North Dakota Law Review

Volume 60 | Number 1 Article 5

1984

Taxation - The Amount Realized on the Sale of Property Encumbered by a Nonrecourse Mortgage Must Include the Full Balance of the Mortgage Even Though the Fair Market Value of the Property Is Less Than the Morthgage Balance

Gary Hazelton

TAXATION — THE AMOUNT REALIZED ON THE SALE OF PROPERTY ENCUMBERED BY A NONRECOURSE MORTGAGE MUST INCLUDE THE FULL BALANCE OF THE MORTGAGE EVEN THOUGH THE FAIR MARKET VALUE OF THE PROPERTY IS LESS THAN THE MORTGAGE BALANCE

In August of 1970 Clark, Incorporated and Clark Pelt formed a general partnership for the purpose of constructing an apartment complex in Duncanville, Texas.[1] Six days later the partnership borrowed $1,851,500 on a nonrecourse[2] basis from Farm & Home Savings Association.[3] Subsequently, John F. Tufts and three others were admitted as general partners into the partnership.[4] The apartment complex was completed in 1971.[5] Each partner claimed his share of depreciation and ordinary partnership losses as income tax deductions in 1971 and 1972.[6] The deductions, totaling $439,972, subtracted from the partnership's basis in the property, $1,851,500, resulted in an adjusted basis of $1,455,740.[7]

On August 28, 1972, Fred Bayles, a third party, bought each partner's interest in the partnership.[8] Although the fair market value of the partnership property was less than $1,400,000, Bayles assumed the nonrecourse mortgage of $1,851,500 as consideration for the property.[9] The partners treated the fair market value of the property at the time of the sale as the amount realized from the sale.[10] The partnership's adjusted basis, $1,455,740, was deducted

1. Commissioner v. Tufts, 103 S.Ct. 1826, 1828 (1983).
2. *Id.* at 1828. A nonrecourse mortgage is a mortgage in which the borrower is not personally liable; seizure of the property securing the mortgage is the lender's only recourse upon default. Note, *Federal Income Tax Treatment of Nonrecourse Debt,* 82 COLUM. L. REV. 1498 (1982).
3. 103 S.Ct. at 1828.
4. *Id.*
5. *Id.*
6. *Id.* at 1829.
7. *Id.* The basis of property is its cost. I.R.C. § 1012 (West 1983). The adjusted basis of property is its basis adjusted for expenditures, receipts, losses, depreciation deductions, and other items that are chargeable to the capital accounts. I.R.C. § 1016 (West 1983).
8. 103 S.Ct. at 1829.
9. *Id.*
10. *Id.* Section 1001(b) of the Internal Revenue Code states that the amount realized from the

from the amount realized resulting in a $55,740 partnership loss.[11] The loss was reported on the partners' federal income tax returns for the year of the sale.[12]

The Commissioner of Internal Revenue (Commissioner) contended that the amount realized was the unpaid balance of the nonrecourse mortgage, $1,851,500, rather than the fair market value of the property sold.[13] Proceeding on this contention, The Commissioner determined that the sale resulted in a capital gain of approximately $400,000.[14]

The Tax Court held that the full balance of the nonrecourse mortgage was includable in the amount realized.[15] The Court of Appeals for the Fifth Circuit reversed and ruled that the amount realized need only include the nonrecourse mortgage up to the fair market value of the securing property.[16] The United States Supreme Court reversed the court of appeals decision and *held* that the amount of an assumed nonrecourse mortgage is includable in the amount realized from the sale regardless of whether the amount of the mortgage exceeds the fair market value of the property securing it.[17] *Commissioner v. Tufts,* 103 S.Ct. 1826 (1983).

The controversy surrounding the *Tufts* decision is the result of footnote 37 of the United States Supreme Court opinion in *Crane v. Commissioner.*[18] The Court in *Crane* held that when a taxpayer sells property encumbered by a nonrecourse mortgage having a balance *less than* the fair market value of the encumbered property, the nonrecourse mortgage balance must be included in the amount realized.[19] The *Crane* Court was not required to determine what the

---

sale or other disposition of property is the sum of money received plus the fair market value of any property received. I.R.C. § 1001(b) (West 1983).

11. *Id. See* I.R.C. § 1001(a) (West 1983). Section 1001(a) states that the gain or loss on the sale or disposition of property is determined by subtracting the property's adjusted basis from the amount realized. *Id.*

12. 103 S.Ct. at 1829. Although the individual partners did not claim their respective shares of partnership loss on their individual tax returns, each did claim the loss in his petition to the Tax Court. *Id.* at n.l.

13. *Id.* at 1829 & n.2.

14. *Id.* The Commissioner computed the gain by subtracting the partnership's adjusted basis of $1,455,740 from the mortgage balance of $1,851,500. *Id.* at n.2. The Commissioner characterized the gain as capital gain pursuant to I.R.C. & 741. *See* I.R.C. § 741 (West 1983) (provides for characterization of gain on sale of partnership interest).

15. Tufts v. Commissioner, 70 T.C. 756, 770 (1978), *rev'd,* 651 F.2d 1058 (5th Cir. 1981), *rev'd,* 103 S.Ct. 1826 (1983).

16. Tufts v. Commissioner, 651 F.2d 1058, 1063 (5th Cir. 1981).

17. 103 S.Ct. at 1834.

18. 331 U.S. 1 (1947). Mrs. Crane inherited an apartment building that her husband had owned. Crane v. Commissioner, 331 U.S. 1, 3 (1947). The building passed subject to a nonrecourse mortgage, that was equivalent to the fair market value of the building. *Id.* Subsequently, Mrs. Crane sold the building. The purchaser paid Mrs. Crane $3000 in cash and assumed the mortgage as consideration for the sale. *Id.* The Commissioner contended that the amount Mrs. Crane realized on the sale was not merely the cash received, but also the full amount of the assumed mortgage balance. *Id.* at 3-5.

19. *Id.* at 14.

tax consequences would be when the mortgage balance is greater than the fair market value of the mortgaged property.[20] Nevertheless, the Court chose to address the issue in footnote 37 of its opinion.[21] The premise underlying footnote 37 is that because a mortgagor is not personally liable on a nonrecourse loan, he cannot realize a benefit equal to the assumed mortgage when the value of the property is less than the mortgage balance.[22] In general, three theories of the proper characterization and tax treatment of transactions involving the sale of property subject to a nonrecourse mortgage have developed as a result of footnote 37.[23] Each theory attempts to attribute a taxable benefit to the taxpayer in a different manner.[24]

The economic benefit theory is frequently employed to attribute a taxable benefit to a taxpayer.[25] Under the economic benefit theory, if a debt of a taxpayer is decreased or eliminated by a third party, the taxpayer receives an economic benefit and, therefore, realizes taxable income.[26] Generally, the amount of income the taxpayer realizes is the amount by which the debt is decreased.[27] However, the applicability of this principle is questionable when the fair market value of property sold subject to a nonrecourse mortgage is less than the mortgage balance.[28] The

---

20. Note, *supra* note 2, at 1498. The author notes that the *Crane* Court did not explicitly reach the issue of whether nonrecourse debt in excess of fair market value is includable in amount realized. *Id.*

21. 331 U.S. at 14 n.37. Footnote 37 of the *Crane* decision states:

> Obviously, if the value of the property is less than the amount of 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.

Id.

22. *Id.* The Court in *Crane* noted that a discharge or reduction in personal debt results in income to the taxpayer. *Id.* at 13 (citing United States v. Hendler, 303 U.S. 564 (1938)). Since the mortgage in *Crane* was a nonrecourse mortgage, the mortgagor was not personally liable for its repayment. Thus, the Court apparently believed its discharge could not attribute income to the taxpayer. *See* 331 U.S. at 14 n.37.

23. *See* Newman, *The Resurgence of Footnote 37: Tufts v. Commissioner*, 18 WAKE FOREST L. REV. 1 (1982). The three theories arising from footnote 37 in *Crane* are the economic benefit theory, the tax benefit theory, and the double deduction theory. *See id.*

24. *Id.*

25. *See, e.g.*, Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929) (corporation's payment of officers' income tax held to be an economic benefit to the officers); Millar v. Commissioner, 577 F.2d 212 (3d Cir. 1978) (cancellation of taxpayer's $245,000 nonrecourse debt held to be economic benefit to taxpayer), *cert denied*, 439 U.S. 1046 (1978).

26. *See* United States v. Kirby Lumber Co., 284 U.S. 1 (1931) (a corporate taxpayer realizes taxable gain when it retires outstanding debt at less than the original issue price).

27. Treas. Reg. § 1.61-12(a) (1968). As an example, § 1.61-12 (a) states, "If . . . an individual performs services for a creditor, who in consideration thereof cancels this debt, the debtor realizes income in the amount of the debt." *Id.*

28. *See* Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane Case*, 33 TAX L. REV. 277, 281 (1978). Because a taxpayer is not personally liable on a nonrecourse loan, it is questionable whether in the

question in this situation is whether the benefit received by the seller can exceed the fair market value of the property sold.[29]

In *Millar v. Commissioner*[30] the United States Court of Appeals for the Third Circuit applied the economic benefit theory.[31] In *Millar* the taxpayers pledged stock as security for a $245,000 nonrecourse loan.[32] Subsequently, the nonrecourse loan was satisfied by the surrender of the stock.[33] At the time of surrender the stock had an adjusted basis of $39,492 — much less than the mortgage balance.[34] Because the surrender of an asset with an adjusted basis of $39,492 for the cancellation of a debt of $245,000 resulted in an economic benefit to the discharged party, the court held that the taxpayer had realized a gain of $205,508.[35]

One commentator has noted that because a taxpayer holding property subject to a nonrecourse mortgage may abandon the property without incurring personal liability, the mortgage obligation is illusory.[36] Therefore, the discharge of a nonrecourse obligation cannot support an economic benefit theory.[37] Selling property subject to a nonrecourse debt is analogous to selling property subject to local property taxes.[38] Like taxes, a nonrecourse debt must be paid by the taxpayer to retain his property.[39] A person

---

event of discharge he can realize a personal benefit to the extent of a loan balance. *Id.* at 281.

29. *Compare* Rosenberg, *Better to Burn Out Than to Fade Away?, Tax Consequences on the Disposition of a Tax Shelter,* 71 CALIF. L. REV. 87, 116 (1983) (the full amount of nonrecourse debt assumed by a purchaser of mortgaged property should be included in the seller's amount realized) *with* Bittker, *supra* note 28, at 281-82 (the amount realized from the sale of mortgaged property should not exceed the fair market value of the property).

30. 577 F.2d 212 (3d Cir.), *cert. denied,* 438 U.S. 1046 (1978).

31. Millar v. Commissioner, 577 F.2d 212, 213 (3d Cir.), *cert. denied,* 438 U.S. 1046 (1978). The taxpayers in *Millar* contributed borrowed funds to a corporation, thereby increasing their bases in their respective shares of stock. 577 F.2d at 213. The shareholders pledged their stock as security for the borrowed funds. *Id. See* Treas. Reg. § 118-1 (1983) (contributions to a corporation are treated by the shareholder as an additional price paid for the stock).

32. 577 F.2d at 213.

33. *Id.* The taxpayers in *Millar* executed nonrecourse demand notes that they subsequently failed to pay. *Id.* At the time of default the stock that secured the notes was worthless. *Id.*

34. *Id.* In *Millar* the shareholders elected to have the corporation taxed as a small business corporation. *Id.* Accordingly, they claimed deductions and reduced their bases in their stock for losses incurred by the corporation. *Id.* at 215. *See* I.R.C. §§ 1366(a) (1) (B) (allows shareholders to deduct their pro rata share of losses of an "S" corporation); 1336(d) (1) (shareholders' bases in stock of an "S" corporation are reduced, but not below zero, for deductions taken under § 1366(a)) (West 1983).

35. 577 F.2d at 215. The court in *Millar* noted that the loan enabled the taxpayers to increase their bases in the stock and take sizable deductions against that basis. *Id.* The court reasoned, therefore, that the taxpayers realized a taxable gain through the cancellation of the loan. *Id.* To have ruled otherwise would have allowed the taxpayers "the type of double deduction of which the Supreme Court so clearly disapproved in *Crane.*" *Id.*

36. Bittker, *supra*, note 28, at 282. Professor Bittker contends that the *Crane* Court has "[o]verstated the resemblance between nonrecourse and personal obligations." *Id.* at 282.

37. Bittker, *supra* Note 28, at 284. The commentator notes that "taxpayers cannot benefit by being 'relieved' of liabilities for which they are not liable." *Id.*

38. Bittker, *supra* note 28, at 282.

39. Bittker, *supra* note 28, at 282.

who disposes of unprofitable property does not recognize an economic benefit by being relieved of the burden to pay property taxes in the future.[40] Similarly, a person relieving himself of future mortgage payments by transferring property subject to a nonrecourse loan cannot realize an economic benefit.[41]

This analogy has been attacked on the premise that the obligation to pay future property taxes is dissimilar to the obligation to repay a nonrecourse debt.[42] Unlike relief from a nonrecourse mortgage, relief from property taxes creates no present enjoyment of the proceeds.[43] Therefore, it is not valid to equate nonrecourse debt with future property taxes.

Another rationale that frequently is used to attribute a taxable benefit to a taxpayer is the tax benefit theory.[44] When a taxpayer receives loan proceeds, he does not realize income because it is assumed that he will repay the loan at a future date.[45] Likewise, the taxpayer may purchase depreciable property with the loan proceeds, include the amount of the proceeds in the property's basis, and take depreciation deductions against that basis without realizing income from the proceeds.[46] However, if the loan obligation is subsequently decreased or eliminated, tax consequences will arise.[47] Should such an event occur, the tax benefit theory requires the taxpayer to realize income because he has received free tax benefits by taking depreciation deductions against an amount he will not be required to repay.[48]

The tax benefit theory raises the issue of whether the income realized from the sale should be characterized as ordinary income or capital gain.[49] The majority of decisions have elected to include

---

40. Bittker, *supra* note 28, at 282.

41. Bittker, *supra* note 28, at 282. The Court of Appeals for the Fifth Circuit in *Tufts* adopted Professor Bittker's property tax analogy. Tufts v. Commissioner, 651 F.2d 1058, 1062 (5th Cir. 1981).

42. *See* Newman, *supra*, note 23 at 12 (1982).

43. Newman, *supra* note 23 at 12. The commentator suggests treating the receipt of nonrecourse loan proceeds as a present amount realized, on a short sale theory, because the loan proceeds are presently being enjoyed. *Id.* A "short sale" involves the sale of property that one may not yet own. The transaction is not taxable until the property is delivered at the close of the transaction. *Id.* n.85.

44. *See* Millar v. Commissioner, 577 F.2d 212, 214-16 (3d Cir.), *cert. denied,* 439 U.S. 1046 (1978). The *Millar* court noted that if a taxpayer is not required to recognize gain from the discharge of nonrecourse debt, he will be allowed a double tax benefit. 577 F.2d at 214-16. *See* Tufts v. Commissioner, 70 T.C. 756, 765 (1978). The Tax Court in *Tufts* noted that a taxpayer selling property subject to a nonrecourse mortgage may have enjoyed the tax benefits that accompany depreciation deductions. *Id.*

45. Commissioner v. Tufts, 103 S.Ct. 1826, 1831 (1983).

46. Newman, *supra* note 23, at 2 n.11.

47. *See, e.g.,* United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1983) (redemption of corporate bonds at less than issue price triggers gain to corporation).

48. *See* Rosenberg, *supra* note 29, at 95. When a taxpayer incurs a deductible expense and is subsequently relieved from the obligation to pay the expense, he has offset his gross income with expenses that he has not, in reality, incurred. *Id.*

49. *See* Rosenberg, *supra* note 29, at 95-113. Gain from the sale or exchange of a capital asset is

the reduction or elimination amount in the taxpayer's amount realized on the disposition of property.[50] The result may be capital gains treatment for the entire amount of income.[51] A contrary view would include the entire reduction or elimination amount in the taxpayer's gross income as income from a discharge of indebtedness.[52] The result would be taxing the entire amount of gain as ordinary income.[53] Treating the entire gain as ordinary income may seem harsh when, arguably, it may have been derived from the sale of property that may qualify for capital gain treatment.[54] Conversely, treating the entire gain as capital gain may seem to give the taxpayer a windfall when the depreciation deductions exceed the amounts the seller has actually paid for the property.[55]

In an attempt to overcome these seemingly inherent defects, an amicus curiae in *Tufts* suggested treating the reduction or elimination of the nonrecourse mortgage and the disposition of the property as separate transactions.[56] The sale transaction would treat the fair market value of the property as the sale proceeds.[57] A capital gain or loss figure would then be determined by subtracting the cost basis from the sale proceeds.[58] Concerning the borrowing

---

capital gain. I.R.C. § 1222 (West 1983). See I.R.C. § 1221 for a definition of capital asset.

50. Rosenberg, *supra* note 29, at 95. *See, e.g.*, Millar v. Commissioner, 577 F.2d 212, 214-16 (3d Cir. 1978) (amount of nonrecourse debt discharged in transfer of stock is includible in amount realized on disposition); Tufts v. Commissioner, 70 T.C. 756, 770 (1978) (amount of nonrecourse debt assumed in sale of real property includable in amount realized).

51. *See* Tufts v. Commissioner, 70 T.C. at 770. The reduction or elimination amount is included in amount realized on the sale of property and if the property is a capital asset or a § 1231 asset, any gain is a capital gain. *See* Rosenberg, *supra* note 29, at 92-95. Section 1231 of the Internal Revenue Code affords capital gain treatment to gains from the sale or exchange of property used in a taxpayer's trade or business. I.R.C. § 1231 (West 1983).

52. Rosenberg, *supra* note 29, at 113-14.

53. *See* I.R.C. § 61(a) (12) (West 1983). Section 61(a) (12) requires income from a discharge of indebtedness to be included in gross income, and therefore taxed as ordinary income. *Id.*

54. *See* 103 S.Ct. at 1837 (O'Connor, J., concurring). Justice O'Connor conceded that to reach an equitable result, gains from the sale of encumbered property and the discharge of the debt should receive separate treatment; the sale as capital gains and the discharge as ordinary income. *Id.*

55. *See* Rosenberg, *supra* note 29, at 99-100. Professor Rosenberg uses the following example to illustrate the point: Taxpayer *T* buys depreciable real property for $400,000; *T* furnishes $20,000 cash and incurs a $380,000 nonrecourse mortgage. The property is sold by *T* while still subject to the $380,000 mortgage. During his ownership, *T* has taken $100,000 of depreciation deductions. Accordingly, *T* has offset ordinary income and reduced his basis by $100,000. *Id.* at 99. *See* I.R.C. § 1016(a) (2)A (West 1983) (basis is reduced by deductions for depreciation). Twenty thousand dollars of depreciation deductions are attributable to *T*'s initial cash outlay. Eighty thousand dollars of deductions are thus attributable to the mortgage and should be added back to ordinary income. To include the $80,000 in amount realized would not accomplish this result. Rosenberg, *supra*, at 99. The $80,000 would be taxed at capital gain rates and, thus, $48,000 would not be recovered. *Id.* at 100. *See* I.R.C. § 1202 (West 1983) (allows a deduction from gross income of 60% of net capital gains).

56. *Tufts*, 103 S.Ct. at 1836 (O'Connor, J., concurring). Justice O'Connor stated that she would have adopted the separate transaction approach had the Court been "writing on a clean slate." *Id.*

57. *Id.*

58. *Id.* at 1837. Under the separate transaction approach, the sale proceeds will include the fair market value of the property at the date of sale. *Id.*

transaction, the taxpayer would realize ordinary income to the extent the mortgage balance exceeds the fair market value of the property surrendered.[59]

Another commentator contends that an application of the separate transaction theory to a case such as *Tufts* could result in no net gain or loss on the disposition of the property.[60] Thus, there would be no tax consequences from the disposition.[61] The taxpayer, therefore, will have enjoyed substantial tax benefits through previous depreciation deductions while suffering little or no out-of-pocket loss.[62]

Professor Rosenberg suggests a complex two-pronged analysis that he contends would reach the correct result.[63] The first prong determines the amount of gain the taxpayer must include in ordinary income.[64] The amount of ordinary income would be the portion of the unpaid cost basis that the taxpayer has deducted through depreciation.[65]

The second prong determines the amount of gain that will be treated as long term capital gain.[66] That amount is the excess of the property's fair market value over its adjusted basis at the date of the sale.[67] Adjusted basis is original cost basis reduced by the amount of depreciation deductions taken and the amount of the unpaid cost basis not deducted as depreciation.[68] Professor Rosenberg contends that this approach best reflects the benefits derived by the taxpayer from taking deductions against an amount he will not be required

59. *Id.* The separate transaction approach would treat the excess of the mortgage balance over the fair market value of secured property as a cancellation of indebtedness. *Id.* Income from the cancellation of indebtedness is ordinary income. I.R.C. § 61(a)(12) (West 1983).

60. *See* Rosenberg, *supra* note 29, at 105-06. Professor Rosenberg contends that the separate transaction approach conceivably could allow the gain from the borrowing transaction to be offset by a loss from the sale transaction. *Id.*

61. *See* Rosenberg, *supra* note 29, at 106.

62. Rosenberg, *supra* note 29, at 106.

63. Rosenberg, *supra* note 29, at 112. Professor Rosenberg concedes that his approach is complex but notes that "the idea that equity should give way to simplicity has not been, and hopefully will not become, one of the principles of our income tax system." *Id.*

64. Rosenberg, *supra* note 29, at 109.

65. Rosenberg, *supra* note 29, at 109. "Unpaid cost basis" is the excess of the mortgage balance over the fair market value of the property. *Id.* If a taxpayer has depreciated 25% of the cost of a property, and the nonrecourse mortgage balance of the property exceeds its fair market value by $180,000, 25% of $180,000 would be the portion of "unpaid cost basis" that must be included in gross income upon the sale of the property. *Id.* at 112.

66. Rosenberg, *supra* note 29, at 109.

67. Rosenberg, *supra* note 29, at 109. Professor Rosenberg would limit the amount of gain subject to capital gain treatment to the excess of a property's fair market value over its adjusted basis. This amount would be excluded from being treated as ordinary income. The remaining gain, the amount of the mortgage in excess of fair market value, would be ordinary income to the extent that it has been previously deducted as depreciation. *Id.*

68. Rosenberg, *supra* note 29, at 109. Professor Rosenberg offers the following example: Taxpayer *T* has property with an original cost of $400,000, $20,000 of which was paid and $380,000 of which was financed through a nonrecourse loan. *T* takes $100,000 of depreciation deductions

to repay.[69]

The double deduction theory is the third theory used to attribute a taxable benefit to a taxpayer.[70] The theory is based on two premises. First, when loan proceeds are used to purchase depreciable property, and the loan obligation is subsequently reduced or eliminated, the taxpayer receives free tax benefits through previous depreciation deductions.[71] Second, the failure to include the nonrecourse debt in amount realized may allow the mortgagor to claim a tax loss on the disposition of property when he has suffered no corresponding economic loss.[72] The taxpayer therefore would enjoy both depreciation deductions and a loss deduction against a basis amount that he will not be required to repay.[73] Both the *Crane* Court and the *Millar* court acknowledged

against the property. *T* then sells the property when its fair market value is $200,000. The sole consideration for the sale is the assumption of the mortgage by the buyer. The amount and character of income from the sale can be computed as follows:

Step 1:			
		Balance of nonrecourse mortgage assumed	$380,000
		Less fair market value of property at date of sale	(200,000)
		Unpaid cost basis	$180,000
		Percentage of cost basis deducted	25%
		Portion of unpaid cost basis deducted previously as depreciation and currently includible in ordinary income	$45,000
Step 2:			
	a)	Unpaid cost basis	$180,000
		Less portion of unpaid cost basis deducted previously	(45,000)
		Unpaid cost *not* deducted	$135,000
	b)	Original cost basis	$400,000
		Less depreciation taken	(100,000)
		Less unpaid cost basis *not* deducted	(135,000)
		Adjusted cost basis	$165,000
	c)	Fair market value at date of sale	$200,000
		Less adjusted cost basis	(165,000)
		Capital gain	$35,000

Thus, *T* would have income of $80,000 — $45,000 ordinary income and $35,000 capital gain. *Id.* at 112.

69. *See* Rosenberg, *supra* note 29, at 109.

70. *See* Millar v. Commissioner, 577 F.2d 212, 215 (3d Cir.), *cert. denied,* 439 U.S. 1046 (1978). The *Millar* court relied on the double deduction theory. *Id.* See *supra* notes 30-35 for a discussion of *Millar.*

71. Rosenberg, *supra* note 29, at 95.

72. Commissioner v. Tufts, 103 S.Ct. 1826, 1834 (1983). For example, if the partnership in *Tufts* were not required to include the full amount of the nonrecourse loan in their amount realized on the sale of the encumbered property, but rather were only required to include the fair market value of the property, the partnership could have shown a $55,740 loss, adjusted basis of $1,455,740 over fair market value of $1,400,000, when the actual burden of the loss fell on the mortgagee. *Id.* at 1829.

73. *See* Rosenberg, *supra* note 29, at 95.

the validity of the double deduction theory.[74]

In *Tufts v. Commissioner*[75] the United States Supreme Court held that the *Crane* rule applies when the nonrecourse mortgage balance exceeds the fair market value of the property transferred.[76] The amount the mortgage is reduced or eliminated will therefore be included in amount realized.[77] Any gain will be characterized as gain on the disposition of property.[78]

Although the *Crane* decision has been interpreted as ultimately resting on the economic benefit theory, the tax benefit theory, and the double deduction theory,[79] the Court refused to adopt any such interpretation.[80] Rather, it interpreted *Crane* to rest on the broader theory that a nonrecourse mortgage in this context may be treated as a true loan.[81] The Court noted that although a similarity exists between the tax benefit rule and the *Crane* rule, its analysis of *Crane* focuses on the obligation to repay a loan and its subsequent extinguishment.[82] The Court's analysis applies whether or not deductions have been taken against the encumbered property.[83]

The theory that the transaction should be treated as partly a sale of property and partly a cancellation of indebtedness was noted by the Court as a justifiable mode of analysis.[84] However, under this theory gain from the cancellation of indebtedness may qualify for deferment under section 108 of the Internal Revenue Code (Code).[85] The Court declined to decide whether gain realized under

---

74. *See Crane,* 331 U.S. at 16; *Millar,* 577 F.2d at 215.

75. 103 S.Ct. 1826 (1983).

76. *Tufts,* 103 S. Ct. at 1831. The *Crane* rule requires the full amount of the nonrecourse mortgage to be included in the amount realized on the sale of the property securing the mortgage when the fair market value of the property is equal to or greater than the mortgage balance. 331 U.S. at 11. See *supra* notes 18-24 and accompanying text for a discussion of *Crane.*

77. 103 S.Ct. at 1833 n.11. The Court's decision in *Tufts* is consistent with the treasury regulations. *Id.* at 1837 (O'Connor, J., concurring). *See* Treas. Reg. § 1.1001-2(b) (1982). Section 1.1001-2(b) provides that the amount received from a sale due to the assumption of nonrecourse liability is not limited by the fair market value of the property sold. *Id.*

78. 103 S.Ct. at 1833 n.11.

79. *See* Millar v. Commissioner, 577 F.2d 212, 215 (3d Cir.), *cert. denied,* 439 U.S. 1046 (1978) (interpreting *Crane* as supporting the double deduction theory); Estate of Levine v. Commissioner, 634 F.2d 12, 17 (2d Cir. 1980) (interpreting *Crane* as resting on an economic benefit theory).

80. 103 S.Ct. at 1831.

81. *Id.* The effect of treating the nonrecourse loan as a true loan is to create a presumption that persons borrowing on a nonrecourse basis will treat their indebtedness as a personal liability. *Id.* at 1832.

82. *Id.* at 1832 n.8.

83. *Id.*

84. *Id.* at 1833 n.11. The Court noted that although the separate transaction theory may be plausible, the Commissioner has not adopted it and no existing authority required the courts to adopt it. *Id.*

85. *Id.* at 1837 (O'Connor, J., concurring). Section 108 of the Internal Revenue Code divides the occurrence of cancellation of indebtedness into three categories: (1) that which occurs in bankruptcy, (2) that which occurs when the taxpayer is insolvent, and (3) that which occurs when the discharged debt is a qualified business indebtedness. *See* I.R.C. § 108(a) (1) (West 1983). In a bankruptcy situation the benefit accruing from the discharge may be used to reduce certain tax attributes of the taxpayer such as existing operating losses, credit carryovers, capital loss carryovers

its approach would qualify for similar treatment.[86] By not deciding whether such a sale or disposition falls within the concept of cancellation of indebtedness, the Court avoided deciding whether its decision creates an exception to section 108 of the Code.

In disposing of Tufts' alternative argument that section 752 of the Code provides a fair market value limitation on the amount realized on the sale or disposition of partnership property, the Court relied on the legislative history of section 752.[87] Congress intended the fair market value limitation language of section 752[88] to apply only to transactions between a partner and a partnership.[89] That language was found to be inapplicable to a sale of a partnership interest.[90] The Court found that the statute was enacted to prevent partners from inflating their bases in the partnership and not to provide special tax treatment for partnerships.[91] Section 752 of the Code, therefore, was held to be inapplicable to sales of partnership interests to third parties.[92]

Following the Supreme Court's decision in *Tufts v. Commissioner,* a taxpayer selling or disposing of property encumbered by a nonrecourse mortgage will be required to include the mortgage balance amount in amount realized.[93] The effect of the Court's decision will be twofold. First, there will be some confusion in the near future about which transactions still qualify

and basis in the taxpayer's business property. I.R.C. § 108(b) (West 1983). When qualified business indebtedness is involved, the taxpayer may elect to reduce the basis of his depreciable property rather than treating the benefit accuring from the discharge as income. I.R.C. § 108(c) (West 1983). Qualified business indebtedness is any indebtedness incurred by a corporation or an individual in connection with property used in his trade or business. I.R.C. § 108(d)(4) (West 1983). In all three categories, income from the discharge will ultimately be realized when the tax attributes subject to the reduced basis are sold, assuming tax attributes existed to be reduced. The time between the discharge and the sale of the tax attributes is the deferment period. *See* I.R.C. § 108 (West 1983).

86. 103 S.Ct. at 1833 n.11.

87. *Id.* at 1835.

88. I.R.C. § 752 (c) (West 1983). Section 752 provides, "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." I.R.C. § 752(c) (West 1983).

89. 103 S.Ct. at 1836. *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. A236, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4017, 4377. The House Report states, "The transfer of property subject to a liability by a partner to a partnership, or by the partnership to a partner, shall, to the extent of the fair market value of such property, be considered a transfer of the amount of the liability along with the property." *Id.*

90. 103 S.Ct. at 1836. I.R.C. § 752(d) states, "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." I.R.C. § 752(d) (West 1983). *See also* S. REP. No. 1622, 83d Cong., 2d Sess. A236, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 5048. The Senate Report states, "When a partnership interest is sold or exchanged, the general rule for the treatment of the sale or exchange of property subject to liabilities will be applied." *Id.*

91. 103 S.Ct. at 1836. The Court interpreted the legislative intent of § 752(c) to be the prevention of a partner's selling property to the partnership for a price greatly in excess of its fair market value and thereby taking tax deductions greatly in excess of the amount the partner is at risk. *Id.*

92. *Id.*

93. *Id.* at 1834.

for deferment under section 108. Second, the decision could mean excessive capital gains treatment for taxpayers disposing of unprofitable property encumbered by a nonrecourse loan.

GARY HAZELTON