



1-1-1982

From Crane to Tufts: In Search of a Rationale for the Taxation of Nonrecourse Mortgagors

Patricia A. Cain

Santa Clara University School of Law, pcain@scu.edu

Follow this and additional works at: <http://digitalcommons.law.scu.edu/facpubs>

Recommended Citation

11 Hofstra L. Rev. 1

This Article is brought to you for free and open access by the Faculty Scholarship at Santa Clara Law Digital Commons. It has been accepted for inclusion in Faculty Publications by an authorized administrator of Santa Clara Law Digital Commons. For more information, please contact sculawlibrarian@gmail.com.

HOFSTRA LAW REVIEW

Volume 11, No. 1

Fall 1982

FROM *CRANE* TO *TUFTS*: IN SEARCH OF A RATIONALE FOR THE TAXATION OF NONRECOURSE MORTGAGORS

*Patricia A. Cain**

I. INTRODUCTION

In 1947, the Supreme Court of the United States decided the case of *Crane v. Commissioner*.¹ This case has been credited with laying down two major principles of tax law: (1) The face amount of nonrecourse liability shall be included in basis for purposes of depreciation deductions;² and (2) any outstanding balance on the nonrecourse liability shall be treated as an amount realized upon disposition of the property.³

For a long while, *Crane* was accepted as an absolute statement of the law with respect to the two principles it embodied. In *Mayer-son v. Commissioner*,⁴ for example, the face amount of a purchase money nonrecourse liability⁵ was included in the property's basis for depreciation purposes, though the liability was not to be paid for

Copyright © 1982 by Patricia A. Cain.

* Professor of Law, University of Texas School of Law. B.A., 1968, Vassar College; J.D., 1973, University of Georgia School of Law.

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

2. *See id.* at 11. Although the exact issue before the Court involved the computation of gain upon disposition of the mortgaged property, *id.* at 2, and not the validity of prior depreciation deductions, the Court had to consider the basis/depreciation issue in order to compute adjusted basis, which is a necessary element in the computation of gain. Gain equals "amount realized" upon disposition less "adjusted basis." I.R.C. § 1001(a)(1976).

3. 331 U.S. at 13.

4. 47 T.C. 340 (1966), *acq.* 1969-2 C.B. xxiv.

5. The nonrecourse liability in *Crane* was attached to inherited property and, thus, did not represent a purchase money obligation of Mrs. Crane.

ninety-nine years.⁶ *Crane* was believed to require such a result.⁷

More recent decisions, however, have established meaningful exceptions to the rule embodied in *Crane's* principle number one. Thus, for example, if the nonrecourse liability represents a contingent, nonascertainable amount, it may be improper to include it in basis.⁸ Additionally, if the fair market value of the property secured by the nonrecourse mortgage is less than the promised purchase price, inclusion of the liability in the property's basis for depreciation purposes might not be warranted.⁹

6. 47 T.C. at 352.

7. *Id.* at 351; see also *Blackstone Theatre Co. v. Commissioner*, 12 T.C. 801, 804 (1949), *acq.* 1949-2 C.B. 1; *Parker v. Delaney*, 186 F.2d 455, 458 (1st Cir. 1950). The Tax Court in *Mayerson* correctly analyzed *Crane* as holding that the absence of personal liability on a mortgage indebtedness was not alone sufficient to preclude inclusion of the debt in depreciable basis. The Tax Court considered whether the agreement as a whole, including the 99 year repayment provision, created a *real* obligation to pay the purchase price reflected in the face amount of the nonrecourse note. In holding for the taxpayer, the court said: "[A]fter viewing the totality of the circumstances and all the evidence of record we have found and hold that a valid debt obligation was created by the purchase-money mortgage in question." 47 T.C. at 352.

8. See, e.g., *Gibson Prods. Co. v. United States*, 460 F. Supp. 1109 (N.D. Tex. 1978), *aff'd*, 637 F.2d 1041 (5th Cir. 1981); *Lemery v. Commissioner*, 52 T.C. 367 (1969), *aff'd per curiam*, 451 F.2d 173 (9th Cir. 1971); *Redford v. Commissioner*, 28 T.C. 773, 779 (1957) (Forrester, J., concurring).

Note that although these cases involve "valid debt obligation[s]," *Mayerson*, 47 T.C. at 352, the amount of the liability is unknown. Presumably, where the amount of liability is unknown, to give advance credit by including the liability in basis would create accounting problems beyond the capability of our present tax system. Just as an accrual basis taxpayer is not allowed to take a current deduction for accrued liabilities until "the amount thereof can be determined with reasonable accuracy," Treas. Reg. § 1.461-1(a)(2) (1957), no taxpayer should be given an advance credit in the form of a basis increase for liabilities to be paid in the future which are similarly uncertain in amount. The *Mayerson* court held, however, that the face amount of the liability was properly included in basis even though that amount might be reduced in the future if certain contingencies were met. See 47 T.C. at 352.

It is unclear whether this exception for liabilities contingent in amount should be considered a special exception for the inclusion of nonrecourse liabilities in basis or whether it extends to taxpayers who assume personal liability for contingent liabilities as well. See *Albany Car Wheel Co., Inc. v. Commissioner*, 40 T.C. 831 (1963), *aff'd per curiam*, 333 F.2d 653 (2d Cir. 1964). The *Albany Car Wheel* court first reasoned that the contingent character of the liabilities, although they had been personally assumed by the taxpayer, precluded them from being included in basis, and then subsequently stated that the taxpayer had not really assumed the liabilities. *Id.* at 839-41. For a further discussion of this issue, see Halpern, *Liabilities and Cost Basis: Some Fundamental Considerations*, 7 J. REAL EST. TAX'N 334 (1980); Landis, *Liabilities and Purchase Price*, 27 TAX LAW. 67 (1973).

9. See *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976) (nonrecourse debt due in 10 years exceeded value of purchased real estate); *Siegel v. Commissioner*, 78 T.C. 659 (1982); *Brannen v. Commissioner*, 78 T.C. 471 (1982) (nonrecourse notes for purchase of movie films exceeded films' value); Rev. Rul. 79-432, 1979-2 C.B. 289 (art print tax shelter in which nonrecourse debt exceeded value of depreciable master plate). For a discussion of recent

With regard to *Crane's* second principle, the inclusion of nonre-course debt in amount realized, the courts have been less amenable to creating exceptions. Taxpayers have tried to distinguish *Crane* on its facts to avoid the recognition of gain that results from a strict application of principle number two. For example, some have argued, without success, that abandoning the mortgaged property or deeding it to creditors is not a *Crane*-type disposition.¹⁰ Others have argued that if the liability exceeds the property's fair market value at the time of disposition, the *Crane* rule of full inclusion in amount realized does not apply.¹¹ Indeed, in *Crane's* famous footnote 37,¹² the Court suggested that principle number two might be limited to cases in which the mortgaged property has a value at the time of disposition at least equal to the face amount of the mortgage.¹³ Many commentators have emphasized, however, that the footnote is merely dictum.¹⁴ In addition, although taxpayers continue to rely optimistically on its continued viability, most courts have agreed with the commentators, holding that the footnote is not only dictum, but that it is bad dictum, and thus has no legal status.¹⁵

In the case of *Tufts v. Commissioner*,¹⁶ however, the Fifth Circuit has taken a different approach. The court reviewed the *Crane* decision in close detail and reached a conclusion that breathes new

cases involving this exception, see Gans, *Re-examining The Sham Doctrine: When Should an Overpayment Be Reflected in Basis?*, 30 BUFFALO L. REV. 95 (1981).

10. See *Parker v. Delaney*, 186 F.2d 455 (1st Cir. 1950)(taxpayer's characterization of transaction as abandonment of property to mortgagee banks did not prevent it from being disposition upon which gain was realized).

11. For examples of negative judicial response to this argument, see *Millar v. Commissioner*, 577 F.2d 212 (3d Cir.), cert. denied, 439 U.S. 1046 (1978); *Parker v. Delaney*, 186 F.2d 455 (1st Cir. 1950)(court found value equal to debt); *Estate of Delman v. Commissioner*, 73 T.C. 15, 28 (1979); *Tufts v. Commissioner*, 70 T.C. 756, 769-70 (1978), rev'd, 651 F.2d 1058 (5th Cir. 1981), cert. granted, 102 S. Ct. 2034 (1982).

12. 331 U.S. at 14 n.37.

13. In footnote 37, 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.

Id.

14. See, e.g., Halpern, *Footnote 37 and the Crane Case: The Problem That Never Really Was*, 6 J. REAL EST. TAX'N 197, 221-22 (1979); Rollyson, *Recent Cases and Rulings*, 3 J. REAL EST. TAX'N 495 (1976) (supporting conclusion of Service in Rev. Rul. 76-111, 1976-1 C.B. 214, which gives no effect to footnote 37).

15. See cases cited *supra* note 11.

16. 651 F.2d 1058 (5th Cir. 1981), cert. granted, 102 S. Ct. 2034 (1982).

life into footnote 37.

The taxpayers in *Tufts* had secured \$1.8 million in nonrecourse financing for the purpose of constructing an apartment complex.¹⁷ After claiming significant depreciation deductions in excess of their cash investment,¹⁸ they transferred their interest in the complex to a third party.¹⁹ Under the second principle of *Crane*, the disposition should have triggered a gain of approximately \$400,000.²⁰ Relying on footnote 37, however, the taxpayers argued that the amount realized should not include the full \$1.8 million of outstanding debt because the property's value had declined to \$1.4 million.²¹ In holding for the taxpayers on this point, the Fifth Circuit stated: "Because . . . we have serious reservations about the *Crane* decision, we decline to extend it beyond the facts of that case, and we therefore conclude that the fair market value limitation so '[o]bviously' anticipated by footnote 37 is warranted."²²

The *Tufts* decision thus created a classic conflict between the circuits.²³ Furthermore, the Fifth Circuit's express reservations about the *Crane* decision and desire to limit *Crane* to its facts,²⁴ have given taxpayers a sufficiently reasonable basis for taking aggressive tax return positions upon the disposition or abandonment of failing tax shelters.²⁵ The Treasury long has been concerned that taxpayers

17. *Id.* at 1059. In point of fact, the taxpayers in *Tufts* were limited partners and the nonrecourse financing was made available to the partnership. For purposes of discussion in this article, however, the partnership will be ignored since it is a nontaxable entity.

18. Under the first principle of *Crane*, depreciable basis included the nonrecourse debt on which no payments were made. At the time of the transfer, therefore, the debt exceeded the property's adjusted basis by over \$300,000.

19. 651 F.2d at 1059. The individuals actually transferred their partnership interests. Such a transfer in this case produces the same tax results that an outright transfer of the building would have produced. For purposes of simplicity, I am ignoring the partnership aspects of this case as I believe the issues are the same, whether the building was held in a partnership or by the taxpayers individually. *See supra* note 17.

20. *See* 651 F.2d at 1059.

21. *See id.*

22. *Id.* at 1063.

23. The Third Circuit's opinion in *Millar v. Commissioner*, 577 F.2d 212 (3d Cir.), *cert. denied*, 439 U.S. 1046 (1978), is in direct conflict, as is the Tax Court's opinion in *Estate of Delman v. Commissioner*, 73 T.C. 15 (1979).

24. 651 F.2d at 1063.

25. According to ABA Comm. on Ethics and Professional Responsibility, Formal Opinion 314 (1965), *reprinted in* 51 A.B.A. J. 671 (1965), if there is a reasonable basis for taking a particular position on a tax return, there is no need to disclose what that basis is, or that it might be questionable. For a discussion of the problems that this "reasonable basis" approach presents to the tax collector, see Kurtz, *Remarks to the American Institute of Certified Public Accountants*, 103 DAILY TAX REPORT J-3, May 26, 1977, *reprinted in* B. WOLFFMAN & J. HOLDEN, *ETHICAL PROBLEMS IN FEDERAL TAX PRACTICE* 36-39 (1981).

who rely on *Crane* to include nonrecourse debt in basis in order to claim high depreciation deductions, will not include the outstanding balance in the amount realized upon disposition, on the theory that they fall within the exception of footnote 37.²⁶ *Tufts* significantly increases this concern.

On May 3, 1982, the Supreme Court granted the Government's petition for certiorari in *Tufts*.²⁷ Thus, for the first time since 1947, the Court will address the issue of nonrecourse debt and its role in tax shelter financing. At long last, the speculation regarding *Crane's* footnote 37 may be laid to rest.

The present Supreme Court can approach the *Tufts* case in a number of different ways. For example, it could review the 1947 decision in *Crane* and conclude that the two principles adopted in that decision are applicable to the taxpayers in *Tufts* and dismiss footnote 37 as meaningless dictum. In my opinion, this approach would require both a reexamination of the underlying rationale in *Crane* and an explanation of why footnote 37 is irrelevant to that rationale. On the other hand, the Court might determine that *Crane's* two principles are valid, but that the appropriate rationale is something other than the explanation offered by the *Crane* Court. This approach would allow the Court to adopt its own rationale and explain why the property's fair market value at the time of disposition is irrelevant. Finally, the Court might analyze the *Crane* Court's concern with fair market value and conclude that footnote 37 implicitly states a valid legal proposition which is consistent with the rationale in *Crane* and which ought to be given effect. The effect, however, should not be the effect endorsed by the Fifth Circuit, i.e., total forgiveness of the tax upon final disposition.

The Fifth Circuit arguably concluded that since footnote 37 correctly limits "amount realized" to the property's fair market value at the time of disposition, it necessarily follows that gain at the time of disposition must, likewise, be limited. This latter limitation, however, is not a logical corollary to the former. *There is no language in footnote 37 which requires that any gain attributable to*

26. For a suggestion of the potential widespread use of footnote 37 in tax shelter schemes, see Ginsburg, *The Leaky Tax Shelter*, 53 TAXES 719, 730 (1975). The Treasury's concern actually goes beyond potential taxpayer reliance on footnote 37. Even if the property has not declined in value, many taxpayers fail to report income upon the disposition of a tax shelter investment. Since many such dispositions do not involve any payment of cash to the transferor, the existence of a taxable event is more likely to escape notice. See The President's 1978 Tax Program, Department of the Treasury, at 65 (Jan. 30, 1978).

27. 102 S. Ct. 2034 (1982).

*the amount of the debt in excess of the property's value should forever go untaxed.*²⁸

Opponents of footnote 37 have advanced a number of theories which accurately explain why this excess of debt over value does constitute taxable gain. To the extent these opponents conclude, however, that taxable gain ought to be computed under section 1001 by including the entire debt in the amount realized, thereby treating the entire gain as a disposition of property gain, their reasoning suffers from the same logical defect as that of the Fifth Circuit.

It is my opinion that footnote 37 should be read as correctly limiting the amount realized to the property's fair market value at the time of disposition. Whereas it is true that such a limitation will reduce the section 1001 gain in a case such as *Tufts*, my reading of footnote 37 would also allow the Court to find additional gain which is attributable to the excess debt. I believe it is important to identify this additional gain as one which results from something other than receiving an amount realized upon disposition of the property.

The purpose of this article is to support my interpretation of footnote 37 as one which is consistent with the reasoning in *Crane* and as one which deserves implementation as a matter of tax policy. This article will demonstrate that the reasoning in *Crane* suggests that "amount realized" is a statutorily defined term which serves only to identify the true sales price of the transferred property, irrespective of the amount of debt outstanding. This view of the Court's reasoning is supported by its apparent focus on the total consideration for the transfer at the time of disposition.²⁹

This article also demonstrates that limiting the amount realized to the property's fair market value at the time of disposition is a theoretically sound approach because it serves to produce overall tax consequences consistent with fundamental tax principles. Specifically, this approach denies potential capital gains characterization to any economic benefit derived from the property which is unrelated to

28. For the text of footnote 37, see *supra* note 13. The footnote states that if the mortgage exceeds the value, the mortgagor cannot realize a benefit equal to the mortgage. 331 U.S. at 14 n.37. The Court's attention, however, was focused on the benefit at the time of disposition. Thus, this language should be interpreted as meaning that the mortgagor cannot realize a benefit equal to the mortgage *at the time of disposition*. It is the "time of disposition" benefit that the Court is characterizing as the amount realized. Prior benefits may produce current income taxable under some theory other than one which identifies it as an amount realized under § 1001, I.R.C. § 1001 (1976). See *infra* text accompanying notes 247-96.

29. See I.R.C. § 1001(b) (amount realized is amount of money received plus fair market value of any property received).

the sale or exchange of the property. In *Tufts*, this approach would result in excluding the entire nonrecourse debt from the amount realized, thereby taxing the gain attributable to the amount of debt in excess of basis as ordinary income.

The article's focus, however, is beyond *Crane* and *Tufts*. Its principle objective is to identify a workable rationale for nonrecourse debt transactions which can explain the result in *Crane*, support the desired result in *Tufts*, and provide predictability for fact situations between and beyond these two cases.

In pursuing this objective, the article begins with a detailed analysis of *Crane*, particularly its facts. My purpose is to highlight a number of factual considerations and related legal issues that were totally omitted from the Supreme Court's final opinion in the case.³⁰ Indeed, the detailed analysis will be more than mere review. It will provide new information which should both be of interest academically and also provide some insight as to the *Crane* Court's reasoning process.

The next section of the article will focus on three different rationales previously discussed in the *Crane* literature: (1) the Economic Benefit Rationale,³¹ (2) the Tax Benefit Rationale,³² and (3) the Double Deduction Rationale.³³ In point of fact, the three rationales are not necessarily as distinct as their separate nomenclature might suggest.³⁴ Although each can be used to identify the correct total gain upon the disposition of property subject to nonrecourse debt, I submit that none of them answers the question of how the resulting gain ought to be *characterized* for tax purposes. Thus, Part III of this article concludes with a discussion of what effect the property's decline in value ought to have on characterization of gain.

Part IV of the article focuses on an additional rationale that ought to be considered in nonrecourse mortgage transactions, the Uniform Treatment Rationale. I suggest that this is the rationale implicitly adopted in *Crane* to support principle number one. With

30. Many facts were omitted from the Supreme Court opinion. For example, the Court failed to mention that Mrs. Crane's depreciation deductions yielded her virtually no tax benefit. See *infra* notes 78-79 and accompanying text.

31. See *infra* notes 179-95 and accompanying text.

32. See *infra* notes 196-210 and accompanying text.

33. See *infra* notes 211-15 and accompanying text.

34. The separately identified rationales have not been developed in the *Crane* literature in a manner consistent with my own explanation of each rationale. For purposes of the analysis in this article, however, each rationale will be discussed separately and potential differences between them will be suggested.

respect to principle number two, the Uniform Treatment Rationale is offered as an analytical tool for answering the question left open by the other three rationales, i.e., how should the resulting gain, especially in footnote 37 cases, be characterized?

As indicated earlier, my ultimate thesis is that the total gain in a case such as *Tufts* is not one that is derived from a sale or exchange of property. To the extent it is not, the potential for favorable capital gains treatment ought to be eliminated. I further suggest in Part IV's discussion of the Uniform Treatment Rationale that in appropriate cases the nondisposition-of-property gain might be characterized as discharge of indebtedness income. This characterization raises the issue of whether the nonrecourse mortgagor can claim relief under section 108.³⁵

II. THE *Crane* CASE

A. *The Facts*

1. *An Overview.*—In 1932, Beulah Crane inherited an apartment building from her husband.³⁶ At the time of Mr. Crane's death, the property was subject to an outstanding mortgage in the amount of \$262,042.50 which included principal of \$255,000 and accrued unpaid interest of \$7,042.50.³⁷ The property was appraised in the decedent's estate tax return at a value which exactly equalled the outstanding mortgage plus accrued interest.³⁸ Thus, Mrs. Crane claimed a depreciable basis in the property under the forerunner to section 1014 of \$262,042.50.³⁹

35. I.R.C. § 108 (Supp. IV 1980) (allowing certain taxpayers to defer recognition of gain which results from discharge of debt). See *infra* notes 264-65. The issue of whether § 108 relief is available cannot be resolved in the *Tufts* case as it is not an issue which is properly before the Court.

The only issue before the Court is whether the face amount of the outstanding nonrecourse liability is properly included in "amount realized." Even if the availability of § 108 relief were an issue before the Court, it is unlikely that the taxpayers in *Tufts* would qualify. See *infra* text accompanying notes 282-96. It should also be pointed out that the taxable years involved in the *Tufts* case predate the 1980 amendments to § 108. Thus, even if the issue were before the Court, it would have to be resolved on the basis of prior law. See *infra* notes 263-64.

36. *Crane v. Commissioner*, 331 U.S. 1, 3 (1947).

37. *Id.*

38. *Id.*

39. *Id.* at 4. It should be emphasized that under § 1014, basis is equal to the fair market value of the inherited property at the date of death. I.R.C. § 1014 (1976). If the inherited property is viewed as the physical asset itself, then any liens attached to the property should be considered irrelevant for the purpose of basis. That is, the existence of the lien neither increases nor decreases the basis otherwise determined under § 1014. But see *infra* note 77.

For the years 1932 through 1936, the property was held by the decedent's estate. Income and deductions were accounted for in the estate's income tax returns.⁴⁰ Subsequently, the property was distributed to Mrs. Crane as beneficiary and, accordingly, she accounted for the relevant income and deductions in her individual tax returns for 1937 and 1938.⁴¹ During this period, no payments were made to reduce the outstanding debt.⁴²

In 1938, Mrs. Crane sold the apartment building, subject to a then outstanding mortgage indebtedness of \$270,857.71.⁴³ The building was sold to an unrelated purchaser for \$2,500 cash, net of selling expenses.⁴⁴ Mrs. Crane reported a \$2,500 gain on the sale and characterized it as a long term capital gain.⁴⁵

The Commissioner asserted a deficiency, claiming that Mrs. Crane recognized an ordinary gain of \$24,031.45 on the sale of the building and a capital loss on the sale of the land of \$528.85.⁴⁶ The

40. Record at 6-7.

41. *Id.*

42. Only partial payment of current interest was made. *Id.* at 25-26. By 1938, the debt together with accrued interest amounted to \$270,857.71. *See* 331 U.S. at 3.

43. The increase of \$8,815.21 represents an additional accumulation of unpaid interest attributable to the years 1932 to 1938. *See supra* text accompanying note 37.

44. 331 U.S. at 3.

45. *See id.* at 4.

46. *Id.* at 5. The Commissioner determined these figures as follows:

1. Of the original § 1014 basis, \$207,042.50 was allocated to the building and \$55,000 to the land. *Id.* at 4.

2. Allowable depreciation at two percent per annum totalled \$24,845.10 for the years 1932 through 1937 (2% x 6 years x \$207,042.50). Mrs. Crane claimed and was "allowed" \$3,200 depreciation for 1938. Thus, the total of allowable and allowed depreciation was \$28,045.10. *Id.* at 4 & n.5.

3. The building's basis must be reduced by this total amount even though depreciation actually claimed by Mrs. Crane totalled only \$25,200, and even though most of the deductions produced no tax benefit. *Id.* at 3 n.2; *see id.* at 4.

4. The amount realized upon disposition included the \$2,500 cash plus the amount of *principal* outstanding on the mortgage as of Mr. Crane's death, \$255,000, for a total of \$257,500. *Id.* at 3. The Commissioner eliminated the accrued interest as of Mr. Crane's death from the amount realized on the theory that interest is a deductible item. *Id.* at 4 n.6. This theory is correct only if the accrued interest would have been deductible by Mrs. Crane. Since the interest had accrued during Mr. Crane's lifetime, however, it should be viewed as *his* interest and, thus, not deductible by Mrs. Crane. *See* Rev. Rul. 58-129, 1958-1 C.B. 93.

5. Allocating the total amount realized according to relative fair market values produced an amount realized on the land of \$54,471.15 and an amount realized on the building of \$203,028.85.

6. Loss on the land was thus \$528.85 (\$54,471.15 realized less \$55,000 basis) and gain on the building was \$24,031.45 (\$203,028.85 realized less \$178,997.40 adjusted basis).

7. Since the building was a business asset subject to depreciation, it was not a capital asset. Revenue Act of 1938, c. 289, § 117(a)(1), 52 Stat. 447 (now codified at I.R.C. §

Supreme Court agreed with the Commissioner's characterization of the transaction,⁴⁷ specifically holding that:

(1) Mrs. Crane's original basis in the property was its fair market value at Mr. Crane's death, \$262,042.50, undiminished by the outstanding mortgage liability;⁴⁸ (2) that basis must be adjusted downward by the amount of depreciation *allowable*, i.e., \$28,045.10;⁴⁹ (3) the amount realized upon disposition included both the cash received (\$2,500) and the outstanding principal on the mortgage liability (\$255,000), despite Mrs. Crane's lack of personal liability on the debt.⁵⁰

Thus, Mrs. Crane was required to pay taxes on a net gain of

1221(2)(1976)). Thus, gain on the building was ordinary gain. (Note that in 1938 there was no provision in the tax law comparable to current I.R.C. § 1231 which would have allowed capital gain on the sale of this type of asset).

47. *Crane*, 331 U.S. at 4-5.

48. *Id.* at 11. The Revenue Act of 1938, c. 289, § 113(a)(5), 52 Stat. 447 (current version at I.R.C. § 1014(a), (b)(1976)), provided:

(a) BASIS (UNADJUSTED) OF PROPERTY.—The basis of property shall be the cost of such property; except that . . . (5) PROPERTY TRANSMITTED AT DEATH.—If the property was acquired by bequest, devise, or inheritance, . . . the basis shall be the fair market value of such property at the time of such acquisition.

49. *See* 331 U.S. at 4, 11. The Revenue Act of 1938, c. 289, 52 Stat. 447, provided:

(b) ADJUSTED BASIS.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) GENERAL RULE.—Proper adjustment in respect of the property shall in all cases be made—

. . . .

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear . . . to the extent allowed (but not less than the amount allowable) under this Act

Id. § 113(b)(current version at I.R.C. §§ 1011, 1016(a)(2) (1976)).

Also applicable was the following provision:

(a) BASIS FOR DEPRECIATION.—The basis upon which exhaustion, wear and tear . . . are to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property.

Id. § 114(a).

50. *See* 331 U.S. at 4, 14. The applicable provision under the Revenue Act of 1938, c. 289, § 111(b), 52 Stat. 447 (current version at I.R.C. § 1001(b)(1976)), defined "amount realized" as follows:

(b) AMOUNT REALIZED.—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.

Section 111(a), *id.* § 111(a), provided the general formula for computation of gain that is now found in the current provision, I.R.C. § 1001(a)(1976), i.e., gain = amount realized less adjusted basis.

\$23,767.03,⁵¹ the rough equivalent of her past depreciation deductions with respect to the property.⁵² This result initially appears justifiable on a tax-benefit theory.⁵³ This theory, however, presents certain difficulties, given the particular facts of the case.

2. *The Particular Facts.*—Although the record does not state the date on which Mrs. Crane's deceased husband acquired the apartment building, the taxpayer's petition to the Tax Court does indicate that the mortgage was made in 1924.⁵⁴ Mr. Crane died in 1932⁵⁵ during the early years of the depression. It seems fair to infer that the property had declined significantly in value from the date Mr. Crane acquired the property until his death in 1932.⁵⁶ Indeed, but for Mr. Crane's untimely death, the 1938 disposition of the apartment building might have produced a taxable loss.⁵⁷

Mrs. Crane inherited the apartment building at a time when the outstanding mortgage was in default for nonpayment of principal and interest.⁵⁸ Since she was unable financially to cure the default,

51. Ordinary gain of \$24,031.45, less 50% of her capital loss of \$528.85. 331 U.S. at 5.

52. The actual depreciation claimed was \$25,500. *Id.* at 3 n.2. The allowable depreciation was computed as \$28,045.10. *Id.* at 4; *see supra* note 48. The further discrepancy between allowable depreciation and taxable gain stems from the fact that \$7,042.50 of accumulated interest was included in the basis for depreciation purposes, but was not included as part of the amount realized. *See supra* notes 37, 46 and accompanying text.

53. It seems equitable that a taxpayer who takes depreciation deductions on the basis of a borrowed capital contribution should be required to include those deductions in taxable income if he or she is in some way relieved from paying back the borrowed capital.

54. There were two mortgages involved; one was made in 1923, the other in 1924, and the two were consolidated on February 8, 1924. Record at 5-6.

55. 331 U.S. at 3.

56. Indeed, the property was originally listed in Mr. Crane's estate tax return at a value less than the outstanding mortgage. Upon review, the Commissioner adjusted the value upwards and the taxpayer accepted the adjustment. Petitioner's Reply Brief at 5. Evidencing the likely decline in the property's value is the significant number of depression era tax cases involving property whose value declined to less than 50% of its value at the time of acquisition. Most of these cases involve the issue of whether disposition of the property results in ordinary or capital loss. *See, e.g.,* *Rogers v. Commissioner*, 103 F.2d 790 (9th Cir. 1939) (property acquired in 1927 for \$105,000; value in 1932 no more than \$38,000); *O'Keefe v. Commissioner*, 44 B.T.A. 290 (1941) (property acquired in 1928 for \$50,750; value in 1937 approximately \$9,000); *Hoffman v. Commissioner*, 40 B.T.A. 459 (1939), *aff'd per curiam*, 117 F.2d 987 (2d Cir. 1941) (property acquired in 1928 for \$160,000; value in 1934, \$65,000).

57. If we assume that Mr. Crane's basis in the building in 1923 was 50% greater than its value at his death in 1932, *see supra* note 56, he would have had a basis for depreciation of approximately \$310,000. Using the agreed upon depreciation rate of two percent per annum, he would have been entitled to approximately \$93,000 in depreciation deductions between 1923 and 1938. Thus, his adjusted basis at the time of disposition in 1938 would have been \$217,000. Since the amount realized with respect to the building was only \$203,028.25, Mr. Crane would have recognized a taxable loss on the sale of approximately \$14,000.

58. *See* Record at 16 (Stipulation of Fact (11)).

she entered into an agreement with the mortgagee whereby she would turn over monthly rental payments, net of operating expenses, to the mortgagee, to be applied to property taxes and interest due.⁵⁹ Apparently, these net rentals were insufficient to cover interest payments as they accrued. Thus, in 1934, upon an additional payment of \$2,500 by Mrs. Crane, the mortgagee agreed to reduce the rate of interest on the outstanding debt to four percent.⁶⁰

Despite this reduction, Mrs. Crane's payments were insufficient to cover the interest as it accrued.⁶¹ In 1938, under threat of foreclosure, Mrs. Crane negotiated a sale of the property to a third party.⁶² Upon closing, she received \$2,500 net in cash.⁶³ The record does not indicate what arrangements were made between the new owner of the property and the mortgagee for the future liquidation of the outstanding mortgage debt.

Although tax consequences do not necessarily follow cash flow, it is important for a full understanding of Mrs. Crane's position to review the above facts from a cash flow perspective. First, no cash was available to her from rentals on the property as it was all turned over to the mortgagee. Nor did the turning over of these net rentals create any indirect economic benefit to Mrs. Crane. It did not, for example, discharge any personal liability attributable to her.⁶⁴ Second, she obtained no economic benefit through use of the property since it was being used by the tenants.⁶⁵ Had she never assumed ownership of the property, her net economic position would have been the same.⁶⁶ In fact, she paid \$2,500 of her own funds in an attempt to keep the property⁶⁷ and upon final disposition she recouped that \$2,500.⁶⁸ Thus, absent tax considerations, she had no economic gain.⁶⁹

59. *Id.* at 19-25.

60. *Id.* at 25-26.

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

62. *Id.*

63. *Id.*

64. The payments were used to take care of property taxes for which Mrs. Crane was not personally liable. Any residue was credited towards past due interest. Record at 19-25.

65. Had the property been available for Mrs. Crane's personal use as, for example, a residence, then arguably the consumption value stemming from such use would have been an economic benefit.

66. Of course, by assuming ownership she acquired a potential economic benefit hinging on the property's future increase in value. The property's value presumably did increase, since Mrs. Crane was paid \$2,500 for her equity in 1938. *See supra* note 63 and accompanying text.

67. *See supra* text accompanying note 60.

68. 331 U.S. at 4.

69. It is more likely that she suffered some degree of economic loss. For example, if the

Before an accurate conclusion regarding Mrs. Crane's true economic gain can be reached, however, the tax effects of the described events must be considered. For example, if Mrs. Crane's payment of \$2,500 in 1934 was a payment of interest properly deductible for tax purposes in that year, then the \$2,500 receipt in 1938 must be considered a taxable recoupment of that expenditure. In that case, the \$2,500 receipt must be treated as an economic gain in 1938 and reported as gross income at that time.⁷⁰

In addition, as the true owner of the building, Mrs. Crane theoretically was entitled to the gross rents.⁷¹ As such, she would have had an initial taxable economic benefit equal to the amount of the gross rents. However, since all of the gross rentals were expended in the same year they were received, and were expended on items properly deducted for income tax purposes, there was no net economic benefit and no taxable income.

There is, however, one remaining tax consideration which is independent of annual cash flow: *depreciation*. In some contexts, depreciation is merely a means of accounting for a prior cash expenditure.⁷² In other contexts, it has nothing to do with a prior cash expenditure.⁷³ In the case of mortgaged property, depreciation de-

legal fees attributable to her ownership of the property were satisfied out of her own funds, rather than income produced from the property, the net result would be an economic loss.

70. See I.R.C. § 451 (1976).

71. It could be argued that, in substance, Mrs. Crane was merely acting as the mortgagee's agent in collecting the rents; that pursuant to her initial agreement with the mortgage bank, she was never entitled to any of the rents, but was bound to turn them over directly to the bank for the purpose of discharging someone else's obligation. Since this agreement was to stay in effect until such time as her deceased husband's obligation was no longer in default, perhaps she should not have been considered the owner of the property for tax purposes until such time as she was relieved from the agreement. Although this characterization of the situation was not specifically argued by Mrs. Crane during the litigation, it is implied in her argument that she never really owned anything other than the equity in the property. See *infra* note 97 and accompanying text.

72. For example, if Mrs. Crane had purchased the property for \$262,000 cash in 1932, she would have accounted for the expenditure tax-wise through subsequent depreciation deductions.

73. For example, if Mrs. Crane had inherited the property free and clear of any liens in 1932 when it was worth \$262,000, she still would have been entitled to the same depreciation deductions discussed earlier, see *supra* note 72, even though she had made no cash expenditure whatsoever. Although it is true that her husband probably made some cash expenditure in the past, it might have been more or less than the amount of depreciation deductions Mrs. Crane would be entitled to take after his death. This anomaly results from the basis rule contained in § 1014 and the failure of our tax system to restrict depreciation deductions to actual capital investment by the taxpayer. The result can be attacked or defended using various tax policy arguments. At any rate, the rule with respect to inherited property has been part of our tax system from its beginning and, thus, is presumably here to stay. *But see* *Friend v. Commis-*

ductions often give a taxpayer advance credit for subsequent cash expenditures.⁷⁴

As the record indicates, Mrs. Crane utilized the standard depreciation rules during the years 1932 through 1938.⁷⁵ She claimed approximately \$3,500 a year in depreciation deductions for a total of \$25,200 over the seven year period involved.⁷⁶ In effect, she was given tax deductions for cash expenditures she had not yet made.⁷⁷ Surprisingly, the record indicates something further: Mrs. Crane received virtually no tax benefit from these depreciation deductions because there was insufficient income against which the deductions could be offset.⁷⁸ During the seven year period, approximately \$3,000 of the claimed depreciation actually served to reduce taxable

sioner, 119 F.2d 959 (7th Cir. 1941). *Friend* involved a lease having a premium value to the lessor because it provided for rentals in excess of the going market rate. Upon the death of the original lessor, the beneficiary asserted that the premium value determined at the date of death constituted a basis upon which depreciation could be calculated since the lease was a wasting asset. The court said the step-up at death provisions were meant to give heirs a basis for gain or loss upon disposition only and were not intended to create a depreciable cost basis where none had existed previously. *Id.* at 961. *But see* Commissioner v. Moore, 207 F.2d 265 (9th Cir. 1953).

74. This is especially true under the new Accelerated Cost Recovery System which allows a taxpayer to write off a building's cost over 15 years, even though it may be subject to a 30 or 40 year mortgage. I.R.C. § 168 (West Supp. 1982). *See also* Mayerson v. Commissioner, 47 T.C. 340 (1966) (99 year mortgage term); *supra* notes 6-7 and accompanying text.

75. *See supra* note 46.

76. *Id.* The Commissioner, however, asserted she was entitled to claim somewhat higher depreciation deductions. *See supra* note 47.

77. Of course, strictly speaking she was not being given credit for the nonrecourse debt in advance of its payment in the same manner as a taxpayer who acquires property through purchase with nonrecourse funds. Her basis was determined as the fair market value of the property unreduced by the mortgage debt. She was, however, being given an advance credit indirectly because the net value of the property she inherited was zero. Disregarding the mortgage liability has the same effect as including it in basis.

78. Record at 6-7. In only three of the seven years at issue would the elimination of the depreciation deduction have produced any tax liability. Thus:

<u>Year</u>	<u>Income Eliminating Depreciation</u>	<u>Tax</u>
1932 (estate)	3,438.61	92.26
1933 (estate)	1,569.76	22.79
1937 (Mrs. Crane)	1,294.41	6.60

Id.

income.⁷⁹

B. *The Issues Presented*

The Supreme Court phrased the issue in *Crane*⁸⁰ as follows: "The question here is how a taxpayer who acquires depreciable property subject to an unassumed mortgage, holds it for a period, and finally sells it still so encumbered, must compute her taxable gain."⁸¹

This general statement of the issue necessarily involves a number of specific subsidiary issues relevant to the computation of gain. These subsidiary issues include: (1) What was the "property" acquired by Mrs. Crane in 1932 and sold in 1938? (2) What was her original basis in the property? (3) Must that basis be adjusted for depreciation in order to determine the adjusted basis figure to be used in the computation of gain formula?⁸² (4) What was the amount realized in 1938?

Additionally, if the Court adopted the Commissioner's computation of Mrs. Crane's gain, it would have to address the constitutional argument raised by the taxpayer. This argument was that to tax her on the statutorily computed gain would violate the Constitution by taxing her on something other than income as that term is used in the sixteenth amendment.⁸³

<u>79.</u> <u>Year</u>	<u>Depreciation Necessary to Produce</u> <u>Zero Tax Liability</u>
1932	2,242.51
1933	869.97
1937	<u>194.41</u>
TOTAL	3,306.89

Id.

Although the absence of tax benefit was not included in the list of stipulated facts at the trial level, the relevant tax returns for the past years were introduced into evidence and the fact was never disputed. The absence of tax benefit was pointed out at least seven times in the briefs filed with the Supreme Court. *See* Petition for Writ of Certiorari and Brief in Support Thereof at 4, 6; Brief for Petitioner at 3, 6, 46; Brief for the Respondent at 8; Petitioner's Reply Brief at 4.

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

81. *Id.* at 2.

82. Gain = Amount Realized less Adjusted Basis. I.R.C. § 1001(a)(1976). Whether or not this is the correct formula to be used in a nonrecourse mortgage transaction can be considered a subsidiary issue. The Court, however, never considered another alternative and, thus, implicitly resolved this issue at the outset.

83. Specifically, the taxpayer argued that since the tax which the Commissioner sought to impose was not really on income, but instead was on capital, it would violate the provisions of article I of the Constitution which requires such a tax to be apportioned among the States, *see* U.S. CONST. art. I. Brief for the Petitioner at 50.

C. *The Court's Holding*

The Court's ultimate holding regarding computation of gain was that the existence of the nonrecourse liability did not affect any of the elements in the statutory formula for calculation of gain.⁸⁴ Thus, original basis was not affected by the existence of the liability. The availability of depreciation deductions and the concomitant adjustments to basis were not affected. Finally, amount realized was held to include the debt to the same extent it would have been included had Mrs. Crane been personally liable.⁸⁵ Thus, the Court held that Mrs. Crane had statutory income to the extent the cash boot and outstanding debt exceeded her adjusted basis in the property.⁸⁶

The Court further held that the resulting statutory income was constitutional income and thus satisfied the requirements of the sixteenth amendment.⁸⁷ The fact that Mrs. Crane's income resulted from depreciation deductions that gave her virtually no tax benefit was not addressed directly by the Court. Nonetheless, the Court's holding on the constitutional issue implies that absence of tax benefit should not affect statutory calculation of gain, nor does it affect Congress' power to tax that gain.

D. *The Court's Rationale*

The Supreme Court's failure to articulate its rationale in *Crane* has created much speculation about what its primary rationale actually was.⁸⁸ It has also generated much discussion about what the rationale should have been.⁸⁹ This article will now focus on the former, i.e., on what the *Crane* Court itself most likely considered as the main justification for its holding.

1. *Primary Rationale for Principle Number One: Inclusion of*

84. See 331 U.S. at 13.

85. See *id.* at 14.

86. See *id.*

87. See *id.* at 15-16.

88. See, e.g., Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane Case*, 33 TAX. L. REV. 277 (1978); Del Cotto, *Basis and Amount Realized Under Crane: A Current View of Some Tax Effects in Mortgage Financing*, 118 U. PA. L. REV. 69 (1969); Newman, *The Resurgence of Footnote 37: Tufts v. Commissioner*, 18 WAKE FOREST L. REV. 1 (1982).

89. Commentators have accepted the *Crane* result as correct. Dissatisfied with the Court's explanation of the result, however, they have developed their own theories for explaining its correctness in *Crane* as well as in other cases involving nonrecourse debt. See, e.g., Friedland, Tufts and Millar: *Two New Views of the Crane Case and Its Famous Footnote*, 57 NOTRE DAME LAW. 510 (1982); Simmons, *Nonrecourse Debt and Amount Realized: The Demise of Crane's Footnote 37*, 59 OR. L. REV. 3 (1980).

Nonrecourse Liability in Depreciable Basis.—As noted earlier, the *Crane* Court did not hold that nonrecourse debt, in and of itself, created depreciable basis. Tax basis, both for depreciation purposes and for purposes of determining gain upon disposition, is statutorily defined.⁹⁰ In Mrs. Crane's case, the applicable statute provided for a tax basis in inherited property equal to the property's fair market value at death.⁹¹ The specific holding in *Crane* was that the existence of nonrecourse mortgage liability with respect to inherited property did not affect the normal application of the section 1014 basis rule.⁹² Nonetheless, the *Crane* principle regarding basis was readily applied to cases involving cost basis under section 1012⁹³ because it was perceived that "the rationale of the opinion is equally applicable to property acquired by purchase or exchange."⁹⁴

The *Crane* rationale respecting depreciable basis can be identified best by focusing on the issue as it was presented to the Supreme Court by the contestants. The Commissioner argued that Mrs. Crane had inherited property consisting of land and a building, that basis is determined by the fair market value of the property on the date of inheritance,⁹⁵ and that the existence of any mortgage, nonrecourse or otherwise, had no bearing on the basis issue.⁹⁶ Mrs. Crane, on the other hand, argued that she inherited a mere equity of redemption whose value was zero because of the mortgage liability.⁹⁷

If one focuses on Mrs. Crane's legal rights with respect to the property at the time of her husband's death, the logic of her argument is evident. The mortgage was in default at Mr. Crane's death.⁹⁸ Mrs. Crane, as his beneficiary, could acquire ownership rights in the property only by paying off the debt, and since the debt was equal to the property's value, the equitable rights she possessed were worth nothing.

90. See I.R.C. §§ 1011-1016 (1976 & West Supp. 1982) (basis rules).

91. See *supra* note 48.

92. See 331 U.S. at 11.

93. See *Mayerson v. Commissioner*, 47 T.C. 340 (1966), *acq.* 1969-2 C.B. xxiv; *Blackstone Theatre Co. v. Commissioner*, 12 T.C. 801 (1949), *acq.* 1949-2 C.B. 1; *Parker v. Delaney*, 186 F.2d 455 (1st Cir. 1950). The use of cost basis is granted by statute. I.R.C. § 1012 (1976).

94. Greenbaum, *The Basis Of Property Shall Be The Cost Of Such Property: How Is Cost Defined?*, 3 TAX L. REV. 351, 355 (1948).

95. 331 U.S. at 7 (relying on I.R.C. § 113 (1938) (current version at I.R.C. § 1014 (1976))).

96. See *id.* at 4.

97. *Id.* at 3.

98. *Id.*

Mrs. Crane asserted that the definition of "property" should be derived from a legal analysis of the taxpayer's "bundle of rights" with respect to the physical asset.⁹⁹ The Court addressed the issue, however, as one of statutory construction. Employing a plain meaning approach, the Court concluded that property, for purposes of determining basis, means a physical asset.¹⁰⁰ The Court's opinion would have been more satisfactory had it dealt directly with the taxpayer's argument and admitted that her characterization of the "property" she inherited was correct, but that nonetheless, for depreciation purposes, the "property" in question was the physical asset.

The Court reasoned, quite correctly, however, that utilizing an equity basis for depreciation purposes, was inconsistent with our developed scheme of accounting for depreciation and would create significant administrative difficulties.¹⁰¹ This line of reasoning, however, lends only indirect support to the Court's stated principle that nonrecourse debt must be included in depreciable basis. That is, although our depreciation scheme and concern with administrative difficulties lead to a conclusion that an equity basis for depreciation purposes is undesirable, they do not necessarily answer the ultimate question: Should a taxpayer who owns property subject to a nonrecourse mortgage liability be entitled to depreciation deductions in excess of cash investment?

Mrs. Crane argued that she was not entitled to depreciation deductions, because she bore no risk of loss.¹⁰² If the building declined in value, it would have been the mortgagee bank, not Mrs. Crane, who suffered the real economic loss. Since she did not invest her own funds and since the net value of the property she inherited was zero, she had nothing to lose by not paying this debt.¹⁰³

Her argument appears sound as a matter of law. The right to claim depreciation deductions on property does not necessarily accrue to the holder of the legal title.¹⁰⁴ Potential risk of loss is a nec-

99. *Id.* at 3, 6.

100. *Id.* at 6. The Court actually cited to *Webster's Dictionary* in support of the plain meaning of the word "property." *Id.* at 6 n.14.

101. *Id.* at 10. The most obvious difficulty would be a recalculation of the depreciable equity basis each year, with an increase warranted any time payments of mortgage principal were made.

102. *Id.* at 11.

103. *See id.* at 3. Her situation is clearly different from that of a personally liable mortgagor who has invested no funds in property with an equity of zero. The personally liable mortgagor will, nonetheless, bear the risk of loss if the property declines in value because the mortgagee bank can recover any resulting deficiency from such an obligor.

104. *See Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939) (lessee entitled to

essary prerequisite to claiming the deduction.¹⁰⁵ Thus, since Mrs. Crane bore no risk of loss at the time she inherited the property, logically she should not have been entitled to depreciation deductions.

The Supreme Court, however, regarded her “no risk of loss” argument as one that essentially involved a question of fact. It stated rather summarily that she had failed to establish factually that there was no risk of loss and that the Tax Court, as finder of fact, had failed to make any such finding.¹⁰⁶ In focusing on the factual nature of her argument, the Supreme Court failed to offer a satisfactory rationale for the legal principle that the opinion set forth and which has been followed since 1947.¹⁰⁷ Nonrecourse mortgagors are entitled to depreciation deductions computed on a basis which includes the nonrecourse debt, even though, as a matter of property law, the risk of loss does not fall on the mortgagor.

Although the Court refused to acknowledge that the principle it implicitly set forth regarding depreciation deductions was an exception to the normal risk of loss requirement, it did make a few observations that support a possible rationale for this exception. In discussing Mrs. Crane’s failure to establish her factual premise, the Court emphasized: (1) that there was no evidence that the property’s value ever fell below the outstanding mortgage debt,¹⁰⁸ (2) that Mrs. Crane’s receipt of boot in 1938 suggested that the property had instead risen in value,¹⁰⁹ and (3) that a different rule might be appropriate in cases involving property worth less than the mortgage debt.¹¹⁰

These observations regarding the relationship between the property’s value and the debt suggest that principle number one of the *Crane* case ought to be applied in limited fact situations.¹¹¹ The

depreciation deduction). *Lazarus* was cited by the *Crane* Court. 331 U.S. at 11 n.32.

105. See *Royal St. Louis, Inc. v. United States*, 578 F.2d 1017 (5th Cir. 1978) (depreciation deduction denied owner-lessor in sale and leaseback situation because lease required lessee make good any economic loss; thus, lessor bore no risk of economic loss).

106. 331 U.S. at 11. It could be argued, however, that the Tax Court implicitly made such a finding as a matter of law since it accorded her a zero basis and held that the basis should not be reduced by depreciation. See *id.* at 5.

107. *Crane* has only been modified slightly. See *supra* notes 8-9 and accompanying text.

108. 331 U.S. at 12.

109. *Id.*

110. *Id.*

111. Indeed, application of the principle has been so limited in subsequent decisions. See, e.g., *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976); *Narver v. Commissioner*, 75 T.C. 53 (1980), *aff’d*, 670 F.2d 855 (9th Cir. 1982).

Court's earlier expression of concern with respect to administrative difficulties, coupled with its emphasis on the property's fair market value, lends support to the rationale I identify as the Uniform Treatment Rationale, i.e., that nonrecourse mortgagors ought to be accorded uniform tax treatment with personally liable mortgagors, provided such uniform treatment is warranted by the economic reality of the situation. The relationship of the property's fair market value to the outstanding debt is an indicator of the economic reality.

The suggested economic reality is that a mortgagor, whether personally liable or not, will in fact pay off the mortgage debt to protect his or her investment in a property whose value exceeds the debt. Since it is the assumption of future payment which justifies inclusion of mortgage in basis when the mortgagor is personally liable, if the facts support the same assumption in the case of a nonrecourse mortgagor, then he or she ought to be accorded like treatment. Thus, although the *Crane* Court did not explicitly articulate a rationale in support of principle number one, its indication that the fair market value at the time of acquisition might affect its conclusion regarding basis,¹¹² implicitly suggests the Uniform Treatment Rationale.

2. *Primary Rationale for Principle Number Two: Inclusion of Nonrecourse Debt in Amount Realized.*—Having rejected Mrs. Crane's argument that what she inherited and sold was a mere equity in the physical asset, the Court, as a matter of consistency, had to reject her argument that she realized only \$2,500 on the sale.¹¹³ Perhaps the need for consistency provides a sufficient explanation for the establishment of principle number two. Both litigants did argue that consistency at each end of the transaction was required.¹¹⁴ Therefore, once the Court sided with the Commissioner's position regarding depreciable basis, consistency demanded that the Court also side with the Commissioner by including the outstanding mortgage in amount realized.¹¹⁵

The Court could have justified this part of its holding as being a necessary corollary to the inclusion of outstanding mortgage debt in basis. Indeed, the government specifically argued that including the

112. See 331 U.S. at 12.

113. See *id.* at 13.

114. See Brief for the Petitioner at 32; Brief for the Respondent at 7.

115. Indicative of the Court's concern with consistency is its observation that "[i]f the 'property' to be valued on the date of acquisition is the property free of liens, the 'property' to be priced on a subsequent sale must be the same thing." 331 U.S. at 12 (footnote omitted).

mortgage in the amount realized could be justified "solely on the ground that it is a condition for permitting the taxpayer to include it in basis."¹¹⁶

The Court declined, however, to adopt the government's suggested rationale, instead choosing a more complicated approach. It attempted to explain why the nonassumption of a nonpersonal liability constituted "money" or "other property" received by the seller,¹¹⁷ thereby attempting to satisfy the statutory definition of amount realized.¹¹⁸ Within the context of this explanation, the Court dropped its famous footnote 37, suggesting that the mortgage would not represent an amount realized if it exceeded the property's fair market value.¹¹⁹ Had the Court opted for the rationale suggested by the government, presumably it would have established an absolute rule that once the mortgage had been included in basis, it must also be included in amount realized. Under this approach, the property's fair market value at the time of disposition would have been considered completely irrelevant. The Court's concern with fair market value, therefore, appears to be an implicit rejection of the government's suggested consistency rationale and the rationale's concomitant rule regarding the inclusion of the debt in the amount realized when the debt has been included in basis.

However strong the equitable arguments might be in support of the absolute rule suggested by the government, the *Crane* Court committed itself to a rationale which could explain how the transfer of the nonrecourse liability might fit within the explicit statutory definition of amount realized. In this respect, its approach was similar to that of the Board of Tax Appeals in *Brons Hotels, Inc. v. Commissioner*.¹²⁰ The court in *Brons Hotels* was attracted to the logic of the equitable principle that a recourse liability should be included in amount realized upon disposition merely because it had been included in the basis upon acquisition.¹²¹ Nonetheless, the Board felt it inappropriate to adopt such a rule as a matter of equity because the term "amount realized" had been specifically defined by Congress.¹²²

116. Brief for the Respondent at 27.

117. See 331 U.S. at 13-14.

118. I.R.C. § 1001(b)(1976).

119. 331 U.S. at 14 n.37.

120. 34 B.T.A. 376 (1936). *Brons Hotels* is cited in the *Crane* opinion as relevant authority. 331 U.S. at 13 nn.34 & 35.

121. See 34 B.T.A. at 379.

122. See *id.* at 381-82.

Neither the *Brons Hotels* court nor the *Crane* Court considered what the result in their respective cases might have been had they been unable to fit the transfer of the mortgage liabilities within the statutory definitions of amount realized. It should be pointed out, however, that a failure to find that the transfer of the liability constituted an amount realized would not necessarily mean that the disposition of the property resulted in no taxable income to the transferor.¹²³ Once this point is understood, footnote 37 begins to take on new importance. The footnote merely indicates that if the value of the property is less than the mortgage, and the mortgagor is not personally liable, then the full amount of the mortgage debt may not represent true sales price,¹²⁴ i.e., actual consideration to be paid for the property, a concept implicitly embodied in the statutory term "amount realized." In this fact situation, "a different problem might be encountered."¹²⁵ Indeed, I suggest that in this factual situation, the difference might be production of ordinary income, rather than capital gain.¹²⁶

Thus, the reasoning of the *Crane* Court might be described as follows: (1) Since the liability was properly included in depreciable basis, consistency demands that it be considered in the computation of gain upon disposition, and (2) if the transfer of the liability at disposition can be viewed as "money" or "other property" received, then the proper way to consider it in the gain computation process is as an amount realized. The Court struggled, however, with the statutory meaning of "money" or "other property" as part of the definition of amount realized.

The approach the Court adopted was to analogize Mrs. Crane's situation with that of a seller who disposes of similar property sub-

123. Herein lies the fallacy of the arguments in cases such as *Millar v. Commissioner*, 577 F.2d 212 (3d Cir.), *cert. denied*, 439 U.S. 1046 (1978), and *Tufts v. Commissioner*, 651 F.2d 1058 (5th Cir. 1981), *cert. granted*, 102 S. Ct. 2034 (1982). Since the government limited itself to arguing that the liability constituted an amount realized, the taxpayer responded with an argument based on footnote 37 in *Crane*, which suggests that the liability not be included in the amount realized if the property's fair market value is less than the liability. The transfer of the liability, however, might well trigger income to the transferor, under some other theory, such as tax benefit. In this case, the income would not represent a § 1001 gain from the sale of property, *see* I.R.C. § 1001(a) (1976), and should not be entitled to preferential capital gains treatment. *See infra* text accompanying notes 218-46. The government appears to have conceded the capital gains issue. *See* Rev. Rul. 76-111, 1976-1 C.B. 214. Thus, the government's current position is also in conflict with my reading of *Crane*.

124. *See* 331 U.S. at 14 n.37. For full text of footnote 37, *see supra* note 13.

125. 331 U.S. at 14 n.37.

126. *See supra* note 123; *infra* notes 239-46.

ject to a mortgage liability for which the seller is personally liable.¹²⁷ The Court assumed, and Mrs. Crane conceded, that if she had been personally liable, the transfer effectively would have relieved her of personal liability and that the relief of liability would have been properly characterized as an amount realized.¹²⁸ The Court concluded:

[W]e think that a mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and for additional consideration, realizes a benefit in the amount of the mortgage as well as the boot. If a purchaser pays boot, it is immaterial as to our problem whether the mortgagor is also to receive money from the purchaser to discharge the mortgage prior to sale, or whether he is merely to transfer subject to the mortgage. . . . Or put in another way, we are no more concerned with whether the mortgagor is, strictly speaking, a debtor on the mortgage, than we are with whether the benefit to him is, strictly speaking, a receipt of money or property. We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.¹²⁹

Although the *Crane* Court's analogy to a personally liable mortgagor is a logical approach and produces justifiable results, the assertion that the benefit to the nonrecourse mortgagor upon disposition "is as real and substantial . . . as if a personal debt . . . had been assumed by another"¹³⁰ is simply not true. There is a qualita-

127. See 331 U.S. at 13.

128. *Id.* In point of fact, the Supreme Court had never directly considered the issue of whether or not the effective relief would have been an amount realized under the principles of section 1001, I.R.C. § 1001(b)(1976). The *Hendler* case, *United States v. Hendler*, 303 U.S. 564 (1938), relied on by the *Crane* Court, 331 U.S. at 13 n.34, was not a § 1001 case and, furthermore, it involved the assumption plus immediate payment of the liability. *Hendler*, 303 U.S. at 566. Payment of a liability had been held to be income under *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929), but assumption absent payment is arguably a different issue because the release to the seller is not immediate. *Brons Hotels*, 34 B.T.A. 376 (1936), is directly on point regarding the treatment of assumption absent payment as a present economic benefit, see *id.* at 381-82, but it is a § 1031 case, I.R.C. § 1031 (1976).

129. 331 U.S. at 14 (footnotes omitted).

130. *Id.* Commentators have stressed that this passage from *Crane* identifies an economic benefit that is not really present. See, e.g., Bittker, *supra* note 88, at 282. The Supreme Court, however, recently quoted this passage from *Crane* with approval, suggesting that the reality of the transaction was one in which the taxpayer "realized an economic benefit." Die-

tive difference between *X*'s agreement to pay a debt that otherwise I will have to pay and *X*'s agreement to pay a debt that I may choose to disregard at any time I decide I no longer wish to keep the mortgaged property.¹³¹

The conceptual difficulty with the Court's approach to the statutory language lies in the statutory language itself. According to section 1001, gain is to be measured by subtracting adjusted basis from the seller's total receipts.¹³² This approach is not problematic so long as the entire purchase price is being paid to the seller.¹³³ When, however, part of the purchase price is being paid to the seller's mortgagee, the seller's receipt is necessarily an indirect one, even if the seller is personally liable.

There has never been a statutory provision specifically applicable to sales of mortgaged property; the only statutory provision that appears relevant, therefore, is section 1001. Thus, it is necessary either to characterize the purchaser's payments to the seller's mortgagee as "money" or "other property" received by the seller, or else compute the gain under some judicially created formula. Although the latter approach is possible, and has been suggested by some commentators,¹³⁴ the *Crane* Court felt constrained to identify the gain by applying the specific statutory language. In doing so, it stretched the ordinary meaning of "economic benefit," enabling it to find an indirect receipt of "money" similar to the "economic benefit" that a personally liable mortgagor recognizes upon disposition of the mortgaged property.

On the one hand, if the seller is personally liable on the mort-

drich v. Commissioner, 102 S. Ct. 2414, 2418 (1982) (payment of gift tax by donee constitutes amount realized to donor, creating taxable income to extent tax exceeds donor's basis in transferred property).

131. Professor Bittker analogizes relief from nonrecourse debt to "the relief one obtains from local real property taxes by disposing of the property" in which the identifiable economic benefit is the "value of the taxes that will not be paid in the future." He observes that no one would suggest this is a real economic benefit to the transferor. Bittker, *supra* note 88, at 282.

132. I.R.C. § 1001(a).

133. If the purchase price is paid partly in present cash and partly in future cash, as evidenced by the purchaser's note or other promise to pay, the receipt of present cash will be treated as "money" and the promise of future cash will be treated as "other property," included in the amount realized to the extent of its fair market value. See generally Cain, *Taxation of Promises to Pay*, 8 GA. L. REV. 125, 130-34 (1973). Of course, under the installment method of reporting, the seller need not recognize gain until the future payments of cash are actually received. I.R.C. § 453.

134. See *infra* text accompanying note 194; see Adams, *Exploring the Outer Boundaries of the Crane Doctrine: An Imaginary Supreme Court Opinion*, 21 TAX L. REV. 159, 168 (1966).

gage and the purchaser pays off the mortgagee as part of the purchase price, it is easy to identify the payment as a present economic benefit to the seller whose liability is thereby discharged.¹³⁵ The payment on the seller's behalf would be treated as a receipt of money by the seller and thus would constitute an amount realized. On the other hand, if the seller is personally liable on the mortgage and the purchaser merely promises, either explicitly (by assuming) or implicitly (by taking "subject to"), to pay off the mortgage in the future, then it is more difficult to characterize the benefit as a current indirect receipt of money.¹³⁶

Nonetheless, it has long been standard practice to treat the assumption of a mortgage as an indirect receipt of money by the seller.¹³⁷ In addition, there were specific regulations supporting that practice with respect to installment sales of mortgaged realty.¹³⁸ Furthermore, both established practice and the installment sales regulations treated implicit assumptions (e.g., the purchaser takes "subject to") in the same manner as actual assumptions. In a pre-*Crane* Supreme Court opinion,¹³⁹ a taxpayer challenged the installment sales regulations.¹⁴⁰ The Court explained the practical necessity for currently taxing the mortgage-in-excess-of-basis element of

135. *Cf.* *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929) (employer's payment of employee's tax liability constitutes income); *United States v. Hendler*, 303 U.S. 564 (1938) (assumption and payment of corporate liabilities by third party should be treated as direct payment of money to corporation and constitutes taxable boot to corporate obligor). Although *Hendler* was cited in *Crane* for the proposition that assumption of the liability would be sufficient to create an amount realized, 331 U.S. at 13 n.34, there is nothing in the *Hendler* opinion to indicate that assumption, absent an immediate payment, would be sufficient. The *Hendler* Court's emphasis was on the discharge that actually resulted from the assuming corporation's payment of the debt. *See supra* note 128.

136. Conceptually, the promise to pay the debt in the future appears similar to a promise to pay the seller the balance of the purchase price in future installments and, thus, it seems more appropriate to characterize the resulting economic benefit to the seller as other property. *See supra* note 133. Since the debt is not actually discharged until paid and since the seller remains secondarily liable until final discharge, mere assumption of the liability cannot create the type of economic benefit identified by the Supreme Court in both *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929), and *United States v. Hendler*, 303 U.S. 564 (1938).

137. O.D. 409, 2 C.B. 77 (1920) (seller must treat purchaser's assumption of mortgage as receipt of cash even though mortgagee refused to release seller from liability on debt). *See Brons Hotels, Inc. v. Commissioner*, 34 B.T.A. 376 (1936).

138. Treas. Reg. 69, Article 44 (August 28, 1926). The same provision can now be found in Treas. Reg. § 1.453-4(c) (1958), which essentially provides that the assumption of a mortgage shall be treated as a payment in the year of sale to the extent it exceeds the property's basis. This approach to mortgages, therefore, is similar to treating the entire mortgage as an amount realized under § 1001.

139. *Burnet v. S. & L. Bldg. Corp.*, 288 U.S. 406 (1933).

140. *See id.* at 412-13.

gain, rather than spreading it over future periods as the purchaser made the future mortgage payments.¹⁴¹ Although the opinion focuses on installment sales gains, the practical considerations are the same for a cash basis taxpayer computing gain under section 1001.¹⁴² In both cases it is justifiable to treat the seller's liability as though it had been discharged if the understanding is that the purchaser is to discharge it in the future. Under section 1001, this constructive discharge is treated appropriately as a receipt of money for purposes of determining the amount realized.

If the *Crane* Court had engaged in the foregoing analysis, then it might have found it easier to justify its view that a nonrecourse mortgagor's position is analogous to that of the personally liable mortgagor and, thus, that the tax consequences ought to be the same. In other words, the economic benefit to the personally liable mortgagor is not a real present benefit when the property is transferred subject to the mortgage. Nonetheless, the amount of the mortgage which the purchaser is going to pay in the future is a real part of the sales price and thus should be treated as an amount realized at the time of sale. Likewise, the nonrecourse mortgagor receives no real present economic benefit at the time of disposition. If, however, the mortgage liability is to be paid by the purchaser, it does constitute a real part of the sales price and should be treated as an amount realized.¹⁴³

Finally, in both personal liability and nonrecourse situations, if the fair market value of the property at the time of disposition is less than the outstanding mortgage, full payment by the purchaser is un-

141. *See id.* at 414.

142. The installment seller had argued that it received no "payment" until the purchaser actually made payments on the mortgage. *See id.* at 412. The cash basis seller computing gain under § 1001 could make a parallel argument that he or she had received no payment constituting money for amount realized purposes until the future payments actually discharged the seller's liability. One of the practical difficulties in either case is that once the property is transferred and the purchaser takes over the mortgage payments, the seller is no longer involved as a practical matter and has no knowledge of the actual payments made on the mortgage liability. Thus, it is easier to treat the transfer of the mortgage as a payment or receipt of money in the year of sale.

143. Likewise, in *Diedrich v. Commissioner*, 102 S. Ct. 2414 (1982), the Supreme Court identified the donee's assumption of the donor's gift tax liability as the sale price, thereby constituting an amount realized under § 1001. The gift tax liability in *Diedrich* is similar to the nonrecourse liability in *Crane* in that the liability would not have arisen, but for the donor's decision to make a taxable transfer. Similarly, Mrs. Crane's liability resulted from her decision to accept the benefit of the inherited property and, with it, the tax benefit of depreciable basis.

likely¹⁴⁴ and it is questionable whether the mortgage liability ought to be treated as an amount realized.¹⁴⁵ The Supreme Court seems to have intuitively understood this problem and indicated its sense that this situation might be different by including footnote 37 in its opinion.

In conclusion, then, the *Crane* Court's reasoning with respect to principle number two suggests a two-pronged approach. First, because the mortgage was included in depreciable basis, consistency may well require that the unpaid balance be considered as part of the sales price upon disposition.¹⁴⁶ Second, the unpaid mortgage balance will, in fact, be considered part of the sales price, and thus an amount realized, if the facts indicate that the purchaser intends to pay off the mortgage. Footnote 37 suggests that if the fair market value of the property is less than the mortgage, it cannot be assumed that the purchaser will, in fact, pay off the mortgage.¹⁴⁷ In this case, the difference between the property's value and the debt should not be characterized as an amount realized. How this difference ought to be characterized is a question which the *Crane* Court did not have to face because it assumed on the facts before it that the purchaser would pay off the full amount of the outstanding mortgage.¹⁴⁸ The

144. With respect to a personally liable mortgagor, the difference between the property's value and the outstanding debt has been characterized as discharge of indebtedness income when the mortgagee agreed to cancel the entire debt upon disposition of the property and the seller was insolvent. *Danenberg v. Commissioner*, 73 T.C. 370 (1979). There is regulatory authority for this approach under § 1001. See *Treas. Reg. § 1.1001-2(c) example 8* (1980). These regulations specifically deny the same type of treatment to a nonrecourse mortgagor, thereby ignoring the impact of footnote 37 in *Crane*.

145. If a personally liable mortgagor transfers the property subject to the mortgage and the purchaser does not agree to pay off the mortgage debt unless the property's value increases sufficiently to warrant payment, then the potential future payment appears too contingent to justify full inclusion of the debt in the amount realized. See *Corn Exch. Bank v. United States*, 37 F.2d 34 (2d Cir. 1930) (accrual basis creditor need not recognize as income currently accrued interest if there was sufficient doubt that debtor would pay interest in future). Sufficient doubt as to the future ability of a seller/mortgagee to collect on a vendor note has been held to prevent characterization of the note as an amount realized under § 111(b), current § 1001. *George W. Potter*, 7 T.C.M. (CCH) 622 (1948). If the purchaser subsequently transferred the property subject to the vendor's lien note, it would seem logical that the tacit assumption by the new purchaser to pay the original debt should not be treated as an amount realized if future payment is still speculative.

146. See *supra* note 115 and accompanying text.

147. Although it cannot be assumed that the mortgage will be paid in this situation, other facts may indicate that it will be. For example, a purchaser may be willing to pay \$1.8 million for property worth only \$1.4 million, if the payments are to be made over a sufficiently long period of time at relatively low interest rates. See *infra* note 245.

148. See 331 U.S. at 3 (Court states property sold "subject to the mortgage"); see also *id.* at 12.

proper characterization of this difference is a topic that will be discussed in Part IV of this article.

3. *Rationale for the Court's Rejection of Mrs. Crane's Constitutional Argument.*—Since Mrs. Crane received no readily identifiable economic benefit from the property, she argued that the Commissioner's computation of gain according to the existing statutory rules resulted in a taxable gain that did not constitute "income" as that term is used in the sixteenth amendment.¹⁴⁹ The Court responded by holding that income is something more than the "direct receipt of cash."¹⁵⁰ It also disagreed with her characterization of the transaction as "a ruinous disaster."¹⁵¹ It was not "a ruinous disaster" in the Court's view because she had been entitled to and had claimed depreciation deductions during her seven year holding period.¹⁵² The Court then concluded:

The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain. We have already showed that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets. The Sixteenth Amendment does not require that result any more than does the Act itself.¹⁵³

This passage from the *Crane* opinion was misunderstood by the Fifth Circuit in *Tufts*.¹⁵⁴ Other courts have focused on the "double deduction" language as the key explanation for the result in *Crane*. These subsequent cases, however, differed from *Crane* in that the taxpayers in these cases actually received a tax benefit from the deductions they claimed.¹⁵⁵ Thus, the threat of double deductions in

149. Brief for the Petitioner at 50.

150. 331 U.S. at 15.

151. *Id.*

152. *Id.*

153. *Id.* at 15-16 (footnotes omitted).

154. Judge Thornberry, writing for the majority in the *Tufts* appellate decision, 651 F.2d at 1060 n.4, expressed the court's "uncertainty as to the exact nature of the 'double deductions' that concerned the [*Crane*] Court," and assumed that the reference was an endorsement of a portion of Judge Hand's opinion in *Commissioner v. Crane*, 153 F.2d 504, 505 (2d Cir. 1945), *aff'd*, 331 U.S. 1 (1947). He concluded that the court could not understand why, if the property had depreciated, the taxpayer was required upon disposition "to somehow 'surrender' the previous deductions or the gain that he never realized." 651 F.2d 1060 n.4. Of course, Mrs. Crane did realize a gain because it was assumed from the payment of boot that her property had appreciated in value. The Fifth Circuit is on strong ground, however, by identifying the "double deduction" passage from *Crane* as having nothing to do with the amount realized. Instead, as will be shown, the passage is referring to the mandatory adjustment to basis requirement. See *infra* text accompanying notes 166-68.

155. See *Millar v. Commissioner*, 577 F.2d 212, 215 (3d Cir.), *cert. denied*, 439 U.S.

these cases was real and presented an additional justification for applying the statutory formula for computation of gain.

What is overlooked by the commentators and courts is that there was no threat of a double deduction in *Crane*. The *Crane* Court applied the statutory formula to compute a gain of approximately \$24,000 on a transaction that had yielded Mrs. Crane only \$2,500 in cash and a \$3,000 tax benefit, which resulted in a mere \$200 tax savings.¹⁵⁸ The previously quoted passage regarding double deductions more likely reflects the *Crane* Court's concern with the potential for double deductions in other cases than its finding of an actual double deduction in Mrs. Crane's case. Indeed, I suggest that this portion of the *Crane* decision is merely a reaffirmation of an earlier Supreme Court decision in which the Court had considered the issue of when a taxpayer must recognize depreciation and what effect depreciation ought to have on basis.

When the *Crane* Court stated that it had "already showed that [if the taxpayer could exclude allowable deductions from consideration in computing gain] the taxpayer can enjoy a double deduction . . . on the same loss of assets,"¹⁵⁷ it was echoing its earlier opinion in *United States v. Ludey*.¹⁵⁸ The *Ludey* case involved a taxpayer who had claimed depletion and depreciation deductions in an aggregate amount less than the amount allowable.¹⁵⁹ The issue was whether the taxpayer was required to adjust his basis downward by the full amount of allowable depreciation. If so, his sale of the property would have resulted in a taxable gain, whereas he had claimed a taxable loss on the transaction. There was no applicable statute during the years in question which required such an adjustment.¹⁶⁰ In

1046 (1978); *Tufts v. Commissioner*, 70 T.C. 756, 769 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981), *cert. granted*, 102 S. Ct. 2034 (1982).

Mrs. Crane offset approximately \$3,000 of otherwise taxable income by claiming depreciation, thereby saving approximately \$200 in taxes. *See supra* notes 78-79.

156. *See supra* notes 78-79 and accompanying text.

157. 331 U.S. at 16.

158. 274 U.S. 295 (1927). The *Crane* Court could not have been referring to any demonstration of the potential enjoyment of a double deduction in the prior portion of its opinion in *Crane*, because there is nothing in the prior portion of the opinion that makes any such demonstration. Furthermore, the *Crane* quote regarding double deductions is lifted practically word for word from a similar passage in *Ludey*. *See infra* text accompanying note 161. As further support for the likelihood that the Court was referring to *Ludey*, see Brief for the Respondent at 22-23, *Crane*, which states: "As this Court noted in [*Ludey*], unless the statute is construed as requiring an adjustment of the basis on account of depreciation, the taxpayer would get a double deduction for the loss of the same capital asset."

159. *See* 274 U.S. at 297.

160. The adjustment is now required by statute. I.R.C. § 1016(a)(2)(B) (1976). The

deciding the issue against the taxpayer, the Court stated:

The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. When the plant is disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties. Any other construction *would permit a double deduction for the loss of the same capital assets.*¹⁶¹

In other words, the Supreme Court viewed the depreciation of the plant as an actual physical event which occurs with the passage of time. The tax accounting rules have always required that the taxpayer account for this phenomenon each year as the physical depreciation occurs.¹⁶² Waiting until the plant is sold at its depreciated value and claiming the entire loss resulting from physical wear and tear in that year is not allowed.¹⁶³ This approach would put the loss suffered in the wrong tax period. The mandatory adjustment to basis on account of depreciation prevents the taxpayer from claiming the loss in the year of disposition.

The Supreme Court stretched this point, however, when it concluded that a failure to adjust basis on account of depreciation "would permit a double deduction."¹⁶⁴ True, a double deduction would result if the taxpayer had actually claimed a prior depreciation deduction and then subsequently claimed a loss in the year of disposition because he or she had not reduced basis as required. In a case such as *Crane*, however, if the taxpayer claims depreciation deductions which result in no tax benefit, it is difficult to see how the taxpayer "enjoyed" the first deduction and thus should not be permitted to "enjoy" the same deduction at the time of disposition.¹⁶⁵

The real problem that Congress sought to correct by enacting the mandatory adjustment to basis rules was not potential double deductions, but instead the taxpayer's potential control over the tim-

first such statutory requirement was enacted in 1924. *See* 274 U.S. at 297 n.2.

161. 274 U.S. at 301 (emphasis added) (footnote omitted).

162. *See* I.R.C. § 167(b) (1976) (providing for methods of calculating "an annual allowance"). *But see id.* § 168 (1982) which creates a new accounting method for depreciation by allowing accelerated deductions well in excess of actual physical depreciation.

163. *See id.* § 167(b) (1976).

164. 274 U.S. at 301.

165. *See supra* text accompanying note 153 (*Crane* Court describes taxpayer as enjoying a deduction).

ing of depreciation losses for tax purposes. Specifically, Congress was concerned that taxpayers would fail to claim depreciation losses in low income years, and instead claim the loss in a later, high income year.¹⁶⁶ The mandatory downward adjustment to basis rules prevent taxpayers from controlling the year in which depreciation will be recognized.¹⁶⁷

In order to grant adequate protection against taxpayer manipulation, the rules were enacted as absolutes. The Supreme Court in *Ludey* endorsed the absolute nature of these rules.¹⁶⁸ Likewise, the *Crane* Court held that no exception to these rules was warranted even though Mrs. Crane received no prior tax benefit and was not able to claim a subsequent loss, but instead was forced to report an artificial gain. In so holding, the Court again endorsed the absolute nature of these rules, ignoring the fact that Mrs. Crane's case did not present the potential for taxpayer abuse that the rules were intended to prevent.

It should be noted, in conclusion, that the resulting artificial gain to Mrs. Crane was caused not only by the timing requirement regarding recognition of depreciation loss, but also by the application of another timing principle: Gain can only be recognized when it is realized.¹⁶⁹ Assume that Mrs. Crane's building was appreciating due to market factors at the same time it was depreciating due to physical forces. The combination of the two timing principles would prevent her from offsetting appreciation gain with depreciation loss. Had she been able to make an offset, her net gain on the property would have been \$2,500 plus the \$3,000 in depreciation deductions which had been utilized to offset other income. Thus, it was the application of tax accounting principles coupled with the fact that income must be accounted for on a yearly basis¹⁷⁰ which caused her

166. For a discussion of the legislative history on this point, see Lischer, *Depreciation Policy: Whither Thou Goest*, 32 Sw. L.J. 545, 552-53 (1978).

167. For example, if the taxpayer elects not to recognize depreciation in year one, the property's basis will nonetheless be reduced so that year one's depreciation cannot be recognized in a later year.

168. See 274 U.S. at 300-01. The Supreme Court went even further in another pre-*Crane* case, *Virginian Hotel Corp. v. Helvering*, 319 U.S. 523 (1943). The Court held that the taxpayer was required to adjust basis downward by the amount of the claimed depreciation in excess of the actual allowable depreciation, even though the excess resulted in no tax benefit. See *id.* at 526-28. This result was subsequently reversed by Congress. See I.R.C. § 1016 (a)(2)(B) (1976).

169. See *Eisner v. Macomber*, 252 U.S. 189 (1920).

170. See *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931).

fictitious gain problem.¹⁷¹

4. *Crane Rationale: Conclusion.*—Based on the foregoing analysis, it is my opinion that the reasoning of the Supreme Court in *Crane* suggests a rationale in which footnote 37 should not be dismissed as mere dictum. The Court's overriding concern with the property's fair market value throughout the transaction is important. First, the Court suggested that the property's fair market value at the time of acquisition might have some bearing on principle number one.¹⁷² Subsequent courts correctly have followed this suggestion and disallowed the inclusion of nonrecourse debt in basis when the property's fair market value was less than the debt, thus transforming what was dictum in *Crane* into law.

My analysis of *Crane* indicates that the dictum contained in footnote 37 also merits legal status. Although *Tufts*¹⁷³ does adopt footnote 37 as law, it does so for the wrong reasons. Furthermore, the Fifth Circuit's holding is incorrect to the extent that it automatically allows that portion of gain attributable to debt in excess of the property's value to go untaxed. The court, however, is correct in expressing concern about the *Crane* decision in general.¹⁷⁴ Its concern stems from the fact that it interpreted *Crane*'s reasoning regarding the amount realized as being primarily based on a perceived economic benefit at the time of disposition.¹⁷⁵ As the foregoing discussion illustrates, the perceived economic benefit is not as real and substantial as the *Crane* Court purports.¹⁷⁶

According to my analysis of the *Crane* Court's reasoning, the presence of a real and substantial economic benefit at the time of disposition is not necessary to justify inclusion of the mortgage debt in the amount realized. The purchaser's payments, both present and future, to the extent they are made to the seller or the seller's mortgagee, ought to be included in the amount realized. The future payments to the mortgagee ought to be treated as presently received by

171. This problem is not likely to arise under the current tax system because, although the accounting principles are unchanged, the integrity of the taxable year has been eroded by liberalization of the net operating loss carryover provisions. See I.R.C. § 172(b) (West Supp. 1982). The current carryover period under § 172 is 15 years. *Id.* § 172(b)(1)(B). In 1932, the year Mrs. Crane acquired the property, the carryover was limited to one year.

172. See 331 U.S. at 12 (taxpayer did not prove "that the value of the property was ever less than the amount of the lien").

173. *Tufts v. Commissioner*, 651 F.2d 1058 (5th Cir. 1981), cert. granted, 102 S. Ct. 2034 (1982).

174. See *id.* at 1063.

175. *Id.* at 1061-62.

176. See *supra* text accompanying notes 78-79.

the seller when the property is transferred, if the facts indicate that payments are likely to be made.¹⁷⁷ If the property declines in value, as contemplated in footnote 37, the assurance of future payment in full to the mortgagee is absent. Thus, the justification for including the full debt in the amount realized, on the theory that its future payment is a constructive present receipt, is also absent.

Despite the absence, however, of a constructive present receipt that fits within the statutory definition of "amount realized," there may be another type of constructive present receipt or economic benefit derived from the transaction as a whole.¹⁷⁸ In footnote 37 cases, presence of this other receipt or benefit is a sufficient basis for taxing the nonrecourse mortgagor upon disposition. Since *Crane* was not a footnote 37 case, the Supreme Court did not have to develop a rationale to explain the appropriate result in such cases. The next two parts of this article discuss potential rationales that do attempt to explain the appropriate result in footnote 37 cases.

III. BEYOND *Crane*: IN SEARCH OF A RATIONALE

This part of the article focuses on three alternative rationales which have been offered by others as explanations for why nonrecourse debt ought to be included in amount realized. All of these alternative rationales ignore the effect of the fair market value of the property at time of disposition. Thus, after presenting a brief explanation of the three rationales, I analyze the effect of their failure to incorporate the fair market value limitation suggested by footnote 37.

A. *The Economic Benefit Rationale*

I agree with the Fifth Circuit in *Tufts*¹⁷⁹ that the Economic Benefit Rationale, as developed in *Crane*,¹⁸⁰ is an unsatisfactory explanation of the amount realized issue.¹⁸¹ The root of my dissatisfaction is that there simply was no real economic benefit at the time of disposition, even though the Supreme Court attempted to demon-

177. This approach is necessary to avoid the administrative difficulties that would result if the future payments were treated as receipts to the seller only when made by the purchaser. See *supra* note 142.

178. Courts have failed to consider tax treatment differentiations and, thus, have rejected footnote 37 for the wrong reasons.

179. *Tufts v. Commissioner*, 651 F.2d 1058 (5th Cir. 1981), *cert. granted*, 102 S. Ct. 2034 (1982).

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

181. See *supra* text accompanying notes 175-76.

strate that there was. I am willing, however, to call the disposition of the mortgage debt, along with the property, a constructive economic benefit, *only if* the mortgage is included in basis *and* the facts at the time of disposition support the conclusion that the debt, in fact, will be paid by the transferee or fully satisfied in some other manner.

At least one commentator contributing to the *Crane* literature has suggested that the *Crane* Court may have been correct in searching for an economic benefit to justify its holding but that the Court erred when it focused on the economic benefit at the time of disposition.¹⁸² The commentator argues that, instead, the Court should have focused on "the economic benefit the taxpayer receives from the entire transaction, particularly the initial untaxed benefit of borrowing."¹⁸³ The benefit of borrowing is initially untaxed because it is assumed that the taxpayer will subsequently pay back the borrowed funds.¹⁸⁴ The benefit can be identified either as the receipt of borrowed cash or the receipt of property acquired with borrowed funds.

Under this theory, it is the economic benefit at the time of disposition, plus any prior identifiable economic benefit, that must be included in the amount realized.¹⁸⁵ The prior economic benefit must be recognized upon disposition of the property because at that time it is no longer assumed that the borrowed funds will be repaid and thus the justification for allowing the benefit to go untaxed disappears.¹⁸⁶

According to this rationale, however, the property's fair market value at the time of disposition is irrelevant. A decline in market value would have no effect on the value of the prior economic benefit. Thus, this rationale does not appear consistent with the Court's inclusion of footnote 37 in its opinion.

There are other criticisms of this rationale. First, it presents some minor conceptual difficulty. In cases involving a cash borrowing against previously acquired property, the prior economic benefit is easily identified. It is the receipt of cash, a benefit which is retained upon subsequent disposition of the property. In cases involving the acquisition of property with nonrecourse funds, the prior economic benefit is less readily identified. The progenitor of this rationale sug-

182. Simmons, *supra* note 89, at 4-5.

183. *Id.* at 4.

184. See *Woodsam Assocs., Inc. v. Commissioner*, 198 F.2d 357, 359 (2d Cir. 1952); Simmons, *supra* note 89, at 5.

185. Simmons, *supra* note 89, at 34, 41.

186. *Id.*

gests that the prior benefit is the receipt of the property and that the measure of the benefit is the property's value.¹⁸⁷ Unlike the cash, however, the property is not retained. Viewed at the time of disposition, the prior benefit is the use of the property from the time of acquisition to the time of disposition. Specifically, from a tax viewpoint, the benefit is the creation of a tax basis which has permitted past depreciation deductions to be claimed that "permit tax-free receipt of other income."¹⁸⁸

At this point, a second difficulty arises. The emphasis on a prior economic benefit, such as the tax-free receipt of otherwise taxable income, suggests that if the prior depreciation deduction did not, in fact, offset otherwise taxable income, as was the case in *Crane*, then full inclusion of the debt in amount realized may not be justifiable. In other words, the ability to claim depreciation deductions is not an economic benefit unless the deductions produce tax savings. Thus, if this rationale were applied to Mrs. Crane, the amount realized would have been \$5,500.¹⁸⁹ Viewing the transaction as a whole, the entire \$5,500 should represent taxable gain. To arrive at this gain under section 1001's formula,¹⁹⁰ however, would require using a basis of zero. Since the statute specifically requires using the same basis for computing gain and depreciation,¹⁹¹ use of a zero basis appears to be prohibited.

The Economic Benefit Rationale is alternatively explained by the same author as a theory which identifies taxable gain by subtracting the capital invested in the property from the capital recovered from the property.¹⁹² Viewed in this light, Mrs. Crane recovered \$2,500 in cash and an additional \$3,000 in depreciation.¹⁹³ The remaining depreciation claimed by Mrs. Crane cannot be viewed as a recovery of capital because it produced no benefit. Since she invested no capital of her own, the full recovery of \$5,500 is taxable gain.

187. *Id.* at 17.

188. *Id.* at 18.

189. This figure is computed as follows: \$2,500 cash received at disposition, plus \$3,000 in deductions offset against \$3,000 of otherwise taxable income. The full \$3,000 should be treated as an amount realized, rather than the \$200 tax savings, because the depreciation deduction is the equivalent of a \$3,000 cash deduction which otherwise would have been necessary to reduce taxable income to zero.

190. See I.R.C. § 1001(a) (1976); *supra* note 2.

191. See I.R.C. § 167(g).

192. Simmons, *supra* note 89, at 18.

193. See 331 U.S. at 3.

Although this approach correctly identifies her taxable gain, it does so by using a computation method other than that prescribed by section 1001. Of course, in most cases the resulting gain will be the same under either computational method. Nonetheless, for those cases in which depreciation deductions have not produced full tax benefit, only the "capital recovered minus capital invested" formula¹⁹⁴ will work correctly. Section 1001's formula will work only if the mortgage is excluded from basis. Although this latter approach may be theoretically sound, it is not supported by the statutory language.¹⁹⁵

B. *The Tax Benefit Rationale*

The Tax Benefit Rationale is essentially no different from the Economic Benefit Rationale.¹⁹⁶ In cases involving depreciable property, the Tax Benefit Rationale would identify the taxpayer's prior depreciation deductions as sufficient justification for including nonrecourse debt in the amount realized. In effect, the taxpayer "recaptures" the prior deduction when the property is transferred subject to a mortgage that exceeds the adjusted basis of the property.

Like the Economic Benefit Rationale, the Tax Benefit Rationale implies that if prior depreciation deductions produced no tax benefit, the justification for including the full mortgage debt in the amount realized is weakened. This is due to the fact that the rationale suggests an application of the tax benefit rule.

The tax benefit rule requires that a taxpayer who recovers an item which provided a prior deduction report the recovery in income.¹⁹⁷ Thus, if taxpayer *A* claims a bad debt deduction in year one and in year five the debtor unexpectedly pays off the debt, then taxpayer *A* has taxable income upon the payoff. In its current form, the tax benefit rule would exclude any recovery if the prior deduction resulted in no tax benefit.¹⁹⁸

194. Simmons, *supra* note 89, at 18.

195. The real problem is that Congress has defined gains resulting from dispositions of property in a manner that is difficult to apply to mortgaged property. Therefore, the courts have had to stretch the plain meaning of the existing statutory language to include what is clearly a gain on mortgaged property. The courts appear unwilling to endorse a judicially created alternative to § 1001's formula, presumably because they view the existing statutory scheme as one which preempts alternative approaches. It is this deference to Congress which feeds the ongoing controversy concerning the meaning of the statutory term "amount realized."

196. See *supra* text accompanying notes 179-95.

197. See articles cited *infra* note 198.

198. Although the judicial and administrative development of the tax benefit rule did

The rule is now codified in section 111 of the Internal Revenue Code.¹⁹⁹ Neither the statutory rule, nor the judicially created rule, has ever been applied, directly or indirectly, to situations involving depreciation deductions.²⁰⁰ As a general principle, it makes good sense to exempt depreciation from the class of deductions that may be recovered. Whereas bad debts which have been deducted may be recovered when they are subsequently repaid,²⁰¹ and deductible theft losses may be recovered when the property is returned,²⁰² it is difficult to conceptualize an analogous recovery of a depreciation deduction. This is because physical depreciation is a fact that occurs with the passage of time. Depreciation deductions account for this fact and are allowed on the basis of a recognized accounting convention.²⁰³ When property is sold for a price in excess of its depreciated basis, the sales proceeds do not represent a recovery of the physical depreciation. Instead, they represent a payment attributable to another fact: market appreciation.

Of course, to the extent that Congress has endorsed depreciation deductions that are not attributable to the fact of physical depreciation,²⁰⁴ the sales proceeds received upon disposition more closely resemble, at least in part, a recovery of prior deductions. Congress appears to have recognized this resemblance when it enacted the recapture provisions of sections 1245 and 1250.²⁰⁵

Whereas applying the tax benefit rule to tax the recovery of prior deductions should result in ordinary income, using the rule as a rationale for including nonrecourse debt in the amount realized would not necessarily produce ordinary income. Instead, the gain re-

not consistently embrace this exclusionary portion, it has been a recognized aspect of the rule since 1942 when the statutory forerunner of § 111, I.R.C. § 111 (1976) (originally enacted as Revenue Act of 1942, ch. 619, § 116, 56 Stat. 798, 812-13), was enacted. See Bittker & Kanner, *The Tax Benefit Rule*, 26 U.C.L.A. L. REV. 265 (1978); Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129 (1943); Tye, *The Tax Benefit Doctrine Reexamined*, 3 TAX. L. REV. 329 (1948).

199. I.R.C. § 111 (1976).

200. See Bittker & Kanner, *supra* note 198, at 278-79.

201. Treas. Reg. § 1.111-1(a)(1960).

202. I.R.C. § 165(e)(1976).

203. *Id.* § 168 (West Supp. 1982).

204. For example, the new Accelerated Cost Recovery System (ACRS) of the Internal Revenue Code, *id.*, seems to have less of a direct relationship to actual physical depreciation since it allows an asset's cost to be written off over a period much shorter than its actual physical life. See *id.* § 168(b) (fifteen year period).

205. *Id.* §§ 1245, 1250 (1976 & West Supp. 1982) (these provisions override the capital gains provisions converting gain attributable to "recapture of depreciation" as ordinary income).

sulting from the disposition may be considered a gain resulting from the sale or exchange of property, rather than from the recovery of a prior deduction, and as such may be entitled to capital gains treatment.²⁰⁶

In summary, the Tax Benefit Rationale suggests that nonrecourse debt should be included in the amount realized if the debt has provided the taxpayer with prior tax benefits. Usually the debt will have provided sufficient benefits in the form of prior depreciation deductions. There are several situations, however, in which this prior benefit will be absent. First, if the mortgage debt is not included in basis, no tax benefit, in the form of depreciation, attributable to the mortgage, will occur.²⁰⁷ Second, no tax benefit will occur where the taxpayer has insufficient income to be offset by the deductions.²⁰⁸

In the former situation, there is no justification for including the debt in the amount realized. In the latter, the justification also appears to be lacking because the analogy to the tax benefit rule suggests noninclusion when the prior *deduction* produces no tax benefit.²⁰⁹ It can be argued, however, that the analogy is one which does suggest inclusion of the mortgage in the amount realized, unless the *mortgage* itself produces no tax benefit. If the mortgage is properly included in basis initially, then it produces the benefit of tax basis at that time, and the fact that the taxpayer subsequently fails to produce sufficient income to reap full enjoyment of the tax basis can be considered irrelevant. This approach to tax benefit analysis is consis-

206. The ability to characterize the gain as one resulting from a sale or exchange may be another reason the courts have preferred to compute gain under § 1001, rather than creating their own formula to compute the gain. See *supra* note 198. It is somewhat more difficult to conceptualize the gain resulting from a "capital recovered minus capital invested" formula as one that results from a sale or exchange. The difficulty stems from the fact that recovery of capital may occur bit by bit over the entire holding period of the property whereas the gain from a sale or exchange connotes a receipt in the year of disposition.

207. A purchase money mortgage debt may not be included in basis either under § 465, I.R.C. § 465 (1976), or under the rule set forth in *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976) (inclusion of debt in basis may not be allowed where property's fair market value is less than nonrecourse debt). See also *Narver v. Commissioner*, 75 T.C. 53 (1980), *aff'd*, 670 F.2d 855 (9th Cir. 1982).

A nonrecourse debt resulting from a present cash loan secured by previously acquired property would also result in noninclusion of the mortgage debt in basis. The Tax Benefit Rationale, however, is not necessary to justify inclusion of the debt in the amount realized since the receipt of the loan proceeds is sufficiently identifiable as money received by the taxpayer.

208. This possibility has been greatly reduced, however, by the extension of the Net Operating Loss Carryover to 15 years. See I.R.C. § 172(b)(1)(B) (West Supp. 1982); *supra* note 171.

209. See *supra* text accompanying notes 196-98.

tent with the result in *Crane*, where there was virtually no tax savings, and with the mandatory adjustment to basis requirement under section 1016.²¹⁰ Thus, if one considers initial basis as a tax benefit because it creates the potential for future useful deductions, the Tax Benefit Rationale could be used to justify full inclusion of the outstanding mortgage in amount realized in all cases in which the mortgage had been included in basis. The Economic Benefit Rationale, on the other hand, would support inclusion only if the debt had been included in basis *and* had actually produced useful deductions.

C. *The Double Deduction Rationale*

It was demonstrated in Part II of this article that the *Crane* Court's reference to double deductions was merely a reiteration of the Court's earlier holding that basis must be reduced by allowable depreciation despite the fact that the prior deductions yielded no tax benefit.²¹¹ Nonetheless, the Third Circuit in *Millar v. Commissioner*²¹² and the Tax Court in *Tufts*²¹³ considered the *Crane* Court's concern with double deductions as the primary rationale for the Court's holding on the amount realized issue.²¹⁴ Both courts readily rejected the taxpayers' footnote 37 arguments because they concluded that limiting the amount realized to the property's fair market value would, in each case, give the taxpayers a double deduction benefit.²¹⁵

The benefit in *Millar* and *Tufts* was the claiming of deductions in excess of invested after-tax capital. Strictly speaking, this benefit is not the same as that which a taxpayer would derive from failure to reduce basis by allowable depreciation upon disposition. It is, however, a benefit that is equally unwarranted.

Presumably, current deductions in excess of invested capital are warranted on the assumption that future capital will be invested. If the capital has not been invested by the time of final disposition of the property, then it becomes necessary to create a constructive investment of the requisite capital. Treating the mortgage debt balance as an amount realized accomplishes a constructive investment

210. This section requires that an adjustment to basis *shall* be made. I.R.C. § 1016(a)(1976).

211. *United States v. Ludey*, 274 U.S. 295 (1927). See *supra* note 158.

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

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

214. See 577 F.2d at 215; 70 T.C. at 769. For a discussion of these two opinions and their purported use of the double deduction issue, see Newman, *supra* note 88, at 17-19.

215. 577 F.2d at 215; 70 T.C. at 770.

of the requisite after-tax capital. The result is the same as if the taxpayer had received the full sales price in cash, thereby triggering gain; and then paid off the mortgage debt in cash, thereby investing the requisite after-tax capital.

The *Crane* Court reasoned that the threat of double deductions was a sufficient justification for the mandatory adjustment to basis requirement.²¹⁶ The adjustment remained mandatory even in cases, such as *Crane*, in which the first deduction produced no tax benefit.²¹⁷ Similarly, the threat of deductions in excess of invested capital may be considered sufficient justification for a mandatory inclusion of mortgage debt in the amount realized. Thus, the Double Deduction Rationale, more clearly than the Economic Benefit and Tax Benefit Rationales, presents a coherent theory for including the debt in the amount realized, in the absence of either economic or tax benefit. This rationale suffers, however, from the same deficiency as the other rationales in that it fails to consider the effect of an actual decline in the mortgaged property's value.

D. *The Effect of a Decline in the Mortgaged Property's Value*

The three rationales discussed in this section of the article have been offered by courts and commentators as a justification for principle number two in *Crane*: inclusion of nonrecourse debt in the amount realized. In Part II of this article, I attempted to demonstrate that the actual reasoning of the *Crane* Court—as suggested by footnote 37—would not support full inclusion of the debt if the fair market value of the property had declined below the outstanding debt. Although these rationales serve the function of correctly identifying the amount of taxable income that is recognized upon the final transfer of property, each incorrectly treats the nonrecourse debt as an amount realized and categorically considers the resulting income as a section 1001 disposition of property gain. This is beyond the congressional intent of section 1001.

If gain is computed under section 1001, and it results from a disposition which can be characterized as a sale or exchange of a capital asset, the gain will be taxed as capital gain,²¹⁸ subject to recapture.²¹⁹ Alternatively, the gain may be accorded capital gains treatment under section 1231, likewise subject to the recapture

216. See 331 U.S. at 15-16.

217. See *supra* notes 78-79 and accompanying text.

218. I.R.C. § 1221 (1976).

219. *Id.* §§ 1245, 1250 (1976 & West Supp. 1982)(recapture provisions).

provisions.²²⁰

Consider the effect of this approach in *Tufts*. The original basis of over \$1.8 million had been adjusted downward, due to depreciation deductions of almost \$400,000.²²¹ By the time of disposition, the property had actually declined in value more than the total of prior depreciation deductions.²²² Inclusion of the unpaid \$1.8 million mortgage debt in the amount realized resulted in a section 1231 gain of just under \$400,000.²²³ The section 1250 recapture rule applied, taxing as ordinary income only the amount of depreciation in excess of straight line depreciation. Thus, out of a total gain of almost \$400,000, only \$47,099 was characterized as ordinary income.²²⁴

This result seems inappropriate. Since the property had actually declined in value, no market appreciation was present to support capital gains treatment. Section 1250's partial recapture rule was meant to reflect the fact that, if property is sold for a gain, a portion of the sales proceeds received upon disposition is "attributable to a rise in price levels generally rather than to an absence of a decline in the value of the property."²²⁵ Thus, it is appropriate to tax this portion of the gain as a capital gain because "[t]he portion representing the rise in value is comparable to other forms of gains which quite generally are treated as capital gains."²²⁶ When the gain is attributable solely to the fact that the taxpayer has taken depreciation deductions on a basis which includes a nonrecourse debt, on which no payments have been made, and there is in fact no rise in value, then the conceptual justification for characterizing part of the gain as a capital gain is not present.

Of course, it is possible to reach the desired result²²⁷ even if one includes the full amount of the debt in the amount realized. Under this approach, one would first identify debt in excess of basis as the total gain computed under the section 1001 formula.²²⁸ At this point, characterization of the gain would be determined by asking whether

220. *Id.*

221. 651 F.2d at 1059.

222. *Id.*

223. *See* 70 T.C. at 762.

224. *See id.*

225. S. REP. NO. 830, 88th Cong., 2d Sess. 133 (1964), *reprinted in* 1964 U.S. CODE CONG. & AD. NEWS 1673, 1807; H.R. REP. NO. 749, 88th Cong., 1st Sess. 102-03 (1963), *reprinted in* 1964 U.S. CODE CONG. & AD. NEWS 1313, 1411.

226. *Id.*

227. The desired result is to tax the "debt in excess of value" gain as ordinary income.

228. *See supra* note 2.

the gain resulted from a "sale or exchange."

The judicial response to the sale or exchange issue has been inconsistent and confusing.²²⁹ The courts have placed unwarranted emphasis on the meaning of the terms "sale" and "exchange" in order to resolve the ultimate issue of characterization.²³⁰ A more satisfactory and direct approach would be to consider the transaction as a whole and determine the character of the resulting gain or loss by asking whether capital treatment is in accord with the statutory purpose of the capital gain and loss provisions.²³¹ Because a substantial body of case law focuses on the meaning of sale or exchange,²³² however, this analysis should be considered in the context of a footnote 37 case, such as *Tufts*.

The issue that has arisen most frequently is whether a deed in lieu of foreclosure constitutes a sale or exchange for purposes of determining whether the resulting loss to the nonrecourse mortgagee

229. For a discussion of the inconsistent and confusing history of the judicial response, see *Freeland v. Commissioner*, 74 T.C. 970, 975 (1980).

230. See, e.g., *Stokes v. Commissioner*, 124 F.2d 335 (3d Cir. 1941); *Jamison v. Commissioner*, 8 T.C. 173 (1947), *acq.* 1947-1 C.B. 2 (voluntary deed to state to avoid payment of property taxes not a sale); *Lapsley v. Commissioner*, 44 B.T.A. 1105 (1941) (no sale or exchange upon nonrecourse mortgagor's reconveyance to seller/mortgagee); *Baird v. Commissioner*, 42 B.T.A. 970 (1940); *Commonwealth, Inc. v. Commissioner*, 36 B.T.A. 850 (1937). See also cases cited *supra* note 56. On the issue of characterization of gain, see *Hudson v. Commissioner*, 20 T.C. 734 (1953), *aff'd sub nom. Ogilvie v. Commissioner*, 216 F.2d 748 (6th Cir. 1954), holding that collection of a judgment debt by an assignee for value does not constitute a sale or exchange. See *id.* at 736. But see I.R.C. § 1232 (1976 & West Supp. 1982) (granting sale or exchange treatment to certain collections on corporate notes at maturity).

231. This approach is admittedly easier in the case of a gain, especially if the gain results in a bunching of income in one tax period due to several years of unrealized appreciation. One of the many articulated statutory purposes for preferential capital gains treatment has always been to mitigate the bunching effect. See *Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 134 (1960). With respect to losses, the approach is more difficult because there is no concomitant statutory purpose in the capital loss limitation. For example, if nondepreciable property is declining in value steadily over a number of years, but the taxpayer is not allowed to recognize the loss until final disposition, there appears to be no independent justification for further penalizing the taxpayer by limiting the recognized loss to a partially deductible long term capital loss. The only satisfactory justification for the limited deductibility of capital losses is that since the taxpayer has control over the timing of recognition of both gains and losses, then the gains and losses ought to be netted, and losses ought to be carried forward to prevent manipulation by the taxpayer. The manipulation which the special treatment of capital losses seeks to avoid is the conversion of all gains into long term gains and of all losses into short term losses, recognized in different tax years. For a discussion of the relevant legislative history, see *Helvering v. Hammel*, 311 U.S. 504, 507-10 (1941). If a taxpayer, however, has one single capital investment that ultimately results in a loss, the characterization as a long term capital loss results in limited deductibility which is difficult to justify.

232. See cases cited *supra* note 230.

should be characterized as ordinary or capital. There are a significant number of pre-*Crane* cases holding that the transaction is not a sale or exchange, but rather, an abandonment, and thus ordinary loss is appropriate.²³³ The apparent rationale for this holding is that the transferor receives no consideration upon transfer and, absent consideration, there can be no sale or exchange.²³⁴

The Tax Court, in *Freeland v. Commissioner*,²³⁵ however, has recently reversed its position on this issue, citing *Crane* as relevant authority. The Court stated: "We believe the holdings of *Crane* . . . mandate the conclusion that *relief* from indebtedness, even though there is no personal liability, is sufficient to support a sale or exchange."²³⁶

The taxpayer in *Freeland* countered by arguing that even if *Crane* did lend support to the finding of a sale or exchange in transfers by nonrecourse mortgagors, footnote 37 should, nonetheless, be read as creating an exception.²³⁷ The Tax Court responded by stating that "even if the amount realized was limited to the fair market value of the property, that would involve only the amount of gain or loss, not whether there was consideration to support a sale."²³⁸

This response by the Tax Court is in direct conflict with my reading of footnote 37. The footnote should not be read as a limitation on the *amount* of gain. It should only be read as suggesting exactly what the taxpayer in *Freeland* argued: If the nonrecourse debt exceeds the property's value, then *relief* from the debt should not be viewed as consideration for the transfer. Thus, to that extent, it should not be considered an amount realized.

I have equated "amount realized" with "consideration for the transfer" on the theory that the *Crane* Court contemplated this equation when it wrote footnote 37. Alternatively, based on the taxpayer's argument in *Freeland*,²³⁹ one might argue that the debt is included in the amount realized, but that footnote 37 should be read

233. See cases cited *supra* note 230.

234. See cases cited *supra* note 230.

235. 74 T.C. 970 (1980).

236. *Id.* at 981.

237. The taxpayer in *Freeland* had invested \$9,188 of his own money in the purchase of land, giving a nonrecourse note in the amount of \$41,000 for the balance. The property's value subsequently declined to \$27,000. Thus, the footnote 37 fact situation was present, albeit in a loss, rather than a gain, transaction. The only issue was whether the \$9,138 loss should be characterized as capital or ordinary.

238. 74 T.C. at 982.

239. See *supra* text accompanying note 237.

as an implicit recognition by the Court that *relief* from the debt does not constitute "sale or exchange" consideration, except to the extent of the property's fair market value.

Both approaches would produce the same result in *Tufts*. My approach, as opposed to the *Freeland* approach, is to exclude the debt in excess of value from the amount realized, thus removing that amount of gain from section 1001, and thereby removing the implication that it is a sale or exchange gain.²⁴⁰ Absent a sale or exchange, there can be no resulting capital gain.²⁴¹

Finally, there is one further argument that can be made in support of my position that the excess gain²⁴² does not warrant capital gains treatment. This argument is based on an expansion of the *Arrowsmith* rule.²⁴³ Loosely, *Arrowsmith* stands for the proposition that it is appropriate to consider the tax effect of prior events in order to determine the correct tax treatment of current events.²⁴⁴

240. A "sale or exchange" is considered a subclass of the more inclusive class of all dispositions of property. Thus, absent a "disposition of property" gain, there could be no "sale or exchange" gain.

241. Although I interpret the *Crane* Court's line of reasoning with respect to footnote 37 as supporting the ultimate conclusion that "debt in excess of value" gain should not be characterized as a capital gain, it should be pointed out that capital gains characterization could not have been considered by the *Crane* Court.

Crane dealt with depreciable property which was sold in 1938. The characterization of gain rules applicable at that time always would have produced ordinary income upon disposition. This is because even a sale or exchange of depreciable property resulted in ordinary income. See *supra* note 46 (paragraph 6).

It should also be pointed out that my interpretation of footnote 37 supports no sale or exchange in dispositions that produce gain, such as in *Tufts*. It does not necessarily follow, however, that there is no sale or exchange in dispositions that produce loss, such as in *Freeland*. Using my amount realized approach in *Freeland* would suggest that there was consideration for the transfer to the extent of the property's fair market value, i.e., \$27,000. See *supra* note 237. Basis, at the time of disposition, should include the \$9,188 actual cash investment, see *supra* note 237, plus only that amount of the nonrecourse liability supported by the property's value, i.e., \$27,000. See cases cited *supra* note 9. The resulting loss of \$9,188 can then be correctly computed under § 1001 as a disposition of property loss. Whether the disposition should be characterized as a sale or exchange is unresolved under this analysis and, as I have suggested earlier, see *supra* text accompanying note 231, is an inquiry which begs the ultimate question: Should the loss be limited by the capital loss provisions?

242. The excess gain is attributable to the amount of debt in excess of the property's value.

243. *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952). This case held that the characterization of a current loss deduction as ordinary was prohibited by the fact that the present loss was integrally related to a prior capital gains transaction. See *id.* at 8-9. To my knowledge, the *Arrowsmith* rule has never been used to convert what appears to be a current capital gain into ordinary income because of its relationship to prior ordinary deductions. To do so would thus require an expansion of the rule beyond its current application.

244. See *id.*

The current event in *Tufts* is a taxable gain. To the extent the gain is attributable solely to prior depreciation deductions, which in retrospect should not have been allowed because the necessary cash investment to support the deductions will never be made,²⁴⁵ the *Arrowsmith* rule could be applied to characterize the current gain as ordinary income. Because of the recognized integrity of the taxable year, the prior depreciation deductions should be allowed to stand if, in the year claimed, the available facts indicated that the debt would be paid, either by the taxpayer or by a subsequent purchaser. When the property's value subsequently declines below the mortgage amount, however, the justification for the prior deductions disappears. At the time of disposition, the deductions should be recaptured as ordinary income. This recapture is different from recapture under sections 1245 and 1250, which merely reconciles allowable tax depreciation with actual depreciation in value. Here, the recapture results from a prior inclusion of an amount in depreciable basis which, in hindsight, should not have been included.

In conclusion, the decline in the property's fair market value should be viewed as a fact which is directly related to the issue of capital gains treatment. The legislative history of the capital gains provisions and of section 1250 suggest that preferential treatment is warranted if *appreciated* property is transferred.²⁴⁶ The sale or exchange requirement for capital gains treatment implicitly suggests a transaction in which the transferor is cashing out on past appreciation by receiving consideration therefor. Finally, the *Arrowsmith* rule lends indirect support for denying capital gains treatment to that portion of the gain attributable to debt in excess of value.

The three rationales discussed in this section of the article do

245. This assumes that the necessary cash investment will not be made by either the taxpayer or the purchaser in *Tufts*, because the established fair market value is insufficient to suggest that full payment will be made. Of course, the purchaser may in fact be willing to make full payment because the mortgage payment terms may be so favorable, e.g., a low interest rate, that the payment of \$1.8 million over time under such terms is equivalent to a payment in cash of \$1.4 million, the established value of the property. If this is the case, the taxpayers should be entitled to treat the entire gain as § 1001 gain, a portion of which can be reported as capital gains under § 1231.

Of course, if this is the case, then the Commissioner should have argued before the Tax Court that the property's value, subject to such an attractive financing package, was in fact \$1.8 million, rather than the \$1.4 million asserted by the taxpayers. Apparently, no such argument was made.

246. See S. REP. NO. 830, 88th Cong., 2d Sess. (1964), reprinted in 1964 U.S. CODE CONG. & AD. NEWS 1673, 1805; H.R. REP. NO. 749, 88th Cong., 1st Sess. (1963), reprinted in 1964 U.S. CODE CONG. & AD. NEWS 1313, 1409, 1573.

not consider the capital gains versus ordinary income issue. Nor do they offer any analytical tools for resolving the issue. In the following section, a final rationale will be developed which can serve as an analytical tool for addressing and resolving the characterization of income issue.

IV. THE UNIFORM TREATMENT RATIONALE

In Part II of this article, I argued that the *Crane*²⁴⁷ Court's reasoning with respect to principle number one suggested an underlying rationale which I have called the Uniform Treatment Rationale.²⁴⁸ It should be noted that this rationale does not explain why any purchase money mortgage should be included in basis. Nor does it assume that such inclusion is correct as a matter of tax theory. Rather, it merely recognizes the existence of an established rule: A personally liable mortgagor must include a bona fide purchase money debt in the depreciable basis.²⁴⁹

Given this rule, the issue becomes whether the absence of personal liability creates a sufficient distinction to justify applying a different rule to nonrecourse mortgagors. The *Crane* Court decided it did not. Presumably, the absence of personal liability does not, by itself, suggest that the mortgage debt will not be paid. Since the personally liable mortgagor is allowed to include the debt in basis on the assumption that it will be paid in the future, there is no reason to treat nonrecourse mortgagors any differently provided the facts indicate that they also will pay their debts.

The likelihood of future payment is indicated by facts other than the existence of personal liability. In cases decided subsequent to *Crane*, courts have considered the fair market value of the property to be the most relevant fact²⁵⁰ because if the fair market value exceeds the liability, then the taxpayer is likely to pay off the lower liability in order to keep the more valuable property.²⁵¹ Indeed, in one case,²⁵² market value merely equaled the liability, yet was found

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

248. See *supra* text accompanying notes 108-12.

249. 331 U.S. at 13.

250. See, e.g., *Bolger v. Commissioner*, 59 T.C. 760 (1973). See also cases cited *supra* note 111.

251. See Gans, *supra* note 9, at 96-104 (describing the "Likelihood-of-Payment" test).

252. *Bolger v. Commissioner*, 59 T.C. 760, 770 (1973). Of course, this also was the case in *Crane*, i.e., that fair market value equaled debt. The *Crane* case, however, did not involve § 1012 basis, I.R.C. § 1012 (1976), which presumes an eventual cash investment in the property. Thus, the likelihood of payment at the time of acquisition was not the *Crane* Court's main

sufficient to support the "likelihood-of-payment" test.²⁵³

Uniform treatment of the two types of mortgagors can be viewed as furthering two goals of tax policy:²⁵⁴ horizontal equity²⁵⁵ and practicality.²⁵⁶ The goal of horizontal equity is furthered by taxing similarly situated taxpayers in the same manner. The two mortgagors are similarly situated to the extent the facts suggest that the mortgage at the time of acquisition will be repaid. The goal of practicality is furthered because it is more convenient, from an administrative point of view, to compute allowable depreciation deductions on the full advance credit basis of the nonrecourse mortgaged property than to make annual adjustments to basis which reflect the actual cash invested.²⁵⁷ In addition, uniform treatment for depreciation purposes relieves the Commissioner from the administrative burden of determining which mortgages are truly with full recourse and which are not.²⁵⁸

Similarly, the Uniform Treatment Rationale may be used to explain the tax consequences to a nonrecourse mortgagor upon the final disposition of the mortgaged property. If absence of personal liability is considered an insufficient distinction for purposes of original basis and availability of depreciation,²⁵⁹ it likewise may be con-

focus.

253. See *supra* notes 251-52. The presumption that debt will be repaid where the value of the property equals the debt makes little sense unless the property is likely to appreciate in value or produce other future benefits. On the other hand, future appreciation and future benefit are considerations that presumably affect current fair market value. The result in *Bolger v. Commissioner*, 59 T.C. 760 (1973), may reflect the court's recognition that assignments of fair market value are rarely certainties and, thus, a close enough equivalency between value and the mortgage liability ought to be sufficient to satisfy the likelihood-of-payment test.

254. For an excellent discussion of tax policy goals, see Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567 (1965). But see Popkin, *The Taxation of Borrowing*, 56 IND. L.J. 43, 56 (1980) (questioning of equity and policy implications of allowing depreciation deductions to be claimed on basis which includes nonrecourse debt; pointing out that nonrecourse borrowers in such situations often fail to report income at time of disposition even though debt exceeds basis, thereby ignoring *Crane's* principle number 2).

255. See Sneed, *supra* note 254, at 574-80.

256. See *id.* at 572-74.

257. The difficulties involved in computing depreciation on a basis that does not include nonrecourse debt was a major concern in the *Crane* opinion. See 331 U.S. at 9-10.

258. See Bittker, *supra* note 88, at 282. Professor Bittker points out that the *Crane* Court opted for uniform treatment and that the Court's action was justifiable for reasons similar to those I have suggested in the text. It should be noted, however, that transactions covered by § 465 do require an administrative determination as to the existence of personal liability. See I.R.C. § 465 (1976 & West Supp. 1982).

259. Presumably, it still is, outside of those transactions specifically covered by § 465. I.R.C. § 465 (1976 & West Supp. 1982). Section 465 would still permit nonrecourse liabilities to be included in basis for purposes of calculating the appropriate depreciation deduction. The

sidered an insufficient distinction for purposes of treating the nonrecourse mortgagor differently from his or her personally liable analogue at the time of final disposition.

Therefore, in those cases in which the mortgage debt would be included in the amount realized if the mortgagor had been personally liable, the nonrecourse debt likewise should be included. The result would be to characterize the entire gain as one derived from the disposition of property, and capital gains treatment should be available to the nonrecourse mortgagor to the same extent such treatment is available to a personally liable mortgagor. This was the approach implicitly endorsed by the *Crane* Court.²⁶⁰

Not every personally liable mortgagor, however, is required to include the full amount of the outstanding mortgage in the amount realized upon final disposition. Consider the case of a hypothetical taxpayer, *A*, who borrows money from Bank *X* to acquire a depreciable building. *A* is personally liable on the mortgage note. Several years later, the building's value falls below the remaining balance on the mortgage debt. Due to depreciation deductions claimed by *A*, the building's adjusted basis is less than both the property's value and the debt. As a result of the adverse economic conditions that led to the property's decline in value, *A* is unable to continue making the required mortgage payments. In this fact situation, the most likely final disposition of the property will be a foreclosure sale or a deed to the mortgagee bank in lieu of foreclosure. Upon disposition, it is unlikely that the full amount of the mortgage will be included in the amount realized, because it is unlikely that it will be paid or otherwise satisfied in full.

Presumably, the foreclosure sale will bring a price equal to the property's fair market value, thus satisfying *A*'s debt to Bank *X* only to the extent of the property's value. If Bank *X* pursues *A* for the deficiency, *A*'s payment of the debt will produce no tax consequences.²⁶¹ Thus, the final tax result to *A* will be a section 1001 gain²⁶² equal to the difference between the property's value and its

deduction, however, can only be claimed for tax purposes to the extent the taxpayer is "at risk" and a taxpayer is not considered at risk with respect to nonrecourse purchase money debt, except to the extent he or she has offered other assets as security for the debt. *See id.* § 465(b). The "at risk" rules are inapplicable to real property. *See id.* § 465(c)(3)(D).

260. *See supra* text accompanying notes 108-12.

261. Payment of a debt is a neutral transaction for tax purposes. In addition, the debt has already been accounted for by its inclusion in basis and the resulting depreciation deductions it thereby made available.

262. *See* I.R.C. § 1001(a)(1976) (formula for gain computation).

adjusted basis.

On the other hand, Bank *X* may elect to cancel *A*'s debt in full, either upon foreclosure or upon acceptance of the deed in lieu of foreclosure. In this case, *A*'s disposition of the mortgaged property and the concurrent cancellation of the debt produce two distinct tax consequences. First, *A* has disposed of the property in a transaction which triggers gain computed under section 1001. Second, to the extent that the property's value is insufficient to satisfy *A*'s personal obligation to the mortgagee, *A*'s liability has been forgiven, producing discharge of indebtedness income to *A*.²⁶³

The gain, if any, under section 1001 should be computed by subtracting the adjusted basis from the fair market value of the property at the time of disposition. The character of this gain will likely be determined under section 1231, subject to recapture under either sections 1250 or 1245. Discharge of indebtedness income should be computed by subtracting the fair market value of the property from the outstanding balance on the debt. If *A* can qualify for the relief provided under section 108,²⁶⁴ then recognition of this income can be deferred.²⁶⁵ If *A* cannot qualify, then the discharge of indebtedness income should be reported as ordinary income.

Now, assume the existence of *A*₁, a nonrecourse mortgagor, who is an exact analogue to *A*, but for the absence of personal liability on the mortgage note. Since *A*₁ is not personally liable, Bank *X* has no choice but to satisfy its outstanding debt in an amount equal to the property's value and to forego the remaining debt. *A*₁'s situation is thus similar, at the time of disposition, to the situation of taxpayer *A* whose deficiency has been forgiven.

To grant *A*₁ the same tax treatment as *A* in this situation would give effect to *Crane*'s footnote 37. It would not, however, relieve *A*₁

263. In *Danenberg v. Commissioner*, 73 T.C. 370 (1979), the Tax Court recognized that a transfer of property to satisfy creditors to whom the insolvent taxpayer was personally liable could involve two separate transactions. Thus, the taxpayer in *Danenberg* was required to recognize gain on the portion of the transaction that represented a disposition of property. *Id.* at 386. The other portion, representing discharge of indebtedness income, went untaxed because the taxpayer qualified under the judicially created insolvency exception, *see id.* at 388-89, which has been codified by § 108. I.R.C. § 108 (Supp. IV 1980). *See infra* notes 264-65.

264. I.R.C. § 108. This provision is available to taxpayers whose debts are discharged in bankruptcy, to taxpayers who are insolvent, and to taxpayers whose discharge debt represents "qualified business indebtedness." *Id.* § 108(a)(1).

265. Although § 108(a) excludes qualified discharge of indebtedness income from immediate inclusion in gross income, subsections (b) and (c) require the taxpayer to reduce either certain tax attributes or depreciable basis by the amount of the excluded income. *Id.* § 108(b), (c). The effect of these provisions is to defer recognition of the income to future tax periods.

from paying taxes on the gain reflected in the difference between the property's value and the face amount of the debt. Instead, the difference would be characterized as discharge of indebtedness income and should either be recognized as ordinary income in the year of disposition or be temporarily excluded from income under section 108.

Commentators who have considered the possibility of treating the difference between the debt balance and the fair market value of the mortgaged property as discharge of indebtedness income have quickly rejected the notion on the theory that no such income can possibly exist absent personal liability.²⁶⁶ The Tax Court has also rejected the notion on the same theory.²⁶⁷

The approach of the commentators and the Tax Court, however, ignores the underlying policy of section 108²⁶⁸ and fails to consider the transaction as a whole. It is an approach based on the *United States v. Kirby Lumber*²⁶⁹ definition of discharge of indebtedness income. This definition states that such income can only arise when the discharge frees assets that the creditor might otherwise reach to satisfy the debt.²⁷⁰ Under this definition, it is true that A_1 recognized no such income at the time the property was transferred to the mortgagee in lieu of foreclosure. The mortgagee, in making the loan nonrecourse, had agreed from the beginning that all other assets would be

266. See, e.g., 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, 322-23 (1977); Javaras, *Nonrecourse Debt in Real Estate and Other Investments*, 56 TAXES 801, 806-07 (1978); Simmons, *supra* note 89, at 37 n.177.

267. See *Estate of Delman v. Commissioner*, 73 T.C. 15 (1979). Delman had been a partner in a partnership that had acquired § 1245 property, I.R.C. § 1245 (1976 & West Supp. 1982), with nonrecourse debt. See 73 T.C. at 19-22, 35. The partnership deeded the property to its creditors at a time when its fair market value was less than the outstanding debt. See *id.* at 25. The taxpayer attempted to characterize the difference between the value and the debt as discharge of indebtedness income. The taxpayer further asserted that the insolvency exception applied to exempt the income from taxation. See *id.* at 28, 31. The court held that under *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), no discharge of indebtedness income could arise unless the debt cancellation served to increase the taxpayer's net worth by freeing up other assets. 73 T.C. at 32. Since a nonrecourse mortgage affects only the asset which stands as security, its disappearance from the taxpayer's balance sheet, together with the asset's disappearance, produces no effect on net worth. *Id.* at 33. Although the Tax Court's strict doctrinal approach to the issue can be criticized, the result in *Delman* is correct on other grounds. The insolvency exception should have been available only to the extent that the partners were insolvent. The taxpayer's argument, however, was based on the insolvency of the partnership.

268. See *infra* text accompanying notes 278-80.

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

270. See *id.* at 3.

free from liability. If one considers this aspect of the transaction, it is possible, even within the *Kirby Lumber* definition, to conceptualize discharge of indebtedness income, which results upon the final "transfer" of nonrecourse debt.

In other words, in order to identify the requisite "freeing up" of assets,²⁷¹ one only needs to view the transaction from beginning to end.²⁷² The initial agreement by the lender to look only to the mortgaged property for satisfaction of the debt constitutes an initial freeing up of other assets. There is no debt discharge income at that time because the mortgaged property appears sufficient to cover the debt and thus the benefit of having other assets freed from the obligation has no value. The value of the prior agreement should, however, be recognized for tax purposes if there is a subsequent decline in the mortgaged property's value. When the mortgaged property declines in value, and is thus insufficient to cover the debt, the benefit of the prior freeing up can be viewed as producing a present benefit that is equal in value to the difference between the debt and the property's value. The amount of this difference represents the amount in value of other assets that, absent the nonrecourse agreement, could have been reached to satisfy the debt. Thus, under this analysis the difference could be characterized as *Kirby Lumber* discharge of indebtedness income.²⁷³

With respect to A_1 , it has already been argued that the amount realized ought to be limited to the property's fair market value independent of the Uniform Treatment Rationale.²⁷⁴ It has also been

271. A "freeing up" of assets is the key concept in the *Kirby Lumber* definition.

272. This process is similar to that used in the Economic Benefit Rationale to identify prior economic benefits.

273. If personal liability were a prerequisite for discharge of indebtedness income, what should be the result if a mortgagee elected to reduce the balance owed on a nonrecourse note by \$10,000? If the secured property had not declined in value, surely the \$10,000 ought to result in discharge of indebtedness income. Since the mortgagor is being allowed to retain the property, it is the secured property itself which is being freed from the creditor's claim. Of course, if the mortgagee is also the seller of the property, the \$10,000 reduction will be treated as a reduction in the original purchase price under § 108, thereby reducing the property's basis. Otherwise, the reduction in basis could be accomplished under the provision in § 108 dealing with trade or business indebtedness. I.R.C. § 108(c). In recently issued Rev. Rul. 82-202, 1982-48 I.R.B. 5, the Service indicated that prepayment of a nonrecourse mortgage liability in exchange for a reduction in the amount of the liability produced *Kirby Lumber* income. Section 108 relief was not available because the taxpayer was neither bankrupt nor insolvent, and the liability was not qualified business indebtedness.

274. This is so on the basis of *Crane's* footnote 37 which focuses on the constructive economic benefit to the seller of having the mortgage debt paid off by the purchaser in the future. See *supra* text accompanying notes 237-45.

demonstrated that such a limitation does not necessarily result in nontaxation of the gain represented by the excess of the debt over the value.²⁷⁵ All three rationales discussed in Part III of this article correctly identify this excess as taxable income. If the gain attributable to the excess is not included in the amount realized, then it should not be viewed as resulting from the sale or exchange of a capital asset. The logical conclusion is that the excess should be treated as ordinary income.

The only purpose in the foregoing attempt to characterize the excess as discharge of indebtedness income, rather than some other type of income, is to justify taxing the nonrecourse mortgagor, A_1 , in the same manner as the personally liable mortgagor, A . Under current law there are two possible tax consequences to A . The amount of the discharge will either be taxed as ordinary income or it will be subject to the relief provisions of section 108.²⁷⁶

Since A_1 should be taxed on the excess of the debt over the

275. See *supra* text accompanying notes 237-45.

276. There are no cases involving personally liable mortgagors in A 's situation who have been required to report the difference between the debt and the property's value as ordinary income. In the past, both the Commissioner and the courts have been willing to accept the mortgagor's characterization of the transaction as a single disposition of property in which the full amount of the mortgage debt is considered an amount realized. See *Lutz & Schramm*, 1 T.C. 682 (1943); *Main Properties, Inc.*, 4 T.C. 364 (1944), *acq.* 1945 C.B. 5 (both cases imply that either taxpayer had gain from exchange of property or no income from debt discharge due to insolvency exception). As a practical matter, if the disposition is a deed in lieu of foreclosure, accompanied by full cancellation of the debt, the property's fair market value may not be established at the time of disposition. This is especially true if the mortgagee had initially sold the property to the mortgagor on the installment basis. In this case, the fair market value is irrelevant to both parties since the seller/mortgagee has not yet reported the full gain under § 453, I.R.C. § 453 (1976), and his recoupment of the property is taxed under § 1038 which focuses on the cash received, *id.* § 1038 (1976), and not the fair market value of the property.

The courts, however, have not been consistent in their approach to taxpayers who have deeded property to creditors in cancellation of outstanding debts. A number of early cases held that the full amount of the cancellation resulted in *Kirby Lumber* income which did not have to be recognized because the taxpayer was insolvent at the time of discharge. The insolvency exception to *Kirby Lumber* was first adopted in *Lakeland Grocery Co. v. Commissioner*, 36 B.T.A. 289 (1937). For an application of the insolvency exception, see *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95 (5th Cir. 1934) (holding no income under insolvency exception even though facts involved transfer of property whose value exceeded basis). *Accord* *Main Properties, Inc. v. Commissioner*, 4 T.C. 364 (1944), *acq.* 1945 C.B. 5. The bifurcated approach, subsequently endorsed in *Danenburg v. Commissioner*, 73 T.C. 370 (1979), was not argued or considered in these cases. The *Danenburg* case presents the most conceptually sound approach, i.e., bifurcating the foreclosure transaction into two elements of gain. See *id.* at 386-88. Although the result in that case was to give the taxpayer the benefit of the insolvency exception with respect to the amount of discharge of indebtedness gain, *id.* at 389, the transaction should have been bifurcated even if the taxpayer had been insolvent. The result would have been ordinary income in the amount of the discharge.

property's value at ordinary rates,²⁷⁷ regardless of whether the excess is characterized as discharge of indebtedness income, the only practical effect of such a characterization is to make section 108 deferral available to A_1 . Thus, the underlying issue is not whether A_1 's transaction, viewed in its entirety, creates the type of income envisioned in *Kirby Lumber*, i.e., a freeing-up of assets which thereby produces income. Rather, the issue is whether A_1 ought to be entitled to the relief provisions of section 108 in order to defer recognition of the portion of the gain reflected in the excess of the debt over the value of the property. Thus, the focus should be on the statutory purpose of section 108 and whether A_1 's overall fact situation is one intended to be covered by that provision. If it is, relief should be granted.

It should be pointed out that the Uniform Treatment Rationale merely serves as a guide in this case. The theory of the rationale is that if A and A_1 are sufficiently similarly situated, they should be accorded uniform tax treatment. As an analytical tool, the rationale should be used to identify the particular facts in A 's situation that enable him to utilize section 108. The next step is to determine whether the same facts are present in A_1 's situation. If they are, then granting A_1 relief under section 108 appears justified. The Uniform Treatment Rationale serves merely as a guide because the primary analysis requires an identification of the statutory purpose behind section 108 and an independent conclusion as to what facts are sufficient to support its application.

The policy underlying section 108 recognizes that discharge of debt usually results in situations involving taxpayers who are suffering from economic setbacks that prevent them from meeting their loan payments as they fall due.²⁷⁸ Although the discharge effectively produces current taxable income, section 108 is intended to relieve the debtor from being "burdened with an immediate tax liability."²⁷⁹ There is nothing in the legislative history to indicate that bankrupt, insolvent, or financially troubled debtors who are not personally liable should be so burdened.²⁸⁰

277. This portion of the gain should not be viewed as resulting from the sale or exchange of a capital asset since there is no consideration to support a sale or exchange.

278. S. REP. NO. 1035, 96th Cong., 2d Sess. 10 (1980), reprinted in 1980 U.S. CODE CONG. & AD. NEWS 7017, 7025.

279. *Id.*

280. In the hearings on the changes to § 108 there is one reference to the fact that *Kirby Lumber* does not apply to create discharge of indebtedness income in cases involving no personal liability. The reference was merely in an introductory statement contained in a document prepared by the Interstate Natural Gas Association of America. See *Written Comments on*

Given this policy behind section 108, characterizing A_1 's transfer of the nonrecourse debt as an event that results in a constructive freeing-up of assets is an unsatisfactory approach to answering the ultimate question.²⁸¹ Thus, the potential similarities between A and A_1 must be reviewed more closely.

The nonrecourse mortgagor's potential debt discharge actually occurs at the beginning of the transaction, whereas the personally liable mortgagor's discharge necessarily occurs at the conclusion of the transaction. Thus, from the lender's point of view, the nonrecourse mortgagor's financial situation at the conclusion of the transaction is irrelevant. The lender has no choice but to accept the subsequent loss, having elected at the outset to look only to the property for satisfaction of the debt. In the case of the personally liable mortgagor, however, the lender will only discharge the debt if the mortgagor's financial situation at the conclusion of the transaction warrants it.

Applying the analytical framework of the Uniform Treatment Rationale, therefore, requires a comparison of A_1 's financial situation at the conclusion of the transaction with that of a personally liable mortgagor whose deficiency is likely to be forgiven. The fact that in both cases the fair market value of the property has declined below the mortgage debt is, in my opinion, not a sufficient similarity, although it does suggest financial difficulty. Evidence of the bankruptcy or insolvency of the nonrecourse mortgagor, on the other hand, would suggest that a valid comparison can be made between A_1 and A . Other evidence of financial difficulty, short of bankruptcy or insolvency, presents a more difficult case from a practical point of view. Consider the problems of proving that had the taxpayer been personally liable, the mortgagee bank would have forgiven the amount of the debt in excess of the property's value or in excess of the price it might bring at a foreclosure sale. The court would be placed in the position of making a decision normally made by bankers. Should banking officials, properly qualified as expert witnesses,

Certain Aspects of H.R. 5043 Before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, 96th Cong., 2d Sess. 65 (1980). The statute itself defines indebtedness broadly enough to include nonrecourse liabilities. See I.R.C. § 108(d)(1)(B). See also Rev. Rul. 82-202, 1982-48 I.R.B. 5.

281. The *Kirby Lumber* reasoning which originated the "freeing up" concept was merely a means of demonstrating that the taxpayer had taxable income. Whether the taxpayer should be accorded relief from immediate taxation on this income is an entirely different issue which should focus on independent factual considerations. See *supra* notes 266-73 and accompanying text.

be allowed to testify as to their opinion regarding the issue? My own sense of the situation is that, absent evidence of bankruptcy or insolvency, the practical difficulties suggest that other evidence should be severely limited. Perhaps bona fide forgiveness of other debts on which the taxpayer is personally liable during the same time period is evidence that ought to be considered. What evidence should be considered relevant and what quantum of evidence should be considered sufficient to establish the taxpayer's right to use section 108 are issues more appropriately resolved on a case by case basis.

Proof of financial difficulty sufficient to warrant the potential application of section 108, however, is not dispositive of the matter. Absent bankruptcy or insolvency, the taxpayer may claim section 108 relief only with respect to the discharge of "qualified business indebtedness."²⁸² In the case of corporations, all debt is treated as qualified.²⁸³ For an individual, however, the debt will qualify only if it is "incurred or assumed . . . by [the] individual in connection with property used in *his* trade or business."²⁸⁴

In other contexts, it has been held that the trade or business of a corporation will not be considered the trade or business of the individual shareholder.²⁸⁵ Given the generally recognized legal distinction between a corporation and its shareholders, it is fair to conclude that nonrecourse debt incurred for the purpose of acquiring corporate stock should not be viewed as qualified business indebtedness of the individual shareholder. Thus, the debt in *Millar*²⁸⁶ should fail to qualify under section 108, because the borrowed funds were invested in a corporation for use in its trade or business.²⁸⁷

The potential availability of section 108 in a case such as *Tufts*,²⁸⁸ however, presents a more difficult question, because the nonrecourse debt was incurred at the partnership level.²⁸⁹ Section 108(d)(6) requires that the existence of qualified business indebted-

282. I.R.C. § 108(a)(1)(C).

283. *Id.* § 108(d)(4)(A)(i).

284. *Id.* § 108(d)(4)(A)(ii) (emphasis added).

285. See *Whipple v. Commissioner*, 373 U.S. 193, 202 (1963) (business of corporation viewed as separate from that of shareholder in determining whether shareholder's bad debt deduction was result of nonbusiness debt); *Wheeler v. Commissioner*, 241 F.2d 883, 884 (2d Cir. 1957).

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

287. *Id.* at 214.

288. *Tufts v. Commissioner*, 651 F.2d 1058 (5th Cir. 1981), *cert. granted*, 102 S. Ct. 2034 (1982).

289. *Id.* at 1059.

ness be determined at the partner level.²⁹⁰ Unless the trade or business of the partnership is attributable to the partners, section 108(d)(6) would seem to prevent a solvent partner from ever claiming relief under section 108(a)(1)(C).²⁹¹ Congress, however, presumably intended for section 108(a)(1)(C) to be available to solvent partners,²⁹² and thus the focus on the *individual's* trade or business in section 108(d)(4) must be irrelevant in the partnership context.

An argument could be made for allowing a solvent partner in financial difficulty²⁹³ to claim section 108 relief upon "discharge" of a nonrecourse debt which would otherwise trigger immediate taxable income.²⁹⁴ The facts necessary to support such an argument are, however, likely to be a rare occurrence. Indeed, in the limited partnership context, where nonrecourse financing is heavily utilized to produce valuable tax benefits,²⁹⁵ section 108 relief should prove to be

290. I.R.C. § 108(d)(6). The existence of bankruptcy or insolvency must also be determined at the partner level. *See id.*

291. *Id.* § 108(a)(1)(C). Relief is available to solvent taxpayers only if the discharged debt is a qualified business indebtedness. Although the debt may qualify at the partnership level, § 108(d)(4)'s definition of qualified business indebtedness focuses on the trade or business of the individual. If the debt is incurred by the partnership in connection with property used in *its* trade or business, then it cannot simultaneously be viewed as incurred by the individual partner in connection with property used in *his* trade or business, unless the partnership's trade or business is also viewed as the partner's trade or business.

292. Congressional intent on this point can be inferred from the provisions contained in §§ 108(c) and 1017(b)(3)(C). The former provision limits the potential exclusion for discharge of qualified business indebtedness to amounts for which the taxpayer makes a corresponding basis adjustment in depreciable property. *See id.* § 108(c). The latter provision creates a special rule for partnership interests. It allows them to be treated as depreciable property by the partner to the extent of the partner's proportionate interest in the depreciable property of the partnership, provided there is a concurrent basis reduction in the property at the partnership level. *Id.* § 1017(b). Thus, if a solvent general partnership with solvent partners had a full recourse debt discharged, there should be no income for any of the partners, provided the partnership reduced its basis in depreciable property by the amount of the discharge. The partners' basis would be reduced proportionately by the amount of the discharge. *See id.* §§ 731, 752.

293. The test of financial difficulty ought to be applied at the partner level as are the tests of bankruptcy and insolvency.

294. Note that reduction of a nonrecourse liability in the absence of a disposition of the property which secures the debt should not result in immediate taxable income, unless the reduction exceeds the remaining undepreciated basis. Instead, it should only result in an immediate reduction in basis.

295. Use of nonrecourse debt in limited partnerships is essential for a successful tax shelter, because limited partners are allowed to include a pro rata share of such debt in their partnership basis. Since a partner can only deduct partnership losses to the extent of basis, nonrecourse debt serves to create additional basis which supports early deductions in excess of actual invested capital. The "at risk" provisions of § 465, I.R.C. § 465, prevent this result in certain limited partnerships.

generally unavailable to limited partners. Even if, as in *Tufts*, the partnership's investment becomes worthless, it is unlikely to cause either insolvency or severe financial difficulty to a limited partner, who typically invests minimal capital in exchange for large tax deductions in order to shelter high earnings or income from other investments.²⁹⁶

Thus, in cases involving limited partners and Subchapter S shareholders who benefit from nonrecourse loans, application of the Uniform Treatment Rationale in a footnote 37 fact situation is most likely to produce an element of ordinary income to those taxpayers who have claimed tax deductions in excess of their actual investment. In rare cases involving nonrecourse mortgagors who are bankrupt, insolvent, or perhaps are otherwise in sufficient financial difficulty, the rationale can be used to support relief under section 108.

V. CONCLUSION

*Crane*²⁹⁷ held that nonrecourse mortgage liabilities must be included in basis for the purpose of computing depreciation deductions. The implicit theory for the holding is that if the nonrecourse mortgagor can be presumed to pay off the liability in the future, there is no reason for treating him or her any differently from the personally liable mortgagor who, on the same theory, is given credit for mortgage liabilities in tax basis prior to actual payments.

In addition, *Crane* held that any outstanding liability at the time of final disposition of the property ought to be considered an "amount realized" for purposes of computing gain under section 1001.²⁹⁸ In footnote 37, however, the Court suggested that the result might be different if the fair market value of the property at the time of disposition was less than the mortgage debt. Unfortunately, the Commissioner, the courts, and the commentators have interpreted footnote 37 as an either-or proposition. That is, they have concluded that *either* the full amount of the debt is included in the

296. Even if financial difficulty short of insolvency is present, an additional argument can be made against making § 108 relief available to a limited partner in a situation such as *Tufts*. The argument is that it may be acceptable to characterize qualified business indebtedness of the partnership as qualified business indebtedness of a partner who is liable on the debt; it does not make sense, however, to do so in the case of partners who are shielded from liability and who, as limited partners, are passive investors in much the same sense as shareholders of a corporation.

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

298. *See id.* at 14; I.R.C. § 1001(a)(1976)(formula for gain computation).

amount realized *or* the portion not so included escapes taxation.²⁹⁹ The three rationales discussed in Part III of this article reflect this interpretation of footnote 37.

What has been consistently overlooked is that the amount realized upon disposition can be limited to the property's fair market value without resulting in the nontaxation of gain attributable to the excess debt. The exclusion of the excess debt from the amount realized merely removes this element of gain from the operation of section 1001. The result is that this element of gain should not be considered as gain resulting from the disposition of the property. Although the disposition triggers the gain, the gain itself is attributable to something else. The gain is attributable to what may be characterized as prior beneficial tax deductions in excess of invested capital or a prior receipt of cash which will not be repaid. Or, the gain may simply result from a judicially imposed rule: If nonrecourse mortgagors are treated the same as personally liable mortgagors at the beginning of the transaction, then equity demands that they be treated the same at the conclusion. Under this latter approach, the nonrecourse mortgagor's final disposition of the property should be viewed as relieving the mortgagor from payment of the mortgage liability, thus creating a present economic benefit similar to that experienced by personally liable mortgagors whose liability is assumed, satisfied, or cancelled.

The most significant result of bifurcating total gain into section 1001 gain and this other gain is that the former may qualify for capital gains treatment whereas the latter should result in ordinary income. The policy behind preferential capital gains treatment supports this result because the property has not appreciated.

Whereas all three of the rationales discussed in Part III can be used to identify the total realized gain in a footnote 37 case, they do not indicate how this total gain should be taxed. Indeed, by treating the entire gain as a section 1001 gain, the rationales implicitly support potential capital gains treatment. Although it is possible to include the full debt in the amount realized and then use the "sale or exchange" requirement as a means of characterizing a portion of the section 1001 gain as ordinary income, I prefer to avoid the artificiality of the "sale or exchange" analysis. Limiting the amount realized to the property's value is appealing because it is a more direct approach. Moreover, it gives the term "amount realized" a meaning

299. *See supra* note 14.

which is more consistent with its context, i.e., as consideration offered and accepted for the transfer of the property.

The Uniform Treatment Rationale, under which the amount realized would be so limited, provides an answer to the characterization question and adds one additional consideration with respect to the deferred recognition of gain under section 108. As with the other three rationales, the Uniform Treatment Rationale would treat the entire amount of a nonrecourse debt in excess of the basis as realized income upon the disposition of the property. It would do so in every case.³⁰⁰ Its theoretical basis for doing so, however, is somewhat different than the others. According to the Uniform Treatment Rationale, realized gain results because we have opted for a system that ignores the absence of personal liability in appropriate cases involving nonrecourse mortgage transactions. Presumably, we have opted for this system for reasons involving administrative considerations and because the economic reality of certain nonrecourse transactions is sufficiently similar to that of transactions involving personal liability.³⁰¹

The Uniform Treatment Rationale merely recognizes that we have adopted this system. It assumes that if the economic reality of two different transactions, one involving nonrecourse debt and one not, is sufficiently similar, then uniform tax treatment of each transaction is warranted.

Thus, capital gains treatment should be available to a nonrecourse mortgagor who disposes of property in a transaction having an economic reality equivalent to a sale or exchange by a personally liable mortgagor. If the fair market value of the property is less than the debt, a personally liable mortgagor would not be able to sell or exchange the property for the full amount of the debt. Nonetheless, if the debt is cancelled, as it effectively is in every case involving a nonrecourse mortgagor, the cancellation will trigger taxable income. If the personally liable mortgagor must recognize the amount of the excess debt as ordinary income, then so should the nonrecourse mortgagor. If the personally liable mortgagor is entitled to defer recogni-

300. The realized gain under the Uniform Treatment Rationale would not be affected by whether prior deductions produced tax benefit since presence or absence of tax benefit is irrelevant in the case of a personally liable mortgagor. *See supra* text accompanying notes 93, 104-07 (discussion of this issue with respect to the other rationales).

301. This system has been substantially abolished under § 465, I.R.C. § 465, which preserves the administrative considerations regarding the computation of depreciation, but prohibits recognition of depreciation for tax purposes unless the taxpayer has sufficient capital at risk. *See id.*

tion of that income under section 108 because he or she is bankrupt or insolvent, then the bankrupt or insolvent nonrecourse mortgagor should be entitled to the same relief. Whether the nonrecourse mortgagor ought to be accorded section 108 relief absent bankruptcy or insolvency is a more difficult question. The Uniform Treatment Rationale suggests, however, that relief should be available if the nonrecourse mortgagor's financial situation is sufficiently similar to that of a personally liable mortgagor, for whom such relief was intended.

In conclusion, it is my opinion that the Supreme Court should give effect to *Crane's* footnote 37 in *Tufts*³⁰² by holding that section 1001 gain should be limited to an amount equal to the property's value less the adjusted basis. Since *Tufts* involves property whose basis exceeds its value, no section 1001 gain would result.³⁰³

Next, the Supreme Court should uphold the Commissioner's determination of the taxpayers' realized gain, computed as the amount by which the debt exceeds the adjusted basis. The gain should be taxed as ordinary income because the mortgage debt should not be considered an amount realized.³⁰⁴ Thus, the gain should not be considered as one which results from a sale or exchange of a capital asset or from a section 1231 transaction. Characterization of the gain as anything other than section 1231 gain is, however, an issue that is not properly before the Court. It is an issue that can only be judicially resolved if the Commissioner asserts such a position in a future case.³⁰⁵

302. *Tufts v. Commissioner*, 651 F.2d 1058 (5th Cir. 1981), cert. granted, 102 S. Ct. 2034 (1982).

303. In the Tax Court, the taxpayers in *Tufts* asserted that application of footnote 37 should produce a taxable loss to the extent their basis exceeded the property's value. 70 T.C. at 761. The Tax Court did not consider this argument since it found a taxable gain on the transaction, and the issue was not raised on appeal. At any rate, it should be pointed out that footnote 37 would never support a loss in a situation such as *Tufts*. Under the first principle of *Crane*, basis should only include nonrecourse debt when it can be assumed that the debt will be paid. Under the reasoning in *Crane*, once the property's value dips below the debt, the assumption is no longer tenable. Thus, the taxpayers in *Tufts* should not be allowed to assert a basis for loss purposes which includes a mortgage debt that they obviously will never pay.

304. Professor Wayne Barnett has filed an amicus brief with the Supreme Court in the *Tufts* case in which he similarly concludes that the gain upon disposition should not be characterized as a capital gain. This brief is well worth reading for his novel analysis of the issue. He describes the gain in *Tufts* as a *liability gain* as opposed to an *asset gain*. As such, the gain is similar to "income from the discharge of indebtedness," a type of income statutorily covered by §§ 61(a)(12) and 108. His analysis, although different from my own, is consistent with the approach I have taken and with my reading of the *Crane* decision.

305. In order to assert this position, the Commissioner would have to withdraw Rev. Rul. 76-111, 1976-1 C.B. 214, which currently lends support to treating the entire gain in a footnote 37 case as one derived from a sale or exchange.

Finally, section 108 relief should not be available to the taxpayers in *Tufts* under the Uniform Treatment Rationale. Even if the resulting income could be characterized as constructive discharge of indebtedness income, the taxpayers do not appear to be otherwise entitled to claim relief under section 108.³⁰⁶ The possibility of section 108 relief for other nonrecourse mortgagors, however, is an issue that should remain open for consideration in an appropriate fact situation.

306. See *supra* note 295 and accompanying text.

