obliged at some future date to pay off the mortgage, he is subrogated under the mortgage since the land remains the primary fund for the payment of the mortgage debt. But the transferor remains personally liable for the mortgage debt, even after a transaction in which the grantee assumes personal liability.

The point that has been lost sight of is that no arrangement between transferor and transferee can discharge the personal liability of the transferor-mortgagor to the mortgagee. 20 The only additional benefit accruing to a transferor from a sale to a grantee who assumes is that, in the eventuality of the transferor being held to his personal liability under the mortgage, he may sue his grantee personally for reimbursement. 21 What he has accomplished is not merely to have himself remitted to the status of a personal surety, but further to reduce himself from primary to secondary surety responsibility. In contrast, the transferor in a Grantee's Option sale, while also remitting himself from principal to surety, has no right of personal recovery against his grantee, since the only personal liability under the mortgage is that of the transferor and it survives a Grantee's Option sale. 22

However limited may be the effect of the transaction on the transferor's personal liability in both a Grantee-to-Discharge and a Grantee's Option case, it is nevertheless apparent that the benefits to transferors in such cases are in no way akin to the benefits accruing to a transferor

19 See U.S. Treas. Reg. 118, § 39.113(a)(6)-2(b), Example 2 (1952). For examples of the ingenious arguments which have been thought to be necessary to justify the result in these cases, see Braunfeld, supra note 18; Note, 60 Harv. L. Rev. 1324 (1947).
20 Storke and Sears, supra note 3, at 185, 193.
21 Id. at 193.
22 Id. at 197.
in an Extended Grantee's Option sale. It is true, of course, that the latter might be said to be a "real" principal (as distinguished from a "personal" principal), in the sense that the mortgage is a principal debt of the property owner with the source of payment limited to realty owned by him; and in the same fashion it might be said that in parting with the property the owner rids himself of this "real" liability and passes it on to the next taker. But there is obviously no personal benefit to the transferor in shedding a liability for which he was never at any time indebted. If the basis for including the amount of the mortgage in the "amount realized" from Grantee-to-Discharge and Grantee's Option sales is found in the effect of the transaction on the indebtedness of the transferor, there is no comparable basis in Extended Grantee's Option cases.

Actually, insulation of the transferor against personal liability does not provide a sturdy hook on which to hang tax consequences even in cases of Grantee-to-Discharge and Grantee's Option. As noted above, the transferor's personal liability remains substantially intact after the sale. When the grantee also assumes the personal liability, the transferor merely succeeds in erecting another personal liability before his own to make good on a deficiency judgment in the event the property declines in value below the amount of the mortgage after the sale, and the mortgage is foreclosed. Such value as this might have must be further discounted by the improbability of its being utilized by the transferor, because exposure to a deficiency judgment is generally remote and contingent when the sale is made. Hence the benefit to the transferor probably counts for little in the parties' calculations. Certainly a grantee would rarely enter into a transaction on these terms if he had reason to feel that he might one day have to confer the benefits of an assumption clause on the transferor. Slight as is this benefit, even it is lacking in a Grantee's Option transaction.

It is clear that the benefits from a sale transaction in terms of its

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23 Judge Learned Hand stated this succinctly in the following excerpt from the Circuit Court's opinion in the Crane case, 153 F.2d 504 (2d Cir. 1945):

The mortgagee is a creditor, and in effect nothing more than a preferred creditor, even though the mortgagor is not liable for the debt. He is not the less a creditor because he has recourse only to the land, unless we are to deny the term to one who may levy upon only a part of his debtor's assets. When therefore upon a sale the mortgagor makes an allowance to the vendee of the amount of the lien, he secures a release from a charge upon his property quite as though the vendee had paid him the full price on condition that before he took title the lien should be cleared, or as though it were a condition upon the sale of Whiteacre that the vendee should clear the vendor's Blackacre of a mortgage. In neither case would anyone question the conclusion that the vendor had received "property (other than money)"; yet the effect is precisely the same of the transaction at bar.
effect on the transferor's personal liability under a mortgage are illusory. Actually, the only types of sales giving a personally indebted mortgagor the benefit of an absolute release from personal liability are what Professors Storke and Sears call the "Clean Methods." Under the Clean Methods, the grantee may pay off the mortgage at the closing, or refinance the mortgage, or the original mortgagee might consent to a novation. These transactions are clean for the transferor, because they have the effect of cutting off all further liability of the transferor under the mortgage. The transferor can also accomplish this result in a Grantor-to-Discharge sale if he secures a release of the lien.

**Transfers with Complex Debt Adjustments**

Even if adjustment or discharge of a transferor's personal liability provided an analytically sound basis for "realization" of taxable benefit, it is apparent that such a basis would be unworkable, because of endless variations that are possible in sale transactions, each affording a different kind or degree of adjustment of liability. What significance would a court attach to an assumption of liability by a grantee where the transferor himself had not been personally liable on the mortgage bond? This type of transaction where a grantee assumes after a "break in the chain" of assumption—which might be called "Resumed Grantee-to-Discharge"—is without legal significance in some states, such as New York, which narrowly restrict recovery by third-party beneficiaries (in this case, the mortgagee). But there are states which permit the mortgagee to recover from any assuming grantee, regardless of the break. The transferor himself derives absolutely no personal benefit from the assumption, except to the extent he may have personal or business reasons for conferring a benefit on the mortgagee. Would this warrant different treatment than the Extended Grantee's Option case would be accorded by a court disposed not to include the mortgage in the consideration received in an Extended Grantee's Option sale?

Another case that would afford difficulty under a rigid "debt assumption" test of realization is where two parcels of land are under the first lien of the same debt, and one of the parcels is doubly-charged with a junior lien attaching only to it. In this situation, where the senior mortgagee has a mortgage on two tracts and the junior mortgagee on only one, the doctrine of lien marshalling is generally called into play,

24 Storke and Sears, supra note 3, at 187.
25 See p. 614 supra.
26 Storke and Sears, supra note 3, at 198-9.
to require the senior mortgagee to first satisfy his debt out of the singly-charged tract.\(^{27}\)

If the original mortgagor were to sell the singly-charged tract, a few jurisdictions hold that the junior mortgagee’s equity, i.e., that the tract not covered by his mortgage shall be first applied to the discharge of the senior debt, is not operative against a vendee of the singly-charged tract. These courts apply instead a rule of pro rata liability.\(^{28}\) Had this sale been a Grantee-to-Discharge, would the amount of the mortgage to be included in the “amount realized” by the transferor depend upon the jurisdiction governing the sale? And what would be the extent of realization, in the majority or minority states, if the doubly-charged tract were sold Grantee-to-Discharge?

Turning now to subdivided plots, who assumes what in cases of later sales of plots which before subdivision comprised parts of a single tract under a blanket mortgage? Suppose the separate plots were sold in Grantor-to-Discharge transactions. That was described above as the case where the grantee pays the transferor the full value of the property without offset for the encumbrance, imposing on the transferor the duty of satisfying the mortgage. In the event of default under the mortgage the doctrine of suretyship marshalling may be invoked to apply a rule of “forced sale in inverse order of alienation.”\(^{29}\) This means that the last plot sold originally is the first to be charged with the mortgage, and so on up the ladder until the plot first sold. Thus, successive purchasers of the various plots may hold their property as “real” principals when looking up the ladder to earlier purchasers, and as “real” sureties when looking down the ladder.

Grantees from the original purchasers generally are held to take subject to these equities;\(^{30}\) but the ground rules change if any original purchaser has assumed the entire mortgage,\(^{31}\) and the rules change again if all of the original purchasers acquired their titles in Grantee-to-Discharge deals.\(^{32}\) It is not hard to imagine the difficulties of analyzing realization for tax purposes if any of the original purchasers were to sell his property in a Grantee-to-Discharge, or Extended Grantee’s Option, or whatever, and the tax case had to be decided on a basis of the assumption or extinguishment of the transferor’s liability under the blanket mortgage.

\(^{27}\) Id. at 201-2, 209.
\(^{28}\) Id. at 209.
\(^{29}\) Id. at 201-4.
\(^{30}\) Id. at 204-5.
\(^{31}\) Id. at 205.
\(^{32}\) Id. at 206-7.
If debt discharge is not the test of realization, then what is? And will any other theory provide an acceptable hypothesis for realization in all cases of the disposition of mortgaged property?

The sale of mortgage property has two distinct elements, the disposition of the property, and the discharge from, or adjustment of, responsibility for the mortgage debt. Each of these may have its own separate tax consequences. The property disposition produces gain or loss, as on a sale or exchange under Internal Revenue Code Section 111, depending upon the relation of the "amount realized" to the basis. The debt payment, or debt assumption which is its equivalent, normally has no tax consequences (unless the debt is assumed or discharged at a discount, in which event ordinary income from the gratuitous cancellation of indebtedness may be realized).

The two elements are necessarily interrelated and easily confused, because the discharge from, or assumption of, the mortgage accrues to the owner as consideration for the disposition of the property. Thus, because the consideration takes the form of debt discharge or debt assumption to the extent of the mortgage, it was inevitable that the cases would characterize the taxpayer's realization of income as stemming from debt assumption or discharge. In other words, the courts appear to have tricked themselves into looking for an equivalent of debt discharge in order to support a tax.

There are principally two arguments which have been made to explain why realization depends on debt discharge or its equivalent. The more naive of these is that taxable income can arise only on a release from liability, and where the owner is not liable for the mortgage debt, the disposition of his property cannot effect for him a release from liability. This argument simply confuses the concept of ordinary income from debt cancellation with the unrelated concept of gain attributable to the consideration received on the disposition of the property. While in these cases the consideration for the property often takes the form of debt assumption, or its equivalent, the applicable concept is gain on the exchange of property for a valuable consideration; and so gratuitous release from liability is not a factor.

The other argument, and the one which seems to have bothered the court in the *Crane* case, correctly treats debt assumption as merely a form of consideration for the property, but maintains that without debt assumption there is no consideration and, therefore, no taxable benefit. What this argument fails to apprehend is that even in the cases of a
seller personally liable on the mortgage, the buyer’s assumption of the liability is not what gives rise to taxable income on the disposition of the property, unless the seller were to fail to give adequate consideration for the assumption. Observe, however, that the seller gives up property of a value equal to the debt to get the benefit of the debt assumption. It is quite the same as if the taxpayer, owing $10 to Y, paid this sum to X who assumed the debt. The only difference, where the taxpayer, instead of paying $10 cash to X, transfers to X property worth $10 on the same terms, is that the taxpayer is also disposing of a piece of property.

It is the disposition of the property that gives rise to taxable income in the latter instance. The taxable benefit lies in the payment received for it. The debt assumption, serving as an element of the payment, constitutes good consideration for the property and so figures in the gain or loss from the disposition of the property; but it is not the tax producer. Thus, where the taxpayer paid $10 to X to have him assume an obligation to Y, he got good consideration for his $10, but he did not realize any taxable income because of it. In the same way, where the taxpayer transfers property to X in consideration for X’s assumption of a liability to Y, the taxpayer does not realize any income or incur a tax because X assumes his liability. He realizes income only because he disposes of his property. In fact, if his basis is greater than the market value of the property, he will realize a loss. It is only where the value of the property exceeds his basis that he has taxable income.

An owner of mortgaged property will receive the same amount of consideration on the disposition of his property whether or not he is personally liable on the mortgage. Debt assumption may be lacking as an element of consideration in cases of unindebted owners; but that does not make for an absence of any consideration, unless the unindebted owner is to be assumed to have given up his property without receiving any consideration to the extent of the amount of the mortgage. This is obviously absurd, because the unindebted owner has no less to sell, and is entitled to no less consideration, than the indebted mortgagor. The latter can command no more cash over and above the mortgage than the former. In each case, the amount of the mortgage is automatically an offset against the amount of cash that would otherwise be paid for the property. The amount of this offset is readily conceded to be part of the consideration received by the latter, because it represents a debt for which he is personally liable; although we have seen that the extent of the effect of even a Grantee-to-Discharge transaction on the trans-
feror's personal liability is minimal. Moreover, the owner's personal liability, or lack of it, obviously has no bearing on the amount of consideration he is entitled to receive for his property. The only thing that affects this is its intrinsic value; and the transferor is fully compensated for his property if he receives on its transfer the amount of the intrinsic value in cash and lien extinguishment.

That the lien extinguishment is without personal benefit to the underdebted transferor is no bar to its recognition as part of the consideration received for the property. The mortgage debt, even though not personally owed, is, after all, primarily payable out of the charged property. It is important not to forget that the personal liability of the transferor's predecessor in interest—that is, the person who conveyed the property to him, presumably in a Grantee's Option sale—has become only a surety liability.33 One can reify the land by calling the realty the principal debtor; but it is more helpful to view as the principal debtor the person whose property can be appropriated as the primary fund for the payment of the mortgage debt.

In terms of a taxpayer's net worth, he is just as well off to get, in exchange for the property, release from a debt collectible only out of that property (assuming the property is worth at least as much as the debt), as he is to have a debt for which he is personally liable assumed by another or discharged.34 As an accounting proposition in both cases the transferor charges off the debt in crediting the asset account to which the debt related.

**TAXATION OF “FORCED” DISPOSITIONS**

The foregoing analysis of the reason for inclusion of the full amount of the mortgage in every type of transaction, without regard to the personal liability of the transferor, holds up well enough until one comes to cases of "negative equities"—a term describing the condition of the mortgage exceeding the value of the property, so that there is an absence of any value to the owner's equity, viz., basic value 7, mortgage 10. When the property gets into this state, the owner is forced to think seriously of disposing of his property, generally to the mortgagee in discharge or partial discharge of the mortgage, sometimes via foreclosure, occasionally by abandonment; and sometimes the owner is fortunate

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33 See p. 617 supra.

34 Analogously, the gratuitous cancellation of a debt collectible only out of property would result in ordinary income, to the extent the taxpayer's equity were increased, in the same way as if he were personally liable therefor. See Central Paper Co. v. Comm'r, 158 F.2d 131 (6th Cir. 1946).
enough to find a speculator who is willing to take a chance on the property for a nominal price.

It obviously takes some explaining to justify counting the full amount of the mortgage as consideration received by an unindebted transferor who drops his property in foreclosure at a time when it is worth less than half of the mortgage standing against it. Even more explaining is forthcoming when it appears, in those instances where the tax basis of the property (as distinguished from its basic value) also may be less than the mortgage, that the result of including the full amount of the mortgage in the "amount realized" is to charge the owner with a taxable gain on the occasion of his loss of the property in foreclosure! It was precisely this situation that prompted the Supreme Court in the *Crane* case to remark that in such an instance "the mortgagor who is not personally liable cannot realize a benefit equal to the mortgage." 35

There is something paradoxical about charging a taxpayer with gain from the sale or exchange of property in a year in which he loses his property to the mortgagee and receives nothing of any tangible value; that is, his net assets are not increased; generally no money or other property comes to him as a result of the foreclosure sale; and if he is not personally liable on the mortgage, no debt for which he is in any way liable is discharged. On the surface, all that happens is that he loses an asset for which he receives nothing.

Yet, logically the gain realized in these cases where the tax basis of the property is less than the amount of the mortgage is nothing more than the converse of the loss that would be realized were the basis higher than the amount of the mortgage. The relationship of tax basis to mortgage should have no bearing on whether the full amount of the mortgage must be included in the "amount realized."

Nevertheless, the courts have preferred to avoid facing this problem by refusing to acknowledge the existence of a negative equity in several cases. In the *Crane* case, the court jumped on the buyer’s willingess to give some “boot” as proof of a positive equity. In *Parker v. Delaney*, 36 where the taxpayer took over property held by a bank after foreclosure, giving back only a mortgage and no cash, and then operated it for about 10 years, quitclaiming it to the bank when the mortgage was in default, the court said there was no evidence that the value of the property was less than the mortgage! And in *Woodsam Associates, Inc.*, 37 where tax-

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35 331 U.S. 1, 14, n. 37 (1947).
36 186 F.2d 435 (1st Cir. 1950).
37 16 T.C. 649 (1951), aff'd 198 F.2d 357 (2d Cir. 1952).
pioneer's predecessor had mortgaged the property for more than its original cost and the taxpayer later lost the property in foreclosure, the Tax Court refused to make a finding as to the value of the property, notwithstanding unchallenged testimony that it was worth roughly $60,000 less than the mortgage.

Even where the owner is personally liable on the mortgage, it is difficult to justify a finding that the owner has "realized" the full amount of the mortgage in consideration for the assignment of his property which is worth less than the mortgage; for it seems perfectly obvious that where the mortgagee accepts the property in full discharge of the mortgage, though it is not worth as much as the debt, the owner has received the benefit of some debt cancellation, which is taxable as ordinary income.\(^{38}\)

If the property is worth less than the debt, the creditor only receives *pro tanto* consideration for his debt—on the above figures, only 7 out of the 10. Conversely, the only consideration he gives to the property owner is *pro tanto* discharge of the debt; the balance of what he gives to the property owner is gratuitous forgiveness of the unsatisfied portion of the debt. The property owner does not get this portion of the debt discharge as consideration for his property, any more than, if he had paid the creditor an equal amount in cash, it could be said that the full amount of the debt discharge was attributable to and given in consideration for the cash payment.

The cases have, nevertheless, ignored the debt forgiveness feature, and called the entire amount of the difference between the basis and the mortgage capital gain on the disposition of the property.\(^{39}\) In a loose sense, of course, the debt is being given up for the property, and perhaps the simplicity of operation warrants the merging of the debt cancellation and the true consideration. The only effect of this is to convert ordinary income into capital gain (with judicial sanction).

But where the owner is not personally liable, it is hard to justify counting the full amount of the mortgage, even under any relaxed theory of consideration. His debt is limited to the value of his property since that is the only source of its payment. Any excess of the mortgage over the value of the property must be extinguished willy-nilly, and

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\(^{39}\) O'Dell & Sons Co., 8 T.C. 1165 (1947), aff'd, 169 F.2d 247 (3d Cir. 1948) (foreclosure); Peninsula Properties Co., 47 B.T.A. 84 (1942) (voluntary conveyance).
cannot be productive of debt cancellation income. Consequently, to charge him with the full amount of the mortgage constitutes more than just converting ordinary debt cancellation income into capital gain. This accounts for the Supreme Court's dictum that the mortgagor who is not personally liable cannot realize a benefit equal to the mortgage where the value of the property is less than the amount of the mortgage.

Nevertheless, the cases which have had to decide the problem have reached the same result as where the mortgagor is personally liable, that is, they have included the full amount of the mortgage as capital gain. In one of the earliest cases to find a gain under the circumstances of a negative equity, the taxpayer had acquired improved real property on its organization in August 1924. Its cost was not indicated in the opinion. Five months later, in January 1925, the taxpayer received a loan of $361,000, to secure which it gave its bond and mortgage on the property. In 1934 the debt was reduced by amortization to $300,000, and the taxpayer was released of personal liability on the mortgage. In 1937, when the mortgage was past due, the taxpayer transferred the property to the mortgagee in lieu of foreclosure. The property was then worth $97,000, and had an adjusted basis of $257,435.42. The Tax Court held that the taxpayer realized a gain in 1937 in the amount of the difference between the basis and the debt. It noted, in passing, that "the $300,000 was received by the petitioner in 1925, but the taxable transaction took place in 1937." It also observed that the release of personal liability in 1934 was not an event having tax consequences.

In the Woodsam case, the Second Circuit expressly declined to follow the implications of the above-mentioned Crane dictum. In simplified form, the facts were that an individual acquired property for a total purchase price in cash and mortgage liability of $300,000, and subsequently refinanced the mortgage, getting a new mortgage of $400,000 without personal liability. Thereafter the individual conveyed the property to his corporation in a tax-free transfer under section 112(b)(5), the corporation taking subject to but not assuming the mortgage. The property was still later foreclosed when the mortgage was substantially unchanged, but the property had fallen off in value quite considerably. The court required the corporate taxpayer to include the full amount of the mortgage in the "amount realized," and report gain on this basis.

41 Lutz & Schramm Co., 1 T.C. 682 (1943).
There is obvious practical and equitable justification for the results in the above two cases, because otherwise the taxpayer would have escaped accounting for excessive depreciation in the former case, and for the mortgage profit realized in the latter case. One alternative that could be devised to assure taxing the profits made by mortgaging property for more than cost would be to levy the tax at the time of placing the mortgage. The author has made the argument for the earlier tax elsewhere, but this argument was expressly repudiated by the court in the Woodsam case, largely because the indebtedness resulting from the mortgage borrowing was thought to preclude realization of gain.

Nevertheless, a couple of new sections in the House version of the currently pending Revenue Code of 1954, come close to adopting the position rejected in the Woodsam opinion. One, Section 356(2), accelerates the tax on the mortgage profit, not to the time of placing the mortgage, but to the time of transfer where the property is transferred to a controlled corporation in an otherwise tax-free transfer after having been mortgaged for more than the amount of its cost basis. Another new section, 308(c), would impose a tax on the mortgage profit of a corporation on the occasion of declaring a dividend in kind of the mortgaged property. It is probable that these sections are products of the revelations of tax avoidance possibilities inhering in "mortgaging out"—i.e., borrowing against the property without personal liability more money than is represented by the owner's investment—which have been a highlight of the recent Congressional hearings into the Federal Housing Administration.

Another technique which can be suggested for assuring full accounting for all mortgage or depreciation benefits, but without indulging in the fiction of realization in the full amount of the mortgage, is to treat the excess of the mortgage over the value of the property as debt forgiveness, with a corollary reduction of the owner's tax basis by the amount of debt forgiven. A similar technique has been employed in cases involving cancellation of indebtedness incurred in connection with the acquisition of property. While debt cancellation is normally productive of ordinary income, these cases permit reduction of the cost basis as a substitute for the realization of debt cancellation income.

The justification for extending this technique to the case of an unabated mortgagor is that if his basis includes the full amount of his

43 See Hirsch v. Comm'r, 115 F.2d 656 (7th Cir. 1940); see also Rabkin & Johnson, Federal Income, Gift and Estate Taxation, §§ 36.05, 36.06.
mortgage, or if the basis reflects an amount of original cash investment which has been subsequently recouped through a subsequent mortgage borrowing, it is obviously unfair to allow him to compute gain or loss with all of this in his basis, if he is not also required to account for this amount via inclusion of the full amount of the mortgage as "amount realized" on the disposition of the property. The suggested technique would take out of the basis that part of the mortgage which is not accounted for on disposition—that is, the excess of the mortgage over the property's value—and require the property owner to count as consideration for his property only the value of the property.

The First Circuit, to achieve an equitable result which would prevent a taxpayer from avoiding accounting for depreciation deductions taken in excess of any cash investment, would even require an unindebted owner to report income on an abandonment of the mortgaged property, but would make the income reportable as ordinary income rather than capital gain (even where the property is a capital asset) for the reason that an abandonment does not constitute a "sale or exchange." 4

This court viewed ordinary income on an abandonment of property carried with a negative basis (i.e., where the tax basis is less than the mortgage) as simply the converse of the ordinary loss found in cases of the abandonment of mortgaged property with a positive basis. 45 It is submitted that there is no real converse to an abandonment loss, any more than there could be a converse to a casualty loss. Perhaps the answer is to declare that mortgaged property cannot be "abandoned" within the meaning of that concept for tax purposes. 46 That is, if the property has any value, the mortgagee will claim it and satisfy his debt out of it; and to this extent the owner receives consideration even on an abandonment, with the result that he has a sale or exchange which would qualify for capital treatment if the property is a "capital asset."

Collateral support for this position is found in the Oregon Mesabi Corporation case, 47 where the Tax Court, dealing with a contention of taxpayer that its quitclaiming of overencumbered land to the county for taxes amounted to an abandonment since it received no consideration, saw no substantial difference between this and a foreclosure. Said the Court:

In the present case, petitioner, in order to avoid foreclosure for unpaid taxes, conveyed the property to the County. If it had not made the con-

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44 Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950), cert. denied 341 U.S. 926 (1950).
45 See cases cited note 9 supra.
46 See, to this effect, Braunfeld, supra note 18, at 436-445.
veyance and the County had foreclosed in the same year, there is no question that its loss would have been a capital loss. We cannot see why a different result should be reached because of the giving of the quitclaim deeds. The conveyance to the County was as much a "forced" conveyance as a foreclosure sale would have been. The fact that a consideration did not move to petitioner is immaterial.

Had such a fundamental approach prevailed in the decision of other cases of loss on the disposition of over-encumbered property, this field would not now be cluttered with rules by which the receipt of a little "boot" may change an ordinary loss into a capital loss, and where a voluntary conveyance in lieu of foreclosure is one thing, but a foreclosure is another, and an abandonment is something else again.

**Nominal Sales to Strangers**

One other type of case of "negative equity" remains for consideration—that is, where property encumbered in an amount at or near the amount of the mortgage is sold for a nominal amount of cash to a stranger (as distinguished from the mortgagee or one buying at a foreclosure sale). It was noted above that the *Crane* case appears to have involved such a deal. A variation of this is found in cases where the property is conveyed to the mortgagee for a nominal consideration, but with the mortgage not being permitted to merge.\(^4\)

The question occurs whether the owner should be required to include in his "amount realized" the full amount of the mortgage plus the "boot," just as if the property were actually worth more than the mortgage and commanded the boot on its market value. Since the cases include the full mortgage even in cases of negative equity, it would seem that the same result should follow in these hybrid cases *a fortiori*, with the addition of the "boot" to the "amount realized." Furthermore, it does not make any difference to the transferor why the grantee is taking over the property and paying a nominal sum, so that it would be hard to justify a different result from the Extended Grantee's Option cases of actual positive equity.

The rule should possibly be different in Grantee's Option cases, that is, where the transferor is liable on the bond, but the grantee does not assume it. Here, since the property is worth less than the mortgage and, as events stand then, it is likely that the transferor will be called upon to satisfy a deficiency judgment in the future, it might not be good policy to charge him with the full amount of the mortgage plus

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the "boot" at the time of his sale, only to give him a compensating loss when the deficiency is subsequently required to be paid. An alternative would be to charge him with only the value of the property (if it can be readily established) plus the "boot" as consideration received on his sale, and to charge him with additional income (probably debt cancellation income) only if the mortgage is subsequently discharged without his having to pay any deficiency. Authorities are lacking either way.

**TRANSFEROR'S BASIS FOR GAIN OR LOSS**

No matter what terms one uses to explain the inclusion of the amount of the mortgage in the "amount realized" on disposition, there will always be some who will feel uncomfortable about an unindebted transferor "realizing" the amount of a mortgage debt. It should be pointed out that, simply in terms of tax result, it would not be necessary to count the mortgage in the "amount realized" if an amount equivalent to the mortgage were also excluded from the tax basis for the property; for the amount of taxable gain or loss does not depend alone on the "amount realized," but rather on a comparison of this amount with the basis.\(^{49}\)

Thus, in the *Crane* case for example, the taxpayer could have been said to have "realized" only the $2,500 "boot" that she reported; and her original basis could be said to have been zero on her acquisition of the property, by excluding the amount of the mortgage, and to have then been adjusted downward to minus $28,000 by reason of depreciation allowable. The result would be a gain of $30,500, as the Commissioner found. This mode of computation has been suggested in a concurring opinion in one case.\(^{50}\)

There are, however, several objections to this technique. For one thing, it would obviously require the acceptance of a minus basis in certain cases, which is something abhorrent to the tax law.\(^{51}\) Moreover, basis is derived from what is paid for the property; and where the property has been bought without encumbrances and the mortgage is placed afterwards, the basis would initially equal the full purchase price and would have to be reduced by the amount of the mortgage—presumably on the occasion of the placing of the mortgage. Only where the encumbrance is a purchase money mortgage, or otherwise figures in the consideration paid for the property, could the amount of the mortgage be left out of the basis at the outset, with the taxpayer's basis being limited to his equity in the property.

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\(^{49}\) See Int. Rev. Code § 111.

\(^{50}\) Magruder, Ch. J., concurring in Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950).

\(^{51}\) See *Crane v. Comm'r*, 331 U.S. 1, 10 (1947).
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However, the Supreme Court in the *Crane* case expressly rejected an equity basis wherever the mortgage is reflected in the purchase price of the property, as where the buyer gives a purchase money mortgage, or assumes an existing one, or even simply takes subject to one. Thus, where what has been called above the "basic bargain price" is $25,000, being paid $10,000 in cash and $15,000 in mortgage debt, the tax basis is $25,000. This rule is even applied where the mortgagee himself acquires the property without permitting the mortgage to merge.

The Supreme Court's conclusions regarding the inclusion of purchase money encumbrances in basis were primarily rationalized in terms of depreciation. The basis for depreciation is by statute the same as the basis for gain; and if this basis were dependent upon the owner's equity in his property, depreciation deductions would follow amortization of the mortgage. This would require repeated recomputations of basis and of annual depreciation allowances. The Court noted that the amount of depreciation allowances would thereby be sharply curtailed in relation to the physical exhaustion of the property. More precisely, of course, the distortion of the depreciation account would be manifested by understatement in the earlier and presumably bigger income years of the property and exaggeration in the declining income years.

The Court's fundamental objection to a shifting basis for depreciation is obviously sound. Such criticism as has been directed at the *Crane* depreciation rule pertains only to the possibility it opens up to an investor to recapture substantially more than his net cash investment via depreciation deductions, or to continue to take depreciation deductions

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52 See text accompanying note 15 supra.
54 Int. Rev. Code § 114(a).
55 The author of a Comment in 26 Texas L. Rev. 796 (1948) gives the example of a building, with an estimated life of 50 years, bought by the taxpayer for $20,000 cash, subject to a mortgage of $60,000, which the taxpayer is to amortize at the rate of $1,500 per year for 40 years. If the down-payment and each subsequent payment were amortized over the remaining life of the building from the date of each payment, the schedule of depreciation allowances would be as follows: 1st year—$400.00; 2d year—$430.60; 3d year—$461.85; . . . 41st to 50th years—$2,880.00 (each year). Thus the allowance for the last years is more than seven times that for the first year.
56 For treatment of the problems of depreciation of mortgaged property generally, see Braunfeld, supra note 18 (Part III), 25 Taxes 155 (1947); Comment, 26 Texas L. Rev. 796 (1948); Notes, 13 U. of Chi. L. Rev. 510 (1946), 6 Tax L. Rev. 319 (1951). For function of depreciation deduction, see Comm'r v. Crane, 153 F.2d 304 (2d Cir. 1945), aff'd 331 U.S. 1 (1947).
57 E.g., Comment, 26 Texas L. Rev. 796 (1948); Note, 21 So. Calif. L. Rev. 112 (1947); cf. Note, 13 U. of Chi. L. Rev. 510 (1946). Observe, however, that this excessive depreciation will be taxed (though only at capital gain rates, if the property is a
after his equity is wiped out by a decline in the actual value of the property. These considerations are not likely to cause the overturning of the Crane rule of basis for depreciation; and there is obvious virtue to an identical basis for the computation of both depreciation and gain or loss, which lies not merely in the resultant statutory symmetry but also in the avoidance of administrative complications on audit that could seriously disrupt the workings of our system of voluntary self-assessment. Hence, inclusion of the mortgage in the “amount realized,” even if it were not analytically supportable, would be preferable to excluding the mortgage from basis.

CONCLUSION

The first sin in the cases of taxation of transfers of mortgaged property involved a failure to identify the element in the transaction that made for “realization.” There followed a host of cases in which the results were made to depend on whether or not the transferor’s debt was assumed, or whether he himself was even personally liable. Further distinctions were based on the kind of disposition involved, i.e., whether voluntary sale, foreclosure sale, or abandonment.

Hence, all of these cases appear to be erroneously premised. Having made “debt discharge,” or its equivalent, the *sina qua non* to realization of consideration in the amount of the mortgage, the cases then overstated the effect of a sale on the personal mortgage indebtedness of the transferor. And so error mounted on error until in relatively recent cases courts have found it difficult under the rigid “debt discharge” test to find realization of gains which their consciences tell them must be taxed, as when a taxpayer on disposing of property has a tax basis that is lower than the amount of the mortgage, signifying a prior untaxed benefit to him at least to the extent of the excess of mortgage over basis. Even so, the fact that the earlier precedents may have formulated the issues erroneously appears to have gone unsuspected.

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58 Note, 49 Col. L. Rev. 845 (1949). The notewriter in 13 U. of Chi. L. Rev. 510 (1946), while concurring in the view that a taxpayer should not be allowed to take depreciation deductions after the absence of equity makes it unlikely that he will pay off the mortgage, if he is not personally indebted for it, nevertheless points to the complications for taxpayer and the Government if depreciation deductions are made dependent on the actual value of the property at any given time.
The judicial instincts have, nevertheless, been unerring in the recent cases. If the reasoning has been arguable, the results have not. A correct appreciation of the significance of each of the separate elements of debt discharge and property disposition inhering in every transfer of mortgaged property would have simply enabled the cases to have been decided more easily, not more soundly. But if a return to the errors that marked the earlier cases is to be avoided in the harder cases that lie ahead, judicial analysis of sale and other transactions involving mortgaged property will have to be made anew.