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Commissioner v. Tufts: A Sound Decision

Roger H. Randall

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COMMISSIONER V. TUFTS: A SOUND DECISION

INTRODUCTION

For federal income tax purposes, gross income includes the net gain or loss derived from dealings in property.[1] The amount of gain or loss is the difference between the taxpayer's adjusted basis[2] in the property and the amount realized upon disposition of the property.[3]

Consider a partner in an apartment development financed almost entirely with a nonrecourse mortgage loan.[4] The property is worth about $400,000 less than the unpaid debt at disposition. The Third Circuit, based on its decision in *Millar v. Commissioner*,[5] would find the amount realized to be the the full amount of the unpaid debt, assumed by the new owner. Treasury Regulation 1.1001-2[6] is similarly dispositive, if it is entitled to effect.[7] Recently, however, in *Commissioner v. Tufts*,[8] the Fifth Circuit majority disagreed with the Third Circuit's decision in *Millar* and ignored the regulation.[9] The United States Supreme Court granted *certiorari* to resolve this

1. I.R.C. § 61(a)(3) (1976). *See also* I.R.C. §§ 1201-1256 (1976 & Supp. V 1981 & West Supp. 1983) (on treatment of, and rules for determining, capital gains and losses).

2. I.R.C. §§ 1011(a), 1012, 1014, 1016(a)(1)-(2) (1976 & Supp. V 1981).

3. I.R.C. § 1001(a) (1976 & Supp. V 1981). The term "amount realized" is defined in I.R.C. § 1001(b) as "the sum of any money received plus the fair market value of the property (other than money) received." I.R.C. § 1001(b).

4. A mortgage conveys an interest in property to secure the performance of an obligation. If the debt is paid according to the terms of the note, the creditor-mortgagee's lien is discharged, i.e., the security interest is extinguished.

A nonrecourse mortgage conveys a security interest in the property, but the mortgagor does not personally oblige himself to pay the debt that the property secures. If there is default, the creditor-mortgagee's only remedy is to foreclose his lien on the property. The creditor-mortgagee has no recourse against the mortgagor for any of the debt not satisfied by the value of the property. The nonrecourse mortgage serves to remove the mortgagor's other assets from the reach of the creditor-mortgagee. *See* G. OSBORNE, MORTGAGES § 103 n.22 (1970); Note, *Federal Income Tax Treatment of Nonrecourse Debt*, 82 COLUM. L. REV. 1498, 1498 & n.1 (1982).

5. 67 T.C. 656 (1977), *aff'd in part. part*, 577 F.2d 212, 215 (3d Cir.), *cert. denied*, 439 U.S. 1046 (1978). *See infra* notes 34-41 and accompanying text.

6. Treas. Reg. § 1.1001-2 (1980). Section 1.1001-2 reads in pertinent part: "The fair market value of the security [mortgaged property] at the time of sale or disposition is not relevant for the purposes of determining under [the amount realized paragraph] of this section the amount of liabilities from which the taxpayer is discharged or treated as discharged." § 1.1001-2(b). The regulation was promulgated on Dec. 11, 1980, during the pendency of *Commissioner v. Tufts* before the court of appeals. Tufts v. Commissioner, 651 F.2d 1058, 1065 n.1 (5th Cir. 1981), *rev'd*, 103 S. Ct. 1826, 1833 n.9 (1983). The facts hypothesized are based on the *Tufts* facts.

7. The regulation is interpretive of I.R.C. § 1001(b). *See* Treas. Reg. § 1.1001-2, T.D. 7741, 1981-1 C.B. 430, 430-31. The regulation will not be given effect if it is "unreasonable and plainly inconsistent with the revenue statutes." Fulman v. United States, 434 U.S. 528, 533 (1978) (quoting Commissioner v. South Texas Lumber Co., 333 U.S. 496, 501 (1948)). *See also* Bingler v. Johnson, 394 U.S. 741, 750 (1969) (applying the same statement).

8. 651 F.2d 1058 (5th Cir. 1981), *rev'd*, 103 S. Ct. 1826 (1983).

9. *See* 651 F.2d at 1060, 1063-64 n. 9. Judge Williams, in his concurring opinion, would hold the regulation to be in conflict with the "plain language of the statute," because the value of the release must correspond to the value of the property securing the nonrecourse indebtedness. 651 F.2d at 1065 (Williams, J., concurring); *but see infra* notes 138-41 and accompanying text. Therefore, the regulation, regardless of its interpretive effect, is invalid, according to Judge Williams. 651 F.2d at 1065.

conflict between the circuits.

On May 2, 1983, the Supreme Court ruled against the taxpayer's argument that amount realized should be limited to the fair market value of the property in question. In *Tufts*, the Supreme Court decided that when a taxpayer disposes of property encumbered by a nonrecourse obligation, the outstanding amount of the obligation must be included in the amount realized for the purposes of gain or loss determination, and that the fair market value of the property is irrelevant to this calculation.[10]

This comment will examine the evolution of the principles forming the context of the *Tufts* decision, and it will critique the Supreme Court's application of those principles. As this critique will illustrate, the Supreme Court not only reached the correct result, but the Court reached that result for sound reasons.

I. BACKGROUND

A. *Foundation of the* Tufts *Controversy*

Whether the value of the property is a ceiling on amount realized is vitally important to owners of unprofitable real estate developments encumbered by a nonrecourse mortgage incurred to purchase or improve the property.[11] A nonrecourse mortgage limits the personal liability of an owner while it allows him the full cost as a depreciable basis.[12] But if an owner's amount realized is a function of the unpaid debt and not of the property's value, he could incur a tax *gain* on disposition of the property that has lost value since acquisition.[13]

There is something "counter-intuitive"[14] about recognizing a gain when the property has declined in value and, as in *Tufts*, the taxpayer received no cash from the sale.[15] It is arguable that, if the property does in fact decline in value as depreciation deductions presume, a taxpayer should not need to recognize those deductions as a gain.[16]

In addition to this apparent inconsistency when value is not a limitation on amount realized, there existed at the time of the *Tufts* appeal to the Supreme Court a confusion of principles. There appeared to be two rationales available to support the rule that the amount realized includes the full

10. 103 S. Ct. at 1836.

11. *Cf.* Perry, *Limited Partnerships and Tax Shelters: The* Crane *Rule Goes Public*, 27 TAX. L. REV. 525, 528 (1972) (Because the mortgage is included in the cost basis, a taxpayer can take depreciation charges in excess of the cash contribution. This is significant to taxpayers investing in property subject to a prior lien.).

12. I.R.C. § 1012 (1976). *See infra* text accompanying note 18. *But see, e.g.*, Gladding Dry Goods, 2 B.T.A. 336, 338 (1925) (holding a capital investment by the taxpayer, not just ownership, is required before depreciation is allowed). This notion of requiring capital investment was effectively overruled by Crane v. Commissioner, 331 U.S. 1 (1947). *See* Note, *Federal Income Tax Treatment of Nonrecourse Debt*, 82 COLUM. L. REV. 1498, 1512-13 & n.91 (1982).

13. *See generally* Halpern, *Footnote 37 and the* Crane *Case: The Problem That Never Really Was*, 6 J. REAL EST. TAX'N 197, 199 (1978) (concerning failing tax shelters).

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

15. 103 S. Ct. at 1829. *See infra* text accompanying note 84.

16. *See Tufts*, 651 F.2d at 1060-61 n.4.

amount of unpaid debt: the economic benefit theory and the tax benefit theory. A conflict between the circuits was probable.

B. *The Development of the Law*

For a complete understanding of the *Tufts* opinion, a foundation is needed. The economic benefit and tax benefit theories evolved in two intertwined lines of cases which will be discussed in four segments. The tax benefit line of decisions began with the Supreme Court holding in *Crane v. Commissioner*.[17]

1. *Crane*: Basis and Amount Realized Include Nonrecourse Mortgage

The *Crane* case stands for two rules. First, basis includes nonrecourse debt when incurred by the taxpayer's transferor and assumed by the taxpayer.[18] Second, amount realized also includes the nonrecourse debt remaining unpaid at the time of transfer.[19] The Supreme Court reached the latter conclusion based on the following: 1) "property" in the definition of amount realized[20] should mean the same as in the definition of basis,[21] because of the functional relation between basis and amount realized;[22] and, 2) the absence of personal liability is of no consequence, because a taxpayer who transfers property subject to a mortgage receives a benefit as real and substantial as if the mortgage were discharged, or as if it were a personal debt assumed by another.[23] Thus, the taxpayer is faced with the same capi-

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

18. 331 U.S. at 11. In 1966, this rule was extended by the Tax Court to *new* nonrecourse debt known as purchase-money mortgages. Mayerson v. Commissioner, 43 T.C. 340, 351 (1966). The absence of personal liability was immaterial. *Id.* at 351-52. *See also* Bolger v. Commissioner, 59 T.C. 760, 771 (1973) (a 100% financed acquisition and a minimal cash flow did not matter for the right to a depreciable basis). For a criticism of *Mayerson* see Del Cotto, *Basis and Amount Realized Under* Crane: *A Current View of Some Tax Effects in Mortgage Financing*, 118 U. PA. L. REV. 69, 71-75 (1969). For a general criticism of including nonrecourse debt in basis see Note, *supra* note 12, at 1511-14.

Other types of liens are properly included in basis. *See, e.g.*, Blackstone Theatre Co. v. Commissioner, 12 T.C. 801, 805 (1949) (unpaid tax liens to which the property was bought subject are included in basis, no matter when the tax liens are ultimately paid or for how much).

This comment deals only with the extent of the inclusion of nonrecourse debt in amount realized. On the basis rule of *Crane* there is extensive literature. *See, e.g.*, Friedland, Tufts & Millar: *Two New Views of the* Crane *Case and Its Famous Footnote*, 57 NOTRE DAME LAW. 510, 513-15 (1982); Perry, *Limited Partnerships and Tax Shelters: The* Crane *Rule Goes Public*, 27 TAX. L. REV. 525, 527-42 (1972); Simmons, *Nonrecourse Debt and Basis: Mrs. Crane Where Are You Now?* 53 S. CAL. L. REV. 1, 6-14 (1979).

19. 331 U.S. at 13.

20. I.R.C. § 1001(b) (1976 & Supp. V 1981).

21. I.R.C. § 1014(a)(1) (1976 & Supp V 1981). If the *property* to be valued on the date of acquisition is the property free of liens, then the *property* priced on a subsequent sale must be the same thing. 331 U.S. at 12. *See* Maguire v. Commissioner, 313 U.S. 1, 8 (1941).

22. 331 U.S. at 12. The Court did not explain what "functional relation" means. The Court had already concluded that *property* in § 1014(a)(1), defining basis, refers to the value of the property undiminished by mortgages. *Id.* at 11.

23. *Id.* at 14. For criticism on the identification of personal liability and nonrecourse liability, see Bittker, *supra* note 14, at 281-82. *See also infra* notes 138-41 and accompanying text on comparison of this idea with debt relief cases.

In this case, the Supreme Court also implied what the rule would be if the value of the property were less than the debt: the amount realized would be the value. *See* 331 U.S. at 14 n.37 (dictum).

tal gain treatment regardless of the type of mortgage lien.

The taxpayer in *Crane* had, during her six years of ownership, claimed $25,000[24] of the allowable $28,045 depreciation.[25] The Court appeared to want to prevent a double deduction that it believed would result if the amount realized did not include the amount of unpaid debt.[26] This tax benefit reasoning was later developed in *Parker v. Delaney*[27] and *Millar v. Commissioner*.[28]

2. *Parker* and *Millar*: Tax Benefit Theory

The tax benefit theory concerns inclusion of unpaid debt in amount realized to account for the depreciation deductions taken on a basis that included the debt. In *Parker v. Delaney*, the First Circuit held that where the owner, who had acquired the property subject to a mortgage, conveyed the property to a mortgagee in satisfaction of the debt, it was a disposition for the purposes of computing a gain or loss.[29] Therefore, *Crane* controlled on determining the amount realized.[30] As in *Crane*, a taxpayer here took depreciation deductions on a basis equal to the amount of the mortgage.[31] This reduced his basis to $31,291 less than the amount of the debt when conveyed to the mortgagee.[32] The *Parker* decision holds the difference is a taxable gain, and represents the amount of depreciation taken in excess of the taxpayer's capital investment.[33]

In *Millar*, the taxpayers, upon receipt of loan funds from a corporate organizer, executed nonrecourse notes secured solely by their stock in a Subchapter S corporation.[34] They simultaneously contributed the funds to the capital of the corporation, increasing their bases in the stock. After a period of substantial tax losses that benefitted the shareholders, the stock was repossessed for default on the notes.[35]

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24. 331 U.S. at 3 n.2. In *Crane*, the taxpayer acquired the property from a decedent.

25. *Id.* at 4.

26. *Id.* at 15-16. "The crux of this case, really, is whether the law permits her to exclude allowable [depreciation] 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." *Id.* In other words double deduction refers to recognizing a loss on the sale in addition to the depreciation claimed.

27. 186 F.2d 455 (1st Cir. 1950), *cert denied*, 341 U.S. 926 (1951).

28. 577 F.2d 212 (3d Cir.), *cert. denied*, 439 U.S. 1046 (1978).

29. 186 F.2d at 457, 459. *See* I.R.C. § 1001(a) (1976 & Supp. V 1981).

30. 186 F.2d at 458.

31. *Id.* at 457.

32. *Id.* at 458.

33. *See id.* at 459. For criticism of the *Parker* holding see Note, *supra* note 12, at 1505.

34. 577 F.2d at 213. A qualifying Subchapter S corporation is not taxed as an entity, but instead, its profits and losses flow through to its shareholders in proportion to each shareholder's interest. *See* I.R.C. §§ 1363(a), 1366(a) (West Supp. 1983). Section 1366(d)(1) limits losses deductible each year by a shareholder to the adjusted basis of his stock plus any debt of the corporation to the shareholder.

35. Millar v. Commissioner, 540 F.2d 184, 185 (3d Cir. 1976) (remanding the case to the tax court). A repossession of property securing a debt constitutes a taxable sale or exchange. *See* Helvering v. Hammel, 311 U.S. 504, 510 (1941); R. O'Dell & Sons Co. v. Commissioner, 169 F.2d 247, 248 (3d Cir. 1948); Unique Art Mfg. Co. v. Commissioner, 8 T.C. 1341, 1342-43 (1947). *See also* Freeland v. Commissioner, 74 T.C. 970 (1980) (applying the same rule in an abandonment of property to a mortgagee).

The Third Circuit emphasized the tax benefit reasoning[36] with which the *Crane* opinion concluded.[37] The taxpayers' bases were reduced by the passed-through operating losses of the corporation. These losses were a substantial tax benefit.[38] In surrendering their devalued stock[39] in exchange for the cancellation of the mortgage, the taxpayers clearly realized a taxable gain equal to the value of the cancelled obligation less the adjusted basis of their surrendered stock.[40]

Thus, in both *Parker* and *Millar* the courts followed *Crane*. The decisions emphasize that the gain represents the depreciation claimed in excess of amortization of the nonrecourse debt secured by the property ultimately surrendered to the mortgagee.[41]

3. *Lutz & Schramm Co.*: Economic Benefit Theory

The economic benefit theory concerns accounting for loan proceeds in amount realized because the loan proceeds are untaxed. Before *Crane* and its infamous footnote 37,[42] the United States Tax Court's decision in *Lutz & Schramm Co. v. Commissioner*[43] began an important line of cases. Lutz & Schramm Company, subsequent to purchasing its property, mortgaged it to secure a new loan of $361,000.[44] After financial difficulties the taxpayer transferred the mortgaged property to the creditor in full satisfaction of the mortgage.[45] At the time of the transfer, the property had been depreciated to an adjusted basis of $257,435[46] while its value had declined to $97,000.[47]

The court held that the facts of no personal liability and a low fair market value were immaterial,[48] and the amount realized equaled the unpaid debt.[49] The court reasoned that the issue was not whether the taxpayer realized income from the discharge of indebtedness,[50] but whether the taxpayer realized a gain upon disposition of the property.[51] The net result was that the taxpayer received $300,000 without restriction[52] by mortgaging property with a basis of only $257,435, and by making no repayment until

36. *See* 577 F.2d at 215.

37. *See supra* note 26 for the *Crane* text implying a tax benefit to the taxpayer.

38. 577 F.2d at 215. Subchapter S losses are analogous to depreciation deductions. *See* Comment, Millar: *Requiem for* Crane's *Footnote 37*?, 41 U. PITT. L. REV. 343, 345-46 (1980).

39. The value of the stock was less than the unpaid debt. 577 F.2d at 215.

40. *Id.* at 215.

41. *See also* Rev. Rul. 76-111, 1976-1 C.B. 214, 215 (value of depreciated property disposed of to mortgagee is immaterial; unpaid debt cancelled upon the transfer is the amount realized).

42. *See supra* note 23.

43. 1 T.C. 682 (1943).

44. *Id.* at 684.

45. *Id.* at 685.

46. *Id.* at 689.

47. *Id.* at 685.

48. *Id.* at 689.

49. *Id.*

50. *See* Bialock v. Commissioner, 35 T.C. 649 (1961) (debts satisfied by transfer of all assets of debtor business; result similar to *Lutz & Schramm*, but based on discharge of indebtedness principle because creditor was *not* a mortgagee).

51. 1 T.C. at 689.

52. The taxpayer had transferred certain property to the creditor to reduce the debt to $300,000. *Id.* at 684.

A reinvestment of the borrowed funds in capital improvements to the property would,

foreclosure.[53] Thus, the economic benefit theory was born.[54]

The principle of *Lutz & Schramm* was extended in *Mendham Corp. v. Commissioner*[55] and *Woodsam Associates, Inc. v. Commissioner*[56] to the situation where property is acquired subject to the prior owner's post-acquisition mortgage. In both cases the courts held that the gain upon foreclosure equaled the unpaid mortgage less the basis adjusted for the taxpayer's depreciation deductions.[57] The Tax Court in *Mendham* emphasized that the gain on the sale must reflect the ultimate profit from the entire operation.[58] The *Woodsam* court concluded that the value of the property at foreclosure was immaterial.[59]

Crane's economic benefit principles were applied in *Johnson v. Commissioner*.[60] The taxpayer had borrowed $200,000 against his highly appreciated securities[61] just before a gratuitous transfer of the stock to his children.[62] The notes were then re-executed to relieve the taxpayer of any personal liability.[63]

The Sixth Circuit held that the $200,000 was gross income on a clear economic benefit theory, noting that Dr. Johnson had received $200,000 free and clear of any obligation to repay that amount from any property in his possession.[64] It made no difference to what use the $200,000 was put, even if it was used to pay the gift tax.[65] The court then found *Crane* dispositive: Johnson had shed a $200,000 debt by transferring the encumbered stock to his children, so his amount realized is that debt, regardless of the fact that he was not personally liable.[66]

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however, justify an increase in basis. *See* I.R.C. § 1016(a)(1) (1976 & Supp. V 1981); Treas. Reg. § 1.1016-2 (1960).

53. 1 T.C. at 689.

54. For thorough discussions of the economic benefit theory, see Halpern, *supra* note 13, at 208-20 (1979); Simmons, *Nonrecourse Debt and the Amount Realized: The Demise of* Crane*'s Footnote 37*, 59 OR. L. REV. 3, 16-18 (1980).

55. 9 T.C. 320 (1947).

56. 198 F.2d 357 (2d Cir. 1952).

57. *Woodsam*, 198 F.2d at 359; *see Mendham*, 9 T.C. at 325.

58. 9 T.C. at 324. Two commentators have noted their approval of the decisions in *Lutz & Schramm* and *Mendham*. *See* Ginsburg, *The Leaky Tax Shelter*, 53 TAXES 719, 730 (1975); Simmons, *supra* note 54, at 13-14 (1980).

59. 198 F.2d at 359.

60. 495 F.2d 1079 (6th Cir.), *cert. denied*, 419 U.S. 1040 (1974).

61. *Id.* at 1080. The taxpayer's basis in the stock equalled approximately $10,000, and the stock was worth at least $200,000. *See id.* at 1080 & n.2.

62. *Id.* at 1080.

63. *Id.*

64. *Id.* at 1083.

65. *Id.* The taxpayer did argue that the $150,000 he paid in gift tax should escape taxation. *Id.* at 1081. This argument was disposed of by the Supreme Court in 1929. *See* Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 729 (1929). *Accord* Guarantee Title & Trust Co. v. Commissioner, 313 F.2d 225, 228 (6th Cir. 1963); Schaeffer v. Commissioner, 258 F.2d 861, 864 (6th Cir. 1958); Malone v. United States, 326 F. Supp. 106, 112 (N.D. Miss. 1971), *aff'd*, 455 F.2d 502 (5th Cir. 1972).

66. 495 F.2d at 1083. The court of appeals recognized the absence of personal liability by a taxpayer was persuasive but not dispositive. *Id. See also* First Nat'l Indus., Inc. v. Commissioner, 404 F.2d 1182 (6th Cir. 1968), *cert. denied*, 394 U.S. 1014 (1969) (donor of property subject to a mortgage was charged with capital gain for the gift).

4. *Delman*: The Most Recent Case Resting on the *Crane* Tax Benefit Principle

In *Estate of Delman v. Commissioner*,[67] taxpayers who had purchased equipment subject to a nonrecourse mortgage defaulted and the seller-mortgagee repossessed the goods.[68] At the time of foreclosure, the unpaid debt was $1,182,542, and the taxpayers' basis had been depreciated to $504,625.[69] The value of the equipment had declined to $400,000.[70] The Tax Court held that the partners collectively realized a gain of $1,182,542 minus $504,625, equalling $677,917. The value of the property was irrelevant.[71]

The court relied on *Lutz & Schramm*, *Mendham*, *Woodsam*, *Millar*,[72] and the Tax Court's decision in *Tufts*.[73] As in *Millar* and *Tufts*,[74] the taxpayers here benefitted from the nonrecourse loans by including them in basis and consequently in depreciation deductions.[75] These depreciation deductions supplied the taxpayers with tax losses.[76]

The taxpayers argued that cases applying the tax benefit rule[77] were inapplicable because those decisions required an actual receipt of funds or a discharge of liability increasing the taxpayer's net worth before income resulted.[78] The court countered by applying *Crane*: no such requirements exist when a sale or exchange of property subject to a nonrecourse liability takes place.[79] Neither element was present in *Crane*. The *Crane* court had concluded that the nonrecourse liability was properly included in amount realized.[80]

The taxpayers also argued that neither the instant facts nor those in *Millar* or *Tufts* involved new money obtained by nonrecourse financing subsequent to the initial purchase, and therefore the fair market value irrelevancy rule, upheld in *Lutz & Schramm*, *Mendham*, and *Woodsam*, is inapplicable.[81] The court responded that those decisions rest on the economic benefit theory and the economic benefit achieved by subsequent mortgaging can also be achieved by a purchase-money mortgage, as in the instant case.[82]

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67. 73 T.C. 15 (1979).

68. *Id.* at 25.

69. *Id.* at 27-28.

70. *Id.* at 28.

71. *See id.* at 37.

72. *Id.* at 28.

73. *Id.* Commissioner v. Tufts, 70 T.C. 756 (1978), *rev'd*, 651 F.2d 1058 (1981), *rev'd*, 103 S. Ct. 1826 (1983).

74. *See infra* text accompanying note 91.

75. 73 T.C. at 30.

76. *Id.*

77. *See, e.g.*, Tennessee Carolina Transp. Inc. v. Commissioner, 582 F.2d 378 (6th Cir. 1978), *cert. denied*, 440 U.S. 909 (1979).

78. 73 T.C. at 30 n.3.

79. *Id.* *See infra* note 123 and accompanying text.

80. 73 T.C. at 30 n.3 (interpreting the *Crane* decision).

81. *Id.* at 30-31 n.5.

82. *Id.* (dictum).

5. Summary of the Law Before *Tufts*

The existing rules and reasoning prior to the court of appeals decision in *Tufts* can be easily summarized. A tax benefit results from the debt's inclusion in basis which in turn contributes to depreciation deductions. Therefore where property is acquired subject to a mortgage or by means of a new mortgage, it is fair to include in amount realized the amount of debt unpaid, because the difference between it and adjusted basis represents the amount of depreciation claimed in excess of the loan principal paid. The value of the property does not matter.

Depreciable basis does not include the mortgage amount when property is mortgaged for cash subsequent to acquisition. Nevertheless, the unpaid mortgage debt must be included in amount realized to avoid an untaxed economic benefit because the loan proceeds were never taxed. As with the tax benefit theory, the decline in the property's value does not reduce the untaxed economic benefit.

II. *COMMISSIONER V. TUFTS*

A. *The Facts*

The taxpayers in *Tufts* were general partners building an apartment complex. They contributed a total of $44,212 of their own money and borrowed $1,851,000 from a bank, securing the debt with a nonrecourse mortgage.[83]

After completion of the apartment complex, a shortfall in revenue caused the partners to convey their interests to an unrelated third party solely in consideration of the selling expenses and the assumption of the nonrecourse mortgage.[84] At this time, the debt was $1,851,500, the value of the property was only $1,400,000, and the partners had depreciated the property down to $1,455,740.[85]

The issue was whether the amount realized is *all* of the unpaid debt or is limited to the value of the property given up. This issue could be determined either by prior judicial interpretation or by the Internal Revenue Code provision[86] concerning the treatment of liabilities to which partnership property is subject if that provision applies to the sale of partnership interests.[87]

B. *The Holding*

First, the Court identified section 752(d) as controlling: liabilities incurred in the sale or exchange of a partnership interest are to be treated in the same manner as liabilities are treated in connection with the sale or ex-

83. 103 S. Ct. at 1828-29.

84. *Id.* at 1829.

85. *Id.* at 1829 nn.1-2.

86. I.R.C. § 752(c) (1976 & Supp V 1981). Section 752 contains a fair market value limitation. *See infra* note 97.

87. The sale of partnership interest is governed by I.R.C. § 752(d) (1976 & Supp V 1981). *See infra* note 97.

change of property not associated with partnerships.[88]

The Court then adopted *Crane*: inclusion of the debt in basis requires inclusion in amount realized. But here, the Court announced as its reasoning that it is the economic benefit of the original loan proceeds, untaxed because of the obligation to repay, that justifies inclusion. This is true regardless of the property's value.[89] Unless the outstanding amount of the mortgage is deemed to be realized upon disposition, the loan proceeds will ultimately go untaxed.[90]

The Court found its rule consistent with Treasury Regulation 1.1001-2(b),[91] Revenue Ruling 76-111,[92] *Millar*,[93] *Mendham*,[94] and *Lutz & Schramm*.[95] Moreover, to permit the taxpayer to limit his amount realized to the value of the property would be to permit recognition of tax loss for which he has suffered no corresponding economic loss.[96]

The partners argued that Congress intended asymmetrical treatment in the sale or disposition of partnership property under section 752(c), because they believed this section should apply to section 752(d).[97] The Supreme Court, as did the Tax Court,[98] met this argument with the legislative history of section 752.[99] The mention of a fair market value limitation occurred only in the context of transactions between the partner and the partnership.[100] The fair market value limitation on the liability to which property is subject does not apply to sales of partnership interests to unrelated third parties.[101]

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88. 103 S. Ct. at 1829. *See infra* note 97.

89. 103 S. Ct. at 1831. *Crane* rests on the Commissioner's policy of identical treatment of recourse and nonrecourse debt, which the *Tufts* Court accepted as reasonable. *Id.* at 1831-32. Thus, the purchaser's assumption of the mortgage was accounted for in the computation of amount realized. *Id.* at 1832 (citing United States v. Hendler, 303 U.S. 564, 566-67 (1938)). The Court declines to call the economic benefit a cancellation of indebtedness. For the Court's discussion see 103 S. Ct. at 1833 n.11.

90. *Id.* at 1832.

91. Treas. Reg. § 1.1001-2(b) (1980). *See supra* note 6.

92. Rev. Rul. 76-111, 1976-1 C.B. 214, 215. *See supra* note 41.

93. *See supra* notes 34-40 and accompanying text.

94. *See supra* notes 55-58 and accompanying text.

95. 103 S. Ct. at 1832-33. The *Lutz & Schramm* decision is discussed *supra* notes 43-54 and accompanying text.

96. 103 S. Ct. at 1834.

97. 103 S. Ct. at 1835. Section 752 reads in part:

> (c) For the purposes of this section [752], 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) 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.

98. I.R.C. § 752. 70 T.C. at 767-68.

99. H.R. REP. NO. 1337, 83d Cong., 2d Sess., A236, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4017, 4091-98; S. REP. NO. 1622, 83d Cong., 2d Sess., 405, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4721-33.

100. Treas. Reg. § 1.752-1(c) (1982) is consistent with this limited applicability of section 752(c). *See also* Simmons, Tufts v. Commissioner: *Amount Realized Limited to Fair Market Value*, 15 U.C.D. L. REV. 577, 611-13 (1982) (criticizing the Fifth Circuit's opposite interpretation of this legislative history).

101. 103 S. Ct. at 1836. For a discussion of the § 752 issue see Charyk & Sexton, *Liabilities in Excess of Fair Market Value: The Consequences of the Reversal of the* Tufts *Case*, 10 J. REAL EST. TAX'N 159 (1982); Simmons, *supra* note 100, at 609-16.

The legislative history applied by the Supreme Court is quite direct, and will not be ana-

Justice O'Connor, in her concurring opinion, would reach the same result, but would separate the excess of the debt over the value of the property as income from cancellation of indebtedness, and not include it in amount realized.[102] This would allow *that* part of the gain to be treated as ordinary income instead of as capital gain.[103] She declined to adopt this judicially, though, because of the Commissioner's position in Revenue Ruling 76-111[104] and the decisions in *Millar* and *Delman*.[105] Justice O'Connor recognized the majority's interpretation of the definition of amount realized is defensible, because the reference of section 1001(b) to amount realized *from* the sale or other disposition of property can reasonably be read to allow the collapse of the two aspects of the transaction.[106]

III. ANALYSIS

The results in *Millar*, *Delman*, and *Tufts* in the Tax Court appear to be well reasoned decisions, yet the reasons given have engendered a notion that the tax benefit of the depreciation deductions matters. *Millar*, *Delman*, and the Tax Court in *Tufts* all view *Crane* as a tax benefit rule for recapturing depreciation.[107] That view of the *Crane* reasoning is misleading. *Crane*'s novel term "functional relation" is conclusionary and should not be applied in the unified economic benefit analysis presented by the Supreme Court in *Tufts*. If the Supreme Court in *Tufts* failed, it was in neglecting to firmly discard this misleading emphasis on depreciation in *Millar* and *Delman*.[108]

A. *A Unified Economic Benefit Rule*

Adjusted basis and amount realized form a continuum and function in tandem[109] to account, upon disposal of property previously mortgaged for

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lyzed in this comment. The logic for potential tax shelter abuse was mentioned. *See* 103 S. Ct. at 1836.

102. *Tufts*, 103 S. Ct. at 1836 (O'Connor, J., concurring) (adopting argument of *amicus curiae* submitted by Professor Wayne G. Barnett). *See also* Del Cotto, *supra* note 18, at 87 (advancing same rule). *But see Tufts*, 103 S. Ct. at 1833 n.11 (majority agrees that this could be a justifiable mode of analysis, except the Commissioner has not adopted it and the code does not require it, plus the amicus's approach assumes recourse and nonrecourse debt may be treated identically). *See also infra* note 141.

103. It is important to classify the unpaid debt in excess of the property's value as debt relief, not amount realized, because the former is ordinary income, I.R.C. § 61(a)(12) (1976), while the latter may result in capital gain treatment, I.R.C. § 1202(a) (1976 & Supp. V 1981). *Tufts*, 103 S. Ct. at 1837 (O'Connor, J., concurring).

104. Rev. Rul. 76-111, 1976-1 C.B. 214, reflected in Treas. Reg. § 1.1001-2 (1980). *See supra* notes 6, 41.

105. *See supra* notes 34-41, 67-82 and accompanying text. *See also* Peninsula Properties Co. v. Commissioner, 47 B.T.A. 84, 92 (1942) (unsecured debt settled at a discount by transfer of securities; amount realized reflects debt relief but is a capital gain).

106. 103 S. Ct. at 1838 (O'Connor, J., concurring).

107. *See, e.g.*, *Tufts*, 70 T.C. at 764; *see supra* text accompanying notes 34-41, 67-82. At least two commentators view the tax benefit aspect of *Crane* and, therefore, the reasoning in *Millar*, *Delman*, and *Tufts* in the Tax Court, as correct. *See* Bittker, *supra* note 14, at 282; Friedland, Tufts *and* Millar: *Two New Views of the* Crane *Case and Its Famous Footnote*, 57 NOTRE DAME LAW. 510, 526-28 (1982).

108. *See* 103 S. Ct. at 1832 n.8.

109. *See* Sanders, *Sup. Ct., Ending* Crane *Controversy, Says Nonrecourse Debt Is Always Part of Sales Price*, 59 J. TAX'N 2, 4 (July 1983); Simmons, *supra* note 54, at 18.

the owner's benefit, for that original untaxed[110] accession to that property[111] or some other property.[112] The exact amount of benefit depends upon how much capital is retained at the end of the transaction compared to how much was invested.[113] Basis, including any reductions for depreciation[114] or Subchapter S losses,[115] and amount realized, including any reductions for payments of principal, together account for the excess of capital extracted from the property transaction over the after-tax capital actually invested.[116]

This rule explains *Lutz & Schramm* and its progeny.[117] None of the loan proceeds have been taxed, so at the close of the mortgage transaction when the debt disappears by conveyance to the mortgagee, the proceeds are ripe for taxation. At this point the economic benefit to the taxpayer becomes ascertainable and equals the amount of previously enjoyed capital that now need not be repaid.

The economic benefit rule fully justifies the results in purchase-money mortgage cases,[118] where the taxpayer or his transferor mortgaged the capital asset to acquire it. The mortgaging enables a tax-free receipt of the capital asset itself, such as real property or securities.[119] The amount of this debt is included in basis because of the obligation to repay,[120] and it is included in amount realized, to the extent it has not been amortized, because the inclusion in amount realized serves to tax the accession to the capital beyond what after-tax capital was committed in the form of repayment of the debt. Otherwise, the gain of capital would escape taxation simply because of the nonrecourse nature of the mortgage.

Millar is illustrative. In *Millar* the taxpayers acquired the Subchapter S stock without taxation and they enjoyed this capital asset by having the tax losses pass through to their own tax returns,[121] sheltering other income from taxation. They clearly acquired and enjoyed a capital asset, so at its disposal to the mortgagee, their gain properly reflected the difference between the capital extracted and their own capital committed to the asset, their amortization of the mortgage. The decline in the property's value did not affect that excess of capital extracted over capital invested, and thus the value at the time of foreclosure was irrelevant. Exactly the same rationale applies in *Delman* where, because the taxpayers owned the business assets directly as

110. Loan proceeds are not taxable. *See* Popkin, *The Taxation of Borrowing*, 56 IND. L.J. 43, 43 & n.1 (1980); 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 5.12 (1981) (cases annotated therein). *See also* Halpern, *supra* note 13, at 221.

111. *See, e.g.*, *Millar*, 577 F.2d 212; *Delman*, 73 T.C. 15.

112. *See, e.g.*, *Johnson*, 495 F.2d 1079; *Lutz & Schramm*, 1 T.C. 682.

113. *See* Halpern, *supra* note 13, at 228 (an account must be made of the after-tax investment initially credited with that amount remaining unpaid at the time of the transfer).

114. Depreciation is a return of capital. *See* Doyle v. Mitchel Bros. Co., 247 U.S. 179, 185-88 (1918) (taxable income does not include restoration of capital). Because it is a return of capital, basis is reduced. *See* I.R.C. § 1016(a)(2) (1976 & Supp. V 1981). *See generally* Simmons, *supra* note 18, at 6-14; Note, *supra* note 12, at 1511 n.85.

115. Subchapter S losses are also a return of capital. *See supra* note 38.

116. *See* Simmons, *supra* note 100, at 593-94, 604, 606-09.

117. *See supra* notes 43-59 and accompanying text.

118. *See supra* notes 29-41, 67-82 and accompanying text.

119. *See supra* note 110.

120. *See supra* note 18. *See generally* Simmons, *supra* note 54, at 20 n.82.

121. *See supra* note 34.

partners, the depreciation deductions shielded other income. The actual economic benefit[122] of the capital asset was a tax shelter, so the effect was termed a tax benefit.[123]

B. *The Economic Benefit Does Not Depend on Depreciation*

The economic benefit rule does not depend on depreciation having been claimed.[124] This is illustrated by a variation on the facts in *Tufts*. The Code might have allowed more or less depreciation than was claimed or none at all.[125] The depreciation does not trigger the rule. It is simply additional capital extracted by the partners, and is reflected by an increased gain or decreased loss by adjusting their bases downward. If the partners had pledged the property by a second nonrecourse mortgage to borrow $100,000 for purposes other than the development, when they sold their interests subject also to that mortgage, they would have in addition realized that $100,000. This additional $100,000 gain would not have been attributable to any depreciation claimed; it was never added to the basis.[126]

The Fifth Circuit held in *Tufts* that value must limit the amount realized[127] in part because the court completely misunderstood the economic benefit theory.[128] The court of appeals reasoned that any tax benefits that a taxpayer receives in the form of prior deductions are factored into the gain equation[129] by adjustment to basis.[130] Therefore, it does not appear logical that, if the property does in fact decline in value as was assumed by Congress, the taxpayer must be taxed on an amount realized that reflects a recapture of depreciation, the debt in excess of value. Adjusted basis already reflects that depreciation claimed, resulting in a double taxation on the same

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122. *See Delman*, 73 T.C. at 31 n.5 (dictum) (the court recognizes the economic benefit of the taxpayer's use of the property while limiting his liability).

123. *Id.* The tax benefit rule is codified at I.R.C. § 111 (1976 & Supp. V 1981), and it does not apply to recovery of depreciation deductions. Treas. Reg. 1.111-1(a) (1956). *Cf.* Commissioner v. Anders, 414 F.2d 1283, 1287-88 (10th Cir.), *cert. denied*, 396 U.S. 958 (1969) (earlier expenses recouped in sale of rental items preceding liquidation were not a recovery of depreciation, therefore ordinary income and not capital gain).

For a comparison of the § 111 tax benefit rule and the depreciation aspect of the economic benefit rule, see Del Cotto, *supra* note 18, at 84 n.81. For a better application and thorough analysis of the tax benefit rule, see Hillsboro Nat'l Bank v. Commissioner, 103 S. Ct. 1134, 1142-49 (1983). On the tax benefit rule generally, see Bittker & Kanner, *The Tax Benefit Rule*, 26 U.C.L.A. L. REV. 265 (1978).

124. *See* 103 S. Ct. at 1832 n.8. *See generally* Simmons, *supra* note 54, at 18-21; Note, *supra* note 12, at 1526-29.

125. Depreciation deductions are still a matter of legislative grace. *See* Perry, *supra* note 11, at 534.

126. *See* Halpern, *supra* note 13, at 225-27 (commenting that the amount realized rule of *Crane* does not depend on depreciation having been claimed, that depreciation deductions need only be indirectly taken into account).

127. 651 F.2d at 1063.

128. The court of appeals doubted the "double deduction" language in *Crane*. 651 F.2d at 1060 n.4. *See supra* note 26. The Supreme Court in *Tufts* just avoided that part of *Crane* by deciding *Tufts* on other grounds, an economic benefit theory. 103 S. Ct. at 1833 n.10. *See infra* text accompanying notes 136-37.

129. *See* I.R.C. § 1001(b). Gain equals amount realized less basis adjusted for depreciation and other returns of capital.

130. 651 F.2d at 1061.

component of gain.[131]

The court's reasoning is flawed. Depreciation is itself a return of capital, as is amount realized; they are *not* the same component of gain. The amount realized less adjusted basis serves to tax the combined recoveries of capital in excess of the original investment.

The court's reasoning can be viewed also as an erroneous assumption that the taxpayer has actually lost capital by the devaluation of the property, when in truth the taxpayer has lost capital only to the extent he has invested capital by amortization of the debt,[132] which is accounted for by the economic benefit rule.

The *Tufts* facts provide a good illustration of this erroneous assumption. The taxpayers claimed that they lost $55,740,[133] which necessarily means they invested that much more in capital than they extracted by the end of the whole transaction. This is not supported by the facts. In the course of ownership they invested only $44,212 but extracted in the form of depreciation a total of $439,722.[134] This benefit of excess capital returned to them did not depend on the value of the property. The property could have been worthless when transferred subject to the mortgage, and their economic benefit, ascertainable at the close of the transaction, would still have been calculated as above. This is where the court of appeals erred. The basis, adjusted by returns of capital, and amount realized, reflecting the investment of capital, completely account for the economic benefit. The taxpayer has not lost any capital unless he has amortized the debt as fast as he has depreciated the property.[135]

The Supreme Court in *Tufts* recognized the economic benefit of tax-free loan proceeds and that the loan proceeds would go untaxed at the close of the transaction if amount realized did not include the unpaid debt.[136] In support of this conclusion, the Supreme Court reasoned that the taxpayer loses nothing by devaluation of the property below the unpaid debt and, therefore, he should recognize no tax loss.[137]

C. Tufts *Concerns Disposal of Mortgaged Property*

Some commentators have found inconsistency between the inclusion of nonrecourse debt beyond value and the principle of discharge of indebted-

131. *Id.* at 1061 n.4. At least two commentators agree with this reasoning. *See* Newman, *The Resurgence of Footnote 37*: Tufts v. Commissioner, 18 WAKE FOREST L. REV. 1, 10 (1982); Pietrovito, Tufts v. Commissioner, *A Limitation on the Inclusion of Nonrecourse Liabilities in Amount Realized*, 11 CAP. U.L. REV. 265, 281-82 (1982).

132. The mortgagee who forecloses at a value less than the unpaid debt has a deductible loss under I.R.C. §§ 165 or 166(a)(2) (1976 & Supp. V 1981).

133. 103 S. Ct. at 1829. The taxpayers calculated their loss by subtracting the property's value, $1,400,000, from its adjusted basis, $1,455,740. *Id.* at 1829 n.1.

134. *Id.* at 1829.

135. For an excellent presentation of this unified economic benefit analysis, see Simmons, *supra* note 54, at 4, 18-21, 27-31; Simmons, *supra* note 100, at 602-09.

136. *See Tufts*, 103 S. Ct. at 1832, 1833 n.11, 1834.

137. *Id.* at 1834.

ness,[138] which relies on a freeing of the taxpayer's assets to the claims of other creditors.[139] There need not be any consistency, because the discharge of indebtedness principle originated in cases not involving the ownership and disposal of a mortgaged capital asset.[140] They are not applicable because there was not an adjusted basis and an amount realized accounting for the ultimate gain reflecting the net accession to capital at the close of the transaction.[141] As presented earlier in this analysis, such gain in value is not a function of the value of the property at disposition.

The inclusion of debt in amount realized beyond the value of the property is not inconsistent with the purchase money exception to the discharge of indebtedness principle.[142] The exception properly applies only where the debtor continues to own the property after the reduction in debt,[143] and where the parties actually agree to reduce the price of the property transferred.[144]

CONCLUSION

The Tax Court in *Tufts* reached the same result as the Supreme Court, but the implication that the recovery of depreciation deductions is the heart of the justification weakens the Tax Court's reasoning.[145] The tax shelter aspect is just the particular economic benefit that the owner values.[146] The Supreme Court did note that the basis, adjusted for depreciation as a return of capital, and amount realized, including all unpaid debt, factor in depreciation but do not depend on it[147] in accounting for the net economic benefit to the taxpayer.

The *Tufts* opinion buries *Crane*'s footnote 37.[148] Although dictum, the footnote generated much controversy and necessitated the Supreme Court's

138. Bittker, *supra* note 14, at 284; Del Cotto, *supra* note 18, at 85; Note, *supra* note 12, at 1502 n.31; Comment, *supra* note 38, at 349.

139. *See* Simmons, *supra* note 100, at 599. A nonrecourse mortgage by definition is a lien only on that asset, so its discharge frees no other assets. *See Delman*, 73 T.C. at 32. *See also id.* at 31 & n.6. The court of appeals in *Tufts*, 651 F.2d at 1062, analogized relief from nonrecourse debt to relief from future property taxes by selling the property, which provides no relief. That is a *non sequitur*. Capital gains do not need a pure debt relief justification. *See Tufts*, 103 S. Ct. at 1833 n.11 (the freeing of assets is irrelevant).

140. *See* Commissioner v. Jacobson, 336 U.S. 28 (1949) (repurchase by debtor of leasehold bonds at discount); United States v. Kirby Lumber Co., 284 U.S. 1 (1931) (retirement of corporate debt at a discount); Bialock v. Commissioner, 35 T.C. 649 (1961) (satisfaction of unsecured debts by a transfer of assets).

141. *See* Simmons, *supra* note 54, at 37 n.177. In *Tufts*, the Court chooses not to characterize the transaction as cancellation of indebtedness. 103 S. Ct. at 1833 n.11 ("We note only that our approach does not fall within certain prior interpretations of that doctrine." The freeing-of-assets theory "is irrelevant to our broader approach.").

142. *Contra* Del Cotto, *supra* note 18, at 77-79.

143. *See* Hirsch v. Commissioner, 115 F.2d 656, 658 (7th Cir. 1940). *See generally* Simmons, *supra* note 54, at 35-40.

144. *See* Millar v. Commissioner, 67 T.C. 656, 661, *aff'd in part*, 577 F.2d 212 (3d Cir.), *cert. denied*, 439 U.S. 1046 (1978).

145. 70 T.C. at 765.

146. Congress can always limit this benefit. *See, e.g.*, I.R.C. § 465 (1976 & Supp. V 1981) (taxpayer's depreciation limited to his capital at risk; presently not applicable to real estate).

147. 103 S. Ct. at 1832 n.8.

148. Crane v. Commissioner, 331 U.S. 1, 14 n.37 (dictum implying that amount realized

attention in *Tufts* to overrule the unsound court of appeals decision[149] which had briefly elevated that dictum to law.

Due to the depth of precedent to the contrary, Justice O'Connor's approach,[150] distinguishing the capital gain from the debt relief, was not persuasive to the majority. The loss to the Treasury, however, is the practical result of a Congressional policy to tax capital gains more favorably than other income.[151]

Treasury Regulation 1.1001-2(b)[152] resolved *Tufts* in advance of the appeal to the Fifth Circuit, but the court of appeals impliedly found it a distortion of amount realized.[153] The Supreme Court has sustained it with sound reasoning.

Roger H. Randall

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should be limited to value). *Crane*'s footnote 37 has not been persuasive to the courts. *See Tufts*, 103 S. Ct. at 1831; *Millar*, 577 F.2d at 214; *Tufts*, 70 T.C. at 765-66; *Delman*, 73 T.C. at 29-30.

The court of appeals in *Tufts* reached a result consistent with footnote 37, based on a fundamental disagreement with *Millar*'s interpretation of *Crane* as a depreciation recapture rule, 651 F.2d at 1060-61, and based on a view of the debt relief as the economic benefit and, therefore, necessarily limited to the property's value. 651 F.2d at 1061-62. *Accord* Bittker, *supra* note 14, at 282. This reasoning overlooks the untaxed economic benefit of the loan proceeds originally. *See supra* text accompanying notes 109-23.

149. 651 F.2d 1058 (5th Cir. 1981). Had the Supreme Court not reversed the Fifth Circuit, the Treasury Department would have proposed overriding the result to Congress. *See Taxes on Parade*, Release No. 54, STAND. FED. TAX. REP. (CCH) (Nov. 4, 1981) (speech by a treasury officer to the American Institute of Certified Public Accountants).

150. 103 S. Ct. at 1836-37 (O'Connor, J., concurring).

151. I.R.C. § 1202(a). For the justifications of capital gain treatment, see Rosenberg, *Better to Burn Out than to Fade Away? Tax Consequences on the Disposition of a Tax Shelter*, 71 CAL. L. REV. 87, 100-103 (1983). *But see* I.R.C. §§ 1245, 1250 (1976 & Supp. V 1981) (taxing some of the capital gain as ordinary income).

152. Treas. Reg. § 1.1001-2(b) (1980) (value is irrelevant to amount realized). *See supra* note 6.

153. 651 F.2d at 1064 n.9. *See also id.* at 1064 (Williams, J., concurring) (expressly finding the regulation inconsistent with the plain language of I.R.C. § 1001(b)).