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# Contra Tufts: The Case against the Fair Market Value Limitation on Amount Realized

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# *Comments*

# Contra *Tufts*: The Case Against The Fair Market Value Limitation on Amount Realized

As the title suggests, the main thrust of this comment is an exploration of *Tufts v. Commissioner*,[1] a case recently handed down by the United States Court of Appeals for the Fifth Circuit; it should be noted, however, that this narrative has its roots in the early decades of the present century. This saga begins in 1932 when Mrs. Beulah Crane inherited an apartment building and lot subject to a nonrecourse mortgage from her late husband.[2] The widow Crane sold the property in 1938,[3] and then the problem arose. Mrs. Crane and the Internal Revenue Service (hereinafter referred to as I.R.S.) disagreed about the proper method with which to calculate the gain realized by the taxpayer on the sale of the building.[4] Basically, the controversy revolved around two issues: (1) whether the amount of nonrecourse debt to which property is subject should be included in calculating the basis of property received from a decedent;[5] and (2) whether the taxpayer must include the amount of such nonrecourse debt assumed by the buyer in amount realized upon the disposition of property subject to a nonrecourse mortgage.[6]

Choosing to fight, Mrs. Crane battled relentlessly against the Commissioner of Internal Revenue (hereinafter referred to as the Commissioner). The dispute was finally resolved by the United States Supreme Court.[7] In the end, the views of the Commissioner were adopted,[8] but

1. 651 F.2d 1058 (5th Cir. 1981) *cert. granted*, 50 U.S.L.W. 3881 (U.S. May 3, 1982) (No. 81-1536).
2. Crane v. Commissioner, 331 U.S. 1, 3 (1947).
3. *Id.*
4. *See id.* at 3-5.
5. *See id.* at 5-11.
6. *See id.* at 12.
7. *See id.* at 1.
8. *See generally* 331 U.S. 1.

it cannot be said that Mrs. Crane lost.[9]

The holding in *Crane v. Commissioner* allows taxpayers to include the amount of nonrecourse debt in calculating basis.[10] Because depreciation deductions are calculated from the taxpayer's basis in property,[11] an increase in basis results in increased yearly depreciation deductions. Thus the *Crane* case laid the foundation for most tax shelters.[12]

While taking advantage of the benefits[13] resulting from being able to include the amount of nonrecourse debt in basis, taxpayers have balked at complying with the second portion of the *Crane* holding which requires that they include the nonrecourse debt assumed by the buyer in the amount realized.[14] Attempting to avoid complying with this mandate, taxpayers have argued that footnote 37 of *Crane*[15] limits the amount realized to the fair market value of the property, if that value is less than the amount of debt assumed by the buyer.[16] This proposition was never accepted by a court,[17] until 1981, when the Fifth Circuit decided *Tufts*. In *Tufts* the Fifth Circuit held that the amount realized must be limited to the fair market value of the property transferred if the amount of the nonrecourse debt exceeded the fair market value.[18] In reaching this conclusion, the Fifth Circuit rejected the "economic benefit"[19] theory, which it saw as the theoretical justification for the *Crane* doctrine.[20]

The purpose of this comment is to show that if the portion of the *Crane* doctrine which allows nonrecourse debt to be included in basis is left undisturbed, and it should be,[21] then the full amount of nonre-

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9. See Bittker, *Tax Shelters, Nonrecourse Debt, and the* Crane *Case*, 33 TAX L. REV. 277, 283 n.11 (1978) (hereinafter cited as Bittker), wherein the author offers an autographed copy of his article to the I.R.S. lawyer to write the best essay entitled "Pyrrhic Victories I Have Come to Rue."
10. *See* 331 U.S. at 11.
11. *See* I.R.C. §167(g) (1976 & Supp. IV 1980).
12. Bittker, *supra* note 9, at 283.
13. See text accompanying notes 66-83 *infra*, for a description of these benefits.
14. *See* 331 U.S. at 14.
15. See text accompanying note 92, *infra*.
16. *See generally* Millar v. Commissioner, 577 F.2d 212 (3d Cir. 1978), Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950); Mendham Corp. v. Commissioner, 9 T.C. 320 (1947) (cases in which this argument has been made).
17. *See* Del Cotto, *Basis and Amount Realized Under* Crane: *A Current View of Some Tax Effects in Mortgage Financing*, 118 U. PENN. L. REV. 69, 85-86 (1969) [hereinafter cited as Del Cotto]. *But see* 186 F.2d at 458. Dicta in this case indicates that the First Circuit accepted the theory suggested by footnote 37, but the court went on to find that the fair market value of the property at least equaled the amount of the nonrecourse debt. *Id.*
18. *See* 651 F.2d 1058, 1063 (5th Cir. 1981), *cert. granted*, 50 U.S.L.W. 3881 (U.S. May 3, 1982) (No. 81-1536).
19. See notes 169-178 and accompanying text *infra*.
20. *See* 651 F.2d at 1061.
21. *See generally* Simmons, *Nonrecourse Debt and Basis: Mrs. Crane Where Are You Now?*, 53 S. CAL. L. REV. 1 (1979) [hereinafter cited as Simmons I]. See notes 152-167 and accompanying text *infra*.

course debt assumed by a transferee must be included in the transferor's amount realized, regardless of the fair market value of the real property.[22]

This comment will commence with a detailed discussion of the *Crane* case,[23] followed by a generalized discussion of real estate tax shelters, their goals, and the mechanics behind them.[24] The role of the depreciation deduction in tax shelters will be discussed at length, with emphasis placed on the governmental policies sought to be implemented by allowing depreciation deductions.[25] Finally, the relation of the *Crane* doctrine to tax shelters will be explored through a two-part analysis: (1) the advantages created by including nonrecourse debt in basis; and (2) the disadvantages created by mandating that the full amount of nonrecourse debt assumed be included in the amount realized.[26] The latter necessitates an inquiry into the underlying rationale of footnote 37 and why this theory is so very attractive to investor taxpayers.[27]

The facts and the holding of the *Tufts* case will be discussed in detail, as will the the significance of the Fifth Circuit's adoption of the fair market value limitation of footnote 37.[28] This will be followed by a brief discussion the purpose of which is to illustrate that despite the problems involved, the inclusion of nonrecourse debt in basis is the most practical and theoretically consistent solution to the problem of how to treat nonrecourse debt when calculating basis.[29] The holding in *Tufts* will then be shown to be unacceptable and indefensible.[30] The arguments made by the Fifth Circuit will be explained, carefully analyzed, and refuted.[31] This comment concedes that the Fifth Circuit's analysis of the "economic benefit" theory is the only logical one, and that the holding in *Tufts* is consistent with the rationale of the "economic benefit" theory. The Fifth Circuit's analysis, however, it will be argued, is too simplistic because it ignores the *Crane* court's concern with what it termed "double deductions."[32] The Fifth Circuit argues that even if the Supreme Court had been concerned with the occur-

22. "Failure to include the full amount of the debt in amount realized permits an investor to obtain an unjustified tax benefit . . . ." Simmons, *Nonrecourse Debt and Amount Realized: The Demise of* Crane's *Footnote 37*, 59 OR. L. REV. 3, 4 (1980) [hereinafter cited as Simmons II].
23. See notes 36-65 and accompanying text *infra*.
24. See notes 66-74 and accompanying text *infra*.
25. See notes 75-80 and accompanying text *infra*.
26. See notes 81-89 and accompanying text *infra*.
27. See notes 90-93 and accompanying text *infra*.
28. See notes 102-135 and accompanying text *infra*.
29. See notes 143-167 and accompanying text *infra*.
30. *See* Bittker, *supra* note 9, at 284.
31. See notes 168-205 and accompanying text *infra*.
32. *See* Crane v. Commissioner, 331 U.S. 1, 16 (1947).

rence of "double deductions," that concern was unmerited because double deductions are made impossible by the necessary adjustments to basis.[33] It will be shown that this argument is fallacious and evidences an acute misunderstanding of the delicate interrelation between the various provisions of the Internal Revenue Code (hereinafter referred to as I.R.C.), dealing with basis, depreciation, and amount realized.[34]

Finally, taxpayer Tufts' assertion that the fair market value limitation set forth in footnote 37 was enacted into law by I.R.C. section 752(c) will be explored at length, and refuted through an examination of Congressional discussion made pursuant to its enactment.[35]

## *CRANE*

The *Crane* case is a pivotal one in tax history.[36] In a two-part holding that has become known as the *Crane* doctrine the United States Supreme Court (1) allowed taxpayers to include the full amount of nonrecourse debt in calculating their basis in property,[37] and (2) mandated that the amount of nonrecourse debt, which the transferee assumed or took subject to,[38] be included in the amount realized for purposes of calculating gain or loss on the transaction.[39]

### *A. The Facts and Arguments*

The *Crane* case involved the sale of an apartment building that Mrs. Beulah Crane had inherited from her husband in 1932.[40] The building was encumbered by a nonrecourse debt of $262,042.50[41] and was appraised at a value equal to the debt for federal estate tax purposes.[42] For seven years she took deductions for taxes, interest, and depreciation.[43] In 1938 the taxpayer sold the property to a third party who assumed the nonrecourse debt and paid $3000 cash.[44] A gain of $1250

33. *See* Tufts v. Commissioner, 651 F.2d 1058, 1061 (5th Cir. 1981).
34. See notes 179-197 and accompanying text *infra*.
35. See notes 210-235 and accompanying text *infra*.
36. *See* Friedland, Tufts *and* Millar: *Two New Views of the* Crane *Case and Its Famous Footnote*, 57 THE NOTRE DAME LAW. 510 (1982) [hereinafter cited as Friedland].
37. *See* Crane v. Commissioner, 331 U.S. 1, 11 (1947).
38. "[O]n a sale or exchange of the encumbered property, this liability is included in the amount realized on the sale or exchange, whether the buyer assumes the liability or merely takes the property subject thereto." Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX L. REV. 225, 227 (1959). For purposes of this comment the terms "assumes the liability" and "takes subject to the liability" will be used interchangeably.
39. *See* 331 U.S. at 14.
40. *Id.* at 3.
41. *See id.* (consisting of $255,000 of principal and interest in default amounting to $7,042.50).
42. *See id.*
43. *See id.* The depreciation deductions claimed and allowed totaled $25,500. *Id.* at n.2.
44. *See* 331 U.S. at 3.

was reported as resulting from this transaction.[45] The Internal Revenue Service assessed a deficiency, claiming that the taxpayer had realized a net taxable gain of $23,767.03.[46] The widely differing figures resulted from different interpretations of two terms: basis in property[47] and amount realized.[48]

The Internal Revenue Code defines the basis in property received from a decedent as the fair market value of the property at the time of death.[49] Mrs. Crane argued that the *property* she had received from her late husband was the equity in the property, not the building.[50] At the time of Mr. Crane's death, the fair market value and the amount of the mortgage were deemed to be equal;[51] therefore, the taxpayer argued, her basis in the property was zero.[52] Furthermore, Mrs. Crane contended that the amount realized[53] on the transfer of the property was the net cash received, $2,500.[54] A capital gain of $1,250 was declared after the taxpayer took advantage of the then current fifty percent capital gains deduction.[55]

The Commissioner argued that the *property* Mrs. Crane inherited was the entire building not just her late husband's equity in the building.[56] This position was consistent with the actions of the taxpayer in taking depreciation deductions for almost seven years[57] and calculating the deduction from a basis equal to the fair market value of the building at the time of Mr. Crane's demise.[58] The Commissioner also contended that the amount realized by the taxpayer involved the principal amount of the mortgage assumed by the buyer.[59]

45. *See id.*

46. *See id.* at 4.

47. *See* Internal Revenue Code of 1939, c. 1, §113(a)(5), 53 Stat. 41 (current version at I.R.C. §1014(a) (1976 & Supp. IV 1980)).

48. *See id.* §111(b), at 47 (current version at I.R.C. §1001(b) (1976 & Supp. IV 1980)).

49. *See id.* §113(a)(5), at 41.

50. *See* 331 U.S. at 3.

51. *Id.*

52. *Id.* at 3-4.

53. *See* Internal Revenue Code of 1939 §111(b) at 37 (defining amount realized as "the sum of any money received plus the fair market value of the property (other than money) received").

54. *See* 331 U.S. at 3 (of the $3,000 cash received, $500 was used to pay for the expense of the sale).

55. *See* Internal Revenue Code of 1939 §117(b), at 47 (current version at I.R.C. §1202 (1976 & Supp. IV 1980)) (the deduction has been increased to sixty percent of the net capital gain, subsequent to the *Crane* case).

56. *See* 331 U.S. at 4.

57. *See id.* at 3.

58. *See* Internal Revenue Code of 1939 §23(n), at 14 (current version at I.R.C. §167(g) (1976 & Supp. IV 1981)). The basis from which the depreciation deduction is calculated is the taxpayer's basis in the property for determining gain or loss from the dispostion of the property. *Id.*

59. *See* 331 U.S. at 4.

### *B. The Holding*

The Court rejected Mrs. Crane's contention that the *property* which she had received from her husband was merely his equity in the building.[60] The Court reached this conclusion by arguing that *property* and *equity* are not synonymous.[61] The I.R.C. speaks in terms of the basis in *property* not in *equity*,[62] and there is, furthermore, no evidence that Congress has used the two words interchangeably or with confusion.[63] The Court went on to formulate what is often referred to as the *Crane* doctrine. This two-part holding accepted the views posited by the Commissioner. The first part of the *Crane* doctrine requires the taxpayer to include the full amount of the nonrecourse debt in calculating the tax basis.[64] The second part mandates that the amount of nonrecourse debt assumed by the transferee be included in the amount realized for purposes of calculating gain or loss on the transaction.[65]

### *C. The Practical Significance of* Crane*: Tax Shelters*

*Crane* allows the taxpayer to include the amount of nonrecourse debt in calculating the basis of the property acquired from a decedent.[66] Subsequent cases extended the *Crane* doctrine by authorizing taxpayers to include the full amount of nonrecourse debt in the basis of property purchased by the taxpayer,[67] resulting in an increase in the taxpayer's basis. The depreciation deduction allowed is calculated from the tax basis.[68] Because the depreciation deduction is calculated from basis and *Crane* allows the taxpayer an increased basis, it allows higher depreciation deductions. This forms the foundation for tax shelters.[69]

Tax shelters are investments undertaken to fulfill specific tax saving goals, deferral of taxation, and conversion of ordinary income to capital gains.[70] Deferral is achieved when the tax deductions from the investment exceed the taxable income generated. These losses may then offset the taxpayer's income which is unrelated to the investment activ-

60. *See generally id.*
61. *See id.* at 6-7.
62. *See id.* at 6.
63. *See id.* at 8 (in those instances when either the Congress or the Treasury intended to convey the meaning of *equity*, it did so by the use of appropriate language).
64. *See id.* at 11.
65. *See id.* at 14.
66. *See generally id.*
67. *See generally* Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950); Blackstone Theatre Co. v. Commissioner, 12 T.C. 801 (1949).
68. *See* I.R.C. §167(g) (Supp. IV 1980).
69. *See* Simmons I, *supra* note 21, at 58.
70. *The President's 1978 Tax Reduction and Reform Proposals: Hearings Before the House Ways and Means Comm., on the President's 1978 Tax Program*, 95th Cong., 2d Sess. 224 (1978), *reprinted in* 3 TAX MGMT. (BNA) *Series LII* §465 [hereinafter cited as President's Proposals]; *see* Del Cotto, *supra* note 17, at 95.

ity.[71] Emphasis must be placed on the fact that over the life of the transaction the taxpayer will pay taxes on the same income.[72] The payment, however, is deferred until the income generated exceeds the losses.[73] By deferring the payment of taxes, the investor has, in effect, obtained an interest-free loan from the federal government.[74]

The mechanism that allows the tax losses generated by the investment to exceed the income generated is the depreciation deduction.[75] The purpose of this deduction is to allow the taxpayer to recover the cost of an asset used in the trade or business[76] or "held for the production of income"[77] tax free while the asset is in use.[78] Over the years, depreciation allowances have been liberalized.[79] Congress has enacted these liberalized methods of calculating depreciation deductions on the theory that an accelerated recovery of capital by investors, through large tax deductions during the early years of the asset's life, would increase the supply of capital in the market place; this would then lead to increased investment activities and thus result in business expansion.[80]

If the investment is debt financed, two further benefits accrue to the taxpayer.[81] First, the investor is able to enjoy the depreciation deduction without an extensive out-of-pocket investment and the interest

71. President's Proposals, *supra* note 70, at 224.

72. *See* A. ARNOLD, TAX SHELTERS IN REAL ESTATE TODAY 5 (1979) [hereinafter cited as ARNOLD]; *see also* Del Cotto, *supra* note 17, at 95.

73. President's Proposals, *supra* note 70, at 224.

74. President's Proposals, *supra* note 70, at 224; ARNOLD, *supra* note 72, at 5.

75. President's Proposals, *supra* note 70, at 224.

> Depreciation deductions offset current gross income and thus allow the investor to receive income from the property or from other sources without current tax liability. For tax purposes, this tax-free income represents a return of the capital committed to the property and is accounted for by reducing basis. (footnote omitted)

Simmons II, *supra* note 22, at 20.

76. I.R.C. §167(a)(1) (1976 & Supp. IV 1980).

77. *Id.* §167(a)(2).

78. H.R. REP. No. 1337, 83d Cong., 2d Sess. 22 (1954), *reprinted in* 2 TAX MGMT. (BNA) §167.

79. *See id.*; *see also* I.R.C. §168 (setting forth the new methods of depreciation).

80. H.R. REP. No. 1337, 83d Cong., 2d Sess. 24 (1954), *reprinted in* 2 TAX MGMT. (BNA) §167. The Committee states:

> The faster tax writeoff would increase available working capital and materially aid growing businesses in the financing of their expansion. For all segments of the American economy, liberalized depreciation policies should assist modernization and expansion of industrial capacity, with resulting growth, increased production, and a higher standard of living.

*Id.* But see President's Proposals, *supra* note 70, at 55, wherein former Secretary Blumenthal states:

> Typically, shelter investments are made not because of anticipated economic productivity, but in anticipation of the various tax preferences that are packaged together by shelter promoters to provide optimum tax writeoffs. This drain of investment dollars into shelter activities creates economic distortions and harms legitimate profit-seeking businesses.

81. *See* President's Proposals, *supra* note 70, at 224 (describing leverage as the use of someone else's money to finance an investment activity).

paid on the debt is usually deductible.[82] The *Crane* doctrine makes debt-financed investments even more attractive because the taxpayer can include the full amount of the debt in basis, thus enjoying the depreciation deductions, without being personally liable on the debt.[83]

Traditionally, however, there has been a dark side for taxpayers who have invested in tax shelters.[84] This occurs once the large depreciation deductions have been taken and the taxpayer's basis has been reduced.[85] The investment begins to produce taxable income.[86] The taxpayer, at this time, may find it wise to sell or transfer the property to a third party. If the buyer takes subject to the nonrecourse, then *Crane* mandates that the seller include the amount of debt assumed in the amount realized.[87] Since the taxpayer's basis has been adjusted downward to reflect the depreciation deductions taken,[88] a gain will be realized, a gain that must be included in gross income.[89]

In attempts to vitiate the consequences resulting from the inclusion of the nonrecourse debt assumed by the transferee in the amount realized, taxpayers have argued that an exception to this mandate was created by the United States Supreme Court in *Crane*.[90] These arguments are based on footnote 37 of *Crane*, considered to be the most famous footnote in tax history.[91] The court stated:

> 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.[92]

For many years taxpayers have been taking advantage of the portion of the *Crane* doctrine which allows them to include the full amount of nonrecourse debt in basis, thus increasing their depreciation deductions. Taxpayers have asserted that footnote 37 provides authority for limiting the amount realized by the taxpayer to the fair market value of

82. ARNOLD, *supra* note 72, at 5; *see also* I.R.C. §163.
83. *See generally* Crane v. Commissioner, 331 U.S. 1 (1947).
84. *See* Comment, Tufts v. Commissioner—*The Resurrection of* Crane's *Footnote 37*, 9 FLA. ST. U.L. REV. 575, 580 (1982).
85. *See* I.R.C. §1016 (which provides that the tax basis must be adjusted downward to reflect the extent of the depreciation deduction taken, or to the extent allowable).
86. *See* Comment, *supra* note 84, at 580.
87. *See* Crane v. Commissioner, 331 U.S. 1, 14 (1947).
88. *See* I.R.C. §1016.
89. *See* I.R.C. §61(a)(3) (including gains from dealings in property in gross income).
90. *See generally* Estate of Levine v. Commissioner, 634 F.2d 12 (2d Cir. 1980); Millar v. Commissioner, 577 F.2d 212 (3rd Cir. 1978); Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950).
91. *See* Bittker, *supra* note 9, at 277.
92. 331 U.S. at 14 n.37 (emphasis added).

the property, if that value is less than the amount of the debt.[93]

In *Millar v. Commissioner*[94] (hereinafter referred to as *Millar*), the United States Court of Appeals for the Third Circuit rejected the taxpayer's contentions that footnote 37 created an exception to the amounts realized portion of *Crane*.[95] Two months after the decision in *Millar*,[96] the United States Tax Court followed the lead of the Third Circuit and in the case of *Tufts*[97] it rejected the taxpayer's argument.[98] It appeared as if the taxpayers would never obtain a victory in this area; one learned commentator even heralded the "Demise of Crane's Footnote 37."[99] During the summer of 1981, however, the Fifth Circuit reversed the Tax Court's decision in *Tufts*,[100] demonstrating that footnote 37 was alive and well.[101]

## *TUFTS V. THE COMMISSIONER*

In *Tufts*, the United States Court of Appeals for the Fifth Circuit held that when property subject to a nonrecourse debt is transferred to a buyer who assumes the debt, the seller's amount realized is limited to the fair market value of the property, if that value is less than the amount of the nonrecourse debt.[102] Concluding that "the fair market value limitation so '[o]bviously' anticipated by footnote 37 is warranted,"[103] the Fifth Circuit became the first court in the country to accept the proposition that footnote 37 created an exception to the amount realized portion of the *Crane* doctrine.[104] Since *Tufts* is destined to be a significant case,[105] it is worthwhile to examine in depth the facts that gave rise to the controversy.

### *A. The Facts*

In 1970, the Tufts became partners in a general partnership. The partnership undertook to build an apartment complex costing

93. *See generally* Millar v. Commissioner, 577 F.2d 212 (3d Cir. 1978); Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950); Mendham Corp. v. Commissioner, 9 T.C. 320 (1947).
94. 577 F.2d 212 (3d Cir.), *cert. denied*, 439 U.S. 1046 (1978).
95. *See generally id.*
96. *See* Simmons II, *supra* note 22, at 29.
97. Tufts v. Commissioner, 70 T.C. 756 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981).
98. *See generally id.*
99. *See* Simmons II, *supra* note 72, at 3 (this article is entitled *Nonrecourse Debt and Amount Realized: The Demise of* Crane's *Footnote 37*).
100. *See* Tufts v. Commissioner, 651 F.2d 1052, 1063 (5th Cir. 1981).
101. *See id.*
102. *Id.*
103. *Id.*
104. *See* Del Cotto, *supra* note 17, at 85-86.
105. *See* Simmons, Tufts v. Commissioner: *Amount Realized Limited to Fair Market Value*, 15 U.C.D. L. REV. 577, 577-78 (1982). [hereinafter cited as Simmons III].

$1,851,500,[106] totally financed by nonrecourse debt.[107] During 1970, the Tufts made a cash contribution of $2,771 to the partnership.[108] From 1970 to 1972 the taxpayers claimed and were allowed deductions for ordinary losses totalling $82,984.25,[109] and depreciation deductions of $27,008.75.[110] In 1972 the partners, having failed to turn the venture into a profit-making enterprise, sold their partnership interests to a third party who took subject to the nonrecourse mortgage and paid no boot.[111] At the time of the sale, the fair market value of the complex was determined to be $1,400,000.[112] The fair market value of the Tufts' interest was $350,000, their share of the partnership liability assumed by the transferee was $462,875.[113] This was exactly the situation described by the Supreme Court in footnote 37 of *Crane*; the fair market value of the property was less than the amount of nonrecourse debt assumed by the buyer.

The taxpayers indicated a loss[114] on their federal income tax return for 1972.[115] They used footnote 37 to support their contention that the amount realized should be limited to the fair market value of the transferred property, when that amount is exceeded by the nonrecourse debt assumed by the buyer.[116] The Commissioner, asserting that the full amount of nonrecourse debt must be included in the amount realized, determined that the taxpayers had realized a gain.[117]

The focal issue in *Tufts* is whether the amount realized by the taxpayer in a taxable exchange should be limited to the fair market value of the property interest, when the fair market value is less than the amount of the nonrecourse debt assumed by the transferee. The Tax Court favored the Commissioner's view and held that the taxpayers

106. *See* Tufts v. Commissioner, 70 T.C. 756, 759 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981) (the adjusted basis of the Tuft's partnership interest was $462,875).
107. *See id.* at 758.
108. *See id.* at 759.
109. *See id.* at 760.
110. *See id.*
111. *See id.* at 761.
112. *Id.*
113. *Id.* at 762.
114. *See* I.R.C. §1001 (1976 & Supp. IV 1980) (loss is defined as the amount by which the adjusted basis exceeds amount realized).
The loss was calculated by the following equation:

| | | |
|---|---|---|
| | Amount Realized | - $350,000 |
| (minus) | Adjusted Basis | - $355,563 |
| | Loss | - $ 5,563 |

115. *See* 70 T.C. at 761.
116. *See* Tufts v. Commissioner, 651 F.2d 1058, 1059 (5th Cir. 1981).
117. *See* 70 T.C. at 761; *see also* I.R.C. §1001(a) (gain is the excess of the amount realized over the adjusted basis).

| | | |
|---|---|---|
| | Amount Realized | - $462,875 |
| (minus) | Adjusted Basis | - $355,563 |
| | Gain | - $107,312 |

had to include the full amount of the nonrecourse debt assumed by the buyer in the amount realized, regardless of the fair market value of the property at the time of the transaction.[118] The Fifth Circuit Court of Appeals, acknowledging that their decision was "in direct conflict with decisions in other circuits,"[119] reversed the decision of the Tax Court.[120]

### *B. The Holding*

Finding fault with what it considered to be the theoretical foundation for the *Crane* doctrine,[121] the Fifth Circuit determined that the amount realized by the taxpayer who sold property encumbered by a nonrecourse mortgage should be limited to the fair market value of the property if that value is less than the amount of the debt.[122]

The Fifth Circuit's holding is very favorable to taxpayers. This will be shown by examining the vastly different tax consequences that can result from the same transaction depending on whether the *Millar* view or the *Tufts* view is followed.

### *C. The Significance of* Tufts

The *Tufts* court voiced serious doubts about the validity of the *Crane* doctrine, and refused, therefore, to extend it.[123] Part of the Court's concern stems from a recognition of the "potential for abuse"[124] inherent in *Crane*. The Fifth Circuit, however, increases the potential for abuse because its holding eliminates the mechanism created by the *Crane* court to counterbalance the tax benefits which accrue to taxpayers when they are allowed to include the amount of nonrecourse debt in basis. The basis portion of *Crane* creates large "paper losses"[125] that shelter unrelated income. The portion of *Crane* which requires the taxpayer to include the amount of nonrecourse debt assumed by the buyer in the amount realized provides a mechanism for bringing the previously untaxed income into the system to be taxed.[126]

> Failure to include the full amount of the debt in amount realized permits an investor to obtain an unjustified tax benefit . . . the allowance of depreciation deductions in excess of the actual investment

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118. *See* Tufts v. Commissioner, 70 T.C. 756, 770 (1978).
119. 651 F.2d at 1063 n.9.
120. *Id.* at 1063.
121. *See id.* at 1062.
122. *See id.* at 1063.
123. *See id.*
124. *See id.* at 1063-64 n.9.
125. *See* President's Proposals, *supra* note 70, at 55 (statement of W. Michael Blumenthal).
126. Bittker, *supra* note 9, at 282.

over the period the property is held.[127]

Under *Tufts* the taxpayer is still allowed to include the full amount of nonrecourse debt in basis and thereby enjoys the increased depreciation deductions. The fair market value limitation that *Tufts* sanctions, however, results in *tax free* income to the taxpayer, not deferral of taxation, the traditional goal of tax shelters.[128]

The split in the circuits created by *Tufts* may subject taxpayers involved in similar transactions to significantly different tax consequences. The true impact of *Tufts* is illustrated by an example using the figures from the *Tufts* case. A taxpayer in the Third Circuit which follows *Millar* must include the full amount of the nonrecourse debt, assumed by the transferee, in the amount realized.

| | | |
|---|---|---|
| | Amount Realized | = $462,875 |
| (minus) | Adjusted Basis | = $355,563 |
| | Gain | = $102,312 |

The amount realized by a taxpayer in the Fifth Circuit or in the newly created Eleventh Circuit, which elected to follow the precedents established by the Fifth Circuit as they existed on September 30, 1981,[129] is limited to the fair market value of the property.

| | | |
|---|---|---|
| | Amount Realized | = $350,000 |
| (minus) | Adjusted Basis | = $355,563 |
| | Loss | = $ 5,563 |

One taxpayer incurs a loss, the other a considerable gain in identical transactions.

The provisions of the I.R.C. should be interpreted so as to create a uniform system of taxation.[130] There is no rational basis for a taxpayer in one area of the country to incur a loss, while a taxpayer in a different area realizes a taxable gain on an identical transaction. The fortuitous circumstances of geographic location should not be the determinative factor in assessing tax consequences.[131]

Tax shelters have been criticized as "unfair and unjust,"[132] it has been asserted that these devices frustrate the goals of a progressive tax system,[133] and that "the continuing spectacle of high income taxpayers paying little or no tax[134] through the use of tax shelters seriously

127. Simmons II, *supra* note 22, at 4.
128. ARNOLD, *supra* note 72, at 5.
129. *See* Bonner v. City of Pritchard, 661 F.2d 1206, 1209 (11th Cir. 1981).
130. *See* Burnet v. Harmel, 287 U.S. 103, 110 (1932).
131. *See id.*
132. President's Proposals, *supra* note 70, at 35 (testimony of W. Michael Blumenthal).
133. President's Proposals, *supra* note 70, at 55 (statement of W. Michael Blumenthal).
134. "Data recently compiled by the I.R.S. graphically illuminated the disturbing impact of tax shelters. Through the use of tax preferences, thousands of affluent Americans are reporting

undermines taxpayer morale."[135] The decision in *Tufts* is certain to add to the abuses and inequities which already exist.

## TOWARDS A RESOLUTION OF THE DILEMMA CREATED BY FOOTNOTE 37

The *Tufts* Court asserts that "there is simply no relationship between basis, adjustments to basis and amount realized,"[136] contrary to the assertion of some scholars that the analytical complexities involved in the *Crane* doctrine arise as a result of the interrelationship between the statutory formula for determining gain or loss and the formula for calculating depreciation deductions.[137] The element common to both formulas is *basis*.[138] Basis is the figure from which the depreciation deduction is calculated;[139] it is adjusted downward to reflect the amount of depreciation actually taken, or allowable,[140] and finally the adjusted basis is subtracted from the amount realized to determine gain or loss.[141] Since the concept of basis is central to the *Crane* doctrine, and the manner in which the *Crane* court chose to handle the problem[142] of nonrecourse debt and its inclusion in basis, this concept will be the subject of a brief discussion which undertakes to defend the *Crane* position.

### *A. Including Nonrecourse Debt In Basis*

The *Tufts* court reveals that in its opinion "[t]he real crux of the problem, . . . is the taxpayer's ability to manipulate his basis and adjusted basis through the use of nonrecourse financing."[143] The court goes on to suggest that the solution to this problem cannot be achieved by distorting the definition of amount realized.[144] The solution lies in dealing "directly with the definitions of 'basis' and 'adjusted basis,' either judicially or through legislation."[145] By this statement the Fifth Circuit implies as much dissatisfaction with the portion of *Crane* which allows the taxpayer to include the full amount of nonrecourse debt in basis, as the dissatisfaction it expressed with the portion of the *Crane*

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poverty-level incomes for tax purposes." President's Proposals, *supra* note 70, at 55 (statement of W. Michael Blumenthal).

135. President's Proposals, *supra* note 70, at 226 (footnote added).
136. Tufts v. Commissioner, 651 F.2d 1058, 1064 n.9 (5th Cir. 1981).
137. Simmons I, *supra* note 21, at 14-15.
138. *See generally* I.R.C. §§167(g), 1001, 1016 (1976 & Supp. IV 1980).
139. *See id.* §167(g).
140. *See id.* §1016(a)(2).
141. *See id.* §1001(a).
142. The problem is the potential for abuse. 651 F.2d 1064 n.9.
143. *Id.*
144. *See id.*
145. *Id.*

holding which requires the taxpayer to include the amount of debts assumed by the transferee in the amount realized.[146]

*1. The Problem*

A theoretical foundation for the dissatisfaction of the Fifth Circuit with the basis portion of *Crane* does exist. Increased basis leads to increased depreciation deductions.[147] The purpose for allowing depreciation deductions is to permit the investor to recover tax free, the cost of the asset used in the trade or business or held for the production of income;[148] this in turn will free capital to be invested and thus promote economic expansion.[149] To the extent that a taxpayer's basis in property includes the debt on which the taxpayer is not personally liable, allowing a depreciation deduction does not fulfill the purpose behind the allowance of the depreciation deduction because (1) the taxpayer has not yet made an investment which needs to be recovered, and (2) since the taxpayer is not personally liable on the debt, there is no assurance the investment will be made in the future. The theoretical weakness inherent in the basis portion of *Crane* has been examined and exposed by the Fifth Circuit.[150] The court suggests that the problems arising from *Crane* should be solved by dealing "directly with the definitions of 'basis' and 'adjusted basis' either judicially or through legislation."[151] How should nonrecourse debt be treated when calculating basis? An examination of the alternative treatments of nonrecourse debt which have been discussed by the courts and scholars through the years, however, will reveal that the solution put forth in *Crane* is the preferable alternative.[152]

*2. The Alternative*

Mrs. Crane proposed that the taxpayer's basis should be limited to the taxpayer's equity in the property.[153] The Supreme Court noted that the I.R.C. defines "basis of property"[154] and then points out that the term *property* is not equivalent to *equity*.[155] Adoption of this method of calculating basis would ignore section 1012 of the I.R.C. which directs that "the basis of property shall be the *cost* of such property," and sec-

146. *Id.* at 1063.
147. *See* notes 66-69 and accompanying text *supra*.
148. H.R. REP. No. 1337, 83 Cong., 2d Sess. 22 (1954), *reprinted in* 2 TAX MGMT. (BNA) §167.
149. *Id.* at 24.
150. 651 F.2d at 1064 n.9.
151. *Id.*
152. *See generally* Simmons I, *supra* note 21.
153. Crane v. Commissioner, 331 U.S. 1, 3 (1947).
154. *See* I.R.C. §§1012, 1014, 1015 (1976 & Supp. IV 1980).
155. *See* 331 U.S. at 6.

tion 1014 which defines the basis for property acquired from a decedent as "the fair market value of the property at the date of the decedent's death." Since equity is the excess of the fair market value of the property over the amount of the mortgage,[156] constant reevaluation of the fair market value of the property would be required to ascertain the taxpayer's equity, and therefore the basis, if Mrs. Crane's proposal were accepted. Needless to say this system would be an administrative nightmare.[157] A system which would calculate the taxpayer's basis in property from the taxpayer's equity would be inconsistent with the mandate of Treasury Regulation 1.167 (a)-1[158] describing the depreciation allowance as:

> . . . that amount which should be set aside for the taxable year in accordance with a reasonably *consistent* plan . . . , so that the aggregate of the amount set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property.[159]

If the taxpayer's equity were allowed to constitute the basis, a "reasonably consistent plan" for determining the depreciation deduction would be impossible to implement. The taxpayer could foreseeably manipulate the situation to his advantage by making payments when large deductions were needed.[160]

Another alternative to including the full amount of the nonrecourse debt in basis is to calculate the basis from the taxpayer's equity, and to calculate the depreciation deduction from the fair market value of the property at the time of purchase.[161] This theory presumably entails the use of the taxpayer's equity as the "basis" for determining gain or loss, and the use of the fair market value at the time of purchase as the "basis" for determining the depreciation deduction. This method would be totally inconsistent with the legislative mandate that "[t]he basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property."[162]

A final alternative would be to eliminate depreciation deductions which exceed the amount actually invested by the taxpayer, or for which he or she is personally liable. Recently, section 465 of the I.R.C.,

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156. *See id.* at 3.
157. *See id.* at 10.
158. Courts have accorded certain regulations "force of law status." *See* J. FREELAND, S. LIND, R. STEPHENS, FUNDAMENTALS OF FEDERAL INCOME TAXATION 36 (3d ed. 1981).
159. Treas. Reg. §1.167(a)-1, T.D. 7203, 1972-2 C.B. 30 (emphasis added).
160. *See* 331 U.S. at 10.
161. *See id.* at 9-10.
162. I.R.C. §167(g) (1976 & Supp. IV 1980).

which limits a taxpayer's deductions in such a manner,[163] was enacted; Congress, however, failed to include investments in real property within the broad sweep of the "at-risk provisions."[164]

The various alternatives to the basis portion of *Crane* which have been discussed are more problematic than allowing the taxpayer to include the full amount of nonrecourse debt in basis.[165] The *Crane* solution is preferable because it is administratively manageable,[166] and it takes into consideration the function of depreciation as a tax accounting device based on estimates of the annual cost of using an asset to produce income, and matching that cost to the income produced.[167] If this system exists, however, it must be coupled with a mechanism which allows previously sheltered income to be brought back into the system to be taxed. The amount realized portion of *Crane* provides this type of a mechanism.

### *B. Including Nonrecourse Debt in Amount Realized*

The full amount of nonrecourse debt should be included in the amount realized upon the disposition of the property, regardless of the fair market value of the property. Any other solution to this problem would exempt otherwise taxable income from taxation.[168] An analysis of the reasoning used by the Fifth Circuit in reaching its decision in *Tufts* will reveal that it is based on false premises and evidences an acute misunderstanding of the problem involved.

The Fifth Circuit in *Tufts* expresses the opinion that the portion of *Crane* that mandates that the amount of nonrecourse debt assumed by the buyer of property be included in the amount realized is based on the "economic benefit" theory. The "economic benefit"[169] theory is based on language in *Crane* to the effect

> 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. . . . We are . . . 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

163. *See id.* §465.

164. "The effectiveness of the at risk limitation . . . will be enhanced by expanding its application to certain closely held corporations and to all activities other than real estate." President's Proposals, *supra* note 70, at 229.

165. *See generally* Simmons I, *supra* note 21.

166. *See* 331 U.S. at 10.

167. *See* Simmons I, *supra* note 21, at 1.

168. *See* Simmons II, *supra* note 22, at 4.

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

if they were his personal obligations.[170]

The *Tufts* court does not dispute that when the taxpayer is personally liable on a note and sells the property to a third party who takes subject to the note, the "economic benefit" to the taxpayer is equal to the amount of the note.[171] The court, however, voiced grave misgivings about the application of the "economic benefit" theory to the situation in which the taxpayer is not personally liable on the debt,[172] because

> [i]f the taxpayer decides, for any reason whatsoever, that he no longer wants the burdens and responsibilities that accompany ownership, he can transfer the property to a third party with absolutely no regard to that party's willingness or ability to meet the mortgage obligations, yet rest assured that his other assets cannot be reached.[173]

Therefore, the court refused to extend the *Crane* holding beyond its facts.[174]

The Fifth Circuit's analysis of the "economic benefit" theory is essentially sound.[175] If the taxpayer is not personally liable on the debt the economic benefit obtained if the buyer takes subject to the debt is limited to the value of the building, which is the only asset the taxpayer would lose if he or she defaulted on the note.[176] If the holding in *Crane* pertaining to amount realized is founded on the "economic benefit" theory, then the result in *Tufts*, that the amount realized should be limited to the fair market value of the property, is the only logical one.[177] The Fifth Circuit's argument, however, is based on the false premise that "economic benefit" is the theoretical foundation of the *Crane* doctrine.[178] This proposition coupled with the Fifth Circuit's assertion that the Supreme Court was not concerned with the possibility of double

170. 331 U.S. at 14 (footnotes omitted).

171. *See* 651 F.2d at 1061.

> That proposition and the economic principle from which it derives are indisputable: when a debt on which a taxpayer is personally liable is discharged, the taxpayer is freed from the necessity of paying the obligation with cash or other assets equal in value to the principal amount of the debt.

*Id.*

172. *See id.* at 1063.

173. *Id.* at 1062.

174. *See id.* at 1063.

175. *See* Bittker, *supra* note 9, at 282 ("The benefit rationale of *Crane* is unpersuasive . . . ."); *see also* Del Cotto, *supra* note 17, at 85.

176. See Del Cotto, *supra* note 17, at 85, wherein Professor Del Cotto suggests that:

> To the extent that the amount of the mortgage exceeds the value of the property, no property of a mortgagor not personally liable could be used to satisfy the mortgage. Thus the taxpayer would get no 'benefit' to this extent from the disposition of the property subject to the mortgage. If the 'economic benefit' theory is to be applied consistently, no gain is realized in this amount.

177. "Consistent application of a theory of 'economic benefit' limits the amount of the mortgage that is realized . . . ." Del Cotto, *supra* note 17, at 85.

178. See Del Cotto, *supra* note 17, at 84 wherein the author postulates that the "economic benefit" theory was "not essential to the decision" in *Crane*; *see also* Bittker, *supra* note 9, at 285 n.14 ("in my view, the economic benefit theory should be rejected as wholly fallacious,").

deductions evidences a failure to comprehend the complexities of the issues involved.

### *C. Double Deductions*

In *Crane* the United States Supreme Court asserted that

> "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 [sic] that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets."[179]

The Third Circuit in *Millar* held that this was the theoretical foundation for the decision in *Crane*.[180] In *Tufts* the Commissioner invoked

> the *Crane* double deduction language in support of a tax benefit theory: the argument, in essence, is that a taxpayer who has previously enjoyed the benefit of large tax deductions, without placing his own assets at risk, has, by taking those deductions, improved his economic position, thus realizing gain.[181]

Rejecting this argument the Fifth Circuit asserts that, in its opinion, the double deduction language was not the theoretical foundation for the decision in *Crane*.[182] The *Tufts* court supports its assertion by pointing out that the Supreme Court did not raise the issue of double deductions until the last paragraph of the *Crane* opinion, and then only in response to the constitutional argument made by the taxpayer.[183]

The Fifth Circuit's position fails to consider the exact language used by the Court when it voiced its concern about the possibility of "double deductions." The *Crane* Court indicated that the "*crux* of this *case*, really is whether the law permits her to exclude allowable deductions. from consideration in computing gain."[184] This was the main issue of the *case*, not just of the constitutional argument. Furthermore, the Court went on to state that "we have already *showed* [sic] that, if it does, the taxpayer can enjoy a double deduction, . . . ."[185] The Supreme Court was under the impression that the subject had been discussed and proven earlier in the opinion. The Court's failure to use the appellation "double deduction" prior to the last paragraph in the opinion does not signify that it was unconcerned with the concept embodied by this term. On the contrary, the Court's language indicating that the "crux of the case" was whether Mrs. Crane would, in effect, be

179. Crane v. Commissioner, 331 U.S. 1, 15-16 (1947) (emphasis added).
180. *See* Millar v. Commissioner, 577 F.2d 212, 215 (3d Cir. 1978); *see also* Simmons II, *supra* note 22, at 22.
181. Tufts v. Commissioner, 651 F.2d 1058, 1060 (5th Cir. 1981).
182. *See id.*
183. *See id.*
184. 331 U.S. at 15 (emphasis added).
185. *Id.* at 15-16.

allowed a double deduction, evidences that the Court considered this to be a pivotal issue.

Perhaps anticipating that its argument, asserting that the concern for avoiding double deduction did not constitute the theoretical justification for the *Crane* decision, could be considered weak, the Fifth Circuit provided an alternative.[186] The court argued that even if the Supreme Court had been concerned with the possibility of the taxpayer obtaining a double deduction, the concern was unwarranted.[187] To justify this proposition the Fifth Circuit made the following argument. Gain from the disposition of property is the difference between the amount realized and the adjusted basis of the property.[188] The I.R.C. mandates that basis be adjusted downward to the extent of the depreciation deduction taken or allowed.[189]

> 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.[190]

The Fifth Circuit's "contention has, because of its simplicity, a beguiling appeal to it."[191] Upon close examination, however, the argument proves to be illogical because it is based on a false premise. The following argument will show that the rationale behind mandating that adjustments to basis be made is totally different from that mandating that the full amount of nonrecourse debt assumed by the buyer be included in the amount realized.

The depreciation deduction enables the taxpayer to recover tax free the investment made in an income producing asset.[192] Basis is the figure from which the depreciation deduction is calculated.[193] Basis is also the figure that is subtracted from amount realized to determine the gain realized by a taxpayer upon the disposition of property.[194] If basis is not adjusted downward the taxpayer would recover tax free, an amount exceeding the cost of the asset.

This is illustrated by a simple example. Taxpayer acquires a depreciable asset at a cost of $1000. The asset has a useful life of five years

186. *See* 651 F.2d at 1060-61.
187. *See id.*
188. *See id.* at 1061.
189. *See id.*
190. *Id.*
191. McCabe Co. v. Commissioner, 42 T.C. 1105, 1109 (1964).
192. *See id.*
193. *See generally* I.R.C. §167 (1976 & Supp. IV 1980).
194. *See id.* §1001(a).

and the taxpayer elects to use the straight-line method to depreciate it. The taxpayer holds the asset for three years and takes depreciation deductions totaling $600. At the end of the fourth year the taxpayer sells the asset to a third party for $500. At this point the taxpayer has recovered $600 of the original investment, through the depreciation deduction. If the basis is not adjusted to reflect that recovery, then the formula for calculating gain or loss would be:

| | | | |
|---|---|---|---|
| | Amount Realized | = | $ 500 |
| (minus) | Basis | = | $1000 |
| | Loss | = | $ 500 |

An additional deduction would accrue to the taxpayer, to account for the $500 loss. Together with the previous $600 deduction the taxpayer would recover $1100, $100 over the original investment. If basis had been adjusted downward to reflect the depreciation taken the taxpayer would have realized a gain of $100 after recovering, tax free, the cost of the asset. The reason for mandating that basis be adjusted downward operates whether the depreciable asset was paid for in cash, financed by recourse debt, or by nonrecourse debt.[195]

The problem that arises when a taxpayer is allowed to take depreciation deductions, which enable the taxpayer to recover an investment, an investment not yet made because the property is financed by debt, is a different matter altogether. The *Tufts* court's assertion that

> [t]o 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,[196]

illustrates that it failed to comprehend the argument made by the Commissioner and the concerns voiced by the Supreme Court in the last paragraph of the *Crane* opinion. Perhaps the unfortunate use of the term "double deduction" is responsible for creating the confusion that permeates the footnote 37 area.

One learned commentator has correctly pointed out that Mrs. Crane did not receive the benefit of a "double deduction."[197] She merely took advantage of the yearly depreciation deductions available to her while she owned the building.[198] The same commentator, however, has asserted that Mr. and Mrs. Tufts did enjoy a "double deduction" because they took the depreciation deductions and then claimed a long term

195. *See generally id.* §1016.
196. 651 F.2d at 1061.
197. *See* Simmons II, *supra* note 22, at 27.
198. *See* Crane v. Commissioner, 331 U.S. 1, 3 n.2 (1947).

capital loss upon the disposition of the property.[199] This interpretation of the term "double deduction" is counter-intuitive. A double deduction implies taking the same deduction twice, i.e., taking the yearly depreciation deduction twice in the same year. The taxpayers in *Tufts* took the depreciation deductions that they were entitled to. Later, when the Commissioner determined a deficiency they claimed a capital loss deduction. Mr. and Mrs. Tufts did not attempt to take the same deduction twice; they claimed two separate deductions.

If Mrs. Crane did not enjoy a double deduction, what did the Supreme Court mean when it stated that unless the law allowed her to include allowable deductions in computing gain she would enjoy a double deduction?[200] Although the term "double deduction" is a misnomer the idea expressed by the *Crane* Court is not difficult to discern. The basis portion of *Crane* allows

> investors to deduct depreciation, . . . even though financed by nonrecourse borrowing, hence exceeding their current cash outlay; but when the investment is sold, the nonrecourse liabilities are includable in the amount realized in computing gains, so that the deductions taken in the earlier years are—or should be—recaptured at the end of the road.[201]

An example will illustrate these concepts. A taxpayer purchases a building used in the production of income, totally debt financed for $30,000. The building's useful life is fifteen years, at the end of which the salvage value is zero. The straight-line method of depreciation is used. The taxpayer holds the building for three years and pays nothing on the principal debt. At the end of the three years the taxpayer sells the building, which has a fair market value of $20,000, to a third party who takes subject to the nonrecourse debt and pays no boot. During the three years in which he held the property the taxpayer claimed and was allowed a total of $6,000 in depreciation deductions. The taxpayer had made no cash investment, therefore, the deduction did not serve to recover any investment; instead it sheltered other income from taxation. Upon the disposition of the property the taxpayer will be allowed to recoup the balance of the total investment, $24,000 ($30,000 - $6,000), because the I.R.C. does not provide for the amount received by the taxpayer for property to be taxed; only gain is taxed, that is, the amount received by taxpayer after the dollars invested have been recovered.[202] The taxpayer in this case will recover, through deductions

199. *See* Simmons II, *supra* note 22, at 30-31.
200. 331 U.S. at 15-16.
201. Bittker, *supra* note 9, at 283.
202. *See* I.R.C. §1001(a).

and the resulting decrease in taxable income, the full $30,000 investment. The problem here is that the taxpayer never invested his or her own $30,000. It is totally inconsistent with the purpose of allowing depreciation deductions to allow this taxpayer to recover a $30,000 investment that was never made. If the full amount of the nonrecourse debt is included in the amount realized, this inconsistency is eliminated. When this is done the taxpayer realizes a gain of $6,000 ($30,000 - $24,000). This amount equals the amount of otherwise taxable income the taxpayer was allowed to "shelter" from the federal tax collector by taking the depreciation deduction before making the investment.

If the *Tufts* holding is left undisturbed, the taxpayer in this hypothetical will incur a loss of $4,000.[203] He or she will also have "recovered" the $30,000 investment that was never made and $6,000 of otherwise taxable income will never be taxed. "These indefensible tax results arise only because footnote 37 of *Crane* attaches weight to something that cannot possibly affect the taxpayer once he disposes of the property, that is, its value."[204]

*Tufts* has created a split in the circuits,[205] "[d]eclining real estate values coupled with more liberal depreciation allowances make the fact pattern envisioned by the footnote more likely to arise."[206] The time is ripe for the Supreme Court to delve into the mysteries of footnote 37 and decide the issue once and for all.[207] The preceding discussion illustrates that the high Court should reject the theories posited in *Tufts* and extend the amount realized holding in *Crane* to those situations in which the amount of the nonrecourse debt assumed by the buyer of property exceeds the fair market value of the property.[208] Since the Supreme Court has granted certiorari in *Tufts*[209] the opportunity to sound the death knell for footnote 37 is at hand. If the Court rejects the rationale of the footnote, do Mr. and Mrs. Tufts lose all hope of winning their case? They do not because of a clever argument put forth by their attorneys.

## SECTION 752

The taxpayers in *Tufts* argued that since the case involved the sale of a partnership interest, subsection 752(d) operated to limit the amount

203. 24,000 − 20,000 = 4,000.
204. Bittker, *supra* note 9, at 284.
205. Friedland, *supra* note 36, at 520.
206. Friedland, *supra* note 36, at 513.
207. *See* Friedland, *supra* note 36, at 520.
208. *See generally* Bittker, *supra* note 9.
209. *See* Commissioner v. Tufts, 50 U.S.L.W. 3881 (U.S. May 3, 1982) (certiorari granted).

realized to the fair market value of the building.[210] This argument was rejected by the Tax Court.[211] The Fifth Circuit did not base its opinion on the taxpayer's interpretation of subsection 752(c),[212] but language in a footnote suggests that the holding in the case is consistent with Congressional mandate as evidenced by subsection (c).[213] Because the Supreme Court has granted the Commissioner's petition for a writ of *certiorari* in *Tufts*, and the taxpayers may rely on this rationale, when the United States Supreme Court hears arguments, it is imperative to analyze the function of section 752, and determine the merits of the taxpayer's argument.

Section 752 provides:

> Treatment of certain liabilities
>
> (a) Increase in partner's liabilities. - 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.
>
> (b) Decrease in partner's liabilities. - 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.
>
> (c) Liability to which property is subject. - For purposes of this section, 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.
>
> (d) Sale or exchange of an interest. - 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.[214]

The taxpayers argued that the fair market value limitation of subsection (c) applies to limit the amount realized upon the sale or exchange of a partnership interest.[215] The Commissioner countered with the assertions that (1) subsection (c) applies only to calculate the basis in property distributed by or contributed to the partnership,[216] and (2) the sale or exchange of a partnership interest to a third party is governed

210. *See generally* Brief for Appellants, and Reply Brief for Appellant, Tufts v. Commissioner, 651 F.2d 1058 (5th Cir. 1981).

211. *See* Tufts v. Commissioner, 70 T.C. 756, 769 (1978).

212. *See generally* Tufts v. Commissioner, 651 F.2d 1058 (5th Cir. 1981).

213. *See id.* at 1063 n.8.

214. I.R.C. §752 (1976 & Supp. IV 1980).

215. *See* 651 F.2d at 1063 n.8.

216. *See id.*

by subsection (d).[217] The position taken by the Commissioner, as will be shown, is the more rational view.

To support its claim that the decision reached in *Tufts* is consistent with the "congressional understanding of the *Crane* case,"[218] the Fifth Circuit states that "§752(c) is generally regarded to be an intended codification of the *Crane* doctrine."[219] To support that proposition, the court cites an article by Alan W. Perry.[220] The court, however, omits to add that Perry's statement applies only to the basis portion of *Crane*,[221] a distinction that did not escape the Tax Court.[222] If the purpose of section 752 is to provide the basis of a contribution of encumbered property to a partnership, on distribution of such property by a partnership to a partner, then it is tantamount to blasphemy to cite subsection (c) as providing a fair market limitation to amount realized, when a partnership interest is sold to a party not involved in the partnership.

The exploration of subchapter K of the I.R.C., which deals with "partners and partnerships"[223] will illustrate that section 752, except for subsection (d), deals with basis. Section 705 provides that the basis in a partner's interest shall be the basis of the interest contributed.[224] It also provides that the basis shall be decreased by the extent of distributions made by the partnership.[225] Section 752 mandates that an increase of a partner's liabilities resulting from an increase in the partnership's liabilities or from an assumption by the partner of the partnership's liabilities will be considered as a contribution of money by such a partner.[226] This will then increase the partner's basis in the partnership's interest.[227] A decrease in a partner's share of the liabilities of the partnership resulting from the assumption of the liabilities of the partnership will be treated as a distribution by the partnership,[228] and thus will serve to decrease the partner's basis in the partnership interest.[229] Subsection (a) provides a mechanism for attaching a value to the liabilities. This is the function of subsection (c), as evidenced by the committee

217. *See id.*
218. *Id.*
219. *Id.*
220. *See id.*
221. See Perry, *Limited Partnerships and Tax Shelters: The* Crane *Rule Goes Public*, 27 TAX L. REV. 525, 542 (1972), wherein the author asserts that "[s]ection 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." (emphasis added).
222. *See* Tufts v. Commissioner, 70 T.C. 756, 767 (1978).
223. *See generally* I.R.C. §§701-761 (1976 & Supp. IV 1980).
224. *Id.* §705(a).
225. *Id.* §705(a)(2).
226. *Id.* §752(a).
227. *Id.* §705(a).
228. *Id.* §752(b).
229. *Id.* §705(a)(2).

reports made pursuant to section 752. "*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."[230] When an interest in a partnership is transferred to a third party the "*liabilities* shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships."[231] Section 752(d) does not limit the amount realized because it is a mechanism for assessing basis. Section 752 is consistent with the interpretation the courts have given *Crane*.[232] Another reason exists for arguing that subsection (c) does not limit the *amount realized*. If it limited the amount realized to the fair market value of the property, the limitation would have to operate on recourse as well as nonrecourse debt, because subsection (c) is not limited to nonrecourse liability.[233] This would be unacceptable even to the Fifth Circuit[234] and would certainly extend past the boundaries of the dicta stated in footnote 37.[235]

## CONCLUSION

*Crane*, in allowing the taxpayer to include nonrecourse debt in basis, provides a great advantage to the taxpayer holding depreciable property financed by a nonrecourse mortgage. The depreciation deduction allows the taxpayer to recover an investment not yet made, and thereby shelters other income. This is accomplished without the need of an extensive out-of-pocket investment by the taxpayer, and with the assurance that none of the taxpayer's other assets may be reached by the creditor. If the full amount of nonrecourse debt assumed by the buyer of the property is included in the amount realized, then the income which was previously sheltered is recaptured and taxed, because a higher gain is realized. If the amount realized is limited to the fair market value of the property, when that value is less than the amount of the debt, then a portion of the previously sheltered income is never recaptured, and totally escapes taxation. If the basis portion of *Crane* is left undisturbed, and it should be, then the fair market limitation

230. H.R. REP. No. 1337, 83d Cong., 2d Sess. 237 (1954), *reprinted in* TAX MGMT. (BNA) §752 (emphasis added).
231. I.R.C. §752(d).
232. *See* Gibson Products Co. v. United States, 460 F. Supp. 1109, 1117 (N.D. Tex. 1978). "[T]he taxpayer who seeks to invoke the [basis portion of] the *Crane* case must still show that the value of the property securing the nonrecourse debt is equal to or greater than the amount of the debt." *Id.*
233. *See* I.R.C. §752(c).
234. Tufts v. Commissioner, 651 F.2d 1058, 1061 (5th Cir. 1981).
235. Crane v. Commissioner, 331 U.S. 1, 14 n.37.

which is considered in footnote 37, and achieves the status of law in *Tufts*, should be abolished.

On its face the *Tufts* case appears to provide a great advantage to those taxpayers who can afford to invest in real estate tax shelters. *Tufts*, however, could be a double-edged sword as evidenced by the statement of the court to the effect that the abuses from tax shelters result from the taxpayer's ability to include the nonrecourse debt in calculating basis, and its suggestion that the solution to the problem is for the courts or the Congress to deal with the basis problem directly.[236] This obscure comment made in a footnote should fill the hearts of taxpayers with fear and trembling and could provide a consolation to the Commissioner. If the *Tufts* holding is upheld, further abuses are certain to result and it would not be illogical to assume that those abuses will be countered by restrictive provisions, somewhat akin to the at-risk provisions of the I.R.C. The comments of the Fifth Circuit indicate that it would not be adverse to tightening the screws if the proper case arose.

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236. *See* 651 F.2d at 1064 n.9.