MORTGAGING OUT AND RELATED PROBLEMS
RALPH R. NEUHOFF†

Under favorable conditions it is sometimes possible for a builder of property to mortgage it when completed for a sum measurably in excess of his cost, so that even before he sells the property or commences to operate it, he has, economically speaking, a profit in cash and in hand.

It is the purpose of this article to analyze the federal income tax law applicable to such situations. The interplay between the philosophy that increase of wealth should, in general, be subject to income taxation and the doctrine that there must be an outward event before an increase in economic wealth becomes taxable, has placed a burden upon the courts which they may not have handled too well. Furthermore, Congress has singled out several situations for special discriminatory treatment, probably in order to prevent a taxpayer from following through on the advantage gained by mortgaging out. Since the legislation applicable to these special situations is not necessarily called for by the logic of the situation, it is advisable for a taxpayer operating in this general area to be informed of it.

I. HOW THE SITUATION MAY ARISE

Let us take a simple example:

A building contractor buys land for $15,000
He erects a building thereon at a cost of $85,000

Total $100,000

Let us suppose that by reason of his technical ability and industry the builder was able to dispense with the services of an architect, a surveyor and a general superintendent of construction, having performed all of these functions himself, with the result that, aided possibly by a strongly rising market for this type of property, the structure when completed is worth $130,000.

Let us suppose also that sooner or later he finds it possible to place a mortgage upon the property for $115,000, and that the builder, either by using a straw party, or in some other manner,¹ is not personally liable upon the mortgage.

† Partner, Neuhoff & Schaefer, St. Louis, Missouri.

¹ If the builder uses a separate corporation to carry out the transaction and the corporation is able to "mortgage out," as we use that term, in other words, to defray the entire cost of the project out of the proceeds of the loan and still have funds remaining, it may be necessary to get the funds out of the corporation.
In this example:
The amount of the encumbrance is $115,000
The basis (disregarding depreciation deductions) is 100,000
Difference $15,000

For want of a better term we characterize this type of transaction as "mortgaging out." Some learned authors have called this difference "negative basis." It may be questioned whether this is a proper term because actually the "basis," as that term is used in the Internal Revenue Code, is positive and is equivalent to the cost in our example, unless it has become necessary to subtract depreciation allowed or allowable. Indeed, it is an axiom of income tax law that a basis of less than zero is not permitted, so there never could be a negative basis in that sense.

Let us say that the property is foreclosed. The results would be as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreclosure sale price (market value)</td>
<td>$130,000</td>
</tr>
<tr>
<td>Basis</td>
<td>100,000</td>
</tr>
<tr>
<td>Difference</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

and into the hands of the owner-stockholder before he gains any advantage. Such would be the case where the corporation would be vulnerable on a claim for the deficiency. The various expedients utilized by the stockholder-owner to possess himself of the funds may themselves incur a tax liability. As we shall see under Section V, "Related Problems," infra, Congress has singled out some of these transactions for special treatment. The question of the stockholder-owner's liability to report income because he has possessed himself of the funds referred to is distinct from the question of the liability on the corporation itself for having mortgaged out.

2. Schlesinger, Disposition of Property Having a Negative Basis, N.Y.U. 15th Inst. on Fed. Tax 339, 340 (1957), stated:

Although such liberal lending seems to have disappeared in today's money market, during recent years it has been possible for a builder to finance his entire construction cost out of mortgage proceeds. In this procedure, commonly called 'mortgaging out,' the mortgagee has depended principally on (a) the credit standing of the prospective tenant, and (b) the certainty that there will be rental income for payment of the mortgage loan. The proposed construction cost of the building and its intrinsic value for the purposes of resale, have been secondary considerations.


5. In Beulah B. Crane, 3 T.C. 585, 591 (1944), aff'd, 331 U.S. 1 (1947), the Tax Court held that basis could not be adjusted to a minus quantity. See also, Jack L. Easson, 33 T.C. 963 (1960); Rev. Rul. 54—421, 1954—2 Cum. Bull. 162; Surrey & Warren, Cases on Federal Income Taxation 645 (1960 ed.). In various sections the Code takes care to prevent a basis from falling below zero, e.g., Int. Rev. Code of 1954, §§ 1021, 733, 387(e).
The income tax law requires this difference to be taxed as income to the building contractor or his corporation even though by reason of the foreclosure sale the titleholder is being deprived of his property. There is nothing improper about calling this a gain of $30,000, nor is there anything improper about requiring the contractor to pay income tax on this gain, for he will have received it in two increments as follows:

1. On mortgaging out $15,000
2. On foreclosure an additional $15,000

Total amount received $30,000

Take a different example, keeping the same cost of $100,000. Assume that the market value is only $105,000 but that, as before, the mortgage placed on the property is $115,000. The equity will then be as follows:

<table>
<thead>
<tr>
<th>Mortgage</th>
<th>$115,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value</td>
<td>$105,000</td>
</tr>
<tr>
<td>Equity</td>
<td>minus $10,000</td>
</tr>
</tbody>
</table>

The amount of this equity is negative. It means that the value of the property is less than the mortgage. It is an economic term and is correctly used.

Again let us suppose the property is foreclosed for its market value and that the purchaser is not the mortgagee.

From the mortgagor's standpoint, the transaction is as follows:

| Proceeds of foreclosure sale | $105,000 |
| Deduct basis to mortgagor    | $100,000 |
| Taxable gain to mortgagor    | $ 5,000   |

From the mortgagee's standpoint, the transaction is as follows:

| Amount of mortgage | $115,000 |
| Deduct proceeds of foreclosure sale | $105,000 |
| Deficiency—bad debt | $ 10,000 |


7. Disregarding expense of sale, the $130,000 proceeds of the foreclosure sale will be applied first to the payment of the mortgage of $15,000 and the balance of $115,000 will be paid to the mortgagor.

8. See generally Treas. Reg. § 1.166-6 (1959), which indicates that where a mortgagee does purchase at a foreclosure sale, contrary to the supposition in our example, this might have two consequences, namely, a bad debt loss of the difference between the sale price and the amount of the debt, and loss or gain measured by the difference between the amount of the obligations of the debtor which are applied to the purchase price and the fair market value of the property.
Let us imagine two situations, one in which the mortgagor is personally liable for the deficiency and the other in which he is not.9

1. Mortgagor Personally Liable

Excess cash—proceeds of mortgage $15,000
Less deficiency paid therefrom 10,000
Leaves free cash of $ 5,000

This is consistent because the property cost the builder $100,000 and it was sold under the mortgage for $105,000, resulting in a gain of $5,000.

2. Mortgagor Not Personally Liable

Amount of mortgage $115,000
Proceeds of foreclosure sale applied 105,000
Deficiency $ 10,000

The deficiency of $10,000 is, of course, a loss to the mortgagee and it is matched by tax free income in the hands of the mortgagor, as is evident from the following:

Proceeds of the loan were $115,000
Less cost 100,000
Excess cash in hands of mortgagor $ 15,000

The sale was for $105,000
Deduct basis 100,000
Taxable gain to mortgagor $ 5,000

By hypothesis, mortgagor has received funds at the time of mortgaging of $ 15,000
He was taxed on a gain of 5,000

Difference—tax free income $ 10,000

Speaking more generally, if property costs $100,000 and increases in value to $130,000 and is mortgaged for something less than $130,000, so that there is an adequate margin between the market value and the

9. In the ordinary case where the mortgage contains a covenant or promise to pay the debt, or the debt is evidenced by a separate written obligation, there is personal liability on the mortgagor for the whole amount of the debt and he may be compelled to make good any deficiency. 59 C.J.S. Mortgages § 774 (1949). But if the mortgage or note contains a stipulation that the mortgagee shall look only to the mortgaged premises for the amount of his debt, or that no general execution shall issue on foreclosure, there is no personal liability for the deficiency. Ibid. This is, of course, different from the question whether the court may order payment of any deficiency in connection with the foreclosure suit. Under some statutes, a deficiency judgment may not be entered in a foreclosure suit and the mortgagee is relegated to an action at law for the deficiency. Id. § 777.
amount of the mortgage, there will be no incentive to the owner to let the property go for the mortgage even though he would have a clear profit over cost by simply taking the mortgage money and forgetting about the property.

On the other hand, if property costs $100,000 and does not increase in value and is mortgaged, nevertheless, for anything over $100,000, say for $115,000, there will, in many instances, be a strong incentive to the owner to forget about the property and decamp with the mortgage money intact. This is what is really meant by mortgaging out. Also in this situation there would be a strong tendency to regard the excess of the mortgage money over the cost as a gain. It has been referred to as a windfall. It may result in a corresponding loss to the mortgagee as in the example given above. In this view, the property has been sold to the mortgagee. But observe that the difference is a gain or windfall only if the mortgage is not paid off when it falls due. If the mortgage is paid off when due, the amount of the mortgage compared with the cost is irrelevant—it cannot result in economic gain. Considering the transaction as a whole, it might as well have been anything.

Put another way—mortgaging out is against public policy only if it results in a windfall, that is, if the mortgagor has a profit by simply expending money to build and by finding a mortgagee willing to reimburse him for the cost of the building plus a differential, without having created any value by his effort. This can only happen if the mortgage is not repaid.

Normally a mortgagee wants the money back when the loan falls due and not the possession of the property. The reason for demanding that there be an equity at the time of the loan is that this represents the stake of the mortgagor, or the guarantee of good faith, or the margin of safety of the mortgagee.

Where there is no equity there is no guarantee of good faith and where there is a negative equity there is an incentive for bad faith. It may be that the mortgagee is misled as to the amount of sound value represented by a project. A lender may well assume that if the design is right and the location is right, the fact that the money was spent to produce the building guarantees as a practical matter that the value is there. Obviously, one way of obtaining a loan in excess of cost would be to mislead the lender as to the actual cost—pad it, in other words.

Since the philosophy of the income tax law requires that income tax shall be levied only on transactions, it is necessary for tax liability, or possibly we should say tax accountability, that the transaction under consideration shall have ended. If, in the examples which we have given, the transaction under review is deemed to be started
when the builder purchases the land and erects a building thereon, it is necessary to fasten upon the end of the transaction. If a mortgage is placed upon the property and the mortgage is later repaid, the income tax law views this as a separate transaction irrelevant to the determination of gain or loss upon the construction of the building. However, as a matter of logic, it would be possible to make a separate class out of situations where there was either actually no intention of repaying a mortgage, or repayment was unlikely because it would be disadvantageous to the mortgagor. In such cases the beginning of the transaction could be deemed to be the purchase of the land and the erection of the building; and the ending of the transaction could be deemed to be the receipt from the mortgagee of the proceeds of the mortgage if the proceeds exceeded the mortgagor’s basis, and therefore, economically, he already had a profit which he could reasonably expect to keep.

This condition would be satisfied whenever the proceeds of the mortgage exceeded the basis and the mortgagor was under no compulsion to repay the mortgage.

II. EXAMPLES

The following examples are designed to show the consequences of excess or deficiency of market value with respect to the amount of mortgage which governs the equity and of excess or deficiency of market with respect to basis which governs the potential for gain or loss:¹⁰

<table>
<thead>
<tr>
<th>Case I</th>
<th>Cost of land and building (basis)</th>
<th>Market</th>
<th>Mortgage</th>
<th>Equity</th>
<th>Excess of market over basis</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Case II</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cost of land and building (basis)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Case III</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cost of land and building (basis)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

¹⁰ In the following examples:
a—Indicates mortgaging out.
b—Indicates a negative equity.
c—Indicates market is higher than basis.
### Case IV

<table>
<thead>
<tr>
<th>Cost of land and building (basis)</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market</td>
<td>100,000</td>
</tr>
<tr>
<td>a Mortgage</td>
<td>115,000</td>
</tr>
<tr>
<td>b Equity</td>
<td>15,000</td>
</tr>
<tr>
<td>Excess of market over basis</td>
<td>zero</td>
</tr>
</tbody>
</table>

### Case V

<table>
<thead>
<tr>
<th>Cost of land and building (basis)</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market</td>
<td>105,000</td>
</tr>
<tr>
<td>a Mortgage</td>
<td>115,000</td>
</tr>
<tr>
<td>b Equity</td>
<td>10,000</td>
</tr>
<tr>
<td>c Excess of market over basis</td>
<td>5,000</td>
</tr>
</tbody>
</table>

### Case VI

<table>
<thead>
<tr>
<th>Cost of land and building (basis)</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market</td>
<td>100,000</td>
</tr>
<tr>
<td>Mortgage</td>
<td>100,000</td>
</tr>
<tr>
<td>Equity</td>
<td>zero</td>
</tr>
<tr>
<td>Excess of market over basis</td>
<td>zero</td>
</tr>
</tbody>
</table>

### Case VII

<table>
<thead>
<tr>
<th>Cost of land and building (basis)</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market</td>
<td>95,000</td>
</tr>
<tr>
<td>a Mortgage</td>
<td>130,000</td>
</tr>
<tr>
<td>b Equity</td>
<td>35,000</td>
</tr>
<tr>
<td>Excess of market over basis</td>
<td>5,000</td>
</tr>
</tbody>
</table>

### Case VIII

<table>
<thead>
<tr>
<th>Cost of land and building (basis)</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market</td>
<td>95,000</td>
</tr>
<tr>
<td>Mortgage</td>
<td>95,000</td>
</tr>
<tr>
<td>Equity</td>
<td>zero</td>
</tr>
<tr>
<td>Excess of market over basis</td>
<td>5,000</td>
</tr>
</tbody>
</table>

### III. Definitions

*Mortgaging out* will be used to indicate any case where the amount of the mortgage on property at the time it is made is greater than the basis of the property given as security, regardless of whether the market value justifies the amount of the mortgage.

*Negative equity* indicates that market value is less than the amount of mortgage on the property at the time referred to.

*Basis less than market* indicates that the market value of the property given as security is greater than its basis. It might be called "potential for gain."

*Basis* means basis under the Internal Revenue Code which may initially be equivalent to cost.

### IV. Basic Principles

A. First Principle

Merely placing a mortgage on property, even though it is in excess of the cost of the property given as security, does not, without more,
result in taxable income.\textsuperscript{11} Case II above is an example, the propriety of which would not be questioned. Case IV would apparently be improper where the negative equity existed at the time that the mortgage was placed on the property, since the mortgagee obviously would not intend that such a situation should arise and one would suspect that he was induced to make the loan by misrepresentation of some sort.

The first principle applies even where there is no personal liability of the mortgagor.\textsuperscript{12} Where there is a positive equity such as in Case II above, there is no incentive for the owner to let the property go for the mortgage, even though he would have a clear profit over cost by simply taking the mortgage money and forgetting about the property. On the other hand, where there is no equity, as in Case IV, there will be, in many instances, a strong incentive to the owner to forget about the property. This is where mortgaging out probably got its bad name. Apparently the motive of the mortgagor is immaterial,\textsuperscript{13} and this is so even where the mortgagor intends to let the property go and, therefore, has, in his eyes, "sold" the property to the mortgagee.

As stated before, from practical considerations, an income tax should only be applied to an identifiable event. Normally, this implies that there has been a definite transaction which had a beginning and an ending. The courts apparently feel that the placing of the mortgage on the property is the \textit{beginning} of a transaction and not the ending of another transaction which began when the land was bought and property was built.\textsuperscript{14} The rule could have been otherwise, apparently, in examples such as Case IV above, at least to the extent of putting the burden on the buyer to show that he did not intend to let the property go upon foreclosure at the time he placed the mortgage on the property.

We do know, of course, that every transaction which definitely

\textsuperscript{11} Woodsam Associates, Inc. v. Commissioner, 198 F.2d 357 (2d Cir. 1952). See 1 Mertens, Law of Federal Income Taxation § 5.12 (Zimet, Stanley & Killcullen rev. 1956, Supp. 1960), which states: "The mortgaging of property for an amount in excess of its basis does not result in a realization of income even when the mortgagor is not personally liable to repay the loan."

\textsuperscript{12} Woodsam Associates, Inc. v. Commissioner, supra note 11; Schlesinger, supra note 6, at 341, citing Lurie, Mortgagor's Gain on Mortgaging Property for More Than Cost Without Personal Liability, 6 Tax L. Rev. 319 (1951).

\textsuperscript{13} I am unable to find direct authority for this statement, but the discussion in Woodsam Associates, Inc. v. Commissioner, supra note 12 is consistent.

\textsuperscript{14} Id. at 359. The court expressly declined to treat the borrowing as closing the transaction, stating that the taxpayer merely augmented existing mortgage indebtedness when she borrowed each time, and far from closing the venture, remained in a position to borrow more if and when circumstances permitted and she so desired, and accordingly, that she had never "disposed" of the property to create a taxable event.
increases one's wealth is not necessarily the occasion of an income tax. For example, *Knop v. United States*\textsuperscript{15} held that a mere advantageous purchase, without more, is not the occasion of an income tax. In the *Knop* case the taxpayer bought a one-half interest in certain land from her brother for $44,225 which was conceded to be worth $67,500 at the time of the conveyance. She gave a note in payment, which her brother had previously given her. The government claimed that this was a trade or exchange of the note for something worth $67,500 and since the basis of the note was considerably less, that she had a capital gain. The court held that the payment of the note was like the payment of cash and relied on the general principle that merely making an advantageous purchase is not the occasion of income from a taxable standpoint.

One should distinguish instances involving compensation for personal service. A strong case could be made for taxing the economic gain where a taxpayer was in the business of building such houses and the increase in market value was merely the result of his efforts, skill and know-how which, in a different context, would earn compensation, as, for example, when he performed the same services for someone else for hire.\textsuperscript{16} Observe that pay for services rendered to others is taxable when received even if received in property other than money, but if one creates value in property by working for himself, this is not income until sold or exchanged.

The doctrine applies to loans guaranteed under the National Housing Act Amendments of 1942.\textsuperscript{17} It also applies to mortgages insured by the Federal National Mortgage Association.\textsuperscript{18}

\textsuperscript{15} 234 F.2d 760 (8th Cir. 1956). See also Palmer v. Commissioner, 302 U.S. 63 (1937) and Fred Pellar, 25 T.C. 299 (1955), which held that taxpayers did not receive income by virtue of construction of a residence for them where the cost of construction and the fair value of the residence materially exceeded the agreed price paid to the contractor. Possibly the Tax Court could have rested its decision on the doctrine that a gift is not taxable income but instead it grounded its decision on the doctrine that purchase of property for less than its value does not of itself give rise to taxable income. See generally 1 Mertens, Law of Federal Income Taxation § 5.13 (Zimet, Stanley & Killen, reissued 1956, Supp. 1960).

\textsuperscript{16} Commissioner v. Gross, 236 F.2d 612 (2d Cir. 1956), affirming 23 T.C. 756 (1955). Here the Commissioner unsuccessfully contended that distributions by building corporations out of proceeds of a FHA building loan to stockholders who collaborated in the housing projects were in the nature of compensation for services, taxable as ordinary income. See also W. H. Weaver, 25 T.C. 1067, 1084 (1956); George M. Gross, 23 T.C. 756 (1955), to the same effect. Compare Arthur A. Lynch, 29 T.C. 1174 (1958). No case has been noted which holds that the mere act of mortgaging out in the particular instance was not compensation, but the failure of the court to find compensation in the situations involved in the cases cited above is significant.


B. Second Principle

A voluntary sale of property for a price in excess of basis will result in taxable income. An example would be Case I above if the property is sold for anything over basis. It would also apply in Case II above if it were sold for anything over basis. The mortgaging out which is present in Case II is irrelevant.

C. Third Principle

A foreclosure sale of property at a price in excess of basis plus expenses of sale results in taxable income. An example would be Case II if the bid is in excess of the basis. Here also mortgaging out is irrelevant.

D. Fourth Principle

Voluntary sale of the equity for something of value is deemed a sale for the mortgage plus the amount of the equity. This is so at least where the value of the property is not less than the amount of the mortgage. One of the leading cases on this is Crane v. Commissioner. Here the taxpayer was the sole beneficiary under the will of her husband. He owned at his death an apartment building subject to a mortgage. The property was appraised for federal estate tax purposes at a value exactly equal to the total amount of the encumbrance. Taxpayer, after her husband's death, entered into an agreement with the mortgagee whereby she was to continue operating the property, collect the rents, pay necessary expenses, reserve $200 monthly for taxes, and remit the net rentals to the mortgagee. This plan was followed for nearly seven years until, with the mortgagee threatening foreclosure, petitioner sold to a third party for $3,000 cash, subject to the mortgage, and paid $500 expenses of sale. The Commissioner determined a net taxable gain of $28,767.03 on the theory that the property acquired and sold was not the equity, but the physical property itself diminished by allowance depreciation of $28,045.10. Since the total amount of the mortgage was added to the $2,500 net cash receipts in order to determine the selling price, this calculation gave a gain of $24,031.45 on the building, and a

19. This is the ordinary sale at a profit governed by Int. Rev. Code of 1954, § 1002, and is included here merely as a predicate for the Third Principle.


capital loss of $528.85 on the land. The Supreme Court upheld the Commissioner's contentions.

A footnote in the Crane case states: "Obviously if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize the benefit equal to the mortgage." Accordingly, it has been argued that where there is a negative equity, as in Case IV, the sale of the equity may not necessarily be deemed within the Fourth Principle. It should be observed, however, that such a sale is dangerous and to be avoided where possible.

V. RELATED PROBLEMS

Where a taxpayer as an individual has mortgaged out and is in possession of funds upon which an income tax has not been paid, he cannot merely allow the property to be foreclosed if, as will normally be the case in such a situation, the foreclosure price will be in excess of the basis and will, under the Third Principle mentioned above, result in a closed transaction which may reflect income. We have also seen under the Fourth Principle that he cannot make a voluntary conveyance and part with the property prior to foreclosure in that manner because this also will reflect income. He might consider placing the property in a corporation of which he would own all of the stock.

If this could be done successfully, he would have no income as a result of the transfer to the corporation and the corporation could conceivably be formed with no other assets so that even though it was in receipt of taxable gain as a result of the subsequent foreclosure, it would have no assets with which to respond to the income tax imposed on that gain.

Again the building contractor may have used the corporation which does the mortgaging out, and in this event he would like to have the corporation make a distribution of the excess cash resulting from mortgaging out prior to the foreclosure so that when the foreclosure took place, the corporation would be an empty shell and unable to pay the income tax levied on the constructive gain.

Here the builder would not expect to receive the proceeds entirely tax free, but according to the Internal Revenue Code, he would presumably apply the proceeds first against the basis for the stock of the corporation in his hands and the remainder would be taxed at capital gains rates. This would be a much lighter burden than

22. Crane v. Commissioner, 331 U.S. 1, 14 n.37 (1946).
23. Lurie, supra note 3, at 71, 86.
accepting the proceeds of the mortgaging out as ordinary income and, of course, would be better than having the corporation taxed on the gain resulting from the foreclosure sale under circumstances whereby the corporation might well be held to be holding such assets under such circumstances that the gain would be ordinary income to the corporation and not capital gain.

Congress has done some “loophole closing” in a rather effective manner so that it has become very difficult for the taxpayer who has mortgaged out, either with or without utilizing a corporation, to capture effectually the fruits of his achievement and not be deprived of them by subsequent events. We turn now to the special provisions of the Internal Revenue Code above referred to.

Section 357(c)

Although under section 357(a) of the Internal Revenue Code a taxpayer is permitted to receive stock of a corporation under section 351 in an exchange for stock or securities and even have liabilities assumed if the purpose is not a prohibited one, this is specifically rendered inapplicable by section 357(c) in those cases where the sum of the liabilities assumed plus the liabilities to which property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to the exchange. In such event the excess is considered a gain from sale or exchange of a capital asset or of property which is not a capital asset, as the case may be. But where the property transferred is subject to the allowance for depreciation, then by section 1239 (applicable to sale from an individual to a controlled corporation) the gain from such a transfer is deemed to be a gain from sale or exchange of property which is neither a capital asset nor property described in section 1231. Section 1231 property is property used in a trade or business and held for more than six months. The net result is to deprive the gain of capital asset treatment where the property transferred is subject to depreciation.

It will be seen that by reason of section 357(c) a taxpayer is not able to convey to a corporation in a tax free exchange, the property which has been mortgaged. If the taxpayer had been able to do so, as stated before, the corporation might have been substituted as the obligor, (assuming that the taxpayer was not personally liable on the mortgage) so that when the foreclosure sale took place, the profit thereby reflected would be income to a corporation which might have no other assets and, therefore, not be in any position to pay the income tax thereby incurred. The net result of section 357(c) is that the transfer itself brings down the house of cards and the taxpayer making the transfer to the corporation incurs a gain or loss by that very transfer.
Section 312(j)

Where a corporation mortgages out and the loan is guaranteed by the United States, a distribution by the corporation is ordinary income and not capital gains. Section 312(j) specifically so states. This applies regardless of the percentage of the loan guaranteed and it applies to guarantees of FHA loans. It also applies to guarantees of any other federal agency. It should be noted, however, that by section 312(j)(1)(B), the basis for this purpose only is not regarded as reduced by depreciation. This remedy may not go far enough. For example, it does not apply to loans not insured by the United States Government, but by others, although the public policy involved would seem to be the same. The dividends received credit under section 34 of the Internal Revenue Code does not apply. It has been suggested that under section 341, the distribution of proceeds of mortgaging out would be held to be made by a collapsible corporation.

It will be observed that section 312(j) is directed to a different kind of tax reduction device. Here the corporation does the mortgaging out and the problem is to have a distribution by the corporation to the stockholders which will not be subject to taxation as an ordinary dividend. The situation frequently arose under so-called "608" real estate construction projects. After the construction was completed, the builder would discover that his cost estimates were high and that the particular corporation had funds remaining out of the proceeds of the loan guaranteed by the FHA after defraying all

28. Mertens Code Commentary, op. cit. supra note 26, suggests that this is because it would doubtless be held that such a distribution was made by a "collapsible corporation" and that the amount so received would be taxable at ordinary income tax rates. This may not be self-evident. Observe that Int. Rev. Code of 1954, § 341(a) (3), provides for treatment of certain distributions made by a collapsible corporation as gain from the sale or exchange of property which is not a capital asset. This eliminates the dividends received credit as to these distributions. A distribution referred to is one which under § 301(c) (3) (A) is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from a sale or exchange of property. Section 301(c) (3) (A) provides in general that the portion of a distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from sale or exchange of property. Accordingly, the question reverts back to the inquiry whether the distribution is from a collapsible corporation. Ordinarily an apartment building, for example, would be "property" described in § 1231(b), which brings it within the purview of § 341(b) (3) (D) so that if it had been held for less than three years it would (if the other requirements of § 341 are met) be a collapsible corporation. If the foregoing is correct, the classification as a collapsible corporation might be avoided by delaying the distribution out of the proceeds of mortgaging out until three years from the completion of the project.
of the costs of the project. Inasmuch as mortgaging out did not result in income on its books, the corporation might have no earned surplus and yet it would have funds which it could pay out to its stockholders. This was the situation in *Commissioner v. Gross.*

The Court of Appeals of the Second Circuit held in 1956 that certain pro rata cash distributions by the building corporations to the common stockholders in 1948 and 1949 were to be applied first against basis, and only the excess was to be taxable as long-term capital gain.

Inasmuch as under the Internal Revenue Code, a distribution can be taxed as a dividend to the stockholders only if the corporation possesses earnings and profits, section 312(j) creates earnings and profits even though the corporation has not realized any gain. Immediately prior to the distribution, earnings and profits are considered to be increased by the amount of the excess mortgage funds, and immediately after the distribution, earnings and profits so credited are reduced by the amount of the distribution.

It will be seen that this section places a substantial obstacle in the way of the builder since he must either allow the windfall profits arising out of mortgaging out to remain in the corporation, or must accept them as an ordinary dividend, neither of which is very palatable.

Even without section 312(j), it might well be with respect to 1950 or later years, that the provisions of the Internal Revenue Code with respect to collapsible corporations would tax the amount of the excess of the distribution over the stockholders' basis, as if it were a dividend.

Section 311(c)

The corporation which has succeeded in obtaining a windfall by mortgaging out might contemplate distributing all of the property to the stockholders. However, if it does so, under section 311(c), a gain will be recognized to the distributing corporation in an amount equal to the excess by which the liability on the property exceeds the adjusted basis of such property. There is a proviso that in the case of a distribution of property subject to a liability which is not assumed by the shareholder, the amount of gain to be recognized under the preceding provision shall not exceed the excess, if any, of the fair market value of such property over its basis. This is one more instance of singling out mortgaging out situations and placing a burden upon the taxpayer on account of a mortgaging out situation. It will be observed here that the general rule of section 311 is that no gain or loss shall be recognized to the corporation on the distribution

29. Note 16 supra.
with respect to its stock or property. This is, of course, a different question from recognizing gain or loss to the stockholders.

**CONCLUSION**

From the foregoing it will appear that: (1) Mortgaging out without more does not result in taxable income. (2) However, if one mortgages out property and then places it in a corporation, he is not permitted to do this tax free even though he obtains eighty percent or more of the stock. (3) A voluntary sale of property for a price in excess of cost or basis will result in income and in this connection the selling price of mortgaged property where the mortgage remains on the property is the sum of the mortgage plus the amount paid for the equity. (4) The same thing happens at a foreclosure sale, that is, the selling price or amount bid for the property is compared with the basis and if it is higher than the basis, it may result in taxable income to the owner, who at that time is losing his property.

**Suggested Precautions**

When one has mortgaged out, he may feel tempted to let the property go under a foreclosure sale. Before doing this, however, the situation should be carefully analyzed to find out whether the Crane situation is presented. This is for the reason that if the price bid at the foreclosure sale, either by mortgagee or anyone else, is in excess of the basis of the property in the hands of the mortgagor, the difference, under the Crane doctrine, will be reportable as income. It is true that in the Crane case, there was a voluntary conveyance rather than a foreclosure sale. However, the reason that the taxpayer was held to have received income was that there had been a disposition and we have already seen above that a foreclosure sale is also a disposition. It should be particularly noted that the basis must be reduced by the amount of depreciation allowed or allowable. This could be a very considerable sum and frequently it is found that the basis so reduced by depreciation is less than the market value of the property even though the market value of the property is less than the amount of the mortgage.

If the taxpayer does not want to permit the property to be foreclosed while he owns it, and is afraid to arrange a sale of it for any valuable consideration, he may conclude that the only thing to do is to abandon the property.

It may prove difficult to abandon the property, and, more important, it is not clear that abandonment will serve to avoid the impact of the Third Principle.31

It has been suggested32 that a mortgagor who is not personally obligated for the debt might give the property away and retain the mortgage profits free of income tax liability and that this is the only
means for making a disposition of the property without subjecting excess mortgage money to taxation. The author cited points out that although the donor of what he calls negative basis property may avoid taxation of a mortgage profit, his successor in title to the property may face liability if he makes a taxable conveyance, and that the owner may make a gift to a tax-exempt organization instead. Even here the author cited cautions the reader that the donee organization should not be one dealing in real estate lest it be deemed to have "unrelated business income" as defined by section 512 of the Internal Revenue Code.

31. 3 RIA 1960 ¶ M-3202 states that: "[T]he First Circuit indicated in the Parker case . . . that the same rule would be applied even if the property had been abandoned. . . ." However, the opinion of the court refers to an abandonment to the banks in the particular case, and it is not clear whether an abandonment, generally speaking, is to be deemed equivalent to a "disposition" resulting in a gain or loss.

32. Schlesinger, supra note 6, at 342.

33. Id. at 349.