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Nonrecourse Financing and Tax Shelter Abuse: The Crane Doctrine Before and After the At Risk Provisions

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INTRODUCTION

Tax shelters owe their existence, whether intended or not, to our statutory scheme of taxation.\footnote{A tax shelter frees current income from current tax liability. This income is from two sources. It may arise from the activity of the tax shelter ("related" income), or it may be from some other source ("unrelated" income). There are three main sheltering features, deferral, leverage, and conversion, although a given tax shelter may not contain them all.} Congress has enacted provisions to channel investments into targeted areas to promote economic and social policy.\footnote{Deferral is the postponement of tax liability. This is achieved by the generation of deductions which are then used as offsets against income. In the prototypical tax shelter, these deductions exceed the income produced by the tax shelter (at least in the early years of the activity) and are thus available to offset unrelated income.} Thus the investment credit\footnote{Leverage is the use of borrowed funds in the tax shelter activity. Under the tax laws, it is the purchase price and not the out-of-pocket investment that determines the tax consequences. The deductions are the same whether the taxpayer pays all or only a part with his own funds. It is therefore possible for the taxpayer to deduct an amount greater than his investment, through the use of borrowed funds.} and ac-

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1. A tax shelter frees current income from current tax liability. This income is from two sources. It may arise from the activity of the tax shelter ("related" income), or it may be from some other source ("unrelated" income). There are three main sheltering features, deferral, leverage, and conversion, although a given tax shelter may not contain them all.


3. I.R.C. §§ 38, 46-48 (1954). The investment credit is generally available for tangible property (except buildings and their components) which have a useful life (see note 51 infra) of at least 3 years. It is taken in the taxable year during which it is put into service by the taxpayer. As a credit against tax, it acts as a tax forgiveness against other income of the taxpayer. There is no element of deferral because this uncollected tax will
Accelerated depreciation were enacted to induce investment in capital equipment to modernize our industrial base, while the deductibility of interest payments supports the goal of individual home ownership.

However, these statutory inducements predictably result in some "investments [that] are motivated by excessive concern with the tax benefits associated with them, [and] not their economic merits." This is the result because the Internal Revenue Service provisions are written in broad terms and are embalmed by (1) judicial interpretations that enhance the positive short term tax advantages available on certain types of investments, while sowing confusion regarding the potential longer term liabilities involved; (2) the effects of inflation and two income families driving more taxpayers into high tax brackets from which they seek relief; and (3) promoters who, in the classical American tradition, find a need and fill it.

As this situation developed over time, Congress made periodic attempts to remedy the problem. One such remedy was the

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4. I.R.C. § 167 states in pertinent part: "(a) . . . There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income."

Any "reasonable allowance" that produces deductions in excess of the straight line method for the early years of the property's life is considered accelerated depreciation.

5. I.R.C. § 163(a) provides that "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."
adoption of the so-called “At Risk Provisions” (ARP) of the 1976 Tax Reform Act. This was intended to deal with abuses arising from the use of nonrecourse financing in certain types of activities. Nonrecourse financing has been an accepted part of tax shelter planning since the Supreme Court's holding in *Crane v. Commissioner* in 1947.

This Comment will examine the history of nonrecourse financing and tax shelters from the fabled *Crane* holding to the new reality of the ARP. This will be done by dividing the Comment into four parts. Part I will discuss the period preceding the passage of the Tax Reform Act of 1976, focusing on the *Crane* doctrine and subsequent attempts by the Internal Revenue Service (IRS) to define and limit the use of nonrecourse debt. Part II will highlight the factors that contributed to the growing abuse of tax shelters. Part III, in general terms, will examine the statutory scheme of the ARP, including the proposed regulations and several Revenue Rulings interpreting the statute. Part IV

will shift that amount of earned income into “unearned” income subject to a higher rate of taxation.

Conversion has been limited by the addition of the “recapture” provisions of I.R.C. §§ 1245, 1250. When depreciable property is sold for a gain, depreciation is “recaptured” as ordinary income, not as a capital gain. In the case of most real property (I.R.C. § 1250) only the excess depreciation over straight line is so reclassified, while all other property is subject to recapture of all depreciation taken.

8. I.R.C. § 465 [hereinafter referred to as the ARP].
10. In a nonrecourse loan there is no personal liability for repayment by the borrower. Typically, the purchased property is the sole security given. Thus the lender's only recourse on default is to force the sale of the security.
11. See I.R.C. § 465(c). The primary exclusion from the ambit of these provisions is the ownership of real property.
13. A Treasury Regulation is an official interpretation of an Internal Revenue Code section. As such, it is presumptively valid. It may be attacked on the ground that it does not comply with congressional intent. In theory, either party may attack the validity of the regulation, but the IRS only infrequently attacks its own regulations. Thus, complying with a regulation offers a “safe harbor” from IRS entanglements.

A Proposed Regulation has no official current force or effect. It does serve at least two functions. This “draft” of a regulation advises tax planners on what the official IRS interpretation will be. It also allows for criticism, so that the “bugs” may be removed before the final regulation is released. Given the advanced warning, the final regulation may be given retroactive effect and cover the period during which the Proposed Regulation was released. This can be done when the underlying statute has been in force during the applicable period.

A Revenue Ruling is an IRS opinion on a fact situation that is considered to have more than limited applicability. It has no evidentiary value, but does indicate the probable position that the IRS will take in a given controversy. It should be noted, however,
will discuss the current status of the *Crane* doctrine.

I. DEVELOPING THE CRANE DOCTRINE

A. The *Crane* Decision

As a preliminary matter, certain terms need to be defined. Generally, the taxpayer's "basis" in property is "the cost of such property." However, when the property is inherited, the basis in the hands of the acquiring party is "the fair market value of the property at the date of the decedent's death." Adjustments to basis are made to reflect depreciation deductions taken under section 167. Upon sale or other disposition of the property, the amount realized is "the sum of any money received plus the fair market value of the property (other than money) received." "The gain from the sale or other disposition of property shall be the excess of the amount realized . . . over the adjusted basis. . . ."

Any discussion of the use of nonrecourse financing for tax sheltered transactions must start with the Supreme Court's decision in *Crane v. Commissioner.* In simplified form, the facts of *Crane* are as follows. Mrs. Crane inherited an apartment building and land from her husband during the Great Depression. It had a fair market value of $250,000 and was subject to a mortgage in the same amount. She operated the property for several years and claimed depreciation deductions totalling $25,000. With the mortgagee threatening to foreclose, she sold the property subject to the mortgage to a third party for $2,500 cash net. She argued that the "property" she inherited was the equity—the fair market value of the property less the encumbrances on it. Thus it would have had a zero value and therefore a zero basis in her hands when she inherited it. No depreciation

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that the IRS is much more likely to change its position in a Revenue Ruling than in a Treasury Regulation.

14. I.R.C. § 1012. Basis should be viewed as the measure of the actual economic investment made by the purchaser to obtain the property.

15. *Id.* § 1014. This "stepped up" basis is in contrast to the treatment of gifts where the donee's basis is the same as that of the donor. See *Id.* § 1015.

16. *Id.* § 1016(a)(2).

17. *Id.* § 167.

18. *Id.* § 1001(b).

19. *Id.* § 1001(a).

can be taken on a zero basis and, because neither she nor the transferee ever assumed the mortgage, her amount realized was the $2,500. Therefore her gain was $2,500 (the amount realized minus the zero basis).

The Commissioner computed the taxpayer's gain as $27,500. His theory was that the "property" inherited was the real estate undiminished by the mortgage, so that her basis under section 1014 was $250,000, the adjusted basis under section 1016 was $225,000 ($250,000 minus depreciation of $25,000), and the amount realized was $252,500 ($2,500 in cash plus the $250,000 mortgage subject to which the buyer took the property). Thus, the "gain" was $252,500 minus $225,000 as per section 1001.

The Court agreed with the Commissioner. It gave three reasons for concluding that "property" meant the real estate and not the "equity." First, the "ordinary, everyday" dictionary definition of property is either "the physical thing which is a subject of ownership, or . . . it is the aggregate of the owner's rights to control and dispose of that thing" and neither is a synonym for "equity." Second, neither Congress nor the Treasury has ever been confused in their uses of these terms and, further, because Congress had long been silent in the face of Treasury Regulations which had used "property" in the ordinary sense, this interpretation may now be considered to have the force of law. Third, the Court was concerned with the effect depreciation would have on adjustments to basis if "property" meant "equity." Significant administrative problems would be created because the basis would constantly need to be recomputed as mortgage payments reduced the outstanding principal and increased equity.

21. 331 U.S. at 3. This argument was inconsistent with the reality of the depreciation deductions of $25,000 actually taken by the taxpayer. However, this inconsistency does not go to the merits of the case, because the IRS would here have been able, subject to the statute of limitations, to assess deficiencies for these deductions if the taxpayer had prevailed.

22. I.R.C. § 1014.

23. Id. § 1016.

24. Id. § 1001(a).

25. 331 U.S. at 6-7.

26. Id. at 8.

27. Id. at 9-10.
Finding that the basis was the value of the property unreduced by the mortgage, the Court then quite easily found that the taxpayer was the appropriate party to be entitled to depreciation, reserving judgment on whether the result would be different if the unassumed mortgage was worth less than the value of the property. 28

Turning to the determination of the "amount realized," the Court rejected the proposition that this amount could be as little as $2,500. 29 It continued by pointing out that there need not be an actual receipt by the seller of money or other property for an amount to be considered as part of the "amount realized." 30 Of significance was the following analysis by the Court:

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. . . . We are . . . 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. 31

Therefore, the Court approved the Commissioner's inclusion of the amount of the unassumed mortgage in the amount realized. In its now famous footnote thirty-seven, 32 the Court reserved judgment as to whether this would be proper if the mortgage exceeded the value of the property. To add additional emphasis, the Court pointed out that the "crux of this case, really, is

28. Id. at 11. On the authority of Helvering v. Lazarus & Co., 308 U.S. 252 (1939), that depreciation is allowed to the party actually bearing the capital loss, Mrs. Crane argued that she was not the appropriate party. Because she was not personally liable for the mortgage, she felt the mortgagor should be entitled to the depreciation allowance. Id. at 11 & 11 n.32.
29. Id. at 14.
30. Id. at 13.
31. Id. at 14.
32. Id. at 14 n.37. Footnote 37 states in full:
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.
whether the law permits [the taxpayer] to exclude allowable deductions from consideration in computing gain.”

B. THE BASIC CONCEPT

There has been a significant amount of literature focusing on the Crane decision and its implications. It has included opinions concluding that the Court reached the wrong result, that it reached the proper result for the wrong reason, and an imaginary Supreme Court decision deciding the meaning of the famous footnote. This Comment’s focus, however, is limited to the meaning and scope of the Crane doctrine and will not attempt to critique the Supreme Court’s analysis. It has been noted that the Supreme Court had its choice of three unpalatable determinations. First, it could have found that the differences between nonrecourse and personal liability were significant enough to warrant different tax treatments. However, in many instances there are no true economic differences between the two. A second possibility would have been to find that a case by case analysis was necessary to determine the appropriate

33. Id. at 15.
35. Del Cotto, supra note 34, at 73. The author argued that the question was not the meaning of the word “property” alone but the meaning of the statutory phrase “property acquired by . . . devise.” Since the fair market value of the real estate equalled the mortgage when Mrs. Crane inherited it, the only way to get the underlying property was to pay for it. “It is a strange inheritance that must be purchased!” Id. The value of the property inherited must therefore be zero.
36. Bittker, supra note 34, at 284. Bittker argues that the economic benefit rationale of the Court in Crane is wrong. He thinks that the “amount realized” should include the face value of the indebtedness as a balancing entry to bring tax results into conformity with economic results.
37. Adams, supra note 34.
38. Bittker, supra note 34, at 282.
39. For example, if a corporation’s only asset is the purchased property, there is no meaningful difference. This occurs where a sale to a lessor is involved and the lender is looking primarily to the value of the property, and the presence or absence of personal liability by the lessor is relatively unimportant.
treatment for nonrecourse debt and basis inclusion. This would have created great uncertainty and administrative inefficiency. The path chosen by the Court was to treat personal and nonrecourse liability uniformly.

Such uniform treatment does not mean that nonrecourse indebtedness will be automatically included in basis. What it does mean is that it will not be excluded solely on the ground that there is no personal liability.40 We will now examine the cases subsequent to Crane, to follow the development of the doctrine and determine the limits of its applicability. The IRS has attempted to prevent nonrecourse debt from being included in basis, using arguments that the purchase price (or part of it) was too contingent or speculative to be included in basis, or that the transaction was something other than a sale, such as a lease or option.

C. Refinement of the Doctrine

In Mayerson v. Commissioner41 the taxpayer was offered an office building for a cash price of $275,000. Because of the age and condition of the property, the taxpayer was unable to arrange third party financing. The arrangement that was worked out was for a purchase price of $332,500 with $10,000 to be paid initially and the remainder payable pursuant to a nonrecourse ninety-nine-year mortgage at 6% interest with principal payments not required. Additionally, the purchase price would be reduced to $275,000 if paid in the first year, and $298,000 if paid in the second. At the time, it was understood that the taxpayer would attempt to secure conventional financing. Five years subsequent to taking possession, the taxpayer renegotiated the balance due on the purchase price by paying $200,000 in cash.

The IRS argued that the transaction was merely a long term

40. In subsequent cases Crane has been extended to the purchase of property as well as inherited property. See Blackstone Theatre v. Commissioner, 12 T.C. 801 (1949)(Taxpayer purchased property subject to tax liens. Held, the amount of the liens is includable in taxpayer's basis); Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950), cert. denied, 341 U.S. 926 (1951)(Taxpayer, who was not personally liable on the mortgage, turned property back to the mortgagee. Held, the amount realized was equal to the indebtedness, where the fair market value of the property equalled the amount of the mortgage. In essence this was Crane without the presence of boot).

lease coupled with an option to buy because of the indefinite price, the absence of recourse, the small initial payment, and the ninty-nine-year lease.\textsuperscript{42} The Tax Court held for the taxpayer. The court found that there was no indication of sham, and that there was a clear intent by the parties to conclude a sale.\textsuperscript{43} It further found that there was no intent to allow the mortgage to run for its stated 99-year term.\textsuperscript{44}

In furtherance of the notion that the \textit{Crane} doctrine stands for the uniform treatment of personal and nonrecourse liabilities for inclusion in basis, the court reasoned that “[t]axpayers who are not personally liable for encumbrances on property should be allowed depreciation deductions affording competitive equality with taxpayers who are personally liable for encumbrances or taxpayers who own unencumbered property.”\textsuperscript{45} It went on to say that the “effect of such a policy is to give the taxpayer an advance credit for the amount of the mortgage. This appears to be reasonable since it can be assumed that a capital investment in the amount of the mortgage will eventually occur despite the absence of personal liability.”\textsuperscript{46} Finally, after deciding that there should be basis inclusion, the court opted for the full $332,000 rather than a reduced amount, because the discount “merely provided an incentive for very early retirement of the mortgage which did not occur.”\textsuperscript{47}

In \textit{Roemer v. Commissioner}\textsuperscript{48} the taxpayer negotiated a purchase price of $275,000, which was to be reduced to $200,000 if paid within six years and ten months. The Tax Court disallowed the inclusion of the $75,000 discount in basis because of the compelling incentive to pay the note off within the discount period. In doing so, the court determined that this discount was too speculative to be included in the taxpayer’s basis.

In \textit{Marcus v. Commissioner}\textsuperscript{49} the taxpayer had purchased several bowling alleys. In each case a purchase price at well over

\begin{footnotesize}
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\item[42.] \textit{Id.} at 350.
\item[43.] \textit{Id.} at 352.
\item[44.] \textit{Id.}
\item[45.] \textit{Id.}
\item[46.] \textit{Id.}
\item[47.] \textit{Id.} at 354.
\item[48.] 69 T.C. 440 (1977).
\item[49.] 30 T.C.M. (CCH) 1263 (1971), \textit{aff'd in an unreported decision} (3d Cir. 1974).
\end{itemize}
\end{footnotesize}
fair market value was negotiated subject to a nonrecourse note with no interest due.\textsuperscript{50} Further, the useful life\textsuperscript{51} chosen by the taxpayer was substantially less than the term of the note. The Tax Court found that because many of the payments on the note were due after the useful life of the assets had expired, the chance of payments was not substantial enough, in light of the lack of liability on the part of the taxpayer, and the entire amount of the note was excluded from basis because the taxpayer’s liability was “contingent and not ascertainable.”\textsuperscript{52} However, the court did allow the taxpayer to deduct as depreciation payments actually made on the notes under the principle of \textit{Associated Patentees v. Commissioner}\textsuperscript{53} that each payment reflects the annual cost of ownership and use.\textsuperscript{54}

This is a confusing decision because in the court’s logic only payments scheduled after the expiration of the useful life were too contingent to be ascertained. It would have been reasonable

\begin{itemize}
  \item \textsuperscript{50} The purchase price was calculated as the sum of the fair market value of the property plus all the interest that would be paid over the term of the note assuming a 6\% interest rate. This arrangement allowed the seller to receive capital gains treatment for the interest portion of the payments, which otherwise would have been received as ordinary income, and the purchaser to use accelerated depreciation on the interest amounts by having them included in his basis. This was a common practice at the time and did not affect the court’s decision.

  \item This abuse has been addressed by \textsection 483, which imputes a minimum rate of interest on such transactions. Currently this rate is 7\%. \textit{See Treas. Reg. \textsection 1.483-1(c)(2)(ii)(B)(1980).}

  \item \textsuperscript{51} Treas. Reg. \textsection 1.167(a)-1(b)(1978) states in pertinent part that “the . . . useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income.”

  \item \textsuperscript{52} 30 T.C.M. (CCH) at 1273. A leading case is \textit{Albany Car Wheel Co. v. Commissioner}, 40 T.C. 831 (1963), \textit{aff’d per curiam}, 333 F.2d 653 (2d Cir. 1964) (Taxpayer purchased assets and assumed liabilities of predecessor. Taxpayer valued a liability for severance pay under a union contract at $50,000, even though it had negotiated a much more favorable arrangement with the union and attempted to include that amount in its basis. \textit{Held}, liability not includable for two reasons: one, because of all the contingent factors, no set sum could be estimated; two, under the renegotiated contract the likelihood of future liability was too speculative). \textit{See also} Columbus and Greenville Ry. \textit{v. Commissioner}, 42 T.C. 834 (1964), \textit{aff’d per curiam}, 358 F.2d 294 (5th Cir. 1966); \textit{Redford v. Commissioner}, 28 T.C. 773 (1957); Rev. Rul. 55-675, 1955-2 C.B. 567.

  \item 4 T.C. 979 (1945) In \textit{Associated Patentees} the taxpayer purchased patents in return for a promise to pay 80\% of the income from them to sellers. Taxpayer paid sellers $42,000 in the taxable year and attempted to deduct that amount as a royalty payment. \textit{Held}, the payment was a capital expenditure in acquisition of the patents, but it was a reasonable allowance for the depreciation of the patents and was thus deductible in the taxable year.

  \item \textsuperscript{54} 30 T.C.M. (CCH) at 1274.
\end{itemize}
to allow inclusion in basis for those amounts due before the useful life had been exceeded. Alternatively, because the seller's actions clearly indicated that the useful life of the bowling alleys was at least as long as the term of the note, the court might have found that the taxpayer was using too short a useful life, and merely disallowed excess deductions based on the shorter life assumed by the taxpayer.

In *Bolger v. Commissioner* 55 a format frequently used by the taxpayer was challenged by the IRS. Typically, the taxpayer would form a financing corporation with an initial capitalization of $1,000. The corporation would then purchase property after it had located a suitable tenant. In short order, often on the same day, (1) the seller would convey title, (2) a net lease 56 would be entered into, (3) financing would be obtained from an institutional lender, and (4) the corporation would then convey the property to its shareholders, subject to the lease and mortgage and without any cash payment or promise thereof by the shareholders. The shareholders, as the owners of the property, then claimed depreciation deductions which were contested by the Commissioner. Quoting liberally from *Mayerson*, 57 and invoking the spirit of *Crane*, 58 the Tax Court argued that if the taxpayer had been personally liable on the mortgage there would be no question that the amount of the debt would be includable in his basis, and because it had been stipulated that the fair market value of the property was not less than the amount of the mortgage, there would be an immediate equity in the property, which was enough to ensure that the taxpayer would treat the liability as if it were his own. 59 Therefore, the taxpayer could include the amount of the mortgage in his basis and take depreciation based on that amount.

*Carnegie Productions v. Commissioner* 60 is an example of a movie tax shelter that was unsuccessful. The taxpayer entered into an agreement with Columbia Pictures, whereby in exchange

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56. The court said that “payment by the lessee of all taxes, insurance, repairs, etc., . . . indicates] a net lease.” Id. at 762.
57. Id. at 770.
58. Id.
59. Id.
60. 59 T.C. 642 (1973).
for Columbia’s payment of $75,000 and its promise to provide all
funds necessary for completion of the film (with the taxpayer
not liable for repayment of the advances), taxpayer would pro-
duce and deliver to Columbia a finished motion picture based on
a screenplay he owned. In addition, upon receipt of the picture
by Columbia, taxpayer would convey the sole, exclusive, and ir-
revocable right to rent, lease, license, exhibit, distribute, and
otherwise use the picture, and to have all rights available under
the copyright, including the renewal term. Taxpayer then
claimed a depreciation deduction based on the total cost of mak-
ing the film. The court had no trouble in concluding that
"[f]rom the terms of the contract and an examination of the ac-
tions of the parties, the conclusion is inescapable that Columbia
became the real ‘owner’."61 The taxpayer had retained nothing
that could be considered a depreciable interest; therefore the de-
preciation was disallowed.62

A case not dealing with nonrecourse debt but potentially
relevant for its holding concerning a different kind of deduction,
is Goldstein v. Commissioner.63 The taxpayer won $140,000 in
the Irish Sweepstakes. She then borrowed a large sum of money
at 4% interest, prepaid $80,000 worth of interest, and invested
the remaining loan proceeds in U.S. Treasury Notes paying be-
tween 1% and 1½%. Although the statute that permits the de-
duction of all interest paid on indebtedness is silent as to intent
and clearly does not require a business motive,64 the court none-
theless found that there must be a purpose apart from the antic-
ipated tax consequences to qualify for deductibility.65 Therefore
the $80,000 interest deduction was totally disallowed.

The final case to be examined is Estate of Franklin v. Com-
missioner.66 A limited partnership of which decedent was a
member had purchased land and a motel building. The motel
had been purchased by the sellers a few months before for ap-
proximately $660,000. The partnership purchased this property
for $1,224,000 payable as follows:

61. Id. at 653.
62. Id. at 653-54.
64. See I.R.C. § 163(a); text of section at note 5 supra.
65. 364 F.2d at 740.
66. 64 T.C. 752 (1975), aff’d, 544 F.2d 1045 (9th Cir. 1976).
[1] $75,000 paid as prepaid interest at the time of sale;
[2] Monthly payments for a ten-year period based on a 25-year amortization schedule at 7½% interest. At the same time the partnership net leased the motel to the seller for the same amount of rent;
[3] The approximate balance of $975,000 was payable ten years after the sale on a nonrecourse basis, less the amount of any mortgages on the property by the sellers.

The IRS disallowed the taxpayer's share of the partnership losses, arguing that the transaction was either a sham or an option to buy the property after ten years. The Tax Court agreed with the IRS that the transaction merely amounted to an option. It distinguished *Crane* and *Mayerson* because this situation involved a variable price determined ten years later, the seller retained significant indicia of ownership, and the purchase price had no relation to current value but did resemble an option to purchase at a later date.

On appeal, the Ninth Circuit agreed with the disallowance of basis inclusion but for its own reason. For the Ninth Circuit, the key was that the purchase price had not been shown to approximate the fair market value. To the court there would not be a buildup of equity which would entice the taxpayer to continue to make payments on the note. The court reserved judgment on what adjustments to basis would need to be made in the event that an equity position was reached. This holding is squarely in agreement with the IRS position taken in Revenue Ruling 69-77 that where the transaction is designed to "improperly create or inflate depreciation deductions . . . the Service will disallow unwarranted depreciation deductions."

Except for the aberrant *Marcus* decision, a consistent theme that nonrecourse debt is generally available for basis in-

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67. *Id.* at 762; See note 56 *supra*.
68. 544 F.2d at 1048. Of significance is the court's determination that the taxpayer had failed to satisfy his burden of proof to demonstrate that the price paid was a reasonable one. This holding marks the first time a court concluded that the taxpayer needed to make an affirmative showing of value.
69. *Id*.
70. *Id.* at 1048-49.
72. For a discussion of *Marcus*, see text accompanying notes 49-54 *supra*.
clusion emerges from the cases. Prior to the Franklin holding, this meant that if a showing was made that a bona fide transac­tion was intended by the parties, basis inclusion would follow. Franklin, to the degree that it is precedent, limits such transac­tions to purchases for reasonable value so there is real likelihood that the mortgage will be repaid. Franklin further holds that the burden is on the taxpayer to establish the reasonableness of the purchase price.73

D. The “Amount Realized” Controversy of the Crane Doctrine

Once the issue of basis inclusion has been resolved favorably, what remains is the resolution of the “amount realized” problem on the sale or other disposition of the property. Where the fair market value of the property exceeds the indebtedness, Crane holds that amount realized includes the face amount of any nonrecourse indebtedness.74 Not so easily disposed of is the situation in which the indebtedness exceeds the value of the property. This is the situation envisioned in footnote thirty-seven of Crane.75 As late as 1978, one commentator opined that this issue was still unresolved.76 In fact, there has been a clear split in the literature as to what the correct resolution should be.77

Let us consider a hypothetical situation. Taxpayer (T) purchases a building worth $5,000 for the inflated price of $10,000, with $1,000 down and a nonrecourse note for the remaining $9,000. Thus T has a basis of $10,000 in the property. Assume T operates the building for a time during which $3,000 of allowable depreciation is taken, thus reducing T’s adjusted basis to $7,000. If T then defaults, what is the “amount realized”?78 The Court in Crane included the amount of the nonrecourse mortgage in the “amount realized,” because it was convinced that the taxpayer was receiving an economic benefit equal to that received by a mortgagor who had assumed personal

73. For a discussion of Franklin, see text accompanying notes 66-71 supra.
74. 331 U.S. at 14; see text accompanying note 31 supra.
75. Id. at 14 n.37; see note 32 supra.
76. Bittker, supra note 34, at 284.
77. For citations, see McGuire, Negative Capital Accounts and the Failing Tax Shelter, 3 J. REAL ESTATE TAX 439, 440-42 (1976).
78. I.R.C. § 1001(b).
Clearly there is no such equivalent benefit here. But how should the benefit be measured? In *United States v. Davis* the Supreme Court held that to determine the value of property received in an arm's length transaction, one must look to the value of the property given up. Combining the economic benefit rationale of *Crane* and the fair market value of *Davis*, it can be argued that the amount realized is the fair market value of the abandoned building, which for purposes of this hypothetical is still $5,000. Thus T would realize a gain of $5,000 minus $7,000 or a loss of $2,000! In this way, T is "punished" for this uneconomic transaction in which deductions of $3,000 were received to shelter other unrelated income, and also suffers an additional capital loss of $2,000 for tax purposes. Alternatively, if the "amount realized" was held to include the full value of the mortgage, T would be found to have a taxable gain of $3,000 which effectively reclaims the deductions previously taken.

Not surprisingly then, the IRS rejected footnote thirty-seven of *Crane*. The Service has held that where a debtor surrendered property securing a nonrecourse loan to a creditor in payment of the loan, "the transfer of assets in . . . cancellation of indebtedness is equivalent to a sale upon which gain or loss is recognized in the amount of the . . . indebtedness . . . cancelled" and that "whatever inference may be drawn from footnote 37 in the *Crane* case," the amount of indebtedness cancelled "is the amount realized." It must be noted that although the concept of cancellation of indebtedness income was well established, no court, at that time, had ever held that the discharge of nonrecourse indebtedness results in such income.

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79. 331 U.S. at 14.
82. The leading case is *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931). The taxpayer had issued notes and then subsequently repurchased them at a discount. The difference between the face value and the purchase price was held to generate income on the theory that it had freed that amount of the taxpayer's assets.
83. See *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519 (1934); *Hiatt v. Commissioner*, 35 B.T.A. 292 (1937); *Hotel Astoria, Inc. v. Commissioner*, 42 B.T.A. 759 (1940). The theory behind these decisions is that because there was no personal liability, no assets of the taxpayer were freed by the discount on the liability, and thus no income was generated.
In marked contrast to this heated controversy is the ease with which a pre-Crane court resolved this problem. In *Lutz & Schramm Co. v. Commissioner* the taxpayer had borrowed $300,000 from a lender in 1925. In 1934 the lender accepted a nonrecourse note secured by property of the taxpayer in discharge of the debt. The property was transferred in full discharge of its obligation to the lender in 1937 when it had a fair market value of only $97,000. Not forced to deal with the “economic benefit” analysis of *Crane*, the Tax Court found “[t]he net result of the transaction was that the [taxpayer] received $300,000 for its property. The $300,000 was received by the [taxpayer] in 1925, but the taxable transaction took place in 1937. . . .” Further, it noted that taxpayer had “enjoyed the full benefit from the receipt of $300,000” by transferring the property.  

Recently, in *Millar v. Commissioner* both the Tax Court and the Third Circuit joined the IRS in rejecting footnote thirty-seven. Taxpayers had borrowed $500,000 to purchase stock in a corporation. This was secured solely by the stock so purchased. When the taxpayers defaulted on the loan, the lender foreclosed and took the virtually worthless stock. Echoing the sentiment expressed above in *Lutz & Schramm Co.*, the Third Circuit stated:

> This finding is totally in keeping with the spirit and reasoning of *Crane* . . . . [T]he taxpayers utilized those funds to increase the basis of their stock, which then permitted them to claim sizable deductions calculated against that basis . . . . [T]he taxpayers clearly realized taxable gain equal to the value of the cancelled obligation, less the adjusted basis of their surrendered stock.  

What we have seen develop was a potentially two-tiered pol-

84. 1 T.C. 682 (1943).  
85. *Id.* at 688.  
86. *Id.* at 689.  
88. 577 F.2d at 215. This result was followed in *Tufts v. Commissioner*, 70 T.C. 756 (1978). There, the taxpayers sold their partnership interests in an apartment complex for $1,400,000. The property was subject to nonrecourse indebtedness of $1,810,500. *Held*, the amount realized was $1,810,500.
icy concerning nonrecourse indebtedness. On the one hand, to afford competitive equality, there was a clear policy to allow inclusion of nonrecourse indebtedness in basis. On the other, there was at least the implication in footnote thirty-seven of Crane that nonrecourse debt would be allowed a competitive advantage when the purchased property was disposed of.

II. DEFINING THE ABUSE

The pursuit of tax shelters produced "investments . . . motivated by excessive concern with the tax benefits associated with them, [and] not their economic merits." To understand why this occurred, several factors need to be considered.

As a general proposition, the adversarial nature of the marketplace protects against sales in excess of value, that is, those sales not economic in substance. In the tax shelter area, this adversarial relationship is definitely weakened when nonrecourse debt is involved. A major incentive for the buyer is the presence of short-term tax advantages. This is achieved by the bunching of deductions in the early years, which allows the taxpayer to avoid or defer tax liability on current income from other sources. Depreciation, the investment credit, and interest paid on indebtedness, are all directly proportional to the purchase price. Thus the higher the purchase price the larger the amount of outside income that avoids taxation. This is not the stuff that arms-length transactions are made of.

The limited partnership was the most commonly used vehicle for the tax sheltered investment. Unlike a corporation, a partnership is generally not considered a separate entity for tax purposes. The individual partners are separately taxed on their share of the partnership gains, and can deduct partnership losses to the extent of the adjusted basis in their partnership interest. When an investor enters a partnership, his basis in

90. I.R.C. § 701 states that "[a] partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities."
91. Id. § 702(a).
92. Id. § 704(d). Adjusted basis is defined in I.R.C. § 705.
the partnership interest is the amount invested plus his share, if any, of the partnership liabilities. 93 Under a Treasury Regulation a limited partner may include in his basis his share of the nonrecourse loans to the partnership.94 This interpretation puts the limited partner on equal footing with the individual investor who obtained nonrecourse financing after Crane. It also allows the investor to make a relatively small, passive investment and still be able to use the advantage of leverage.

A further factor in the abuse equation was the uncertainty surrounding Crane's footnote thirty-seven.95 Given the apparent disagreement among the tax professionals about the "amount realized" on a failing shelter and the undoubted fact that, to the layman, the concept of having gain in such a situation is counter-intuitive, another reason for being unconcerned with the fairness of the purchase price develops.

Not to be overlooked is the enticement of deferral. If a tax shelter is able to defer tax liability from year one to year x, then another tax shelter in year x may further defer the tax liability. Even if the first tax shelter activity had economic substance, a significant attraction of the subsequent shelters would be the amount of immediate shelter they offer. This also weakens the normal adversarial relationship of the parties to a transaction.

The House Ways and Means Committee noted that many of these shelters were economically inefficient because a large percentage of the equity raised went to pay syndication fees.96 This occurred in part because investors tended to know little about the industries they were investing in, thereby cultivating a climate conducive to waste and fraud.97 The Committee was further concerned about "individual's use [of] artificial deductions, ones that do not accurately reflect their current expenses, to generate losses which they use to offset tax on unrelated income."98 As stated, the Committee's concern was not an attack

93. Id. § 722.
95. For a discussion of this uncertainty, see text accompanying notes 74-88 supra.
97. Id. at 8-9; [1976] U.S. CODE CONG. & AD. NEWS at 2903.
98. Id. at 8; [1976] U.S. CODE CONG. & AD. NEWS at 2903.
on the use of nonrecourse financing, but represented a more basic desire to fundamentally change the underlying structure of tax shelters in general. The Committee wanted to limit the sheltering ability to the particular activity in which a taxpayer was engaged. If the activity generated no income, then no deductions would be allowed.

The Senate Finance Committee was more directly concerned with abuse generated by the use of nonrecourse loans. It wanted to prevent the deduction of tax losses in excess of economic risk. It found that this abuse was also being achieved by the use of “guarantees, stop-loss agreements . . . and other devices” which resulted in amounts for which the taxpayer had no real risk of loss being attributed to basis. The Finance Committee was also concerned that these activities were an unproductive use of investment funds.

III. THE "AT RISK" PROVISIONS

Section 465 was added to the Internal Revenue Code as part of the Tax Reform Act of 1976. Conceptually it adopts the Senate’s concerns about tax shelter abuse, that is, it attempts to limit the amount of loss deductions attributable to a transaction to that amount in which the taxpayer has an actual risk of economic loss. At the outset one thing should be made clear. Section 465 is not a basis rule but rather a limitation on deductions related to a particular activity that is income generating. For example, consider a taxpayer with an amount at risk of $100 and income of $1,000 from certain activity. If the taxpayer’s deductions for that activity total $800 then they will be allowed in full, but if the deductions total $1,500 then only $1,100 (the $1,000 income plus the $100 “at risk”) will be allowed in the current taxable year.

Section 465 is applicable to individuals, subchapter S
corporations,105 and closely held corporations where five or fewer individuals own more than 50% of the stock,106 unless the entity is engaged in real estate, or such closely held corporation is involved in equipment leasing.107 The heart of the section is its determination of the amount at risk in subsection (b).108 In general, the amount at risk is the sum of (1) the amount of money and the adjusted basis of property contributed by the taxpayer to the activity, and (2) amounts borrowed to be used in the activity where the taxpayer is personally liable for repayment.109

There are exceptions to this general rule designed to deal with suspect borrowing. Thus amounts which are borrowed from a person who has an interest in the activity (other than as a creditor) or has a section 267(b)110 relationship to the taxpayer are not considered at risk.111

I.R.C. § 704(d), was added to the Code. It provided that, to the extent that § 465 did not apply to an activity, the adjusted basis of a partner's interest in the partnership would not include any portion of partnership liability for which the partner had no personal liability. This combination attacked the problem in two ways. It reduced the leverage benefits available to the most popular tax shelter vehicle, the limited partnership, and at the same time limited the general scope of statutory regulation to the types of activities that were considered most abusive.

In the Revenue Act of 1978, I.R.C. § 465 was expanded to its present scope, and the special partnership basis rule of § 704(d) was repealed as unnecessary. This was done because it was determined that activities not covered by § 465 as originally enacted were being abused.

104. I.R.C. § 565(a)(1)(A). This includes partnerships. See id. § 701.
105. I.R.C. § 465(a)(1)(C). Subchapter S corporations are defined in id. §§ 1371-79. In many ways shareholders of such an electing corporation are treated like limited partners. One significant difference is that the corporations' nonrecourse debt is not allocated to the shareholders, so that the amount of loss deductions available is limited to the actual investment.

106. Corporations which are not Subchapter S corporations cannot pass on losses directly to their shareholders, thus there is no sheltering of the shareholder's outside income. However, in the case of the closely held corporation, there is incentive to keep earnings at the corporate level and avoid taxing the dividend income to the shareholder. Although the accumulated earnings tax exists to police such activity, it was felt that tax shelters were being used solely to generate large paper losses to shield the accumulation of corporate earnings from this tax.

108. Id. § 465(b).
109. Id.
110. Id. § 267(b). For an individual, this category includes close family members and corporations which are either directly or indirectly more than 50% owned by the individual.

111. In the past, these types of loans have been the source of abuse. A recourse loan from a related party may in reality be nonrecourse. A loan from an interested party may in fact be an investment in the activity. See Rev. Rul. 72-135, 1972-1 C.B. 200; Rev. Rul. 72-350, 1972-2 C.C. 394. Apparently the presumption is that if the loan is truly recourse,
Proposed Regulation 1.465-8 states that:

For the purposes of this section it is not necessary for a person to have any incidents of ownership in the activity in order to have an interest in the net profits of the activity. For example, an employee of an independent contractor any part of whose compensation is determined with reference to the net profits of the activity will be considered to have an interest in the net profits of the activity.112

Where borrowed amounts are secured by property not used in the activity, these amounts (to the extent of the net fair market value of taxpayer's interest in such property) will be included in the amount at risk, unless such property is directly or indirectly financed by indebtedness secured by property used in the activity.113 More simply put, if the ultimate source of security for a loan arises out of the original activity, the loan amount is not considered to be at risk.

Another limiting factor is stated by Proposed Regulation 1.465-1(b): "Regardless of the form a transaction may take, the taxpayer's amount at risk will not be increased if the transaction is inconsistent with normal commercial practices or is, in essence, a device to avoid section 465."114 This seems to be consistent with the logic in Goldstein denying the interest deduction.115

As noted in Part II, the Senate was concerned with the general problem of taxpayers being able to deduct amounts in excess of true economic liability. Thus, overriding the entire at risk definition is section 465(b)(4) which states that "[n]otwithstanding any other provision of this section, a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop-loss agreements, or other similar arrangements."116

113. I.R.C. § 465(b)(2).
Thus to the degree that the taxpayer's investment is protected from economic loss, it will not be considered to be at risk.

The calculation of the amount at risk is done at the close of the taxpayer's taxable year.\textsuperscript{117} When an amount is taken as a loss deduction, the amount at risk is reduced by that amount.\textsuperscript{118} If an amount is not available for deduction because of the applicability of the ARP, such amount is carried forward as a potentially available deduction.\textsuperscript{119} Withdrawals of assets from the activity that were at risk will reduce the amount at risk, while assumption of additional liabilities will increase the amount at risk. To police manipulation of the amount at risk (because it is calculated at the end of the taxable year only), the IRS will examine the conduct of the taxpayer to determine the allowance of certain adjustments to the amount at risk.\textsuperscript{120} Further, if the amount at risk is reduced below zero (by removing an amount at risk from the activity), it will then be recaptured as ordinary income.\textsuperscript{121} For example, if a tentative calculation of the amount at risk showed $100, then the removal of $200 of personal liability from the activity would, at year end, produce an amount at risk of $100. The taxpayer would then have to include this amount as part of his current income, thus "recapturing" a similar amount that had previously been taken as a deduction against income.

In Revenue Ruling 77-401,\textsuperscript{122} the two individual members of a general partnership engaged in a road paving business had each contributed $15,000 to the enterprise. The partnership then purchased equipment costing $160,000 paid for by $10,000 down...

\begin{footnotes}
\item[117] \textit{Id.} § 465(a)(1).
\item[118] \textit{Id.} § 465(b)(5).
\item[119] \textit{Id.} § 465(a)(2).
\item[120] Proposed Treas. Reg. § 1.465-4, \textit{Fed. Taxes} (P-H) § 20,648.34 (1979) states: If a taxpayer engaged in a pattern of conduct which is not within normal commercial practice or has the effect of avoiding the provisions of section 465, the taxpayer's amount at risk may be adjusted to reflect more accurately the amount which is actually at risk. For example, increases in the amount at risk occurring toward the close of a taxable year which have the effect of increasing the amount of losses which will be allowed to the taxpayer under section 465 for the taxable year will be examined closely. . . .
\item[121] I.R.C. § 465(e).
\end{footnotes}
with the balance of $150,000 secured only by the equipment. In its first taxable year, ending September 30, 1977, the business incurred a loss of $46,000. On September 29, 1977 the partnership purchased $50,000 in U.S. Treasury notes with a cash down payment of $5,000, and a $45,000 note with full recourse against the partnership and secured by the Treasury notes. The interest rate payable on the $45,000 purchase money note was greater than the return received by the partnership on the $50,000 in Treasury notes. The Ruling held that the $45,000 note was not to be included in the calculation of the amount at risk. The Ruling failed to give the reasons for its determination. It was silent not only as to whether the lack of economic viability (the fact that the interest expense exceeded the potential interest income) of the Treasury note caused or contributed to the exclusion, but also as to whether the fact that the Treasury note transaction was so unrelated to the general activity of the partnership was a factor.

In a much clearer case of substance over form, Revenue Ruling 77-39123 involved a situation where an individual purchased a used motion picture film, paying 20% in cash and the balance with a full recourse note, the principal and accrued interest on which were payable out of 50% of the gross proceeds from the movie. If that was insufficient, payment was to be made ten years thereafter. Simultaneously, the maker of the note (the movie purchaser) entered into an agreement with a third party who was obligated, at the end of ten years, to lend the amount of any unpaid balance on the purchaser's note. At that time, and in such event, the purchaser would execute a one-year nonnegotiable note payable to that third party for the amount borrowed. That note would be renewable, at the maker's option, from year to year until the debt would be fully paid from gross receipts derived from distribution of the film. This note was ostensibly full recourse. The Ruling held that the personal liability of the movie purchaser was illusory, and this in turn made his personal liability to the seller of the movie also illusory. Therefore, only the amount of the 20% down payment was considered to be at risk.

Another imaginative attempt to avoid the effect of section

465 was outlined in Revenue Ruling 78-413. There the taxpayer purchased one of the programs in a television series from the owner of the series. For the same price, another investor purchased from the same seller another program in the series. Each investor paid part of the purchase price in cash and executed a note for the unpaid balance. The notes were identical, including the maturity dates. Prior to the maturity date, payments were due only to the extent of and solely from a fixed percentage of the distribution proceeds from the purchased film. As part of the arrangement, the seller sold to each investor, for a nominal amount, the right to the unpaid balance on the other's note at maturity. Arrangements for distribution of the films were made for the series as a whole. The Ruling found that the taxpayer was not at risk for the amount of the note, because he was protected from economic loss because of his right to the unpaid balance due on the other investor's note, which would exactly equal any amount of money due on his note.

What emerges is a comprehensive attack on the use of non-recourse financing in certain situations. This attack criticizes not only the form of the transaction, but also its substance. Thus, where applicable, section 465 does not give competitive equality to financing that is either nonrecourse on its face or suspect because of the relationship between the lender and the borrower/purchaser. In addition, where the circumstances indicate that there is no risk of loss, such amounts will not be considered to be at risk.

IV. THE REMAINS OF CRANE

Part I established that the Crane doctrine afforded non-recourse liabilities competitive equality with other methods of purchasing property. Part II examined some of the factors that were involved in turning competitive equality into a competitive advantage. Part III looked at a statutory attempt to control abuse of nonrecourse indebtedness. To determine the current relevance of Crane, we must examine two distinct areas, those activities subject to section 465, and those that are not.

In the realm of section 465 activities, the Crane doctrine is

125. Examples are discussed in text accompanying notes 123 and 124 supra.
no longer valid. In dealing with the abusive use of nonrecourse financing, Congress has rescinded the notion of competitive equality at the heart of Crane. Only to the extent that leveraged deductions offset income earned by the particular activity, will the tax implications of nonrecourse financed purchases equate with purchases financed with personal liability. Where the difference is more formal than real, such transactions will still be subject to the limitations of section 465. Thus section 465 says, in effect, that the way to gain full equality with purchases financed with personal liability is to become personally liable.

Competitive equality is still available for transactions outside the scope of section 465. The law that was developed in Part I is still valid for these transactions. It must be remembered that the Crane doctrine does not hold that nonrecourse debt must be included in basis. Rather, it holds that absent some other reason for excluding it, such as an amount that is too contingent, nonrecourse indebtedness will not be excluded from basis solely because there is a lack of personal liability in the investment.