

# Notes

## Tax Shelters, Nonrecourse Debt, and the *Crane* Case

Tax shelters have evoked an abundance of journalistic speculation, expert commentary and legislative action, but surprisingly few litigated cases. The paucity of litigation is especially odd, since shelters seem to generate business losses almost as rapidly as tax deductions, especially for surgeons, orthodontists, accountants, lawyers and other gullible folks. With so many tax shelters in ruins, why have we not had a flood of tax cases contesting deficiency notices based on the theory that the unpaid balance of an investor's nonrecourse debt is an "amount realized" on a foreclosure, abandonment or similar event? Knowledgeable practitioners to whom I have put this question in recent months have not been able to explain the dearth of deficiency notices and lawsuits, but some have suggested that taxpayers may "forget" when a venture collapses that the Internal Revenue Service is interested in the fact that their tax deductions in prior years exceeded their cash outlays. In fact, taxpayers who prepare their own returns may neglect to report gains when a tax shelter collapses even if they have excellent memories. After all, the notion that a business failure can produce taxable income is counter-intuitive, and so is the idea that investors benefit when they are "relieved" of nonrecourse debt. Tax experts can entertain both ideas with equanimity, to be sure, but we listen to a different drummer.

What about returns prepared for taxpayers by professionals? I suspect that it is not uncommon for them to disregard the possibility of gain on the foreclosure or abandonment of a tax shelter on the authority of the most famous footnote in tax history, note 37 to *Crane v. Commissioner*,<sup>1</sup> suggesting that gain cannot be realized on the disposition of property subject to a nonrecourse debt in excess of its basis, unless the taxpayer receives cash or other property to boot. Fully recognizing that the validity of this idea has already been subjected to analysis by many commentators,<sup>2</sup> I want to make still another assault on the citadel. As an incurable pedagogue, I hope that my readers will forgive me for beginning at the beginning.

### Background

If the owner of mortgaged property is personally liable on the bond and sells the encumbered property under a contract requiring the purchaser to pay off the debt at the closing, it is self-evident that the resulting relief from liability is equivalent to a payment of money to the mortgagor, and that it is includable in the amount realized by him under section 1001(b). In *Old Colony Trust Co. v. Commissioner*, decided in 1929, the Supreme Court held that an employer's payment of an employee's federal and state income taxes

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<sup>1</sup> 331 U.S. 1 (1947).

<sup>2</sup> For citations, see McGuire, *Negative Capital Accounts and the Failing Tax Shelter*, 3 J. REAL ESTATE TAX. 439, 440-42 (1976); Johnson, *Tax Models for Nonrecourse Employee Liability*, 32 TAX L. REV. 359, 391-92 (1977).

was tantamount to a payment of the same amount directly to the employee,<sup>3</sup> and this hoary principle was later applied by the Court, in *United States v. Hendler*, to a buyer's assumption and payment of the bonded indebtedness of a predecessor company pursuant to a merger agreement: "The Hendler Company [the seller] was the beneficiary of the discharge of its indebtedness. Its gain was as real and substantial as if the money had been paid it and then paid over by it to its creditors."<sup>4</sup>

The same principle has long been applied if the buyer assumes or takes subject to the debt, rather than paying it off at the closing,<sup>5</sup> though this action may be substantially less beneficial to the seller than an immediate discharge from the liability. Since the seller's continuing secondary liability is a sword of Damocles, which will fall on him if the property declines in value and the buyer becomes insolvent, only a gullible taxpayer would accept at full value the judicial assurance that an assumption of the debt (let alone a transfer of the property subject to the debt) is tantamount to payment. If, on the other hand, the seller does not worry about secondary liability because it is minimized or eliminated by local anti-deficiency legislation<sup>6</sup> or because he is and expects to remain insolvent, he is even less likely to regard the buyer's action as the equivalent of cash.

Despite these shortcomings in the theory that the seller of mortgaged property gets the equivalent of cash whether the buyer pays off the debt at the closing or merely assumes or takes subject to it, there are good reasons for not attempting to distinguish among these transactions in applying section 1001(b). The economic value to the seller of the buyer's action in assuming or taking subject to the debt is a function of many variables: (1) the amount of cash paid at the closing, (2) the improvements that the buyer may make to the property, (3) the probable value of the property when the payments of interest and principal are due, (4) the likelihood that the buyer will be able to make good on a deficiency judgment if there should be one, (5) the seller's probable financial status if the mortgagee proceeds against him in the event of default by the buyer and (6) other elusive imponderables. If these uncertainties had to be weighed in determining the amount realized by the seller, the computation of gain or loss on every routine sale of mortgaged property would be plunged into uncertainty. Thus, while the buyer's action in assuming or taking subject to a mortgage is not equivalent to payment in real life, it is reasonable to treat them the same for tax purposes.

### Nonrecourse Debt

The foregoing observations just described must be qualified if the seller of mortgaged property is not personally liable for the debt, because he either

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<sup>3</sup> 279 U.S. 716 (1929).

<sup>4</sup> 303 U.S. 564, 566 (1938). The acquiring company assumed the liability for its predecessor's first mortgage bonds, current bank loans and merchandise accounts payable; the bonds were paid off a week after the merger date, and the loans and accounts payable were paid during the following month. *See Hendler v. United States*, 17 F. Supp. 558 (D. Md. 1936).

<sup>5</sup> *Crane v. Comm'r*, 331 U.S. 1 (1947) (reaffirmed earlier decisions to the same effect).

<sup>6</sup> *See OSBORNE, MORTGAGES 702-24* (2d ed. 1970).

acquired the property subject to the debt or borrowed against it on a non-recourse basis. The problem of fitting nonrecourse debt into the statutory framework can be illustrated by a simple example: Assume that a taxpayer purchased *Blackacre* for \$10,000, paying \$2,000 in cash and taking subject to an existing mortgage of \$8,000, and later sold the property for \$11,000 to a buyer who paid \$3,000 in cash and took subject to the mortgage, which had not been amortized and hence still amounted to \$8,000. A businessman knowing nothing of the Code would unhesitatingly compute the gain on selling *Blackacre* as \$1,000, either by subtracting the purchase price of \$10,000 from the sales price of \$11,000 or—more likely—by subtracting the cash paid out (\$2,000) from the cash received (\$3,000). Turning to section 1001(b), however, it is not easy to see how the amount realized by the seller—defined as “the sum of any money received plus the fair market value of the property (other than money) received”—amounts to \$11,000.

Since the seller has no liability on the debt, and will not care whether the buyer pays the mortgage at maturity or defaults, he is not likely to think that he got the equivalent of \$8,000 in cash when the buyer took subject to the mortgage. On the other hand, the seller could not have effected a sale and thereby converted the value of his equity (\$3,000, in our example) into cash except by finding a buyer who would either pay off the debt or take subject to it. For this reason, the buyer's decision to take subject to the mortgage is as beneficial to the seller as actual payment of the debt, since one or the other is an indispensable condition to his getting the \$3,000 of cash from the buyer. Indeed, the seller will often be better off if the buyer takes subject to the debt rather than paying it off, since the buyer may be willing to pay a premium to keep the existing mortgage in force on a nonrecourse basis. Thus, something can be said in favor of describing the amount realized by the seller as \$11,000, since this reaches a rational result, even though it strains the words used in section 1001(b).

In *Crane v. Commissioner*, the Supreme Court bent the statutory language to meet the perceived need. The facts, somewhat simplified, were that the taxpayer inherited an apartment building worth \$250,000, subject to a mortgage of the same amount, held it for seven years, during which she took \$25,000 of depreciation deductions (based on a claimed basis under section 1014 of \$250,000), and then sold it, subject to the unamortized mortgage, for \$2,500 in cash. She reported \$2,500 of gain on the sale, based on the theory that (1) the property acquired by her from her husband's estate was only the equity in the building, which had a value at that time of zero, entitling her to a zero basis under section 1014 (relating to property acquired from a decedent), and (2) the amount realized for the equity when she sold it was \$2,500.<sup>7</sup>

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<sup>7</sup> This contention was manifestly inconsistent with her use of a basis of \$250,000 in computing depreciation; and, had she prevailed in the litigation, the Service would have been able to assess deficiencies for the presale years, subject to the statute of limitations. An adjustment of taxes for the presale years would have been relatively painless; according to the taxpayer's petition in the Tax Court (Supreme Court Record at 7), the depreciation claimed was of so little tax benefit that its elimination would have increased the taxes owed by the taxpayer and her husband's estate (which had claimed the depreciation for most of the period between his death and the sale) by only \$122.

The government computed the taxpayer's gain in *Crane* as \$27,500, arguing that (1) the "property" inherited by the taxpayer was the real estate, not the equity; (2) her unadjusted basis under section 1014 was \$250,000; (3) her adjusted basis under section 1016 was \$225,000 (\$250,000 less depreciation of \$25,000); and (4) the amount realized was \$252,500 (\$2,500 in cash plus \$250,000, the amount of the mortgage to which the buyer took subject). Thus, the government's computation of gain was:

(1) Amount realized		
(a) Cash		\$ 2,500
(b) Mortgage		250,000
(c) Total		<u>\$252,500</u>
(2) Less: Adjusted basis		
(a) Unadjusted basis	\$250,000	
(b) Less: Depreciation	<u>25,000</u>	
(c) Adjusted basis		<u>225,000</u>
(3) Gain (line (1)(c) less line (2)(c))		<u>\$ 27,500</u>

The Court upheld the Service's theory of the transaction. It agreed that the property inherited by the taxpayer was the real estate, not the equity, giving three reasons for this conclusion: First, the Court noted that the "ordinary, everyday" dictionary meaning of "property" is either "the physical thing which is a subject of ownership" or "the aggregate of the owner's rights to control and dispose of that thing."<sup>8</sup> Second, the Service had consistently interpreted section 1014 as using the term "property" in this familiar sense. Last, the Court concluded that if property referred only to the taxpayer's equity, the allowable depreciation deductions would be based on this amount and would seriously understate the actual exhaustion of the property; moreover, since the taxpayer's equity changes whenever the mortgage is amortized, the depreciation basis would have to be repeatedly recomputed.

Having concluded that the taxpayer's unadjusted basis for the property under section 1001(b) was \$250,000, the Court turned to the taxpayer's claim that, her equity being worth nothing, she incurred no economic loss when the property deteriorated. Reserving judgment on the validity of this claim if the property had been worth less than the mortgage (which would have meant that the economic loss from physical exhaustion would fall on the mortgagee), the Court held that in the absence of such a showing, the burden of deterioration fell on the taxpayer, entitling her to depreciate the property. This, in turn, required a reduction of her basis under section 1016 by the amount of the depreciation allowed or allowable.

Finally—"at last," in its words—the Court turned to the phrase "amount realized," as used in section 1001(b). Since the taxpayer's property consisted of a building worth more than \$250,000, the Court held, in effect, that the amount realized *must* have been close to that amount; limiting the amount realized to the \$2,500 of cash received by the seller would require accepting "the absurdity that she sold a quarter-of-a-million dollar property for roughly

<sup>8</sup> 331 U.S. at 6.

one per cent of its value, and took a 99 per cent loss.”<sup>9</sup> The Court’s interpretation of section 1001(b) was, in essence, a by-product of its views about the taxpayer’s basis for the property and her concomitant right to compute depreciation on that basis:

Petitioner concedes that if she had been personally liable on the mortgage and the purchaser had either paid or assumed it, the amount so paid or assumed would be considered a part of the “amount realized” within the meaning of [section 1001(b)]. The cases so deciding have already repudiated the notion that there must be an actual receipt by the seller himself of “money” or “other property,” in their narrowest senses. It was thought to be decisive that one section of the Act must be construed so as not to defeat the intention of another or to frustrate the Act as a whole, and that the taxpayer was the “beneficiary” of the payment in “as real and substantial [a sense] as if the money had been paid it and then paid over by it to its creditors.”

Both these points apply to this case. The first has been mentioned already. As for the second, we think that a mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and for additional consideration, realizes a benefit in the amount of the mortgage as well as the boot. If a purchaser pays boot, it is immaterial as to our problem whether the mortgagor is also to receive money from the purchaser to discharge the mortgage prior to sale, or whether he is merely to transfer subject to the mortgage—it may make a difference to the purchaser and to the mortgagee, but not to the mortgagor. Or put in another way, we are no more concerned with whether the mortgagor is, strictly speaking, a debtor on the mortgage, than we are with whether the benefit to him is, strictly speaking, a receipt of money or property. We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.<sup>10</sup>

The Court was, of course, right in asserting that the owner of mortgaged property must keep up the payments if he wants to retain the property and that *for this period of time*, he must treat the debt as a personal obligation whether he is personally liable or not. It does not follow, however, that the benefit to him from transferring the property subject to the mortgage is the same in both cases. If you crave gourmet meals, you must pay for them so long as your addiction continues; but once you break the habit, you need pay only for those you bought on credit in the past, not for those that you will skip in the future. So it is with mortgages. Nonrecourse obligations can be

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<sup>9</sup> *Id.* at 13.

<sup>10</sup> *Id.* at 13–14 (footnotes omitted). Referring to these observations, an imaginary Supreme Court opinion acknowledges: “It would have been better had we stopped [before making these two points]. On both counts we were sadly misled.” Adams, *Exploring the Outer Boundaries of the Crane Doctrine: An Imaginary Supreme Court Opinion*, 21 TAX L. REV. 159, 175 (1966).

disregarded as soon as the property is sold, given away, or abandoned; personal liability persists even after the property has been disposed of, whether the new owner assumes or takes subject to the debt.

Thus, *Crane* overstates the resemblance between nonrecourse and personal obligations. On the other hand, had the Court established a legal distinction between them, it would have produced some economic anomalies. For many real estate holding companies, for example, the distinction is purely formal: If the corporation's only asset is the mortgaged property, personal liability on the bond adds nothing to the mortgage, unless the officer-shareholders make the mistake of letting the rents or other income accumulate in the corporate treasury, thus augmenting the assets available to the lender if there is a default. Similarly, individuals who have no significant assets other than mortgaged property (or who keep their other assets in a mattress) may well regard the distinction between nonrecourse and personal liability as a formality.

Thus, the Court in *Crane* had to choose one of three alternatives: (1) a sharp line between nonrecourse and personal obligations, which would often not correspond to economic reality; (2) a case-by-case scrutiny of purported personal liability in order to decide whether it is more like nonrecourse debt than "true" personal liability, a process that would create a heavy administrative burden and foster uncertainty; and (3) uniform treatment of both types of liability, notwithstanding their genuine differences. In opting for the third of these approaches, the Court would have been more persuasive if it had acknowledged that apples and oranges were being put in the same bin for reasons of administrative simplicity, not because they were interchangeable. Relief from a nonrecourse debt is not an economic benefit if it can be obtained only by giving up the mortgaged property. It is analogous to the relief one obtains from local real property taxes by disposing of the property: Like nonrecourse debt, the taxes must be paid to retain the property; but no one would suggest that the disposition of unprofitable property produces an economic benefit equal to the present value of the taxes that will not be paid in the future.

Although the benefit rationale of *Crane* is unpersuasive, the result reached by the Court was justifiable because it brought the tax consequences of the taxpayer's dealings with her property into harmony with economic reality by recapturing her depreciation deductions to the extent that they exceeded her investment in the encumbered property. The value ascribed to the alleged relief she obtained from a liability for which she was not liable was, at bottom, a balancing entry that was appropriate if—but only if—viewed in its tax context. Like the tax benefit doctrine, the *Crane* principle is a creature of the tax system, and it would be equally superfluous if the federal income tax were repealed. In the absence of an income tax, it would be instantly obvious that the taxpayer in *Crane* realized a profit of \$2,500 on inheriting worthless property and selling it for \$2,500; and that her profit would have been exactly the same if the property, instead of being subject to a \$250,000 mortgage when inherited and sold, had been unencumbered on both dates or had been subject to a mortgage of \$1 million on both dates, provided the equity was worthless when the property was inherited.

The facts giving rise to *Crane* were unusual: Not many taxpayers inherit property worth the same amount as the debt by which it is encumbered, and still fewer succeed in selling this type of property at a gain. But *Crane's* re-

verberations belie its modest origin. By holding that nonrecourse liabilities are includable in the taxpayer's basis for property, *Crane* laid the foundation stone of most tax shelters,<sup>11</sup> while the corollary of this basis rule—that the termination of nonrecourse liability is an amount realized when the property is sold or disposed of—is the booby trap waiting for tax sheltered investors when their venture is wound up. Thus, tax shelters enable investors to deduct depreciation, drilling expenses and similar items as rapidly as the expenditures are made, even though financed by nonrecourse borrowing, hence exceeding their current cash outlay; but when the investment is sold, nonrecourse liabilities are includable in the amount realized in computing gains, so that the deductions taken in the earlier years are—or should be—recaptured at the end of the road.

### Debt in Excess of Value—

#### Footnote 37 of *Crane*

In *Crane*, the taxpayer did not contend that the unpaid debt exceeded the value of the encumbered property at the time of the sale, and her receipt of \$2,500 in cash from the purchaser would have refuted such a claim. In footnote 37, however, the Court observed: "Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case."<sup>12</sup>

The implication of footnote 37—that the amount realized on disposing of property encumbered by a nonrecourse mortgage cannot exceed its value—may have been strengthened by the Supreme Court's later decision in *United States v. Davis*, holding that the value of the property received in an arm's length exchange can be determined by looking to the value of the property given up.<sup>13</sup> If property transferred in an arm's length exchange has no net value (the situation envisioned by footnote 37 to *Crane*), the *Davis* doctrine ("you get what you give") would ascribe a zero value to the amount realized, thus converting the speculative suggestion of footnote 37 into a rule of law.

But this would produce a startling result, which can be illustrated by assuming that a taxpayer purchases *Blackacre* for \$100,000, making a down payment of \$25,000 and giving the seller a nonrecourse purchase money mortgage of \$75,000 for the balance; that the value of the property rises to \$300,000, enabling the taxpayer to increase the face amount of the mortgage from \$75,000 to \$250,000 (the increase of \$175,000 being received by him in cash); that *Blackacre's* value (unencumbered) then drops to \$40,000; and, finally, that the taxpayer transfers it to an incorrigible optimist subject to the unpaid mortgage of \$250,000. If the amount realized by the taxpayer is only \$40,000 (the value of the property), as implied by *Crane*, he will realize a loss of \$60,000 (*Blackacre's* cost of \$100,000, less the amount realized of

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<sup>11</sup> An autographed copy of this article is hereby offered for the best essay by an Internal Revenue Service lawyer entitled "Pyrrhic victories I have come to rue."

<sup>12</sup> 331 U.S. at 14 n.37.

<sup>13</sup> 370 U.S. 65 (1962).

\$40,000), although his economic gain over the years was \$150,000 (\$175,000 of cash received on increasing the mortgage, less \$25,000 of cash paid as a down payment)!

These indefensible tax results arise only because footnote 37 of *Crane* attaches weight to something that cannot possibly affect the taxpayer once he disposes of the property, that is, its value. Whether the value of the property at that time is just barely sufficient to pay off the debt, or falls short of that amount, and what happens to its value thereafter, are matters of concern to the mortgagee and the new owner; but the old owner has no reason to worry about these matters. It has been argued above that the result in *Crane* can be justified only if the amount realized by a taxpayer who disposes of property encumbered by nonrecourse debt in excess of its basis is viewed as a balancing entry, which brings the tax results into conformity with economic reality. If this is its function, the amount realized should be computed by reference to the taxpayer's adjusted basis, the amount of the nonrecourse debt, and the cash or other property (if any) received by him. If it falls out that the property is worth less than the debt, that is the lender's misfortune; but this should no more affect the taxpayer's tax returns than it affects his economic position.

### Conclusion

Nonrecourse debt can exceed the adjusted basis of the encumbered property because the taxpayer (or a predecessor in interest) (1) borrowed against the property, pledging it as security for the loan, and/or (2) expensed, depreciated or amortized the property in an amount exceeding his cash outlay. In the first situation, the borrowed funds were excluded from the debtor's income when received on an assumption—that the offsetting liability would ultimately be discharged by payment of the debt—that, in retrospect, has proved erroneous. In the second situation, deductions were allowed on a similar assumption—that they were required to restore the taxpayer's capital outlay—that has, similarly, proved to be erroneous. In either case, a balancing entry—inclusion of the excess amount in gross income—is required when the taxpayer closes his account with the Service by disposing of the property, without regard to the value of the property at that time.

Though it reached the right result, *Crane* introduced confusion into this area by asserting that taxpayers receive a "benefit" on disposing of property subject to nonrecourse debt. Since taxpayers cannot benefit from being "relieved" of liabilities for which they are not liable, the contrary theory of *Crane* was bound, as footnote 37 demonstrates, to generate anomalies. To cope adequately with tax shelters, the government and the courts will have to develop a theory, akin to the tax benefit doctrine, that is not dependent on the value of the encumbered property when it is foreclosed, abandoned or otherwise disposed of. A few straws can be detected in the wind, but they have not yet been woven into a coherent alternative to footnote 37.<sup>14</sup>

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<sup>14</sup> See *Woodsam Assocs., Inc. v. Comm'r*, 198 F.2d 356 (2d Cir. 1952); *Gavin S. Millar*, 67 T.C. 656 (1977) (gain realized on surrender of stock in discharge of nonrecourse debt, regardless of the stock's fair market value); *Mendham Corp.*,

9 T.C. 320 (1947). Revenue Ruling 76-111, 1976-1 C.B. 214, disregarded the value of property encumbered by a purchase money obligation in excess of basis in determining the owner's gain or loss on transferring the property back to the seller in settlement of the debt, but it sidesteps footnote 37 ("whatever inference may be drawn from footnote 37 in the *Crane* case"), without offering an alternative rationale. Moreover, only a year later, the Service cited *Crane* in support of the proposition that nonrecourse debt in excess of the value of the encumbered property is less significant than debt for which the taxpayer is personally liable; while the point is true enough, reliance on *Crane* helps to perpetuate its anomalous ramifications. See Rev. Rul. 77-110, 1977-1 C.B. 7. There have been earlier suggestions that tax benefit or cancellation of indebtedness principles should supplement the economic benefit rationale espoused by *Crane*. See, e.g., Adams, *Exploring the Outer Boundaries of the Crane Doctrine: An Imaginary Supreme Court Opinion*, 21 TAX L. REV. 159 (1966); Del Cotto, *Basis and Amount Realized under Crane: A Current View of Some Tax Effects in Mortgage Financing*, 118 U. PA. L. REV. 69, 85-86 (1969); McGuire, *Negative Capital Accounts and the Failing Tax Shelter*, 3 J. REAL ESTATE TAX. 439, 448 (1976); Rollyson, *Recent Cases and Rulings—Service Turns the Tables on the Crane Doctrine*, 3 J. REAL ESTATE TAX. 495 (1976). As the text of this article indicates, in my view, the economic benefit theory should be rejected as wholly fallacious, in order to make way for a more comprehensive balancing entry theory.

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