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Crane and Tufts in Reverse: The Fair Market Value Firewall

Rodney P. Mock*

ABSTRACT

This article examines the appropriate tax treatment of property (subject to nonrecourse debt in excess of its fair market value) in the corporate context. The article reviews the Supreme Court cases of Crane and Tufts and their subsequent statutory and regulatory influence on over-leveraged contributions and distributions. Academics and other commentators contend the cost basis in certain transactions of such property could be anything from zero to the fair market value of the property, or equal to the amount of encumbering debt. In the corporate arena, academics argue the fair market value basis limits under Internal Revenue Code §§ 301(d) and 334(a) to the distributee shareholder of such property produces illogical and inconsistent results at both the shareholder and entity levels. At the entity level, § 362(d)(1) also limits a transferee corporation’s basis in such property to its fair market value. This article discusses the “functional relationship” between basis and amount realized in light of excess debt property contributions and distributions. The article concludes with a finding that Crane and Tufts’ desired symmetry is preserved under such circumstances producing consistent economic results for both the corporation and the shareholders.

I. INTRODUCTION

There is a darker side to the U.S. Supreme Court cases of Crane v. Commissioner and Commissioner v. Tufts where very little legal guidance exists, leaving academics with no intellectual reprieve. The question never squarely addressed in either case, as it was on the reverse side of the transaction (i.e., the buyer’s side versus the seller’s side), was: what exactly is a taxpayer’s “basis” when property is purchased (or transferred) and the property is subject to nonrecourse debt in excess of the property’s fair market value (‘excess debt prop-

* Rodney P. Mock, J.D. LL.M., California Polytechnic State University, Assistant Professor, Business Building (03), Office No. 03-424, Telephone No. (805) 756-2730, Email: rmock@calpoly.edu.
Academics have theorized three possible purchaser basis outcomes for excess debt property: (1) zero, (2) the fair market value of the property, or (3) the entire amount of debt encumbering the property. The issue of excess debt property and its appropriate basis has been extensively debated in the partnership context. It has also been analyzed outside of the entity context, in various purchase transactions. This Article will discuss the proper basis of such property in the corporate context. The Article will elaborate on excess debt property implications after Crane and Tufts, following their logic through various Subchapter C contributions and distributions. It will also focus particular attention on the basis of such property to a transferee corporation and distributee shareholder under §§ 362(d)(1), 301(d) and 334(a) of the Internal Revenue Code of 1986, as amended (the “Code”). This article does not discuss corporate distributions of excess debt property subject to recourse debt, which arguably constitutes a capital contribution in the amount of the excess debt assumed by the shareholder. Furthermore, it is difficult to conceive of any situation where a shareholder or corporation would willingly suffer economically by assuming recourse debt in excess of the secured property’s fair market value in light of the basis limitations described herein. Whereas, with nonrecourse debt, because only the lender is

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2. The United States Supreme Court in Crane discussed nonrecourse debt that was “less than” the property's fair market value, and in Tufts, the Court never discussed the basis of the purchaser of the property, which was valued at less than the nonrecourse debt that it was subject to.

3. Erik M. Jensen, The Unanswered Question in Tufts: What Was the Purchaser’s Basis?, 10 VA. TAX REV. 455, 483-84 (1991) (“Bayles acquired the Tufts property in a fully taxable transaction, and his basis in the property was therefore his cost. Cost is not a self-defining concept, however, and it is applied in different ways in different contexts. Putting aside the effect of the small amount of cash paid, everyone assumes the controlling figure for Bayles should have been one of three numbers: $1.85 million (reflecting the entire amount of the liability); zero (treating the obligation as no liability at all with respect to Bayles); or $1.4 million (limiting the basis to the fair market value of the unencumbered property). Each figure has some arguments in its favor, and each set of arguments is presented in turn.”).


6. Charlotte Crane, Toward a Theory of the Corporate Tax Base: The Effect of a Corporate Distribution of Encumbered Property to Shareholders, 44 TAX L. REV. 113, 144 (1988) (“The amendments produce inappropriate results where recourse liabilities exceed the fair market value of the property to which they relate. Current § 336(b) ignores the fact that the shareholder could have provided the same benefit to the corporation through a contribution to capital. When a shareholder assumes liabilities exceeding the fair market value of the property, the excess should not produce corporate gain.”).
liable for the debt, receiving excess debt property subject to such debt is theoretically plausible.

The language of §§ 362(d)(1), 301(d), and 334(a) create what the author calls a "fair market value firewall," or absolute limit, to a transferee’s basis in such property, notwithstanding the excess debt assumed. Some academics argue a fair market value limit to basis produces inconsistent and illogical results at both the corporate and shareholder levels. In furtherance of this discussion, this article will review the origins of inclusion of nonrecourse debt in a taxpayer’s “basis” and the “amount realized.” The article will hypothesize the basis of such property as being one of the three possibilities mentioned above. At its conclusion, the author contends the fair market value limits are entirely consistent with the symmetrical or functional relationship between basis and amount realized as discussed in Crane and Tufts. The relationship is preserved as a direct consequence of the treasury regulations. Before discussing the fair market value firewall to basis, however, a review of the landmark cases of Crane and Tufts is warranted.

II. The Birth of Nonrecourse Debt Basis

In the vast majority of taxpayer transactions, the beginning point for any basis analysis is a taxpayer’s unadjusted “cost basis” under § 1012. Naturally, there are several exceptions to cost basis for property acquired by inheritance, gift, in nonrecognition transactions, etc., but this topic is left untouched for a future discussion. A taxpayer’s basis (regardless of how acquired) is then adjusted upward or downward under § 1016 to account for depreciation deductions, capital expenditures, etc. The concept of a taxpayer receiving a cost basis when purchasing property is commonly understood, even among non-

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7. I.R.C. § 301(d) (2006) (“The basis of property received in a distribution to which subsection (a) applies shall be the fair market value of such property.”); § 334(a) (“If property is received in a distribution in complete liquidation, and if gain or loss is recognized on receipt of such property, then the basis of the property in the hands of the distributee shall be the fair market value of such property at the time of the distribution.”); § 362(d)(1) (“In no event shall the basis of any property be increased under subsection (a) or (b) above the fair market value of such property (determined without regard to section 7701(g)) by reason of any gain recognized to the transferor as a result of the assumption of a liability.”).


9. I.R.C. § 1012(a) (“The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses).”)

tax professionals, as the rationale has been around for some time now—long before the case of *Crane*, which memorialized the fundamental tax principle of debt basis. The *Crane* case involved a taxpayer’s basis in inherited property, and its primary holding of including debt in basis was later extended to purchase money debt transactions. *Crane* debt basis concepts can now also be found in certain statutory sections involving various corporate transactions. Under the present law, cost basis principles apply regardless of whether or not a purchaser pays with cash, borrows the funds to acquire the property, “assumes” debt in connection with the acquisition of property, or takes property “subject to” debt. Put another way, it is now generally understood that debt is to be included in cost basis, regardless of whether it is “recourse” or “nonrecourse.”

Prior to the *Crane* case, the law concerning debt basis was not as clear, particularly with regard to property acquired encumbered by “nonrecourse” debt. The legal issue was whether taxpayers should receive a tax benefit of basis “credit” for debt they were not economically at risk for. Additional basis for nonrecourse debt is, of course, a good thing for a taxpayer, as less gain (or more loss) is recognized upon disposition of the subject asset, and depreciation deductions on depreciable property will be greater as a consequence of the higher basis (assuming the at-risk and passive activity rules do not apply).

13. See infra notes 115-254 and accompanying text.
14. Recourse debt exists where the obligor remains personally liable for the debt. Whereas, nonrecourse debt is debt in which the creditor’s only recourse is against the collateral secured by the debt, if any. Lenders in real estate transactions will typically lend on a nonrecourse basis because of the appreciating nature of the asset. When dealing with partnership liabilities, the regulations specifically provide definitions of recourse and nonrecourse liability in Treas. Reg. § 1.752-1 (2005).
15. Because the lender of nonrecourse debt has no “recourse,” except against the collateral secured thereby, a purchaser generally never “assumes” nonrecourse debt, at least with respect to any economic risk of loss. A purchaser may assume or take over the payments and the obligation to remit net rentals from the asset to the lender, but a purchaser is not going to assume any personal exposure, and a seller would have no incentive to entice a purchaser to do so. The property is, therefore, taken “subject to” the nonrecourse debt.
16. In the recourse context, the buyer typically “assumes” debt the seller is personally liable for and, therefore, such is identical to purchasing with cash, as the seller is being relieved of a personal obligation as a result of the assumption.
17. See I.R.C. §§ 465, 469 (2006). The “at-risk” rules in § 465 limit a taxpayer’s ability to use nonrecourse debt to generate allowable losses, except for in certain qualified real estate financing arrangements. This is because the taxpayer is not at-risk in the activity to the extent it is financed by nonrecourse debt. The “passive activity” rules contained in § 469 limit a taxpayer’s ability to claim passive losses which can only be deducted against “passive income.” A passive activity is any trade or business in which the taxpayer does not materially participate. Limited partners in limited partnerships almost always fail the material participation test. There are
As discussed in greater detail below, \textit{Crane} held that nonrecourse debt should be included in a taxpayer's basis.\footnote{18} As a direct result of \textit{Crane}, nonrecourse debt is now generally understood to be part of a purchaser's cost basis.\footnote{19} For estate tax purposes, nonrecourse debt may also be part of a beneficiary's stepped-up (or down) basis under § 1014, in that the date of death (or alternative valuation date) "fair market value" basis is unreduced by any debt the devised or bequeathed property may be subject to.\footnote{20} The same holds true for property acquired by gift under § 1015.\footnote{21} A donee takes a "carryover" basis equal to that of the donor, again undiminished by any debt encumbering the property. The logic of \textit{Crane} debt basis is also evidenced in Subchapter C when contributions are made to a corporation by its shareholders, and when a corporation distributes its property to shareholders. In each scenario, the transferee corporation or shareholder takes a fair market value basis in the assets received, again unreduced by any subject mortgages.\footnote{22}

The Supreme Court decided the \textit{Crane} case in 1947, and it involved the Revenue Act of 1938.\footnote{23} The taxpayer in the case was Beulah Crane, an elderly woman who inherited an apartment building and land from her late husband, which was subject to debt in the amount of $262,042, of which $7,042 was interest in default.\footnote{24} The court records were not clear on whether or not the debt was recourse to Mr. Crane, but the Commissioner and Mrs. Crane both agreed the debt was "nonrecourse" as it applied to her.\footnote{25} On the date of her husband's death, the property had a fair market value exactly equal to the

\begin{thebibliography}{9}
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\item 18. The Court also held that such debt is included in the taxpayer's amount realized, which is discussed later in this article.
\item 19. I.R.C. § 1012.
\item 20. I.R.C. § 1014(a).
\item 21. I.R.C. § 1015(a).
\item 22. A general definition of "fair market value" cannot be found in the I.R.C. for income tax, estate, and gift tax purposes, although courts have adopted the definition contained in the treasury regulations, which state, "[t]he fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Treas. Reg. §§ 1.170A-1(c)(2) (as amended in 2005); 1.412(c)(2)-1(c)(1) (1993); 1.1445-1(g)(7) (as amended in 2003).
\item 23. See \textit{Crane} v. Comm'r, 331 U.S. 1, 4 (1947).
\item 24. \textit{Id.} at 3 ("Petitioner was the sole beneficiary and the executrix of the will of her husband, who died January 11, 1932. He then owned an apartment building and lot subject to a mortgage, which secured a principal debt of $255,000.00 and interest in default of $7,042.50. As of that date, the property was appraised for federal estate tax purposes at a value exactly equal to the total amount of this encumbrance.").
\item 25. \textit{Id.}
\end{thebibliography}
amount of debt encumbering it. The parties did not dispute the property’s appraised value or the outstanding loan amount. After inheriting the property, Mrs. Crane continued to operate the apartment building for nearly seven years, during which time she remitted the net rentals to the mortgagor, and, for tax purposes, she reported gross rentals as income and deducted real property taxes, operating expenses, interest paid on the mortgage, and depreciation for the physical exhaustion of the building. During her brief period of ownership, the arrearage of interest on the mortgage grew to $15,857. This presumably was because the country was in a great depression and the net rent was insufficient. Eventually, the mortgagor threatened her with foreclosure. To avoid foreclosure, Mrs. Crane sold the property to a third party for $3,000 cash, subject to the non-recourse mortgage (principal and accrued interest). To facilitate the sale, Mrs. Crane paid $500 to cover various sale-related expenses. After the disposition, she reported taxable gain in the amount of $1,250 on her tax return. Her stance was that for the purposes of determining her inherited basis in the apartment building and the land, the fair market value of such property at the time of her husband’s death, and the term “property” in the statute (i.e., the Revenue Act of 1938) referred only to her “equity” interest, and therefore her inherited basis was zero. Applying the same rationale to her “amount realized,” she concluded it was $2,500 (i.e., the net-cash received), resulting in $2,500 of realized capital gain (i.e., $2,500 − $0), of which, only $1,250 was recognized under the then-existing capital gain rules. Her tenuous tax position naturally was entirely inconsistent with her previously claimed depreciation deductions totaling

26. Id.
27. Id. at 5 n.4 (“The parties stipulated as to the relative parts of the 1932 appraised value and of the 1938 sales price, which were allocable to land and building.”).
28. Crane, 331 U.S. at 3.
29. Id.
30. Id.
31. Id.
32. Id.
33. Id.
34. Id. at 3-4 (“Petitioner reported a taxable gain of $1,250.00. Her theory was that the ‘property’ which she had acquired in 1932 and sold in 1938 was only the equity, or the excess in the value of the apartment building and lot over the amount of the mortgage. This equity was of zero value when she acquired it. No depreciation could be taken on a zero value. Neither she nor her vendee ever assumed the mortgage, so, when she sold the equity, the amount she realized on the sale was the net cash received, or $2,500.00. This sum less the zero basis constituted her gain, of which she reported half as taxable on the assumption that the entire property was a ‘capital asset.’”).
35. Id.
$28,045 against the illusive building basis. The depreciation deductions were premised on the notion that she inherited property with a basis above zero.

The Commissioner disagreed with Mrs. Crane, stating her inherited basis in the property was its fair market value at the date of her husband's death, undiminished by the mortgage, and as a consequence, Mrs. Crane recognized $23,767 of gain on the sale of the building. The Commissioner was not exactly a "big fan" of Mrs. Crane's theory that the term "property" for the purposes of determining basis referred only to her equity in the asset, rather the Commissioner contended the term "property" referred to the physical property itself, not its mere equity. The U.S. Tax Court, on the other hand, agreed with Mrs. Crane's imaginative definition, and thus, her initial basis was zero. The Commissioner appealed to the Court of Appeals for the Second Circuit, and the Court of Appeals reversed the lower court's decision in favor of the Commissioner. The case then proceeded up to the U.S. Supreme Court to resolve the issue.

The Supreme Court held that the plain meaning of "property" meant a "physical thing" that is subject to ownership and not mere equity as suggested by Mrs. Crane. The Court stated that if Con-
gress intended to convey the meaning of "equity," it would have done so with appropriate statutory language.\textsuperscript{43} In addition, if basis only represented a property's equity, it would have a direct negative impact on depreciation calculations, as the annual deductions computed under such a theory would only represent a fraction of a depreciable property's true physical exhaustion.\textsuperscript{44} The Court concluded that Mrs. Crane's inherited basis in the building and the land was the full value of the property, unreduced by any mortgages.\textsuperscript{45}

III. The Crane Court's Economic Benefit Entanglement

Although the debt was nonrecourse, and the purchaser neither paid-off the debt, nor expressly assumed it, the fact that the property was taken "subject to" the debt was sufficient to require its inclusion in Mrs. Crane's amount realized.\textsuperscript{46} Making the same argument, Mrs. Crane unsuccessfully asserted again that the only property she sold was her equity interest, and thus, the nonrecourse debt should not be included in her amount realized.\textsuperscript{47} The Court disagreed. The Court initially rested its holding on the "functional relationship" between the taxpayer's basis and amount realized, reasoning that because "property" includes debt in Mrs. Crane's tax basis, symmetrical treatment warrants similar treatment for her amount realized.\textsuperscript{48}

The Court stated, "The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain. We have already showed that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets."\textsuperscript{49} The Court's loose "double deduction" language generated some confusion later on for lower courts attempting to wrestle with Crane's peculiar phraseology, as the real issue at hand was not necessarily

\begin{itemize}
\item \textsuperscript{43} Crane, 331 U.S. at 8.
\item \textsuperscript{44} Id. at 9-10.
\item \textsuperscript{45} Id. at 11 ("We conclude that the proper basis under § 113(a)(5) is the value of the property, undiminished by mortgages thereon, and that the correct basis here was $262,042.50.").
\item \textsuperscript{46} Id. at 14 ("[W]e think that a mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and for additional consideration, realizes a benefit in the amount of the mortgage as well as the boot.").
\item \textsuperscript{47} Id. at 13 ("She argues, conversely, that because only $2,500.00 was realized on the sale, the 'property' sold must have been the equity only, and that consequently we are forced to accept her contention as to the meaning of 'property' in § 113. We adhere, however, to what we have already said on the meaning of 'property,' and we find that the absurdity is avoided by our conclusion that the amount of the mortgage is properly included in the 'amount realized' on the sale.").
\item \textsuperscript{48} Crane, 331 U.S. at 12 ("[T]he functional relation of the two sections requires that the word mean the same in one section that it does in the other.").
\item \textsuperscript{49} Id. at 15-16.
\end{itemize}
about Mrs. Crane being able to deduct losses twice. The ability to exclude subsequent gain is also not conceptually identical to deducting a tax loss twice, even though both may result in a reduction in income. The Court's double deduction language in this regard did not attack the core issue. The real issue was that Mrs. Crane was permitted to receive income "tax-free" when she received her debt basis, and symmetry demands the nonrecourse debt also be included in her amount realized upon a subsequent disposition or sale. Otherwise, her previous tax-free receipt of income would forever escape taxation. In other words, Mrs. Crane took depreciation deductions against her income, deductions generated by her debt basis. Without such a reconciling event, she would have received the income she took deductions against tax-free. Furthermore, if her depreciation deductions were not "recaptured" by including the nonrecourse debt in the amount realized, then she would be permitted to deduct losses she did not "economically" sustain.

To illustrate, assume a building has a date of death value of $100x and nonrecourse debt encumbering it of $100x. Further assume Mrs. Crane inherits the property and pays interest only on the mortgage. She also claims tax depreciation deductions in the amount of $40x. She then sells the property at a time when its fair market value is $110x. The buyer pays nothing more than $10x cash and takes the property subject to the nonrecourse debt. Under Mrs. Crane's theory, her "amount realized" would be $10x, representing the cash received for the "equity" in the property. As a result, she would recognize a tax loss of $50x (i.e., $10x - $60x). This does not make any sense economically, however, as she is not "losing" anything – the lender is. The application of such a theory would permit her to fully utilize the debt basis she acquired tax-free against $100x of her income (i.e., $40x in depreciation, $10x offsetting the $10x of recognized gain, and a

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50. Laura E. Cunningham & Noel B. Cunningham, The Story of Tufts: The "Logic" of Taxing Nonrecourse Transactions, in BUSINESS TAX STORIES 239, 245 (Steven A. Bank & Kirk J. Stark eds., 2005) ("[T]he problem in Crane was not that Mrs. Crane would be permitted to deduct losses twice, it was that inclusion of the liability in basis amounts to tax free receipt of income, and when that liability is extinguished, the income must be accounted for, or forever escape taxation. A contrary result would allow deduction by her of losses she did not economically suffer. While the Crane court seemed to grasp that notion, by cloaking the problem in terms of a 'double deduction' the essential point was muddied, and as we shall see, created confusion for later courts.").

51. Id.

52. Id.

53. For the sake of simplicity, I am excluding the land from the analysis, as land is not depreciable apart from improvements or physical developments added to it. See Treas. Reg. § 1.167(a)-2 (1960).
Income that, but for the tax-free debt basis, she would have paid taxes on. Under the Court's theory, however, the entire nonrecourse debt would be included in her amount realized, and she would recognize \$50x in gain (i.e., \$110x - \$60x). Her gain recognized and realized thereby fully offsets the \$40x in depreciation previously claimed, and her newfound \$10x of cash.

When the *Crane* court inelegantly used the phrase "double deduction," one envisions claiming depreciation deductions on an asset and also a loss on its subsequent sale. A loss on the sale or exchange of any asset occurs when a taxpayer's basis is in excess of the amount realized. It is the amount of basis in excess of the amount realized that is taken as a tax loss (assuming no loss limitations apply). As discussed below, this is not always the case, however, for some taxpayers. The Court's "double deduction" language may also have meant the taxpayer was permitted to take depreciation deductions during the life of the asset, and then offset any gain on its disposition with remaining debt basis. This interpretation, as illustrated below, is also strained.

Assume Mrs. Crane instead claimed \$90x of depreciation on the building before its sale, with the property still having nonrecourse debt of \$100x and a fair market value of \$110x. Under Mrs. Crane's "equity only" theory, again, her amount realized would be \$10x. This time, however, she would have no gain or loss from the transaction, as her \$10x basis remaining would exactly offset the amount realized (i.e., \$10x - \$10x). Notice that the Court's concept of claiming a "double loss" does not exist here. A loss is only taken at a sale if basis is in excess of the amount realized. Mrs. Crane's theory nevertheless would allow her to fully utilize her tax-free debt basis against \$100x of her income without the necessity of a loss at the sale (i.e., \$90x via depreciation deductions and \$10x against the cash received). Under the Court's theory, Mrs. Crane's amount realized would again be \$110x and her realized and recognized gain would be \$100x (i.e., \$110x - \$10x), thus fully recapturing the \$90x of depreciation deductions previously taken and taxing her on the receipt of \$10x in cash.

If the above property were fully depreciated under Mrs. Crane's interpretation, she would recognize \$10x of gain (i.e., \$10x - \$0x). Even so, the taxpayer would still not be claiming losses twice. Under this scenario, although the taxpayer was permitted to take depreciation deductions, she has no remaining debt basis to offset any subsequent gain. Under these circumstances, she would have received \$100x of tax-free debt basis that offset \$100x of her actual income in the form of depreciation deductions. Under the Court's approach, her
amount realized would be $110x resulting in $110x of income (i.e., $110x – $0x). Notice how the Court’s approach properly accounts for all of the depreciation previously claimed and the cash received.

The above examples illustrate that when Mrs. Crane received the $100x of nonrecourse debt tax-free and was permitted to include that debt in her basis, the “functional relationship” between basis and amount realized warranted symmetrical treatment between the two. No one would doubt that if rather than acquiring the property subject to the nonrecourse debt, the purchaser had simply paid Mrs. Crane cash directly to pay off the debt, then the cash received would be included in her amount realized. The conceptual difficulty encountered with including nonrecourse debt in Mrs. Crane’s amount realized resides in the fact that her “debt relief” at the sale is not the same as liability relief in the recourse context, where debt relief is the functional equivalent of receiving cash. In other words, a purchaser’s assumption of recourse debt is the same as the seller receiving cash outright. When a seller is personally liable for debt and the recourse debt is forgiven by a lender, this triggers discharge of indebtedness income. This is also very similar to receiving cash directly. On the other hand, when a purchaser acquires property subject to nonrecourse debt (or a lender forecloses on the property), the original owner is not exactly being “relieved” of anything, as the original owner was not personally liable or economically at risk for the obligation in the first place – unlike recourse debt, where debt relief is identical to receiving cash if the debt is assumed in a sale (or forgiven by the lender). If property is foreclosed upon, and the lender later forgives recourse debt, this also triggers discharge of indebtedness income, as the taxpayer was permitted to receive the loan proceeds and Crane debt basis tax-free.

Now, if a lender “loaned” a taxpayer $100x cash, pursuant to a nonrecourse promissory note securing no collateral, the “loan” is characterized as a “gift” or taxable income (most likely a gift). A lender, however, would never engage in such a spectacular transaction, as nonrecourse debt logically must be secured by collateral, otherwise the lender is giving away “free money.” The tax-free receipt of income in the nonrecourse scenario will thus always be evidenced in the tax basis of the secured collateral – usually real estate. Receiving a tax basis in many respects is substantially similar to receiving the proceeds directly, because once a taxpayer has tax basis, the taxpayer may depreciate its depreciable collateral, generating depreciation deductions. As set forth in the examples above, if the asset is sold later at a loss (regardless of whether the asset was depreciable), per Mrs.
Crane's theory, the taxpayer may then also enjoy a loss deduction. These deductions, whether depreciation or loss deductions, would be claimed against the taxpayer's income, reducing it accordingly. As a result, the taxpayer is indirectly receiving the reduced income "tax-free." 54 Although the path of analysis is slightly attenuated, it is just a matter of stepping over to the vantage point on the other side of the fence to see the taxpayer's tax-free receipt of income. It would be another story if a taxpayer had no offsetting income to fully utilize the deductions and losses. Nevertheless, conceptually, it is the tax-free receipt of income that justifies symmetrical inclusion of nonrecourse debt in a seller's amount realized.

Notwithstanding this intrinsic symmetrical relationship, the Crane court in the middle of its majority opinion abruptly resigned its functional relationship line of reasoning. As if attempting to catch a butterfly with intellect, the Court chased after a completely new theory, focusing on Mrs. Crane's "economic benefit" received when she was relieved of the nonrecourse debt. In its analysis, the Court analogized nonrecourse debt to recourse debt, stating that in certain circumstances they should be treated as the same. 55 According to the Crane court, an owner of mortgaged property will treat nonrecourse debt exactly like recourse debt if the property's fair market value is greater than the debt. 56 In other words, in holding that nonrecourse debt should be included in the seller's amount realized, the court centered on the fact that if a seller has an "equity interest" in the property sold (subject to the nonrecourse debt), the seller presumably would treat the nonrecourse debt just like any other debt (i.e., recourse debt). 57

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54. Tax deductions are not "dollar-for-dollar," like certain credits are, as deductions merely reduce a taxpayer's taxable income, which is subject to a marginal tax rate. Notwithstanding this idea, a taxpayer can economically receive an identical amount of income "tax-free" to the extent of the loan proceeds. For example, assume an asset has a fair market value of $100x and is subject to nonrecourse debt in the amount of $100x. Further assume the asset's basis is depreciated to zero and the taxpayer received $100x of depreciation deductions. The taxpayer was permitted to offset her other taxable income by $100x, which is identical to the taxpayer receiving the loan proceeds of $100x directly. I suspect the only difference is a matter of timing, and time-value-of-money principles, as the taxpayer had to wait with regard to the depreciation deductions and thereby the receipt of the tax-free income, unless the property was qualifying property under I.R.C. § 179 and the taxpayer elected to expense the entire amount permitted under the statute.

55. Crane v. Comm'r, 331 U.S. 1, 14 (1947) ("We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.").

56. Id.

57. See Cunningham & Cunningham, supra note 50, at 244.
seller with an equity interest in property will most likely not walk away from the property, surrendering it to the jaws of foreclosure. Rather, the seller will avoid foreclosure at all costs by making payments to protect its underlying equity interest. This is because the seller has an economic interest or benefit in the transaction; namely, the amount of boot received, representing the excess of the property's fair market value over nonrecourse debt assumed. In hindsight, the underpinnings of the Crane decision should have rested exclusively on the functional relationship analysis. The Court nevertheless felt compelled to walk out onto an anemic analytical plank and bifurcated its analysis, focusing on Mrs. Crane's theoretical economic benefit in the transaction. Recourse debt and nonrecourse debt, however, are not always treated identically—particularly if the property is foreclosed upon or deeded back to the lender in lieu of foreclosure. Unlike in Crane, if property is subject to recourse debt and foreclosed upon, only the fair market value of the property is included in the amount realized, not the entire amount of the debt. If the lender in the future decides to forgive any deficiency, this constitutes "discharge of indebtedness income" under § 108 at that particular point in time. When property subject to recourse debt is surrendered to the lender in lieu of foreclosure, similar results occur. Only the fair market value of the asset is considered in satisfaction of the obligation, and thus, included in the amount realized. Any outstanding obligation amount, if and when forgiven, again constitutes discharge of indebtedness income at such time.

In the end, the Crane court determined Mrs. Crane's amount realized was comprised of the principal amount of the nonrecourse debt outstanding and the cash boot received. The Court stated that be-

58. See Cunningham & Cunningham, supra note 50, at 244.
59. See Cunningham & Cunningham, supra note 50, at 244.
60. See Cunningham & Cunningham, supra note 50, at 244.
61. See Cunningham & Cunningham, supra note 50, at 244.
62. Treas. Reg. § 1.1001-2(a)(2) (1980) ("The amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under section 61(a)(12). For situations where amounts arising from the discharge of indebtedness are not realized and recognized, see section 108 and § 1.61-12(b)(1).")
63. Under I.R.C. § 108 (2006), discharge of indebtedness income is included in the taxpayer's gross income. This is assuming none of the exclusions under § 108(a) apply, such as bankruptcy, insolvency, qualified farm indebtedness, qualified real property business indebtedness, or qualified principal residence indebtedness. Discharge of indebtedness income is "ordinary" in character, whereas if nonrecourse debt is included in a seller's amount realized, the character of such depends on the asset sold or otherwise disposed of (e.g., such may be long term capital gain receiving more preferential tax rate treatment).
64. Crane v. Comm'r, 331 U.S. 1, 14 (1947).
cause no evidence was introduced that the lien on the property was more than the property's value, and the buyer was willing to take the property six and one-half years later, subject to the debt, and pay a substantial amount of cash, the property must have had a fair market value greater than the amount of debt at the time of the sale.\footnote{Id. at 11-12.} Some academics contend Mrs. Crane had no equity in the property whatsoever, and thus, the \textit{Crane} rule applies to property valued equal to or greater than the nonrecourse debt.\footnote{See Cunningham \& Cunningham, \textit{supra} note 50, at 244 ("In fact, Mrs. Crane had no equity to speak of in the property . . . .'\).} Because the exception contained in footnote 37 of the \textit{Crane} opinion, discussed below, only applies to debt in excess of the encumbered property's fair market value, it is understandable why one would lean towards extending the \textit{Crane} holding to property of equal value. The problem with this interpretation, though, is that a seller has no economic interest in such a transaction, as there is no equity, and therefore the Court's economic benefit rationale fails under such circumstances.

A last ditch argument postured by Mrs. Crane's counsel was that the gain from the transaction was not "income" within the meaning of the Sixteenth Amendment of the U.S. Constitution because she did not directly receive cash.\footnote{Id.} This argument quickly fell apart, however, as she claimed depreciation deductions on the building for nearly seven years, making recapture justified.\footnote{Id., at 15 n.42 ("In the course of the argument[,] some reference was made, as by analogy, to a situation in which a taxpayer acquired by devise property subject to a mortgage in an amount greater than the then value of the property, and later transferred it to a third person, still subject to the mortgage, and for a cash boot. Whether or not the difference between the value of the property on acquisition and the amount of the mortgage would in that situation constitute either statutory or constitutional income is a question which is different from the one before us, and which we need not presently answer.'\).} During this discussion, the Court stated that it declined to answer whether a taxpayer would have statutory or constitutional income if property were inherited subject to debt in excess of fair market value, and the property were subsequently disposed of for cash boot while still subject to the mortgage.\footnote{Id. at 15.} What is pertinent here, for our later discussion concerning corporate distributions of excess debt property, is that the Court appears to be implying that if Mrs. Crane had inherited the property with a date of death value less than the nonrecourse debt, her basis would have been limited to the property's fair market value.\footnote{Id. at 11-12.} By limiting basis to fair market value at acquisition, a new issue arises, pivoting delicately on
whether or not after applying the Court's limitation the devisee would have income on a later disposition of the property, particularly if the full amount of nonrecourse debt is required to be included in the amount realized.\footnote{71}

IV. \textit{Tufts and the Most Notorious Legal

Footnote in History}

What the \textit{Crane} court failed to adequately address, and left for the case of \textit{Commissioner v. Tufts} to resolve over thirty-five years later, was whether or not nonrecourse debt should be included in a seller's amount realized when the debt is in excess of the property's fair market value.\footnote{72} The \textit{Crane} court reserved this question in footnote 37 of its opinion as an apparent exception to the economic benefit analysis.\footnote{73} For more than three decades after the \textit{Crane} decision, the notorious footnote spun unpredictably like a spring-loaded piñata, stuffed with unanswered questions exhaustively debated among academics and practitioners.\footnote{74} It was as if each time a commentator took a swing at the colorful footnote, additional unresolved legal issues would fall out.\footnote{75} Even the lower courts had issues with \textit{Crane}'s mysterious foot-

\begin{itemize}
\item \footnote{71}{Id.}
\item \footnote{72}{\textit{Crane}, 331 U.S. at 14 n.37 ("Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.").}
\item \footnote{73}{Id.}
The U.S. Tax Court and Third Circuit Court of Appeals simply refused to acknowledge the footnote's presence, contending that doing so would defeat the spirit of the *Crane* holding. The Fifth Circuit Court of Appeals, on the other hand, decided to abide by the footnote and ruled against the Commissioner, triggering a divisive split among the circuits that launched the *Tufts* case to the U.S. Supreme Court. It is important to keep in perspective that *Crane* permitted taxpayers to include nonrecourse debt in basis, causing an entire cottage industry of tax shelter transactions to arise, where taxpayers claimed depreciation deductions on nonrecourse debt encumbered property. It was a win-win situation for taxpayers, as they received immediate tax deductions with no economic risk of loss, and if the value of the property fell below the amount of the debt, they could argue such was not included in the amount realized. At the time of the *Tufts* decision, taxpayers were dumping their once high basis tax shelters that had become worth less than the encumbering nonrecourse debt.


76. See Cunningham & Cunningham, *supra* note 50, at 245 ("The loose end left dangling by footnote 37 remained unresolved until *Tufts*. Prior to *Tufts*, most courts addressing the issue, including the Tax Court and the Third Circuit, had refused to find that footnote 37 represented an exception to the general principal of inclusion of debt in amount realized. Nevertheless, in 1981, the Fifth Circuit ruled against the government, and the resulting split in the Circuits brought the issue back to the Supreme Court.").

77. See Cunningham & Cunningham, *supra* note 50, at 245.

78. See Cunningham & Cunningham, *supra* note 50, at 245.


80. Angela Prendergast, *The Crane Controversy Continues*, 59 CHI.-KENT L. REV. 731, 731-33 (1983) ("Although *Crane* is the foundation for tax law governing many real property transactions, including many tax shelters, until *Tufts[,] no court allowed the taxpayer to benefit from the plain language of *Crane's* footnote 37. . . . Relying on a footnote in *Crane*, in *Tufts v. Commissioner*, the United States Court of Appeals for the Fifth Circuit recognized an exception to the general rule of inclusion. In *Tufts*, because the fair market value of property secured by a nonrecourse mortgage had declined, upon disposition of the property, the taxpayer received less than the amount of the mortgage. The Fifth Circuit refused to include the entire amount of the nonrecourse mortgage in the amount realized even though the taxpayer had taken depreciation deductions using a basis which included the nonrecourse mortgage. The court held that the portion of a nonrecourse mortgage that must be included in the amount realized upon disposition of the property securing the mortgage is limited to the fair market value of the property. The *Tufts* holding is in direct conflict with the earlier Third Circuit holding in *Millar v. Commissioner*. [Millar v. Comm'r, 439 U.S. 1046 (1978).] The *Millar* court, under similar facts, included the full amount of a nonrecourse mortgage in the amount realized.").
The case of Commissioner v. Tufts was decided in 1983. The facts involved a general partnership that was committed to constructing an apartment complex. The partnership had obtained a nonrecourse loan in the amount of $1,851,500 in 1970 to construct the complex. The security for the loan was the apartment complex itself. Under the rules of partnership taxation, the debt was collectively reflected in the partners' respective outside bases. The primary asset of the partnership was the complex (subject to the nonrecourse debt). The partners contributed very little in the way of capital contributions to the venture. In fact, their total combined capital contributions only equalled $44,212. In 1971, the apartment complex was completed. The partners were allocated their respective items of loss and depreciation deductions in the tax years 1971 and 1972. These deductions totaled $439,972. After adjusting the partners' bases upward for their nominal capital contributions made and downward for the deductions claimed, the collective outside bases of the partners in their partnership interests (which was the partnership's inside basis in the asset) equalled $1,455,740 in 1972.

In 1971 and 1972, the city where the complex was located suffered a severe economic decline. As a direct consequence, the partnership's rental income dropped and was significantly less than originally anticipated. Without sufficient rental income, the partnership was unable to make payments on the mortgage. To avoid foreclosure, the part-

82. Id. at 302.
83. Id.
84. Id.
86. Tufts, 461 U.S. at 302.
87. See id. ("On August 1, 1970, respondent Clark Pelt, a builder, and his wholly owned corporation, respondent Clark, Inc., formed a general partnership. The purpose of the partnership was to construct a 120-unit apartment complex in Duncanville, Tex., a Dallas suburb. Neither Pelt nor Clark, Inc., made any capital contribution to the partnership. . . . Pelt later admitted four friends and relatives, respondents Tufts, Steger, Stephens, and Austin, as general partners. None of them contributed capital upon entering the partnership. The construction of the complex was completed in August 1971. During 1971, each partner made small capital contributions to the partnership; in 1972, however, only Pelt made a contribution. The total of the partners' capital contributions was $44,212.").
88. Id.
89. Id.
90. Id.
91. Tufts, 461 U.S. at 302.
92. Id.
93. Id. at 303.
94. Id.
95. Id.
ners sold their respective partnership interests to an unrelated third party named Fred Bayles.\textsuperscript{96} Mr. Bayles had agreed to assume the nonrecourse mortgage, and reimburse each partner's sales expenses up to $250.\textsuperscript{97} On the date of the transfer, the property had a fair market value of $1,400,000.\textsuperscript{98} After the sale, the partnership reported a tax loss of $55,740, which was allocated to the partners.\textsuperscript{99} The partnership's calculation of the loss was based on the difference between the property's adjusted basis of $1,455,740 and $1,400,000, its fair market value at the time of the sale.\textsuperscript{100} As a result, not only did the partners benefit from the depreciation deductions claimed against the property's\textit{Crane} debt basis, but they also incurred a loss on disposition of the complex – all with no genuine economic risk of loss.\textsuperscript{101} The Commissioner disagreed with the partnership's characterization of the "amount realized," contending that the partnership really had a capital gain in the amount of $395,760.\textsuperscript{102} Under the Commissioner's theory, the full amount of nonrecourse debt (i.e., $1,851,500) was included in the partnership's amount realized, notwithstanding the fact that it exceeded the property's fair market value.\textsuperscript{103} It became the perfect storm eagerly awaiting Supreme Court navigation. The U.S. Tax Court upheld the Commissioner's deficiencies, while the Fifth Circuit Court of Appeals reversed the Tax Court, questioning the theoretical underpinnings of the\textit{Crane} decision.\textsuperscript{104}

The Supreme Court in\textit{Tufts} began by reciting\textit{Crane}, and stating that it was not inclined to overrule it.\textsuperscript{105} The Court asserted that

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\item \textsuperscript{96}\textit{Tufts}, 461 U.S. at 303. The court states that Mr. Bayles "assumed" the mortgage but this is a matter of phraseology, as he did not assume any personal exposure; the debt was nonrecourse. He merely took the property subject to the mortgage. This article will discuss the issue of assuming recourse debt and taking property subject to nonrecourse debt in greater detail \textit{infra}.
\item \textsuperscript{97}\textit{Id}.
\item \textsuperscript{98}\textit{Id}.
\item \textsuperscript{99}\textit{Id}. The partners did not claim their allocated portion of the loss from the sale of the complex on their respective returns until they petitioned the Tax Court.
\item \textsuperscript{100}\textit{Id}.
\item \textsuperscript{101}\textit{Tufts}, 461 U.S. at 303.
\item \textsuperscript{102}\textit{See id}.
\item \textsuperscript{103}\textit{Id}. The court in footnote 2 acknowledges the total gain recognized was $395,760, but for the purposes of the main text of the opinion, rounds the number off to $400,000.
\item \textsuperscript{104}\textit{Id} at 303-04.
\item \textsuperscript{105}\textit{Id}. at 307 ("This case presents that unresolved issue. We are disinclined to overrule\textit{Crane}, and we conclude that the same rule applies when the unpaid amount of the nonrecourse mortgage exceeds the value of the property transferred.\textit{Crane} ultimately does not rest on its limited theory of economic benefit; instead, we read\textit{Crane} to have approved the Commissioner's decision to treat a nonrecourse mortgage in this context as a true loan. This approval underlies\textit{Crane}'s holdings that the amount of the nonrecourse liability is to be included in calculating both the basis and the amount realized on disposition. That the amount of the loan exceeds the fair market value of the property thus becomes irrelevant.").
\end{itemize}
whether or not the unpaid amount of the mortgage exceeds the value of the property transferred is irrelevant, as the Crane rule still applies.\textsuperscript{106} The Crane economic benefit analysis was then relegated to mere dicta by the Tufts court.\textsuperscript{107} Any other conclusion would have made the Tufts court a prisoner of footnote 37, leading to absurd and abusive tax results.\textsuperscript{108} The Court stated, in pertinent part, "Crane ultimately does not rest on its limited theory of economic benefit; instead, we read Crane to have approved the Commissioner's decision to treat a nonrecourse mortgage in this context as a true loan."\textsuperscript{109} By holding that nonrecourse debt should be included in the amount realized regardless of the asset's fair market value, the court wedged its decision squarely into Crane's functional relationship rationale.\textsuperscript{110} The Court maintained that when a taxpayer receives a loan, he incurs an obligation to repay that loan at some point in the future, and because of the obligation to repay, the loan proceeds do not constitute income.\textsuperscript{111} Likewise, when the taxpayer repays the obligation, the transaction is tax-neutral.\textsuperscript{112} Because the Crane court decided to include nonrecourse debt in a taxpayer's cost basis when it is "true debt," in the case where the property is later sold or otherwise disposed of, the extinguishment of the mortgagor's obligation to repay justifies inclusion of the debt in the taxpayer's amount realized.\textsuperscript{113} Without such symmetrical treatment, the taxpayer would be receiving the proceeds of the nonrecourse loan tax-free via a Crane debt basis, as illustrated above.\textsuperscript{114}

\textsuperscript{106} Tufts, 461 U.S. at 307.
\textsuperscript{107} See id.
\textsuperscript{108} Id.
\textsuperscript{109} Id.
\textsuperscript{110} Id. at 313 ("Nothing in either § 1001(b) or in the Court's prior decisions requires the Commissioner to permit a taxpayer to treat a sale of encumbered property asymmetrically, by including the proceeds of the nonrecourse obligation in basis, but not accounting for the proceeds upon transfer of the encumbered property.").
\textsuperscript{111} Tufts, 461 U.S. at 307.
\textsuperscript{112} See id.
\textsuperscript{113} Id. at 308-09.
\textsuperscript{114} Id. at 309-10 ("The rationale for this treatment is that the original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay. Moreover, this treatment balances the fact that the mortgagor originally received the proceeds of the nonrecourse loan tax-free on the same assumption. Unless the outstanding amount of the mortgage is deemed to be realized, the mortgagor effectively will have received untaxed income at the time the loan was extended and will have received an unwarranted increase in the basis of his property.").
V. **Crane and Tufts Symmetry in Corporate Contributions**

The above *Crane* and *Tufts* discussion in the corporate context begins by evaluating shareholder contributions of property subject to nonrecourse debt, particularly excess debt property. Under § 351(a), shareholders may contribute "property" to a controlled corporation (without gain or loss recognition), so long as they receive "solely stock" of the corporation in exchange.\(^{115}\) While "control," for purposes of § 351(a) is defined in § 368(c),\(^{116}\) the term "property" is not defined in the I.R.C. or regulations. The courts and the Internal Revenue Service (the "Service"), however, have defined "property" to include just about any asset (e.g., intangibles, real property, accounts receivable, inventory, money, etc.). In other words, the courts and the Service have broadly interpreted the term to include any legally owned asset that can be identified, valued, and transferred.\(^{117}\) Services and certain indebtedness of the controlled corporation (and accrued interest) are specifically excluded from the definition of property under § 351(d).\(^{118}\) At the moment, § 351(a) and the regulations do not distinguish between property worth more than its subject debt and property worth less than its encumbering debt (i.e., excess debt property).\(^{119}\) In other words, similar to *Crane*, an asset encumbered by debt is still considered "property," as debt has no bearing on whether it is property.

For example, assume Mrs. Crane contributes an apartment building with a fair market value of $175x (subject to $190x of nonrecourse debt) into X Corporation in exchange for 10 shares of X Corporation stock. Immediately after the exchange, X Corporation is solvent, and Mrs. Crane owns all of X Corporation's stock. Under the current rules, the exchange would qualify for § 351(a) nonrecognition.\(^{120}\) This

\(^{115}\) I.R.C. § 351(a) (2006) (“No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation[,] and immediately after the exchange[,] such person or persons are in control (as defined in section 368(c)) of the corporation.”).

\(^{116}\) I.R.C. § 368(c) (“For purposes of part I (other than section 304), part II, this part, and part V, the term “control” means the ownership of stock possessing at least 80[%] of the total combined voting power of all classes of stock entitled to vote and at least 80[%] of the total number of shares of all other classes of stock of the corporation.”).

\(^{117}\) Hempt Bros., Inc. v. United States, 490 F.2d 1172, 1175 (3rd Cir. 1974) (“We fail to perceive any special reason why a restrictive meaning should be applied to accounts receivables so as to exclude them from the general meaning of “property.” Receivables possess the usual capabilities and attributes associated with jurisprudential concepts of property law. They may be identified, valued, and transferred.”).

\(^{118}\) I.R.C. § 351(d).

\(^{119}\) I.R.C. § 351(a).

\(^{120}\) Id.
is the case even though the property is clearly “underwater.” The Treasury, however, has proposed regulations that would treat the exchange as a taxable transaction.\textsuperscript{121} The proposed regulations state that if a shareholder transfers property without any net value, or the transferee receives property without any net value, then the property requirement of § 351(a) is not satisfied.\textsuperscript{122} Property has “net value” when the fair market value of the transferred property exceeds the sum of the amount of liabilities of the transferor assumed by the transferee, and any boot received by the transferor in connection with the exchange.\textsuperscript{123} As stated previously, this net value limitation on property is strikingly similar to the taxpayer’s argument set forth in \textit{Crane}.\textsuperscript{124} Substantively, Proposed Treasury Regulation § 1.351-1(a)(iii) provides that if property does not have net value in the transferor and transferee’s hands, it is not “property” for the purposes of § 351(a).\textsuperscript{125} Recall that Mrs. Crane made a similar argument (albeit under a different statutory section); namely, that property was limited to equity. The Court, however, stated that if the legislature wanted to use the word “equity,” they would have.\textsuperscript{126} The same logic should arguably apply when interpreting § 351(a), and thus, the Treasury might be exceeding its congressionally delegated authority here with the proposed regulation.

In sum, to avoid recognition of gain or loss, a transferor must: (1) transfer property, (2) be in control immediately thereafter, and (3)

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\item \textsuperscript{121} Prop. Treas. Reg. § 1.351-1(a)(2), Ex. 4 (1996) (“A, an individual, transfers an apartment building with a fair market value of $175x to Corporation X. The building is subject to a nonrecourse obligation of $190x and no other asset is subject to that liability. A receives 10 shares of Corporation X stock in the exchange. Immediately after the exchange, Corporation X is solvent and A owns 100% of its outstanding stock. Under paragraph (a)(1)(iii) of this section, the 10 shares of Corporation X stock received by A will not be treated as issued for property because the fair market value of the apartment building does not exceed the amount of A’s liabilities assumed by Corporation X. Therefore, section 351 does not apply to the exchange.”).
\item \textsuperscript{122} Id. at (a)(1)(iii) (“Stock will not be treated as issued for property if either – (A) The fair market value of the transferred property does not exceed the sum of the amount of liabilities of the transferor that are assumed by the transferee in connection with the transfer and the amount of any money and the fair market value of any other property (other than stock permitted to be received under section 351(a) without the recognition of gain) received by the transferor in connection with the transfer. For this purpose, any obligation of the transferor for which the transferee is the obligee that is extinguished for federal income tax purposes in connection with the transfer is treated as a liability assumed by the transferee; or (B) The fair market value of the assets of the transferee does not exceed the amount of its liabilities immediately after the transfer . . . .”).
\item \textsuperscript{123} Id.
\item \textsuperscript{124} See \textit{Crane v. Comm’r}, 331 U.S. 1, 6-8 (1947).
\item \textsuperscript{126} See \textit{Crane}, 331 U.S. at 8.
\end{itemize}
receive solely stock of the transferee corporation. If the shareholder receives any property other than "solely stock" of the transferee corporation (including nonqualified preferred stock) in exchange for the transferor's property, the property is considered "boot." The receipt of boot may trigger the recognition of gain (but not loss) in an amount equal to the lesser of the transferor's realized gain or the fair market value of the boot property received. Under certain nonrecognition provisions in the Code, such as §§ 1031, 1035, and 1036, a transferor's relief from liabilities is considered the functional equivalent of the receipt of boot. The issue under § 351(a) is whether or not a transferee corporation's assumption of debt is treated as boot received by the transferor. Generally speaking, when a corporation assumes the liability of a transferor, § 357(a) provides that the assumption of such liability shall not be considered boot for the purposes of determining gain recognition. Section 357(d) then specifies which rules are used for evaluating whether or not a liability is considered "assumed" by the transferee for the application of § 357. Section 357(d) was enacted by Congress because it was concerned that taxpayers were taking advantage of § 357 when debt was secured by more than one asset, in which case, taxpayers would transfer assets to multiple entities in an attempt to count debt basis

128. Treas. Reg. § 1.351-2(a) (2000) ("If an exchange would be within the provisions of section 351(a) if it were not for the fact that the property received in exchange consists not only of property permitted by such subsection to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property. No loss to the recipient shall be recognized.").
129. I.R.C. § 351(b).
130. See I.R.C. § 1031 (involving nontaxable like kind exchanges of property held for productive use in a trade or business or for investment); I.R.C. § 1035 (involving certain exchanges of insurance policies); I.R.C. § 1036 (dealing with stock-for-stock exchanges of stock of the same corporation).
131. I.R.C. § 351(b).
132. I.R.C. § 357(a).
133. I.R.C. § 357(d). Section 357(d) treats a recourse liability as being assumed to the extent the transferee corporation agrees to assume the liability. A transferee corporation is only treated as having assumed a recourse liability when based on the facts and circumstances the transferee has agreed to and is expected to satisfy the debt (or any portion thereof) whether or not the transferor shareholder is relieved of the liabilities. Therefore the transferee corporation must expressly agree to the assumption of recourse debt. Nonrecourse liabilities on the other hand are generally treated as "assumed" to the extent the transferred assets are "subject to" the nonrecourse debt. Id. Under section 357(d)(2) the amount of nonrecourse liability considered assumed is reduced by the lesser of: (A) the amount of the liability that the transferor shareholder agrees to (and is expected to) satisfy or (B) the fair market value of the other assets securing the nonrecourse debt. Id. § 357(d)(2).
more than once. "Recourse debt" is considered assumed under § 357(d) only to the extent that the transferee corporation agrees to (and is expected to) satisfy the liability. Whereas, "nonrecourse debt" is considered assumed to the extent the transferred asset is "subject to" the debt. Currently, the Treasury is contemplating proposing regulations that would align the nonrecourse debt rules more closely with those of recourse debt, so that agreements between the transferee and transferor would be considered.

To illustrate § 357(a), assume Mrs. Crane acquires a depreciable asset for $100x. The purchase price consists of $10x cash and $90x in nonrecourse debt secured by the asset. Under Crane principles, her cost basis is $100x, which includes $90x of debt basis. Assume interest-only is required on the promissory note and Mrs. Crane depreciates the asset by $5x. At a time when the asset has a fair market value of $120x and an adjusted basis of $95x Mrs. Crane contributes it (subject to the $90x of nonrecourse debt) to X Corporation in exchange for 100 shares of X Corporation (out of 300 outstanding). The 100 shares are collectively valued at $30x (i.e., the net contribution amount). Pursuant to a prearranged plan of incorporation, shareholders Z and Y each transfer $30x cash in exchange for 100 shares each. The control and property requirements of § 351(a) are satisfied.

Per Crane and Tufts, Mrs. Crane’s amount realized in the exchange includes the full amount of nonrecourse debt the transferred asset is subject to. Mrs. Crane’s realized gain in from the exchange is $25x (i.e., $30x + $90x – $95x). Fortunately for Mrs. Crane, the general rule of § 357(a) applies, and the transferee’s assumption of the debt will not be considered boot for the purposes of gain “recognition” under § 351(a). X Corporation’s assumption is treated as boot, however,

138. I.R.C. § 351(a). The shareholders transferred property in exchange for stock of the corporation and they have control immediately after the exchange (i.e., 100%).
139. Comm’r v. Tufts, 461 U.S. 300, 317 (1983) (“When a taxpayer sells or disposes of property encumbered by a nonrecourse obligation, the Commissioner properly requires him to include among the assets realized the outstanding amount of the obligation. The fair market value of the property is irrelevant to this calculation.”).
140. I.R.C. § 357(a) (“Except as provided in subsections (b) and (c), if – (1) the taxpayer receives property which would be permitted to be received under section 351 or section 361 without the recognition of gain if it were the sole consideration, and (2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer, then such assumption shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section 351 or 361 as the case may be.”).
for the purposes of determining Mrs. Crane's stock basis in the shares received (i.e., it reduces her stock basis).\textsuperscript{141} The assumption of debt is also considered boot when calculating her "realized" gain (i.e., it increases her amount realized and thus her realized gain).\textsuperscript{142} As a result, Mrs. Crane would "realize" $25x of gain, but would not recognize any gain.\textsuperscript{143} After the exchange, her stock basis would be $5x (i.e., $95x - $90x).

Notice how the inclusion of the nonrecourse debt above in Mrs. Crane's amount realized is consistent with the "functional relationship" discussion in \textit{Crane} and \textit{Tufts}. In other words, the inclusion of the debt in her asset basis warranted such in her amount realized. The fact that she does not recognize any gain in the exchange is nevertheless consistent with \textit{Crane} and \textit{Tufts}, as the Service is returned its original $90x of tax-free debt basis from Mrs. Crane when her stock basis was correspondingly reduced by a like amount. Put another way, the tax-free receipt of $90x of debt basis, fully offset $90x of realized gain resulting in a tax-neutral transaction. This is identical to receiving $90x of loan proceeds tax-free and repaying the lender in full at a future point in time.

There are two exceptions, however, to the general rule of § 357(a) contained in subsections (b) and (c).\textsuperscript{144} Subsection (b) of § 357 involves transfers where the assumption is part of a "tax avoidance purpose," or there is no "bona fide business purpose" for the assumption.\textsuperscript{145} The burden is on the transferor to prove that the assumption was not part of a tax avoidance transaction and there was a bona fide business purpose.\textsuperscript{146} In determining tax avoidance, courts and the Service will generally look at the length of time between the

\begin{footnotesize}
\textsuperscript{141} I.R.C. § 358(a)(1)(A). Under this statutory section, when an exchange qualifies for § 351, the transferor shareholder's stock basis is generally equal to the adjusted basis of the property transferred, plus any gain recognized by the transferor minus the fair market value of boot received by the transferee corporation (which includes any money received and debt assumed).

\textsuperscript{142} I.R.C. § 358(d)(1).

\textsuperscript{143} Treas. Reg. § 1.357-1(a) (as amended in 1961) ("Section 357(a) does not affect the rule that liabilities assumed are to be taken into account for the purpose of computing the amount of gain or loss realized under section 1001 upon an exchange.").

\textsuperscript{144} I.R.C. § 357.

\textsuperscript{145} I.R.C. § 357(b)(1) ("If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to the assumption described in subsection (a) – (A) was a purpose to avoid Federal income tax on the exchange, or (B) if not such purpose, was not a bona fide business purpose, then such assumption (in the total amount of the liability assumed pursuant to such exchange) shall, for purposes of section 351 or 361 (as the case may be), be considered as money received by the taxpayer on the exchange.").

\textsuperscript{146} I.R.C. § 357(b)(2).
\end{footnotesize}
taxpayer’s incurrence of the debt and the assumption by the corporation. The closer in time, the more likely tax avoidance has occurred. A business purpose exists when the liabilities assumed are associated with the business, and it does not exist when the debts are personal in nature (e.g., home mortgage, credit card obligations, car loans, etc.). Without such a rule taxpayers could easily avoid boot recognition by incurring debt shortly before the exchange.

To demonstrate, assume Mrs. Crane owns an asset with a fair market value of $100x and an adjusted basis of $50x. She would like to exchange said asset for X Corporation stock under § 351(a). She would also like $20x of cash, but she prefers not to sell the asset to an unrelated third party. One planning scenario, would be for Mrs. Crane to contribute the asset into the corporation and receive in the exchange $20x in cash along with X Corporation stock. The cash received, however, would be considered boot and she would recognize $20x of gain (i.e., the lesser of $20x boot or $50x realized gain). To avoid this harsh result, she may take out $20x of debt secured by the asset shortly before the exchange, pocket the loan proceeds, and point to the general rule of § 357(a) for nonrecognition. Under these circumstances, her realized gain would be $50x ($80x + $20x – $50x), none of which would be recognized under § 357(a). However, § 357(b) would then step in to disallow this tax avoidance transaction. As a result, the assumed debt would be treated the same as receiving $20x cash outright from X Corporation, all of which she would recognize just as in the first scenario. In preventing this tax avoidance transaction, § 357(b) taints “all” liabilities as boot (i.e., not just those incurred for a tax avoidance or non-business purpose). The character of Mrs. Crane’s recognized gain would be determined by looking at the character of the asset transferred.

The final exception to § 357(a) is subsection (c). This subsection provides that the transferor recognizes gain under § 351(a) to the ex-

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147. I.R.C. § 357(a).
148. Treas. Reg. § 1.357-1(c) (as amended in 1961) (“The benefits of section 357(a) do not extend to any exchange involving an assumption of liabilities where it appears that the principal purpose of the taxpayer with respect to such assumption was to avoid Federal income tax on the exchange, or, if not such purpose, was not a bona fide business purpose . . .”).
149. Id. (“In such cases, the total amount of liabilities assumed or acquired pursuant to such exchange (and not merely a particular liability with respect to which the tax avoidance purpose existed) shall, for the purpose of determining the amount of gain to be recognized upon the exchange in which the liabilities are assumed or acquired, be treated as money received by the taxpayer upon the exchange.”).
150. I.R.C. § 357(c)(1) (“In the case of an exchange – (A) to which section 351 applies, or (B) to which section 361 applies by reason of a plan of reorganization within the meaning of section 368(a)(1)(D) with respect to which stock or securities of the corporation to which the assets are
tent that the liabilities assumed exceed the total adjusted bases of the assets transferred.\textsuperscript{151} Again, the character of any recognized gain would vary depending on the assets transferred.\textsuperscript{152} Unlike § 357(b), however, § 357(c) is not a "boot rule," in that, if the rule is triggered gain is recognized regardless of whether or not there is any realized gain.\textsuperscript{153} Section 357(c) is also distinguishable from § 357(b), because only the excess debt over the adjusted bases of the assets transferred is recognized;\textsuperscript{154} whereas, if § 357(b) applies, all liabilities are tainted as boot received in the exchange.\textsuperscript{155}

To illustrate, assume Mrs. Crane claimed depreciation deductions totaling $15x (rather than $5x) in the first example where the asset previously had a cost basis of $100x. Under these circumstances, her adjusted basis would be $85x. Further assume that she transfers the asset into X Corporation when its fair market value is $120x in exchange for 100 shares. The asset is also subject to $90x of nonrecourse debt. Accordingly, Mrs. Crane’s amount realized would be $120x (i.e., $30x + $90x) and her realized gain would be $35x ($120x − $85x).

Under § 357(c) she would recognize $5x of gain (i.e., the amount of debt in excess of basis).\textsuperscript{156} The logic behind this rule is twofold: (1) to avoid negative basis to the transferor shareholder, and (2) to allow the transferor to receive a Crane and Tufts-like benefit when relieved of liabilities in excess of basis which must be properly accounted for (i.e., the taxpayer previously received tax-free debt basis).

The negative basis phenomenon is easily illustrated. If the general rule of § 357(a) applied without the exception, Mrs. Crane’s stock basis at the conclusion of the transaction would be negative $5x (i.e., $85x - $90x). The Code, however, does not permit negative basis, so § 357(c) steps in to prevent this result triggering recognition of $5x of gain. Therefore, Mrs. Crane’s stock basis at the conclusion of the exchange is zero (i.e., $85x + $5x - $90x). This result is consistent with both Crane and Tufts, as Mrs. Crane received tax-free debt basis of $90x and was permitted to claim $5x of tax depreciation against it, which offset her income. Without such a rule, Mrs. Crane’s $5x tax-

\textsuperscript{151} Treas. Reg. § 1.357-2(a) (as amended in 1980).
\textsuperscript{152} Id.
\textsuperscript{153} I.R.C. § 357(c)(1) (2006).
\textsuperscript{154} Treas. Reg. § 1.357-1(c) (as amended in 1961).
\textsuperscript{155} Id.
\textsuperscript{156} I.R.C. § 357(c).
free receipt of income would forever escape taxation – an absurd result § 357(c) is specifically designed to prevent.

On the transferee corporation's side, under § 1032(a) the corporation recognizes no gain or loss when it exchanges its own stock for money or property.\textsuperscript{157} This rule applies regardless of whether or not § 351(a) is satisfied by the transferor shareholders.\textsuperscript{158} The corporation also does not recognize gain or loss upon the receipt of services for its stock, as services are treated as a contribution of property or money under § 1032(a).\textsuperscript{159} With regard to "capital contributions" of money or property by shareholders, the receipt of such is excluded from the corporation's gross income under § 118(a).\textsuperscript{160} Shareholders making these voluntary pro-rata capital contributions also recognize no gain or loss, because they are not contributing anything in "exchange" for stock (or "boot").\textsuperscript{161} They are merely paying more for their respective shares already owned.\textsuperscript{162} If an exchange qualifies for nonrecognition under § 351(a), or if shareholders make voluntary pro-rata capital contributions, the corporation's basis in the assets received is governed by § 351(h)(2).\textsuperscript{163} If, on the other hand, the exchange fails to qualify for nonrecognition, the corporation receives a cost basis in the assets under § 1012(a).\textsuperscript{164}

\textsuperscript{157} I.R.C. § 1032(a) ("No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. No gain or loss shall be recognized by a corporation with respect to any lapse or acquisition of an option, or with respect to a securities futures contract (as defined in section 1234B), to buy or sell its stock (including treasury stock).")

\textsuperscript{158} \textit{Id.}

\textsuperscript{159} Treas. Reg. § 1.1032-1(a) ("A transfer by a corporation of shares of its own stock (including treasury stock) as compensation for services is considered, for purposes of section 1032(a), as a disposition by the corporation of such shares for money or other property.").

\textsuperscript{160} I.R.C. § 118(a) ("In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.").

\textsuperscript{161} Treas. Reg. § 1.118-1 ("In the case of a corporation, section 118 provides an exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer. Thus, if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. In such a case the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company.").

\textsuperscript{162} \textit{Id.}

\textsuperscript{163} I.R.C. § 1032(b) ("For basis of property acquired by a corporation in certain exchanges for its stock, see section 362."); I.R.C. § 351(h)(2) ("For the basis of stock or property received in an exchange to which this section applies, see sections 358 and 362.").

\textsuperscript{164} I.R.C. § 1012(a) ("The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses).")
Section 362(a) provides a corporation receives a transferred basis in the assets received, increased by any gain recognized by the transferor.\textsuperscript{165} Section 362(d), however, limits the corporation’s increase in basis to the fair market value of the property received (determined without regard to § 7701(g)) as a result of any gain recognized by the transferor attributable to the corporation’s assumption of liabilities.\textsuperscript{166} Section 7701(g) was enacted after Tufts in 1984, codifying the Supreme Court’s holding.\textsuperscript{167} Section 7701(g) provides a “clarification” to the Code’s determination of “fair market value” as applied to Subtitle A of the Code (Income Taxes) when debt is involved.\textsuperscript{168} It states, in pertinent part, “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.”\textsuperscript{169} The legislative history of this particular subsection indicates it was intended to reaffirm the Tufts holding that the entire nonrecourse liability is to be included in the amount realized regardless of the fair market value of the property sold or otherwise disposed of.\textsuperscript{170}

Section 7701(g) was enacted several years after Treasury Regulation § 1.1001-2(b), which had already specified that the full amount of liabilities are to be included in the amount realized upon a sale or disposition, regardless of the fair market value of the secured asset.\textsuperscript{171} The Treasury issued Treasury Regulation § 1.1001-2(b) while Tufts was be-

\textsuperscript{165.} I.R.C. § 362(a) (“If property was acquired on or after June 22, 1954, by a corporation – (1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or (2) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.”).

\textsuperscript{166.} I.R.C. § 362(d)(1) (“In no event shall the basis of any property be increased under subsection (a) or (b) above the fair market value of such property (determined without regard to section 7701(g)) by reason of any gain recognized to the transferor as a result of the assumption of a liability.”).


\textsuperscript{168.} I.R.C. § 7701(g).

\textsuperscript{169.} Id.


\textsuperscript{171.} Treas. Reg. § 1.1001-2(b) (1980) (“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.”).
The regulation applies to any "sale or disposition" of property, and a disposition of property includes a transfer of property in satisfaction of liabilities to which it is subject. The regulation specifically excludes from its application contributions and distributions in the partnership context, but not in the corporate context. The regulation also contains limiting language on the Tufts inclusion rule, stating, "In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property." When enacting § 7701(g), Congress did not specify whether the new provision modified the results in any way obtained under this regulation. Put another way, it is unclear whether § 7701(g) requires inclusion of all nonrecourse liabilities in the amount realized upon disposition of debt property, or just that amount of debt originally included in the property's basis at acquisition.

To illustrate the above discussion, assume Mrs. Crane transfers property with a fair market value of $100x and adjusted basis of $40x into X Corporation in exchange for X Corporation stock. The property is subject to nonrecourse debt of $120x. Further assume the requirements of § 351(a) are satisfied. Under § 357(c) the transferred property's debt is in excess of its adjusted basis by $80x. Mrs. Crane thus recognizes $80x of gain on the exchange. Her stock basis is $0x (i.e., $40x + $80x − $120x). X Corporation's basis in the transferred property is limited to the property's fair market value of $100x, notwithstanding the nonrecourse debt of $120x assumed. This is because X Corporation received a transferred basis of $40x under § 362(a)(2), which was then increased by the $80x of gain recognized by the transferor, however, such was limited to the property's fair market value of $100x under § 362(d)(1).

If one week later, X Corporation disposes of the property through foreclosure (or sells the property to another party for nothing more

174. Id. at (a)(4)(iv).
175. Id. at (a)(3).
179. I.R.C. § 357(c).
180. Id.
than assumption of the debt), X Corporation’s amount realized would be $100x under the above quoted treasury regulation.\footnote{Treas. Reg. § 1.1001-2(a)(3) (1980).} If, on the other hand, § 7701(g) is interpreted blindly, or as a modification to the regulation, X Corporation’s amount realized would include the full amount of the nonrecourse debt (i.e., $120x).\footnote{I.R.C. § 7701(g).} Thus, X Corporation would recognize and realize $20x of phantom gain (i.e., $120x – $100x) that it did not economically sustain.\footnote{Id.} The Code and the regulations, however, should be interpreted consistently when possible, in a manner that adheres to the basic “tax logic” discussed in \textit{Crane} and \textit{Tufts}.\footnote{Goldberg, \textit{supra} note 172, at 75 (“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.”).} Tax logic that requires symmetrical treatment of nonrecourse debt in a taxpayer’s basis and amount realized to ensuring tax-free basis is properly accounted for, and no more. The above regulation is consistent with this tax logic, as a taxpayer should only have a “tax gain” to the extent the taxpayer benefited economically with tax-free debt basis.\footnote{Goldberg, \textit{supra} note 172, at 76 (“The Supreme Court’s analysis and result in \textit{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.”).} Subjecting a taxpayer to a tax on fictitious gain, where no tax-free receipt of income occurred, would defy elementary tax logic and produce illogical results. This is the same absurd unsymmetrical result that \textit{Crane} and \textit{Tufts} sought to avoid. Section 7701(g) should therefore be read uniformly with the treasury regulation to produce the correct dynamic relationship between basis and amount realized.\footnote{Treas. Reg. § 1.1001-2(a)(3) (1980).} Simply put, if the debt was not included X Corporation’s basis at acquisition, it should not be included in X Corporation’s amount realized at disposition.\footnote{Id.} Unlike the taxpayers in \textit{Tufts}, X Corporation did not receive the benefit of “tax-free” basis to the extent § 362(d)(1) limited the transferred asset’s basis to its fair market value.\footnote{I.R.C. § 362(d)(1).} As a consequence, X Corporation should have no \textit{Crane} or \textit{Tufts} obligation to include such in its amount realized.\footnote{Section 362 contains three additional limitations to a corporation’s transferred basis that are outside the scope of this discussion.}
As mentioned previously, some academics have alleged that the purchaser’s basis in *Tufts* could have been one of three possibilities: (1) zero, (2) fair market value, or (3) the full amount of nonrecourse debt. In the corporate context, the statutory limitation of § 362(d)(1) is most analogous to Professor Marvin Chirelstein’s fair market value basis position.\(^{191}\) Professor Chirelstein contends that where a purchaser acquires property, subject to nonrecourse debt and exceeding the property’s fair market value, the purchaser’s basis should be limited to the property’s fair market value.\(^{192}\) Although X Corporation does not acquire the transferred property in a purchase transaction, the same principle nevertheless should apply; namely, “no one would be willing to pay more for property, or borrow more to buy it, than the property was actually worth.”\(^{193}\) An arm’s-length buyer should be acquiring property at a “cost” that reflects fair market value, and the buyer’s basis should not exceed such.\(^{194}\) The same holds true for X Corporation: it should not be exchanging its stock for nonrecourse debt property, or receiving capital contributions of such, at a cost greater than fair market value. Unlike the purchaser in *Tufts*, however, a transferee corporation under § 362(d)(1) is expressly prohibited by statute from acquiring a basis greater than the fair market value of the excess debt property.\(^{195}\) Acquiring a basis in excess debt property in excess of fair market value is therefore simply not an option in the context of contributions to corporations.

On the other hand, a transferee corporation receiving a zero basis in a transferred asset arguably is possible, if the debt assumed is a “contingent liability,” and not “true debt” as required in *Tufts*. The pivotal case that set forth the general rule for determining whether or not debt is true debt, and thus should be included in basis, is the U.S. Tax Court case of *Mayerson v. Commissioner*.\(^{196}\) *Mayerson*, while discussing the principles of *Crane*, held that purchase money nonrecourse debt should be included in basis, “since it can be assumed that

\(^{191}\) Chirelstein, *supra* note 5, at 261 (“Pretty clearly . . . where the property is known to be worth less than the non-recourse debt at the time the property is acquired, the purchaser’s basis should be limited to the lower value figure.”).

\(^{192}\) Chirelstein, *supra* note 5, at 261.

\(^{193}\) Chirelstein, *supra* note 5, at 261.

\(^{194}\) Chirelstein, *supra* note 5, at 261.

\(^{195}\) Transferee corporations are also required to reduce the bases of transferred assets under § 362(e) when the transferor’s collective bases of the assets transferred exceeds the transferor’s collective fair market value in the transferred assets. An election can be made, however, to reduce the stock basis of the transferor, rather than the entity’s bases. The rules of § 362(e) prevent the importation of built-in losses. Otherwise, shareholders could “double up” on their losses at the shareholder and entity level.

a capital investment in the amount of the mortgage will eventually occur despite the absence of personal liability.\textsuperscript{197} Whereas, obligations that are "contingent" or "indefinite" in nature are excluded from basis.\textsuperscript{198} A later case entailing a further expansion of the contingent debt analysis, was \textit{Gibson Products Co. v. United States}, which held when liabilities are "excessively contingent" they are not "true liabilities" and thereby should not be included in one's cost basis.\textsuperscript{199} As is recalled from \textit{Tufts}, the court specifically couched the Crane debt basis holding on its true debt nature. The \textit{Gibson} court stated, among other things:

\begin{quote}
[I]n a true lending transaction, there exists the reasonable likelihood that the lender will be repaid in light of all reasonably foreseeable risks. In other words, there must be 'a reasonable basis for the prediction that the ability of the borrower to repay will not be wholly or substantially contingent upon the success or failure of the business venture.'\textsuperscript{200}
\end{quote}

The court further stated, "[i]n a true lending transaction, the borrower normally possesses assets nearly equal or greater in value than the amount of indebtedness, whether or not those assets are hypothecated to secure the debt."\textsuperscript{201} A number of cases and rulings have ruled in a similar fashion.\textsuperscript{202} True debt issues with nonrecourse debt also arise in seller-financed and related party transactions, where the parties inten-

\begin{footnotes}
\item 197. \textit{Id.}
\item 198. \textit{Id.} at 353:
\item An example of the type of contingency referred to in the preceding proposition was present in the \textit{Albany Car Wheel Co.} case. In that case we found that the purchaser-taxpayer's obligation under the purchase agreement to procure a release of the predecessor's liability under a union contract for severance pay was of such a contingent nature that it could not be considered a part of the cost of the assets acquired. Whether it would ever be necessary to satisfy any severance pay obligations was unknown at the time of the sale. Similarly, in the \textit{Lloyd H. Redford} case the amount of a note was held not to be includable in basis since the note was only payable from profits and it was uncertain whether there would ever be profits. It was held in the \textit{Columbus & Greenville Railway Co.} case that basis did not include any amount of a mortgage where there was no primary responsibility and no fixed indebtedness for which the taxpayer or its property was liable.
\item 200. \textit{Id.} at 1047.
\item 201. \textit{Id.} at 1046.
\item 202. \textit{Albany Car Wheel Co., Inc. v. Comm'r}, 40 T.C. 831 (1963) (basis of properties subject to mortgage reduced because obligations were too contingent); \textit{Redford v. Comm'r}, 28 T.C. 773 (1957) (cost of property received in assuming lease obligations too contingent for present valuation); Rev. Rul. 80-235, 1980-2 C.B. 299 (nonrecourse obligation could not be included in basis because movie proceeds too contingent to repay debt); Rev. Rul. 55-675, 1955-2 C.B. 567 (taxpayer's cost basis was reduced because taxpayer's obligation to pay employee's severance pay was too contingent).
\end{footnotes}
tionally attempt to inflate the purchase price to obtain a higher cost basis.\(^\text{203}\)

In the corporate context, the same true debt discussion should continue to apply. This means that if a shareholder transfers an asset subject to a contingent liability into a corporation, the liability under § 362(a) should not be part of the transferee corporation’s basis in the asset; in which case, the asset’s basis attributable to the debt is zero. This again is consistent with *Crane* and *Tufts*. As a result, there also should be no gain recognized at the shareholder level under § 357(b) and (c), because the contingent debt is not taken into account. Although, it is plausible the Service could argue the debt had a “tax avoidance purpose,” and thus shareholder level recognition occurs.\(^\text{204}\)

If continent debt is not taken into account, it should also not reduce the shareholder’s stock basis under §§ 357(a) and 358(d). If the contingent debt is later repaid, however, or if it transforms itself into a “true loan,” a number of unanswered questions arise.\(^\text{205}\) With most corporate contributions, though, contingent debt is unlikely, because of the recognition scare of § 357(b), expressly prohibiting tax avoidance debt and non-business debt. Moreover, contingent debt incurred by a shareholder as a debtor should not be reflected in the asset’s basis anyway under the above rules. In which case, there is no debt basis attributable to the contingent debt transferring to the corporation under § 362(a)(2).

VI. CORPORATE DISTRIBUTIONS OF *CRANE AND TUFTS* PROPERTY

Regardless of how a corporation acquires excess debt property, *Crane* and *Tufts* issues spark again when the corporation decides to distribute such property to its shareholders. Excess debt property may be distributed to a shareholder in a “nonliquidating distribution” under § 301.\(^\text{206}\) A corporation may also distribute such property in a “liquidating distribution” under § 331.\(^\text{207}\) Section 332 also contains a set of rules (not discussed herein) that apply when a subsidiary liqui-

\(^{203}\) Estate of Franklin v. Comm’r, 544 F.2d 1045, 1049 (1976) (“For debt to exist, the purchaser, in the absence of personal liability, must confront a situation in which it is presently reasonable from an economic point of view for him to make a capital investment in the amount of the unpaid purchase price.”).

\(^{204}\) Boris I. Bittker & James S. Eustice, Federal Taxation of Corporations and Shareholders § 3.06 (7th ed. 2000).

\(^{205}\) Id. (For example, was the assumption of debt for tax avoidance purposes under § 357(b), does § 357(c) apply, is the transferor’s stock basis reduced under § 358(d), does the transferee increase its basis, etc.?).


\(^{207}\) I.R.C. § 331.
dates into its parent, providing nonrecognition to the two affiliated corporations. A liquidating distribution occurs when a corporation (in the status of liquidation) makes one or a series of distributions in complete cancellation or redemption of its stock. A corporation is in the "status of liquidation" when it ceases to be a going concern and is merely winding up its affairs, paying debts and divesting itself of its assets. Whether a distribution of property is a liquidating or nonliquidating distribution can affect, among other things, whether the transferor corporation is permitted to recognize losses, the amount and character of the gain recognized by the shareholder, and whether the shareholder recognizes a loss.

When a corporation decides to make a nonliquidating distribution to a shareholder, under § 311(b)(1), if the property is appreciated, it will recognize gain (but not loss) as if it sold the property at its fair market value to the distributee shareholder. Under § 311(b)(2), if the distributed property is subject to a liability, the rules of § 336(b) apply. Section 336(b) (which also applies to liquidating distributions) states that if the distributed property is subject to a liability, or the shareholder assumes the liability, the fair market value of the dis-

208. I.R.C. § 332.
209. Although there is no definition of the term "liquidation" in the Code, the regulations for § 332 make an attempt at defining it (which can be equally applied to § 331). Cf. Treas. Reg. § 1.332-2(c) (1960):

"To constitute a distribution in complete liquidation within the meaning of section 332, the distribution must be (1) made by the liquidating corporation in complete cancellation or redemption of all of its stock in accordance with a plan of liquidation, or (2) one of a series of distributions in complete cancellation or redemption of all its stock in accordance with a plan of liquidation. Where there is more than one distribution, it is essential that a status of liquidation exist at the time the first distribution is made under the plan and that such status continue until the liquidation is completed. Liquidation is completed when the liquidating corporation and the receiver or trustees in liquidation are finally divested of all the property (both tangible and intangible). A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders. A liquidation may be completed prior to the actual dissolution of the liquidating corporation. However, legal dissolution of the corporation is not required. Nor will the mere retention of a nominal amount of assets for the sole purpose of preserving the corporation's legal existence disqualify the transaction.

210. Id.
211. I.R.C. § 311(b)(1) ("If – (A) a corporation distributes property (other than an obligation of such corporation) to a shareholder in a distribution to which subpart A applies, and (B) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation), then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value.").
212. I.R.C. § 311(b)(2) ("Rules similar to the rules of section 336(b) shall apply for purposes of this subsection.").
tributed property shall be not less than the amount of the liability.\textsuperscript{213} This deemed fair market value rule is another codification of the \textit{Tufts} rule as applied to corporations, and it is consistent with § 7701(g) and Treasury Regulation § 1.1001-2(b). Section 336(b) was enacted as part of the Tax Reform Act of 1986.\textsuperscript{214} Prior to the Tax Reform Act, liquidating and nonliquidating distributions of appreciated property generally did not trigger corporate level gain under the longstanding \textit{General Utilities} doctrine.\textsuperscript{215} Section 7701(g) was enacted two years prior as part of the Tax Reform Act of 1984.\textsuperscript{216} The House Ways and Means Committee for the Tax Reform Act of 1986 did not specify whether or not § 336(b) should be applied to other provisions of Subchapter C.\textsuperscript{217} A few academics, as discussed in further detail below, argue that it should.\textsuperscript{218}

To demonstrate, assume X Corporation decides to make a nonliquidating distribution to its shareholder Mrs. Crane. The corporation distributes Blackacre with a fair market value of $100x, adjusted basis of $80x and subject to $120x of nonrecourse debt. X Corporation recognizes $40x of gain under §§ 311(b)(2) and 336(b) (i.e., the fair market value of the distributed asset is deemed to be no less than the debt). This result is nevertheless entirely consistent with \textit{Crane} and \textit{Tufts}, as X Corporation presumably at one point received $120x of \textit{Crane} debt basis tax-free, and the corporation must now account for such under \textit{Tufts}.

If X Corporation above has $200x of current E&P, Mrs. Crane received a distribution of property under § 301(a), the entire distribution of which would be treated as a dividend because the corporation had sufficient E&P at the close of its tax year. If the corporation, on the other hand, did not have sufficient E&P, such would have been a return of her stock basis, and then a sale or exchange of the stock. Section 301(b)(1), however, provides the “amount distributed” equals the money received, plus the fair market value of any property received. Under § 301(b)(2), the amount distributed is reduced (but not

\textsuperscript{213} I.R.C. § 336(b) ("If any property distributed in the liquidation is subject to a liability or the shareholder assumes a liability of the liquidating corporation in connection with the distribution, for purposes of subsection (a) and section 337, the fair market value of such property shall be treated as not less than the amount of such liability.").


\textsuperscript{215} Gen. Util. & Operating Co. v. Helvering, 296 U.S. 200 (1935). The Tax Reform Act of 1986 effectively repealed this case as well as § 311(a)(2), which previously permitted a corporation to make certain distributions of appreciated assets to its shareholders without a corporate level tax.


\textsuperscript{217} Randall & Stewart, \textit{supra} note 8, at 55.

\textsuperscript{218} Randall & Stewart, \textit{supra} note 8, at 55.
below zero) by any corporate liabilities the shareholder assumes, or any liabilities to which the distributed property is subject to. Thus, Mrs. Crane therefore receives nothing in the above distribution, other than underwater property, and has no taxable income or gain. Section 301(d) then states Mrs. Crane’s basis in the property “shall be the fair market value of such property,” notwithstanding any excess debt assumed.

Professors Randall and Stewart in an article contend that this fair market value basis limit to the distributee shareholder is inappropriate, because the mortgage must ultimately be satisfied to retain the property, regardless of the fair market value of the property. The professors also argue the distributee shareholder’s “amount distributed” in such a transaction would be a negative amount (i.e., $20x). If the deemed fair market value rule of §§ 311(b)(2) and 336(b) were applied at the shareholder level, the professors argue, the results would be more consistent, because the amount distributed would be zero and the basis in property would be equal to the amount of the nonrecourse debt the property is subject to (i.e., $120x). The professors’ argument fails to adequately consider, however, the statutory language of § 301(b)(2), which expressly states that when reducing the amount distributed for liabilities the amount shall be reduced “but not below zero.” Under the expressed language of the statute, the amount distributed stops at zero, and can never be a negative amount (e.g., $20x). Although Mrs. Crane receives a limited fair market value basis in the excess debt property, her amount realized upon a subsequent disposition or sale will also be limited under Treasury Regulation § 1.1001-2(a)(3). Therefore, the regulation ensures Crane and Tufts’ principles of symmetry are followed.

To demonstrate the regulation, assume Mrs. Crane disposes of the property one year later, at a time when its basis and fair market value are both $100x. The property continues to be subject to nonrecourse debt of $120x. The purchaser provides no consideration other than assumption of the debt. Treasury Regulation § 1.1001-2(a)(3) triggers a correct result, as her amount realized will be limited to $100x (i.e., the amount of debt originally included in her acquisition basis). She

219. Randall & Stewart, supra note 8, at 62.
222. Upon receiving the excess debt property, if the shareholder were then to pay down the principal of the nonrecourse debt, presumably those payments are applied only against the debt included in basis for the purposes of determining her amount realized under the treasury regulation.
will thus recognize no gain or loss under §1001. This again follows the tax logic discussed in this article, as Mrs. Crane’s tax-free basis was previously limited. The professors’ argument that applying a deemed fair market value equal to the amount of the nonrecourse debt to the shareholder’s amount distributed under §301(b)(2) and debt basis under §301(d) would “produce results that are consistent with the economic substance of the transactions” is not necessarily true given the regulation’s corresponding adjustment to the amount realized. Put another way, the regulation ensures the functional relationship between basis and amount realized is properly maintained.

The professors also take issue with the distributing corporation’s tax consequences. If you recall, X Corporation recognized $40x of gain in the above distribution because of the deemed fair market value rule under §§311(b)(2) and 336(b). Because of the distribution, X Corporation must also make proper adjustments to its E&P. A corporation’s E&P reflects its ability to pay dividends. When a corporation distributes appreciated property in a nonliquidating distribution, it increases its E&P by any “E&P gain” from the distribution. E&P gain is measured by the difference between the property’s “E&P basis” and its fair market value under §312(b). E&P is then reduced by the fair market value of the appreciated property distributed under §312(a). Section 312(c), however, states in making adjustments to E&P under subsections (a) or (b), “proper adjustment” shall be made for any debt to which the distributed property is subject to, or any debt the shareholder assumes in connection with the distribution. Rightfully so, the professors contend §312 does not make any reference whatsoever to the special liability rule of §§311(b)(2) and 336(b).

224. T.D. 7741, 1981-1 C.B. 430 (1980) (“Some comments suggested that to the extent a liability incurred by reason of the acquisition of property was excluded from the taxpayer’s basis, its discharge should not be treated as an amount realized. This is consistent with the Service’s ruling and litigating position and is adopted by the Treasury decision.”).
226. I.R.C. § 312(b)(1) (“On the distribution by a corporation, with respect to its stock, of any property (other than an obligation of such corporation) the fair market value of which exceeds the adjusted basis thereof – (1) the earnings and profits of the corporation shall be increased by the amount of such excess . . . .”).
227. Id.
228. I.R.C. § 312(a). E&P is also reduced by any taxes paid on the corporation’s recognized gain, if any. When loss property is distributed, E&P is reduced by the asset’s adjusted basis rather than its FMV. Id.
229. I.R.C. § 312(c) (“In making the adjustments to the earnings and profits of a corporation under subsection (a) or (b), proper adjustment shall be made for – (1) the amount of any liability to which the property distributed is subject, and (2) the amount of any liability of the corporation assumed by a shareholder in connection with the distribution.”).
for purposes of determining the "fair market value" of the distributed asset for E&P purposes.\footnote{230} For example, assume X Corporation's E&P basis is $80x in the previous example (i.e., the same as its tax basis). The corporation's E&P gain is arguably either $20x ($100x - $80x) or $40x ($120x - $80x) under § 312(b), depending on how fair market value is construed. As for the E&P decrease, it is either a negative $20x ($100x - $120x) or $0x ($120x - $120x) as a result of the proper adjustment for debt, again depending on whether or not a deemed fair market value is utilized.\footnote{231} Section 312(a) and (c) are not clear on how to deal with a negative decrease when the "adjustment" involves debt exceeding the fair market of the asset distributed. The professors argue it is only logical to ignore any negative decrease in the calculation, and thus E&P in our example, under the traditional definition of FMV, would be adjusted upward by $20x.\footnote{232} The professors also contend, however, that this result is not entirely consistent with the underlying economic realities of the transaction.\footnote{233} This is because X Corporation's economic ability to pay dividends was arguably enhanced by $40x when it was relieved of $120x of debt encumbering land with an E&P basis of $80x.

The professors state in a footnote that one could plausibly make an argument that a negative deease of $20x mathematically is the same as a positive increase of $20x (which would trigger the appropriate $40x increase in E&P).\footnote{234} On the other hand, if the fair market value of the distributed asset is deemed to be at least equal to the amount of debt relief E&P would be adjusted by $40x ($40x - $0x) if the negative decrease is ignored. This result would adequately reflect the corporation's increased ability to pay dividends. In light of such, the professors state the deemed fair market value rule of §§ 311(b)(2) and 336(b) should be applied to § 312 for the purposes of calculating E&P.\footnote{235} This, of course, would have to be codified by Congress. This author suggests one need not even stretch the imagination so far to obtain such desired results, as § 7701(g) specifically states, "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

\footnote{230}{Randall & Stewart, supra note 8, at 60.}
\footnote{231}{Randall & Stewart, supra note 8, at 61-62.}
\footnote{232}{Randall & Stewart, supra note 8, at 61-62. ("While different interpretations may explain how to deal with a negative decrease in E&P, it is doubtful the drafters of the statute contemplated such a result.").}
\footnote{233}{Randall & Stewart, supra note 8, at 61-62.}
\footnote{234}{Randall & Stewart, supra note 8, at 61 n.23.}
\footnote{235}{Randall & Stewart, supra note 8, at 64.}
treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject." \(^{236}\) It seems rational that the above rule should equally apply to § 312(b) when determining E&P gain, as the general principles are the similar to those for computing "tax" gain. When computing tax gain, the deemed fair market value rule applies to the distributing corporation, so why not for E&P gain? The same holds true for Treasury Regulation § 1.1001-2(b), which requires the full amount of discharged liabilities in the taxpayer's amount realized, regardless of the fair market value of the security. \(^{237}\)

As stated previously, § 312(c) provides a corporation is allowed to make proper adjustments to account for liabilities under § 312(a) and (b). \(^{238}\) A proper adjustment for the purposes of the E&P increase and decrease arguably includes deeming fair market value to be at least equal to the nonrecourse debt assumed.

With liquidating distributions similar issues arise. The liquidating corporation has a deemed fair market value equal to at least the amount of debt assumed under § 336(b). \(^{239}\) Shareholders receiving liquidating distributions, rather than dividend treatment, receive sale or exchange treatment. \(^{240}\) Similar to nonliquidating distributions, however, a shareholder's basis in the excess debt property is limited to the property's fair market value under § 334(a). \(^{241}\) As discussed above, and among other academics, the fair market value limitation is not as fatal as it appears at first glance due to the regulations requiring remediating symmetrical treatment. \(^{242}\)

To demonstrate, assume X Corporation makes a liquidating distribution of Blackacre to Mrs. Crane (fair market value $100x, adjusted basis $80x and subject to $120x nonrecourse debt) in complete redemption of her shares, which collectively have a basis of $150x. \(^{243}\) Under § 336(a), the corporation will recognize gain or loss as if it sold the property to Mrs. Crane for its fair market value. \(^{244}\) Because the property is excess debt property it will have a deemed fair market

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238. I.R.C. § 312(c).
239. I.R.C. § 336(b).
242. Crane, supra note 6, at 137-38 ("If, however, the debt is nonrecourse, the liability should not produce additional basis; that is, it should not trigger an immediate additional loss. The likelihood of actual payment on this debt is not sufficient to warrant taking payment into account at this time.").
243. This article is ignoring any share block issues concerning stock acquired at different times with different allocated bases and holding periods.
244. I.R.C. § 336(a).
value under § 336(b). X Corporation will recognize $40x in gain (i.e., $120x – $80x). On the shareholder’s side, rather than receiving a dividend, Mrs. Crane has a sale or exchange of her stock. Section 331(a) provides, “amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.” Section 331(c) further states that for the purposes of determining gain or loss recognition the principles of § 1001 apply.

Professors Randall and Stewart contend the tax consequences to the distributee shareholder in transactions such as the one above are unclear depending on how fair market value is determined. Mrs. Crane’s amount realized could be either $0x or a negative $20x, resulting in a loss of $150x or a loss of $170x respectively. A negative amount realized, however, does not make sense as she only has an economic loss of $150x reflected in the basis of her stock. Mrs. Crane would also be limited to a fair market value basis in the asset under § 334(a). The professors argue that if fair market value were deemed to be at least equal to the amount of the debt using the rule of § 336(b), the illogical consequence of a negative amount realized and inflated tax loss would be avoided, as the amount realized would be zero.

The professors further state that the basis in such excess debt property distributions should not be limited to the property’s fair market value, as the distributee nevertheless must satisfy the full amount of debt to retain the property. With regard to determining Mrs. Crane’s gain or loss, this author would argue Mrs. Crane’s amount realized is limited to zero, under the general principles of § 1001 and its regulations, which simply do not permit a negative amount realized. When Mrs. Crane received the property she received an asset of no value, and therefore her amount realized should rightfully be

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245. I.R.C. § 336(b).
246. I.R.C. § 331(a).
247. I.R.C. § 331(c).
248. Randall & Stewart, supra note 8, at 59 (“The obvious cause of this confusing result is that a different definition of ‘fair market value’ is being applied at the corporate level than at the shareholder level.”).
249. Crane, supra note 6, at 129 (“There is one situation in which § 336(b) provides an appropriate result: That is, where the corporate debt associated with the property transferred is non-recourse after the transfer. The shareholder takes the property subject to the debt, but he will never be called upon to pay on the debt from his personal resources. As long as the fair market value of the property exceeds the amount of the debt, the fact that the creditor has recourse only against the encumbered property does not make a difference.”).
251. Randall & Stewart, supra note 8, at 59.
252. Randall & Stewart, supra note 8, at 60.
253. I.R.C. § 1001(b).
The fact that her basis in the property distributed is limited to fair market value is also economically consistent, as discussed previously the regulations prevent the full amount of liabilities in her amount realized upon a later sale or disposition.

VII. Conclusion

As mentioned in this article, the cases of Crane and Tufts and the tax-free receipt of income principles specified therein are an integral part of the various Subchapter C provisions involving contributions and distributions of excess debt property. A methodical journey through the applicable statutory sections indicates consistent symmetrical treatment throughout, between a taxpayer's basis and amount realized, which is critical to maintaining an economic reality that is not distorted. This is a harmonious reality, because it prevents taxpayers from claiming tax losses not economically suffered, and from receiving the tax-free receipt of income which forever escapes taxation. Although certain academics have argued that the fair market value statutory limitations to basis on excess debt property produces economically illogical and inconsistent results in the corporate context this author disagrees. The functional relationship between basis and the amount realized as originally conceived in Crane and Tufts is maintained in Subchapter C with the assistance of the treasury regulations.