NOTES

THE SALE OF MORTGAGED REAL ESTATE UNDER THE INDIANA GROSS INCOME TAX: A JUDICIAL LESSON IN SEMANTICS

Twenty years ago, in the depths of America's greatest economic depression, the Indiana General Assembly enacted, along with other emergency tax measures, the Gross Income Tax Law.[1] It is generally conceded that the limitations placed upon property tax rates by the 1932 special session of the Legislature necessitated the creation of a new source of revenue.[2] Contemporary writers pointed out that the preference for a gross income tax was by no means unanimous.[3] One alternative proposal was a net income tax, and it was perhaps due to

1. IND. ANN. STAT. §§ 64-2601 to 64-2635 (Burns 1951).

2. "In 1929, the total [property] tax delinquency was $5.5 million. It increased from $11.4 million in 1931 to $19.2 million in 1932." Weller, *The Indiana Gross Income, Excise, and Intangibles Tax Laws of 1933*, p. 6, unpublished M.A. thesis, Department of Economics and Sociology, Indiana University (1935). Because of such delinquencies and the extraordinary burden thrust upon property by the depression, the Indiana Farm Bureau and others were instrumental in the passage of the $1.50 Property Tax Limit Law of 1932. See HAIG AND SHOUP, THE SALES TAX IN THE AMERICAN STATES 238 (1934). See also IND. ANN. STAT. §§ 64-307, 64-309 (Burns 1951). State revenue is still limited to fifteen cents upon each one-hundred dollars of taxable property.

". . . [T]he limitations did indicate a necessity for relief of the tax burden on property and emphasized the need for a new source of revenue." Northrup, *Indiana Gross Income Tax*, 25 IND. L.J. 148 (1949). Reportedly, one of the primary reasons for the tax was to keep the schools open. Weller thesis, *supra* at 13. See also BACK, THE INDIANA GROSS INCOME TAX 8 (1950).

The purpose of the Gross Income Tax Law was to broaden the basis of taxation, to relieve property of some of the burden of maintaining government, and to reach those who paid little or no property tax and who received benefits or potential benefits from the instrumentalities of the government for which they did not carry a proportionate share of the burden. Storen v. J. D. Adams Mfg. Co., 212 Ind. 343, 7 N.E.2d 941 (1937), *rev'd in part and modified in part*, 304 U.S. 307 (1938), *mandate of Supreme Court complied with*, 214 Ind. 707, 15 N.E.2d 1016 (1938).

3. HAIG AND SHOUP, *op. cit. supra* note 2, at 240, contains an analysis and summary of the opposition to the tax. According to the Weller thesis, *op. cit. supra* note 2, at 9, the Indiana Chamber of Commerce "was, perhaps, the most active opponent of the tax." Other types of taxes proposed were a sales tax and a net income tax. See Northrup, *supra* note 2, at 149, 150.

F. C. McClurg, General Counsel, Indiana Department of State Revenue, who began his services with the Department on April 27, 1933, was on the scene at the time the tax was adopted and describes the situation as follows: "A sales tax was seriously considered and emissaries were sent to Mississippi to study that State's tax act. It was found that sales everywhere were at an extremely low ebb except sales of human necessities and that a high rate would be necessary in order to raise the required revenue. It was concluded therefore that what was needed was the widest possible tax base coupled with the lowest possible rate. A Gross Income Tax appeared to be the only answer. . . .

". . . Indiana was somewhat at a disadvantage compared to other States in the

the misconception that such a tax would have been unconstitutional[4] that some of the present day problems have developed, particularly the taxability of receipts from the sale of mortgaged real estate.[5]

At the inception, the Gross Income Tax statute contained no specific reference to the amount of taxable income derived from the sale of mortgaged property, and even today there are no provisions directly concerning such transactions.[6] Presumably, from the general tenor of the Act and the broad tax base initially intended, the full sales price of the property could have been considered income. However, the Gross Income Tax Division of the Department of State Revenue, in administering the tax, recognized economic and social realities. Due to the

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matter of the immediate raising of revenue since other States could borrow money and issue bonds." Communication to the INDIANA LAW JOURNAL.

4. Three times the voters of the state had rejected constitutional amendments which, if approved, would have authorized the legislature to pass a net income tax law. The last time was at the general election of November 8, 1932, where the vote was 701,045 for, and 209,076 against; under the construction placed on Article XVI, Section 1 of the Indiana Constitution at the time, it was considered as having been defeated. See, Weller thesis, *op. cit. supra* note 2, at 42. But see IND. CONST. Art. X, § 8 (Income Tax), which was declared effective under authority of *In re* Todd, 208 Ind. 168, 193 N.E. 865 (1935), wherein it was held that a majority of those voting was sufficient for approval.

5. The problem which is the subject matter of the instant note presumably would not have arisen under a net income tax. For example, under the Federal Income Tax, INT. REV. CODE §§ 22(a), 111 (Supp. 1952), the vendor of real property is taxable only on the profit realized from the sale. Saunders v. United States, 101 F.2d 133 (5th Cir. 1939); *cf.* 13 B.T.A. 291 (1928).

Also, when the mortgage neither constitutes a liability of the mortgagor nor is responsible for a part of the aggregate benefit received in a sale by the mortgagor of his interest, the amount paid by another to redeem the property from the mortgage should be eliminated from the computation of gain by the mortgagor for income tax purposes. Hilpert v. Comm'r of Internal Revenue, 151 F.2d 929 (5th Cir. 1945). But see Surrey and Warren, *The Income Tax Project of the American Law Institute: Gross Income, Deductions, Accounting, Gains, and Losses, Cancellation of Indebtedness*, 66 HARV. L. REV. 761, 832 (1953), Table II-A.

For a compilation of the various states which have a net income tax, see CCH STATE TAX GUIDE SERV. ¶ 28-000 *et seq.* (1948).

6. IND. ANN. STAT. § 64-2601(m) (Burns 1951), contains a lengthy and general definition of the term gross income. No distinction is made between sales of real property and sales of other types of property. The subsection does provide that "gross receipts" are taxable without any deductions on account of the cost of the property sold. Section 64-2606 lists a number of specific exemptions, none of which includes the value of real estate mortgages. See also INDIANA GROSS INCOME TAX REGULATIONS 46, Series VII, Reg. 1002 (1946).

It is significant that two other states which, at one time, had gross receipts taxes similar to the Indiana tax, no longer tax income from the sale of real property. MISS. CODE ANN. §§ 10104, 10108 (Supp. 1950); S.D. CODE § 57.2602(1) (1939). The Territory of Hawaii has a gross income tax, but it specifically excludes gross receipts from the sale of real property. HAWAII REV. LAWS c. 101, § 5444 (1945). The only state which has a tax even remotely resembling the Indiana gross income tax is West Virginia. W.VA. CODE ANN. § 959 (1949). The West Virginia Business and Occupation Tax is much more complicated, however, having some twenty-three different rate classifications plus a surtax. CCH STATE TAX GUIDE SERV. ¶ 62-962 (1948).

depression almost all real estate was necessarily mortgaged; in some instances sales of property were made in a desperate effort to salvage even a small sum in the face of rapidly declining property values, while other sales were forced transfers. Consequently, in order to alleviate the tax burden the Department applied the tax only to the amount received by the vendor for his equity in the property.[7]

This generous and uncomplicated policy continued in effect until 1946, at which time the Department promulgated Regulation 3405, resulting in a new and somewhat different treatment of the sale of mortgaged real estate.[8] The underlying reason for this change was to differentiate between the property owner who never actually received the money due to the fact that the mortgage existed on the property at the time the seller acquired it or was executed by the seller as security for part of the purchase price, and the property owner who did obtain the proceeds of the loan in that the mortgage was executed by the seller as security for borrowed money received by, or credited to him.[9] Section 1 of Regulation 3405 permitted the former to deduct the unpaid balance of the mortgage debt from the sales price irrespective of the

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7. This policy is reflected in the first series of regulations, issued July 1, 1934. Art. 24, Reg. 100, reads: "Taxpayers selling property upon which there is a mortgage lien will be deemed to be selling only an equity therein when the mortgage lien is assumed by the purchaser, and only the amount received in cash, notes or other property will be reported for gross income tax. In all such cases the lien must actually exist against the property so sold. However, when a taxpayer sells mortgaged property and uses the proceeds from such sale to satisfy the lien against it he will be considered as having taxable gross receipts in the full amount of the sale price." In a communication to the INDIANA LAW JOURNAL, the General Counsel for the Indiana Department of State Revenue states: "Regulation 2804 (issued in 1943) reiterated the policy of the newly-born Gross Income Tax Division in 1933. It was written liberally because of humane reasons, since in that depressed period, mortgage burdens were heavy and property owners were hard pressed to pay, and often wholly unable to pay, even the interest."

8. INDIANA GROSS INCOME TAX REGULATIONS 46, Series VII, Reg. 3405 (approved April 27, 1946). *"Sale of Mortgaged Property.* Persons selling real estate upon which a mortgage exists will be subject to the following rules with regard to the exaction of gross income tax.

1. In cases where the mortgage existed upon the property at the time the property was acquired by the seller, regardless of whether the mortgage was executed by a former holder or by the seller as security for part of the purchase price at the time of his purchase, the unpaid balance of the mortgage may be deducted from the entire sales price, irrespective of the arrangement for assumption or satisfaction of the mortgage when the property is sold.
2. If any mortgage existing on real property at the time of sale was executed by the seller of such real estate as security for borrowed money received by, or credited to, such seller, then no deduction whatsoever may be taken by the seller, regardless of whether the mortgage is assumed by the purchaser; satisfied by the purchaser or a third party; or satisfied by the seller with funds provided by the purchaser or other parties."

9. Communication to the INDIANA LAW JOURNAL from F. C. McClurg, General Counsel, Indiana Department of State Revenue.

terms of the transaction, while the latter was denied any deduction under Section 2.[10]

This state of affairs went unchallenged until 1951, when the Indiana Supreme Court in *Ralph L. Shirmeyer, Inc. v. Indiana Revenue Board*,[11] held that when a purchaser, who took property *subject* to the unpaid balance of a mortgage, paid off the debt to the mortgagee, the seller constructively received the amount of the mortgage loan inasmuch as the buyer discharged the seller's obligation; consequently the entire sales price was taxable income to the seller. Since the vendor-mortgagor in this particular case executed the mortgage, covering part of certain vacant lots, to obtain funds to construct a dwelling house and make improvements upon the real estate described in the mortgage, it would seem that the transaction would fall squarely within Section 2 of Regulation 3405.[12] Encouraged by this favorable decision, the Commissioner of State Revenue ruled that Regulation 3405 would not be applicable to any sale of property occurring after July 24, 1951,[13] and that no deduction would be allowed in any sale of mortgaged real estate even though the mortgage may have existed thereon at the time the seller acquired it.[14] The ruling evidently was based upon an understanding that the *Shirmeyer* decision had modified Regulation 3405, but it is difficult to perceive how this interpretation was reached.

In December, 1952, the Indiana Supreme Court decided *Indiana Department of State Revenue v. Colpaert Realty Corp.*,[15] and *Department of State Revenue v. Crown Development Co.*,[16] which held that in the sale of mortgaged real property, where the purchaser *assumes*

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10. See note 8 *supra*.

11. 229 Ind. 586, 99 N.E.2d 847 (1951).

12. See note 8 *supra*. The court in the *Shirmeyer* case based its determination of taxability upon a construction of subsections (h), (i), and (m) of Section 64-2601 (Burns 1951). No reference is made in the opinion to the Regulations.

13. The *Shirmeyer* case was decided on July 23, 1951.

14. Legal Ruling No. 15-51, November 8, 1951: "For the purpose of assessing gross income tax on and after July 24, 1951, no deduction from gross sales price of real estate or other property will be allowed on account of any encumbrances thereon whether such encumbrances are secured by mortgage or otherwise. The kind of encumbrance or the time and manner of its origin will be considered as immaterial in assessing tax as will the manner in which the mortgage or other encumbrance is assumed or paid by the grantee. 'Encumbrances' shall include notes secured by mortgage as well as liens, assessments and other obligations secured by the real estate."

In the Brief for Appellants, p. 145, Department of State Revenue v. Crown Development Co., 109 N.E.2d 426 (Ind. 1952), Category D transactions, in which the indebtedness was assumed or incurred by the taxpayer when it acquired legal title to the mortgaged real estate, were considered to be covered by the provisions of Section 1 of Reg. 3405. Category D transactions were not involved in the appeal inasmuch as they were conceded by the appellee.

15. 109 N.E.2d 415 (Ind. 1952).

16. 109 N.E.2d 426 (Ind. 1952).

and agrees to pay the mortgage indebtedness, the vendor-mortgagor receives taxable income only in the amount of its equity in the property. In these cases, the plaintiffs were Indiana corporations engaged in the business of buying, subdividing, improving, leasing, mortgaging, and selling real estate. The numerous transactions in question took place in 1946, immediately following the promulgation of Regulation 3405, and in 1947 and 1948. The plaintiffs had paid gross income taxes only upon the amount represented by the sale of their "equity" in the realty; the Department took steps to tax plaintiffs on the amount constituting the mortgage value in each sale.[17]

The transactions involved in these cases were broken down into several categories, each of which was considered separately.[18] For purposes of discussion, however, it is only necessary to distinguish between those transactions where the parties entered into a novation agreement and the more common situation where the purchaser assumed and agreed to pay off the mortgage debt but no formal substitution of liability was made. In the former, the vendor-mortgagor was completely relieved from liability to the mortgagee. It was argued by the state that this was a "payment of his . . . debts . . . by a third party for his direct benefit," as provided in the gross income tax statute.[19] The court reasoned that "[t]he term 'payment', in its legal import, means the satisfaction of a debt by money or the representative of money, and not by novation, compromise, or accord and satisfaction";[20] and, therefore, "[t]he release or discharge of the debts or other obligations of the taxpayer by methods other than payment would . . . not constitute the constructive receipt of income under the Act."[21] The court seems markedly constrained to confine its interpretation of "pay-

17. In the *Shirmeyer* case, *supra* note 11, the plaintiff had already paid the tax and was seeking a refund of the alleged overpayment.

18. In the *Colpaert* case these were designated as B, C, and D. Class B transactions contained an "Agreement for Substitution of Liability" executed by the vendor-mortgagor, the purchaser, and the mortgagee, whereby "the mortgagee agreed to look to the purchaser for payment of the mortgage, and released the appellee from all personal liability for the payment thereof." Class C transactions involved an assumption of the mortgage debt, but "the mortgages were not paid or released during the year in which the property was deeded to the purchaser." Class D transactions were like Class C except that the mortgages were paid off within the year of conveyance. 109 N.E.2d 415, 417 (Ind. 1952).

In the *Crown Development* case, the categories were designated as A, B, and C. In Class A transactions "within the taxable year, the purchaser procures a new loan and pays off the construction mortgage which purchaser had assumed and agreed to pay." Class B and Class C transactions were practically identical with those Classes in the *Colpaert* case, 109 N.E.2d 426, 427 (Ind. 1952).

19. IND. ANN. STAT. § 64-2601(i) (Burns 1951).

20. 109 N.E.2d 415, 419 (Ind. 1952).

21. *Ibid.*

ment" to the narrowest limits.[22] It has been held, in this jurisdiction as well as in others, that payment can be made in anything that the creditor will accept as payment,[23] and, in the principal cases, the mortgagee was clearly a party to the agreements for substitution of liability between the vendor-mortgagor and the purchaser. Moreover, the court held that since the vendor-mortgagor had been released of all liability to pay the debt by the novation agreement, even the later actual payment of the mortgage indebtedness by the purchaser could not constitute a taxable event as it would be "the payment of the debt or obligation of the purchaser who had assumed and agreed to pay it."[24]

Where no formal substitution of liability was entered into, the Department contended that by the act of assumption the vendor-mortgagor received "credits" as stipulated by the statute.[25] The court ruled otherwise, however, and pointed out that the actual payment of the mortgage debt by the purchaser who had assumed and agreed to pay it did not constitute taxable income to the vendor-mortgagor, since to be taxable the payment by the purchaser must have been the payment of "expenses, debts, or other obligations by a third party for his (the appellee's) direct benefit."[26] According to the numerous cases cited by the court, where there is an assumption of the mortgage by the purchaser, he becomes the principal debtor and the vendor-mortgagor becomes a surety.[27] In such a situation, the court reasoned that "the *direct* benefit to be derived from the subsequent payment of it must be

22. The only two cases cited in direct support of the court's view were procedural actions involving questions of pleading. Stone v. Webster, 65 Idaho 392, 144 P.2d 466 (1943); McPike Drug Co. v. Williams, 104 Okla. 244, 230 Pac. 904 (1924).

23. Tilford v. Roberts, 8 Ind. 254 (1856); Baum v. Nord, 88 Ind. App. 674, 682, 164 N.E. 294, 297 (1928); Roberts v. Vonnegut, 58 Ind. App. 142, 156, 104 N.E. 321, 326 (1914). *Cf.* United Mfg. Co. v. Mitchell, 342 Ill. App. 201, 95 N.E.2d 507 (1950); Kirk v. Welch, 212 Minn. 300, 3 N.W.2d 426 (1942).

24. 109 N.E.2d 415, 419 (Ind. 1952).

25. IND. ANN. STAT. § 64-2601(h) (Burns 1951).

26. 109 N.E.2d 415, 421 (Ind. 1952).

27. Black v. Krauss, 119 Ind. App. 529, 537, 85 N.E.2d 647, 650 (1949). See also Halstead v. LaRue, 177 Ind. 660, 98 N.E. 638 (1912); Todd v. Oglebay, 158 Ind. 595, 64 N.E. 32 (1902); Hancock v. Fleming, 103 Ind. 533, 3 N.E. 254 (1885); Ellis v. Johnson, 96 Ind. 377 (1884); Hill v. Minor, 79 Ind. 48 (1881); Snyder v. Robinson, 35 Ind. 311 (1871).

This also appears to be the general rule in many other jurisdictions. See, *e.g.*, Bloch v. Budish, 279 Mass. 102, 180 N.E. 729 (1932); Woodruff v. Germansky, 194 App. Div. 898, 184 N.Y. Supp. 958 (1st Dep't 1920), *aff'd*, 233 N.Y. 365, 135 N.E. 601 (1922); Harris v DePaulina, 40 Ohio App. 57, 178 N.E. 225 (1931). *But cf.* Fish v. Glover, 154 Ill. 86, 39 N.E. 1081 (1894).

This appears to be the legal basis for the court's ultimate determination. For some undisclosed reason the court permits the entire issue to turn upon the legal status of the parties involved in the transfer as a consequence of the terms of the transaction.

said to flow to the purchaser, and the benefit flowing to the grantor-mortgagor is secondary, incidental, consequential and remote, and therefore indirect within the meaning of the statute."[28]

The foregoing excerpt from the opinion in the *Colpaert* case aptly portrays the play on words involved in these recent decisions. Even if the word "direct" had not been in the statute, it is conceivable that the court, assuming it was desirous of deciding in favor of the taxpayers, could have reached the same result by finding that there was not that quality or degree of "benefit" to the vendor-mortgagor (taxpayer) which the legislature contemplated, and so the payments by the assuming purchaser did not constitute taxable receipts by the vendor-mortgagor.

Finally, in the *Colpaert* case, the court stated that its views were in harmony with the rules of the Department of State Revenue prior to 1946,[29] and held that Section 2 of Regulation 3405 "insofar as it purports to make transactions under categories C and D taxable, transcends the statute."[30] Section 2 of Regulation 3405 and the 1951 ruling apparently have been dealt a fatal blow.[31] As noted previously,[32] there is no particular reference to real estate sales in the statute, and the Department has contended that since no specific deduction is provided for in the statute for cases of real estate mortgage transactions, the Department, in allowing deductions prior to 1946, was acting extralegally and gratuitously. Therefore, neither the taxpayer nor the court should have any standing to complain when the Department withdraws one

28. 109 N.E.2d 415, 422 (Ind. 1952).

29. See note 7 *supra*.

30. 109 N.E.2d 415, 423 (Ind. 1952). Also see note 18 *supra*. Strangely, transactions under Category B escaped this denunciation by the court. If Section 2 of Reg. 3405 is invalid as to Categories C and D, it certainly should have the same effect as regards the novation agreements since the regulation concerns itself only with the status of the property at the time the seller acquired it and not with the terms of the immediate sale.

In the *Crown Development* case, the Department elected not to rely upon Reg. 3405. Instead, patterning its argument after the holding in the *Shirmeyer* case, it contended that the right to make the assessment was contained within the gross income tax statute, as a matter of construction. The court failed to agree with this contention.

31. See note 30 *supra*. Subsequent to the *Colpaert* and *Crown Development* decisions, the Gross Income Tax Division issued a bulletin, Information to Personnel 53-1, dated January 14, 1953, entitled Liability for Gross Income Tax on Receipts from Sale of Mortgaged Real Estate. In this bulletin the Department sets out four classes of transactions and carefully delineates the tax treatment of each one. No one of the four classes exactly falls within the language of Sections 1 or 2 of Reg. 3405, indicating that perhaps the Department no longer will endeavor to apply this regulation to sales of mortgaged real estate; for all practical purposes, therefore, Reg. 3405 is now a nullity. In addition, the Commissioner's Legal Ruling No. 15-51, *supra* note 14, impliedly can no longer be applicable.

32. See note 6 *supra*.

or all of the deductions from application, since, in so doing, the Department is only acting in a legal and proper manner.[33]

It seems clear that what the court is saying in the *Colpaert* and *Crown Development* cases is that an exclusion arises through logical progression in those transactions where the purchaser assumes the mortgage debt of the vendor; that is, payment by the purchaser to the mortgagee is not for the "direct benefit" of the vendor-mortgagor, therefore it is not income, and not within the purview of the statute. If the amount of the mortgage debt were income, the court would find it difficult to say that it is deductible in some situations and not deductible in others, or that it is deductible at all. But, if it is not income, which is what the language of the opinions indicates, then failure to tax it does no harm to the statute or the situation in the *Shirmeyer* case where the court said the purchaser's payment was income to the vendor-mortgagor.

In its argument to the court in the *Colpaert* and *Crown Development* cases, the Department made numerous references to the *Shirmeyer* case[34] and has subsequently contended that in order to hold as it did, the court should have reversed the *Shirmeyer* decision.[35] One might contend that the court had done so by implication were it not for the fact that the court pointedly distinguished that case on the ground that in the *Colpaert* and *Crown Development* cases the purchasers "assumed and agreed" to pay the mortgage indebtedness instead of taking "subject" to it as in the *Shirmeyer* case, where "the acceptance of the deed subject to the mortgage imposed upon the purchasers no liability to pay the mortgage debt."[36] This distinction, though narrow, is a valid one, and there would seem to be little doubt that the decisions are compatible, at least to that extent.[37]

A review of the Indiana cases involving the sale of mortgaged property affords support to the position adopted by the court. Certainly there is no doubt that when a grantee of real estate assumes the pay-

33. Based upon a communication to the INDIANA LAW JOURNAL from the General Counsel, Indiana Department of State Revenue.

34. See Brief for Appellants, *Colpaert* and *Crown Development* cases.

35. Contention made in a communication to the INDIANA LAW JOURNAL from the General Counsel, Indiana Department of State Revenue.

36. 109 N.E.2d 415, 421 (Ind. 1952).

37. As noted p. 83 *infra,* the distinctions drawn by the court are adequately supported by Indiana cases. Whether these differing results should have been reached policy-wise is, of course, problematical. Significantly, the Indiana Supreme Court was comprised of identical personnel when it decided all three cases.

In a letter from one of the Deputy Attorneys-General to the Commissioner of Revenue the position was taken that the decisions of these three cases were completely compatible and in no way inconsistent.

ment of a debt secured by a mortgage on the property, he becomes personally bound to the mortgagee creditor; and, as between the grantee and his grantor, the former becomes the principal debtor, while the latter becomes a surety.[38] In contrast, where real estate is conveyed subject to a mortgage, the grantee does not, because of the conveyance, become personally liable to discharge the mortgage indebtedness.[39] The court also noted that unless a transaction clearly comes within one of the provisions of the statute defining gross income, it cannot be taxed as such. And, where there is doubt, tax statutes are to be construed more strongly against the state and in favor of the citizen.[40] This "strict construction" approach emphasizes the danger of too much generality in the tax coverage provisions.

From a "cause and effect" point of view, the distinction presented in these cases represents a somewhat inane attitude. If a seller constructively receives taxable income when a purchaser who takes subject to the mortgage pays it off, it seems unrealistic to treat the transaction differently when the purchaser assumes the mortgage debt and satisfies it. The final effect is the same, the vendor-mortgagor is saved the cost of paying the mortgage debt which he incurred himself and which he otherwise would have had to pay.[41]

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38. See cases, note 27 *supra.*

39. Mutual Benefit Life Insurance Co. v. Lindley, 97 Ind. App. 575, 183 N.E. 127 (1933). *See* also Bunch v. Grave, 111 Ind. 351, 12 N.E. 514 (1887); Stamper v. Link, 117 Ind. App. 212, 69 N.E.2d 600 (1947); Slate v. Peoples Mutual Savings and Loan Ass'n, 104 Ind. App. 460, 8 N.E.2d 101 (1937); Kinney v. Heuring, 44 Ind. App. 590, 87 N.E. 1053, *rehearing denied,* 88 N.E. 865 (1909); Hancock v. Wiggins, 28 Ind. App. 449, 63 N.E. 242 (1902). *Accord,* Fonda v. Miller, 411 Ill. 74, 103 N.E.2d 98 (1952); Fair Oak Bldg. & Loan Ass'n of Leet Twp. v. Kahler, 320 Pa. 245, 181 Atl. 779 (1935).

The conveyance of land subject to a mortgage is merely the conveyance of an equity in the lands. Wayne International Bldg. & Loan Ass'n v. Beckner, 191 Ind. 664, 134 N.E. 273 (1922).

40. Indiana Department of State Revenue v. Colpaert Realty Corp., 109 N.E.2d 415, 418 (Ind. 1952). See Department of Treasury v. International Harvester Co., 221 Ind. 416, 47 N.E.2d 150 (1943); see also United States v. Merriam, 263 U.S. 179, 188 (1923); Walgreen v. Gross Income Tax Div., 225 Ind. 418, 420, 75 N.E.2d 784, 785 (1947); Oster v. Department of Treasury, 219 Ind. 313, 317, 37 N.E.2d 528, 529 (1941); Gross Income Tax Department of Treasury v. Harbison-Walker Refractories Co., 113 Ind. App. 695, 702, 48 N.E.2d 834, 837 (1943).

41. See Note, 22 Iowa L. Rev. 390 (1937), where the doctrine of constructive receipts in relation to the federal income tax is discussed. An elementary example is where pursuant to a contract a debt or other obligation is discharged by another for the taxpayer's benefit. This concept of taxable income through the realization of savings has its basis in the fact that "there lie, beyond the field of strictly legal obligations, *modes of behavior so common and recurring* as to justify the assumption there also that payment through another channel constitutes the effectuation of a saving." *Id.* at 395. In other words, it is common behavior for a debtor to pay his debts, so it may be assumed that when a third person does so for him it saves the debtor from doing what he normally would do. Is it unreasonable to assume, in the principal cases, that

Although there is some foundation for the legalistic dichotomy relied upon in these cases, the court's dismissal of Regulation 3405 because it allegedly went beyond the scope of the statute is a legal basis for invalidation which can be turned around and applied to the court itself. To begin with, the theory of a gross income tax precludes any consideration whatever of the cost or outlay needed to acquire the income.[42] The taxpayers involved here were commercial real estate companies, and the mortgages on the property were solely for the purpose of financing its improvement. Should not the amount of the mortgage debt involved in the sale be taxed as gross income to the vendor-mortgagor when the mortgage was executed covering the property "in the ordinary course of the business", regardless of whether the purchaser takes subject to or assumes the mortgage? By analogy to retail merchants, the mortgages represented to these development companies merely a part of the cost of the goods sold, or of doing business, which is not ordinarily deductible. Unless real estate developers can be classified as a privileged business to which only gross earnings are taxable,[43] such

the vendor-mortgagor would have paid the mortgage debt had it been unsuccessful in persuading the purchaser to take over the obligation?

In Richard R. Deupree, 1 T.C. 113 (1942), the petitioner, instead of taking additional authorized salary in cash, instructed his aides to buy a $50,000 single premium annuity policy for his benefit. It was held that he could just as well have had $50,000 in cash, so he was taxed as if he had received that amount. From this an analogy may be drawn, *i.e.,* if the original mortgagor in the *Colpaert* case, in selling the developed property, had so desired, he could have insisted that the purchaser pay the total amount to him (or have taken a mortgage himself from the purchaser); instead he directs the purchaser to pay the mortgage debt to the original mortgagee. Should he escape taxation?

In determining what constitutes a benefit within the meaning of Section 1(h) of the statute [§ 64-2601(h)], the Indiana Supreme Court said: "A person confers a benefit upon another if he gives to the other possession of or some other interest in money, land . . . *satisfies a debt or a duty of the other,* or in any way adds to the other's security or advantage. He confers a benefit not only where he adds to the property of another, but also where he saves the other from expense or loss. The word 'benefit,' therefore, denotes any form of advantage." Ralph L. Shirmeyer, Inc. v. Indiana Revenue Board, 229 Ind. 586, 595, 99 N.E.2d 847, 851 (1951). The court approved this definition of the word "benefit" in the *Colpaert* case and agreed that the vendor-mortgagor would be benefited by the assuming purchaser's payment, but as the court felt that he would merely be indirectly benefited, no taxable income was charged to him as a consequence. 109 N.E.2d 415, 421 (Ind. 1952).

42. "Some courts have shown a[n] . . . inability to distinguish sharply between net and gross income taxes . . . [the] distinction seems to be whether the law permits the deduction of the cost of goods sold or similar direct costs of the business. If such deduction is allowed, the tax is usually treated as one on net income even though the ordinary overhead expenses are not permitted to be deducted. If such a deduction is not allowed, it is treated as a gross income tax." *A Symposium on State Income Taxation,* 22 IOWA L. REV. 181, 260 (1937). Gross income is defined as gross receipts which allows no deductions for business expenses or cost of goods sold. *Cf.* Department of Treasury of Indiana v. Crowder, 214 Ind. 252, 15 N.E.2d 89 (1938).

43. Which is doubtful from the language of the statute. IND. ANN. STAT. §§ 64-2601(n), 64-2601(p) (Burns 1951). While gross earnings, in effect, do permit

vendor-mortgagors should not be exempt from taxation on the amount of the mortgage indebtedness. Nevertheless, the legal consequence of these decisions is to recognize, and allow deduction of, the cost of doing business, so that, in effect, only the gross earnings of these taxpayers were made liable for the gross income tax. It can be argued that these decisions "transcend the statute".

Furthermore, it remains to be considered whether the end result is a fair one. To those who believe that the tax is an unjustifiable burden which seriously handicaps the transferability of real estate, it is understandably a welcome relief. The conclusion is inescapable, however, that there exists in these decisions a noticeable element of inequity. Illustrative of this is the fundamental disparity which the Department of State Revenue attempted to adjust when it promulgated the 1946 Series of Regulations,[44] in order to eliminate what was considered an illogical and unfair treatment of vendors of mortgaged property. For example, *A* purchases a farm for $30,000. He pays $15,000 in cash and assumes a mortgage debt of $15,000 encumbering the property. He later sells the farm for $40,000, receiving $25,000 in cash and making arrangements with the purchaser to pay off the mortgage debt. Irrespective of the arrangements for assumption or satisfaction of the mortgage when the property is sold, under Section 1 of Regulation 3405, the Department permitted *A* to deduct the unpaid balance of the mortgage from the entire sales price, inasmuch as *A* never actually received the money represented by the mortgage debt.[45] Contrast the foregoing with the situation where *A2* inherits a $30,000 farm unencumbered. He borrows $15,000, giving a mortgage on the farm as security, which he spends for personal pleasures. *A2* later sells the farm for $40,000, receiving $25,000 in cash and arranging with the purchaser for settlement of the mortgage debt. Since *A2* has had the benefit of the money,[46] the Department determined that *A2* should now be subject to gross income tax on the full sales price regardless of the terms of the transaction, and Section 2 of Regulation 3405 so provided.[47] In the light

the exclusion of the cost of the goods sold, they are not the same as net income in that they include selling and administrative expenses, and where gross earnings are computed on each transaction losses are not deductible. See Northrup, *supra* note 2, at 164.

44. See notes 8, 9, and 10 *supra,* and accompanying text.

45. See note 8 *supra.*

46. *A2* was not taxable when he originally received it since it was "borrowed money." IND. ANN. STAT. § 64-2601(m) (Burns 1951); INDIANA GROSS INCOME TAX REGULATIONS 46, Series VII, Reg. 1206 (1946).

47. See note 8 *supra.* Examples based on materials from a communication to the INDIANA LAW JOURNAL from the Indiana Department of State Revenue.

of these decisions[48] in the first hypothetical case, if the last purchaser took the farm subject to the mortgage, *A* evidently would be liable for gross income tax on the entire sales price; in the second example, if *A2* could prevail upon the purchaser to assume the mortgage, *A2* would be taxable only on the $25,000 cash payment.

Aside from legal and equitable considerations, one may wonder what, if any, underlying and unexpressed policy prompted the court to arrive at these decisions? Did the court feel impelled to favor real estate transactions over those sales involving personal property?[49] And why should not the deduction of real estate mortgages be permitted in all cases?[50] Many other questions could be posed, but the answers must be mere conjecture. The arguments of the litigants contain several items which perhaps serve to throw some light on these matters, but the court failed to discuss them.[51] One particular argument advanced by the taxpayers in the *Crown Development* case may have influenced

48. Indiana Department of State Revenue v. Colpaert Realty Corp., 109 N.E.2d 415 (Ind. 1952); Department of State Revenue v. Crown Development Co., 109 N.E.2d 426 (Ind. 1952); Ralph L. Shirmeyer, Inc. v. Indiana Revenue Board, 229 Ind. 586, 99 N.E.2d 847 (1951).

49. This is not incomprehensible, particularly when it is recalled that the Department of State Revenue reflected just such an attitude in its early treatment of these transactions. See note 7 *supra*. The court in the *Colpaert* case, at 109 N.E.2d 415, 422, refers to the administration of the Act by the Department from 1933 to 1946 and makes much of the fact that the legislature effected no statutory changes over that period. The contention by the court that such legislative inaction indicates satisfaction with the construction placed upon the statute by those charged with the administration of it is a rather tenuous argument since, to a great extent, the impetus for many past revisions has come from the Department itself. Moreover, the legislative acquiescence in Reg. 3405 itself from 1946 to date is an equally important fact which cannot be ignored.

It seems unlikely that any question of unconstitutional discrimination could be validly raised on the grounds that deduction of mortgage indebtedness is permissible in sales of real property and not allowed in sales of personal property. See State *ex rel.* Lewis v. Smith, 158 Ind. 543, 63 N.E. 25, (dissent) 63 N.E. 214, *rehearing denied*, 64 N.E. 18 (1902). *Cf.* Miles v. Department of Treasury, 209 Ind. 172, 193 N.E. 855 (1935); Dowd v. Stuckey, 222 Ind. 100, 51 N.E.(2d) 947 (1944).

"The court should have considered the entire field of debt securities and pointed out distinctions if any exist, but by leaving chattel mortgages and other encumbrances out of the picture it might be considered . . . that they thought that real estate mortgage encumbrances are in a special category. And in administering the tax act it seems to me that the Department will have to regard them so at least until the question of other encumbrances is tested." Communication to INDIANA LAW JOURNAL from General Counsel, Indiana Department of State Revenue.

50. Since the *Shirmeyer* case has been upheld, they cannot be. See Bulletin 53-1, Gross Income Tax Division, Indiana Department of State Revenue, *supra* note 31.

51. *E.g.*, ". . . [W]hy limit the contentions of mortgage deductions to *real estate* sales, or to a *mortgage encumbrance*? Why not the matter of *chattel mortgages*, or other *liens*, or any other type of debt upon either real or personal property such as forfeited real estate security or appearance bonds, or mechanics' liens, etc.?" Brief for Appellant, p. 218, Indiana Department of State Revenue v. Colpaert Realty Corp., 109 N.E.2d 415 (Ind. 1952).

the court to some degree in reaching its decision. They contended that to hold them liable to pay gross income tax on the entire sales price would subject taxpayers to an undue burden and hardship in that the mortgage payments, in most instances, would be made over a period of fifteen or twenty years, and in order for the taxpayer to know when it realized taxable receipts it "would be required either to insist that the mortgage payments be made to the taxpayer and taxpayer in turn make them to the mortgagee, or else insist upon the mortgagee advising taxpayer of each and every payment."[52] Admittedly, this presents a serious problem which could be virtually insurmountable, as is further pointed out in the argument that "the first assuming purchaser might sell the property with a second purchaser assuming the mortgage, and so forth. Taxpayer conceivably, in these days of rapid turnover of real estate would lose complete contact with the ultimate assuming purchaser."[53]

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52. Brief for Appellee, pp. 44, 45, Department of State Revenue v. Crown Development Co., 109 N.E.2d 426 (Ind. 1952).

53. *Ibid.* The question naturally arises as to where the ultimate liability would lie in a situation involving several successive grantees. *E.g.*, A, the original mortgagor, sells Blackacre to B, who takes subject to the mortgage; B then transfers to C, C to D, D to E, and E to X, all such grantees taking subject to the mortgage debt. In this situation, under the general rule that where real estate is conveyed subject to a mortgage the grantee does not become personally liable, see note 39 *supra*, A would continue to be primarily liable on the mortgage, and should X pay off the indebtedness to the mortgagee, it would be considered taxable income to A, not to X's immediate grantor (E), since E never became personally liable on the mortgage debt.

The converse set of facts would be where A, the original mortgagor, sells Greenacre to B, who assumes and agrees to pay the mortgage debt; B then transfers to C, C to D, D to E, and E to X, each successive grantee assuming the mortgage. Here, following the general rule that such a grantee becomes the principal debtor and his grantor becomes a surety, see note 27 *supra*, X would be primarily liable to the mortgagee and A would be nothing more than a remote surety. *Accord:* Carnahan v. Tousey, 93 Ind. 561, 563 (1884).

Obviously the situation could become quite complicated if the succeeding grantees deviate from the terms of tbe initial transfer. For instance, A, the original mortgagor, sells Blueacre to B, who takes subject to the mortgage debt; B then conveys to C, C to D, and D to E, each subsequent grantee taking the property subject to the mortgage. E then transfers to X, who assumes and agrees to pay the mortgage debt. Under the rules it seems that X logically would become primarily liable to the mortgagee, even though his immediate grantor (E) was not personally obligated on the mortgage; A would become a surety. When X pays off the mortgagee, per the *Colpaert* and *Crown Development* cases, *none* of the parties would be considered as receiving taxable gross income; although, if E had paid it off, A ostensibly would have been subject to tax under the *Shirmeyer* rule. If a hardship exists in these circumstances, it is not on the taxpayer alone! *Contra:* Harvey v. Lowry, 204 Ind. 93, 183 N.E. 309 (1932), where Harvey sold a piece of real estate to P.K., subject to a valid, recorded judgment lien in favor of Anderson. P.K. later conveyed to V.D.B., who made no covenant to discharge encumbrances. Then the property was sold in execution of the judgment with Anderson buying in at the sheriff's sale for an amount less than the judgment debt. Within the year of redemption V.D.B. conveyed the real estate to Lowry, who knew that Anderson held a sheriff's certifi-

Of course, the same argument could be made in relation to transactions where the purchaser takes the property subject to the mortgage debt. The court may have overlooked this contingency in the *Shirmeyer* case, but it had an opportunity to reconsider the problem in the *Crown Development* case and yet the *Shirmeyer* decision still stands. Possibly, in the earlier case, the court thought that since the vendor-mortgagor remained primarily liable to the mortgagee, the latter would as a matter of course inform the vendor-mortgagor whenever the vendee made a payment on the mortgage debt.[54]

One may also wonder whether the court took full cognizance of the potential consequences implicit in the decision of the principal cases. Initially, a tremendous administrative burden will be thrust upon the Department of State Revenue. It is always difficult to police transactions where the original vendor-mortgagor is taxable on payments made by the vendee to the mortgagee, but where the vendor-mortgagor is only taxable on payments where the vendee took the property subject to the mortgage debt, the task becomes virtually impossible. It will be necessary for the Department to examine every conveyance made each year and follow-up the transaction for a number of succeeding years or, in

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cate of sale. Lowry expressly assumed and agreed to pay the encumbrance on the property as part of the purchase price. Lowry then purchased the certificate of sale from Anderson, taking a receipt in full. Meanwhile Anderson had obtained satisfaction of his deficiency judgment by levying against other real property belonging to Harvey. Harvey then sued Lowry for this balance of the judgment debt which he had been forced to pay. The court held that Harvey had no contractual claim against Lowry by reason of the personal liability assumed by Lowry; that Lowry's contract was for the benefit of Anderson and not for the benefit of Harvey. The court pointed out that where successive grantees assume the mortgage the last grantee becomes primarily liable and the remote grantor is a surety, but if the immediate "grantor is not personally obligated to pay the encumbrance debt one of the essential factors is missing and the promise of the grantee to pay the encumbrance can not create a situation in which both the grantor and grantee are obligated to discharge a claim to a third person, the discharge of which should ultimately fall upon the grantee As between the grantee and grantor the grantee is immediately and solely liable to discharge the obligation; and the third party can not assert a claim against the grantor personally. In the instant case no principal-surety relationship arose between the appellee Lowry and his immediate grantor for the reason that his grantor was not personally obligated to discharge the encumbrance against the real estate. Since there was no continuous chain of principal-surety relation running from the grantee, Lowry, to his remote grantor, the appellant, there is no basis in the successive conveyances for the creation of a principal-surety relation between the appellant and appellee." *Id.* at 101, 183 N.E. at 311. How would the court treat these facts tax-wise?

54. The fact that the purchasers in the *Shirmeyer* case paid off the mortgage in full within the same year may have had some bearing on the court's lack of concern for the problem of successive grantees. BACK, *op. cit. supra* note 2, at 111, suggests a requirement that "upon the sale of real estate title could not pass until the gross income tax on the transaction has been paid." It is doubtful whether such a program could be effectuated. At most, perhaps, the tax could be made a lien on the property enforceable against anyone in possession.

the alternative, trust the vendor-mortgagor to report the factual details of the transaction and acknowledge his liability. All of this is in addition to the usual burden of determining the amount of taxable payments made by vendees during successive tax periods.[55]

Moreover, as soon as that segment of the general public which at one time or another will be selling real property becomes aware of the potential tax saving available as a consequence of this new exemption doctrine, all sales of mortgaged real estate quite likely will involve an assumption of the mortgage debt by the purchaser. Of course, market conditions will have some effect on these transactions; during a decline in real estate prices, the purchaser may insist on taking subject to the mortgage debt since it minimizes his investment risk in that he only stands to lose at most what he paid for the vendor-mortgagor's equity in the property. The threat of a deficiency judgment would be eliminated, and if the price of the land continues to fall, such a purchaser can default and let the mortgagee proceed against the property itself and/or the vendor-mortgagor on the debt.[56] Nevertheless, in times of stable or rising prices, such as currently prevail, most purchasers of real estate, with the possible exception of speculators, should offer little objection to assuming the mortgage obligation.[57]

A not unrealistic extension of this exemption benefit envisages the mortgaging of all real property prior to sale, followed by the proper form of transfer as distinguished by the court in order to escape taxation. Where the mortgage was executed for the obvious purpose of avoiding a tax on the sale, it is problematical whether the scheme would succeed.[58] But it certainly might be worth the effort if a large potential

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55. Of course, a similar problem was possible under Reg. 3405 in that taxability depended upon whether the mortgage existed on the property at the time it was acquired by the seller or whether the seller mortgaged the property subsequent to its acquisition. In this situation, however, all sales apparently were considered taxable since the terms of the immediate sale had no bearing on the tax liability and the burden was on the seller to prove the existence of the mortgage at the time the property came into his hands.

56. See discussion in FULLER, BASIC CONTRACT LAW 567 (1947), where it is also pointed out that an assumption of the mortgage by the purchaser is probably the most common type of agreement concerning payment of the mortgage debt.

57. Almost all sales will involve an assumption of the mortgage and the policing problem referred to may be to a great extent eliminated. Nevertheless, since some purchasers doubtlessly would still take subject to the mortgage, the Department would continue to be faced with the choice of policing closely or abandoning all efforts to obtain revenue from sales of mortgaged real estate.

58. INDIANA GROSS INCOME TAX REGULATIONS 46, Series VII, Reg. 3402 (1946), provides: ". . . [I]f the Division adjudges the property has been mortgaged for the purpose of sale and the avoidance of tax, the receipt or crediting to the mortgagor of the mortgage money will be considered as payment on the sale price of the property and will be taxable. . . ." In other words, since borrowed money is not ordinarily

tax saving were at stake. Such a development affecting the form of mortgaged real estate transactions will produce at least one result which is definitely adverse from the standpoint of the state, a sizeable loss of gross income tax revenue.[59] This, in turn, will necessitate a correspond-

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taxable to the recipient, the Department is attempting to protect against an actual sale under the guise of a mortgage transaction. Where the transfer is not made to the mortgagee, however, this regulation evidently would not apply.

The extension contemplated is a legitimate mortgage transaction followed shortly thereafter by a sale to a purchaser who is not the mortgagee. It should not make any difference that the seller mortgaged the property solely for purposes of sale, since the court, in the *Colpaert* and *Crown Development* cases, did not concern itself primarily with the reasons prompting the execution of the mortgages by the vendors. If it had, the court might have recognized that the mortgages clearly represented a part of the cost of doing business to the commercial vendors involved, which is not as yet deductible in any other type of transaction under the Indiana gross income tax. *Cf.* note 43 *supra,* and accompanying text. Patently, the court was gripped with fascination at the neat distinction which it created between direct and indirect benefits. All potential tax avoiders should make this the theme of their scheme!

59. The loss of the additional taxes sought in the *Colpaert* and *Crown Development* cases alone amounted to a total of $38,460.96 plus penalties and interest. Brief for Appellant, pp. 80, 91, 101, 110, 118, Indiana Department of State Revenue v. Colpaert Realty Corp., 109 N.E.2d 415 (Ind. 1952); Brief for Appellant, pp. 78, 79, Department of State Revenue v. Crown Development Co., 109 N.E.2d 426 (Ind. 1952).

Adequate statistical information is not available as to the total number of sales of mortgaged real estate annually in Indiana, nor as to the total amount of property values involved in such sales. However, a survey of the deeds and mortgages recorded in nine principal Indiana counties reveals that the number of mortgages placed on record each month was equivalent to approximately 74.4% of the total number of deeds which were recorded monthly. Indiana Business Review, Dec., 1951, p. 8; Indiana Business Review, March, 1953, p. 8. While this is not an exact indication, it gives some basis for speculation that a mortgage is involved in almost three-fourths of all real estate sales in Indiana, which in turn is one measure of the potential revenue loss.

As to losses from past transactions, the Department has invoked the Statute of Limitations, so that these decisions will not affect the years prior to 1949. Also those seeking refunds are being required to fill out questionaires in order to establish their claims. See Gross Income Tax Division, Indiana Department of State Revenue, Bulletin 53-1 (Jan. 14, 1953); Communication to INDIANA LAW JOURNAL from Deputy Attorney-General John J. McShane.

On March 24, 1953, the total number of claims for refunds exceeded 3000. Information as to the amounts involved is not available, but if they averaged only $200 each, they would reflect a revenue loss of over half a million dollars, not to mention the cost of processing such claims. Furthermore, the total number of claims arising out of past transactions will not be known until January 31, 1956, which is the deadline under the Statute of Limitations for excessive payments made between February 1, 1952, and January 31, 1953. From an interview with the General Counsel, Department of State Revenue.

An interesting newspaper story appeared on the morning following the rendition of the *Colpaert* and *Crown Development* decisions in which the State Revenue Commissioner is quoted as saying that these rulings would "[r]educe gross income on future real estate transactions alone by hundreds of thousands of dollars annually." Indianapolis Star, Dec. 17, 1952, p. 1, col. 8. A follow-up item in the issue of December 20, 1952, p. 1, col. 4, stated that some estimates of refunds had ranged into the millions of dollars. The extent of future losses will, of course, depend upon what sellers of real estate do and upon the reaction of the courts to mortgage formalities purely for tax avoidance.

ing reduction in state expenditures, or, more likely, an increase in other forms of taxation.[60]

So far as the depletion of revenue is concerned, the state will be fortunate if the loss is restricted to real estate sales. The court's language in the *Colpaert* and *Crown Development* cases, which narrowed the doctrine of constructive receipts[61] may invite further effort toward procuring exemptions from taxation in transactions involving other types of liens and encumbrances, such as chattel mortgages.[62] Although

60. Thus, the tax burden will be shifted to other elements in the taxpaying population. Obviously, the commercial real estate developers and sellers stand to benefit most since the bulk of their income is derived from the sale of real property.

An interesting sidelight has developed as a result of the controversy over retention of the state bonus tax (a surtax added to the Gross Income Tax in 1949 to finance payment of World War II veterans' bonuses and which is due to expire at the end of 1953). The bonus tax has yielded a sizeable amount of revenue, *e.g.*, $32.3 million in 1952. See State of Indiana, REPORT OF THE TAX STUDY COMMISSION 73, table 6 (1952). Its continuation would serve to offset the actual and potential loss of revenue as a consequence of the decisions in the principal cases. Significantly, the following item appeared in the editorial page of the Indianapolis Star, July 23, 1953, p, 18, col. 1: "The Chairman of the tax committee of the Indianapolis Real Estate Board has proposed that the state soldiers bonus be made a permanent tax and the funds allotted to the cities and towns of the state." The Star opposed the proposal. For the full news story see Indianapolis Star, July 22, 1953, p. 1, col. 7. Much of the burden from retaining the bonus tax would not be borne by the real estate group.

In a communication to the INDIANA LAW JOURNAL, the General Counsel, Indiana Department of State Revenue, states that "the last sentence of Reg. 100 [Series I, issued July 1, 1934, see note 7 *supra*] . . . is still being enforced and we find that it will cover 70 per cent of all sales of real estate." In other words, past experience indicates that in over two-thirds of the sales of mortgaged property, the purchaser pays the full price and the seller uses this money to pay off the mortgage.

61. See note 41 *supra*. INDIANA GROSS INCOME TAX REGULATIONS 46, Series VII, Reg. 1006 (1946), defines constructive receipts. See also IND. ANN. STAT. §§ 64-2601(h), 64-2601(i) (Burns 1951).

The recent publication by the Indiana State Bar Association, INDIANA TAXES (1953), includes a section at 221 specifically devoted to constructive receipts under the Indiana gross income tax. The *Shirmeyer, Colpaert,* and *Crown Development* cases are discussed therein, but no particular suggestions or recommendations are offered.

62. The State Revenue Commissioner commented that these recent decisions might "[p]ossibly be construed to apply to chattel mortgages on automobiles, jewelry, furniture and other items and provide another gross income tax 'dodge' which would further lessen the state's income." Newspaper interview, *supra* note 59. "The authorities agree that a chattel mortgage transfers title *conditionally*—the same as does a real estate mortgage. In the latter the estate remains in the mortgagor and in the case of chattel mortgages the title and possession also so remains. But owing to the strict warranty characteristics inherent in real estate mortgages, it might possibly be developed that a sufficient difference exists to justify a distinction." Communication to the INDIANA LAW JOURNAL from the General Counsel, Indiana Department of State Revenue.

INDIANA GROSS INCOME TAX REGULATIONS 46, Series VII, Reg. 3407 (1946), expressly states: "Except as to immunity from tax on borrowed money or repayment thereof, chattel mortgages will not fall within the above Regulations." *I.e.*, no dedutions. Several states impose a tax on the sale of tangible personal property and exclude sales of real property. It is not unusual, then, that a differentiation is made between real estate mortgages and chattel mortgages by the Indiana Department of State

only sales of real property were considered in the principal cases, it is worthy of note that the court did not specifically restrict application of the doctrine set forth to land transactions and real estate mortgages.

Chattel mortgages are frequently utilized in automobile sales. At present automobile dealers are taxed upon the entire sales price of the automobile, excluding the value allowed for a used car traded in.[63] A common practice in the automobile trade is for dealers to finance the purchase of their new cars from the manufacturer,[64] usually by means of a trust receipt.[65] When the dealer offers an automobile for sale, the finance company or bank which financed the purchase from the manufacturer holds a security interest in that chattel. The retail purchaser either pays the dealer in cash, signs a conditional sales contract, or executes a chattel mortgage on the automobile as security for a note.[66] Where the purchaser is given credit, the dealer, in order to obtain his money promptly, ordinarily sells the consumer paper to a bank or finance company. Thus, the dealer steps out of the picture, but to what extent depends upon which one of the three general bases on which finance companies purchase installment contracts from the dealers is used.[67] Where the wholly nonrecourse agreement is utilized,[68] the dealer's responsibility ordinarily has ended with the purchase of the consumer paper by the finance company,[69] and a reasonably accurate analogy may be drawn between these circumstances and the situation where the purchaser of mortgaged real estate assumes and agrees to pay the mortgage debt and the vendor-mortgagor is relieved of pri-

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Revenue. See, *e.g.*, ARIZ. CODE ANN. § 73-1302 (1939); HAWAII REV. LAWS c. 101, § 5444 (1945); MISS. CODE ANN. § 10104 (Supp. 1950); N.C. GEN. STAT. § 105-167 (1950).

63. INDIANA GROSS INCOME TAX REGULATIONS 46, Series VII, Regs. 1304, 1305 (1946). However, under Reg. 1305, the seller of the new article must report and pay tax upon the amount received from the subsequent sale of the used article accepted, if it is sold outright, or upon the "boot" received in a subsequent transaction involving an exchange of the property.

64. Most dealers do not have the funds to purchase outright the large number of cars which they handle. PHELPS, THE ROLE OF THE SALES FINANCE COMPANIES IN THE AMERICAN ECONOMY 23 (1952); F.T.C., REPORT ON MOTOR VEHICLE INDUSTRY 920, 921 (1940).

65. F.T.C. REPORT, *supra* note 64, at 921.

66. See Adelson, *The Mechanics of the Installment Credit Sale*, 2 LAW & CONTEMP. PROB. 218, 219 (1935).

67. These are (1) specific nonrecourse but subject to a general repurchase agreement; (2) wholly nonrecourse to the vending dealers; and (3) full recourse to the vending dealers. F.T.C. REPORT, *supra* note 64, at 927; Adelson, *supra* note 66 at 220.

68. F.T.C. REPORT, *supra* note 64 at 932. "There is probably no finance company that follows exclusively the practice of purchasing these installment contracts wholly without recourse to the dealers. However, most of the independent finance companies make their purchases under this plan to the extent of probably 80 percent or more of the total volume of installment contracts purchased."

69. See Adelson, *supra* note 66, at 221.

mary liability. That is, if there is no constructive receipt by the vendor-mortgagor in the real property transaction, may it not be contended that, except for the dealer's profit, there is no taxable gross income received by the automobile dealer when the retail purchaser pays off the balance of the indebtedness on the automobile to the finance company?

Unquestionably there are differences in the two types of transactions as they now exist which would require adjustment before the automobile transaction fully conforms to the pattern designed by the court in the *Colpaert* and *Crown Development* cases in qualifying for the tax exemption.[70] But, this new concept of constructive receipt may lend

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70. Perhaps it would be necessary to shift to the chattel mortgage security device in place of trust receipts, although it may be possible for the trustee (dealer) to transfer his interest in the motor vehicle subject to the security interest of the finance company. Commercial Credit Co. v. Peak, 195 Cal. 27, 31, 231 Pac. 340, 342 (1924). See also IND. ANN. STAT. § 51-609(2)(c) (Burns 1951) (Liberty of Sale). There would seem to be little difficulty connected with an assignment of the chattel mortgage debt to the purchaser, and such device would facilitate a closer analogy to the real estate transaction. Ostensibly, an automobile dealer with a large annual turnover of new cars would be more than willing to make any reasonable adjustments necessary to realize a potential gross income tax saving of several thousands of dollars (1000 automobiles at $15 taxes on each sale represents a $15,000 gain per year). Even the smaller dealers would seek the tax saving if it could be obtained simply and easily. The big question mark concerns the banks and finance companies. An interview with a bank loan officer indicates that the "floor-planners" might be reluctant to abandon the trust receipt in favor of some other type of security, since they feel that the former provides them with greater protection against an unreliable dealer. Also, the dealers are financed at an almost negligible rate of interest, and the financiers would be unwilling to extend such favorable terms to an assuming purchaser for any length of time. Possibly the biggest single factor which could motivate the banks and finance companies to accommodate the dealers in this respect is the element of keen competition currently existing among those seeking the valuable consumer paper from the automobile dealers. See Note, 28 IND. L. J. 638, 643 (1953).

It is submitted that an arrangement can and may be worked out which will prove satisfactory to all parties and which will enable the automobile dealer to obtain his gross income tax saving. *E.g.*, the banks and finance companies could finance the purchase of the car from the manufacturer, accepting a chattel mortgage on the automobile as security along with a demand or extremely short-term note from the dealer. When the dealer sells the car, he will assign the chattel mortgage and note to the assuming purchaser, who then becomes primarily liable to the finance company. The finance company, which does not want the car but rather its money plus interest, will then enter into a substitute long-term installment contract with the purchaser, who will sign in consideration for his release from liability on the chattel mortgage and note assumed. The dealer should escape taxation, because when the assuming purchaser pays off the chattel mortgage debt, he is paying off his own debt and it is immaterial as to the manner in which he satisfies it.

Conceivably as an added incentive to induce the banks and finance companies to go along, the dealer may forego a part of his so-called "dealer's reserve" (share of the finance charges). Most dealers could do so and still profit from the arrangement. *Id.* at 642.

Reportedy, most used-car purchases by automobile dealers are financed with the chattel mortgage security device. So, even though the plan outlined should prove to be not feasible, an opportunity for gross income tax saving is available by merely having the used-car purchaser assume the dealer's chattel mortgage indebtedness.

itself readily to the sale of other types of encumbered property,[71] and the automobile transaction is suggested as an example in which the potential tax saving may be great enough to warrant any adaptation that may be necessary.

This material furnishes at least a partial idea of the muddle that has developed through the attempted administration and enforcement of a gross income tax to sales of mortgaged real estate over a period of twenty years, and it presents a challenge almost as serious as the test which faced the Legislators in the early months of 1933. Before offering any suggestions as to what should be done, it is necessary to determine whether the courts or the Legislature should attempt to unravel the problem, or whether their actions are both essential to a solution.

The Indiana gross income tax has undergone a number of substantive changes. Briefly, the more important revisions have been a narrowing of the base of the tax for financial institutions, insurance carriers, retail merchants, and public terminal grain and soybean handlers with full transit privileges; a broadening of the tax base for partnerships and joint ventures; a reduction in the tax rate for retail merchants selling at retail and for dry cleaners and launderers; and an allowance to retailers of a $3000 exemption as opposed to a $1000 basic exemption granted to all other taxpayers.[72] In addition, as noted earlier, the Department of State Revenue through its administrative regulations permitted the deduction of mortgage indebtedness in sales of real property.[73] These changes, particularly the limitation of taxability to gross earnings in the case of financial institutions,[74] and the nonstatutory freeing of the mortgage debt from taxation both by the Department and more recently by the court,[75] would appear to be in violation of the spirit of a gross income tax.[76] While no attempt is made to doubt

71. The pertinent section in INDIANA TAXES (1953), concludes as follows: "The decisions of the Supreme Court in the recent mortgage cases are landmark decisions in Indiana on the doctrine of constructive receipt and should be carefully studied for their effect in all constructive receipt cases." *Id.* at 227.

72. State of Indiana, REPORT OF THE TAX STUDY COMMISSION 67 (1952)

73. See note 7 *supra.*

74. IND. ANN. STAT. §§ 64-2601(n), 64-2601(p) (Burns 1951); INDIANA GROSS INCOME TAX REGULATIONS 46, Series VII, Regs. 104, 1005 (1946).

75. Even though Reg. 3405 is considered invalidated, the *Colpaert* and *Crown Development* decisions have the same result.

76. See note 42 *supra.* Northrup, *Indiana Gross Income Tax,* 25 IND. L.J. 148, 160 (1949), distinguishes several types of taxes on the basis of their relationship to gross receipts. A pure gross receipts tax "includes all material values acquired from certain sources defined by the statute." The Indiana gross income tax is considered to fall under category (2); "Other taxes may be based on gross receipts, but allow exemptions either in terms of certain amounts or certain sources." The other categories set out are: "(3) Gross profits taxes include gross receipts less the cost of the goods sold. (4) And a net income tax is measured by gross receipts less all business expenses." Manifestly, the changes referred to move the Indiana tax, in

the policy of the Legislature, these illustrations do raise the question whether this state does, in the fullest sense, continue to have a gross income tax?

The fact that some of the alterations which have been made go to the heart of the customary concept of a gross income tax emphasizes the importance of having the Legislature, the creator and sponsor of this revenue-raising device, assume primary responsibility for providing the ultimate solution to any problems in connection therewith.[77]

Three possible courses of action are indicated. The Legislature can amend the statute so as to specifically cover the tax treatment of sales of mortgaged property.[78] A variety of opinions would be forthcoming,

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part at least, into the third classification. Again, at 164, "the growing use of the gross earnings base illustrates a tendency of the gross income tax to break down into separate types of taxes." HAIG AND SHOUP, THE SALES TAX IN THE AMERICAN STATES, 237 *et seq.* (1934), make numerous references to the Indiana gross income tax as a "sales" tax. Back, in his comprehensive study of the Indiana gross income tax, seems to consider the tax as both a form of retail sales tax and "essentially a transaction or turnover tax on business." BACK, THE INDIANA GROSS INCOME TAX 82 (1950).

In Gross Income Tax Division v. Bartlett, 228 Ind. 505, 515, 93 N.E.2d 174, 179 (1950), the court attempts a precise definition of "gross income" and concludes that it means "total receipts." Such, of course, is of little assistance, since the task remains to define "receipts." This judicial definition was cited with approval in the *Shirmeyer* case, 229 Ind. 586, 592, 99 N.E.2d 847, 849 (1951), but was either overlooked or considered unnecessary in the *Colpaert* and *Crown Development* cases.

The difficulty of formulating the income concept is suggested by Fisher, *A Practical Schedule for an Income Tax,* 15 TAX MAG. 379 (1937). ". . . [N]umerous unsatisfactory definitions are collected. Kleinwächter concluded from his own studies that it was impossible to define income satisfactorily and many writers since have echoed that opinion."

77. "Moreover, it seems to us that there should enter into the minds of this court the fact that the presented issues are for the legislature to determine. If the legislature feels that it is a proper policy to measure taxable receipts under the Act by the amount of an extinguished contingent liability, then let the legislature say so in an amendment to the Act. Until such time as the legislature acts, it seems to us that the Court should treat the conclusions of law of the trial court as the correct ones." Brief for Appellee, p. 46, Department of State Revenue v. Crown Development Co., 109 N.E.2d 426 (Ind. 1952).

And, as the Court said in the *Colpaert* case, 109 N.E.2d 415, 418 (Ind. 1952), "the legislature may provide that, for purposes of taxation, the amount of the mortgage indebtedness or a part of it may be deducted from the assessed valuation of the mortgaged premises." The cases cited in support of this proposition refer to general real property taxes; however, the Indiana Court has indicated thereby that it deems such matters to be within the scope of the legislative function.

78. This could be accomplished very simply in at least two ways. (1) Change the wording of § 64-2601(i) to read: "payment of his expenses, debts, or other obligations by a third party for his benefit, *direct or indirect.*" Or, it might suffice merely to extricate the word "direct" from in front of "benefit." (2) Add to the exclusionary provisions of § 64-2601(m) the proviso that "the amount of the mortgage debt existing on real property at the time of the sale *shall* [or *shall not*] be included in the computation of taxable gross income." Of course, if the amendments were contrary to the *Colpaert* and *Crown Development* rulings, much opposition would come from the commercial real estate interests. In connection with the proposal of legislative action, it is interesting to note that certain spokesmen for the real estate groups,

no doubt, as to how such transactions should be handled. It is submitted that, prior to any form of amendment, the Legislature should be fully acquainted with every aspect of the problem, *i.e.,* hardships on taxpayers, loss of revenue to the state, administrative difficulties, impediment to real estate transfers, desirability or undesirability of fostering real estate developments, effect of tax policy in times of financial depression, and the frequency of occurrence of transactions requiring coverage. Only with a clear understanding of the problem and a complete recognition of the impact of any proposed method of solution can the lawmakers act intelligently to prevent a recurrence of the present situation. As noted, the entire series of administrative regulations in regard to sales of mortgaged real estate apparently were without any clear foundation in the statute. No doubt much could be said in support of the Department's initial policy of exemption, but the problems which have arisen as a consequence illustrate the fallacy of a statute which, in an effort to be all encompassing, fails to clearly and unequivocally cover a specific and common situation.

An extreme remedy would be repeal of the gross income tax and the substitution of another type of tax. Whether this would provide a satisfactory answer or only create new problems is, of course, problematical.[79] It is highly doubtful that the gross income tax could be replaced at the present time; it has proved to be such a bountiful source of revenue,[80] that there would certainly be much opposition to its removal.[81]

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among them Mr. Robert M. Reel, Executive Secretary of the Indiana Real Estate Association, said that "although property owners benefited directly and themselves mostly indirectly by the decision, they favored clarification of the 1933 Gross Income Tax Act so such 'unjust' taxation cannot be imposed in the future." Indianapolis Star, Dec. 18, 1952, p. 3, col. 5.

In the Mississippi General Sales Tax statute, which taxes gross receipts derived from trades, business, etc. (applies only to sales of tangible, personal property), the term "business" is defined to include "all acts engaged in with the object of gain, benefit, or advantage either *direct* or *indirect*." (emphasis added) MISS. CODE ANN. § 10104 (Supp. 1950).

79. Certainly with a net income tax the specific problem in controversy could not have arisen. See note 5 *supra*. However, the Federal net income tax is not without its own problems. See Surrey and Warren, *supra* note 5.

80. The Report of the Tax Study Commission, *supra* note 72, at 73, table 6, shows that the gross income tax yield has increased from $10,395,800 in 1933-4 to $95,085,000 in 1951-2 (exclusive of the veterans' bonus tax). Table 13, at page 100, discloses that the gross income tax is clearly the largest single source of State revenue, supplying almost twice as much income to the State government as the gasoline tax which ranks second as a producer of revenue. According to an estimate of the Department of State Revenue, the yield from the gross income tax for 1952-3 will total approximately $105,000,000. The upward trend has not abated, but appears to be intensifying; as noted, the effects of the principal cases will not aid in this respect.

81. The REPORT OF THE TAX STUDY COMMISSION, *supra* note 72, at 81, states: "The Commission recommends that the State of Indiana adopt no new major taxes at this time, and that the gross income tax be retained as a major source of state

Finally, of course, the Legislature could just sit tight and hope that the problems will work out themselves. Legislative inaction in reference to this matter during the past twenty years leads one to wonder whether the reason is indifference or whether opposing interests have created an impasse from which neither side will yield.[82] It is possible, too, that the Indiana Supreme Court may reconsider the matter policy-wise and relax its somewhat technical and legalistic attitude should another case arise. Meanwhile, though, no one can be absolutely certain what the ultimate extension of the principal cases will be or what action can be taken by taxpayers in reliance upon the potential development of the doctrine of constructive receipts.

FELA VENUE ABUSE: NECESSITY FOR CONGRESSIONAL AMENDMENT

Recurring discussion in the cases, law reviews, and professional journals concerns the propriety of the Federal Employers Liability Act[1] as a means of redressing injuries sustained by railway workers through the negligence of a railroad or its agents.[2] Not the least of the grounds for criticism of FELA is the breadth of the workman's choice of venue[3] and the consequent tendency to use it to harass the defendant railroad.[4]

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revenue." The Commission studied other types of taxes. *Id.* at 154, for an appraisal of retail sales, net income, and net worth taxes for Indiana.

"I think that the gross income tax was intended to be an emergency measure with a short life. But since it proved to be a fountain of finance exceeding the most fantastic expectations the politicians began to magnify its 'good' points and defend it. It is a revenue-raiser deluxe. . . ." Communication to the INDIANA LAW JOURNAL from the General Counsel, Indiana Department of State Revenue.

82. It is significant that no remedial legislation was introduced or adopted during the 1953 Session of the Indiana General Assembly, particularly since the *Colpaert* and *Crown Development* decisions had been reported but a few days prior to the opening of the Legislature and should have been fresh in the minds of those present.

1. 35 STAT. 65 (1908), 45 U.S.C. § 51 *et seq.* (1946). Hereinafter referred to as FELA.

2. The most recent analysis of FELA as a method of redressing railroad employee injuries is Parker, *FELA or Uniform Compensation for All Workers?*, 18 LAW & CONTEMP. PROB. 208 (1953).

3. 36 STAT. 291 (1910), 45 U.S.C. § 56 (1946), as amended, 62 STAT. 989 (1948), 45 U.S.C. § 56 (Supp. 1952). "Under this chapter an action may be brought in a district court of the United States, in the district of the residence of the defendant, or in which the cause of action arose, or in which the defendant shall be doing business at the time of commencing such action. The jurisdiction of the courts of the United States under this chapter shall be concurrent with that of the courts of the several States."

"A civil action in any State court against a railroad or its receivers or trustees, arising under sections 51-60 of Title 45, may not be removed to any district court of the United States." 28 U.S.C. 1445(a) (Supp. 1950).

4. The broad venue enables the employee to bring suit a large distance from