

BRIEF FOR RESPONDENT

No. 68

In the Supreme Court of the United States

OCTOBER TERM, 1946

BEULAH B. CRANE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT
COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The opinion of the Tax Court of the United States (R. 34-45) is reported in 3 T. C. 585. The opinion of the Circuit Court of Appeals (R. 53-56) is reported in 153 F. 2d 504.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 28, 1945. (R. 57.) The petition for a writ of certiorari was filed on March 25, 1946, and granted on April 29, 1946. (R. 57-58.) The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer received under her husband's will an apartment house, worth about \$262,000 at the time of his death and subject to a mortgage of \$255,000 and accrued interest of about \$7,000, so that her equity in the property was zero. For seven years she collected the rents, paid the operating expenses, interest on the mortgage, and taxes, and was allowed deductions for depreciation on the full value of the building without any reduction on account of the mortgage. At the end of that period the taxpayer sold the property, subject to the mortgage, for a net sum of \$2,500.

The question presented is the amount of taxpayer's gain, which depends upon (1) the unadjusted basis of the property within the meaning of Section 113 (a) (5) of the Revenue Act of 1938 and the applicable Treasury Regulations, (2) the adjusted basis of the property within the meaning of Section 113 (b) (1) (B), and (3) the amount realized upon the sale within the meaning of Section 114 (a) and (b).

STATUTES AND REGULATIONS INVOLVED

The statutes and Regulations involved will be found in the Appendix, *infra*, pp. 35-38.

STATEMENT

The parties filed a stipulation of facts (R. 14-34) which was adopted by the Tax Court as

part of its findings of fact. (R. 35.) The stipulated facts not set forth in the Tax Court's findings were expressly included by reference. The findings of the Tax Court (R. 35-38) may be summarized as follows:

The taxpayer was the sole legatee and devisee of her husband, who died on January 11, 1932, and was also the executrix of his estate. The decedent owned an apartment house, which at the time of his death was subject to a mortgage in the amount of \$255,000, and on which there was due accrued interest in the amount of \$7,042.50, so that the total lien on the property was \$262,042.50. For the purpose of the federal estate tax, the property was appraised as of the date of decedent's death at a value of \$262,042.50, the exact amount due on the mortgage. (R. 35-36.)

On February 1, 1932, and at all times thereafter until the property was sold in November, 1938, the mortgage was in default for the nonpayment of interest. (R. 36.) In the early part of 1932 the taxpayer and the mortgagee entered into an agreement whereby the taxpayer was to operate the apartment house property, collect the rents, and pay for all necessary repairs and other expenses, reserve \$200 a month for the payment of taxes, and remit the balance to the mortgagee at the end of each month on account of the mortgage. (R. 36.) The net rentals from the premises for the years 1932 to 1938, inclusive, were paid to

the mortgagee by the taxpayer in accordance with the agreement. (R. 36.)

In 1938 when the mortgagee was about to foreclose the mortgage, the taxpayer, in order to avoid such action, entered into a contract to sell the property *subject to the mortgage* for a cash consideration of \$3,000. Pursuant to the contract, the taxpayer conveyed the property on November 29, 1938, and received \$3,000 in cash, out of which she paid expenses in the amount of \$500. The taxpayer was not a party to the mortgage, and did not at any time assume any personal liability upon the mortgage. (R. 36-37.)

Taxpayer filed income tax returns for the estate and for herself for the years between the death of decedent and the sale of the property, in which she reported the rentals from the apartment house as gross income, and claimed deductions for interest paid on the mortgage and for the taxes and operating expenses of the property. She claimed deductions for depreciation each year, ranging from \$3,200 to \$3,900, and aggregating \$25,500. (R. 37.)

In her return for 1938, the taxpayer reported a capital gain of \$2,500 from the sale of the apartment house property, and included one-half, or \$1,250, in her income. The Commissioner determined that the taxpayer sustained a capital loss of about \$500 from the sale of the land, and that she realized an ordinary gain of about \$24,000

from the sale of the building. (R. 38.) The taxpayer sought a review of the Commissioner's determination in the Tax Court, which decided in favor of the taxpayer; it held that the basis of the property was zero, that no depreciation allowance could be made on such a basis, and that the gain was limited to \$2,500, which represented the total "amount realized." (R. 43.) Two members of the Tax Court dissented. (R. 45.) The Commissioner appealed to the Circuit Court of Appeals, which reversed the decision of the Tax Court, with Judge Swan dissenting. (R. 53-57.)

SUMMARY OF ARGUMENT

The amount of gain realized by the taxpayer upon the sale of the apartment house which she inherited under the will of her husband is the difference between the amount realized and the adjusted basis. Accordingly, it is necessary under the statute to ascertain first the unadjusted basis, secondly, the adjusted basis, and finally the amount realized.

1. The principal controversy in regard to the unadjusted basis is whether the word "property" in the statute and Regulations means the physical thing, the apartment house, or the taxpayer's net cash interest in the apartment house. The value of the apartment house was about \$262,000, whereas the taxpayer's net cash interest in it on the critical date was zero. This Court has held

that the words of a statute are to be interpreted in their usual, ordinary and everyday meaning; and that this rule applies to taxing acts. Property ordinarily connotes ownership and ownership relates to the physical thing without taking into account any liens or encumbrances. If Congress had intended to make the taxpayer's net cash interest on the date of acquisition the basis for determining gain or loss, it would have used an appropriate term like "cash interest," "equity," or "equity of redemption."

The taxpayer in this case was the sole owner of the property from the date of her husband's death, and she alone had the right to possess, use and dispose of it. She collected the rents and paid the operating expenses. She claimed and was allowed depreciation on the basis of the full value of the apartment house without any reduction on account of the mortgage. She paid interest on the mortgage while she was in possession of the property and claimed and was allowed deductions for interest just as though she were the mortgagor. She reported the rentals as gross income and claimed deductions for the operating expenses of the property. She paid taxes on the property and claimed deductions in income tax returns on that account. When she sold the property, she sold the physical property itself.

The phraseology of the Regulations and the reference in the Regulations to the federal estate

tax clearly show that the value of the physical thing, rather than the value of taxpayer's net cash interest was intended as the basis of the property.

It would be unreasonable to construe the Regulations as meaning the taxpayer's net cash interest in the property, for such a construction would introduce administrative complication and confusion.

The construction of the word "property" in the statute and the Regulations is a question of law. Therefore the court below was free to reverse the decision of the Tax Court on the ground that it had erred on questions of law.

2. The Revenue Act expressly provides for the adjustment of the basis on account of depreciation to the extent allowed, but not less than the amount allowable. That provision is merely a legislative enactment of a rule laid down by this Court, which decided that the basis would have to be adjusted on account of depreciation in order to determine gain or loss even though the statute under consideration did not expressly require it.

In this case, the land was not subject to depreciation and therefore its basis need not be adjusted. But in regard to the building the taxpayer had been allowed depreciation in the aggregate amount of \$25,500, and the amount allowable could readily be computed from the unadjusted basis of the building, the stipulated rate of depreciation and

the period during which it was held by the taxpayer.

Whether the taxpayer received a tax benefit from the depreciation allowance is immaterial, because this Court has decided that even though the taxpayer does not receive a tax benefit from depreciation, the basis must be adjusted on account of depreciation.

3. In regard to the amount realized, the word "property" in the statute should be construed in the same manner that it was construed in the basis provision so that the symmetry of the Act may be preserved. If the word "property" means the physical thing, the fair market value of the real estate sold by the taxpayer was \$258,000 because the purchaser bought the property subject to a mortgage of \$255,000 and paid \$3,000 in cash. Obviously, he could have paid off the mortgage and owned the property free and clear at a cost of \$258,000. If we are right that the basis of the property included the \$255,000 mortgage, it would be absurd to eliminate the mortgage from the selling price and to say that the taxpayer sold the property for \$3,000 gross or \$2,500 net. That would result in a loss of more than \$200,000 for the taxpayer, although she concedes and the Tax Court decided that she realized a gain of \$2,500. The only way in which a reasonable result could be obtained is to add the principal amount of the mortgage to the amount of cash received.

Since the parties stipulated how the selling price should be allocated between the land and the building, it is a simple matter to ascertain the gain or loss on the sale of the land and the building. The gain on the building roughly approximates the amount of depreciation accrued during the period the taxpayer held it.

While the taxpayer did not assume personal liability on the mortgage, she stood in the shoes of the mortgagor, enjoyed all the tax benefits to which the mortgagor was entitled and attempted to meet the obligations of the mortgage. Under such circumstances it is not unreasonable to treat her as though she were the mortgagor.

ARGUMENT

INTRODUCTORY

Section 111 (a) of the Revenue Act of 1938 (Appendix, *infra*) provides in part that the gain from the sale of property shall be the excess of the amount realized therefrom over the adjusted basis provided in Section 113 (b) (Appendix, *infra*) for determining gain. Section 113 (b) requires an adjustment of the unadjusted basis of property as defined in Section 113 (a) (Appendix, *infra*). Therefore, the first step in determining the amount of gain realized by the taxpayer is to ascertain the unadjusted basis of the property within the meaning of Section 113 (a), and the second step is to determine the ad-

justed basis within the meaning of Section 113 (b). The third and last step is to ascertain the amount realized from the sale of the property within the meaning of Section 111 (a), which in turn is defined in Section 111 (b) as the sum of any money received plus the fair market value of the property (other than money) received.

I. UNADJUSTED BASIS

The property in question consisted of an apartment house and the land on which it stood, which the taxpayer acquired as sole devisee under the will of her husband who died in 1932. For the purpose of the federal estate tax, the property was appraised as of the date of his death at a value of \$262,042.50. The unadjusted basis applicable here is defined by Section 113 (a) (5), which provides that the basis of property acquired by bequest, devise, or inheritance "shall be the fair market value of such property at the time of such acquisition." Article 113 (a) (5)-1 of Treasury Regulations 101 (Appendix, *infra*) provides that the time of the acquisition of such property is the death of the decedent, and that the value of property as of the date of the death of the decedent as appraised for the purpose of the federal estate tax shall be deemed to be its fair market value at the time of the death of the decedent.

In regard to the unadjusted basis the principal controversy is whether the word "property" in

the statute and Regulations means the physical thing, the apartment house, or the taxpayer's net cash interest in the apartment house. The value of the apartment house was \$262,042.50. (R. 36.) At the time of the decedent's death, the property was subject to a mortgage in the amount of \$255,000 principal and \$7,042.50 accrued interest, or an aggregate sum of \$262,042.50, which meant that the taxpayer had a net cash interest in the property on the date of her husband's death of zero. (R. 36.) This Court has held that the words of a statute are to be interpreted in their usual, ordinary and everyday meaning; and that this rule applies to taxing acts. *Old Colony R. Co. v. Commissioner*, 284 U. S. 552, 560-561. "Property" ordinarily connotes ownership (*Legal Tender Cases*, 79 U. S. 457, 551), or the right to possess, use and dispose of the physical thing (*United States v. General Motors Corp.*; 323 U. S. 373, 377-378). The statute has been consistently so construed.

The point was squarely decided more than ten years ago in *City Bank Farmers Trust Co. v. Bowers*, 68 F. 2d 909 (C. C. A. 2d), certiorari denied, 292 U. S. 644. That case involved an estate tax case where the decedent's securities amounting to \$1,049,000 had been pledged with a bank to secure loans in the sum of \$557,000. In assessing the tax the Commissioner included in the gross estate the total value of the pledged