3 T.C. 585 (1944)

When property is inherited subject to a non-recourse mortgage equal to the property's fair market value, the heir's initial tax basis is zero; upon sale, the amount realized only includes cash received, not the mortgage balance.

Summary

Crane inherited an apartment building subject to a mortgage equal to its fair market value. She operated the building, paid expenses, and remitted net rentals to the bank holding the mortgage. Later, to avoid foreclosure, she sold the property for $3,000, subject to the existing mortgage. The Tax Court addressed how to calculate her gain or loss. The court held that Crane's basis in the property was zero, the amount realized was the cash received ($2,500 after expenses), and that the gain was allocable between the land (capital gain) and the building (ordinary income).

Facts

William Crane died owning an apartment building in Brooklyn, subject to a mortgage of $255,000 plus accrued interest. The property's appraised value for estate tax purposes was equal to the mortgage debt. His widow, Beulah Crane, inherited the property and became the sole legatee. Crane was not personally liable for the mortgage. To avoid foreclosure, Crane sold the property to Avenue C Realty Corporation for $3,000 in cash, subject to the existing mortgage balance of $255,000 plus interest. She received $2,500 net cash after expenses.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Crane's income tax, arguing that the amount realized from the sale included the mortgage balance. Crane challenged this assessment in Tax Court.

Issue(s)

1. Whether the amount of the non-recourse mortgage should be included in the "amount realized" by Crane from the sale of the property.

2. Whether Crane's basis in the inherited property should be zero, given that the mortgage equaled the property's fair market value at the time of inheritance.

3. Whether the basis of zero can be reduced on account of depreciation of the building.

Holding

1. No, because Crane was not personally liable for the mortgage and received no direct benefit from its existence at the time of sale, the amount realized only

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included the cash she received.

2. Yes, because the property's fair market value at the time of inheritance was entirely offset by the mortgage, resulting in no equity value for Crane.

3. No, because under Section 113 (b) (1) (B) of the Revenue Act of 1938, the basis of zero cannot be reduced further due to depreciation.

Court's Reasoning

The court reasoned that the "amount realized" under Section 111(b) of the Revenue Act of 1938 is "the sum of any money received plus the fair market value of the property (other than money) received." Since Crane only received $2,500 in cash and was not personally liable for the mortgage, she did not receive any additional benefit or consideration related to the mortgage when she transferred the property. Regarding basis, the court stated that "the interest of petitioner in the apartment house property had no fair market value whatever when acquired by her." The court determined the petitioner's unadjusted basis is zero. The court found the building was a non-capital asset, and the gain should be allocated between the land (capital gain) and the building (ordinary income).

Practical Implications

This case clarifies the tax treatment of inherited property encumbered by debt, particularly non-recourse mortgages. While later overturned by the Supreme Court, the Tax Court decision highlights the complexities of determining tax basis and amount realized when liabilities are involved. The later Supreme Court ruling in *Crane v. Commissioner*, 331 U.S. 1 (1947), reversed the Tax Court and held that the amount realized includes the amount of the non-recourse mortgage, regardless of whether the taxpayer is personally liable. This ensures that taxpayers cannot avoid tax liability by including depreciation deductions in their basis without also including the corresponding debt relief in the amount realized upon sale. The *Crane* rule is fundamental to understanding tax shelters and real estate transactions.

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