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Tufts and *Millar*: Two New Views of the *Crane* Case and Its Famous Footnote

*Jerold A. Friedland**

I. Introduction

No case has had a greater impact on the tax law than *Crane v. Commissioner*.[1] The decision, which was instrumental in the creation of highly-leveraged, no-risk tax shelters, has generated commentary[2] and controversy for nearly thirty-five years. Recent decisions by different United States Courts of Appeals[3] dealing with the meaning of what has been called "the most famous footnote in tax history"[4] indicate that the controversy is alive and well. These decisions about the applicability of *Crane*'s footnote 37 illustrate a fundamental disagreement about the rationale and scope of the entire *Crane* holding. This article will examine the reasons for that disagreement.

When *Crane* was before the Supreme Court of the United States, Chief Justice Vinson posed the issue in a disarmingly simple way: "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 so encumbered must compute her taxable gain."[5] Actually, the issue framed by the Chief Justice did not quite reflect the case before the Court nor the scope of its eventual decision. *Crane* dealt only with the sale of property subject to a nonrecourse mortgage where the value of the property was greater than the principal on the mortgage. In such circumstances, the Court believed that the

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1 331 U.S. 1 (1947).

2 A number of excellent articles explore many aspects of *Crane*. Among them are: Adams, *Exploring the Outer Boundaries of the* Crane *Doctrine: An Imaginary Supreme Court Opinion*, 21 TAX L. REV. 159 (1966); 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); Ginsburg, *The Leaky Tax Shelter*, 53 TAXES 719 (1975); McGuire, *Negative Capital Accounts and the Failing Tax Shelter*, 3 J. REAL ESTATE TAX. 439 (1976); Weiss, *The* Crane *Case Updated*, 32 TAX LAW. 289 (1979).

3 Millar v. Commissioner, 577 F.2d 212 (3d Cir. 1978), *cert. denied*, 439 U.S. 1046 (1978); Tufts v. Commissioner, 651 F.2d 1058 (5th Cir. 1981), *rev'g* 70 T.C. 756 (1978).

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

5 331 U.S. at 2.

tax consequences should be the same as if there were personal liability for the loan:

> We are . . . concerned with the reality that an owner of property, mortgaged at a figure less than than 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.[6]

Since it was well established that the discharge of a personal obligation resulted in taxable gain,[7] the consequences should be the same for transfers of nonrecourse debt. Thus, the amount realized included the full amount of the mortgage.

The Court made it clear that its holding was limited to cases where the value of the property exceeded the mortgage. Annexed to its statement that a nonrecourse mortgagor in such circumstances "realizes a benefit in the amount of the mortgage" was the now famous footnote 37:

> 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 subject to the mortgage without receiving boot. This is not this case.[8]

The meaning of footnote 37, however, has been somewhat less than obvious, at least to the lower courts. The basic uncertainty about the footnote is whether it was intended to create an exception to the principal holding of *Crane* with respect to the amount realized on the discharge of nonrecourse debt, or merely to reserve that issue for future decisions. In *Tufts v. Commissioner*,[9] the Fifth Circuit recently decided that the footnote does indeed create an exception to *Crane*. The *Tufts* court held that "the fair market value of the property securing a nonrecourse debt limits the extent to which the debt can be included in the amount realized on disposition of the property."[10] The court was quite blunt about its reason for following footnote 37; it thinks the *Crane* case was wrongly decided. As the opinion sums up: "Because we have serious reservations about the *Crane* decision, we

6 *Id.* at 14.
7 United States v. Hendler, 303 U.S. 564 (1938).
8 331 U.S. at 14 n.37.
9 651 F.2d 1058 (5th Cir. 1981).
10 *Id.* at 1063.

decline to extend it beyond the facts of that case."[11]

On the other side of the footnote are the Tax Court (which was reversed in *Tufts*),[12] the Third Circuit[13] and probably the Second Circuit,[14] which have decided that whatever implications can be drawn from the note must be disregarded. Interestingly, the thrust of the arguments made by these courts is not that the statement is mere dictum in a lowly footnote, but that it is wrong and entirely inconsistent with the principal rationale for the *Crane* decision. *Crane* is viewed as having established a judicial "tax benefit" rule which prevents the abuses that would result if nonrecourse debt could be used to provide high basis property and generous tax losses without any counterbalancing gain upon disposition of the property.

While *Tufts* was on appeal to the Fifth Circuit from the Tax Court, the Internal Revenue Service attempted to elevate their position in the case to the status of regulations.[15] The new regulations were adopted as final in December 1980, and not surprisingly, go beyond the courts in disregarding footnote 37.[16] Without any discussion of tax benefit or any other rationale, the regulations declare that "the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition."[17] Although the majority's opinion in *Tufts* ignored the existence of these regulations, Judge Williams made it clear in his concurring opinion that he thinks them invalid.[18]

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11 *Id.*

12 Millar v. Commissioner, 67 T.C. 656 (1977), *aff'd in part*, 577 F.2d 212 (3d Cir.), *cert. denied*, 439 U.S. 1046 (1978); Tufts v. Commissioner, 70 T.C. 756 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981); Estate of Delman v. Commissioner, 73 T.C. 15 (1979).

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

14 Estate of Levine v. Commissioner, 634 F.2d 12 (2d Cir. 1980).

15 Treas. Reg. § 1.1001-2 (1980). This new section of the regulations includes in amount realized any liabilities included in basis. *See* Treas. Reg. §§ 1.1001-2(a)(1), -2(a)(4) (1980).

16 Treas. Reg. § 1.1001-2(b) (1980) provides:

> The fair market value of the security at the time of sale or disposition is not relevant for purposes of determining under paragraph (a) of this section the amount of liabilities from which the taxpayer is discharged. Thus, the fact that the fair market value of the property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from being treated as money received from the sale or other disposition of the property. However, see paragraph (a)(2) of this section for a rule relating to certain income from discharge of indebtedness.

Treas. Reg. § 1.1001-2(a)(4) (1980) provides: "For purposes of this section -

(i) The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability."

17 Treas. Reg. § 1.1001-2(a)(1) (1980).

18 Judge Williams wrote:

> I concur with the result reached by our panel because the Commissioner's position

The differences of opinion in this area are of more than academic interest. The disagreement between the courts goes to the very heart of the *Crane* decision, which in turn goes to the heart of much of the tax law governing property transactions. The Service's new regulations go beyond any theory proffered by any court and may indeed be invalid, as Judge Williams suggests. Declining real estate values coupled with more liberal depreciation allowances make the fact pattern envisioned by the footnote more likely to arise. In light of these factors, it is once again time for a foray into the realm of *Crane*.

II. The *Crane* Decision

Although this article is mainly concerned with the ramifications of footnote 37, the decisions in which the footnote has been an issue can only be understood in terms of the rationale that the deciding courts perceived to be the basis of *Crane*. The facts of the case are relatively simple. The taxpayer inherited from her husband an apartment building and lot which was subject to a mortgage for which she had no personal liability. The value of the property when she inherited it was just equal to the balance on the mortgage. The taxpayer operated the building for seven years, claiming substantial depreciation deductions on her tax returns. These deductions were computed by using the fair market value of the building at her husband's death as the adjusted basis, undiminished by the outstanding liability. Faced with an imminent foreclosure because of arrearage on the debt, the taxpayer sold the property to a third party who took it subject to the mortgage. The taxpayer was also paid a relatively small amount of cash in the transaction.

Since the problem that the Court posed for itself was to compute the amount of the taxpayer's gain in these circumstances, the Court first had to determine the adjusted basis for the property and then the amount realized on the sale. The basis of property acquired from a decedent is ordinarily the fair market value of "such property" on

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> is inconsistent with the plain language of I.R.C. § 1001(b) and I.R.C. § 752(c). I part company with the majority opinion because it rests on a difference of opinion with the Service over the construction of § 1001 in light of the *Crane* doctrine. I doubt we have authority to strike down the Commissioner's interpretation on the basis of "serious reservations about the *Crane* decision." We are authorized, however, to invalidate administrative regulations that conflict with the statute on which they purport to be based.

651 F.2d at 1063-64 (Williams, J., concurring).

the date of death.[19] The question raised in *Crane* was whether "such property" referred to the full value of the underlying asset or only to the equity inherited (the value less the liabilities). After much discussion, the Court concluded that the "proper basis . . . is the value of the property, undiminished by mortgages thereon."[20]

The Court also concluded that the amount realized on the sale included the full amount of the nonrecourse mortgage liability that was transferred with the property. Since the taxpayer's basis had been adjusted downward by some $25,000 due to accumulated depreciation deductions while the mortgage principal remained constant, the sale resulted in a substantial amount of taxable income. The Court was unimpressed by the taxpayer's contention that she was being taxed on a transaction that was "by all dictates of common sense . . . a ruinous disaster."[21]

A. *The Basis Holding*

Why did the Court feel compelled to include the full amount of the fair market value in the property's adjusted basis? Although the decision offers several rationales, including a dictionary definition of "property" and the Service's consistent administrative construction of that word, it has been suggested that the "controlling force" behind *Crane* was the Court's concern about depreciation policy.[22] This view appears well supported. The Internal Revenue Code requires the basis for computing depreciation to be the same as the basis for computing gain or loss on a sale or exchange.[23] Because the depreciation deduction is an allowance for the actual exhaustion, or wear and tear of property as it is used in a trade or business, depreciation must account for the declining value of the property, not merely the owner's equity. Therefore, the Court concluded that the use of an equity basis would be contrary to "implicit principles of income tax depreciation."[24]

The taxpayer argued that it was not necessary to equate her basis for depreciation with her basis on a sale or exchange because she should never have been allowed to take the depreciation deductions at all. Since depreciation is allowable only to the taxpayer who actu-

19 I.R.C. § 1014(a)(1).
20 331 U.S. at 11.
21 *Id.* at 15.
22 *See* 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).
23 I.R.C. § 167(g).
24 331 U.S. at 10.

ally bears the loss of capital through exhaustion of property, the nonrecourse nature of the liability would cause such losses to fall on the mortgagee. Surprisingly, the Court did not reject this argument as a matter of law, but held rather that the taxpayer had not established her "factual premise."[25] Because the value of the property was never shown to be less than the amount of the mortgage, a decline in the value of the property could not be considered borne by the mortgagee. The fact that the buyer was willing to pay the taxpayer some cash "boot" in addition to taking the building subject to the liability allowed the Court to infer that the value of the property was always at least equal to the mortgage.[26]

But would a decline in value to less than the mortgage actually shift the loss to the mortgagee? Perhaps the converse of that question is more pertinent. Could the nonrecourse mortgagor be *denied* depreciation deductions when the value of the property is less than the mortgage? There is an indication that this situation was not beyond the Court's contemplation: "So long as the mortgagor is in possession the mortgagee cannot take depreciation deductions, *even if he is the one who actually sustains the capital loss*, as section [167] allows these only on property used in the trade or business."[27] Ultimately, the Court dodged the issue in a statement quite similar in tone to the later footnote 37:

> Whatever may be the rule as to allowing depreciation to a mortgagor on property in his possession which is subject to an unassumed mortgage and clearly worth less than the lien, we are not faced with that problem and see no reason to decide it now.[28]

B. *The Amount Realized Holding*

The most perplexing aspect of *Crane* is the Court's rationale for including in the seller's amount realized the amount of nonrecourse debt that the property was subject to when sold. The Code defines this amount realized as the sum of the money and the value of the property received on the sale.[29] Where the sale is accompanied by an assumption or payment of the seller's personal obligation, the amount realized includes the amount of the debt from which the

25 *Id.* at 11.
26 *Id.* at 12.
27 *Id.* at 10 n.28 (emphasis added).
28 *Id.* at 12.
29 I.R.C. § 1001(b).

seller is relieved.[30] The purchaser's payment of the personal obligation is clearly equivalent to a direct payment to the seller. But, if the purchaser pays or assumes an amount for which the seller had no personal liability, the issue is whether this is also equivalent to a direct payment to the seller.

The Court assured us that there is such an equivalence *if* the value of the property exceeds the amount of the mortgage. *United States v. Hendler*[31] was cited to establish that the amount realized is not based solely on the receipt of money or property but upon whether the taxpayer is the "beneficiary" of a payment in "as real and substantial [a sense] as if the money had been paid to it and then paid over by it to its creditors."[32] The opinion then concludes that the transfer of a nonrecourse debt, when the value of the property exceeds the mortgage, yields precisely such a "benefit."[33] But in *Hendler* the benefit to the taxpayer arose from the discharge of a personal liability, that is, of an amount the taxpayer would otherwise be required to pay itself. This distinction is negated by equating nonrecourse debts with those carrying personal liability. The *Crane* Court was convinced of 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."[34] Thus, when the taxpayer transfers property subject to a nonrecourse debt, "the benefit to him will be 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."[35]

C. *The Constitutional Argument*

Having disposed of the taxpayer's arguments about adjusted basis and amount realized, the *Crane* Court addressed her final contention: that the Service's position was not permitted by the Constitution. The "gain" being taxed, she maintained, was merely a tax concept, and therefore beyond the authority granted to the Congress by the sixteenth amendment to tax amounts that are actually "income."[36] Mrs. Crane wondered, as have many readers of the Court's opinion since, how the sale of a property which never gener-

30 United States v. Hendler, 303 U.S. 564 (1937).
31 303 U.S. 564 (1937).
32 331 U.S. at 13.
33 *Id.* at 14.
34 *Id.*
35 *Id.*
36 *Id.* at 15.

ated enough income to pay the interest on the mortgage, and which was sold under threat of foreclosure for $3,000 (less $500 expenses of sale), could be considered to yield almost $25,000 in taxable "income."

But the taxpayer's $3,000 in equity at the time of the sale was not held to be the appropriate standard for measuring income. The Court was more concerned about the substantial depreciation deductions taken by the taxpayer over all the years she owned the property. These deductions were allowed, at least in theory, for the physical exhaustion and consequent decline in value that the building could be expected to experience. But the price paid by the purchaser indicated that this decline in value had not actually occurred and that the taxpayer had not sustained a loss on the property equal to the deductions allowed her. The Court concluded its opinion on this note:

> The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain. We have already shown that if it does, the taxpayer can enjoy a double deduction, in effect, on the loss of the same assets. The Sixteenth Amendment does not require that result any more than does the Act itself.[37]

III. *Millar*

Considering the impact of the decision on the tax law, especially in providing a modus operandi for the tax shelter industry, *Crane* has generated surprisingly little litigation. One reason for this scarcity may be that tax practitioners simply do not include any gain in their clients' returns when a tax shelter is disposed of.[38] Reliance is placed upon a literal reading of footnote 37 for the proposition that the *Crane* holding is limited to situations where the taxpayer receives cash or other boot.[39]

After *Crane*, there were indications that some courts would not

37 *Id.* at 15-16.

38 *See* Bittker, *Tax Shelters, supra* note 4, at 277.

39 Some recent commentators have expressed agreement with this position:

> Until the law is clarified by court decision or legislation, the uncertainty appears to justify . . . taking the position that footnote 37 of *Crane* supports the proposition that a transferor of property . . . subject to a nonrecourse note does not realize income in an amount greater than the fair market value of property.

McGuire, *Negative Capital Accounts and the Failing Tax Shelter*, 3 J. REAL EST. TAX. 439, 453 (1976). *See also* Handler, *Tax Consequences of Mortgage Foreclosures and Transfers of Real Property to the Mortgagee*, 31 TAX LAW REV. 193, 223 (1976). *But see* Weiss, *The* Crane *Case Updated*, 32 TAX LAW. 289, 311 (1979), where the demise of the footnote may have been prematurely

be inclined to follow the footnote's implication.[40] In 1976 the Service published a ruling which appeared to reject the footnote without rationale.[41] However, the very first case to deal with the factual situation clearly envisioned by footnote 37 was *Millar v. Commissioner*, which was first decided by the Tax Court[42] and later affirmed by the Third Circuit.[43]

The taxpayers in *Millar* were shareholders in a Subchapter S corporation that had been organized by a business associate. The corporation's stock had been issued to them at a time when it had no value and they did not make any capital contribution or pay any consideration for it. In order to provide working capital for the venture, the business associate advanced a number of loans, totalling $500,000, to all the shareholders in proportion to their stockholdings. The shareholders in turn contributed these borrowed funds to the corporation. The loans were made to the shareholders on a demand, nonrecourse basis and were secured solely by their stock. The corporation suffered net operating losses of almost $600,000 over a three year period and the stock became virtually worthless.

Since this was a Subchapter S corporation, its net operating losses passed through to the shareholders.[44] This resulted in substantial tax savings for the shareholders and also caused corresponding reductions in the bases for their stock. The taxpayers did not report any gain from the disposition of their stock in the foreclosure. They relied upon *Crane*'s footnote 37 as authority for their position since the value of the stock was clearly less than the amount of the nonrecourse debt it secured.

The Third Circuit framed the issue succinctly: "We must determine . . . whether footnote 37 of *Crane* creates an exception to the principal holding of *Crane* . . . ."[45] The first question then is what was the principal rationale behind *Crane*. For the answer, the court

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heralded: "The footnote 37 implications which appeared to provide a basis for limiting the amount of the gain have been uniformly rejected."

40 *See* Woodsam Assocs., Inc. v. Commissioner, 16 T.C. 649 (1951), *aff'd*, 198 F.2d 357 (2d Cir. 1952); Mendham Corp. v. Commissioner, 9 T.C. 320 (1947); Mayerson v. Commissioner, 47 T.C. 340 (1966), *acq.*, 1969-1 C.B. 21.

41 Rev. Rul. 111, 1976-1 C.B. 214. This ruling recites precisely the same facts and conclusion as are now found in an illustrative example of the new regulations. Treas. Reg. § 1.1001-2(c) Example 7 (1980). *See* notes 14 & 15 *supra*. *See also* Rollyson, *Recent Cases and Rulings*, 3 J. REAL EST. TAX. 495 (1976) for an excellent analysis of the ruling.

42 67 T.C. 656 (1977).

43 577 F.2d 212 (3d Cir. 1978).

44 I.R.C. § 1374.

45 577 F.2d at 214.

analyzed the portion of the *Crane* decision addressing the taxpayer's constitutional argument. As previously noted, this discussion in *Crane* was aimed at refuting the taxpayer's contention that she had no "income" in a constitutional sense because there had been no actual or constructive receipt of money or property.[46] It was in this context that the *Crane* Court stated that the "crux" of the case concerned whether previous deductions taken against property must be accounted for in computing gain upon the disposition of the property.[47]

The *Millar* court concluded that this concern about possible double deductions reflected the "principal reasoning" of *Crane*.[48] Applying this reasoning to the case before it, the court found that the taxpayers used the borrowed funds to increase the bases for their stock in the Subchapter S corporation which then permitted them to claim large loss deductions. Therefore, the shareholders clearly recognized gain to the extent that the amount of the cancelled nonrecourse note exceeded their stock's basis (which of course had been reduced to the extent that the corporate losses were deducted on their individual returns). This result, the court maintained, was mandated by *Crane*:

> A finding that the taxpayers did not realize gain as a result of this exchange, after having realized the full economic benefit of this transaction, would entitle them to the type of double deductions of which the Supreme Court so clearly disapproved in *Crane*.[49]

But doesn't footnote 37 create an exception to this principal reasoning when the amount of the nonrecourse debt exceeds the value of the property? Although the court concedes that a literal reading of the note would create such an exception, it declined to accept such a reading.[50] The footnote was dismissed as dictum dealing with a hypothetical set of facts not actually passed upon in the *Crane* decision.[51] More importantly, the court viewed the footnote as inconsistent with its own view that *Crane* is primarily concerned with preventing double tax benefits.[52] Of course, the question that the court failed to address is just what the Supreme Court intended to have so "obviously" explained by inserting the footnote.

46 *See* Section II *supra*.
47 *See* note 37 *supra*.
48 577 F.2d at 215.
49 *Id.*
50 *Id.*
51 *Id.*
52 *Id.* at 215-16.

IV. *Tufts*

Tufts v. Commissioner[53] presented essentially the same issues as *Millar* with respect to footnote 37. Since the disposition of a partnership interest was involved, it also raised questions about the proper construction of certain Code sections in Subchapter K. The Tax Court[54] followed its own and the Third Circuit's rationale in *Millar* with respect to the footnote and extended that rationale in construing the partnership provisions. However, the Court of Appeals for the Fifth Circuit totally disagreed with the *Millar* interpretation of *Crane* and reversed the Tax Court. Thus, the circuits have split and the stage is set for an eventual reexamination of *Crane* by the Supreme Court.

The taxpayer in *Tufts* was a general partner in a partnership formed to construct and operate an apartment complex. The construction was financed by a $1.8 million loan secured by a mortgage note which provided that neither the partnership nor any partner was personally liable for its repayment. All the partners included their proportionate shares of $1.8 million liability in the bases for their partnership interests and made small cash contributions that were also included in basis. Over a few years of operation, the partnership experienced substantial tax losses, both from operations and depreciation, which were claimed as deductions by the partners and which decreased the bases for their partnership interests.

Adverse economic conditions caused the value of the property to decline to $1.4 million while the principal outstanding on the mortgage remained at $1.8 million. At this point, all the partners sold their partnership interests to the same unrelated third party who paid them no consideration (except a $250 reimbursement for their expenses in the sale). The buyer took the property subject to the nonrecourse mortgage.

A. *The Tax Court Decision*

The taxpayers contended that they had no income from the sale of the property under footnote 37's exception to *Crane*. The Tax Court quickly rejected that argument, citing the Third Circuit's *Millar* decision for two propositions: first, "that the principal reason for the *Crane* holding was to prevent the double tax deduction that would otherwise result;"[55] and second, that footnote 37 cannot pro-

53 651 F.2d 1058 (5th Cir. 1981).
54 70 T.C. 756 (1978).
55 *Id.* at 765.

vide an exception to this because "the result would be totally inconsistent with the rationale for the holding."[56]

The alternate argument presented by the taxpayers was that Code section 752(c) expressly compels the same result as would footnote 37 when a partnership interest is sold.[57] The court agreed that the language of that section is "broad enough to support the taxpayers' contention."[58] However, if the partnership provisions were construed to impose the same outcome that was rejected in *Millar*, then the partnership vehicle could be used to accomplish the very result *Crane* sought to prohibit. Rather than acquiesce in such an outcome, the court suggested that the meaning of the statute is "not so clearly delineated as to preclude reliance upon the legislative history and the regulations."[59] These sources indicated to the court that the fair market value limitation of section 752(c) was intended to operate only with respect to determining basis when property was contributed to or distributed from a partnership. It would not then operate to limit the amount realized on the *sale* of an interest in a partnership. The court believed this interpretation of the Code to be amply warranted: "[I]f we accept the petitioners' interpretation of the statute, Congress has, in codifying the *Crane* doctrine, legislated the very result *Crane* sought to prohibit."[60]

B. *The Fifth Circuit Decision*

The Fifth Circuit completely rejected the *Millar* view of *Crane*: "We do not agree that this concern for double deductions was the principal reason underlying the *Crane* decision."[61] The Third Circuit's and Tax Court's reliance on the statement in *Crane* that the "crux" of the case concerned these double deductions was in error because it was read out of context. That statement was primarily a response to the taxpayer's constitutional argument, appearing at the end of the opinion *after* the Court had decided the case on wholly different grounds. The holding in *Crane*, the court maintained, does not mandate the inclusion of any previously allowed *tax* benefits in the amount realized.[62]

The court viewed *Crane* as concluding only that a taxpayer re-

56 *Id.* at 766.
57 *Id.*
58 *Id.* at 768.
59 *Id.* at 769.
60 *Id.*
61 651 F.2d at 1060.
62 The decision states: "We therefore prefer to read this expression of concern as prima-

ceives an *economic* benefit which must be included in the amount realized when property is sold for more than the amount of its nonrecourse encumbrance.[63] A "compelling reason" why this limited holding should not be expanded to include strictly *tax* benefits in amount realized is the fact that such benefits are already accounted for through the Code's basis mechanism:

> [A]ny tax benefits that the taxpayer may have received in the form of prior deductions have already been factored into the gain equation through adjustments to basis. Since these deductions have been accounted for through adjustments to basis, it follows logically that they cannot also support an expansion of the definition of amount realized. To account for these deductions twice in the same equation by expanding the definition of amount realized as well as adjusting basis downward would, we think, be taxing the taxpayer twice on the same component of gain.[64]

Had the court stopped at this point, its opinion would be less startling. Readers could have assumed that the court meant that footnote 37 *does* create an "obvious" exception to *Crane*; that there is no economic benefit derived from abandoning property that is subject to a mortgage greater than its value. However, the court goes on to question whether there is an economic benefit in the amount of the debt even if the property is worth *more* than the mortgage. Finding this underlying economic benefit theory to be "seriously flawed"[65] led the court to have "serious reservations" about the entire *Crane* decision.[66] Since *Crane* is probably wrong, the Fifth Circuit panel saw no reason to extend it to situations beyond its particular facts.

The court believed that *Crane*'s economic benefit theory was flawed because it is based upon the erroneous premise that an owner of property worth more than its mortgage must "treat the conditions of the mortgage exactly as if they were his personal obligations."[67] This premise, the court was convinced, is valid only if the owner wants to *keep* the property. However, once the owner decides to dispose of it, the equivalence between nonrecourse debt and debt carrying personal liability is lost. The court suggested that a person owning property subject to a nonrecourse debt can transfer it "to a

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rily a response to Mrs. Crane's constitutional argument, and not as the principal justification for the statutory holding that the Court had announced earlier in the opinion." *Id.*

63 *Id.* at 1061.

64 *Id.*

65 *Id.* at 1062.

66 *Id.* at 1063.

67 *Id.* at 1062 (citing 331 U.S. at 14).

third party with absolutely no regard to that party's willingness or ability to meet the mortgage obligations, yet rest assured that his other assets cannot be reached."[68] Although it was conceded that in *Crane* the taxpayer realized some benefit when the purchaser took the property subject to the mortgage, the court doubted that the amount of that benefit equalled the amount of the nonrecourse debt.[69]

In a rather rare judicial attempt to achieve clarity, the Fifth Circuit majority thought it necessary to append a lengthy footnote to the end of its decision "to put this case in its proper perspective."[70] It obviously felt compelled to justify its decision in light of the conflicting case law and commentary asserting that a failure to apply the tax benefit doctrine of cases like *Millar* invites abuses of the tax system. The court's response was that whatever potential for abuse does exist stems from the inclusion of unrealistically large amounts of nonrecourse debt in *basis*. "The real crux of the problem," the court maintained, "is the taxpayer's ability to manipulate his basis and adjusted basis through the use of nonrecourse financing."[71] The appropriate solution to this problem is not to "distort the definition of amount realized,"[72] but rather to judicially or legislatively restrict the amounts includible in the basis against which losses may be deducted.

V. The Basis Approach

The portion of the *Crane* decision concerning adjusted basis could easily have been read as limited to situations where property is inherited. In *Mayerson v. Commissioner*,[73] the Internal Revenue Service advanced the argument that *Crane* need not be extended beyond that situation. The adjusted basis at issue in *Crane* was determined by reference to the fair market value of the property, while in cases of purchases and other acquisitions, basis is determined with reference to cost. The Tax Court, however, believed that the reasoning for *Crane* was equally applicable to purchases. This conclusion appears to have been based on the notion that the ultimate concern of *Crane* was for depreciation policy. That policy is well summarized in the Tax Court's decision in *Mayerson*:

68 *Id.* at 1062.
69 *Id.* at 1063.
70 *Id.* at 1063 n.9.
71 *Id.*
72 *Id.*
73 47 T.C. 340 (1966), *acq.*, 1969-1 C.B. 21.

> Taxpayers who are not personally liable for encumbrances on property should be allowed depreciation deductions affording competitive equality with taxpayers who are personally liable for encumbrances or taxpayers who own unencumbered property. The effect of such a policy is to give the taxpayer an advance credit for the amount of the mortgage. This appears to be reasonable since it can be assumed that a capital investment in the amount of the mortgage will eventually occur despite the absence of personal liability.[74]

Whatever the desirability of putting nonrecourse mortgagors on a par with other property owners with respect to depreciation deductions, one may question whether it is reasonable to assume that an investment equal to the nonrecourse mortgage will eventually be made. Certainly it becomes highly questionable when the amount of the mortgage to be included in basis exceeds the value of the underlying property. Nevertheless, in *Brountas v. Commissioner*,[75] the Tax Court felt constrained by its own decisions in *Millar* and *Tufts* to include the full amounts of nonrecourse notes in basis in such a situation. The Fifth Circuit, faced with essentially identical facts in *Gibson Products v. United States*,[76] indicated that it would limit the liabilities includible in basis to no more than the value of the property securing the debts.

Both cases dealt with limited partnerships that purchased interests in oil and gas leaseholds and drilling contracts. Large portions of the purchase prices were in the form of nonrecourse notes payable solely out of profits from future oil and gas production. Since these profits were highly speculative, the face amounts of the notes greatly exceeded the fair market values of the oil and gas interests securing them. The cases thus presented two issues to the courts: first, whether these nonrecourse notes were actually "liabilities" of the partnership includible in the bases of the partners for their partnership interests; and second, assuming they were liabilities, whether the amount includible in basis is limited to the fair market value of the security.

In *Brountas*, the Tax Court held that the nonrecourse notes had value and commercial reality and thus would be treated as true liabilities for the purchase price. The court concluded that the reasoning of *Crane* and its own reasoning in *Tufts* (which it viewed as a

74 47 T.C. at 352.

75 73 T.C. 491 (1979).

76 637 F.2d 1041 (5th Cir. 1981).

"lineal descendent of *Crane*"[77]) mandate inclusion of the full amounts of the nonrecourse notes in the taxpayers' bases. "The *Crane* doctrine," the court stated, "is basically a symmetrical one — a taxpayer includes nonrecourse liabilities in his basis, but he must also include such liabilities in the amount he realizes upon disposition of the encumbered property."[78] Such symmetry requires inclusion of the *full* amount of liabilities in basis because the court had already held that the full amount is included in amount realized; there is no fair market value limitation on either side of the equation.

The Fifth Circuit's holding in *Gibson* illustrates the approach it would take to control the tax abuses that result from the use of nonrecourse financing. Because the notes were not secured by sufficient assets, and payment was contingent on oil and gas production, the court concluded that the notes did not represent true loans. Before this court would accept *Mayerson*'s assumption that a nonrecourse mortgagor will eventually invest an amount equal to the liability in the property, there must be "a reasonable basis for the prediction that the ability of the borrower to repay will not be wholly contingent upon the success or failure of the business venture."[79]

By finding no true partnership liabilities, the court was not re-

77 73 T.C. at 573.

78 *Id.* at 574.

79 637 F.2d at 1047 (quoting Fielder, *Drilling Funds and Nonrecourse Loans — Some Tax Questions*, in 24th SOUTHWESTERN LEGAL FOUNDATION INSTITUTE ON OIL & GAS TAXATION 527, 534 (1973)). The Fifth Circuit cited *Gibson* in its *Tufts* decision as representing the appropriate solution to the problems of potential tax abuse posed by cases like *Tufts* and *Millar*. The decision in *Tufts* also alluded to the fact that Congress has already acted to curb much of this abuse by enacting I.R.C. § 465. *See* 651 F.2d at 1063-64 n.9. Section 465 was legislated to control a rapidly expanding tax shelter industry. Most shelters depend upon the high leverage and low risk provided by nonrecourse financing. The *Crane* doctrine would allow these obligations to be included in the basis of limited partnership interests or the basis of interests in other similar ventures in proportion to the amount of an investor's actual cash contribution. These out-of-pocket contributions were usually relatively small. Thus, each partner could take depreciation and other deductions greatly in excess of the amounts actually invested. Congress' solution in 1976 was to limit a taxpayer's allowable deductions to amounts that were actually "at risk" in the venture, notwithstanding the amount of "loss" actually sustained.

The Tax Reform Act of 1976 applied these loss limitations to certain specified activities that were viewed as particularly prone to tax shelter abuse. These activities were motion picture production, farming, equipment leasing and oil and gas exploration and production. A special provision was applied to partnerships by I.R.C. § 704(d) to exclude, from the basis of a partner's partnership interest, for purposes of deducting losses from the venture, any partnership liabilities for which the partner had no personal liability. Thus, after 1976, most of the deductions taken by the taxpayers in *Brountas* and *Gibson* would not have been allowed. The Revenue Act of 1978 expanded the § 465 limitations to *all* activities and thus the specific partnership provision of § 704(d) was no longer required. Current § 465 continues to exempt the "holding" of real estate from its loss limitation rules.

quired to decide the extent to which nonrecourse partnership liabilities may be included in the basis of a partnership interest. In a footnote, however, the court certainly indicated its probable holding on the Subchapter K question:

> While not deciding the issue, we regard the district court's reasoning persuasive in concluding that the nonrecourse indebtedness of a partnership can be included in a partner's basis only to the extent that it equals or exceeds the market value of the property securing the debt.[80]

VI. The Tax Benefit Approach

It is clear that the Tax Court and Second and Third Circuits have established a new judicial tax benefit rule based upon language found in *Crane*.[81] Some commentators who disagree with the original premise of *Crane*, or with the subsequent interpretation used by some courts, would still support a tax benefit analysis in order to prevent tax abuse.[82] Professor Bittker, for example, who was quoted at length by the Fifth Circuit in *Tufts* for his criticisms of *Crane*'s logic, supports the tax benefit through the making of a "balancing entry."[83]

In *Estate of Delman v. Commissioner*,[84] another footnote 37 fact pattern, the Tax Court was confronted with this very tax benefit argu-

80 637 F.2d at 1045 n.8. The court has obviously misstated its intended meaning. What is actually meant is that nonrecourse debt can be included in basis only to the extent of the value of the property securing the debt. That was the holding of the district court the footnote refers to. *See* 460 F. Supp. 1109 (N.D. Tex. 1978). The Internal Revenùe Service has also adopted this position. In Rev. Rul. 81-278, 1981-2 I.R.B. 10, the Service ruled that a nonrecourse note is not includible in the basis of a partnership interest nor in the partnership's basis for contributed property where the fair market value of the property securing the note did not at least approximate the amount of the note.

81 It is certainly clear to the Fifth Circuit. In its *Gibson* opinion that court sums up *Millar* and the Tax Court's opinion in *Tufts* succinctly: "Both *Tufts* and *Millar* are tax benefit cases." 637 F.2d at 1045 n.8.

82 *See* 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); Rollyson, *Recent Cases and Ruling*, 3 J. REAL EST. TAX. 495 (1976); A. WILLIS, 1 PARTNERSHIP TAXATION 87 (2d ed. Cum. Supp. 1981).

83 Bittker, *Tax Shelters*, *supra* note 4 at 28. Professor Bittker adopts a "balancing entry" theory: "[T]he result in *Crane* can be justified only if the amount realized by a taxpayer who disposes of property encumbered by nonrecourse debt in excess of its basis is viewed as a balancing entry, which brings the tax results into conformity with economic reality."

In a final footnote to his article, Professor Bittker indicates that "the economic benefit theory should be rejected as wholly fallacious, in order to make way for a more comprehensive balancing entry theory." *Id.* at 284-85 n.14.

84 73 T.C. 15 (1979).

ment. The taxpayer contended that *Millar* was wrongly decided under the weight of authority of cases dealing with the traditional tax benefit rule.[85] These cases would require an actual receipt of funds or the discharge of a liability that would increase a taxpayer's net worth before any income results.[86] The discharge of a nonrecourse liability secured by property worth less than the liability would not, of course, increase a taxpayer's net worth. The Tax Court's response was simple — those cases do not apply to dispositions of property subject to nonrecourse liability. The tax benefit rule envisioned by *Crane* is of a different order.[87]

Apparently, the court in *Delman* does not maintain that the *Crane* doctrine will include nonrecourse liabilities in amount realized even though there has been no tax benefit from including the liability in basis. Responding to the taxpayer's argument that there was no evidence that any individual partners enjoyed tax benefits flowing from partnership losses, the court stated that the benefit can be inferred from the facts in the case.[88] Specifically left open is whether the amount realized by any particular partner would include his share of nonrecourse liability if he could establish that he actually achieved no tax savings from the partnership.

85 This rule has developed through case law and has been partially codified in I.R.C. § 111. Under the Code provision, gross income does not include income attributable to the recovery of bad debts, prior taxes or delinquencies except to the extent that a deduction with respect to these items resulted in a "tax benefit" in a prior tax year. Treas. Reg. § 1.111(a) (1956) extends the rule to "all other losses, expenditures, and accruals . . . ." Conversely, gross income includes recoveries of these amounts, which would otherwise be nontaxable returns of capital, to the extent that a deduction in a prior year resulted in a tax savings. However, it is not merely the tax savings that is included in income, but the amount of the *deduction* that yielded the benefit. Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967). Thus, the actual *tax* paid may be more or less than the tax savings depending upon the applicable tax rates.

86 In South Lake Farms, Inc. v. Commissioner, 324 F.2d 837 (9th Cir. 1963), the Ninth Circuit refused to apply the rule to a liquidation under I.R.C. § 336 to tax the corporation on a benefit where the money was actually recouped by the shareholders after the liquidation. However, in Tennesse-Carolina Transp., Inc. v. Commissioner, 582 F.2d 378 (6th Cir. 1978), *cert. denied*, 440 U.S. 909 (1979), the Sixth Circuit concluded that the tax benefit rule could apply even though there was no actual physical recovery of an asset or sum. *Accord*, First Trust & Sav. Bank v. United States, 614 F.2d 1142 (7th Cir. 1980). But in *Tufts*, the Fifth Circuit appears to reject the application of the tax benefit rule to include depreciation deductions taken in prior years in income upon disposition of the depreciated property. 651 F.2d at 1061. Such "recapture" is already provided for by the adjustment to basis made with respect to depreciation deductions. "In contrast," the court maintained, "the tax benefit rule is designed only to prevent the taxpayer from making actual personal gains through *unwarranted* deductions." 651 F.2d at 1061 n.6 (emphasis added).

87 73 T.C. at 30 n.3.

88 *Id.* at 30 n.4.

Notwithstanding the large portion of the *Crane* opinion devoted to describing the *economic* benefit to the taxpayer, the Tax Court in *Delman* was quite direct in asserting that a *tax* benefit alone would support its holding. This assertion was made in response to the taxpayer's contention that the Tax Court in *Millar* and *Tufts* was not justified in relying on cases like *Woodsam Associates, Inc. v. Commissioner*,[89] *Mendham Corp. v. Commissioner*,[90] and *Lutz & Schramm Co. v. Commissioner*,[91] where the taxpayers had economically benefitted from post-acquisition borrowing. Although these cases were cited by the court for support in *Millar* and *Tufts*, they are factually and conceptually quite distinguishable.[92] Since the mortgages in those cases were taken out *after* the securing property was acquired, there was no resulting increase in basis. Thus, there was no need to consider whether it was necessary to the "symmetry" of *Crane* to include the amount of the mortgages in the amount realized. Instead, the borrowings were viewed as nontaxable advanced receipts on a later, final, taxable disposition.[93] The fact that the taxpayers had unrestricted use of the borrowed funds was seen as an *economic* benefit rather than a tax benefit.

VII. Conclusion

Unquestionably, the Fifth Circuit in *Tufts* provides a more accurate analysis of what *Crane* actually says — and perhaps of what the Supreme Court intended to say. It is also clear that *Crane* tried to create an economic equivalence between recourse and nonrecourse debt that simply does not exist. In the final analysis, however, *Crane* was not an economics case. Therefore, *Crane* must be read in light of its decision on the technical tax question before the Court and the effect of that decision on the entire tax system.

At the outset, the Court noted that the taxpayer had benefitted from large depreciation deductions and that the amount of gain she would recognize under its decision would just equal the aggregate of these deductions.[94] Thus, *Crane is* a tax benefit case and must be viewed as such. While *Millar* does not have as much support in the language of *Crane* as does *Tufts*, *Millar* is much better supported by

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89 16 T.C. 649 (1951), *aff'd*, 198 F.2d 357 (2d Cir. 1952).

90 9 T.C. 320 (1947).

91 1 T.C. 682 (1943), *nonacq.*, 1943 C.B. 35.

92 *See* McGuire, *Negative Capital Accounts and the Failing Tax Shelter*, 3 J. REAL EST. TAX. 439 (1976).

93 *See* Woodsam Assocs. v. Commissioner, 198 F.2d at 359.

94 331 U.S. at 12.

the actual holding. The confusion about the "principal reasoning" of *Crane* stems from the Court's unsuccessful attempt to provide a non-tax rationale for what was essentially a pure tax decision.

What of footnote 37? The *Millar* court put this question in its proper perspective by describing the footnote as "involving a clearly different time and clearly different legal circumstances."[95] Whatever the Supreme Court actually had in mind when it appended that note to its decision is forever lost to legal history and is now only speculation. What is known is that *Crane*'s allowance of nonrecourse debt in computing adjusted basis has created a great many obstacles to providing a fair and administrable tax system. It would be unfortunate if a footnote would hinder the removal of some of these obstacles.[96]

95 577 F.2d at 215.

96 It appears likely that the Treasury Department will seek legislative reversal of *Tufts*. In an address to the American Institute of Certified Public Accountants Conference on Federal Taxes in October, 1981, the Assistant Secretary for Tax Policy announced that this matter was one of the major legislative areas being considered for submission to Congress. *Taxes on Parade*, Release No. 54, STAND. FED. TAX REP. (CCH) (Nov.4, 1981).