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NONRECOURSE MORTGAGE INDEBTEDNESS AS AN AMOUNT REALIZED: FOOTNOTE 37 REVISITED

by Holly A. Cox

The proper determination of the amount realized[1] on transfer of property subject to a nonrecourse debt[2] when the fair market value of the property is less than the unpaid balance of the indebtedness has remained an unresolved issue since the Supreme Court first posed the question in footnote 37 of *Crane v. Commissioner*.[3] Footnote 37 suggests that the amount realized in such a situation should represent the actual economic benefit received by the taxpayer on disposition of the property, thus limiting the amount realized to the fair market value of the transferred property. Consistent application of the footnote 37 rationale, however, results in an unacceptable tax advantage for investors holding property subject to nonrecourse financing.[4] To avoid this result, recent cases have rejected the economic benefit rationale of footnote 37, holding that the amount realized may include tax benefits resulting from the use of nonrecourse debt in basis. Further, these cases have determined the amount realized without regard to the fair market value of the underlying property or the actual economic benefit realized by a taxpayer on transfer of the property financed by nonrecourse debt.[5] In light of the statutory language of Internal Revenue Code section 1001(b) and the holding of *Crane v. Commissioner*, this precedent is open to challenge.

Resolution of this issue is important to the courts, to the tax bar, and also to the many investors who seek the tax sheltering benefits and limited risk that nonrecourse financing can provide. Most investors would be surprised to learn that taxable gain can result from the collapse of a tax sheltering business transaction. As Professor Bittker concisely states, the entire

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1. The term "amount realized" is defined by I.R.C. § 1001(b) as follows: "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

2. Nonrecourse financing involves a loan in which the borrower has no personal liability for repayment. The lender has recourse only to the underlying security in the event of default. *See* BLACK'S LAW DICTIONARY 1778 (rev. 4th ed. 1968). For this reason, nonrecourse financing is difficult to obtain. Lending institutions are conservative in estimating whether the value of the underlying security is sufficient to pay off the loan in the event of default. Thus, the value of the securing asset must be equal to or greater than the amount of the loan before an institution will make the loan, and there must be no reasonable expectation of decline in value. The general reputation of the buyer and the economic feasibility of a successful project are also important considerations to the institutional lender.

3. 331 U.S. 1, 14 n.37 (1947).

4. *See* discussion at section II *infra*.

5. Millar v. Commissioner, 577 F.2d 212, 215, *cert. denied*, 439 U.S. 1046 (1978); Estate of Delman v. Commissioner, [1979] TAX CT. REP. (CCH) (73 T.C.) Dec. 36,380; Tufts v. Commissioner, 70 T.C. 756, 764-66 (1978).

notion is "counter-intuitive."[6] Recent precedent, however, confirms this result. This Comment analyzes existing case law in terms of accepted and fundamental principles of income taxation, and concludes that statutory means for achieving an equitable tax treatment of the footnote 37 situation are readily available and are conceptually preferable to the judicial redefinition of "amount realized" advanced in recent cases.

I. GAIN OR LOSS ON THE DISPOSITION OF ENCUMBERED PROPERTY

A. *In General*

The amount of gain or loss recognized on the sale of property is determined by computing the difference between the adjusted basis of property and the amount realized at sale.[7] The cost basis and amount realized provisions of the Internal Revenue Code operate concurrently to give an accurate reflection of a taxpayer's yearly income.[8] One function of the cost basis provision is to insure that the return of a taxpayer's capital investment is not treated as recognized income.[9] As a return of capital is not a taxable event,[10] basis is subtracted from the gross proceeds received on the sale, the amount realized, to determine the taxpayer's gain. A taxpayer thus will not be taxed both on the return of capital and on his profits.[11]

The basis and amount realized provisions of the Code also operate concurrently with the depreciation provisions. The amount of the annual depreciation deductions is intended to represent that portion of the cost of a capital asset that is attributable to the income that the asset generates in that tax year.[12] By deducting this portion of the asset's cost against current income, the taxpayer is allowed to account periodically for the return of his capital investment rather than only upon the asset's disposition. In or-

6. Bittker, *Tax Shelters, Nonrecourse Debt and the Crane Case*, 33 TAX L. REV. 277, 277 (1978).

7. I.R.C. § 1001(a). I.R.C. § 1012 states that the basis of property shall be its cost unless otherwise provided. Adjusted basis is defined in I.R.C. § 1016. I.R.C. § 1016(a)(1) provides that an upward adjustment shall be made for all items properly chargeable to the capital account, except carrying charges described in § 266 and circulation expenditures described in § 173. I.R.C. § 1016(a)(2) requires that a downward adjustment be made in the amount of the depreciation allowable under I.R.C. § 167. I.R.C. § 1001(b) defines the amount realized on the sale or other disposition of property. The text of I.R.C. § 1001(b) appears at note 1 *supra*.

8. *See* Surrey & Warren, *The Income Tax Project of the American Law Institute: Gross Income, Deductions, Accounting, Gains and Losses, Cancellation of Indebtedness*, 66 HARV. L. REV. 761, 803-05 (1953).

9. 3A J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 21.01, at 10 (1977).

10. *Id.*

11. This concept has been explained as follows:

> The key which unlocks the door to understanding here is the general rule that both the taxpayer and the Commissioner are to be kept whole no matter how many transactions and permutations occur. Gain is in the end to be completely taxed once, but only once. Conversely, loss in the end is to be completely deducted (apart from artificial statutory limitations) once, but not more than once.

3A J. MERTENS, *supra* note 9, § 21.01, at 10-11 (footnote omitted).

12. *See generally* Lischer, *Depreciation Policy: Whither Thou Goest*, 32 SW. L.J. 545, 571-73 (1978).

der to assure that the taxpayer may not take credit for the same return of capital twice, the Code requires that the taxpayer adjust the basis of the asset downward in an amount equal to the depreciation allowable.[13]

If a cash transaction is involved, a purchaser's cost basis in property is simply the amount of cash paid for the property; the amount realized on its sale is the amount of cash received. If the taxpayer acquires property either by means of a purchase-money mortgage or by assumption of existing liabilities, his cost basis in the property includes the amount of that indebtedness and is not limited to the taxpayer's equity therein.[14] As the taxpayer is personally liable for the indebtedness, it is a very real part of his cost for the property even though the entire purchase price will not be paid until some future date.[15]

The amount of the taxpayer's recourse liabilities also is included as an amount realized on the subsequent disposition of the encumbered property.[16] When a purchaser assumes or takes subject to a mortgage for which the seller was personally liable, the seller is in roughly the same position as if the purchaser had paid the seller for the full value of the property in cash and the seller in turn had paid the mortgagee.[17] The seller therefore has realized an economic benefit in the amount of the mortgage, and the amount of the mortgage properly is considered as an amount realized. When property is encumbered by a nonrecourse mortgage, however, the propriety of including the amount of the mortgage either in the cost basis of the property or in the amount realized on disposition of the property is less certain. The leading judicial treatment of this issue is the United States Supreme Court decision of *Crane v. Commissioner*.[18]

B. *Crane v. Commissioner*

In *Crane* the taxpayer inherited an apartment building subject to a mortgage that secured a principal debt of $255,000 and unpaid interest of $7,042.50. Pursuant to an agreement with the mortgagee, the taxpayer, Mrs. Crane, continued to manage the property and pay all expenses. For seven years, Mrs. Crane claimed deductions for taxes, operating expenses, interest, and depreciation. Despite her efforts, the interest due doubled and the mortgagee threatened foreclosure. Consequently, Mrs. Crane sold the building to a third party, who took the property subject to the mortgage and paid $3,000 cash, including selling expenses of $500. Mrs. Crane reported a taxable gain of $1,250, reasoning that her basis in the property was zero, that the amount she realized was $2,500, and that half of this

13. I.R.C. § 1016(a)(2).

14. 3A J. MERTENS, *supra* note 9, § 21.11, at 41. For a general discussion of the inclusion of indebtedness in cost basis, see Landis, *Liabilities and Purchase Price*, 27 TAX LAW. 67 (1973).

15. 3A J. MERTENS, *supra* note 9, § 21.11, at 41.

16. United States v. Hendler, 303 U.S. 564, 566 (1938). *See also* Adams v. Commissioner, 58 T.C. 41, 64 (1972).

17. *Id.; see* note 42 *infra*.

18. 331 U.S. 1 (1947).

amount was taxable income because the property sold was a capital asset. The Commissioner, however, computed Mrs. Crane's gain to be $23,767.03. This figure was based on an adjusted basis that included the full value of the property inherited and an amount realized that included the full amount of the indebtedness. The Supreme Court upheld the Commissioner's assessment.[19]

Basis. Under section 113(a)(5) of the Revenue Act of 1938,[20] Mrs. Crane's basis was the fair market value of the property she inherited. For federal estate tax purposes, Mrs. Crane's property had been valued at $262,042.50, equal to the amount of the mortgage debt plus the unpaid interest.[21] To determine the fair market value of the property, the Court found it necessary to define the word "property" for purposes of applying the Revenue Act. Mrs. Crane argued that her inheritance had no net value because her equity in the property was zero. She insisted, therefore, that the fair market value of her property was zero and consequently the basis in her inheritance was zero. Thus, Mrs. Crane computed her gain to be $2,500, the difference between a zero basis and $2,500 net cash received on the transfer. The Court rejected this contention, concluding that the fair market value of the property she inherited was the value of the land and buildings themselves undiminished by mortgages, and not the value of the equity therein.[22]

The Court discussed three reasons by which it arrived at its holding. The Court first determined that "property" is either the physical asset that is the subject of ownership or the sum of the owner's rights to control and dispose of the asset.[23] Secondly, the Court noted that the regulations required that the value of inherited property be determined without regard to any mortgage indebtedness attached to the property.[24] Finally, and most importantly, the Court emphasized that a conclusion that "property" meant equity would have a devastating effect on the depreciation deduction.[25] The Court noted that the Revenue Act required that the basis from which the depreciation deduction is allowed be identical to the basis used to calculate gain or loss on the sale of property. Thus, the Court concluded that if the basis were limited to Mrs. Crane's equity, the annual allowance for depreciation also would have to be calculated with regard to an equity

19. *Id.* at 14.

20. Pub. L. No. 75-554, § 113(a), 52 Stat. 447, 490 (1938) provided that the basis of property acquired from a decedent is the fair market value of the property. Presently, I.R.C. § 1014 provides the same treatment.

21. 331 U.S. at 6.

22. *Id.* at 11; *accord,* Commissioner v. Fortee Properties, Inc., 211 F.2d 915 (2d Cir. 1954).

23. 331 U.S. at 6. The Court stated that the words of the Revenue Act should be given their ordinary and everyday meaning and thus used the dictionary definition of the word "property." *Id.*

24. *Id.* at 7.

25. *Id.* at 9. For a further discussion of the depreciation deductions in I.R.C. § 167, see text at notes 12 & 13 *supra.*

basis,[26] and consequently, the amount of the deductions would not reflect the corresponding physical exhaustion of the property.[27] Additionally, the taxpayer would be able to control the timing of his deductions by changing his equity in the property.[28] Furthermore, the Court noted that even if the Revenue Act allowed the depreciation deductions to be calculated with reference to the value of the property and then subtracted from the taxpayer's equity therein,[29] a negative basis could result, a concept the Court found objectionable.[30] Finally, the Court found that the administrative burden that would result from the use of an equity basis would be unacceptable.[31]

The fact that the Court found the fair market value of the property to be exactly equal to the mortgage indebtedness is a coincidence that should not lead one to conclude that *Crane* stands for the proposition that mort-

26. 331 U.S. at 9 n.26.

27. *Id.* at 9.

28. *Id.* at 10. It is a fundamental principle of the tax law that a taxpayer will not be allowed to manipulate the timing of his depreciation deductions. *See* Commissioner v. Kennedy Laundry Co., 133 F.2d 660 (7th Cir.), *cert. denied*, 319 U.S. 770 (1943). In furtherance of this objective, the Code requires that basis be reduced by the amount of depreciation allowable, whether or not it is taken. I.R.C. § 1016.

29. 331 U.S. at 9 n.26.

30. The Tax Court also has rejected the notion of a negative basis. Beulah B. Crane, 3 T.C. 585, 591 (1944). Congressional disapproval of a negative basis can be found in I.R.C. § 362(c)(2). *See also* Treas. Reg. § 1.362-2(b) (1955). Nevertheless, some support for the concept of a negative basis can be found in Easson v. Commissioner, 294 F.2d 653 (9th Cir. 1961), and in Judge Magruder's concurring opinion in Parker v. Delaney, 186 F.2d 455, 459-60 (1st Cir. 1950), *cert. denied*, 341 U.S. 926 (1951). In *Parker* the taxpayer acquired property subject to an unassumed mortgage of $273,000 with no capital investment. Under the *Crane* doctrine, $273,000 was used as the basis from which depreciation in the amount of $45,000 was taken. During his ownership, the taxpayer paid $14,000 on the principal. Thus, the unpaid balance of the debt was $259,000 when the property was abandoned to the mortgagee. The taxpayer's adjusted basis at the time of the transfer was $228,000. The court held that the unpaid balance of the mortgage was an amount realized under *Crane* and found the taxpayer had realized gain in the amount of $31,000.

Judge Magruder reached the same result through the use of an equity basis. By excluding the unpaid portion of the debt from cost basis, the original basis was limited to the $14,000 paid toward satisfaction of the mortgage. Exclusion of the debt from the amount realized limited the amount realized to zero. Judge Magruder reasoned that because the taxpayer received no cash consideration on the transfer of the property, he had not realized any amount under I.R.C. § 1001(b). The difference between the majority's computations and Judge Magruder's can be shown as follows:

	Majority	Magruder
Original Cost	$273,000	-0-
Addition to Basis	-0-	$14,000
Depreciation Allowed	$45,000	$45,000
Adjusted Basis	$228,000	($31,000)
Amount Realized	$259,000	-0-
Gain Recognized	$31,000	$31,000

M. CHIRELSTEIN, FEDERAL INCOME TAXATION—A LAW STUDENT'S GUIDE TO THE LEADING CASES AND CONCEPTS ¶ 13.01 (2d ed. 1979). For further discussion of the concept of a negative basis, see generally Cooper, *Negative Basis*, 75 HARV. L. REV. 1352 (1962).

31. 331 U.S. at 10. Taking the mortgagor's equity as the basis would require the basis to be changed with each payment on the mortgage. This would result in repeated basis and allowance calculations.

gage indebtedness is automatically included in basis. *Crane* in fact states that mortgage indebtedness is *not* a factor in determining basis.[32] Basis, whether cost basis or fair market value basis, is determined as an amount undiminished by any nonrecourse indebtedness to which the property is subject.[33] By way of example, had Mrs. Crane inherited property with a value less than the amount of the nonrecourse indebtedness, the Court properly would have given her a basis equal to the fair market value of the property only.[34]

Amount Realized. Following the literal language of section 111(b) of the Revenue Act of 1938,[35] Mrs. Crane argued that the only money she received, and therefore the only amount realized, was the $2,500 cash paid by the buyer. The Court disagreed with Mrs. Crane's analysis, stating that limiting her amount realized to the actual cash received would result in "the absurdity that [Mrs. Crane] sold a quarter-of-a-million dollar property for roughly one per cent of its value, and took a 99 per cent loss."[36] The Court emphasized that the amount realized provision could not be construed so as to "frustrate the Act as a whole,"[37] and held that the amount realized was not limited to the $2,500 cash received, but included the amount of the mortgage as well.[38] The Court noted that prior judicial decisions had established the general rule that amount realized is not limited to the actual receipt of money or other property, but also encompasses the receipt of any economic benefit accruing to a taxpayer.[39] Specifically,

32. *Id.* at 11.

33. *E.g.*, Gibson Prods. Co. v. United States, 460 F. Supp. 1109 (N.D. Tex. 1978). In *Gibson Products* the court stated, "[T]he *Crane* doctrine does not establish an 'iron-clad guarantee' that all nonrecourse liabilities may be included in a taxpayer's cost basis." *Id.* at 1119. *But see* Brountas v. Commissioner, [1980] DAILY TAX REP. (BNA) No. 2, H-1, H-13 (T.C. Jan. 3, 1980) (seemingly advancing an iron-clad rule that when nonrecourse indebtedness is included in amount realized, it is also included automatically in cost basis in order to maintain symmetry between the basis and amount realized provisions of the Code).

34. *Accord*, Adams, *Exploring the Outer Boundaries of the Crane Doctrine: An Imaginary Supreme Court Opinion*, 21 TAX. L. REV. 159, 165 (1966).

35. The Revenue Act of 1938, Pub. L. No. 75-554, § 111(b), 52 Stat. 447, 484 contains the same amount realized provision as is now embodied in I.R.C. § 1001(b). The statutory language appears at note 1 *supra*.

36. 331 U.S. at 13.

37. *Id.*

38. *Id.*

39. *Id. E.g.*, United States v. Hendler, 303 U.S. 564, 566 (1938) (assumption and payment of corporation's bonded indebtedness is tantamount to the receipt of cash and as such is to be treated an income); Haass v. Commissioner, 37 B.T.A. 948, 955 (1938) (assumption of indebtedness will be regarded as the receipt of "other property or money," expressly following Brons Hotels, Inc., 34 B.T.A. 376 (1936)); Brons Hotels, Inc. v. Commissioner, 34 B.T.A. 376, 379, 381 (1936) (faced with the challenge that the assumption of indebtedness was not "money" or "other property" within the amount realized provision of the Code, the Board of Tax Appeals found that a taxpayer who has been relieved of a debt that has been used as part of cost basis should be deemed to have received a cash equivalent when the debt passes to the transferee). *See also* Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 729 (1929) (payment by employer of employee's income taxes is income to the employee); United States v. Boston & Maine R.R., 279 U.S. 732, 734 (1929) (payment of lessor's income taxes according to lease agreement is income to lessor); *cf.* Douglas v. Willcuts, 296 U.S. 1, 8 (1935) (alimony payments are not income but are paid in discharge of the general obligation to support).

the Court cited *United States v. Hendler*,[40] which held that the assumption of a recourse debt by another was equivalent to the receipt of cash by the taxpayer.[41] The *Hendler* decision rested on the theory that on the transfer of encumbered property the transferor realizes a benefit "as real and substantial as if the money had been paid it and then paid over by it to its creditors."[42] Mrs. Crane conceded that, on the authority of *Hendler*, if her transferee had taken the property subject to a mortgage for which she was personally liable, she would have benefitted and realized the full amount of the indebtedness. Nevertheless, Mrs. Crane asserted that she did not receive the same benefit as described in *Hendler* because her transferee had taken the property subject to a mortgage for which she was not personally liable. The Court disagreed and sought to define the benefit Mrs. Crane had realized. The Court reasoned that the economic realities of the circumstances required the conclusion that a mortgagor holding property valued at a figure equal to or greater than the amount of the mortgage the property secures must treat the debt as though it were a personal obligation.[43] By this analysis, the Court equated recourse with nonrecourse indebtedness.[44]

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40. 303 U.S. 564 (1938).

41. *Id.* at 566. The *Hendler* doctrine is now embodied in I.R.C. §§ 357(c), 358(d), 1031(d).

42. 303 U.S. 564, 566 (1938). Actually, if the buyer assumes the debt, the seller remains primarily liable on the debt and has an action over against the buyer unless the lender has accepted the assignment. If the buyer takes the property subject to the debt, the seller likewise remains personally liable, and is subrogated to the lender's right to foreclose against the secured property. Thus, the benefit to the seller may not be strictly identical to the situation where the buyer has transferred cash. In most cases, however, the result will be roughly the same. *See* Bittker, *supra* note 6, at 278.

43. 331 U.S. at 14. Professor Bittker suggests that the Court's treatment of the nonrecourse liability as a personal obligation for the purposes of determining gain on the transfer of property is in accord with the economic reality of the specific fact situation before the Court. Bittker, *supra* note 6, at 282. Bittker suggests that individuals with no assets other than mortgaged property will see little distinction between recourse and nonrecourse financing. *Id.* These individuals are more than likely unconcerned with the tax sheltering aspects of nonrecourse financing as they have no other assets to shelter. For a discussion of the tax sheltering aspects of nonrecourse financing, see section II *infra*.

44. 331 U.S. at 14. In concluding that Mrs. Crane would treat the liability as a personal obligation, the Court noted, for example, that she had treated the gross rentals from the apartment building as income to her, used the money to pay the interest on the indebtedness, and then taken a deduction for the interest paid. *Id.* at 14 n.38. The Court was correct in concluding that a mortgagor will treat the indebtedness as personal to him for the purposes of obtaining available tax deductions. Nevertheless, it may be incorrect to assume further that all mortgagors will treat a nonrecourse indebtedness as a personal obligation for all purposes. Most commentators interpret the Court's reasoning to mean that all mortgagors holding property with a value at least equal to the indebtedness will have the same incentive to satisfy the debt as the Court identified Mrs. Crane as having. *See, e.g.*, Adams, *supra* note 34, at 165; Del Cotto, *Basis and Amount Realized Under Crane: A Current View of Some Tax Effects in Mortgage Financing*, 118 U. PA. L. REV. 69, 75 (1969). *But see* Adams, *supra* note 34, at 175, in which the author suggests that the Court was "sadly misled" in this assumption; Bittker, *supra* note 6, at 281. It is correct to conclude that an individual who has not sought nonrecourse financing primarily for the tax sheltering benefits it affords will treat the obligation as a personal one. *See* note 43 *supra*. When applied to the sophisticated investor seeking the tax sheltering aspects of nonrecourse financing, however, such reasoning ignores the economic realities of the situation. The availability of depreciation deductions without actual investment, *see* note 62 *infra*, and the availability of the interest deduction, *see* I.R.C.

The Court's conclusion that a mortgagor holding property with a fair market value at least equal to the nonrecourse indebtedness will treat that obligation as a personal one in all cases may be questionable in light of economic realities. It is nevertheless apparent that this fiction was essential to the Court's determination that Mrs. Crane had realized an amount that included the amount of the nonrecourse indebtedness.[45] The Court could have relied solely on the proposition that equity and the necessary symmetrical relationship between basis and amount realized supported the inclusion of nonrecourse debt in amount realized when the debt has been included in basis. The opinion strongly suggests, however, that the presence of an economic benefit that can be equated with the receipt of cash or property is necessary to justify the inclusion of an item as an amount realized.[46]

The importance of an actual economic benefit to the determination of amount realized is further evidenced in the opinion's famous footnote 37,[47] in which 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. That is not this case.[48]

The Court thus recognized that its analysis focusing on the economic benefit to the taxpayer will not support the inclusion of the full amount of nonrecourse indebtedness as an amount realized when the value of the

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§ 163, are the main concerns of the tax shelter seeking investor. Indeed, this may be the mortgagor's only interest in the property, and he may have no incentive whatsoever to satisfy the debt. In fact, it is highly probable that when the interest and depreciation deductions are no longer adequate to shelter the outside ordinary income of the taxpayer-mortgagor, he will merely allow the property to be repossessed and invest again in another tax sheltering venture. Many times even the mortgagee does not expect the debt to be repaid. Assuming the mortgagee is a commercial lender, its interest in the investment lies in the rate of return it will receive from the interest charged. Repayment of the debt is of no concern to the lender as long as the value of the securing asset remains at least equal to the amount of the indebtedness. The lender can readily foreclose and get its investment back. Professor Bittker appears to have reached a similar conclusion:

> The Court was, of course, right in asserting that the owner of mortgaged property must keep up the payments if he wants to retain the property and that *for this period of time*, he must treat the debt as a personal obligation whether he is personally liable or not. It does not follow, however, that the benefit to him from transferring the property subject to the mortgage is the same in both cases.

Bittker, *supra* note 6, at 281 (emphasis in original).

45. *See* Adams, *supra* note 34, at 169 (concluding that the *Crane* Court found the receipt of an economic benefit essential); *cf.* Del Cotto, *supra* note 44, at 84 (concluding that the economic benefit reasoning was not essential to the decision).

46. *Cf.* Brountas v. Commissioner, [1980] DAILY TAX REP. (BNA) No. 2, H-1, H-13 (T.C. Jan. 3, 1980) (concluding that the *Crane* doctrine is basically a symmetrical one).

47. Footnote 37 has been labeled the most famous footnote in tax history. Halpern, *Footnote 37 and the Crane Case: The Problem that Never Really Was*, 6 J. REAL EST. TAX. 197, 199 (1979); Bittker, *supra* note 6, at 277.

48. 331 U.S. at 14 n.37.

property is less than the nonrecourse mortgage.[49] As the mortgagee cannot reach the taxpayer's personal holdings to satisfy the debt, the taxpayer is freed from liability on the transfer of the property and thereby realizes an economic benefit, but only to the extent of the fair market value of the property.[50] The amount of the indebtedness in excess of the property's fair market value thus may not be considered an amount realized.[51]

Despite the Court's strong reliance on the economic benefit theory, the Court did indicate a possible alternative basis for its holding:

> The crux of this case, really, is whether the law permits [Mrs. Crane] to exclude allowable deductions from consideration in computing gain. We have already showed that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets. The Sixteenth Amendment does not require that result any more than does the Act itself.[52]

49. Most commentators agree. *See, e.g.*, Adams, *supra* note 34, at 169; Bittker, *supra* note 6, at 283-84; Del Cotto, *Sales and Other Dispositions of Property Under Section 1001: The Taxable Event, Amount Realized, and Related Problems of Basis*, 26 BUFFALO L. REV. 219, 318 (1977); Del Cotto, *supra* note 44, at 85; Ginsburg, *The Leaky Tax Shelter*, 53 TAXES 719, 731 (1975); Halpern, *supra* note 47, at 216; Handler, *Tax Consequences of Mortgage Foreclosures and Transfers of Real Property to the Mortgagee*, 31 TAX L. REV. 193, 226 (1976); Lurie, *Mortgages with "Negative Equities" and "Negative Bases"*, 10 N.Y.U. INST. FED. TAX. 71, 86 (1952); McGuire, *Tax Shelter Partnerships—Liabilities in Excess of Basis*, 36 N.Y.U. INST. FED. TAX. 1443, 1468-69 (1978). A taxpayer holding property worth less than the amount of the financing thereon in fact has incentive to abandon the property rather than satisfy the debt. Default is, however, not entirely without consequence to the taxpayer. A default on a nonrecourse loan can do severe harm to a taxpayer's credit rating and reputation, and thus there may indeed by an incentive to satisfy the mortgage. It is generally agreed, however, that the requisite incentive to satisfy the debt obligation is lacking, and thus it is economically unrealistic to include anything above the fair market value of the property as an amount realized.

50. *See* Del Cotto, *supra* note 44, at 85.

51. There is some case support for limiting the amount realized to the fair market value of the property. *See* Leland S. Collins, 22 T.C.M. (CCH) 1467 (1963) (holding income is limited to the amount of a debtor's assets that are freed by the debt cancellation; therefore, the amount of the indebtedness released, or the fair market value of the underlying security, is the proper measure of the amount realized). *Collins*, however, deals only with cancellation of indebtedness income, not with gain realized on the transfer of property. A recent case, Estate of Delman v. Commissioner, [1979] TAX CT. REP. (CCH) (73 T.C.) Dec. 36,380, holds that the cancellation of indebtedness theory does not apply to the transfer of nonrecourse financed property. *See* note 122 *infra* and accompanying text.

52. 331 U.S. at 15-16 (footnote omitted). U.S. CONST. amend. XVI provides: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." There is no settled definition of income. I.R.C. § 61 simply states that "gross income means all income from whatever source derived." Several more precise definitions of income have been advanced. In Eisner v. Macomber, 252 U.S. 189, 207 (1920), the Court characterized income as "the gain derived from capital, from labor, or from both combined." In a subsequent case, Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955), income was defined as "accessions to wealth." The concept of income is perhaps more easily understood as encompassing any "economic benefit." W. ANDREWS, BASIC FEDERAL INCOME TAXATION 39 (1979). It is generally agreed that the receipt of an economic benefit is a prerequisite to a finding that a taxpayer has received income and thus has realized this amount. *See id.*; Adams, *supra* note 34, at 169. Mrs. Crane contended that the Court was attempting to tax her on an amount not properly considered income under the sixteenth amendment because she realized no economic benefit on the transfer of her property. 331 U.S. at 15. Mrs. Crane's theory finds support in Adams, *supra* note 34, at 181.

This language implies that the Court was concerned largely with the tax equities underlying the transaction. The Court had noted previously that limiting the amount realized to the cash received while allowing a basis that includes the nonrecourse liability would cause the absurd result that Mrs. Crane had realized a ninety-nine per cent loss.[53] Because she had computed depreciation deductions with reference to the full fair market value of the property, the double deduction referred to in the quoted language would occur if Mrs. Crane's basis did not include the nonrecourse liability. If her basis were zero, as she claimed, the amount of these deductions could not reduce her basis without producing a negative basis. Therefore, unless a negative basis could be tolerated,[54] she would be able to account for her return of capital both by current deduction and on final disposition.[55]

The Court's criticism of the possibility of a double deduction indicates that the Court recognized the practical need to prevent double accounting of a return of capital. It is doubtful, however, that the Court found such practical needs sufficient in themselves to justify alteration of the statutory definition of amount realized. Rather, it is apparent that the Court interpreted the Revenue Act to require a finding of economic benefit before an amount could be realized, a requirement the Court satisfied when it concluded that the same economic benefit results from the transfer of nonrecourse-financed property as accrues from the transfer of recourse-financed property. Thus, it can be concluded fairly that the Court's economic benefit approach is more than a mere "balancing entry" to obtain the desired result.[56] Rather, the Court found the existence of an economic benefit a prerequisite to realization.[57]

II. THE NONRECOURSE TAX SHELTER AND FOOTNOTE 37

The *Crane* rule laid the foundation for one of the most notable tax shelters presently available to the investor.[58] Cases decided subsequent to

53. 331 U.S. at 13.

54. *See* note 30 *supra* and accompanying text.

55. The double deduction was first referred to by Judge Learned Hand in the circuit court of appeals decision. Commissioner v. Crane, 153 F.2d 504, 505 (2d Cir. 1945).

56. *See* Bittker, *supra* note 6, at 282, 284. Bittker suggests that the economic benefit theory is "wholly fallacious" and "can be justified only if the amount realized by a taxpayer who disposes of property encumbered by nonrecourse debt in excess of its basis is viewed as a balancing entry, which brings the tax results into conformity with economic reality." *Id.* at 284. *See also* Brountas v. Commissioner, [1980] DAILY TAX REP. (BNA) No. 2, H-1, H-13 (T.C. Jan. 3, 1980), in which the court stated, "The Crane doctrine is basically a symmetrical one—a taxpayer includes nonrecourse liabilities in his basis, but must also include such liabilities in the amount he realizes upon dispositions of the encumbered property."

57. Realization is a statutory prerequisite to taxation, Eisner v. Macomber, 252 U.S. 189, 207 (1920), and is considered by some to be a constitutional prerequisite as well. *See* Mullock, *The Constitutional Aspects of Realization*, 31 U. PITT. L. REV. 615, 616 (1970); *cf.* Lowndes, *Current Conceptions of Taxable Income*, 25 OHIO ST. L.J. 151, 172 (1964) (concluding realization probably is not constitutionally required). *See also* note 52 *supra*.

58. The function of a tax shelter is the creation of tax deductions that can be taken not only against the income produced by the tax sheltered investment but also against other unrelated income. The investment form most frequently used to construct the tax shelter is

Crane expanded the *Crane* basis rule to include nonrecourse liabilities in a taxpayer's *cost* basis under Code section 1012.[59] Even though nonrecourse financing does not represent an actual cost to the taxpayer, these cases have justified inclusion of the nonrecourse debt in cost basis at least partially on the assumption that as long as the value of the securing asset equals or exceeds the encumbrance, the taxpayer will eventually make a capital investment in the amount of the indebtedness in order to retain the secured property.[60] The tax shelter arises because the inclusion of nonrecourse liabilities in cost basis of depreciable property will often result in a taxpayer's being allowed depreciation deductions[61] in excess of his actual cash investment.[62] These depreciation deductions can be used to offset or-

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the limited partnership. For a discussion of the benefits of the limited partnership and an introduction to tax shelters generally, see Wiesner, *Tax Shelters—A Survey of the Impact of the Tax Reform Act of 1976*, 33 TAX L. REV. 5 (1977).

59. *See, e.g.*, Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950), *cert. denied*, 341 U.S. 926 (1951); Mayerson v. Commissioner, 47 T.C. 340 (1966), *acq.* 1969-1 C.B. 21; Blackstone Theatre Co. v. Commissioner, 12 T.C. 801 (1949), *acq.* 1949-2 C.B. 1. For a discussion of the propriety of the inclusion of nonrecourse indebtedness in cost basis, see Del Cotto, *supra* note 44, at 71-76.

The *Crane* doctrine originally applied to sales of property. Parker v. Delaney, 186 F.2d 455, 458-59 (1st Cir. 1950), extended the application of the doctrine to the disposition of property by abandonment. *Cf.* Commissioner v. Crane, 153 F.2d 504, 505 (2d Cir. 1945) (abandonment of property not a taxable event). Estate of Delman v. Commissioner, [1979] TAX CT. REP. (CCH) (73 T.C.) Dec. 36,380, extends the *Crane* doctrine to the repossession of mortgaged property. For a discussion of the application of the *Crane* doctrine to dispositions by gift and transfers at death, see Del Cotto, *supra* note 44, at 89-95. In addition, *Crane* involved a voluntary sale. A division of authority exists on the question of whether payments to the mortgagee of condemned property are includable as an amount realized by the seller on an involuntary sale. *See* Commissioner v. Fortee Properties, Inc., 211 F.2d 915, 916 (2d Cir. 1954) (condemnation award to mortgagee not a recognizable gain to owner of condemned property), *aff'd*, 259 F.2d 689 (9th Cir. 1958).

60. Mayerson v. Commissioner, 47 T.C. 340, 351-52 (1966), *acq.* 1969-1 C.B. 21. In *Mayerson* the court stated:

> The element of the lack of personal liability has little real significance due to common business practices. . . . Taxpayers who are not personally liable for encumbrances on property should be allowed depreciation deductions affording competitive equality with taxpayers who are personally liable for encumbrances or taxpayers who own unencumbered property. The effect of such a policy is to give the taxpayer an advance credit for the amount of the mortgage. This appears to be reasonable since it can be assumed that a capital investment in the amount of the mortgage will eventually occur despite the absence of personal liability.

One recent case concludes that because nonrecourse indebtedness will be included as an amount realized on the disposition of the encumbered property, *e.g.*, Tufts v. Commissioner, 70 T.C. 756 (1978), *appeal docketed*, No. 79-2258 (5th Cir. Apr. 23, 1979), it must also be included in cost basis, regardless of the fair market value of the securing property. Brountas v. Commissioner, [1980] DAILY TAX REP. (BNA) No. 2, H-1, H-13 (T.C. Jan. 3, 1980). For a further discussion of *Tufts* and related cases, see section III *infra*.

61. The depreciation deduction is found in I.R.C. § 167. An annual deduction is allowed for the wear, tear, and physical exhaustion of business or investment properties. The purpose of the deduction is not to measure the actual physical exhaustion of the asset. Rather, the deduction is designed to allow the taxpayer to recoup his original investment over the period of the useful life of the asset. *See generally* J. CHOMMIE, FEDERAL INCOME TAXATION § 62 (2d ed. 1973).

62. This feature is the key to the working of any tax shelter. Typically, the taxpayer borrows a substantial amount of the capital needed to purchase the investment. This use of borrowed funds is called leverage. Under *Crane* and subsequent decisions borrowed funds

dinary rental income from the property, and if there is an excess, to shelter the taxpayer's other outside ordinary income. The result is magnified if accelerated depreciation is available.[63] The taxpayer has an additional advantage in that the sale of investment property will generally result in capital gain.[64] Since the depreciation deductions originally reduced the taxpayer's ordinary income, the taxpayer has effectively converted ordinary income into capital gain.[65]

Application of the amount realized portion of the *Crane* holding substantially eliminates the tax advantage of nonrecourse financing by including the amount of depreciation deductions taken in excess of actual investment as gain on the property's subsequent disposition. This result is demonstrated by a hypothetical investment involving the following figures:

Cost Basis	$100x	(100% nonrecourse financing)
Fair Market Value	$100x	
Adjusted Basis	$60x	
Cash Received on Disposition	$10x	
Amount Realized	$110x	

In this example, the taxpayer has acquired property with no actual cash investment. Under *Crane* his basis includes the $100x nonrecourse financing. Assume the taxpayer takes $40x depreciation over the course of two years. If he has not yet begun to amortize the mortgage, deductions exceed investment by $40x. The taxpayer then sells the property to a buyer who pays $10x cash boot and takes the property subject to the mortgage. *Crane* requires the amount realized to be $110x: the $10x cash boot plus the $100x indebtedness. The taxpayer's gain is then $50x; $10x represents the cash received, and $40x equals the amount of depreciation taken over investment. The amount claimed as depreciation in excess of investment has thus been effectively recaptured as gain. Although the taxpayer may have realized substantial tax advantages by the deferral of gain recognition[66]

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are included as part of the taxpayer's cost basis. *See* note 59 *supra* and accompanying text. From this basis the annual depreciation deduction is taken. I.R.C. § 167. If the property is heavily leveraged, the allowable depreciation is likely to exceed the taxpayer's actual cash contribution. Thus, the more heavily leveraged the asset is, the greater the benefit of the tax shelter. Deferral of the recognition of income is also a benefit of a tax shelter. Because the shelter results in substantial losses during the initial years, income realized during these years will be sheltered from taxation. For a general discussion of the leverage and deferral aspects of a tax shelter, see Wiesner, *supra* note 58, at 6.

Congressional reaction to tax shelters is evidenced in I.R.C. § 465, which limits the amount of loss and depreciation deductions available to a taxpayer to the amount at which the taxpayer is at risk. A taxpayer is not considered at risk with respect to nonrecourse financing. I.R.C. § 465(b)(4). I.R.C. § 465(c)(3)(D)(i), however, expressly excludes real estate investments from the at-risk limitation, leaving such investments the only area where depreciation can be taken without regard to the at-risk limitation. For a general discussion of the workings of I.R.C. § 465, see Collins & Doliner, *The "At Risk" Provisions: The Internal Revenue Code's New Double Basis Concept*, 30 U. FLA. L. REV. 185, 200 (1977).

63. I.R.C. § 167(b)(2).

64. I.R.C. § 1231.

65. The benefit of the conversion of ordinary income into capital gain for § 1231 property is limited, however, by the recapture provisions of I.R.C. §§ 1245 & 1250.

66. *See* note 62 *supra*.

and the possible conversion of ordinary income into capital gain,[67] inclusion of the amount of the nonrecourse indebtedness as an amount realized assures at least a partial recoupment of the earlier deductions taken in excess of investment. Recapture of the excess deductions results whether (a) the inclusion of the nonrecourse indebtedness is justified under the economic benefit theory applied in *Crane* or (b) simply by recognizing that tax equity requires a balancing entry adjustment to amount realized to achieve the desired result.

The choice of approach does make a difference when the value of the transferred property has fallen below the face amount of the nonrecourse mortgage. The economic benefit analysis has been criticized because it does not produce a satisfactory result in this situation.[68] Emphasis on the tax equity approach would require that the full amount of the mortgage be included as an amount realized in order to recapture the full extent of past depreciation deductions taken in excess of economic investment. The difference in approach can be illustrated by the following figures:

	Economic Benefit	Tax Equity
Cost Basis	$100x	$100x
Fair Market Value	$ 50x	$ 50x
Adjusted Basis	$ 60x	$ 60x
Cash Received on Disposition	-0-	-0-
Amount Realized	$ 50x	$100x
Gain/Loss	($10x)	$40x

Using the economic benefit approach, the gain on disposition is computed as the difference between the adjusted basis, $60x, and the amount realized, $50x. Thus, use of the fair market value as the maximum limit on the amount realized results in a loss of $10x. Since the taxpayer has taken $40x in depreciation deductions on a zero cash investment and can claim a loss of $10x on disposition, the taxpayer has received a double deduction resulting in a clear windfall. In contrast, the tax equity approach results in a gain of $40x, or the differences between the adjusted basis, $60x, and the unpaid balance of the nonrecourse indebtedness, $100x. Recognition of the functional relation between basis and amount realized thus recaptures the $40x previously claimed as depreciation and prevents the recognition of a loss. This is clearly the more equitable and reasonable result.

Taxpayers in recent cases have argued that the *Crane* decision rests solely on the economic benefit theory and that footnote 37 requires the amount realized to be limited to the fair market value of property transferred when the value of the property is less than the mortgage it secures.[69]

67. *See* note 65 *supra* and accompanying text.

68. A strong criticism of the economic benefit theory appears in Bittker, *supra* note 6, at 284 n.14, in which he states, "[I]n my view, the economic benefit theory should be rejected as wholly fallacious, in order to make way for a more comprehensive balancing entry theory." In commenting on the Court's theoretical misuse of the economic benefit theory, Bittker states, "Since taxpayers cannot benefit from being 'relieved' of liabilities for which they are not liable, the contrary theory of *Crane* was bound, as footnote 37 demonstrates, to generate anomalies." *Id.* at 284.

69. Millar v. Commissioner, 577 F.2d 212 (3d Cir.), *cert. denied*, 439 U.S. 1046 (1978);

The courts, however, have consistently held otherwise. In *Millar v. Commissioner*[70] and *Tufts v. Commissioner*[71] the courts rejected footnote 37 as a limitation on the amount realized and included the unpaid balance of the mortgage indebtedness as an amount realized using a theory of tax benefit. The most current decision, *Estate of Delman v. Commissioner*,[72] expressly affirms the holdings of *Millar* and *Tufts*.

III. POST-CRANE DECISIONS

Millar v. Commissioner[73] was the first case to address directly the issue presented in footnote 37. In *Millar* the taxpayers were shareholders of a subchapter S corporation engaged in strip-mining operations. To acquire $500,000 in working capital the taxpayers executed nonrecourse notes secured by their stock in the corporation. After contributing the $500,000 to the corporation, the taxpayers were entitled to a $500,000 basis.[74] The corporation suffered substantial operating losses, which along with investment tax credits and interest payments on the notes, were reflected in downward adjustments to the taxpayers' bases. The strip-mining venture subsequently failed, rendering the stock in the corporation worthless. When the taxpayers defaulted on the note payments, the holder of the notes foreclosed and acquired the stock. The United States Court of Appeals for the Third Circuit held that on the authority of *Crane* the taxpayers realized a gain on the transfer of the stock, computed as the difference between the adjusted basis of the stock ($40,000) and the unpaid balance of the nonrecourse notes ($245,000).[75] The court justified this result by emphasizing the tax advantage the taxpayers realized by including the amount of the debt in the original basis of their stock.[76] Specifically, taxpayers had been allowed to take $205,000 in deductions against an original basis that included the full amount of a nonrecourse mortgage, upon which no payment had been made. Significantly, the court interpreted the tax equity analysis to be the "principal reasoning" of *Crane*[77] and emphasized that limiting the amount realized to the actual economic benefit realized by the taxpayers at the time the property was transferred would result in a windfall to the taxpayers.[78] The *Millar* holding thus effectively required the taxpayers to account for the inclusion in basis of a debt that later events indicated would not be repaid as an amount realized on a subsequent transfer.

Estate of Delman v. Commissioner, [1979] TAX. CT. REP. (73 T.C.) Dec. 36,380; Tufts v. Commissioner, 70 T.C. 756 (1978).

70. 577 F.2d 212, 215 (3d Cir. 1978), *cert. denied*, 439 U.S. 1046 (1978).
71. 70 T.C. 756, 766 (1978).
72. [1979] TAX CT. REP. (CCH) (73 T.C.) Dec. 36,380. *See also* Brountas v. Commissioner, [1980] DAILY TAX REP. No. 2, H-1 (T.C. Jan. 3, 1980).
73. 577 F.2d 212 (3d Cir.), *cert. denied*, 439 U.S. 1046 (1978).
74. I.R.C. § 1376(a).
75. 577 F.2d at 216.
76. *Id.*
77. *Id.* at 215.
78. *Id.*

Confronted with similar facts, the Tax Court, in *Tufts v. Commissioner*,[79] followed the holding and reasoning in *Millar*. In *Tufts* the taxpayers were general partners in a partnership that entered into a building loan agreement to finance construction of an apartment complex. The lender advanced the partnership $1,851,000 in exchange for a deed of trust and a note for which neither the partners nor the partnership assumed any personal liability. Under Code section 752,[80] the partners' bases included their proportionate share of the nonrecourse liability. From this basis each partner took his share of the loss and depreciation deductions, resulting in an adjusted basis of $1,455,740. Due to adverse economic conditions the venture failed, and each partner sold his interest to a third party. The buyer agreed to pay selling expenses up to $250 and took the apartment complex subject to the $1,851,000 mortgage. By this time, the fair market value of the complex had fallen to $1,400,000. Citing *Crane* and *Millar*, the Tax Court held that the partners realized the full $1,851,000.[81] Like *Millar*, the *Tufts* court concluded that the result was consistent with *Crane*, and rejected footnote 37 as a dictum.[82]

Although *Millar* and *Tufts* reached an equitable result and are in conformity with the tax equity language of *Crane*, their conclusion that the receipt of a prior tax advantage may constitute an amount realized on the disposition of property obscures the theoretical basis and statutory definition of amount realized. The statutory definition of amount realized encompasses only money or property received as consideration for the transfer of property.[83] Even decisions that have expanded the concept of amount realized beyond the literal receipt of money or property have found that the benefits realized have a substantially similar economic effect to the receipt of money or property from the transferee.[84] Furthermore, emphasis on the presence of an economic benefit as essential to the

79. 70 T.C. 756 (1978).

80. I.R.C. § 752. For a general discussion of I.R.C. § 752, see Epstein, *The Application of the Crane Doctrine to Limited Partnerships*, 45 S. CAL. L. REV. 100, 105 (1972); Perry, *Limited Partnerships and Tax Shelters: The Crane Rule Goes Public*, 27 TAX. L. REV. 525, 542 (1972).

81. 70 T.C. at 768-70.

82. In rejecting footnote 37, the *Millar* court stated,

> 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 . . . . Viewed in that perspective, we believe that the rationale of the Supreme Court's principal reasoning, analysis and holding in *Crane* is more clearly the measure by which the transaction *sub judice* should be decided.

577 F.2d at 215-16.

83. *See* note 1 *supra*.

84. United States v. Hendler, 303 U.S. 564 (1938), justified the inclusion of recourse liability assumed by a buyer as an amount realized by the seller on the theory that the economic effect was the same as if the buyer has provided the seller with cash to pay off the mortgage. *See* note 42 *supra* and accompanying text. Crane v. Commissioner, 331 U.S. 1 (1947), found that the transfer of property subject to a nonrecourse liability could result in an amount realized on the theory that a borrower would treat a nonrecourse liability as if he were personally liable on the debt; therefore, the reasoning of *Hendler* could be extended to the nonrecourse situation.

concept of amount realized is supported by the *Crane* opinion. Had the *Crane* Court been able to justify inclusion of Mrs. Crane's nonrecourse debt as an amount realized solely on the basis of tax equity, it would not have relied so heavily on the fiction that personal liability can be implied whenever the value of the securing asset is equal to or greater than the debt for which no personal liability in fact exists. The court further would not have created an exception to its rule—footnote 37.

Because of the refusal of courts to recognize that prior tax benefits are not within the scope of amount realized, taxpayers have advanced alternative arguments designed to circumvent the courts' disregard of the economic benefit theory. For example, in *Tufts* the taxpayers argued that if footnote 37 did not limit the amount realized to the fair market value of the property on the date of disposition, then Code section 752(c) did.[85] In general, section 752 pertains to the tax treatment of contributions by partners to the partnership, of distributions by the partnership to the partners, and of sales or exchanges of partnership interests. Under section 752(a) a partner's basis will increase as his share of the partnership liabilities increases. Conversely, section 752(b) requires a decrease in a partner's basis as his share of the partnership liabilities decreases. Section 752(c) provides that liabilities on partnership property will be included in the partner's basis only to the extent of the fair market value of the encumbered property. The taxpayers in *Tufts* argued that the fair market value limitation on basis in section 752(c) applied to the amount realized provision on sale of partnership interests under section 752(d), which provides that sales or exchanges of partnership interests will be given the same treatment as sales or exchanges of nonpartnership property. The court rejected this contention,[86] concluding that the legislative history[87] and the regulations[88] relating to section 752(c) were substantial evidence that section 752(d) was

85. 70 T.C. at 766. Section 752 provides:

§ 752. 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.

86. 70 T.C. at 767.

87. The legislative history of § 752 can be found in H.R. REP. No. 1337, 83d Cong., 2d Sess. A236 (1954) and S. REP. No. 1622, 83d Cong., 2d Sess. 405 (1954).

88. *See* Treas. Reg. § 1.752-1(c) (1960).

intended to operate independently of section 752(c).[89] Thus, the court held that section 752(c) applied only where a partner had contributed encumbered property to the partnership within section 752(a), or when the partnership had distributed encumbered property to the partner within section 752(b).[90]

The court also noted that section 752 is generally regarded as a codification of the *Crane* basis rule.[91] Reasoning that the taxpayer's interpretation of the interplay between subsections 752(c) and 752(d) would result in the type of double deduction *Crane* sought to prohibit, the court concluded that Congress could not have intended to codify *Crane* and at the same time legislate the very result *Crane* sought to prevent.[92] The court thus found that because section 752(d) treats the sale of partnership interests in the same manner as the sale of nonpartnership property, the amount realized must include the nonrecourse indebtedness on the authority of *Millar*.[93]

In the recent case of *Estate of Delman v. Commissioner*[94] the Tax Court examined the tax consequences of the repossession of equipment that had been purchased by nonrecourse financing. Taxpayers, general partners in Equipment Leasing Company (ELC), had organized ELC and National Teleproductions Corporation (NTP) for the purpose of acquiring a mobile television van and entering into the business of producing television programs. Under a sales contract for the purchase of the necessary equipment, NTP made a down payment and agreed to pay the balance of $1,284,612 in installments. NTP then entered into a sale-leaseback transaction with ELC, and ELC took the equipment subject to the nonrecourse debt. When ELC failed to make the payments on the balance due under the sales contract, the equipment was repossessed.

When the partnership acquired the equipment, the partners took a basis of $1,284,612. By the time the equipment was repossessed, the partners had taken allowable depreciation in the amount of $779,986.20, leaving them with an adjusted basis of $504,625.80. The balance due under the sales contract was $1,182,542.07, and the fair market value of the equipment had fallen to $400,000.

The taxpayers advanced three novel arguments to avoid the recognition of gain in the footnote 37 situation. The taxpayers first argued that section 111[95] precluded a finding that an amount had been realized under section

89. 70 T.C. at 767-69.

90. *Id.* at 769. The fair market value language of § 752(c) is also not a limitation on the determination of a partner's cost basis. Brountas v. Commissioner, [1980] DAILY TAX REP. (BNA) No. 2, H-1 (T.C. Jan. 3, 1980).

91. 70 T.C. at 767; *see* A. WILLIS, WILLIS ON PARTNERSHIP TAXATION 195 (1971); Perry, *supra* note 80, at 542.

92. 70 T.C. at 769.

93. *Id.* at 769-70.

94. [1979] TAX CT. REP. (CCH) (73 T.C.) Dec. 36,380, at 4064.

95. I.R.C. § 111 provides: "(a) *General Rule.*—Gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount."

1001(b). Section 111, the statutory tax benefit rule,[96] provides generally that if a deduction is taken in one year and there is a recovery of the previously deducted item in a subsequent year, the recovery must be treated as income to the taxpayer.[97] Only the amount that resulted in a tax benefit in the year of deduction, however, is treated as income.[98] Case law[99] and the regulations[100] have required that there be an actual recovery of the previously deducted item in the subsequent year before the tax benefit rule can be invoked. The recovery can take the form of an actual receipt of money or other property,[101] or the freeing of assets resulting in an increase in the taxpayer's net worth.[102] In *Delman* the taxpayers argued that the recovery requirement of the tax benefit rule had not been met because they had received no money or other property on the repossession and had not experienced an increase in net worth on being released from the nonrecourse indebtedness. The taxpayers insisted, therefore, that they realized no economic benefit and that the court was precluded from finding that an amount had been realized. The court rejected this argument, citing *Crane* and concluding that the statutory tax benefit rule was not applicable to the transfer of nonrecourse financed property.[103] The *Delman* court emphasized that although the plaintiff in *Crane* had neither received cash in the amount of the depreciation she had taken nor been discharged from a liability resulting in an increase in her net worth, the Supreme Court nevertheless found that she had realized an amount that included her nonrecourse mortgage.[104] The *Delman* court thus concluded that the taxpayers had taken the tax benefit language out of context and that the cases cited in support of the taxpayers' argument were "theoretically and factually" distinct from the case at bar.[105]

96. By its terms, § 111 applies only to bad debts, prior taxes, and delinquency amounts. Its scope, however, has been broadened by regulations to include all other "losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years." Treas. Reg. § 1.111-1(a) (1960). The regulations further provide that § 111 does not apply with respect to depreciation deductions. *Id.*

97. *See* J. CHOMMIE, *supra* note 61, § 90.

98. *See, e.g.*, Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967).

99. Nash v. United States, 398 U.S. 1, 4-5 (1970) (tax benefit rule not applicable because there was no recovery); Commissioner v. South Lake Farms, Inc., 324 F.2d 837, 840 (9th Cir. 1963) (deductions for cost of growing crops not income under tax benefit theory where element of actual recovery is lacking).

100. Treas. Reg. § 1.111-1(a)(2) (1960).

101. *See, e.g.*, Rothensies v. Electric Storage Battery Co., 329 U.S. 296, 298 (1946) (refund of excise taxes previously deducted is a recovery for the purpose of the tax benefit rule); Merchants Nat'l Bank v. Commissioner, 199 F.2d 657, 659 (5th Cir. 1952) (repayment of a previously deducted bad debt is a recovery for purpose of tax benefit rule).

102. *See, e.g.*, Bear Mfg. Co. v. United States, 430 F.2d 152, 154 (7th Cir. 1970) (previously deducted liability expense is recovered when liability terminates); *cf.* Tennessee Carolina Transp., Inc. v. Commissioner, 65 T.C. 440, 451 (1975) (Tannenwald, J., joined by six justices dissenting) (liquidating distribution of stock does not cause a corporate taxpayer to receive an economic benefit).

103. [1979] TAX CT. REP. (CCH) (73 T.C.) Dec. 36,380, at 4074.

104. *Id.*

105. *Id.* at 4079 n.5. Although the *Delman* court is correct in concluding that the tax benefit cases cited by the taxpayers are factually distinct from *Millar, Tufts*, and *Delman*, the theoretical distinction is less clear. Under § 111 and *Millar* and *Tufts*, a taxpayer is made to

The taxpayers next urged that *Millar* and *Tufts* be overruled.[106] Specifically, the taxpayers claimed that *Millar* and *Tufts* unjustifiably relied on *Woodsam Associates, Inc. v. Commissioner*,[107] *Mendham Corp. v. Commissioner*,[108] and *Lutz & Schramm Co. v. Commissioner*[109] in support of their holdings that the full unpaid balance of a nonrecourse indebtedness is includable as an amount realized.[110] The taxpayers sought to distinguish the latter group of cases on the ground that each involved a post-acquisition refinancing. When funds are borrowed against property subsequent to its original acquisition, the borrower is free to use the funds for his personal benefit rather than apply them to the property.[111] In contrast, purchase-money financing must be used against the property and is included in basis.[112] Emphasizing this distinction, *Woodsam, Mendham*, and *Lutz & Schramm* held that the amount of the subsequent refinancing was realized when the taxpayers transferred the encumbered property in discharge of the debt because a direct cash benefit had resulted.[113] The taxpayers in *Delman* asserted that because they had not been free to use the funds for their own benefit, *Woodsam, Mendham*, and *Lutz & Schramm* were inapposite, and thus they had realized no income. The court dismissed this argument, concluding that the tax benefit rationale underlying the *Millar* and *Tufts* decisions was sufficient to justify its holding.[114] Nevertheless, the court did make some noteworthy comments in response to the taxpayers' challenge. The court stated that it saw little difference between the economic benefits resulting from the use of purchase money financing and post-acquisition financing.[115] The court concluded that regardless of the type of underlying financing, the taxpayer is still able to enjoy the use of property without risking any of his own funds[116] and thereby enjoy the benefit of having this amount freed for use elsewhere.[117]

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account for deductions that were proper when taken, even though they subsequently turned out to be unjustified. In the case of a bad debt, the deduction is allowed under § 166. When the debt is later repayed, § 111 requires that the taxpayer account for the prior deduction in the year of recovery because the deduction is no longer warranted. The same basic theory was explicitly applied in *Millar* and *Tufts* and was recognized in *Crane*. In those cases nonrecourse debt had been included in basis and depreciation computed thereon on the theory that a capital investment in the amount of the debt and the allowable depreciation would be made at some future time. *See* Mayerson v. Commissioner, 47 T.C. 340, 352 (1966), *acq.* 1969-1 C.B. 21. When the property was later transferred and it became apparent that the anticipated investment had not occurred, the holdings of those cases required the taxpayer to account for the depreciation previously allowed in excess of actual investment.

106. [1979] TAX CT. REP. (CCH) (73 T.C.) Dec. 36,380, at 4079 n.3.

107. 16 T.C. 649 (1951), *aff'd*, 198 F.2d 357 (2d Cir. 1952).

108. 9 T.C. 320 (1947).

109. 1 T.C. 682 (1943).

110. [1979] TAX CT. REP. (CCH) (73 T.C.) Dec. 36,380, at 4074 n.5.

111. If the funds are applied to the property, then an adjustment to basis results. I.R.C. § 1016(a)(1); Treas. Reg. §§ 1.1016-2(a) & (b) (1960).

112. I.R.C. § 1012.

113. 16 T.C. at 654; 9 T.C. at 323; 1 T.C. at 689.

114. [1979] TAX CT. REP. (CCH) (73 T.C.) Dec. 36,380, at 4079 n.5.

115. *Id.*; *accord*, Halpern, *supra* note 47, at 218-21.

116. [1979] TAX CT. REP. (CCH) (73 T.C.) Dec. 36,380, at 4079 n.5.

117. *Id.* at 4074.

Although the *Delman* court is correct in concluding that a taxpayer benefits from the use of borrowed funds, this benefit is not realized on the transfer of the property, and therefore it is questionable whether it properly may be considered an amount realized.

Finally, the taxpayers argued that a recognized exception to the cancellation of indebtedness doctrine, first enunciated in *United States v. Kirby Lumber Co.*,[118] was applicable to their case. Under the *Kirby* rule, cancellation of an indebtedness results in income to a taxpayer because his assets have been freed, resulting in an increase in net worth.[119] An exception to this rule occurs when the taxpayer remains insolvent after the debt cancellation.[120] Under the insolvency exception no income is realized, on the theory that the taxpayer has not realized an increase in net worth.[121] The taxpayers in *Delman* argued that because the partnership was insolvent before and after the repossession, the insolvency exception to the *Kirby* rule applied, and they realized no income. The court held, however, that *Kirby* and its exceptions applied only when indebtedness was discharged, and not when nonrecourse-financed property was transferred.[122] The court reasoned that the repossession resulted in no change in the taxpayers' net worth because the taxpayers were not personally liable on the indebtedness.[123] Therefore, because the *Kirby* rule was inapplicable, the insolvency exception was irrelevant. In so holding, the court again emphasized that the basis for its decision lay in the tax equity approach employed in *Millar* and *Tufts*.[124]

The most recent Tax Court case, *Brountas v. Commissioner*[125] further evidences this emphasis on tax equity consequences. In *Brountas* the Tax

118. 284 U.S. 1 (1931). *Kirby* held that a corporate taxpayer, when it purchased its own bonds in the open market at a discount, realized income because of the resulting increase in the corporation's net worth. The *Kirby* doctrine is codified in I.R.C. §§ 61(a)(12), 108, 1017. *See also* Commissioner v. Jacobson, 336 U.S. 28 (1949) (repurchase of bonds at a discount results in taxable income). For a discussion of the theory of cancellation of indebtedness, see Blattner, *Debt Cancellation*, 30 N.Y.U. INST. FED. TAX. 237 (1972).

119. *See generally*, J. CHOMMIE, *supra* note 61, § 13.

120. *See* Treas. Reg. § 1.61-12(b) (1960). Other exceptions to the cancellation of indebtedness doctrine exist. No taxable income arises if the debt release is a contribution to corporate capital, Hartland Assocs. v. Commissioner, 54 T.C. 1580 (1970); if the debt cancellation was in fact merely a reduction in the purchase price, Hirsch v. Commissioner, 115 F.2d 656 (7th Cir. 1940); if a gift was intended, Commissioner v. Jacobson, 336 U.S. 28 (1949); Helvering v. American Dental Co., 318 U.S. 322 (1943); or if there is a release to a partnership qualifying as a distribution of partnership assets, Stackhouse v. United States, 441 F.2d 465 (5th Cir. 1971).

121. *See, e.g.*, Transylvania R.R. v. Commissioner, 99 F.2d 69, 72 (4th Cir. 1938); Conestoga Transp. Co. v. Commissioner, 17 T.C. 506, 513 (1951); Quinn v. Commissioner, 31 B.T.A. 142, 145 (1934).

122. [1979] TAX CT. REP. (CCH) (73 T.C.) Dec. 36,380, at 4075. For a general discussion of the applicability of *Kirby* to the transfer of nonrecourse financed property, see Del Cotto, *supra* note 44, at 76-79.

123. [1979] TAX CT. REP. (CCH) (73 T.C.) Dec. 36,380, at 4075; *accord*, Hotel Astoria, Inc. v. Commissioner, 42 B.T.A. 759 (1940); Fulton Gold Corp., 31 B.T.A. 519 (1934); *cf.* Blattner, *supra* note 118, at 252-53 (concluding discharge of nonrecourse debt does result in increase in taxpayer's net worth).

124. [1979] TAX CT. REP. (CCH) (73 T.C.) Dec. 36,380, at 4075.

125. [1980] DAILY TAX REP. (BNA) No. 2, H-1 (T.C. Jan. 3, 1980).

Court held that, because the amount realized by a taxpayer in the disposition of nonrecourse financed property includes the face amount of the indebtedness,[126] the taxpayer's cost basis must also include the amount of the nonrecourse indebtedness, unlimited by the fair market value of the securing asset.[127] The holding recognizes that if a taxpayer will be disadvantaged by having to include the full amount of the indebtedness as an amount realized on disposition, tax equity and the symmetrical relationship between basis and amount realized require that the taxpayer be given the full tax benefit he will be charged with on disposition by allowing him to include also the full amount of the indebtedness in his basis.[128] The court thus relied on principles of symmetry and equity to reach a determination of a taxpayer's cost basis that has no necessary relationship with the actual amount of the taxpayer's reasonably anticipated capital investment.[129] Existing Tax Court precedent now clearly establishes the use of a tax equity approach to justify inclusion of the full amount of nonrecourse indebtedness, regardless of the fair market value of the securing asset, as both an amount realized on disposition[130] and as an element of cost basis on acquisition, despite the emphasis placed on the value of the underlying security in *Crane v. Commissioner*, the seminal decision in this area, and the only Supreme Court case on point.

IV. Proposed Solutions and Alternatives

Several commentators have offered alternative approaches to the footnote 37 situation that would achieve the equitable result of *Millar, Tufts*, and *Delman*, yet not disturb the traditional scope of amount realized. One proposal suggests that the amount of the depreciation deductions should be calculated based on the sum of the taxpayer's actual cash contributions plus the face amount of the nonrecourse financing, while at the same time, the deductions should be limited to the taxpayer's equity investment.[131] Thus, to deduct the full amount of depreciation allowable, the taxpayer's payments on the mortgage must keep pace. It is suggested, however, that this solution is unworkable as it distorts income by underestimating the portion of the asset's actual economic cost attributable to the early

126. The Tax Court cited to Tufts v. Commissioner, 70 T.C. 756 (1978), *appeal docketed*, No. 79-2258 (5th Cir. Apr. 23, 1979).

127. [1980] Daily Tax Rep. (BNA) No. 2, H-1, H-13 (T.C. Jan. 3, 1980).

128. Judicial recognition of the symmetrical relationship between basis and amount realized now appears to have come full circle. In *Millar, Tufts*, and *Delman*, for example, the Tax Court emphasized that if nonrecourse indebtedness is included in basis, symmetry requires that it must also be included in amount realized. *Brountas* recognized the inverse of this proposition in holding that when nonrecourse liability is included as an amount realized, it must also be included in basis.

129. *Id.*

130. *See also* Proposed Treas. Reg. § 1.1001-2, [1979] STAND. FED. TAX REP. (CCH) (U.S. Tax Cas.) ¶ 8911 (fair market value not relevant to determination of amount realized).

131. *See* Del Cotto, *supra* note 44, at 98-99; Perry, *supra* note 80, at 539; Note, *Tax Consequences of the Disposition of Property Subject to an Unassumed Mortgage*, 49 COLUM. L. REV. 845, 851 (1949).

years.[132] Furthermore, amortization of the debt in high income years would allow the taxpayer to control the timing of his deductions.[133] The most fundamental objection to such an approach, or to any other suggestion limiting the amount of depreciation allowable, however,[134] is section 465.[135] Section 465 excepts real estate from the at-risk limitations, evidencing strong congressional intent to maintain real estate tax shelters.[136]

Recognizing that judicial expansion of the historical scope of amount realized is not necessarily the best avenue for change, one commentator has suggested that Congress should be called upon to amend section 1001(b) to include nonrecourse indebtedness as an amount realized without regard to the value of the underlying security.[137] It has also been suggested that section 111 could be broadened to bring deductions taken in excess of actual investment within the reach of the tax benefit rule.[138] Statutory solutions such as these are especially meritorious since it is well-settled that it is the province of Congress, not the judiciary, to remove inequities that result from consistent application of existing law.[139] Thus, *Millar* and *Tufts* are inappropriate attempts at judicial expansion of a statutorily codified area of the law.

Yet another appealing alternative appears in a recent article by James Halpern.[140] Halpern suggests that footnote 37 is a "problem that never really was."[141] He theorizes that "[f]ootnote 37 presents no problem if it is viewed only as a warning that the theory of the case then before the Court [*Crane v. Commissioner*], although adequate to deal with the facts of the case, might not be adequate to deal with the facts of a harder one."[142] The issue then becomes what theory the Court would have used had it been presented in fact with the more difficult footnote 37 case. There are several possible answers to this question. First, it is arguable that the Court responded to this issue in the closing language of *Crane*. Recognizing that a double deduction would result if Mrs. Crane's tax benefits were not accounted for, the Court stated, "The Sixteenth Amendment does not require that result any more than does the Act itself."[143] This language may indicate that the Court would employ a tax equity approach, as did *Millar, Tufts*, and *Delman*, were the footnote 37 case before the Court.[144] Sec-

132. Perry, *supra* note 80, at 539.
133. *Id.* at 540; *see* note 28 *supra*.
134. *See* Del Cotto, *supra* note 44, at 101-02, in which the author suggests that the gain on the disposition of property should be recaptured expressly as ordinary income to the extent the taxpayer's depreciation deductions exceed his equity investment. This suggestion has been criticized on the grounds that it lacks theoretical support and creates a large administrative burden. Perry, *supra* note 80, at 540.
135. *See* note 62 *supra*.
136. I.R.C. § 465(c)(3)(D).
137. McGuire, *supra* note 49, at 1467.
138. *Id.* at 1467-68.
139. *See, e.g.*, Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399, 403 n.5 (1967).
140. Halpern, *supra* note 47.
141. *Id.*
142. *Id.* at 224.
143. 331 U.S. at 16.
144. Halpern, *supra* note 47, at 225.

ondly, it is possible to identify an economic benefit in the full amount of the nonrecourse debt if the focus is not narrowed to the value received at the time the property is transferred. Halpern makes use of this concept stating:

> [T]he potential amount that can be realized if the property is transferred still subject to the mortgage should in no way be restricted to the time-of-transfer value of the property.
>
> In any case . . . it is the value of what was received *at that time* (i.e., when the present holder acquired the mortgage) that counts. If value at least equal to the mortgage was *then* received, that is the *receipt* that counts; that is the *receipt* that can give rise to a full measure of realized gain under Section 1001 if the property is transferred before the mortgage has been fully repaid.[145]

The Court might indeed find such an approach appealing in that it is consistent with *Crane*'s attempt to identify an economic benefit before holding that an amount had been realized. This approach, however, ignores the fact that amount realized, by definition, refers to the benefit received by a taxpayer on disposition, not on acquisition.[146] It may be bending the statutory language of section 1001(b) too far to conclude that it is broad enough to relate back to benefits received on acquisition.

It is noteworthy that all of the offered alternatives rely either on the expansion of the concept of amount realized or on limiting the amount of depreciation allowable. Perhaps a more logical solution would be to focus on basis. The inequity in the footnote 37 situation arises because nonrecourse debt is included as part of a taxpayer's *cost* basis on the assumption that the debt will be satisfied eventually,[147] an assumption that hindsight proves to be false. As it is the original basis calculation that has proved inaccurate, the more logical solution would be to make a basis adjustment to reflect the actual cost to the taxpayer. The basis adjustment would be made in an amount equal to the excess of the nonrecourse debt over the fair market value of the property at the time of disposition, because it is this amount that the lender cannot satisfy either by proceeding against the property or the debtor. Such a basis adjustment will effect the recapture of deductions taken in excess of actual investment without relying on an artificial concept of amount realized. This result is demonstrated by the following hypothetical:

Acquisition Indebtedness	\$100x	(100% nonrecourse debt)
Cost Basis	\$100x	
Adjusted Basis	\$ 60x	
Fair Market Value on Disposition	\$ 70x	

Under *Millar, Tufts*, and *Delman* the amount realized on this transaction would be \$100x, the unpaid balance of the nonrecourse debt. The tax-

145. *Id.* at 221 (emphasis in original).
146. I.R.C. § 1001(b).
147. Mayerson v. Commissioner, 47 T.C. 340 (1966), *acq.* 1969-1 C.B. 21.

payer's gain would thus be \$40x. This is equal to the amount of depreciation taken in excess of investment. Using the alternative basis adjustment, a gain of \$40x also results. Under this approach the amount realized equals the fair market value of the property on disposition, \$70x. As the basis must be adjusted to reflect the actual cost to the taxpayer, basis would equal \$30x, rather than \$60x, resulting in a gain of \$40x. This analysis avoids an artificial calculation of amount realized, and is consistent with traditional notions of accounting for prior tax benefits by an adjustment to cost basis.[148]

Gibson Products Co. v. United States,[149] although conflicting with the Tax Court's opinion in *Brountas v. Commissioner*,[150] supports the notion that cost basis must accurately reflect the actual cost of an asset to a taxpayer. In *Gibson Products* the United States District Court for the Northern District of Texas held that nonrecourse indebtedness is not includable in cost basis when the debt is a contingent one,[151] or when the fair market

148. For example, § 1017 allows an adjustment to basis when indebtedness for which a deduction was allowed is discharged.

149. 460 F. Supp. 1109 (N.D. Tex. 1978). In *Gibson Products* the taxpayer, a limited partner in an oil and gas drilling venture, gave a single nonrecourse note to secure both the purchase price of five oil and gas leases and an agreement with the vendor of the leases to fulfill certain drilling obligations. The note was secured by the oil and gas leases, the operating equipment on the leases owned by the limited partnership, and eight percent of all hydrocarbons produced by any well on any of the leases. The court noted that it could be concluded on the facts that the debt was not a bona fide debt, but rather an equity interest. Under I.R.C. § 705, an equity interest would have no effect on the taxpayer's basis in the partnership. *See also* Backar v. Western States Producing Co., 547 F.2d 876 (5th Cir. 1977). The court declined to base its decision on this point, however, due to the parties' relative inattention to the issue. 460 F. Supp. at 1120.

150. [1980] DAILY TAX REP. (BNA) No. 2, H-1 (T.C. Jan. 3, 1980); *see* text at note 126 *supra*. Support for the court's approach in *Gibson Products* can be found in Rev. Rul. 79-432, [1980] 10 FED. TAX REP. (CCH) ¶ 6272, to appear in 1979-53 I.R.B. 20, which holds that a taxpayer's cost basis in an art tax shelter is limited to the fair market value of the property securing a nonrecourse note. *See also* Rev. Ruls. 78-29, 1978-1 C.B. 62; 77-110, 1977-1 C.B. 58.

151. Generally, if a note is payable from profits only, it is a contingent obligation because there is no guarantee there will be any profits. Redford v. Commissioner, 28 T.C. 773, 777 (1957). In *Gibson Products* the court found that the obligation to satisfy the debt rested completely on the amount of oil and gas produced by the purchased leases. 460 F. Supp. at 1114. *See also* Rodman v. Commissioner, 542 F.2d 845 (2d Cir. 1976); Denver & Rio Grande W. R.R. v. United States, 505 F.2d 1266 (Ct. Cl. 1974); Columbus & G. Ry. v. Commissioner, 42 T.C. 834 (1964), *aff'd per curiam*, 358 F.2d 294 (5th Cir.), *cert. denied*, 385 U.S. 827 (1966); Albany Car Wheel Co. v. Commissioner, 40 T.C. 831 (1963). The outer limit of the contingent liability cases is Mayerson v. Commissioner, 47 T.C. 340 (1966). In *Mayerson* the court held that a taxpayer who purchased a 79-year lease with substantial nonrecourse financing could include the debt in basis. The court so held despite the fact that the parties agreed to reduce the face amount of the note if it were paid off in the first two years, and if not paid then, no payments were due for 99 years. The court rejected the Commissioner's argument that these facts rendered the liability contingent. *But see* Del Cotto, *supra* note 44, at 80-82, in which it is argued that repayment in *Mayerson* was contingent and so highly unlikely that it should not have been included in basis. Del Cotto argues that even if the liability were not contingent, the likelihood of amortization at the end of 99 years was so slight as to justify exclusion of the debt in basis. *Id.* at 82.

The Service acquiesced in *Mayerson*, 1969-1 C.B. 21, based solely on the fact that an arm's-length transaction creating a bona fide purchase and debt obligation clearly was involved. The Service stated, however, that it would scrutinize any transaction set up for the sole purpose of improperly creating or deflating depreciation deductions. 1969-1 C.B. at 59. *See* value of the property securing the indebtedness does not at least equal the face amount of the nonrecourse indebtedness.[152] The Court cited favorably the economic benefit rationale advanced in *Crane* and footnote 37[153] and reasoned that when the value of property securing a nonrecourse indebtedness does not at least equal the amount of that indebtedness, it no longer can be assumed that the taxpayer will eventually make a capital contribution in this amount.[154] Thus, inclusion of the debt in cost basis is unwarranted.[155] Although *Gibson Products* focused on the determination of cost basis at acquisition of the property, its basic premise was that cost basis must be reflective of actual cost. There appears to be no reason why this premise cannot be applied statutorily to require a retroactive basis adjustment at subsequent disposition when it becomes clear that a taxpayer will not make the anticipated capital contribution that justified including the amount of the debt in basis in the first instance.

V. CONCLUSION

The key to the resolution of the footnote 37 issue lies in the definition of amount realized. The basic issue is whether amount realized is limited to the receipt on the transfer of property of an economic benefit having the effect of a receipt of cash or property, or whether the amount realized can be expanded, without statutory amendment, to include the prior receipt of some tax advantage. If amount realized is limited to economic benefits received on the transfer of property, footnote 37 must attain the status of law, for it cannot be said that a taxpayer who transfers property subject to a nonrecourse indebtedness greater than the property's value receives an economic benefit to the extent of the face amount of that indebtedness. A

also Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976) (denying depreciation deductions where taxpayer had no equity investment and the debt had economic significance only if the property later appreciated in value); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966) (denying depreciation deductions where taxpayer had no reason to engage in transaction except to secure deduction), *cert. denied*, 385 U.S. 1005 (1967).

152. 460 F. Supp. at 1115. *Cf.* Brountas v. Commissioner, [1980] DAILY TAX REP. (BNA) No. 2, H-1, H-13 (T.C. Jan. 3, 1980) (holding fair market value to be immaterial to the determination of cost basis). The court in *Gibson Products* applied the law as it existed in 1972. I.R.C. § 465(b)(4) was therefore inapplicable.

153. 460 F. Supp. at 1117.

154. *Id.*

155. The holding in *Gibson Products* is consistent with earlier decisions holding that excess debt over fair market value is not includable as part of a taxpayer's cost basis. *See* Morris v. Commissioner, 59 T.C. 21 (1972) (worthless debt used solely to inflate the true cost of property in order to acquire a high depreciable basis cannot be included as cost basis), *acq.* 1973-2 C.B. 3; Marcus v. Commissioner, 30 T.C.M. (CCH) 1263 (1971) (debt upon which taxpayer routinely defaults and fails to make interest payments is illusory and not includable in basis); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966) (denying depreciation deductions where a taxpayer had no reason to engage in the transaction except to receive the deduction); Rev. Rul. 77-110, 1977-1 C.B. 58 (ruling that as the taxpayer could not prove the value of the property at least equalled the debt, the debt could not become a part of the taxpayer's basis). *But see* Bolger v. Commissioner, 59 T.C. 760 (1973) (100% financing approved as part of basis). For a general discussion of the Service's challenges to inclusion of debt in basis, see Rabinowitz, *Real Estate and Federal Income Tax: The Status of the Law Today*, 32 N.Y.U. INST. FED. TAX. 1593, 1598-1602 (1974).

taxpayer benefits, or receives income subject to taxation on the disposition of encumbered property, only to the extent that his assets are freed by relief from the indebtedness. Thus, on the transfer of property encumbered by nonrecourse indebtedness, the economic benefit, the amount realized, may never exceed the fair market value of the property.

Equitable considerations demand, however, that excess depreciation taken over investment be accounted for on a subsequent disposition of the property. This can be accomplished in one of several ways. First, the courts can force the judicial expansion of the notion of economic benefit to include the advantage secured when a taxpayer claims deductions in excess of actual investment, as an amount realized. *Millar, Tufts*, and *Delman* do exactly that. This method, however, represents an unwarranted judicial usurpation of the legislative function. If the recapture of excess depreciation taken over investment is to be effected by including nonrecourse debt as an amount realized, a more appropriate alternative would be to call upon Congress to amend the Internal Revenue Code in one of several ways. Congress could amend section 1001(b) to include excess depreciation as an amount realized. Alternatively, section 111 could be amended to require taxation of excess depreciation under the tax benefit rule. It is suggested, however, that the same result can be obtained without an artificial expansion of the amount realized provision by statutorily requiring an adjustment to cost basis in the footnote 37 situation. A retroactive adjustment to cost basis is theoretically more correct than an artificial addition to amount realized when the literal definition of amount realized in section 1001(b) fails to achieve an equitable result in the footnote 37 situation. In light of the conceptual difficulties arising from the application of existing precedent, statutory amendment appears to be the only proper solution.