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Limiting Losses Attributable to Nonrecourse Debt: A Defense of the Traditional System Against the At-Risk Concept

Glenn E. Coven†

The proper treatment of transactions involving debt remains one of the most perplexing issues in the federal income tax system. The separate-transaction system—in which the loan and the use of the loan proceeds are viewed as distinct transactions—that has nominally governed since the Supreme Court's decision in *Crane v. Commissioner*¹ has never secured universal acceptance. When that system did not appear to produce the desired result, the courts, the Commissioner, and the Congress have reverted to the pre-*Crane* single-transaction system of treating the loan and the use of the loan proceeds as aspects of a single transaction. The inherent conflict between these two systems has produced complexity and uncertainty in the taxation of debt-financed property transactions.

Much of this vacillation has stemmed from legal arrangements that might excuse a borrower or constructive borrower from repaying the entire amount of a loan. Under the separate-transaction approach, a borrower who uses loan proceeds to purchase property can include those proceeds in the calculation of his basis.² The borrower thus has the ability to claim losses and deductions for the entire amount of the indebtedness. If the loan is without recourse, however, the borrower might not bear an economic burden equivalent to the deductions claimed. This possibility made the separate-transaction approach appear to allow some taxpayers to take undeserved deductions. Accordingly, when the loan does not entail personal liability, there has been a tendency to replace the separate-transaction analysis with one or another manifestation of what is referred to herein as the "at-risk" concept.³ Thus, whether the courts apply a single-transaction analysis to a borrowing,⁴ the Treasury Depart-

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1. 331 U.S. 1 (1947).

2. See, e.g., *id.* at 11 (value of nonrecourse loan included in basis).

3. See *infra* note 10 and accompanying text.

4. See cases cited *infra* note 23.

nment denies a basis adjustment to a limited partner,⁵ or Congress enacts legislation prohibiting certain deductions,⁶ the effect is the same: the purchaser of property is denied basis to the extent of his financing.

The concurrent use of two systems has also caused severe problems in administering the tax laws. In particular, the provisions controlling the tax consequences for partnerships involved in debt-financed transactions have never been satisfactory. Recent litigation has demonstrated that the basis provisions are unworkable,⁷ and Congress has directed the Treasury Department to revise those rules promptly.⁸ Those revisions, in turn, will likely require a significant modification of the proposed regulations providing for the allocation of income and expense among partners.⁹ Before the Treasury Department makes any revisions, however, it should recognize that the source of the difficulties resides in the at-risk concept,¹⁰ and it should inquire whether the perceived benefits of the at-risk analysis justify the cost in confusion and complexity.

This Article argues that the resulting cost is not warranted, and that the at-risk concept in any of its manifestations is wrong in principle. The Article also demonstrates that applying the traditional separate-transaction system to any bona fide transaction involving loans and loan proceeds will yield a correct income tax result. Since the greatest deviation from this system has occurred in the treatment of transactions involving

5. See, e.g., Treas. Reg. § 1.752-1(e) (1960).

6. See, e.g., I.R.C. § 465 (1982 & Supp. II 1984).

7. See, e.g., *Raphan v. United States*, 3 Ct. Cl. 457 (1983), *rev'd in part*, 759 F.2d 879 (Fed. Cir. 1985).

8. Tax Reform Act of 1984, Pub. L. No. 98-369, § 79(b), 98 Stat. 4494, 4597 (1984).

9. See Treas. Reg. § 1.704-1(b) (1985). Like the regulations under § 752 for limited partners, the newly enacted regulations under § 704 import at-risk concepts. In general, the regulations deny loss allocations to partners who are not required to restore deficits in their capital accounts, and in certain cases the rules allocate these losses to other partners. *Id.* § 1.704-1(b)(2)(ii)(b).

The § 704 regulations as recently enacted do not deal specifically with the treatment of nonrecourse debt. However, the proposed regulations did contain a discussion of this topic and applied a special rule to allocating losses attributable to recourse and nonrecourse borrowing. See *id.* § 1.704-1(b)(4)(iv) (proposed March 9, 1983). This section was reserved when the other subsections of the regulation were adopted. See T.D. 8065, 1986-5 I.R.B. 4, 19.

This Article does not attempt to explore the changes that should be made in the § 704 regulations. However, if the distinctions drawn under the § 752 regulations and the at-risk concept are both discarded as suggested here, the § 704 regulations would require revision to delete reliance on similar notions.

10. The heart of the at-risk concept is embodied in § 465. The at-risk rule of this section bars many taxpayers from deducting losses attributable to an activity which are in excess of the taxpayer's basis attributable to an equity investment and amounts borrowed for which the taxpayer is personally liable. Thus, deductions attributable to a nonrecourse borrowing might not be deductible as incurred. Losses in excess of the at-risk amount must be carried forward, and may be applied against subsequent profits or increases in the at-risk amount attributable to new investment.

The origin of § 465 is described *infra* at text accompanying notes 133-40. While intended only as a limitation on tax-shelter losses, the section, as written, acts as a modification of the general basis rules and occasionally is so viewed. See, e.g., *Commissioner v. Tufts*, 461 U.S. 300, 309 n.7 (1983).

conduit entities, this Article initially addresses the treatment of limited partners and of nonrecourse borrowing by partnerships.¹¹

Part I of this Article demonstrates that the failures of the present law governing partnership taxation arise directly from the fact that the regulations under subchapter K¹² inadequately implement the *Crane* doctrine and the separate-transaction system of analysis. The proper revision of the basis allocation rules, therefore, must adapt that system more faithfully. Part II develops the form that the partnership rules would assume if they were fashioned in conformity with the principles of the *Crane* system. This section also shows that the resulting system would be simpler and far more rational than current law.

The deviations from the separate-transaction system in the partnership basis and at-risk rules reflect the belief that the traditional rules inadequately tax persons claiming losses not accompanied by an economic detriment. That belief, however, is erroneous. Part III demonstrates that the traditional approach to cancellation-of-indebtedness income, with minor modifications, produces an appropriate tax liability and that the at-risk limitations are technically unnecessary. By incorporating a minor but important revision to the taxation of cancellation-of-indebtedness income, the simplified rules would eliminate the potential for taxpayer abuse as effectively as the complex restrictions now in effect. Part IV then discusses nontheoretical justifications for the at-risk rules and notes that while the rules may help combat fraud, they are overly broad and must be revised in order to provide taxpayers with the proper tax consequences of bona fide transactions.

I

THE EXISTING SYSTEM AND ITS DEFICIENCIES

A. *The Statutory Pattern*

The taxation of partnerships is based on a blend of the entity and aggregate conceptions of a partnership.¹³ In the taxation of ongoing partnership activities, the aggregate or conduit approach predominates:

11. Although this Article addresses the taxation of partnerships, the conclusions reached herein with respect to limited partners could equally apply to the taxation of shareholders in corporations electing to be taxed under subchapter S, I.R.C. §§ 1361-1379 (1982 & Supp. II 1984). The taxation of S corporations now largely conforms to the taxation of partnerships. However, S corporation shareholders, like limited partners and in part for the same reasons, are not entitled to a basis adjustment attributable to an entity-level borrowing. See I.R.C. § 1367(a) (1982 & Supp. II 1984) (describing when basis in shareholder's stock may be increased).

12. I.R.C. §§ 701-761 (1982 & Supp. II 1984).

13. For a general discussion of partnership taxation, see 1 & 2 W. MCKEE, W. NELSON & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* (1978). For a discussion of the entity and aggregate concepts, see 1 *id.* § 1.02.

partnerships are not taxable entities,¹⁴ and partners are taxed directly on their allocable share of partnership income and expenses.¹⁵ Nevertheless, a partnership is an entity in which the several partners have invested. For measuring gain or loss on that investment, either upon a sale of a partnership interest¹⁶ or upon a distribution from the partnership,¹⁷ each partner has a tax basis for his partnership interest.¹⁸

When a partnership borrows money to purchase property, the partnership's tax basis in that property includes the proceeds of the borrowing.¹⁹ If the property is depreciable or otherwise generates a tax loss, the partnership measures those losses against that basis. These losses are then allocated to the partners who can deduct the losses from their individual taxable incomes. However, since taxpayers may not recognize losses in excess of their investment,²⁰ partners may not claim losses with respect to partnership activities in excess of their tax basis for their interests in the partnership.²¹

Obviously, the effect of the partnership's loan and subsequent purchase of property on each partner's basis will determine how much of the expenses and losses each partner can deduct. An aggregate approach to the taxation of partnership borrowing would treat the partnership as a mere conduit. The transaction would be reconstructed for tax purposes as if the partners borrowed the money as individuals, contributed the

14. I.R.C. § 701 (1982).

15. *Id.* § 702(a) (1982 & Supp. II 1984).

16. *Id.* § 741 (1982).

17. The taxation of partnership distributions consists of a relatively complicated blend of aggregate and entity concepts. In general, however, gain is recognized only on the distribution of cash in excess of a partner's adjusted basis for his partnership interest. *Id.* § 731(a)(1) (1982). On the other hand, property distributions are nonrecognition transactions in which the partnership basis for the distributed property carries over to the distributee partner. *Id.* § 732 (1982).

18. *Id.* §§ 722 (Supp. II 1984), 742 (1982). In general, a partner's basis for a purchased partnership interest is equal to the amount paid; thus, basis acquired by a contribution to the partnership equals the sum of the cash and the adjusted basis of property transferred to the partnership. The partner's basis is thereafter increased by profits allocated to the partner and reduced by losses and distributions to the partner. *Id.* § 705 (1982 & Supp. II 1984).

19. Apparently, the Commissioner has historically permitted taxpayers to increase the basis of acquired property by the amount of any indebtedness issued to the seller or the amount of any indebtedness that encumbered the property at the time it was acquired. See Greenbaum, *The Basis of Property Shall Be the Cost of Such Property: How Is Cost Defined?*, 3 TAX L. REV. 351, 356 (1948). In *Crane*, 331 U.S. at 11, the Supreme Court held that this treatment of indebtedness was applicable to both recourse and nonrecourse loans, as long as the property's value equalled or exceeded the total indebtedness. This separate-transaction approach to indebtedness, regardless of the character of the debt, has become associated with the *Crane* decision.

20. For dispositions of property, see I.R.C. § 1001(a) (1982) (amount of loss for income tax purposes equals excess of basis over amount realized on disposition). See also *id.* § 165(b) (1982) (basis for determining deduction for any loss not compensated by insurance is same as basis for determining loss on sale or other disposition of property).

21. *Id.* § 704(d) (1982). Excess losses, however, may be carried forward and claimed when sufficient basis becomes available.

proceeds to the partnership, and then used the proceeds to acquire partnership assets. Thus, the partners in the aggregate would be treated as having made an investment in the partnership equal to the amount borrowed. That investment would increase the partners' basis for their partnership interests and would permit partners to claim losses attributable to the expenditure of the loan proceeds as incurred.

On the other hand, under an entity approach a partnership's loans would have no effect upon the partners. While the partnership would acquire a basis for any property purchased with the proceeds, each partner's basis for his individual partnership interest would not change. Each partner's basis would increase by any profits the partnership earned and attributed to the partners, some of which presumably would be used to retire the indebtedness, but the basis would not be increased by the partnership's borrowing. As a result, partners could not deduct partnership losses in excess of their actual cash investment plus profits accumulated in prior years. If the partnership actually incurred economic losses, a partner might not be able to claim his share until the disposition of his partnership interest.²²

The distinction between the aggregate and entity approaches parallels the early debate about whether a borrowing and subsequent purchase constitute separate transactions or a single taxable event. Proponents of the separate-transaction approach viewed the purchaser as borrowing cash and using that cash to acquire property. As a result, the taxpayer acquired a basis in the property and could claim depreciation and other deductions in the same manner and to the same extent as someone acquiring property with his own funds. Proponents of the single-transaction approach, however, viewed the debt as an obligation to pay the purchase price for the property. The taxpayer's basis was therefore limited to the actual cash paid for the property and increased by payments in discharge of the loan.²³ In developing the consequences of transaction

22. Tax losses, of course, are not always accompanied by economic losses. Several provisions of the Code deliberately permit the claiming of tax losses in advance of economic losses for the purpose of stimulating investment. See, e.g., I.R.C. § 46 (1982 & Supp. II 1984) (investment tax credit); *id.* § 168 (West Supp. 1986) (accelerated cost recovery); *id.* § 613 (1982) (percentage depletion). The deferral of tax losses until an economic loss occurs has the effect of completely eliminating the investment incentive feature of these allowances.

The entity approach is also currently applied to S corporations. As a result, shareholders of S corporations must plan their transactions carefully or risk losing the benefit of accelerated income tax deductions. See Coven & Hess, *The Subchapter S Revision Act: An Analysis and Appraisal*, 50 TENN. L. REV. 569, 599-604 (1983).

23. There are, of course, other implications. Suppose, for example, the taxpayer benefitted from the cancellation of the debt. Under the separate-transaction analysis the taxpayer is taxed immediately on the amount forgiven. See *United States v. Kirby Lumber Co.*, 284 U.S. 1, 3 (1931). Under the single-transaction approach, however, the cancellation simply represents a failure to pay the full purchase price for the property and has no tax consequences. The taxpayer thus merely obtains a basis in the property equal to the amount of the note actually discharged. See, e.g., *Hotel*

involving debt-financed property, the courts and the Commissioner differed over whether to approach the borrowing and the purchase as separate and independently taxable events or as steps in a single transaction.²⁴

In *Crane v. Commissioner*, the Supreme Court adopted the separate-transaction approach for most debt-financed property. Mrs. Crane had inherited property that was subject to a nonrecourse debt presumably equal to the unencumbered value of the property. She eventually sold the property, still subject to the debt, and reported the sale using a single-transaction analysis. Under that approach, her basis would have been limited to the net value of the property when inherited, or zero, and the amount realized upon the disposition would have been limited to the \$3,000 cash actually received. The Supreme Court, however, sustained the Commissioner's contention that the separate-transaction analysis the Court had previously extended to property encumbered with recourse debt²⁵ should be applied to Mrs. Crane's property sale. The Court concluded that the financial consequences of recourse and nonrecourse debt were too similar to justify the application of two radically different patterns of taxation. Accordingly, the taxpayer's basis for the property was the unencumbered value of the property when inherited, as reduced by allowable depreciation, and the amount realized on the sale included the amount of the debt that burdened the property.

When Congress revised the partnership taxation rules seven years later, it adapted the *Crane* approach to the computation of a partner's tax basis for his partnership interest. Thus, a partnership-level borrowing is treated as if the partners had borrowed cash and had contributed that cash to the partnership.²⁶ Conversely, the partnership's repayment of the loan is treated as if the partnership had distributed cash to the partners and the partners had discharged the liability to the lender.²⁷ As

Astoria, Inc. v. Commissioner, 42 B.T.A. 759, 764 (1940); *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519, 521 (1934).

After the *Crane* decision a hybrid approach emerged. Basis was computed under a separate-transaction approach, but either the single-transaction or a blend of the separate- and single-transaction approaches was applied to the cancellation of debts. See, e.g., *Collins v. Commissioner*, 22 T.C.M. (CCH) 1467 (1963).

24. The Board of Tax Appeals and the Tax Court preferred the single-transaction approach. See, e.g., *Crane v. Commissioner*, 3 T.C. 585, 590-91 (1944), *rev'd*, 153 F.2d 504 (2d Cir. 1945), *aff'd*, 331 U.S. 1 (1947); *Lutz & Schamm Co. v. Commissioner*, 1 T.C. 682, 689 (1943); *Hotel Astoria*, 42 B.T.A. at 763. The Commissioner, however, preferred the separate-transaction approach, see, e.g., *Peninsula Co. Ltd. v. Commissioner*, 47 B.T.A. 84, 91 (1942), that the Supreme Court ultimately adopted. See *Crane*, 331 U.S. at 11; *United States v. Hendler*, 303 U.S. 564, 566 (1938). The development of a clear rule was retarded by the Commissioner's tendency to assert a single-transaction analysis when that would produce a larger deficiency. See, e.g., *Lutz*, 1 T.C. at 687.

25. *Helvering v. American Chicle Co.*, 291 U.S. 426, 430 (1934).

26. I.R.C. § 752(a) (1982) (increase in partner's share of partnership liabilities considered a contribution of money to partnership).

27. *Id.* § 752(b) (1982) (decrease in partner's share of partnership liabilities considered a

a result, a partnership-level borrowing increases the aggregate tax basis of the partners' interests in the partnership by the amount borrowed. Furthermore, absent atypical changes in the partnership structure, the aggregate outside basis will equal the partnership's inside basis for its properties.²⁸ Accordingly, the partners may generally claim losses generated by partnership operations in accordance with the normal timing rules of the Code.²⁹

For partnership taxation purposes, the character of the partnership borrowing is irrelevant. As long as the partnership is obligated to repay the debt,³⁰ nonrecourse and recourse debts are treated identically. Furthermore, the fact that all or a portion of a borrowing might not be repaid does not alter the tax consequences of the investment of the loan proceeds. Since the borrowing and the use of the proceeds are treated as separate transactions, the potential or actual failure to repay the debt does not affect the tax consequences of the property ownership. Rather, transactions involving the loan proceeds produce their own tax consequences.³¹

B. The Section 752 Regulations

The Code, however, does not say which partners should be treated as making the constructive contribution of loan proceeds, and thus does not prescribe a method for allocating basis to the partners upon the expenditure of loan proceeds. In drafting regulations covering the allocation procedures, the Treasury Department equated a partner's right to a basis increase with his ultimate liability to repay the loan upon the failure of the partnership business.³² The regulations therefore attach great sig-

distribution of money to partner). The constructive distribution is then taxed as an actual cash distribution. *Id.* § 731 (1982).

When the discharge of the liability also produces a deduction, as would the discharge of an account payable for supplies, the mandated reconstruction becomes more complicated. While the partner is treated as having repaid the creditor, the partnership claims the deduction and then allocates it to the partners according to the ratio for sharing tax losses. That ratio may not correspond to the ratio by which the partners are treated as having discharged the liability.

28. This equality may be marred by transfers of partnership interests, thereby producing a new basis for the partnership interest, or by the suspension of losses in excess of a partner's basis for his partnership interest.

29. The Code codified this result at I.R.C. § 752(c) (1982). The scope of this section, however, is limited by the caveat that a nonrecourse liability is to be treated as a recourse liability only to the extent of the fair market value of the encumbered property. *Cf. Crane*, 331 U.S. at 14 n.37 (reserving judgment on treatment of nonrecourse loans when amount of debt exceeds value of security).

30. A partnership is obligated to repay a nonrecourse borrowing up to the amount of the security's fair market value.

31. The propriety of this result is discussed *infra* in Part III.

32. Treas. Reg. § 1.752-1(e) (1960).

nificance to the state law concepts of general and limited partners, as well as to the distinctions between recourse and nonrecourse borrowing.

Under the regulations, when a partnership incurs a recourse loan, the resulting increase in basis is allocated solely to the general partners in the proportion determined by the partnership's loss-sharing ratio.³³ A limited partner who has no further obligation to contribute to the partnership, and thus no personal obligation to participate in the repayment of the loan, is not entitled to any increase in basis.³⁴

This principle suggests that when a partnership incurs a nonrecourse obligation, none of the partners are entitled to a basis adjustment, since none of the partners have a personal obligation to repay the debt. That conclusion, however, is clearly incorrect under both *Crane* and section 752. Thus, the regulations permit all members of either a general³⁵ or limited partnership to increase the basis for their partnership interests in the proportion in which partnership profits are allocated among the partners—presumably because those profits, rather than individually owned assets, are the source of the nonrecourse loan's repayment.³⁶

C. The Failure of the Regulatory Solution

1. The Lack of Principled Justification

The regulations thus adopt the separate-transaction approach for general partners³⁷ but resurrect the single-transaction approach for limited partners in the case of a recourse borrowing. Consequently, limited partners are denied any basis adjustment attributable to expenditures made from the proceeds of a partnership's recourse borrowing. As both Congress and the Supreme Court seemingly rejected the single-transaction approach to the computation of basis in other situations, the current use of that approach for limited partnerships requires a compelling legal or economic justification.

Obviously, the principles established in *Crane* do not support this regulatory pattern. The Treasury Department presumably imposed this

33. *Id.*

34. The regulations under § 704(b) governing the allocation of partnership items draw a similar distinction. Rather than distinguishing between general and limited partners, the regulations distinguish between partners by the existence of an obligation to restore deficits in their capital-account balances upon liquidation. See Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2) (1985). Such a deficit could occur if losses attributable to the expenditure of loan proceeds were allocated to a partner in excess of the amount of his equity investment.

35. The regulations do not specifically address the allocation of basis attributable to a nonrecourse borrowing by a general partnership. However, the logic of the regulations suggests that the allocation should be in proportion to the profit-sharing ratio, since this is the formula followed for limited partnerships.

36. See 1 W. MCKEE, W. NELSON, & R. WHITMIRE, *supra* note 13, at § 8.01[1].

37. The use of the loss-sharing ratio in the allocation, however, is questionable. See *infra* Part II.

relatively harsh treatment upon limited partners in activities not motivated by tax concerns because limited partners are insulated from economic losses that exceed their investment in the partnership, as enhanced by accumulated profits.³⁸ Mrs. Crane, however, enjoyed the same degree of insulation. The nonrecourse loan burdening her property at the time it was inherited equalled the unencumbered value of the property, and therefore she could not have sustained an economic loss.

The narrow issue presented to the Supreme Court in *Crane* was whether the separate-transaction system previously adopted for recourse indebtedness should apply to nonrecourse loans. The Supreme Court agreed with the Commissioner's contention that Mrs. Crane had a tax basis in the property that included the amount of the debt, and thus was entitled to depreciation deductions from that basis.³⁹ Rejecting the contrary position adopted by the Tax Court,⁴⁰ the Supreme Court held that as long as the fair market value of the encumbered property exceeded the amount of the indebtedness, the tax consequences of recourse and nonrecourse financing were to be identical.⁴¹

The regulations under section 752 take the opposite approach. Indeed, the regulations are fundamentally inconsistent with *Crane*, for they adopt the distinction between recourse and nonrecourse debt that *Crane* had discarded and give each type of indebtedness a different treatment. While a limited partner cannot claim a basis increase attributable to a recourse borrowing, he shares equally with general partners in the basis increase attributable to a nonrecourse borrowing.⁴² Furthermore, while the basis increase attributable to a recourse borrowing is allocated in accordance with the loss-sharing ratio, the basis increase attributable to a nonrecourse debt is allocated in accordance with the profit-sharing ratio.⁴³ As a result, the regulations revent in the tax system the complexities that *Crane* had largely eliminated.

These regulations might be justified if the nature of partnership indebtedness had economic significance. From the limited partner's perspective, however, it matters little whether the partnership finances its operations through recourse or nonrecourse debt. The obligation to

38. The Senate Committee on Finance noted this fact and with respect to tax shelters, concluded that "it is not equitable to allow these individual investors to defer tax on income from other sources through losses generated by tax sheltering activities, to the extent the losses exceed the amount of actual investment the taxpayer has placed at risk in the investment." S. REP. No. 938, 94th Cong., 2d Sess. 45, 51 (1976), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3481, 3482. While it only discusses tax shelters, however, § 465 clearly applies to all limited partnerships.

39. *Crane v. Commissioner*, 331 U.S. 1, 6 (1947).

40. *Crane v. Commissioner*, 3 T.C. 585 (1944), *rev'd*, 153 F.2d 504 (2d Cir. 1945), *aff'd*, 331 U.S. 1 (1947).

41. *Crane*, 331 U.S. at 14.

42. Treas. Reg. § 1.752-1(e) (1960).

43. *Id.*

repay a nonrecourse debt is, of course, limited to the value of the property securing the debt. If the value of the security falls below the face amount of the loan, the lender might not be repaid in full. By virtue of the nonrecourse aspect of the loan agreement, some portion of the economic loss incurred by the partnership is in effect shifted to the lender.

On the other hand, in the event of default on a recourse debt, the lender may reach other assets of the partnership. Should those other assets be insufficient to discharge the debt, the lender, at least in theory, may reach the separate assets of the general partners. However, in no event may the lender reach any of the limited partner's assets not dedicated to the partnership. Pursuant to the partnership agreement, the limited partners are not obligated to repay any portion of the indebtedness, and may shift that economic burden to the general partners. Whether the loss is shifted to the lender under the loan agreement or to the general partner under the partnership agreement is of no economic consequence to the limited partner. Accordingly, at least from the limited partner's perspective, the regulations create vast differences in tax results that are not accompanied by any underlying economic justifications.

If the loan is with recourse, the tax penalty of the basis allocation is particularly egregious, for the limited partners may actually bear part of the economic loss. Should the value of the partnership assets be sufficient to repay the debt, the limited and general partners will in fact share the economic burden of repaying the loan. However, the limited partners will not have received an increase in basis attributable to the loan they helped repay.⁴⁴ The system's purported rationale thus may conflict with economic realities in many situations.

The justification for this harsh treatment of limited partners must therefore lie in the greater potential liability of general partners for recourse loans. However, closer examination reveals that this contingent economic liability does not justify the deviation from a separate-transaction approach to partnership debt. Most partnerships do not become bankrupt, and hence they discharge their debts with partnership assets. Moreover, unless the partnership assets were overvalued at the time of the loan, even a bankrupt partnership will normally discharge more of its debt with partnership assets than with the separate assets of its general partners. As a result, the economic burden of repaying partnership debt with partnership assets is greater than the economic burden of discharging partnership debt with the separate assets of the general partners.

44. While the limited partners may obtain an increase in basis as the partnership derives the income that is used to repay the loan, that basis will not have been available in the prior years when the partnership losses may have been incurred. In some cases, that income will not be realized until partnership properties are applied to the repayment of the loan.

Difficulties in collecting from the general partners further diminish the economic significance of this potential liability. Because state law imposes substantial procedural obstacles to the collection of deficiency judgments⁴⁵ and, perhaps, because lenders do not want to damage customer relations, secured creditors typically do not pursue deficiency judgments against general partners. Thus, even though access to a general partner's personal assets may be necessary to repay the loan fully, this legal liability does not commonly produce an actual economic detriment.

In practice, therefore, it is of little economic significance to a general partner whether the partnership incurs a recourse or a nonrecourse debt. For the regulations to permit these technical arrangements to produce substantial differences in tax effects is simply inappropriate. By allocating basis, and thus the ability to claim losses from the investment of partnership funds, as a function of potential liability for repayment, the regulations place undue weight upon the improbable, pathological case and ignore the probable, normal case. Since most partnership debt is discharged without invoking the personal liability of the general partners, that potential liability should play little, if any, role in the allocation of basis.

2. *Abuses and Responses*

The regulatory pattern under section 752 has always drawn criticism. One commentator characterized the treatment of limited partners as absurd,⁴⁶ and others have suggested that the regulations be revised.⁴⁷ Nevertheless, those regulations precipitated little controversy in the twenty years following their adoption, presumably because during that period the Commissioner paid relatively little attention to the intricacies of partnership taxation.⁴⁸ In the 1970's, however, the Commissioner and Congress began to move more aggressively against abuses by the tax shelter industry. The "at-risk" rules of section 465,⁴⁹ one of the techniques adopted to curb such abuses, followed the section 752 regulations in distinguishing between recourse and nonrecourse indebtedness. As a result, the distinctions drawn by the section 752 regulations came under great

45. CAL. CIV. PROC. CODE §§ 580a, 580b (West 1976). See generally G. OSBORNE, G. NELSON & D. WHITMAN, *REAL ESTATE FINANCE LAW* §§ 8.1 -8.3, at 524-36 (1979).

46. Hill, *Bases of Partnership Interests*, 15 N.Y.U. INST. ON FED. TAX'N 57, 68 (1957).

47. See Epstein, *The Application of the Crane Doctrine to Limited Partnerships*, 45 S. CAL. L. REV. 100 (1972); Perry, *Limited Partnerships and Tax Shelters: The Crane Rule Goes Public*, 27 TAX L. REV. 525 (1972).

48. Professor Zeitlin has noted that "over the years [there have been] relatively few partnership audits and hence few cases . . . [T]he problem in the partnership field has generally been too few cases rather than too many." Zeitlin, *Foreword* to 1 W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 13, at vi.

49. I.R.C. § 465 (1982 & Supp. II 1984).

pressure as practitioners probed the lines between recourse and nonrecourse indebtedness on the one hand, and between a limited and general partner on the other. That pressure quickly exposed the errors inherent in those regulations.

Observers have long recognized that while the regulations create burdensome complexity for bona fide commercial partnerships,⁵⁰ they do little, if anything, to interfere with the tax-reduction objectives of the well-advised taxpayer. Small business partnerships, for example, typically assign limited interests to inactive family members or to employees. Not uncommonly, those limited partners have relatively small capital accounts. There is no apparent reason why limited partners who will be taxed on a percentage of partnership profits used to repay a loan should not also be entitled to claim a corresponding percentage of deductions produced by the expenditure of the loan proceeds.⁵¹ Under the current section 752 regulations, however, limited partners may not deduct losses or expenses in excess of their cash investment and accumulated profits.⁵² Rather, these deductions are deferred until the limited partner's capital account is enlarged either by a further investment or by an allocation of profits.⁵³ While the taxpayer may subsequently claim those deductions, their value is diminished by the deferral of the tax benefit.

To avoid this deferral, many partnerships specially allocate losses in excess of a limited partner's investment to the general partners even though that special allocation is inconsistent with the general business objectives of the partnership.⁵⁴ Since the general partners are frequently in a higher tax bracket than are the family members or employees who are the limited partners, the regulations encourage, if not force, tax planning that the parties otherwise would not have adopted.

Sophisticated taxpayers may also manipulate the regulations by simply redefining partnership obligations, thereby altering the technical legal relationships among the partners and allowing for a more favorable allocation of basis. This manipulation of the section 752 regulations can, and does, occur because taxpayers have come to understand that their technical obligations, while important for determining tax liability, rarely result in economic consequences.⁵⁵

By creating a conflict between the lender's need for adequate secur-

50. See, e.g., *Block v. Commissioner*, 41 T.C.M. (CCH) 546 (1980).

51. Part III of this Article considers and rejects the technical objection that these partners will not bear the economic burden of those losses.

52. Treas. Reg. § 1.752-1(e) (1960).

53. *Id.* § 1.704-1(d)(1) (1960), as amended by T.D. 6771, 29 Fed. Reg. 15,571 (1964).

54. This reallocation is specifically permitted by I.R.C. § 704(b) (1982).

55. Under current law such manipulation is rarely required to obtain a right to increase basis; the partnership simply incurs nonrecourse liabilities. However, a partnership with recourse liabilities may increase a limited partner's basis by having the partner agree to make contributions to

ity and a limited partnership's desire for nonrecourse debt, the section 752 regulations encourage taxpayers to blur the distinctions between recourse and nonrecourse liability. Governmental response to these manipulations has been mixed. In *Long v. Commissioner*,⁵⁶ for example, the Tax Court computed the basis of general partnership interests when some of the partners had personally guaranteed a portion of an otherwise nonrecourse mortgage. The section 752 regulations require that an increase in basis be allocated to all of the partners in accordance with the profit-sharing ratio only when "none of the partners have any personal liability" with respect to the loan.⁵⁷ Since some of the partners had incurred some personal liability, the court treated the entire loan as a recourse obligation and allocated basis to the general partners in accordance with the loss-sharing ratio.⁵⁸

Three years later the Commissioner adopted a contrary position, and ruled that a partial-recourse note should be treated as two separate obligations, with the basis allocation made separately with respect to each segment of the divided note.⁵⁹ To the extent of any personal liability, the basis increase should be allocated in accordance with the rules governing recourse liabilities. The adjustment attributable to the balance of the note should then be allocated to all partners in accordance with their interest in partnership profits.⁶⁰

The Tax Court's resolution of the allocation problem in *Arthur Long* is less than satisfactory. The court's decision would treat the entire amount of an outstanding nonrecourse note as a recourse obligation if a single partner personally guaranteed repayment of an insignificant fraction of the obligation. Such an economically insignificant act would not only invoke a different ratio for the allocation of basis, thus precipitating constructive contributions and distributions among the partners, but would also, and far more dramatically, exclude limited partners from the allocation. Furthermore, taxpayers wishing to avoid the consequences of *Arthur Long* would have probed the possibilities of dividing a single note

the partnership in the future. See 1 W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 13, § 8.03 (risk assumed by the limited partner may be "modest," depending upon adequacy of security).

The allocation regulations under § 704(b) may expand the use of such techniques. Under those regulations, special allocations may be sustained more easily if the partners are required to restore deficits in their capital accounts upon withdrawal from the partnership. Treas. Reg. § 1.704-1(b)(2)(ii)(c) (1985). Apparently, some limited partnerships are now requiring deficit restoration, although they do not contemplate that the limited partners will actually be required to make payments to the partnership.

56. 77 T.C. 1045 (1981). In keeping with general tax parlance, this case will be referred to in the text as *Arthur Long*.

57. Treas. Reg. § 1.752-1(e) (1960).

58. *Long*, 77 T.C. at 1075.

59. Rev. Rul. 84-118, 1984-2 C.B. 120. This ruling subsequently was clarified. See Treas. Announcement 85-19, 1985-5 I.R.B. 31.

60. Rev. Rul. 84-118, 1984-2 C.B. 120.

into two separate obligations, each being entitled to the treatment the Commissioner ultimately conceded was available for all partial-recourse notes.

Moreover, other Code sections also prescribe different tax consequences for recourse and nonrecourse indebtedness. Under the at-risk rules of section 465, for example, taxpayers may not claim losses attributable to the expenditure of a nonrecourse loan,⁶¹ although no such limitations obtain for deductions attributable to a recourse liability. The approach to recourse obligations adopted in *Arthur Long* is not acceptable for the purposes of section 465, for it would permit taxpayers to avoid the limitations of that section by entering into an economically insignificant guarantee. Accordingly, the *Arthur Long* approach might treat an obligation as a recourse debt for basis allocation purposes, but as a nonrecourse debt for the purposes of section 465. While that sort of inconsistency is not alien to the Code, it is an obviously undesirable source of confusion and complexity.

The Commissioner's ruling avoided all of the arbitrariness and complexity inherent in *Arthur Long*. However, the ruling points out the flaw in the distinction between recourse and nonrecourse debt, for in the most common circumstances involving a partial-recourse loan, the ruling strips the distinction of all meaning. The justification for different tax consequences of recourse and nonrecourse borrowing must lie in the greater likelihood that a nonrecourse borrowing will not be repaid. However, to the extent that a nonrecourse indebtedness is adequately secured, the distinction evaporates. With an adequate partial guarantee, the lender as a practical matter is as likely to be paid in full as he would be if the loan were with recourse.⁶² Under the Commissioner's ruling, however, a taxpayer can effectively create a recourse debt, yet preserve part of the favorable allocation of basis attributable to nonrecourse indebtedness.⁶³

As between these two approaches to partial-recourse indebtedness, the Commissioner's present position is vastly more practical, although it

61. See Treas. Reg. § 1.465-25(b)(1)(i) (proposed June 5, 1979).

62. In its study of this issue, the American Law Institute conceded that a partial-recourse debt is indistinguishable from a recourse debt, provided there is no reasonable chance of the security's value falling below the amount of the guarantee. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, SUBCHAPTER K 273 (1984) [hereinafter cited as "ALI PROPOSAL"]. Nevertheless, the ALI endorsed the Commissioner's treatment of such a borrowing as two separate notes with the resulting basis to be allocated separately. *Id.*

63. The Treasury Department has attempted to penalize this technique through the proposed regulations under § 704(b). Under those regulations, losses are treated as attributable first to recourse borrowing and only thereafter to nonrecourse borrowing. Treas. Reg. § 1.704-1(b)(4)(iv) (proposed March 9, 1983); *id.* § 1.704-1(b)(5) example 17(i). As a result, the first losses incurred by a partnership having a dual financing arrangement do not fall within the safe harbor rule applicable to losses attributable to nonrecourse indebtedness.

is also far more favorable to the tax shelter industry. The point, however, is that there is no satisfactory resolution to these sorts of questions because the regulatory distinction between recourse and nonrecourse indebtedness does not reflect a substantial economic reality.

Techniques involving partner guarantees or other obligations that do not flow from the loan agreement are functionally similar to partial-recourse indebtedness. Consider a limited partnership that owns property subject to a nonrecourse liability. All of the partners' tax bases therefore reflect an adjustment attributable to that borrowing. Assume further that the partnership is having trouble making the loan payments. To prevent foreclosure, the partnership agrees to assume the obligations on the loan. That assumption, of course, increases the exposure of the limited partners to liability. Prior to the assumption, the limited partners only risked the loss of their share of the encumbered property; now, they also risk the forfeiture of their interest in other partnership assets. Nevertheless, the section 752 regulations remove the amount of the loan from the tax basis of the limited partnership interests.⁶⁴ In an attempt to prevent that result, the limited partners personally obligate themselves to repay all or a portion of the borrowing.⁶⁵ The limited partners thus have assumed an actual financial obligation with respect to the loan indistinguishable from the liability of a general partner. A rule of law that would not permit those limited partners to include an allocable portion of the borrowing in the basis for their partnership interests, to say the least, would be untenable.

The regulations, however, produce precisely this undesirable result. The regulations allocate basis attributable to recourse liabilities only to general partners.⁶⁶ Without question, a limited partner guarantee does not cause that partner to become a general partner. Accordingly, the Tax Court has twice held that guarantees of recourse obligations by limited partners do not permit those partners to increase the basis for their partnership interests.⁶⁷ That result, which seems mandated by the literal language of the regulations, is unreasonable. A limited partner who is personally obligated to repay a portion of a loan is not abusing the tax

64. *Id.* § 1.752-1(f) (1960).

65. That assumption might take the form of a guarantee running directly to the lender, or it might represent an indemnification of the general partners should the general partner be called upon to discharge the loan from personal assets.

66. Treas. Reg. § 1.752-1(e) (1960).

67. *Block v. Commissioner*, 41 T.C.M. (CCH) 546 (1980); *Brown v. Commissioner*, 40 T.C.M. (CCH) 725 (1980). The Commissioner had previously ruled that indemnification of a general partner by a limited partner does not permit an increase in the limited partner's basis even if the indemnification is required by the limited partnership agreement. The Commissioner reached this result because the limited partner indemnified the general partner in his individual capacity, and thus was not obligated to contribute additional money to the partnership. Rev. Rul. 69-223, 1969-1 C.B. 184.

system by attempting to claim a proportionate share of the losses attributable to the expenditure of the proceeds.

On the other hand, ignoring liabilities created by side agreements might work to the taxpayer's advantage. For instance, suppose a limited partnership is formed to construct and operate an apartment building. The venture promises to be quite profitable but will produce tax losses in its early years due to accelerated cost recovery allowances.⁶⁸ In order for the limited partners to be able to claim those tax incentive allowances, the financing must be on a nonrecourse basis. The lender, however, refuses to make a nonrecourse loan. If side agreements have no effect upon basis allocations, it should follow that the general partner may personally guarantee the repayment of the loan without jeopardizing either the loan's nonrecourse character or the subsequent basis adjustment to the limited partners.

In *Raphan v. United States*,⁶⁹ the Court of Claims agreed with this analysis. In that case, the general partners guaranteed a nonrecourse construction loan. The limited partners took title to the property subject to the security interest, but never assumed the loan.⁷⁰ The court correctly noted that the general partner's guarantee did not alter the economic interests of the limited partners, since the guarantee had to be satisfied with the individual assets of the general partner. The court then concluded that the guarantee did not alter the nonrecourse character of the loan.⁷¹

Congress and the Treasury Department reacted swiftly. A horrified Commissioner immediately issued a public ruling to the contrary.⁷² Congress enacted legislation providing that section 752 should be applied without regard to the result reached in *Raphan*.⁷³ Moreover, Congress instructed the Treasury Department to amend the section 752 regulations to provide for the treatment of all such side agreements.⁷⁴ The conference report on that somewhat unusual piece of legislation suggested that the regulations should reflect the manner in which partners actually bear the economic risk of loss, although the general structure of the regulations should remain in place.⁷⁵

The Treasury Department will have difficulties completing that assignment, for the problem of partner guarantees cannot be logically

68. See, e.g., I.R.C. § 168 (West Supp. 1986).

69. 3 Ct. Cl. 457 (1983), *rev'd in part*, 759 F.2d 879 (Fed. Cir. 1985).

70. *Id.* at 465.

71. *Id.* at 465-66.

72. Rev. Rul. 83-151, 1983-2 C.B. 105.

73. Tax Reform Act of 1984, Pub. L. No. 98-369, § 79(a), 98 Stat. 4494, 597 (1984).

74. *Id.* § 79(b), 98 Stat. at 597.

75. H.R. REP. NO. 861, 98th Cong., 2d Sess. 868 (1984), *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 697, 1556.

and consistently resolved within the context of the distinctions drawn under the section 752 regulations. As the Court of Claims observed in *Raphan*, it is economically irrelevant to the limited partner whether the general partners guarantee a nonrecourse debt.⁷⁶ It is thus inappropriate dramatically to alter the tax consequences for the limited partner, as the Commissioner's ruling requires, on the basis of a shift in the risk of loss between the lender and the general partners.

That improper result, however, is not a unique aspect of partner guarantees; rather, it is the result of the distinctions drawn in the regulations between recourse and nonrecourse indebtedness, and between general and limited partners. As already noted, the character of any partnership borrowing is of little relevance to a limited partner.⁷⁷ The presence of a side agreement should be made irrelevant to the limited partners, but not by ignoring the agreement's financial consequences, as *Raphan* suggests. Since one of the borrowers will repay the debt, treating that debt as not involving personal liability would be irrational. Instead, the distinction drawn in the regulations between recourse and nonrecourse indebtedness, and between limited and general partners, should be eliminated.

D. The Proposed Revisions of the American Law Institute

The American Law Institute has attempted to resolve some of the deficiencies in the section 752 regulations. While endorsing the distinctions between general and limited partners and between recourse and nonrecourse indebtedness, the ALI has proposed that side agreements and other arrangements altering the liabilities of partners be taken into account.⁷⁸ While this intermediate proposal will eliminate the major absurdities produced by the regulations, this proposal unavoidably increases the complexity of the section 752 regulations and may create inappropriate results of their own.

Under the ALI proposal, for example, a limited partner who guarantees recourse partnership liabilities may adjust his outside basis with respect to the guaranteed debt.⁷⁹ Thus, the proposal does not eliminate the distinction between a general and limited partner; rather, it introduces a third factor, the existence of a guarantee. Unfortunately, the allocation suggested by this new factor may not be any more rational than the allocation produced under the prior rules. For example, consider a limited partnership having two general partners and three limited partners, each having a twenty percent interest in profits and losses. If a

76. *Raphan*, 3 Ct. Cl. at 466.

77. See *supra* text accompanying notes 43-44.

78. ALI PROPOSAL, *supra* note 62, at 253-80.

79. *Id.* at 274.

limited partner guarantees repayment of a partnership debt, he would apparently be entitled to a basis adjustment equal to one-third of the guaranteed obligation, even though his actual exposure to liability is far greater. On the other hand, the limited partner would apparently be entitled to this basis adjustment even if the obligation guaranteed was already fully secured, and thus as a practical matter did not alter the partner's exposure to liability.

Another problem with the ALI proposal is its repudiation of *Raphan*. Like the Commissioner, the ALI would treat a nonrecourse liability guaranteed by a general or, apparently, a limited partner as a recourse liability, but only with respect to the guaranteeing partner.⁸⁰ Notwithstanding the logical consistency of the ALI proposal, the practical consequences of this treatment of nonrecourse indebtedness are troubling. For example, nothing apparently prevents a limited partner from volunteering to guarantee a partnership's nonrecourse liability, should his basis be inadequate to absorb contemplated losses. This guarantee would shift the entire basis adjustment attributable to the liability from all other partners to the guaranteeing limited partner. Once again, that result would follow even if the liability were adequately secured and the guarantee had no non-tax consequences.

The ALI's proposal giving effect to secondary liabilities of partners would improve the existing system, but nevertheless remains flawed. Since the fundamental distinctions drawn by the regulations and by the ALI generally have little, if any, economic significance, modifications based upon those distinctions can only draw different, but equally arbitrary lines. Moreover, the ALI proposal would increase the complexity of the basis allocation regulations. In turn, those complexities would increase the likelihood that taxpayers would be denied basis adjustments, and thus the ability to claim their anticipated share of partnership losses, because of insignificant technical changes in their legal relationships.

The theoretical inconsistencies inherent in the section 752 regulations persisted for two decades without being seriously questioned only because the consequences were universally ignored. Recent litigation has demonstrated that these regulations draw unnecessary and irrelevant distinctions and are unworkable in practice. In its impending revisions, the Treasury Department should abandon these distinctions and implement a system more consistent with the fundamental principles of the tax system.

80. *Id.* at 273.

II

ALLOCATION OF BASIS UNDER THE *CRANE* SYSTEM

The distinctions made under the section 752 regulations do not make economic sense. That conclusion, however, does not reveal how basis should be allocated among the general and limited partners. This section will show how a system of basis allocation consistent with *Crane* and the spirit of section 752 would operate.

Reading *Crane* and section 752 together, all partners, regardless of potential relief from repayment, should be regarded as constructively borrowing the proceeds of a loan actually obtained at the partnership level and then constructively contributing the proceeds to the partnership. For these purposes, it is irrelevant whether the borrowing is with or without recourse, or whether the borrower is a general or limited partnership.⁸¹ Under *Crane*, basis allocation does not depend on an individual partner's potential relief from the obligation to discharge the indebtedness.

Although neither *Crane* nor the aggregate approach adopted in Subchapter K prescribes a method for allocating basis among partners, the allocation must be consistent with the concepts underlying these authorities. Thus, the basis allocation should not be controlled by reference to the loan itself, but rather by reference to the ownership of property acquired with the proceeds. Basis, of course, represents the level of a taxpayer's investment in property. Accordingly, the basis a partner acquires in a partnership by virtue of a partnership borrowing should reflect the ownership or equity interest that the partner will acquire in partnership properties obtained through the expenditure of the loan proceeds. The ratio in which partners acquire an equity interest in partnership properties, of course, is the ratio in which partnership profits are shared.

Upon a partnership's obtaining a loan and using the proceeds to acquire property, no partner acquires an immediate equity interest in the property purchased because the value of the purchased asset is entirely offset by the obligation to repay the loan. However, as the partnership earns income and uses that income to repay the loan, the net worth of the partnership, and thus of its partners, increases. To the extent that partnership retains income or applies income to the repayment of its indebt-

81. In *Crane*, the Supreme Court specifically held that recourse and nonrecourse indebtedness are subject to the same pattern of taxation as long as the nonrecourse indebtedness resembles a full-recourse borrowing. *Crane*, 331 U.S. at 14. That resemblance exists when the value of the encumbered property exceeds the amount of the liability, thus guaranteeing repayment.

The Court, of course, did not address the distinction between general and limited partners. Nevertheless, for present purposes, the distinction between the two kinds of partners is analogous to the distinction between recourse and nonrecourse indebtedness, as both nonrecourse debtors and limited partners are partially protected from the full economic impact of certain losses.

edness, the tax basis and capital accounts of the individual partners will be increased in the ratio in which partnership profits are allocated. As the loan is repaid, however, the bases of the partners will be reduced.⁸² The net effect of this series of transactions is to convert the basis originally produced by the loan into a basis attributable to the partnership profits.

The loan obtained by the partnership merely accelerated the time at which properties were acquired and therefore should not have any effect upon the ratio in which the partners are treated as owning those partnership properties. Rather, the basis created by the loan should be viewed as an acceleration of the basis that would be obtained by the ultimate payment for the properties through the application of partnership profits to the retirement of the loan. Accordingly, replacing the loan proceeds with partnership profits as the source of payment for the partnership properties should not alter the ratio in which basis is allocated among the partners. That result can only be achieved if the initial allocation of basis attributable to the loan is allocated in the ratio in which profits are shared.

The current approach to basis allocation can produce inappropriate results when a partnership shares losses and profits in different proportions. Under the regulations, general partners share the basis increase resulting from a recourse loan according to the ratio in which they share losses.⁸³ If a partner assumes a greater proportion of partnership losses than profits, he can claim losses attributable to the expenditure of the proceeds at a rate faster than that at which he must report the profits used to repay the borrowing. Conversely, if a partner's proportionate interest in profits exceeds his interest in losses, allocating basis pursuant to the loss-sharing ratio will deny that partner the opportunity to report losses to the same extent he must report taxable profits.

Assume, for example, that the two members of *AB* general partnership share losses equally but allocate seventy percent of the profits to *A* and thirty percent to *B*. For simplicity, an equity investment by the partners will be ignored. In year one, the partnership borrows \$100; in year two the partnership earns \$100, and in year three it repays the loan. Under current law, *A* and *B* each initially obtained a basis of \$50 attributable to the loan. After the allocation of the profits in year two, *A*'s basis is increased to \$120 while *B*'s basis is only increased to \$80. Upon the repayment of the loan in year three, the basis of each partner is reduced by \$50, resulting in a basis of \$70 for *A* and \$30 for *B*. Those amounts will also be reflected in the partners' capital accounts and thus will represent their economic interests in the partnership. The resulting seventy-

82. See I.R.C. §§ 733(1), 752(b) (1982).

83. Treas. Reg. § 1.752-1(e) (1960).

thirty basis allocation accurately reflects the partners' economic interests in the partnership for it was produced by the allocation of profits and contains no adjustment attributable to a partnership loan. However, the initial fifty-fifty allocation of basis attributable to the loan required by the present regulations did not reflect the partners' economic interests in the partnership. That allocation was entirely arbitrary and improper. Under the allocation rules proposed here, the initial allocation of basis attributable to the loan would properly have been of \$70 to *A* and \$30 to *B*.

On the other hand, had the partnership lost money in year two, *B* should not be able to deduct losses in excess of thirty percent of the amount borrowed, since he will only be taxed on thirty percent of the profits that will be used to repay the loan.⁸⁴ Similarly, subject to the limitation imposed by the loss-sharing agreement, *A* should be able to claim losses up to seventy percent of the amount borrowed, although present law would limit his deductions to fifty percent.

The impropriety of current law becomes particularly apparent when the partnership fails to repay the debt in full, thereby generating cancellation-of-indebtedness income. If the basis increase attributable to a loan has been allocated in accordance with the loss-sharing ratio, the cancellation of the debt will produce a basis reduction in the same proportion. However, the partners will also be subject to cancellation-of-indebtedness income, producing a corresponding increase in their outside basis. Properly, the net effect should create no change in a partner's basis for his partnership interest, but the partner should be taxed on his share of the income generated by the cancellation.⁸⁵ Under the existing regulations, however, partners whose profit-sharing interests exceed their loss-sharing interests will be taxed on the cancellation of the loan in an amount greater than the amount of basis that they previously had by virtue of the borrowing.

The unfairness inherent in this situation lies not in the allocation of the cancellation-of-indebtedness income, for the partners' profit-sharing ratio properly reflects the economic benefit received by virtue of the cancellation. Rather, the unfairness lies in the allocation of basis in accordance with a loss-sharing ratio. That ratio deprives some partners of a portion of the basis attributable to the borrowing and assigns that basis to other partners.

In addition, since a partner's basis is currently reduced in accord-

84. Of course, if the partnership cannot repay the loan and the partners are required to make contributions to the partnership, those contributions will increase the basis of their partnership interests and support claiming the loss. See I.R.C. § 722 (1982). Normally, those contributions will be made in proportion to the loss-sharing ratio.

85. Under *Crane*, the cancellation of the loan does not affect basis, but does produce income on the loan transaction. *Crane*, 331 U.S. at 11, 12, 14.

ance with the loss-sharing ratio but increased in accordance with the profit-sharing ratio, the net basis adjustment caused by the cancellation of the debt in fact produces a shift in basis which ultimately conforms to the profit-sharing ratio. While this results in the proper allocation, the basis shift is artificial and unnecessary. For example, assume that in general partnership *PL*, *P* is entitled to sixty percent of the profits and *L* is charged with sixty percent of the losses. If the partnership obtains a one-hundred dollar recourse loan and buys property with the proceeds, forty dollars of basis will be allocated to *P* and sixty dollars will be allocated to *L*. Ignoring any changes that might be produced by partnership income or loss, a cancellation of the debt will reduce each partner's basis to zero.⁸⁶ However, sixty dollars of the income generated by the cancellation will be allocated to *P* and forty dollars will be allocated to *L*, thereby increasing their respective bases by those amounts.

As a result, *P* will be taxed as if he had received and retained sixty dollars, although prior to the cancellation he was a constructive borrower of only forty dollars. The cancellation, in effect, produces a shift in basis of twenty dollars from *L* to *P*. This shifting basis is irrational because the transactions have no net economic significance. The ultimate basis allocation, however, is rational because the profit-sharing ratio defines a partner's interest in the burden of repaying the indebtedness.

Under the proposal made here, this shifting of basis would not occur. The allocation of basis from the loan would correspond to the same profit-sharing ratio in which the cancellation-of-indebtedness income would be allocated. Thus, upon a cancellation, the reduction in basis from the repayment and the increase in basis from the income would be identical. In addition, each partner would be taxed on an amount that precisely equaled the economic benefit that had been obtained from the loan now cancelled.

III

THE "AT-RISK" CONCEPT AND THE PROPER CALCULATION OF CANCELLATION-OF-INDEBTEDNESS INCOME

Discerning the proper basis allocation at the partnership level does not end the analysis. The proposed basis allocations would allow some partners to take deductions attributable to borrowed funds although they remained free of any obligation to repay the loan. Consequently, some partners might never incur economic losses equivalent to the tax losses that the basis allocation permitted them to claim. That result is entirely consistent with the principles of *Crane* but is not consistent with the "at-

86. See I.R.C. §§ 732(1), 752(b) (1982).

risk" concept of section 465.⁸⁷ If the justifications for the expansion of *Crane* suggested earlier in this Article are theoretically sound, then the concepts and policies underlying the at-risk rules are not.

The policy issues involved in this debate are not unique to partnerships. The proper tax treatment of any nonrecourse borrower should determine the treatment of any limited partner or of any partner in a partnership that borrows on a nonrecourse basis. Therefore, this section will analyze how the full extension of *Crane* would apply to individual purchasers of property. The analysis then will be extended to cover both general and limited partnerships that borrow money on a nonrecourse basis.

A. Borrowers in General

When the loan involves personal liability, the tax system does not limit deductions and losses attributable to the spending of loan proceeds.⁸⁸ This result is, of course, theoretically sound. If a loan bears a market rate of interest, the amount borrowed will equal the present value of the obligation to repay the principal with interest. The receipt of loan proceeds, therefore, does not change a borrower's net worth and does not increase the borrower's income.

On the other hand, the expenditure of the loan proceeds does produce a decrease in the borrower's net worth, just as if the expenditure were from the borrower's own assets. If a loss or expense resulting from the expenditure would be deductible had the taxpayer expended his own funds, the same result should therefore follow from the expenditure of loan proceeds.

It would, of course, be possible to tax loans on a cash-flow basis by including the loan proceeds in taxable income and permitting a deduction upon repayment. That system, however, would reduce the after-tax proceeds available to the taxpayer. While a deduction upon repayment would correspondingly reduce the present value of the obligation to repay, it would not affect the present value of the interest to be paid. Accordingly, the present value of the obligations to pay interest and to repay the loan would exceed the amount of the after-tax proceeds of the loan available to the taxpayer.

For example, the present value of the obligation to repay a \$100 loan in ten years, discounted at an after-tax interest rate of eight percent, is approximately \$45. The present value of the obligation to pay the interest on that loan, compounded semi-annually, is \$55. Thus, the present value of the repayment burden offsets the \$100 of proceeds. Now

87. I.R.C. § 465 (1982 & Supp. II 1984).

88. See *supra* note 19.

suppose the borrower were subject to a tax rate of forty percent and the receipt of the proceeds were taxable. The taxpayer would then receive after-tax proceeds of \$60. If the repayment of the principal were deductible, the burden of repayment would be reduced to a future value of \$60, and a present value of \$27. The present value of the interest obligation would not change. Thus, the present value of the obligation to repay the loan would be the sum of \$27 and \$55, or \$82. The taxpayer, however, only received \$60 after taxes. Consequently, this treatment of the borrowing would produce an after-tax economic loss to the taxpayer.⁸⁹

The less favorable results produced under the cash-flow approach to the taxation of loans is not surprising; the imposition of tax in exchange for a deferred deduction will always be unfavorable to the taxpayer. The less favorable treatment, however, is not justifiable, for the cash-flow approach causes the burden of repayment to exceed the benefit obtained from the loan. This suggests that the separate-transaction approach is the preferable method of loan taxation.

However, there is another aspect to the separate-transaction system of accounting for indebtedness. Not only does the receipt of loan proceeds not constitute taxable income, but the expenditure of the proceeds is given its normal tax consequence. Altering either aspect of this system improperly increases the tax cost of borrowing. While the impropriety of including loan proceeds in taxable income is generally acknowledged, it has not been as uniformly recognized that it would be improper to penalize the expenditure of the loan proceeds. The at-risk rules, for example, bar many deductions derived from the expenditure of the proceeds of a nonrecourse loan.⁹⁰ Disallowing legitimate deductions because they are attributable to the expenditure of borrowed money in effect imposes a tax cost on borrowing. Indeed, the after-tax effect of disallowing these deductions would be precisely the same as directly taxing the loan, since the disallowance of a deduction is the equivalent of an increase in taxable income by the same amount.

B. Nonrecourse Debt and the Relevance of the Obligation to Repay

As noted, one of the justifications for the at-risk rules is the concern that a borrower not personally obligated to repay the full amount of a loan will in fact not repay.⁹¹ The courts, however, have developed far more direct ways to treat similar situations. For example, when someone

89. This example also helps illustrate why a cash-flow treatment of debt might be appropriate under a different tax system. Under a cash-flow consumption tax, for example, the theoretical tax imposed upon the receipt of the loan proceeds and of the income produced by the investment of those proceeds would be deferred until those amounts were consumed. See Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1167-69 (1974).

90. See I.R.C. § 465 (1982 & Supp. II 1984).

91. See *supra* text accompanying note 2.

purports to borrow money but is not obliged or does not intend to repay the borrowing, the purported borrower is usually taxed because he is in receipt of compensation⁹² or another form of income.⁹³ The logic is that if a receipt is not intended to be repaid, the receipt is not a loan and should not be treated as such for tax purposes. Thus, unless the receipt is specifically excluded from the income tax base,⁹⁴ it should be subject to an immediate tax.

Once treated as taxable income, however, the expenditure of this income should have the same tax consequences as the expenditure of funds derived from any other source. The source of the money in a purported loan should have no bearing upon the tax consequences of a subsequent transaction in which property is acquired. In other words, assumptions concerning the chances of a loan's repayment may affect the tax consequences of the receipt of the proceeds, but they should not be relevant to the tax consequences of the expenditure of the proceeds.⁹⁵

Both nonrecourse loans and limited partnerships raise the possibility that a transaction initially appearing to constitute a loan may eventually resemble the receipt of taxable income. In either case, money may be transferred subject to an obligation to repay, only to have the borrower default and leave the lender without the ability to collect the full amount of the loan. These loans thus contain uncertainty both as to whether repayment will occur and as to the proper tax consequences of the transaction.⁹⁶ However, both logic and *Crane* suggest that this uncertainty should only affect taxation of the receipt—not the use—of the borrowed

92. *Collins v. Commissioner*, 22 T.C.M. (CCH) 1467 (1963) (In holding that taxpayer's receipt of \$15,000 in exchange for nonrecourse note secured by property worth \$300 was not a gift, court implied it was taxable income.).

93. *Cf. James v. United States*, 366 U.S. 213 (1961) (embezzled money taxable as income).

94. Some exclusions from income are listed in I.R.C. §§ 101-127 (1982 & Snpp. II 1984).

95. The Supreme Court has not clearly grasped this distinction. In *Commissioner v. Tufts*, 461 U.S. 300 (1983), the Court based its current treatment of recourse loan expenditures on an "assumption" that the borrowing would be repaid. *Id.* at 308. As the previous discussion illustrates, that equation is improper. The potential failure of repayment should have no bearing upon the tax consequences of the use of the loan proceeds. Consequently, the assumption that a borrowing will be repaid should have no bearing upon the tax consequences of the expenditure of the proceeds.

The Court's failure to grasp the distinction is somewhat surprising, for lower courts have distinguished between borrowed money and taxable income in other contexts. In *Collins v. Commissioner*, 22 T.C.M. (CCH) 1467 (1963), for example, the taxpayer purported to borrow \$15,000, issuing in exchange a nonrecourse note secured by property worth \$300. When the value of the security had dropped to \$100, the holder returned both the security and the note to the taxpayer. The Tax Court readily determined that the transaction yielded cancellation-of-indebtedness income in the amount of \$100. Although not confronted with the issue, the court further implied that in the year of the purported borrowing the taxpayer realized \$14,700 in immediately taxable compensation. *See also infra* note 132.

96. Indeed, when a borrower issues a nonrecourse note in exchange for property, it may be uncertain whether the seller has received anything at all. Particularly in the more abusive tax shelters, the face amount of the nonrecourse note may exceed any demonstrable value for the property acquired.

proceeds. If the tax consequences of the expenditure are unaffected by whether the receipt is a nontaxable loan that will be repaid or is taxable income that will be retained, those consequences should follow despite the intermediate possibility that repayment will not occur.

The at-risk concept, however, produces a different result. Section 465 denies taxpayers certain tax deductions attributable to the expenditure of the proceeds of nonrecourse borrowing. Losses attributable to the property acquired may only be claimed against profits generated in the same activity or against future equity investments.⁹⁷ Accordingly, the uncertainty created by the fact that a nonrecourse borrowing might not be fully repaid affects the deductions attributable to the expenditure of the proceeds.

Penalizing the property transaction because of the uncertainty created by the character of the borrowing can only be justified if the standard tax rules do not produce an appropriate tax liability. If the correct tax liability is imposed under *Crane* and the separate-transaction system upon the failure to repay a nonrecourse borrowing, then the at-risk concept imposes an unjust penalty and is technically unnecessary.

1. Repayment

The uncertainty created by nonrecourse indebtedness will be resolved in one of two ways. The borrower will either repay the debt or obtain a full or partial cancellation of his obligation under the loan agreement. If the debt is repaid in full, the application of the at-risk penalty will prove to have been unnecessary and excessively harsh. Notwithstanding the initial uncertainty, the borrower will have borne the full economic burden attributable to his transaction in precisely the same manner as a recourse borrower. Thus, if it could be accurately predicted that a nonrecourse loan would be repaid in full, it would be improper to penalize the nonrecourse borrower through deferring his ability to claim deductions.

Furthermore, the form of repayment is not material. A debt is repaid when a borrower transfers to the lender cash or property having a value equal to the outstanding balance of the loan. Of course, the transfer of property to the lender should be treated as though the transferor sold the property to a third party and used the proceeds of the sale to discharge the debt.⁹⁸ However, there is no abuse of tax policy in treating

97. I.R.C. §§ 465(a)(2), 465(b)(1)(A) (1982).

98. That is, to the extent that the value of the property transferred in repayment exceeds its tax basis, the transfer must produce a gain to the transferor. Under the proposed system, if the amount of the liability extinguished exceeds the value of the property, the difference would constitute a partial cancellation of the debt and would be taxed as such. See *infra* notes 100-04 and accompanying text.

a direct transfer of property to the lender as repayment. The borrower has parted with value as fully as if he had repaid the debt with cash.

Nor does it matter that the property transferred is the property that secured the borrowing or, if the initial receipt of the property represented a genuine purchase,⁹⁹ that the property was initially acquired from the lender. Those transactions must be carefully scrutinized to ensure that they represent an actual purchase and an actual debt; however, if the initial transaction was negotiated in good faith, the manner of discharging the resulting liability is irrelevant. In each circumstance, the taxpayer has parted with an economic value and has thereby discharged a liability.

2. Failure to Repay

If the at-risk concept is not technically justifiable when a nonrecourse debt is actually repaid, its justification must be that the general tax rules produce an improper tax liability when the loan is forgiven. In fact, however, those rules can produce an adequate tax liability, although a minor modification in present law is necessary in some circumstances.

When a recourse loan is not repaid, the cancellation-of-indebtedness doctrine established in *United States v. Kirby Lumber Co.*¹⁰⁰ causes the borrower to be taxed on the amount of indebtedness forgiven. This result is quite proper. To the extent that the taxpayer receives value that he will not repay, he derives an accretion to wealth that should be included in his tax base. Thus, when the assumption that a loan will be repaid proves erroneous, a tax should be imposed to the same extent as if the receipt of the loan proceeds constituted income.

In the context of nonrecourse debt, when the uncertainty of repayment is resolved by a failure to repay, the receipt should be treated as generating taxable income. Regardless of a borrower's personal liability, a cancellation of debt results in an increase in personal wealth¹⁰¹ that

99. Problems of genuine purchase have often arisen for the courts. For example, when repayment is contingent upon deriving income or profit from an investment, the courts have properly regarded the amount payable under the note as too speculative to permit the transaction to be brought within the *Crane* system. See, e.g., *Gibson Products Co. v. United States*, 637 F.2d 1041, 1047-48 (5th Cir. 1981). Similarly, when the surrounding circumstances demonstrate not only that a taxpayer does not intend to discharge a purchase money obligation but also that at all times it would be economically irrational for him to do so, the courts have concluded that the transaction does not represent a bona fide purchase and have denied the taxpayer the tax consequences of the ownership of the property. See, e.g., *Estate of Franklin v. Commissioner*, 544 F.2d 1045, 1048-49 (9th Cir. 1976). The results in these cases are entirely sound and would not be altered by the proposal made here.

100. 284 U.S. 1, 3 (1931).

101. While it seems clear that the cancellation of a nonrecourse debt does increase income, the issue has not been finally resolved by the courts. See *infra* note 132. Moreover, the amount and character of that income, when joined with a transfer of property, are still debated questions. See,

should be included in a taxpayer's personal income. *Kirby Lumber* contains nothing to the contrary, and its extension to nonrecourse debt is perfectly consonant with *Crane* and the principles contained therein.¹⁰²

In one important respect, however, the tax imposed under *Kirby Lumber* differs from the tax that would have been imposed had the receipt been treated as income when received. Under *Kirby Lumber*, the tax is imposed at the time an indebtedness is cancelled, and not at the time of the purported borrowing.¹⁰³ This tax deferral may provide an excessively favorable benefit to taxpayers. With the aid of hindsight, it is apparent that a taxpayer who defaults on a nonrecourse loan obtained income but managed to defer the corresponding tax for the life of the liability. Furthermore, the taxpayer may have spent that income in a manner that generated tax deductions which were taken before the debt was cancelled. The apparent deferral of tax and the resulting mismatching of income and deduction may thus provide the major technical justification for the at-risk concept.

a. Cancellation in General

With perfect foresight, the Commissioner could subject only the amount of the loan that would not be repaid to current taxation. That omniscience would eliminate the need for the at-risk concept. There could be no objection to deducting the expenditure of income already taxed since the potential mismatching of income and deductions would have been eliminated.

Even if such foresight were possible, it would not be proper to tax the entire amount of principal destined not to be repaid as long as the taxpayer continues to pay interest on the loan. These interest payments cause the taxpayer to obtain only a partial cancellation of the debt. While the receipt of the proceeds may no longer be offset by the present value of the obligation to repay the principal, they remain offset by the present value of the obligation to pay interest. Accordingly, if perfect

e.g., *Commissioner v. Tufts*, 461 U.S. 300 (1983); Rosenberg, *Better To Burn Out than Fade Away? The Consequences of the Disposition of a Tax Shelter*, 71 CALIF. L. REV. 87 (1983).

102. The cancellation-of-indebtedness doctrine will not produce taxable income if the taxpayer validly elects to either reduce the basis of depreciable properties or otherwise forego tax benefits. I.R.C. §§ 108(c), 1017 (1982). Whenever available, this relief reduces the tax imposed under *Kirby Lumber* and prevents the achievement of an appropriate tax liability.

The conclusions reached herein suggest that § 108 is overbroad, and perhaps considerably so. However, the relief provided by that section is equally available to recourse and nonrecourse borrowers and thus does not constitute a reason for discriminating against basis allocations attributable to nonrecourse indebtedness.

103. This timing flows automatically from the assumptions of a tax based on net worth and the initial decision to exclude the proceeds of a loan from income. Under the current rules, the original borrowing does not produce a taxable increase in net worth, and income is not generated until the liability is eliminated through the cancellation of the loan.

foresight allowed for an immediate tax at the time the loan was obtained, the amount subject to tax would be only equal to the present value of the obligation to repay the principal at the time of forgiveness.

For example, the present value of an obligation to repay a \$100 loan after ten years, discounted at an after-tax interest rate of eight percent, is approximately \$45, and the present value of the after-tax interest burden is \$55. If it could be foreseen that the taxpayer would not repay the principal amount but would make each interest payment as it became due, the \$100 receipt would remain offset by the \$55 obligation to pay interest but would not be offset by the \$45 obligation to repay the principal. Accordingly, the taxpayer would have obtained a \$45 accretion to wealth and should be taxed on that amount.¹⁰⁴

If the present value of the amount ultimately forgiven were taxable upon receipt of the proceeds but the tax was deferred until cancellation of the liability, it would be proper to charge interest on the deferred tax liability from the time the proceeds were obtained to the time the tax was imposed. Continuing the preceding example, suppose the rate of tax was forty percent. The taxpayer's liability then would be forty percent of \$45, or \$18, were the tax imposed at the time of loan. If the tax were imposed ten years later, interest should be charged. At an after-tax rate of eight percent, the total interest charge would be \$22, making the total tax liability \$40.

That \$40, however, is precisely the amount of tax collected under *Kirby Lumber* and the cancellation-of-indebtedness doctrine. Taxing the full amount forgiven in the year of cancellation, then, is equivalent to taxing the present value of the amount cancelled in the year the loan is obtained and charging interest for the period of time in which that tax liability remains unpaid. The result is not surprising. At the assumed rate of interest, a tax on \$45 today is the equivalent of a tax on \$100 ten years from now.

The foregoing demonstrates that the remedy imposed under *Kirby Lumber* for failing to repay a loan is adequate. Thus, there is no technical reason for penalizing a nonrecourse borrower by restricting his ability to obtain the normal tax consequences for the expenditure of loan proceeds. The at-risk concept, therefore, lacks a technical justification, as long as the taxpayer is taxed upon the cancelled amount.

104. Alternatively, the cancellation of the debt can be viewed as taking place at the time the last interest payment is made. In order to compare the nominal amount of the debt cancelled with the equivalent amount at the time of the borrowing, the nominal amount must be discounted back to the time of the borrowing. In the example above, the nominal amount cancelled is one hundred dollars, which is equivalent to \$45 when discounted back to the time of the borrowing. Thus \$45 is the amount that should have been taxed at the time of the borrowing, had all future events been known.

b. The Special Case of Forgiven Interest

Taxing the principal forgiven, however, will not produce a sufficient tax liability in cases where the taxpayer did not pay interest on the amount purportedly borrowed. In such cases, again assuming perfect foresight, the borrower should be taxed on the full face value of the loan at the time of receipt since that amount is not offset by any future interest liability. And, as before, an interest charge on the tax owed must be imposed if the tax is not collected until the debt is formally forgiven. However, merely taxing the loan principal when the debt is subsequently cancelled will not result in a tax liability that completely compensates for the absence of actual interest payments.

The cancellation of the interest obligation also produces a cancellation that is properly subject to tax.¹⁰⁵ Since the taxpayer received value in the form of the use of the borrowed proceeds, the failure to make interest payments represents a taxable accretion to wealth. Taxation of that income, however, should be treated differently from the forgiveness of loan principal. Analytically, the forgiveness of any debt represents first a transfer of value from the lender to the borrower and then an immediate retransfer of that value to the lender. The first constructive transfer produces income for the borrower. However, in this case, the second constructive transfer also produces a deduction, since the constructive payment is for interest¹⁰⁶ and interest payments are deductible.¹⁰⁷ This deduction therefore offsets the income received upon the constructive transfer, and no tax liability should result.

When a lender forgives the payment of interest, the borrower benefits from the cancellation in precisely the same manner as if the lender had forgiven repayment of a portion of the principal. Consequently, the cancellation should be considered as taxable income to the borrower. However, the borrower is in the same position as if he derived a cash

105. *United States v. Little War Creek Coal Co.*, 104 F.2d 483 (4th Cir. 1939); *cf.* Rev. Rul. 76-316, 1976-2 C.B. 22 (corporation's forgiveness of interest owed by solvent subsidiary results in income to subsidiary when interest payments had been deducted in previous years under accrual accounting system).

106. The Commissioner and Congress have often overlooked this aspect of the cancellation of deductible liabilities. See Coven, *Liabilities in Excess of Basis: Focht, Section 357(c)(3) and the Assignment of Income*, 58 OR. L. REV. 61,63-66 (1979) (analyzing consequences of incorporating a business and having corporation assume all liabilities under § 357). Congress, however, has provided partial solutions. For example, the discharge of an indebtedness does not produce income to the extent that the payment of the liability would have been deductible. I.R.C. § 108(e)(2) (1982); *see also id.* § 357(c)(3) (1982) (assumption of deductible liability not taxed).

This same result should follow when a taxpayer assumes a debt upon the transfer of property. However, the consequences of assuming deductible liabilities are not governed by statute and are often overlooked in litigation. *See, e.g., Estate of Levine v. Commissioner*, 634 F.2d 12, 18 n.14 (2d Cir. 1980) (court observed that taxpayer failed to raise the issue).

107. I.R.C. § 163 (1982 & Supp. 1984).

receipt from the lender and had used that cash to pay interest on the loan; his actual net worth has not changed. Had the taxpayer actually paid the interest, he would have been entitled to a deduction; thus, he should not be left in a different position merely because the payment of interest was constructive. The forgiveness of interest produces constructive income and should produce an offsetting constructive deduction.

Under the normal operation of the *Kirby Lumber-Crane* system, the constructive interest deduction offsets the income from the cancellation of the obligation to pay interest, and a tax is imposed only upon the cancellation of the principal amount of the indebtedness. As shown above, that amount of tax is inadequate. As a result, the *Kirby Lumber-Crane* system does not produce the correct tax liability in such circumstances.

A correct tax liability can be created consistently with *Kirby Lumber* in either of two ways. One method would impose an actual interest charge on the deferral of the tax liability on the principal to the extent the lender forgives the interest. When the borrower does not pay interest or repay principal, thereby creating a deferred tax liability, the Code could impose an interest charge on the tax produced by the cancellation for the period during which interest was forgiven.

To illustrate, assume that a taxpayer with a marginal tax rate of forty percent borrows \$100 for ten years at an after-tax interest rate of eight percent. The lender, at the end of six years, forgives all subsequent interest payments as they become due and ultimately forgives the principal at the end of the tenth year. A proper tax liability would have been obtained by imposing a \$40 tax at the end of the sixth year had the loan been forgiven at that time. Suppose, however, that the tax was deferred until the principal was formally forgiven in the tenth year. The proper result would be to impose a tax of \$40 at the end of the tenth year and charge interest on that amount for the four years the interest was forgiven.

The same result could also be achieved by disallowing the deduction for the constructive interest payment with respect to the forgiven principal. Thus, a proper correction would occur if the amount of the forgiven interest were treated as taxable income. The interest on the unpaid principal would be rendered nondeductible, not because it is theoretically inappropriate to permit a deduction for the constructive interest payment, but simply because denying the deduction provides a convenient substitute for imposing an interest charge on the deferred tax liability. This alternative solution has the slight advantage of administrative ease, but it is theoretically incorrect. Imposing an actual interest charge would thus be preferable.

C. Kirby Lumber and Partnership Debt

Applying the same concepts can ensure the proper taxation of the cancellation of partnership debts. *Kirby Lumber* provides an adequate correction if the partnership is taxed at the time the debt is cancelled and the interest has either been paid by the partnership or has been forgiven and taxed as suggested above. If the basis attributable to the partnership loan has been allocated in accordance with the profit-sharing ratio, the corrective tax liability automatically will fall in the same proportions. The partner who has been treated as a borrower and granted a basis adjustment will also be taxed on the corresponding portion of the cancellation-of-indebtedness income.¹⁰⁸

To ensure the adequacy of the correction, however, the partners must also bear the interest costs involved in the deferral of tax liability. This interest burden must be allocated in the same manner as the basis increase attributable to the borrowing, in order to prevent some partners from benefitting from the cancellation of the debt.

Current law does not require that interest be allocated in this manner. The partners may allocate any expense, including interest on a partnership borrowing, in any proportion they desire, provided the economic burden and tax benefits of the expense are allocated in the same proportions.¹⁰⁹ Interest on a partnership borrowing, however, differs from other partnership expenses because it represents the cost of a borrowing that has increased the partners' bases for their partnership interests and has thus permitted the deduction of current losses. Permitting one partner to deduct an interest expense attributable to another cannot be justified. In this respect, at least, the allocation rules are unduly flexible and should be amended to require that interest on a partnership loan be allocated to the partners in the same proportion as the basis increase those partners receive by virtue of the borrowing. If the suggestions recommended in this Article are adopted, the interest expense will be allocated in accordance with the profit-sharing ratio. Each partner will thus bear the burdens associated with the repayment or cancellation of a debt in the same proportion that each benefitted from obtaining the loan.

D. The Application to Limited Partners

A limited partner may benefit from the economic equivalent of debt cancellation even though the partnership fully repays the loan. The repayment of any partnership loan is treated as though the partnership distributed cash to the partners and the partners used the cash to dis-

108. See *supra* text accompanying note 85.

109. Treas. Reg. § 1.704-1(b) (1985).

charge the liability.¹¹⁰ As long as the value of a partner's interest in partnership assets, including unrealized appreciation, exceeds his share of partnership liabilities, this treatment adequately reconstructs the transaction in accordance with the aggregate approach to partnership basis.¹¹¹ However, if the partner's share of the cancelled liability exceeds the value of his interest in the partnership (and he is not obligated to make any further contribution to the partnership), the partner cannot properly be viewed as having discharged his entire share of the liability. His obligation to repay the debt is limited to his interest in partnership assets, and those assets are insufficient. To the extent of the insufficiency, other partners have in fact discharged the liability.

Assume, for example, that limited partnership *GL* had previously incurred a nonrecourse debt to finance the acquisition of depreciable property. Through disproportionate allocations of depreciation, limited partner *L*'s basis has been reduced to zero and his capital account shows a deficit. Partner *G*, however, has a positive capital account. The property has appreciated in value and in fact is worth more than the sum of the remaining debt and *G*'s capital account. On these facts, *L*'s partnership interest has value, and if the partnership were liquidated, *L* would receive a distribution. Thus, if the nonrecourse debt is paid off by the partnership, it is entirely reasonable to view the transaction as if the partnership had distributed cash to *L* and *L* had discharged his own share of the loan.

Alternatively, the value of the property might exceed the amount of the loan but that excess might not equal the size of *G*'s capital account. In that event, the partnership would be solvent but *L*'s interest would have no value; on a liquidation of the partnership, only *G* would be entitled to a distribution after the loan had been repaid. While the repayment of the loan would not result in cancellation-of-indebtedness income to the partnership, it is not realistic to view *L* as repaying his share of the loan. The value of his interest in the partnership is not sufficient to support a distribution of the required amount to him. Rather, *G* has discharged a portion of *L*'s liability out of assets that *G* would otherwise have received upon the partnership's liquidation.

110. I.R.C. §§ 731, 752 (1982).

111. See *supra* text accompanying notes 21-29. If the constructive distribution exceeds a partner's basis for his partnership interest, the partner will be taxed as if he had sold a portion of his partnership interest. If the distribution does not exceed the value of the partner's interest, he has realized a portion of the appreciation inherent in his share of partnership properties and should be taxed as if he had sold those properties.

If the partnership has elected the optional basis adjustment provided by §§ 734 & 754, the partnership can increase the basis for partnership properties to the extent that the distributee partner has been taxed. Thus, the transaction is treated as if the distributee partner sold his interest in partnership properties to the other partners. See I.R.C. § 734 (1982 & Supp. II 1984); *id.* § 754 (1982).

In substance, *G* has advanced amounts to limited partner *L* to permit repayment of the indebtedness. Whether that advance will ripen into cancellation-of-indebtedness income depends on whether the partnership credits future profits to *L* as a source for reimbursing *G*. If not, a cancellation of debt will occur, and the limited partner should be taxed accordingly.¹¹²

If, prior to the loan's repayment, the limited partner had borne his share of the interest cost,¹¹³ taxing him on his share of the cancelled liability will produce an appropriate corrective tax result. The tax on that amount is the economic equivalent of a tax at the time of the loan on the present value of the liabilities not repaid, plus interest. The resulting tax is also equivalent to denying the limited partner an initial basis increase attributable to the borrowing in an amount equal to the present value of the amount of the borrowing that he will not repay.¹¹⁴ Moreover, since this procedure affects only those limited partnerships in which a true cancellation of debt occurs, and then only to that extent, it is better tailored to economic realities than are the at-risk rules.¹¹⁵

Present law incorrectly taxes the shift in the economic burden of repaying partnership loans. All constructive distributions attributable to repayment of partnership indebtedness are treated as actual distributions. As a result, those distributions are not taxed unless they exceed a partner's basis for his partnership interest.¹¹⁶ If a partner recognizes gain,

112. If thereafter *L* is allocated part of the partnership profits, he will be taxed on that amount but will not obtain any economic benefit from that allocated income until his capital account increases to zero. If the partnership earns enough money, *L* will eventually reimburse *G*, albeit without the payment of interest on the temporary "loan."

113. Those expenses would be borne through charges to the partner's capital accounts.

114. Taxing the forgiven interest is the same as disallowing a deduction for a constructive payment of the same amount. See *supra* text accompanying notes 89-90.

115. Because the limited partner may ultimately repay his share of partnership liabilities discharged by other partners, it would not be unreasonable to defer the taxation of that cancellation of indebtedness. However, there are overwhelming practical reasons for imposing an immediate tax upon the cancellation of a limited partner's liability. Whether a partner benefits, either permanently or temporarily, from a discharge of indebtedness depends on whether his share of the liability repaid by the partnership exceeds the value of his partnership interest. Calculation of the tax therefore requires the valuation of the partner's interest in the partnership. It is difficult enough to value a partnership interest contemporaneously. If the tax consequences are deferred, the proper computation of tax liability will require an impossibly burdensome retroactive valuation of the partnership interest. The burdens and imprecisions of retroactively valuing these interests would make it virtually impossible to defer the tax consequences of such a transaction.

Furthermore, taxing a borrower on the cancellation of debt produces an appropriate tax liability only if the borrower has been paying interest. While the discharge on behalf of a limited partner whose partnership interest has become worthless resembles an advance from the "creditor" partners, that advance is not a loan in the traditional sense and certainly does not bear interest. Accordingly, the deferred taxation of the cancelled debt will never produce an adequate remedy. For these reasons it seems preferable to require the valuation of limited partnership interests at the time the indebtedness is repaid.

116. I.R.C. § 731(a) (1982).

however, the distribution is taxed as the sale of a partnership interest and warrants capital gains treatment.¹¹⁷

Under the current system, the value of the partner's interest in the partnership is not material. Thus, the entire amount of the constructive distribution is treated as a gain on the taxpayer's investment in the partnership, notwithstanding that the amount of the distribution exceeds the value of the partnership interest and in substance represents a discharge of the distributee partner's liabilities. That discharge, of course, should not be eligible for the favorable capital gains rate of tax.¹¹⁸ Subchapter K should therefore be revised to tax constructive distributions caused by the repayment of liabilities as cancellation of debts, but only if the distributee partner is not obligated to make further contributions to the partnership, and only to the extent the distribution exceeds the gross value of the partner's interest in partnership assets.¹¹⁹

E. The Impact of Tufts

The current system will not impose the proper tax liability unless the tax rate applicable to the cancellation of debt corresponds to the tax rate that would have applied at the time of the borrowing. As discussed earlier, if the government could determine that a loan will not be repaid, then it should tax the purported borrower at ordinary income rates.¹²⁰ The receipt would represent a windfall gain not related to the disposition of a capital asset, and there would be no justification for imposing the far

117. These consequences of a distribution are subject to the provisions of I.R.C. § 751 (1982 & Supp. II 1984). This section may classify a distribution as ordinary income, but such a result occurs because of the nature of the partnership assets, not the presence of cancellation-of-indebtedness income.

118. The proper taxation of the discharge of a partner's liability cannot be achieved by merely recharacterizing as ordinary income the income produced by a distribution. Gain on a distribution is determined by reference to basis; discharge of the partner's liability is determined by reference to value. If the partnership assets contain unrealized depreciation in value, it is entirely possible that a constructive distribution will exceed the value, but not the basis, of the partner's interest. The excess of a constructive distribution over value should be taxable at ordinary income rates even though under present law the distribution would be treated as a nontaxable return of capital. It is not clear, however, that this refinement is essential to an initial revision of subchapter K.

119. A limited partner who has been taxed because he apparently benefited from a discharge of indebtedness will be overtaxed if he uses profits later credited to him to "reimburse" the "creditor" partners. Those profits will tend to restore the limited partner's deficit capital account to zero but will not entitle him to an actual distribution upon the liquidation of the partnership. Instead, the value represented by those profits will be distributed to the "creditor" partners. Crediting those profits to the limited partner, however, will increase the limited partner's outside basis, I.R.C. § 705(a)(1)(A) (1982), and thus, will create a loss offsetting the previous tax on the apparent cancellation of his indebtedness. Under current law, the offsetting loss will be a capital loss obtained on his ultimate withdrawal from the partnership. To properly reverse the effects of the earlier imposition of tax, the loss should be an ordinary loss and should be available in the year that profits are credited to the limited partner. Again, it is not clear that the enhanced accuracy this refinement produces justifies the resulting complexity.

120. See *supra* text accompanying notes 92-94.

less burdensome capital gains rate of taxation. Accordingly, a proper correction will not be obtained unless the system taxes cancellation of debt at ordinary income rates.

While no one has seriously suggested that a cancellation of indebtedness should be otherwise taxed,¹²¹ in practice the tax consequences of a debt cancellation have been greatly confused by the decision in *Commissioner v. Tufts*.¹²² The facts in that case reflect a typical tax shelter. With no material equity invested, the taxpayer's partnership acquired a building with the proceeds of a \$1,800,000 nonrecourse loan. Somewhat atypically, the actual depreciation of the building exceeded the tax depreciation, so when the partners sold their partnership interests, the building's adjusted basis exceeded its \$1,400,000 fair market value by \$50,000. The purchaser, who acquired the building subject to the \$1,800,000 indebtedness, did not make a substantial cash payment to the selling partners. The taxpayers treated the amount realized on the sale as the fair market value of the building and thus claimed a \$50,000 loss. Presumably relying upon the ambiguous state of the law, the sellers ignored the resulting \$400,000 relief from indebtedness. The Commissioner, perhaps afraid of confronting the ambiguous cases concerning the cancellation of nonrecourse indebtedness, argued that the taxpayers realized the full \$1,800,000 face amount of the liability of which the selling partners had been relieved. The Supreme Court concurred in the Commissioner's analysis and thus treated the taxpayers as if they had sold a building worth \$1,400,000 for \$1,800,000. As a result, the taxpayers were permitted to treat the \$400,000 income from the disposition as capital gains rather than as cancellation-of-indebtedness income.¹²³

The *Tufts* decision is economically unjustifiable, for it permits taxpayers to convert ordinary income into capital gains. To the extent the proceeds of the sale qualify for the preferential capital gains rate, the cost of failing to repay a debt will be more than halved, and taxpayers will be able to secure a substantial after-tax advantage by incurring a debt they do not repay. Accordingly, before the proposals made here can be implemented, the decision in *Tufts* must be overturned, either judicially or by congressional action.¹²⁴

121. But see Chirelstein, *Fruit-Tree and the Ordinary Income Base*, 1 U. BRIDGEPORT L. REV. 1 (1980) (when cancellation of indebtedness occurs because of fluctuation in interest rates, income should be eligible for capital gains taxation). Of course, all cancellations of indebtedness do not occur for that reason. See, e.g., *Commissioner v. Tufts*, 461 U.S. 300 (1983) (sharp decline in property value caused by dislocation of local economy).

122. 461 U.S. 300 (1983).

123. *Id.* at 312. Indeed, the Court explicitly discussed the treatment of the cancellation as capital gains and not as ordinary income. *Id.* at 310-11 n.11.

124. Insofar as cancellation-of-indebtedness income is taxed at ordinary income rates by virtue of depreciation recapture, the *Tufts* approach would not in fact impair the proposal made here. See

A reversal of the decision in *Tufts* would be entirely appropriate, for that decision is unsound in principle. This Article is not the occasion for a detailed dissent from the Supreme Court's characterization of the gain realized in *Tufts* as attributable to the sale of property rather than the cancellation of a debt. However, the general outline of the objection to that decision can be simply stated. Intuitively, the decision appears erroneous because people do not sell property worth \$1,400,000 for \$1,800,000; nor do people pay \$1,800,000 for property worth \$1,400,000. The very suggestion that such a transaction occurred raises an inference that, in fact, something else occurred as well.

When property is conveyed to a lender in complete satisfaction of a debt, two transactions occur simultaneously: the property is sold and the debt is extinguished. In keeping with other Code applications,¹²⁵ neither transaction should be ignored, and each must be taxed in accordance with economic reality. Thus, to the extent that value is transferred to the lender, the debt is repaid; to the extent that the extinguished debt exceeds the value of the property transferred, the debt is cancelled. Further, the property has been sold and the amount realized on the sale must equal the amount of the debt that has been repaid by transferring the property, which is the value of the property. As a result, both transactions should produce precisely the same tax consequences as they would produce if they had occurred separately.

The facts in *Tufts*, however, were more complex, for the property was not conveyed to the lender but rather to an unrelated third party. Nevertheless, the consequences to the seller should not be different. When property subject to an indebtedness is sold, the transaction is reconstructed for tax purposes as if the purchaser had refinanced the acquisition of the property, paid cash to the seller, and the seller had discharged his own liability.¹²⁶ That reconstruction ensures that the transaction is taxed in accordance with its underlying economic reality and in exactly the same manner as if it were a sale for cash. Thus, the amount of this constructive refinancing must equal the amount the seller originally agreed to pay for the property and would have paid in a cash purchase.¹²⁷ When the property is subject to a nonrecourse debt, how-

I.R.C. §§ 1245 (West 1982 & Supp. 1986), 1250 (1982 & Supp. II 1984); see also *Estate of Delman v. Commissioner*, 73 T.C. 15 (1979).

125. Somewhat inconsistently, when a property sale is financed by the seller and the loan bears an inadequate interest rate, the Code is rather rigorous in dividing the purported purchase price into its true principal and interest components. See I.R.C. § 1274 (West Supp. 1986); cf. *id.* § 467 (Supp. II 1984) (imputing an interest factor on deferred payments for services or of rent).

126. Cf. *United States v. Hendler*, 303 U.S. 564 (1938) (assumption of taxpayer's debt in corporate merger treated as though taxpayer had been paid by entity assuming debt).

127. It has been argued that the result in *Tufts* can be justified by analogizing the right to discharge the debt through a transfer of the property to a put. Andrews, *On Beyond Tufts*, 61 TAXES 949, 956 (1983). The put analogy, however, is a strained construction of a loan agreement

ever, that amount cannot exceed the value of the property.¹²⁸ Since the debt can be discharged by a transfer of the property, the value of the property is the maximum amount that the buyer has agreed to pay for the property. In reality, the fact that the face amount of a nonrecourse note exceeds the value of the encumbered property has become irrelevant.

Accordingly, the buyer should acquire a basis in the property equal to its market value and the seller should be treated as receiving that same amount on the sale. That treatment of the seller is entirely correct because, under the terms of a nonrecourse loan agreement, the seller may discharge his obligation for that amount. Plainly, under the reconstruction of the transaction, the seller should not be treated as transferring any greater amount to the lender. To the contrary, as to the seller, the excess of the amount of the debt over the property value has been cancelled and should be subject to tax at ordinary income rates.¹²⁹

There are several reasons why the Supreme Court did not adopt the separate-transaction analysis in *Tufts*.

Most prominent among them is the fact that the Commissioner did not argue for that result. In her concurring opinion, Justice O'Connor suggested that the separate-transaction analysis was preferable to the one adopted by the Court but that the Commissioner had applied a single transaction analysis for too long for the Court to impose a different result on its own motion.¹³⁰ Moreover, some statutory¹³¹ and judicial¹³² doc-

that limits the right of the lender to seek a deficiency judgement. Moreover, that analogy is of little assistance in resolving the consequences of a transfer to a third party as occurred in *Tufts*.

128. In *Tufts* the Supreme Court acknowledged the *Hendler* reconstruction, *Tufts*, 461 U.S. at 308-09, but overlooked its economic reality basis. Thus the Court erroneously treated the amount of the constructive refinancing as the face amount of the debt. *Tufts*, 461 U.S. at 310.

129. As to the buyer, the full amount of the loan remains outstanding and, if the property appreciates in value, must be paid. In that event, the buyer would be entitled to an increase in basis for the actual amount of any payments on this contingent obligation that exceeds the amount of the debt that was taken into account in the original basis computation.

130. *Tufts*, 461 U.S. at 317-20 (O'Connor, J., concurring).

131. Cf. I.R.C. § 108 (1982 & Supp. II 1984) permits some taxpayers to defer the recognition of cancellation-of-indebtedness income by reducing the basis of depreciable property or otherwise foregoing tax benefits.

132. For no obvious reason the notion has persisted that the pre-*Crane* rule, which applied a single-transaction analysis to exempt the cancellation of a nonrecourse indebtedness from tax, survived the decision in *Crane*. In *Tufts*, the Supreme Court referred to that obsolete rule with acceptance, if not approval, 461 U.S. at 310-11 n.11, thus breathing new life into that ill-conceived notion. The correct rule, enunciated in *Kirby Lumber*, has been recognized by the courts, *Collins v. Commissioner*, 22 T.C.M. (CCH) 1467 (1963), and apparently is the rule currently applied by the Commissioner. Rev. Rul. 82-202, 1982-2 C.B. 36 (noting that value of encumbered property exceeded face amount of nonrecourse debt). The contrary suggestion in *Tufts* should be disregarded.

In *Collins*, however, the court did not entirely shed the remnants of the single-transaction analysis. The court viewed the taxpayer as having borrowed \$300 on a nonrecourse basis and pledging stock as security for the loan. When the lender later cancelled the debt, the value of the stock had declined to \$100. The Court held the cancellation taxable but limited the amount subject

trines might defer or even eliminate the tax on the cancellation of a debt while leaving the gain on a sale fully taxed. None of those reasons, however, undermine the theoretical propriety of the preceding analysis. The taxpayer in *Tufts* should not have been entitled to any such relief from current taxation. Nevertheless, the result-oriented underpinnings of the *Tufts* decision were an insufficient foundation for the Court's disposition.

IV

POLICY JUSTIFICATIONS FOR THE AT-RISK CONCEPT

The foregoing has demonstrated that the at-risk concept is an unnecessary technical component of the income tax system. The concept, however, might be defensible on other grounds. This section briefly notes the policy considerations that may underlie the at-risk rules and argues that, while the objectives of curbing fraudulent valuations and tax shelters are valid, the at-risk rules do not adequately address such problems.

Retaining some form of the at-risk rules for policy reasons, however, would not alter the conclusions reached in the previous sections. Since the at-risk concept is not necessary for the creation of appropriate tax burdens, it should not play a role in allocating basis attributable to partnership loans or in allocating losses among partners attributable to the expenditure of loan proceeds.

A. Tax Shelters

Section 465 represents a congressional compromise to restrict the excessive use of tax shelters. The House of Representatives had proposed that taxpayers be barred from deducting certain losses against income generated in unrelated activities.¹³³ The Senate, however, concluded that this limitation was too draconian and suggested that only losses attribu-

to tax to the \$100 value of the stock. The tax-benefit concept applied by the court was, of course, erroneous. There was no reason to offset the loss on the stock against the gain from the cancellation of the indebtedness because the stock had not yet been sold and the loss thus remained unrealized. Aside from that infirmity, associating the loss on the stock with the gain from the cancellation of the debt is improper under the *Crane* separate-transaction analysis.

The Tax Court recently committed a similar error in a case that apparently involved recourse indebtedness. In *Vukasovich, Inc. v. Commissioner*, 49 T.C.M. (CCH) 147 (1984), the court permitted cancellation-of-indebtedness income to be offset by losses incurred on the expenditure of loan proceeds. As in *Collins*, the invocation of the tax-benefit rule was improper since those losses apparently had produced prior tax deductions. While these cases suggest that the tax-benefit rule may offset the taxation of cancellation-of-indebtedness income regardless of the character of the debt, they also support the proposition that cancellation of either recourse or nonrecourse indebtedness generates taxable cancellation-of-indebtedness income under *Kirby Lumber*.

133. H.R. 10612, 94th Cong., 1st Sess., § 101(a) (1975).

table to nonrecourse financing be so limited.¹³⁴ The result was the at-risk rules of section 465.

The section 465 rules did not emerge from theoretical reservations over the treatment of nonrecourse debts. Rather, they were designed to reduce certain accelerated deductions generated by tax shelter activities.¹³⁵ Section 465 focused on nonrecourse debt because tax-shelter limited partnerships needed to use nonrecourse financing to achieve their objectives, whereas traditional businesses claiming the same deductions tended to employ recourse financing arrangements. The at-risk rules, therefore, should be viewed as an expedient designed to curb taxpayer abuse of technically sound provisions.

Except where taxpayers have been able to exploit the imperfections or exceptions contained in section 465, the at-risk provisions appear to have retarded the abuses at which they were aimed.¹³⁶ This gain, however, has not been achieved without heavy cost. The previous sections of this Article indicate the theoretical inconsistencies of the at-risk rules. The complexities of these provisions have led to uncertainty and litigation. Clearly, an equally effective, but less costly and complex, method of restricting tax shelters would be desirable.¹³⁷

When the at-risk rules were adopted, it was generally assumed that a tax shelter could be readily recognized but not statutorily defined. The legislation of that period thus identified a series of symptoms of tax shelter abuse and imposed restrictions whenever those symptoms appeared. Hence Congress enacted provisions covering farming syndicates,¹³⁸ net leases,¹³⁹ and nonrecourse debt.¹⁴⁰

However, congressional ability to address the tax shelter problem generally seems to be improving. With a decade of experience in attacking shelters, Congress and the Treasury Department have begun to draft rules specifically aimed at tax shelters and to undertake the required statutory definitions.¹⁴¹ To date, the definitions supplied have been both

134. S. REP. No. 938, 94th Cong., 2d Sess. 47 (1976), reprinted in 1976 U.S. CODE CONG. & AD. NEWS 3483.

135. *Id.*

136. See Shine, *Exotic Tax Shelters Compared With Real Estate, the King of Shelters*, 37 N.Y.U. INST. ON FED. TAX'N, 9-1 to 9-20 (1979).

137. Furthermore, § 465 does not generally apply to the holding of real property, a major shelter activity. I.R.C. § 465(c)(3)(D) (1982).

138. *Id.* §§ 447, 464 (1982).

139. *Id.* § 57(c) (1982).

140. *Id.* § 465 (1982 & Supp. II 1984).

141. The provisions are both procedural and substantive. *E.g.*, *id.* § 6111 (Supp. II 1984) (requiring registration of tax shelters); *id.* § 461(i) (Supp. II 1984) (limiting deductions by cash method tax shelters); *id.* § 1274(b)(3)(B) (Supp. II 1984) (altering computation of principal amount of debt for purposes of computing original issue discount); *id.* § 6661(b)(2)(C)(ii) (1982) (statutory definition of tax shelter for limited purposes if imposing penalties on entity substantially understating tax liability).

vague and excessively broad,¹⁴² but they are at least as accurate as the proxies employed a decade ago.

This statutory evolution provides a superior approach to the tax shelter problem. Nonrecourse debt is a highly unreliable indicator of tax shelter abuse. Not all tax shelters employ nonrecourse indebtedness; some do not employ debt at all.¹⁴³ On the other hand, nonrecourse debts finance certain purely commercial, non-tax shelter activities that should not suffer the punitive sanctions of section 465. With its increased sophistication, the Treasury Department is now better able to tailor its attack on tax shelters than it was ten years ago. Accordingly, it is no longer necessary for Congress to rely upon the second-best solution contained in section 465.¹⁴⁴

B. *Fraudulent Valuations*

Another argument in support of the at-risk concept may have greater merit. Even if the cancellation-of-indebtedness doctrine imposes an appropriate tax liability, it is nevertheless inappropriate to permit taxpayers to claim fraudulently inflated tax allowances. Deductions based upon fictitious information are already unlawful¹⁴⁵ and should remain impermissible. Furthermore, inflated deductions create the potential for manipulation of the Code's timing provisions that the proposed system may not entirely eliminate.

Although an inflated basis can result when property is subject to recourse financing, taxpayers are far more likely to acquire property at a higher purchase price when their actual liability to pay is limited to the true value of the property acquired. Such fraud is difficult for the Commissioner to address on an individualized basis. The at-risk rules eliminate the possibility of depreciating a fraudulent basis and thus can be defended as an anti-fraud provision. While the at-risk penalty may be

142. See 31 C.F.R. § 10.33 (1985) (governing practice of issuing tax shelter opinions). For this purpose, a tax shelter constitutes an investment in which either the deductions exceed income or the credits offset the tax on all income produced. The definition further offers a lengthy list of exclusions that would otherwise be covered by this extraordinarily broad definition, including municipal bonds and individual retirement accounts. The temporary regulations to the tax shelter registration offer a somewhat more realistic definition requirement. See Treas. Reg. § 301.6111-1T (1984) (defining tax shelter as investment in which one could reasonably infer that the investment will produce losses twice the amount of taxpayer's contribution during any of first five years of operation).

143. See Martin, *Tax Shelters: 1984 Style*, 36 MAJOR TAX PLANNING, 6-32 to 6-40 (1984), for numerous examples.

144. Congress has also enacted a series of supplemental or alternative taxes on both individuals and corporations. See, e.g., I.R.C. § 55 (Supp. II, 1984) (alternative tax on individuals); *id.* § 56 (Supp. II, 1984) (add-on tax for corporations). In addition, § 291 reduces by twenty percent the amount of certain preferential deductions corporations may claim. For a criticism of this approach, see Coven, *The Alternative Minimum Tax: Proving Again that Two Wrongs Do Not Make a Right*, 68 CALIF. L. REV. 1093 (1980).

145. I.R.C. §§ 6700-6701, 7201-7209 (Supp. II, 1984).

theoretically unsound and overbroad, the chance of fraud inherent in nonrecourse financing may be sufficiently serious to justify eliminating nonrecourse debt from a taxpayer's basis in potentially abusive situations.

The at-risk rules, however, were not crafted with that objective in mind. If Congress retains any form of the provision because of its anti-fraud potential, the rules will require substantial revision. Real estate, for example, is highly susceptible to fraudulent overvaluation,¹⁴⁶ yet section 465 presently excludes real property from its scope.¹⁴⁷ Conversely, other transactions lacking the potential for fraudulent valuation should be excluded from the scope of the at-risk rules.

CONCLUSION

When those responsible for creating the tax system have doubted that the separate-transaction system produced an appropriate tax burden, they have tended to revert to the single-transaction approach. Rather than adjust the tax consequences of the borrowing, they have altered the normal tax consequences of spending the loan proceeds. The Treasury did so in the section 752 regulations, Congress followed suit in section 465, and the Supreme Court did likewise in *Tufts*. In each instance, the introduction of an inconsistent analysis of debt-financed property transactions has produced confusion and complexity.

This Article has demonstrated that the separate-transaction system, properly developed and supplemented, produces an entirely sound method of taxation. Evaluating the impact of *Kirby Lumber* discloses that restricting deductions under the at-risk rules is unnecessary and often excessively harsh, and that the extension of traditional rules can eliminate improper tax avoidance. In revising the section 752 regulations, the Treasury Department should adopt the dictates of *Crane* and reject the contrary implications of the at-risk concept. Congress should also abandon the at-risk rules in favor of more precisely tailored sanctions on tax shelters engaged in fraudulent overvaluations. Both steps would simplify and promote the rationality of the Code.

146. See, e.g., *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976).

147. I.R.C. § 465(e)(3)(D) (1982).