Volume 12 | Issue 3 Article 1

3-15-1985

Crane and Tufts: Resolved and Unresolved Issues

John Zimmerman

Crane and *Tufts:* Resolved and Unresolved Issues

JOHN ZIMMERMAN*

Crane v. Commissioner *and its famous footnote 37 have inspired much controversy and commentary. This article discusses the issues and unresolved questions surrounding the calculation of gain from relief of nonrecourse indebtedness. It does so through a thorough analysis of the actions of the courts, the Congress, and administrative agencies. The author concludes by suggesting several possible courses of action in resolving remaining ambiguities.*

"No case has had greater impact on the tax law than *Crane v. Commissioner."*[1] It is well known among students of tax law as the case which established the method of calculating gain when a taxpayer sells property for an amount greater than the principal of the nonrecourse mortgage fixed to the property.[2] The decision has also generated considerable commentary, controversy, and numerous questions.[3]

Beulah Crane inherited an apartment building from her husband which was encumbered by a nonrecourse note of $262,000.00. She took depreciation deductions, and then sold the building for $2,500.00 plus relief from the indebtedness. No payments were made against the nonrecourse note while she held the building. Mrs. Crane included a $2,500.00 gain on her tax return. The Commissioner, however, argued that she should also take into account the previous

* B.A., Glassboro State College, 1970; M.S. Taxation, Golden Gate University, 1983; certified CPA in Pennsylvania and California; published in TAXES, CPA JOURNAL, ESTATES, GIFTS & TRUSTS JOURNAL, TAXATION FOR ACCOUNTANTS, PRACTICAL ACCOUNTANT, and TAX NOTES.

1. Friedland, Tufts *and* Millar: *Two New Views of the* Crane *Case and Its Famous Footnote,* 57 NOTRE DAME LAW. 510, 510 (1982). The case appears in 331 U.S. 1 (1947).

2. 331 U.S. at 2. Chief Justice Vinson framed the issue in these words: "The question here is how a taxpayer who acquires depreciable property subject to an unassumed mortgage, holds it for a period, and finally sells it still so encumbered, must compute her taxable gain." *Id.*

3. *See, e.g.,* Adams, *Exploring the Outer Boundaries of the Crane Doctrine: An Imaginary Supreme Court Opinion,* 21 TAX L. REV. 159 (1966); Bittker, *Tax Shelters, Non-Recourse Debt and the* Crane *Case,* 33 TAX L. REV. 277 (1978); Weiss, *The Crane Case Updated,* 32 TAX LAW. 289 (1979).

depreciation deductions in calculating her gain. Since she had taken deductions, but had never paid any money on the note, it was contended that she had realized economic benefit from the building. Crane, on the other hand, argued that her equity in the building was zero because, as conceded by the Court, its fair market value was equal to the amount of the nonrecourse note. As a result, she contended, her basis in the property was zero.[4]

The Supreme Court held for the Commissioner on the theory that the taxpayer had received an economic benefit from the depreciation deductions which she had taken. Since the nonrecourse note comprised the basis in the building, it was reasoned that the taxpayer should be required to account for economic benefits realized from such basis. The Court rejected Crane's assertion that property and equity were synonymous. Rather, it opted for the interpretation that property "means the land and building themselves, or the owner's legal rights in them, undiminished by the mortgage . . . ."[5]

Since the *Crane* decision in 1947, tax shelters have become more sophisticated and courts have been forced to develop other criteria for determining whether or not deductions are valid. This has been especially noticeable in cases where the nonrecourse indebtedness ex-

---

4. 331 U.S. at 3-5.

5. *Id.* at 6. The underlying logic of *Crane* has been cited by courts when dealing with related issues. In Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950), the taxpayer abandoned property after taking depreciation deductions. The mortgage at the time of abandonment exceeded the adjusted basis of the property. The taxpayer sought to distinguish his situation from Mrs. Crane in that he did not sell his property. However, the First Circuit found no substantive difference between the two transactions. Section 111(b) of the Internal Revenue Code (now § 1001(b)) stipulated that "amount realized" came from the "sale or other disposition of property . . . ." I.R.C. § 111(b) (1939). Abandonment was held to fall into the category of "other disposition." *See also* Blackstone Theatre Co. v. Commissioner, 12 T.C. 801 (1949).

In Estate of Levine v. Commissioner, 634 F.2d 12 (2d Cir. 1980), the taxpayer gifted business property which had a liability in excess of its basis. The liability assumed consisted of a nonrecourse note and personal expenses incurred by Levine. The court found the assumption of personal expenses to constitute a "sale element" and therefore combined both the nonrecourse note and personal expenses as the total amount realized. The excess portion over the property's adjusted basis was recognized as gain. The *Levine* court, however, unintentionally following in the footsteps of *Crane's* famous footnote 37 (*see infra* notes 9-17 and accompanying text) left the door open for nonrecognition in a similar situation by implying that a different result might occur if the sale element were not present in the transfer. *Id.* at 16-17. *See also* Johnson v. Commissioner, 495 F.2d 1079, 1083 (6th Cir. 1974). Although the issue in *Levine* has not been definitively decided, the Supreme Court in *Diedrich v. Commissioner* has cited *Crane* in support of the proposition that where a donee pays a gift tax on property received and the tax exceeds the donor's basis, the excess of gift tax over basis is income to the donor. 457 U.S. 191, 195-96 (1982). The Court's focus on an economic benefit as a result of liability relief, albeit gift tax instead of mortgage relief, leaves little doubt that a similar conclusion would be reached even if the *Levine* sale element were missing. *Id.* at 197-99. Similarly, the Tax Court has found income recognition on a charitable contribution where the liability exceeded the property's adjusted basis. Guest v. Commissioner, 77 T.C. 9 (1981).

ceeds the fair market value of the property. In such cases, the investment in the property necessary for deductions has been found lacking regardless of the owner's legal rights since the lack of true indebtedness denotes the absence of legitimate investment. As the Ninth Circuit noted in *Estate of Franklin v. Commissioner*: "It is fundamental that depreciation is not predicated upon ownership of property but rather upon an investment in property."[6] This has now become the position of the Internal Revenue Service.[7] Another view,

---

6. 544 F.2d 1045, 1049 (9th Cir. 1976). *See also* Fuchs v. Commissioner, 83 T.C. 79, 101 (1984); Dean v. Commissioner, 83 T.C. 56, 77 (1984); Odend'hal v. Commissioner, 80 T.C. 588, 604-05 (1983); Wildman v. Commissioner, 78 T.C. 943, 952 (1982); Siegel v. Commissioner, 78 T.C. 659, 684 (1982); Brannen v. Commissioner, 78 T.C. 471, 493 (1982); Hager v. Commissioner, 76 T.C. 759, 774 (1981); Narver v. Commissioner, 75 T.C. 53, 98 (1980), *aff'd per curiam*, 670 F.2d 855 (9th Cir. 1982); Mayerson v. Commissioner, 47 T.C. 340, 350 (1966). Similarly, deductions have been denied where the obligation was too contingent. *See* Gibson Products Co. v. United States, 637 F.2d 1041 (5th Cir. 1981); Columbus & Greenville Railway Co. v. Commissioner, 42 T.C. 834 (1964); Albany Car Wheel Co. v. Commissioner, 40 T.C. 831 (1963), *aff'd per curiam*, 333 F.2d 653 (2d Cir. 1965); Redford v. Commissioner, 28 T.C. 773 (1957). *Compare* these last four cases *with Mayerson*, 47 T.C. at 350-54, where deductions were allowed on nonrecourse indebtedness even though principal payments were not due for 99 years.

7. Rev. Rul. 82-244, 1982-2 C.B. 5; Rev. Rul. 78-29, 1978-1 C.B. 62; Rev. Rul. 77-110, 1977-1 C.B. 58.

The taxpayer dilemma of being denied basis because of inflated property value was argued by the petitioner in *Brannen* who foresaw:

> a situation in which [the IRS] will receive the best of all possible results at both ends of a transaction. A nonrecourse note will be excluded from a taxpayer's initial basis, thus reducing the amount of depreciation deductions to which a taxpayer is entitled over the useful life of the property, while the full amount of the debt will be included in the amount realized upon disposition of the property, thus increasing the amount of gain realized.

78 T.C. at 495. The problem was addressed by the enactment of Regulation 1.1001-2(a)(3), Treas. Reg. § 1.1001-2(a)(3) (1980), which limits the amount of gain recognition to the amount of the liability included in the basis. However, it is uncertain if there is a provision prohibiting the Service from denying basis altogether when the note exceeds the fair market value of the property. Although section 1274(b)(3), I.R.C. § 1274(b)(3) (Supp. 1984) (added July 18, 1984, Pub. L. No. 98-369), appears to allow basis in such situations, at least to the extent of fair market value, such an interpretation appears to have been rejected by the Joint Committee on Taxation in its report on the Tax Reform Act of 1984. *See* [3 Tax Reform Act of 1984] STAND. FED. TAX REP. (CCH) 119 (Jan. 12, 1985). However, section 752(c) could be interpreted to allow basis to partnerships in such situations. *See infra* notes 56-78.

The courts had never been faced with the hypothetical problem presented in *Brannen* before the enactment of Regulation 1.1001-2(a)(3). While Brannen's argument can be seductively simple, it ignores the nature of deductions and gains. For example, suppose a building is worth $500.00, but is encumbered by an inflated nonrecourse note of $1,000.00. The taxpayer takes $200.00 in depreciation deductions and walks away from the note. The full amount of the depreciation will be offset against ordinary income. However, the gain recognition will be capital. Thus, the taxpayer gets a $200.00 deduction but only has to recognize $80.00 as income because of the 60% capital gain exclusion which is applicable to real estate depreciated on the straight line method. By however, known as the doctrine of economic interests in property, allows depreciation and loss deductions where an economic interest is established even if the taxpayer lacks the requisite legal ownership.[8]

Although the Commissioner prevailed in *Crane*, the decision has been referred to as a "Pyrrhic Victory" because including nonrecourse debt in depreciable basis has become the "foundation for the typical modern tax shelter."[9] The advantages of nonrecourse debt were lessened by the at risk rules of section 465 of the Internal Revenue Code which were enacted into law in 1976.[10] Section 465, which deals with situations where deductions exceed income, requires debt to be recourse before losses can be recognized.[11] However, the at risk rules do not apply to real estate.[12] Therefore, real estate tax shelters remain the most popular.

The major unresolved issue in *Crane* was cryptic footnote 37. It states:

> Obviously, if the value of the property is less than the amount of the mort-

---

artificially inflating the basis of the building, the taxpayer has received a net benefit of $60.00 to which he would otherwise not be entitled (an extra $100.00 deduction because of the inflated note, less $40.00 gain recognition upon relief of the liability).

Assuming the taxpayer in the above example is in the 50% tax bracket, overall tax savings would be $30.00 ($60.00 x 50%). Unless deductions were denied in such situations, taxpayers could consistently create an artificial basis to increase deductions. *See* Milbrew, Inc. v. Commissioner, 710 F.2d 1302 (7th Cir. 1983); Narver v. Commissioner, 75 T.C. 53 (1980), *aff'd per curiam*, 670 F.2d 855 (9th Cir. 1982). Similarly, interest deductions have been denied on inflated nonrecourse notes. *See* Beck v. Commissioner, 678 F.2d 818 (9th Cir. 1982); Hager v. Commissioner, 76 T.C. 759 (1981).

Brannen's argument, however, had some validity because his property was not real estate. *See infra* note 25. Unlike real estate, the depreciated portion of non-real property included in the sales price must be recaptured as ordinary income. The facts of *Brannen* arose before the passage of the at risk rules of section 465, which would now disallow deductions for losses on nonrecourse property, except real estate, regardless of the character of the gain upon disposition. I.R.C. § 465 (1982).

8. *See* Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946); United States v. Cocke, 399 F.2d 433 (5th Cir. 1968); Choate v. Commissioner, 141 F.2d 641 (10th Cir. 1944); Rev. Rul. 77-176, 1977-1 C.B. 77; Rev. Rul. 68-361, 1968-2 C.B. 264; Sneed, *The Economic Interest - An Expanding Concept*, 35 TEX. L. REV. 307 (1957).

9. Bittker, *Tax Shelters, Non Recourse Debt and the* Crane *Case*, 33 TAX L. REV. 277, 283-84 (1978); Bolling & Stover, *The Supreme Court's Second Look at* Crane*: What Should It Do?*, 61 TAXES, Feb. 1983, at 139. *But see infra* note 32.

The basis will not, however, be increased if property is refinanced unless the loan proceeds are invested in the property. *See* Woodsam Assocs. v. Commissioner, 198 F.2d 357 (2d Cir. 1952), where the Second Circuit would not allow a taxpayer to step up a property's basis from a refinancing loan which was not used to improve the property.

10. Act of Oct. 4, 1976, Pub. L. No. 94-455, 90 Stat. 1531 (codified as amended I.R.C. § 465 (1982)).

11. I.R.C. § 465(b)(2) (1982). "[A] taxpayer shall be considered at risk with respect to amounts borrowed for use in an activity to the extent that he—

(A) is personally liable for the repayment of such amounts, or

(B) has pledged property, other than property used in such activity, as security for such borrowed amount . . . ." *Id.*

12. I.R.C. § 465(c)(3)(D) (1982) ("the holding of real property (other than mineral property) shall be treated as a separate activity, and subsection (a) shall not apply to losses from such activity").

> gage, 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 this case.[13]

It has never been determined why the Supreme Court found it necessary to make this remark. Footnote 37 has been the subject of much commentary and speculation over the years. However, the Supreme Court has now heard a footnote 37 case and ruled that the fair market value of the property is not a limiting factor in gain recognition.[14] In *Commissioner v. Tufts,* the Court declared that where the fair market value of property drops below the liability, gain recognition is still required where depreciation deductions have been taken.[15] It held that, footnote 37 notwithstanding, *Crane* stands "for the broader proposition . . . that a nonrecourse loan should be treated as a true loan."[16] Consequently, the "taxpayer must account for the proceeds of obligations he has received tax free and included in basis."[17] In 1984, the *Tufts* decision was codified in section 7701(g) of the Internal Revenue Code.[18]

Major concerns in this area center around two sections of the Internal Revenue Code. Section 1001,[19] dealing with gain realized from relief of indebtedness, has generated most of the controversy. A newer issue deals with the correct interpretation of section 752(c).[20] Does section 752(c) deal with gain realization limitations and basis of a partnership, or only basis? While the Supreme Court answered many questions in *Tufts,* there are still unresolved issues. This article will focus on the controversy and the remaining issues.

I. Relief of Nonrecourse Indebtedness

Prior to *Crane,* the issue raised in footnote 37 had appeared to be well settled. Even though the Supreme Court had left open the possibility that relief of nonrecourse indebtedness in excess of a prop-

13. 331 U.S. at 14 n.37.
14. Commissioner v. Tufts, 461 U.S. 300 (1983).
15. *Id.*
16. *Id.* at 313.
17. *Id.*
18. I.R.C. § 7701(g) (Supp. 1984) (The Tax Reform Act of 1984, as amended July 18, 1984, Pub. L. No. 98-369, clarification of fair market value in case of nonrecourse indebtedness).
19. I.R.C. § 1001 (1982).
20. I.R.C. § 752(c) (1982) ("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").

erty's fair market value would not constitute gain, the Tax Court had ruled on the issue as early as 1943—four years before *Crane*. In *Lutz & Schramm Co. v. Commissioner,*[21] the Tax Court rejected arguments that, because the fair market value of the property was less than the nonrecourse liability being relieved, gain would also be limited to the property's value.[22] Instead, the full amount of the liability over depreciable basis was determined to be gain.[23] In a similar case, the Tax Court made it clear that its holding in *Lutz & Schramm* had dealt with the issue "not from the standpoint of the elimination of an indebtedness . . . but as gain upon the final disposition of property."[24] The court was still holding this position in 1979.[25]

---

21. 1 T.C. 682 (1943).

22. *Id.* at 685-89.

23. *Id.* In *Lutz & Schramm,* the indebtedness was created by borrowing cash against the value of the property. The Tax Court recognized that the petitioner "had received and used for its own benefit" the proceeds of the loan. *Id.* at 689. Although the court was clearly stating that an economic benefit arising from nonrecourse financing had to be included in income, a lesser noticed aspect of the decision was the legitimizing of income deferral through loan proceeds instead of outright sale. For example, in *Lutz & Schramm,* loan proceeds of $300,000.00 were received in 1925, but relief of the indebtedness of this amount did not occur until 1937, the year in which the Tax Court required gain recognition. The value of such income deferral occurs when taxpayers who need immediate cash but want to defer recognition of gain on a sale borrow money against the fair market value of property in one year and default in a later year. The gain will then be recognized in a later year. *See also Woodsam Assocs.*, 198 F.2d at 357.

This technique also allows a taxpayer to utilize a sort of modified tax straddle. For example, the taxpayer can borrow money on a nonrecourse arrangement against the fair market value of the property. If the value of the property goes up, it can be sold for a greater amount than the encumbrance. If it goes down, the taxpayer can walk away from the nonrecourse note and pocket what has already been received. To date, however, there have been no tax cases litigated which deal with such an issue.

24. Mendham Corp. v. Commissioner, 9 T.C. 320, 323 (1947). The *Mendham* court sought to distinguish the *Lutz & Schramm* decision from the one in Nutter v. Commissioner, 7 T.C. 480 (1946). In *Nutter,* the taxpayer had pledged securities as collateral for a loan. The lender subsequently cancelled the loan obligation in exchange for the pledged securities. However, the value of the securities had dropped below the amount of the loan proceeds. In refusing to hold for gain recognition, the *Nutter* court found appropriate the language used by the Supreme Court in Commissioner v. American Dental Co., 318 U.S. 322, 330 (1943), that the transaction "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." 7 T.C. at 483. The bond purchase language refers to the Supreme Court's holding in *Kirby Lumber* where gain recognition was required when a corporation retired its bonds at less than the issuing price. United States v. Kirby Lumber Co., 284 U.S. 1 (1931).

In *Nutter,* however, the cost basis of the securities exceeded the amount of the proceeds. The court did not address itself to what the result would be if the amount of the loan proceeds were to exceed the cost basis. Apparently, the spirit of the Supreme Court's decisions in *Crane* and *Tufts* would call for gain recognition. *See* the discussion of *Millar, infra* notes 26-27 and accompanying text, which addresses the issue of relief of nonrecourse indebtedness in excess of stock basis.

25. *See* Estate of Delman v. Commissioner, 73 T.C. 15 (1979) (partnership held leasing equipment with a basis of $504,000.00, fair market value of $400,000.00, and nonrecourse note of $1,182,000.00. Upon repossession of the equipment, the partnership was required to recognize gain on the difference between the note and adjusted basis).

It is worth emphasizing that footnote 37 clearly stated that a different problem "*might*" arise where the nonrecourse debt exceeded the property's fair market value, not that it would. The speculative nature of footnote 37's language was recognized by the Third Circuit in *Millar v. Commissioner*,[26] where subchapter S corporation stockholders surrendered stock in exchange for their release from nonrecourse obligations. Because the obligation exceeded the fair market value of the stock, the shareholders argued that there was no gain because of the exception of footnote 37. In rejecting this argument, the Third Circuit noted: "First, it must be remembered that the footnote in *Crane* was dictum. Furthermore, the footnote was but a postulate or hypothetical observation with respect to a hypothetical set of facts not before the Court and, indeed, involving a clearly different time and clearly different legal circumstances."[27]

In 1981, the Fifth Circuit went against the weight of authority in its *Tufts v. Commissioner* decision.[28] In *Tufts,* a partnership had held property which had declined in value to $1.4 million and was encumbered by a nonrecourse note of $1.8 million. The partnership had taken approximately $400,000.00 of deductions on the note. The Fifth Circuit agreed with the petitioners that they should not be required to recognize any gain based upon their relief from the indebtedness. The court cited footnote 37 in *Crane* as justification for a fair market value limitation. It rejected the economic benefit theory because of the fact that a taxpayer could walk away from a nonrecourse note at any time without consequences and would no longer have to contend with the burden of ownership. Consequently, the court held, there was no real relief of ownership because there was no burden of ownership. The court also rejected the idea of a double deduction theory, expressed in *Crane,* that a taxpayer who takes large deductions, without being at risk, has improved his economic position:

> Since [these] 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 . . . would, we think, be taxing the taxpayer twice on the same component of gain.[29]

---

26. 577 F.2d 212 (3d Cir. 1978).
27. *Id.* at 215.
28. 651 F.2d 1058 (5th Cir. 1981), *rev'd,* 461 U.S. 300 (1983).
29. *Id.* at 1061. The court also stated that "[t]here is simply no relationship between basis, adjustments to basis, and amount realized, except where Congress has specifically legislated for recapture." *Id.* at 1064 n.9. *See* Simmons, *Nonrecourse Debt and Amount Realized: The Demise of* Crane's *Footnote 37,* 59 OR. L. REV. 3, 21 (1980), and Simmons, Tufts vs. Commissioner: *Amount Realized Limited to Fair Market*

It is one of the ironies of tax law that such circumstances as existed in *Millar* and *Tufts* should even be at issue. Before *Crane,* it had already been well settled that relief of recourse indebtedness was the equivalent of the receipt of money.[30] Even the petitioner conceded as much in *Crane,*[31] as did the circuit court in *Tufts.*[32] The logical result of the Fifth Circuit decision is that one who has not risked capi-

---

Value, 15 U.C.D. L. REV. 577 (1982). Elsewhere, Simmons writes, "[t]he relationship between debt, basis, and amount realized do [sic] not vary with the personal liability of the debtor. Whether or not the personal liability exists, the debtor must provide for satisfaction of the debt before he or she may realize a gain from encumbered property." Simmons, *Nonrecourse Debt and Basis; Mrs. Crane, Where Are You Now?,* 53 S. CAL. L. REV. 1, 14 (1979).

The *Tufts* decision generated a great deal of commentary, most of it unfavorable. In addition to the articles cited throughout this study, see also: Hemming, *Footnote 37 of* Crane *Reviewed,* 1 B.U.J. OF TAX L. 65 (1983); Newman, *The Resurgence of Footnote 37,* Tufts v. Commissioner, 18 WAKE FOREST L. REV. 1 (1982); Comment, *Tufts v. Commissioner: Crane's Footnote 37 Reviewed,* 34 BAYLOR L. REV. 675 (1982); Comment, *Federal Income Tax Treatment of Nonrecourse Debt,* 82 COLUM. L. REV. 1498 (1982); Comment, Tufts—*The Resurrection of* Crane's *Footnote 37,* 9 FLA. ST. U. L. REV. 575 (1981); Comment, *Federal Income Taxation — Determination of the Amount Realized on Disposition of Property Subject to a Nonrecourse Mortgage,* 11 MEM. ST. U.L. REV. 611 (1981); Comment, Crane's *Footnote Thirty-Seven Gets the Boot,* 11 SETON HALL L. REV. 679 (1981); Note, *The Continuing Controversy over* Crane's *Footnote 37.* Tufts v. Commissioner, 1982 B.Y.U. L. REV. 753; Note, *The Amount Realized Upon Disposition of Property Secured by a Non-Recourse Mortgage is Limited By the Fair Market Value of Such Property*—Tufts v. Commissioner, 31 EMORY L.J. 242 (1982); Note, *Income Tax: Gain Computation . . .* Tufts v. Commissioner, 55 TEMP. L. Q. 162 (1982).

30. United States v. Hendler, 303 U.S. 564 (1938); Pendler v. Commissioner, 110 F.2d 477 (4th Cir.), *cert. denied,* 310 U.S. 650 (1940); Haass v. Commissioner, 37 B.T.A. 948 (1938); Bron Hotels, Inc. v. Commissioner, 34 B.T.A. 376 (1936). *See also* Odell & Sons v. Commissioner, 8 T.C. 1165 (1947); Avery & Sons v. Commissioner, 26 B.T.A. 1393 (1932).

31. 331 U.S. at 13.

32. 651 F.2d at 1061. The Fifth Circuit could have avoided some of its conceptual problems by applying the valid investment criteria to *Tufts* for deductions which other courts have used in non-*Tufts* cases when dealing with nonrecourse notes. *See supra* note 6 and accompanying text. The court could have reasoned that since the investment which gave rise to the deductions must be valid in order for those deductions to be sustained, the amount of the investment would not change with a fluctuation in the fair market value of the underlying property. The court, however, implied that a nonrecourse note by its very nature denoted the absence of investment when it stated: "The argument, we suppose, is that it is somehow unfair for a taxpayer to enjoy the benefit of substantial deductions without having invested his own funds or placed his own assets at risk." 651 F.2d at 1064 n.9.

The Fifth Circuit's attitude may have stemmed from its belief that since nonrecourse notes do not impose a burden of ownership, *id.* at 1062, the requisite investment was lacking. Such an attitude, however, is clearly out of step with those decisions which have sought to measure the investment by the property's value in relation to the amount of the nonrecourse liability. *See supra* note 6.

Even where all the burden of ownership has been found lacking, deductions have been sustained on nonrecourse indebtedness. In Bolger v. Commissioner, 59 T.C. 760 (1973), the Tax Court allowed the lessor of nonrecourse properties to take depreciation deductions where the lessees agreed to pay all taxes, insurance and repair costs. Lease payments were made directly to the institutional lender in satisfaction of payments on the mortgage. For an analysis, see Lurie, *Bolger's Building: The Tax Shelter That Wore No Clothes,* 28 TAX L. REV. 355 (1973).

tal can, in some circumstances, be entitled to greater tax benefits than one who has. The issue was not lost on the Supreme Court in its review of *Tufts v. Commissioner.*[33] In justifying its decision to reverse the circuit court and to include the full amount of the nonrecourse note in basis regardless of the property's fair market value, it stated: "Because no difference between recourse and nonrecourse obligations is recognized in calculating basis, *Crane* teaches that the Commissioner may ignore the nonrecourse nature of the obligation in determining the amount realized upon disposition of the encumbered property."[34]

The semantics used in *Crane* concerning the terms "double deduction" and "economic benefit" have contributed to the controversy. Some tax scholars have questioned the accuracy of using these terms. Indeed, the Fifth Circuit in *Tufts* several times cited an article by Professor Boris Bittker calling into question such usage.[35] While Bittker agreed with the results of the *Crane* case because it brought the tax consequences into harmony with economic reality, he rejected the economic benefit theory.[36]

33. 461 U.S. 300 (1983).

34. *Id.* at 309. Although the Supreme Court recognized that *Crane* allowed basis for both recourse and nonrecourse notes, the *Tufts* Court in its own footnote opened the way for more controversy and confusion. In note 5, the Court stated that the Commissioner might have argued that a nonrecourse mortgage does not constitute true debt and could be considered a contingent liability. The Court expressed "no view as to whether such an approach would be consistent with the statutory structure and, if so, and *Crane* were not on the books, whether that approach would be preferred over *Crane's* analysis." *Id.* at 308 n.5.

There are some serious problems with the Court's apparent reservation. Gibson Products v. United States, 637 F.2d 1041 (5th Cir. 1981), is cited by the Court as support for the contingent debt possibility. In *Gibson Products*, a partnership was disallowed basis because the liability was contingent upon oil well production. This was not the case in either *Tufts* or *Crane* where the liability was fixed despite its nonrecourse nature. There is simply no judicial or statutory support for expanding the definition of a contingent liability to a fixed nonrecourse note. The at risk rules of section 465 were an indirect codification of the principle of allowing nonrecourse financing to be included into the basis of real property. Although section 465 deals with allowable deductions when losses exist, and not computation of basis, its exclusion of real estate from the at risk provisions makes it clear that the basis from which the deductions flow must be left intact. *See supra* notes 11-12 and accompanying text. Moreover, Treasury Regulation 1.752-1(e) specifically allows a partnership basis for nonrecourse liabilities on real property. Treas. Reg. § 1.752-1(e) (1956). Consequently, an acceptance of the contingent liability hypothesis as it might be applied to partnerships could only be achieved by statute.

35. 651 F.2d at 1062-63 & n.7.

36. Bittker, *Tax Shelters, Nonrecourse Debt and the* Crane *Case*, 33 TAX L. REV. 277, 281-84 (1978). *See also* Simmons, *Nonrecourse Debt and Amount Realized*, *supra* note 28, at 21, who also calls into question the economic benefit theory.

Similarly, the double deduction argument of the *Crane* Court can be seen as questionable. There was no double deduction in the literal sense of the term since Crane actually took depreciation only once. What the Court appeared to be saying in *Crane* was that deductions taken should be accounted for upon disposition of the property, otherwise the effective realized gains would not be recognized.[37]

Another theory put forth to justify the *Crane* decision is the tax benefit theory, which holds that prior items of deduction which are later recouped must be recognized in income. Professor Friedland, for example, argues that *Crane* is a tax benefit case, not an economics case. "The confusion about the 'principal reasoning' of *Crane* stems from the Court's unsuccessful attempt to provide a non-tax rationale for what was essentially a pure tax decision."[38]

The use of the tax benefit theory to reject footnote 37 suffers from an obvious weakness: it refers to losses which have been taken and later recovered (e.g., bad debt deductions), but does not apply to depreciation in the literal sense. Rather, it invokes the spirit of the law that "the taxpayer is made to account for depreciation allowable without economic investment."[39] It could therefore be argued that an expansion of the tax benefit theory to include depreciation would be justified as comporting with the policy behind the statute. There have been no tax benefit theory cases which have involved the issues present in *Crane.*[40]

The benefit a taxpayer receives from depreciation deductions—whether tax or economic—is equally as real as if the same taxpayer received cash by borrowing money secured by property. If the taxpayer forfeits the property in order to cover the debt, he has a recognized gain to the extent that he has not invested the borrowed funds in the property. Had he invested such funds in the property, he would have been liable for gain to the extent of that part of the note which has not been repaid but on which depreciation has been taken. Such results inure even if the fair market value of the property is less than the liability which encumbers it.[41] Whether the taxpayer has borrowed money against his property, which he does not repay,

37. Author's interpretation. *See also* Pino-Anderson, *Contra* Tufts: *The Case Against Fair Market Value Limitation on Amount Realized,* 14 PAC. L.J. 79, 98-100 (1982).

38. Friedland, *supra* note 1, at 529.

39. Del Cotto, *Basis and Amount Realized Under* Crane: *A Current View of Some Tax Effects in Mortgage Financing,* 118 U. PA. L. REV. 69, 85 (1969).

40. The principle of tax benefit has been recognized in depreciation cases. *See* Texaco, Inc. v. United States, 579 F.2d 614, 616 (Ct. Cl. 1978); Russell Wolf & Co. v. Commissioner, T.C.M. (P-H) 59, 126 (1959).

41. *Lutz & Schramm,* 1 T.C. at 683; *see also Woodsam Assocs.,* 198 F.2d at 357 (involving refinancing proceeds); Halpern, *Footnote 37 and the* Crane *Case: The Problem That Never Really Was,* 6 J. REAL ESTATE TAX. 197, 216-21 (1979) (using the terms "economic pluses" and "minuses"). *But see* McGuire, *On the Treatment of Realization*

or takes depreciation deductions on which there is a nonrecourse note, the result is the same—he has enriched himself. The receipt of cash would be an economic enrichment while depreciation is a tax enrichment. The substance is the same even though the form is different.

This cash equivalent logic was used by the Supreme Court in *Tufts*. The Court argued persuasively that Tufts had received a "mortgage loan with the concomitant obligation to repay by the year 2012."[42]

> The only difference between that mortgage and one on which the borrower is personally liable is limited to foreclosing on the securing property. This difference does not alter the nature of the obligation; its only effect is to shift from the borrower to the lender any potential loss caused by devaluation of the property.[43]

The Court went on to note that the mere fact that the property had dropped in value did not erase the fact that Tufts had received the loan proceeds tax free.

> From the mortgagor's point of view, when his obligation is assumed by a third party who purchases the encumbered property, it is as if the mortgagor first had been paid with cash borrowed by the third party from the mortgagee on a nonrecourse basis, and then had used the cash to satisfy his obligation to the mortgagee.[44]

II. SECTION 1001(B) ISSUE

The Treasury Department, mindful of the conflicts which had arisen, enacted regulation 1.1001-2(b) in December, 1980,[45] which stated that the fair market value of the security was irrelevant for the purposes of determining gain: "Thus, the fact that the fair market value of the 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."[46] Since the issues in *Tufts* arose prior to the promulgation of this regulation, the Fifth Circuit did not have to address its validity. However, in a persuasive and well reasoned concurring opinion, Judge Williams cited the language of the court to support a finding that the regulation constitutes a distortion of "the definition

of Gain on Recapturing Prior Deductions—Some Thoughts on Millar, Tufts *and Footnote 37,* 6 J. REAL ESTATE TAX. 132, 140-41 (1979) (supporting the *Tufts* position).

42. 461 U.S. at 311.

43. *Id.* at 311-12.

44. *Id.* at 312. The Court, in essence, was rejecting the Fifth Circuit's view that "[i]t is not a solution to distort the definition of amount realized by finding an economic benefit equivalent to cash where none exists." 651 F.2d at 1064 n.9.

45. Treas. Reg. § 1.1001-2(b) (1980).

46. *Id.*

of amount realized."[47] The majority opinion never specifically referred to the regulation.[48] However, in response to Judge Williams, the majority did not disassociate itself from this particular remark,[49] leaving the impression that the same decision would be reached if a post-regulation 1.1001-2(b) case were to come before the court.

Admittedly, there is precedent for judicially overturning a regulation which is inconsistent with a statute.[50] Judge Williams cited the language of section 1001(b), which defines the amount realized as "the sum of any money received plus the fair market value of the property (other than money) received."[51] He saw this fair market value limitation as justification for the court's holding. The majority, however, disagreed with Williams that section 1001(b) was applicable.[52] This problem in statutory construction will be even more evi-

47. 651 F.2d at 1064 (Williams, J., concurring).

48. *Id.* at 1063 n.9.

49. *Id.*

50. *See* the Supreme Court's decision in United States v. Vogel Fertilizer Co., 455 U.S. 16 (1982), where the Treas. Reg. § 1.1563-1(a)(3), example 1 definition of a controlled group was found to conflict with section 1563(a). *See also* Rowan Cos. v. United States, 452 U.S. 247 (1981); Manhattan General Equip. Co. v. Commissioner, 297 U.S. 129 (1936); Commissioner v. General Mach. Corp., 95 F.2d 759 (6th Cir. 1938); Corner Broadway—Maiden Lane, Inc. v. Commissioner, 76 F.2d 106 (2d Cir. 1935); American Standard, Inc. v. Commissioner, 602 F.2d 256 (Ct. Cl. 1979); Joseph Weidenhoff, Inc. v. Commissioner, 32 T.C. 1222 (1959).

Generally, however, courts are inclined to defer to the regulations unless they are clearly inconsistent with the statute. *See* National Muffler Dealers Ass'n v. United States, 440 U.S. 472, 477, 488 (1979); Fulman v. United States, 434 U.S. 528, 534 (1978); United States v. Correll, 389 U.S. 299, 307 (1967); Commissioner v. South Tex. Lumber Co., 333 U.S. 496, 501 (1948); Allen Oil Co. v. Commissioner, 614 F.2d 336 (2d Cir. 1980). A regulation will not be found to conflict with a statute where the Secretary has been granted specific authority by the code section to prescribe the regulations. For example, section 1502 of the Internal Revenue Code grants the Secretary specific authority to prescribe regulations for consolidated tax returns. I.R.C. § 1502 (1982).

51. I.R.C. § 1001(b) (1982).

52. 651 F.2d at 1064 n.9 (Williams, J., concurring). It could be argued, as did Judge Williams, that the language of the code stands on its own. *See infra* notes 56-85. However, it appears from reading Treasury Regulation 1.1001-1(a) that section 1001(b) may not have been meant to cover liabilities. Treas. Reg. § 1.1001-1(a) (1972). This would be one explanation for the enactment of Treasury Regulation 1.1001-2 in December, 1980, which deals exclusively with liabilities. Treas. Reg. § 1.1001-2 (1980).

Nevertheless, the failure of the majority of the circuit courts to emphasize the literal construction of section 1001(b) probably deprived it of the strongest argument which could have been made to justify the *Tufts* decision. Instead of addressing statutory construction, the court sought to delve into the more abstract and theoretical areas of tax law. Consequently, the Supreme Court never had to address the language of the statute, focusing instead on *Crane's* footnote 37 as well as tax and economic theories. Indeed, had the Fifth Circuit adopted the view of Judge Williams and pressed its case, a Supreme Court reversal could have been attacked as a rewriting of the statute.

Only Justice O'Connor, in a concurring opinion for the Supreme Court, mentioned section 1001(b). Her view was that the Court should defer to the language of Regulation 1.1001-2, which supports the Service's position. 461 U.S. at 317-20 (O'Connor, J., concurring). However, Justice O'Connor's view ignores the fact that the regulation was promulgated after the facts in *Tufts* arose. Therefore, if the Court had found the dent in dealing with section 752(c).[53] In any event, the language of section 1001(b) does not differentiate between recourse and nonrecourse notes. Consequently, applying section 1001(b) to such situations would ignore the long-standing principle that the full amount of recourse notes must be used for gain purposes.

The Supreme Court in *Tufts* never addressed itself to the specific language of section 1001(b), as did Judge Williams in his concurring opinion. Rather, it took the approach that "[w]hen the obligation is canceled, the mortgagor is relieved of his responsibility to repay the sum he *originally received* and thus realizes value to that extent within the meaning of [section] 1001(b)."[54] In effect, the Court held that fair market value is to be measured for gain purposes at the time the obligation is incurred, not upon disposition. Good reason exists to dispute such an analysis since, as noted earlier, it is inconsistent with the language of section 1001(b).[55] However, the Court may have felt that its interpretation was in keeping with the spirit, if not the letter, of the law.

By taking the approach that fair market value for gain purposes is to be measured at the time the obligation is incurred, the Supreme Court closed off other problems presented by *Tufts* and *Crane*. The Fifth Circuit's decision in *Tufts* effectively created a two-tiered basis system, with one basis for depreciation—the amount of the note—and one for gain—the fair market value of the property. If the fair market value of the property were to shift below the amount of the note, so would the basis for gain. However, the basis for depreciation would remain constant as the original amount of the note. The Supreme Court's reversal of the Fifth Circuit has resolved this issue in favor of a single basis for gain and depreciation.

III. SECTION 752(C) ISSUE

Section 752(c), which applies only to partnerships, states that "[f]or 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

---

regulation to be in compliance with the statute, it would then have had to decide whether the regulation should be applied retroactively. *See supra* note 40.

53. *See infra* notes 56-85 and accompanying text.

54. 461 U.S. at 312 (emphasis added).

55. *See supra* note 52 and accompanying text. Of course, the amount of the loan "originally received" will be reduced by principal payments for gain recognition purposes.

as a liability of the owner of the property."[56] The respondent in *Tufts* argued that even if footnote 37 of *Crane* did not limit the partnership's gain, section 752(c) did.[57]

The major distinguishing feature between the facts in *Millar*[58] and those in *Tufts* is that the former involved a subchapter S corporation while the latter involved a partnership. The difference in basis computation between these two types of entities is that partners receive basis for liabilities while subchapter S corporation shareholders do not.[59]

Section 752(c) is likely to result in as much confusion in interpretation as has footnote 37. For example, the statute does not differentiate between recourse and nonrecourse debt.[60] One of the two leading texts in the area of partnership taxation argues that "it seems relatively clear" that section 752(c) refers only to nonrecourse liabilities.[61] In fact, the issue is anything but clear. Neither the regulations under section 752(c)[62] nor the Congressional Committee Reports[63] limit the section to nonrecourse liabilities. However, the Internal Revenue Service has ruled that a limited partnership's basis would be limited to $400.00, the fair market value of the property, where the partnership paid $500.00 in cash for the property and assumed a nonrecourse note for $1,500.00.[64]

Another problem with section 752(c) lies in its use to limit gain

---

56. I.R.C. § 752(c) (1982).

57. 461 U.S. at 314; 651 F.2d at 1063 n.8.

58. *See supra* note 27 and accompanying text.

59. On these differences, see Cantor & Brill, *The S Corporation: An Alternative for Syndication*, 61 TAXES 227, 232-36 (1983). *See also* Miller, *Walking Tour Through S Land*, 10 J. REAL ESTATE TAX. 237-38 (1983).

60. *See supra* note 56 and accompanying text.

61. W. MCKEE, W. NELSON & R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS 7-12 (1977). The authors, however, acknowledge that neither the statute nor the regulations specifically support this position. The other standard texts by Willis on partnership taxation do not address the issue directly. *See* 1 A. WILLIS, PARTNERSHIP TAXATION (2d ed. 1976); 1 A. WILLIS, S. PENNELL & P. POSTLEWAITE, PARTNERSHIP TAXATION (3d ed. 1982). However, in the 1976 edition, Willis writes that "if property having a fair market value of $10,000 and subject to an encumbrance of $12,000 is contributed to a partnership, the amount of § 752(a) increase in the partners' shares of partnership liabilities is limited to the $10,000 fair market value of the property." 1 A. WILLIS, PARTNERSHIP TAXATION § 22.09, at 262 (2d ed. 1976).

Since Willis helped to write the statutes on partnership taxation, the fact that he does not distinguish between recourse and nonrecourse notes may be significant. On the other hand, it could be argued that Willis would have realized the significance of extending his statement to recourse notes and, therefore, would have specifically mentioned such an extension. However, Willis died in 1981.

62. Treas. Reg. § 1.752-1 (1956).

63. H.R. REP. NO. 1337, 83rd Cong., 2d Sess. 236-37 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 405 (1954).

64. Rev. Rul. 80-42, 1980-1 C.B. 182-3. The ruling stated that the purchaser, a limited partnership, had to show that the payment in excess of fair market value was "not for a purpose other than the acquisition of the . . . rights." *Id.* Nothing in the facts of the ruling indicates that such a situation existed, even though the general partner was

even though it was designed to deal only with the limitation of basis. An examination of the Committee Reports on section 752, Treasury Regulation 1.752-1 and the other provisions of section 752 tend to confirm this view. There is nothing in any of these sources that deals with gain. Rather, section 731 of the Internal Revenue Code deals with gain or loss situations of partnerships.[65] Whatever the Congressional intent may have been, the language of the code stands on its own.

In *Helvering v. Cannon Valley Milling Co.*, the Eighth Circuit refused to restrict a statute's applicability because of a limitation suggested in the Congressional Report, on the grounds that the limitation was not in the section itself.[66] The Seventh Circuit has stated that "[c]ourts have no right, in the guise of construction of an act, to either add words or to eliminate words from the language used by congress."[67] This position is illustrated in *Diamond v. Commissioner*, where the Seventh Circuit held that the receipt of a future profits interest in a partnership for services rendered was taxable under section 61 of the Internal Revenue Code in the year of receipt.[68] Arthur Willis, who had helped to write the statutes on partnership taxation, marshalled an impressive amount of authority as support in arguing that a future profits interest should not be taxable under Treasury Regulation 1.721-1.[69] Nevertheless, the court found such an interest taxable because the Code contained no specific exemption for such interest, and section 61 includes as gross income all income "from whatever source derived," unless directly excepted by another section.[70]

---

a majority shareholder in the corporation selling the property. The ruling does not deal with section 752.

65. I.R.C. § 731 (1982) (extent of recognition of gain or loss in partnerships).

66. 129 F.2d 642, 645 (8th Cir. 1942).

67. De Soto Sec. Co. v. Commissioner, 235 F.2d 409, 411 (7th Cir. 1956).

However, in Helvering v. Owens, 305 U.S. 468 (1939), the taxpayer took a casualty loss for the basis of non-business property. The Service argued that the loss must be limited to the fair market value of the property if lower than cost. Even though the statute did not distinguish between business and non-business property for basis purposes, the Supreme Court upheld the Commissioner's view. *Id.* at 471. Although the Court went against the statutory construction, a possible explanation may be in "the Court's implicit determination to reach an eminently sensible result despite the [Internal Revenue Code] draftsman's ineptitude." Bittker, *Income Tax Loopholes*, 17 TAX COUNSELOR'S Q. 429-30 (1974).

68. 492 F.2d 286 (7th Cir. 1974).

69. A. WILLIS, *supra* note 61, § 11.01, at 119-22. The *Diamond* court also noted that there was "a startling degree of unanimity that the conferral of a profit-share as compensation for services is not income at the time of conferral . . . ." 492 F.2d at 289.

70. I.R.C. § 61 (1982) (gross income includes compensation for services).

The problem presented by section 752(c) was not lost on the Tax Court which initially upheld the Commissioner in *Tufts.*[71] That court reasoned persuasively that the section referred only to basis, not gain.[72] However, it also conceded that section 752(c) "is broad enough to support petitioners' interpretation . . . ."[73] The court's conclusion that gain was not limited was supported by reference to section 752(d)[74] which states that "[i]n 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."[75] Thus, section 752(d) would appear to bring section 752(c) gain recognition situations under the authority of those cases which hold that footnote 37 of *Crane* does not limit gain recognition to the fair market value of property securing a nonrecourse note.[76]

Daniel Simmons presents a strong argument that, unless section 752(d) were independent of section 752(c), and therefore allowed to control the amount of gain, it would serve no function in the statutory scheme.[77] On the other hand, Judge Williams, in his concurring opinion in *Tufts,* reasonably argued that the "specific imposition of a fair market value limitation in § 752(c) would control over § 752(d)'s general reference to the computation embracing the § 1001 definition in the partnership taxation context."[78] The majority, however, de-

---

71. Tufts v. Commissioner, 70 T.C. 756 (1978).

72. *Id.* at 766-69.

73. *Id.* at 768.

74. *Id.* at 768-69.

75. I.R.C. § 752(d) (1982).

76. 70 T.C. at 768. The Tax Court reaffirmed this position in Estate of Delman v. Commissioner, 73 T.C. 15, 33-34 (1979); and Brountas v. Commissioner, 73 T.C. 491, 573 (1979), *vacated and remanded on other grounds,* 692 F.2d 152 (1st Cir. 1982).

77. Simmons, Tufts v. Commissioner*: Amount Realized Limited to Fair Market Value,* 15 U.C.D. L. REV. 577, 613 (1982).

78. 651 F.2d at 1066. Justice Williams was correct in his view that a specific limitation would control a general reference. However, there is good reason to believe that such an interpretation would not be applicable to section 752.

Such limitations generally fall into two categories. The first is where the statute *specifically* provides an exemption from the general purpose of the statute. For example, section 165(a) allows a deduction for casualty losses sustained during the taxable year. I.R.C. § 165(a) (1982). However, section 165(h) imposes a limitation on such losses for non-business property. I.R.C. § 165(h) (1982).

The second type of limitation is where one statute specifically exempts certain situations from the general provisions of another statute. For example, in Hempt Bros. v. United States, 490 F.2d 1172 (3d Cir. 1974), the taxpayer, a cash basis partnership, effectuated a tax free incorporation under section 351. Among the items transferred to the corporation were accounts receivable. The Hempt brothers argued that the partnership, not the corporation, should be taxed on the accounts receivable, otherwise the transfer would constitute an assignment of income in violation of section 61. However, the Third Circuit found the specific exception of section 351 to override the general provisions of section 61. *Id.*

Section 752(c) cannot be interpreted to be a specific limitation upon section 752(d) voted only a footnote to section 752(c),[79] stating in essence that, since the gain was limited by the fair market value based on other concepts of law, it made no difference if section 752(d) embraced those other concepts or not.[80]

The Supreme Court, like the Tax Court, felt that section 752(c) could be applied to a sale or disposition of partnership property.[81] However, it found section 752(d) to be inconsistent with 752(c).[82] To resolve the issue, the Court looked to the history of the statute and, like most commentators on the issue, found section 752(c) to apply to basis only.[83]

While the Supreme Court has cleared the air with respect to the particular basis issue in section 752(c) presented in *Tufts*, the statute still presents some unresolved problems. With basis limited by fair market value, there could be continuous shifts in basis if the value were to fall below the amount of the nonrecourse or recourse note. Even though the Service has never attempted to argue this point, authorities in the area have not ruled out the possibility of basis shifts.[84]

As was noted earlier in the discussion of *Crane's* footnote 37, the Supreme Court's decision in *Tufts* should effectively inhibit any potential attempt to shift basis because it has standardized the basis for gain (and hence the basis for depreciation) with the original obliga-

---

because there is no clear indication in section 752(c) that it is to serve such a function. Consequently, Simmons' view, *supra* note 77 and accompanying text, is the better one.

79. 651 F.2d at 1063 n.8.

80. *Id.* Just as the Fifth Circuit failed to address the statutory construction issue of section 1001(b), *see supra* note 50, a similar shortcoming in the opinion was evident with regard to section 752(d). Since section 752(d) provides that partnership liabilities "shall be treated as liabilities in connection with the sale or exchange of property not associated with partnerships," I.R.C. § 752(d) (1982), a finding that the construction of section 1001(b) supported Tufts' position would have also served to limit the gain by reason of section 752(d) because section 752(d) implicitly requires a partnership to look to other sections for the appropriate treatment—namely section 1001 which deals with such issues.

81. 461 U.S. at 314.

82. *Id.*

83. *Id.* at 316 n.17 (citing Reg. 1.752-1(c) as authority for the proposition that section 752(c) refers only to transactions between a partnership and a partner).

84. Some commentators, *see* W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 61, at 7-13, believe that Reg. 1.752-1(c) inhibits the possibility of this happening while not ruling it out altogether. Willis leaves open the possibility but also feels that Reg. 1.752-1(c) could limit the chance of this happening. A. WILLIS, *supra* note 61, § 22.09, at 262-63. However, the 1982 edition of PARTNERSHIP TAXATION, published after Willis' death and revised by two other authors, categorically states that Reg. 1.752-1(c) will prohibit a basis shift. A. WILLIS, S. PENNELL & P. POSTELWAITE, *supra* note 61, § 44-03. The regulation itself, however, does not directly address the issue.

tion on the property.[85] Although the Court was addressing the problem from the perspective of footnote 37 and section 1001(b), the same logic would seem to apply to section 752(c) since the issues in both sections are closely related. Should the Service ever attempt to shift a partner's basis down by using section 752(c), the taxpayer could argue that the language of the Supreme Court in *Tufts* prohibits such a position. Implicit in the Court's reasoning was that the basis for depreciation should not fluctuate if it is the same for gain upon acquisition.

The Supreme Court's ruling on section 752(c) is consistent with its position on section 1001(b) and footnote 37. Had the Court accepted the limitation on section 752(c) argued by Tufts, it would have been offering taxpayers a way around the basic principles it was formulating in that case. Taxpayers could avail themselves of the fair market value limitation, to which they would otherwise not be entitled, simply by forming a partnership.

IV. CONCLUSION

Although the Supreme Court has now resolved many of the problems surrounding *Crane's* footnote 37, section 1001(b), and section 752(c), there are still issues remaining. Even though the problems discussed above have not yet arisen, it is only a matter of time before they may be forced on the Service and, possibly, the courts.

The remaining issues should be addressed by the Treasury Department through additional regulations. Such regulations should clearly state whether or not section 752(c) is applicable to recourse as well as nonrecourse notes. As the statute now stands, an interpretation extending it to recourse notes could be justified. However, such an interpretation could put section 752(c) in conflict with the at risk rules of section 465. Even though section 465 deals with the allowance of deductions when losses exist, not the computation of basis, the section clearly recognizes that both loss deductions and basis are inextricably linked because without basis there can be no depreciation deductions. Section 465(b) defines at risk to include amounts borrowed on which a taxpayer is personally liable.[86] There are no fair

---

85. *See supra* note 54.

86. The conflict could arise in the following type of situation. The partnership purchases oil and gas property with a recourse note for $5,000.00 when the fair market value of the property is $4,000.00. The partnership sustains losses of $5,000.00 on the property. Section 752(c) could be read to allow losses on only $4,000.00. However, under section 465, loss deductions on the full $5,000.00 would be allowed. Section 465(d) states, however, that the at risk rules only apply to the excess of deductions over income. Consequently, section 465 could not be argued in a situation where there were no losses.

market value limitations.

A further problem of including recourse notes in section 752(c) is that such treatment runs counter to section 1012 which defines the basis of property as its cost.[87] The *Crane* doctrine holds that the cost of property includes liabilities. The only limitations placed upon *Crane* have been where *non*recourse notes have exceeded the value of the encumbered property or the liability is contingent.[88] The application of section 752(c) to recourse notes would create a situation where the fair market value limitation would apply only to partnerships, not individuals. This would defeat the purpose of Subchapter K—the partnership area of the Internal Revenue Code—which is supposed to apply tax rules to partners in partnerships in the same manner as the law is applied to individuals.[89]

The next area which needs to be addressed by the Treasury is the determination of basis when the nonrecourse note exceeds the value of the property but basis is limited to the fair market value by reason of section 752(c). As noted earlier, the IRS has been successful in denying basis altogether in some cases where property is encumbered by an inflated mortgage note.[90] Where basis is either denied in total or restricted by reason of section 752(c), gain recognition upon relief of the liability is limited to the extent of depreciation deductions allowed by reason of Regulation 1.1001-2(a)(3). Thus, where the nonrecourse note is $200.00 and the property's fair market value is $150.00, the basis for gain is $150.00 less depreciation deductions taken.

However, taxpayers will make principal payments on nonrecourse property. The principal payments could be added to the initial fair market value of the property for purposes of depreciation deductions. For example, if in the above situation, the taxpayer makes a principal payment of $5.00 on the note, the amount of basis for depreciation, and gain, would be increased to $155.00. Once the taxpayer made $50.00 in principal payments, the full amount of the $200.00 note would be eligible for depreciation deductions.[91] This approach as-

87. I.R.C. § 1012 (1982).

88. *See supra* note 6. Of course, the at risk rules of section 465 also impose limitations on nonrecourse financing.

89. I.R.C. §§ 701-761 (1982).

90. *See supra* notes 6-7 and accompanying text. Section 752(c) has not been cited by taxpayers, in cases where basis was disallowed in total to the partnerships, for the proposition that basis should be allowed at least to the extent of the value of the property.

91. The actual mechanics of this procedure would be as follows: In year one the value of the property is $150.00, being depreciated over 15 years. The property is en-

sumes, however, that basis is not disallowed altogether.

Utilizing this technique would avoid the many tax and accounting problems inherent in shifting the basis with the fair market value of the property.[92] Rather, the initial basis would remain fixed at the fair market value with increases only occurring with each principal payment. By taking steps to address these issues now, the Treasury can help to avoid potential litigation in the future.

---

cumbered by a note of $200.00. The depreciation for year one is $10.00 ($150.00 ÷ 15). In year two the taxpayer pays $14.00 on the mortgage. The deduction for year two is $11.00 ($150.00 + $14.00 − $10.00 taken in year one = $154.00 ÷ 14 years, the remaining life of the building). Such an approach is consistent with Proposed Regulation 1.168-2(d)(3)(ii), example two, which deals with contingent purchase prices. [1985] 3 STAND. FED. TAX REP. (CCH) 22,543.

If the property is real property, an allocation will have to be made between the land and building. *See generally* G. ROBINSON, FEDERAL INCOME TAXATION OF REAL ESTATE 15-7 to 15-8 (1984).

92. *See supra* notes 84-85 and accompanying text.