FEDERAL INCOME TAX PROBLEMS OF MORTGAGORS AND MORTGAGEES

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"Sometimes a hair divides the false and true."

Omar Khayyám.

WE are beginning to harvest a crop of tax problems which have their origin in the many foreclosure proceedings instituted at the depth of the Depression. We have discovered that foreclosure proceedings, and indeed, even voluntary conveyances in lieu of foreclosures, pose many awkward problems for both mortgagors and mortgagees. May the mortgagee upon bidding in the mortgaged property realize interest income if his bid is large enough to include not only the principal of the debt, but all or a part of the accrued, but unpaid interest? On the other hand, if the bid is less than the mortgage debt, does the mortgagee sustain a loss deductible for tax purposes? And, if the mortgagee has taken such a loss, should it be treated as an ordinary loss, a bad debt, or a capital loss? These questions are vitally important; moreover, they tie into the cost basis to be used by the mortgagee upon any later disposition of the property by him, and thus may determine whether he has gain or loss upon such subsequent disposition. The mortgagor¹ also has his problems. When and to what extent does he have a deductible loss on account of the worthlessness or disposition of his equity in the mortgaged property? And is his loss an ordinary or a capital loss? Finally, surprising as the result may appear to the layman, there may be a question whether foreclosure has brought a capital gain to both mortgagor and mortgagee.

This Article presents a study of the problems which face the mortgagor and mortgagee today under the Federal Income Tax.

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1. It is assumed that the property of mortgagors is business property or property acquired with a profit motive. See Lloyd Jones, 39 B. T. A., Mar. 7, 1939. This is not essential with respect to the debts of mortgagees.

I. *Interest Income Upon Foreclosure Sales*

Several lower federal courts have held that a mortgagee is in receipt of taxable income when his bid price at a foreclosure sale includes the interest due on the principal of the mortgage.² In *Helvering v. Midland Mutual Life Insurance Company*,³ the Supreme Court sustained the Commissioner of Internal Revenue in an assertion that a mortgagee was in receipt of taxable interest when it bid at the foreclosure sale the principal of the mortgage debt *plus accrued interest*, applying the amount of the debt and the interest due to the payment of the bid, and that it was immaterial that the value of the properties foreclosed was less than the principal of the mortgage debt. The bid of the mortgagee was regarded as being the equivalent of a bid by an outsider, and, under familiar principles of constructive receipt, the Court held that the taxpayer had in effect received payment in full of the mortgage debt, plus interest, and had applied the cash so constructively received to the purchase of the property at the foreclosure sale. In reply to the taxpayer's argument that the Commissioner's interpretation was in conflict with the realities of the situation, and that the taxpayer had received nothing but the property, which was in fact worth less than the principal of the mortgage debt, the Court said, "The 'reality' of the deal here involved would seem to be that respondent valued the protection of the higher redemption price as worth the discharge of the interest debt for which it might have obtained a judgment."⁴

This decision has been forcefully criticised on two grounds:⁵ that the protection of the higher redemption price was a shadowy right in view of the infrequency of redemptions by mortgagors; and that even assuming that the possibility of recoupment is of some value, it is nothing more than a right to recoup a loss, which should not be taxed as income.

2. See *National Life Ins. Co. v. United States*, 78 Ct. Cl. 369, 4 F. Supp. 1000 (1933); *Helvering v. Missouri State Life Ins. Co.*, 78 F. (2d) 778 (C. C. A. 8th, 1934); *Prudential Ins. Co. of America*, 33 B. T. A. 332 (1935); *American Central Life Ins. Co.*, 30 B. T. A. 1182 (1934); *Ewen MacLennan*, 20 B. T. A. 900 (1930); *Midland Mutual Life Ins. Co.*, 19 B. T. A. 765 (1930); *Reserve Loan Life Ins. Co.*, 18 B. T. A. 359 (1929); *Manomet Cranberry Co.*, 1 B. T. A. 706 (1925).

3. 300 U. S. 216 (1937). For comments upon this decision, see Ramsey, *Mortgage Foreclosures and Income Taxes* (1937) 15 TAX MAG. 579; (1937) 50 HARV. L. REV. 988. Mr. Justice McReynolds vigorously dissented on the ground that, "The notion that Congress intended to tax the mere hope of recouping a loss sometime in the future should be definitely rejected . . . Divorced from reality taxation becomes sheer oppression." *Helvering v. Midland Mutual Life Ins. Co.*, 300 U. S. 216, 227 (1937).

4. *Helvering v. Midland Mutual Life Ins. Co.*, 300 U. S. 216, 224-5 (1937).

5. Heineman, *Income Tax Problems in Mortgage Foreclosures* (1937) 32 ILL. L. REV. 189. Mr. Heineman also suggests that if a foreclosure bid is to be regarded as having the incidents of a bid by a third person, it may follow under some trust deeds and deposit agreements that interest may be discharged, leaving principal unsatisfied, in cases in which there is a bid in partial satisfaction of notes and accrued interest.

Mr. Justice Brandeis, speaking for the Court, said further that income "may be realized upon a change in the nature of legal rights held, though the particular taxpayer has enjoyed no addition to his economic worth."⁶ The statement is true enough as a general principle, but it misses the point of the question whether the taxpayer in the *Midland Mutual* case received taxable income. That question is determined by the character of what is actually or constructively received, not by any comparison of economic worth on two different dates. Mr. Justice Brandeis apparently intended merely to emphasize the importance of "legal effect," as distinguished from the "realities" urged by the taxpayer as governing the situation.

It should not be assumed from the *Midland Mutual* case that the mortgagee receives taxable interest income where there is a *voluntary surrender* of the mortgaged premises without any foreclosure proceedings. There is then an exchange of the debt for the land.⁷ Where the property so surrendered has a value at the time of acquisition by the mortgagee not in excess of the principal amount of the loan, the due and unpaid interest is not taxable income to the mortgagee.⁸

It is a poor argument that cannot be used by both sides: the corollary of the rule of the *Midland Mutual* decision is that the mortgagor in the situation involved becomes entitled to a deduction of interest constructively paid by him. The Board of Tax Appeals has so held.⁹ The mortgagee, of course, has control of the bid price, and the lesson of the *Midland Mutual* case is available to those who have not already made their bids.¹⁰ In the future mortgagees will avoid making bids automatically, for purposes of bookkeeping convenience, at a figure which includes accrued interest.

II. *Distinction Between Position of Mortgagor and Mortgagee*

The first necessity in a discussion of losses of mortgagors and mortgagees is to distinguish between the positions of the respective parties. Except to the extent that the capital gain and loss provision¹¹ may apply,

6. *Helvering v. Midland Mutual Life Ins. Co.*, 300 U. S. 216, 225 (1937).

7. See *infra* p. 1326.

8. See *Manhattan Mutual Life Ins. Co.*, 37 B. T. A. 1041 (1938), decided after the *Midland Mutual* case, and following *Helvering v. Missouri State Life Ins. Co.*, 78 F. (2d) 778 (C. C. A. 8th, 1934). See also *Prudential Life Ins. Co. of America*, 33 B. T. A. 332 (1935); *American Central Life Ins. Co.*, 30 B. T. A. 1182 (1934).

9. *Harold M. Blossom*, 38 B. T. A. 1136 (1938).

10. It has been contended that a taxpayer reporting on the accrual basis does not escape tax by excluding the interest debt from the bid price. Citation is made of *Spring City Foundry Co. v. Comm'r*, 292 U. S. 182 (1934). But it is doubtful, as noted by Miss Ramsey, whether this decision goes so far as to require the reporting of a technical accrual which will in all reasonable expectancy never be collected. Ramsey, *Mortgage Foreclosures and Income Taxes* (1937) 15 TAX MAG. 579.

11. 52 STAT. 500, 26 U. S. C. § 101 (Supp. 1938).

if the mortgagee reacquires the property, any deduction allowable to a mortgagee is a deduction under the *worthless debt provision of the Revenue Act*.¹² The mortgagor, on the other hand, is the owner of *property*, as distinguished from a *debt secured by the property*. He must, therefore, seek elsewhere in the Statute for his deduction. His deduction, if any, is dependent upon the provision¹³ allowing for the deduction of losses in transactions in trade or business, or entered into for profit,¹⁴ and the further so-called capital gain and loss provision. Worthless debts were formerly deductible in their entirety, whereas the deductibility of capital losses was severely limited.¹⁵ Worthless debts are still deductible in full unless the debt is represented by corporate bonds, debentures, notes, or evidences of indebtedness with interest coupons or in registered form.¹⁶ The relationship of the bad debt, the ordinary loss and capital loss provisions is, therefore, of the essence of the problems under discussion. The attempt of mortgagees will usually be to take advantage of the bad debt provision and to avoid the limitations of the capital loss provision; but this is not invariably true, for a taxpayer with slim proof of a proper charge-off may be driven to the protection of the capital loss provision premised upon a sale or exchange of property.¹⁷

III. *When Is the Loss of the Mortgagor Deductible?*

It is axiomatic that losses, to be deductible for tax purposes, must be actually sustained. This requirement is often expressed in a different way by the statement that there is no deductible loss until there is a closed or completed transaction. Mere loss or diminution in value is not enough to constitute a closed transaction. There must ordinarily be a sale or other disposition of title to the property. But the definition of a closed transaction is not such a simple matter when the question arises in concrete cases. There may under some circumstances be a closed transaction without any sale whenever identifiable events have occurred which would definitely satisfy a reasonable man, as distinguished from a taxpayer with the incorrigible hopefulness of a Mr. Micawber, that his investment is wholly worthless.¹⁸ The latest Treasury Regulations phrase this principle as follows:¹⁹ ". . . losses for which an amount

12. 52 STAT. 462, 26 U. S. C. § 23 (k) (Supp. 1938). See *Brown v. United States*, 95 F. (2d) 487 (C. C. A. 3d, 1938).

13. 52 STAT. 461, 26 U. S. C. § 23(e), (f) (Supp. 1938).

14. This distinction is brought out sharply in the case of *Macdonald Engineering Co.*, 35 B. T. A. 3, 9 (1936); cf. *Harry Payne Bingham*, 38 B. T. A. 913 (1938); (1939) 48 YALE L. J. 1289.

15. 52 STAT. 500, 26 U. S. C. § 101 (Supp. 1938) and previous Acts.

16. 52 STAT. 462, 26 U. S. C. § 23(k) (Supp. 1938).

17. *Hale v. Helvering*, 85 F. (2d) 819 (App. D. C. 1936).

18. See *United States v. White Dental Co.*, 274 U. S. 398 (1927).

19. U. S. Treas. Reg. 101, Art. 23(e)-1.

may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained during the taxable period for which allowed. *Substance and not mere form will govern in determining deductible losses.*"²⁰ (Italics supplied.)

An honest-minded Treasury should not object to an inquiry as to how such a sententious maxim is applied in practice. A problem quite analogous to that of the mortgagor arose in the early and now leading *Schwarzler* case.²¹ The taxpayer tried in 1919 to abandon certain New York City lots. There was no foreclosure, but in 1917 there had been a City tax lien which was later cancelled. In 1919 there were accumulated liens for taxes, assessments and interest amounting to \$19,106.13, which were in excess of the value of the lots. The Board of Tax Appeals did its duty to vacant legal principles by sustaining the Commissioner in denying a loss deduction for 1919 on the ground that, under real property law, title to real property cannot be abandoned.²² After a merciful variation in a later case,²³ a technically minded Board soon returned in the *Greenleaf Textile* case²⁴ to the pathway of the *Schwarzler* rule. Here again there was no foreclosure—there was merely an attempted abandonment of Florida real estate. The Board held that the retention of title throughout the tax period by a taxpayer prevented the closing of the transaction, which was essential to the deduction of loss.²⁵ The Board still clings to this artificial doctrine.²⁶

So much for the rule as to the time losses should be taken in cases where the technical step of foreclosure is missing. In cases where there has been a foreclosure proceeding, the Treasury, in a series of General Counsel's Memoranda,²⁷ stated at first that the loss of the mortgagor was deductible in the year of the foreclosure sale, and was not to be postponed until the year in which the period of redemption expired.

20. This bromide is constantly obstructing clear thinking in tax cases. See PAUL, STUDIES IN FEDERAL TAXATION (1937) 88; PAUL, SELECTED STUDIES IN FEDERAL TAXATION, SECOND SERIES (1938) 200.

21. A. J. Schwarzler Co., 3 B. T. A. 535 (1926).

22. The Board stated the alternative ground that any deduction to which the taxpayer might have been entitled would be a deduction for 1917 when there was a sale for taxes.

23. C. U. Connellee, 4 B. T. A. 359 (1926).

24. 26 B. T. A. 737 (1932), *aff'd*, 65 F. (2d) 1017 (C. C. A. 2d, 1933).

25. The Board mentioned *Denman v. Brumback*, 58 F. (2d) 128 (C. C. A. 6th, 1932), but did not attempt to distinguish the case.

26. T. J. Bosquett, 39 B. T. A., Apr. 14, 1939; *Collateral Mortgage and Investment Co.*, 37 B. T. A. 630 (1938); see also *Consolidated Brick Co.*, 17 B. T. A. 831 (1929); *Coalinga-Mohawk Oil Co.*, 25 B. T. A. 261 (1932), *aff'd*, 64 F. (2d) 262 (C. C. A. 9th, 1933), *cert. denied*, 290 U. S. 637 (1933).

27. XIII-1 CUM. BULL. 120 (1934) (California); XIII-1 CUM. BULL. 123 (1934) (Illinois); XIII-2 CUM. BULL. 194 (1934) (Kansas).

But this sensible position did not survive the test of Board approval in the *J. C. Hawkins* case.²⁸ There the Board, disregarding distinctions of degree of title divestment upon tax sales,²⁹ held that there could be no closed transaction giving a deductible loss to the mortgagor until the expiration of his period of redemption. The Treasury accepted this legalistic conclusion,³⁰ and its determined position is now the one stated by the Board in the *Hawkins* case.³¹ The same principle has even been applied in determining the year of deductibility for worthless stock held by a *shareholder* in a *corporate* mortgagor.³² As a wooden rule of thumb, its application in such a case would seem clearly indefensible.

Against the trend of the earlier decisions stands the case of *Denman v. Brumback*.³³ There a taxpayer, who had charged off on his books land which had become worthless, was permitted to deduct his loss in 1922, even though legal title to the land, pursuant to tax sale, was not transferred until the following year. The case was distinguished on the theory that the bond issue authorization and special tax assessment making the land worthless were identifiable events not appearing in the other cases. But this distinction can hardly survive the recent decision of *Rhodes v. Commissioner*,³⁴ in which the same court turned the "searchlight of reason" on the principle that a loss on real estate is not deductible so long as the taxpayer retains title. In that case, certain Florida real estate, acquired in 1925, was damaged in September, 1926 and again in September,

28. 34 B. T. A. 918 (1936), *aff'd per curiam*, 91 F. (2d) 354 (C. C. A. 5th, 1937); see also *Derby Realty Corp.*, 35 B. T. A. 335 (1937), involving a Michigan foreclosure. Cf. *W. Z. Morton*, 38 B. T. A. 534 (1938); there the right of redemption was not clear and absolute.

29. See *Frederick Krauss*, 30 B. T. A. 62 (1934).

30. 1937-2 CUM. BULL. 115 (1937), revoking the General Counsel's Memoranda, *supra* note 27.

31. It is not easy to reconcile with this line of authority the case of *Tompkins v. Comm'r*, 97 F. (2d) 396 (C. C. A. 4th, 1938), involving the purchase of real estate by a joint adventure subject to a trust deed securing notes on the realty. The joint adventure consisted of a partnership and a corporation; there was a default by the corporation adventurer, at which time the non-defaulting adventurer, the partnership, purchased the real estate at the foreclosure sale to prevent greater loss. The partnership was held entitled to a deduction; the usual situation described in the *Hawkins* case—that of a mortgagor who permits the sale of mortgaged property, buying it in on the foreclosure sale and then attempting to take a deduction upon the sale—was held to be different, in that it involved continuation of the old status of the holder of the property. The case where the old status is closed "by an identifiable event having no relation to tax avoidance" and an entirely new relationship is commenced by the purchase of the property in a new and distinct undertaking with reference to which future gain or loss should be reckoned was found to be dissimilar.

32. *Alexander A. Altschuler et ux.*, B. T. A. Memo Op. promulgated Aug. 27, 1938, appearing in 384 C. C. H. 1938 Fed. Tax Serv. ¶ 7632-C. But see *I. T. 3,255*, CUM. BULL. Feb. 27, 1939.

33. 58 F. (2d) 128 (C. C. A. 6th, 1932).

34. 100 F. (2d) 966 (C. C. A. 6th, 1939).

1927, by hurricanes. After the second hurricane the taxpayer decided that the property was worthless; he could find no purchaser for it, and he refused to make further payments under his purchase contract. There was no foreclosure of the first and second mortgages on the property, which the taxpayer had assumed in 1925; and at that time he gave a third mortgage to secure the payment of purchase money notes. The sellers obtained judgment upon these notes, and the taxpayer paid the judgment. In 1928 he received an unsolicited cash offer of approximately \$1,000 (about 1/20th of his purchase price) which he accepted; he then assigned his purchase contract to the purchaser. The Board denied the deduction for 1927, holding that the loss occurred in 1928. The circuit court of appeals reversed, in an opinion which constantly emphasized the test of a "common sense" interpretation of the tax laws.³⁵ The court first referred to the battle-scarred principle that the income tax law is concerned only with "realized gains" and "ascertained losses,"³⁶ and then stated the exception applicable in cases of losses "which are so reasonably certain in fact and ascertainable in amount as to justify their deduction and in certain circumstances even before they are absolutely realized." After disposing of the Commissioner's argument based on the small recovery in 1928, the court discussed at length the Florida real estate situation in 1926 and 1927, and concluded that the 1926 hurricane, its recurrence in 1927, the collapse of Florida land speculation in the latter year, the petitioner's unsuccessful efforts to sell in 1926 and 1927, and his complete charge-off on his books in 1927 "were the identifiable events that established the loss in that year." The court refused to distinguish the loss on one of the properties involved where judgment against the taxpayer was obtained in 1927 on account of the purchase money notes, for the reason that the Board rested its decision largely on the rule that a loss on real estate is not deductible so long as the taxpayer retains title.

The *Rhodes* case seems to reflect the correct answer to this problem. The term "identifiable event" has been defined as "an incident or occurrence that points to or indicates a loss—an evidence of a loss."³⁷ A deduction should be permitted, and indeed should be required, where there is not merely a partial shrinkage of value of real estate,³⁸ but rather a complete elimination of all value attested by the convincing identifiable event of abandonment of the property by the owner in recognition of complete absence of any utility or worth in his property. Such a rule

35. The Board did not discuss the question at any length, merely citing some of the leading cases and relying particularly on *Frederick Krauss*, 30 B. T. A. 62 (1934).

36. See *Lucas v. American Code Co.*, 280 U. S. 445, 449 (1930).

37. See *Industrial Rayon Corp. v. Comm'r*, 94 F. (2d) 383, 384 (C. C. A. 6th, 1938).

38. See *De Loss v. Comm'r*, 28 F. (2d) 803 (C. C. A. 2d, 1928), *cert. denied*, 279 U. S. 840 (1929).

accords with the recognition by the Bureau of Internal Revenue itself that an abandonment of oil and gas rights, even with the retention of title, justifies the taking of loss at the time of abandonment if the property abandoned is actually worthless as a matter of objective fact.³⁹ Numerous court decisions are to the same effect.⁴⁰ In such cases the fact that the taxpayer's lease has not expired or been cancelled, or that he has not obtained the consent of the public authorities to make an abandonment, does not of itself preclude the deduction in the year of actual abandonment.⁴¹ These principles have been applied to property other than real property, and a loss allowed in the year in which there has been no technical disposition of the property.⁴² It is hornbook tax law that a deduction on account of worthless stock may not be postponed to a date subsequent to the year in which the stock becomes worthless.⁴³ As intimated in the *Rhodes* case, there has never been any sound legal basis for a distinction in treatment between real estate losses and losses on other types of property; identity of treatment is called for by every consideration of fairness and equity.⁴⁴ Moreover, the status of title to mortgaged property is a more complicated problem than the Board has seemed to realize. It is not unknown that a mortgagee should acquire technical title to the property under local property law either upon default on the mortgage or even upon the execution of the mortgage.⁴⁵ This point does not seem to have been brought to the Board's attention in any of the cases.

39. VII-1 CUM. BULL. 168 (1928).

40. See *Sam Cook*, 25 B. T. A. 92 (1932); *Belridge Oil Co.*, 11 B. T. A. 127 (1928); *A. H. Fell*, 7 B. T. A. 263 (1927); *B. G. Adams*, 5 B. T. A. 113 (1926); *A. L. Huey*, 4 B. T. A. 370 (1926); *Kilby Car & Foundry Co.*, 4 B. T. A. 1294 (1926); *Thomas Thorkildsen*, 2 B. T. A. 570 (1925); cf. *Ingle v. Gage*, 52 F. (2d) 738 (W. D. N. Y. 1931); *Ashland Iron & Mining Co. v. United States*, 74 Ct. Cl. 172, 56 F. (2d) 466 (1932). See also *In re Sentinel Oil Co.*, 27 F. Supp. 304 (1939).

41. *Minneapolis, St. P. & S. S. M. Ry. Co.*, 34 B. T. A. 177 (1936).

42. See *United States v. Hardy*, 6 F. Supp. 946 (S. D. W. Va. 1933), *aff'd*, 74 F. (2d) 841 (C. C. A. 4th, 1935); *Liberty Baking Co. v. Heiner*, 37 F. (2d) 703 (C. C. A. 3d, 1930); *Dean et al. v. Hoffheimer Bros. Co.*, 29 F. (2d) 668 (C. C. A. 6th, 1928); *Reuben H. Donnelley Corp.*, 26 B. T. A. 107 (1932); *Automatic Transportation Co.*, 3 B. T. A. 505 (1926); *Appeal of Dilling Cotton Mills*, 2 B. T. A. 127 (1925). See also *Art Metal Construction Co. v. United States*, 84 Ct. Cl. 312, 17 F. Supp. 854 (1937).

43. See *Darling v. Comm'r*, 49 F. (2d) 111 (C. C. A. 4th, 1931), *cert. denied*, 283 U. S. 866 (1931); *Royal Packing Co. v. Comm'r*, 22 F. (2d) 536 (C. C. A. 9th, 1927); *John Crosby Brown*, 27 B. T. A. 176 (1932); *Remington Typewriter Co.*, 4 B. T. A. 880 (1926). See also *De Loss v. Comm'r*, 28 F. (2d) 803 (C. C. A. 2d, 1928), *cert. denied*, 279 U. S. 840 (1929). See also *Bair v. United States*, 20 F. Supp. 191 (E. D. Pa. 1937); *Charles Heiss*, 36 B. T. A. 833 (1937); *Walter W. Moyer*, 35 B. T. A. 1155 (1937); *Gilbert H. Pearsall*, 10 B. T. A. 467 (1928); *Isidor Sack et al.*, B. T. A. Memo. Op. promulgated Oct. 5, 1938, appearing in 384 C. C. H. 1938 Fed. Tax Serv. ¶7659-C.

44. Administrative convenience may be aided by the arbitrary rule in force, but administrative necessities have survived the difficulties of valuation inherent in a practical test of the worthlessness of personal property.

45. 1 JONES, MORTGAGES (8th ed. 1928) §§ 18-68.

IV. *Is the Loss of the Mortgagor an Ordinary or a Capital Loss?*

The next question is whether the mortgagor sustains an ordinary or a capital loss. It is important because ordinary losses are deductible in full, whereas the deduction of capital losses is severely limited by the Statute. An ordinary loss may not require a sale or exchange, whereas "capital gains" or "capital losses" arise only from the *sale or exchange* of capital assets, as that term is defined in the Revenue Act of 1938.⁴⁶

Some time ago in a General Counsel's Memorandum,⁴⁷ it was ruled, without consideration of the question whether the mortgagor had any personal liability, that upon the loss of property by foreclosure the mortgagor sustains a capital loss. In a later ruling,⁴⁸ affecting the status of the creditor's loss, it was recognized that the compromise of a debt for a cash consideration because of the inability of the debtor to pay does not result in a capital loss, but rather an ordinary loss.⁴⁹ Notwithstanding this mortgagee ruling, the Treasury is apparently still sticking, without refinement, to the position that the loss of the mortgagor is a capital loss; but the Board, in a series of cases,⁵⁰ has partially overruled this position. In *Commonwealth, Inc.*, the owner of property subject to a mortgage deeded it to the mortgagee for a nominal consideration. There could be no release of liability under the mortgage, since the taxpayer had not assumed the mortgage liability, but had taken title subject thereto. The Board held that the execution of the deed "marked the close of a transaction whereby petitioner abandoned its title," and that the loss of the taxpayer was not a *capital*, but an *ordinary* loss.⁵¹ The Circuit Court of Appeals for the Third Circuit, in a group of cases each of which involved a foreclosure sale for a price less than the amount of the mortgage, leaving nothing for the taxpayer, has affirmed the Board in treating the loss involved as an ordinary loss. The court places its decision on three grounds:

(1) That the intention of Congress was not to include *involuntary* sales in Section 117;

(2) That the word "sale" in its usual signification means a voluntary sale for a consideration and not a sheriff's sale in which the

46. 52 STAT. 500 (1938), 26 U. S. C. A. § 101 (a) (1) (Supp. 1938).

47. XIII-1 CUM. BULL. 120 (1934).

48. I. T. 3121, 1937-2 CUM. BULL. 138 (1937); see also I. T. 3159, 1938-1 CUM. BULL. 188 (1938).

49. See *Hale v. Helvering*, 85 F. (2d) 819 (App. D. C. 1936).

50. *Commonwealth, Inc.*, 36 B. T. A. 850 (1937); *Sol Greisler*, 37 B. T. A. 542 (1938), *aff'd sub nom.*, *Comm'r v. Freihofer*, 102 F. (2d) 787 (C. C. A. 3d, 1939); *H. L. Rust, Jr. et al.*, 38 B. T. A. 910 (1938).

51. *Commonwealth, Inc.*, 36 B. T. A. 850 (1937). The same decision has been made when there was no voluntary conveyance of property, but a sale under foreclosure proceedings. *C. Griffith Warfield*, 38 B. T. A. 907 (1938).

owner of the property is not a party and receives no consideration; and

(3) That the mortgagor's properties had become wholly worthless at the time of foreclosure, so that the foreclosure sales had no reality as sales so far as the taxpayer's equities of redemption were concerned, it being impossible to *sell* what has wholly disappeared.⁵²

A distinction was made in another recent decision of the Board in the *Betty Rogers* case,⁵³ in which the taxpayer and his wife paid cash for property, assumed the note secured by a mortgage upon the property, and delivered their own note secured by a trust deed on the property. Citing the leading case of *United States v. Hendler*,⁵⁴ the Board held that the loss of the taxpayers was a capital loss *because the conveyance of the property to the mortgagee was accompanied by a surrender to the taxpayers of their note for \$38,000*. Thus the taxpayers "gave up all their right, title and interest in the real property for the equivalent of \$38,000 . . ." The transaction was likened to a transfer of the property to a third person for \$38,000 in cash, which was then used to satisfy the indebtedness. This would have been a sale, and the Board held that the situation was not changed where the property was transferred directly to the creditor in satisfaction of the indebtedness.⁵⁵ However, the Board

52. *Comm'r v. Freihofer*, 102 F. (2d) 787 (C. C. A. 3d, 1939). See also *Lloyd Jones*, 39 B. T. A., Mar. 7, 1939.

53. *Betty Rogers et al.*, 37 B. T. A. 897 (1938), *aff'd*, 103 F. (2d) (C. C. A. 9th, May 1939). And see *Harry Payne Bingham*, 38 B. T. A. 913, 920 (1938), to the effect that the rule applicable in the *Rogers* case as to the capital nature of the mortgagor's loss was equally applicable to the mortgagee's loss. For a case in which a solvent mortgagor was held in receipt of taxable income by reason of a reduction of the mortgage debt, see *L. D. Coddon & Bros., Inc.*, 37 B. T. A. 393 (1938). For a further distinction see *Isaac Philips*, B. T. A. Memo Op. promulgated March 30, 1939, appearing in 393 C. C. H. 1934 Fed. Tax Serv. ¶7254-A, in which the taxpayer acquired the property subject to a first mortgage when he bid in the property after foreclosing the second mortgage, and then conveyed the property to the first mortgagee, receiving as consideration a release from his liability for taxes on the property; the Board held that the transaction was a sale or exchange, making the loss subject to the capital loss limitation. For a further refinement of the *Rogers* doctrine, see *C. L. Grandsten & Co.*, 39 B. T. A. No. 144 (1939), holding a cash payment to the vendor as consideration for a release from liability deductible in full by the mortgagor as an ordinary loss. See also *Morris Polin*, 39 B. T. A. No. 139 (1939); and compare *Harold R. Smith*, 39 B. T. A. No. 127 (1939), applying the *Rogers* principle to the surrender by petitioner of his interest in certain land contracts to the vendor in cancellation of his debts under the contract.

54. 303 U. S. 564 (1938), and also citing *E. F. Simms*, 28 B. T. A. 988, 1030 (1933).

55. *Commonwealth, Inc.*, 36 B. T. A. 850 (1937) was distinguished on the ground that the taxpayer in that case received nothing in consideration of the transfer of the property to the mortgagee. The deed in *Betty Rogers et al.*, 37 B. T. A. 897 (1938) mentioned a consideration of \$10 and "in addition . . . full satisfaction of all obligations secured by the deed of trust (the \$38,000 note)." The deed also recited that the consideration received by the grantors is "equal to the fair value of the grantors' interest in said land." In *Harry Payne Bingham*, 38 B. T. A. 913 (1938), involving "substantially similar facts," a loss was claimed by the mortgagee.

is totally unsuccessful in distinguishing the *Hale* and *Dallas Transfer* cases, cited in the opinion; in both of these cases the settlement of a debt by partial payment was held to be an ordinary loss, and not a sale or exchange. Assuming that the land transferred to the mortgagee in the *Rogers* case did not have a value in excess of the mortgagor's liability, the mortgagee received nothing to which he was not already legally entitled, and it is difficult to see how anyone but a meticulously technical tax lawyer would regard the mortgagee as a *seller of the notes*. On the other hand, to treat the mortgagor as *selling the land* is inconsistent with numerous cases holding, for example, that gains from the redemption of bonds⁵⁶ or from an insurance annuity⁵⁷ are ordinary income. Nor can the *Rogers* type of transaction properly be an "exchange," since the mortgagor gets nothing of re-exchangeable value.

Even if the *Rogers* doctrine should be finally upheld, a large corner has been chipped off its compass by Section 117(a)(1) of the 1938 Act, which now allows a full loss upon the sale or exchange of depreciable property. Therefore, even if there is a sale by the mortgagor, he will now be entitled to an ordinary deduction with respect to the allocable amount representing buildings on the mortgaged property — assuming them to be business buildings, as in the *Rogers* case.

V. *When does the Mortgagee have a Closed Transaction?*

The Treasury takes the position that the mortgagee has a closed transaction in the year of foreclosure, resulting in gain or loss by reference to the market value at the date of foreclosure sale.⁵⁸ This conclusion has two questionable aspects. The reference to market value is of dubious legality,⁵⁹ and more basically, it is open to reasonable doubt whether there is a closed transaction at the time of foreclosure.

There are decisions recognizing that the mortgagee has a closed transaction at the time of foreclosure,⁶⁰ but it must be admitted that there is much to be said from the practical standpoint for the continuing transaction theory adopted by the district court in the *Hadley Falls* case.⁶¹

56. John H. Watson, Jr., 27 B. T. A. 463 (1932).

57. Frank J. Cobbs, 39 B. T. A., Mar. 22, 1939.

58. U. S. Treas. Reg. 101, Art. 23 (k)-3. See also I. T. 3121, 1937-2 CUM. BULL. 138 (1937); I. T. 3159, 1938-1 CUM. BULL. 188 (1938).

59. This question is discussed *infra* pp. 1329-1330.

60. See *Brown v. United States*, 95 F. (2d) 487 (C. C. A. 3d, 1938).

61. *Hadley Falls Trust Co. v. United States*, 22 F. Supp. 346 (D. Mass. 1938). The Government's successful contention in this case was counter to its own Regulations. The issue relevant to the present discussion involved the taxpayer's attempt to deduct a loss arising out of the foreclosure of certain property. The district court held, despite Reg. 74, Art. 193, which was virtually identical with the present Art. 23 (k)-3 as to this point, that the taxpayer could not deduct from its gross income the amount by which either the mortgage debt or the purchase price at the foreclosure sale exceeded the fair

This theory underlies the reorganization provisions.⁶² Certainly, the theory is alluring if its converse is to result in gain at the time of foreclosure. There could be no more unpropitious time for the taxation of the gain than when the mortgagee is in the doubly unfortunate position of having a loss of income and a badly frozen asset.⁶³ Relief for this situation would perhaps carry the denial of capital losses when the mortgagee is unwillingly taking over the mortgaged property.

VI. *The Result of a Closed Transaction in the Case of a Mortgagee*

The position of the Treasury on the question of the type of loss sustained by the mortgagee is obscurely delineated in I. T. 3121,⁶⁴ and examples are given in I. T. 3159.⁶⁵ In the former of these rulings it is said:

(1) Where a debt is compromised for a cash consideration because of inability of the debtor to pay, the creditor's loss is an *ordinary* loss, and not a *capital* loss;⁶⁶

(2) Where the debt secured by the mortgage is compromised by the transfer by the debtor of the title to the mortgaged property to the creditor in exchange for a release of the debtor from his obligation to the creditor, the loss of the creditor is a capital loss;⁶⁷

(3) If the mortgage is foreclosed and the creditor buys the mortgaged property at a price equal to the basis of the note representing the unpaid indebtedness, no deduction may be taken by the creditor as a bad debt;⁶⁸ and

(4) If the fair market value of the property⁶⁹ is less than the bid price, the creditor sustains a capital loss.⁷⁰

Although the difference between the basis for the debt and the bid price is apparently an ordinary loss where the mortgagee buys the prop-

market value of the property. The court stated its inability to "see how a mortgagee, buying the property at a foreclosure sale, can be deemed for tax purposes to have suffered a loss if the property is worth less than he paid for it," and indicated that a loss was properly allowable only upon a later sale by the mortgagee.

62. See MAGILL, *TAXABLE INCOME* (1936) 146.

63. It is adding insult to injury to tax the mortgagee upon the receipt of taxable interest.

64. 1937-2 CUM. BULL. 138 (1937).

65. 1938-1 CUM. BULL. 188 (1938).

66. See U. S. Treas. Reg. 101, Art. 23 (k)-3. So far we have an adoption of the decision of *Hale v. Helvering*, 85 F. (2d) 819 (App. D. C. 1936).

67. See Harry Payne Bingham, 38 B. T. A. 913 (1938); (1939) 48 YALE L. J. 1289.

68. The emphasis here, as in the *Midland Mutual* case, is upon the bid price; cf. U. S. Treas. Reg. 101, Art. 23 (k)-3.

69. The fair market value of the property will be presumed to be the amount for which it is bid in by the taxpayer in the absence of clear and convincing proof to the contrary. U. S. Treas. Reg. 101, Art. 23 (k)-3.

70. This is a highly doubtful point.

erty at a foreclosure sale,⁷¹ the Board has held in the *Bingham* case⁷² that a creditor has a capital loss where he reacquires property by means of a settlement, the value of the property at the time being less than the amount of the notes, and a release and cancellation of the mortgage and surrender of the notes being part of the transaction. The unrealism of the result in this case is matched only by the illogical reasoning employed to reach it. As Member Smith pointed out in his dissenting opinion, the mortgage notes were not in reality sold or exchanged back to the mortgagor; they were extinguished and the debt cancelled. Although the majority in the *Bingham* case rely upon the prior Board decision in the *Rogers* case, the theories upon which the Board proceeded in the two cases are actually irreconcilable. In the latter opinion the Board preferred to treat the mortgagor as a seller of the mortgaged real estate to the creditor in consideration of the cancellation of the notes. If there was a sale of the mortgaged premises by the debtor to the creditor, then on that analysis the creditor must have *purchased* the property, giving rise to neither gain nor loss. The Board in the *Rogers* case treated the transaction as a sale because the result was the same as though the mortgagor had sold the property to a third party for cash and applied the cash on the mortgage debt. This method of reasoning is also inconsistent with the result in the *Bingham* case. If the mortgagor sells the property to an outsider for cash, and then uses the cash to compromise the mortgage debt, then according to I. T. 3121, the creditor may deduct the unpaid balance as an ordinary loss. If the argument of equivalent results is to be applied, there is no reason for a different treatment if the mortgagee accepts the property (having a value less than the debt) directly from the mortgagor instead of receiving cash which has been realized by the mortgagor upon a sale to an outsider.

The woods get thicker when we discover that a mortgagee may have gain as well as loss. The Regulations state:⁷³

"If mortgaged or pledged property is lawfully sold (whether to the creditor or another purchaser) for less than the amount of the debt, and the mortgagee or pledgee ascertains that the portion of the

71. See Estate of Henry N. Brawner, Jr., 36 B. T. A. 884 (1937).

72. *Harry Payne Bingham*, 38 B. T. A. 913 (1938). *Hale v. Helvering*, 85 F. (2d) 819 (App. D. C. 1936) is distinguished by pointing out that it involved no acquisition of property by the debtor, or any transfer of property to him, whereas in the *Bingham* case such a transfer occurred. See (1939) 48 YALE L. J. 1289.

73. U. S. Treas. Reg. 101, Art. 23 (k)-3. See also U. S. Treas. Reg. 94, Art. 23 (k)-3; U. S. Treas. Reg. 86, Art. 23 (k)-3; U. S. Treas. Reg. 77, Art. 193; U. S. Treas. Reg. 74, Art. 193; U. S. Treas. Reg. 69, Art. 153 (the first Regulation to adopt this rule); cf. U. S. Treas. Reg. 45, Art. 153 as previously promulgated. See also U. S. Treas. Reg. 101, Art. 44-3. This consistent administrative interpretation of the Statute on a debatable point may have imbedded the Regulation in the Statute. See *Helvering v. Reynolds Tobacco Co.*, 59 Sup. Ct. 423 (1939); *National Home Owners Service Corp.*, 39 B. T. A., Apr. 12, 1939; (1939) 39 COL. L. REV. 716.

indebtedness remaining unsatisfied after such sale is wholly or partially uncollectible, and charges it off, he may deduct such amount (to the extent that it constitutes capital or represents an item the income from which has been returned by him) as a bad debt for the taxable year in which it is ascertained to be wholly or partially worthless and charged off. In addition, if the creditor buys in the mortgaged or pledged property, loss or gain is realized measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by him) and the fair market value of the property. The fair market value of the property shall be presumed to be the amount for which it is bid in by the taxpayer in the absence of clear and convincing proof to the contrary. If the creditor subsequently sells the property so acquired, the basis for determining gain or loss is the fair market value of the property at the date of acquisition.

"Accrued interest may be included as part of the deduction only if it has previously been returned as income."

This Regulation consists of two parts:⁷⁴ the first part, permitting a bad debt deduction when the mortgaged or pledged property is sold either to the mortgagee or an outside purchaser; and the second, calling for the recognition of gain or loss where the creditor "buys in" the mortgaged or pledged property by applying the mortgage notes against the bid price. Apparently, there is no recognition of gain or loss pursuant to the terms of the Regulation where the mortgaged or pledged property is not acquired by the creditor in foreclosure proceedings. Thus where a deed is given in lieu of foreclosure, the Regulation has no application, and the difference between the creditor's debt basis and the value of the property measures his gain or loss, as the case may be.⁷⁵ The original transaction, where the mortgage is a purchase money mortgage, and

74. Hulse, *Mortgage Foreclosures Under the Federal Income Tax Regulations* (1936) 14 TAX. MAG. 451.

75. Harry Payne Bingham, 38 B. T. A. 913 (1938); Henry Heldt, 16 B. T. A. 1035 (1929); Chemical National Bank of New York, 30 B. T. A. 178 (1934). See Josephine C. Bowen, 37 B. T. A. 412 (1938), wherein the taxpayer exchanged her entire mortgage debt for Home Owners Loan Corporation bonds of a less face value and was allowed a capital loss. Cf. Harold S. Denniston *et al.*, 37 B. T. A. 834 (1938), wherein a worthless debt deduction was allowed, and the Bowen case was distinguished on the ground that there was no surrender of the entire indebtedness, a new unsecured note being given for the balance of the debt, and on the further ground that no bad debt loss was claimed in the Bowen case with respect to the balance of the debt.

Whether or not a new note is given for the balance of the debt, the "substance," as distinguished from the "form," of the transaction is that there is a partial loss in either case, which is due to the permanent reduction in the value of the loan and which should be deductible in full, if written off before acquiring the H.O.L.C. bonds. Cf. Henry R. Huntting, 32 B. T. A. 495 (1935).

the reacquisition are thus treated, according to their form, as two transactions.⁷⁶

The theory underlying the quoted Regulation is that when the creditor or mortgagee buys in at a foreclosure sale, he exchanges his mortgage notes for the mortgaged property,⁷⁷ and that this exchange should be regarded as a closed transaction with gain or loss measured by *value*. But the Supreme Court's reasoning in the *Midland Mutual Life Insurance* case⁷⁸ adopts as the *controlling fact the amount bid at the foreclosure sale*,⁷⁹ from which it might seem to follow that (1) the basis of the property acquired by the mortgagee is the amount bid at the foreclosure sale and not, as stated in the Regulations, the fair market value of the property bid in at the time of acquisition; (2) the mortgagee should have a bad debt deduction to the extent that the basis of the debt exceeds the amount bid at the foreclosure sale and is ascertained to be worthless and charged off;⁸⁰ and finally (3) capital gain or loss is realized by the mortgagee to the extent of the difference between his basis for the portion of the debt applied against the bid price and the amount bid at the foreclosure sale. The fair market value of the property at the time of the foreclosure sale becomes wholly immaterial. Yet this is hardly a more satisfactory rule than that stated in the Regulations.

The existing Regulation puts a severe administrative valuation burden upon the Treasury,⁸¹ and the confusion which may arise if the Regulation be finally upset as being in contravention of the *Midland Mutual Life* case is easily imagined. If a mortgagee resells property bid in upon a foreclosure for more than the foreclosure bid price, he may be taxed

76. *Nat Webb, Jr. et al.*, 22 B. T. A. 1249, 1252 (1931); *Home State Bank*, 15 B. T. A. 121 (1929); *A. W. Shaw*, 13 B. T. A. 716 (1928). See *Jacob M. Dickinson, Jr. et al.*, Ex'rs, 18 B. T. A. 790 (1930), involving a reacquisition by foreclosure of property sold in an installment transaction.

77. See *Manhattan Mutual Life Ins. Co.*, 37 B. T. A. 1041 (1938), citing on this point *Helvering v. Missouri State Life Ins. Co.*, 78 F. (2d) 778 (C. C. A. 8th, 1935); *Henry Heldt*, 16 B. T. A. 1035, 1037 (1929).

78. *Helvering v. Midland Mutual Life Ins. Co.*, 300 U. S. 216 (1937); see also *Ramsey, Mortgage Foreclosures and Income Taxes* (1937) 15 TAX MAG. 579, 581.

79. This was what the Commissioner unsuccessfully contended in *Suncrest Lumber Co.*, 25 B. T. A. 375 (1932). See *Manomet Cranberry Co.*, 1 B. T. A. 706 (1925), explained in *Henry Heldt*, 16 B. T. A. 1035 (1929); *Edward S. Phillips*, 9 B. T. A. 1016 (1927).

80. See *Brown v. United States*, 95 F. (2d) 487 (C. C. A. 3d, 1938).

81. *Helvering v. Midland Mutual Life Ins. Co.*, 300 U. S. 216, 225 (1937); see PAUL, *STUDIES IN FEDERAL TAXATION* (1937) 178; statement of Mr. A. W. Gregg as to discovery value quoted in PAUL AND MERTENS, *LAW OF FEDERAL INCOME TAXATION* (1934) § 21.53. This argument may easily be carried too far. The Treasury is reasonably experienced at valuation. The same objection may be made at several other points of our system of taxation, but at these points one does not avoid a task because it is difficult. See opinion of Member Sternhagen, *Safe Deposit & Trust Co. of Baltimore*, Ex'r, 35 B. T. A. 259 (1937), *aff'd*, 95 F. (2d) 806 (C. C. A. 4th, 1938).

upon the difference between his reselling price and the bid price, although he may already have been taxed upon the excess of the fair market value of the property at the time of the foreclosure over the bid price. On the other hand, if he resells the property for less than the foreclosure bid price, the mortgagee may be entitled to a loss, although he has already been allowed a loss⁸² equal to the excess of the amount of his bid over the fair market value of the property at the time of the foreclosure.⁸³

Under the rule set forth in the Regulations, the loss of the mortgagee upon a foreclosure is split into two separate parts where there is a deficiency and the fair market value of the property differs from the bid price.⁸⁴ One part consists of the difference between the mortgagee's basis for the principal debt and the bid price (the amount of the deficiency). This would constitute an ordinary bad debt if the deficiency were uncollectible, as one must admit it usually is,⁸⁵ unless he is "methodically ignorant of what everybody knows."⁸⁶ The other part consists of the difference between the bid price and fair market value of the property, which would constitute a capital loss⁸⁷ — or perhaps (?) gain, if the fair market value of the property exceeded the bid price.⁸⁸

82. See, however, *Ilfeld Co. v. Hernandez*, 292 U. S. 62, 68 (1934).

83. Section 820 of the 1938 Act, and the doctrine of estoppel, may alleviate these inequities, but not with respect to any period prior to 1932. See Maguire, *Surrey and Traynor, Section 820 of the Revenue Act of 1938* (1939) 48 YALE L. J. 509, 719; Kent, *Mitigation of the Statute of Limitations in Federal Tax Cases* (1939) 27 CALIF. L. REV. 109; Legis. (1939) 39 COL. L. REV. 460.

84. See *Brown v. United States*, 95 F. (2d) 487 (C. C. A. 3d, 1938), in which this point was called to the court's attention. Brief for appellant, p. 15. Dealing principally with the question whether the taxpayer had charged off the debt, the court seems to approve the Regulations. U. S. Treas. Reg. 77, Art. 193; at least it allowed as an ordinary bad debt deduction \$34,699.73, the difference between the debt basis and the value of the mortgaged premises at the time bid in (\$98,650.73 less \$63,951) for a nominal consideration of \$50. Thus, a gain of \$63,951 offset a total loss of \$98,050.73. But cf. *Hadley Falls Trust Co. v. United States*, 22 F. Supp. 346 (D. Mass. 1938) in which the court denied the validity of U. S. Treas. Reg. 74, Art. 193 as applied to a claimed loss.

85. True, the mortgagee must show that he could not with diligent effort collect the deficiency. See *Vancoh Realty Co.*, 33 B. T. A. 918 (1936).

86. FRANK, *LAW AND THE MODERN MIND* (1930) 159, quoting Bentham's definition of jurisprudence.

87. See Heineman, *Income Tax Problems in Mortgage Foreclosures* (1937) 32 ILL. L. REV. 189, 193. Mr. Heineman suggests that the most feasible way to deal with this situation is to amend the regulations so as to provide for a single bad debt deduction. This criticism applies equally to the view based upon the *Midland Mutual* case. Under both this method and the one set forth in the regulations there is a split of the transaction into two parts; in the former case the dividing line is at the point of the bid price, in the other it is at the fair market value of the property.

88. See Egbert J. Henschel *et al.*, Ex'rs, B. T. A. Memo. Op. promulgated April 30, 1938, appearing in 384 C. C. H. 1938 Fed. Tax Serv. ¶7236-B; cf. *Brown v. United States*, 95 F. (2d) 487 (C. C. A. 3d, 1938); I. M. Davis, 2 B. T. A. 359 (1925), wherein the property reacquired was worth only the cost of the mortgage.

VII. Conclusion

A summary of the confusion in the authorities will serve to show the ridiculous hodge-podge of conflicting rules for the guidance of mortgagors and mortgagees in a depression period. The law and administrative rulings seem to be in the following condition:

(1) Irrespective of the fair market value of the property, a mortgagee constructively receives taxable income if his foreclosure bid price includes accrued interest; the mortgagor has an equivalent item of deductible, constructively paid interest. But unless the fair market value of the property is equal to the principal debt plus accrued interest, the mortgagee receives no taxable income if his mortgagor is obliging enough to lose his interest deduction by deeding the property voluntarily to the mortgagee.

(2) A mortgagor's loss on foreclosure is deductible at the time of foreclosure sale in states, like New York, which allow no period of redemption, but not until the equity of redemption has expired in states, like California, which allow such a period; but if the mortgagor deeds the mortgaged property voluntarily to the mortgagee, his loss is deductible when he does so, wherever the property may be situated.

(3) A mortgagor's loss is an ordinary loss if his property is taken from him by foreclosure; it is an ordinary loss if the mortgagor is not liable for the mortgage debt and voluntarily deeds the mortgaged property to the mortgagee; it is a capital loss if the mortgagor is liable for the mortgage debt and secures a release of indebtedness upon his voluntary conveyance.

(4) The mortgagee's bad debt is deductible at the time of acquisition of the mortgaged property; it is not postponed, as is the mortgagor's loss, to the later date of expiration of the period of redemption. But there is much to be said for the argument that the mortgagee has no loss deduction whatever when he acquires the mortgaged property.

(5) If the mortgagee compromises the mortgage debt for cash with a debtor who is unable to pay, he has a bad debt deduction, but if he releases the debtor from obligation, in return for a conveyance of the property, he has a capital loss. If the mortgagee forecloses, he may have no bad debt deduction, a capital loss, both a bad debt deduction and a capital loss, or even a bad debt deduction and a capital gain, depending upon the relationship in amount of the mortgage debt, the bid price and the market value of the property. But this administrative rule may be wrong; it may be wrong if the bid price controls, as intimated in the *Midland Mutual Life* case.

(6) If the market value controls, as the Regulations state, the basis of the foreclosed property in the hands of the mortgagee is that market value; if the bid price controls, as intimated in the *Midland Mutual Life*

case, the basis is that bid price. If the law settles in favor of the bid price, there will be many claims for double taxation upon the resale of the property by the mortgagee, and likewise many claims for double deduction, except as Section 820 (operative only for years after 1931) or the doctrine of estoppel ameliorates this confusion.

"The simple tool" of Euclidean logic⁸⁹ seems to have made a bad mess of the income tax as it affects mortgagors and mortgagees. The process of trial and error has produced an extraordinary crop of blunders. To use Mr. Justice Frankfurter's expression,⁹⁰ it is time for a reappraisal of the whole situation in the light of a rule of reason, as distinguished from transcendental rules of reasoning. The two quite different things have been badly confounded. The result is as deplorable as may be imagined. The uniform application of a scheme of nationwide taxation is impaired.⁹¹ Litigation is multiplied for overworked courts far behind schedule.⁹² No one can know when we will extricate ourselves from an intolerable, unknown and unknowable futility.⁹³

The obscurity is one which does damage. It promotes justifiable taxpayer dissatisfaction, which in itself is bad for an income tax.⁹⁴ Such revenue as is immediately collected will cost dearly in the long run. And mortgagors and mortgagees deserve a better fate. They both have their unavoidable troubles in a depression period. The former is losing his savings; the latter is exchanging an income-producing property for a frozen asset. We carry coals to Newcastle when we add the riddle of conflicting decisions and the problem of a harsh denial of a tax loss or the taxation of income which is far from being the equivalent of cash.

There is little excuse for a prolongation and intensification of the chaos of this situation. There is plenty of need for caution against the acceptance of glib woolgathering arguments in favor of tax simplification,⁹⁵ but there is no need for *avoidable* complexity. The present disorder is avoidable, by a statute if in no other way. One method suggested, so far as mortgagees are concerned, is to treat acquisitions by mortgagees, on foreclosure or otherwise, as giving rise neither to bad debt deductions nor gain or loss, but rather as effecting a substitution of the property

89. HOLMES, COLLECTED LEGAL PAPERS (1920) 306.

90. Frankfurter, *Joseph Redlich* (1937) 50 HARV. L. REV. 389.

91. PAUL, SELECTED STUDIES IN FEDERAL TAXATION, SECOND SERIES (1938) 6.

92. Traynor, *Administrative and Judicial Procedure For Federal Income, Estate, and Gift Taxes—A Criticism and a Proposal* (1938) 38 COL. L. REV. 1393.

93. Traynor, *Administrative and Judicial Procedure For Federal Income, Estate, and Gift Taxes—A Criticism and a Proposal* (1938) 38 COL. L. REV. 1393, 1410.

94. Gaskill, *Preserving a Willing Attitude Among Taxpayers* (1938) 16 TAX. MAG. 649.

95. See Eichholz, *Should the Federal Income Tax Be Simplified?* (1939) 48 YALE L. J. 1200. See PAUL, SELECTED STUDIES IN FEDERAL TAXATION, SECOND SERIES (1938).

for the debt. The basis of the property acquired by the mortgagee⁹⁶ could then be the adjusted basis of the debt, increased by costs of acquisition, and decreased by any payment in reduction of the principal debt plus costs of acquisition, or any bad debt deduction allowed after the acquisition of the property. This method would work possible hardship by denying a bad debt deduction to mortgagees when in the great majority of cases there is a bad debt at the time of acquisition by the mortgagee. Another possible solution, perhaps more in accord with realities, would be to allow a bad debt deduction at the time of acquisition, based upon the difference between the debt basis and fair market value, which could be presumed to be the bid price in the absence of evidence to the contrary, and to allow the fair market value, properly adjusted, as a basis for the property acquired. This allowance of a bad debt deduction would be partially paid for by the mortgagee in terms of a reduced basis for the property, but would not indefinitely postpone the opportunity to deduct an economic loss. Whether the relatively rare case in which market value exceeds the debt basis calls for a capital gain tax is a quite separate problem; such cases might be handled as bargain purchases,⁹⁷ leaving the gain to be taxed upon later resale, with a basis limited to bargain purchase price meanwhile.

As things are now in the case of mortgagors, the general rule is controlled by the special case. Things should be put the other way around; we need a rule for breaking a rule.⁹⁸ A realistic statute could state a useful and workable rule which recognized that redemption by mortgagors is sufficiently infrequent to permit the allowance of loss when it actually occurs, and that the rare case of redemption may be covered by special provision, such as the one we have adopted for recovered bad debts.

96. There would have to be a further adjustment as to properties acquired before the amendment of the Statute on account of the treatment accorded the transaction under existing Regulations.

97. The relationship between mortgagor and mortgagee does not ordinarily contemplate that the mortgagee should be enriched at the expense of the debtor or realize more than what would repay the debt with costs and expenses; *Honeyman v. Jacobs*, 59 Sup. Ct. 702 (1939). See *Helvering v. Salvage*, 297 U. S. 106 (1936); *Comm'r v. Van Vorst*, 59 F. (2d) 677 (C. C. A. 9th, 1932); *Delbert B. Geeseman*, 38 B. T. A. 258 (1938); *Gordon M. Evans*, 38 B. T. A. 1406 (1938); *Charles E. Adams*, 39 B. T. A., Feb. 9, 1939. Cf. *Albert Erskine*, 26 B. T. A. 147 (1932).

98. CARDOZO, *THE PARADOXES OF LEGAL SCIENCE* (1928) 64.