If the decision of this Court in *John Kelley Co.* v. *Commissioner* had preceded the decision of the Circuit Court of Appeals in this case, or had been brought to its attention, it is inconceivable that the Second Circuit would have reversed the Tax Court. Any doubt in the minds of the Circuit Judges whether the *Dobson* case was still law, or what effect should be given to it, would have been dispelled by the emphatic language of this Court in the *Kelley* case.

Such flagrant disregard of the *Dobson* rule requires the reversal of the judgment of the Second Circuit and the reinstatement of the determination of the Tax Court.

POINT II.

The Second Circuit erred in holding that the principal amount due on the defaulted mortgage of $255,000, which was a lien upon the real estate when Mrs. Crane inherited it and for the payment of which Mrs. Crane was not liable, was part of the "amount realized" by Mrs. Crane upon the sale.

We repeat the statutory definition found in Section 111(b), viz.:

> "(b) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

Reg. 111, Sec. 29.111-1 says:

> "The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property which is received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value."

The question is, therefore, (1) What, if any, property other than money did Mrs. Crane receive? and (2) What, if anything, was the fair market value of such property?

Accepting the finding of the Tax Court that Mrs. Crane was not a party to the mortgage or to the bond which secured it, and that she did not at any time assume any personal liability upon the bond or mortgage (R. 37), the Circuit Court of Appeals said (R. 54):

> "Although the taxpayer was the devisor's sole legatee, the Commissioner does not suggest that she was liable upon his bond, if indeed he was himself liable. The case is therefore to be decided on the assumption that her only relation to the mortgagee was that as devisee of the land, she took it encumbered by the lien of the mortgage."

Upon this agreed state of facts, the rights and liabilities of the title holder and of the mortgagee under the law of New York where the mortgaged premises were situate, were well settled and clear.

Mrs. Crane's ownership of the real estate was subject and subordinate to the lien of the mortgage; she had the right to possession of the mortgaged premises unless she voluntarily relinquished possession by sale or other transfer, or involuntarily lost it by foreclosure. *Barson* v. *Mulligan*, 191 N. Y. 306, 315, 316. She had in fact surrendered to the mortgagee the right to the rents, profits and other income, thus making the Bowery Savings Bank virtually a mortgagee in possession and leaving herself only the equity of redemption. *Barson* v. *Mulligan*, *supra*; *Becker* v. *McCrea*, 193 N. Y. 423, 428. She could only reacquire the right to receive and enjoy the income of the apartment house by curing the default. *Tiernan* v. *Marsh*, 54 N. Y. 599, 606.

Those were her rights and privileges. As for liabilities, she had none. She was not liable at law or in equity for the mortgage debt, or for the performance of any covenants of the mortgage either by contract (R. 37, 54), as devisee, *Hauselt* v. *Patterson*, 124 N. Y. 349, 357, or as owner *Smith* v. *Truslow*, 84 N. Y. 660, 662. In the City of New York there is no personal liability upon the owner for the payment of real estate taxes. *New York City Charter*, Section 155, *et seq.*

The Bowery Savings Bank as mortgagee had the right to enforce payment of the mortgage debt, including principal, interest, arrears of taxes, and advances it may have made to protect the mortgage, primarily out of the real estate by means of foreclosure and sale, and, secondarily, subject to statutory limitations, against the individuals personally liable for the mortgage debt by means of deficiency judgment. *Chase National Bank* v. *Guardian Realties, Inc.*, 283 N. Y. 350, 361; *Matter of Wilbur* v. *Warren*, 104 N. Y. 192, 197. But the Bank had no rights against Mrs. Crane. *Belmont* v. *Coman*, 22 N. Y. 438; *Elliott* v. *Sackett*, 108 U. S. 132; *Shepherd* v. *May*, 115 U. S. 505.

When Mrs. Crane contracted to sell her equity in the real estate (R. 29) and conveyed it to the Avenue C Realty Corporation subject to the mortgage and unpaid taxes, she received $2,500 in cash and conveyed to the purchaser all of her rights above enumerated. Beyond that she received nothing whatsoever of any kind or nature, directly or indirectly, whether positively by way of tangible or intangible property or choses in action, or negatively by being released or indemnified from some actual or contingent or supposed liability on the mortgage.

While the purchaser agreed to accept a conveyance "subject to" the mortgage, the purchaser did not by contract, deed, or otherwise, assume or agree to pay the mortgage debt or any part thereof. (Contract, Ex. K, pp. 26-32; Deed, Ex. L, pp. 32-34) *Dingeldein* v. *Third Avenue Railroad Co.*, 37 N. Y. 575, 577; *Belmont* v. *Coman, supra.*

Analyzing and summarizing the rights and liabilities of the parties before and after the sale, we find the following situation:

Party	Before	After
Mrs. Crane	*Rights:* Usual incidents of ownership above stated, with exception noted.	$2,500 (after expenses)
	Liabilities: None.	No change.
Bowery Savings Bank	*Rights:* Primary against the land; secondary against individuals, if any, personally liable, not including Mrs. Crane, or purchaser.	No change.
	Liabilities: None.	No change.
Purchaser	*Rights:* $3,000 (in bank).	Same incidents of ownership enjoyed by Mrs. Crane as above stated, with same exception noted.
	Liabilities: None.	No change.

The theory which the Commissioner urged upon the Circuit Court of Appeals and upon this Court, in arguing that Mrs. Crane received "property (other than money)" valued at $255,000, was stated in his brief, thus:

> "She * * * was obliged to pay interest on the mortgage as long as she held the property. * * * She was relieved of these obligations when she sold the property, subject to the mortgage, and thus the cash alone is not the full measure of the consideration she received. In the absence of any evidence to the contrary as to the value of these benefits, it would seem reasonable to value them in the amount of the principal of the mortgage, because that figure represents the capitalized value of her obligation."

Flatly and categorically, the foregoing assertion by the Commissioner is entirely unsupported by the evidence, by the stipulation between the parties and by the findings of the Tax Court, and is unqualifiedly contrary to the fact.

Nothing could be clearer than that Mrs. Crane was *not* obliged to pay interest on the mortgage. The sale of her interest in the real estate did *not* relieve her of any obligation arising under the mortgage or the mortgage bond because she was never under any such obligation. She did *not* receive any release from the obligation of the mortgage. None was ever executed or delivered. Mrs. Crane needed none because she was under no obligation. Furthermore, even if she had been under such a liability, the sale would *not* have affected it in the slightest. Many a person liable on a mortgage has had a deficiency judgment taken against him long after he has sold the mortgaged real estate, and after it has changed hands many times.

The Commissioner's argument is simply this: If I own a horse and sell it for $100, the "amount realized" is not only the $100 paid by the buyer in cash but also the value of the hay, oats and straw which I would have had to buy if I had continued to own the horse and desired to keep it alive, from which I have been "relieved" because I sold it! This is the same kind of "benefit" that a highwayman graciously confers when he "relieves" the traveller of the burden of carrying his watch!

The Second Circuit, adopting the substance of the Commissioner's argument, reasoned as follows (R. 55):

> "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 the 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 any one question the conclusion that the vendor had received "property (other than money)"; yet the effect is precisely the same as the transaction at bar."

We cannot follow the Court's argument. Take the statement that Mrs. Crane's situation was in effect the same as if the purchaser had paid off a mortgage on another parcel of real estate owned by Mrs. Crane which she did not sell but retained. The assertion is simply not so. Continued beneficial ownership of Blackacre which had been made free and clear of mortgage cannot possibly be the same as not owning any real estate at all.

Take the other statement that Mrs. Crane's situation was in effect the same as if the contract had required the buyer to pay $255,000 in cash to the mortgagee to satisfy the mortgage. (Incidentally it would have taken at least $270,857.71 to clear the mortgage lien, R. 16, not $255,000.) Again, it simply is not so. In the case supposed, the buyer would have to obtain $255,000 in cash from somewhere—the Court did not say where—and would have received unencumbered real estate; Mrs. Crane would have received all cash and would have sold the real estate free and clear of the mortgage. The Second Circuit saw no difference between that situation and a sale of real estate subject to the mortgage. Nevertheless, the difference is a very real one, both from the buyer's point of view (because in case of a purchase subject to a mortgage, he does not ever have to pay the principal of the mortgage or even the interest thereon, if he does not wish to do so; the land is obligated for the payment, but neither the buyer nor the seller is obligated), and from the seller's point of view (in the case of a sale free and clear of a mortgage the seller receives cash while in the case of a sale subject to a mortgage, she receives nothing), and from the mortgagee's point of view (who in this case would have been happy to find his mortgage paid in full). All of this was carefully pointed out in *Belmont* v. *Coman, supra,* and repeated in *Dingeldein* v. *Third Avenue Railroad Co., supra, Matter of Wilbur* v. *Warren, supra,* and other cases.

Further reflection shows many other respects in which Judge Hand's second hypothetical case differs from the sale subject to the mortgage which occurred in the case at bar.

> (1) It would require the consent of the mortgagee, or the procuring of a new mortgage elsewhere. Does anyone suppose that, in view of the bad record of this mortgage, the Bowery Savings Bank would be willing to place a new mortgage on the property, not merely for $255,000, but for this amount plus interest of $15,857.71? How could it legally be done in view of the statutory 60% limitation on the mortgage investments of a savings bank? (Banking Law, Sec. 235(6)(a))
>
> (2) It would require the execution of a satisfaction piece by the Bowery and the production, surrender and cancellation of the old bond and mortgage, and the payment of filing fees.
>
> (3) It would require a title search and a survey, and the preparation of a new bond and mortgage by an attorney, and other expenses which somebody would have to pay for.

> (4) It might well have disclosed the existence of mechanics' or other liens subordinate to the Bowery mortgage which would have to be disposed of in some way before a new mortgage of equal lien could be substituted.
>
> (5) A New York mortgage tax would have to be paid upon the new mortgage at the rate of 50¢ per $100, or at least $1,275 plus recording fees. *N. Y. Tax Law,* Sec. 253; *People ex rel. Banner Land Co.* v. *State Tax Commissioner,* 244 N. Y. 159, 162.
>
> (6) There would be a new mortgagor who would be personally liable on the bond, either Mrs. Crane or the purchaser, or a dummy, and the individuals personally liable on the old mortgage would be released and discharged.
>
> (7) The new bond and mortgage would be free from the restrictions imposed on the old bond and mortgage by the New York mortgage moratorium statutes.

This was not what was done here or contracted for. There was no Blackacre. There was no new mortgage. No mortgage was discharged. The old one continued. Neither actually, figuratively, nor by way of equivalent was there "a release from a charge upon his property". The very act which, according to Judge Hand, benefited Mrs. Crane's property to the extent of $255,000, simultaneously divested her of the property itself.

If mortgaged assets should be destroyed without insurance (I. R. C., Sec. 23e), or if they had been captured by the enemy (I. R. C., Sec. 127), Congress expressly allowed the owner to deduct the amount of his loss, presumably the value of the asset less the mortgage lien. Under the Commissioner's argument there would have been no loss, but the owner would have received a benefit equal to the mortgage even if he was not liable for the mortgage debt and the liability of the persons obligated had continued. According to the Second Circuit the transaction would have been precisely the same as if the enemy had paid the owner the full amount of the mortgage in cash.

Emphasizing this intention of the parties and refuting Judge Hand's argument, was the provision in the contract of sale, to which the Second Circuit did not refer, that the purchase price was $3,000 for the equity conveyed by the seller without deduction for the mortgage principal, etc. (R. 29). No clearer language could be used to show that Mrs. Crane was to receive, and did in fact receive, no money or property other than the sum of $3,000 in cash, and that the mortgage was to remain undisturbed.

Let us consider further where Judge Hand's disregard of the mortgage lien would lead. A mortgage is not the only form of encumbrance on real property which may reduce the cash purchase price payable to the seller. Suppose real property is sold subject to a restrictive covenant, or subject to an easement such as a right of way or for the flowage of water, or subject to mineral or oil or timber rights. In each case the seller is the title holder of the real estate sold. In each case the beneficiary of the restrictive covenant or holder of the easement or other right is not a co-tenant. In each case the burden is that of the land alone and no personal liability rests on the seller or purchaser. In each case the conveyance describes the property by metes and bounds, or other description, and conveys it to the purchaser "subject to" the lien in question.

In case of a sale of such property, no one would think for a minute that the seller had received in "property (other than money)" the amount by which the encumbrance had reduced the value of the real estate. Nevertheless, in the case of a mortgage lien, the Circuit Court of Appeals

believed that Mrs. Crane received in money and property (other than money) the identical amount that she would have received if she had owned and sold the property free and clear. In a word, although the mortgagee received nothing and the purchaser paid nothing, and Mrs. Crane had nothing which she could spend or use to pay a tax, still she received "property (other than money)" having a "fair market value" of $255,000 over and above the cash consideration of $2,500!

Needless to say, our research has disclosed no court (except the Second Circuit) which has taken such views. All the decisions which have come to our attention hold otherwise.

When the case at bar was argued and briefed, the opinion of the Circuit Court of Appeals, Fifth Circuit, in *Hilpert v. Commissioner*, 151 F. 2d 929, reversing 4 T. C. 473, had not been announced and was not available to Court or counsel.

In its essentials, there is little difference between the *Hilpert* case and the case at bar. Mr. and Mrs. Hilpert owned real estate in Florida. In consideration of $65,000 they conveyed it to a money-lender subject to a repurchase agreement exercisable at their option. The Florida court had held that this was an equitable mortgage under which they had the right to redeem. Pending the decision of the Florida court, they made a contingent contract to sell the real estate for $17,067.67 cash, and the purchaser agreed to pay the money necessary to redeem. Following the decision of the Florida court title was closed. It was conceded that the Hilperts were not liable on the mortgage. The question arose whether the redemption price was part of the "amount realized" by the Hilperts on the sale.

The Tax Court announced the same rule which it adopted in the case at bar. It said (p. 475):

"There is no dispute as to basis. The controversy relates to the amount of the consideration. It is true that all that petitioners received upon the sale was the cash paid to them by the vendees. * * * Only when the facts are so peculiar that the mortgage neither constitutes a liability of the seller nor is responsible for a part of the aggregate benefit received can it safely be eliminated from the computation of gain."

For reasons not material here, the Tax Court held that the rule did not apply.

It is interesting to notice that Judges Smith and Disney, who dissented in Mrs. Crane's case, dissented from the contrary holding in the *Hilpert* case. Adopting, although belatedly, the same point of view which we have consistently advocated, the dissenting Judges said (p. 477):

"They sold whatever rights they had under the decree of the court for a cash consideration of $17,067.67. That is all they realized from such sale. How then can it be held that they realized taxable income upon such sale of $66,399.45, a part of which was capital gain and a part ordinary income? How can an actual gain of $17,067.67 be transmuted into a taxable gain of $66,399.45?

The Tax Court's holding seems to me to be entirely unrealistic. The taxpayers cannot have a taxable gain from the sale in 1939 of any greater amount than they actually received, namely $17,067.67."

The Circuit Court of Appeals, Fifth Circuit, reversed the Tax Court, and held that the amount of the mortgage or redemption price was not part of the amount realized by the Hilperts.

The Fifth Circuit said (p. 931):

"We find no fault with the foregoing statement of legal principles but only in their application to the peculiar facts in this case. We think that the Tax Court erred in its view as to what the Hilperts received."

It continued (p. 933):

"Since there was no note, no covenant, and no agreement to repay the $65,000, and no enforceable obligation against the Hilperts in the transaction, the Tax Court was wrong in holding that the payment of the $54,364.07 by Lawton Investment Company in redeeming the property was a benefit received by the sellers out of that purchase. The case clearly comes within the exception stated by the Tax Court that when the mortgage neither constitutes a liability of the seller nor is responsible for a part of the aggregate benefit received it is appropriate that the amount paid by another to redeem property from the mortgage should be eliminated from the computation of gain to the mortgagor.

Since there was no personal liability that could accrue against the Hilperts, all that they got out of the transaction was the $17,067.67."

It concluded (p. 933):

"We agree with the dissenting opinion in the Tax Court that the Tax Court's holding seems to be entirely unrealistic. The appetite for taxes is not so voracious, the commands of the statute are not so inexorable, as to require the doing of an injustice when there is open another course that is more fully consonant with law and reason and which course, if followed, will lead neither to evasion by the taxpayer nor extortion by the Government."

There are also the decisions in the Third Circuit.

Polin v. *Commissioner*, 114 F. 2d 174;
Commissioner v. *Green*, 126 F. 2d 70;
Stokes v. *Commissioner*, 124 F. 2d 335.

In *Polin* v. *Commissioner, supra,* the taxpayer at the time of the foreclosure of the mortgage was given a release from liability on the mortgage bond. The Commissioner claimed that thereby he had received property (other than money), equal in value to the amount due on the mortgage plus interest. It was proven, however, that the taxpayer had received a release some ten years before, so that actually he received nothing at the time of the foreclosure. The Circuit Court of Appeals, Third Circuit, held that the taxpayer had received nothing which could be made subject to an income tax, thereby reversing both the Commissioner of Internal Revenue and the Board of Tax Appeals which had sustained the Commissioner's position.

Circuit Judge Jones said, at page 176:

> "The petitioner's release from liability on account of the obligations of the bond, for which the agreement of April 23, 1934, provided, furnished no consideration to the petitioner and his associates for their action in surrendering the property to the mortgagee. The bond itself had already provided that the obligors' liability for the obligations of the bond should be limited to the property conveyed by the mortgage securing the bond and that no other property of the obligors should be taken in satisfaction of the bond's requirements. This limitation upon the obligee's right to recovery applied to the obligor's promise to pay taxes on the mortgaged property as well as to their promises to pay the principal and interest called for by the bond. The provision in the agreement relieving the obligors of any personal liability under the bond was no more than a repetition of what the obligee had stipulated in the bond. The agreement of April 23, 1934 did not, therefore, relieve the petitioner from anything for which he was liable to the obligee and, consequently, he received nothing in exchange for his part in turning over the mortgaged property to the mortgagee."

See also *Commissioner* v. *Green*, 126 F. 2d 70, where the mortgage which the seller had not assumed or agreed to pay, was treated as no part of the "amount realized" upon the conveyance of the mortgaged property. See also the discussion in *Stamler* v. *Commissioner*, 145 F. 2d 37.

No argument is needed to show the conflict between those decisions and the decision of the Second Circuit in the case at bar.

There is also the line of decisions dealing with transfers of the mortgaged property to the mortgagee in lieu of foreclosure.

> *Bingham* v. *Commissioner*, 105 F. 2d 971;
> *Hale* v. *Helvering*, 85 F. 2d 819;
> *Turney's Estate* v. *Commissioner*, 126 F. 2d 712.

In no such case that has been brought to our attention was the amount of the mortgage debt considered "amount realized" by the transferor, except where the transferor was liable for the debt and the debt was discharged, or there was a cash consideration as in *Blum* v. *Commissioner*, 133 F. 2d 447.

If Mrs. Crane had conveyed the real estate to the Bowery Savings Bank subject to the mortgage, without cash consideration, Judge Hand's statement that she "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", would have applied just as much as to the actual transaction where she conveyed it to Avenue G Realty Corporation and received $2,500 in cash. Yet Judge Hand concedes that, in the case supposed, there would have been no "amount realized" and no tax.

We cannot understand why the identity of the transferee, or the presence of a single peppercorn, or "six cents", or $100, or $2,500, should control whether the mortgage was part of the "amount realized" by the transferor. Undoubtedly, the cancellation of the debt, if there is a debt, or a release of liability if there is liability, constitutes property received. But where the debt remains and no liability is released or discharged, the holding that the mortgage was "amount realized" in the case at bar was inconsistent with those decisions that it is not "amount realized" where the transferee happens to be the mortgagee.

The Revenue Act used the word "received". It used the expression "fair market value". These expressions should not be passed by without notice. They mean that money or property other than money must have passed into Mrs. Crane's hands, or that she received some intangible benefit sufficiently realistic to have a fair market value. They require that whatever money or property received by Mrs. Crane having sufficient substance and value to be the incidence of an income tax, must also be sufficiently substantial and valuable to supply the wherewithal with which to pay it.

From whatever angle the transaction is viewed, Mrs. Crane received nothing, certainly nothing having a fair market value or any value at all, except the sum of $2,500 in cash. That was the amount realized—nothing more.

(2).

Even if we should assume for the purpose of argument the correctness of the Court's theory of property rights arising from the sale, the "fair market value" of $255,000 attributed to the "property (other than money)" which Mrs. Crane was held to have received, cannot be substained under the law of New York. Such valuation can only be based on the assumption that the "liability" so "dis-

charged" was $255,000. (Actually it was $270,857,71 if we add to the mortgage principal of $255,000, for which Mrs. Crane was not liable, the mortgage interest of $15,857.71 for which she also was not liable and which she never received.)

The law of New York in its mortgage mortatorium statutes forbids liability in such unconscionable amounts, and in the case of a moratorium mortgage such as this, executed prior to July 1, 1932, provides that a deficiency judgment, if granted, shall be the amount due on the mortgage with interest and costs less the market value as determined by the Court, or the sales price upon the foreclosure sale, whichever is greater (*Civil Practice Act*, Section 1083-a).

It is self-evident that, if Mrs. Crane had been personally liable on the bond and mortgage, no deficiency judgment could have been recovered against her. *Heiman* v. *Bishop*, 272 N. Y. 83.

These relevant facts and elements of value must be taken into consideration in fixing the "fair market value" of the "property" which Mrs. Crane is alleged to have "received". When examined they conclusively demonstrate that the fictitious "release" of liability was utterly valueless because the existence and enforcement of such supposed liability was barred as contrary to public policy of the State of New York.

We submit, therefore, that the Circuit Court of Appeals erred in reversing the Tax Court's finding that Mrs. Crane received only $2,500, and in including within the "amount realized" the sum of $255,000 unpaid principal of the mortgage for which Mrs. Crane was not liable and which the purchaser did not assume or agree to pay, and which was unenforceable against anybody under the mortgage moratorium statutes of New York.

POINT III.

The Second Circuit erred in holding that the unadjusted basis of the property received by Mrs. Crane under her husband's will was the value of the real estate free and clear of the mortgage, and in adjusting such basis by the amount of depreciation allowed or allowable in previous years. The unadjusted basis of the mortgaged real estate was the value of the equity which the Tax Court held to be zero, and such unadjusted basis cannot be reduced to a minus quantity by the deduction of depreciation.

As previously stated, Section 113(a)(5) provided that in the case of property transmitted at death the basis should be "the fair market value of such property at the time of such acquisition". *Prima facie,* this means the value as determined in federal estate tax proceedings. Reg. 111, Sec. 29.113(a)(5)-1(c).

I. R. C. Sec. 802(a) provides that for the purpose of the estate tax, the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, "to the extent of the interest therein of the decedent at the time of his death".

That this means, in the case of mortgaged property, the decedent's equity is established by the regulations and long settled Treasury practice.

In Reg. 105, Sec. 81.38, it is provided as follows:

> "If decedent's estate is liable for the amount of the mortgage or indebtedness, the full value of the property subject to the mortgage or indebtedness must be included as part of the value of the gross estate; the amount of the mortgage or indebtedness being in such case allowed as a deduction. But if decedent's estate is not so liable, only the value of the equity of redemption (or value of the property, less the indebtedness) need be returned as part of the value of the gross estate."

In the instructions for Schedule A "Gross Estate—Real Estate" of the current Estate Tax Return, Form 706, after providing that if the decendent's estate is liable for the mortgage debt the amount of such liability must be included as a deduction in Schedule L, the instructions continue as follows:

> "If, however, the decedent's estate is not liable for the amount of the mortgage, only the value of the equity of redemption (or value of the property less the indebtedness) need be extended in the value column as part of the gross estate, in which case no deduction for the indebtedness is allowable under Schedule L."

Likewise, under the Estate Tax Return, Form 706, revised September, 1931, which was filed by Mr. Crane's executrix, a mortgage on which the decedent was personally liable was required to be included under Schedule I "Debts of Decedent", while a mortgage for which the decedent was not personally liable was required to be listed under Schedule J "Mortgages, Individual Losses and Support of Dependents".

Similarly in the case of the gift tax under I. R. C. Sec. 1000, which imposes a tax on the "transfer * * * of property by gift," never to our knowledge has the Commissioner attempted to impose a tax upon a gift of mortgaged real estate without deducting the amount of the mortgage. This is true, notwithstanding Sec. 1005 which provides: "If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift".

In order to see what was meant by "property" under these two taxes and how it is to be valued, we shall compare the applicable regulations.

Gift Tax Reg. 108, Sec. 86.19	**Estate Tax Reg. 105, Sec. 81.10**
"The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell. The value of a particular kind of property is not to be determined by a forced sale price. Such value is to be determined by ascertaining as a basis the fair market value at the time of the gift of each unit of the property. For example, in the case of shares of stock or bonds, such unit of property is a share or a bond. All relevant facts and elements of value as of the time of the gift should be considered."	"The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell. The fair market value of a particular kind of property includible in the gross estate is not to be determined by a forced sale price. Such value is to be determined by ascertaining as a basis the fair market value as of the applicable valuation date of each unit of the property. For example, in the case of shares of stock or bonds, such unit of property is a share or a bond. All relevant facts and elements of value as of the applicable valuation date should be considered in every case."

It is self-evident that in the case of both taxes, mortgaged real estate must be valued upon the identical basis and in the identical manner. The "property" which is to be valued cannot be the equity under one section and the unencumbered real estate under the other. The parallel between the two sections is too striking.

Again in computing the deduction from gross estate for property previously taxed, the amount of the mortgage or other lien is deducted. (I. R. C. Sec. 812(c); *Ransbottom* v. *Commissioner*, 148 F. 2d. 280).

See also the case of the stamp taxes on conveyances where the amount of a mortgage to which the property is subject is excluded in determining the amount of revenue stamps to be affixed to the deed (I. R. C. Sec. 3482).

These three tax statutes, dealing as they do with taxable transfers and one of them expressly incorporated in the computation of gain or loss for the purpose of income tax, are of the highest importance. All alike adopt the theory of the Tax Court that, in the case of mortgaged real estate, only the equity is transferred by the owner or received by the transferee, and that the mortgage lien is deducted in determining the fair market value of the property transferred or the consideration for the conveyance.

The only possible reason for using estate tax valuations, as the basis for gain or loss in the case of property acquired under a will or by intestacy, is because the "property" sold is the same "property" received from the decedent.

It ought to be self-evident that the interest of the devisee cannot possibly be any greater than that of the decedent, and that, if the decedent owned and devised encumbered real estate, the devisee could not possibly receive the real estate free and clear.

In holding that the value of the property which Mrs. Crane received from her husband was \$262,048.50, although the Commissioner in estate tax proceedings held it to be zero, the Circuit Court of Appeals has used the word "property" as it appears in Section 113(a)(5) in a different sense from that used in the estate tax provisions describing what is transmitted by a decedent at death, thereby destroying the correlation between those two divisions of the Revenue Act which Congress was careful to establish.

Undoubtedly real estate is "property". But a bond and mortgage secured by real estate is also "property", *DeGanay* v. *Lederer*, 250 U. S. 376, 381, and the "fair market value" of that "property" in the hands of the Bowery Savings Bank was at least $255,000.

Obviously Mrs. Crane did not and could not sell the Bowery's "property" consisting of the mortgage lien valued at $255,000 or more. All she could sell was what she owned, which was the encumbered real estate worth only $2,500 after expenses. To hold that, although the Bowery's mortgage was not disturbed, Mrs. Crane received $257,500, is to create a duplication of values incredible even in this inflationary age.

Judge Hand was impressed with the formalities of real estate conveyancing. He said (R. 55):

> "But the lien of a mortgage does not make the mortgagee a co-tenant; the mortgagor is the owner for all purposes; indeed that is why the 'gage' is 'mort', as distinguished from a 'vivum vadium'. *Kortright* v. *Cady*, 21 N. Y. 343, 344. He has all the income from the property; he manages it; he may sell it; any increase in its value goes to him; any decrease falls on him, until the value goes below the amount of the lien. * * *"

It is extraordinary that *Kortright* v. *Cady* was cited. By the very definition in that case upon which Circuit Judge Hand relied, the mortgage covering No. 395 Clinton Street was *vivum vadium*, because under the agreement with Mrs. Crane the Bowery Savings Bank received the net rents and applied them to the liquidation of the debt and was, for all intents and purposes, a mortgagee in possession.

Common law considerations, however, have nothing to do with the case at bar. The rule relied upon by Circuit Judge Hand was the common law rule and, as was pointed out in *Kortright* v. *Cady, supra*, at page 347:

> "In this State, the law is well settled that a mortgage is a mere security or pledge of the land covered by it for the money borrowed or owing, and referred to in it, and that the mortgagor remains the owner of the estate mortgaged, and may maintain trespass as against even the mortgagee. The debt, in the eye of the law, thus becomes the principal, and the landed security merely appurtenant and secondary; and the rights of the parties must be governed by those principles of law applicable to analogous cases."

We see no reason why "these unwitty diversities of the law of property derive from medieval concepts as to the necessity of a continuous seizin" (*Helvering* v. *Hallock*, 309 U. S. 106, 118) should govern the disposition of this case.

The realities of the situation compel the conclusion that at the date of Mr. Crane's death the lien of the mortgage was equal to the value of the real estate and that the fair market value of the property which Mrs. Crane received was exactly zero.

As we view it, the point which really disturbed the Second Circuit was the following conclusion of the Tax Court (R. 43):

> "In view of this holding, it is unnecessary to decide or consider the question of whether or not depreciation on the property for prior years was properly allowed or allowable in those years; but since depreciation in the amount of $3,200 was allowed for the taxable year 1938, and that year is before us, we hold that such depreciation was improperly allowed for the reason that there is no basis upon which to compute depreciation—the unadjusted basis being zero."

It so happened that the correctness of this holding was not involved in the appeal to the Circuit Court of Appeals. The disallowance of depreciation claimed in Mrs. Crane's

1938 income tax return was one of the elements which resulted in the deficiency of $27.77. If Mrs. Crane had desired to question the correctness of this holding, she could have raised the point by appeal or cross-appeal from the imposition of the $27.77 deficiency. Since no such appeal was taken the question was not before the Circuit Court of Appeals.

For this reason it was and is the law of the case that depreciation was improperly allowed to Mrs. Crane for 1938, because there was no cost, value or other basis upon which to compute depreciation. In effect, the real estate was fully depreciated. The Circuit Court of Appeals had no right to reopen the point which was not before it on the Commissioner's appeal. Similarly since the deduction of depreciation in 1938 which the Tax Court disallowed was no different from the deduction by Mrs. Crane in the prior years which were barred by the statute of limitations, it was and is the law of the case that depreciation was improperly claimed by Mrs. Crane for those years as well.

The law of the case, unappealed from, being that Mrs. Crane was not entitled to deduct depreciation during the years that she owned the property, the attempt by the Commissioner and by the Circuit Court of Appeals to require Mrs. Crane to pay a tax which includes the amount of such depreciation improperly deducted, was entirely out of place. *Tait v. Western Maryland Railway Co.*, 289 U. S. 620.

Nevertheless, we do not wish to evade arguing the point. We think that the Tax Court was correct.

It is well settled that the amount deducted annually as "depreciation" does not represent the extent of the physical loss suffered by the property through deterioration, obsolescence and similar causes, but is governed entirely by the amount which the particular owner happened to pay for the property. *United States v. Ludey*, 274 U. S. 295, 301. Take for example, two similar houses built at the same time at identical cost. Suppose some years later they happen to be acquired by different individuals, one of whom paid $50,000 while the other paid $100,000. The physical loss sustained by each building would be the same, but by accounting practice and by tax law the amount of annual depreciation allowable to the second purchaser would be double that allowed to the first.

As this Court said in *Detroit Edison Co. v. Commissioner*, 319 U. S. 98, at page 102:

> "But we think the statutory provision that the 'basis of property shall be the cost of such property' (§113(a)) normally means, and that in this case the Commissioner was justified in applying it to mean, cost to the taxpayer. A property may have a cost history quite different from its cost to the taxpayer. * * * But generally and in this case the Commissioner was in no error in ruling that the taxpayer's outlay is the measure of his recoupment through depreciation accruals."

Nothing can be clearer than the fact that Mrs. Crane's "cost" or "outlay" was zero. She paid nothing. The value of what she received was zero. There was nothing to recoup through depreciation accruals. Consequently the Second Circuit was entirely mistaken in rewriting the formula for determining gain or loss so as to permit the insertion of a deduction for depreciation predicated upon the physical wear and tear and obsolescence suffered by the buildings, instead of the cost thereof to Mrs. Crane.

Circuit Judge Hand made yet another point. He said (R. 55):

> "* * * unless the 'adjusted value' of the buildings is not computed upon the same value in finding

the subtrahend in the equation of gain, the taxpayer gets a double deduction. By hypothesis he will have been allowed deductions seriatim, based upon the actual value of the buildings; and he will in addition have got a reduction in his gain to the extent to which actual 'wear and tear' has reduced the selling price. Manifest justice demands that he must surrender one or the other, and the only question is whether the language of the statute forbids that result."

The Court overlooked the language of the statute. It does not say that the title holder *must* be allowed to deduct depreciation from annual income, nor does it specify how the amount of allowable depreciation shall be computed.

It permits deduction of—

> "A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) (1) of property used in the trade or business, or (2) of property held for the production of income." I. R. C. Sec. 23(1).

This must mean that the person entitled to deduct depreciation is the one who suffers the loss through the occurrence of physical wear and tear or obsolescence. Ordinarily this is the title holder but it is not always so.

In *Detroit Edison Co.* v. *Commissioner, supra,* this Court denied to the titleholder a deduction for depreciation of facilities paid for by its customers. Conversely in *Helvering* v. *Lazarus & Co.,* 308 U. S. 252, where title was held by a bank in trust for certificate holders and the taxpayer had the use of the building under a long term lease from the trustee with an option to purchase, the tenant was permitted the deduction.

This Court said, at page 254:

> "While it may more often be that he who is both owner and user bears the burden of wear and exhaustion of business property in the nature of capital, one who is not the owner may nevertheless bear the burden of exhaustion of capital investment. Where it has been shown that a lessee using property in a trade or business must incur the loss resulting from depreciation of capital he has invested, the lessee has been held entitled to the statutory deduction."

See also:

> *Duffy* v. *Central Railroad Co.,* 268 U. S. 55;
> *Cogar* v. *Commissioner,* 44 F. 2d. 554;
> *Reisinger* v. *Commissioner,* 144 F. 2d. 475;
> *Helvering* v. *Terminal Railroad Ass'n,* 89 F. 2d. 739;
> *Bonwit Teller, Inc.* v. *Commissioner,* 136 F. 2d. 978; Cert. denied 320 U. S. 794;
> *Georgia Railway & Electric Co.* v. *Commissioner,* 77 F. 2d. 897, cert. denied 296 U. S. 601.

See also I. R. C. Sec. 23(e)2, which in certain cases permits a life tenant of depreciable property to take depreciation, but denies it to the title holder.

If we stop to consider who it was that suffered the loss through wear and tear in the present case, it is self-evident that the Bowery Savings Bank was the sufferer. Circuit Judge Hand himself suggested that when he pointed out that no decrease in value falls on the owner "until the value goes below the amount of the lien" (R. [illegible]).

The Bowery Savings Bank which held the mortgage was the party affected by depreciation. With the lapse of time the value of the mortgaged premises became less and less.

If the Bowery Savings Bank had foreclosed the mortgage and been successful in selling the mortgaged premises at cost less depreciation, it would have sustained a loss equivalent to the accumulated depreciation which it could have used as a deduction in its federal income tax return.

> *Gardner Printing Co.* v. *Commissioner*, 4 B. T. A. 37;
>
> *Even Realty Co.* v. *Commissioner*, 1 B. T. A. 355.

Although the Second Circuit talked about double deductions, its ruling would open the door wide to such practice.

Many title holders of mortgaged real estate with little or no equity have ultimately lost their property through foreclosure or a deed in lieu of foreclosure without consideration. The Second Circuit would permit such title holders to take annual deductions for depreciation, although they had nothing to lose, and would not charge them with a gain when they lost their property. But the mortgagee, when it resold the property at a price which would presumably reflect the wear and tear suffered, would be permitted a loss represented by the difference between the amount of the mortgage loan and the amount realized.

This is a very frequent occurrence. Yet both the title holder and the mortgagee would be permitted to get the benefit of a deduction for the same physical depreciation.

The double deduction in Mrs. Crane's case, if it exists at all, was due only to the error of Mrs. Crane in claiming depreciation which she was not entitled to and the error of the Commissioner in failing to disallow it. The evidence showed that the actual amount of tax loss to the Treasury was between $150 and $200. Mrs. Crane is permitted to retain this unwarranted benefit, solely by reason of the statute of limitations which prevents the Commissioner from reopening her returns.

There is nothing extraordinary about this. The statute of limitations represents a public policy which sometimes works in favor of the taxpayer protecting him in an underpayment of tax, and sometimes in favor of the Treasury permitting the retention of an unjust over-collection. Assuredly, the operation of the statute in Mrs. Crane's favor to the extent of $150 to $200 of tax does not justify the effort to collect from her in another way a tax more than ten times as great.

There is another fallacy in the opinion of the Circuit Court of Appeals. Recognizing that a conveyance of mortgaged real estate is a sale, whether brought about by foreclosure or by deed to the mortgagee in lieu of foreclosure (*Helvering* v. *Hammel*, 311 U. S. 504), Judge Hand sought some theory by which a gains tax on such a transaction might be avoided. The solution which he advanced was to treat the transfer as an "abandonment" to the mortgage. He warned that "a slight sum of money will make the transaction a sale" and added that "escape is open to the mortgagor as soon as he decides to treat the venture as at an end" (R. 56).

Suppose the mortgagee refuses to accept a deed,—what then? The mortgagee frequently refuses to accept a deed and insists on foreclosure, either where there are encumbrances junior to his mortgage which he desires to eliminate, or where the owner has a bad record or is financially irresponsible, or where the mortgagee does not wish to run the risk of having an unmarketable title which he might have difficulty in selling. Indeed, the petition in this case alleged that Mrs. Crane tendered a deed to the Bowery which refused to accept it (R. 18). Certainly no "escape" was open to Mrs. Crane under Judge Hand's theory.

In actual practice where the mortgagee is willing to accept a deed in lieu of foreclosure, the owner almost invariably receives a cash consideration of from $100 to $500, *i. e.*, slightly less than foreclosure costs. Even where no cash is involved, the mortgagee at least is generous enough to pay and thereby relieve the owner of paying the cost of conveyancing. We should suppose that that was "a slight sum of money"; or property, which would subject the owner to a huge gains tax under Judge Hand's theory. But apparently this is not the case.

Undoubtedly, the owner can "terminate the venture" by conveying the real estate to a dummy whom he may have to pay for the accommodation. This is just as effective an abandonment as a conveyance to the mortgagee, but Judge Hand would hold the transaction taxable.

As we remarked (Brief, p. 34), there is no substance in these distinctions. Why should Mrs. Crane have a gain of some $20,000 if she conveyed the property without consideration to John Doe but none if she conveyed it to the Bowery Savings Bank? Why should she have a gain of $23,767.03 when she conveyed it to Avenue C Realty Corp. for $2,500 "in order to avoid foreclosure", but no gain if she "abandoned" it to the Bowery for $2,500? Why is the mortgage "property received" in one case and not in the other?

These tangled results of the Second Circuit's holding are due solely to its effort to escape from an artificial situation of its own creation, which it recognized as illogical, unjust and intolerable.

Under the decision of the Tax Court, the owner is only taxed on what he actually received. When the equity of the owner was wiped out, no further annual deduction for depreciation was permissible, because the owner suffered no loss, the actual loss being that of the mortgagee. Consequently, when he lost the property there would be no depre-

ciation which could be used to "adjust" the basis and create a fictitious "gain".

Remedial measures in cases of improper deduction for depreciation lie in permitting returns for statute-barred years to be reopened for the disallowance of depreciation deductions, rather than the creation of an imaginary "amount realized", a fictitious "basis", a mythical "gain", and the imposition of tax dependent upon the presence or absence of a few pennies or dollars of consideration and the identity of the transferee.

Therefore, we regard as completely unsound and fallacious the Commissioner's terror-stricken argument that, if the Tax Court in this case should be sustained, devisees of real estate subject to a mortgage will be deprived of depreciation allowances based upon the fair market value of the buildings, or that the allowance for depreciation will change every time the devisee amortizes part of the mortgage, or that there would be a "minus basis" for the devisee when the mortgage exceeds the fair market value of the property at the date of the decedent's death.

A minus basis is a mathematical and legal absurdity as the Tax Court pointed out (R. 43), *Woolford Realty Co. v. Ross*, 286 U. S. 319, 327. There is not the slightest danger that any of these consequences will ensue, so long as the Commissioner follows the language which Congress laid down, limiting the allowance for depreciation to the taxpayer's cost and denying such allowance to taxpayers who suffer no loss through physical wear and tear.

We respectfully submit that Mrs. Crane's gain could not and did not exceed the sum of $2,500, the net consideration which she received for her interest in the apartment house, and that the Tax Court was correct in so holding.

POINT IV.

Mrs. Crane received no income within the meaning of the 16th Amendment except the sum of $2,500 on which she paid an income tax. The determination of the Second Circuit that she received income of $24,031.45, if required by the Revenue Act, violated Article I of the Constitution and the 5th Amendment thereto.

The shocking injustice of imposing an "income" tax of $1,932.99 upon a fictitious "gain" of $24,031.45, when in fact Mrs. Crane only received the sum of $2,500, compels consideration of the constitutional safeguards enjoyed by American citizens against arbitrary impositions of this character.

It is well settled that the 16th Amendment did not enlarge the field of taxation open to Congress under Article I, Section 8 of the Constitution, but simply removed in the case of a tax on income the restrictions as to uniformity and apportionment imposed upon the taxing power of Congress by Section 9 of that Article.

We may concede that the power of Congress to tax its citizens has few, if any, limits. We may even grant, at least for the purpose of this argument, that Congress has power under the Constitution to make a capital levy for the support of the Government.

But in such case, as in the case of every tax under Article I of the Constitution, except only an income tax as to which special provision is made in Amendment 16, the requirements as to uniformity and apportionment among the several States must be observed. *Pollock* v. *Farmers Loan & Trust Co.*, 158 U. S. 601.

Therefore, if the Revenue Act of 1938 should be so construed as to characterize as "income" a fictitious figure

which is not, in fact, income, derived by the use of mathematical imaginaries, a tax on such "income" cannot claim the protection of the 16th Amendment, and must fall because the requirements of Article I were not followed. *Eisner* v. *Macomber*, 252 U. S. 189.

Applying these firmly established principles to the case at bar, a construction of the Revenue Act of 1938 which would attribute to Mrs. Crane a "gain" or "income" in excess of $2,500, could not meet the test of constitutionality. *Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170; *Edwards* v. *Cuba Railroad Company*, 268 U. S. 628; *Nicholas* v. *Fifteenth Street Investment Company*, 105 F.2d. 289.

The meaning of the word "income" in the 16th Amendment is the same as when used in common speech. *Eisner* v. *Macomber, supra*, at p. 207; *Sprouse* v. *Commissioner*, 122 F. 2d. 973, aff'd. 318 U. S. 604.

The action of a majority of the Second Circuit in the case at bar in transforming into a highly profitable transaction, an event which, in the ordinary meaning of language and by all dictates of common sense, was a ruinous disaster, emphasizes anew the need of the individual citizen for those safeguards against arbitrary governmental action as established by the Bill of Rights and contained in the limitations of the Constitution.

When Mrs. Crane is singled out and told that her gain was $24,031.45 which she did not receive, instead of $2,500 which she did receive, if the statute justified the Court's decision, the need for constitutional protection is clear. If Mrs. Crane is treated thus, why should not her fictitious "income" be $240,314.50 or $2,403,145? Or any sum of money which approves itself to the Commissioner's fancy?

We respectfully submit that the alleged gain of $24,031.94 was not "income" within the meaning of the

16th Amendment, as laid down in the decisions of this Court cited under this point heading. The levying of a tax thereon was not an income tax within the purview of the 16th Amendment, but was, in fact, a capital levy made without apportionment and without regard to any census or enumeration and consequently violated Article I, Section 9, and the 5th Amendment to the Federal Constitution.

POINT V.

The judgment of the Circuit Court of Appeals should be reversed and the judgment of the Tax Court of the United States should be affirmed.

Respectfully submitted,

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