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CRANE'S FOOTNOTE 37 LAID TO REST

*Commissioner v. Tufts*¹

The question of whether the amount realized on the sale of real property includes the full amount of nonrecourse debt² when the mortgage debt exceeds the fair market value of the property has plagued tax practitioners since the Supreme Court's decision in *Crane v. Commissioner*.³ In *Crane*, the Court held that nonrecourse debt must be included in the amount realized from the sale of real property subject to such debt.⁴ The mortgage debt in *Crane* was less than the fair market value of the property.⁵ Footnote 37 suggested, however, that if the fair market value of the property was less than the amount of the nonrecourse debt, then the amount realized might be limited to the property's fair market value if the taxpayer received no boot⁶ on the disposition of the property.⁷

Many commentators have criticized footnote 37 on the grounds that if taxpayers are not always required to include the full amount of nonrecourse debt in the amount realized upon disposition, there would be an enormous potential for tax shelter abuse.⁸ This problem was created by the *Crane* hold-

1. 103 S. Ct. 1826 (1983).

2. A nonrecourse debtor is not personally liable on the debt; the property is the principal debtor. Such an *in rem* transaction can occur if the note and mortgage exempt the mortgagor from personal liability, or if the mortgagor with personal liability conveys the property to a person who takes subject to the mortgage and releases the mortgagor from personal liability. See Dailey & Gaffney, *Anatomy of a Real Estate Tax Shelter: The Tax Reform Scalpel*, 55 TAXES 127, 139 (1977). See generally R. KRATOVIL & R. WERNER, *MODERN MORTGAGE LAW AND PRACTICE* 148-50 (2d ed. 1981).

3. 331 U.S. 1 (1947).

4. *Id.* at 13; see notes 22-32 and accompanying text *infra*.

5. 331 U.S. at 11-12.

6. In this context, 'boot means cash or other consideration used to balance an exchange. See BLACK'S LAW DICTIONARY 166 (rev. 5th ed. 1979). Under the Code, "boot" generally refers to property exchanged that does not qualify under a non-recognition provision. See, e.g., I.R.C. § 1031(b) (1982).

7. 331 U.S. at 14 n.37:

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

8. See, e.g., Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane Case*, 33 TAX L. REV. 277, 284 (1978); Note, *Federal Income Tax Treatment of Nonrecourse Debt*, 82 COLUM. L. REV. 1498, 1503 (1982); Comment, Tufts—*The Resurrection of*

ing, which requires that nonrecourse debt be included in the basis of property acquired with the proceeds of such a loan, thus allowing depreciation deductions on the amount of the debt to be used to offset other income.⁹

As long as the full amount of the nonrecourse debt is included in the amount realized from the sale, there is no tax shelter abuse. This inclusion "recaptures" the benefits received by the taxpayer from being allowed to depreciate the amount of the debt. Abuse does result where the nonrecourse debt exceeds the fair market value of the property and the amount realized from the disposition of the property is limited to its fair market value. The taxpayer has been allowed the benefit of depreciation deductions on the full amount of the nonrecourse debt and must "recapture" only that portion of the nonrecourse debt as does not exceed the fair market value of the encumbered property.

In *Commissioner v. Tufts*,¹⁰ the Supreme Court firmly rejected the footnote 37 implication and held that the fair market value of the underlying property was irrelevant in determining the amount realized on the disposition of such property.¹¹ *Tufts* renders an end to over thirty years of confusion concerning *Crane* and will have an important impact in partnership taxation and tax shelter planning.

In August, 1970, Tufts joined a general partnership. The partnership had received a \$1,851,500 nonrecourse loan, with which it constructed an apartment complex. Due to poor economic conditions, the complex generated insufficient income for the partnership to pay any of the principal due on the debt.¹² In August, 1972, when the fair market value¹³ of the property did not

Crane's Footnote 37, 9 FLA. ST. U.L. REV. 575, 579 (1981). Although the potential for abuse was recognized by the court of appeals in *Tufts*, the majority felt that any correction should come from legislative action, rather than through extending *Crane*, a decision they had "serious reservations about." *Tufts v. Commissioner*, 651 F.2d 1058, 1063-64 & n.9 (5th Cir. 1982), *rev'd*, 103 S. Ct. 1826 (1983).

If non-recourse mortgages contribute to the basis of property, then they must be included in the amount realized on its sale. Any other course would render the concept of basis nonsensical by permitting sellers of mortgaged property to register large tax losses stemming from an inflated basis and a diminished realization of gain. It would also permit depreciation deductions in excess of a property holder's real investment which could never be subsequently recaptured.

Estate of Levine v. Commissioner, 634 F.2d 12, 15 (2d Cir. 1980) (Friendly, J.).

9. *Crane*, 331 U.S. at 11. See generally Newman, *The Resurgence of Footnote 37: Tufts v. Commissioner*, 16 TAX NOTES 803, 804 (1982); Comment, *Contra Tufts: The Case Against the Fair Market Value Limitation on Amount Realized*, 14 PAC. L.J. 79, 84-87 (1982).

10. 103 S. Ct. 1826 (1983).

11. *Id.* at 1836.

12. *Id.* at 1828-29.

13. Fair market value is "the price at which . . . property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." Treas. Reg. § 25.2512-1 (1983).

exceed \$1,400,000, each partner sold his interest in the partnership¹⁴ to an unrelated third party, who received the apartment complex subject to the nonrecourse liability of \$1,851,500. Each partner reported the sale on his individual income tax return for 1972, including the full amount of the nonrecourse debt in the complex basis. Thus, each had been using that amount in the computation of depreciation expense deductions. All indicated that a loss had been suffered on the transaction.¹⁵ They argued that in determining the amount realized on the sale, the nonrecourse liability could only be included to the extent of the fair market value of the underlying property.¹⁶

The Internal Revenue Service (IRS) did not dispute the inclusion of the full amount of the nonrecourse debt in the basis of the partnership interest. The IRS did, however, include the full amount of the debt in the amount realized on the sale,¹⁷ which resulted in a taxable gain on each partner's proportionate share of his interest in the partnership.¹⁸ The Tax Court agreed with the IRS and ruled that the full amount of nonrecourse debt was includable in the amount realized on the sales, even though the debt exceeded the fair market value of the property.¹⁹ The United States Court of Appeals for the Fifth Circuit reversed and held that the amount realized by the taxpayer was limited to the fair market value of the property securing the nonrecourse debt.²⁰ The Supreme Court reversed, holding that the fair market value of the underlying property was irrelevant and that the full amount of the outstanding nonrecourse liability should be included in determining the amount realized.²¹

An analysis of the issues in *Tufts* must begin with *Crane*. Mrs. Crane inherited an apartment building that was subject to a nonrecourse mortgage equal to the fair market value of the property. She held the property for several years and included the full amount of the mortgage in calculating depreciation expense deductions. Upon sale of the property, she reported a realized gain of \$2,500, the net amount of cash she had received from the buyer.²²

14. The gain from a sale or exchange of an interest in a partnership is treated like the gain or loss from a sale or exchange of a capital asset, unless unrealized receivables or substantially appreciated inventory is involved. I.R.C. § 741 (1982).

15. *Id.* § 1001(a) provides that the loss from the sale of property shall be the excess of the adjusted basis provided in *id.* § 1011 for determining loss over the amount realized. *Id.* § 1001(b) defines "amount realized" as the sum of any money received plus the fair market value of the property (other than money) received.

16. *Commissioner v. Tufts*, 70 T.C. 756, 763 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. 1981), *rev'd*, 103 S. Ct. 1826 (1983).

17. 70 T.C. at 762.

18. *Id.* at 761.

19. *Id.* at 770.

20. 651 F.2d at 1063. The court found that: (1) the taxpayers did not receive an economic benefit in excess of the property's fair market value, *id.* at 1062; (2) the concepts of adjusted basis and amount realized are not related, *id.* at 1064 n.9; and (3) I.R.C. § 752 (1982) limits the amount realized to the property's fair market value, *id.* at 1063 n.8.

21. 103 S. Ct. at 1836.

22. 331 U.S. at 3-4.

Mrs. Crane maintained that this was the amount realized and that her equity basis in the property was zero.²³ The Court disagreed; it held that the full amount of the nonrecourse debt was to be included in the amount realized from the sale.²⁴

Unlike *Tufts*, the mortgage debt in *Crane* was less than the fair market value of the property at the time of its sale.²⁵ According to the *Crane* Court, so long as the property is worth more than the amount for which it is mortgaged, the owner will continue to make his payments just as if he were personally liable on the note.²⁶ When the property is worth less than the mortgage, the owner might abandon the property to the mortgagee, who could not then collect any money from the owner on the nonrecourse loan.²⁷ The ambiguity in the Court's reasoning²⁸ led to conflicting decisions by courts confronted with situations like *Tufts*.²⁹

Crane had two underlying rationales: the tax benefit theory³⁰ and economic benefit analysis.³¹ The *Crane* result is the same under either theory, since the fair market value of the property exceeded the amount of the nonrecourse debt.³² In cases such as *Tufts*, however, the distinction is critical.

In its simplest form, the tax benefit rule requires that the recovery within a taxable year of an item previously deducted be included in gross income to the extent it produced a tax benefit in the prior year.³³ The concern in cases such

23. *Id.* at 3.

24. *Id.* at 14.

25. Mrs. Crane was paid an additional \$3,000 (less \$500 expenses of sale) for the property. *Id.* at 3. The Court apparently treated the sale as an arm's length transaction.

26. 331 U.S. at 14. Otherwise, the owner would lose the difference between the fair market value of the property and the mortgage when the mortgagee forecloses. Such a course of action would not make economic sense.

27. See note 2 *supra*.

28. See Del Cotto, *Basis & Amount Realized Under Crane: A Current View of Some Tax Effects in Mortgage Financing*, 118 U. PA. L. REV. 69, 82-88 (1969); see also notes 37-40 and accompanying text *infra*.

29. Compare *Millar v. Commissioner*, 577 F.2d 212, 215 (3d Cir. 1978) (tax benefit analysis) with *Tufts*, 651 F.2d at 1062 (economic benefit analysis).

30. See *Crane*, 331 U.S. at 15-16.

31. *Id.* at 13-14. Although the *Crane* Court did not use the phrases "tax benefit" or "economic benefit," the terminology has been widely used in connection with the case. See, e.g., Bittker, *supra* note 8, at 284.

32. Mrs. Crane received a net additional amount of \$2,500, 331 U.S. at 3, which means that in an arm's length transaction the property's fair market value exceeded the debt. Since economic benefit analysis places a fair market value limitation only on the debt's inclusion in amount realized, the entire amount of the debt is included so long as the fair market value of the property exceeds the amount of the debt, as in *Crane*.

33. 1 J. MERTENS, *THE LAW OF FEDERAL INCOME TAXATION* § 7.34 (J. Doheny rev. 1981). The Supreme Court recently characterized the tax benefit rule in *Hillsboro Nat'l Bank v. Commissioner*, 103 S. Ct. 1134 (1983):

[T]he tax benefit rule will "cancel out" an earlier deduction only when a

as *Tufts* is with the depreciation expense deduction,³⁴ which has provided the taxpayer with an income tax shelter.³⁵ While specific "tax benefit" language is not found in the *Crane* decision, the concept of a functional relationship between basis, depreciation, and amount realized, and the concept of "double deductions," can be viewed as corollaries to tax benefit analysis.³⁶

Under economic benefit analysis, before an amount can be taxable, there must be a real gain to support that tax liability.³⁷ It can be argued that a taxpayer does not receive an economic benefit in excess of the property's fair market value when she sells her partnership interest and the purchaser assumes the nonrecourse liability. Because a nonrecourse mortgagor is not personally liable on the debt, none of her property other than the mortgaged real estate can be used to satisfy the mortgage, and this would be the extent to which the taxpayer really received anything in the transaction.³⁸

If tax benefit analysis is used, the full amount of the nonrecourse liability would be included in the amount realized, since this is the amount that has been used in prior tax calculations to determine basis and depreciation. It is generally recognized that the taxpayer should not be able to take advantage of the double deductions³⁹ that would result if he is allowed to take depreciation expense deductions based on the full amount of the nonrecourse debt but is not forced to use an amount derived in a like manner when computing taxable gain.⁴⁰

A related argument which supports the "full inclusion" approach is that the Code sections concerning basis,⁴¹ depreciation,⁴² and the amount realized from sale⁴³ must be applied consistently to numbers that are symmetrical.⁴⁴

careful examination shows that the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based. That is, if that event had occurred within the same taxable year, it would have foreclosed the deduction.

Id. at 1143-44.

34. I.R.C. §§ 167-168 (1982).

35. Fairness requires that these deductions be recaptured when the property is disposed of. See Bittker, *supra* note 8, at 283. I.R.C. § 111 (1982) codifies the tax benefit rule as to bad debts, prior tax payments, and delinquency amounts. With certain exceptions, the courts have applied the rule to recovery of all other losses, expenditures, and accruals. See 1 J. MERTENS, *supra* note 33, § 7.34.

36. Newman, *The Resurgence of Footnote 37: Tufts v. Commissioner*, 18 WAKE FOREST L. REV. 1, 9 (1982); see *Crane*, 331 U.S. at 15-16.

37. *Tufts*, 651 F.2d at 1062-63; see *Eisner v. Macomber*, 252 U.S. 189, 207 (1920); 1 J. MERTENS, *supra* note 33, § 5.04.

38. See Del Cotto, *supra* note 28, at 85.

39. *Commissioner v. Crane*, 153 F.2d 504, 505-06 (2d Cir. 1945), *aff'd*, 331 U.S. 1 (1947).

40. 331 U.S. at 15-16.

41. I.R.C. § 1012 (1982).

42. *Id.* §§ 167-168.

43. *Id.* § 1001.

44. See 331 U.S. at 12; see also Del Cotto, *supra* note 28, at 83-84.

Otherwise, inequities occur,⁴⁵ as illustrated by the lower court decisions in *Tufts*. The Tax Court used the tax benefit analysis, in conjunction with an analysis of I.R.C. section 752⁴⁶ on partnerships,⁴⁷ while the Fifth Circuit Court of Appeals applied economic benefit analysis.⁴⁸ Although both courts purported to rely on *Crane*,⁴⁹ the Fifth Circuit determined that the taxpayers suffered a \$55,740 loss,⁵⁰ while the Tax Court found a \$395,760 gain.⁵¹

The loss determined by the Fifth Circuit is easy to see on paper but hard to find in economic terms. The taxpayers had the benefit of depreciation expense deductions for the years that they held the property.⁵² In those years they were able to offset other income and decrease their taxes, sheltering the income they received from other sources.⁵³ If taxpayers who leverage to achieve tax shelter results never have to account for the deductions they are allowed to take (through inclusion of the entire amount of the debt in amount realized at the time of the disposition of the property), then a loophole already in existence would be excessively broadened.⁵⁴

A discussion of double deductions does not appear until the concluding

45. Judge Thornberry, writing for the majority of the court of appeals in *Tufts*, seemed confused on this point. He indicated that the Code is designed to solve the double deduction problem by forcing a taxpayer to make adjustments for any depreciation he has previously taken. 651 F.2d at 1061. He was concerned with the adjusted basis. Only the amount realized, however, was at issue. The double deduction problem is solved if the nonrecourse debt is used for determining basis *and* amount realized. A simple example will illustrate. *T* owned property with an original basis of \$600 (all nonrecourse debt). In years one and two, *T* takes a \$10 depreciation expense deduction. *T* "sells" the property when it has a fair market value of \$500, but the nonrecourse debt is still at \$600. The adjusted basis of the property will be \$580. See I.R.C. §§ 1011, 1016 (1982). If the amount realized from the sale is limited to the fair market value of the property, then *T* has lost \$80 on the sale. The result is inequitable because *T* has deducted \$20 from a prior year's income without investing any after-tax dollars. See also *Estate of Levine v. Commissioner*, 634 F.2d 12, 18-19 (2d Cir. 1980) (nonrecourse liability as basis in a gift transaction).

46. (1982).

47. See 70 T.C. at 763-70.

48. See 651 F.2d at 1059-63. Although the Fifth Circuit used this analysis, Judge Thornberry indicated that the court did not like the theory and had "serious reservations about the *Crane* decision," even when economic benefit analysis is used instead of tax benefit analysis. *Id.* at 1062-63.

49. 651 F.2d at 1059-63; 70 T.C. at 763-64.

50. While the Fifth Circuit did not specifically set out this amount, it is the figure that would result from the court's fair market value limitation on the debts inclusion in amount realized. *Id.* at 1063. The amount would be calculated as follows: \$1,400,000 (amount realized) less \$1,455,740 (adjusted basis) equals \$55,740 (loss).

51. 70 T.C. at 752; see note 17 *supra*.

52. 70 T.C. at 760.

53. *Id.* at 769-70; see, e.g., Newman, *supra* note 9, at 804; see also Note, *Tax Consequences of the Disposition of Property Subject to an Unassumed Mortgage*, 49 COLUM. L. REV. 845, 849 (1949).

54. See Del Cotto, *supra* note 28, at 82-86.

paragraph of *Crane*,⁵⁵ where the Court also addressed Mrs. Crane's constitutional argument.⁵⁶ The judges in the Fifth Circuit believed that the placement of this phrase limited the applicability of tax benefit analysis to Mrs. Crane's constitutional argument.⁵⁷ When the case is read as a whole,⁵⁸ the Fifth Circuit's conclusion seems unjustified.⁵⁹

The implication of footnote 37 seems to be contrary to the basic policies of *Crane*.⁶⁰ If the mandates of footnote 37 are followed, there would be no consistency between the amounts used to determine basis and depreciation, and the figure used to determine the amount realized from the sale.⁶¹ The mortgage amount would be used in the former figure,⁶² while the lower fair market value amount would be used to determine the latter figure.⁶³

The open questions of footnote 37 are answered in *Tufts*.⁶⁴ The Supreme Court found that *Crane* did not rest on economic benefit analysis alone, but on a broader analysis of the "obligation to repay and its subsequent extinguishment."⁶⁵ More fundamentally, *Tufts* was based on the need for symmetrical tax treatment of purchases and dispositions of property subject to nonrecourse

55. 331 U.S. at 15-16.

56. *Id.* Mrs. Crane argued unsuccessfully that she had no income within the meaning of the sixteenth amendment. 331 U.S. at 15; see U.S. CONST. amend. 16, § 1.

57. 651 F.2d at 1060.

58. See *Crane*, 331 U.S. at 6-16.

59. The Court concluded that the "crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain. If it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets." *Id.* at 15-16 (footnote omitted).

60. Some courts have refused to take footnote 37 literally and have followed the basic policies of the *Crane* case even when the nonrecourse debt exceeds the fair market value of the property. See, e.g., *Millar v. Commissioner*, 577 F.2d at 215-16.

61. See notes 41-45 and accompanying text *supra*.

62. *Crane* requires the full amount of the nonrecourse liability to be included in basis. 331 U.S. at 11. This amount will also be used in figuring depreciation. I.R.C. § 167(g) (1982).

63. *Crane's* footnote 37 implies a fair market value limitation.

64. The *Tufts* Court indicated that it merely followed *Crane*. 103 S. Ct. at 1831-34. This is not true. While *Crane* does stand for the proposition that nonrecourse debt is a component of basis and amount realized, it does not mean that nonrecourse debt is to be treated for all tax purposes as if it was a personal liability loan.

The *Crane* Court was working within the Code. Since Mrs. Crane inherited the property from her husband, its initial basis was governed by I.R.C. § 113(a)(5) (1938) (current version at I.R.C. § 1014 (1982)). Under this section, the basis of such property was its fair market value at the decedent's death. Mrs. Crane argued that "property" really meant equity, a position unsupported by the Code. The fact that a portion of the fair market value consisted of nonrecourse debt was of no concern to the *Crane* Court. Its concern with the basis element of computing gain or loss was whether "property" should in that case mean "equity." Answering this question in the negative meant that the full value of the debt was included in basis. From that point, the *Crane* decision rests on the idea that there must be a functional relationship between code sections. See 331 U.S. at 12-13; see also notes 41-45 and accompanying text *supra*.

65. 103 S. Ct. at 1832 n.8.

debt.⁶⁶

Initially, the Court observed that two tax advantages accompany a nonrecourse loan. First, the taxpayer receives money to purchase the property and is not taxed on the receipt of such money because she has an obligation to repay the money.⁶⁷ Moreover, because there is an obligation to repay the loan, the debt is included in the basis as a portion of the purchase price, which results in larger depreciation deductions.⁶⁸ The Court concluded that these two advantages must be taken into account when the taxpayer disposes of the encumbered property by including the full amount of the nonrecourse liability in the amount realized, even when the debt exceeds the fair market value of the property.⁶⁹

The result is sound, but the analysis is somewhat lacking. Throughout its opinion, the Court discussed a nonrecourse debtor's "obligation" to repay.⁷⁰ In this notion lies the fallacy. There is no real obligation on the part of a mortgagor unless she is personally liable on the loan. So long as the loan is nonrecourse, any "obligation" to repay is a result of the mortgagor's desire to keep her equity in the property. She will repay the loan as long as the property is worth as much or more than the outstanding loan on the property. When the value of the property decreases substantially below the principal due on the debt, the mortgagor's motivation to make the loan payments decreases.⁷¹ If the mortgagor chooses to discontinue repayment, the mortgagee can sell the property to recover the debt. The mortgagee, however, has no cause of action against the mortgagor for any deficiency, since the mortgagor has no personal liability on a nonrecourse loan. The property is the principal debtor.⁷² Although the failure to recognize this lack of obligation is a flaw, *Tufts* can be defended as necessary for consistent application of the Code provisions.⁷³

If there were no consistency in the method used to determine the relevant numbers which are used to compute gain or loss upon the sale or disposition of

66. *Id.* at 1832.

67. *Id.* at 1831; see *Stayton v. Commissioner*, 32 B.T.A. 940, 942-43 (1935); 1 J. MERTENS, *supra* note 33, § 5.12.

68. 103 S. Ct. at 1831-32.

69. *Id.* at 1832-34. The Court did not indicate that for policy reasons it was choosing to treat nonrecourse debt as if it was a personal liability loan; rather, the Court discussed nonrecourse indebtedness as identical to a personal liability loan. The only difference is that the nonrecourse lender bears the risk of loss. *Id.* at 1833-34.

70. *E.g., id.* at 1833. The Court indicated that *Crane* was based on the assumption that the debt would be fully repaid. *Id.* at 1832.

71. This is especially true when, as in *Tufts*, the mortgagor's default occurs early in the repayment period. At such time, most of the money that the mortgagor has paid to the mortgagee would represent interest, so the mortgagor would not lose a substantial amount of money by discontinuing repayment.

72. See note 2 *supra*.

73. This concept was mentioned in *Tufts*. 103 S. Ct. at 1830. The necessity arose because the *Crane* Court accepted the IRS position allowing the inclusion of nonrecourse liability in basis, permitting the liability to be depreciated. The *Tufts* case would not have arisen if *Crane* had placed an "at risk" limit on basis.

property, the figures could be easily manipulated to the taxpayer's advantage. If the full amount of nonrecourse debt is not included in amount realized, taxpayers who use leveraging in a declining market would forever escape the payment of tax.⁷⁴ *Tufts* solved this tax problem. As a result, taxpayers who use nonrecourse debt to finance real estate ventures will always include the full amount of such nonrecourse debt upon disposition of that property. This will be so even if the taxpayer has not been taking advantage of depreciation expense deductions in prior tax years and has therefore received no prior tax benefit.⁷⁵ No longer is there the potential for a taxpayer to have the tax benefits of a nonrecourse loan without eventually being accountable for such benefits through inclusion of the entire amount of the nonrecourse liability in the amount realized.⁷⁶

In addition to arguing the applicability of footnote 37, the taxpayers in *Tufts* attempted to use I.R.C. section 752(c)⁷⁷ to support their contention that the fair market value of the property limits the amount a taxpayer must include in amount realized on disposition of such property.⁷⁸ The Supreme Court interpreted section 752 as not placing any such limit on inclusion of nonrecourse debt in amount realized when a partnership is sold. Rather, the Court viewed section 752(c) as limiting only the taxability of partnership contributions and distributions.⁷⁹

Subsections (c) and (d) of section 752 are of primary concern in *Tufts*. Section 752(c) provides that a liability to which property is subject is treated

74. Realistically, the extent to which nonrecourse debt is included in amount realized, beyond fair market value, will have little effect on the revenue taken in by the Treasury each year. Typically, real estate does not decrease in value over time, and the *Tufts* problem only occurs when such a decrease has taken place.

75. This is the position adopted by the Treasury. See notes 90-94 and accompanying text *infra*.

76. The problem in *Tufts* never would have arisen were it not for the exclusion of real estate from the "at risk" provisions. See I.R.C. § 465(c)(3)(D) (1982). This section is the IRS response to the position it advocated in *Crane*. See note 73 *supra*. Under § 465 a taxpayer can take a loss deduction only to the extent that he has property at risk. A person is at risk, in any particular venture, to the extent he has invested cash, contributed property, or has outstanding personal liability loans. I.R.C. § 465(b) (1982). A taxpayer is not considered at risk for a nonrecourse loan. *Id.* § 465(b)(4).

77. (1982): "[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." This section applies only to a transaction between a partnership and its partners.

78. 70 T.C. at 766. Section 752 is regarded as a codification of the *Crane* doctrine for partnerships. See Perry, *Limited Partnerships and Tax Shelters: The Crane Rule Goes Public*, 27 TAX L. REV. 525, 542 (1972) (citing A. WILLIS, PARTNERSHIP TAXATION 195 (1971)). The Tax Court rejected the idea that § 752 imposed a fair market value restriction on the amount of nonrecourse debt included in amount realized. 70 T.C. at 769. The Fifth Circuit found a fair market value limitation through use of economic benefit analysis and footnote 37. 651 F.2d at 1063. *But see id.* at 1065-66 (Williams, J., concurring) (fair value limit found in § 752).

79. 103 S. Ct. at 1834-36.

as a partner's liability to the extent of the fair market value of the property.⁸⁰ Section 752(d) indicates that when an interest in a partnership is sold, one is to follow the general rules for sales and exchanges of property.⁸¹ I.R.C. section 1001 is the general rule that deals with the determination of gain or loss on the sale or other disposition of property.⁸² Gain or loss is determined by subtracting the property's adjusted basis from the amount realized.⁸³ "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."⁸⁴ In *Tufts*, the dispute between the taxpayers and the IRS centered around the "amount realized" portion of the formula to determine gain or loss.⁸⁵

The first problem in determining how much of the nonrecourse debt should be included in the amount realized is whether to categorize nonrecourse debt as property or money. Such a categorization is not easy since nonrecourse indebtedness is itself somewhat illusory.⁸⁶ If it is property, then section 1001(b) states that there would be a fair market value limitation on its inclusion in amount realized, assuming the fair market value of the debt equals the fair market value of the property.⁸⁷ If the debt constitutes "money," then no such express statutory limitation exists. There is ample support for the notion that nonrecourse debt should be considered money and not property.⁸⁸ Since section 1001(b) is somewhat ambiguous on this issue,⁸⁹ it is proper to look to

80. See note 77 *supra*.

81. (1982). In other words, one would use § 1001.

82. (1982).

83. *Id.* § 1001(A).

84. *Id.*

85. The taxpayers wanted the fair market value limitation implied in footnote 37 to apply, while the Commissioner wanted to include the full amount of the nonrecourse debt. 651 F.2d at 1060.

86. See note 2 *supra*.

87. *Cf.* *United States v. Davis*, 370 U.S. 65 (1962) (value of property received equivalent to worth of property given up).

88. See, e.g., *Crane*, 331 U.S. at 13-14; see also *United States v. Hendler*, 303 U.S. 564, 566 (1938). But see *Tufts*, 651 F.2d at 1065 (Williams, J., concurring) (release from nonrecourse indebtedness must be considered property, and the fair market value limitation should apply to the value of the underlying property).

89. The legislative history is not particularly helpful. Section 1001(b) traces its origins to § 202(b) of the 1918 Act. 1 J. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAWS (1953-1939), at 1534 (1954). Section 202(b) became § 202(c)(1) in the 1921 Act. 1 J. SEIDMAN, *supra*, at 1534. The language used in these two codes, however, bears little resemblance to the present statute. See J. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS (1938-1861), at 789, 898 (1938).

The pertinent portion of § 1001(b) first appeared in its present form in the 1924 Act as § 202(c). 1 J. SEIDMAN, *supra* at 686. The full text of § 1001(b) contains some limitations that are not pertinent to *Tufts*, which were added much later. This language was carried forward, intact, to the 1926 Act as § 202(c), to the 1939 Act as § 111(b), and to the 1954 Act as § 1001(b). See 1 J. SEIDMAN, *supra*, at 1534.

While there is ample congressional discussion concerning the fair market value

the Treasury Regulations for guidance.⁹⁰

Regulation section 1.1001-2(b)⁹¹ indicates that a release from nonrecourse indebtedness should be considered money and not property.⁹² The regulation also specifically states that the entire amount of the nonrecourse debt should be included in the amount realized, even if the fair market value of the underlying property is less than the total debt.⁹³ This regulation seems to squarely answer the question posed by *Tufts*. While this regulation does not have the force of law since it is interpretative in nature, it can be applied retroactively,⁹⁴ and that is important in *Tufts* since it was promulgated while the case was pending.⁹⁵ There is, however, one final area of inquiry: the validity of regulation section 1.1001-2(b).

In dealing with the Code, "[t]he choice among reasonable interpretations is for the Commissioner, not the Courts."⁹⁶ In light of the philosophy underlying *Crane*, regulation section 1.1001-2 seems quite reasonable. While footnote 37 might indicate that the *Crane* Court would not include the full amount of the nonrecourse debt in amount realized when the fair market value of the underlying property is less than the nonrecourse debt, the Court actually held that the full amount of the debt involved in *Crane* should be so included. The footnote was merely dictum. Regulation section 1.1001-2 is not inconsistent

limitation that § 1001(b) places on the inclusion of property in amount realized, there is no discussion that is pertinent to the *Tufts*-type case. There is no indication whether nonrecourse debt is to be considered "property" or "money." The congressional discussion centered around the operation of the provision in the more typical situation and in cases where the dispute was over fair market value of property other than money. 1 J. SEIDEMAN, *supra* at 686. *But cf.* *Smith v. Commissioner*, 324 F.2d 725, 726 (9th Cir. 1953) (solvent third party's assumption of taxpayer's obligation may be "money received" under § 1001(b)).

90. An interpretative regulation is proper where the code is ambiguous. *Magruder v. Washington, Baltimore & Annapolis Realty Corp.*, 316 U.S. 69, 74 (1942).

91. (1980). This regulation was promulgated on Dec. 12, 1980, during the *Tufts* appeal.

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

The fair market value of the security at the time of sale or disposition is not relevant for purposes of determining . . . the amount of liabilities from which the taxpayer is discharged. . . . Thus, the fact that the fair market value of the property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from being treated as money received from the sale or other disposition of the property.

93. *Id.* § 1.1001-2(b).

94. The Secretary of the Treasury has broad discretion to prescribe the extent of such a regulation's retroactive application. I.R.C. § 7805 (1982).

95. The decision by the Tax Court was announced in 1978; the regulation was promulgated in 1980; the decision by the Fifth Circuit was announced in 1981.

96. *Tufts*, 651 F.2d at 1065 (Williams, J., concurring) (quoting *National Muffler Dealers Ass'n, Inc. v. United States*, 440 U.S. 472, 488 (1979)). Judge Williams believed this regulation to be unreasonable because he felt that it conflicted with the statute. This is due to his inappropriate categorization of nonrecourse debt as property. See notes 88-89 *supra*.

with the Code,⁹⁷ nor is it inconsistent with *Crane* when that decision is viewed in its totality. It constitutes a common sense solution to a problem created by the uncertainties that grew out of footnote 37.

If I.R.C. section 752(d), through its incorporation of section 1001, is used, there is no fair market value limitation on the portion of debt to be included in amount realized.⁹⁸ The question then becomes whether section 752(c) operates to impose a fair market value limitation on the sale of partnership interests.⁹⁹ Section 752(c) does say "for purposes of this section," which seems to indicate that this section's fair market value limitation on the inclusion of debt would also apply to subsection (d),¹⁰⁰ which expressly covers sales of an interest in a partnership. An examination of the legislative history of section 752, however, indicates that subsection (c) was intended to be narrowly applied, and that the sale of an interest in a partnership was intended to be excepted from the fair market value limitation.¹⁰¹

Further support for the independence of subsection (d) is supplied by the Treasury's regulation concerning section 752.¹⁰² In the regulation's discussion of subsection (c), there are only two situations for which the use of the fair market value limitation is indicated: when property subject to a liability is contributed by a partner, or when property subject to a liability is distributed to a partner.¹⁰³ These two situations directly relate to subsections (a) and (b)

97. A court can invalidate a regulation only if it is unreasonable and inconsistent with the Code. *Delta Metalforming Co. v. Commissioner*, 632 F.2d 442, 449 (5th Cir. 1980).

98. Under § 1001, the full amount of the nonrecourse liability is included in the amount realized. *Treas. Reg. § 1.1001-2(1)* (1980); see notes 90-95 and accompanying text *supra*.

99. I.R.C. § 752 (1982). See text accompanying note 77-81 *supra*.

100. I.R.C. § 752(d) (1982).

101. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 1, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4017, 4376-77.

Frequently, a partner will assume partnership liabilities or a partnership will assume a partner's liabilities. In some cases this occurs as the result of a contribution of encumbered property by the partner to the partnership or as the result of a distribution of such property by the partnership to the partner. The provisions of this section prescribe the treatment for such transferred liabilities. . . .

The 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 liability along with the property. . . .

. . . When a partnership interest is sold or exchanged, the general rule for the treatment of the sale or exchange of property will be applied. *Id.* at A236-37, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS at 4376-77.

102. *Treas. Reg. § 1.752-1* (1955). This regulation was issued when the 1954 code was enacted and thus is "entitled to great weight." 70 T.C. at 768 (citing *Commissioner v. South Tex. Lumber Co.*, 333 U.S. 496 (1948); *Fawcus Machine Co. v. United States*, 282 U.S. 375 (1931)).

103. While the regulation does not expressly state that these are the only instances for the fair market value limitation, such an inference is logical. *Treas. Reg. §*

of section 752.¹⁰⁴ No mention is made of the sale of an interest in the partnership. Indeed, the regulation later reiterates that this is to be treated as "the sale or exchange of property not associated with partnerships."¹⁰⁵

The fair market value limit of section 752(c) was probably intended to prevent partnerships from including excess debt in their bases. Upon sale of a partnership interest, the partner no longer has a connection with the partnership. His gain or loss is determined by deducting his adjusted basis in the partnership from the amount realized from the sale. In such a case, he can have a loss as well as a gain. The basis of the interest is not changed by the transaction. The basis only determines whether the transaction itself will result in a gain or loss to the taxpayer. Considering the above analysis of section 752, the Supreme Court properly determined that the sale of the partnership interest in *Tufts* would be governed by the ordinary sale or exchange rules of section 1001.

In *Tufts*, the Supreme Court, through an expansion of *Crane*, effectively adopted regulation section 1.1001-2. Since the full amount of the nonrecourse debt will now always be included in amount realized, potential abuses in this area of the tax law will be minimized. The *Tufts* decision is a logical way to deal with the question of inclusion of nonrecourse debt in the amount realized. Such a rule is necessary to insure that the computational results of determining gain and loss and disposition of encumbered property are fair to all taxpayers.

Those who are able to take advantage of tax shelters must be accountable at some point. That point arrives when the property is disposed of, and accountability comes by including the entire amount of nonrecourse debt in amount realized. Fairness requires this be done. The *Tufts* Court recognized this need and rendered its decision accordingly. Finally, the question posed in footnote 37 has been properly put to rest.

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1.752-1(c) (1955) provides:

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.

104. I.R.C. § 752(a), (b) (1982); see note 76 *supra*.

105. Treas. Reg. § 1.752-1(d) (1955). As indicated in note 77 *supra*, to treat the sale of an interest in a partnership in this manner means that the rules of § 1001 will be followed and thus no fair market value limitation will be applied.