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CASE NOTES

The Continuing Controversy Over *Crane*'s Footnote 37: *Tufts v. Commissioner*

In 1947 the United States Supreme Court handed down a seminal tax case, *Crane v. Commissioner*,[1] which has become an important element in most tax shelters.[2] The Supreme Court held that a mortgage, whether recourse or nonrecourse, is included in the basis of acquired property and that upon disposition of the property the unpaid balance of the mortgage is to be included in the amount realized.[3] However, the Court observed in what has been called "the now infamous Footnote 37,"[4]

> 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.[5]

Thus, the Court implied that in certain dispositions of property subject to nonrecourse liability the amount realized might be limited to the value of the property. Although the Internal Revenue Service has specifically rejected the implication of footnote

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1. 331 U.S. 1 (1947). Mrs. Crane inherited an apartment building from her husband in 1932. The property was subject to a nonrecourse mortgage of $255,000. During the seven years she held the property, Mrs. Crane had allowable depreciation deductions of $28,045.10. Late in 1938, Mrs. Crane sold the property subject to the mortgage for $2,500 net cash. She reported only $2,500 as capital gain on sale based on the theory that all she had inherited was an equity in the building which was equal to zero, and that when she sold the equity, the amount realized was the net cash received. The Commissioner, on the other hand, asserted that Mrs. Crane had a gain of $23,767.03, the difference between the nonrecourse mortgage and the adjusted basis. *Id.* at 3-5.

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

3. 331 U.S. at 6, 14.

4. Townsend, *Footnote 37 of Crane: What Is the Nature of the Income?*, 4 REV. TAX'N INDIVIDUALS 128, 136 (1980).

5. 331 U.S. at 14 n.37.

37,[6] its applicability has generated considerable comment and controversy.[7]

The demise of footnote 37 seemed assured[8] when in 1978 the Third Circuit handed down *Millar v. Commissioner.*[9] In *Millar* the court held that although the amount of a nonrecourse debt exceeded the fair market value of the property securing the debt, the total liability must be included in the amount realized upon disposition of the property.[10] Subsequently, however, the Fifth Circuit in *Tufts v. Commissioner,*[11] reversed a Tax Court decision and limited the amount realized on the sale of partnership property to its fair market value, which was less than the amount of the nonrecourse mortgage on the property. This decision has reopened the question of the validity of *Crane*'s footnote 37 and created a split in the circuits.

I. THE *Tufts* CASE

In August 1970, John Tufts and others formed a general partnership for the purpose of constructing an apartment complex in Duncanville, Texas.[12] Farm & Home Savings Association agreed to provide a $1,851,500 nonrecourse loan to the partner-

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6. Rev. Rul. 76-111, 1976-1 C.B. 214. In this Ruling the Service commented on the tax consequencs of the transfer of cattle in exchange for cancellation of debt owed to the seller. Although the value of the cattle had decreased to below the amount owed to the seller, the Service concluded:

> Whatever inference may be drawn from footnote 37 in the *Crane* case, the unpaid balance on the sales contracts, which indebtedness was cancelled upon the transfer of the herds . . . is the amount realized by the taxpayers on such sales . . . regardless of the fair market value of the herds at the time of their return to the seller.

Id. at 215.

7. *See, e.g.,* Adams, *Exploring the Outer Boundaries of the* Crane *Doctrine; An Imaginary Supreme Court Opinion,* 21 TAX L. REV. 159 (1966); Bittker, *supra* note 2; Del Cotto, *Basis and Amount Realized Under* Crane: *A Current View of Some Tax Effects in Mortgage Financing,* 118 U. PA. L. REV. 69 (1969).

8. *E.g.,* Simmons, *Nonrecourse Debt and Amount Realized: The Demise of* Crane's *Footnote 37,* 59 OR. L. REV. 3 (1980).

9. 577 F.2d 212 (3d Cir.), *cert. denied,* 439 U.S. 1046 (1978). In *Millar* the taxpayers were shareholders of a subchapter S corporation. The organizer of the corporation advanced $500,000 to the taxpayers in exchange for nonrecourse notes. Taxpayers' obligations to the organizer were secured only by stock in the corporation, which had been given to the taxpayers without consideration by the organizer of the corporation. Corporate losses were passed through to the taxpayer, reducing their basis. The organizer foreclosed on the stock, which then had a fair market value of zero. Millar v. Comm'r, 540 F.2d 184, 185-86 (3d Cir. 1976).

10. 577 F.2d at 215-16.

11. 651 F.2d 1058 (5th Cir. 1981).

12. *Id.* at 1059.

ship for construction of the apartment complex with interest only payments from September 1970 to April 1972.[13] Each partner included a proportionate share of the nonrecourse debt in his partnership basis[14] and claimed ordinary loss and depreciation deductions based on the full amount of the nonrecourse debt for the taxable years 1970 to 1972.[15] In August 1972, one year after completion of the complex, each partner sold his interest in the partnership property to an unrelated party. The purchaser agreed to pay a maximum of $250 for expenses incurred in the sale of the property,[16] but paid nothing for the property itself. Rather, he acquired the partnership property subject to the existing nonrecourse mortgage liability of $1,851,000.[17] Because of unfavorable economic conditions in the community, the fair market value of the property at the time of sale did not exceed $1,400,000.[18] Each of the partners reported the sale of the partnership interest as a loss on his 1972 return but claimed no deduction for the loss.[19] However, the Commissioner determined that each partner had realized a gain on the sale of his partnership interest equal to the difference between the partner's adjusted basis in his partnership interest in the property and his proportionate share of the nonrecourse debt.[20]

Taxpayers paid the deficiency and petitioned the Tax Court for a refund alleging that they had a long term capital loss, rather than gain, on the sale of the property.[21] The taxpayers argued that footnote 37 in *Crane* required a decision in their favor. They also contended that when the value of property is less than the nonrecourse liability, there is no economic benefit to the taxpayers except to the extent of the fair market value of the property.[22] The Tax Court rejected the taxpayers' arguments, relying on the Third Circuit's reasoning in *Millar* that "the principal reason for the *Crane* holding was to prevent the

13. 70 T.C. at 758.

14. 651 F.2d at 1059.

15. 70 T.C. at 759-60.

16. 651 F.2d at 1059.

17. 70 T.C. at 761.

18. *Id.* at 760-761.

19. *Id.* at 761. No reason was given for reporting the loss without claiming a deduction.

20. *Id.* at 761-62.

21. *Id.*

22. *Id.* at 763-64.

double tax deductions which would otherwise result."[23] Taxpayers also argued that Internal Revenue Code section 752(c)[24] provides that "the amount realized upon the sale of a partnership interest includes a partnership nonrecourse liability only to the extent of the fair market value of the partnership property which is subject to the liability."[25] Based upon legislative history and the corresponding regulations, the Tax Court rejected this argument by holding that the limitation in subsection 752(c) applies only to subsections 752(a) and (b) but not to subsection 752(d).[26]

The United States Court of Appeals for the Fifth Circuit reversed the Tax Court and held that "the fair market value of the property securing a nonrecourse debt limits the extent to which the debt can be included in the amount realized on disposition of the property."[27] The Fifth Circuit rejected the Third Circuit's view in *Millar* that the principal reason for the *Crane* decision was a concern for double deductions.[28] The court asserted that the Supreme Court in *Crane* justified its result on an economic benefit theory derived from the principle that "when a debt on which a taxpayer is personally liable is discharged, the taxpayer is freed from the necessity of paying the obligation with cash or other assets equal in value to the principle amount

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23. *Id.* at 765.

24. In its entirety I.R.C. § 752 (1976) provides:

§ 752. Treatment of certain liabilities.

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

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

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

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

25. 70 T.C. at 766.

26. *Id.* at 769.

27. 651 F.2d at 1063 (footnote omitted).

28. *Id.* at 1060.

of the debt."[29] Because the Fifth Circuit viewed the economic benefit theory assertedly underlying the *Crane* decision as "seriously flawed,"[30] it declined to extend *Crane* beyond its facts.

Judge Williams concurred in the result, but reasoned instead that the Commissioner's position was "inconsistent with the plain language of I.R.C. § 1001(b) and I.R.C. § 752(c)."[31] He argued that the language of section 1001(b)[32] would impose tax liability in this case only to the extent of the fair market value of the property which was transferred subject to the nonrecourse debt[33] and that section 752(c) would apply to all of section 752.[34]

II. Analysis

In *Tufts* the Fifth Circuit incorrectly limited the amount realized upon sale of property subject to a nonrecourse debt to the fair market value of the property. The policy considerations underlying the *Crane* decision require that the full amount of the nonrecourse debt be included in amount realized regardless of the fair market value of the property, a result contrary to the implication of footnote 37 in *Crane*. Furthermore, Congress has legitimized *Crane* by reenacting the relevant statutes and also, in the case of real estate, by enacting a new statute.

Although not articulated by the Court, the underlying policy of the *Crane* decision appears to be that when a taxpayer has had a benefit of allowable deductions by inclusion of a nonre-

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29. *Id.* at 1061.

30. *Id.* at 1062-63.

31. *Id.* at 1064 (Williams, J., concurring).

32. I.R.C. § 1001 (1976) provides in part:

(a) Computation of gain or loss.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) Amount realized.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

33. 651 F.2d at 1065 (Williams, J., concurring).

34. *Id.* at 1066.

course mortgage in basis, the law must be interpreted at the other end of the transaction as requiring the taxpayer to account for those deductions upon the sale of property. Because of the Fifth Circuit's reservations about the results in *Crane,* it concluded that "the fair market value limitation so '[o]bviously' anticipated by footnote 37 is warranted."[35] Limiting amount realized on the sale of property to its fair market value—the result implied in *Crane*'s footnote 37 and adopted by the Fifth Circuit in *Tufts*—runs counter to the policy underlying the *Crane* decision.[36]

In *Tufts,* depreciation deductions were calculated on the full amount of the nonrecourse debt on the property, but recapture was calculated on the fair market value of the property upon disposition. Because a nonrecourse mortgage is includable in basis, Mr. Tufts had a basis in partnership property of $456,646 yet invested only $2,771 cash in the partnership.[37] His basis was adjusted to $355,653 by deductions for losses and depreciation totalling $109,993 during 1970-1972.[38] When the Fifth Circuit limited the amount realized to a fair market value of $1,400,000, Mr. Tufts' proportionate share was $350,000, resulting in a loss upon sale of the property of $5,653.[39] Had the court determined the amount realized to be $1,851,500, the full amount of the nonrecourse debt, Mr. Tufts' proportionate share would have been $462,875, resulting in a gain of $107,222.[40] This would have accounted for the benefit Mr. Tufts received by taking the nearly $110,000 in prior deductions that were not accounted for under the *Tufts* decision.[41] The *Tufts* decision not only results in a tax-free gain to the taxpayer to the extent of the difference between the fair market value of the property and the amount of the nonrecourse mortgage but also permits a loss deduction upon disposition of the partnership property.

The *Tufts* decision and footnote 37 of *Crane* could lead to

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35. 651 F.2d 1063.

36. Leading commentators have generally agreed that footnote 37 should not be followed. *See supra* note 7.

37. 70 T.C. at 759, 762.

38. *Id.* at 759-60.

39. *Id.* at 758, 762.

40. *Id.*

41. It has been suggested that footnote 37 should be applied only when the owner of property takes no depreciation deductions, a hypothetical posed in the petitioner's reply brief in *Crane.* Note, *Millar: Requiem For Crane's Footnote 37?,* 41 U. PITT. L. REV. 343, 350-51 (1980).

even more peculiar results. For example, assume that a taxpayer purchases property for $100,000, paying $10,000 in cash and $90,000 derived from a nonrecourse mortgage; that the property increases in value to $150,000 and the taxpayer increases the mortgage by $40,000, received in cash; that the value of the property subsequently declines to $80,000 when the taxpayer sells it to an optimistic unrelated third party who takes the property subject to the mortgage. The implication of footnote 37 and the holding of the Fifth Circuit in *Tufts* would limit the amount realized to $80,000. The results to the taxpayer would be a $20,000 loss for tax purposes but a net cash gain of $30,000 ($40,000 received by increasing the mortgage less the $10,000 cash down payment).[42] These results occur because significance is suddenly attached to the fair market value of the property, when previously the full amount of the nonrecourse debt was the determining factor in calculating the tax consequences to the taxpayer.[43]

The Fifth Circuit concluded that the *Crane* decision was based upon an economic benefit received when the mortgage on which the taxpayer is not liable passes to a new owner.[44] The court correctly determined that this theory is seriously flawed. An economic benefit can only be obtained by giving up the mortgaged property on which there is no personal liability. "It is analogous to the relief one obtains from local real property taxes by disposing of the property. . . . [N]o one would suggest that the disposition of unprofitable property produces an economic benefit equal to the present value of taxes that will not be paid in the future."[45] By limiting its consideration to the economic

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42. Bittker, *supra* note 2, at 283-84.

43. Only the mortgagee and the new owner are legitimately concerned with the fair market value of the property upon transfer. The new owner can include the nonrecourse debt in his basis only up to the fair market value of the property. At first blush this appears to contradict the Commissioner's position in *Tufts*. However, these two positions—not allowing inclusion in basis of nonrecourse debt in excess of fair market value and yet requiring the inclusion in amount realized of nonrecourse debt in excess of fair market value—are both consistent with the Commissioner's position against allowing tax-free gain. Unless the nonrecourse mortgage is included in amount realized upon disposition, the mortgagor has had a tax-free receipt of mortgage money and could walk away with tax-free cash even though the nonrecourse debt was not included in basis and depreciation deductions on that amount were thereby precluded. *See, e.g.*, Estate of Franklin v. Comm'r, 544 F.2d 1045 (9th Cir. 1976); Hager v. Comm'r, 76 T.C. 759 (1981); Rev. Rul. 77-110, 1977-1 C.B. 58.

44. 651 F.2d at 1061-62.

45. Bittker, *supra* note 2, at 282.

benefit theory, the Fifth Circuit implicitly rejected any other theory that might adequately explain the results and policy underlying *Crane*.

Although commentators agree that the results in *Crane* are correct, they disagree as to which theory best explains those results. Cancellation of indebtedness,[46] tax benefit,[47] negative basis,[48] and balancing entry[49] have all been suggested as theories supporting the *Crane* decision, but Professor Bittker's balancing entry theory appears to state most closely the policy underlying the *Crane* decision. The balancing entry theory is premised on the idea "that taxpayer's income over the long haul can be correctly computed only by requiring recoveries to be included in gross income if the debts or other items were deducted in prior years."[50] The result in *Tufts*, limiting amount realized to fair market value, fails to bring the tax consequences of the taxpayers' dealings with the partnership property into harmony with economic reality by not recapturing previously taken loss and depreciation deductions to the extent they exceed fair market value. This is contrary to the policy underlying *Crane*. Therefore, footnote 37, because it would allow such a result, should have been disregarded.

Upon closer examination, it appears that the Fifth Circuit's

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46. *See, e.g.*, Halpern, *Footnote 37 and the* Crane *Case: The Problem That Never Really Was*, 6 J. REAL EST. TAX'N 197, 225-28 (1978); Townsend, *supra* note 4, at 137-51. This view holds that when the nonrecourse liability is transferred with the property upon disposition, whether the transferee assumes the debt or takes the property subject to the mortgage, the relief from the debt should be income to the transferor. *Cf.* United States v. Kirby Lumber Co., 284 U.S. 1 (1931) (holding that relieving a debtor of his debt results in income to the debtor).

47. *See, e.g.*, McGuire, *Tax Shelter Partnerships—Liabilities in Excess of Basis*, 36 N.Y.U. INST. FED. TAX'N 1443, 1463-68 (1978). This rationale looks to the tax benefit previously received by the taxpayer, such as depreciation deductions reducing the taxpayer's tax liability, and suggests that the taxpayer must in some way account for that tax benefit upon disposition. This view is analogous to the tax benefit rule codified in I.R.C. §§ 111, 186 (1976), which provides for inclusion in gross income of recovery of specific items that resulted in an income tax benefit for the year of deduction. Under this view, recovery of deductions would be limited to the tax benefit actually received.

48. *See, e.g.*, Parker v. Delaney, 186 F.2d 455, 459-60 (1st Cir. 1950) (Magruder, C.J., concurring), *cert. denied*, 341 U.S. 926 (1951). *See generally* Lurie, *Mortgagors with "Negative Equities" and "Negative Bases"*, 10 N.Y.U. INST. FED. TAX'N 71 (1952). Congress and the Internal Revenue Service appear to have disapproved of negative basis. *See, e.g.*, I.R.C. §§ 705(a)(3), 1021, 1376(b)(2) (1976); Treas. Regs. § 1.614-6(a), T.D. 7728, 1980-2 C.B. 236; § 1.817-3, T.D. 6886, 1966-2 C.B. 251.

49. *See* Bittker, *supra* note 2, at 282-284.

50. B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 5.7.1, at 5-46 (1981).

difficulties with *Crane* run deeper than its rejection of the economic benefit theory. The court also appears to object to the inclusion of any nonrecourse debt in basis. The court stated that the "real crux of the problem, then, is the taxpayer's ability to manipulate his basis and adjusted basis through the use of nonrecourse financing."[51] The court's concerns about *Crane* are to some extent understandable. The *Crane* decision allows a taxpayer to make sizable deductions when the taxpayer has little or no cash investment because nonrecourse debt is included in basis. The Fifth Circuit, however, actually compounded the problem by limiting amount realized to fair market value. As long as the Internal Revenue Service and the courts include the full nonrecourse liability in amount realized, the taxpayer does not reap tax-free gain on disposition of the mortgaged property. But if a court allows the taxpayer to limit amount realized to fair market value when the nonrecourse liability exceeds the fair market value, as the Fifth Circuit did in *Tufts,* the taxpayer receives a tax-free gain. Judge William's concurring opinion correctly criticized the majority in *Tufts* for failing to recognize that "*Crane* is the law,"[52] and questioned the "authority to strike down the Commissioner's interpretation on the basis of 'serious reservations about the *Crane* decision.' "[53] *Crane* continues to govern and it should be followed. The Fifth Circuit may have legitimate reservations about the impact of the *Crane* decision, but "that argument is properly directed at the Congress, not at the courts."[54]

Although Congress initially approved the result in *Crane* by reenacting[55] sections 111 and 113 (now sections 1001 and 1014) of the Internal Revenue Code,[56] it has since responded to the tax shelter abuses allowed by *Crane* by enacting I.R.C. section 465. Section 465 limits allowable losses and deductions to the amount the taxpayer has at risk. Debt is considered at risk only to the

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51. 651 F.2d at 1064 n.9.

52. *Id.* at 1064 (Williams, J., concurring).

53. *Id.*

54. 651 F.2d at 1062 n.7.

55. The reenactment doctrine has been stated as follows: "Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change . . . ." Lorillard v. Pons, 434 U.S. 575, 580 (1978).

56. Revenue Act of 1938, ch. 289, § 111(b), 52 Stat. 447, 484 (1938) (codified as amended at I.R.C. § 1001(b) (1976)); Revenue Act of 1938, ch. 289 § 113(a)(5), 52 Stat. 447, 490 (1938) (codified as amended at I.R.C. § 1014 (1976)).

extent that the taxpayer is personally liable for repayment or has pledged other property as security.[57] The at-risk limitations change that portion of the *Crane* rule which allows inclusion of nonrecourse debt in basis and its subsequent deduction in excess of the at-risk amount. These at-risk limitations apply to all business investments except real estate.[58] Thus, Congress has continued both aspects of the *Crane* rule with respect to real estate: inclusion of nonrecourse liability in basis and the subsequent inclusion of nonrecourse liability in amount realized upon disposition of the property. Because of Congress's continued sanctioning of *Crane* in cases of real estate, Mr. Tufts' investment in real estate should have been within the *Crane* rule. Although there may be legitimate concerns with potential abuses of *Crane*, it continues to govern real estate investments.

III. Conclusion

Fair market value should not limit the amount realized on the sale of property subject to a nonrecourse mortgage. When a taxpayer has benefited by inclusion of a nonrecourse mortgage in basis and had allowable deductions as a result, the taxpayer should account for those deductions upon disposition of the property. This policy, which underlies the *Crane* decision, requires that the full amount of the nonrecourse mortgage be included in the amount realized regardless of fair market value.

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57. I.R.C. § 465 (1976) provides in part:

(b) Amounts considered at risk.—

(1) In General.—For purposes of this section, a taxpayer shall be considered at risk for an activity with respect to amounts including—

(A) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and

(B) amounts borrowed with respect to such activity (as determined under paragraph (2)).

(2) Borrowed amounts.—For purposes of this section, a taxpayer shall be considered at risk with respect to amounts borrowed for use in an activity to the extent that he—

(A) is personally liable for the repayment of such amounts, or

(B) has pledged property, other than property used in such activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer's interest in such property).

No property shall be taken into account as security if such property is directly or indirectly financed by indebtedness which is secured by property described in paragraph (1).

58. I.R.C. § 465(c)(3)(D) (Supp. III 1979).

Since *Crane*'s footnote 37 and its embodiment in *Tufts* require a contrary result, they should not be followed.

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