Florida Law Review

Volume 35 | Issue 5 Article 6

December 1983

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NONRECOURSE LIABILITIES AS TAX SHELTER DEVICES AFTER *TUFTS:* ELIMINATION OF FAIR MARKET VALUE AND CONTINGENT LIABILITY DEFENSES

INTRODUCTION

Thirty-six years ago, the United States Supreme Court construed the term "property" for purposes of determining the realized gain or loss under applicable provisions of the Internal Revenue Code.[1] In *Crane v. Commissioner*,[2] the Court ruled that "property" refers to physical property itself, or the owner's rights to possess, use and dispose of it. The Court rejected the taxpayer's contention that property is synonymous with "equity," or the property's value in excess of liens.[3] The Court accordingly held that the taxpayer who sold encumbered real property had to include in amount realized the outstanding balance of a mortgage.[4] Because *Crane* involved real property encumbered by a nonrecourse mortgage,[5] investors quickly discovered that by using nonrecourse debts they could leverage investments by taking large deductions against other sources of taxable income, outlaying minimal cash and avoiding the risk of liability.[6] *Crane* thus laid the foundation for the modern day tax shelter.[7]

To curb the expanding use of such tax shelters, the Commissioner retreated from his *Crane* position regarding nonrecourse debt. In the 1970s and 1980s, the IRS adopted internal programs to counter tax shelter abuse.[8] The Service also successfully solicited a congressional alliance which resulted in the adoption of the "at risk" rules in 1976[9] and TEFRA in 1982.[10] In addition

1. The applicable provisions of the Code include Int. Rev. Code of 1939, ch. 1, §§ 111(a) (gain or loss); 111(b) (amount realized); 113(a)(5) (carryover basis from decedent); 113(b) (adjusted basis); 114(a) (depreciable basis), 52 Stat. 484, 484, 490, 493, 494 (current versions at I.R.C. §§ 1001(a), 1001(b), 1014(a), 1011, 167(g) (1982)).

2. 331 U.S. 1 (1947).

3. *Id.* at 7.

4. *Id.* at 13.

5. A nonrecourse debt is a debt in which the borrower is not personally liable. Upon default the lender looks solely to the underlying secured property for satisfaction. Dailey & Gaffney, *Anatomy of a Real Estate Tax Shelter: The Tax Reform Scalpel*, 55 TAXES 127, 139 (1977). Real property may be acquired by incurring a nonrecourse debt when (1) a third party lends purchase funds and secures the debt with the purchased property; (2) the vendor carries back a purchase-money mortgage; and (3) the vendee assumes or takes subject to existing mortgage. Drye, *The Income Tax Effect of Mortgages*, 17 WASH. & LEE L. REV. 1, 3 (1960); Note, *Federal Income Tax Treatment of Nonrecourse Debt*, 82 COLUM. L. REV. 1498, 1498 n.1 (1982) [hereinafter cited as *Federal Tax Treatment*].

6. Calkins & Updegraft, *Tax Shelters*, 26 TAX LAW. 493, 507 (1973).

7. Bittker, *Tax Shelters, Nonrecourse Debt, and the* Crane *Case*, 33 TAX L. REV. 277, 283 (1978).

8. *See* Testimony of Roscoe Egger, Commissioner of Internal Revenue, Before the Subcommittee on Oversight of the House Ways and Means Committee, House of Representatives (Sept. 28, 1982), IR-82-111, 9 Fed. Taxes (P-H) (1982) ¶ 55,315, at 55,506, *reprinted in* 68 A.B.A. J. 1674 (1982); 17 TAX NOTES 65 (Oct. 4, 1982) [hereinafter cited as Egger].

9. 90 Stat. 1520 (codified at I.R.C. § 465 (1982)).

10. Pub. L. No. 94-248, 96 Stat. 324 (1982).

to these congressional and administrative actions, the IRS has taken court action against flagrant uses of nonrecourse liability.[11] Generally, the Service asserts a two-pronged attack against nonrecourse debt: first, the amount of the debt must reasonably approximate the value of the property; and second, unless the facts indicate the nonrecourse loan most likely will be repaid, the loan is considered too contingent for inclusion in basis.[12]

Although the nonrecourse mortgage balance in *Crane* was less than the property's value,[13] in footnote 37 the Court implied a different result might be reached when the balance of the mortgage exceeds the value of the secured property.[14] Recently, in *Commissioner v. Tufts*,[15] the taxpayer relied on footnote 37 in arguing that the unpaid balance of a nonrecourse loan should be included in amount realized upon disposition only to the extent of the property's value.[16] The Supreme Court, however, agreed with the Commissioner that the *Crane* doctrine required including the entire unpaid balance of the loan in amount realized, even when the loan exceeds the property's fair market value.[17] Although the Court recognized that nonrecourse debt in some situations may be considered contingent, this position is inconsistent with the *Crane* view that nonrecourse debt should be treated the same as recourse debt since each is deemed a true loan.[18]

The ultimate significance of *Tufts* may be in the Court's reasoning rather than its holding. Such reasoning may undermine, if not overturn, the Commissioner's dual-pronged test for determining whether nonrecourse debt is included in basis. This article first examines *Crane* and the tax shelter enabled by that decision. Next, the article traces judicial, legislative and administrative attempts to curb tax shelters involving nonrecourse debt from the time of *Crane* until the *Tufts* decision. Finally, the *Tufts* case and its effect on the Commissioner's fair market value and contingent liability defenses are analyzed. This article concludes that *Tufts* appears to limit these defenses and thus may prompt a revival of tax shelters.

NONRECOURSE DEBT AND TAX SHELTERS IN THE AFTERMATH OF *Crane*

In *Crane*,[19] the taxpayer inherited an apartment building subject to a nonrecourse mortgage.[20] She operated the apartment for many years, taking depreciation on the property's total basis undiminished by the nonrecourse

11. *See infra* notes 61-86 and accompanying text.
12. *See infra* notes 128-30 and accompanying text.
13. 331 U.S. at 14.
14. *Id.* at 14 n.37.
15. 103 S. Ct. 1826 (1983).
16. *Id.* at 1829-30.
17. *Id.*
18. *Id.* at n.5.
19. 331 U.S. 1 (1947). For further discussion of the facts in *Crane*, see Simmons, *Nonrecourse Debt and Amount Realized: The Demise of* Crane's *Footnote 37*, 59 OR. L. REV. 3, 5-10 (1980).
20. 331 U.S. at 3 n.1.

loan.[21] Threatened with foreclosure, she sold the property for a small cash payment with the buyer taking subject to the mortgage.[22]

The taxpayer argued that the amount realized on this sale was equal to the cash received because the "property" sold was merely her equity interest. Although the buyer took subject to the nonrecourse mortgage, the taxpayer contended that discharge of this debt for which she was not personally liable was of no benefit to her and thus did not constitute a gain. The Commissioner disagreed and claimed the amount realized on the sale was the value of the property undiminished by the nonrecourse mortgage.[23] The Commissioner computed the gain by adding the outstanding balance of the loan to the cash received and subtracting the property's original basis as reduced by depreciation.

In resolving the dispute, the Supreme Court distinguished "equity" and "property" by examining the meaning of "property" as it is used for determining basis.[24] If basis included merely the equity value of property, depreciation would sometimes have to be taken against a negative basis or disallowed entirely.[25] Additionally, depreciation against an equity basis would require repeated redetermination of depreciation against a constantly changing reduced basis. The Court agreed with the Commissioner that such a result would place an overwhelming accounting burden on the IRS and the taxpayer.[26] The Court concluded that the proper basis for determining either depreciation, gain or loss, or the amount realized is the value of the property undiminished by the nonrecourse mortgage.[27]

Crane left several issues unresolved which troubled courts[28] and commentators.[29] The property in *Crane* was acquired by inheritance and disposed of by sale, and at neither time was its value less than the nonrecourse mortgage.[30] There was much speculation over whether the *Crane* doctrine extended to property acquired other than by inheritance, such as by purchase when basis is determined by cost, not fair market value.[31] Because the *Crane* Court ap-

21. *Id.* at 3.

22. *Id.*

23. *Id.* at 4.

24. *Id.* at 9.

25. *Id.* at 9-10.

26. *Id.* at 6-10.

27. *Id.* at 11.

28. *See infra* notes 61-86 and accompanying text.

29. *See, e.g.*, Adams, *Exploring the Outer Boundaries of the* Crane *Doctrine; An Imaginary Supreme Court Opinion*, 21 TAX L. REV. 159, 159-60 (1966); Bittker, *supra* note 7, at 278-85; Comment, *Depreciation of Property Subject to an Unassumed Mortgage: Implications of the* Crane *Decision*, 26 TEX. L. REV. 796, 805-06 (1948).

30. 331 U.S. at 3-4.

31. *See* Adams, *supra* note 29, at 159 ("[i]t is still not entirely clear whether the rule of the *Crane* case is applicable when property is acquired by purchase rather than by inheritance"). *Compare* Comment, 33 IOWA L. REV. 143, 148 n.27 (1947) (*Crane* may be limited to situations involving inheritances) *with* Comment, *supra* note 29, at 805 ("[a] logical extension of the *Crane* doctrine would be [to include] property acquired by purchase"); *and* Greenbaum, *The Basis of Property Shall Be The Cost of Such Property: How is Cost Defined?*, 3 TAX L. REV. 351, 355 (1948) (*Crane* doctrine equally applicable to purchase or exchange).

parently assumed taxpayers would continue fulfilling mortgage conditions to protect a positive equity interest,[32] many questioned *Crane*'s applicability in cases where the mortgage balance exceeds the property's value.[33] Despite this uncertainty regarding the doctrine's scope, all agreed *Crane* permitted a tremendous potential tax shelter for a high tax bracket taxpayer.[34]

Limited Partnerships as Tax Shelters

The essence of a tax shelter is to generate current losses within the first years of investment and thus insulate an investors other income from tax.[35] The importance of *Crane* for investors was its decision that nonrecourse debt must be included in the basis of property subject to depreciation.[36] The taxpayer is allowed a current deduction for a noncash expense depreciation.[37] Because the taxpayer is not personally liable for the nonrecourse debt, the burden of depreciation in excess of the taxpayer's investment is borne by the lender and only potentially by the taxpayer should the property generate profit.[38] The *Crane* doctrine and depreciation rules thus interacted to allow full deductions with minimal risk,[39] laying the foundation for a number of tax

Many commentators also queried whether *Crane* would apply to nonsale dispositions, such as abandonments, transfers in cancellation of indebtness, and charitable donations. *See, e.g.*, Adams, *supra* note 29, at 160; Meyer, *Disposition of Real Estate Where Mortgage Indebtedness Exceeds "Tax Basis"*, 7TH ANN. N.Y.U. INST. FED. TAX'N 338, 339-48 (1949). *See generally* Spears, *Mortgages in Excess of Basis*, 1959 S. CAL. TAX INST. 883, 889-98.

32. 331 U.S. at 14. *See Federal Tax Treatment, supra* note 5, at 1501.

33. *See, e.g.*, Del Cotto, *Basis and Amount Realized under* Crane: *A Current View of Some Tax Effects in Mortgage Financing*, 118 U. PA. L. REV. 69, 84-86 (1969); Perry, *Limited Partnerships and Tax Shelters: The* Crane *Rule Goes Public*, 27 TAX L. REV. 525, 528-29 (1972). *Cf.* Braunfeld, *Subject To a Mortgage* (pt. 3), 25 TAXES 155, 156 (1947) (the depreciation deduction is dependent only upon the cost, and is quite independent of the value of the secured property at time of acquisition or thereafter).

34. *E.g.*, Bittker, *supra* note 7, at 283; Ginsburg, *The Leaky Tax Shelter*, 53 TAXES 719, 719 (1975); Perry, *supra* note 33, at 526-30.

35. *See* Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 379 n.123 (1972). *See also* Ginsburg, *supra* note 34, at 719 ("A tax shelter, at its simplest, is an investment that succeeds in generating a mismatching of income and deductions: the deductions now; the income, like sermons and soda water, the morning after."); Newman, *The Resurgence of Footnote 37*: Tufts v. Commissioner, 18 WAKE FOREST L. REV. 1 (1982) (gives examples of various forms of tax shelters); Perry, *supra* note 33, at 536 n.44 (setting forth various problems in defining a tax shelter). The term "tax shelter" only recently has been accepted in general usage among courts, the Service and commentators. *See* Shefsky, *Take the Helter Out of Shelter*, 58 TAXES 299, 299-300 (1980).

36. *See* Drye, *supra* note 5, at 17 ("[t]he most important outgrowth of the *Crane* case is that it permits a taxpayer to secure at a relatively low out-of-pocket cost a high depreciation basis"); Perry, *supra* note 33, at 527 ("the purchase and sale of nondepreciable, nondepletable property is unaffected by *Crane*").

37. *See* Bolger v. Commissioner, 59 T.C. 760, 771 (1973). *See also* McKee, *Partnership Allocations in Real Estate Ventures*: Crane, Kresser *and* Orrisch, 30 TAX L. REV. 1, 1 (1974).

38. McKee, *supra* note 37, at 3-4.

39. Bittker, *supra* note 7, at 283. One commentator suggested that the tax shelter benefits may lie more with the depreciation rules than with *Crane*. McKee, *supra* note 37, at 2 n.6; McKee. *The Real Estate Tax Shelter: A Computerized Exposé*, 57 VA. L. REV. 521, 534-35 (1971) (the difference between actual economic and tax depreciation provides real estate investors a tax shelter).

shelters in the 1960s and 1970s.[40]

Most popular among the various forms of investment structures available for tax shelters is the limited partnership.[41] An amalgam of specialized state statutory law and federal income tax law,[42] the limited partnership has attributes of both general partnerships and corporations.[43] Four features combine to make the limited partnership the preferred mode for tax shelter investment. First, limited liability permits persons to combine resources for investment purposes while limiting their losses to assets committed to the venture.[44] Second, taxpayers may take current deductions for depreciation without cash expenditure.[45] This together with a third factor, *Crane*'s inclusion of nonrecourse debt in depreciable basis, permits the taxpayer substantial depreciation deductions which greatly exceed any economic investment.[46] Thus, huge sums of capital may be accumulated which, together with funds borrowed on a nonrecourse basis, may be invested in projects that generate tremendous amounts of depreciation deductions. Fourth, because depreciation deductions are incurred at the entity level, limited partnerships are particularly attractive as tax shelters. Unlike a corporation, a partnership is not a separate taxpaying entity;[47] the partnership's taxable income[48] is passed through to the partners who report the income and losses in their individual capacities.[49] Con-

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40. *See generally* Lurie, *Bolger's Building: The Tax Shelter That Wore No Clothes*, 28 TAX L. REV. 355 (1973); McGuire, *Negative Capital Accounts and the Failing Tax Shelter*, 3 J. REAL EST. T. 439 (1976); Wangard, *Use of Nonrecourse Loans in Tax Planning: The Possibilities and Pitfalls*, 39 J. TAX'N 286 (1973).

41. S. REP. No. 94-938, 94th Cong., 2d Sess. 47 (1976), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 4072-73; Epstein, *The Application of the Crane Doctrine To Limited Partnerships*, 45 S. CAL. L. REV. 100 (1972); Ginsburg, *supra* note 34, at 719-20; Kanter, *Real Estate Tax Shelters*, 51 TAXES 770, 786 (1973). For other forms of tax sheltering organizations, see Greenberg, *Forms of Organization for Holding and Developing Real Estate*, 29TH ANN. N.Y.U. INST. FED. TAX'N 1129, 1134-57 (1971); Kanter, *supra* at 771; Rabinowitz, *Realty Syndication: An Income Tax Primer for Investor and Promoter*, 29 J. TAX'N 92, 92 (1968).

42. *See, e.g.*, State v. Williams, 196 Kan. 274, 411 P.2d 591, 598 (1966) (limited partnerships were unknown at common law); Danoff v. United States, 499 F. Supp. 20, 22 (D. Pa. 1976) (limited partnership has unique position under federal tax law), *See generally* Rhodes, *Real Estate Limited Partnerships: Selected Tax Considerations*, 72 NW. U.L. REV. 346, 352-55 (1977). Limited partnership interests are also securities under federal securities law, Frazier v. Manson, 651 F.2d 1078, 1080 (5th Cir. 1981), and thus promoters must comply with the requirements of the Security and Exchange Commission. SEC v. Murphy, 626 F.2d 633, 640 (9th Cir. 1980); 15 U.S.C. § 77a-77aa (1982).

43. *See, e.g.*, Vulcan Furniture Mfg., Corp. v. Vaughn, 168 So. 2d 760 (Fla. 1st D.C.A. 1964) (failure to file annual report and secure renewal certificate results in loss of limited partnership status).

44. Epstein, *supra* note 41, at 100.

45. McKee, *supra* note 37, at 1. *See* I.R.C. § 167(a) (1982). In this respect, tax deductions differ from the actual economic depreciation of assets. McKee, *supra* note 39, at 534-35. *See supra* notes 35-39 and accompanying text.

46. Epstein, *supra* note 41, at 101-03; McKee, *supra* note 37, at 2.

47. I.R.C. § 701 (1982).

48. *See id.* § 703(a).

49. *Id.* §§ 701-702(a). *See generally* Davies, *The Administrative Assault Upon the Real Estate Tax Shelter*, 54 TAXES 505, 506-08 (1976).

sequently, limited partners may use the partnership's depreciation deductions to offset other personal income and thereby shelter that income from tax.[50]

A limited partner is not, however, automatically entitled to use the depreciation deductions incurred by the limited partnership. Under the Code's scheme, such deductions may not exceed the adjusted basis of the partner's interest in the limited partnership.[51] The adjusted basis is generally equal to the sum of money and the adjusted basis of property contributed by the partner to the partnership,[52] adjusted to reflect partnership operations.[53] Most importantly for tax shelter purposes, a partner's basis is increased by his share of nonrecourse liabilities incurred by the partnership.[54] The regulations incorporate the *Crane* doctrine by providing that when no partner is personally liable for a partnership obligation, all partners, including limited partners, share in that liability.[55] Partners share partnership liabilities in the same ratio that they share partnership profits, ostensibly on the theory that the liability will be repaid from income derived from the property.[56]

To shelter income, the limited partnership invests capital contributions from partners and funds from nonrecourse borrowing in depreciable assets. Because *Crane* permits including the nonrecourse debt in basis, large depreciation deductions in excess of actual capital may be taken. In addition, the regulations allow limited partners to increase their adjusted basis in the partnership interest by their respective shares of nonrecourse debt.[57] Thus when the depreciation deductions are passed through to the limited partners, they can take the deductions against other income and are not limited by their equity interest. All the while the limited partners are protected by limited liability.[58]

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50. *See* Epstein, *supra* note 41, at 100; McKee, *supra* note 37, at 1.

51. I.R.C. § 704(d) (1982). Any loss deductions not allowed in a year are carried over to subsequent taxable years until basis is increased. *Id.*

52. *Id.* § 722.

53. *Id.* § 705(a).

54. *Id.* § 752(a). *See* Rhodes, *supra* note 42, at 352-55.

55. Treas. Reg. § 1.752-1(e) (1956). *See* S. REP. No. 94-938, 94th Cong., 2d Sess. 46 (1976), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 4071-72; Frank E. Sellers, 36 T.C.M. 305, 318 n.14 (1977), *aff'd*, 592 F.2d 227 (4th Cir. 1979); Rhodes, *supra* note 42, at 353 n.41.

56. McKee, *supra* note 37, at 26.

57. Technically, the adjusted basis in the partnership interest is not directly increased by the nonrecourse debt. Under Treas. Reg. § 1.752-1(e) (1956), the limited partners share in partnership nonrecourse obligations. Section 752(a) treats this as a contribution of money and sections 705(a) and 722 combine to provide that the contribution of money increases the basis in the partnership interest. Treas. Reg. § 1.721-1(a) (1956) provides that such contribution may be made either to a new or existing partnership. *See* McKee, *supra* note 37, at 26 n.46.

58. *See* Epstein, *supra* note 41, at 100. Additional tax benefits may be granted to the limited partners if the partnership agreement contains special provisions allocating additional depreciation deductions to them above their profit share. I.R.C. § 704(b)(2) (1982). However, any such allocation must have substantial economic effect. *Id;* Treas. Reg. § 1.704-1(b)(2) Ex. (5) (1956). *But see* Prop. Treas. Reg. § 1.704(b)(4)(iv), 48 Fed. Reg. 9871 ("Allocations of loss or deduction (or item thereof) attributable to nonrecourse debt which is secured by partnership property do not have substantial economic effect since the creditor bears the

Assault on Tax Shelters Notwithstanding Crane

The income sheltering potential afforded by limited partnerships after the *Crane* decision motivated the IRS to take steps to curb tax shelter abuse.[59] Early post-*Crane* cases[60] quickly established the battlelines between the IRS and taxpayer in disputes over the issues left unresolved by *Crane*. Recent legislative enactment of at risk rules and other statutory succor have aided the Commissioner's attack against tax shelters and nonrecourse debt. In conjunction with this judicial and legislative action, the Commissioner began a direct administrative attack in the 1970s.

Judicial Development

To limit the revenue decreasing implications of *Crane*, the IRS successfully argued in a series of cases that contingent or indefinite nonrecourse debt cannot be included in the basis of property.[61] In *Redford v. Commissioner*,[62] for example, the taxpayer gave a note as partial payment for the purchase of property.[63] This note was payable solely from future profits and would become null and void if the lender breached an ancillary agreement between the parties.[64] Because future profits were uncertain, the tax court refused to permit

economic burden of any losses attributable thereto. Thus such allocations must be made in accordance with the partners' interests in the partnership.").

59. Because limited partnerships are given such a favored treatment in the tax law, courts and the Service have strictly construed regulation § 1.752-1(e) allowing inclusion of nonrecourse debt in the basis of the partnership interests of the limited partners, and have rejected various schemes by taxpayers to take advantage of the provision while even further limiting potential liability. *See, e.g.*, Danoff v. United States, 499 F. Supp. 20, 23 (M.D. Pa. 1979); Rev. Rul. 69-223, 1969-1 C.B. 184 (idemnity agreement by a limited partner idemnifying loss of a general partner does not increase basis of partnership interest of limited partner). *See also* Block v. Commissioner, 41 T.C.M. 546, 552 (1980); Brown v. Commissioner, 40 T.C.M. 725, 731-34 (1980), *aff'd*, 51 A.F.T.R.2d 83-348 (9th Cir. 1983) (guaranty agreement from limited partner to creditor does not increase basis of partnership interest of limited partner); Rev. Rul. 72-135, 1972-1 C.B. 200 ("nonrecourse loan" made by general partner does not increase basis of partnership interest of limited partner); *see also* Backar v. Western States Producing Co., 547 F.2d 876, 880 n.3 (5th Cir. 1977); Gibson Prod. Co. v. United States, 460 F. Supp. 1109, 1119 (N.D. Tex. 1978), *aff'd*, 637 F.2d 1041 (5th Cir. 1981) ("nonrecourse loan" made by third party does not increase basis of partnership interest of limited partner); Rev. Rul. 72-350, 1972-2 C.B. 394. For a similar treatment concerning a general partner, see Hamilton v. United States, 687 F.2d 408, 415 (Ct. Cl. 1982) (alleged "nonrecourse loan" from limited partners); Danoff v. United States, 499 F. Supp. 20, 23 (M.D. Pa. 1979) (basis of limited partner in partnership interest dependent upon "limited partner-general partner-creditor relationship").

60. Mendham Corp. v. Commissioner, 9 T.C. 320 (1947) (*Crane* extended to foreclosure of mortgage exceeding basis); Blackstone Theatre Co. v. Commissioner, 12 T.C. 801 (1949), *acq.* 1949-2 C.B. 1 (*Crane* applied in purchase context).

61. *See* Columbus & Greenville Ry. v. Commissioner, 42 T.C. 834, 849 (1964), *aff'd per curiam*, 358 F.2d 294 (5th Cir.), *cert. denied*, 385 U.S. 827 (1966); Albany Car Wheel Co. v. Commissioner, 40 T.C. 831, 841 (1963), *aff'd per curiam*, 333 F.2d 653 (2d Cir. 1964); Redford v. Commissioner, 28 T.C. 773, 778 (1957). *See also* Las Vegas Land & Water Co., 26 T.C. 881, 885 (1956); Rev. Rul. 55-675, 1955-2 C.B. 567. *See generally* Del Cotto, *supra* note 33, at 79-82.

62. 28 T.C. 773 (1957).

63. *Id.* at 775. The property involved was a nondepreciable tract of land. *Id.*

64. *Id.* at 776.

the obligation to be included in basis.[65] Subsequent cases similarly disallowed a loan's inclusion in basis when the amount of payments was too speculative to determine with any degree of certainty.[66]

In an attempt to further restrict the situations in which nonrecourse debt could be included in basis, the Commissioner argued that the *Crane* doctrine should be limited to cases involving property acquired by inheritance or devise. The court in *Manuel D. Mayerson,*[67] however, refused to adopt the Commissioner's contention. In that case, the taxpayer purchased depreciable real property with a purchase-money note secured solely by the property. Under the agreement, the taxpayer could either prepay the note within the first two years and realize a sizable reduction in price or pay within ninety-nine years from the date of sale.[68] The IRS disallowed the taxpayer's claimed depreciation,[69] positing that the nonrecourse purchase-money mortgage was not includible in depreciable basis.[70]

Although *Crane* involved inherited property, the basis of which is its fair market value, the *Mayerson* court held *Crane* applicable when property is purchased and its basis is its cost. Noting that lack of personal liability accorded with common business practices,[71] the court decided a taxpayer purchasing property on a nonrecourse basis should be treated similarly to one purchasing property unencumbered or with recourse debt. The court reasoned that the taxpayer who finances with a nonrecourse mortgage is effectively given an advance credit for the mortgage amount.[72] The court assumed that a capital investment in the amount of the mortgage would eventually occur despite the lack of personal liability.[73]

The Commissioner conceded defeat on the "purchase" issue,[74] but in Revenue Ruling 69-77[75] sternly cautioned taxpayers that the value of the mortgaged property was not at issue in *Mayerson.* Because *Crane* expressly declined to decide the issue, the Commissioner stated he would continue to counter inclusion of nonrecourse obligations in basis when the obligation exceeded the property's fair market value.[76] The Commissioner emphasized

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65. *Id.* at 778.

66. *See, e.g.,* Albany Car Wheel Co. v. Commissioner, 40 T.C. 831 (1963); *aff'd per curiam,* 333 F.2d 653 (2d Cir. 1964), which involved the purchase of business assets and an assumption of the seller's severance pay liability to its employees under a union contract. The court disallowed the liability's inclusion in basis because the buyer's payment was too "speculative." *Id.* at 841. *See also* Columbus & Greenville Ry. v. Commissioner, 42 T.C. 834 (1964), *aff'd per curiam,* 358 F.2d 294 (5th Cir.), *cert. denied,* 385 U.S. 827 (1966). This contingent liability defense will be addressed more fully *infra* at notes 174-88 and accompanying text.

67. 47 T.C. 340 (1966), *acq.* 1969-1 C.B. 21.

68. *Id.* at 342.

69. *Id.* at 346.

70. *Id.* at 351.

71. *Id.*

72. *Id.* at 352.

73. *Id.* at 351-52.

74. 1969-1 C.B. 21.

75. 1969-1 C.B. 59.

76. *Crane*'s footnote 37 suggested that a different result might be reached in determining amount realized when the secured property's value is less than the remaining balance on the

that *Mayerson* could not be relied upon in future cases unless the property was acquired in a bona fide, arm's length purchase at fair market value, and the nonrecourse loan was a bona fide debt obligation.[77] The Commissioner also warned that the IRS would be vigilant against any attempt by taxpayers to inflate purported purchases of property to take advantage of depreciation deductions.[78]

The Commissioner's view later received judicial sanction in *Estate of Franklin v. Commissioner*.[79] That case involved a classic tax shelter of depreciable real property purchased by a limited partnership.[80] The limited partners took depreciation deductions on the full purchase price, including the nonrecourse note, and interest deductions on the monthly installments.[81] The Commissioner disallowed these deductions on the grounds that the entire transaction was a sham because the taxpayers did not show that the property's value approximated the purchase price.[82]

The court upheld the IRS's position because the taxpayers had not met their "burden" of showing the purchase price did not exceed the fair market value of the property.[83] To substantiate a "sale" involving nonrecourse debt, the court required proof that the purchase price was reasonably equal to the fair market value so that the buyer would soon realize an equity in the property.[84] The court apparently adopted *Crane*'s assumption that a prudent purchaser with equity would not abandon payments on the note and subject the property to foreclosure.[85] Following the "spirit" of Revenue Ruling 69-77, the court denied interest deductions on the grounds that absent a showing of property value, nonrecourse debt is not to be treated as a bona fide obligation.[86]

In sum, the courts endorsed a two-pronged attack by the Commissioner against nonrecourse debt. First, unless the nonrecourse loan will almost certainly be repaid, the loan is considered too contingent or speculative for in-

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nonrecourse mortgage. 331 U.S. at 14 n.37. Because the Supreme Court found a "functional relation" between the Code's treatment of amount realized and depreciation, *id.* at 12, footnote 37 also suggested an argument for a difference in determining depreciable basis should the value be less than the balance of the nonrecourse debt.

77. Rev. Rul. 69-77, 1969-1 C.B. 59.

78. *Id.*

79. 544 F.2d 1045 (9th Cir. 1976).

80. *Id.* at 1046.

81. *Id.* at 1046.

82. *Id.* at 1046, 1048. The Commissioner also argued that in substance the transaction merely amounted to an option. *Id.* at 1046. This argument was successful with the Tax Court, 64 T.C. 752, 771 (1975), but the appellate court chose instead to rest its holding on the fair market value defense. 544 F.2d at 1047.

83. *Id.* at 1048, 1048 n.4, 1049. Although the question of value was raised at trial, sufficient evidence was not presented, and the court did not believe remand was warranted. *Id.* at 1046 n.4.

84. *Id.* at 1048.

85. *Id.* The court asserted that under the facts it was unnecessary to decide the tax consequences should the fair market value of the property subsequently increase and yield an equity interest. *Id.* at 1048-49. The court proposed the consequences may involve determining the proper basis of the property at the date the equity interest commenced. *Id.* at 1049 n.5.

86. *Id.* at 1049, 1049 n.6.

clusion in basis. Second, the debt amount must reasonably approximate the secured property's value before it may be included in basis.

Congressional Action

Not only did the courts aid in the Commissioner's attempts to limit the scope of *Crane*, but Congress later offered additional assistance in the fight against tax shelters. In passing the "at risk" rules of the Tax Reform Act of 1976,[87] Congress expressly sought to eliminate the use of nonrecourse leveraging in limited partnership tax shelters.[88] These rules limit annual deductible losses for an activity[89] to the aggregate amount for which the taxpayer is personally economically at risk.[90] Most importantly, the taxpayer is not considered at risk with respect to nonrecourse financing.[91] The 1976 Act was aimed at four traditional tax shelter activities: farming, oil and gas exploration, operations relating to motion picture films or video tapes, and equipment leasing.[92] The at risk rules virtually eliminated the attractiveness of these activities because investors could no longer limit liability and still obtain large tax write-offs.[93]

Congress and the Department of Treasury quickly discovered the at risk rules had not gone far enough in battling tax shelters.[94] In an effort to stymie increasing tax shelter activity,[95] Congress enacted the Revenue Act of 1978[96] which extended the at risk rules to all activities except real estate.[97] Although

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87. 90 Stat. 1520 (codified at I.R.C. § 465 (1982)).

88. Pub. L. No. 94-455, 90 Stat. 1525 (1976); Rhodes, *supra* note 42, at 347-48; Sax, *Lawyer Responsibility in Tax Shelter Opinions*, 34 TAX LAW. 5, 10 (1980).

89. I.R.C. § 465(c)(1) (1982); S. REP. No. 94-938, 94th Cong., 2d Sess. 48 (1976), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3439, 3483.

90. *See* I.R.C. § 465(a) (1982).

91. *Id.* § 465(b)(4).

92. S. REP. No. 94-938, 94th Cong., 2d Sess. 48 (1976), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3439, 3483.

93. *See generally* Comment, *Nonrecourse Liabilities: A Tax Shelter*, 29 BAYLOR L. REV. 57 (1977).

94. *See* H.R. REP. No. 1445, 95th Cong., 2d Sess. 68 (1978), *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 7046, 7104-05; Simmons, *Nonrecourse Debt and Basis: Mrs. Crane Where Are You Now?*, 53 S. CAL. L. REV. 1, 68-69 (1979).

95. Simmons, *supra* note 94, at 68.

96. Pub. L. No. 95-600, 92 Stat. 2763 (1978) [hereinafter cited at 1978 Act].

97. I.R.C. §§ 465(c)(3)(A), (D) (Supp. II 1978); STAFF OF JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE ACT OF 1978, 96th Cong., 1st Sess. 130-32 (official print. 1979). Congress identified three types of tax shelter problems remaining from the 1976 Act, which the 1978 Act attempted to address. The first problem was that only four activities were directly covered by the at risk rules, and this was solved by extending the rules to all but real estate activities. *Id.* The remaining two problems were that the at risk rules did not apply to closely held corporations, and that the rules did not adequately deal with situations where the taxpayer received distributions after having used his at risk basis to support losses in a prior year. *Id.* at 130. These issues were resolved by extending the at risk provisions to closely held corporations, through I.R.C. § 465(a)(1)(B) (Supp. II 1978), and by requiring recapture of losses through I.R.C. § 465(e) (1982). *Id.* at 134-146; Sax, *supra* note 88, at 10. In addition, for the first time attention was directly focused on partnership level compliance, a penalty was imposed for failure to file the partnership return, see I.R.C. § 6698 (Supp. II 1978), and the statute of limitations was extended for federally registered partnerships. *Id.* §§ 6501(q), 6511(g).

directed at curbing misuse of tax shelters, the 1976 Act and 1978 Revenue Act may have actually exacerbated the problem. While investors could be reasonably assured of advantageous results prior to the legislation, afterwards neither leverage nor deductions could be readily obtained.[98] Rather than offering investment devices with economic substance, promoters turned to abusive schemes structured solely for tax benefits.[99]

To counteract the abuses, Congress shifted emphasis away from purely substantive tax shelter areas by enacting two tax acts with important administrative provisions. Due to various factors retarding economic growth, attitudes changed and Congress debated long-range tax reductions for the first time in recent history.[100] The result was enactment of the Economic Recovery Tax Act of 1981 (ERTA),[101] a multi-year program designed to upgrade the nation's industrial base and stimulate productivity while decreasing taxes and governmental spending.[102] Because the mainspring of ERTA was economic stimulation, not tax reform, it offered an interesting array of changes. Drastic remodeling of depreciation rules facilitated tax shelter usage; whereas the cap on individual income tax rates, extension of the at risk rules to investment tax credit[103] and a new civil penalty for understating taxes due to overvaluing property tended to impede shelter usage.[104]

With a renewed commitment to raising revenue and achieving tax equity,[105] Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).[106] TEFRA also reflected Congress' increasing concern regarding tax shelters. Responding to the lack of specific Code provisions relating to tax shelter promoters, TEFRA furnished two new administrative weapons: a civil penalty for promoting abusive tax shelters premised on unattainable tax benefits or gross valuation overstatement,[107] and injunctive authority to prevent any action which may give rise to the civil penalty.[108] In addition, TEFRA

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98. Sax, *supra* note 88, at 10-11.
99. *See* Egger, *supra* note 8, at 55,506.
100. Briner, *Economic Recovery Tax of 1981*, 15 AKRON L. REV. 325, 325 (1981).
101. Pub. L. No. 97-34, 95 Stat. 172 (1981).
102. STAFF OF JOINT COMM. OF TAXATION, 97th Cong., 1st Sess. 17, 20, GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981 (official print 1981).
103. *See* I.R.C. § 46(c)(8) (1982).
104. *See* I.R.C. §6659 (1982).
105. SENATE COMM. ON FINANCE, REPORT ON H.R. 4961, TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, 97th Cong., 2d Sess. 96-97, *reprinted in* FED. TAXES (P-H) (1982), ¶ 59,547 (Rep. B. 31, Vol. LXIII (Sec. 2) (July 15, 1982)). In a sense, TEFRA represented a reversal of the movement begun by ERTA to reduce taxes. For example, a drastic shift from ERTA occurred in the area of "safe-harbor leasing", with TEFRA's addition of new section 168(i) and amendment to section 168(f)(8).
106. Pub. L. No. 97-248, 96 Stat. 324 (1982).
107. I.R.C. § 6700 (1982).
108. *Id.* § 7408. These sanctions supplement other potential civil, or criminal, penalties which may be imposed under certain circumstances. I.R.C. §§ 6694, 7206(2) (1976). *See generally* Sokoly & Miner, *Continuing Attack Against Abusive Tax Shelters and Questionable Reporting Positions: New Penalties for Promoters, Tax Advisors and Taxpayers*, 57 J. TAX'N 288 (1982).

imposed a penalty upon tax shelter investors who substantially underpay taxes.[109]

Administrative Attack

To supplement judicial and congressional action, the IRS adopted internal programs in the 1970s and early 1980s to counter tax shelter abuse. The Commissioner launched his first major[110] anti-tax shelter campaign in 1973 with the announcement of several new strict policies.[111] First, the IRS stepped-up its audit program examining partnership level information returns involving tax shelters.[112] The program initially focused on the oil and gas industry,[113] and was subsequently extended to real estate, farming and motion picture shelters.[114] Second, the Commissioner instituted a program of preannounced revenue rulings directed at specific tax shelter arrangements.[115]

In early 1974, the IRS set forth its view of the tax consequences when a limited partner sold or exchanged partnership interest or withdrew from a partnership which had nonrecourse debt.[116] In 1975, the IRS ruled that a limited partner recognized gain on the transfer of partnership interest to a

109. I.R.C. § 6661 (1982).

110. Precursors to the Commissioner's virulent attack are found in early revenue rulings. In Rev. Rul. 68-643, 1968-2 C.B. 76, the Service expressed dismay at "certain abuses which had arisen with respect to prepayment of interest by taxpayers" using the cash method, and revoked an earlier ruling that interest prepayment may not result in income for the taxable year of prepayment. 1968-2 C.B. at 77. Additionally, two revenue rulings involving nonrecourse loans made to oil and gas limited partnerships held that the loans should be treated as capital contributions for tax purposes, thereby disallowing any increase in the limited partner's basis in the partnership. Rev. Rul. 72-135, 1972-1 C.B. 200; Rev. Rul 72-350, 1972-2 C.B. 394. For discussion of the effect of nonrecourse debt on the basis of a limited partner's interest in a partnership, see *supra* notes 51-56 and accompanying text.

111. *See* Egger, *supra* note 8, at 55,507. The Service announced that it would instigate a program of audits and advanced rulings aimed against so-called "abusive" tax shelters. Schlenger, *Comments on the Proposed Regulations on Tax Shelters Opinions*, 59 TAXES 173, 173 (1981) (announcement by acting Commissioner Alexander, at the Cleveland Tax Institute (Nov. 15, 1973)). The Administration earlier in the year had presented its viewpoint about tax shelters to the House Ways and Means Committee, as part of the total input received by Congress leading up to the Tax Reform Act of 1976.

112. *See* Sax, *supra* note 88, at 14. Since the partnership is not a taxable entity under I.R.C. § 701 (1982), it previously had not been an independent audit target. Partnerships were typically audited only as a result of an investigation of an individual's return. Sax, *supra* note 88, at 14. Recently, TEFRA enacted legislation providing for a unified partnership audit proceeding. *See* I.R.C. §§ 6221-32, 6511(g), 7422(g), 7485(b) (1982).

113. *See* Kurtz, *Commissioner's Remarks on Abusive Tax Shelters*, 55 TAXES 774, 774 (1977). The IRS combined resources with the Federal Securities and Exchange Commission in an effort to identify audit targets. *Id.*

Since tax shelter limited partnerships are treated as securities, the Federal Securities and Exchange Commission also has a direct interest in the ongoings in the tax shelter industry. *See supra* note 42; *see also* Shefsky, *Publicly Offered Shelters: Can the SEC and the IRS be Served*, 53 TAXES 516 (1975) (discusses a potential conflict between compliance with SEC and IRS rules).

114. Kurtz, *supra* note 113, at 774.

115. *See* Sax, *supra* note 83, at 11-12.

116. Rev. Rul. 74-40, 1974-1 C.B. 159.

charitable organization when his share of the partnership's nonrecourse debt exceeded his basis in the interest.[117] The third and final facet of the IRS's anti-tax shelter program was to increase court action against uses of nonrecourse liability in contexts dissimilar to the *Crane* situation.[118]

Although the IRS was successful in making some inroads into the tax shelter area, the administrative effort received necessary assistance from both Congress and the courts in 1976.[119] Congress passed the at risk rules and other legislation[120] targeted against specific shelter characteristics of tax deferral such as conversion of ordinary into capital gain and leveraging through nonrecourse loans.[121] Judicial assistance came with *Estate of Franklin*,[122] which required a taxpayer to show that the property's purchase price at least approximates its fair market value before the taxpayer could take a deduction attributable to nonrecourse debt.[123]

Buoyed by this legislative and judicial action, the IRS began an even more aggressive attack on tax shelters. The auditing program, which instigated tax shelter review as a regular part of the examination format, went beyond the former selective approach.[124] Additionally, improved communication methods were established among the SEC, state securities agencies, and IRS district and regional offices. Finally, the Service printed an examination handbook to apprise field agents of tax shelter industry terminology and operations.[125]

The IRS soon realized that although the 1976 Act eliminated many forms of tax shelters, promoters found novel means of investment and unusual business entities to slip through the legislative bindings.[126] To counter these new tax shelter devices, the Commissioner adopted an innovative program in which revenue rulings were specifically tailored for certain tax shelter arrangements and were strategically announced for maximum coverage.[127] In one of those rulings, Revenue Ruling 77-110,[128] the Commissioner used for the first time the dual-pronged defense of fair market value and contingent liability. That ruling

117. Rev. Rul. 75-194, 1975-1 C.B. 80.

118. This court action was successful, as the Commissioner's contingent liability defense was accepted by the Court of Claims. *See* Denver & Rio Grande Western R.R. v. United States, 505 F.2d 1266, 1270-71 (Ct. Cl. 1974).

119. Schlenger, *supra* note 111, at 174.

120. *See supra* notes 87-93 and accompanying text.

121. Sax, *supra* note 88, at 9.

122. 544 F.2d 1045 (9th Cir. 1976). For a discussion of this decision, see *supra* notes 79-86 and accompanying text.

123. 544 F.2d at 1048-49.

124. Kurtz, *supra* note 113, at 774-75.

125. *Id.* at 775. *See* Internal Revenue Service, No. 4326, Examination Tax Shelters Handbook 1-160 Index Stand. Fed. Tax Rep. (CCH) (1979) ¶ 300 (current version Index Stand. Fed. Tax Rep. (CCH) (1983) ¶ 300) [current version hereinafter cited as *Handbook*].

126. Kurtz, *supra* note 113, at 774, 776.

127. Sax, *supra* note 88, at 11. In 1977, the Service issued a series of thirteen rulings, nine of which were issued on October 31, and thus are referred to as the "Halloween Massacre" rulings, *see* Schlenger, *supra* note 111, at 175. These rulings addressed various shelter arrangements to give "guidance to investors who might otherwise be misled as to the IRS position." *See* Kurtz, *supra* note 113, at 776. For a list of the Halloween rulings, see Sax, *supra* note 88, at 11 n.41.

128. 1977-1 C.B. 58.

expressly adopted *Estate of Franklin*, and declared a partnership must demonstrate that the purchased property's value approximates the nonrecourse debt, before including the amount of the note in basis for depreciation.[129] The Commissioner further stated that if payment on the note is speculative, the note amount cannot be included in basis.[130] This dual-prolonged defense has since been used as the primary judicial weapon against nonrecourse debt and tax shelters.

In another attempt to curb new tax shelter devices, the Commissioner focused on professional tax advisors. A principal item in a tax shelter promotional package is an alleged tax expert's opinion letter which attests to representations concerning the prospective investor's tax benefit.[131] Recognizing that illfounded claims within these opinions contribute to tax shelter abuses,[132] in 1980 the IRS turned its attention to the authors of tax opinions.[133] The Treasury Department proposed amendments to Circular 230, the rules governing attorneys' practice before the IRS.[134] The amendments deal specifically with tax shelter opinions and set forth standards for practice and disbarment.[135]

STATUS OF NONRECOURSE DEBT AT THE TIME OF *Tufts*

Testifying before a House of Representatives subcommittee in late September 1982, the Commissioner of Internal Revenue depicted the tax shelter industry as no longer a business where promoters merely "stretched" the law in marketing deductions. Instead, as a result of the congressional, judicial and administrative attempts to curb their use, the tax shelter industry now in-

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129. The Commissioner's test apparently compared the property's fair market value to the amount of the nonrecourse note. The court in *Estate of Franklin*, 544 F.2d at 1045, compared the property's fair market value to the property's purchase price.

130. 1977-1 C.B. at 59.

131. *See* Sharp v. Coopers & Lybrand, 649 F.2d 175, 183 (3d Cir. 1981); New York State Bar Association Tax Section, *Report of the Tax Section Executive Committee on the Treasury's Proposed Amendment to Circular 230 and Standards Applicable to Tax Opinions Used in Offering Tax Shelter Investments*, (pt. 1) 53 N.Y. ST. B.J. 202, 202 (1981) [hereinafter cited as *N.Y. Tax*].

132. *See American Bar Association Section of Taxation Statement on Proposed Rule Amending Circular 230 with respect to Tax Shelter Opinions*, 34 TAX LAW. 745, 745 (1981).

133. *See* Sax, *supra* note 88, at 5.

134. The various authorities governing the attorneys' position vis-á-vis the I.R.S. are as follows: 31 U.S.C. § 1026 (1976) authorizing the Treasury Department to issue rules and regulations governing practice before the I.R.S., Circular 230, 31 C.F.R. §§ 10.0-.91 (1983) containing the Department's authorized rules for practice; and A.B.A. Commission on Ethics and Professional Responsibility, Formal Op. 314 (1965) setting forth the ethical relationship existing between the attorneys and IRS.

135. 45 C.F.R. 58594 (Sept. 4, 1980). The Treasury General Counsel indicated four general types of tax opinions with which the Treasury was concerned:

(1) Intentionally false or totally incompetent opinions;
(2) Disclaims knowledge of accuracy of facts opinions;
(3) Non- or hypothetical opinions; and
(4) Reasonable basis opinions.

See N.Y. Tax supra note 131, at 205, 233-34, 292 (pt. 2); Sax, *supra* note 88, at 15.

volves intricate schemes and even open violation of the law.[136] The Commissioner stated, however, that the major tax legislation[137] of the 1980s had provided the IRS with new tools to combat these abusive shelters. He warned investors[138] and promoters[139] to expect an aggressive litigation program involving criminal prosecution for fraud[140] as well as continued action in civil matters.[141]

Nonrecourse Debt on Disposition:
Includibility in Amount Realized

In 1947, the Tax Court applied *Crane* to a mortgage foreclosure and ruled the *Crane* doctrine would not be restricted to a sale situation.[142] After that, the only questions remaining were how far the *Crane* doctrine would be extended and whether it would be limited to the property's fair market value upon disposition. The first question was answered by 1983, when courts had extended the doctrine to all manner of dispositions. As to the second question, a line of court decisions and revenue rulings posited that *Crane*'s footnote 37 permitted including nonrecourse debt in amount realized on property disposition, even when such debt exceeded the property's value.[143]

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136. Egger, *supra* note 8, at 55,505-06. The Commissioner characterized the movement by the shelter industry as one of continual "leapfrogging"; that is, whenever the Service or Congress has acted to stymie shelter growth, promoters and investors have found ways to jump over the roadblocks. *Id.* at 55,506. Some recent case law shows the variety of areas and schemes in which tax shelters have spread. *E.g.*, United States v. Carruth, 699 F.2d 1017 (9th Cir. 1983) (cattle breeding); United States v. Everett, 692 F.2d 596 (9th Cir. 1982) (sale and leaseback), *cert. denied*, 103 S. Ct. 1498, 1502 (1983); United States v. Drape, 668 F.2d 22 (1st Cir. 1982) (coal); United States v. Winograd, 656 F.2d 279 (7th Cir. 1981) (commodity tax straddles), *cert. denied*, 455 U.S. 989 (1982); Sharp v. Coopers & Lybrand, 649 F.2d 175, 179 (3d Cir. 1981) (oil and gas "ponzi scheme", requiring investment by two limited partners to cover obligations of one); SEC v. Murphy, 626 F.2d 633 (9th Cir. 1980) (cable television systems); United States v. Crum, 529 F.2d 1380 (9th Cir. 1976) (domesticated beavers).

137. For a discussion of this legislation, see *supra* notes 100-08 and accompanying text.

138. Egger, *supra* note 8, at 55,508. The investor is subject to penalties such as the overvaluation penalty I.R.C. § 6659 (1982); a 50% penalty of the interest due on underpayment due to negligence, *id.* § 6653(a)(2); an underpayment penalty imposed on investors in abusive shelter transactions, *id.* § 6701; increased interest on underpayment, *id.* § 6621(a); and criminal prosecution for knowingly participating in a fraudulent scheme. *Id.* § 7206. Egger, *supra* note 8, at 55,508.

139. Egger, *supra* note 8, at 55,508. Penalties for the promoter include civil sanctions, I.R.C. § 6700 (1982); injunctions, *id.* § 7408; and criminal prosecutions. *Id.* § 7206(2).

140. Some recent criminal cases have involved overt tax fraud. *E.g.*, United States v. Carruth, 699 F.2d 1017 (9th Cir. 1983) (nonexistent transactions by promoter of over 100 limited partnerships in cattle breeding); United States v. Everett, 692 F.2d 596 (9th Cir. 1982) (backdated documentation by promoter in sale/leaseback), *cert. denied*, 103 S. Ct. 1498 (1983); United States v. Winograd, 656 F.2d 279 (7th Cir. 1981) (illegal promoter commodity straddle), *cert. denied*, 455 U.S. 989 (1982); United States v. Crum, 529 F.2d 1380 (9th Cir. 1976) (promoter backdated purchase contract).

141. *See* Egger, *supra* note 8, at 55,507-08.

142. Mendham Corp. v. Commissioner, 9 T.C. 320, 323-25 (1947). *See also* Woodsam Assoc. v. Commissioner, 198 F.2d 357, 359 (2d Cir. 1952); Freeland v. Commissioner, 74 T.C. 970, 981 (1980).

143. *See* Townsend, *Footnote 37 of* Crane: *What is the Nature of the Income?*, 4 REV.

In *Woodsam Assocs. v. Commissioner*,[144] the Tax Court first dealt with a taxpayer's argument that under *Crane*, the amount realized on disposition was limited to the property's value.[145] That case involved a mortgage foreclosure,[146] but unlike Mrs. Crane, the taxpayer received no "boot" in the transfer.[147] The court stated that even if *Crane*'s footnote 37 provided an exception to the debt's includibility, that exception would not be available to this taxpayer.[148] In dictum, however, the court indicated it was not persuaded *Crane* intended any exception for cases in which the nonrecourse debt exceeded the property's fair market value.[149] In Revenue Rulings 76-111[150] and 78-164,[151] the IRS adopted the *Woodsam* dictum in ruling that a transfer of property in cancellation of indebtedness[152] and a voluntary conveyance of real property to a mortgagee[153] require full inclusion in amount realized of amount of debt exceeding the property's value.

The issue concerning a fair market value exception to *Crane* was again raised in *Millar v. Commissioner*.[154] The Third Circuit rejected the taxpayer's argument, and noted *Crane*'s footnote 37 was just "a postulate of hypothetical observation."[155] The court, however, refused to rule out a possible exception and stated its holding was limited to the facts.[156] The Tax Court nonetheless used *Millar*'s dictum in *Tufts v. Commissioner*,[157] and *Estate of Delman v. Commissioner*[158] to reject taxpayer's arguments that *Crane* provided an exception to the extent debt exceeds value.

Nonrecourse Debt on Acquisition: Includibility in Basis

Having long ago lost its attack on the inclusion of nonrecouse debt in basis

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TAX. INDIV. 128, 143-44 (1980); Comment, *Crane's Footnote 37 Gets the Boot*, 11 SETON HALL 679, 683-87 (1981).

144. 16 T.C. 649 (1951), *aff'd*, 198 F.2d 357 (2d Cir. 1952).

145. *Id.* at 635-55. *See also* Lutz & Schramm Co. v. Commissioner, 1 T.C. 682, 688-89 (1943) (pre-*Crane* case).

146. 16 T.C. at 655.

147. *Id.* Boot is an amount received over and above the mere transfer of the property. In *Crane* the taxpayer received $3,000 in the exchange. 331 U.S. at 3.

148. 16 T.C. at 655.

149. *Id.* Taxpayer also unsuccessfully raised the argument on appeal. The Second Circuit noted that *Crane* applied whether the loan was equal to or less than the value of the property, and the fact the taxpayer did not receive boot was no proof that the value was less than the outstanding loan. 198 F.2d at 359.

150. 1976-1 C.B. 214.

151. 1978-1 C.B. 264.

152. Rev. Rul. 76-111, 1976-1 C.B. at 215.

153. Rev. Rul. 78-164, 1978-1 C.B. at 264-65.

154. 577 F.2d 212, 214 (3d Cir.), *aff'g on this issue*, 72 T.C. 756 (1977), *cert. denied*, 439 U.S. 1046 (1978).

155. *Id.* at 215.

156. *Id.* at 216.

157. 70 T.C. 756, 764-66 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981), *aff'd*, 103 S. Ct. 1826 (1983).

158. 73 T.C. 15, 28-30 (1979).

when property is purchased,[159] the IRS relied upon other weapons to eliminate the use of nonrecourse debt in tax shelters. By the time *Tufts* was decided, a multi-directed strategy of attack had apparently been established. Criminal prosecutions were a recognized sanction for flagrant abuse.[160] The newly enacted shelter promoter penalty[161] and injunction provisions[162] provided the IRS with additional weapons. Finally, the Commissioner had developed four interrelated arguments against the inclusion of nonrecourse debt in basis: at risk rules, addition to tax for overvaluing assets, the contingent liability defense, and the fair market value defense.

The Commissioner has communicated his views on the at risk provisions primarily by publishing revenue rulings and proposed regulations.[163] In 1979, the Commissioner proposed an extensive set of regulations for guidance in the application of the at risk legislation.[164] Additionally, since 1977, the IRS has issued annually approximately two revenue rulings aimed at the at risk limitation deductions and related issues.[165] These rulings convey the IRS's position on tax shelter promoted benefits.[166]

Property overvaluation has been increasingly used by wily promoters to circumvent the tax shelter obstacles created by Congress and the IRS.[167] To frustrate such overvaluation, in 1981 Congress enacted ERTA section 6659[168]

159. *See* Mayerson v. Commissioner, 47 T.C. 340 (1960), *acq.* 1969-1 C.B. 21.

160. *E.g.*, United States v. Everett, 692 F.2d 596 (9th Cir. 1982) (backdating of documents), *cert. denied*, 103 S. Ct. 1498 (1983); *In re* United States of America, (CCH) 83-1 U.S.T.C. ¶9358 (1983) (filing of false and fraudulent partnership returns under I.R.C. § 7206(2)). *See* Egger, *supra* note 8, at 55,508 (continued criminal prosecutions should aid in directly attacking current shelter problems).

161. I.R.C. § 6700(a) (1982).

162. *Id.* § 7408. Egger, *supra* note 8, at 55,508. *See, e.g.*, United States v. Hutchinson, (P-H) 51 A.F.T.R.2d 1131 (S.D. Cal. 1983). For a discussion of the new statutes see *supra* notes 105-08 and accompanying text.

163. *Cf.* Peters v. Commissioner, 77 T.C. 1158, 1162-63 (1981). *See* Zobel & Shore, *The IRS Crackdown On Valuation Abuses: How Far Does It Go; And What Does It Portend?*, 52 J. TAX'N 276, 277 (1980).

164. Prop. Reg. §§ 1.465-1 to -95.44, Fed. Reg. 32235 (1979). The proposed regulations are authorized pursuant to I.R.C. § 465(c)(3)(C) (1982). *See generally* Hewitt & Pennell, *How At-Risk Proposals Deal with Encumbered Property, Suspended Losses, Depositions*, 52 J. TAX'N 44 (1980); Hewitt & Pennell, *Working with the Proposed At-Risk Regs: Needed Clarification, Unresolved Problems*, 51 J. TAX'N 342 (1979).

165. Rev. Rul. 82-225, 1982-2 C.B. 100; Rev. Rul. 82-123, 1982-1 C.B. 82; Rev. Rul. 81-283, 1981-2 C.B. 115; Rev. Rul. 80-327, 1980-2 C.B. 23; Rev. Rul. 80-72, 1980-1 C.B. 109; Rev. Rul. 79-255, 1979-2 C.B. 17; Rev. Rul. 79-432, 1979-2 C.B. 289; Rev. Rul. 78-413, 1978-2 C.B. 167; Rev. Rul. 78-412, 1978-2 C.B. 166; Rev. Rul. 78-175, 1978-1 C.B. 144; Rev. Rul. 77-397, 1977-2 C.B. 178; Rev. Rul. 77-398, 1977-2 C.B. 179.

166. Sax, *supra* note 88, at 11-12. Recent developments indicate the IRS's interest in the at risk area has not waned. The IRS has developed a new Form 6198 for computing deductible loss from at risk activities for use in taxable years beginning in 1983. I.R. 83-66 (Apr. 18, 1983).

167. Egger, *supra* note 8, at 55,505.

168. Pub. L. No. 97-34, § 722(a), 95 Stat. 341 (1981). Section 6659 only applies to income, not any other tax, such as estate tax. It was not targeted specifically at tax shelters but at property valuation disputes in general. It does apply, however, to limited partnership tax shelters. *See* Rev. Rul. 82-225, 1982-2 C.B. 100; Rev. Rul. 82-37, 1982-1 C.B. 214.

which imposed a penalty for understating income tax due to property overvaluation.[169] The understatement must be at least $1,000[170] and the property must have been acquired within five years as of the close of the tax year.[171] The Commissioner has ruled the penalty applies to individual partners when the overvaluation was made by the partnership on the partnership return,[172] and to tax shelter programs in which nonrecourse debt is used.[173]

In addition to the at risk provisions and the overvaluation penalty, the Commissioner has employed the contingent liability and fair market value defenses in opposing the inclusion of nonrecourse debt in basis. Confusion exists between these defenses and their relationship to nonrecourse debt.[174] In two post-*Crane* cases, the Tax Court refined the contingent liability defense which provides that a nonrecourse obligation cannot be included in basis if it is too speculative.[175] These cases established that the contingent liability defense does not apply when the amount of the nonrecourse obligation is fixed and the only contingency is whether the payment will be made or the mortgage foreclosed.

In *Manuel D. Mayerson*,[176] the taxpayer financed a real estate purchase with a nonrecourse purchase-money note.[177] The purchase agreement provided that the purchase price would be reduced if the obligation was paid off within the first two years.[178] The Commissioner argued this potential price reduction made the note too contingent to be included in basis.[179] The Tax Court ruled to the contrary, considering the reduction a "bonus discount" which did not make the purchase price indefinite.[180] The court noted that in order to discharge the lien, the taxpayer would have to pay the then-fixed amount; therefore, the obligation was not contingent or indefinite.[181]

The second case, *David F. Bolger*,[182] involved corporations formed with

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169. I.R.C. § 6659(a) (1982).

170. *Id.* § 6659(d).

171. *Id.* § 6659(c)(2). The statute provides for the penalty's waiver upon a good faith showing of a reasonable basis for the valuation. *Id.* § 6659(e).

172. Rev. Rul. 82-37, 1982-1 C.B. 214.

173. Rev. Rul. 82-225, 1982-1 C.B. 100.

174. *See* Rev. Rul. 81-262, 1981-2 C.B. 164, 165 (taxpayer unable to show property had fair market value equal to the amount of the note, thus the note deemed a contingent obligation); Del Cotto, *supra* note 33, at 80-82 ("[e]merging from [the] cases is a rule of retrospective analysis rather than a reasoned approach to the problem of contingent obligations" and recourse debt); *Federal Tax Treatment*, *supra* note 5, at 1514-24 (nonrecourse liabilities are contingent in nature).

175. Gibson Prod. Co. v. United States, 460 F. Supp. 1109, 1115 (N.D. Tex. 1978), *aff'd*, 637 F.2d 1041 (5th Cir. 1981). For an argument that nonrecourse liabilities by their very nature are contingent and never should be included in basis, see Note, *supra* note 5, at 1514-24. *See also* Del Cotto, *supra* note 33, at 79-81.

176. 47 T.C. 340 (1966), *acq.* 1969-1 C.B. 21.

177. *Id.* at 342.

178. *Id.*

179. *Id.* at 353.

180. *Id.* at 354.

181. *Id.* at 353-54. For a criticism of the Tax Court's analysis of the nonrecourse liability in *Mayerson*, see Del Cotto, *supra* note 33, at 71-82.

182. 59 T.C. 760 (1973).

nominal capitalization for the single purpose of acquiring title to depreciable properties. By acquiring long term leases and issuing the corporations' own negotiable promissory notes, the corporations obtained maximum financing while avoiding state law restrictions on loans to the individual shareholders.[183] The corporations then sold the properties subject to the mortgages to their respective taxpayer/shareholders for nominal consideration.[184] The shareholders thus became the alleged owners of the properties for allowable depreciation but personal liability was limited.

The Commissioner denied the taxpayers' claimed depreciation partly on the grounds that the nonrecourse debt should be considered contingent and not includible in basis.[185] The Commissioner argued that the likelihood the taxpayers would be required to make any mortgage payments was so speculative that each loan should not be considered part of the acquisition cost.[186] The Tax Court rejected this argument declaring that the contingent liability defense applies when the underlying obligations "by their terms" are contingent.[187] The court distinguished cases such as *Mayerson* and *Bolger* where the obligation is fixed, and the only speculative fact is whether payments will be made or the mortgage foreclosed.[188]

Because the IRS considers valuation the "prime consideration" in separating "good" from "abusive" tax shelters,[189] it is not surprising that the fair market value defense has moved to the core of the IRS's anti-tax shelter campaign. The contingent liability and fair market value defenses have become the primary judicial weapons used by the Commissioner against nonrecourse debt which is outside of the at risk rules. In fact, the combined defenses have become a two-pronged threshold test in which taxpayers bear the burden of proof in arguing for the inclusion of nonrecourse debt in basis.[190]

Revenue Ruling 82-225[191] epitomizes the relationship between the IRS's various arguments and perhaps best illustrates the Service's overall strategy for dealing with nonrecourse loans. The ruling involved a tax shelter promotion

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183. *Id.* at 761-62.

184. *Id.* at 763.

185. *Id.* at 771. The Commissioner also argued unsuccessfully that the corporations should be considered shams and not separate entities for tax purposes, *id.* at 766-67, and that if the corporations were treated as separate entities, they and not the taxpayers were entitled to the depreciation deductions. *Id.* at 767-69. The Commissioner also asserted that the nonrecourse note should not be considered part of the cost basis notwithstanding its potential contingent nature. *Id.* at 770. For a discussion of a possible argument in *Bolger* that the leases may have divested the single-purpose corporations of any depreciable interest which to pass to the shareholders, see Hilton v. Commissioner, 74 T.C. 305, 349-50 (1980), *aff'd*, 671 F.2d 316 (9th Cir. 1982).

186. 59 T.C. at 771.

187. *Id.*

188. *Id.*

189. *Handbook, supra* note 125, § 366(1).

190. *E.g.*, Gibson Prod. Co. v. United States, 460 F. Supp. 1109, 1115 (N.D. Tex. 1978), *aff'd*, 637 F.2d 1041 (5th Cir. 1981); Mahoney v. United States, 48 A.F.T.R.2d (P-H) ¶ 81-5312, at 81-6131, -6139 (Ct. Cl. 1981); Rev. Rul. 81-262, 1981-2 C.B. 164; Rev. Rul. 78-29, 1978-1 C.B. 62; Rev. Rul. 77-110, 1977-1 C.B. 58.

191. 1982-2 C.B. 100.

of a video program. The investors' cost was 17,000x dollars, 1,300x payable by cash down and the balance by alleged recourse note. The note, however, was convertible to a nonrecourse obligation if certain events occurred.[192] The ruling concluded that the note's initial recourse nature was designed solely to circumvent the at risk limitations. The note would thus be treated initially as a nonrecourse loan.[193] Although the ruling was primarily directed at the at risk rules, it also stated that unless the value of the property purchased by each investor approximated the note's amount it could not be included in basis, and no interest deduction would be allowable.[194] The ruling additionally declared that the section 6659 overvaluation penalty might apply.[195]

THE *Tufts* DECISION AND ITS TAX SHELTER RAMIFICATIONS

In *Commissioner v. Tufts*,[196] taxpayers formed a general partnership to construct a large apartment complex.[197] None of the partners contributed any capital upon entering the partnership.[198] To finance the construction, the partnership obtained a nonrecourse loan of $1,851,500 from a savings and loan association in exchange for a note and deed of trust covering the property.[199] The project was completed in 1971, and the depreciation deductions on the complex were passed through to the partners for the taxable years 1971 and 1972.[200] Because of adverse economic conditions, the rental income from the apartment was insufficient to make note payments in August, 1972.[201] Facing possible foreclosure, the partners sold their interest to a buyer who paid the sales expense and took the property subject to the nonrecourse encumbrance.[202]

At the time of sale, the complex's adjusted basis reduced for depreciation was $1,455,740, and its fair market value was $1,400,000.[203] The principal amount on the note remained $1,851,500.[204] In reporting the sale for tax purposes, the partners claimed a loss of $55,740, the difference between the property's fair market value and adjusted basis.[205] The Commissioner held taxpayers actually had a gain of approximately $400,000, the difference between the remaining unpaid balance of the note and adjusted basis.[206]

On petition to the Tax Court, the partners argued that under *Crane*'s footnote 37 the amount realized on the sale was limited to the property's fair

192. *Id.*
193. *Id.* at 101.
194. *See id.* This statement was based on Rev. Rul. 77-110, 1977-1 C.B. 58.
195. 1982-2 C.B. at 101.
196. 103 S. Ct. 1826 (1983).
197. *Id.* at 1828.
198. *Id.*
199. *Id.*
200. *Id.* at 1829. Partners take into account income and losses of the partnership in their individual capacities, I.R.C. §§ 701, 702(a) (1982).
201. 103 S. Ct. at 1829.
202. *Id.*
203. *Id.* at 1829.
204. *See id.* n.2.
205. *Id.* n.1.
206. *Id.* n.2.

market value.[207] The Tax Court instead agreed with the Commissioner that fair market value was immaterial to the determination and ruled the *Crane* doctrine required including the full balance of nonrecourse debt in amount realized. [208] Reversing the Tax Court, the Fifth Circuit expressly disagreed with the Tax Court's analysis of *Crane* and questioned the theoretical underpinnings of *Crane* itself.[209]

On certiorari,[210] the Supreme Court reversed the Fifth Circuit and extended the *Crane* doctrine to require including a nonrecourse mortgage in amount realized when the mortgage exceeds the value of the property transferred.[211] The Court reasoned that this conclusion followed from *Crane*'s treatment of a nonrecourse mortgage as a true loan.[212] When the taxpayers sold the property subject to the mortgage, it was analogous to receiving cash borrowed by the buyer from the mortgagee on a nonrecourse basis and using that cash to pay off their mortgage.[213] The Court thus deemed proper the sellers' full inclusion of nonrecourse debt in amount realized.[214]

In simply equating nonrecourse debt with recourse debt for realization purposes, the *Tufts* court eliminated prior speculation that the *Crane* doctrine was grounded on an "economic benefit theory."[215] A property owner is not

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207. Tufts v. Commissioner, 70 T.C. 756, 763-64 (1978).

208. *Id.* at 763. The Tax Court relied upon Millar v. Commissioner, 577 F.2d 212 (3d Cir.), *cert. denied*, 439 U.S. 1046 (1978), in which the Third Circuit had refused to limit amount realized to value on facts similar to *Tufts*. 70 T.C. at 767.

209. Tufts v. Commissioner, 651 F.2d 1058, 1063 n.9 (5th Cir. 1981), *rev'd* 103 S. Ct. 1826 (1982). For a fuller discussion of the Fifth Circuit's decision, see Comment, *The Resurrection of* Crane's *Footnote 37*, 9 FLA. ST. U.L. REV. 575, 591-97 (1981); Note, *Footnote Thirty-Seven Exception of* Crane, 55 TEMPLE L.Q. 162, 171-78 (1982).

210. The Commissioner's petition to the Fifth Circuit for a rehearing was denied. Commissioner's Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit, Commissioner v. Tufts, 651 F.2d 1058 (1983), *reprinted in* 15 BNA Law Reprints, Tax Series, No. 4 at 1, 7 (1982/83 Term) [hereinafter cited as Cert. Petition]. The Commissioner grounded the petition on three arguments: (1) the circuit court's holding conflicted with that of the Third Circuit in Millar v. Commissioner, 577 F.2d 212 (3d Cir.), *cert. denied*, 439 U.S. 1046 (1978), Cert. Petition, *supra* at 11-13; (2) both the relevant Code provisions (I.R.C. §§ 1001(b), 1011(a), 1012, 1016) (1976)) and the teaching of *Crane* pertaining to basis, dictated equivalent treatment between basis and amount realized, Cert. Petition, *supra* at 13-23; and (3) Congress in discussing the passage of the Tax Reform Act of 1976, had recognized inclusion of full nonrecourse debt in amount realized upon dispositions. *Id.* at 23-24.

211. 103 S. Ct. at 1831.

212. *Id.* at 1831. Viewed as a loan, the proceeds of the nonrecourse mortgage did not constitute income, since the mortgage was accompanied by a corresponding obligation to repay. *Id.*

213. *Id.* at 1834.

214. *Id.*

215. Other theories which had evolved to explain the *Crane* decision include the tax benefit theory and the discharge of indebtedness theory. The tax benefit theory developed from *Crane*'s "double deduction" that because the taxpayer had previously taken depreciation deductions from the property's total value, allowing her to escape inclusion of the nonrecourse debt in amount realized would be tantamount to giving her a double deduction on the same loss. *Id.* The tax benefit theory essentially provided that the taxpayer who had previously enjoyed the benefit of large tax deductions, without placing his own assets at risk,

personally liable for the nonrecourse mortgage, but he nevertheless has a strong incentive to make the payments and thereby avoid foreclosure on his property.[216] Many commentators explained *Crane*'s inclusion of nonrecourse debt in amount realized as a recognition of the economic relief afforded a taxpayer who sells property subject to an outstanding nonrecourse mortgage.[217] This theory would have limited the amount realized upon disposition to the property's value. Otherwise, when the nonrecourse debt exceeded the prop-

had, by taking those deductions, improved his economic position, thus realizing gain. 651 F.2d at 1060. Because this theory appeared to match tax benefits and deductions, confusion arose as to whether the "tax benefit" concept of *Crane* was the same as the traditional tax benefit rule. *See, e.g.*, Bittker, *supra* note 7, at 282; 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, 323-24 (1977); Townsend, *supra* note 143, at 151-53. *Compare* Estate of Delman v. Commissioner, 73 T.C. 15, 30 n.3 (1979) (tax benefit rule is "theoretically" distinct from application of *Crane*, to nonrecourse debt) *with* Tufts v. Commissioner, 651 F.2d 1058, 1060 (5th Cir. 1981), *rev'd on other grounds*, 103 S. Ct. 1826 (1983) (taxpayer defense to *Crane* by application of tax benefit rule) [and] Townsend, *supra* note 143, at 151-53 (*Estate of Delman* decision rested on tax benefit notions, as part of tax benefit rule). The Tax Benefit Rule is a judicially developed principle (with limited congressional sanction, I.R.C. § 111 (1982)), which attempts to incorporate some degree of transactional equivalence threatened by the annual accounting requirement of the Code, *id.* § 446(a), in which the taxpayer receives a benefit for a deduction in one taxable year, which because of some additional benefit received in a subsequent year requires income inclusion in the latter year. Hillsboro Nat'l Bank v. Commissioner, 103 S. Ct. 1134, 1142-44 (1983). For a discussion of the Tax Benefit Rule, see Bittker & Kanner, *The Tax Benefit Rule*, 26 U.C.L.A. L. REV. 265 (1978).

The discharge of indebtedness theory attempted to relate *Crane* to the Supreme Court's decision in United States v. Kirby Lumber Co., 284 U.S. 1 (1931). *Kirby Lumber* noted that, upon discharge of debt, a taxpayer no longer must satisfy that obligation with cash or other assets, and this indirect freeing of assets gives rise to income. *Id.* at 3. Some commentators believed this rationale was or should be the foundation for *Crane*. *E.g.*, Del Cotto, *supra* note 33, at 87; Kaster, *Tax Solutions and SEC Problems for Shaky Real Estate Shelters*, 44 J. TAX'N 146, 147 (1976); Townsend, *supra* note 143, at 145-51. For a discussion of the Discharge of Indebtedness Doctrine, see Bittker & Thompson, *Income from the Discharge of Indebtedness: The Progeny of* United States v. Kirby Lumber Co., 66 CAL. L. REV. 1159 (1978); Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX L. REV. 225 (1959).

216. As the *Crane* court noted, "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." 331 U.S. at 14.

217. *E.g.*, Teitelbaum v. Commissioner, 346 F.2d 266, 269 (7th Cir. 1965); Commissioner v. Fortree Properties, Inc., 211 F.2d 915, 916 (2d Cir. 1954). The Economic Benefit Theory rested upon the reasoning of *Crane* 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. . . . [A]n 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.

331 U.S. at 14 (footnotes omitted). *See Tufts*, 651 F.2d at 1061-62; *Federal Tax Treatment*, *supra* note 5, at 1500-02.

erty's value, the taxpayer's incentive to make payments and avoid foreclosure would be eliminated.[218]

Consistent with *Crane*'s basic precept of symmetry between depreciable basis and amount realized,[219] the *Tufts* court also equated nonrecourse and recourse debt in computing basis.[220] The basis for a purchased asset is its cost to the taxpayer.[221] When a taxpayer purchases an asset with recourse loan proceeds, he includes the loan amount in determining the asset's cost because he has an obligation to repay the loan.[222] The *Tufts* court correspondingly held that when nonrecourse loan proceeds are applied toward an asset's purchase, that loan amount also constitutes part of the asset's cost or basis.[223] Because fair market value is irrelevant in ascertaining the cost of property to a taxpayer who purchases with cash or a recourse loan, it is likewise irrelevant when property is purchased with proceeds of a nonrecourse loan.[224]

In footnote 5, the *Tufts* court acknowledged that *Crane* could have distinguished nonrecourse debt as a "contingent liability" and thus excluded it from basis on the ground that it was not part of the taxpayer's investment, but simply a joint investment by the taxpayer and mortgagee.[225] The Court emphasized, however, that this approach was not adopted in *Crane* or applied in *Tufts*.[226] Because *Crane* treated nonrecourse mortgage as a true loan, a taxpayer's basis includes the full amount of nonrecourse debt, regardless of its contingent nature or whether it exceeds the property's fair market value.[227]

As in *Crane*, the Commissioner initiated and won *Tufts* on the revenue-producing contention that nonrecourse debt should be included in amount realized. Much to the Commissioner's chagrin, the symmetrical treatment of basis and amount realized also dictated that nonrecourse debt be included in depreciable basis. Consequently, *Tufts*' principal impact may be to foster the booming tax shelter industry initiated by *Crane*.[228]

Overthrow of the Contingent Liability and Fair Market Value Defenses

In *Tufts*, the Commissioner contended that the nonrecourse mortgage should be included in amount realized,[229] and the established defenses to in-

218. *See* Tufts v. Commissioner, 651 F.2d at 1962; Bittker, *supra* note 7, at 281; Del Cotto, *supra* note 33, at 85.
219. *See* Crane v. Commissioner, 331 U.S. at 12.
220. 103 S. Ct. at 1831-32.
221. Detroit Edison Co. v. Commissioner, 319 U.S. 98, 102 (1943); I.R.C. § 1012 (1982).
222. *See* 103 S. Ct. at 1831-32.
223. *Id.*
224. *Id.*
225. *Id.* at 1831-32 n.5.
226. *Id.* The Court declined to express views whether such a contingent liability approach would be acceptable or preferable, it only noted that *Crane* was inconsistent with such an approach. *Id.*
227. *Id.* at 1831-32.
228. *See supra* notes 36-41 and accompanying text.
229. Brief for Petitioner, Commissioner v. Tufts, 103 S. Ct. 1826 (1983), *reprinted in* 15 BNA Law Reprints, Tax Series, No. 4 at 1, 61-62 (1982/83 Term).

cludibility in basis should be left intact.[230] The taxpayer countered that the Commissioner's position would result in an asymmetrical treatment of basis and amount realized: the seller would be taxed on the full amount of nonrecourse debt and yet the buyer would receive a cost basis of only the property's fair market value.[231] In response, the IRS agreed that the buyer's cost basis would equal the fair market value. The Commissioner assured the Court that symmetry would nevertheless be maintained because only the amount of debt includible in basis would have to be reported in amount realized on disposition.[232]

At first blush, the IRS's argument appears sound because *Crane*'s symmetry requirement is seemingly met. However, once either the fair market value or contingent liability defense is applied, questions arise as to how much, if any, of the nonrecourse debt should be included in the buyer's basis and when it should be included. Because courts have adopted various answers to these questions, a taxpayer could never be certain of his property's depreciable basis.

For example, in *Estate of Franklin*,[233] the court applied the fair market value defense to deny any depreciation or interest deductions attributable to nonrecourse debt in excess of the property's value.[234] The court expressly declined to decide the impact on basis in subsequent years if the property value increased and revealed a clear equity interest.[235] The court suggested that depreciable basis may be deemed to commence at the date the increments to the purchaser's equity commenced.[236] The court did not explain the tax consequences if the equity interest thereafter began to fall due to a decrease in the property value.

In *Denver & Rio Grande Western Railroad Co. v. United States*,[237] the Court of Claims offered a different solution to the problem of fluctuating basis. The court adopted the contingent liability defense and denied the taxpayer's depreciation deductions.[238] As the taxpayer made actual payments for the property, the basis would be "built up . . . year-by-year."[239]

Yet another means of calculating basis was adopted in *Gibson Products Co.*

230. *Id.* at 65 n.16.

231. Brief for Respondents, Commissioner v. Tufts, 103 S. Ct. 1826 (1983), *reprinted in* 15 BNA Law Reprints, Tax Series, No. 4 at 1, 148-49 (1982/83 Term).

232. Reply Brief for Petitioner, Commissioner v. Tufts, 103 S. Ct. 1826 (1983), *reprinted in* 15 BNA Law Reprints, Tax Series, No. 4 (1982/83 Term) at 1, 162-63. The IRS based this assertion on Treas. Reg. § 1001-2(a)(3) (1980).

233. 544 F.2d 1045 (9th Cir. 1976).

234. *Id.* at 1048-49.

235. *Id.*

236. *Id.* at 1049 n.5. The court in Brannen v. Commissioner, 78 T.C. 471 (1982), also evaded the problem of fluctuating basis associated with the fair market value defense. That court refused to permit depreciation deductions because the property's fair market value did not equal the purchase price including nonrecourse debt. *Id.* at 498-99. In response to the taxpayer's concern regarding symmetry, the court declared that because the loan was not included in basis, "absent a change in circumstances," it would not be included in amount realized upon disposition.

237. 505 F.2d 1266 (Ct. Cl. 1974).

238. *Id.* at 1269-71.

239. *Id.* at 1270.

v. United States.[240] The district court stated that the fair market value defense precluded even increasing basis for the portion of nonrecourse debt up to the property's fair market value.[241] In affirming the district court's result based on the grounds that the debt was not a true loan,[242] the Fifth Circuit approved the district court's interpretation of the fair market value defense.[243] Interestingly, the IRS has interpreted the circuit court's decision as standing for the proposition that when nonrecourse debt exceeds the property's value, it is includible in basis to the extent of the value. *Crane*'s "functional relation" concept is maintained by only including the amount originally included in basis in the amount realized on disposition.[244]

If *Tufts'* facts are applied to these various approaches to excess nonrecourse debt, it becomes clear a taxpayer would never know what his property's depreciable basis may be. In *Tufts,* the third party purchased depreciable property valued at $1,400,000 for $250 cash, taking subject to the nonrecourse mortgage of $1,851,500.[245] Under *Tufts* apparent holding, the taxpayer would have a cost basis of $1,851,750, including the cash and mortgage, for depreciation purposes. The Commissioner took the position in his reply brief that the basis would be $1,400,000, the property's fair market value. However, where the property's value had not been previously stipulated, a purchaser could not be certain of the rule a court would apply. Under *Estate of Franklin,* the court might deny any depreciable basis for the debt until the new property owner acquired equity.[246] The *Denver & Rio Grande* rule might give him an initial basis of $250 for his cash contribution and increase the basis with each cash payment on the debt.[247] The *Gibson Products Co.* decision might also disregard the entire debt even up to the property value.[248]

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240. 460 F. Supp. 1109 (N.D. Tex. 1978), *aff'd,* 637 F.2d 1041 (5th Cir. 1981).

241. *Id.* at 1117 n.10. The district court held that both the contingent liability and fair market value defenses required excluding the nonrecourse loan from basis. *Id.* at 1115.

242. Gibson Prod. Co. v. United States, 637 F.2d 1041, 1045 (5th Cir. 1981).

243. *Id.* at 1045 n.8.

244. Cert. Petition, *supra* note 210, at 18 n.9; Brief for Petitioner, *supra* note 229, at 65 n.16.

The IRS combines the two defenses in a confusing manner in its tax shelter handbook. If the nonrecourse loan amount "greatly exceeds" the property's value, then the entire loan amount is "contingent" and not includible in basis, if the loan is "not contingent," however, an amount equal to the value of the property is includible in basis. Handbook, *supra* note 125, § 3(18)0(2). *But cf.* Rev. Rul. 68-362, 1968-2 C.B. 334 (assuming or taking property subject to a mortgage, in connection with the acquisition of property to which it relates, entitles purchaser to include amount of mortgage in basis "as though the purchaser had paid cash in the amount of the mortgage," citing *Crane*).

245. 103 S. Ct. at 1828.

246. *See supra* text accompanying notes 233-36.

247. *See supra* text accompanying notes 237-39. The fact that some of these decisions did not involve real property is of no consequence to the criticism of the Commissioner's reply argument, since the defenses of Contingent Liability and Fair Market Value have been applied to various types of properties without discrimination. *See* Fox v. Commissioner, 80 T.C. 972, 1019-23 (1983).

248. *See supra* text accompanying notes 240-44. Moreover, on audit, the basis might depend on whether the auditor viewed a $400,000 variance in excess debt as "greatly" exceeding value. *See supra* note 244.

Because a taxpayer's basis cannot be adequately determined when the fair market value or contingent liability defense is applied, elimination of these defenses appears to be a necessary corollary to *Crane*'s rule of symmetry between basis and amount realized. *Tufts*' holding that a nonrecourse mortgage must be treated as a true loan in computing both basis and amount realized, regardless of fair market value, is thus laudably consistent with *Crane*. In fact, a principal reason the *Crane* court held nonrecourse debt includible in basis was to avoid the accounting burden associated with recognizing a fluctuating basis.[249] As both *Estate of Franklin* and *Denver & Rio Grande* reveal, such a basis concept would require basis to be changed with each mortgage payment, and would consequently grant the mortgagor control over the timing of his depreciation allowances. Not only would this result entail great administrative problems, it would also conflict with depreciation principles, since the purpose of depreciation deductions is to account for the consequences of time and use on a taxpayer's capital assets.[250]

Possible Assault on Tax Shelters Notwithstanding Tufts

If indeed *Tufts* has destroyed the contingent liability and fair market value defenses,[251] new means of attacking nonrecourse debt as a taxsheltering device will have to surface.[252] The test apparently established in *Tufts* treats recourse and nonrecourse liabilities alike. Thus a nonrecourse debt, regardless of its amount, the property's fair market value or the terms of payment, is includible in basis.[253] The only arguments available to the Commissioner would be to

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249. 331 U.S. at 10.

250. Detroit Edison Co. v. Commissioner, 319 U.S. 98, 101 (1943).

251. In at least two recent cases, petitions for certiorari were filed after the fair market defense was successfully invoked by the Commissioner on appeal but were denied by the Supreme Court. CRC Corp. v. Commissioner, 693 F.2d 281, 283-84 (3d Cir. 1982), *cert. denied*, 103 S. Ct. 2453 (1983); Brountas v. Commissioner, 692 F.2d 152, 157-58 (1st Cir. 1982), *cert. denied*, 103 S. Ct. 2453 (1983).

252. *Tufts* may have also undermined the effectiveness of ERTA's overvaluation penalty, I.R.C. § 6659, as a means of attacking nonrecourse debt. The statute indicates that a valuation overstatement of adjusted basis occurs when the adjusted basis claimed on the return exceeds 150% of the amount determined to be correct. *Id.* § 6659(c)(1). Under the *Tufts* rationale, however, the inclusion of nonrecourse debt in basis is totaly unrelated to the property's value. An inflated nonrecourse note that bears no conceivable connection to the property's value could consequently be includible in basis without violating the 150% test, thus frustrating the penalty provision. If this is the case, only § 465 of the original four defenses to nonrecourse debt remains available to the Commissioner after *Tufts*. *See supra* text accompanying note 163.

253. The Supreme Court stated that the Commissioner in *Crane* had chosen to accord nonrecourse debt the same treatment as recourse debt. Commissioner v. Tufts, 103 S. Ct. at 1831. Nonrecourse debt differs from recourse debt only in that the mortgagee's remedy for breach is limited to foreclosing on the securing property. This limited remedy does not alter the nature of the obligation, but simply shifts to the mortgagee the risk of loss caused by declining property value. *Id.* at 1833. *Cf.* Rev. Rul. 95, 1953-1 C.B. 162 (whether mortgage indebtedness is assumed or property taken subject to indebtedness, for purposes of depreciation and gain or loss upon sale or disposition, "the mortgage indebtedness is treated in the same manner as cash paid," citing *Crane*).

challenge whether a particular nonrecourse debt is in fact debt, and if so, whether grounds exist for denying loss deductions attributable to the debt.

When particularly flagrant abuses of nonrecourse debt occur, the Commissioner might argue that tax policy precludes treating the nonrecourse liability as debt. In *Hager v. Commissioner*,[254] the court broached the possibility that if a large nonrecourse loan is used to purchase property, but no equity interest is obtained, the sale might be considered a sham and disregarded for federal tax purposes.[255] Because the cases involving sham transactions were or could have been decided under the contingent liability or fair market value defenses,[256] however, the contours of this separate defense are ill-defined. Of particular difficulty is articulating factors that indicate a transaction is actually a "sham." Since *Tufts* declared nonrecourse debt equivalent to recourse debt and unrelated to the property's fair market value, merely looking to the excess liability over value would seem insufficient.[257]

Another approach for attacking the validity of nonrecourse debt as debt is similar to a debt/equity analysis. This approach was suggested in *Gibson Products Co. v. United States*.[258] That case applied both the contingent liability and fair market value defenses[259] to deny deductions attributable to nonrecourse debt. In light of the economics of the transaction, the district court noted that it could also conclude the debt "was not in fact a debt, but an equity interest."[260] The IRS has also taken this stance regarding alleged nonrecourse loans to limited partnerships.[261]

To limit losses, the Commissioner has the clout of the at risk rules to combat the covered activities.[262] Additionally, the Commissioner can use Code section 446(b) to limit loss deductions attributable to nonrecourse debt.[263] This section empowers the Commissioner to deny a present deduction if he believes it does not clearly reflect income.[264] The Supreme Court has in-

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254. 76 T.C. 759 (1981).

255. *Id.* at 775 n.8. *Cf.* Estate of Franklin v. Commissioner, 544 F.2d 1045, 1046 (9th Cir. 1976) (one argument by Commissioner was that acquisition of property was a "sham"). The Commissioner has used *Hager*'s suggested argument in subsequent cases. *E.g.*, Gibson Prod. Co. v. United States, 637 F.2d 1041, 1047 (5th Cir. 1981); Brannen v. Commissioner, 78 T.C. 471, 499 n.5 (1982). *See also* Rev. Rul. 78-30, 1978-1 C.B. 133; Rev. Rul. 77-125, 1977-1 C.B. 130, providing that guarantor, not maker, of nonrecourse loan is entitled to deductions.

256. *See* cases cited *supra* note 255.

257. *E.g.*, Gibson Prod. Co. v. United States, 637 F.2d 1041, 1047 (5th Cir. 1981).

258. 460 F. Supp. 1109, 1119 (N.D. Tex. 1978), *aff'd on other grounds*, 637 F.2d 1041 (5th Cir. 1981). *See also* Backar v. Western States Producing Co., 547 F.2d 876, 880 n.3 (5th Cir. 1977).

259. 460 F. Supp. at 1115.

260. *Id.* at 1119.

261. Rev. Rul. 72-350, 1972-2 C.B. 394; Rev. Rul. 72-135, 1972-1 C.B. 200.

262. *See supra* notes 87-93, 162-66 and accompanying text.

263. I.R.C. § 446(b) provides: "If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income."

264. Treas. Reg. § 1.446-1(a)(2) (1957).

terpreted section 446(b) as giving the Commissioner broad discretion to set aside a taxpayer's method of accounting concerning any item of income or deduction not reflecting income.[265] The Commissioner is increasingly utilizing that section to combat tax shelter abuse, thus laying the groundwork for a major incursion into excessive nonrecourse debt and tax shelters.[266] Section 446(b) has been successfully used to deny deductions for prepaid interest,[267] prepaid cattle feed,[268] and advance fees to a general partner.[269] Because courts have ruled that section 446(b) applies at the partnership level involving partnership property,[270] a direct threat to depreciation and nonrecourse debt exists. Section 446(b) has also been applied to deny depreciation deductions not tied to income flow.[271] Sufficient grounds have thus been provided for the position that partnership depreciation deductions attributable to excessive nonrecourse debt not clearly reflect property income.

Conclusion

The footnote 37 controversy has finally been resolved by the *Tufts* decision. All the grand conjecture and debate has terminated after three and a half decades with a fizzle: a nonrecourse loan is simply a loan, fully includible in amount realized regardless of the fair market value of the securing property. The Commissioner's two major weapons against the tax shelter industry and nonrecourse debt, the fair market value and contingent liability defenses appear to have received a death blow from *Tufts*. The elimination of these defenses will not halt the Commissioner's attack but only refocus it. As he did with the at risk rules, the Commissioner may seek Congressional assistance. The *Tufts* court itself hinted that Congress might statutorily eliminate the equivalence between recourse and nonrecourse debt.[272] In the meantime, the Commissioner may begin to argue that a given transaction involving nonrecourse debt does not involve true debt. Finally, the Commissioner may turn

265. Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542 (1979). *See* RCA Corp v. United States, 664 F.2d 881 (2d Cir. 1981), *cert. denied*, 102 S. Ct. 1958 (1983).

266. *See* Palen, *Tax Shelters After the St. Patrick's Day Massacre: What's Out; What's Left*, 53 J. TAX'N 322, 323-24 (1980). *See also* Handbook, *supra* note 125, at §§ 200, 300, 500, 600.

267. *E.g.*, Ferrill v. Commissioner, 684 F.2d 261, 265 (3d Cir. 1982); Duffy v. United States, 690 F.2d 889, 899 (Ct. Cl. 1982).

268. *E.g.*, Dunn v. United States, 468 F. Supp. 991, 994 (S.D.N.Y. 1979).

269. *E.g.*, Estate of Boyd v. Commissioner, 76 T.C. 646, 667 (1981).

270. *E.g.*, Van Raden v. Commissioner, 71 T.C. 1083, 1103 (1979), *aff'd on other grounds*, 650 F.2d 1046 (9th Cir. 1981); Resnick v. Commissioner, 66 T.C. 74, 81 (1976), *aff'd per curiam*, 555 F.2d 634 (7th Cir. 1977). *Cf.* Brannen v. Commissioner, 78 T.C. 471, 504-05 (1982) (whether activity is trade or business determined at partnership level).

271. *E.g.*, Rev. Rul. 79-285, 1979-2 C.B. 91; Rev. Rul. 78-199, 1978-1 C.B. 66; Rev. Rul. 78-30, 1978-1 C.B. 133. *Cf.* Rev. Rul. 78-30, 1978-1 C.B. 133; Rev. Rul. 77-125, 1977-1 C.B. 130, providing that the guarantor, not the maker, is entitled to deductions on a nonrecourse loan to be satisfied solely from earnings from property.

272. 103 S. Ct. at 1832 n.7.

full attention to his discretionary ace-in-the-hole, section 446(b). Should that occur, *Tufts* may yet become the Commissioner's victory.[273]

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273. Since the *Tufts* decision courts have failed to properly address the impact of its holding equating recourse and nonrecourse loans, or the possible elimination of the fair market value or contingent liabilities defenses. In fact the courts have virtually ignored *Tufts* in continuing to apply the defenses to overturn nonrecourse loans. *E.g.*, Brannen v. Commissioner, 53 A.F.T.R.2d (P-H) 579, 583 n.4 (11th Cir. 1984) (*Tufts* not relevant regarding includibility of nonrecourse loans in basis); Carolina, Clinchfield & Ohio Ry. v. Commissioner, 82 T.C. No. 68, at 3214-15 (1984) (*Tufts* not applicable to contingent liabilities); Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184, 196, 196 n.9 (1983) (*Tufts* limited by fair market value defense); Flowers v. Commissioner, 80 T.C. 914, 943-44 n.44 (1983) (*Tufts* not applicable to unreasonably and artificially inflated amount of nonrecourse indebtedness); Webber v. Commissioner, 47 T.C.M. 32, 53 n.12 (1983) ("the applicability of [the fair market value defense] to tax shelter transactions involving nonrecourse indebtedness has been held by [the Tax Court] to be unaffected by [*Tufts*]").