

Tufts v. Commissioner: Amount Realized Limited to Fair Market Value

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The computation of gain or loss on the disposition of property that is subject to a nonrecourse obligation has long been under the shadow of footnote 37 of the United States Supreme Court's opinion in Crane v. Commissioner. In Tufts v. Commissioner the Fifth Circuit Court of Appeals recently held that amount realized on the disposition of such property includes the nonrecourse obligation only to the extent of the fair market value of the property that secured the nonrecourse obligation. This article examines Tufts v. Commissioner and maintains that the Fifth Circuit Court of Appeals erred in adopting the fair market value limitation on amount realized in these transactions. The article concludes that the functional relationship between basis and amount realized requires that the full amount of unpaid nonrecourse debt to which transferred property is subject be included in amount realized. Consequently, the taxpayer will account for the tax-free receipt of the benefit of borrowing.

INTRODUCTION

With its recent opinion in *Tufts v. Commissioner*,** the Fifth Circuit Court of Appeals revitalized an issue that has vexed students of income taxation for thirty-four years. If the United States Supreme Court chooses to resolve the issue addressed in *Tufts*,¹ its opinion could have the theoretical significance of such

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** The United States Supreme Court granted *certiorari* in the *Tufts* case as this article went to print. *Tufts v. Commissioner, cert. granted*, No. 81-1536 (May 1, 1982).

¹ 651 F.2d 1058 (5th Cir. 1981), *rehearing denied* Oct. 19, 1981.

tax classics as *Eisner v. Macomber*,² *Helvering v. Horst*,³ *United States v. Kirby Lumber Co.*,⁴ *Commissioner v. Glenshaw Glass*,⁵ and *Crane v. Commissioner*,⁶ the case first giving rise to the controversy addressed in *Tufts*.

In *Tufts*, the Fifth Circuit held that amount realized on disposition of property that is encumbered by a nonrecourse liability includes the amount of the liability only to the extent of the fair market value of the transferred property. This decision is in direct conflict with the 1978 Third Circuit decision in *Millar v. Commissioner*.⁷ It also conflicts with several opinions of the United States Tax Court.⁸ The *Tufts* result may transfer vast sums of tax revenue from the vaults of the United States Treasury to the pockets of tax shelter investors. The Fifth Circuit ruling will allow investors to receive a benefit not anticipated by many tax advisors. The controversy between the circuits is ripe for resolution by the nation's highest court.

Tufts addresses the controversy given birth to, but left open by, footnote 37 of the Supreme Court's opinion in *Crane v. Commissioner*.⁹ The Fifth Circuit held that the reasons underlying *Crane* warranted the conclusion that the amount of nonrecourse liability included in amount realized should be limited to the fair market value of the encumbered property.¹⁰ In so doing, the Fifth Circuit rejected three previous justifications for including nonrecourse debt in amount realized: The theory articulated in *Millar v. Commissioner* that it is necessary to include the full amount of nonrecourse liability in amount realized to avoid double deduction;¹¹ the theory raised by the *Crane* court that an economic benefit to the seller justifies including nonrecourse lia-

² 252 U.S. 189 (1919).

³ 311 U.S. 112 (1940).

⁴ 284 U.S. 1 (1931).

⁵ 348 U.S. 426 (1955).

⁶ 331 U.S. 1 (1947), *aff'g* 153 F.2d 504 (2d Cir. 1945), *rev'g* 3 T.C. 585 (1944).

⁷ 577 F.2d 212 (3d Cir. 1978), *cert. denied*, 439 U.S. 1046 (1978).

⁸ *Estate of Delman v. Commissioner*, 73 T.C. 15, 28 (1979); *Tufts v. Commissioner*, 70 T.C. 756, 763-66 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981); *Millar v. Commissioner*, 67 T.C. 656, 660 (1970), *aff'd*, 577 F.2d 212 (3d Cir. 1978); *Woodsam Assoc. v. Commissioner*, 16 T.C. 649, 654-55 (1951), *aff'd*, 198 F.2d 357 (2d Cir. 1952); *Mendham Corp. v. Commissioner*, 9 T.C. 320, 323-25 (1947); *Lutz & Schramm Co. v. Commissioner*, 1 T.C. 682, 688-89 (1943).

⁹ 331 U.S. 1, 14 (1947).

¹⁰ *Tufts v. Commissioner*, 651 F.2d 1058, 1063 (5th Cir. 1981).

¹¹ *Id.* at 1060-61.

bility in amount realized;¹² and the suggestion by Professor Bittker that the *Crane* decision to include the nonrecourse liability in amount realized is "justifiable because it brought the tax consequences of the taxpayer's dealings with her property into harmony with economic reality by recapturing her depreciation deductions to the extent that they exceeded her investment in the encumbered property."¹³

The Fifth Circuit correctly rejected these theories. But the *Crane* decision relied upon another theory, which the Fifth Circuit overlooked in *Tufts*. In addition to its economic benefit analysis,¹⁴ the *Crane* court held that the amount realized must include the full amount of nonrecourse liability because of the "functional relation" of the basis provisions of the Internal Revenue Code to the definition of amount realized.¹⁵

As the *Crane* court anticipated, the correct resolution of the amount realized issue requires an examination of each component of the Internal Revenue Code's gain equation¹⁶ and recognition of the functional relation of the various parts to the whole. The Internal Revenue Code defines the amount realized from the sale or other disposition of property as the "sum of money received plus the fair market value of the other property received."¹⁷ The functional relationship between amount realized and basis requires that amount realized include not only money and property received at the instant of disposition, but also the amount of money and the fair market value of property that the taxpayer receives tax-free from any borrowing that is released at disposition. Solely in this fashion will amount realized and basis account for the untaxed economic benefit of borrowing that is included in basis. Amount realized and adjusted basis together serve to measure the difference between after-tax capital invested in a transaction and the capital withdrawn over the course of the investment.¹⁸ This measurement is made at the

¹² *Id.* at 1061-63.

¹³ *Id.* at 1062 n.7, quoting Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane Case*, 33 TAX L. REV. 277, 282 (1978).

¹⁴ *Crane v. Commissioner*, 331 U.S. 1, 14 (1947).

¹⁵ *Id.* at 12.

¹⁶ I.R.C. § 1001.

¹⁷ *Id.* § 1001(b).

¹⁸ The author first discussed this concept in Simmons, *Nonrecourse Debt and Amount Realized: The Demise of Crane's Footnote 37*, 59 ORE. L. REV. 3 (1980) [hereinafter cited as Simmons, *Nonrecourse Debt and Amount Real-*

close of the investment upon disposition. Only then is the information needed for the calculation easily available.¹⁹

Resolution of the issues raised in *Tufts* also requires an examination of section 752 of the Code, which contains rules regarding the treatment of a partner's share of partnership liabilities. The Fifth Circuit did not directly address the application of section 752, concluding that its interpretation of *Crane's* footnote 37 made the inquiry unnecessary.

A brief examination of the *Crane* decision is necessary to frame the issues raised by the *Tufts* case. Then the *Tufts* opinion and the problems that it addressed will be examined.

I. CRANE V. COMMISSIONER²⁰

A. *The Crane Decision*

In 1932, Mrs. Beulah B. Crane inherited an apartment building from her deceased husband.²¹ The building was encumbered by a mortgage equal to the fair market value of the property as included in Mr. Crane's gross estate for federal estate tax purposes.²² Mrs. Crane was not personally liable for the mortgage.²³ Nonetheless, she included the full mortgage in her apartments' basis for computing depreciation deductions.²⁴ She operated the apartments for nearly seven years, including the rent in her gross income and claiming deductions for depreciation, taxes, interest, and operating expenses.²⁵ In 1938, on threat of foreclosure, Mrs. Crane sold the building. The purchaser paid \$3,000 in cash and took the property subject to Mrs. Crane's nonrecourse liability.²⁶

Mrs. Crane asserted that she had inherited only an equity interest with a value of zero from her husband.²⁷ She thus claimed a zero basis in this interest under section 113(b)(5) of the Reve-

ized]. The *Tufts* case makes this eulogy a bit premature.

¹⁹ *Woodsam Assoc. v. Commissioner*, 198 F.2d 357, 359 (2d Cir. 1952); *Mendham Corp. v. Commissioner*, 9 T.C. 320, 323 (1947).

²⁰ 331 U.S. 1 (1947).

²¹ *Id.* at 3.

²² *Id.*

²³ *Id.* at 3-4.

²⁴ *Id.* at 3 n.2.

²⁵ *Id.* at 3.

²⁶ *Id.*

²⁷ *Id.*

nue Act of 1938,²⁸ the predecessor to section 1014 of the 1954 Code.²⁹ Mrs. Crane subtracted her zero basis from an amount realized of \$2,500, (\$3,000 cash less \$500 selling expenses), producing a gain of \$2,500.³⁰

The Commissioner contended that Mrs. Crane's basis in the apartment was its full fair market value unreduced by the encumbrance.³¹ This basis was reduced by depreciation allowable while Mrs. Crane operated the apartments.³² The Commissioner computed Mrs. Crane's amount realized by adding the unpaid liability to the cash received.³³ The commissioner asserted approximately \$24,000 gain on the building and a \$528 loss on the land.³⁴ The gain was attributable to the adjustments of Mrs. Crane's basis resulting from allowable depreciation.

The Supreme Court adopted the Commissioner's argument. The Court began its analysis with the question of Mrs. Crane's

²⁸ Section 113(a) of the 1938 Act, 52 Stat. 490-93, provided that basis equaled the "cost" of the property except that the basis of property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, equaled the fair market value of the property at the time of the acquisition. The Court noted that Mrs. Crane's zero basis claim was inconsistent with her prior depreciation deductions. *Crane v. Commissioner*, 331 U.S. 1, 3 n.2 (1947).

²⁹ I.R.C. § 1014(a) provides, "Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, be exchanged or otherwise disposed of before the decedent's death by such person, be—(1) the fair market value of the property at the date of the decedent's death"

³⁰ *Crane v. Commissioner*, 331 U.S. 1, 4 (1947).

³¹ The Court described the gain as a "taxable gain" of \$1250. Taxable income included only one-half of the long term capital gain. Rev. Act of 1938, Pub. L. No. 75-554, ch. 289, § 117(a), (b), 52 Stat. 447, 500-01. The current provision is I.R.C. § 1202(a) which provides a deduction for 60 percent of an individual's net long term capital gains.

³² *Crane v. Commissioner*, 331 U.S. 1, 4 (1947).

³³ Although Mrs. Crane was in arrears in her interest payments, the Commissioner included only the principal in amount realized "because the difference was attributable to interest due, a deductible item." *Id.* at 4 n.6.

³⁴ The Commissioner allocated \$55,000 of basis and \$54,471.15 of amount realized to the land. \$207,042.50 of Mrs. Crane's original basis was allocated to the building. This basis was reduced to \$178,997.40 by allowable depreciation. \$203,028.85 of Mrs. Crane's amount realized was allocated to the building. *Crane v. Commissioner*, 3 T.C. 585, 587 (1944), *rev'd*, 153 F.2d 504 (2d Cir. 1945), *aff'd*, 331 U.S. 1 (1947).

basis. Section 113(b)(5) of the 1938 Act³⁵ provided that the basis of "property" acquired from a decedent "shall be the fair market value of such property at the time of such acquisition." The Court pondered whether the term "property" in section 113(b)(5) was the equivalent of "equity", as Mrs. Crane contended, or whether "property" included "the land and buildings themselves, (or the owner's legal rights in them), undiminished by the mortgage. . . ." ³⁶ as the Commissioner contended.

The Court agreed with the Commissioner for three reasons. First, the Court relied on the plain meaning rule. The opinion noted that "principal standard dictionaries" defined property as "the physical thing which is subject of ownership . . . the aggregate of the owner's rights to control and dispose of that thing."³⁷ It also noted that "equity" was not a synonym for "property", nor could it be correctly so used.³⁸ Second, the Court pointed out that long-standing administrative practice, as evidenced by the Treasury Regulations, required that basis of property acquired from a decedent include the full value of the property as reported in determining the decedent's gross estate, undiminished by liens.³⁹ Finally, and perhaps most importantly, the Court concluded that Mrs. Crane's basis had to include the mortgage because of the relationship between the Code's basis provisions and the depreciation scheme:

Under these provisions, if the mortgagor's equity were the § 113(a) basis, it would also be the original basis from which depreciation allowances are deducted. If it is, and if the amount of the annual allowances were to be computed on that value, as would then seem to be required, they will represent only a fraction of the cost of the corresponding physical exhaustion, and any recoupment by the mortgagor of the remainder of that cost can be effected only by the reduction of his taxable gain in the year of sale. If however, the amount of the annual allowances were to be computed on the value of the property, and then deducted from an equity basis, we would in some instances have to accept deductions from a minus basis or deny deductions altogether. The Commissioner also argues that taking the mortgagor's equity as the § 113(a) basis would require the basis to be changed with each payment on the mortgage, and

³⁵. 52 Stat. 490-93. See note 28 *supra*. The language of § 113 (b)(5) is similar to that of § 1014(a) of the 1954 code. See note 29 *supra*.

³⁶ Crane v. Commissioner, 331 U.S. 1, 6 (1947).

³⁷ *Id.*

³⁸ *Id.* at 7.

³⁹ *Id.* at 7-8.

that the attendant problem of repeatedly recomputing basis and annual allowances would be tremendous accounting burden on both the Commissioner and the taxpayer. Moreover, the mortgagor would acquire control over the timing of his depreciation allowances.

Thus it appears that the applicable provisions of the Act expressly preclude the equity basis, and the use of it is contrary to certain implicit principles of income tax depreciation, and entails very great administrative difficulties.⁴⁰

After resolving the basis issue, the *Crane* court turned to the question of amount realized. The Court concluded for two reasons that Mrs. Crane's amount realized included the full amount of her unpaid nonrecourse liability.

The Court first determined that the "functional relation" between amount realized and basis requires that if the full amount of nonrecourse liability is to be included in basis, the unpaid portion of that liability must be included in amount realized.⁴¹

⁴⁰ *Id.* at 9-10. For a discussion of the relationship between nonrecourse debt, basis, and depreciation, see Simmons, *Nonrecourse Debt and Basis: Mrs. Crane, Where are You Now?*, 53 S. CAL. L. REV. 1, 13-14 (1979) [hereinafter cited as Simmons, *Nonrecourse Debt and Basis*]. See also Adams, *Exploring the Outer Boundaries of the Crane Doctrine: An Imaginary Supreme Court Opinion*, 21 TAX L. REV. 159 (1966); Bittker, *supra* note 13; Del Cotto, *Basis and Amount Realized Under Crane: A Current View of Some Tax Effects in Mortgage Financing*, 118 U. PA. L. REV. 69 (1970); Landis, *Liabilities and Purchase Price*, 27 TAX L. REV. 67 (1974); Perry, *Limited Partnerships and Tax Shelters: The Crane Rule Goes Public*, 27 TAX L. REV. 525 (1972); Wanguard, *Use of Nonrecourse Loans in Tax Planning: The Possibilities and Pitfalls*, 39 J. TAX. 286 (1973).

Under the pre-1981 depreciation scheme, this position made sense because it matched the potential depreciable investment with the periods during which the asset was used to produce income. The depreciable cost of the investment was thereby allowed as a deduction against income produced by the asset as a cost of that income. Under the capital recovery system of the Economic Recovery Act of 1981, Pub. L. No. 97-34, 95 Stat. 172, § 201, adding I.R.C. § 168, the basis rule of *Crane* loses some of its appeal. There may be no reason why the tax system should allow immediate recovery of future capital investment except as an incentive device. This is true whether or not there is personal liability for the future investment. The Code, however, distinguishes between personal liability and nonrecourse debt with the at-risk rules of I.R.C. § 465, except in the case of real estate. I.R.C. § 465(c)(3)(D).

Mrs. Crane could also arguably have determined her basis using cost, the principal amount of the unpaid mortgage. See, e.g., *Vaira v. Commissioner*, 52 T.C. 986 (1969).

⁴¹ As noted in the text accompanying note 14 *supra*, the Fifth Circuit virtually ignored the first of these rationales, the functional relationship between

Section 111(b) . . . defines the 'amount realized' from 'the sale . . . of property' as 'the sum of any money received plus the fair market value of the property (other than money) received,' and § 1(a) defines the gain on 'the sale . . . of property' as the excess of the amount realized over the basis. Quite obviously, the word 'property,' used here with reference to a sale, must mean 'property' in the same ordinary sense intended by the use of the word with references to acquisition and depreciation in § 113, both for certain reasons stated heretofore in discussing its meaning in § 113, and also *because the functional relation of the two sections requires that the word mean the same in one section that it does in the other.* If the 'property' to be valued on the date of acquisition is the property free of liens, the 'property' to be priced for a subsequent sale must be the same thing.⁴²

If the Court had stopped at that point, perhaps the debate over the underlying value of the encumbered property would not have ensued. Unfortunately, the Court developed an additional justification for its result.

Before deciding *Crane*, the Court had held that relief from personal liability on disposition of property is the equivalent of the receipt of cash. The Court had reasoned that the taxpayer's gain on discharge of the indebtedness "was as real and substantial as if the money had been paid it and then paid over by it to its creditors."⁴³ Seeking to bring *Crane* within this concept, the Court added:

[W]e think that a mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and for additional consideration, realizes a benefit in the amount of the mortgage as well as the boot. If a purchaser pays boot, it is immaterial as to our problem whether the mortgagor is also to receive money from the

basis and amount realized, and focused only on the *Crane* court's economic benefit analysis. The Fifth Circuit's only reference to the relationship between basis and amount realized is in a footnote where the court states that "[T]here is simply no relationship between basis, adjustments to basis, and amount realized except where Congress has specifically legislated for recapture." Tufts v. Commissioner, 651 F.2d 1058, 1064 n.9 (5th Cir. 1981)

⁴² *Crane v. Commissioner*, 331 U.S. 1, 12 (1947) (emphasis added). The Fifth Circuit also recognized this principle in *Parker v. Delaney*, 186 F.2d 455, 458 (5th Cir. 1950):

In the case at bar the basis was cost. § 113(a). Depreciation had been computed and deducted on such amounts; and their relationship under § 113 to the question of gain realized under § 111 requires that account be taken of such value or cost in determining the realization on disposition.

⁴³ *United States v. Hendler*, 303 U.S. 564, 566 (1938).

purchaser to discharge the mortgage prior to sale, or whether he is merely to transfer subject to the mortgage — it may make a difference to the purchaser and to the mortgagee, but not the mortgagor. Or put in another way, we are not more concerned with whether the mortgagor is, strictly speaking, a debtor on the mortgage, than we are with whether the benefit to him is, strictly speaking, a receipt of money or property. We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations.⁴⁴

This logic adequately resolved *Crane*. However, in its infamous footnote 37, the Court recognized the shortcoming of this analysis when applied to a different case:

Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not the case.⁴⁵

B. Footnote 37 and Tufts v. Commissioner

In *Tufts* the Fifth Circuit concluded that footnote 37 creates an absolute exception to the *Crane* holding.⁴⁶ That exception, the *Tufts* court concluded, limits amount realized on the disposition of property that is encumbered by a nonrecourse liability to the property's fair market value.

The facts in *Tufts* aid in illustrating the impact of *Crane* and the limitation adopted by the Fifth Circuit in *Tufts*. *Tufts* involved a typical real estate tax shelter. The taxpayers in *Tufts* formed a general partnership to construct a 120-unit apartment complex.⁴⁷ Contributing approximately \$44,000 in cash,⁴⁸ they obtained a nonrecourse loan of approximately \$1,850,000 to finance construction.⁴⁹

Under the *Crane* rule, the full amount of nonrecourse liability

⁴⁴ *Crane v. Commissioner*, 331 U.S. 1, 14 (1947).

⁴⁵ *Id.* at 14 n.37.

⁴⁶ *Tufts v. Commissioner*, 651 F.2d 1058, 1063 (5th Cir. 1981).

⁴⁷ *Tufts v. Commissioner*, 70 T.C. 756, 757-58 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981).

⁴⁸ *Tufts v. Commissioner*, 70 T.C. 756, 761 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981). The partners contributed \$28,351 in 1971 and \$15,861 in 1972.

⁴⁹ *Tufts v. Commissioner*, 70 T.C. 756, 758 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981).

was included in the partnership's basis for the apartment complex and in the basis of each partner's partnership interest.⁵⁰ The partnership's basis in the apartment complex and the combined bases of the partners in their partnership interests, therefore, totalled approximately \$1,900,000.⁵¹ Using this basis, the partners claimed deductions for operating losses and depreciation totalling approximately \$440,000.⁵² If each partner was in a fifty percent marginal tax bracket, the resulting tax savings over the two year duration of the partnership would have been \$220,000 — a 500 percent return on the original \$44,000 investment.

The value of the apartment building later declined to approximately \$1,400,000.⁵³ The partnership made no payments on the loan.⁵⁴ Two years after the building's completion, the partners conveyed their interests in the partnership and its assets to an unrelated purchaser who took the apartment complex subject to the outstanding \$1,850,000 indebtedness and who paid the expenses of sale.⁵⁵ The purchaser gave no further consideration.

The deductions that the partners had taken reduced their collective bases in their partnership interests to approximately \$1,450,000,⁵⁶ which was \$400,000 less than the unpaid balance of the nonrecourse liability. The partners agreed that their amount realized on the sale included the nonrecourse debt. They

⁵⁰ The Commissioner did not dispute the propriety of including the full amount of the nonrecourse debt in basis. *Tufts v. Commissioner*, 70 T.C. 756, 763 n.10 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981). The Tax Court expressly refused to pass on the issue. 70 T.C. at 770 n.13.

⁵¹ *Tufts v. Commissioner*, 70 T.C. 756, 759, 762 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981).

⁵² *Tufts v. Commissioner*, 70 T.C. 756, 759-60, 762 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981).

⁵³ *Tufts v. Commissioner*, 70 T.C. 756, 760 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981). The decline resulted from substantial employee layoffs by major employers in the area and from over-construction of apartments. The Commissioner argued that the fair market value of the apartment complex was at least equal to the nonrecourse indebtedness. 70 T.C. at 763. The Tax Court found, however, that on the date of disposition the fair market value of the complex did not exceed \$1,400,000.

⁵⁴ *Tufts v. Commissioner*, 70 T.C. 756, 761 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981).

⁵⁵ *Tufts v. Commissioner*, 70 T.C. 756, 760 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981). The expenses paid by the purchaser were limited to \$250.

⁵⁶ *Tufts v. Commissioner*, 70 T.C. 756, 760, 762 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981).

claimed, however, that the fair market value of the property limited the amount realized. They therefore reported the sale as a loss, but did not claim any deductions.⁵⁷ In their petitions to the Tax Court, however, the partners claimed a long-term capital loss in the amount of their cash investment and sought a refund for the overpayment of taxes.⁵⁸

The Commissioner contended that the value of the property was immaterial and that the full amount of the unpaid nonrecourse liability was part of the amount realized on the sale of the partners' interests.⁵⁹ Subtracting the partners' adjusted bases from this amount produced a gain of approximately \$400,000.⁶⁰ The Service treated \$47,000 of this gain as ordinary income under section 1250 of the Code,⁶¹ and the remainder as capital gain.⁶² The Tax Court agreed with the Commissioner, but the Fifth Circuit reversed.

The value of the *Crane* rules is obvious from the *Tufts* facts. With a personal investment of only \$44,000 the taxpayers in *Tufts* obtained the tax benefits of a \$1,900,000 investment. Under well-established tax principles, the receipt of the \$1,850,000 loan was not taxable because of the obligation to repay.⁶³ The Commissioner's approach would require the taxpayers to account for the untaxed benefit of their borrowing by including the unpaid debt in amount realized. In addition, the taxpayers would recognize gain to the extent that basis was re-

⁵⁷ *Tufts v. Commissioner*, 70 T.C. 756, 761 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981).

⁵⁸ *Tufts v. Commissioner*, 70 T.C. 756, 761 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981). See I.R.C. § 6512(b). The taxpayers did not raise the refund issue on appeal.

⁵⁹ *Tufts v. Commissioner*, 70 T.C. 756, 763 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981).

⁶⁰ *Tufts v. Commissioner*, 70 T.C. 756, 762 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981).

⁶¹ *Tufts v. Commissioner*, 70 T.C. 756, 762 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981). The recapture provision of § 1250 converts to ordinary gain an amount equal to depreciation taken in excess of that allowed under the straight line method.

⁶² *Tufts v. Commissioner*, 70 T.C. 756, 762 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981).

⁶³ *Woodsam Assoc. v. Commissioner*, 198 F.2d 357, 359 (2d Cir. 1952); *Mendham Corp. v. Commissioner*, 9 T.C. 320, 323 (1947); S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, *FEDERAL INCOME TAXATION* 148 (2d ed. 1972) [hereinafter cited as *SURREY, et al.*].

duced by deductions that allow income from other sources to be received tax-free.

However, the Fifth Circuit's limitation of amount realized to the property's value at disposition precludes this day of reckoning, at least to the extent that the debt exceeds value. Indeed, under the Fifth Circuit's approach, the taxpayers in *Tufts* were entitled to an additional long-term capital loss deduction for the \$40,000 by which their bases exceeded the fair market value of the transferred property.⁶⁴

II. THE TUFTS OPINIONS

A. *The Tax Court and the Double Deduction Theory of Millar v. Commissioner.*

The Tax Court's decision in *Tufts* focused on the benefit of the taxpayers' deductions.⁶⁵ The Tax Court followed a theory that the Third Circuit had developed only two months earlier.⁶⁶ In *Millar v. Commissioner*⁶⁷ the Third Circuit stated that the principal reason for including nonrecourse debt in amount realized was the avoidance of "double deductions."⁶⁸

The taxpayers in *Millar* were shareholders in a coal development company formed by R.J. Jamison.⁶⁹ Jamison had formed the corporation and distributed stock to the taxpayers — his friends, relatives, and business associates.⁷⁰ The shareholders initially received the stock without paying any consideration.⁷¹ Jamison obtained a \$500,000 bank loan to finance the venture, then transferred the \$500,000 to the shareholders in exchange for nonrecourse notes secured by the stock.⁷² The shareholders

⁶⁴ I.R.C. §§ 165(a), 752(d), 1211, 1212.

⁶⁵ *Tufts v. Commissioner*, 70 T.C. 762 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981).

⁶⁶ See also *Estate of Delman v. Commissioner*, 73 T.C. 15 (1979).

⁶⁷ 577 F.2d 212 (3d Cir. 1978), *aff'g* 67 T.C. 656 (1977), *cert. denied*, 439 U.S. 1046 (1978).

⁶⁸ *Millar v. Commissioner*, 577 F.2d 212, 214-15 (3d Cir. 1978).

⁶⁹ The facts of *Millar* are developed in the Third Circuit's first opinion in the case, 540 F.2d 184 (3d Cir. 1976), *vacating and remanding* 34 T.C.M. 554 (CCH 1975).

⁷⁰ *Millar v. Commissioner*, 34 T.C.M. 554, 562 (CCH 1975), *vacated and remanded*, 540 F.2d 184 (3d Cir. 1976).

⁷¹ *Millar v. Commissioner*, 540 F.2d 184, 185 (3d Cir. 1976).

⁷² *Millar v. Commissioner*, 34 T.C.M. 554, 562 (CCH 1975), *vacated and remanded*, 540 F.2d 184 (3d Cir. 1976).

contributed their respective shares of the loan proceeds to the corporation.⁷³ These contributions to capital created a basis in each shareholder's stock equal to the amount of the shareholder's nonrecourse obligation to Jamison.⁷⁴ The shareholders thereby received the tax-free benefit of borrowed capital and created bases in their stock. The shareholders elected to have the corporation taxed as a Subchapter S corporation.⁷⁵ This permitted them to deduct the corporation's net operating losses from their individual incomes,⁷⁶ and thus offset income from other sources. To reflect the return of this invested capital in the form of tax deductions, the Code requires a reduction in the stock's basis.⁷⁷ Thus, losses deducted by the shareholders so reduced their bases in the stock that the amount of their nonrecourse liability to Jamison exceeded their basis.⁷⁸

The corporation ultimately filed a voluntary petition for bankruptcy.⁷⁹ After a demand for payment on the notes proved unavailing, Jamison foreclosed on the stock.⁸⁰ At the time of foreclosure, the shareholders' outstanding nonrecourse liability exceeded the value of the stock.⁸¹ Jamison repaid the \$500,000 bank loan with his own funds.⁸²

The shareholders reported no gain on the foreclosure asserting that the amount realized was limited to the zero value of the stock.⁸³ The Tax Court concluded, however, that the full amount of the shareholder's nonrecourse liability should be included in amount realized. "In our opinion, the value of the stock was im-

⁷³ *Millar v. Commissioner*, 34 T.C.M. 554, 562 (CCH 1975), *vacated and remanded*, 540 F.2d 184 (3d Cir. 1976).

⁷⁴ *Millar v. Commissioner*, 577 F.2d 212, 215 (3d Cir. 1978); I.R.C. § 1016(a)(1); Treas. Reg. § 1.118-1 ("[T]he payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as part of the operating capital of the company.").

⁷⁵ *Millar v. Commissioner*, 540 F.2d 184, 185 (3d Cir. 1976).

⁷⁶ I.R.C. § 1374.

⁷⁷ *Id.* § 1376(b)(1).

⁷⁸ *Millar v. Commissioner*, 577 F.2d 212, 215 (3d Cir. 1978).

⁷⁹ *Millar v. Commissioner*, 540 F.2d 184, 185 (3d Cir. 1976).

⁸⁰ *Id.*

⁸¹ *Millar v. Commissioner*, 577 F.2d 212, 213 (3d Cir. 1978). In its first opinion the Third Circuit described the stock as valueless. *Millar v. Commissioner*, 540 F.2d 184, 185 (3d Cir. 1976).

⁸² *Millar v. Commissioner*, 34 T.C.M. 554, 560 (CCH 1975).

⁸³ *Millar v. Commissioner*, 540 F.2d 184, 186 (3d Cir. 1976).

material. Petitioners had received a cash equivalent in the amount of the notes, whether they were personally liable on such notes or not."⁸⁴

Affirming the Tax Court decision in *Millar*, the Third Circuit developed a different analysis. The court focused on the portion of the *Crane* opinion concerning Mrs. Crane's argument that she had no income within the meaning of the sixteenth amendment on a transaction which was "by all dictates of common sense . . . a ruinous disaster."⁸⁵ The *Crane* court had dismissed this constitutional argument:

She was entitled to depreciation deductions for a period of nearly seven years, and she actually took them in almost the allowable amount. The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain. We have already showed that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets. The Sixteenth Amendment does not require that result any more than does the Act itself.⁸⁶

The Third Circuit adopted this analysis as a justification for including nonrecourse debt in amount realized without regard to the value of the security:

This finding is totally in keeping with the spirit and reasoning of *Crane*. While not personally liable upon the loan from Jamison, the taxpayers utilized those funds to increase the bases of their stock, which then permitted them to claim sizeable deductions calculated against that basis . . . Having substantially reduced the adjusted basis of their stock in this manner and thereafter surrendering their devalued stock in exchange for the cancellation of their indebtedness, the taxpayers clearly realized taxable gain equal to the value of the cancelled obligation, less the adjusted basis of their surrendered stock. A finding that the taxpayers did not realize gain as a result of this exchange, after having realized the full economic benefit of this transaction, would entitle them to the type of double deductions of which the Supreme Court so clearly disapproved in *Crane*.⁸⁷

The Third Circuit refused to accept the taxpayers' assertion that footnote 37 carved out an exception to the *Crane* rule when the unpaid principal of the nonrecourse liability exceeded the

⁸⁴ *Millar v. Commissioner*, 67 T.C. 656, 660-61 (1970), *aff'd*, 577 F.2d 212 (3d Cir. 1978).

⁸⁵ *Crane v. Commissioner*, 331 U.S. 1, 15 (1947).

⁸⁶ *Id.* at 15-16.

⁸⁷ *Millar v. Commissioner*, 577 F.2d 212, 215 (3d Cir. 1978).

value of the property. The court concluded that footnote 37 was *dictum* which "was but a postulate or hypothetical observation with respect to a hypothetical set of facts not before the Court, indeed, involving a clearly different time and clearly different legal circumstances."⁸⁸

In several decisions preceding the Third Circuit's opinion in *Millar*, including its own *Millar* opinion, the Tax Court had focused upon the initial tax-free benefit of borrowing as justification for including nonrecourse indebtedness in amount realized.⁸⁹ In *Tufts*, however, the court changed its course and followed the Third Circuit's analysis.

The Fifth Circuit, on the other hand, rejected the double deduction theory. The court noted that before it had described double deductions, the Supreme Court in *Crane* had found that as a matter of statutory construction Mrs. Crane's amount realized included the full amount of the nonrecourse obligation. The Fifth Circuit asserted that the double deduction rationale applied solely to Mrs. Crane's constitutional argument.⁹⁰

The Fifth Circuit is correct in this view.⁹¹ The Supreme Court concluded that Mrs. Crane realized a statutory gain derived by subtracting basis (as adjusted for allowable depreciation) from amount realized. A double deduction would arise only if Mrs. Crane would first have deducted depreciation, which reduced her basis, and then deducted the statutory gain resulting from the comparison of amount realized with adjusted basis. The po-

⁸⁸ *Id.* See also *Woodsam Assoc. v. Commissioner*, 16 T.C. 649, 655 (1951), *aff'd*, 198 F.2d 357 (2d Cir. 1952).

⁸⁹ *Woodsam Assoc. v. Commissioner*, 16 T.C. 649, 654-55 (1951), *aff'd*, 198 F.2d 357 (2d Cir. 1952); *Mendham Corp. v. Commissioner*, 9 T.C. 320, 323-25 (1947); *Lutz & Schramm Co. v. Commissioner*, 1 T.C. 682, 688-89 (1943).

⁹⁰ The taxpayers in *Tufts* assert essentially the same constitutional argument as Mrs. Crane.

Income has been defined as the gain derived from capital, from labor, or from both combined; and includes profit gained through a sale or conversion of capital assets. *Eisner v. Macomber*, 252 U.S. 189, 207 (1919). If the Taxpayers, individually, did not receive anything of value from the sale of their partnership interests, they did not receive "income"

Brief for Appellants, *Tufts v. Commissioner*, 651 F.2d 1058, (5th Cir. 1981) at 9. The argument in *Tufts* should be rejected for the same reason given by the court in *Crane v. Commissioner*, 331 U.S. 1, 15-16 (1947). See text accompanying note 86 *supra*.

⁹¹ I.R.C. § 1001(a).

tential of a second deduction arises only because of the Court's prior conclusion that Mrs. Crane realized a statutory gain. The *ratio decidendi* of the double deduction portion of the *Crane* opinion is simply that there is no constitutional infirmity in recognizing taxable gain as a result of the reductions to basis caused by depreciation or other basis-reducing reductions. The Court did not offer the double deduction analysis as a justification for its interpretation of the statutory definition of amount realized.

The Fifth Circuit also gave what it described as a "more compelling reason" for rejecting the double deduction theory of *Miller*.⁹² The court concluded that Congress had intended to account for the benefit of deductions with adjustments to basis. Depreciation and other basis-reducing deductions either increase gain or reduce loss on disposition of the property.

Thus, any tax benefits that the taxpayer may have received in the form of prior deductions have already been factored into the gain equation through adjustments to basis. Since those deductions have been accounted for through adjustments to basis, it follows logically that they cannot also support an expansion of the definition of amount realized. To account for those deductions twice in the same equation by expanding the definition of amount realized as well as adjusting basis downward would, we think, be taxing the taxpayer twice on the same component of gain.⁹³

Once again the Fifth Circuit's analysis is correct. The tax benefit of deductions reflected in adjustments to basis does not itself justify including debt in amount realized.⁹⁴ There is no

⁹² *Tufts v. Commissioner*, 651 F.2d 1058, 1060-61. (5th Cir. 1981).

⁹³ *Id.* at 1061.

⁹⁴ At least one commentator has suggested that income is recognized on disposition of property subject to a liability in excess of value under the tax benefit rule. Gain results as a recovery of the prior deductions attributable to the property. Del Cotto, *Sales and Other Dispositions of Property Under Section 1001: The Taxable Event, Amount Realized and Related Problems*, 26 *BUFFALO L. REV.* 219, 323-24 (1977).

There are several problems with this approach. See Simmons, *Nonrecourse Debt and Amount Realized*, *supra* note 18, at 31-34. First, it is doubtful whether the sale or other disposition of the encumbered property would be deemed a recovery of the prior deductions. See, e.g., *Nash v. United States*, 398 U.S. 1 (1970) (no recovery of bad debt reserve on corporate formation under I.R.C. § 351); *Commissioner v. South Lake Farms, Inc.*, 324 F.2d 837 (9th Cir. 1963) (no recovery of previously deducted expenses on liquidation distribution of crops under I.R.C. § 336). *But see Tennessee-Carolina Transp., Inc. v. Commissioner*, 582 F.2d 378 (6th Cir. 1978) (recovery of cost of goods on

need, however, to refer to past deductions in resolving the question of amount realized. The Fifth Circuit missed the point that the initial tax-free receipt of a loan provides ample justification for, and indeed requires, considering a termination of the borrower's unpaid liability as part of the amount realized on disposition of property.

Adjusted basis is the Code's device for accounting for invested capital. It represents capital that is to be returned to the taxpayer without additional tax liability.⁹⁵ Depreciation and operating deductions allow the receipt of some income tax-free.⁹⁶ There is, therefore, a refund of capital in the form of tax-free income that causes a reduction in basis.⁹⁷ If, by the close of a transaction the taxpayer has recovered more capital than the af-

sale under I.R.C. § 337); *West Seattle Nat'l Bank v. Commissioner*, 288 F.2d 47 (9th Cir. 1961) (recovery of bad debt reserve on sale of accounts receivable under I.R.C. § 337); *Weyher v. Commissioner*, 66 T.C. 825, 829 (1976) (the assumption of a liability may be a recovery for purposes of the tax benefit rule).

Second, courts and the Treasury have consistently taken the position that the tax benefit rule does not apply to the recovery of depreciation deductions that were appropriate in the year that they were originally claimed. *Commissioner v. Anders*, 414 F.2d 1283, 1287-88 (10th Cir. 1969); *West Seattle Nat'l Bank v. Commissioner*, 288 F.2d at 49; *Treas. Reg. § 1.111-1(a)*.

Finally, the tax benefit rule does not solve the problem where indebtedness in excess of basis was incurred in a borrowing for cash. Such a borrowing would have no impact on basis. No deductions might be present to trigger the tax benefit rule. Thus, the tax benefit rule does not provide a sufficiently comprehensive theory to explain the inclusion of debt in amount realized in all cases.

⁹⁵ I.R.C. § 1001(a). *See also* *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179 (1918).

⁹⁶ Generally, depreciation deductions are subtracted from gross income in computing an individual's adjusted gross income. I.R.C. § 62(a)(1) & (5). Some depreciation deductions of an employee may be deducted as itemized deductions in computing taxable income. *Id.* §§ 62(a)(1), 63. With respect to corporations, taxable income is computed by subtracting depreciation and other allowable deductions from gross income. Depreciation deductions thereby reduce the base upon which tax liability is computed. Deductions permit the taxpayer to offset gross income with the costs of earning that income, so that only net gain is subject to taxation. In effect, the taxpayer may replace amounts expended in the production of income with receipts from income-producing activity before tax liability results. Depreciation deductions before 1981, and accelerated capital recovery after 1980, *see* I.R.C. § 168, Pub. L. No. 97-34, 95 Stat. 172, § 201, provide deductions returning the taxpayer's investment in depreciable property. The deductions, by reducing taxable income, allow the receipt of gain without tax liability.

⁹⁷ I.R.C. § 1016.

ter-tax capital put into the investment, a gain should be realized.⁹⁸

Borrowing, whether recourse or nonrecourse, allows the receipt of borrowed capital without current tax liability.⁹⁹ Where disposition of the encumbered property relieves the taxpayer of his obligation to replace borrowed proceeds with after-tax capital, he has yet to account for the initial tax-free receipt of the borrowed capital. Including the unpaid principal of the borrowing in amount realized provides this accounting.

Adjustments to basis thus account for capital-extracting deductions during the course of the investment. Amount realized accounts for amounts received in the form of money or property during and at the close of a transaction. Together these concepts function to measure the difference between after-tax capital committed to an investment and the amount of tax-free capital returned by the investment. This is the functional relation between basis and amount realized recognized in *Crane*.¹⁰⁰

The Third Circuit's double deduction theory fails adequately to explain the *Crane* rule for an additional reason. The *Crane* problem may arise where there are no deductions at all. For example, assume that the taxpayer purchases property for \$80,000. After the property has appreciated, the taxpayer borrows \$100,000 cash giving a nonrecourse note secured by the property. On a disposition of the property with the buyer taking subject to the note and giving no additional consideration, the *Crane* rule would require the taxpayer to recognize a \$20,000 gain. The taxpayer invested \$80,000 at the outset of the transaction and recovered \$100,000 without tax liability at the time of the borrowing. The taxpayer had thus obtained \$20,000 more than was invested. Including the amount of the unpaid note in amount realized accounts for this gain.

Under the Third Circuit's double deduction theory, however,

⁹⁸ *Id.* § 1001.

⁹⁹ *SURREY et al.*, *supra* note 63.

¹⁰⁰ See text accompanying note 42 *supra*. Without elaboration, the Fifth Circuit stated that "[T]here is simply no relationship between basis, and amount realized, except where Congress has specifically legislated for recapture." *Tufts v. Commissioner*, 651 F.2d 1058, 1064 n.9 (5th Cir. 1981). This is directly opposed to the Supreme Court's conclusion in *Crane* that nonrecourse debt included in basis must also be included in amount realized because of the functional relationship between basis and amount realized. See *Crane v. Commissioner*, 331 U.S. 1, 12 (1947).

there is no deduction, let alone a "double deduction," that could justify this result. The Fifth Circuit, based on *Tufts*, would also reach the clearly untenable result that the taxpayer need recognize no income.

B. Economic Benefit

The Fifth Circuit also rejected the *Crane* economic benefit theory, labeling it "seriously flawed."¹⁰¹ The Court in *Crane* sought in part to justify its decision on the grounds that "a mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and for additional consideration, realizes a benefit in the amount of the mortgage as well as the boot."¹⁰² The Fifth Circuit pointed out that this theory "rings true only so long as the taxpayer actually wants to keep the property."¹⁰³ *Crane*'s footnote 37 recognizes this limitation on the economic benefit theory where it points out that "if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage."¹⁰⁴ However, the Court said that that problem was not before it in *Crane*.

The Fifth Circuit concluded its opinion in *Tufts* by saying:

Because . . . we have serious reservations about the *Crane* decision, we decline to extend it beyond the facts of that case, and we therefore conclude that the fair market value limitation so '[o]bviously' anticipated by footnote 37 is warranted. We hold that the fair market value of the property securing a nonrecourse debt limits the extent to which the debt can be included in the amount realized on disposition of the property.¹⁰⁵

A mortgagor with a valuable equity interest will protect the property from foreclosure in order to obtain the benefit of that value. That protection is the economic benefit cited in *Crane*. On the other hand, where the value of the security is equal to or less than the nonrecourse obligation, the property owner contemplating abandonment or disposition has no interest in the property's value. As Professor Bittker points out:

¹⁰¹ *Tufts v. Commissioner*, 651 F.2d 1058, 1062 (5th Cir. 1981).

¹⁰² *Crane v. Commissioner*, 331 U.S. 1, 14 (1947).

¹⁰³ *Tufts v. Commissioner*, 651 F.2d 1058, 1062 (5th Cir. 1981), *citing* Bittker, *supra* note 13, at 282, set forth in text accompanying note 106 *infra*.

¹⁰⁴ *Crane v. Commissioner*, 331 U.S. 1, 14 n.37 (1947).

¹⁰⁵ *Tufts v. Commissioner*, 651 F.2d 1058, 1063 (5th Cir. 1981).

Relief from a nonrecourse debt is not an economic benefit if it can be obtained only by giving up the mortgaged property. It is analogous to the relief one obtains from local real property taxes by disposing of the property. Like nonrecourse debt, the taxes must be paid to retain the property; but no one would suggest that the disposition of unprofitable property produces an economic benefit equal to the present value of the taxes that will not be paid in the future.¹⁰⁶

In this sort of situation, therefore, economic benefits at the time of disposition provide no justification for including the value of the security in amount realized. The Fifth Circuit was quite correct in challenging this notion. However, as described above, the *Crane* court provided a more substantial reason for including unpaid liabilities in amount realized.

C. Discharge of Indebtedness Income: The Concurring Opinion

The concurring opinion of Justice Williams in *Tufts* develops yet another theory for limiting amount realized to the fair market value of the security.¹⁰⁷ Justice Williams took note of Treasury Regulation 1.1001-2(b),¹⁰⁸ adopted while the appeal in *Tufts* was pending. Regulation 1.1001-2(b) specifically rejects a fair market value limit on amount realized arising from relief of nonrecourse liabilities. Justice Williams questioned whether the court could overrule these interpretive regulations "on the basis of 'serious reservations about the *Crane* decision.'" ¹⁰⁹ Pointing

¹⁰⁶ Bittker, *supra* note 13, at 282.

¹⁰⁷ *Tufts v. Commissioner*, 651 F.2d 1058, 1063-66 (5th Cir. 1981) (Williams, J., concurring).

¹⁰⁸ Treas. Reg. § 1.1001-2(a)(1) provides that "the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition." Treas. Reg. § 1.1001-2(b) adds:

The fair market value of the security at the time of the sale or disposition is not relevant for purposes of determining under paragraph (a) of this section the amount of liabilities from which the taxpayer is discharged. Thus, the fact that the fair market value of property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from being treated as money received from the sale or other disposition of the property. . . .

T.D. 7741, I.R.B. 1981-5, 15. See also Rev. Rul. 76-111, 1976-1 C.B. 214.

¹⁰⁹ *Tufts v. Commissioner*, 651 F.2d 1058, 1064 (5th Cir. 1981) (Williams, J., concurring).

out that the regulation could be overturned only if it was unreasonable and inconsistent with the statute,¹¹⁰ Justice Williams turned to the language of Internal Revenue Code section 1001(b) to justify the fair market value limitation. Justice Williams stated that release of nonrecourse debt would have been property other than money received within the meaning of the predecessor to section 1001(b).¹¹¹ He then concluded:

Combining the freeing-of-assets theory underlying the cancellation of indebtedness cases, see *United States v. Kirby Lumber Co.*, . . . with the *Crane* principal that recourse and nonrecourse indebtedness be treated alike under § 1001, the fair market value of the release corresponds directly to the fair market value of the property securing the nonrecourse indebtedness. Therefore, § 1001(b) imposes tax liability for receipt of a release of non-recourse indebtedness, but only to the extent of the fair market value of the property transferred subject to the nonrecourse mortgage.¹¹²

The majority opinion responded to Justice William's theory by stating that "property subject to nonrecourse indebtedness is in no sense 'freed' but is actually 'lost' when transferred subject to or relinquished in satisfaction of the debt."¹¹³ The majority also rejected Justice Williams' correlation between the fair market value of the release and the fair market value of the property securing the nonrecourse indebtedness.¹¹⁴ Indeed, the majority even expressed doubt over the *Crane* Court's conclusion that Mrs. Crane herself obtained an economic benefit equivalent to the mortgage when the property had value in excess of that mortgage.

¹¹⁰ *Id.* at 1065, citing *Delta Metalforming Co. v. Commissioner*, 632 F.2d 442, 449 (5th Cir. 1980).

¹¹¹ *Tufts v. Commissioner*, 651 F.2d 1058, 1065 (5th Cir. 1981) (Williams, J., concurring). Justice Williams quoted Justice Learned Hand as saying in *Crane*, "it is the law . . . that . . . the release [of nonrecourse indebtedness] would have been 'property (other than money received)' within the meaning of § 111(b) [now I.R.C. § 1101(b)]." 651 F.2d at 1065 (brackets in original), quoting *Commissioner v. Crane*, 153 F.2d 504, 505 (2d Cir. 1945), *aff'd*, 331 U.S. 1 (1947). The full quotation from Justice Hand's opinion in *Crane* reads: "The taxpayer concedes, as we understand it—in any event it is the law—that, if she had been liable upon the bond and the venture had released her, the release would have been "property (other than money) received" within the meaning of § 111(b)." 153 F.2d at 505.

¹¹² *Tufts v. Commissioner*, 651 F.2d 1058, 1065 (5th Cir. 1981) (Williams, J., concurring).

¹¹³ *Id.* at 1064 n.9.

¹¹⁴ *Id.*

A more compelling reason exists for rejecting Justice Williams' theory. He misinterprets the holding in *United States v. Kirby Lumber Co.*¹¹⁵ Later cases have interpreted *Kirby Lumber* to stand for the proposition that upon discharge of an obligation, income is realized to the extent that the tax-free economic benefit from the borrowing exceeds the amount repaid on the obligation.

The taxpayer in *Kirby Lumber* sold bonds "for which it received their par value."¹¹⁶ Later in the same year the company repurchased the bonds for \$137,521.30 less than it had received.¹¹⁷ The Supreme Court had little difficulty concluding that this amount represented "income."

As a result of its dealings it [Kirby Lumber] made available \$137,521.30 in assets previously offset by the obligation of the bonds now extinct. We see nothing to be gained by the discussion of judicial definitions. The defendant in error has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here.¹¹⁸

The Court distinguished this result from its prior holding in *Bowers v. Kerbaugh-Empire Co.*¹¹⁹ In *Kerbaugh-Empire*, an obligation denominated in German marks for fewer United States dollars than were received at the time of borrowing was released. The Court held that this did not constitute income because the transaction as a whole, including the borrowing, investment of the borrowed funds, and their repayment, had resulted in a loss.¹²⁰ The Court viewed its decision in *Kirby Lumber* as consistent with *Kerbaugh-Empire*.¹²¹ Although the *Kerbaugh-Empire*

¹¹⁵ *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931).

¹¹⁶ *Id.* at 2.

¹¹⁷ *Id.* at 3.

¹¹⁸ *Id.*

¹¹⁹ 271 U.S. 170 (1926).

¹²⁰ The Court in *Kerbaugh-Empire* recognized that the taxpayer received a benefit upon repayment of its loan for less than it had received on the borrowing, but stated: "The loss was less than it would have been if marks had not declined in value; but the mere diminution of loss is not gain, profit or income." *Id.* at 175. The opinion has been cogently criticized for collapsing the loan and investment into a single transaction. SURREY, *et al.*, *supra* note 63, at 277. Nonetheless, the Supreme Court's affirmation of *Kerbaugh-Empire* in its *Kirby Lumber* opinion indicates that the major premise is valid; the transaction as a whole must result in gain before gain is recognized on discharge of an indebtedness.

¹²¹ *United States v. Kirby Lumber Co.*, 284 U.S. 1, 3 (1931).

Company had obtained a freeing of assets, as had the Kirby Lumber Company, Kirby Lumber obtained more capital from the whole transaction than it was called upon to repay, while the Kerbaugh-Empire transactions resulted in an overall loss. The Court's conclusion that the two cases are consistent holds true only if it is recognized that the Court in *Kirby Lumber* focused on the "accession to income" that Kirby Lumber realized when it obtained more from its tax-free borrowing than it was called upon to repay.

Several cases since *Kirby Lumber* have recognized that the decision stands for more than the simplistic "freeing-of-assets theory," or balance sheet improvement, as the ground for realization of income on discharge of indebtedness.¹²² These cases compare the consideration received at the time of borrowing with the capital repaid on the obligation. Thus, corporate borrowers that received less than the par value of bonds on issue, and later repurchased the bonds for more than the initial receipt, but less than the face amount of the debt, were found not to have realized income.¹²³ Similarly, an individual taxpayer who substituted her \$100,000 note for a note of her husband, and who was later relieved of personal obligation with a payment of only \$50,000, was not required to recognize gross income.¹²⁴ In each of these cases, the courts looked to the tax-free economic benefit received from the initial borrowing, and compared that receipt with the capital actually returned in repayment of the obligation. Where the receipt exceeded repayment, income resulted. Where the amount repaid exceeded the tax-free value received from the borrowing, there was not income.

This analysis provides a resolution to the dilemma of nonrecourse debt and amount realized. The solution is consistent with the discharge of indebtedness principles of *Kirby Lumber* and its progeny, and further provides a vehicle for analyzing the tax treatment of debt in all cases.

¹²² See generally J. SNEED, *THE CONFIGURATIONS OF GROSS INCOME*, Ch. XIX, at 311-33 (1967).

¹²³ *Commissioner v. Rail Joint Co.*, 61 F.2d 751 (2d Cir. 1932); *Fashion Park, Inc. v. Commissioner*, 21 T.C. 600 (1954).

¹²⁴ *Bradford v. Commissioner*, 233 F.2d 935 (6th Cir. 1956).

III. THE FUNCTIONAL RELATION BETWEEN BASIS AND AMOUNT REALIZED

Amount realized is easily examined by considering a situation that the Tax Court resolved before the *Crane* decision.¹²⁵ Assume that a taxpayer earns \$1000 from personal services.¹²⁶ This \$1000 will be included in income under section 61 of the Code and the appropriate tax will be paid. If the taxpayer then invests the \$1000 in property, the full \$1000 may be recovered before any gain is realized.¹²⁷ Indeed, it can be asserted that under the sixteenth amendment, the taxpayer cannot be deemed to have realized "income" until he has recovered his original \$1000 of after-tax capital.¹²⁸

"Basis" is the Internal Revenue Code's device for keeping track of the investment that the taxpayer may recover without suffering additional income tax liability.¹²⁹ The \$1000 of capital upon which tax has been paid (after-tax capital) represents the taxpayer's "cost" for the property. A taxpayer who sells the property for \$1500 realizes \$500 of taxable gain, calculated by subtracting the basis from the amount realized on disposition of the property.¹³⁰ The \$500 of gain represents property in the taxpayer's hand upon which no tax has been paid and is thus included in gross income as gain on the disposition of the property.¹³¹ The taxpayer at this point has \$1500 of after-tax capital

¹²⁵ See text accompanying notes 154-165 *infra*.

¹²⁶ The author developed the hypotheticals in this section in Simmons, *Non-recourse Debt and Amount Realized*, *supra* note 18, at 18-21.

¹²⁷ I.R.C. § 1001(a).

¹²⁸ *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179 (1918).

¹²⁹ This is inherent in the statutory scheme. Gross income includes gains derived from dealings in property. I.R.C. § 61(a)(3). Gain from the disposition of property is defined as the "excess of the amount realized therefrom over the adjusted basis provided in section 1011. . . ." *Id.* § 1001(a). Thus, the taxpayer recovers the full amount of adjusted basis before gain is realized.

Unless otherwise provided in the Code, basis is the cost of property, *id.* §§ 1011, 1012, adjusted for additions and removals of capital. *Id.* § 1016. Special basis rules apply to property received from a decedent, *id.* § 1014, acquired by gift, *id.* § 1015, received in certain transactions involving corporations and partnerships, *id.* §§ 358, 362, 722, 723, 733, or received in certain other transactions where gain is not fully recognized, *id.* §§ 1031(d), 1033(b), 1034(e). In general, these basis provisions maintain a running account of amounts invested in and removed from an ongoing transaction.

¹³⁰ *Id.* § 1001 (a).

¹³¹ *Id.* § 61(a)(3).

which may again be invested and recovered without further tax liability.

On the other hand, a taxpayer who sells the property for only \$800 has lost \$200 of the capital upon which tax has already been paid.¹³² If the investment is a transaction entered into for profit, the taxpayer may deduct the \$200 loss.¹³³ That deduction allows the taxpayer to receive \$200 of income from another source without incurring additional tax liability.¹³⁴ As a result, the taxpayer may recover the \$1000 of after-tax capital invested in the property, \$800 returned on sale and \$200 of tax-free income from another source.

In this fashion, basis and amount realized function in tandem to compare the after-tax capital committed to an investment with the capital removed from the investment. Gain results when the amount of capital removed from the investment exceeds the after-tax capital invested. A loss occurs when the after-tax capital committed to an investment exceeds the amount returned from the investment upon the close of the transaction. Section 1001 makes this comparison by requiring the subtraction of adjusted basis from amount realized.

Now assume that the taxpayer borrows \$1200 cash, pledging the property as security for the loan. The taxpayer has now withdrawn not only his original \$1000 of after-tax capital, but has received an additional \$200. Receipt of the \$1200 does not generate gross income, however, because of the taxpayer's offsetting obligation to replace the borrowed capital in the future.¹³⁵ This tax-free capital is included in the basis of property acquired with the borrowed proceeds.¹³⁶ The replacement of borrowed capital normally occurs either through a return of the same \$1200 or, more likely, by repayment of the loan with future

¹³² The Code computes this loss as the excess of the taxpayer's adjusted basis over the amount realized. *Id.* § 1001(a).

¹³³ *Id.* § 165(a), (c).

¹³⁴ Losses on the sale or exchange of long-term capital assets do not provide this dollar for dollar offset. *Id.* § 1211. This is a function of the preferential treatment given to income from capital transactions, and does not affect the fundamental relation of basis and amount realized.

¹³⁵ See SURREY, *et al.*, *supra* note 63.

¹³⁶ Crane v. Commissioner, 331 U.S. 1 (1947); Bolger v. Commissioner, 59 T.C. 760 (1973); Mayerson v. Commissioner, 47 T.C. 340 (1966), *ltd. acq.*, Rev. Rul. 69-77, 1969-1 C.B. 59; Blackstone Theatre Co. v. Commissioner, 12 T.C. 801 (1949), *acq.*, 1949-2 C.B. 1.

after-tax earnings. If, however, the taxpayer transfers the property to another who takes over the obligation, the taxpayer will not replace the \$1200 of borrowed capital with taxed dollars. The taxpayer has invested \$1000 of after-tax capital in the transaction and has recovered \$1200, realizing a \$200 gain on the transaction as a whole. Including the unpaid principal of the borrowing in amount realized will reconcile the economic benefit of this transaction with its tax consequences. The \$1200 of money or other property recovered from the transaction, included in amount realized, is compared with the after-tax dollars invested in the transaction, the taxpayer's basis, to produce a gain of \$200. Basis and amount realized thus act together to compare the after-tax investment with the amount of capital recovered from the investment.

This hypothetical yields three important observations. First, the taxpayer obtains the same \$200 of gain regardless of personal liability. Therefore, the tax consequence of the property's disposition subject to the liability should be the same whether the borrowing is recourse or nonrecourse. Second, the taxpayer obtains the \$200 gain regardless of the fair market value of the property at the time of disposition. Even if the property is worth nothing and is transferred to the creditor in a foreclosure, the taxpayer has extracted \$200 more than was invested. Third, the extent of the gain or loss can be ascertained only after the property's disposition.¹³⁷ While the taxpayer continues to own the property and while the liability is outstanding, whether any or all of the borrowed funds will be replaced with a payment of after-tax capital remains unknown. It is therefore not possible to

¹³⁷ See *Woodsam Assoc. v. Commissioner*, 198 F.2d 357, 359 (2d Cir. 1952); *Mendham Corp. v. Commissioner*, 9 T.C. 320, 323 (1947). See also *Hirsch v. Commissioner*, 115 F.2d 656, 658 (7th Cir. 1940), where the court stated:

[The taxpayer's] ultimate gain or loss can not be determined until liquidation of his capital investment. When costs go into property, whether one is to gain or lose must of necessity remain undecided until the property is sold. Credits upon the cost of the investment do not become gain until we find that what is realized upon sale exceeds the total cost, after deducting such voluntary reductions.

Hirsch holds that reduction of a purchase money indebtedness does not result in income under the *Kirby Lumber* doctrine. *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931). *Accord*, *Helvering v. A.L. Killain Co.*, 128 F.2d 433 (8th Cir. 1942); *Gehring Publishing Co. v. Commissioner*, 1 T.C. 345 (1942). *But see* *Fifth Avenue-Fourteenth Street Corp. v. Commissioner*, 147 F.2d 453 (2d Cir. 1944).

compare the capital invested in the transaction with the capital removed until the date of disposition.

Four years before *Crane*, the Tax Court held in *Lutz & Schramm Co. v. Commissioner*¹³⁸ that gain resulted in the above situation even though the unpaid principal of a non-recourse obligation greatly exceeded the value of the property securing the debt. One year after acquiring its plant the Lutz & Schramm Company borrowed \$361,000, pledging the plant as security.¹³⁹ The mortgage was not a purchase money mortgage.¹⁴⁰ Several years later Lutz & Schramm experienced financial difficulties. In exchange for the transfer of certain claims its creditors agreed to reduce the principal of the debt to \$300,000 and to look only to the security for repayment, without recourse to Lutz & Schramm.¹⁴¹ Depreciation deductions reduced Lutz & Schramm's basis in the pledged property during the period that they operated the plant.¹⁴²

The creditor ultimately received the mortgaged property in satisfaction of the debt. At the time of transfer the property was worth only \$97,000, substantially less than the outstanding unpaid principal of the obligation.¹⁴³ Lutz & Schramm asserted that the fair market value of the transferred property limited the amount realized on disposition. The Tax Court disagreed, saying "[T]he fair market value of the property transferred is immaterial under the provisions of the revenue act in the computation of gain or loss from the disposition of the property."¹⁴⁴ The court concluded:

There is no question of the fact that the petitioner had received and used for its own benefit the \$300,000 and the only repayment it made on this part of the debt was the transfer of the property. The debt was finally satisfied by that transfer. The petitioner's release from personal liability in 1934 was not a taxable transaction although that release may explain in part why the creditor was willing to take property worth only \$97,000 in satisfaction of a debt of \$300,000. The fact remains that the taxable transaction took place in 1937, and the net result of it was that the petitioner, over a period of years, had enjoyed the full benefit from the receipt of

¹³⁸ 1 T.C. 682 (1943).

¹³⁹ *Id.* at 684.

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² *Id.* at 685.

¹⁴³ *Id.*

¹⁴⁴ *Id.* at 689.

\$300,000 by transferring a property which had a basis in its hands for gain or loss of only \$257,434.42.¹⁴⁵

Although the taxpayer's gain in *Lutz & Schramm* resulted from reductions in basis attributable to depreciation deductions,¹⁴⁶ the *Lutz & Schramm* court did not look to the tax benefit of prior deductions to include nonrecourse debt in amount realized.¹⁴⁷ The Fifth Circuit recognized in *Tufts* that the tax benefits of depreciation deductions are "factored into the gain equation through adjustments to basis."¹⁴⁸ The Tax Court in *Lutz & Schramm* also did not look for an economic benefit resulting directly from disposition subject to the encumbrance. Rather, the court recognized that the initial borrowing produced a benefit at the time of the borrowing that may be accounted for in amount realized at the close of the transaction.¹⁴⁹

Although the presence of depreciation or other basis-reducing deductions complicates the analysis, adjusted basis and amount realized continue to function together to measure the after-tax capital invested in a transaction against the capital withdrawn. Assume that our taxpayer invests \$1000 in depreciable property. Assume further that the taxpayer borrows \$1200, pledging the property as security. The borrowing does not reduce the taxpayer's basis of \$1000 in the property.¹⁵⁰ If over a two-year period the taxpayer deducts \$500 of depreciation, that basis will be adjusted downward to \$500.¹⁵¹ The basis adjustment accounts for the capital cost of using the property or, under the Accelerated Capital Recovery System of the 1981 Act,¹⁵² the return of invested capital in the form of tax deductions. Under either system, the initial capital investment is recovered with deductions

¹⁴⁵ *Id.*

¹⁴⁶ *Id.* at 685.

¹⁴⁷ *Id.* at 689.

¹⁴⁸ *Tufts v. Commissioner*, 651 F.2d 1058, 1061 (5th Cir. 1981).

¹⁴⁹ The Tax Court reached the same conclusions in *Millar v. Commissioner*, 67 T.C. 656 (1977), *aff'd on other grounds*, 577 F.2d 212 (3d Cir. 1978) (discussed in text accompanying notes 67-89 *supra*); *Woodsam Assoc. v. Commissioner*, 16 T.C. 649 (1951), *aff'd*, 198 F.2d 357 (2d Cir. 1952); *Mendham Corp. v. Commissioner*, 9 T.C. 320 (1947). *See also* *R. O'Dell & Sons Co. v. Commissioner*, 8 T.C. 1165 (1947) (applying the theory of *Lutz & Schramm* to a personal liability case).

¹⁵⁰ *Woodsam Assoc. v. Commissioner*, 198 F.2d 357, 359 (2d Cir. 1952).

¹⁵¹ I.R.C. § 1016(a)(2).

¹⁵² Pub. L. No. 97-34, 95 Stat. 172, § 201, adding I.R.C. § 168.

that allow the receipt of other income tax-free.

Assume now that the taxpayer conveys the property subject to the \$1200 encumbrance in a transaction that frees the taxpayer from any obligation to repay the loan. Including the full encumbrance in amount realized and subtracting the taxpayer's adjusted basis of \$500 produces a gain of \$700.¹⁵³ Again, the functional relationship between amount realized and basis accounts for the capital extracted from the transaction in excess of the capital actually invested. The taxpayer began with an investment of \$1000 of after-tax capital. The taxpayer recovered that initial \$1000 plus an additional \$200 from the proceeds of the borrowing. The taxpayer also recovered \$500 of tax-free capital through depreciation deductions. Therefore, before disposition, the taxpayer had \$700 tax-free.

Including the unpaid principal of the obligation in amount realized accounts for the tax-free benefit of the \$1200 loan. The \$500 adjustments to basis resulting from depreciation deductions or capital recovery account for the tax-free capital received because of the deductions. The \$700 of realized gain accounts for the taxpayer's extraction of \$1700 of tax-free capital from a transaction into which he invested only \$1000 of after-tax capital.

This realization of gain does not depend solely upon the presence of an economic benefit at the close of the transaction. It is instead a reflection of the economic benefit of the transaction as a whole. Nor does the gain depend upon the fair market value of the encumbered property at disposition or the character of the liability as recourse or nonrecourse.

The preceding hypotheticals consider post acquisition cash borrowing.¹⁵⁴ Resolution of a purchase money debt case requires

¹⁵³ I.R.C. § 1001(a).

¹⁵⁴ The Tax Court rejected the application of *Lutz & Schramm Co. v. Commissioner*, 1 T.C. 682 (1943), to release of purchase money debt on disposition of property acquired for the debt in *Nutter v. Commissioner*, 7 T.C. 480 (1946). Addressing the question of gain, the court stated:

The present transaction, however, was clearly in the nature of a purchase money borrowing . . . [I]t is more akin to a reduction of sale price than to financial betterment through the purchase by a debtor of its bonds in an arms-length transaction [between debtor and creditor] . . . And unlike *Lutz & Schramm, supra*, it cannot be said here that '[t]he property was acquired on August 19, 1924 from a predecessor company, and the mortgage was not placed

an easily made additional logical step. The tax system has long recognized that the unrestricted receipt of property represents income no less than the unrestricted receipt of cash.¹⁵⁵ That income is measured by the fair market value of the property at the time of receipt. When the taxpayer receives property in exchange for a purchase money note, however, the value of the property received is not currently included in the taxpayer's gross income because of the taxpayer's offsetting obligation to repay the note with after-tax capital. To reverse the Supreme Court's analogy from *United States v. Hendler*,¹⁵⁶ the acquisition of property for a purchase money obligation is the same as the receipt of cash from the borrowing and subsequent investment of that cash in acquisition of the property. As in *Lutz & Schramm Co. v. Commissioner*,¹⁵⁷ including the unpaid principal of the borrowing in amount realized upon disposition of the property subject to the encumbrance accounts for the initial tax-free receipt of the value of the acquired property. Under this approach, basis and amount realized again account for the excess of capital removed from a transaction over the after-tax

upon it until January 2, 1925. We, therefore, conclude that the petitioner borrowed the money . . . and used it for its own purpose and benefit.'

Id. at 483. *Nutter's* analogy to a reduction of purchase price is inappropriate. Gain is not recognized on reduction of the purchase price, because the transaction remains open until the disposition of the property. See *Hirsch v. Commissioner*, 115 F.2d 656, 658 (7th Cir. 1940), quoted in note 137 *supra*. *Nutter* concerned the disposition of encumbered property with a basis less than the amount of the liability. Disposition closed the transaction; therefore, a measurement of gain or loss was possible. The court erroneously dismissed the logic of *Lutz & Schramm* without recognizing that a similar benefit exists when the taxpayer borrows money that is used to purchase property.

Before *Tufts*, the only other case to consider nonrecourse debt in amount realized where the debt is used in acquisition of the encumbered property was *Millar v. Commissioner*, discussed in the text accompanying notes 67-89 *supra*.

The taxpayers in *Tufts* argue that *Lutz & Schramm* and related nonpurchase-money-debt cases have no application to their purchase money obligation. Brief for Appellants, *Tufts v. Commissioner*, 651 F.2d 1058 (5th Cir. 1981), at 23-27. The Tax Court in both *Lutz & Schramm* and *Mendham Corp. v. Commissioner*, 9 T.C. 320 (1947), made it clear that it was not considering a purchase money obligation as in *Nutter*. *But see* *Estate of Delman v. Commissioner*, 73 T.C. 15, 28 (1979).

¹⁵⁵ *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929).

¹⁵⁶ 303 U.S. 564, 566 (1938).

¹⁵⁷ 1 T.C. 682 (1943).

capital actually invested.

Assume that the taxpayer uses \$1000 of after-tax capital for a down-payment on a \$10,000 piece of property, giving a \$9000 note secured by the property for the balance of the purchase price. For an investment of \$1000 the taxpayer receives property with a fair market value of \$10,000. The \$9000 receipt in excess of investment does not presently represent gross income because of the taxpayer's obligation to invest \$9000 of after-tax capital in repaying the note in the future. The taxpayer's basis in the property will be \$10,000. On disposition of the property subject to the encumbrance, without more, the taxpayer will realize a \$1000 loss. His amount realized will be \$9000, reflecting the tax-free receipt of the \$9000 value of the property over his actual investment. Subtracting the \$10,000 basis produces a \$1000 loss,¹⁵⁸ reflecting the taxpayer's loss of \$1000 after-tax dollars.

If the taxpayer holds the property and claims depreciation or capital recovery deductions, a gain may result. Assume that the taxpayer claims \$3000 of deductions over the period that he holds the property for the production of income. These deductions allow the taxpayer to receive \$3000 of income without tax liability. Basis is adjusted downward to account for this recovery of the invested capital for which the taxpayer was given credit at acquisition.¹⁵⁹ On disposition of the property subject to the liability, the taxpayer's \$7000 adjusted basis is subtracted from his \$9000 amount realized to produce a \$2000 gain.¹⁶⁰ That gain represents the difference between the \$1000 of after-tax capital invested at the outset and the \$3000 of tax-free capital obtained because of the taxpayer's depreciation or capital recovery deductions. Once again, the functional relationship between amount realized and basis accounts for the overall capital recovered from the transaction. The tax system accounts for all the dollars in the taxpayer's pocket by including them in gross income. However, this result occurs only if amount realized includes the full unpaid principal of the obligation. The taxpayer's benefit from the borrowing is the same regardless of personal liability and has nothing to do with the property's market value at disposition. As the *Crane* court recognized, amount realized and basis working together will account for the full economic and tax benefit of

¹⁵⁸ I.R.C. § 1001(a).

¹⁵⁹ *Id.* § 1016(a)(2).

¹⁶⁰ *Id.* § 1001(a).

property transactions involving debt only when debt is treated the same for the purposes of both basis and amount realized.

This analysis provides the solution to the *Tufts* issue. The partners collectively contributed \$44,000 cash to the partnership's capital.¹⁶¹ Each partner presumably had accounted for this cash in gross income and therefore was entitled to the return of these after-tax dollars without incurring further tax liability. The partnership also borrowed \$1,850,000, evidenced by a nonrecourse note.¹⁶² The partnership received capital tax-free because of the partnership's obligation to return the capital with future payments of after-tax dollars. The partners and partnership were given a credit for both their cash contribution and their promised future contribution of after-tax capital with combined bases in the partners' partnership interests of approximately \$1,900,000.¹⁶³ In this fashion, the partners obtained a building costing \$1,900,000 for a cash contribution of only \$44,000, and the currently tax-free investment of borrowed capital.

During operation of the partnership, the partners collectively claimed approximately \$440,000 of deductions for partnership losses and depreciation.¹⁶⁴ As a result, they received tax-free income from other sources. Because these deductions represented a return of the capital invested and to be invested in the apartment complex, the partners' bases in their partnership interests were reduced by the amount of capital returned.¹⁶⁵

On disposition of their partnership interests, the partners destroyed any assumption that they would repay the tax-free borrowed capital with after-tax dollars. Disposition therefore requires an accounting for the tax-free receipt and use of the value of the building represented by borrowed capital. Including the prior tax-free receipt of the borrowing in amount realized accomplishes this accounting. Amount realized includes in the gain

¹⁶¹ *Tufts v. Commissioner*, 70 T.C. 756, 762 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981).

¹⁶² *Tufts v. Commissioner*, 70 T.C. 756, 758 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981).

¹⁶³ *Tufts v. Commissioner*, 70 T.C. 756, 759, 762 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981).

¹⁶⁴ *Tufts v. Commissioner*, 70 T.C. 756, 759-60, 762 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981).

¹⁶⁵ *Tufts v. Commissioner*, 70 T.C. 756, 760, 762 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981).

equation all the money and other property received from the transaction. Basis has been reduced by the capital extracted over the course of the investment. Amount realized and adjusted basis function in tandem to require the partners to realize gain to the extent that the capital extracted from the investment exceeds the after-tax dollars committed to the investment. Including the debt in amount realized does not cause this gain. That inclusion merely accounts for the value that is received at the time of borrowing and included in basis as after-tax capital. The gain results from the return to the taxpayer of capital from the investment which exceeds the capital that the taxpayer actually invested.

IV. PARTNERSHIP PROVISIONS

The taxpayers in *Tufts* also argue that Internal Revenue Code section 752(c) limited the amount realized on the disposition of their partnership interest to the fair market value of the partnership's real estate.¹⁶⁶ Section 752 contains rules for the treatment of liabilities by partners. Subdivision (a) provides that an increase in a partner's share of or a partner's assumption of partnership liabilities will be treated as a contribution of money by the partner to the partnership.¹⁶⁷ That contribution of money increases the partner's basis in his partnership interest.¹⁶⁸ Conversely, subdivision (b) provides that a decrease in a partner's share of partnership liabilities, or any decrease in a partner's individual liabilities because of an assumption by the partnership, will be treated as a distribution of money to the partner by the partnership.¹⁶⁹ This distribution of money to a partner reduces

¹⁶⁶ Brief for Appellants, *Tufts v. Commissioner*, 651 F.2d 1058 (5th Cir. 1981), at 32-40.

¹⁶⁷ I.R.C. § 752(a) provides: "Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership."

¹⁶⁸ I.R.C. § 722; Treas. Reg. § 1.752-1(a). Nonrecourse liabilities of a limited partnership increase the basis of each limited partner in the same proportion as the limited partner's share of partnership profits. *Id.* § 1.752-1(e). See Perry, *supra* note 135.

¹⁶⁹ I.R.C. § 752(b) provides: "Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership."

the basis in the partner's partnership interest.¹⁷⁰ A capital gain results to the extent that the distribution exceeds basis.¹⁷¹ Section 752(c) limits the application of these rules by providing: "For purposes of this section [752], a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property."¹⁷² Section 752(d) then adds: "In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships."¹⁷³ The issue in *Tufts* is whether the fair market value limitation of subdivision (c) limits subdivision (d), as a literal reading of the first phrase of subdivision (c) would seem to require, or whether subdivision (d) operates independently of the rest of section 752, as a literal reading of subdivision (d) would seem to require.

Referring to legislative history, the Tax Court has concluded on at least three occasions that section 752(d) operates independently of the limitation of subdivision (c).¹⁷⁴ In *Tufts*, the Tax Court held that amount realized includes the full amount of unpaid nonrecourse debt without regard to the value of the encumbered property. Consistent with this, it also held in *Tufts* that the partners' amount realized on disposition of their partnership interests included the full amount of the debt.¹⁷⁵

The Fifth Circuit, on the other hand, concluded that its holding with respect to the fair market value limitation of the *Crane* case extinguished any conflict between subdivisions (c) and (d).¹⁷⁶ Obviously, if the general rule of *Crane* were to limit amount realized to the value of the transferred property, transactions controlled by section 752(d) would be treated in the

¹⁷⁰ *Id.* § 733.

¹⁷¹ *Id.* § 731(a).

¹⁷² *Id.* § 752(c).

¹⁷³ *Id.* § 752(d).

¹⁷⁴ The Tax Court has held that the limitation of § 752(c) applies only with respect to the contribution or distribution of encumbered property. *Brountas v. Commissioner*, 73 T.C. 491, 573 (1979); *Estate of Delman v. Commissioner*, 73 T.C. 15, 33-34 (1979); *Tufts v. Commissioner*, 70 T.C. 756, 766-70 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981). *See also* *Gibson Prods. Co. v. United States*, 637 F.2d 1041, 1045-46 n.8 (5th Cir. 1981).

¹⁷⁵ *Tufts v. Commissioner*, 70 T.C. 766-70 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981).

¹⁷⁶ *Tufts v. Commissioner*, 651 F.2d 1058, 1063 n.8 (5th Cir. 1981).

same manner as transactions controlled by section 752(c).¹⁷⁷ Thus, the section 752 issue is important only if this article wrongly concludes that the Fifth Circuit's holding regarding the *Crane* doctrine is erroneous.

Section 752's legislative history is not crystal clear. Nonetheless, it does give some support to the Tax Court's conclusion that subdivision (d) operates independently of subdivisions (a), (b), and (c). The committee reports indicate that a partner's assumption of partnership liabilities, or the partnership's assumption of a partner's liabilities, will in some cases occur when a partner contributes encumbered property to the partnership or *vice versa*.

The provisions of this section prescribe the treatment for such transferred liabilities. Whenever a partner's individual liabilities are increased because of the assumption by him of partnership liabilities, the amount of the increase shall be treated as a contribution of money by the partner to the partnership. Similarly, when the liabilities of the partnership are increased, thereby increasing each partner's share of such liabilities, the amount of the increase shall be treated as a pro rata contribution by the partners, thereby raising the basis of each partner's interest in the amount of his share of the increase.

Conversely, when a partner's personal liabilities are decreased because a portion of them have been assumed by the partnership,

¹⁷⁷ The Fifth Circuit states that "since § 752(c) is generally regarded to be an intended codification of the *Crane* doctrine [citing Perry, *supra* note 135, at 542] it seems that our holding is consistent with congressional understanding of the *Crane* case." Tufts v. Commissioner, 651 F.2d 1058, 1063 n.8 (5th Cir. 1981). Perry states that, "Section 752 has generally been regarded as a codification of the *Crane* rule for the purpose of determining the basis of a specific asset, i.e., the basis of a partner's interest in a partnership." Perry, *supra* note 135, at 542 (emphasis added). With respect to amount realized on disposition of a partnership interest, Perry adds only that:

[T]o complete the analogy to *Crane*, section 752(d) provides that upon a sale or exchange of the partnership interest, liabilities shall be treated in the same manner as are liabilities in the sale or exchange of other types of property. Thus on disposition of the partnership interest, the partner's share of the liabilities is included in the amount realized for the interest.

Perry, *supra* note 135, at 543.

The Fifth Circuit's statement that its holding is consistent with Congressional understanding of the *Crane* case is correct only if Congress had also intended the limitation of section 752(c) to apply to the rule of subdivision (d). It is equally plausible that Congress intended section 752(d) to operate independently of subdivision (c), so that the *Crane* rule would include liabilities in amount realized regardless of the fair market value of encumbered property.

the amount of the decrease shall be treated as a distribution of money by the partnership to the partner. Similarly, when the liabilities of the partnership are decreased, thereby decreasing each partner's share of such liabilities, the amount of the decrease shall be treated as a pro rata distribution by the partnership, thereby reducing the basis of each partner's interest in the amount of his share of the decrease.

The transfer of property subject to a liability by a partner to a partnership, or by the partnership to a partner, shall, to the extent of the fair market value of such property, be considered a transfer of the amount of the liability along with the property.¹⁷⁸

The last paragraph of this quotation is the only reference in the legislative history to the fair market value limitation of section 752(c). Significantly, the congressional reports refer to the fair market value limitations only in the context of transfers between partners and the partnerships. The committee reports then set out an example of the application of subdivisions (a) and (b),¹⁷⁹ followed in the same paragraph with the statement that:

When a partnership interest is sold or exchanged, the general rule for the treatment of the sale or exchange of property subject to liabilities will be applied. Thus, if a partner sells his interest in a partnership for \$750 cash and, at the same time, transfers to the purchaser his pro rata share of partnership liabilities amounting to \$250, the amount realized by the seller on the transaction is \$1000, which will be applied against the basis of his interest in order to determine gain or loss.¹⁸⁰

No reference is made to the fair market value limitation of subdivision (c). Nor is any general rule indicated for the treatment

¹⁷⁸ H.R. REP. NO. 1337, 83d Cong., 2d Sess. A236 (1954), *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4377; S. REP. NO. 1622, 83d Cong., 2d Sess. 405 (1954), *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 5047.

¹⁷⁹ H.R. REP. NO. 1337, 83d Cong., 2d Sess. A236 (1954), *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4377; S. REP. NO. 1622, 83d Cong., 2d Sess. 405 (1954), *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 5047. The example is: If a partner contributes property with basis of \$1,000, subject to a mortgage of \$500, to a partnership in exchange for a one-half interest in the partnership, the basis of his interest will be \$1,000 (the basis of the contributed property) reduced by \$250 (the amount of his liability with respect to such property assumed by the other partner), or \$750. The contributing partner still remains subject to \$250 of his original \$500 liability.

¹⁸⁰ H.R. REP. NO. 1337, 83d Cong., 2d Sess. A236 (1954), *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4377; S. REP. NO. 1622, 83d Cong., 2d Sess. 405 (1954), *reprinted in* 1954 U.S. CODE CONG., & AD. NEWS 5048.

of the sale or exchange of property subject to a nonrecourse debt in excess of value.

The Treasury Regulations do not offer much additional guidance. The only reference to the fair market value limitation of section 752(c) appears in section 1.752-1(c):

Where property subject to a liability is contributed by a partner to a partnership, or distributed by a partnership to a partner, the amount of the liability, to an extent not exceeding the fair market value of the property at the time of the contribution or distribution, shall be considered as a liability assumed by the transferee.¹⁸¹

Section 1.752-1(d) provides: "Where there is a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships."¹⁸² There is no reference to the fair market value limitation with respect to sales of a partner's interest. The Tax Court held that since the authorities limit their discussions of the fair market value limitation to contributions to and distributions from a partnership, the limitation should apply only to those transactions.¹⁸³ Separate reference in the committee reports and regulations to the provision of section 752(d) that the partnership rules do not apply to disposition of a partnership interest supports this view.

There is an additional reason for interpreting section 752(d) as operating independently of the limitation of section 752(c). Unless section 752(d) is independent, it has no role in the statutory scheme. If section 752(d) were subject to the fair market value limitation of subdivision (c), a transaction treated under section 752(d) would have exactly the same result as if it had been treated under subdivision (a) or (b). Using the example from the committee reports,¹⁸⁴ if the partner sells his partnership interest for \$750 cash and transfers to the purchaser his pro rata share of partnership liabilities amounting to \$250, and if subdivision (d) were not in the Code, the transferring partner would receive a \$250 cash distribution under section 752(b). The

¹⁸¹ Treas. Reg. § 1.752-1(c).

¹⁸² *Id.* § 1.752-1(d).

¹⁸³ See cases cited in note 174 *supra*.

¹⁸⁴ H.R. REP. NO. 1337, 83d Cong., 2d Sess. A236 (1954), reprinted in 1954 U.S. CODE CONG. & AD. NEWS 4377; S. REP. NO. 1622, 83d Cong., 2d Sess. 405 (1954), reprinted in 1954 U.S. CODE CONG. & AD. NEWS 5047. The complete example is set forth in note 179 and the text accompanying note 180 *supra*.

distribution would either reduce basis¹⁸⁵ or result in a capital gain if it exceeded the basis.¹⁸⁶ Assuming that the partner's basis in his partnership interest is \$200, the partner would have a \$50 gain and zero remaining basis. The partner will also realize \$750 from the purchaser. Since the partner's remaining basis is zero, all \$750 will be gain.¹⁸⁷ The partner's total gain on the disposition of his partnership interest would therefore be \$800.¹⁸⁸

Application of subdivision (d) yields the same result. The partner's amount realized consists of the \$250 reduction in partnership liabilities and the \$750 cash, for a total of \$1000. Subtracting the partner's \$200 basis produces the same \$800 gain. A difference in result will occur only if the limitation of subdivision (c) applies to subdivisions (a) and (b), but not subdivision (d), and the value of the interest transferred is less than the \$250 of partnership liabilities. If subdivision (d) of section 752 is to have any meaningful role in the statutory structure, it must mean what it says: that the tax consequences of a sale of a partnership interest is to be determined without regard to the partnership rules of subdivisions (a), (b), and (c). Otherwise, the provision is completely redundant.

An alternative application of section 752, which the Fifth Circuit did not consider in *Tufts*, will also yield the result advocated by the Commissioner.¹⁸⁹ At the outset of their investment, the *Tufts* partners included the full \$1,850,000 of borrowed funds in the bases of their partnership interests. Because section 752(c) provides that the partners' share of the liability may be included in basis only to the extent of the fair market value of the encumbered property, the partners were asserting that the apartment complex was worth at least \$1,850,000. At disposition, however, the partners claimed that the value of the building had declined to \$1,400,000. At that point, the partners asserted the debt could be taken into account under section 752(c) only to

¹⁸⁵ I.R.C. § 733.

¹⁸⁶ *Id.* § 731(a).

¹⁸⁷ *Id.* § 1001(a).

¹⁸⁸ The total gain equals the sum of the \$50 gain resulting from a reduction of the partner's share of partnership liabilities plus the \$750 gain on disposition of the partner's zero basis partnership interest for \$750 cash.

¹⁸⁹ The Commissioner did, however, assert this alternative application of section 752 in a footnote in his brief to the Fifth Circuit Court of Appeals on *Tufts*. Brief for The Appellee at 42 n.22, *Tufts v. Commissioner*, 651 F.2d 1058 (5th Cir. 1981).

the extent of the \$1,400,000 value of the real estate. If this is correct, then there had been a decline in the partnership's liabilities, as limited by section 752(c), equaling the difference between the original borrowing and the value at the time of disposition. This \$450,000 decrease in the partnership's liabilities would cause a pro rata decrease in each partner's share of the partnership liabilities. This would constitute a constructive distribution of money under section 752(b)¹⁹⁰ that would reduce the partner's collective adjusted bases from \$1,450,000 to \$1,000,000.¹⁹¹ If amount realized on the sale of the partners' partnership interest includes the partnership liabilities only to the extent of the value of the encumbered property, as the taxpayers assert, then the partners' collective amount realized would be limited to \$1,450,000. Subtracting the adjusted basis of \$1,000,000 produces a gain of \$450,000. This approximates the gain realized by including the full amount of the partnership's debt in the partners' amount realized and subtracting adjusted basis. This analysis resolves the *Tufts* case without regard to the

¹⁹⁰ *Stackhouse v. United States*, 441 F.2d 465, 469 (5th Cir. 1971).

The legislative history of the Code and the current Treasury regulations make it clear that § 752 applies not only to those instances in which one partner assumes the liabilities of another or the partnership itself assumes the liabilities of a partner. It also applies to those situations in which the liabilities of the partnership itself are decreased, thereby decreasing each partner's share of those liabilities. In that case the amount of the decrease is treated as a pro rata distribution of money to each partner by the partnership. The liabilities of the partnership of course could be decreased in a number of ways: an individual partner could assume certain partnership liabilities, or the partnership could repay an outstanding obligation. . . . [citation omitted] But a reduction of liabilities would also occur if a partnership obligation were forgiven, or as here discharged for a lesser amount than the total due.

Id. Commentators have recognized the possibility that a decline in value of encumbered property results in a distribution under §§ 752(b) and (c), but have suggested that since the depreciation is not realized on a mere decline in value, that a distribution under § 752(b) is not appropriate. W. MCKEE, W. NELSON & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 7.04, at 7-12 n.42 (1977); A. WILLIS, *PARTNERSHIP TAXATION* ¶ 22.09 at 262-63 (2d ed. 1976); Aronsohn, *The Financially Troubled Partnership*, 34TH ANN. N.Y.U. TAX INST. 327, 350-51 n.56 (1976); Ginsberg, *The Leaky Tax Shelter*, 53 TAXES 719, 731 (1975). The realization question is not a problem, however, when the distribution under § 752(b) is deemed to occur on disposition of partnership property or a partner's partnership interest.

¹⁹¹ I.R.C. § 733.

fair market value issue under *Crane*.

CONCLUSION

Tufts v. Commissioner presents the United States Supreme Court with an opportunity to lay to rest once and for all the controversy generated by *Crane's* footnote 37. Resolution of the issue is not difficult when the initial tax-free benefit of borrowing is recognized. Borrowing allows the tax-free receipt of cash or property. Discharge of indebtedness principles create income on release from indebtedness where no disposition of property is involved. Including discharged indebtedness, whether recourse or nonrecourse, in amount realized on disposition of property has the same effect. The amount realized on sale thus includes not only consideration received on the disposition itself, but also the tax-free receipt of borrowed money or property that is not returned by the time of disposition. In this fashion, as the Supreme Court wisely noted in *Crane*, the functional relationship between amount realized and adjusted basis created by the tax statute accurately accounts for gain or loss on the whole transaction.¹⁹² Should the current Supreme Court fail to see the wisdom of its earlier *Crane* opinion, the issue is ripe for immediate Congressional intervention to amend section 1001, making it clear that the untaxed benefit of borrowing is to be included in amount realized.

¹⁹² *Crane v. Commissioner*, 331 U.S. 1, 12 (1947).