10-1-1997

Nonrecourse Debt in Excess of Fair Market Value: The Confluence of Basis, Realization, Subchapter K and the Need for Consistency

Daniel S. Goldberg
University of Maryland School of Law, dgoldberg@law.umaryland.edu

NONRECOURSE DEBT IN EXCESS OF FAIR MARKET VALUE: THE CONFLUENCE OF BASIS, REALIZATION, SUBCHAPTER K AND THE NEED FOR CONSISTENCY

*Daniel S. Goldberg**

I. INTRODUCTION

This Article will explore the issues that arise when the value of property that has been financed with nonrecourse debt declines below the amount of the nonrecourse debt. Such property, referred to in this Article as "excess liability property," raises interesting issues involving realization, potential cancellation of indebtedness income, and, in the context of Subchapter K, the relationship of inside basis to outside basis. Based upon an analysis of these issues, the Article takes the position that the excess liability issue should affect the tax treatment of the property and its owner at the time of acquisition and disposition of the property only. This position has important implications when there has been a significant modification of the nonrecourse liability and impacts on the potential for realization of gain or cancellation of indebtedness income at that point. It further takes the position that the doctrine of *Estate of Franklin*[1] should be applied at the partnership level and not the partner level, and should not be applied on the acquisition of a partnership interest of a partnership that already owns the excess liability property. Under this view, the internal consistency of Subchapter K can be maintained, and Subchapter K will remain consistent with general gain realization and basis provisions of the Code and case law interpreting those provisions. These conclusions are at odds with two recent and important articles dealing with the treatment of nonrecourse debt that has been modified[2] and the excess liability problem in Subchapter K.[3]

This Article uses the excess liability situation to explore the interesting issues that arise when statute, logic, and equity intersect, giving lens to an understanding of the strengths and limitations of each. In that manner, the exploration is instructive in an understanding of some fundamental principles of the income tax in general and partnership tax in particular.

II. THE LANDSCAPE

Since the time tax shelters became a significant part of the American financial culture, investors and tax practitioners have been seeking the eternal fountain of

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*Professor of Law, University of Maryland School of Law; Of Counsel, Tucker, Flyer & Lewis, P.C.; A.B. University of Rochester, 1968; J.D. Harvard Law School, 1971. The author wishes to thank Professor Robert I. Keller of the University of Maryland Law School for his helpful comments with respect to this Article.

[1] Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976), *aff'g*, 64 T.C. 752 (1975).

[2] Linda Sugin, *Nonrecourse Debt Revisited, Restructured and Redefined*, 51 TAX L. REV. 115 (1995) [hereinafter *Sugin*].

[3] Claire E. Toth, *Nonrecourse Debt in Excess of Fair Market Value and Disappearing Basis: The Partnership Paradox*, 50 TAX LAW. 37 (1996) [hereinafter *Toth*].

non-inclusion at the end of the shelter[4] and have pondered the complexities and unpleasantness of living with a tax generator. The real estate tax shelter, which will be the backdrop of this Article, arises because property can generate deductions from depreciation, even though the property has not declined in value. A tax shelter becomes accessible to the risk averse and those of modest means because part of the cost of the property and, therefore, its basis can be paid by use of nonrecourse indebtedness, for which the purchaser is not ultimately liable. There is even a silver lining to the storm cloud that forms during the years of shelter, because the ultimate sale of the property for consideration in the form of debt assumption or relief will generally yield capital gain, which is taxed in a preferential way. These three factors—losses without realization, leverage, and conversion of ordinary income to capital gain—are at the heart of all real estate tax shelters. The interplay of the three tax shelter factors is sometimes seen as an abuse of the requirement in the tax law of realization, pursuant to which no tax is imposed on increases in value until there has been a sale or other disposition of the property. The 1986 Tax Reform Act enacted a global cure for realization abuses under the passive activity loss rules.

Before the 1986 Act, many tax shelter transactions were engaged in through limited partnerships, because that vehicle allows the pass-through to the partners of favorable tax attributes, such as depreciation or losses, for use to offset other income of those partners. Moreover, the limited partnership vehicle insulates the partners, at least the limited partners, from ever having to actually pay out of pocket any of the partnership's liabilities or expenses.

Subchapter K of the Internal Revenue Code (the "Code") governs the tax treatment of partnerships and partners (as well as limited liability companies and members) and provides an intricate relationship between the two. Partnerships are conduits; the partners, not the partnership, are subject to tax.[5] The treatment of the partners, however, is dependent upon the activities of the partnership. In some contexts, the partnership is treated as an entity similar to a corporation. In other contexts, the partnership is treated as an aggregate of all of its partners, similar to co-ownership.

Notwithstanding the enactment of the 1986 Tax Reform Act, which chilled the attitudes of many investors towards entering into new tax shelters, there are still many transactions that occurred before the Act's effective date or that were entered into by taxpayers who were unaffected by the passive loss restrictions. It is not uncommon, therefore, to encounter property whose basis to the owner is substantially below the principal amount of nonrecourse indebtedness secured by the property. More alarming, however, at least to the investor, is the situation faced by many investors, in which the value of the property is also substantially less than the amount of the nonrecourse indebtedness secured by the property. In this latter case, referred to in this Article as "excess liability property," it is not

[4] *See* Martin D. Ginsburg, *The Leaky Tax Shelter*, 53 TAXES 719 (1975); Toth, *supra* note 3.
[5] I.R.C. § 701.

infrequent that the operating income from the property is insufficient to pay operating expenses and debt service. Indeed, many of these properties generate taxable income with insufficient cash flow to service the debt, much less to be available for use by the owner. Often, the owner is a partnership.

To deal with these cash shortfall issues, it is often advantageous to seek to modify the nonrecourse indebtedness that is secured by the property. In other situations, or even in conjunction with debt modifications, it is often helpful to attract new partners into the partnership or replace existing partners with new partners.

III. NONRECOURSE DEBT IN EXCESS OF BASIS

A. *The Non-Partnership Situation*

1. *In General*

The general income tax issues that arise in excess liability situations, *i.e.*, when nonrecourse liabilities exceed both the basis and value of property, involve several provisions of the Code. The provisions involved upon acquisition of excess liability property are sections 1011 and 1012, relating to adjusted basis and basis of property. These sections, in substance, define basis as cost, a term that is amplified and clarified by case law. Basis represents the amount that can be received upon sale of the property without incurring tax. It also represents the amount that can be "recovered" for tax purposes through tax deductions, such as depreciation, and other downward adjustments to basis.

The provision involved upon the disposition of excess liability property is section 1001, relating to the determination of amount and recognition of gain or loss. Specifically, section 1001(b) defines amount realized from the sale or other disposition of property as the sum of any money received plus the fair market value of property (other than money) received. Together, the amount realized and adjusted basis determine gain or loss to a taxpayer upon the sale of the property or other event of realization.

The third fundamental component of determining income (or loss) under the tax system is the concept of realization. Disposition of excess liability property clearly results in realization. But, it is possible, and it has been suggested, that other events could also constitute realization, such as modification of the debt.

2. *Purchase of Property with Nonrecourse Debt that is Less than the Value of the Property*

Frequently, investors purchase real estate by financing the purchase with debt. In general, the basis of property includes not only the cash component of the purchase price but also the debt component, regardless of whether the source of the funds was the seller itself or a third-party financier. Moreover, in general, the debt is includable in the cost of the property and, therefore, its basis even if the debt is nonrecourse, that is, even if the property that serves as security for the debt represents the only asset against which the lender can enforce its claim. Under those circumstances, the purchaser of the property is not personally liable, and the purchaser's other assets are free of claims of the lender.

Suppose that after the purchase of the property financed with nonrecourse debt the value of the property falls below the outstanding nonrecourse indebtedness. The decline in the value of the property does not represent an event of realization[6] any more than would an increase in the value of the property beyond its original purchase price. Rather, an event of realization would occur when the owner sells the property to a third party, who assumes or takes the property subject to the debt, or who pays proceeds that the owner can use to discharge the debt. Further, if the value of the property drops below the balance of the debt and the owner of the property transfers the property to the lender either in foreclosure or in lieu of foreclosure, or the owner of the property transfers the property to a third party who takes the property subject to the liability (regardless of whether the purchaser personally assumes the liability), the transfer constitutes an event of realization. As a result, the transferor is deemed to realize for tax purposes an amount equal to the outstanding balance of the nonrecourse loan and any cash or other property received.[7] This result obtains even if the value of the property is less than the outstanding balance of the nonrecourse indebtedness.[8] The U.S. Supreme Court reached this conclusion in *Commissioner v. Tufts* and explained the decision by resorting to "tax logic" and the necessity for internal consistency in the tax law. In the Court's view, because the nonrecourse indebtedness was respected as a genuine indebtedness when the property was purchased, thereby being included as a part of the cost of the property, it should also be respected as genuine indebtedness when the property is sold. This result should occur regardless of the value of the property securing the indebtedness, and the debt should be included at its face amount as part of the amount realized upon the sale.[9]

Boris Bittker explained this result even before the Supreme Court's decision by reference to the principle that the gain that is subject to ultimate tax should be no more or less than the actual economic gain to the taxpayer from the transaction.[10] Economic gain in a transaction that took place over several years would be measured by initial cash invested as compared to final cash proceeds plus untaxed cash received during the course of the transaction. The net cash received, if a positive amount, would represent a measure of the taxpayer's gain and, if a negative amount, would represent a measure of the taxpayer's loss. Thus, if there were an excess of untaxed cash received over cash invested during the time the property was held, but no additional cash was received upon the disposition of the property, then the disposition should result in a taxable gain in

[6] *See, e.g.*, San Antonio Savings Ass'n v. Commissioner, 887 F.2d 577 (5th Cir. 1989); Reporter Pub. Co., Inc. v. Commissioner, 201 F.2d 743 (10th Cir. 1953).

[7] *See* Commissioner v. Tufts, 461 U.S. 300, 317 (1983).

[8] *Id.* at 307.

[9] *Id.* at 309-10.

[10] *See* Boris I. Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane Case*, 33 TAX L. REV. 277 (1978).

the amount of that excess cash, and the gain would be realized at the time of disposition of the property. The gain realization should be equal to the taxpayer's economic gain from the overall transaction. This gain realization principle, for tax purposes, is necessary in Professor Bittker's view to balance the taxpayer's gain for tax purposes with his gain for economic purposes.[11]

Further, in the event that during the course of ownership of the property the taxpayer reported losses from depreciation for tax purposes, then the reportable gain at the time of the event of realization should not only include the amount of the actual economic gain from the overall transaction, but also, include an additional amount equal to previous losses that were reported. Under Bittker's "balancing entry" theory, the mechanical computation of amount realized by including the nonrecourse debt assumed is necessary, so that the net gain for tax purposes, consisting of taxable gain minus taxable losses, would exactly equal the taxpayer's economic gain.[12]

The kind of analysis demonstrated by the Supreme Court in *Tufts* and by Boris Bittker and other commentators[13] prior to *Tufts* reflects the importance of the overriding principle in tax law that the amount of economic profit and not more should be subject to income tax. This principle has been recognized by the Supreme Court virtually since the inception of the Code.[14] When faced with the possibility of a taxpayer avoiding tax on economic gain through a technical reading of Code provisions, the Supreme Court relied on tax logic to prevent the avoidance.

The regulations now deal specifically with the potential excess liability issue. Regulation section 1.1001-2(b), entitled "Effect of Fair Market Value of Security" provides as follows:

> (b) The fair market value of the security at the time of sale or disposition is not relevant for purposes of determining under paragraph (a) of this section the amount of liabilities from which the taxpayer is discharged or treated as discharged. Thus, the fact that the fair market value of the property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from being treated as money received from the sale or other disposition of the property.[15]

This rule is essentially a restatement of the holding in *Tufts*, although it was actually issued while *Tufts* was being litigated.

The rules discussed above have been applied by several other courts to deal with related types of transactions. The body of law that has developed can be

[11] *Id.* at 283-84.

[12] *Id.* at 284.

[13] *See* James S. Halpern, *Liabilities and Cost Basis: Some Fundamental Considerations*, 7 J. R.E. TAX 334 (1980).

[14] *See* Doyle v. Mitchell Bros. Co., 247 U.S. 179, 183 (1918) (reaching this result and viewing the principle as inherent in the tax law without benefit of the statutory predecessors of sections 61(a)(3), 1001, and 1012).

[15] Reg. § 1.1001-2(b).

summarized as follows: if property is purchased for cash and nonrecourse indebtedness in an amount that is not greater than the value of the purchased property, then the nonrecourse indebtedness will be respected as a true liability for tax purposes upon the purchase.[16] Further, a refinancing that generates an additional liability, even if nonrecourse, does not represent an event of realization.[17] The full amount of the nonrecourse debt continues to be respected, even if the property's value later declines below the outstanding balance of the liability.[18] The mere reduction in value of the owner's property will not result in tax consequences to the owner (or if the owner is a partnership, its constituent partners) until there is an event of realization.[19] Upon disposition of the property, however, an event of realization occurs, causing the entire amount of the nonrecourse liability to be included in the amount realized component of the gain computation.[20] This result is unaffected by the fair market value of the property.

3. *Purchase of Property with Nonrecourse Debt that Exceeds the Value of the Property*

Suppose that a taxpayer purchases property for nonrecourse debt in an amount that substantially exceeds the value of the property. In that case, there is a plethora of authority that would deny the taxpayer inclusion of some or all of the liability in its basis in the property.[21]

In *Estate of Franklin*, the taxpayer sought to include, for purposes of basis and, therefore, depreciation, the full amount of a nonrecourse promissory note issued to the seller as part of the purchase price of the property.[22] Finding that the amount of the nonrecourse promissory note substantially exceeded the fair market value of the property at the time of purchase, the Tax Court viewed the nominal purchaser as a mere option holder rather than the owner of the property in substance.[23] In order to enjoy the benefits and burdens of ownership of the property, the essential ingredients of true ownership for tax purposes, the nominal purchaser would have had to repay the nonrecourse promissory note.

The Court of Appeals for the Ninth Circuit affirmed the result of the Tax Court that the taxpayer was not entitled to depreciation deductions by virtue of

[16] *See* Mayerson v. Commissioner, 47 T.C. 340 (1966), *acq.* 1969-2 C.B. 24.

[17] *See* Woodsam Assoc., Inc. v Commissioner, 198 F.2d 357, 359 (2d Cir. 1952).

[18] *See* Lebowitz v. Commissioner, 917 F.2d 1314 (2d Cir. 1990); Polakof v. Commissioner, 820 F.2d 321 (9th Cir. 1987), *cert. denied*, 484 U.S. 1025 (1988); Estate of Sydney Baron v. Commissioner, 798 F.2d 65 (2d Cir. 1986); Pleasant Summit Land Corp. v. Commissioner, 863 F.2d 263 (3d Cir. 1988), *cert. denied sub nom.* Commissioner v. Prussia 493 U.S. 901 (1989).

[19] *See id.*

[20] *See Tufts*, 461 U.S. at 309.

[21] *See* Estate of Franklin v. Commissioner, 544 F.2d 1045, 1045 (9th Cir. 1976), *aff'g*, 64 T.C. 752 (1975). *See also* cases cited *infra* notes 25 and 26.

[22] *Estate of Franklin*, 64 T.C. at 755. The taxpayer also sought to deduct the interest ostensibly paid to the seller on the nonrecourse promissory note. *Id.*

[23] *Id.* at 762.

ownership of the property nor to interest deductions for payments of nominal interest with respect to the nonrecourse promissory note. The theory employed by the appeals court, however, differed somewhat from the theory employed by the Tax Court. Unlike the Tax Court, the Ninth Circuit viewed the purchaser as the owner of the property. However, it viewed the nonrecourse indebtedness as a "contingent indebtedness" rather than a real indebtedness.[24] The nonrecourse note was contingent upon the property increasing in value beyond the face amount of the note, because only when that occurred would the obligor have the incentive to pay the note. As such, the nonrecourse liability was viewed by the court as uncertain of ultimate payment and was, therefore, not sufficiently certain to be characterized as indebtedness. Thus, notwithstanding that the form of the transaction would appear to yield a basis in the property to the purchaser at least equal to the amount of the purchase money nonrecourse indebtedness, the court found that the substance of the transaction was different than the form. Accordingly, the taxpayer should not achieve the treatment that he would have been accorded had he made a true and actual investment in the property. Several subsequent cases have followed the lead of the Tax Court and Ninth Circuit in *Estate of Franklin* in denying the purchaser basis for all[25] or at least some[26] of

[24] *Estate of Franklin*, 544 F.2d at 1047.

[25] Many cases have held that a purchaser of property for inadequately secured nonrecourse indebtedness took no basis in the property by virtue of the indebtedness. *See* Brannen v. Commissioner, 722 F.2d 695 (11th Cir. 1994) (holding that a taxpayer was not entitled to deduct depreciation attributable to increase in basis resulting from a nonrecourse loan); Brountas v. Commissioner, 692 F.2d 152 (1st Cir. 1982) (holding that nonrecourse notes were too contingent to be included in basis); Lebowitz v. Commissioner, 917 F.2d 1314 (2d Cir. 1990) (declining to assign full fair market value basis to taxpayer's coal rights when the fair market value of those rights was substantially less than the face value of the nonrecourse note); Hildebrand v. Commissioner, 967 F.2d 350 (9th Cir. 1992) (disallowing interest deductions on nonrecourse debt greatly in excess of the value of the interest purchased); Lukens v. Commissioner, 945 F.2d 92 (5th Cir. 1991) (holding that nonrecourse indebtedness was not genuine); Bergstrom v. Commissioner, 37 Fed. Cl. 164 (1996) (holding that when nonrecourse debt exceeds reasonable approximation of fair value, debt is disregarded for purpose of computing basis). *See also* Rev. Rul. 77-110, 1977-1 C.B. 58 (taking the position that an inadequately secured nonrecourse note is too contingent to be classified as a genuine indebtedness).

[26] Some cases have held that a taxpayer was entitled to basis in the property equal to the value of the property at the time of purchase, on the theory that the taxpayer had the incentive to pay a portion of the nonrecourse indebtedness in an amount equal to the value of the property (an amount that the lender would have an incentive to accept) in order to retain the property. Accordingly, that portion should be regarded as a true indebtedness. *See* Pleasant Summit Land Corp. v. Commissioner, 863 F.2d 263 (3d Cir. 1988), *cert. denied sub nom.* Commissioner v. Prussin, 493 U.S. 901 (1989). The Service has announced that it will continue to litigate this issue. A.O.D. 1991-009 (Mar. 29, 1991). *See also* Odend'hal v. Commissioner, 748 F.2d 908 (4th Cir. 1984).

The Third Circuit, in *Pleasant Summit Land Corp.*, interpreted *Odend'hal* as supporting its view, based upon language contained in the opinion. 748 F.2d at 912-14. It is not at all clear, however, that the *Odend'hal* case supports the Third Circuit's view, particularly in light of the result in that case, which affirmed the Tax Court's total exclusion of the nonrecourse debt from basis and its reliance on *Brannen*. *See Brannen*, 722 F.2d at 695. *See also* William D. Andrews, *On Beyond Tufts*, 61 TAXES 949, 953-54 (1983) (arguing in support of this approach).

See also Regents Park Partners v. Commissioner, 63 T.C.M. (CCH) 3131, 1992 T.C.M. (RIA) ¶ 92,336. The Tax Court allowed a purchaser of real property, which was subject to a nonrecourse mortgage held by U.S Department of Housing and Urban Development, the principal amount (plus accrued interest) that "unreasonably exceeded" the fair market value of the property, a basis equal to the nonrecourse indebtedness.[27]

If the nonrecourse indebtedness were not respected, in whole or in part, at the time of purchase, then what treatment is accorded the nonrecourse indebtedness when the property is: (1) transferred to the lender in discharge of the indebtedness; (2) transferred to a third party who assumes the indebtedness; or (3) transferred to a third party who takes the property subject to it? To apply the holding in *Tufts* literally and, thereby, include the full amount of the nonrecourse indebtedness in the amount realized by the owner would treat the putative indebtedness inconsistently and create a break in tax logic. Such a rule would treat the owner in an unfairly harsh manner. The Treasury issued regulations to deal with this problem in the interest of maintaining the preeminence of tax logic and seeking consistent treatment of the indebtedness throughout the transaction.

Regulation section 1.1001-2, entitled "Discharge of Liabilities," recites the rule that the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. In response to the *Estate of Franklin* case, the regulation provides the following:

> (3) *Liability Incurred on Acquisition.* In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the

the value of the property, viewing the excess as contingent and, therefore, not includable in basis. The theory of this view focuses largely on the lender. The lender views the nonrecourse indebtedness as a liability of the debtor in the amount of the value of the property securing the indebtedness because that is the amount that is likely to be collected upon foreclosure. The Tax Court, however, did not view its holding as endorsing the holding in *Pleasant Summit Land Corp.*, because the taxpayer, before it had acquired the property subject to the mortgage, had managed the property and, in the court's view, had ample incentive to make further investments in the property rather than abandon the property. *Id.* at 3131-37.

[27] The exact scope of the *Estate of Franklin* doctrine is still uncertain. The *Estate of Franklin* case involved a particularly abusive transaction. In the case, the taxpayer purportedly purchased property from the seller, consisting of a motel, paying what was termed prepaid interest and giving for the purchase price a nonrecourse promissory note, the face amount of which substantially exceeded the value of the property that secured the note. The note called for payments of principal and interest.

Simultaneously with the sale, however, the taxpayer leased the property back to the seller under a net lease. All payments due from the taxpayer on the promissory note and made to the seller were offset by the rent payments made by the seller-lessee to the taxpayer under the net lease. The seller continued to operate the property as a motel. One result of this arrangement was that the benefits and burdens of ownership regarding the opportunity to profit from an increase in value of the property and the risk of loss from the decrease in value of the property were in the hands of the original seller rather than the taxpayer, who was nominal owner. A second result was that control over the actual use of the property during the term of the lease rested in the hands of the seller. The court denied the taxpayer basis for the nonrecourse note portion of the purchase price, calling the note a mere contingent liability, the payment of which would await an increase in the value of the property that secured the note.

The *Estate of Franklin* doctrine, however, has been applied in less abusive situations than existed in the case itself, that is, in situations when control of the use of the property was in the hands of the nominal owner. The teaching of the *Estate of Franklin* case, as passed down through the years, has focused on the relationship between the value of the property and the principal amount of the nonrecourse indebtedness secured by the property. It appears that the seller's retention of the ability to use the property through a lease arrangement has receded in importance.

extent that such liability was not taken into account in determining the transferor's basis for such property.[28]

The Treasury's decision to ignore the liability upon disposition of the property if it was ignored upon acquisition is consistent with the thrust and analysis in *Estate of Franklin*. The *Estate of Franklin* doctrine is one of substance over form: an item that is a liability in name, but, in substance, does not give rise to an obligation of future payment will not be regarded as a liability for tax purposes.[29] A liability will be respected when it arises only if it reflects an actual obligation of future payment. The substance versus form analysis must be conducted at the time the liability arises, that is, when the property is purchased. Once the liability is disregarded as a sham, not worthy of being regarded as part of the purchase price, it should be disregarded when the owner is relieved of it.

4. *Modification of the Nonrecourse Liability*

As indicated above, a mere decline in value of property that is subject to a nonrecourse liability, causing the property to become excess liability property, will not in itself trigger a realization or a cancellation of indebtedness event. It is possible, however, and it has been asserted that, even absent a disposition of the property subject to the liability, an income generating event could occur with respect to the liability if the liability is modified.[30]

Case law has held that an exchange of old debt for new debt with an equivalent face value does not result in cancellation of indebtedness income.[31] This rule had been applied even if there were a change in the rate at which payments were to be made and the payment obligation became confined to a particular source.[32] Old case law also held that the replacement of a recourse debt by a nonrecourse debt did not result in debt cancellation income to the debtor, even when the taxpayer was in bankruptcy and it was unlikely that the nonrecourse loan would be paid in full.[33]

[28] Reg. § 1.1001-2(a)(3).

[29] *See generally* Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859, 865 (1982).

[30] *See* Sugin, *supra* note 2, at 145.

[31] *See* Great Western Power Co. of California v. Commissioner, 297 U.S. 543, 546 (1936).

[32] *See* Alexander v. Commissioner, 61 T.C. 278 (1973), *acq.* 1974-2 C.B. 1. In *Alexander*, the taxpayer incurred a debt to his former corporation, of which he was the majority shareholder. The obligation was purchased by the purchaser of the corporation's assets and, thereafter, made subject to a provision that it was only payable out of commissions to be earned by the taxpayer from working for the successor to the corporation's business. Because it was reasonable to expect that the commissions would yield sufficient funds to pay the debt, the debt remained a liability of the taxpayer and, therefore, did not give rise to income by reason of cancellation of indebtedness or otherwise when the corporation was subsequently liquidated.

[33] *See* Lutz & Schramm Co. v. Commissioner, 1 T.C. 682, 689-89 (1943), *nonacq.* 1943 C.B. 35 (holding that the owner of property who substituted nonrecourse mortgage for pre-existing recourse mortgage that was satisfied approximately three years later by owner transferring property to lender when property was worth less than the mortgage amount had gain only when the property was transferred and not at the time of the debt substitution).

a. *Significant Modification of Debt: In General.* The viability of these older cases, however, has been called into question by the recent Supreme Court decision in *Cottage Savings Association v. Commissioner*[34] and the regulations issued in response to that case.[35] Those regulations defined the concept of "significant modification" of a debt instrument, which, if it occurs, would be treated as a taxable exchange by the holder of the debt instrument.[36] A significant modification of the terms of the debt instrument includes modifications such as a reduction in the stated principal amount of the debt[37] or a change in interest rate.[38] In general, there are no adverse tax consequences to the debtor from a significant modification of a nonpublicly traded debt instrument as long as there is adequate stated interest[39] and there has been no reduction in the stated principal amount of the debt. The lack of adverse consequences results because the debtor is deemed to issue a new debt instrument in satisfaction of the existing indebtedness and the issuance is treated as if the debtor satisfied the indebtedness with an amount of money equal to the issue price of the new debt instrument.[40] The issue price is determined under the original issue discount (OID) rules of section 1274. If the modified instrument bears adequate interest, the issue price is simply the stated principal amount of the debt. If the modification involved a reduction in the principal amount of the debt or of the interest rate to a rate below the applicable federal rate (AFR), then cancellation of indebtedness income resulting from the debt modification would be determined under the debt-for-debt exchange approach of the regulations. It would be equal to the excess, if any, of the adjusted issue price of the old obligation over the issue price of the new obligation. The issue price of the new obligation is determined under the OID rules of section 1274. As a general rule, when dealing with nonregularly traded debt, as long as the debt, after modification, bears adequate stated interest, its face amount will be regarded as its issue price, and the modification will not result in cancellation of indebtedness income.

If the debt modification, however, results in a deemed exchange of debt, it could result in gain to a holder who purchased that debt at a discount. The holder would be deemed to have exchanged his old, low-basis debt, for new, high issue price debt. The issue price of the nonpublicly traded new debt would be the measure of the holder's amount realized from the modification. The difference between that amount and the holder's basis would be includable as gain to the holder when the debt was repaid (or at the election of the holder, in the holder's income as OID as the debt matured), even if it were unlikely that the debt would

[34] 499 U.S. 554, 566-67 (1991).

[35] Reg. § 1.1001-3.

[36] Reg. § 1.1001-3(b).

[37] Reg. § 1.1001-3(e)(1).

[38] Reg § 1.1001-3(e)(2). There is a de minimis rule to the effect that a small rate change will be ignored for these purposes.

[39] I.R.C. § 1274(c)(1)(A)(i); Reg. § 1.1274-1(b).

[40] I.R.C. § 108(e)(10)(A); Reg. § 1.1274-2.

ever be repaid in the full amount of its stated principal amount. Any such gain should be reportable under the installment method.[41]

[41] To both the holder and the debtor, a significant modification of the debt constitutes an exchange. Pursuant to that exchange, the holder would be deemed to exchange his old, low-basis debt for the new, modified debt. Regulation section 1.1001-1(g)(1) provides that if a debt instrument is issued in exchange for property (the old debt would be considered property), the amount realized attributable to the debt instrument that is regarded as newly issued would be the issue price of the debt instrument as determined under Regulation section 1.1273-2 or section 1.1274-2.

Under those regulations, if the debt instruments were not publicly traded debt instruments or were not issued for publicly traded property, the issue price of the new debt would be determined under section 1274. Reg. § 1.1273-2(d)(1). Regulation section 1.1274-2, in turn, provides that the issue price of a debt instrument that provides for adequate stated interest is the stated principal amount of the debt instrument. Reg. § 1.1274-2(b)(1). Thus, under Regulation section 1.1001-1(g)(1), the amount realized by the holder upon significant modification of the debt is the issue price of the modified debt, which is its principal stated amount.

Fortunately for the holder, the gain from the debt modification could be reportable under the installment method prescribed in section 453, as long as the holder is eligible for such treatment and the treatment is beneficial.

Even if installment sale treatment were available, a receipt by the holder of partial repayment, either from operating funds of the debtor or through refinancing of a portion of the debt, could generate gain to the holder at that time. Only a portion of the holder's basis in the debt instrument could be used to offset the receipt. The portion of the basis available for that purpose, presumably, would be computed in proportion to the ratio of the repayment received to the issue price of the debt. Thus, a debt purchased by the holder at a substantial discount and repaid in part, in an amount, say, equal to the holder's original purchase price for the debt could nevertheless generate a substantial amount of gain at time of partial repayment. This detriment would not arise, however, if the debt were repaid in full either at maturity or prior to maturity.

Moreover, a portion of the holder's gain on the repayment could be treated as ordinary income rather than capital gain, because the excess of the stated principal amount or issue price of the debt instrument over the holder's basis in the instrument would constitute "accrued market discount" within the meaning of section 1276. Further, partial payments of principal received by the holder of an instrument that has accrued market discount are included in gross income as ordinary income to the extent such payment does not exceed the accrued market discount on the debt. I.R.C. § 1276(a)(3)(A). Under this section, accrued market discount is deemed earned ratably, at a constant rate, over the life of the debt instrument. The net impact of these rules on the holder of a debt instrument acquired at a deep discount is that a large amount of any principal payment received prior to the final payment on the debt will be regarded as income rather than return of basis, and that amount will likely be greatly disproportionate to the much smaller income amount that would have been realized by the holder if the actual fair market value of the debt instrument were viewed as its issue price rather than the grossly inflated stated principal amount as of the date of modification.

Finally, it is possible that installment sale treatment would not be available to the holder under section 453(b)(2), or that the holder, although eligible, would be precluded from the financial benefits of such treatment under section 453A. Section 453(b)(2) excludes dealer dispositions, defined in section 453(*l*), from eligibility for installment treatment. Dealer dispositions include the disposition of personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan. Some lenders may fall into this classification, however unusual it may appear.

More importantly, however, holders that engage in this kind of transaction involving debt instruments with substantial principal amounts, if not values, would be subject to section 453A, which, in effect, deprives the installment seller of the benefits of installment sale treatment by imposing an interest charge on the present value of the tax deferral made possible by the installment treatment. The special interest charge rule applies only if certain conditions are met, the most important of which in this context is that the face amount of all such obligations held by the taxpayer which arose during and are outstanding as of the close of such taxable year, exceeds $5 million. *See* I.R.C. § 453A(b)(2)(B).

b. *Significant Modification of Debt: Nonrecourse Debt.* For years, it was conventional wisdom that the modification of a nonrecourse debt secured by real estate would not give rise to cancellation of indebtedness income as long as the stated principal amount of the debt instrument remained unchanged, even if the indebtedness was undersecured before modification and remained undersecured after the modification.[42] Regulations were proposed, however, under section 1274, which called this wisdom into question. Under Regulation section 1.1001-3, a significant modification of undersecured nonrecourse debt would be deemed to be the issuance of a new debt instrument in satisfaction of the old debt instrument. If the nonrecourse debt instrument, as modified, is debt, Regulation section 1.1001-3 references section 1274 and the regulations thereunder to determine the tax consequences of the exchange.[43]

Regulation section 1.1274-1(a) provides that section 1274 and the regulations thereunder apply to any debt instrument issued in consideration for the sale or exchange of property. For purposes of the section and the regulations, property includes debt instruments. Under the general rule, the fair market value of a debt instrument that bears adequate interest and is not publicly traded is its stated principal amount. Thus, in general, as long as the modification leaves that amount unchanged, there would be no tax consequence to the debtor.

Regulation section 1.1274-1(b), however, provides an exception for certain debt instruments, even if they have adequate stated interest and no OID, if the debt instrument is issued in a "potentially abusive situation," as defined in Regulation section 1.1274-3.[44] Regulation section 1.1274-3 defines "potentially abusive situations" to include any situation involving nonrecourse financing. If the exception applies, then notwithstanding the general rule regarding the issue price of a replacement nonrecourse debt instrument as the stated principal amount, the issue price of a replacement nonrecourse debt instrument will be deemed to be the fair market value of the property received in the exchange. In other words, the issue price will be the value of the replacement nonrecourse debt, reduced by any additional amount paid. Presumably, the fair market value of undersecured replacement nonrecourse debt would be the fair market value of the collateral serving as security for the debt.[45] If that were the end of the analysis, the result would be cancellation of indebtedness income to the debtor in the amount of the excess of the liability over the value of the collateral.

Importantly, however, the operating rules set forth in Regulation section 1.1274-3(b), which were added when the regulations became final, create an exception to the exception by specifically providing that: nonrecourse financing does not include an exchange of a nonrecourse debt instrument for an outstanding re-

[42] *See* C. Ronald Kalteyer, *Real Estate Workouts—Original Issue Discount Implications of Troubled Debt Restructurings*, 43 TAX LAW. 579, 580 (1990).

[43] Reg § 1.1274.

[44] Reg. § 1.1274-1(b)(1)(iii).

[45] Reg. § 1.1274-2(b)(3).

course or nonrecourse debt instrument.[46] Thus, the regulations permit replacement nonrecourse debt that is substituted for other nonrecourse debt to be treated as issued for its stated principal amount. It follows that the stated principal amount of a modified nonrecourse debt would constitute its issue price and that the mere modification of an undersecured nonrecourse debt that bears sufficient interest would not give rise to cancellation of indebtedness income to the issuer. This conclusion will hold true as long as the modified debt constitutes debt. If it does not constitute debt, then the section 1274 regulations are not applicable to the modification.

The regulations also provide for different treatment if the modified debt constitutes a contingent debt instrument. A nonrecourse debt that bears adequate fixed interest, however, would not be regarded as a contingent debt instrument even though it was undersecured, as long as the debt did not contain an additional term providing for an "equity kicker" or other indicia of equity ownership. Regulation section 1.1275-4 provides several exceptions to the treatment accorded to contingent payment debt instruments issued for nonpublicly traded property.[47] Most notably, the regulation does not apply to a debt instrument subject to Regulation section 1.1272-1(d), debt instruments that provide for a fixed yield.[48] That regulation states that a debt instrument that provides for one or more contingent payments, such as payments that are dependent upon available cash of the owner of the property, which may not be determinable at the time the debt is modified, will nevertheless be considered noncontingent if all possible payment schedules under the terms of the instrument result in the same fixed yield.[49] The regulation then provides the following:

> For example, the yield of a debt instrument with principal payments that are fixed in total amount but that are uncertain as to time (such as a demand loan) is the stated interest rate if the issue price of the instrument is equal to the stated principal amount and interest is paid or compounded at a fixed rate over the entire term of the instrument.[50]

Further, a debt instrument is not regarded as providing for an alternative payment schedule merely because there is a possibility of impairment of a payment(s)

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[46] Reg. § 1.1274-3(b)(1). Regulation section 1.1273-3(c) gives the Commissioner the authority to designate other non-abusive situations, even if otherwise described under the general rule as a situation involving an abusive situation, because they do not have the effect of significantly misstating basis or amount realized. This additional power given to the Commissioner provides an indication of the kind of abuses with which the regulations are concerned, namely, the abuses of the OID rules that would cause an overstatement of basis or perhaps an overstatement or understatement of amount realized. Further, if the issuer makes a determination that the new instrument is not issued in a potentially abusive situation, that determination is binding on the holder of that instrument, unless the holder discloses on its tax return that it is taking a contrary position. Reg. § 1.1274-3(d). Regardless of the issuer's determination or the holder's compliance with that determination, the Service is still free to challenge it.

[47] Reg. § 1.1275-4(a)(2).

[48] Reg. § 1.1275-4(a)(2)(iii).

[49] Reg. § 1.1272-1(d).

[50] *Id. See also* Reg. § 1.1272-1(j), Ex. (10).

by insolvency, default, or similar circumstances.[51]

Thus, a modified nonrecourse note, even if significantly undersecured, will not implicate the contingent payment debt regulations. Further, it will be treated as an indebtedness without OID as long as the modified instrument continues to bear the original principal amount and a fixed rate of interest at least equal to the applicable federal rate, and does not otherwise contain equity flavored attributes.[52]

c. *Possibility that Modified Nonrecourse Debt Does Not Constitute Debt, in Whole or in Part.* When an undersecured nonrecourse liability is substantially modified and is, therefore, deemed replaced by another undersecured nonrecourse liability of the same nominal face amount (bearing adequate interest), it is possible that the new liability would be evaluated based on its relationship to the value of the property at the time that new liability is deemed to arise rather than on the basis of its stated principal amount. In theory, this possibility could arise by application of the *Estate of Franklin* doctrine. Under that doctrine, the liability could be viewed as wholly or partly contingent, depending upon the theory of the *Estate of Franklin* doctrine that is applied, with the result that all or a portion of the liability would be deemed cancelled.

Alternatively, a taxable event could occur if the original debt were viewed as having been replaced by equity. Under that circumstance, the modification could result in a deemed foreclosure of the property.[53]

The debt modification regulations[54] are far from clear on this point. While not dealing with this question specifically, they provide that a modification of a debt instrument that results in an instrument or property right that is not debt for federal income tax purposes is a significant modification.[55] The regulations further provide, however, that for purposes of the foregoing rule as it affects recourse debts, any deterioration in the financial condition of the obligor between the issue date of the unmodified instrument and the date of modification as it relates to the obligor's ability to repay the debt is not taken into account unless, in connection with the modification, there is a substitution of a new obligor or the addition or deletion of a co-obligor.[56] Instead, the regulations instruct us to

[51] Reg. § 1.1272-1(c)(1).

[52] A problem also could arise if the modified debt instrument bears an interest rate that is clearly excessive. The concept of "potential abusive situation" under Regulation section 1.1274-3(a) includes a debt instrument with clearly excessive interest. Reg. § 1.1274-3(a)(2)(iv). It is problematic whether a significantly undersecured nonrecourse debt could ever provide for "clearly excessive interest" in light of the fact that clearly excessive interest occurs if the interest charge is clearly greater than the arm's-length amount of interest that would have been charged in a cash lending transaction between the same two parties. Reg. § 1.1274-3(b)(3). It is possible, however, that an interest rate substantially above the applicable federal rate that ensures that no return could ever go to the owner of the property may fall into that category. In any event, there is no express exception from the potentially abusive situation category for instruments bearing clearly excessive interest as there is for an exchange of nonrecourse debt for nonrecourse debt.

[53] *See* Sugin, *supra* note 2 at 144.

[54] Reg. § 1.1001-3.

[55] Reg. § 1.1001-3(e)(5)(i).

[56] *Id.*

ignore the financial condition of the debtor. They are silent, however, with regard to the importance of the value of the collateral when a recourse debt is significantly modified.

Presumably, a rule similar to the recourse debt rule would apply in the case of a nonrecourse indebtedness, and factors affecting the likelihood of repayment, such as the value of the property that secures the debt, should be ignored. Under this analysis, there would appear to be no room for the application of the *Estate of Franklin* doctrine to disregard the replacement note as lacking substance even though its principal amount exceeds the value of the property that secures it. This rule make sense because the modification of an excess liability is not an event that causes it to become an instrument that is not properly classified as debt. Rather, it is the reduction in value of the underlying security that could have this effect. As a result, mere modification of the instrument should not trigger a deemed conversion of debt to equity with the resultant cancellation of indebtedness or deemed foreclosure consequences.

This conclusion is consistent with the history of the relevant regulation. As discussed above, the modification of a nonpublicly traded nonrecourse debt that does not reduce its principal amount or its interest rate below the AFR is not regarded as a potentially abusive situation and, therefore, is governed by the general rule of Regulation section 1.1274-1(a). Under that rule, there will be no cancellation of indebtedness income. The exception for nonrecourse debt modifications represents a significant change from the regulations published by the Treasury in proposed form. Under the earlier version of the regulations, a "potentially abusive situation" would have included all nonrecourse liabilities. Under the proposed rule, the modification of a nonrecourse liability, even if it remained nonrecourse, would have caused the issue price of the new indebtedness to be equal to the fair market value of the indebtedness rather than the stated principal amount, as would have been the case with recourse liabilities. As such, the determination of the tax consequences of the modification would have required an appraisal of the collateral. This rule was changed in response to comments on the proposed version,[57] when the regulations were finalized. The exception described above was added to the regulations when they were finalized.

The abandonment of the harsher rule contained in the proposed section 1274 regulations indicates the Treasury's acceptance of the position that the modification of undersecured nonrecourse liabilities should be permitted without adverse tax consequences to the debtor. The final rule permitted the stated principal amount of the modified undersecured nonrecourse liability (which bore adequate interest) to be its principal amount, rather than limiting the principal amount to the fair market value of the collateral securing the liability. That decision should be regarded as incorporating the acceptance that an undersecured nonrecourse

[57] *See* COMM. ON SALES AND FINANCIAL TRANSACTIONS, ABA TAX SEC., *Report on the Proposed Original Issue Discount Regulations*, 40 TAX LAW. 481, 509 (1987).

liability should be regarded as a debt, without regard to the value of the collateral that secures the liability. Otherwise, the Treasury would have made a totally hollow concession, because there could never be a modification of an undersecured nonrecourse liability that was not also a taxable event to the debtor if the new liability were considered as equity rather than debt merely because it was undersecured.

Further, there is substantial uncertainty whether a regulation under section 1001 could itself trigger tax consequences to the debtor, even if there were substantial modification of the debt instrument.[58] Debts are normally not considered property to the debtor. Rather, section 1001 should be applicable to exchanges of debt by the creditor only. Therefore, in the context of debt modifications, the section should not result in tax consequences to the debtor.[59]

On the other hand, a recent article by Linda Sugin takes the position that under current law, a debt restructuring that allows nonrecourse debt to remain undersecured would be treated as a constructive foreclosure, that is, as a transfer of property in satisfaction of the debt.[60] Under that view, the tax consequences of such a restructuring would be governed by *Tufts*. Sugin's analysis of current law proceeds as follows.

When an excess liability is restructured in order to relieve the pressure on the borrower to make current payments to service the debt, such as when the parties agree to defer some of the interest due for several years without changing the yield on the instrument, the restructuring would constitute a significant modification of the instrument within the meaning of Regulation section 1.1001-3. A significant modification, it is argued, has the effect of treating the entire transaction as if a new debt instrument is substituted for the old debt. The new instrument must be evaluated based on the circumstances that exist at the time of modification. Thus, if the new instrument, even if in the form of debt, constitutes equity in substance or would otherwise not be considered true debt, then a taxable event would occur for both lender and borrower. Further, the principle of *Estate of Franklin* would be applied at the time of the restructuring to test whether the new debt should be treated as true debt.

Under this analysis, the restructured nonrecourse debt, if undersecured, could be treated in one of two ways. First, it could be regarded as debt only to the

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[58] *See* TASK FORCE, ABA TAX SEC., *Prop. Regs. § 1.1001-3: Modifications of Debt Instruments [Parts I-V]*, 47 TAX LAW. 987, 1028 (1994) [hereinafter ABA TASK FORCE].

[59] The legislative history, however, indicates that the standard to be applied to the holder with respect to gain or loss determination when a debt is modified should also apply to the issuer with regard to whether cancellation of indebtedness income is realized. *See* H.R. CONF. REP. NO. 964, at 1098 (1990) ("[E]ither or both COD or OID may be created in a debt-for-debt exchange that qualifies as a reorganization, so long as the exchange qualifies as a realization event under Section 1001 for the holder."). *See* Mary K. Wold, *A Comprehensive Tax Guide for Corporation Workouts*, *in* TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATION, AND RESTRUCTURINGS 1996, at 569, 614 (PLI Tax Law and Estate Planning Course Handbook Series No. 394, 1996).

[60] *See* Sugin, *supra* note 2, at 117.

extent of the fair market value of the security. Second, it could be disregarded as debt entirely. In the first case, the restructuring would have the effect of cancelling the indebtedness to the extent that it exceeds the value of the security. This treatment would result in cancellation of indebtedness income to the owner in the amount of the excess. In the second case, the restructuring would constitute a deemed foreclosure of the property.

An example will help illustrate this analysis.[61] Assume that the taxpayer originally purchased the property for $10,000,000, paying $1,000,000 in cash and $9,000,000 in the form of a nonrecourse indebtedness, either given to the seller or borrowed from a third party. Then, assume that the property declines in value to $5,000,000. Suppose that the debt was significantly modified within the meaning of the applicable regulations.[62] Under the first possible analysis, the debt modification would result in $4,000,000 of cancellation of indebtedness income to the owner of the property.

Sugin, however, rejects this result in favor of the second possibility. Under her analysis, the principle of the *Estate of Franklin* would be applied to recharacterize the putative new debt as, in substance, an ownership interest of the lender in the property. This recharacterization would occur because the lender would have the significant attributes of ownership. The risk of loss—the risk of the remaining $5,000,000 in value from the example above—would rest completely on the lender. In addition, the opportunity to profit—the next $4,000,000 of appreciation, as well as current earnings on the property that would be used to pay interest and to repay principal from the example above—would belong to the lender. If, as a result of the modification of the old debt, the lender becomes the owner for tax purposes, then it follows that the nominal owner must have transferred that ownership to the lender, because it is impossible for both nominal owner and lender to be regarded as the owner of the property at the same time.[63] That constructive transfer occurs in satisfaction of the debt, as would be the case in foreclosure. The owner would treat the transaction as a sale. The lender would be permitted a bad debt deduction for the amount of the debt that has remained unpaid.

Sugin reaches this result by combining the principle of *Estate of Franklin* with general notions of debt and equity and the provisions of Regulation section 1.1001-3 dealing with debt modifications. The resulting concoction is then announced as a statement of current law.[64] The conclusion, however, lacks case law authority, which is explained simply by reference to the fact that "taxpayers have no incentive to bring this issue to the government's attention and the government has insufficient information to identify undersecured restructured debt."[65]

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[61] The example is taken from Sugin, *supra* note 2, at 164-65.

[62] This modification could occur in a number of ways, including a small interest rate change or even an abandonment of the requirement that all interest be paid currently.

[63] *See* Sugin, *supra* note 2, at 127-129.

[64] *See* Sugin, *supra* note 2, at 116-17, 118, 127, 128, 129-37.

[65] *See* Sugin, *supra* note 2, at 116-17.

Sugin's argument is inconsistent with Regulation sections 1.1001-3 and 1.1274-1(b), when read in the light of their drafting history. Moreover, it does not represent a good policy choice and, therefore, should not be accepted as the likely result of future judicial analysis. It is best understood and deconstructed on its own terms.

First, her argument is grounded on the assertions that a restructuring of debt must be examined as a modification under section 1001 and that any significant change in terms is treated as a realization event to both lender and borrower. The section 1.1001-3 regulations were written in response to *Cottage Savings Association v. Commissioner.*[66] That case held that an exchange of one package of debt instruments for another similar package of debt instruments of equivalent value but with different debtors constituted a taxable exchange, which permitted Cottage Savings to realize a loss. The value of those debts had declined as a result of the increase in market interest rates since the time of origination of the loans. The Treasury's response to the case was to provide detailed guidance on when a modification of an existing debt should be treated as so substantial so as to be considered an exchange of the old debt for a new debt. From the lender's point of view, the exchange treatment gives rise to the opportunity to realize a loss if the deemed value of the new debt is less than the basis of the old debt.[67]

The regulations, however, go further than merely setting forth the consequences to the lender. Rather, they purport to set forth the treatment of the borrower as well. This treatment will occur even though the debt does not constitute "property" to the borrower, the normal subject matter of section 1001. Normally, one would expect to see regulations affecting the borrower issued under section 108 dealing with cancellation of indebtedness income, an area of the tax law with extensive regulations. It is not at all clear that a debt modification that constitutes an exchange for the lender must constitute an "exchange" or realization event of any kind to the borrower. Symmetry is neither required nor, I would suggest, called for in this context.[68]

The regulations as interpreted by Sugin, however, have an even broader scope. Even though they are interpretative regulations under section 1001, directed primarily at the lender's tax consequences, Sugin's expansive interpretation of them would change well settled notions of realization that have been a fundamental aspect of the federal income tax system since its inception. There have been many cases, including several Supreme Court cases,[69] that have established the position that before there can be recognition of gain there must be realization. Realization requires a sale or other disposition of the property. A mere decline or increase in its value without more does not constitute an event of

[66] 499 U.S. 554 (1991).

[67] The basis of the old debt is generally its principal amount if the lender originated the debt.

[68] *See* ABA Task Force, *supra* note 58, at 1023.

[69] *See* Eisner v. McComber, 252 U.S. 189 (1920); Helvering, v. Bruun, 309 U.S. 461 (1990); Cottage Savings Assoc. v. Commissioner, 499 U.S. 554 (1991); Commissioner v. Tufts, 461 U.S. 300 (1983).

realization. To deem a foreclosure when there has been no actual transfer by the taxpayer of ownership of property at the very least would require a clear and incontrovertible statement in the regulations, which is absent. Further, such a change in established principles of realization may very well be beyond the power of mere interpretative regulations. Altering the rule of realization should require legislative change, and, indeed in some areas, Congress has made such changes.[70] But it is not likely that such a long and well established precept of income taxation would be changed by interpretative regulations, and it is even more unlikely that the section 1.1001-3 regulations would have effected such a change without being explicit about it.

Moreover, as a matter of policy, the wisdom of a constructive foreclosure rule is questionable. A deemed foreclosure rule raises several interesting and unresolvable issues. Suppose, in the above example, the property, subsequent to the debt modification, increases in value back to its original $10,000,000. The debtor, who has remained the owner of the property for state law purposes and in control of the property, now has equity in the property of $1,000,000. At that point, presumably, the debtor should be deemed to be the owner of the property for tax purposes. To accomplish that result, one would have to construct a deemed purchase of the property at some point around the time that the property's value increased above $9,000,000. If the taxpayer became the owner at that point by deemed purchase, then the lender would have become a deemed seller with the attendant gain consequences of the sale of property, which had a basis in the hands of the lender of $5,000,000, its deemed acquisition price. The value of the property would have to be monitored at all times in order to determine, in any given year, whether the nominal owner or lender was the owner for tax purposes and, therefore, entitled to depreciation. If the precise value of the property were in doubt, caution would require that both owner and lender deduct depreciation amounts to ensure that neither is whipsawed by the Service in future audit.

Further, a deemed foreclosure rule draws a greater distinction between recourse debt and nonrecourse debt than is often warranted. Suppose the property in the above example was purchased with cash and recourse debt in the amount of $9,000,000, but the debtor became insolvent by the time the property's value declined to $5,000,000. As a matter of substance, the lender would view the transaction as no different than if the debt were nonrecourse. In both cases, the lender would be looking to the property as the sole means of recovering the amount loaned. Presumably, if the property declined in value to $5,000,000 and the debt were modified to defer payments, a deemed foreclosure arguably would result, following Sugin's logic, because, in substance, the lender has all of the downside risk and virtually all of the upside potential. Yet, the regulations under section 1001 instruct us to ignore the financial condition of the debtor in deter-

[70] *See, e.g.*, mark-to-market rules of section 475.

mining whether the new, modified instrument constitutes a property right that is not debt for federal income tax purposes.[71] Consistency in logic with that applied in the recourse situation would require the application of a similar rule in the nonrecourse situation. Such a rule would ignore the value of the underlying property that secures a nonrecourse indebtedness.

Sugin's argument is, at base, an argument against the current, well-settled general treatment of nonrecourse indebtedness as true debt at the time both of the purchase of property and its disposition. The argument incorporates a discomfort with the treatment of nonrecourse indebtedness as true debt.[72] However, it is not at all clear that adequately secured nonrecourse indebtedness falls more on the equity side of the continuum than the debt side, and the tax law has not viewed it as such. Under current tax law, dating from *Crane*[73] to the more recent *Tufts*[74] case, nonrecourse indebtedness used to acquire property at least equal in value to the amount of the indebtedness has been regarded as true debt, and the purchaser, not the lender, is regarded as the exclusive owner of the property for tax purposes. Nevertheless, Sugin has issued a call to elevate economic substance over form in determining the tax treatment of nonrecourse indebtedness.

In the tax law, form continues to be very important, not simply to provide certainty, which itself is an important goal of the tax law. Form carries with it important rights under state law. For example, the legal and, for state law purposes, equitable owner of property has all of the statutorily protected and common law rights of ownership for nontax purposes. These include the right to control the use of the property, the right to exclude, and the right to transfer the property. Federal bankruptcy law protects those rights as well. In bankruptcy, it is not unusual for a secured creditor, whose secured loan greatly exceeds the value of the property, to be crammed down and repaid in bankruptcy an amount equal to the value of the property and no more. It is an oversimplification of ownership to look simply at who bears the risk of a decline in the value of property.

It may be argued that "who is the owner" is not the question that needs to be answered for purposes of assigning tax attributes from the property, such as depreciation deductions. Rather, the inquiry may focus on the bearer of the risk of economic loss. Under that view, the risk of loss, and not "ownership," would determine the taxpayer who can depreciate the property for tax purposes.[75]

Determining who bears the risk of loss, however, is by no means easy. For example, if the property that secured the nonrecourse indebtedness in the amount of $9,000,000 declined in value to $8,500,000, but the debtor continued to make

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[71] Reg. § 1.1001-3(e)(5)(i).

[72] Sugin is far from alone in this discomfort. *See* Diane M. Anderson, *Note, Federal Income Tax Treatment of Nonrecourse Debt*, 82 COLUM. L. REV. 1498 (1982).

[73] Crane v. Commissioner, 331 U.S. 1 (1947).

[74] *Tufts*, 461 U.S. at 300.

[75] *See* Noel B. Cunningham and Deborah H. Schenk, *Taxation Without Realization: A "Revolutionary" Approach to Ownership*, 47 TAX L. REV. 725 (1992).

mortgage payments as required under the promissory note, it is not at all clear that the economic loss from the reduction in value is borne by the lender. To the contrary, if the lender continues to receive payments on the debt from the debtor, it is hard to see why the lender has borne any risk of loss. At most, if the debt matures and the debtor transfers the property to the lender in lieu of making full payment of the liability, then the value of the property at that time, if it is less than the remaining balance of the loan, produces a loss to the lender. However, it is not until that time that the lender has been financially disadvantaged. Many things can happen between the making of a loan and its maturity, including an increase or decrease in value of the property securing the loan. Further, even if the property's value does not increase, the debtor may choose to retain the property to avoid dislocation, even though the property is worth less than the balance of the debt.[76]

Moreover, tax depreciation may have nothing to do with any decrease in value of the property, because tax depreciation is computed mechanically without reference to actual loss of value established by appraisals from year to year.[77] Indeed, even though the property is being depreciated for tax purposes, it may actually be increasing in value. Allocating depreciation deductions to the lender based upon a risk analysis as to who, hypothetically, bears the risk of loss, may bring one no closer to conforming tax treatment to economic substance. There is no reason to allocate depreciation deductions to the lender, instead of the debtor, on the basis of a risk bearing analysis, because there may have been no economic loss to be borne by anyone.[78]

Thus, risk of loss can be divided between debtor and lender and, indeed, among debtor, lender, and guarantor in any number of ways. Determining who bears the risk of loss in any administratively manageable way for purposes of allocating depreciation may not be feasible under a tax system that seeks to be practical and does not require annual appraisals of property to determine tax consequences. On balance, it would appear that the tax attributes of ownership, such as depreciation, should be assigned to the taxpayer who is regarded as the "owner" of the property, notwithstanding the shortcomings of that approach, and indeed, the Supreme Court of the United States has applied that approach.[79]

There are circumstances, of course, when the taxpayer employs a particular form of a transaction to accomplish a tax result that is inappropriate under the true economic substance of the transaction. For example, the taxpayer in *Estate of Franklin* purportedly purchased property for an amount promised to be paid in the future, secured only by the purchased property. The taxpayer did not even have the opportunity to use the property, a motel, because it was leased back to

[76] Daniel N. Shaviro, *Risk and Accrual: The Tax Treatment of Nonrecourse Debt*, 44 TAX L. REV. 401, 434-35 (1989).

[77] *Id.* at 435-37.

[78] *Id.*

[79] *See* Frank Lyon Co. v. United States, 435 U.S. 561 (1978) (determining the owner in sale leaseback arrangement).

the putative seller. Under those extreme circumstances, when the abuse sought by the participants in the transaction is clear, courts have ignored the form of the transaction and attempted to impose tax consequences based upon its economic substance. The application of substance over form, however, has generally been limited to clear cases when courts have sought to prevent an abuse. The substance over form doctrine must be applied carefully and restrictively because it is not always clear what the substance of a transaction is, although it is generally clear what the form is from referring to the governing documents. Thus, substance over form is an extreme remedy, generally only available to the government in attacking a transaction as being different than its form[80] in order to prevent taxpayer abuse.

In contrast to the normal substance over form application, no abuse occurs when a nonrecourse liability that exceeds the value of the property that secures the liability is modified to reduce the current pay rate of the debt which, in all likelihood, is already in default because of the failure of the debtor to make payments. Perhaps it could be argued that the owner of the property should realize any gain inherent in the property at the time that the value of the property falls below the outstanding liability, or perhaps at the time that the owner defaults on the liability, so that the lender has the legal right to institute foreclosure proceedings to reclaim the property. Those circumstances do not constitute events of realization under current law, however, because realization requires disposition of the property itself. Similarly, modification of the debt, which, if anything, causes the lender to relinquish rights to the property such as the right to receive current payments on the debt, and thereby, makes it more likely that the owner of the property can retain that ownership, is hardly an event that should trigger realization.

Sugin's argument to elevate substance over form, so that a taxpayer who bears the risk of decline in value of property is deemed the owner of the property, represents a proposal for legislative consideration that is not entirely without merit. But it also has drawbacks and inconsistencies with basic principles of current tax law that are generally accepted and necessary to keep the tax system administrable.

Finally, the *Estate of Franklin* doctrine goes to the determination of the purchaser's basis in the purchased property for depreciation purposes. Once the owner is established as the owner of the property for tax purposes and the owner's basis is determined to include the nonrecourse debt because the *Estate of Franklin* doctrine is not applicable, then subsequent changes to the debt should have no impact on the basis of the property, absent specific statutory

[80] Taxpayers are generally stuck with their form. *See, e.g.*, Federal Nat'l Mortgage Ass'n v. Commissioner, 896 F.2d 580, 587 (D.C. Cir. 1990); Estate of Durkin v. Commissioner, 99 T.C. 561, 566 (1992). *See generally* Isenbergh, *supra* note 29, at 881 (questioning the appropriateness of employing the substance over form approach in many situations in which it has been applied).

authorization.[81] For example, if the property in our example increased in value from $10,000,000 to $15,000,000 and was refinanced with nonrecourse indebtedness of $13,000,000, $9,000,000 of which was used to repay the original nonrecourse mortgage, the basis of the purchased property would remain unchanged.[82]

The original debt is includable in basis because it constitutes a part of the purchase price of the property. Whether it remains in force, increases, or is repaid, it would not affect further the basis of the property, which has already been established. Nor should a cancellation of a portion of that debt affect the basis of the property, unless there were explicit statutory permission to do so.[83] Even if the debt ceases to be regarded as debt, the basis in the property, and, therefore, ownership of the property, should remain unaffected. All of the foregoing consequences follow and, indeed, should follow as long as the nonrecourse indebtedness and any substitute indebtedness is treated consistently throughout its existence.

B. *The Partnership Situation*

1. *In General*

In general, a partnership computes its income or loss as if it were an entity,[84] but the partnership itself is not subject to tax.[85] Rather, its profits, losses, and in some case, specific components of each, referred to as "items," pass through to the partners and are subject to tax at the partner level.[86]

The interaction of partnership ownership and the tax consequences to its partners implicates various sections of Subchapter K, dealing with partnerships. The Subchapter K sections that are prominent include sections 705, 722 (to which section 705 refers), and 742. These sections deal with the determination of basis of a partner's interest. In general, they compute a partner's basis in his partnership interest by reference to money or property contributed to the partnership, subject to various adjustments and, with respect to a partner who acquires his interest in a partnership other than by contribution, provide that the basis of the partnership interest is determined under the normal basis sections in the income tax laws discussed previously.

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[81] See section 108(e)(5) for an example of statutory authorization to treat a cancellation of a portion of purchase money indebtedness held by the seller of the property as a reduction in the purchase price of the property. See also section 108(a)(1)(d) dealing with reduction in qualified real property indebtedness, which excludes from income the cancellation of the portion of the debt, but which requires the downward adjustment in basis of depreciable property.

[82] *See* Woodsam Assoc., Inc. v. Commissioner, 189 F.2d 357 (2d Cir. 1952). Realization of the gain represented by the additional borrowing would await the disposition of the property. The unchanged historic basis would ensure that the cash withdrawal would not avoid imposition of a tax upon disposition of the property.

[83] *See supra* note 81.

[84] I.R.C. § 703.

[85] I.R.C. § 701.

[86] I.R.C. § 702.

When partnership liabilities are involved, section 752 provides for the effect that those partnership liabilities have on a partner's basis in his partnership interest ("outside basis"). Briefly, any increase in a partner's share of the liabilities of a partnership is considered a contribution of money by the partner to the partnership and is, thereby, included in that partner's outside basis. Conversely, any decrease in a partner's share of the liabilities of a partnership is considered a distribution of money to the partner by the partnership and, thereby, reduces that partner's outside basis.[87]

Subsections (c) and (d) of section 752 provide further rules, the effect of which are less clear. Specifically, subsection (c), entitled "Liability to Which Property is Subject," provides as follows:

> (c) 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.[88]

The qualifier, "to the extent of the fair market value of such property," and how one treats any excess liability over the fair market value of the property securing the liability, raise interesting issues of interpretation.[89]

In addition, subsection (d), entitled "Sale or Exchange of an Interest," provides as follows:

> (d) 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.[90]

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[87] I.R.C. § 752(a), (b).

[88] I.R.C. § 752(c).

[89] Consistent with section 752(c), the regulations under section 704(b) provide that property contributed by a partner to a partnership should be credited to that partner's capital account in the amount of the fair market value of the property, without taking section 7701(g) into account. Reg. § 1.704-1(b)(2)(iv)(d)(1). Similarly, the regulations provide that the partnership's capital accounting require a partner's capital account to be decreased by the fair market value of the property distributed by the partnership, also without taking section 7701(g) into account to such partner. Reg. § 1.704-1(b)(2)(iv)(e)(1). The applicability of section 7701(g) to those situations reflects the preeminence of section 752(c).

Based upon the Supreme Court's discussion of section 752(c) in *Tufts*, commentators have suggested that the applicability of section 752(c) should be limited to contributions to a partnership of property subject to a nonrecourse liability and distributions of such property from a partnership to a partner. Indeed, the Supreme Court, in holding the entire amount of the nonrecourse indebtedness was included in amount realized, specifically suggested this limitation and did not feel bound to limit the determination of amount realized on the disposition of the property by virtue of the nonrecourse liability to the fair market value of the property.

Professor Stafford, in commenting on this aspect of the Court's holding, believes that the Court interpreted section 752(c) too narrowly and has suggested that the fair market value rule in the subsection should apply to all "transfers" of property by a partner to a partnership or "transfers" by a partnership to a partner. L. Scott Stafford, *Section 752(c): The Other Issue In* Tufts v. Commissioner, 42 TAX LAW. 93, 119 (1988). The concept of "transfer" embedded in Professor Stafford's analysis would extend beyond contributions and distributions of property. It would also extend to sales by partners to partnerships or partnerships to partners. Further, transfers between partners and partnerships of excess liability property could be viewed as sales under section 707(a)(2)(B) and, if such a transfer were viewed as a sale, the purchaser's basis in the acquired property should be subject to the fair market value limitation as well. *Id.* at 114-15.

[90] I.R.C. § 752(d).

All of the above sections of Subchapter K have been in the Code since 1954, and courts have dealt with these sections in deciding important cases relating to the treatment of transactions involving property that was subject to a liability in excess of the property's fair market value. Thus, the Supreme Court in *Tufts* and the Tax Court and the Court of Appeals for the Ninth Circuit in *Estate of Franklin* reconciled these sections, particularly sections 752(c) and 752(d).

Fundamentally, a partner's outside basis will be the determinant of the amount he may recover before incurring tax. Upon an event of realization, the outside basis and the amount realized will determine ultimate gain or loss for tax purposes. It should be noted here, and will be discussed in detail later,[91] that the timing and character of that gain may depend greatly on the partnership's activities and treatment of certain items, and can be affected by transactions with and between partners.

More recently, Congress enacted section 7701(g),[92] a subsection contained in definitional Chapter 79 of the Code. Section 7701(g) was intended as a clarifying amendment to the Code and provides as follows:

> (g) Clarification of Fair Market Value in the case of Nonrecourse Indebtedness — for purposes of subtitle A, in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject.

The legislative history surrounding this section sets forth the intended scope and limitations of the section and indicates that the section was designed, in part, to confirm the Supreme Court's decision in *Tufts*.[93] It was also intended to govern situations in which the fair market value of the property was a determinant of the recipient's or distributor's tax consequences.[94] Importantly, however, it was not intended to affect the tax treatment of actual sales or acquisitions of property subject to liabilities, results governed by *Tufts* and *Estate of Franklin*, respectively, not section 752(c).[95] It should also be noted that this section was enacted several years after the Treasury issued the most significant regulations relating to the excess liabilities over value problem under section 1001.[96]

The foregoing sections of the Code and regulations thereunder must be interpreted consistently, if possible, and in a way that carries out the broad principles of the income tax in a manner consistent with its statutory rules. Thus, the provisions must be interpreted so that a taxpayer's full income is taxed and no more. In addition, they must be interpreted so that the conduit principles apply

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[91] *See infra* text accompanying notes 131-38.

[92] Act of July 18, 1984, Pub. L. No. 98-369, § 75(c), 98 Stat. 494, 595.

[93] *See* Staff of Joint Comm. on Taxation, 98th Cong. 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 239 (Joint Comm. Print 1984).

[94] *Id.*

[95] *Id.*

[96] Reg. § 1.1001-2(b). *See supra* text accompanying note 15.

to the conducting of a transaction through a partnership, which is essentially a pass-through entity.

2. *Allocation of Partnership Liabilities Among Partners*

As discussed above, a partnership that incurs a liability in connection with the purchase of property, whether that liability is recourse or nonrecourse, includes the amount of the liability in addition to any cash purchase price in the basis of the property purchased. The question dealt with by the regulations under section 752 is how those liabilities are shared among the partners. The regulations resolve that issue by referencing to the liability as recourse or nonrecourse, that is, determining whether any partner bears the economic responsibility for the payment of that liability.[97] Regardless of how the liability is shared among the partners and is, thereby, included in their outside bases, the logic of Subchapter K prescribes that the amount of the liability of the partnership must be reflected in the outside basis of the partners in a manner so that the aggregate liability component in those outside bases equals the amount of the partnership's liability.

Suppose that a partnership purchases property for a nonrecourse indebtedness substantially in excess of the value of the property. Under the *Estate of Franklin* doctrine,[98] the partnership's basis in the property could be limited in one of three ways. First, one could contend that the partnership was not the true owner of the property and, therefore, had no recognizable basis in the property.[99] Second, one could contend that even if the partnership is the true owner, it has purchased the property for debt that is contingent and, therefore, not includable in the basis of the purchased property.[100] Third, one could contend that the partnership, while the true owner, purchased the property for debt that was contingent in part, permitting only the noncontingent portion of the debt to be included in the property's basis.[101]

The partners' respective outside bases would also be affected by the application of the *Estate of Franklin* doctrine. The effect would be consistent with the treatment of the partnership. Under the first and second alternatives, the partners' shares of the partnership's liabilities would be zero, because there are no liabilities in the partnership to share. Under the third alternative, the partners' shares of partnership liabilities would be limited, in the aggregate, to the fair market value of the partnership's property at the time of purchase.

Thus, if a partnership purchases property by giving nonrecourse indebtedness that substantially exceeds the value of the property, a classic *Estate of Franklin* situation, the basis consequences to the partnership will also be reflected in the outside bases of the partners. For example, if the debt is viewed as wholly

[97] Reg. § 1.752-1.
[98] *See supra* text accompanying notes 21-27.
[99] *See Estate of Franklin*, 64 T.C. at 762.
[100] *See supra* note 25.
[101] *See supra* note 26.

contingent and, therefore, a nullity at the partnership level, the partners will not reflect any of the debt in their outside bases. If the debt is respected up to the value of the property securing the nonrecourse liability, then the partners will share that limited amount of liability among themselves in their outside bases.[102]

Similarly, if the nonrecourse liability that has been viewed as a nullity under the *Estate of Franklin* doctrine at the time the property was acquired is discharged upon foreclosure of the property or transfer of the property subject to that liability, then the deemed distribution to the partners by virtue of the extinguishment of the liability should be limited to the amount of the liability that was included in those partners' outside bases. This result follows from the principles of Regulation section 1.1001-2(a)(3).[103] Finally, a similar result should obtain if only a portion of the liability is cancelled by the creditor. For example, if the liability is viewed as a nullity when it arose, its cancellation should not give rise to cancellation of indebtedness income to the partnership or to any of its constituent partners. Thus, the excess of the face amount of a nonrecourse liability over the portion, if any, that is respected, if viewed as a nullity to the partnership should also be viewed as a nullity to its constituent partners.

The satisfaction of, or relief from, that liability that has been treated as contingent or unreal, either by virtue of its assumption in the sale of the property, its satisfaction upon foreclosure or deed in lieu of foreclosure, or its forgiveness upon cancellation of a portion of the debt, should have no effect on either the partnership or its partners. The reason for this result is the paramount importance of consistent treatment.

As discussed previously, the *Estate of Franklin* line of cases did not derive from any statutory authority but rather derived from and, indeed, represents an application of the judicially created principle referred to as "substance over form." Under that concept, even though parties to a transaction would refer to an economic relationship as one giving rise to a "liability," no such liability for tax purposes would be respected if the substance of the transaction proved otherwise. If that result obtains with regard to the partnership's tax treatment of the purported liability, the same result must flow through to the partners. Conversely, if the liability of the partnership is respected at the time of acquisition, it should be respected with regard to the partners subsequently, even if the property declines in value below the amount of the debt.

Ultimately, the determination of whether a liability is respected should depend upon whether the obligor under the liability has a true obligation to pay. That determination, then, must be made at the partnership level. In that sense, the treatment of the liability as either a liability or a sham is an entity question in the same manner that taxable income and realization are determined at the partnership level as if the partnership were an entity, and in the same manner in which ownership of property is viewed as ownership by an entity.

[102] *See* Regents Park Partners v. Commissioner, 63 T.C.M. (CCH) 3131, 1992 T.C.M. (RIA) ¶ 92,336.

[103] *See supra* text accompanying note 28.

3. *The Entry of a New Partner*

Suppose a partnership that originally purchased property at its fair market value experiences a decline in value of that property so as to cause the value of the property to be substantially below the amount of the nonrecourse liability secured by the property. At that point, suppose a new partner ("Newpartner") either purchases another partner's interest or enters the partnership through a contribution to the partnership's capital.

This situation can be illustrated by reference to the example dealt with earlier in this Article.[104] In that example, the taxpayer (assume a partnership) purchased property for $10,000,000, paying $1,000,000 in cash and issuing a nonrecourse promissory note for the balance in the amount of $9,000,000, bearing adequate interest. When the value of the property declined to $5,000,000, Newpartner purchased a ten percent interest in the partnership from Oldpartner for nominal consideration (assume zero). As a result of the transaction, Oldpartner's amount realized equals his share of the partnership's liabilities, amounting to ten percent of $9,000,000 or $900,000. Assuming that the basis of the property in the hands of the partnership is equal to its value[105] and that Oldpartner was an original partner, Oldpartner's outside basis in his partnership interest would be $500,000,[106] causing his sale to Newpartner to generate gain in the amount of $400,000.

The treatment of Newpartner as a result of the transaction, however, is more complicated and subject to disagreement. A recent article by Claire Toth[107] examines the tax consequences to a Newpartner who purchases an interest in an "excess liability partnership," *i.e.*, a partnership that owns property which has a fair market value and basis substantially less than the outstanding balance of the nonrecourse indebtedness that is secured by the property. Toth expresses the view that recent case law would limit the purchaser's basis in the partnership interest to the purchaser's share, however that share is determined, of the property's fair market value at the time of purchase of the partnership interest.[108] This view, she contends, I would suggest, mistakenly, is supported by the *Regents Park* case,[109] which in turn relied upon *Estate of Franklin*.[110] Thus, under

[104] *See supra* text accompanying note 61.

[105] This assumption is made only for convenience.

[106] It is also assumed that the partnership has had no transactions with partners that would affect its inside basis.

[107] Toth, *supra* note 3, at 42.

[108] *Id.* at 40.

[109] *Regents Park Partners*, 63 T.C.M. (CCH) at 3132, 3131-17, 1992 T.C.M. (RIA) ¶ 92,336 at 1743. *Regents Park* involved the acquisition of property by a partnership for no consideration other than taking the property subject to an existing nonrecourse note that exceeded the fair market value of the property. The court held that the partnership was entitled to a basis in the property equal to its fair market value and that the indebtedness in excess of that amount should be treated as a contingent liability and not as an addition to basis. The court then determined that the partners' outside bases must exclude that excess amount as well. Importantly, however, the court first limited the partnership's liability for tax purposes to the fair market value of the property, so that limiting the partners' outside basis with regard to the liability to the value of the property was consistent with, and indeed followed from, its principal holding. In this connection, the court noted that "a partner's share of partnership liabilities is a partnership item. Sec. 301.6263(a)(3)-1(a)(1)(v), Proceed. & Admin. Regs." *Id.* at 3132 n.26. Further, the court determined the partners' outside basis by virtue of section 752(c) and 752(a), without mention of section 752(d). *Id.*

this view it appears that the purchaser of the partnership interest, presumably for no consideration, has a basis that is less than her share of partnership liabilities, because, as to Newpartner, a portion of the partnership's liability is viewed as lacking substance or as contingent.

Under Toth's view of existing law, Newpartner's outside basis would be $500,000, consisting of the portion of the nonrecourse indebtedness not exceeding the value of the property, which is allocable to Newpartner's ten percent interest in the partnership.[111] Unlike other partners who are free from the *Estate of Franklin* taint, because they acquired their partnership interests before the property's value fell below the amount of the nonrecourse debt, Newpartner is subject to it in order to prevent the inflated basis abuse. As a result, a liability that is recognized as a true liability inside the partnership loses that character for purposes of determining outside bases—but not as to all of the partners' outside bases—only Newpartner's outside basis.

If the partnership were to then dispose of its property, for example, through foreclosure or deed in lieu of foreclosure, then the partnership would have an amount realized equal to the balance of the nonrecourse indebtedness and gain determined in that manner. Newpartner would be credited with her distributive share of that gain, which would also increase Newpartner's outside basis. Elimination of the liability, however, would correspondingly decrease Newpartner's outside basis as if it were a distribution of cash.[112] Thus, under this analysis, although Newpartner would not treat all of the partnership's liability as a real liability upon purchase of the partnership interest, Newpartner would be required to treat the entire liability as a true liability when relieved of it.

Returning to our example, a foreclosure or deed in lieu of foreclosure would cause the partnership to have an amount realized equal to $9,000,000, the outstanding balance of the nonrecourse indebtedness. Because the partnership's inside basis in the property is $5,000,000, the partnership would realize a $4,000,000 gain. Ten percent of that gain or $400,000 would be allocated to Newpartner as a ten percent partner.[113] Further, under Toth's analysis, Newpartner would experience a deemed distribution under section 752(b) in the amount of $900,000, ten percent of the partnership's nonrecourse liability. This distribution on these facts would be offset by Newpartner's increased basis in the amount of $400,000 by virtue of being allocated a portion of the partnership's gain on the foreclosure or deed in lieu of foreclosure and, in part, by Newpartner's outside basis attributable to a portion of the partnership's liability under the *Estate of*

[110] 544 F.2d 1045 (9th Cir. 1976), *aff'g* 64 T.C. 752 (1975).

[111] Under the alternative view of *Estate of Franklin*, pursuant to which the nonrecourse indebtedness is viewed as wholly contingent, Newpartner would have no outside basis in the partnership interest.

[112] *See* Toth, *supra* note 3, at 46-47.

[113] This would also be consistent with the allocation of minimum gain required under the section 704(b) regulations, pursuant to which Newpartner would step into Oldpartner's shoes. *See* Reg. § 1.704-2(b)(1), -2(b)(2).

Franklin doctrine, namely $500,000. Thus, under this analysis, the partnership's sale of the property would result in $400,000 of taxable gain but no economic gain to Newpartner.

Moreover, if the more aggressive view of *Estate of Franklin* were adopted, so that Newpartner received no outside basis by virtue of the partnership's nonrecourse liability substantially exceeding the value of the partnership's property, then the foreclosure of the property would result in $400,000 of taxable gain to Newpartner, equal to her distributive share of the partnership's $4,000,000 of gain. In addition, Newpartner would realize additional gain of $500,000 under section 731. This additional gain would arise by virtue of Newpartner's receiving a deemed distribution in the amount of $900,000 (resulting from Newpartner's ten percent share of the elimination of the partnership's liability of $9,000,000), which amount exceeded Newpartner's $400,000 outside basis. Newpartner's outside basis was only $400,000, because prior to the sale Newpartner was precluded from including any of the partnership's nonrecourse indebtedness in her outside basis. As a result, the deemed distribution would be offset by only the $400,000 increased basis attributable to Newpartner's distributive share of partnership gain. Accordingly, the net result of the transaction, under the foregoing extension of Toth's analysis, should the more aggressive view of *Estate of Franklin* apply at the partner level, would be taxable gain in the amount of $900,000, but no economic gain to Newpartner.

Similarly, if a portion of the partnership's nonrecourse debt is cancelled, the partners, including Newpartner, would be allocated their respective distributive shares of that separately stated item.[114] For example, if $4,000,000 of the outstanding $9,000,000 of nonrecourse indebtedness were cancelled by the lender, Newpartner's distributive share of that cancellation of indebtedness income would be $400,000. That amount would be includable in Newpartner's income as ordinary income and would increase her outside basis. In addition, Newpartner would have a deemed distribution by virtue of the reduction in the partnership's liabilities in the amount of $400,000, under Toth's view of existing law, yielding no additional gain to Newpartner, but reducing her outside basis by the amount of the distribution. The net result of the debt cancellation to Newpartner, then, would be income of $400,000 without outside basis credit of that amount. But, if Newpartner's portion of the liability was never respected and was viewed as a nullity, how could its cancellation generate income to Newpartner, as Toth suggests would occur under current law absent legislative change? For there to be cancellation indebtedness income outside the partnership context, there must be a debt that has been cancelled. If a taxpayer has no obligation to repay a debt, then its discharge without payment by the taxpayer cannot result in cancellation

[114] *See* Gershkowitz v. Commissioner, 88 T.C. 984 (1987) (holding that cancellation of a nonrecourse debt gives rise to cancellation of indebtedness income).

of indebtedness income.[115] Consistency would require a similar result with regard to a partner's share of a partnership liability that is not respected. Accordingly, under a proper interpretation of Subchapter K, a partnership liability that is not respected with respect to a particular partner should not give rise to cancellation of indebtedness income to that partner when forgiven at the partnership level.

These inconsistencies would cause Newpartner to have taxable income or gain by reason of ownership of the partnership interest in the absence of economic gain. This is an unusual phenomenon found only in penalty or "public policy" provisions of the Code. The structure of the Code causes tax gain ultimately to conform to economic gain, although its timing may diverge and its character may be treated preferentially. Yet, it is the assertion that inconsistencies between tax gain and economic gain can exist and, indeed, are mandated by the interplay of the current provisions of Subchapter K with *Tufts* and *Estate of Franklin* that are at the heart of Toth's analysis. All other consequences and disadvantages to Newpartner enumerated and discussed by Toth, other than disadvantages relating to timing of income and character of income (ordinary or capital), flow from this interpretation of the interaction of the statutory rules of sections 1001 and 752 and the equitable and "tax logic" principals of *Tufts* and *Estate of Franklin*.[116]

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[115] Millar v. Commissioner, 540 F.2d 184, 186 (3rd Cir. 1976). Further, when the taxpayer has executed promissory notes but those notes do not pose a true liability on the taxpayer, the cancellation of those notes do not result in cancellation of indebtedness income. *See also* De Voe v. Commissioner, 52 T.C.M. (CCH) 641, 648, 1986 T.C.M. (RIA) ¶ 86,477, at 2177. In *De Voe*, the taxpayer executed nonrecourse promissory notes in connection with the acquisition of license to sell certain medical equipment. The notes called for payments to be made based upon the number of units of the equipment sold in the taxpayer's sales territory. The Court held that the notes did not have substance and, therefore, would not be respected. It followed, then, that their cancellation could not result in cancellation of indebtedness income.

[116] An inconsistent treatment of partnership liabilities between the partnership and its partners could lead to other anomalous results. For example, if the partnership had excess liability property at the time Newpartner purchases a partnership interest, under the theory of the Tax Court's opinion in *Estate of Franklin*, Newpartner would not be regarded as owning a partnership interest in a partnership that owns the property. Yet, the partnership is entitled to depreciation on the property. Where does Newpartner's share of that depreciation go? If Newpartner were not a partner for tax purposes and Oldpartner ceased to be a partner, presumably depreciation deductions would be allocated to the other partners.

It would also follow that when the property is sold, there is no significant event that occurs with respect to Newpartner, because as to her, the partnership never owned the property. Where does the theoretical distributive share of the gain go? Surely neither the depreciation nor eventual gain would be allocated to Oldpartner, from whom Newpartner purchased her interest. Oldpartner has severed her ties to the partnership. Certainly they should not be allocated among the continuing partners, who were strangers to Newpartner's transaction with Oldpartner.

Alternatively, if Newpartner were regarded as a partner with no outside basis by virtue of the partnership's liability, under the more conventional view of the court of appeals in *Estate of Franklin*, presumably, depreciation could be allocated to her but suspended under section 704(d) because of her lack of outside basis.

Toth asserts that these anomalous results, which she regards as unfair and inappropriate, stem from the "discontinuities between inside and outside basis" embedded in Subchapter K and that the correction of these anomalous results "would almost certainly require legislative changes."[117] They result, in her view, because section 752(d), entitled "Sale or Exchange of an Interest,"[118] prescribes not only the treatment of the liability to the selling partner, but also the treatment to the purchasing partner. The title and express words of the subsection, however, refer to sale or exchange of a partnership interest and appear to focus on the seller's treatment. The purchasing partner's treatment of partnership liabilities, on the other hand, would appear to be governed by subsections (a) and (b) of section 752. Regulation section 1.752-1(h), which explains section 752(d), also focuses on the treatment of the selling partner and the resultant reduction in that partner's share of partnership liabilities. The regulation concludes that the reduction is treated as an amount realized under section 1001. Consistent with the above interpretation of the subsections, the regulation is completely silent as to the purchaser's treatment.

The anomalous results can only be avoided if the new partner and the partnership treat at least Newpartner's proportionate share of the liability consistently.[119] This congruity can be accomplished in two ways: under an entity approach or under an aggregate approach.

Under an entity approach, Newpartner's treatment of both partnership ownership and partnership liability can be reported as deriving exclusively from the partnership's treatment. Thus, a partner who purchases a partnership interest in a partnership which, at the time of the partner's purchase, owns property with a value substantially less than the nonrecourse indebtedness secured by it, should nevertheless take a basis in the partnership interest equal to the amount paid, if any, plus the partner's share of partnership liabilities, determined under the regulations under section 752. The *Estate of Franklin* substance over form doctrine should have no application at the partner level because it should be an entity-level doctrine.

To illustrate the entity approach, consider it in terms of the foregoing example. Newpartner's share of the partnership's gain upon foreclosure would depend upon whether the partnership had made a section 754 election and on the consequences of that election.[120] But, in all events, Newpartner's net tax gain and loss would be consistent with Newpartner's economic gain or loss. A fore-

[117] Toth, *supra* note 3, at 57.

[118] Section 752(d) provides that 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.

[119] As noted by the Tax Court in *Regents Park Partners*, under Regulation section 301.6231(a)(3)-1(a)(1)(v), a partner's share of partnership liabilities is a partnership item. *Regents Park Parnters*, 63 T.C.M. (CCH) at 3132 n.26, 1992 T.C.M. (RIA) ¶ 92,336 at 1745. As such, controversy concerning it would be resolved in a partnership level proceeding.

[120] These issues are discussed in detail later in the Article.

closure resulting in $400,000 of gain to Newpartner as the distributive share of partnership gain would increase Newpartner's basis by that amount. If Newpartner failed to receive a like amount in liquidation of the partnership interest, it would result in an offsetting loss to Newpartner in that same amount upon liquidation of the partnership interest, in which Newpartner would have a basis of $400,000. Alternatively, if the partnership's section 754 election resulted in a section 743(b) special inside basis adjustment to her allocable to the property in the amount of $400,000, the foreclosure would not result in any gain to her. In that event, Newpartner's involvement in the transaction would have resulted in neither taxable nor economic gain or loss. Thus, the treatment that would obtain applying the *Estate of Franklin* doctrine purely at the partnership level maintains the basic consistency of treatment between partner and partnership. This view will be referred to as the entity-level application of *Estate of Franklin*.

Under an aggregate approach, consistency can also be maintained by applying the *Estate of Franklin* doctrine to Newpartner at both the partner level and the partnership level. Application of an aggregate theory could be supported by reference to the partnership anti-abuse rules of Regulation section 1.701-2, under which the Service, with high-level review, is granted the authority to recharacterize partnership transactions to assure a result consistent with the intent of Subchapter K. Subchapter K is designed to tax partnership operations directly to its partners under a conduit principle.[121] It should not create ultimate taxable income when none would exist if the operations were conducted by an individual. Thus, it is possible that the anti-abuse regulations would support the treatment of Newpartner as a direct owner of a portion of the property, subject to a pro rata portion of the liability.[122]

Under application of an aggregate theory, Newpartner, upon purchasing the partnership interest in the previous example, would obtain an outside basis by virtue of the partnership's liability of (presumably) $500,000, computed as ten percent of that portion of the partnership's nonrecourse indebtedness that does not exceed the value of the property. Upon Newpartner's purchase, the partnership in its internal tax accounting for the liability would reduce the liability by the portion of the liability that has been disregarded, that is $400,000. As a result, the partnership's liability for tax purposes would be $8,600,000 ($9,000,000 less $400,000, the disregarded portion of the liability attributable to Newpartner's purchase of the partnership interest). Of that amount, Newpartner would be allocated $500,000 ($900,000 less the disregarded portion of $400,000). The historic partners would be unaffected by Newpartner's entry into the partnership

[121] *See* I.R.C. § 701; 1 WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 1.01[1] (3d ed. 1997).

[122] Reg. § 1.701-2(b)(1). But see Regulation section 1.701-2(e), which may be viewed as carving out from potential aggregate treatment transactions where entity treatment is prescribed and contemplated by the Code or regulations.

and the application of the *Estate of Franklin* doctrine to Newpartner. Their share of the partnership liability would remain $8,100,000 (ninety percent of $9,000,000).

Upon foreclosure of the property, the partnership would realize gain in the amount of $3,600,000, computed as follows: the amount realized equal to the nonrecourse indebtedness that has been satisfied by the transfer ($8,600,000) less the partnership's inside basis in the property ($5,000,000). Of that amount, the historic partners would be allocated gain equal to their aggregate minimum gain ($9,000,000 - $5,000,000 = $4,000,000; $4,000,000 x .90 = $3,600,000.) Newpartner's share of the gain would be computed as follows: amount realized of $500,000, representing the respected portion of the nonrecourse liability as to Newpartner, less Newpartner's outside basis, $500,000 = 0. Under this approach, Newpartner's taxable gain, zero, conforms to Newpartner's economic gain, also zero.

Although this aggregate approach permits a consistent treatment at the partner and partnership level, accomplishing this approach with or without a section 754 election in force and under the mechanics of partnership accounting is complicated and problematic at best. It requires, among other adjustments, a reduction of the partnership's and Newpartner's minimum gain without any chargeback.

In any event, the illogical or inconsistent result that Toth suggests obtains under current tax law should not obtain. Indeed, this result is precluded by overriding principles of the tax law, in general, and Subchapter K specifically, which dictate the interpretation of individual tax provisions. The statutory and common law principles that are applicable to the entry of Newpartner into the excess liability partnership are best interpreted and, indeed, can be easily interpreted without contorting the statute to accomplish the consistent result by reference to both the wording and the legislative intent of the relevant provisions. Moreover, the logic of Subchapter K requires that interpretation.

Professor Ernest Brown, in *The Growing "Common Law" of Taxation*,[123] explains the rationale of this analysis succinctly. In concluding that a taxpayer who received an automobile valued at $5000 as a bonus from his employer or as a lottery prize, obtained a basis of $5000 in the automobile, he states: "we should, I am sure, stretch the word cost almost out of recognizable shape to mean the amount at which the car was taken into income, and we should feel justified in doing so in order to give the statute the quality of rationality."[124]

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[123] Ernest Brown, *The Growing "Common Law" of Taxation*, 34 So. CAL. L. REV. 235 (1961).

[124] *Id.* at 239-40. The tax benefit rule, now partially codified in section 111, also provides a rule to accomplish a fair and rational result. Specifically, the tax benefit rule provides, in the exclusionary context, that when a previously deducted item is recovered subsequently, the recovery does not produce taxable income in the year of the recovery if the prior deduction produced no "tax benefit." The tax benefit rule was originally developed by the courts to prevent tax injustice resulting from the annual accounting period concept and, thereby, to accomplish a more accurate measurement of income. *See* Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370 (1982); United States v. Bliss Dairy, Inc., 460 U.S. 370, 374 n.2 (1983). See also Rowland W. Lassen, *The Tax Benefit Rule and Related Problems*, 20 TAXES 473 (1942), for an historical perspective.

The internal consistency of the Code is nowhere better exemplified than by the seminal case of *Philadelphia Park Amusement Co. v. United States.*[125] In *Philadelphia Park,* the court was asked to determine the basis of property received in a taxable exchange for other property. The basis of the received property was important because the taxpayer abandoned that property in a subsequent year and sought a loss deduction for the abandonment. Notwithstanding that basis is defined as "cost," the court held that the basis of property received in a taxable transaction is equal to its fair market value and not the fair market value of the property given in the transaction if that latter value differs from the value of the property received.

At first glance, this conclusion is counterintuitive; cost normally means what is given to acquire a property. However, because basis in the tax law provides the unifying function of determining and keeping track of the amount that a taxpayer may receive upon disposing of a property without incurring tax, that is, a measure of recovery of capital, its determination must be made with a view towards accomplishing that function. Any other rule that would fail to give the taxpayer basis credit for the amount already included in income with respect to the property would risk taxing that amount twice, an unfair result. It is virtually universally acknowledged in the tax law, as a result, that basis must be determined in order to avoid that result. This same rationale supports a basis of property received as compensation in kind equal to its fair market value when received. This figure is the amount with respect to the property that was included in the taxpayer's income as compensation which the taxpayer should be allowed to recover without incurring further tax.

Tax logic, then, requires that "basis," a term of art in the tax law, should be interpreted with the ultimate goal of ensuring that a taxpayer's economic gain should be accounted for as gain subject to tax, but that no more than the taxpayer's economic gain should be subject to tax. This rule of tax logic, of course, could be modified by a specific congressional provision altering it. However, absent specific provisions in the Code that would either forgive tax[126] or further a specific public policy by taxing a taxpayer on more than the taxpayer's economic gain,[127] the rule of tax logic should obtain.

Another example of a judicial decision accomplishing rationality for the tax law is *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952). In that case, a stockholder who paid off obligations of a liquidated corporation suffered a capital, not an ordinary, loss even though the payment was not in itself a sale or exchange of a capital asset. *See* Brown, *supra* note 123, at 236-37.

[125] 126 F. Supp. 184 (Ct. Cl. 1954).

[126] *E.g.*, section 1014, which allows the beneficiary of a decedent to inherit property with a basis equal to the property's fair market value (or alternate valuation date value), even though the decedent was never subject to tax on the appreciation that occurred during his or her life.

[127] *E.g.*, section 162(c), which denies a deduction for illegal payments and kickbacks, even though such payments are made in connection with the earning of income, and section 67(b), subjecting "miscellaneous itemized deductions" to a two percent floor so that those expenses, which are incurred to earn income, are only allowed to reduce taxable income to the extent they exceed two percent of a taxpayer's adjusted gross income.

The Supreme Court's analysis and result in *Tufts* are consistent with this tax logic and, indeed, are grounded in it. The regulations' treatment of liabilities that are excluded from basis when excess liability property is purchased and the exclusion of those liabilities from amount realized when such property is sold represents another example of adherence to tax logic.[128] Failure to follow a consistent treatment of a liability in dealing with excess liability property simply because the taxpayer's involvement is in the context of Subchapter K would violate that tax logic and would deprive the tax system of its quality of rationality. Inconsistent treatment should require explicit statutory authority. There is no such explicit provision or stated legislative intent to justify any inconsistency here, however. To the contrary, the *Tufts* case emphasizes the overriding importance of treating liabilities consistently in order to accomplish a rational result.

A possible objection to this analysis may arise because of the potential benefit available to Newpartner, who likely could obtain the tax shelter benefit of the partnership in the same manner as if he were a partner in a partnership that had newly purchased the property by means of a nonrecourse indebtedness in excess of the value of the property. Such a new entrant would then become entitled to the timing and character benefits available to tax shelter participants, which were discussed at the outset of this Article.

These benefits, however, are not likely to be as great or as useful as the benefits available during the zenith of tax shelters. Recovery periods are longer now, and the timing advantage would be subject to the passive activity loss rules of section 469, if applicable. Further, as the analysis that follows will demonstrate, the timing tax benefits that Newpartner could derive would be no greater than would be derived by the original partner who was entitled to them had he not sold to Newpartner. Moreover, Newpartner would be subject to the same tax detriments as would the selling partner have been had the selling partner not sold his partnership interest. Thus, any potential abuse by Newpartner would derive from the trade-off of future ordinary income tax deductions during the recovery period of the partnership's property (subject to the timing limitations under the passive activity loss rules) for capital gain treatment in that same amount at the time of disposition of the partnership interest (or sale or foreclosure of the property in the partnership).

From an overall tax revenue perspective, these benefits would be offset by the tax detriment to the seller. Capital gain would be recognized by Oldpartner at the time of sale of her partnership interest to Newpartner. Any resulting aggregate net benefit to the two as a result of the transaction would depend upon the trade-off of timing benefits and preferential rates. In any event, they are likely to be substantially less than the benefits available in the archetypical *Estate of Franklin* situation, in which the tax benefits to the purchaser were not likely to be offset by any immediate detriment to the seller, who would likely report the transaction under the installment method, thereby, deferring gain.

[128] *See supra* text accompanying notes 28-29.

Any potential abuse, however, theoretically can be eliminated without creating incongruity between a partner and partnership. This elimination can be accomplished by adopting the aggregate approach application of the *Estate of Franklin* doctrine. As discussed earlier, however, it is mechanically problematic and lacks support both under current case law (of which there is none) or case law in analogous situations when a section 754 election has not been made.[129] Moreover, section 7701(g) in the partnership context, discussed more fully in the material that follows, lends support to favoring an entity approach.

If an aggregate approach is either unsupportable or impractical, the potential for timing and character benefits could remain. But, the elimination of these potential benefits does not lie in rejecting the requirement of consistent treatment of partnership liabilities, which, as I have argued, are based on the conduit principles of Subchapter K and the rationality of the tax law. Rather, other corrections to timing imperfections should be explored, if the passive activity loss rules prove insufficient and the potential is considered sufficiently abusive. Accordingly, the remaining portion of this Article will focus on and support the entity theory for the application of the *Estate of Franklin* doctrine.

4. *Timing Considerations*

a. *Section 754 Election and Section 743(b) Adjustment.* It is likely that Newpartner, who purchased her partnership interest from Oldpartner, would obtain a timing advantage if the partnership had a section 754 election in effect. Such an election would make Newpartner eligible for a special basis with regard to any partnership property that had a fair market value at the time Newpartner purchased her partnership interest that exceeded its inside basis.[130] The basis adjustment would be limited to Newpartner's proportionate share of the appreciation.[131]

In general, the allocation of the special basis adjustment with respect to Newpartner among the properties of the partnership is governed by section 755. Under that section, partnership assets are grouped between (1) ordinary income assets and (2) capital assets and section 1231 property. Net appreciation attribut-

[129] There is one case in which a U.S. District Court imputed its own section 743(b) adjustment to the inside basis of a purchasing partner in the absence of a partnership section 754 election in order to accomplish "equity" for the partner. *See* Barnes v. United States, 253 F. Supp. 116 (S.D. Ill. 1966.) This case, however, is widely regarded as anomalous and inconsistent with the statute. *See* 2 William S. McKee et al., Federal Taxation of Partnerships and Partners ¶ 24.04[3] n.73 (3d ed. 1997); Stephen Lind et al., Fundamentals of Partnership Taxation: Cases and Materials 271 n.2 (1994). *See also* Rev. Rul. 89-108, 1989-2 C.B. 100 (applying a quasi-aggregate approach to an installment sale by a partnership whose assets consisted in part of inventory); Toth, *supra* note 3, at 58-60 (discussing other authorities). Indeed, Toth identified this approach as a possible administrative way out of the dilemma, but denied the likelihood that such an approach would be adopted, because the purchasing partner could not resort to "outside policy on which to base his claim for relief." Toth, *supra* note 3, at 58. The foregoing discussion in the text of *Philadelphia Park* and *Tufts* may supply the requisite policy basis.

[130] I.R.C. §§ 743(b), 755.

[131] I.R.C. § 755.

able to each group is then allocated among the appreciated assets in each respective group.[132] Assume that the only tangible asset of the partnership is the partnership's excess liability property. Arguably, under section 755 and the regulations under that section, Newpartner's special basis adjustment would cause the inside basis in the property to be no greater than her share of the property's value. Thus, it is possible that the adjustment may leave Newpartner's inside basis at exactly the amount of the common basis, with no appropriate adjustment. Such a result would ameliorate any abuse potential that might otherwise be available for Newpartner, who purchased a partnership interest in a partnership that had excess liability property.

Regulation section 1.755-2T coordinates section 755 with section 1060, a section in the Code that requires the selling partner and purchasing partner to allocate the purchase price, which includes the nonrecourse indebtedness, among the partnership's properties, in order to ensure consistent treatment of the transaction. That regulation provides for the allocation, under appropriate circumstances, of a portion of the purchase price to goodwill or going concern value, under a method referred to as the "residual method." Under the residual method, after the partner's special basis adjustment or any part thereof is allocated to the partnership's assets to bring the partner's inside basis up to her proportionate share of the value of those assets, the remaining amount will be allocated to goodwill or going concern value.[133]

Suppose, that the actual unencumbered value of the excess liability property is less than the purchase price deemed paid by Newpartner, namely, her share of the nonrecourse liability. A portion of the special basis adjustment equal to the excess of Newpartner's proportionate share of the actual value of the property over her proportionate share of the common basis in the property, if there is an

[132] Such an allocation method could yield a result different from allocating special basis among the assets so as to cause Newpartner's inside basis (including common basis and special adjustment) to be equal to Newpartner's share of the asset's value.

[133] First, the fair market value of each item of partnership property (other than property in the nature of goodwill or going concern value) shall be determined on the basis of all the facts and circumstances. Reg. § 1.755-2T(b)(1). Then, the fair market value of partnership property in the nature of goodwill or going concern value (referred to in this section as goodwill) shall be deemed to equal the amount (not below zero) which if assigned to such property would result in a liquidating distribution to the transferee partner equal to such partner's basis for the transferred partnership interest immediately after the transfer (reduced by the amount, if any, of such basis that is attributable to partnership liabilities) if—

> (i) all partnership property were sold immediately after such transfer for an amount equal to the fair market value of such property (as determined under this section), and
>
> (ii) the proceeds of that sale were, after the payment of all partnership liabilities (within the meaning of section 752 and the regulations thereunder), distributed to the partners. Reg. § 1.755-2T(b)(2).

As McKee points out, the regulations under section 1060 take the position that the residual method of valuing goodwill for purposes of section 755 applies to basis adjustments under section 743(b) if assets of the partnership constitute a trade or business for purposes of section 1060(c). *See* McKEE, *supra* note 129, at ¶ 24.04[4]; Temp. Reg. § 1.1060-2T(a)(2).

excess, would constitute a special basis adjustment with regard to the property. The remaining amount of any available basis adjustment would then be allocated to goodwill. Note that goodwill is now depreciable over fifteen years.[134]

Temporary Regulation section 1.755-2T(e) provides an example of the application of the residual method. Adapting this example, if Newpartner purchased for a nominal amount a ten percent interest in a partnership that owned property with a value and basis of $5,000,000, and subject to a liability of $9,000,000, the partnership's goodwill would be valued at $4,000,000 and Newpartner would be entitled to a special basis adjustment of $400,000, allocable to the goodwill.

The application of section 7701(g) to this example would yield a different, more sensible and potentially less abusive result. Section 7701(g) would require the value of the property to be regarded as no less than the nonrecourse indebtedness secured by the property. That is because the hypothetical sale of the property could be for no less than $9,000,000. As a result, by valuing the property at $9,000,000, no amount would be allocated to Newpartner's share of goodwill. Rather, Newpartner's entire special basis adjustment of $400,000 (assuming that the partnership's property has a common basis of $5,000,000) would be allocated to the property.

Thus, it is likely that section 7701(g), which, in short, provides that the fair market value of property is to be treated as being not less than the amount of any nonrecourse indebtedness to which its property is subject, would govern the allocation of the special basis adjustment. This rule is reasonable because, under all situations, the sale or other disposition of the property would relieve the partnership of its obligation under the nonrecourse indebtedness. The amount of the nonrecourse indebtedness, in effect, puts a lower limit on the value of the property as far as the partnership is concerned. Its application would support a special basis adjustment beyond the actual fair market value of the property and up to the amount of the nonrecourse indebtedness. Such a special basis adjustment could yield depreciation deductions to Newpartner in an amount greater than the amount that was available to Oldpartner, whose depreciation deductions would generally be governed by the partnership's common basis.

The extra depreciation deductions in the aggregate, however, would be no greater than the gain already realized by Oldpartner upon his sale of his partnership interest, although the character of Newpartner's deductions would offset ordinary income instead of the capital gain that Oldpartner likely realized. Further, the installment sale rules would not serve to postpone Oldpartner's gain because Oldpartner's share of the partnership's liabilities would be includable in amount realized in the year of disposition.[135]

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[134] I.R.C. § 197.

[135] I.R.C. § 752(d). *See* section 453(b)(1) (defining "installment sale" for purposes of qualifying the sale for the installment method under section 453(a) and requiring at least one payment to be received after the close of the taxable year of the sale). *See also* Reg. § 15A.453-1(b)(3) (including in the computation of payment received in the taxable year, the amount of qualifying indebtedness assumed or taken subject to the extent such indebtedness exceeds the seller's basis in the property); Reg. §§ 15A.453-1(b)(2)(iii) and -1(b)(2)(v) (defining "Contract Price" and "Gross Profit" and assuring that the excess will be includable as gain in the year of disposition).

It should be noted that any benefit derived by Newpartner by virtue of section 7701(g) under this interpretation would be in the nature of a timing and character benefit. Specifically, Newpartner's benefit is a matter of timing and potentially character because deductions resulting from a special inside basis adjustment would reduce Newpartner's outside basis and, therefore, increase any potential gain. Recall that adjustments inside the partnership affect timing and character. Absolute gain or loss is determined by outside basis.

b. *Revaluations of Property.* Suppose Newpartner enters the partnership as a ten percent partner (with a ten percent interest in profits, losses, and distributions) by making a small capital contribution to the partnership at a time when the partnership's property has a basis and value of $5,000,000, subject to a nonrecourse liability of $9,000,000. The entry of Newpartner permits a revaluation of partnership property[136] and, through application of the principles of section 704(c), causes a shift in the allocation of depreciation deductions to Newpartner, to the possible disadvantage of the existing partners, as described below.

In general, the regulations dealing with "revaluations of property" prescribe that upon the occurrence of an appropriate event, capital accounts must be adjusted and that compliance with the regulation requires that the adjustments are based on fair market value of partnership property (taking section 7701(g) into account) on the date of adjustment.[137] Thus, revaluations of property or "book-ups" deem the fair market value of excess liability property to be not less than the amount of the nonrecourse indebtedness. A revaluation of partnership property is appropriate in situations when a new partner enters the partnership or a distribution is made by the partnership to a partner. It is not appropriate when one partner simply purchases the interest of another partner, even if a section 754 election is in effect for the partnership.

Regulation section 1.704-1(b)(2)(iv)(g) allocates depreciation deductions to Newpartner based upon the new book value of the revalued property of the partnership. Thus, Newpartner would be allocated 1/10 of the depreciation computed on a basis of $9,000,000 (subject to the ceiling rule), with the original continuing partners being entitled to the remaining depreciation. Thus, under the regulations issued under section 704(c), a revaluation could affect the allocation of depreciation deductions between a new entering partner and the continuing partners. Any deductions allocated to Newpartner reduce the deductions allocated to the other partners. This result would follow, regardless of whether Newpartner was permitted to include any of the partnership's liability in outside

[136] Reg. § 1.704-1(b)(2)(iv)(f). The example in the text assumes that Newpartner's deemed contribution under section 752(a) is regarded as more than de minimis and principally for a substantial non-tax business purpose.

[137] Reg. § 1.704-1(b)(2)(iv)(f)(1). While the enactment of section 7701(g) post-dates the inside basis provisions of sections 734(b) and 743(b) and the respective regulations issued under those sections, it pre-dates the regulations issued under section 704(b) dealing with "revaluations of property," which deal with similar issues.

basis. However, if Newpartner were precluded from including any partnership liabilities in basis, Newpartner would not be permitted to use the deductions because they would be suspended under section 704(d) due to the absence of outside basis. This result would be unfair and inappropriate for the partners, because it would effectively reduce the aggregate deductions currently available to the partners.

c. *Capital Accounts and Minimum Gain.* Upon purchasing Oldpartner's interest, Newpartner succeeds to Oldpartner's capital account and share of partnership minimum gain. In general, all of the disadvantageous consequences of subsequent foreclosure or cancellation of indebtedness income at the partnership level would pass through to Newpartner just as it would have to Oldpartner. If, however, Newpartner realized ordinary income in the situation of cancellation of indebtedness income or capital gain in the situation of foreclosure or deed in lieu of foreclosure (absent a section 754 election), Newpartner would have an offsetting loss that would arise by virtue of the upward adjustment in outside basis for the distributive share of income or gain from the transaction. As such, Newpartner would have a resulting capital loss upon liquidation of the partnership, which would follow, if not immediately, then eventually. Newpartner may be disadvantaged with regard to timing and character, in that Newpartner may have ordinary income with only an offsetting long-term capital loss, even though the absolute amounts of income and loss would be equivalent.[138]

It is important to note, however, that these disadvantageous consequences incurred when Newpartner inherits Oldpartner's capital account are unaffected by whether Newpartner is entitled to outside basis by virtue of the partnership's excess liability. These consequences may be offset, in whole or in part, under section 743(b), if applicable, by extra depreciation deductions to which Newpartner is entitled by virtue of the special basis or offset to Newpartner's distributive share of capital gain.

IV. CONCLUSION

The potential abuses inherent in excess liability property have been dealt with in the *Estate of Franklin* doctrine and courts that have followed that doctrine. Courts have applied the doctrine to the purchase of property. If the doctrine is not applicable to a situation at that time, then the nonrecourse debt should be regarded as true indebtedness for the duration of the taxpayer's ownership of the property. Modification of the nonrecourse liability should not alter this result, and Regulation section 1.1001-3 should not be interpreted to cause that to happen.

[138] Characterizing items at the partnership level, as discussed above, is similar to other partnership level characterizations. For example, if Newpartner were to purchase a partnership interest a day before the partnership realizes a long-term capital gain, Newpartner would nevertheless treat the distributive share of that capital gain as long-term, even though Newpartner's own holding period in the partnership was short-term. *See* Rev. Rul. 68-70, 1968-1 C.B. 310.

Further, application of the *Estate of Franklin* doctrine proscribes tax shelter abuse. It does not, and indeed should not, however, prescribe punishment by imposing a tax on an amount that exceeds a taxpayer's economic income. Both the courts and the Treasury have acknowledged this in the past and should continue to do so. Analysis of a transaction under the provisions of Subchapter K should not change this result.

Also, no transactions among the partners should have the effect of creating an extra level of tax that would not have existed in the absence of the interposition of a partnership. The statutory provisions, case law, and Treasury regulations can all be interpreted to accomplish this internally consistent result.

Moreover, even when a statute lends itself to an interpretation that might result in an under-counting of taxable income or over-counting of taxable income, as measured against economic income, the courts have taken pains to explicitly disregard that interpretation to adhere to the basic logic of the income tax system and the need for internal consistency of that system. I believe that the courts have chosen this path wisely, because the clear guiding principle of the income tax system, namely to tax economic income, should not be subverted by the imprecision inherent in using language to carry out that principle. When there has been a potential inconsistency, landmark cases such as *Tufts* and *Philadelphia Park* have required a statutory interpretation to be consistent with the guiding principle. In a situation when no court has yet spoken, such as the confluence of the *Estate of Franklin* doctrine with Subchapter K, courts and the Service should follow the unifying guiding principle of the tax law and interpret more narrowly drafted statutory provisions in a manner that is consistent with that principle. Such a course of action is followed when the *Estate of Franklin* doctrine is applied at the partnership rather than the partner level.