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Tufts v. Commissioner: Reopening the Pandora's Box of *Crane*'s Footnote 37

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Tufts v. Commissioner: Reopening the Pandora's Box of *Crane*'s Footnote 37

The United States Supreme Court has granted certiorari to the United States Court of Appeals for the Fifth Circuit to determine whether a taxpayer, upon disposition of property, must include the full amount of nonrecourse liability in the "amount realized" when determining gain or loss on the disposition. The author criticizes the Fifth Circuit's reliance on Crane v. Commissioner*'s infamous footnote 37, which intimates that the amount of nonrecourse debt included by a taxpayer in the amount realized should be limited to the fair market value of the property encumbered by the nonrecourse debt. This limitation results in the inconsistent valuation of nonrecourse debt in the unadjusted basis (depreciable base) on acquisition and in the amount realized on disposition.*

I. INTRODUCTION

The Supreme Court indirectly laid the foundation for a variety of tax shelter devices when it held in *Crane v. Commissioner*[1] that the basis of an investment includes the full amount of any nonrecourse debt used to finance the investment. Additionally, the Court held that, upon disposition of the investment, the seller's "amount realized" from the transaction would include the purchaser's assumption of the nonrecourse debt.[2] In footnote 37 to the

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

2. I.R.C. § 1001 prescribes the gain or loss calculation for sales or dispositions of certain assets and provides in part:

(a) **Computation of gain or loss**

The gain from the sale or other disposition of property shall be the excess of opinion, however, the Court remarked that the nonrecourse debt's disposition value might be limited to the underlying investment's fair market value.[3] Footnote 37 raised the possbility of inconsistent valuations of the debt at disposition: The property's adjusted basis would reflect the face value of the nonrecourse debt while the amount realized would be limited to the property's fair market value. Thus, if the property declined in value, a taxpayer possibly could enjoy a taxable loss on the disposition of the asset without investing any money. After *Crane*, a series of decisions in the United States Courts of Appeals and the Tax Court eliminated the opportunity for differing valuations of nonrecourse debt by ignoring footnote 37's fair market value limitation.[4] Recently, however, in *Tufts v. Commissioner*,[5] the United States Court of Appeals for the Fifth Circuit reinstated footnote 37's fair market value limitation.

In 1970, John and Mary Tufts, together with five other partners, formed a general partnership to construct and operate an apartment complex. The partnership financed the project with $1.8 million of nonrecourse debt secured by a mortgage on the property.[6] Adverse economic conditions caused the property's fair market value to decline to $1.4 million while the mortgage principal balance remained at $1.8 million. In 1972, the partners sold their entire partnership interest to an unrelated third party for a nominal sum.[7] The purchaser acquired the property subject to the non-

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> the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.
>
> (b) **Amount realized**
>
> The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

I.R.C. § 1001(a)-(b) (1976). All statutory references are to the Internal Revenue Code of 1954, unless otherwise specified.

3. 331 U.S. at 14 n.37. The footnote states:

> Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.

4. *See infra* notes 34-42 and accompanying text.

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

6. 651 F.2d at 1059.

7. *Id.* The purchaser agreed to pay up to $250 of the costs of the transaction, irrespective of the property's value.

recourse note.[8] All of the partners deducted depreciation in 1970, 1971, and 1972.[9]

Each partner reported a loss on the sale of his partnership interest,[10] theorizing that section 1001 of the Internal Revenue Code required inclusion of the release from a nonrecourse liability in "amount realized" only to the extent of the fair market value of the property securing the note.[11] The Commissioner determined, however, that each partner should have realized the full amount of the nonrecourse debt.[12] The Tax Court ruled for the Commissioner[13] and the taxpayers appealed. The United States Court of Appeals for the Fifth Circuit, *held*, reversed: "[T]he fair market value of the property securing a nonrecourse debt limits the extent to which the debt can be included in the amount realized on disposition of the property."[14] *Tufts v. Commissioner*, 651 F.2d 1058 (5th Cir. 1981), *cert. granted*, 102 S. Ct. 2034 (1982).

The Fifth Circuit framed the ultimate issue narrowly, considering only whether the full amount of the nonrecourse debt should have been included in the amount realized on disposition, irrespective of the debt's effect on the property's basis and subsequent depreciation deductions.[15] This narrow focus caused the court to ignore policy and equity considerations underlying federal tax law. The Fifth Circuit's use of the fair market value limitation allowed the taxpayer to permanently exclude from income certain tax benefits arising from the inclusion for depreciation purposes of the nonrecourse debt in the investment's basis. Moreover, the court arguably reached the wrong result on the narrowly framed issue.[16]

8. *Id.* at 1059.

9. 70 T.C. 756, 760 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981), *cert. granted*, 102 S. Ct. 2034 (1982).

10. The amounts of the losses were not specified. In their petitions to the Tax Court, each partner alleged that he had realized a deductible long-term capital loss in an amount equal to the full amount of his cash basis, and claimed he was entitled to a refund for overpayment of taxes in an amount to be determined by the court. 70 T.C. at 761.

11. 651 F.2d at 1059.

12. *Id.*

13. 70 T.C. at 770.

14. 651 F.2d at 1063.

15. 651 F.2d at 1063 n.9. The court stated that "the following remarks are necessary to put this case in its proper perspective. First, and most important, the precise issue before this court is extremely narrow: whether the tax court properly included the full amount of nonrecourse debt in amount realized." *Id.*

16. The taxpayer made two arguments for limiting the amount realized to the property's fair market value, one based on *Crane*'s footnote 37 and the other based on I.R.C. § 752(c) (1976). On the footnote 37 issue, the Fifth Circuit's decision conflicts with the positions of the Third Circuit, the Tax Court, and the Treasury Department. *See* Millar v. Com-

II. HISTORICAL BACKGROUND

A. Crane v. Commissioner

The Fifth Circuit began its analysis with a review of the landmark case, *Crane v. Commissioner.*[17] In *Crane*, the taxpayer inherited an apartment building and lot encumbered by a mortgage, which provided the sole security for the debt. The face value of the mortgage and accrued interest equaled the property's fair market value; thus, the taxpayer had no equity in the property. The taxpayer held the property for seven years, deducting $25,500 in depreciation, and then sold it for $2,500. The purchaser acquired the property subject to the mortgage. In calculating the gain on disposition, the taxpayer claimed a zero basis in the property, her equity in the project. Accordingly, the taxpayer arrived at a gain of $2,500.[18]

The taxpayer argued that on the date of acquisition her equity in the property was zero because the property's fair market value equaled the outstanding balance of the nonrecourse debt. She further argued that no depreciation deductions should have been allowed because her equity in the property, and therefore her basis, was zero.[19] The Commissioner countered with the argument that the basis and amount realized should reflect the underlying value of the physical property itself, undiminished by the mortgage.

The Supreme Court reviewed both the acquisition and disposition of Mrs. Crane's property. In determining the property's basis

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missioner, 577 F.2d 212 (3d Cir.), *cert. denied*, 439 U.S. 1046 (1978); Estate of Delman v. Commissioner, 73 T.C. 15, 29 (1979); Woodsam Assocs. v. Commissioner, 16 T.C. 649, 655 (1951), *aff'd*, 198 F.2d 357 (2d Cir. 1952); Rev. Rul. 76-111, 1976-1 C.B. 214. Additionally, the Treasury Regulations disagree with, and commentators have criticized on theoretical grounds, footnote 37. *See* Treas. Reg. § 1.1001-2 (1980); Adams, *Exploring the Outer Boundaries of the* Crane *Doctrine; An Imaginary Supreme Court Opinion*, 21 TAX L. REV. 159 (1966); Bittker, *Tax Shelters, Nonrecourse Debt, and the* Crane *Case*, 33 TAX L. REV. 277 (1978); Del Cotto, *Basis and Amount Realized under* Crane: *A Current View of Some Tax Effects in Mortgage Financing*, 118 U. PA. L. REV. 69 (1969); 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, 317-34 (1977); Friedland, Tufts *and* Millar: *Two New Views of the* Crane *Case and Its Famous Footnote*, 57 NOTRE DAME LAW. 510 (1982); Newman, *The Resurgence of Footnote 37:* Tufts v. Commissioner, 18 WAKE FOREST L. REV. 1 (1982). *But see* Pietrovito, Tufts v. Commissioner: *A Limitation on the Inclusion of Nonrecourse Liabilities in Amount Realized*, 11 CAP. U.L. REV. 265 (1981); Comment, Tufts—*The Resurrection of* Crane's *Footnote 37*, 9 FLA. ST. U.L. REV. 575 (1981). For a discussion of the § 752(c) issue, see *infra* text accompanying notes 67-81.

17. 331 U.S. 1 (1947).

18. *Id.* at 3.

19. *Id.* The Court noted Mrs. Crane's inconsistent position. *Id.* at 3 n.2. Its ruling on the basis issue, however, rendered the point moot. *Id.* at 12.

at the date of acquisition, the Court interpreted section 113(a)(5) of the Internal Revenue Code of 1939[20] to require that the property's unadjusted basis equal Mrs. Crane's ownership interest in the total value of the property, undiminished by the mortgage.[21] Under this approach, basis is not predicated on equity and therefore depreciation would be based on the property's total value.[22] In determining the amount realized upon disposition under section 111(b),[23] the Court discerned a functional relationship between sections 111 and 113,[24] and held that "property," as used in the definition of amount realized under section 111(b) also meant the underlying value of the property undiminished by the mortgage.[25]

The Court next considered whether circumstances existed in which the release of a nonrecourse liability would not result in taxable income. The Court began its analysis with the proposition that the release from *recourse* debt would be includable in the amount realized because the taxpayer was the real beneficiary of the "payment."[26] The Court then posited that owners of property subject to nonrecourse mortgages, desiring to avoid foreclosures, would treat nonrecourse mortgages as if they were personal obligations.[27] This congruence of perspective between the two types of

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20. Internal Revenue Code of 1939, ch. 1, § 113(a)(5), 53 Stat. 1, 41 (current version at I.R.C. § 1014 (West 1967 & Supp. 1982)), provided that the basis of property acquired by devise was the fair market value of that property at the date of the decedent's death.

21. The Court advanced several reasons for holding that the word "property" as used in § 113(a)(5) meant the owner's legal rights in the land and buildings undiminished by any mortgages (as opposed to the owner's equity). The Court supported its interpretation by referring to several dictionaries for the word's ordinary usage, prior administrative construction of the section, Congress's differentiation between "property" and "equity" in other parts of the Act, and the implications of an "equity" construction. 331 U.S. at 6-9.

22. *Id.* at 11.

23. Internal Revenue Code of 1939, ch. 1, § 111(b), 53 Stat. 1, 37 (current version at I.R.C. § 1001(b) (1976)).

24. 331 U.S. at 12.

25. *Id.* Even absent the "functional relation" justification, the Court would have defined property as the underlying value of the property free of liens for the same reasons advanced in its § 113 definition. *See supra* note 21.

26. *Id.* at 13 (citing United States v. Hendler, 303 U.S. 564 (1938)). The Court noted that prior case law had "repudiated the notion that there must be an actual receipt by the seller himself of 'money' or 'other property,' in their narrowest senses." *Id.* at 13. The Court did not, however, attempt to classify the release from liability as either "money" or "other property." One possible interpretation of this language is that the Court, by implication, created an additional category of "amount realized"—an economic equivalent of cash which falls somewhere between "money" and "other property." The Fifth Circuit adopted this interpretation in *Tufts*. *See infra* notes 50-51 and accompanying text.

27. "[T]he reality [is] that an owner of property, mortgaged [with nonrecourse debt] 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 (footnote

property owners resulted in equivalent economic realities and therefore mandated equal treatment of recourse and nonrecourse liabilities. Given this concern for the reality of the situation, the Court concluded that when a taxpayer sells property subject to nonrecourse debt and receives additional consideration, he "realizes a benefit in the amount of the mortgage as well as the boot.[37]"[28]

This extension of tax liability to nonrecourse debt cancellation was founded on an economic benefit theory. Footnote 37, which limited the debt cancellation benefit when the debt exceeded the property's fair market value, became a logically necessary corollary to the Court's economic benefit theory because the release from "liability" on a nonrecourse obligation could never be worth more to a seller than the underlying value of the property. Thus, footnote 37 was an important element of the Court's theoretical position, although unnecessary to a resolution of Mrs. Crane's case.

The Court also addressed Mrs. Crane's alternative argument: The sixteenth amendment[29] does not encompass "income" from the cancellation of nonrecourse debt. Dismissing the taxpayer's contention that the transaction was a ruinous disaster[30] because it resulted in a tax liability in excess of her cash receipt on the sale, the Court stated that the taxpayer had received a tax benefit by including the debt in her basis for depreciation purposes.[31] Because the sixteenth amendment does not require the actual receipt of cash,[32] the transaction was taxable.[33]

B. *Lower Court Decisions*

There have been no post-*Crane* Supreme Court cases on the issue of "amount realized" from the sale or disposition of property subject to nonrecourse debt. Both the Tax Court and the United

omitted).

28. *Id.* For the text of footnote 37, see *supra* note 3. Boot is necessary because it shows that the value of the property is greater than the lien. *See* Parker v. Delaney, 186 F.2d 455, 458 (1st Cir. 1950).

29. U.S. CONST. amend. XVI.

30. Professor Bittker empathized with Mrs. Crane's argument, remarking that "the idea that investors benefit when they are 'relieved' of nonrecourse debt" is "counter-intuitive." Bittker, *supra* note 16, at 277.

31. 331 U.S. at 15. The Court noted on this point that "[t]he crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain." *Id.* (footnote omitted).

32. *Id.*

33. *Id.* at 16.

States Courts of Appeals have, however, examined the issue and eschewed adherence to footnote 37.[34] Three years after *Crane*, the United States Court of Appeals for the First Circuit had the first opportunity to review the *Crane* rule and footnote 37 in *Parker v. Delaney*.[35] In *Parker*, the mortgagee foreclosed on the taxpayer's property. The taxpayer was not personally liable for the debt and received no boot. The court found that boot was not an absolute requirement for application of the *Crane* rule,[36] but served only as evidence that the value of the property was at least equal to the liens on the property.[37] Accordingly, the court applied the *Crane* rule and held that the amount realized upon disposition included the amount of the nonrecourse mortgages, despite the absence of boot. In response to the taxpayer's contention that the property's value was less than the lien and, as a result, *Crane*'s footnote 37 controlled, the First Circuit rested its opinion on the district court's finding that the two values were equal absent any factual basis for concluding otherwise. Thus, the court avoided the harder question of whether it would follow footnote 37.[38]

In a relatively recent case, *Millar v. Commissioner*,[39] the United States Court of Appeals for the Third Circuit directly faced a fact pattern that fell within the bounds of *Crane*'s footnote 37. In *Millar*, the taxpayers transferred stock securing nonrecourse loans in complete satisfaction of their obligations. The value of the stock was less than the outstanding balance on the notes. The taxpayers argued that the amount realized should be limited to the stock's

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34. *See supra* note 16.

35. 186 F.2d 455 (1st Cir. 1950).

36. In *Crane* the Court stated, "[A] different problem *might* be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case." 331 U.S. at 14 n.37 (emphasis added).

37. 186 F.2d at 458.

38. Although the First Circuit did not decide this issue, the court's response to both the boot and fair market value issues indicates that it considered *Crane*'s footnote 37 as prescribing guidelines for future decisions.

In Woodsam Assocs. v. Commissioner, 198 F.2d 357 (2d Cir. 1952), the United States Court of Appeals for the Second Circuit agreed with the result in *Parker*. In *Woodsam*, a mortgagee foreclosed on the taxpayer corporation's property, which was subject to nonrecourse debt. The "amount realized" issue was ancillary to the real question before the court: What was the actual basis of the property? Initially, the taxpayer requested a finding that the value of the property was less than the principal due on the mortgage, bringing the "amount realized" determination within the ambit of *Crane*'s footnote 37. The taxpayer, however, withdrew on this issue—a decision the Second Circuit noted with approval, citing *Parker v. Delaney*. *Id.* at 358 n.1. It is unclear whether the Second Circuit rejected the fair market value limitation of footnote 37 or merely noted that it would be unwilling to find a market value below the loan value on the facts of the case.

39. 577 F.2d 212 (3d Cir.), *cert. denied*, 439 U.S. 1046 (1978).

fair market value pursuant to footnote 37. The Third Circuit, however, rejected the taxpayers' contention that footnote 37 provided a limited exception to the *Crane* rule, and instead regarded the footnote as dictum.[40] The Third Circuit read *Crane* as holding that when taxpayers use debt to increase their depreciable basis, they must also include the unpaid portion of that debt in the amount realized. This holding used a "tax benefit"[41] rationale and came from language used by the *Crane* Court in response to the taxpayer's sixteenth amendment argument: "The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain. We have already showed that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets."[42]

III. *Tufts v. Commissioner*

A. *Footnote 37 Argument*

In *Tufts v. Commissioner*,[43] the Tax Court, relying on *Millar*, thought that *Crane*'s footnote 37 was dictum.[44] On appeal, the United States Court of Appeals for the Fifth Circuit reversed the Tax Court. After analyzing the reasons underlying the *Crane* decision, the Fifth Circuit concluded that the fair market value limitation of *Crane*'s footnote 37 should control.[45] According to the court, *Millar*'s rejection of footnote 37 stemmed from erroneously reading the *Crane* decision as resting on a tax benefit theory.[46] The Fifth Circuit concluded that the Supreme Court's concern for double deductions was unnecessary to the *Crane* decision because the Court already had decided the "amount realized" issue prior to its "double deduction" discussion. The Fifth Circuit chose to regard "this expression of concern as primarily a response to Mrs. Crane's constitutional argument, and not as the principal justifica-

40. *Id.* at 215. The court went on to characterize the footnote as "a postulate or hypothetical observation with respect to a hypothetical set of facts not before the Court and, indeed, involving a clearly different time and clearly different legal circumstances." *Id.*

41. In *Tufts*, the Fifth Circuit characterized the tax benefit theory in *Crane* as "the argument . . . that a taxpayer who has previously enjoyed the benefit of large tax deductions, without placing his own assets at risk, has, by taking those deductions, improved his economic position, thus realizing gain." 651 F.2d at 1060.

42. 331 U.S. at 15-16 (footnote omitted).

43. 70 T.C. 756 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981), *cert. granted*, 102 S. Ct. 2034 (1981).

44. *Id.* at 764-66; *see also* Estate of Delman v. Commissioner, 73 T.C. 15, 29 (1979).

45. 651 F.2d at 1060.

46. *Id*; *see supra* text accompanying notes 41-42.

tion for the statutory holding."[47] The court added that the *Crane* Court's concern for double deductions was irrelevant to the "amount realized" determination because the adjusted basis calculation already reflected depreciation deductions.[48]

The Fifth Circuit read *Crane* as holding that the receipt of an economic benefit provided the conceptual foundation for gain realization under section 1001(b),[49] with the release from a nonrecourse liability being such an economic benefit. Because section 1001(b)'s existing categories—"money" and "property (other than money)"—do not encompass the release from a nonrecourse liability, the Fifth Circuit perceived the necessity for expanding the definition of "amount realized" to include a third category—cash equivalents.[50] Since cash equivalents are not subject to the fair market value limitation imposed on "property (other than money)" in section 1001(b), theoretical consistency within the economic benefit theory requires an express fair market value limitation on cash equivalents.[51] Footnote 37, providing that limitation, became a necessary corollary to the *Crane* economic benefit theory.

After determining footnote 37's purpose, the Fifth Circuit then criticized the economic benefit theory itself. The court questioned the Supreme Court's premise that "an owner of property, mortgaged at a figure less than that at which the property will sell,

47. 651 F.2d at 1060.

48. *Id.* at 1061.

49. "When we look to what the Court said immediately before it announced its conclusion that the Commissioner had properly determined the amount realized, we see that the Court justified its result on a theory of economic benefit . . . ." *Id.*

50. The Fifth Circuit stated, without citation, that "[t]he Supreme Court has held that the definition [of amount realized] can be expanded where an economic benefit equivalent to cash can be identified." *Id.* at 1064 n.9. Perhaps the court was referring to the Supreme Court's assertion that "[t]he cases so deciding have already repudiated the notion that there must be an actual receipt by the seller himself of 'money' or 'other property,' in their narrowest senses." 331 U.S. at 13. It is arguable whether *Crane* carved out a new category or whether the Court merely noted that existing categories would be construed liberally. Judge Williams, concurring in *Tufts*, preferred to characterize the cash equivalency benefit as "property (other than money)," in conformity with Judge Learned Hand's opinion for the Second Circuit in Commissioner v. Crane, 153 F.2d 504, 505 (2d Cir. 1945), *aff'd*, 331 U.S. 1 (1947). Judge Williams noted that "the Supreme Court expressly avoided characterizing the taxable economic benefit . . . as either money or property . . . ." 651 F.2d at 1065 (Williams, J., concurring) (citation omitted).

51. One cannot benefit economically from the disposition of an asset beyond the fair market value of the consideration received in exchange; therefore, amounts realized pursuant to § 1001(b) must be limited to the fair market value of the consideration. The nominal value of "money," the first category of § 1001(b), is its market value because money is the medium of exchange in a market. "Property (other than money)," the second category, has an explicit fair market value limitation. Concomitantly, "cash equivalents," the third category, must be limited to their fair market values.

must and will treat the conditions of the mortgage exactly as if they were his personal obligations."[52] According to the court, the premise lost its validity as soon as the property owner decided to dispose of the property, as did both Mrs. Crane and the Tufts:

> Relief from a nonrecourse debt is not an economic benefit if it can be obtained only by giving up the mortgaged property. It is analogous to the relief one obtains from local real property taxes by disposing of the property. Like nonrecourse debt, the taxes must be paid to retain the property; but no one would suggest that the disposition of unprofitable property produces an economic benefit equal to the present value of the taxes that will not be paid in the future.[53]

Accordingly, the Fifth Circuit concluded that if the taxpayer received any benefit, the benefit received probably was less than the full amount of the nonrecourse debt.[54] The court made no attempt to measure the benefit, other than to note that a *Crane*-type seller would receive "some" benefit along with the boot, because a purchaser had to pay off the mortgage or at least be willing to take the property subject to the mortgage before the seller could realize the boot.[55]

Having discarded the economic benefit theory as theoretically unsound, the court limited *Crane* to its facts, and then summarily applied the fair market value limitation of footnote 37.[56] Relying

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52. 651 F.2d at 1062 (quoting Crane v. Commissioner, 331 U.S. 1, 14 (1947) (footnote omitted)).

53. 651 F.2d at 1062 (quoting Bittker, *Tax Shelters, Nonrecourse Debt, and the* Crane *Case*, 33 TAX L. REV. 277, 282 (1978)). Although it has been suggested that a taxpayer's desire to maintain his financial reputation may constrain him from "walking away" from a nonrecourse obligation, the taxpayer confronts no real legal impediment.

54. 651 F.2d at 1064 n.9.

55. *Id.* at 1063.

56. *Id.* Judge Williams, in his concurring opinion, criticized the majority's treatment of *Crane* because he regarded *Crane* as controlling law. Footnote 37 did not enter into his analysis of the § 1001 issue.

Judge Williams began with the premise that *Crane* mandated equal treatment of recourse and nonrecourse debt for § 1001 purposes. Citing United States v. Kirby Lumber Co., 248 U.S. 1 (1931), Judge Williams noted that the freeing of assets theory treats the release of recourse debt as "property (other than money)." Accordingly, the release of nonrecourse debt must also be treated as "property (other than money)" subject to the fair market value limitation. 651 F.2d at 1063-66 (Williams, J., concurring).

Judge Williams's premise that *Crane* mandated equal treatment of recourse and nonrecourse liabilities in the *Tufts* situation is open to question. *Crane* equated recourse debt with nonrecourse debt when "reality" dictated that an owner of property subject to a nonrecourse mortgage treat the conditions of the mortgage as if they were personal obligations. Specifically, the Court referred to situations in which the property carried a mortgage lower than its fair market value. 331 U.S. at 14. In *Tufts*, the face value of the mortgage exceeded on footnote 37, however, undermines horizontal tax equity because, in determining the amount realized upon the disposition of property, nonrecourse debtors may value the debt at the property's fair market value while recourse debtors must account for the total outstanding balance of their debt as either amount realized or, in certain cases, as a combination of amount realized and cancellation of indebtedness.[57] Additionally, *Tufts* results in the inconsistent valuation of nonrecourse debt by allowing the inclusion of the total value of the debt in the property's depreciable base (unadjusted basis) while requiring that the amount realized include the debt only to the extent of the fair market value of the underlying property. This inconsistent valuation stems from the court's focus solely on the disposition event. By not viewing the transaction as a whole—from acquisition through disposition—the Fifth Circuit was unable to arrive at an equitable and internally consistent result. Moreover, the narrow focus allowed the court to avoid presenting a theoretical justification for the application of footnote 37 within the overall taxation scheme. The rejection of the tax benefit and economic benefit theories, coupled with the Fifth Circuit's failure to provide an alternative framework for future decisions, is the most questionable aspect of *Tufts*.

The Fifth Circuit ignored two theoretically sound methods of accounting for *Tufts*-type transactions. Either the method advanced by the IRS or a retroactive purchase price readjustment (PPR method) would have yielded sound tax results. Under the IRS method, the outstanding balance of the nonrecourse debt at disposition is included in the basis and amount realized. The PPR method differs from the IRS method in that the fair market value of the property at disposition controls both the basis and amount realized. Both methods result in the consistent valuation of the nonrecourse debt in an asset's basis and in the amount realized.

The following example illustrates the different results attained under the *Tufts*, IRS, and PPR methods: Assume that real property is purchased for $1.8 million and financed with nonrecourse debt. After five years the owner reconveys the real property to the creditor because its value has dwindled to $1.4 million. During the period of ownership, the owner deducted depreciation using the straight-line method and did not make any principal payments on the nonrecourse debt.

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its fair market value.

57. *See* Treas. Reg. § 1.1001-2 (1980).

ILLUSTRATION
(*Dollars in Thousands*)

	Tufts	IRS	PPR
Amount realized	$ 1,400	$ 1,800	$ 1,400
Adjusted basis[58]	1,350	1,350	1,050
Capital Gain	$ 50	$ 450	$ 350
Ordinary Income	—	—	100
Total Gain	$ 50	$ 450	$ 450

The $100,000 difference in capital gain between the IRS and PPR methods is the amount of the depreciation adjustment.[59] Under the PPR method, this amount will be "recaptured" as ordinary income, equalizing the total gain recognized under both methods. The separation of gain into ordinary income and capital gain components is not new to tax law.[60]

The depreciation adjustment necessary under the PPR method lessens an abuse inherent in nonrecourse debt financing—an inflated purchase price giving rise to increased depreciation deductions. The PPR method also eliminates the possibility raised by the IRS method of converting excess depreciation deductions into capital gains.[61] Thus, under the PPR method, a taxpayer has no incentive to overvalue an asset at acquisition. Additionally, the PPR method comports with the statutory scheme of section 752.

B. *Section 752 Argument*

1. GENERALLY

The taxpayers in *Tufts* also argued that section 752 of the In-

58. Under the *Tufts* and IRS methods, the adjusted basis would be computed as follows: $1,800 - ($1,800/20 yrs. x 5 yrs.) = $1,350. Under the PPR method, the computation changes to: $1,400 - ($1,400/20 yrs. x 5 yrs.) = $1,050. Because the PPR method's amount realized only includes the fair market value of the asset at the date of disposition, consistency requires that the basis be readjusted *ab initio* which, accordingly, necessitates a depreciation readjustment. The basis reflects depreciation computed on a readjusted acquisition cost of $1,400.

59. ($1,800/20 x 5 yrs.) - ($1,400/20 x 5 yrs.) = $100.

60. *See* I.R.C. §§ 1245, 1250 (1976 & Supp. IV 1980).

61. One problem with the PPR method as proposed is that the statute of limitations may bar an adjustment to depreciation. *See* I.R.C. § 6501(a) (1976). An alternative application of the PPR method, however, obviates this problem: the property's adjusted basis is reduced by its decrease in value. In our example, the gain still would be $450,000: ($1,400 - [$1,350 - $400] = $450). The gain is not, however, separated into components.

ternal Revenue Code[62] limited the amount realized from the release from a nonrecourse "liability" to the fair market value of the property. The Tax Court and the Fifth Circuit approached the section 752 issue by considering whether subsection (d), which governs the sale or exchange of a partnership interest, operates independently of subsection (c), which has been characterized as a codification of *Crane*'s footnote 37.[63] The Fifth Circuit, reversing the Tax Court, stated that section 752(c) limited the amount realized from the taxpayers' disposition of their partnership interest to the fair market value of the property securing the debt.[64] As a matter of statutory construction, the Fifth Circuit correctly interpreted the interplay between subsections (c) and (d).[65] However, a decision for the taxpayer under section 752(c) without reference to section 752(b) creates the same inconsistency in valuation that followed from the Fifth Circuit's holding on the section 1001 issue.[66]

2. SUBSECTIONS (c) AND (d)

Subsection (d) prescribes the treatment of liabilities on the sale or exchange of partnership interests and directs that partnership liabilities be treated like nonpartnership liabilities. Subsection

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62. I.R.C. § 752 (1976) provides:

§ 752. **Treatment of certain liabilities**

(a) Increase in partner's liabilities

Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

(b) Decrease in partner's liabilities

Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

(c) Liability to which property is subject

For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property.

(d) Sale or exchange of an interest

In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.

63. *See* W. McKee, W. Nelson & R. Whitmore, Federal Taxation of Partnerships and Partners ¶ 7.04 n.43 (1977) [hereinafter cited as McKee]; Perry, *Limited Partnerships and Tax Shelters: The* Crane *Rule Goes Public*, 27 Tax L. Rev. 525, 542 (1972).

64. 651 F.2d at 1063 n.8.

65. *See infra* notes 67-81 and accompanying text.

66. *See infra* note 82-83 and accompanying text.

(c) places a fair market value limitation on liabilities and is introduced by the words "[f]or purposes of this section."[67]

Although the Tax Court recognized that subsection (c)'s introduction explicitly states that the fair market value limitation applies to all of section 752,[68] it stated that "such interpretation would be inconsistent with the language of section 752(d) and the rationale for the holding of *Crane*."[69] The Tax Court reviewed section 752's legislative history and found "that the fair market value limitation of subsection (c) was intended to have narrow applicability."[70] The Fifth Circuit, however, did not believe that an in-depth examination of the statute's legislative history was necessary.[71]

The House and Senate Committee Reports explaining section 752 open with a discussion of transfers between partners and partnerships to which subsections (a) and (b) apply,[72] and note that "[t]he transfer of property subject to a liability by a partner to a partnership, or by the partnership to a partner, shall, to the extent of the fair market value of such property, be considered a transfer of the amount of the liability along with the property."[73] The Tax Court interpreted this statement as indicating "that in setting forth the fair market value limitation, Congress had in mind only [subsection (a) and (b)] situations . . . ."[74] This interpretation

67. I.R.C. § 752(c) (1976).

68. "[T]he language of section 752 is broad enough to support the [taxpayer's] interpretation . . . ." 70 T.C. at 768.

69. *Id.*

70. *Id.* at 767.

71. It is arguable whether subsection (d), on its face, so clearly conflicts with subsection (c)'s fair market value limitation that it renders the "[f]or purposes of this section" language ambiguous and therefore subject to further inquiry. One can criticize the Fifth Circuit, however, for an overly formalistic analysis when it halted its examination after the subsection (c) review and did not examine the potential ambiguity arising from subsection (d): "Obviously, our holding [on § 752(c)] extinguishes any conflict that the Commissioner might see in the provisions of § 752." 651 F.2d at 1063 n.8. As the textual discussion following this footnote indicates, whether § 752's legislative history and interpretive regulations express a congressional intent to have subsection (d) operate independently of subsection (c) is an open question.

72. "Frequently, a partner will assume partnership liabilities or a partnership will assume a partner's liabilities . . . . The provisions of this section prescribe the treatment for such transferred liabilities." H.R. REP. No. 1337, 83d Cong., 2d Sess. A236, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4017, 4376 [hereinafter cited as HOUSE REPORT]; S. REP. No. 1622, 83d Cong., 2d Sess. 405, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 5047 [hereinafter cited as SENATE REPORT]. The two committee reports are identical except for a brief introductory remark by the Senate Committee.

73. HOUSE REPORT, *supra* note 72, at A236; SENATE REPORT, *supra* note 72, at 405.

74. 70 T.C. at 768. The Tax Court made a similar argument using the Treasury Regulations. Section 1.752-1(c) of the regulations provides in part:

arises from a negative implication; any inferences beyond the committees' actual words are speculative.[75]

The Tax Court also quoted from the committee reports in its discussion of subsection (d): "When a partnership interest is sold or exchanged, *the general rule for the treatment of the sale or exchange of property subject to liabilities will be applied.*"[76] The Tax Court drew another negative inference from the committees' failure to mention a fair market value limitation[77] and assumed that the general rule for determining "amount realized" required inclusion of the full amount of a nonrecourse liability, irrespective of the property's fair market value.[78] The court cited *Millar* and *Woodsam* for this rule.[79] The committee reports, however, were written before *Millar* had been decided, and *Woodsam* did not embrace a factual situation in which a nonrecourse liability exceeded the property's fair market value.[80] Several commentators have surmised that Congress enacted section 752 to extend the *Crane* doctrine to the partnership arena, with subsection (c) codifying footnote 37.[81] This latter interpretation leads to the conclusion that Congress intended the fair market value limitation to apply also to partnership transactions.

Section 752's legislative history does not clearly indicate whether subsection (d) should operate independently of subsection (c). Therefore, based on statutory construction, section 752(c)'s all-inclusive introductory language justifies the Fifth Circuit's conclusion on this issue.

> (c) *Liability to which property is subject.* Where property subject to a liability is contributed by a partner to a partnership, or distributed by a partnership to a partner, the amount of the liability, to an extent not exceeding the fair market value of the property at the time of the contribution or distribution, shall be considered as a liability assumed by the transferee.

Treas. Reg. § 1.752-1(c) (1956).

75. A counterargument could be made that the committees' failure in the reports to expressly exclude subsection (d) from subsection (c)'s all-inclusive introductory clause manifested the committees' satisfaction with the plain language of the statute.

76. 70 T.C. at 768 (quoting HOUSE REPORT, *supra* note 72, at A236-37, and SENATE REPORT, *supra* note 72, at 405) (emphasis in original)). The committees' language appears within an illustrative example in which the fair market value exceeds the amount of the liability—a *Crane*-type fact pattern. No reference is made to a footnote 37 situation.

77. 70 T.C. at 768.

78. *Id.*

79. *Id.*

80. *See supra* notes 38-42 and accompanying text.

81. *See supra* note 63.

3. SUBSECTION (b)

Section 752(b) eliminates the possibility of inconsistent valuations of nonrecourse debt. Subsection (b) in conjunction with subsection (c) requires a reduction of the taxpayer's basis in the partnership whenever the fair market value of the asset falls below the amount of the nonrecourse liability, because section 752(c) limits the value of the liability to the property's fair market value. Section 752(c)'s fair market value limitation necessitates a constructive distribution under subsection (b), resulting in a reduction of a partner's basis in his partnership interest.[82] Thus, on disposition, the nonrecourse debt would reflect the same value—the fair market value of the property as prescribed by subsection (c)—in both the adjusted basis and the amount realized. This reduction in the adjusted basis and in the amount realized is consistent with the PPR method's basis readjustment.[83]

IV. CONCLUSION

Tufts v. Commissioner allows a taxpayer to enjoy the tax benefit arising from the use of nonrecourse debt without an offsetting tax detriment following the release from this nonrecourse "obligation." The creation of this potential tax abuse renders the *Tufts* result difficult to accept.[84] The Fifth Circuit's holding on the section 1001(b) issue reopens the footnote 37 Pandora's box to all who dispose of real property subject to nonrecourse debt.[85] Additionally, the court erroneously resolved the section 752 issue by failing to revalue the nonrecourse liability in the partnership basis pursuant to section 752(b). A proper result can only be achieved by valu-

82. *See, e.g.*, McKEE, *supra* note 63, ¶ 7.04[2] n.45:

> Any liability which the owner of property is permitted to include in basis should also be included in the amount realized on disposition of the property, in order to accurately reflect gain on the disposition. *To the extent this result is not dictated by § § 752(c) and 752(d)*, upon the sale of a partnership interest, it may be achieved in the form of a constructive distribution under § 752(b).

(emphasis added).

83. *See supra* notes 58-61 and accompanying text.

84. The Fifth Circuit acknowledged the potential for abuse resulting from its decision. The court indicated, however, that the responsibility for remedial action lies with Congress. 651 F.2d at 1064 n.9.

85. The Fifth Circuit's holding would not be applicable outside of the real estate context because of § 465's "at risk" limitation. I.R.C. § 465 (1976 & Supp. V 1981).

ing a nonrecourse liability consistently in both the adjusted basis of an asset and in the amount realized upon its disposition.

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