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DEATH OF A FOOTNOTE: A CURRENT VIEW OF CRANE AND THE ROAD TO TUFTS

SUSAN MARIE HALLIDAY* and THEODORE PAUL MANNO**

I. INTRODUCTION

The Supreme Court, after a generation of uncertainty, settled in 1983 an issue of great importance to taxpayers utilizing nonrecourse financing in tax shelters and other investments.1 The Court, in Commissioner v. Tufts,2 held that the Commissioner may properly require a taxpayer to include the full amount of an unpaid nonrecourse loan in amount realized for purposes of calculating gain or loss on property sold subject to such a debt. The decision requires a taxpayer to include the unpaid debt in amount realized regardless of whether the unpaid amount exceeds the fair market value of the property sold. The Justices’ decision in Tufts reversed a widely debated decision of the Fifth Circuit Court of Appeals3 and eliminated the uncertainty created thirty-six years earlier by “the most famous footnote in the tax law.”4

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The opinions expressed herein are solely those of the authors.

1. Under nonrecourse financing, a creditor can reach only the property which secures the note. The creditor cannot reach the debtor’s other assets. See infra note 17 and accompanying text.


That footnote, footnote thirty-seven to Crane v. Commissioner,\(^6\) suggested that, when nonrecourse debt exceeds the fair market value of the property sold subject to that debt, the fair market value of the property limits the amount a taxpayer must take into account in reporting gain or loss for federal income tax purposes.\(^6\) The value of the tax shelter property at issue in Tufts declined after its purchase, and the Fifth Circuit Court of Appeals accepted the limitation suggested by Crane footnote thirty-seven. As a result, the Fifth Circuit allowed the taxpayers to claim a capital loss from the sale of the property, when the taxpayers had already enjoyed other tax benefits from owning the shelter property.\(^7\) The Supreme Court’s rejection of the footnote thirty-seven limitation and consequent reversal increased the amount realized by the taxpayer from the sale of the property. The resulting capital gain charge significantly and adversely altered the tax treatment of the taxpayer-investor who had disposed of the shelter property.\(^8\)

This Article discusses the historical development of the “footnote thirty-seven problem” and analyzes the Court’s rejection of the limitation suggested in Crane’s footnote thirty-seven. The Article also reviews the recent efforts by the legislative branch of the federal government, in the Tax Acts of 1982 and 1984,\(^9\) to reduce the desirability of certain tax shelter practices. This Article concludes that Tufts is not a judicial attack on tax shelters similar to these legislative efforts, but is rather a prod-

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6. 331 U.S. at 14 n.37. See infra text accompanying note 56.

7. See infra notes 95, 113 and accompanying text.

8. See infra notes 119-27 and accompanying text.

9. See infra notes 151-88 and accompanying text.
uct of the Supreme Court's adherence to stare decisis, and is an illustration of the symmetrical treatment of nonrecourse debt the Court envisioned in Crane.10

II. Crane v. Commissioner

The taxpayer in Crane was a widow who inherited a building from her husband in 1932. The property's fair market value at the time of the husband's death was $262,042.50, and the property was encumbered by nonrecourse debt in the same amount. After operating the building for several years, Mrs. Crane sold it, subject to the debt, for $3,000, and incurred $500 in selling expenses. At the time of the sale, the principal amount of the debt was $255,000.11

The Internal Revenue Code (I.R.C.) provides that gain equals amount realized less adjusted basis.12 "Gain," "amount realized," and "adjusted basis" are terms of art under the Code. In ordinary usage the term "to realize" means "to convert into money," but the tax significance of the term is broader. For tax purposes, "to realize" means the "conversion of property into money, other property, or other economic benefit cognizable for tax purposes."13 The starting point for calculating basis of inherited property is I.R.C. section 1014 (which at the time of Crane was section 113(a)(5)). Section 1014 provides that a taxpayer who acquires property from a decedent takes as his basis the value of the property as stated on the decedent's federal estate tax return.14 In Crane, the taxpayer asserted that a further

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10. See infra notes 192-97 and accompanying text. See Note, Federal Income Tax Treatment of Nonrecourse Debt, 82 Colum. L. Rev. 1498, 1525-30 (1982)[hereinafter cited as Columbia Note] for the view that the Crane rationale does not provide the symmetry the decision purportedly assures.

11. 331 U.S. at 3.

12. I.R.C. § 1001. (1984). In 1947, the year that Crane was decided, the Internal Revenue Code contained the same equation used to calculate gain. Revenue Act of 1938, Pub. L. No. 554, § 111, 52 Stat. 484, 485 (1938)[hereinafter cited as Revenue Act].


14. Revenue Act, supra note 12, § 113(a)(5) contained the same principle as is contained in I.R.C. § 1014 (1984). The rule itself can constitute a tax shelter (albeit one that requires from a taxpayer the ultimate sacrifice). The rule allows a taxpayer and his heirs to entirely avoid income tax on the capital appreciation of property to the time of the taxpayer's death. The Tax Reform Act of 1976 would have changed this "step-up" rule
step in the calculation of basis was necessary, namely, subtraction of the amount of debt secured by the property. Consistent with this assertion, the taxpayer claimed that her original basis in the building was her net equity in it at the time of acquisition. The taxpayer calculated her net equity by subtracting the amount of the debt encumbering the property from its fair market value. Under the circumstances, the taxpayer's net equity was zero because the fair market value equaled the debt at the time of her acquisition; she therefore used zero as her adjusted basis. The taxpayer then calculated amount realized as $2,500 by subtracting her selling expenses of $500 from the $3,000 she received for the encumbered property. Accordingly, the taxpayer reported a gain of $2,500 by subtracting her adjusted basis of zero from the amount realized of $2,500. The Supreme Court

with a provision for a carry-over basis at death. The Revenue Act of 1978 postponed this change, and a provision in the Crude Oil Windfall Profit Tax Act of 1980 finally abandoned it. See Pub. L. No. 96-223, § 401(a), 94 Stat. 229, 299 (1980); Pub. L. No. 95-600, § 702(c), 92 Stat. 2763, 2925-28 (1978); Pub. L. No. 94-455, § 2005, 90 Stat. 1520, 1872 (1976). With respect to decedents dying after December 31, 1976, and before November 7, 1978, the repeal permitted a taxpayer to elect whether to use the carry-over basis rules in lieu of the step-up. Congress also made a limited provision for the use of carry-over basis in the Economic Recovery Tax Act of 1981 [hereinafter referred to as ERTA] in order to combat anticipated abuse of the step-up. Pub. L. No. 97-34, § 425, 95 Stat. 172, 318 (1981); STAFF OF THE JOINT COMM. ON TAXATION, 97TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY ACT OF 1981 at 264-65 (C.I.R. Print 1981). Because ERTA increased the amount of the unified credit available against estate and gift taxes, and provided an unlimited marital deduction, the following would have been possible after the Act: a family member with low basis property could have given it to a relative who had a terminal illness, who anticipated little or no estate tax liability, and who had previously or simultaneously executed a will bequeathing such property to the donor. At the donee's death the original owner would have gotten his property back, and his ownership of it would have been purged of any possibility of capital gains taxation on the appreciation to that date. The House of Representatives' version of ERTA would have discouraged this strategy by denying a stepped-up basis in appreciated property received by a decedent within three years of his death, if the property passed at his death directly or indirectly to the original donor or the donor's spouse. The prohibition in its final form applies only to gifts to a decedent within one year before death. I.R.C. § 1014(e)(1984). The 1984 Act also prevents a "free" step-up by denying use of the alternate valuation date unless the gross estate and the tax are thereby increased. Tax Reform Act of 1984, Pub. L. No. 98-369, § 1023, 98 Stat. 494, 1030 (amending I.R.C. § 2032 (1984)).

15. 331 U.S. at 3-4. The taxpayer reported 50% of the gain as taxable pursuant to then I.R.C. § 117. See Columbia Note, supra note 10, at 1499, noted in Tufts, 461 U.S. at 305 n.5; see infra notes 103-09 and accompanying text for the view that "basis should reflect the taxpayer's equity in property, so that nonrecourse debt is not included in basis." See also Pietrovito, Tufts v. Commissioner, A Limitation on the Inclusion of Non-recourse Liabilities in Amount Realized, 11 CAP. U.L. REV. 265 (1982).
rejected the taxpayer's use of net equity as adjusted basis and established that (1) the basis of property for purposes of calculating gain or loss and depreciation includes any debt incurred in its purchase or receipt, and (2) the amount realized on the sale of property includes relief from any debt encumbering it.18 The Court thus established a symmetrical treatment of debt by mandating that a taxpayer include it in the calculation of both adjusted basis and amount realized.

The Court in Crane treated recourse and nonrecourse debt identically in this respect, despite the disparity of the economic consequences each produces. Recourse debt involves a debtor who is personally liable. A creditor who is a party to recourse debt can reach the property securing the note as well as the debtor's other assets. On the other hand, nonrecourse debt involves a debtor who is not personally liable. A creditor who is a party to nonrecourse debt can reach only the property securing the debt.17 Despite this distinction in types of debt, the Court reasoned that because the value of the property involved in Crane was at least equal to the outstanding mortgage at the time of sale, the taxpayer had an economic incentive to discharge the debt so as to protect her investment.18 In other words, although the debt in Crane was nonrecourse and the taxpayer was therefore not personally liable, she would behave in the same manner as if she were liable because she would receive, by paying off the encumbrance, property worth at least the amount she would expend in so doing.

The Court therefore ruled that the taxpayer's original basis fully included the original amount of the debt. The Court further held that the taxpayer's amount realized included both the $2,500 in hand and an amount equal to the discharge of the balance of the $255,000 debt. Thus, the Court found that the tax-

18. 331 U.S. at 14. See infra notes 34-54 and accompanying text for a discussion of the tax consequences when the amount of the debt is so excessive that the taxpayer does not have this incentive.
payer's amount realized was $257,500.\textsuperscript{19} Although not necessary to the decision, the Court suggested in footnote thirty-seven that, had the debt exceeded the property's fair market value at the time of the sale, the fair market value might have limited the amount of the debt the taxpayer was required to include in amount realized. Footnote thirty-seven and including debt in amount realized troubled tax practitioners for thirty-six years. This uncertainty precipitated the \textit{Tufts} decision.

\textbf{A. The Crane Basis Rule}

The basis calculation \textit{Crane} requires is favorable to taxpayers. It is the "foundation stone of most tax shelters"\textsuperscript{20} because it results in a tax basis for depreciation and other deductions in an amount exceeding, and sometimes far exceeding, cash outlays and the amount of an investor's personal liability.\textsuperscript{21} Commentators suggested that courts should reexamine this basis ("front-end") calculation, rather than the amount realized ("back-end") calculation,\textsuperscript{22} citing a concurring opinion in a First Circuit case as support.\textsuperscript{23} The recent legislative attacks on tax shelters found in the Tax Equity and Fiscal Responsibility Act of 1982, and the Tax Reform Act of 1984,\textsuperscript{24} have not altered the rule in \textit{Crane} that a taxpayer must include nonrecourse debt in the basis of property for purposes of calculating depreciation and gain or

\begin{itemize}
\item \textsuperscript{19} 331 U.S. at 11-14.
\item \textsuperscript{21} See supra sources cited in note 20. A tax shelter is an investment, a significant feature of which is the production of either: (a) deductions, exceeding the income produced by the investment, which are available to offset other income; or (b) tax credits, exceeding the tax on the investment, which are available to offset other taxes. See Treas. Reg. \S 10.33(c)(2)(1984). This tax shelter definition derives from that appearing in Treas. Circular 230, which concerns the rendering of tax shelter opinions. See \textit{generally} Final Treas. Regs., 25 Tax Memo. Memo (BNA) 147, 149 (1984); Goldfin and Cahn, Final Circular 230 Amendments Prescribe Disciplinary Standards for Shelter Opinions, 60 J. Tax'N 330 (1984).
\item \textsuperscript{22} See \textit{generally} Columbia Note, supra note 10.
\item \textsuperscript{23} Parker v. Delaney, 186 F.2d 455, 459-60 (1st Cir. 1950)(Magruder, C.J., concurring).
\end{itemize}
loss.

The application of Crane's basis principles, however, is limited. With respect to investments other than those in real property involving nonrecourse debt, the I.R.C. section 465 "at risk" rules may limit the amount of deductions without affecting basis. Moreover, with respect to both real and personal prop-

25. The basis reduction required upon electing the full investment tax credit is not a function of nonrecourse financing. It applies even when recourse debt or cash constitutes all or part of the purchase price. Prior to the passage of the Tax Equity and Fiscal Responsibility Act of 1982 [hereinafter referred to as TEFRA], the calculation of allowable depreciation deductions was independent of investment tax credit allowable with respect to the property depreciated. TEFRA, however, requires that a taxpayer who receives the investment tax credit for eligible property placed in service on or after January 1, 1983, must reduce his basis for determining depreciation and gain or loss by fifty percent of the credit taken, unless he elects to reduce the credit otherwise allowed by two percentage points. I.R.C. § 48(q)(1) & (4)(B)(ii)(1984). For example, a taxpayer who purchases "5-year property" for $12,000 and who could normally claim a 10% investment tax credit must either reduce his basis to $11,400 and take a full $1,200 credit (10% of $12,000), or maintain a $12,000 basis and take a $960 credit (8% of $12,000). I.R.C. § 168(c)(2)(B)(1984). The availability of this option, an option to expense up to $5,000 of certain tangible depreciable property under I.R.C. § 179(a) and (d)(1)(1984), and an option to use straight-line depreciation under I.R.C. § 168(b)(3)(1984) instead of the accelerated cost recovery system statutory percentage, allow a taxpayer flexibility in choosing whether to take "up front" tax benefits or later deductions.

At least two provisions of the 1984 Tax Reform Act would affect this choice. Section 13 of Subtitle A, "Deferral of Certain Tax Deductions," amends § 179(b)(1) and freezes the expensing limit at $5,000 through 1987. The section postpones the increase to $7,500 originally scheduled for 1984, to 1988 or 1989, and delays the increase to $10,000 until 1990. Similarly, § 11, the first substantive provision of the Act, amends I.R.C. § 48(c)(2)(A) and delays the increase in the amount of used property eligible for the investment tax credit, currently at $125,000. The scheduled 1988 increase to $150,000 will not take place until 1988.

26. The fact that the "at risk" rules of § 465 do not apply to real estate investments was not unintentional. Congress fashioned the statute to apply to certain taxpayers and certain activities. The Tax Reform Act of 1976 introduced § 465 to curtail a taxpayer's ability to claim tax benefits such as depreciation deductions in excess of the sum of his cash investment and recourse obligation in that activity. Congress expanded § 465 in 1978 to cover additional activities and to provide for the recapture of certain prior deductions.

Section 465 does not contradict the Crane treatment of basis. The section limits the deductible net loss from an activity to the amount that a taxpayer places "at risk" in that activity. I.R.C. § 465(a)(1984). A taxpayer may consider "at risk" in an activity an amount that consists of his cash contributions, the adjusted basis of property he contributes, and amounts borrowed for which he has personal liability or for which he has pledged property other than that used in the activity or financed by debt secured by contributed property. I.R.C. § 465(b)(1)(A) and (B)(1984). Borrowed amounts are not "at risk" if borrowed from a lender which has an interest in the activity aside from a creditor relationship or from related parties as described in § 168(e)(4) of the Code. I.R.C. § 465(b)(3)(1984). Moreover, a taxpayer is not "at risk" with respect to amounts purport-
perty, judicial doctrines may impair an investor's ability to include nonrecourse debt in basis. These doctrines are consistent with the well-known principle that, "[A] taxpayer's literal compliance with statutory criteria will not of itself entitle the taxpayer to the desired tax treatment if, in a broad view, that result contravenes an underlying tax policy."27 Certainly, when the circumstances of a contractual undertaking manifest an agreement without economic substance, that is, without a legitimate business purpose other than the avoidance of taxation, courts will disregard its form and label it a "sham transaction."28 Under these principles, a taxpayer cannot include any nonrecourse debt undertaken in the purchase of a property in the property's basis for depreciation purposes when he enters the transaction solely for the purpose of tax reduction without expectation of profit.29

Courts have utilized the sham transaction doctrine to deny depreciation deductions in sale-leaseback arrangements.30 In a typical sale-leaseback arrangement, the original owner of depreciable property sells it to another party. The buyer thereafter rents it to the seller (original owner), and thus the property's "user" remains the same. The parties may structure the terms of the sale and the rental agreement so that the buyer's installment

27. FEC Liquidating Corp. v. United States, 548 F.2d 924, 926 (Ct. Cl. 1977). "[T]he lawyer's passion for technical analysis of the statutory language should always be diluted by distrust of a result that is too good to be true." B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS § 14.51 at 14-128 (1979).


29. See infra text accompanying note 33.

payments for the purchase of the property approximate the seller’s rental payments to him. The court, in *Rice’s Toyota World, Inc. v. Commissioner*, disallowed deductions in such a situation and refused to view the transaction as a sale. As a result, the taxpayer had no basis to depreciate because the transfer of the asset was a sham for federal tax purposes.

A court may not specifically denominate a transaction a sham, but may still deny depreciation and interest deductions if the nonrecourse debt involved is of such magnitude compared to the value of the mortgaged property that the obligor has no economic incentive to discharge the debt. This principle is well stated in *Estate of Franklin v. Commissioner*, and has been characterized as the “prudent abandonment” rule. The rule is

31. See infra notes 43-44 and accompanying text.
33. 752 F.2d 89 (4th Cir. 1985), aff’d in part, rev’d in part 81 T.C. 184 (1983) [hereinafter cited as *Toyota*].
34. “The sham transaction theory is broader in scope than an analysis of whether a nonrecourse debt is properly includable in basis.” 81 T.C. at 197 (citing *Estate of Franklin v. Commr*, 544 F.2d 1045, 1048-49 (9th Cir. 1976). See infra note 36.
35. 544 F.2d 1045 (9th Cir. 1976).
36. See *Toyota*, 81 T.C. at 208. See also Hilton v. Commr, 74 T.C. 305 (1980); Blanton & Ipsen, *How to Preserve the Significant Tax Benefits Available from a Sale and Leaseback Transaction*, 10 TAX’N FOR LAW., 324 (1982). The Ninth Circuit in *Franklin* does not specifically characterize the transaction at issue as a sham, nor does the decision state that the court disregarded it in its entirety, the touchstone of the sham transaction test. See supra note 29 and accompanying text. The Tax Court in *Toyota*, moreover, admits that other courts reserve the term “sham” for a narrow situation in which the transaction used by the taxpayer is, for example, merely a paper transaction or a “fake” transmission of money. Nevertheless, both the Tax Court and the Fourth Circuit in *Toyota* appear to indicate that the “prudent abandonment rule” is more a component of the sham transaction doctrine than a separate doctrine. Accord Mankoff, supra note 4, at 82. For example, the Tax Court’s opinion discusses *Franklin* and its analysis of Narver v. Commissioner, 75 T.C. 53 (1980), and states that in the latter case it “invalidated another sale-leaseback” and “held the transaction was a sham.” *Toyota*, 81 T.C. at 208-09. Consistent with this apparent inclination of the Tax Court to find less substance in the *Franklin* facts than the Ninth Circuit did is the fact that, before that case reached the court of appeals, the Tax Court ruled that the arrangement did not constitute a sale but merely an option to buy, despite the parties’ characterization of it as a sale. Actually, the Tax Court noted in footnote seven to its decision in *Franklin* that while “[i]t may be
stated as follows: When the fair market value of a parcel of property is at least equivalent to its purchase price, payments on nonrecourse debt encumbering the property "would rather quickly yield an equity in the property which the purchaser could not prudently abandon." On the other hand, when the unpaid balance of nonrecourse debt exceeds the fair market value of the property, the incentive to repay the borrowed amount is not present. The taxpayer lacks the incentive to repay because "only an imprudent taxpayer would discharge a nonrecourse debt to retain an asset with a value substantially less than the amount of the debt." The Ninth Circuit reasoned that the transaction was a sham" the judges were reluctant to apply that doctrine to the facts presented because such a conclusion "makes no provision for the tax treatment of the purported $75,000 advance interest payment." Estate of Franklin, 64 T.C. 752, 762 n.7 (1975). The Ninth Circuit, concurring in the Tax Court's result in denying a basis for depreciation, nevertheless rejected the Tax Court's conclusion that the parties' conduct was necessarily inconsistent with a sale.

37. The point in time relevant to this required equivalence between price and property value (or between the amount of unpaid debt and property value) appears to be an aspect upon which the courts have differed. The Tax Court indicated that the "critical factual consideration" is whether the foreseeable value will ever meet the equivalence test. Toyota, 81 T.C. at 204-05. See also Hilton v. Comm'r, 74 T.C. 305 (1980), aff'd, 671 F.2d 316 (9th Cir.), cert. denied, 459 U.S. 907 (1982). The Ninth Circuit, however, has indicated that a present deduction is available when there is only a foreseeable future parity. The Ninth Circuit indicated in dicta that, if and when a purchaser's equity becomes at least equal to the unpaid debt, the allowability of deductions should be determined at that point in time. See infra notes 50-53 and accompanying text. This "wait-and-see" test is much harder to meet than the "foreseeable value" standard, which presumably would allow basis inclusion immediately when there is merely a reasonable possibility of future equivalence. For an analysis of the issues involved if a purchaser's equity satisfies the equivalency test at some point, but a decrease in the property's value puts the purchaser's equity below the unpaid debt after that point, see Rosenberg, Better to Burn Out Than to Fade Away? Tax Consequences on the Disposition of a Tax Shelter, 71 CALIF. L. REV. 87, 118-20 (1983).

38. 544 F.2d at 1048.

39. "Fair market value" is generally defined as the price a willing buyer and a willing seller would reach, neither party being under a compulsion to buy or sell and both having knowledge of all relevant facts. Normally courts do not upset a price reached in arm's length negotiation. See, e.g., McShain v. Comm'r, 71 T.C. 998, 1004 (1979). Bargaining at arm's length presumes an adverse economic interest between buyer and seller. Accordingly, courts are hesitant to accept the parties' price as a true statement of a property's market value in transactions which involve mutual tax benefits. See Brannen v. Comm'r, 722 F.2d 695, 702 (11th Cir. 1984).


41. Toyota, 81 T.C. at 209. An investor's position must be analogous to that of Macbeth after the murders of Duncan and Banquo. "I am in blood stepp'd in so far, that should I wade no more, returning were as tedious as go o'er." W. SHAKESPEARE, MACBETH, Act III, Scene IV, Lines 135-37.
that, under these circumstances, no equity in the property exists. Concurring in the "fundamental" principle that depreciation deductions flow from investment in property and not merely from technical ownership, the court in Franklin ruled that the taxpayer did not have a basis in the property and therefore disallowed depreciation deductions.42

As with many sham transaction cases, Franklin involved a sale and leaseback.43 The taxpayer in Franklin purchased an Arizona motel. The contract of sale recited a price of $1.22 million, and required the purchaser to pay $75,000 of prepaid interest immediately and $9045.36 monthly for ten years. Of each $100,000 payment, only $15,000 was payment of principal. The contract required a "balloon payment" of the remaining debt at the end of the tenth year. The parties anticipated that this balloon payment amount, which was without recourse, would be approximately $975,000. The purchaser leased the property back to the seller for rental payments which closely approximated the amounts of principal and interest to be paid by the purchaser.44 The Ninth Circuit distinguished these facts from those in American Realty Trust v. U.S.,45 Manual A. Mayerson46 and Hud-

42. 544 F.2d at 1049 (citing Gladding Dry Goods Co., 2 B.T.A. 336 (1925)). Accord Brannen v. Comm'r, 722 F.2d at 701-02.
43. Frank Lyon Co. v. U.S., 435 U.S. 561 (1978) is the sale-leaseback decision usually cited for its exhaustive treatment of the sham transaction doctrine. In Frank Lyon Co., the Court held this doctrine inapplicable to the taxpayer's actions. Frank Lyon Co. involved a bank which sold a building to a corporate purchaser and then leased the building from the purchaser because state and federal regulations prohibited the bank from using conventional financing. The lease included an option for the bank to repurchase the building. The Supreme Court found the transaction a legitimate sale-leaseback, not a sham, despite the fact that the bank's rental obligation under the lease was equal to the purchaser's payments under the sale. Id. at 583-84. The Court in Frank Lyon Co. stated that when a transaction "with economic substance... is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties." Id. The Tax Court in Rice's Toyota World, Inc. noted that most courts decided sale-leaseback cases in a fact dependent manner, citing the concern of some commentators concerning the "lack of consistency in the judiciary's approach." Toyota, 81 T.C. at 197-98 (citing Wolfman, The Supreme Court in the Lyon's Den: A Failure of Judicial Process, 66 CORNELL L. REV. 1075 (1981)).
44. The taxpayer in Frank Lyon Co. did not suffer adverse consequences because of this fact. The Tax Court held that the arrangement created an option to buy, not a sale. See supra note 43.
45. 498 F.2d 1194 (4th Cir. 1974).
46. 47 T.C. 340 (1966), acq. in result, Rev. Rul. 69-77, 1969-1 C.B. 59. The court in
speth v. Commissioner" on grounds that the taxpayer in Franklin had not demonstrated, as had the taxpayers in those cases, that the purchase price approximated the value of the property involved. Consequently, the court ruled that, unlike payments by those taxpayers, payments by the taxpayer in Franklin would not give him a substantial stake in the motel property "so long as the unpaid balance of the purchase price exceed[ed] the then existing fair market value" of the property. Therefore, the court reasoned that an investment, the essential requisite for depreciation, was lacking.

Viewed on the whole, the court's language in Franklin does not indicate that the court considered the transaction a sham. Instead, the court indicated in dicta that such substantial tax benefits as depreciation and interest deductions could validly accrue to the taxpayer under the contractual agreement in question if in the future the property's fair market value were to increase "to an extent that permits the purchaser to acquire an equity." The court indicated that the amount of depreciation deductions should be measured by reference to the basis of the property "at the date the increments to the purchaser's equity commenced." Although not specifically stated by the court, the point in time it identified is presumably the date on which the fair market value of the property rises enough to equal the di-

Mayerson noted that the competitive equality afforded recourse and nonrecourse debt in basis calculations is justified from a policy standpoint because commercial real estate is normally financed with nonrecourse debt. Id. at 352. Two commentators criticized Mayerson for not characterizing the debt as contingent in nature and, thus, not properly includable in basis. Del Cotto, Basis and Amount Realized Under Crane: A Current View of Some Tax Effects in Mortgage Financing. 118 U. Pa. L. Rev. 69, 82 (1969); Columbia Note, supra note 10, at 1515-16. The Internal Revenue Service has indicated it will follow Mayerson when the value of the property involved at least equals the debt encumbering it, and the other facts of the transaction indicate a purchase for legitimate business reasons. Rev. Rul. 69-77, 1969-1 C.B. 59. See also Rev. Ruls. 82-225, 1982-2 C.B. 100, 80-42, 1980-1 C.B. 182, 77-110, 1977-1 C.B. 58; Rutgers Note, supra note 4, at 946 n.91.

47. 509 F.2d 1224 (9th Cir. 1975).
48. 544 F.2d at 1048.
49. Id. at 1049. See supra note 42 and accompanying text.
50. 544 F.2d at 1048-49. The Ninth Circuit's indication that a foundation existed in Franklin for building future tax benefits is important because it suggests that the court considered the prudent abandonment rule a test separate from the sham transaction doctrine and not a component thereof. See supra note 36 and accompanying text.
51. 544 F.2d at 1048-49.
52. Id. at 1049 n.5.
minishing unpaid portion of the debt.\textsuperscript{53} In any event, neither \textit{Tufts} nor the 1984 Tax Act appears to impair the vitality of the prudent abandonment rule.\textsuperscript{54} The concept will apparently continue to be an important government weapon for striking down taxpayer attempts to take advantage of \textit{Crane}'s basis rule when the economic facts of a transaction do not justify including non-recourse debt in basis.

\textbf{B. Crane and Amount Realized}

The Supreme Court in \textit{Crane} did not clearly indicate, as it did with respect to basis, whether amount realized includes the full amount of nonrecourse debt. In \textit{Crane}, the property's fair market value was equal to the nonrecourse debt encumbering it when the taxpayer sold it. Under those circumstances, the court required the taxpayer to include the full amount of the nonrecourse debt in amount realized. However, in what became the most celebrated footnote in American tax law,\textsuperscript{55} the Court suggested that the tax code may not always require including the full amount of nonrecourse debt in amount realized. In that footnote, footnote thirty-seven, the Court stated:

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.\textsuperscript{56}

Several decisions that predate, or are contemporaneous with, \textit{Crane} are indicative of the judicial treatment of the tax consequences of transferring mortgaged property subject to non-recourse debt and serve to illustrate the historical controversy.\textsuperscript{57} In \textit{Lutz & Schramm Co. v. Commissioner},\textsuperscript{58} the taxpayer, in 1925, mortgaged certain earlier acquired property for $300,000.

\begin{itemize}
\item \textsuperscript{53} Id. at 1048-49. See \textit{supra} note 37 and accompanying text.
\item \textsuperscript{54} See infra sources cited in note 138.
\item \textsuperscript{55} See \textit{supra} note 4 and accompanying text.
\item \textsuperscript{56} \textit{Crane}, 331 U.S. at 14 n.37.
\item \textsuperscript{57} For a discussion of the controversy, see generally Simmons, \textit{Nonrecourse Debt and Amount Realized: The Demise of Crane's Footnote Thirty-Seven}, 59 OR. L. REV. 3, 11-12 (1980).
\item \textsuperscript{58} 1 T.C. 682 (1943).
\end{itemize}
When the taxpayer experienced business difficulties in 1934, it renegotiated the mortgage agreement with the mortgagee with the result that the debt was secured only by the buildings and improvements covered by the mortgage. In 1937 the taxpayer transferred the mortgaged property to the mortgagee in full satisfaction of the debt. The taxpayer first reported a gain from the transaction, calculated by subtracting its adjusted basis from the amount of the debt satisfied, but later claimed a refund for a gain erroneously reported. In its claim, the taxpayer asserted that it realized no gain from the transfer because the adjusted basis of the property then exceeded its fair market value. The court rejected the assertion, stating that the "fair market value of the property transferred is immaterial under the provisions of the revenue act in the computation of gain or loss from the disposition of the property." 69 The court reasoned that the taxpayer had benefited from using the mortgage proceeds over a period of years and had paid the debt by transferring the property to its creditor. The court therefore found that the taxpayer realized the gain reported in an amount equal to the unpaid amount of the debt less the taxpayer's adjusted basis after depreciation. 60 This gain was gain realized from the disposition of the real property, not from the discharge of the debt.

The facts in Lutz & Schramm Co. were similar to the facts in R. O'Dell & Sons v. Commissioner. 61 R. O'Dell & Sons involved an involuntary transfer of property by foreclosure sale pursuant to state law. After the sale, the mortgagee did not seek a deficiency judgment against the mortgagor, and the court found that the forced disposition of the property fully canceled the debt. Accordingly, the court held that the debtor-taxpayer realized gain to the extent that the extinguished debt exceeded the taxpayer's basis. On appeal, the Third Circuit Court of Appeals affirmed the Tax Court's decision. 62 The court reasoned

69. Id. at 685.
60. Id. at 689. For a discussion of the view that such transactions produce income by the discharge or forgoingness of debt, see infra notes 114-18 and accompanying text. For the view that Justice Blackmun's Tufts decision is consistent with the cancellation of indebtedness approach exemplified by U.S. v. Kirby Lumber Co., and that Justice Blackmun should have identified his "obligation to repay" rationale as the progeny of Kirby, see Rutgers Note, supra note 4, at 956.
61. 8 T.C. 1165 (1947), aff'd, 169 F.2d 247 (3d Cir. 1948).
that mortgage foreclosure by judicial sale constitutes a “sale or exchange” of an asset, and that the debt was fully extinguished because the mortgagee did not bring a deficiency suit within the statutory period.

*Mendham Corp. v. Commissioner*63 is also factually similar to *R. O'Dell & Sons*, except that the taxpayer in *Mendham Corp.* had not placed the mortgage on the property. Instead, the original borrower mortgaged the property, depreciated it, and transferred it, subject to the mortgage, to the corporate taxpayer in a tax-free exchange. In *Mendham Corp.*, the court determined that the satisfaction of the taxpayer's debt, although a predecessor owner had placed the debt upon the property, resulted in gain to the taxpayer upon the taxpayer's disposition of the property. The court held that the “petitioner must be treated here exactly as though it had itself placed the mortgage on the property and benefited by the cash so acquired.”64 The court reasoned that it must view the transaction in its entirety from the loan to the foreclosure because viewing it otherwise would not have accounted for the tax consequences of the loan. The court held that the situation was not distinguishable from *Lutz & Schramm Co.* and *R. O'Dell & Sons*, and, therefore, the successor corporation recognized taxable gain equal to the mortgage proceeds less the adjusted basis of the property.65

One commentator, Professor Joshua Rosenberg, identifies the rationale connecting these cases as the court's view that a taxpayer under these circumstances receives cash for the property at the loan's inception. Professor Rosenberg rejects this rationale, especially in the case of purchase money obligations, when cash is not exchanged. He prefers to view the time of an “exchange” as the point when a property is surrendered to cancel a debt, rather than the point when money is borrowed.66 The debt cancellation, property transfer issue is an important aspect of the *Tufts* decision.

The cases decided after *Crane* and before *Tufts* are also important to understanding the historical significance of footnote

63. 9 T.C. 320 (1947). For a discussion of the case, see generally Simmons, supra note 57, at 12-13.
64. 9 T.C. at 325.
65. Id.
66. Rosenberg, supra note 37, at 114-17.
thirty-seven. In *Parker v. Delaney*, the First Circuit Court of Appeals addressed whether the amount realized from the disposition of properties may exceed the taxpayer's adjusted basis in them calculated in the year the taxpayer conveys the properties to satisfy the debt encumbering them. The taxpayer contended that, by conveying the properties to the mortgagee for no cash subject to the outstanding nonrecourse mortgage, he realized "nothing or in any event nothing in excess of the adjusted basis" of the properties, even though the mortgaged amount exceeded the adjusted basis. The *Parker* court stated that the Court in *Crane* must have assumed that a transaction produced gain to the extent that debt encumbering a property exceeded its adjusted basis, and refused to distinguish *Crane*. Consequently, the court in *Parker* held that the full amount of the debt must be included in amount realized. As in *Crane*, the court observed that the taxpayer included the loan amount in determining the basis of the properties for depreciation purposes. Citing the similar treatment in *Crane*, the court observed that the disposition effectively released the taxpayer from the mortgage obligation, even though he was not personally liable. The taxpayer in *Parker* also argued that the debt exceeded the value of the properties at the time of disposition and, therefore, the exception in footnote thirty-seven to *Crane* should apply. The court, however, found no evidence to substantiate those facts, and deferring to the district court, treated the values as equal.

Authors have cited Judge Magruder's brief concurring opinion in *Parker* for the proposition that the amount of a taxpayer's cash investment in the property should limit depreciation. In other words, a taxpayer could include borrowed funds in the basis for depreciation purposes only to the extent of the principal actually repaid when the deduction is sought. One commentator, however, has noted that the uncertainty produced by *Parker* and similar cases may stem from "the failure to require an appropriate method of depreciation" and not from the *Crane* rule.

67. 186 F.2d 455 (1st Cir. 1950).
68. *Id.* at 458.
69. *Id.*
71. *Id.* at 236.
requiring inclusion of nonrecourse debt in the amount to be depreciated.\textsuperscript{72}

The most important case in the period between the decisions in Crane and Tufts is the Third Circuit Court of Appeals decision in Millar v. Commissioner.\textsuperscript{73} The decisions in Millar and Tufts produced an intercircuit conflict with respect to footnote thirty-seven, which was subsequently resolved by the Supreme Court in Tufts. As in Parker, the court in Millar addressed whether taxpayers must recognize taxable gain upon the surrender of property that completely satisfies a nonrecourse obligation secured solely by the property. At the time of the disposition in Millar, as in Tufts, the value of the nonrecourse obligation exceeded the value of the property. The court recognized a clear confrontation with Crane and held that the footnote did not create an exception to the Crane rule.\textsuperscript{74} Therefore, the court refused to relieve the taxpayers of the otherwise taxable consequences of the surrender.

Millar is an example of the view that Crane rests upon the rationale that tax benefits enjoyed previously by a nonrecourse debtor require full inclusion of the debt in amount realized. To allow otherwise, the court reasoned, would entitle the taxpayer to “the type of double deduction . . . the Supreme Court so clearly disapproved in Crane.”\textsuperscript{75} The Third Circuit’s concern with allowing a double deduction stemmed from the fact that the taxpayers’ original basis in the property was zero, but was increased by the contribution of the nonrecourse loan funds. In Millar, the taxpayers claimed deductions for interest and for a net operating loss which reduced their basis in the property below the outstanding nonrecourse indebtedness. Because the taxpayers had substantially reduced the adjusted basis of the property and surrendered it after it had declined in value to cancel

\textsuperscript{72} Id. See also S. Surrey, P. McDaniels, & J. Pechman, Federal Tax Reform for 1976 19 (1976).

\textsuperscript{73} 577 F.2d 212 (3d Cir. 1978). For a discussion of Millar, see generally Friedland, Tufts and Millar: Two Views of the Crane Case and its Famous Footnote, 87 Notre Dame Law. 510 (1982); Note, Millar: Requiem for Crane's Footnote 37, 41 U. Pitt. L. Rev. 343 (1980).

\textsuperscript{74} 577 F.2d at 215. The Court in Millar cautioned that footnote thirty-seven in Crane was dicta, but found the holding in Crane controlling. Id.

\textsuperscript{75} 577 F.2d at 215. The Supreme Court in Tufts did not address “the validity of the double deduction rationale” in resolving the intercircuit conflict. 461 U.S. 300, 310 n.10 (1983).
their indebtedness, the court found that the taxpayers must recognize taxable gain. The court calculated the amount of the gain as the amount of the outstanding nonrecourse debt less the property’s adjusted basis.\footnote{577 F.2d at 215.}

The Second Circuit confronted a similar issue in \textit{Woodsam Associates v. Commissioner}.

The issue in \textit{Woodsam Associates} was whether a taxpayer realized gain or loss when, after acquiring property which appreciated, the taxpayer placed a nonrecourse mortgage upon it and received cash proceeds exceeding the property’s adjusted basis. The court agreed with the Commissioner that executing the nonrecourse mortgage was not a taxable event and that recognition of gain or loss must be determined after final disposition of the property. Moreover, the court held that such borrowings after acquiring an asset do not increase a taxpayer’s basis. In its determination that no disposition occurred, the court stressed the fact that the taxpayer was the owner of the property “in the same sense after the execution of this mortgage that she was before.”\footnote{198 F.2d 357 (2d Cir. 1952). See generally Simmons, supra note 57, at 13-15.} Once again, the court refused to treat a nonrecourse loan differently from a recourse loan.

Although the two cases differ factually, \textit{Crane} and \textit{Woodsam Associates} are consistent. In each case the court did not distinguish between recourse and nonrecourse borrowings, but instead acknowledged that both types of loans are true loans that generate certain tax consequences. In \textit{Tufts} the Supreme Court similarly emphasized that a nonrecourse loan is a true loan with its attendant tax and economic effects.\footnote{198 F.2d at 359.}

\textit{Estate of Delman v. Commissioner}\footnote{461 U.S. at 307.} is another significant case decided in this time period. In \textit{Estate of Delman}, the court rejected the tax benefit rule\footnote{73 T.C. 15 (1979). For a discussion of the case, see generally Comment, \textit{Nonrecourse Mortgage Indebtedness as an Amount Realized: Footnote 37 Revisited}, 33 Sw. L.J. 1257, 1273-76 (1980).} (as distinguished from the tax

\footnote{81. The tax benefit rule was also the subject of an important Supreme Court decision in 1983, \textit{Hillsboro v. Comm'r}, 460 U.S. 370 (1983), which mandated a tax adjustment for a taxpayer when a later event occurs which is “fundamentally inconsistent” with the assumptions underlying a deduction previously taken. The taxpayer must make the adjustment in the tax year in which the later event occurs. For a recent analysis of...}
benefit rationale\textsuperscript{82} of Millar and Crane) as an alternative to the Crane approach.

In Estate of Delman, a vendor repossessed equipment which a partnership purchased with nonrecourse financing. At the time of repossession, both the partnership's adjusted basis in the property and the remaining balance of the nonrecourse financing exceeded the fair market value of the property. The court determined that the repossession of the property securing the debt constituted a taxable sale or exchange,\textsuperscript{83} and that the taxpayer realized gain equal to the amount by which the balance of the nonrecourse loan exceeded the property's adjusted basis. The Tax Court cited the decisions in Millar, Tufts and Wood-sam Associates as authority for this conclusion.\textsuperscript{84}

As in Millar, the court emphasized the tax benefits the partners realized by including the nonrecourse loan in basis for purposes of computing depreciation. The court, however, distinguished this "tax benefit rationale" from the application of the "tax benefit rule."\textsuperscript{85} The taxpayer in Delman asserted that the operation of the tax benefit rule required an actual receipt of funds or a discharge of a liability, that is an increase in net worth, in order for a taxpayer to realize income. Because neither had occurred, the taxpayer argued that it realized no gain. The court rejected the taxpayer's assertions. Although the court determined that neither a receipt of funds corresponding to prior depreciation deductions nor a discharge of liability resulted in increased net worth, the court relied on Crane and held that the taxpayer realized income which included the amount of the non-recourse liability.\textsuperscript{86}

Professor Rosenberg, who has examined the use of the tax benefit rationale in the cases decided between Crane and Tufts, believes that reliance on this rationale to justify including nonrecourse debt in amount realized is misplaced. He identifies the genesis of the tax benefit rationale in the "double deduction"

\textsuperscript{82} Rosenberg, supra note 37, at 95.
\textsuperscript{83} 73 T.C. at 28 (citing inter alia Helvering v. Hammell, 311 U.S. 504, 506-11 (1941)).
\textsuperscript{84} 73 T.C. at 28.
\textsuperscript{85} Id. at 30 n.3.
\textsuperscript{86} Id. at 30.
language of Crane, and concludes that this rationale did not underlie the Court's decision in Crane. Moreover, he notes that the other traditional explanation of Crane, the so-called "economic benefit rationale" is "contrary to the most basic principles of taxation."  

When the taxpayer in Tufts brought suit before the Tax Court, no lower court had affirmatively accepted the use of footnote thirty-seven to reduce the amount realized upon disposition. Moreover, whether the Supreme Court intended in Crane to allow such a reduction when property declined in value had not been answered.

III. FOOTNOTE THIRTY-SEVEN UPHENDED AND THEN REJECTED

Tufts involved a partnership formed to construct an apartment complex in a suburb of Dallas, Texas. The partnership borrowed $1,851,500 secured by a mortgage which was nonrecourse, both as to the partnership and the partners. The partnership included the amount of the nonrecourse debt in the basis of the property for the purpose of taking depreciation deductions. As a result of depreciation deductions and other adjustments, the property's adjusted basis in August 1972 was $1,455,740.  

By that time, rental income on the apartment complex had declined to the extent that the investment was worth $1,400,000 at most. It was thus a "burnt-out shelter," one which has failed from an economic standpoint. In August 1972 the partners sold their interest to an unrelated party in exchange for his assumption of the $1,851,500 debt.

The Internal Revenue Service asserted that the partnership's amount realized included the full amount of the debt. Therefore, the Service claimed that a $395,760 gain (an amount realized of $1,851,500 minus the adjusted basis of $1,455,740) occurred. The taxpayers claimed that the nonrecourse debt should be included in amount realized only to the extent of the property's fair market value. This treatment would have created a

87. Rosenberg, supra note 37, at 94.
88. 461 U.S. at 302.
89. See Rosenberg, supra note 37, at 87. See also Bertha, supra note 4, at 46.
90. 461 U.S. at 303.
loss in the transaction.\textsuperscript{91}

The Tax Court rejected the taxpayers' claim that footnote thirty-seven to \textit{Crane} limited amount realized to the fair market value of the property sold. Relying on the Third Circuit's decision in \textit{Millar}, the court emphasized the symmetry of the system established by \textit{Crane}.\textsuperscript{92} The court ruled that the taxpayers' inclusion of the full amount of the nonrecourse debt to benefit themselves in taking depreciation deductions required them to include the same amount to their detriment in calculating the amount of gain or loss.\textsuperscript{93}

In a widely criticized decision described by one journal as a "shock"\textsuperscript{94} to tax practitioners, the Fifth Circuit Court of Appeals in \textit{Tufts} became the first tribunal to expressly follow the suggestion in \textit{Crane} footnote thirty-seven. The court held that the taxpayers' amount realized included no part of the nonrecourse debt in excess of the fair market value of the complex.\textsuperscript{95} As a result, the court allowed the investors a tax loss in addition to the tax benefits they had already received from the tax shelter investment. The majority opinion reasoned that when a taxpayer disposes of property subject to nonrecourse debt, he does

\textsuperscript{91} Id.
\textsuperscript{93} 70 T.C. at 770.
\textsuperscript{95} Tufts v. Comm'r, 651 F.2d 1058, 1063 (5th Cir. 1981). It is one of the ironies of legal history that, but for a filibuster involving another jurist, the author of the majority opinion, Judge Thornberry, might have heard \textit{Tufts} as a member of the Supreme Court. Instead, that tribunal reversed Judge Thornberry's Fifth Circuit decision. In 1968, Chief Justice Earl Warren announced his retirement from the Court, but conditioned his departure upon the appointment and confirmation of a successor. President Johnson nominated the Honorable Abe Fortas for that position. Mr. Fortas was already a member of the Court, however, and his elevation necessarily required the appointment of a new Associate Justice. President Johnson nominated Judge Thornberry to succeed Justice Fortas in that position, but opposition to Mr. Fortas' nomination coalesced behind Senator Robert F. Griffin of Michigan, who led a filibuster in the United States Senate which prevented the confirmation from coming before the Senate for a vote. On October 1, 1968, the Senate voted 45 to 43 to end debate, but the result was fourteen votes short of the two-thirds vote required to end a filibuster. \textit{N.Y. Times}, Oct. 2, 1968, \textsection 1, at 1, col. 1. The next day, the Fortas' nomination was withdrawn. \textit{Id.}, Oct. 3, 1968, \textsection 1, at 1, col. 8. When the President announced on October 10, 1968 that he would not nominate another Chief Justice, and that he had asked Warren to remain as Chief Justice, Judge Thornberry's nomination for Associate Justice became moot. \textit{Id.}, Oct. 3, 1968, \textsection 1, at 1, col. 8; \textit{id.}, Oct. 11, 1968, \textsection 1, at 1, col. 4.
not "receive" an economic benefit in the amount of that debt. Citing Professor Bittker, the court likened including such debt relief as an amount received to including future real estate taxes as an amount received because a seller is not obligated to pay them after a sale. The court disagreed generally with Crane's basic scheme of symmetry, and held that "amount realized" under I.R.C. section 1001(b) includes only actual money or value received. Accordingly, the Fifth Circuit ruled that, despite the taxpayers' inclusion of the full amount of the nonrecourse debt in basis for purposes of depreciation, the taxpayers' amount realized could not exceed the fair market value of the property. The court therefore allowed the taxpayers the loss claimed. If this result had been upheld, it would have increased the attractiveness of tax shelters and other highly leveraged nonrecourse investments.

The Fifth Circuit's opinion in Tufts "raised a number of eyebrows and an equal number of anguished cries." The American Bar Association Tax Section's leadership called for participation in Tufts as amicus curiae on the government's side, but the Tax Section was overruled by the Association's Board of Governors. According to the New York Times, the case became somewhat of a cause célèbre. Experts in the Tax Section prepared a Supreme Court brief articulating its position that the Fifth Circuit's ruling was a threat to the fairness and integrity of the tax system, but the Association's Board refused to authorize the filing of the brief. Bar leaders were subsequently accused of acting in fear of offending wealthy clients who would benefit from such tax incentives.

Commentators similarly disagreed with the Fifth Circuit's holding in Tufts. Some commentators proposed rejecting both

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96. 651 F.2d at 1062 (citing Bittker, supra note 4, at 282).
97. 651 F.2d at 1063. The concurring opinion acknowledged the fact that its decision placed a nonrecourse borrower in a better position than one who had risked his own funds in the investment. 651 F.2d at 1066 (Williams, J., concurring). See also Note, Supreme Court Decisions in Taxation: 1981 Term, 36 TAX LAW. (1982).
98. Mankoff, supra note 4, at 79.
the "full inclusion" rule of Crane and the "market value ceiling" rule of Tufts, and called for a fresh approach to the treatment of nonrecourse debt. One student author suggested that the calculation of basis for gain or loss and for depreciation should reflect the taxpayer's equity in the property, and should not include nonrecourse debt. The author further suggested that the Court in Crane adopted the opposite rule with respect to basis simply to justify what it considered to be the correct amount of depreciation, and was then forced by the requirements of consistency to include that same amount of debt in amount realized on disposition. The author assailed the Crane scheme of symmetry as distorting income. In years in which the calculation of depreciation on a property involves basis inflated by nonrecourse debt, income is understated. In the year of the property's disposition, the inclusion of the amount of the debt in amount realized, when no amount is received "in pocket," overstates income. The author characterized the Fifth Circuit's rejection of the Crane symmetry as the use of footnote thirty-seven "as a device" to escape what the court found "intellectually distasteful." The author suggests that only an investor's equity should be used as basis for purposes of depreciation and gain or loss if the property is subject to nonrecourse financing. Utilizing this approach decreases both depreciation deductions available in the years a taxpayer owns property and amount realized in the year of disposition. The author further proposes that the amount of any nonrecourse borrowing after acquiring an asset should immediately decrease basis and that gain should be recognized at the time of the borrowing "to the extent of any excess of mortgage over adjusted basis." The author recognizes that some courts have held mortgaging property not to be a disposition requiring the recognition of gain. However, the author

102. See infra notes 103-18.
103. Columbia Note, supra note 10, at 1500. Cf. B. Cardozo, The Nature of the Judicial Process 34 (1921) (expressing the view that jurists possess "an intellectual passion for elegantia juris, for symmetry of form and substance").
104. Columbia Note, supra note 10, at 1529.
105. Id. at 1500.
106. Id. at 1530.
107. Id. at 1498-99.
108. Id. at 1530 n.198.
states that authority exists for the proposition that "the mortgage transaction has 'the quality of a closed, identifiable, income-realizing event,'"109 and, thus, should be treated as a taxable event.

Professor Rosenberg also assails the result in Crane and Tufts but indicates that the problem cannot be resolved by changing the calculation of basis.110 Instead, he argues that one should view the Fifth Circuit's acceptance of footnote thirty-seven as a "point of embarkation" for reaching the proper tax treatment of a property's disposition:111

To concede that the taxpayer's amount realized on the sale or exchange of his property does not exceed the fair market value of the property disposed of is not to concede that the taxpayer has no tax liability on his disposition of the mortgaged property. Instead, this initial concession simply paves the way for an understanding that taxable income from any given transaction need not be limited by the seller's amount realized.112

The Fifth Circuit's decision concerning the burnt-out shelter "simply ignored the fact" that the taxpayer received "excessive tax benefits" and provided him "still more undeserved tax benefits upon his disposition of the property."113 Rosenberg suggests several compromise approaches based upon the tax benefit rule and the concept of debt cancellation income.114 An examination of Rosenberg's analyses of these approaches is essential to develop an understanding of the conflicting economic and fiscal considerations in Tufts and Crane. The following example is consistent with the use of footnote thirty-seven as a "point of embarkation" because amount realized is limited to the value of the property at the point of disposition. According to this example, an investor who purchases property for $400,000 in exchange for $20,000 cash and a $380,000 nonrecourse note and who subsequently deducts $100,000 for depreciation should recognize $180,000 of ordinary income and $100,000 of capital loss

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109. Id. (citing Lurie, Mortgagor's Gain or Mortgaging Property for More Than Cost Without Personal Liability, 6 TAX L. REV. 319, 323 (1951)).
110. Rosenberg, supra note 37, at 144.
111. Id. at 92.
112. Id. at 95.
113. Id. at 144.
114. Id. at 145.
if he later disposes of the property for $200,000.\textsuperscript{115} Because the adjusted basis at the time of disposition is $300,000 (the original basis of $400,000, less depreciation deductions of $100,000), the capital loss is $100,000 (the excess of the $300,000 basis over the $200,000 received). However, Rosenberg asserts that, because the taxpayer satisfied a debt of $380,000 by surrendering property worth only $200,000, he should recognize debt cancellation income of $180,000. Professor Barnett reached the identical conclusion in the amicus brief submitted to the Supreme Court in \textit{Tufts}.\textsuperscript{116} Consistent with the fact that the taxpayers' counsel in \textit{Tufts} confirmed that such a proposition is "widely feared by many tax practitioners,"\textsuperscript{117} its logic so impressed Justice O'Connor that she might have adopted it had she not felt constrained by the long history of \textit{Crane}'s acceptance to concur in the unanimous opinion of the Supreme Court.\textsuperscript{118}

The Supreme Court granted certiorari in \textit{Tufts} to resolve the conflict between the Third and Fifth Circuits on this vital issue.\textsuperscript{119} Justice Blackmun, writing for a unanimous court, closed

\begin{footnotesmall}
\textsuperscript{115} Id. at 114-16; cf. note 11 to the Supreme Court's decision in \textit{Tufts}. Note 11 states that this rationale, which was also the gist of Professor Barnett's amicus brief (see infra notes 116, 128-30 and accompanying text), would have required the taxpayers in \textit{Tufts} to recognize $450,000 in ordinary income and a $50,000 capital loss. Comm'r v. Tufts, 461 U.S. 300, 310-12 n.11 (1983).

\textsuperscript{116} See 461 U.S. at 310-12 n.11. See also infra notes 128-30 and accompanying text.

\textsuperscript{117} Mankoff, supra note 4, at 79.

\textsuperscript{118} See infra notes 128-36 and accompanying text.

\textsuperscript{119} The Supreme Court's detailed analysis and definitive resolution of this intercircuit conflict must be countenanced by those who wish to establish a National Court of Appeals with power to deny the Supreme Court ultimate jurisdiction over these conflicts. \textit{See generally} Coleman, \textit{The Supreme Court of the United States: Managing its Caseload to Achieve its Constitutional Purposes}, 52 FORDHAM L. REV. 1 (1983).

Some proposals for such a tribunal would vest it with the power to review all certiorari petitions to the Supreme Court. More importantly, these proposals would prevent the Supreme Court from reviewing any denial of that writ by the National Court of Appeals and any decision of that court on the merits after a granting of certiorari. \textit{Id.} at 9. As a result, many intercircuit conflicts, including those of national and historical importance such as the \textit{Tufts-Millar} division on footnote thirty-seven, could be finally decided at a level lower than the tribunal which has traditionally acted in this function. This loss of jurisdiction supports the criticism of the National Court of Appeals concept as an unconstitutional delegation of the authority vested by the founding fathers in "one Supreme Court," and as an innovation which "would deprive the Court of essential functions and information in the selection and resolution of fundamental national issues." \textit{Id. See} \textit{The Federalist} No. 81, at 369 (A. Hamilton)(Hallowell ed. 1857).

Former Secretary Coleman reviewed three recent proposals to relieve the Supreme Court's caseload which would preserve the Court's jurisdiction in these matters. In 1983,
the opening created by Crane footnote thirty-seven a generation before. After an extensive review of authority, Justice Blackmun recognized that Crane requires a symmetrical treatment of non-recourse debt: "Because no difference between recourse and nonrecourse obligations is recognized in calculating basis, Crane teaches that the Commissioner may ignore the nonrecourse nature of the obligation in determining the amount realized upon disposition of the encumbered property."120

The Court reasoned that the only difference between a recourse and a nonrecourse obligation is that in the latter the lender's sole remedy is foreclosing on the encumbered property. Therefore, when a property's value falls below the amount of nonrecourse debt encumbering it, the lender's ability to protect its interest is impaired because it becomes feasible for the borrower to relieve himself of the obligation by abandoning the

Chief Justice Burger proposed the establishment of a special panel of judges, drawn from each federal circuit, empowered to resolve all intercircuit conflicts. This proposal, unlike the National Court of Appeals proposal, would give the Supreme Court the power to grant certiorari after a decision by the panel. Coleman, supra, at 9. Associate Justice Byron White recommends that intercircuit conflicts be resolved by forcing a federal court of appeals to hold an en banc hearing before it promulgates a decision inconsistent with another circuit's decision. The first en banc decision so rendered would bind all other circuits unless and until reviewed by the Supreme Court. Id. at 10. Had this system existed when Tufts was decided, Judge Thornberry would have had to convene the Fifth Circuit en banc before handing down the decision which contradicted Millar. Once promulgated, the decision would have bound all the circuits, including the Third Circuit which, by hearing the case first, would not have had an opportunity to bind all the circuits. Theoretically, eleven circuits could have agreed with Millar, but the Fifth Circuit, by hearing the issue last, could have bound the other circuits to its acceptance of footnote thirty-seven with an adverse decision en banc. Id. at 10.

Mr. Coleman recommended a third alternative. His suggestion shares with Justice White's the advantage of having the conflict resolved in the first instance at the very level at which it was created. Essentially, a litigant adversely affected by a federal appeals court decision which contradicts that of another circuit would be able to petition the court in which he lost for a special rehearing. A tribunal consisting of three judges from each of the two conflicting circuits and one judge designated by the Chief Justice from a "neutral" circuit would conduct the rehearing. Thus, after the Fifth Circuit's decision in Tufts, three judges from the Fifth Circuit, three from the Third Circuit, and a judge appointed by the Chief Justice from one of the other eleven circuits would have reviewed Judge Thornberry's decision. Again, residual power to identify and correct an error by granting certiorari would be within the purview of the Supreme Court. Id. at 13. While it is difficult to argue with the conclusion that the overwhelming caseload of the Court makes it advisable to consider the establishment of a new panel for intercircuit disagreements, any such establishment should not wrest from the Court the ultimate power to hear and correct any decision of that tribunal.

120. 461 U.S. at 309.
property. The adverse effect on the lender is not relevant because it "does not erase the fact that the mortgagor received the loan proceeds tax-free and included them in his basis on the understanding that he had an obligation to repay the full amount." The Court stated that the crux of the rule in Crane was the characterization of a nonrecourse debt as a "true loan," carrying with it an obligation to repay as if the debt were recourse. Justice Blackmun specifically recognized this characterization as a basis for the decision in Tufts, and stated that in view of that fact it was unnecessary to decide whether Millar's attribution of the "double deduction" theory to Crane was correct.

From the debtor's viewpoint, a purchaser's assumption of a liability encumbering the property purchased has the same effect as if the purchaser paid the debtor in cash and the debtor then transferred the cash to the original lender to discharge what he owed. Justice Blackmun's decision specifically rejected the notion that an investor could include nonrecourse debt in basis for depreciation purposes, but exclude all or part of it when computing gain: "Unless the outstanding amount of the mortgage is deemed to be realized, the mortgagor effectively will have received . . . an unwarranted increase in the basis of his property." Therefore, the Court reasoned that allowing a taxpayer to limit the amount realized to the property's fair market value at the time of his sale would allow him "to recognize a tax loss for which he has suffered no corresponding economic loss." The impact of this language with respect to tax shelters is obvious because an important aspect of tax shelters is the availability of tax deductions, credits, and losses when there has been "no corresponding economic loss."

In her concurring opinion, Justice O'Connor indicated that viewing the facts in isolation could lead to a holding consistent with Professor Barnett's position as amicus in Tufts. As Jus-
tice O'Connor interprets Professor Barnett's position, the transaction at issue in the Crane-Tufts situation should be separated into two aspects: (1) the ownership and sale of the property and (2) the arrangement and retirement of the loan. Such a separation calls for treating the mortgage as a separate, independent transaction. Most importantly, according to Justice O'Connor, such an analysis would tax the actual events of the case (which essentially involve the purchase of property with nonrecourse financing coupled with a sale, after a decline in value, to a buyer who assumes the debt) in the same manner as an "economically identical hypothesized transaction."

The Justice's hypothetical transaction consists of a cash purchase of property and the subsequent execution of a nonrecourse loan secured by it. The hypothetical transaction also includes a later cash repayment of the loan at the declining market value of the property and a market value sale of the property to a third party. As mandated by Crane, under the "property aspect" of the transaction, the fair market value of the property at purchase would represent the taxpayer's basis, and its fair market value at disposition would represent the proceeds of its sale. The taxpayer's gain or loss on the sale would equal the difference between the sale proceeds and the acquisition cost. Consequently, the taxation of the property transaction would reflect the economic fate of the property.

Under the "loan aspect" of the transaction, although the mortgagor obtained cash from the mortgagee, the mortgagor has no taxable income because he is obliged to repay the loan. However, when the mortgagor satisfies the debt by surrendering property with a value less than the outstanding balance of the debt, debt cancellation principles dictate that the mortgagor should recognize income equal to the difference between the loan balance satisfied and the property's value. Justice O'Connor notes that, under this approach, taxation of the loan transaction reflects the economic fate of the loan.

Justice O'Connor also considered separating the two aspects
of the transaction important because different types of income are subject to different treatment under the Code.\textsuperscript{133} Separating the transaction allows for ordinary income treatment of the debt cancellation income and capital gain treatment of income from the property aspect of qualifying property.\textsuperscript{134} Despite her concern for separating the transaction, Justice O'Conner joined in the majority decision which included the full amount of nonrecourse debt in amount realized and which tended to collapse the financing and property aspects of the transaction into a single event. In doing so, Justice O'Conner noted that the reference in I.R.C. section 1001(b) to the "amount realized from the sale or other disposition of property" may be read reasonably to permit a computation of amount realized in that manner.\textsuperscript{135} Interestingly, the majority opinion acknowledges that Professor Barnett's assertion that the property and financing portions of the transactions should be accounted for separately could be justified. However, in a more summary fashion, the majority conceded that the Commissioner had not adopted this analysis and that the Code did not compel him to do so.\textsuperscript{136}

Thus, the Court unanimously rejected other approaches, whatever their wisdom, and held that a taxpayer must fully include nonrecourse debt in amount realized upon the disposition of property subject to that debt, regardless of whether the outstanding debt exceeds the property's fair market value.\textsuperscript{137} By so ruling, the Court limited the tax benefits available in burnt-out tax shelters, specifically refused to accept the suggestion in \textit{Crane} footnote thirty-seven, and resolved the controversy which had plagued the determination of the tax results in such situations since the Truman Administration.\textsuperscript{138}

\textsuperscript{133} Id.
\textsuperscript{134} Id.
\textsuperscript{135} Id. at 320.
\textsuperscript{136} Id. at 310-12 n.11.
\textsuperscript{137} Id. at 313.
\textsuperscript{138} Although the Supreme Court's holding that nonrecourse debt must be included in amount realized is unequivocal, there is a common sense exception to it. As discussed above, in \textit{Estate of Franklin}, the Ninth Circuit refused to allow depreciation on the grounds there was no true investment in the property. \textit{See supra} notes 45-54 and accompanying text. The court also denied the taxpayer's interest deductions for amounts paid on the nonrecourse note. In \textit{Estate of Franklin}, the court attempted to define debt in such a situation: "the purchaser, in the absence of personal liability, must confront a situation in which it is presently reasonable from an economic point of view for him to
IV. Tufts and the Taxation of Partnerships

Tufts and several earlier cases\(^\text{139}\) involved business arrangements which were formally organized as partnerships, a business form considered ideal for tax shelters.\(^\text{140}\) The taxpayers in those cases, as in Tufts, argued that I.R.C. section 752(c) required that amount realized on the sale or disposition of partnership property be limited to the fair market value of the property trans-

make a capital investment in the amount of the unpaid purchase price.” 544 F.2d at 1049. In view of the Tufts requirement of symmetry between basis and amount realized, finding that no bona fide debt exists in a particular case should preclude the Commissioner from successfully claiming that the amount of debt discharged upon disposition should be included in amount realized. Accord Andrews, On Beyond Tufts, 61 Taxes 949 (1983), in which the author states:

Franklin is in no way inconsistent with Tufts. The point of Tufts is not that value of the securing property is irrelevant to the treatment of nonrecourse debt, but that the relevant value is value when the debt was incurred, which is exactly consistent with Franklin. It follows also that if nonrecourse debt were properly recorded at the outset at something other than its stated principal amount, because of the value of the securing property or otherwise, then only that amount needs to be taken into income account as a credit on subsequent disposition of the property.

Id. at 954. A Tax Court footnote to Rice’s Toyota World, Inc., a recent Fourth Circuit case, and the statement of a learned commentator also support this conclusion, which is consistent with the Treasury Regulations. See Odend’hal v. Comm’r, 748 F.2d 908, 912-13 (4th Cir. 1984); Toyota, 81 T.C. at 196 n.9; Sanders, supra note 4, at 3 n.5 (citing Treas. Reg. § 1.1001-2(a)(3)(1984)). See also Dorr & Lacy, Crane After Tufts: Still Some Unanswered Questions, 62 Taxes 162, 164-68 (1984). But see Blackburn, Important Common Law Developments for Nonrecourse Notes: Tufting it Out, 18 Ga. L. Rev. 1, 38-41 (1983); Ban, Implications of Supreme Court’s holding that nonrecourse note gain not limited by FMV, 12 Tax’n For Law. 4, 7-3 (1983). Contra Note, Nonrecourse Liabilities as Tax Shelter Devices After Tufts: Elimination of Fair Market Value and Contingent Liability Defenses, 35 U. Fla. L. Rev. 904, 929 (1983)(“Tufts’ holding that a nonrecourse mortgage must be treated as a true loan in computing both basis and amount realized, regardless of fair market value, is thus laudably consistent with Crane”). Furthermore the 1984 Tax Act “Blue Book” adheres to this view, and also confirms that the inartful placement of I.R.C. § 7701(f) is not intended to override Franklin.


ferred. Therefore, these litigants asserted, partnership transactions were beyond the scope of *Crane* because Congress specifically provided for a different treatment of partnership interests in I.R.C. section 752.\textsuperscript{141} Section 752(c) provides that a liability encumbering a property is the property owner’s liability only to the extent of the property’s fair market value. Section 752(d) provides that, in the case of a sale or exchange of a partnership interest, liabilities must be treated in the same manner as nonpartnership related liabilities.

In *Tufts*, each partner in a partnership sold his partnership interest and conveyed his rights in the partnership property to an unrelated third party. Consequently, the partners argued before the Tax Court that the partnership taxation provisions of the Code mandated including nonrecourse liabilities on partnership property only to the extent of the fair market value of the partnership property securing the loan.\textsuperscript{142} The taxpayers arrived at this position by applying the fair market value limitation of I.R.C. section 752(c) to the sale of a partnership interest under I.R.C. section 752(d). The Commissioner contended that the fair market value limitation of I.R.C. section 752(c) applied only to I.R.C. sections 752(a) and 752(b), covering actual or deemed contributions to and distributions from partnerships. The Commissioner further contended that I.R.C. section 752(d) operates independently of I.R.C. section 752(c).\textsuperscript{143} After examining articles, commentaries, legislative history, and regulations applicable to I.R.C. section 752, the Tax Court determined that the Commissioner’s position was consistent with Congress’ intent.\textsuperscript{144} Under section 752, therefore, when a partner contributes property subject to a liability to a partnership, the partnership is deemed to assume the liability in an amount not exceeding the fair market value of the property at the time of contribution. Each partner’s basis in his partnership interest is then adjusted. Further, when a partnership distributes encumbered property to a partner, the partner assumes the liability in an amount limited by the fair market value of the property at distribution. Such a distribution also requires adjustments in each partner’s basis in

\begin{itemize}
\item \textsuperscript{141} 461 U.S. at 314.
\item \textsuperscript{142} 70 T.C. at 766.
\item \textsuperscript{143} *Id.* at 766-67.
\item \textsuperscript{144} *Id.* at 769.
\end{itemize}
his partnership interest.\textsuperscript{145}

The Tax Court gave scant attention to the partnership issue in other cases decided during the appeal in \textit{Tufts}. For example, in \textit{Estate of Delman}, the Tax Court found that the facts did not constitute one of the limited situations controlled by subsection (c) in \textit{Tufts}. Therefore, the court held that I.R.C. section 752(c) was inapplicable.\textsuperscript{146}

In \textit{Tufts}, the Court of Appeals for the Fifth Circuit addressed the partnership issue in a footnote after it discussed footnote thirty-seven.\textsuperscript{147} The court reasoned that because its holding limited the inclusion of nonrecourse debt in amount realized, it eliminated the conflict as to subsections 752(c) and (d). In other words, the court deemed that its disposition of the \textit{Crane} issue required the application of the footnote thirty-seven fair market value limitation to both partnership and nonpartnership transactions. Moreover, the court stated that its resolution of the issue was consistent with the congressional understanding of the \textit{Crane} doctrine because I.R.C. section 752(c) is generally considered to be an intentional codification of \textit{Crane}.\textsuperscript{148}

The Supreme Court similarly decided the \textit{Crane} issue before dealing with the alternative partnership arguments. The Court in \textit{Tufts} examined the structure of the partnership tax statute and its legislative history, and determined that “[w]hile the legislative history is certainly not conclusive, it indicates that the fair market value limitation of section 752(c) was directed to transactions between a partner and his partnership,”\textsuperscript{149} and was not applicable to a transaction between partners and third parties who are not partners. Citing Treasury Regulations for support, the Court rejected the taxpayers’ asserted “partnership exception” and ruled that I.R.C. section 752(c) does \textit{not} limit the amount realized under section 752(d) in the sale of


\textsuperscript{146} 73 T.C. at 34.

\textsuperscript{147} 651 F.2d at 1063 n.8.

\textsuperscript{148} \textit{Id.} (citing Perry, \textit{Limited Partnerships and Tax Shelters: The Crane Rule Goes Public}, 27 Tax L. Rev. 525, 542 (1972)).

partnership interests such as were involved in the case.\textsuperscript{160}

V. TEFRA AND THE TAX REFORM ACT OF 1984

Because some tax shelters, such as the one examined in \textit{Tufts}, rely heavily upon nonrecourse financing, the case has of course affected tax planning in that area. One observer has remarked that society has traditionally viewed tax shelters as “something rich people did in dark places.”\textsuperscript{151} Another commentator notes that the “hue and cry” of Congress and the Treasury Department that such shelters are an “ever increasing drain” on tax revenues and a “sign of the increasing reluctance of taxpayers to accept a self-assessment system of taxation” might lead an observer to “conclude that tax shelters had replaced baseball as our national pastime.”\textsuperscript{152} The drafters of the compliance provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) clearly heard this “hue and cry.”\textsuperscript{153} One provision\textsuperscript{154} imposes a ten percent penalty on a “substantial [tax] underpayment”\textsuperscript{155} but provides that a taxpayer may normally avoid the penalty by showing that: (1) “there is or was substantial author-

\textsuperscript{150} 461 U.S. at 316 n.17 (citing Treas. Reg. § 1.752-1(c)(1984)).

\textsuperscript{151} Wall St. J., Dec. 27, 1983, at 1, col. 6 (quoting Daniel Buompane, vice-president of marketing at E. F. Hutton & Co.). Cf. R. Swanson & B. Swanson, Tax Shelters: A Guide for Investors and Their Advisors 2 (1982): “Despite popular belief, tax shelters were not invented late one April night in the early 1960s by an unscrupulous tax accountant in a shiny suit.”

\textsuperscript{152} Rosen, TEFRA’s New Partnership Auditing Procedures: Was the Small Partner Left Out?, 38 Tax L. Rev. 479, 480 (1983). See also Goldfein and Cohn, supra note 21, at 331.


\textsuperscript{154} I.R.C. § 6651 (1984). In addition to the sanctions listed in the text, TEFRA also provides a special penalty when an underpayment of tax is attributable to the taxpayer’s valuation of property at 150\% or more of its true cost. I.R.C. § 6659 (1984). Although this provision does not single out tax shelters for additional adverse treatment, overvaluation is a perceived abuse in some shelters. This is different from the understatement penalty. See infra text accompanying notes 155-58. It should also be noted that the imposition of a penalty under I.R.C. § 6657 (1984) supersedes any penalty under the substantial understatement of tax rules of I.R.C. § 6651 (1984).

\textsuperscript{155} A “substantial understatement” exists in a taxable year if the amount of the understatement of tax for the taxable year exceeds the greater of ten percent of the tax required to be shown on the return for the taxable year, or $5000. I.R.C. § 6661(b)(1)(1984).
ity for the treatment” chosen by the taxpayer or (2) “relevant facts affecting [the] item’s tax treatment are adequately disclosed in the return or in a statement attached to the return.”\textsuperscript{156} The safe harbor does not apply, however, to an item attributable to a tax shelter.\textsuperscript{157} In that case, the taxpayer may avoid the penalty only if he can present substantial authority for his position and can show that he “reasonably believed that the tax treatment of such item . . . was more likely than not the proper treatment.”\textsuperscript{158} As a result, the taxpayer must overcome a very heavy burden of proof to escape penalty.

TEFRA also provides for the conduct of partnership audits at the partnership level.\textsuperscript{159} The Treasury Department maintained that it needs such auditing power because it is not feasible to separately audit, within the statute of limitations period, each partner in a tax shelter limited partnership\textsuperscript{160} who adopts a highly creative, but questionable, tax position.\textsuperscript{161} Another TEFRA provision attacks tax shelters by imposing a civil penalty on certain persons who organize or participate in the sale of tax shelters. This promoter penalty is now equal to the greater of $1000 or twenty percent of the gross income the organizer or salesperson derives from the shelter. The Internal Revenue Service may exact the penalty in two instances: (1) if a person makes or furnishes a statement about the tax advantages of a shelter which he knows or should know is materially false or fraudulent; or (2) if a person overstates a deduction or credit available to a purchaser of property, by stating that the property is more than twice its real value.\textsuperscript{162} Lastly, TEFRA gives the

\begin{footnotesize}
157. A tax shelter is defined for purposes of the statute as: (1) a partnership or other entity; (2) any investment plan or arrangement; or (3) any other plan or arrangement which has as its principal purpose “the avoidance or evasion of Federal income tax.” I.R.C. § 6661(b)(2)(C)(ii)(1984).
160. Rosen, supra note 152, at 480. \textit{See supra} note 140 and accompanying text.
\end{footnotesize}
Treasury Department the right to seek injunctions against promoters of shelters that it perceives to be abusive. These enactments clearly indicate a concerted effort by Congress and the Treasury Department to protect the public and the revenues from overly aggressive tax shelters. Reports indicate, for example, that as of January 1984, the Internal Revenue Service had audited approximately 340,000 tax shelter returns as part of the tax shelter audit program begun in 1973. Moreover, the Internal Revenue Service has issued numerous pronouncements and rulings against abusive shelters. Clearly, the government is serious in this regard.

If any doubt regarding this situation lingered after TEFRA, the Tax Reform Act of 1984 put it to rest. The new Act contains several provisions relating to partnership taxation, designed to prevent taxpayers from “claiming unintended tax benefits” from the most popular form of tax shelter ownership. The disallowance of tax-free exchange treatment for interests in different partnerships eliminates the possibility of avoiding Tufts by exchanging one encumbered interest for another. The Act includes changes which are intended to prevent partners entering partnerships late in the partnership year from using “tiered” partnerships and “cash-basis” partnerships to retro-

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164. See Smith and Cheris, Gift and Estate Tax Problems as Well as Income Tax Aspects of Tax Shelters Must Be Considered, 11 EST. PLAN. 194 (1984). See generally Garahan, supra note 162. See also Kess & Westlin, Dealing With the Client Wanting Tax Shelter, EST. PLAN. REV., Nov. 1983, at 81 (this source notes that “[t]he odds against the taxpayer in the ‘shelter audit lottery’ have been increased drastically”).

165. The most recent of these at the time of this writing was Rev. Rul. 84-175, 1984-52 I.R.B. 10, stating that the Service will offset an assessed deficiency against a scheduled refund resulting from a NOL carryback if it is “highly likely” that the § 6700 penalty would apply.


actively allocate partnership items to themselves. Another section of the new law prevents partners from shifting among themselves a gain or a loss sustained on property before its contribution to the partnership. The Act includes a provision that prevents limited partners from including nonrecourse debt guaranteed by a general partner in the basis of their partnership interests.

In addition to these and other partnership provisions, the 1984 Act contains several tax shelter compliance provisions which are also indicative of the government's intent to identify and pursue areas of perceived tax shelter abuse. First, the Act increases the TEFRA promoter penalty from ten percent to twenty percent of the amount generated by the project. Secondly, the Act imposes a special rate of interest on underpayments of federal tax when those underpayments are attributable to a "tax-motivated transaction." Normally, the interest charge is at a designated rate determined semiannually and based on the average prime rate charged by commercial


173. TRA 1984, supra note 166, § 143(a)(amending I.R.C. § 6700(a)(1984)).

174. TRA 1984, supra note 166, § 144(a)(amending I.R.C. § 6621 (1984) to add subsection 6621(d)). The definition of "tax motivated transaction" is in subsection 6621(d)(3), added by the new Act.
banks.\textsuperscript{175} However, the new Act provides that, with respect to tax shelter items, the interest charge is 120\% of the normal statutory rate.\textsuperscript{178} Thirdly, the Act extends the injunctive power authorized by TEFRA\textsuperscript{177} to any activity which constitutes the aiding of an understatement of tax liability from a shelter.\textsuperscript{178} The Conference Committee Report specifically states that this provision is intentionally designed to catch both promoter and non-promoter activity in the injunctive net.\textsuperscript{179}

The 1984 Act further addresses the problem of matching an investor to a shelter. Noting that under prior law the Internal Revenue Service lacked "complete and systematic information on which to base its decisions about which tax shelters should be audited,"\textsuperscript{180} the Act requires the registration of certain tax shelters by the promoter.\textsuperscript{181} The penalty for failure to register is the greater of $500 or one percent of the aggregate amount invested in the shelter, but not more than $10,000.\textsuperscript{182} If there is an intentional disregard of the registration requirements, however, the $10,000 ceiling does not apply.\textsuperscript{183} Any taxpayer claiming a deduction or credit from such shelter is subject to a $50 penalty if the taxpayer does not include on his or her own return the tax shelter identification number generated by the registration.\textsuperscript{184} A provision in the Act which requires a shelter organizer to maintain investor lists and to make these lists available to the Inter-

\begin{itemize}
  \item 175. I.R.C. § 6621(b),(c)(1984).
  \item 176. I.R.C. § 6621(d)(1)(1984)(applicable to interest accruing after December 31, 1984). See I.R.C. § 6621(d)(1984)(added by TRA 1984, supra note 166, § 144(c)). For example, in any period that the semiannual designated rate is 11\%, the tax shelter rate would be 13.2\%.
  \item 177. See supra note 163 and accompanying text.
  \item 178. TRA 1984, supra note 166, § 143(b)(amending I.R.C. § 7408 (1984)).
  \item 179. CONF. COMM. RPT., supra note 172, at 227.
  \item 180. Id. at 225.
  \item 181. TRA 1984, supra note 166, § 141(a)(redesignating I.R.C. § 6111 as § 6112, and adding new § 6111). Shelters which must be registered are generally those in which the sum of the deductions and 200\% of the credits exceeds 200\% of the amount contributed by the investor. See I.R.C. § 6111(c)(1984)(as added by the Act); CCH Explanation, supra note 167, at ¶ 647. See generally Martin, Coping With the Tax Shelter Registration and Compliance Requirements: New Law and Regs., 62 J. Tax’N’s 2 (1985).
  \item 182. TRA 1984, supra note 166, § 141(b)(codified as I.R.C. § 6707(a)(1984)).
  \item 183. I.R.C. § 6707(a)(2)(1984)(originally enacted as TRA 1984, supra note 166, § 141(b)).
  \item 184. I.R.C. § 6707(b)(2)(1984)(originally enacted as TRA 1984, supra note 166, § 141(b)).
\end{itemize}
nal Revenue Service upon request further aids "matching." 185

Lastly, two aspects of the Conference Committee Report do not directly relate to specific statutory provisions but are significant to an understanding of the present status of tax shelters. First, the Senate version of the new law would have required the Secretary of the Treasury Department to submit a tax shelter report to Congress. 186 Although this specific provision is not in the final text of the Tax Reform Act, the new law authorized the Treasury Department to study "alternative tax systems," and pursuant to the conferees' statement that the "Secretary will include the substance of the Senate amendment's report in the Treasury's study. . ."," the recent Treasury Proposal on Tax Reform contains key recommendations on shelters. 187

A message from the Congress to the Internal Revenue Service is the second significant aspect of the Conference Committee Report. In their discussion of the Internal Revenue Service's responsibility with respect to Tax Court cases, the conferees indicate their opinion that,

The Service's settlement policy should be fair and flexible and only appropriate cases should be litigated. Although in the recent past the Service has offered to settle many tax shelter cases by permitting taxpayers to deduct out of pocket expenses, the Service no longer routinely offers this as a settlement. This is a constructive change in policy in that a taxpayer


should not expect to be able to deduct out of pocket expenses regardless of the circumstances of his case. The Service should assert, without hesitancy in appropriate circumstances, the penalties that the Congress has provided. In particular, the negligence and fraud penalties are not currently being applied in a large number of cases where their application is fully justified.188

This specific suggestion to the Internal Revenue Service to “get tough” on negligence and fraud penalties bespeaks the continued alliance of the executive and legislative branches in targeting tax shelters. Nevertheless, one should not view the Supreme Court’s decision in Tufts as a part of the concerted effort against sheltered investments. Rather, the considerations previously discussed, including the Crane symmetry scheme, underlie the decision.

VI. Conclusion

A Supreme Court’s affirmance of the Fifth Circuit’s decision in Tufts would have enhanced the attractiveness of leveraged investments because a burnt-out shelter such as the one in Tufts would have produced a tax loss rather than a tax gain.189 However, an affirmance was considered unlikely due to the widespread criticism of the Fifth Circuit opinion, its radical departure from thirty-four years of precedent,190 and its violent sundering of the symmetry inherent in Crane. An affirmance of the Fifth Circuit would have been more surprising than the original decision.191

In Tufts, the Supreme Court chose not to adopt a powerful

188. CONF. COMM. RPT., supra note 172, at 228. See Garahan, supra note 162, at 190 n.23.
189. But see Comment, Contra Tufts: The Case Against the Fair Market Value Limitation on Amount Realized, 14 PAC. L.J. 79 (1982) for the view that a judicial affirmance of the viability of footnote thirty-seven would have led Congress to enact further restrictive legislation to counteract the decision.
190. Rosenberg, supra note 37, at 93; Rutgers Note, supra note 4, at 931 n. 16; Comment, Tufts—The Resurrection of Crane’s Footnote 37, 9 FLA. ST. U.L. REV. 575 (1981).
191. Cf. Mankoff, supra note 4, at 80 (while Mr. Mankoff acknowledges that “many observers expected the result,” he links this to concern over the effect of an affirmance of the Treasury’s attack on tax shelters; this link is contra to the opinion of the present authors).
weapon against tax shelters: the Barnett-Rosenberg analysis.\textsuperscript{192} Under this analysis, an investor would recognize both a capital loss and ordinary income, which would be a devastating scenario for the taxpayer. Had the Court imposed this result on taxpayers, the decision would have been a crushing blow against tax shelters. Instead of establishing this "big stick" approach towards tax shelters, the Court relied on stare decisis and upheld a moderate approach.

\textit{Tufts} is a classic example of Justice Holmes' oft-quoted admonition that, "[T]he life of the law has not been logic, it has been experience."\textsuperscript{193} In her concurring opinion, Justice O'Connor acknowledged the "logical coherence" and "internal consistency" of the bifurcated "separate borrowing transaction" approach.\textsuperscript{194} However, she agreed with her colleagues that this approach should not be a rule of law.\textsuperscript{195} "We do not write on a slate marked only by \textit{Crane},"\textsuperscript{196} she stated, but rather on one marked by numerous lower court decisions and by the Commissioner's long standing and defensible position which collapses and amalgamates the purchase and loan aspects of the transaction.

In this context, \textit{Tufts} is not a judicial chorus to the legislative concert in TEFRA and the Tax Reform Act. The rejection of footnote thirty-seven is \textit{not} a major setback for tax shelters and other investments, but is rather a positive reaffirmation of the general principles of taxation applicable to them.\textsuperscript{197}

\begin{footnotes}
\footnotetext{192} Id. at 79.
\footnotetext{194} 461 U.S. at 319 (O'Connor, J., concurring). See also Rollyson, Service Turns the Tables on the Crane Doctrine, 3 J. Real Est. Tax'n 495, 500-01 (1976).
\footnotetext{195} 461 U.S. at 319 (O'Connor, J., concurring).
\footnotetext{196} Id. See Yang, Tufts: Footnote to Crane, 62 Taxes 118, 123-24 (1984).
\footnotetext{197} See Sanders, supra note 4, at 5; Rice's Toyota World, Inc. v. Comm'r, 31 T.C. at 184 n.9, aff'd in part and rev'd in part (on other grounds), 752 F.2d 89 (4th Cir. 1985); Recent Cases, Partnership Sales: When Nonrecourse Debt Exceeds Fair Market Value, 17 Akron L. Rev. 155, 160 (1983). Contra Recent Decisions, 13 Cum. L. Rev. 707, 729 (1984)("[t]he court's decision to elevate a nonrecourse loan to true loan status represents a clear expansion of \textit{Crane}"); Rutgers Note, supra note 4, at 981 ("[t]he \textit{Tufts} decision resoundingly defeats one more tax shelter opportunity").
\end{footnotes}