The Income Tax Effect Of Mortgages

John W. Drye, Jr.
THE INCOME TAX EFFECT OF MORTGAGES

JOHN W. DRYE, JR.*

Real estate is often referred to as a tax sheltered type of business, and the possibilities of tax underwritten gains from investments therein are well recognized; but very little seems to have been written as to how this all came about. Aside from the benefit of the capital gains tax, the impact of the income tax on real estate operations is mainly reduced by the deductions for property taxes, interest, expenses of operations, and depreciation. The first three of these deductions involve cash payments by the taxpayer and certainly do not artificially enrich him.

Depreciation, however, is a different matter; it involves a reduction in taxable income without a current diminution of the cash inflow. So long as depreciation reasonably measures the gradual reduction in the useful life of a wasting asset and is computed on the taxpayer's real investment in the property, fairness requires the deduction. But when depreciation begins to be computed on a much higher base than the real investment of the owner, the tax shelter comes into being. A mortgage on property can produce this shelter. This seemingly artificial result does not spring (as depletion, for example) from any specific statutory expression of congressional intent; it has been developed in the case law. Mortgages also considerably affect tax computations other than of depreciation.

The important basic law on the effect of mortgages on real estate transactions stems from the reasoning adopted by the United States Supreme Court in Crane v. Commissioner. In that case Mrs. Crane had inherited real estate from her husband, on which there existed at his death a mortgage of $255,000, plus accrued interest of $7,042.50, making a total of $262,042.50. The property was reported at that

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1 331 U.S. 1 (1947).
value in his estate tax return and a deduction taken for the debt in the same amount. The reported figures were accepted by the Commissioner on audit of the return. During the seven years she held the property the allowable depreciation was computed at $28,045.10. She sold the property, subject to the mortgage which she had not assumed, for $3,000. The expenses of sale were $500. She reported in her return a gain of $2,500. The Commissioner contended that the unadjusted basis of the property was $262,042.50, which should be adjusted for depreciation of $28,045.10, and that the gain should be computed by considering the amount realized on the sale as not only the $2,500 net cash received, but also the principal amount of the mortgage.

The Court sustained the Commissioner's contention by these successive steps. It held that "property" acquired by Mrs. Crane, as defined in the statute, constituted the whole property and not the equity, that depreciation was to be computed on the whole value of the building on the property unreduced on account of the mortgage, and that on the sale of the property she received the amount of the mortgage despite the fact that she was not relieved of any personal liability.

Practical considerations, so called, seem to have swayed the Court. Mr. Chief Justice Vinson, writing the opinion of the Court, said:

"Under these provisions, if the mortgagor's equity were the Sec. 113(a) basis, it would also be the original basis from which depreciation allowances are deducted. If it is, and if the amount of the annual allowances were to be computed on that value, as would then seem to be required, they will represent only a fraction of the cost of the corresponding physical exhaustion, and any recoupment by the mortgagor of the remainder of that cost can be effected only by the reduction of his taxable gain in the year of sale. If, however, the amount of the annual allowances were to be computed on the value of the property, and then deducted from an equity basis, we would in some instances have to accept deductions from a minus basis or deny deductions altogether. The Commissioner also argues that taking the mortgagor's equity as the Sec. 113(a) basis would require the basis to be changed with each payment on the mortgage, and that the attendant problem of repeatedly recomputing basis and annual allowances would be a tremendous accounting burden on both the Commissioner and the taxpayer. Moreover, the mortgagor would acquire control over the timing of his depreciation allowances.

"Thus it appears that the applicable provisions of the Act expressly preclude an equity basis, and the use of it is contrary to certain implicit principles of income tax depreciation, and entails very great administrative difficulties."

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2Id. at 9.
"We are rather concerned with the reality 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."³

It is not surprising that Judge Magruder, Chief Judge of the First Circuit, later commented in Parker v. Delaney:

"As an original matter, I would have had some difficulty in understanding how the taxpayer in the Crane case realized more than $3,000 from her sale of the mortgaged property there involved...."⁴

With the holdings of the Crane case in mind, let us examine some of the tax results of the use of mortgages.

**Basis and Depreciation of Mortgaged Real Estate**

When financing is required in connection with the acquisition of real estate, it is generally accomplished through the use of a mortgage in one of three ways: (1) the purchaser borrows funds from a lender, giving as security a mortgage on the property and uses the borrowed funds to meet the purchase price; (2) the vendor accepts a purchase money mortgage; or (3) the purchaser assumes, or takes subject to, a pre-existing mortgage. In each of these cases the purchaser may or may not be obligated on the mortgage debt. The use of a dummy on such obligations has become quite general.

In the first situation described above, the taxpayer's basis under section 1012⁵ is the amount of cash paid for the property. In the second and third situations described above, while neither the Internal Revenue Code nor the Regulations specifically so provide, it appears to be well settled, since the decision in the Crane case, that the basis of the property is the amount of cash paid plus the amount of the mortgage debt, whether or not the purchaser is personally liable on the mortgage debt.⁶ The taxpayer's basis for depreciation accordingly will include the amount of the mortgage debt. Furthermore, even though the mortgage debt is later discharged, while the taxpayer owns the property, at less than its face amount, depreciation for years prior to such discharge will remain unaffected.⁷

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³Id. at 14.
⁴186 F.2d 455, 459 (1st Cir. 1950), cert. denied, 341 U.S. 926 (1951).
⁵All section references herein are to the Internal Revenue Code of 1954 and the Regulations thereunder unless otherwise indicated.
⁷Blackstone Theatre Co., supra note 6.
Sale of Mortgaged Real Estate

Upon the sale of mortgaged property, the amount realized under section 1001 will include the face amount of the mortgage debt, whether or not the taxpayer is personally liable thereon, at least when the value of the property at the time of sale equals or exceeds the mortgage debt. When, however, the taxpayer is not personally liable on the mortgage debt and at the time of disposition the mortgage debt exceeds the value of the property, the rule may be different. The Supreme Court in the Crane case observed:

"Obviously, if the value of the property is less than the amount of the mortgage, the 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."9

Apparently the Court believed that in such a case the amount realized by the taxpayer would be the value of the property transferred. However, if the amount realized is to be so limited, the taxpayer may receive substantial undeserved tax benefits. For example, assume that X purchases vacant land for $5,000 in cash and takes subject to but does not assume a pre-existing mortgage in the amount of $25,000. His basis thus becomes $30,000. Assume further that the property falls in value to $15,000 and is sold at foreclosure for that amount. Under the Crane dictum X would apparently have a tax loss of $15,000, contrasted with an actual loss of $5,000.

To illustrate further the results that may follow from such a rule, assume the same facts except that the property purchased was a depreciable building and that X's adjusted basis was $12,000 when the mortgage was foreclosed. If the amount realized by X is to be limited to the value of the property ($15,000), X would have a recognized gain of $3,000, would have taken $18,000 in depreciation deductions, and would have been out-of-pocket only $5,000—again a completely artificial result.

To follow the Crane dictum and still avoid these tax windfalls it would be necessary to require the taxpayer, upon foreclosure or other disposition of property which has fallen in value below the amount of the mortgage, to reduce its adjusted basis by the excess of the mortgage debt over value. There seems to be no authority or

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8Crane v. Commissioner, 331 U.S. 1 (1947); Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950).
9331 U.S. at 14 n.37.
logical reason for adjusting basis to dovetail with sales price. In addition, if this approach were possible, it would result in many instances in a negative basis, a concept which has not been accepted. So long as the basis principle of the Crane case remains the law, it would seem that the dictum should be ignored and the rule extended all the way to require the seller to include as the amount realized on disposition of the property the amount of the mortgage debt unreduced by the excess of the debt over actual value. This does not seem to produce an unfair result, so long as the mortgage is included in the computation of basis as well as in the amount realized on disposition. Three Tax Court cases have reached this result; however, each case involved a mortgage incurred subsequent to the purchase of the property by the seller or his transferor in a tax-free exchange. Thus, the taxpayer or his transferor in each case had in fact received the proceeds of the mortgage. This fact may be a logical, but it is not a practical, ground of distinction.

Of course, adoption of a rule of law that the mortgagor always realizes the amount of the mortgage when the property is sold or foreclosed will result in hardship in some instances. The profit resulting from adjustment of basis due to allowable depreciation may be taxed at a rate differing from the average rate reductions obtained from depreciation. Much will depend on the tax brackets of the taxpayer over the period of ownership. Such possibilities seem to be more of the "rub of the green" type of result. They should be ignored in the interest of providing a consistent basis for depreciation.

Discharge of Mortgage Debt at Less Than Face Amount When Mortgagor Retains the Property

When the value of property has decreased below the amount of the mortgage debt and the mortgagor and mortgagee agree upon a partial discharge of the mortgage, does the mortgagor receive income from the discharge of indebtedness? Adjustments of this character were not uncommon during the depression.

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\[\text{\textsuperscript{10}The Tax Court rejected such a theory in its opinion in the Crane case, 3 T.C. 585 (1944), holding that when the basis of property reached zero no further adjustments can be made. See the concurring opinion in Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950), for a discussion of negative basis.}\]

\[\text{\textsuperscript{11}Lutz & Schramm Co., 1 T.C. 682 (1943), nonacq., 1943 Cum. Bull. 35; Mendham Corp., 9 T.C. 320 (1947); Woodsam Associates, Inc., 16 T.C. 649 (1941), aff'd, 198 F.2d 357 (2d Cir. 1952).}\]

\[\text{\textsuperscript{12}Witness the Crane case wherein the taxpayer's benefit from depreciation deductions was approximately $150, while she incurred a tax of $1,900.}\]
When a solvent owner is personally liable on a mortgage, it would seem that he would realize income in an amount equal to the amount of indebtedness cancelled. Some courts, however, have held that a mortgagor personally liable on the mortgage, does not realize cancellation of indebtedness income when, through negotiation with the mortgagee, part of the mortgage debt is cancelled and at the time the fair market value has fallen below the amount of the mortgage by an amount at least equal to the amount of the debt cancelled. The amount of the cancellation is instead treated as a reduction of the purchase price. The Second Circuit, however, has viewed this distinction as "irrational" and, if valid, limited to a case wherein the vendor-mortgagee, in negotiations relating directly to the purchase price, agrees to a reduction. The Tax Court apparently limits the rule to agreements between the mortgagor and the vendor-mortgagee. It has been held, however, that no income is realized from the cancellation of an unassumed indebtedness.

Section 108, enacted since these cases were decided, provides that—

"No amount shall be included in gross income by reason of the discharge, in whole or in part, within the taxable year, of any indebtedness for which the taxpayer is liable, or subject to which the taxpayer holds property, if (1) the indebtedness was incurred or assumed—

(A) by a corporation, or

(B) by an individual in connection with property used in his trade or business, and..." the taxpayer files the necessary consent to adjustment in basis.

While the converse of this section would seem to be that income will be recognized to these named types of solvent taxpayers if the consent is not filed, the Senate Report on the Internal Revenue Code of 1954 indicates that section 108 was not intended to have a negative pregnant effect. In speaking of the deletion by the Senate of section 76 of the House bill, which would have dealt with the inclusion of income from the discharge of indebtedness, the report states:

...Commissioner v. Sherman, 135 F.2d 68 (6th Cir. 1943); Helvering v. A. L. Killian Co., 178 F.2d 439 (8th Cir. 1943); Hirsch v. Commissioner, 115 F.2d 655 (7th Cir. 1940); Hextell v. Huston, 28 F. Supp. 521, appeal dismissed, 107 F.2d 1016 (8th Cir. 1949).

Fifth Ave.-Fourteenth St. Corp. v. Commissioner, 147 F.2d 453 (2d Cir. 1944).

Denman Tire & Rubber Co., 14 T.C. 706 (1950), aff'd, 192 F.2d 261 (6th Cir. 1951).

Hotel Astoria, Inc., 42 B.T.A. 759 (1940), acq., 1940-2 Cum. Bull. 4; Fulton Gold Corp., 31 B.T.A. 519 (1934); American Seating Co., 14 B.T.A. 828 (1928), aff'd and rev'd on other issues, 50 F.2d 681 (7th Cir. 1931). This exception was recognized by the court in the Fifth Ave.-Fourteenth St. Corp. case, 147 F.2d 453 (2d Cir. 1944).

“Deletion of this section will leave the situation as it now exists, with the determination as to whether cancellation results in income to the debtor, and to what extent, to be settled according to the rules developed by the courts.”

The result then would appear to be that the statute, subject to filing the necessary consent, assures the benefit of the favorable cases discussed above to taxpayers who find the filing of the consent desirable. “An individual” whose property is not “used in his trade or business” will still find vitality in these decisions, as the Senate Report indicates.

Foreclosures, Conveyances to Mortgagee, and Abandonments—Capital or Ordinary Income or Loss

Foreclosure sales of real estate have been held to give rise to capital gain or loss, not ordinary gain or loss, irrespective of whether the taxpayer owner is or is not personally liable on the mortgage debt.18 The cases involving voluntary conveyances of mortgaged real estate to the mortgagee or abandonments by the mortgagor, however, are indecisive of a specific rule.

In the case of the mortgagor’s conveyance of the mortgaged real estate to the mortgagee and the release by the mortgagee of the mortgagor’s personal liability on the mortgage debt, it has been held that the conveyance creates capital loss because the extinguishment of the debt by the conveyance of the property constitutes an exchange.19 When the mortgagor was not personally liable on the mortgage debt, however, a conveyance of the property to the mortgagee was found to result in an ordinary loss because the taxpayer, not being personally liable, received nothing in exchange for the conveyance.20 However, a nominal consideration ($250) passing from the mortgagee to the mortgagor converted a disposition into an exchange resulting in capital loss.21 Similarly, abandonment of property encumbered by an unassumed mortgage produced an ordinary loss when the owner’s interest was worthless.22 It has been held, however, that a mortgagor personally liable on the mortgage debt cannot realize a loss by abandon-

18Helvering v. Nebraska Bridge Supply & Lumber Co., 312 U.S. 666 (1941); Helvering v. Hammel, 311 U.S. 504 (1941); Commissioner v. Abramson, 124 F.2d 416 (2d Cir. 1942).
19Pender v. Commissioner, 110 F.2d 477 (4th Cir. 1940), cert. denied, 310 U.S. 650 (1940); Rogers v. Commissioner, 103 F.2d 790 (9th Cir. 1939), cert. denied, 298 U.S. 580 (1939).
20Stokes v. Commissioner, 124 F.2d 335 (3d Cir. 1941).
21Blum v. Commissioner, 193 F.2d 447 (2d Cir. 1943).
22Commissioner v. Hoffman, 117 F.2d 987 (2d Cir. 1941); Polin v. Commissioner, 114 F.2d 174 (3d Cir. 1940).
ment (and thereby an ordinary loss) when the abandonment is followed by a foreclosure sale because until the foreclosure sale the property continues to have some value which bears directly on the determination of the amount of the deficiency judgment against the mortgagor.\textsuperscript{23}

The converse of these cases,\textsuperscript{24} holding that an unobligated mortgagor realizes an ordinary loss on deeding the property to the mortgagee, would seem to be that if a gain results the gain would likewise be ordinary. However, in \textit{Lutz & Schramm Co.},\textsuperscript{25} the Tax Court spoke of the taxpayer's gain as being capital gain. A ground for distinguishing this case may be that as the taxpayer had actually received the mortgage proceeds by mortgaging the property after acquiring it, there was an element of exchange present.

There seems to be no reasonable basis, however, for treating the loss or gain to the obligated mortgagor as a capital loss or gain while at the same time giving the unobligated owner the opportunity to select the result. Perhaps this opportunity no longer exists. If the doctrine of the \textit{Crane} case, which was decided after these distinctions were recognized, is applicable, does not the owner of mortgaged property who has no personal liability on the mortgage "receive" the amount of the mortgage (at least to the extent of the value of the property) on an abandonment or voluntary transfer?

Section 1231, furthermore, would allow the obligated mortgagor to treat a loss incurred on a transfer of business property to the mortgagee in extinguishment of the debt as an ordinary loss, provided the mortgagor does not have gains from the sale or exchange of business property or from the involuntary conversion of capital or business assets in excess of such loss. Of course, if in applying section 1231 an overall gain results, the loss suffered on the mortgaged property will have the limited tax effect of a capital loss. Section 1231 may not apply in the case of the unobligated mortgagor if no sale is involved.

An interesting aspect of the problem of the "amount realized" is how the tax shall be computed on a foreclosure sale when the mortgage debt is in excess of the value of the property, but the value of the property is in excess of the adjusted basis. Assuming that the property is not held for sale to customers in the regular course of business, would it be logical to treat the difference between the adjusted basis and market value as capital gain and the excess of indebtedness can-

\textsuperscript{23}Commissioner v. Green, 126 F.2d 70 (3d Cir. 1942).

\textsuperscript{24}See notes 20 and 22 supra, and Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950).

\textsuperscript{25}Lutz & Schramm Co., 1 T.C. 682 (1943).
celled over value as cancellation of indebtedness income—i.e., ordinary income? When the market value of the property was less than basis and the indebtedness cancelled exceeded the basis, the cases\footnote{Ibid.; Mendham Corp., 9 T.C. 320 (1947).} treated the transaction not from the viewpoint of an elimination of indebtedness, but from the viewpoint of gain on the disposition of property. It would appear, therefore, that when basis is less than value and value less than the mortgage debt, the entire transaction will give rise only to capital gain.

Transfers of Mortgaged Real Estate in Corporate Organizations and Reorganizations

The Code permits certain exchanges in connection with corporate organizations and reorganizations to be made tax-free. However, section 357 (c) provides:

"(1) In general—In the case of an exchange—
(A) to which section 351 applies, or
(B) to which section 361 applies by reason of a plan of reorganization within the meaning of section 368(a)(1)(D), if the sum of the amount of liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be."

Thus, regardless of whether or not the transferee-corporation in these instances obligates itself on the mortgage or merely takes subject to it, gain is recognized to the transferor to the extent of the excess of the mortgage over his basis.

For example, assume that X purchases Blackacre for $1,000 in cash and takes subject to a pre-existing mortgage of $19,000. He holds the property for a number of years and takes $5,000 in depreciation, so that his original basis of $20,000 is adjusted to $15,000. X then transfers Blackacre to a corporation in a section 351 transfer when the mortgage debt has been reduced to $18,000. X will have a recognized capital gain (assuming Blackacre is a capital asset) of $3,000, the excess of the mortgage over his basis. The corporation, of course, will get a stepped-up basis of $18,000 under section 362.

In all cases under the reorganization sections the amount of the mortgage existing at the time of transfer is deemed to be realized, although in cases to which section 357(c) does not apply, the tax is
deferred by an adjustment to basis. This adjustment is required by section 358(d) which applies when "another party to the exchange ... acquired from the taxpayer property subject to a liability...."

Thus in the case above, X's basis for his stock will be zero, computed by adding to his basis of $15,000 the amount of the gain recognized on the exchange of $3,000 and then reducing this $18,000 figure by $18,000, the amount of the liability to which the property was subject at the time of the transfer.

On the other hand, if X had also transferred to the corporation Greenacre, an unencumbered parcel worth $10,000 with an adjusted basis of $5,000, the property transferred would have had an aggregate basis of $20,000. As the debt would have been less than basis, no gain would be recognized under section 357(c). However, because of section 358(d) the basis for his stock would be the basis of the property transferred, $20,000, less the mortgage indebtedness of $18,000, or $2,000.

Thus, in the reorganization sections of the Internal Revenue Code Congress has carefully provided that the amount of any mortgage encumbering property transferred pursuant to a corporate organization or reorganization is to be realized, whether or not the transferor is personally liable on the mortgage debt, although recognition of the gain realized is delayed in some instances until disposition of the stock received. These provisions are thus consistent with the rule of the Crane case.

Involuntary Conversions under Section 1033

In regard to pre-1951 involuntary conversions of property into money, section 1033(a)(2) provides generally that no gain shall be recognized if the "money" into which the property was converted is expended in the acquisition of similar property, but to the extent that the money is not so expended gain shall be recognized. In regard to post-1950 involuntary conversions, section 1033(a)(3) provides that the gain shall be recognized to the extent that the "amount realized" upon the conversion exceeds the cost of similar property purchased for the purpose of replacing the converted property.

The Regulations\(^{27}\) provide, furthermore, in regard to both pre-1951 and post-1950 conversions that, if the converted property is encumbered by a mortgage and in a condemnation proceeding the Government pays off the mortgagee directly, the amount so paid the mortgagee

\(^{27}\)Treas. Reg. §§ 1.1033(a)-2(c)(10), 1.1033(a)-3(d).
is considered part of the "money" into which the property was converted or part of the "amount realized," whether or not the taxpayer was personally liable on the mortgage.

The use of the term "amount realized" in section 1033(a)(3) in contrast with the word "money" in section 1033(a)(2) and the separate treatment in section 1033 of transfers before and after 1950 indicates that the former term was carefully selected with an eye to the Crane decision and that the Regulations correctly interpret the law, at least as to conversions after 1950.

With regard to pre-1951 conversions, the new Regulations may not correctly interpret the law. The Regulations under the 1939 Code, while providing generally for the same treatment of mortgages encumbering the property as the new Regulations do, did not mention that they were applicable to both assumed and unassumed mortgages. Moreover, three cases involving section 112(f) of the Internal Revenue Code of 1939 [the former version of section 1033(a)(2)] have come to conflicting conclusions as to whether the owner who is not personally liable on the mortgage debt receives "money" equal to the full amount of the award or merely the net amount of the award after the direct payment by the Government of the mortgage.

All three cases involved similar facts. The taxpayer owned mortgaged real estate and was not personally liable on the mortgage; the Government condemned the property and paid off the mortgage directly out of the award, giving the taxpayer only the net amount of the award. The Second Circuit in the Fortee case held that "property" in section 112(f) of the 1939 Code meant the physical property, not the taxpayer's equity in the property. Relying on the Crane case, the court reasoned that the taxpayer must treat the payment to the mortgagee by the Government as if the taxpayer himself had received the award and then paid off the mortgage. The court concluded that the taxpayer's realized gain must be recognized to the extent of the amount paid the mortgagee. The taxpayer had invested not only the net award received by him but also an additional $2,000 as well from his own funds, but the court did not decide whether the recognized gain should be reduced to the extent of such $2,000.

The Ninth Circuit in the Babcock case held that "property" in

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28Treas. Reg. 111 § 29.112(f)-1.
29Commissioner v. Babcock, 259 F.2d 689 (9th Cir. 1958); Commissioner v. Fortee Properties, Inc., 121 F.2d 915 (2d Cir. 1954); Wala Garage, Inc. v. United States, 163 F. Supp. 379 (Ct. Cl. 1958).
31Commissioner v. Babcock, supra note 29.
section 112(f) of the 1939 Code can be less than complete legal and equitable title, that the purpose of the section was to aid the taxpayer, and that the section is satisfied as long as the net award received by the taxpayer is invested in similar property.

The Court of Claims' decision in the *Wala Garage* case followed the *Fortee* case, but extended it to hold that so long as the taxpayer puts up sufficient money (even though derived from a source other than the award) to cover part or all of the amount of the award given to the mortgagee, the section is satisfied and no gain is recognized to the taxpayer to the extent of the additional sums put up by the taxpayer.

The Tax Court aligns itself with the Ninth Circuit; it had held in favor of the taxpayer in the *Fortee* case and also in the *Babcock* case.

Transfers of Like Property under Section 1031

Section 1031 allows a taxpayer to exchange, without the recognition of gain or loss, property held for productive use in trade or business or for investment, for like property to be so held. If, however, the property transferred is encumbered by a mortgage, the amount of the mortgage debt is treated under section 1031(d) as money received on the exchange, whether the transferee assumes the mortgage debt or merely takes subject to the mortgage debt, and under section 1031(b) gain, if any, is recognized, but not in excess of the amount of the mortgage debt.

When both the property transferred and the property received are encumbered by mortgages, Regulation section 1.1031(b)-1(c) provides that the mortgages shall be offset against each other. In such a case, therefore, the party transferring the property encumbered by the smaller mortgage will not be treated as receiving "money" under section 1031(d), and accordingly no gain will be recognized to such party under section 1031(b). The other party's gain will be recognized, but only to the extent of the excess of the mortgage on the property transferred over the amount of the mortgage on the property received.

While the transfer of property encumbered by a mortgage will result in the recognition of gain under section 1031(b) if the property is transferred for unencumbered property or for property encumbered by a mortgage less than the mortgage encumbering the transferred property, section 1031(c) provides that if a loss results on the transfer the loss will not be recognized.

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32 *Wala Garage, Inc. v. United States*, supra note 29.
Transfer of Mortgaged Real Estate to Charities

Regulation section 1.170-1(c) provides that if a charitable contribution is made in property other than money, the amount of the contribution is determined by the fair market value of the property at the time of the contribution. The taxpayer, furthermore, does not have to include in gross income the excess of fair market value over the adjusted basis of the property.\(^{25}\) As is well known, these rules usually make it advantageous to a taxpayer to give appreciated property to charity instead of cashing in on the value of the property and giving the proceeds to charity.

When the property transferred is encumbered by a mortgage and the property value exceeds the amount of the mortgage, the charitable deduction will be equal to the taxpayer's net equity in the property.

The question that apparently has not been passed upon by the case law or the Revenue Service in any published ruling is whether or not the mortgagor "realizes" the amount of the mortgage on such a gift. Section 1001 provides for the computation of the gain or loss from "the sale or other disposition of property." The word "disposition" would seem to be broad enough to include a transfer by gift.\(^{36}\) In \textit{Lutz & Schramm Co.}\(^{37}\) and \textit{Woodsam Associates, Inc.}\(^{38}\) it was held that while the mortgaging of previously acquired property is not a taxable event, the taxpayer must account for the amount of the mortgage debt when transferring the property even though not personally liable on it. Accordingly, if a gift of mortgaged property is contemplated, the probability that the amount of the mortgage may be "received" should be taken into account in computing the tax benefits from the proposed gift. The Research Institute of America reports the unofficial position of the Commissioner to be that a transfer of encumbered property to a charity results in the realization of "income" to the extent the mortgage debt exceeds the property's basis.

For example, assume that X owns Blackacre valued at $25,000 with an adjusted basis of $15,000 and transfers the property to a charity after placing an unassumed mortgage on it in the amount of $20,000. X would clearly have a charitable deduction of $5,000; he may also have a recognized gain of $5,000 on the transfer.

If the mortgage here had been on Blackacre at the time of purchase

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\(^{26}\)See Herbert's Estate v. Commissioner, 139 F.2d 756 (9th Cir. 1943).  
\(^{27}\)\textit{Lutz & Schramm Co.}, 1 T.C. 682 (1949).  
but X had not assumed it, he might nevertheless realize a taxable gain of $5,000. The only difference between this situation and when X mortgages the property after acquiring it is that in the latter case he would be, so to speak, required to account for actual money he had taken out of the property. This may not be a basis for distinction. The Supreme Court in the *Crane* case, in holding on a nominal sale that the "amount realized" included the amount of an unassumed mortgage, stated:

"We are rather concerned with the reality 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. If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another."\(^{39}\)

When the unobligated owner of appreciated mortgaged property makes a gift of it to charity, the further question is presented as to whether the gain that may be realized is capital or ordinary. It would seem from the above quotation from the *Crane* case that the gain would be capital. To avoid any uncertainty, it would seem wise for the taxpayer, who is willing to abandon the contention that no gain at all is realized upon the gift, to sell the property to the charity for the amount of the mortgage debt, pay it off, and thereby assure himself of the benefits of capital gain treatment.

Perhaps it is fortunate that death has never been considered as the type of disposition that would bring income tax liabilities into existence in the absence of specific statutory provision.

*Income Tax Considerations for the Mortgagee*

Unless and until there is a default in the payments required by the mortgage, the mortgagee includes the interest received in his taxable income, but has no other tax worries. Upon the mortgagor's default the mortgagee can (a) agree to a compromise settlement of the mortgage debt, (b) accept a deed to the property in lieu of the foreclosure, or (c) foreclose on the property.

*Bad Debt Deduction Versus Capital Loss*

The following discussion is limited to the cases in which the mortgage notes are not "securities" within the meaning of section 165(g)(2).

\(^{39}\)331 U.S. at 14.
If the mortgagee and mortgagor make a bona fide agreement to extinguish the mortgage debt completely because of the mortgagor's inability to meet his obligation, and the basis of the indebtedness cancelled exceeds the amount of cash or value of the property received by the mortgagee in consideration thereof, the mortgagee is entitled to a bad debt deduction under section 166 for such excess. If, under the same circumstances, the mortgagee accepts a deed to the property in lieu of foreclosure and extinguishes the debt in consideration thereof, the result will be the same.\textsuperscript{40}

On a foreclosure sale the mortgagee may either bid in the property himself or allow it to be bid in by a third party. In the latter instance he will apply the bid price against the mortgage debt and, if practical, proceed against the mortgagor for the remainder. If the remaining debt is uncollectible, the mortgagee will be entitled to a bad debt deduction under section 166.\textsuperscript{41} If the mortgagee himself bids in the property for less than the debt, applying the mortgagor's notes against the bid price, and the portion of the indebtedness remaining unsatisfied after the sale is uncollectible, the mortgagee again is entitled to a bad debt deduction under section 166.\textsuperscript{42} The amount of the deduction is dependent upon the mortgagee's basis for the debt.\textsuperscript{43}

If the mortgagee is an individual and the debt represents a non-business debt, the loss arising from the worthlessness of the debt will be treated as a short-term capital loss under section 166(d). What constitutes a business debt is a question of fact.

In addition to sustaining a deductible bad debt loss upon his bidding in of the property at a foreclosure sale, the mortgagee may also realize gain or loss on the transaction.\textsuperscript{44} The amount of the gain or loss will be the difference between the fair value of the property and the basis of those obligations of the debtor which the mortgagee applies to the bid price.

For example, assume that X sells Blackacre for $15,000, receiving $5,000 in cash and $10,000 in the purchaser's notes secured by a mortgage in that amount. Assume further that X's basis for the notes is $10,000, that Blackacre falls in value to $5,000, and that X bids in the property for $4,000 upon the mortgagor's default. X applies $4,000

\textsuperscript{40}Kohn v. Commissioner, 197 F.2d 480 (2d Cir. 1952); Commissioner v. Spreckles, 120 F.2d 517 (9th Cir. 1941); Bingham v. Commissioner, 105 F.2d 971 (2d Cir. 1939); I.T. 3548, 1942-1 Cum. Bull. 74.

\textsuperscript{41}Ibid. \textsuperscript{1166-6(a).}

\textsuperscript{42}Ibid. \textsuperscript{1166-6(b).}

\textsuperscript{43}Ibid. at §§ 166(b), 1.166-1(d).

\textsuperscript{44}Ibid. at § 1.166-6(b).
of the mortgagor's notes against the bid price. If the remaining amount due X is uncollectible, he would have a $6,000 bad debt deduction. He would also have a $1,000 gain under Regulation section 1.166-6(b), being the excess of the value of the property over the notes applied to the bid price. Similarly, had X bid in the property for $5,000, he would have had a $5,000 bad debt deduction but no gain.

The Revenue Service takes the position that any such gain or loss is capital, not ordinary, if the notes are capital assets.45

Accrued But Unpaid Interest May Be Taxable to the Mortgagee on Foreclosure

In the Midland Mutual Life Insurance case46 the Supreme Court found that the mortgagor should be charged with interest income when his bid equalled the principal and accrued interest on the debt, even though the value of the property was less than the principal indebtedness. The Sixth Circuit, however, refused to follow this case if an individual taxpayer's bid included unpaid accrued interest, but the value of the property was less than the principal of the debt.47 That Court of Appeals distinguished the case before it from the Midland Mutual case on the ground, among others, that Reg. 77, art. 193 (now Regulation section 1.166-6), applicable to the petitioner but not to a life insurance company, specifically provided for a deductible loss, not a receipt of income, when the mortgagee's basis for the indebtedness cancelled exceeded the value of the property.

If the value of the property exceeds the principal due on the mortgage debt, the mortgagee will be charged with any accrued interest due to the extent of the excess of the value of the property over the principal debt due, whether he acquires the property on foreclosure or has the property voluntarily deeded to him.48 When the value of the property is shown to be less than the principal debt, the mortgagee will not be charged with accrued interest when the property is voluntarily deeded to him or when he bids it in on foreclosure and his bid price does not include interest due.50

46Nichols v. Commissioner, 141 F.2d 870 (6th Cir. 1944).
Mortgagee's Basis for Property Acquired on Foreclosure

The basis of property acquired by the mortgagee on foreclosure or by way of a voluntary deed from the mortgagor is its fair market value when acquired.\(^5\) The bid price, however, the Regulations state, is presumed to be equal to fair market value in the absence of clear and convincing proof to the contrary.\(^6\)

Economic Considerations in Mortgaging Real Estate

The most important outgrowth of the *Crane* case is that it permits a taxpayer to secure at a relatively low out-of-pocket cost a high depreciation base. Using this device, the investor is able to realize a high after-tax yield on his investment in the earlier years and later sell out his interest at capital gains rates.

Numerous examples on various assumptions could be given, but the following will suffice as a simple illustration.

Let us assume that X, a real estate investor in the 50 per cent tax bracket, buys property worth $1,000,000 for $200,000 in cash and a purchase money mortgage of $800,000. The mortgage bears interest at 5 per cent and runs for twenty-five years. Payments on the mortgage amount to $57,000 a year. A 150 per cent declining balance basis method of depreciation is set for the building valued at $800,000 with an estimated twenty-five year life. Gross rentals are $145,000, and operating expenses, including property taxes, are $60,000.

In the first year of operation depreciation ($48,000), interest ($40,000), and operating expenses ($60,000) would exceed gross rentals by $3,000, so that there would be no tax to pay. But the cash outlay would be only the payment on the mortgage of $57,000 and operating expenses of $60,000, or $117,000, leaving $28,000 in cash income. This is a return of 2.8 per cent on the value of the property, but in the first year of operation the entire $28,000 return would be tax-free, and X would have an after-tax yield of 14 per cent on his investment. By the eighth year, because of the declining balance method of depreciation and because a lesser portion of the $57,000 mortgage payment would be attributable to interest, the after-tax yield would be reduced to 5 per cent. At this time X may decide to sell. Assuming the market value of the property was still $1,000,000, he would incur a maximum tax of $78,000, but that tax would be attributable to the depreciation deductions he had theretofore taken and which would

\(^5\) Treas. Reg. § 1.166-6(c).
\(^6\) Ibid.
have saved him $156,000 in taxes at his 50 per cent bracket. Having sold, he could then reinvest and again take advantage of high depreciation rates in the early years.

Another advantage that lies in the use of a mortgage in times of rising prices is the leverage provided by the debt. For example, assume that the value of the property, which was worth $20,000 when purchased for $5,000 cash and a $15,000 mortgage, increases to $25,000. While this represents a 25 per cent increase in value, the value of the mortgagor's equity is increased from $5,000 to $10,000, or a 100 per cent increase. Of course, the opposite of this is also true—any decrease in value is also reflected in the mortgagor's equity; thus if the value of the property decreases 25 per cent, the mortgagor's equity would be worthless. However, real estate investors are noted for being incorrigible optimists.

Futhermore, because the mortgaging of property is not a taxable transaction, the taxpayer can realize on the appreciated value of his property without incurring any tax. For example, assume that X owns property worth $50,000 which has an adjusted cost basis of $25,000. He could mortgage the property for $30,000 and thus realize more than the basis without paying any tax on the transaction.

Conclusion

In the main, the foregoing outlines the steps by which the courts have raised a tax umbrella over real estate investments. It is doubtful if they foresaw the ultimate outcome. However, neither Congress nor the Treasury Department seems to have found fault with it.

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53 Woodsam Associates, Inc. v. Commissioner, 198 F.2d 357 (2d Cir. 1952).