Jackson Reanalyzed: Preventing Tax-Free Escape Upon Transfer of a Partnership Interest

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NOTES

JACKSON REANALYZED: PREVENTING TAX-FREE ESCAPE UPON TRANSFER OF A PARTNERSHIP INTEREST

For the past thirty years, courts have wrestled with the problem of calculating gain when a taxpayer transfers property. Most of the struggles have centered on interpreting and applying the landmark United States Supreme Court decision Crane v. Commissioner. A recent decision by the United States Court of Appeals for the Ninth Circuit, Jackson v. Commissioner, exemplifies the confusion in this area.

In Crane, the Supreme Court held that the amount realized upon the sale of mortgaged property includes the face amount of the mortgage as well as the cash paid by the buyer. Crane, however, addressed only the treatment of debt for which the taxpayer was not personally liable: nonrecourse liability. Jackson addressed a different question—the calculation of gain upon the transfer of property encumbered by a debt for which the transferor remains responsible as a guarantor: recourse liability. The confused analysis of the decision inadvertently opened an escape hatch from “leaky” tax shelters.

1. 331 U.S. 1 (1947).
2. 708 F.2d 1402 (9th Cir. 1983).
3. 331 U.S. at 11, 12; see infra note 71 and text accompanying notes 7-22.
4. Nonrecourse liability is a “[t]ype of security loan which bars the lender from action against the [personal assets of the borrower] if the security value falls below the amount required to repay the loan.” BLACK’S LAW DICTIONARY 953 (5th ed. 1979). In partnerships, the type of liability is important because it determines the proportion of each partner’s liability. Nonrecourse liabilities are allocated in the ratio that profits are shared because these liabilities are repaid, if at all, from the profits of the partnership. The partners are not obligated personally to repay nonrecourse liability. Treas. Reg. § 1.752-1(e) (1956). Recourse liabilities obligate a partner for personal repayment in the event that the partnership’s assets are insufficient. Recourse liability is allocated in the ratio that losses are shared because the risk of repayment is borne by the partners in that proportion.
5. 42 T.C.M. (CCH) 1419-23 (1981).
6. A “leaky” tax shelter is one that has stopped generating losses and has begun producing profit. The term is borrowed from Professor Martin Ginsburg. See generally Ginsburg,
This Note examines the tax consequences of the transfer of a partnership interest encumbered by recourse liability. The Note first reviews Crane and discusses the decision's rationale. The Note then focuses on the interpretive errors in Jackson and the likely ramifications of that decision. The Note concludes that existing statutory alternatives embodying Crane's principles effectively provide for the calculation of gain upon transfer of a partnership interest.

**BACKGROUND**

***Crane v. Commissioner***

Crane established important principles regarding the tax treatment of property encumbered by debt. Mrs. Crane inherited an apartment building from her husband. The building's appraised value equalled precisely the amount of the attached mortgage. Mrs. Crane never assumed personal liability for the mortgage. She operated the rental property for seven years and deducted the depreciation as an operating expense on the building, calculating the depreciation based on the inclusion of the amount of the mortgage in her basis. A buyer then purchased the building, giving Mrs. Crane a small amount of cash and taking the building subject to the mortgage.

Mrs. Crane argued that her basis in the property equalled the excess of the building's value over the amount of the mortgage.

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7. 331 U.S. at 3.
8. Id. at 3-4.
9. Basis represents a taxpayer's capital investment in property. Therefore, an asset's initial basis is usually its cost. I.R.C. § 1012 (1982). During the life of an asset, further capital investment along with improvement of the asset generate additions to basis and depreciation generates deductions from basis, both requiring adjustments. I.R.C. § 1016(a)(1)-(2) (1982). Individuals may deduct the operating expenses of their rental property from the rental revenues that the property generates to determine the amount of rental income to be included in their personal taxable income. I.R.C. § 162(a) (1982) Depreciation is a deductible business expense that is calculated by prorating the cost of the asset (its basis) over a period of years. See I.R.C. § 167 (West 1982 & Supp. 1984).
10. 331 U.S. at 3. Mrs. Crane's argument regarding her basis is inconsistent with the depreciation deductions that she took. Her argument assumed a zero basis. Depreciation represents merely an annual cost allocation of basis. Thus, if Mrs. Crane followed her own argument, her zero basis in the building would have allowed no depreciation deductions. Id. at n.2.
Because the appraised value equalled the amount of the mortgage, her equity was zero when she inherited the property and thus her basis also was zero. She maintained that the $2500 cash realized upon sale less her zero basis was her taxable gain on the sale.\textsuperscript{11} The Supreme Court rejected Mrs. Crane's arguments. It held that the amount realized upon the sale of mortgaged property included the face amount of the mortgage as well as the cash paid by the buyer.\textsuperscript{12} The Court thus calculated Mrs. Crane's gain by subtracting her basis in the building from the total of the cash received plus the mortgage.\textsuperscript{13} The Court's holding is based on the further corresponding holding that, if mortgage liability is included in the amount realized upon sale, it must be included in the seller's basis when acquired.\textsuperscript{14}

\textit{Crane} allows an investor to include debt financing as part of an asset's basis upon which depreciation is calculated. This provides the foundation of the tax shelter.\textsuperscript{15} Taxpayers buy property with

\begin{itemize}
  \item \textsuperscript{11} \textit{Id.} at 4.
  \item \textsuperscript{12} \textit{Id.} at 13.
  \item \textsuperscript{13} \textit{Id.} at 11, 14. The amounts that Mrs. Crane had deducted for depreciation reduced her basis and thus increased her taxable gain upon sale. Mrs. Crane's gain exceeded her net cash proceeds by the same amount that her total depreciation deductions exceeded her original basis net of the mortgage. Thus, the gain on sale essentially accounted for the depreciation deductions.
  \item \textsuperscript{14} \textit{Id.} at 10.
  \item \textsuperscript{15} Tax shelters have been described as investment devices by which an individual obtains an immediate and usually substantial reduction in the amount of tax on income he already has and upon which he would but for obtaining the "tax shelter" have to pay tax. He thus in effect is investing the government's tax dollars rather than his own money. . . . The essence of a tax shelter is the deferral or postponement of tax on current income, accomplished by accelerating future deductions into the current taxable year. Under the present tax accounting rules, in a taxable year in which the taxpayer has already received substantial income in excess of that year's deductions, he can avoid paying tax on all or part of that income by making an investment, prior to the end of the year, which will produce income in succeeding taxable years, but which will in the current year produce only deductions in the form of an artificial "loss."

In such cases, the major emphasis may be on the tax "loss" and the resulting tax saving on the participant's existing income from other and unrelated sources. Since the anticipated tax saving on the participant's other income may equal or exceed the amount of his cash investment in the "tax shelter", economic flaws in the investment itself may be ignored because he is investing tax dollars.
borrowed money and small personal investment. Because the amount of the mortgage is included in the basis, the taxpayer receives a basis disproportionately higher than his own investment. Further, the tax shelter may generate deductions that are large enough to offset ordinary income from other sources. Because the property is heavily mortgaged, the taxpayer receives a disproportionately high after-tax return on his own funds. The tax shelter thus generates deductions that offset ordinary income from other sources.

Although the inclusion of mortgage liability in basis makes the tax shelter possible, it does not produce a total windfall for the investor. Under Crane, upon sale of the property, the taxpayer must include the amount of the outstanding debt as part of the amount realized. The taxable gain upon sale offsets the deprecia-

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16. Accelerated depreciation methods provide larger depreciation deductions in the early years of asset ownership than does the straight line method, which evenly allocates the cost of the asset over its useful life. See generally W. WESTPHAL, ACCOUNTANT'S TAX PRACTICE HANDBOOK 137-38 (1978).

17. See generally Note, Tax Consequences of the Disposition of Property Subject to an Unassumed Mortgage, 49 COLUM. LI. REv. 845 (1949). Note also that sale of the shelter itself may be taxed at capital gains rates. An individual is allowed a 60% deduction on long term capital gains. Section 1221 of the Code indirectly defines a capital asset by describing those items that are not capital assets. Therefore, all other assets held by a taxpayer are by definition capital assets. The principal assets excluded from the definition of a capital asset are inventory and business fixed assets. The principal capital assets held by an individual taxpayer include personal use assets such as a residence or an automobile and assets held for investment purposes. Gain or loss upon sale of these assets is capital rather than ordinary.

18. For example, assume that a taxpayer purchases a building with a fair market value of $100,000 for $50,000 cash and a $50,000 ten-year nonrecourse mortgage. Assume also that the purchaser uses straight line depreciation and the useful life of the building is ten years. The taxpayer then sells the property for $80,000 after five years and the purchaser assumes the mortgage. Over the five years that the taxpayer owns the property, he is allowed to take depreciation deductions as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>CASH PAID</td>
<td>$50,000</td>
</tr>
<tr>
<td>MORTGAGE DEBT INCURRED</td>
<td>50,000</td>
</tr>
<tr>
<td>BASIS OF BUILDING</td>
<td>100,000</td>
</tr>
<tr>
<td>DEPRECIATION RATE BASED ON STRAIGHT</td>
<td>x10%</td>
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<tr>
<td>LINE METHOD FOR PROPERTY WITH A TEN</td>
<td></td>
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<tr>
<td>YEAR USEFUL LIFE</td>
<td></td>
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</tbody>
</table>
tion deductions. Thus, the shelter merely defers the investor's tax obligations.

The Court's analysis in *Crane* is the subject of ongoing debate. The opinion set forth two analyses supporting inclusion of nonrecourse debt in basis and amount realized. Courts and commenta-

<table>
<thead>
<tr>
<th>ANNUAL DEPRECIATION</th>
<th>AMOUNT</th>
<th>10,000</th>
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<tr>
<td>NUMBER OF YEARS PROPERTY HELD</td>
<td>x5</td>
<td></td>
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<tr>
<td>TOTAL DEPRECIATION AT TIME OF SALE</td>
<td>$ 50,000</td>
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</tbody>
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NOTE: Half of the $50,000 depreciation deducted over the five years ($25,000) is due to the inclusion of mortgage debt in the original basis of the asset. *Crane* thus provides a tax benefit in the form of larger depreciation deductions.

Upon the sale of the property, the building's basis is $50,000 (original cost less depreciation). Under *Crane*, the amount realized upon sale is computed as follows:

CASH RECEIVED | $ 80,000 |
OUTSTANDING MORTGAGE DEBT ASSUMED | 25,000 |
TOTAL AMOUNT REALIZED | $105,000 |
LESS: ADJUSTED BASIS OF THE BUILDING AT THE TIME OF SALE | $50,000 |
TAXABLE GAIN | $ 55,000 |

The inclusion of the outstanding debt in the seller's amount realized increased his gain by $25,000 and essentially recaptures the extra $25,000 depreciation that was allowed because of the inclusion of the mortgage debt in the original basis. If the depreciation benefit is not accounted for by including debt in amount realized upon sale of the property, the taxpayer would have received a dual benefit from the debt: extra depreciation and smaller gain upon sale.

19. The gain resulting from including nonrecourse debt in amount realized sometimes is termed a "phantom gain" because it does not arise from the type of consideration that usually comprises amount realized, such as cash and the buyer's assumption of personal liabilities. See W. ANDREWS, BASIC FEDERAL INCOME TAXATION 523 (2d ed. 1979).


21. 331 U.S. at 13-16. Referring to the rationales, an imaginary Supreme Court opined: "It would have been better had [they] stopped [before stating the two rationales] . . . . On both counts we were sadly misled." Adams, *Exploring the Outer Boundaries of the Crane*
tors have labelled these approaches the "economic benefit" and the "double deduction" theories.\textsuperscript{22}

\textit{The Economic Benefit Theory}

The economic benefit theory discussed in \textit{Crane} extended the settled rule that a purchaser's assumption of a taxpayer's \textit{recourse} liability benefits the taxpayer in "as real and substantial [a sense] as if the money had been paid [to the taxpayer] and then paid over by [the taxpayer] to its creditors."\textsuperscript{23} The Court in \textit{Crane} suggested that the sale of property subject to \textit{nonrecourse} debt constitutes an actual economic benefit to the taxpayer as well, even though the taxpayer retains no personal liability for the debt.

The Court realized that, because a lender can foreclose the mortgage, nonrecourse debt essentially imposes personal liability on the property owner. A foreclosure would make the property owner lose his equity. The borrower therefore will treat the debt as if he were personally liable to avoid foreclosure.\textsuperscript{24}

The economic benefit rationale has serious flaws, however. Most notably, it breaks down when the property value is less than the amount of the mortgage.\textsuperscript{25} Further, unlike recourse debt in which personal liability persists, nonrecourse obligations do not concern the taxpayer after sale or abandonment of the property.\textsuperscript{26} This difference exists because the transferor retains no liability after the

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\textmd{\textit{Doctrine; An Imaginary Supreme Court Opinion, 21 Tax L. Rev. 159, 175 (1966).}}
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24. 331 U.S. at 14.
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25. See Del Cotto, \textit{supra} note 22, at 85. If the value of the property is less than the mortgage, the sale of the property cannot satisfy the mortgage. In this situation, the taxpayer would not realize an economic benefit upon disposition of the property because he would not have built any equity to protect. Further, because the debt is nonrecourse, the discharge itself would confer no benefit because the taxpayer never incurred personal liability. The Court's oft-cited footnote 37 in \textit{Crane} explicitly recognized this situation as presenting a different question that the Court declined to consider. See 331 U.S. at 14. Thus, even if the economic benefit rationale is persuasive within the factual context of \textit{Crane}, it does not explain other situations easily.
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sale. Professor Bittker perceptively viewed the economic benefit rationale as merely a semantic result of the Court being forced to choose between three alternatives in distinguishing nonrecourse and recourse obligations.\textsuperscript{27}

The United States Court of Appeals for the Fifth Circuit recently discredited the economic benefit theory in \textit{Tufts v. Commissioner}.\textsuperscript{28} The court agreed that the appeal of the theory diminishes when the taxpayer does not want to keep the property.\textsuperscript{29} Although the Supreme Court's reversal did not expressly reject the economic benefit approach, the Court limited the theory to the facts of \textit{Crane}.\textsuperscript{30}

\textbf{The Double Deduction Theory}

Courts and commentators also have debated the proper interpretation of the double deduction theory.\textsuperscript{31} The Court advocated in-

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\item \textit{See} Bittker, supra note 26, at 282. The alternatives were: (1) to draw a distinct line between nonrecourse and recourse obligations; (2) to create a system of case-by-case scrutiny; or (3) to provide uniform treatment of both types of liability. \textit{Id.} The first alternative would create problems in situations where no practical difference exists. For example, a real estate holding company's only substantial asset is mortgaged property so personal liability adds little to the debtor's security. \textit{Id.} Case-by-case analysis generally is disfavored because it increases the administrative burden on the courts and establishes no clear standards for economic decisions. \textit{Id.} By treating recourse and nonrecourse debt similarly, the Court was forced to adopt the economic benefit fiction to support its approach. Professor Bittker suggested that if the Court admitted that it was choosing administrative simplicity, much future confusion could have been eliminated. \textit{Id.}
\item 651 F.2d 1058, 1062 (5th Cir. 1981), rev'd, 103 S. Ct. 1826 (1983).
\item If the taxpayer decides, for any reason whatsoever, that he no longer wants the burdens and responsibilities that accompany ownership, he can transfer the property to a third party with absolutely no regard for that party's willingness or ability to meet the mortgage obligations, yet rest assured that his other assets cannot be reached. \textit{Id.} This freedom to market wholly undermines the support for the economic benefit theory.
\item 103 S. Ct. at 1831.
\item \textit{See}, e.g., \textit{id.} at 1831-34; Bittker, \textit{Tax Shelters}, supra note 26, at 282. The term "double deduction" apparently was derived from Judge Learned Hand, the author of the court of appeals opinion in \textit{Crane}, who reasoned:
\begin{quote}[U]nless the "adjusted value" of the buildings is not computed upon the same [fair market] value in finding the subtrahend in the equation of gain [adjusted basis], the taxpayer gets a double deduction. By hypothesis [the taxpayer] will have been allowed deductions seriatim, based upon the actual value of the buildings; and he will in addition have got a reduction in his gain to the extent to which actual "wear and tear" has reduced the selling price. Manifest justice demands that he must surrender one or the other . . . .
\end{quote}
\end{itemize}
cluding Mrs. Crane's outstanding mortgage in her amount realized because she received the benefit of including the mortgage in her basis during earlier years.\textsuperscript{32} The larger basis allowed her to deduct depreciation in excess of her actual cash investment in the property. Including the mortgage in basis for the calculation of depreciation required that it be offset by including it in the amount realized upon sale. This approach prevents the taxpayer from receiving depreciation tax benefits without recapture in the form of gain upon sale.\textsuperscript{33}

\textit{Tufts} was a recent attempt to apply the double deduction rationale. The court in \textit{Tufts} considered whether the \textit{Crane} rule applies when the unpaid amount of nonrecourse debt exceeds the fair market value of the property sold.\textsuperscript{34} In \textit{Tufts}, each partner included in the basis for his partnership interest his proportionate share of a $1,850,000 nonrecourse mortgage note, the proceeds of which were used to finance construction of an apartment complex.\textsuperscript{35} At the time the partners sold their partnership interests, the balance of the mortgage note remained $1,850,000, but the fair market value of the apartment complex, which secured the note, had declined to $1,400,000.\textsuperscript{36} The adjusted basis of the apartment complex was approximately $1,455,000.\textsuperscript{37} The government argued that the full amount of the nonrecourse mortgage of $1,850,000

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\item \textsuperscript{153} F.2d 504, 505 (2d Cir. 1945).
\item \textsuperscript{32} See 331 U.S. at 14.
\item \textsuperscript{33} \textit{Id.} As the court of appeals stated in \textit{Crane}, the mortgagor "should be compelled to take the transaction as a whole, including such past advantages as he may have been entitled to as allowances for depreciation." 153 F.2d at 506.
\item \textsuperscript{34} 103 S. Ct. at 1831-36. In \textit{Crane} the Supreme Court held that on the sale of property encumbered with a nonrecourse liability in which the value of the property equals or exceeds the liability, the liability must be included in the amount realized on the sale. In the celebrated footnote 37, the Court made the following reservation:
\begin{quote}
Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.
\end{quote}
\item \textsuperscript{35} 651 F.2d at 1059.
\item \textsuperscript{36} \textit{Id.}
\item \textsuperscript{37} In 1971 and 1972, each partner claimed depreciation deductions amounting to an aggregate total of $108,035, which, along with the operating losses, reduced the basis of the property to $1,455,000 at the time of sale. 70 T.C. 750, 769-78 (1978).
\end{itemize}
had to be included in their amount realized on the sale.\textsuperscript{38} The taxpayers contended that the amount of the mortgage includible in the amount realized was limited to the fair market value of the property, $1,400,000.\textsuperscript{39}

The Tax Court held that the amount realized included the full amount of debt because of the taxpayers' earlier depreciation deductions.\textsuperscript{40} The United States Court of Appeals for the Fifth Circuit reversed.\textsuperscript{41} Relying on Crane's footnote 37,\textsuperscript{42} the court held that a taxpayer's amount realized upon the disposition of property subject to a nonrecourse debt is limited to the fair market value of that property.\textsuperscript{43} The court refused to extend Crane and rejected both of its rationales.\textsuperscript{44} Specifically, the court professed "uncertainty as to the exact nature of the double deductions."\textsuperscript{45} This uncertainty was evident in the court's discussion of the double deduction theory.

The court stated that any tax benefits received in the form of deductions already had been factored into the gain equation through the corresponding downward adjustment of basis.\textsuperscript{46} As a result, the Court reasoned that inclusion of the debt in the amount realized would expand unnecessarily the amount realized and lead to double taxation.\textsuperscript{47} This analysis is seriously flawed, however, because reduction of basis does not sufficiently account for tax benefits in the gain equation.\textsuperscript{48}

\begin{footnotes}
38. 651 F.2d at 1059.
39. Id.
40. 70 T.C. at 769-70.
41. 651 F.2d at 1063.
42. Id. Courts previously had ignored this footnote. Courts encountering this issue uniformly held that the taxpayer's amount realized on the disposition of the property included the full amount of the debt. See, e.g., Millar v. Commissioner, 577 F.2d 212, 214-16 (3d Cir. 1978), cert. denied, 439 U.S. 1046 (1978); Woodsam Assocs. v. Commissioner, 198 F.2d 357, 358 (2d Cir. 1952); Estate of Delman v. Commissioner, 73 T.C. 15, 29-30 (1979).
43. 651 F.2d at 1063.
44. The court rejected the economic benefit theory as "seriously flawed." Id. at 1062; see supra text accompanying notes 25-30.
45. 651 F.2d at 1060 n.4.
46. Id. at 1061.
47. Id.
48. The court misinterpreted the "double deduction" problem. The opinion assumes that basis adjustments required for depreciation by section 1016 of the Code will increase the taxpayer's gain on sale, thereby accounting for prior deductions (i.e. gain is equal to the difference between amount realized and basis, and therefore any decrease in basis increases
The Supreme Court reinstated the Tax Court decision. The Court ruled that the fair market value of the property did not limit the amount of debt that must be included in amount realized.\(^4\) The decision rested on the need for symmetry between inclusion of nonrecourse debt in the taxpayer’s basis and in his amount realized.\(^5\)

Crane: A Balancing Entry Theory

Interpreting *Crane* as resting on a balancing entry concept provides a sounder, more flexible analysis for applying *Crane*. The concept obviates the narrower, attenuated economic benefit and double deduction theories. Professor Bittker proposed viewing the balancing entry as a form of correlative adjustment.\(^6\) He realized this difference and thus increases the gain). But this does not resolve the double deduction problem. The reduction of basis does not have any tax consequences until the time of sale. Failure to include debt in amount realized will produce, at minimum, a smaller gain and in many instances a loss upon sale. Reduction of basis does not produce the requisite gain upon sale if the taxpayer’s amount realized is less than his reduced basis. The outstanding amount of the debt that was included in the taxpayer's depreciable basis must be included in amount realized to mitigate the problem. For a numerical example, see *supra* note 18.

49. 103 S. Ct. at 1831. The Court adopted section 1.1001-2 of the Treasury Regulations by holding that when nonrecourse debt is included in basis the face amount of the liability must be treated as amount realized, even if the face amount exceeds the fair market value of the property at the time of the sale or exchange. *Id.*

50. Symmetric treatment prevents a tax loss which does not represent economic loss and thus prevents frustration of the tax laws. *Id.* at 1834. The Court interpreted *Crane* as resting on an economic benefit theory, but limited that approach to the facts of *Crane*. *Id.*; see *supra* note 18. Assume, for example, that a taxpayer purchases a building with a fair market value of $100,000 for $30,000 cash and a nonrecourse mortgage of $70,000. Assume also that the taxpayer uses straight line depreciation, that the building has a ten-year useful life, and that the taxpayer does not make any payments of principal on the nonrecourse note. Then assume that the taxpayer sells the building after five years for $20,000 cash.

The taxpayer has an actual loss of $10,000 ($20,000 cash received less $30,000 paid) on the transaction. Under *Crane*, the taxpayer’s adjusted basis would be $50,000 ($100,000 less $10,000 depreciation per year for five years) and the amount realized on the sale would be $90,000 ($20,000 cash plus $70,000 assumption of mortgage by purchaser). The taxable gain upon disposition would be $40,000 ($90,000 amount realized less $50,000 adjusted basis). But the taxpayer already has received the benefit of $50,000 in depreciation deductions, making his overall tax loss $10,000, which agrees with his actual out-of-pocket loss.

If, however, the taxpayer’s amount realized equals only the $20,000 cash received, then he realizes a $30,000 tax loss in addition to the $50,000 depreciation he has taken. This does not conform with the transaction’s actual result, an out-of-pocket loss of $10,000.

that the economic benefit rationale of Crane was unpersuasive,\textsuperscript{52} but acknowledged that the Court’s decision was justifiable because it harmonized the tax consequences of the taxpayer’s property dealings with economic reality.\textsuperscript{53} Bittker suggested that “the value ascribed to the alleged relief she obtained from a liability for which she was not liable was, at bottom, a balancing entry that was appropriate if—but only if—viewed in its tax context.”\textsuperscript{54}

When a taxpayer buys property with borrowed funds, he includes the amount of the debt in the asset’s basis. The borrowed funds are excluded from the debtor’s income because the Code assumes that the debtor must repay the loan.\textsuperscript{55} Similarly, a taxpayer deducts depreciation from basis because the Code assumes that the deductions restore the taxpayer’s capital outlay.\textsuperscript{56} When a taxpayer transfers the asset, however, both assumptions fail. The taxpayer makes no further capital outlay and need not repay the debt.\textsuperscript{57} Thus, “a balancing entry [inclusion of the outstanding debt in amount realized to trigger taxable gain]—is required when the taxpayer closes his account with the Internal Revenue Service by disposing of his property. . . .”\textsuperscript{58} The balancing entry, then, is essentially a reversal required because of changed circumstances.

The balancing entry approach represents a necessary counterweight to the annual accounting principle.\textsuperscript{59} Courts long ago recognized that annual tax returns are required because the government needs ascertainable revenue at regular intervals.\textsuperscript{60} Taxpayers are unable to predict the future when they take deductions because transactions often develop over more than a single year. If an assumption underlying the initial deduction later proves erroneous, such as when a “bad debt” actually is paid off, a need for a balancing entry arises.\textsuperscript{61}

\begin{itemize}
\item \textsuperscript{52} Id.
\item \textsuperscript{53} Id.
\item \textsuperscript{54} Id. (emphasis added).
\item \textsuperscript{55} Id. at 284.
\item \textsuperscript{56} Id.
\item \textsuperscript{57} Id.
\item \textsuperscript{58} Id.
\item \textsuperscript{59} Estate of Munter v. Commissioner, 63 T.C. 663, 678 (1975) (concurring opinion).
\item \textsuperscript{60} Commissioner v. Sanford & Brooks Co., 282 U.S. 359, 365 (1931).
\item \textsuperscript{61} See, e.g., Commissioner v. Anders, 414 F.2d 1283 (10th Cir. 1969), cert. denied, 396 U.S. 968 (1969).
\end{itemize}
The Supreme Court also adopted a balancing entry theory in *Tufts*, citing Bittker's analysis.\(^6^2\) Although the Court claimed that its approach differed from the *Crane* rule and the tax benefit rule,\(^6^3\) this is merely an exercise in semantics as Justice Blackmun indicates in his dissent in *Hillsboro National Bank*.\(^6^4\)

The balancing entry approach adequately articulates the rationale underlying *Crane* and the tax benefit theory. A debtor originally receives the proceeds of a loan tax-free based on the assumption that he incurred an obligation to repay the debt. The debtor also can include the amount of the debt to determine the basis of an asset. An adjustment is required when later events contradict the assumption that the taxpayer will repay the debt.

Depreciation deductions presuppose economic investment. If the purchaser of property borrows money to pay the purchase price, a firm obligation to invest presumably exists. When the taxpayer subsequently transfers the property, depreciation deductions have generated a benefit that the taxpayer will never repay through the investment of capital. The taxpayer cannot ignore the tax benefit of the depreciation deductions when calculating gain upon disposition of the property. Unless the amount realized includes the outstanding amount of the debt, the debtor will have received not only untaxed income when he received the loan proceeds but also an unwarranted increase in the basis of his property. A balancing entry that includes the outstanding debt in the amount realized provides the proper tax treatment.

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62. 103 S. Ct. at 1832.
64. Hillsboro Nat'l Bank v. Commissioner, 103 S. Ct. 1134, 1164 (1983). Justice Blackmun viewed the tax benefit rule narrowly and prescribed making the necessary adjustment by amending the original return rather than treating the recovery as income in the year of the adjustment. 103 S. Ct. at 1164-65. Blackmun's narrow view of the tax benefit rule may explain why he attempts to distinguish the rule from the seemingly similar approach that he took in his *Tufts* opinion. *Tufts*, *Crane*, and the tax benefit rule all are based on a balancing entry theory. The balancing entry is required because the original assumption that the debtor incurred an obligation to repay has later proved unfounded.
In *Tufts* the Court recently suggested acceptance of a balancing entry approach as the rationale behind *Crane*.\(^{65}\) Therefore, the balancing entry concept provides a sounder, more flexible analysis for applying *Crane*. The concept obviates the narrower economic benefit and double deduction theories. *Jackson* involved the application of *Crane*'s principles to the transfer of a partnership interest. Again, the confusion concerning the tax treatment of the transfer of an asset that is encumbered by debt stems from varying interpretations of *Crane*. Courts that are presented with cases similar to *Jackson* in the future first must understand that the balancing entry theory calls for taxation upon transfer of the partnership interest. The courts then are free to apply statutory alternatives to calculate the taxable gain.

**JACKSON v. COMMISSIONER**

Donald Jackson, a tax lawyer, and Living Environmentals, Inc. (LEI), a builder, each owned a fifty-percent interest in a joint venture\(^{66}\) to construct apartments. Louis F. Del Castillo controlled the stock of LEI. In September 1972, Jackson and Del Castillo individually signed a promissory note for a short-term loan from Wells Fargo Bank to cover the capital costs of the joint venture.\(^{67}\) Later, Jackson decided to have his wholly owned corporation, Housing Specialists, Inc. (HSI), act as his agent in business transactions to avoid the appearance of competition with his law firm’s builder clients.\(^{68}\) Jackson became an undisclosed principal\(^{69}\) as a result of the agency relationship. HSI then obtained a $795,000 permanent con-
struction loan from Gilbralter Savings & Loan Association. Jackson, as president of HSI, and Del Castillo, as president of LEI, signed the loan. Jackson also guaranteed this loan personally.\(^7\) The joint venture relationship was not mentioned in either the Gilbralter or the Wells Fargo loan documents.\(^7\)

Jackson and LEI signed a formal joint venture agreement in November 1972. The agreement stated that the purpose of the Wells Fargo loan was to assist in financing the joint venture and that the loan constituted capital requiring repayment by the joint venture before any distribution of income to the venturers.\(^7\) The agreement also acknowledged that the Gilbralter loan was obtained for the joint venture.\(^7\) The lenders were not notified of the joint venture agreement. The joint venture reported a loss of $36,222.51 on its 1972 partnership tax return.\(^4\) Jackson's allocated share\(^5\) of the loss was $18,111.26 and he claimed this loss on his individual tax return. The joint venture's partnership tax return reflected the outstanding balances of the two loans as liabilities.\(^7\)

On January 3, 1973, Jackson assigned his one-half interest in the joint venture to HSI, his wholly owned corporation. This assignment abolished the agency relationship.\(^7\) Jackson viewed the transaction both as a complete termination of his individual inter-

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\(^7\) W. 42 T.C.M. at 1414.
\(^8\) Id.
\(^9\) Section 1.17 of the joint venture agreement discussed the capital accounts of each joint venturer and stated in part: "all such sums contributed to the Joint Venture shall constitute capital and shall be repaid to WELLS FARGO BANK prior to the distribution to a Joint Venturer or any principal shareholder or employee of the Joint Venturer of any income or net profits or any other amounts whatsoever." Id.
\(^10\) Id. at 1415 (citing Exhibit A of the joint venture agreement).
\(^11\) Id. at 1414.
\(^12\) A partnership's taxable income is calculated similarly to that of an individual. A partnership is not treated, however, as a separate taxable entity. Rather, certain items of income, gain, loss, deduction and credit are passed through to the partners and are included in their individual returns. Each distributive share of these items generally is determined by the partnership agreement. See I.R.C. §§ 701, 702, 704 (1982); see generally 1 & 2 A. W. McKEE, W. NELSON & R. WHITMIKE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, ¶¶ 1.01, 1-1 to 1-4 (1977).
\(^13\) The total amount of the loans outstanding on December 31, 1972, was $422,450 (Wells Fargo = $24,950; Gilbralter = $397,500). The entire amount borrowed from the Wells Fargo Bank was repaid by the joint venture in 1973.
\(^14\) 42 T.C.M. at 1415.
est in the joint venture with LEI and as a contribution to HSI's capital. Jackson received no additional stock when he transferred his partnership interest. Following the assignment, HSI exercised all managerial powers originally held by Jackson. As a joint venture, HSI had authority to bind the joint venture and had an equal right to possession of property for joint venture purposes.

A dispute arose over the ability of the government to tax Jackson on the transfer of his interest in the joint venture. The Commissioner argued that HSI's assumption of Jackson's joint venture liabilities constituted a sale or exchange under section 1001(a). The Commissioner also argued that this transfer was a taxable gain to the extent that the transferred liabilities exceeded Jackson's basis in the joint venture.

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78. Id. (referring to the minutes of an HSI board meeting).
79. This fact affects the determination of whether the transfer constituted a sale or exchange. Qualification as a sale or exchange is necessary for sections 752(d) or 351 of the Code to apply. See infra text accompanying notes 141-43 and 145-49.
80. 42 T.C.M. at 1415.
81. Id. at 1418.
82. Section 1001(a) of the Code provides in part that "[t]he gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain." Section 1001(b) of the Code defines the amount realized from the sale or other disposition of property as "the sum of any money received plus the fair market value of the property (other than money) received." I.R.C. § 1001(b) (1982).
83. 42 T.C.M. at 1418. Section 1.1001-2(a) of the Treasury Regulations specifically provides that the amount realized upon sale or other disposition of property includes the amount of liabilities from which the transferor is discharged. Treas. Reg. § 1.1001-2(a) (1980). The Tax Court ruled that the regulation was not applicable because it had not been adopted during the years in question. Id. at 1417 n.6. In his brief, the Commissioner argued that this regulation merely interpreted existing law and should be given retroactive effect. The court of appeals never addressed this issue.

The Commissioner argued that Jackson's taxable gain should be calculated as follows:

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<table>
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<tr>
<th>CALCULATION OF JACKSON'S BASIS</th>
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<tr>
<td>IN HIS P/S INTEREST</td>
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<tr>
<td>Contributions to Capital</td>
</tr>
<tr>
<td>50% share of P/S Liabilities</td>
</tr>
<tr>
<td>½ Gilbralter loan             $397,500</td>
</tr>
<tr>
<td>½ Wells Fargo loan            24,950</td>
</tr>
<tr>
<td>Cash                          0</td>
</tr>
<tr>
<td>422,450</td>
</tr>
<tr>
<td>Allocated Share of 1972 P/S Losses $18,111</td>
</tr>
<tr>
<td>Jackson's Basis in his P/S Interest $404,339</td>
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</table>
The Tax Court agreed with the Commissioner. The court ruled that the joint venture was not primarily obligated to extinguish Jackson’s liability because the lenders had not been notified of the joint venture relationship. Thus, the obligation of the joint venture to pay the debt did not provide Jackson any basis because Jackson remained individually liable to the lenders. The court also ruled, however, that Jackson’s contribution of the loan proceeds to the joint venture created a joint venture liability and his share of this liability provided his basis. The court reasoned further that because HSI replaced Jackson, thereby becoming a party to joint venture liabilities, that transaction constituted a sale or exchange.

The United States Court of Appeals for the Ninth Circuit reversed. The court interpreted the Tax Court’s calculation of gain as based on an amount realized to Jackson arising from a relief from liability. The court of appeals focused on Jackson’s continued liability as guarantor and held that because Jackson was not relieved from liability, he received no consideration. Thus, Jackson realized no gain from the transaction with HSI.

<table>
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<tr>
<th>Calculation of Jackson’s Gain Upon Transfer of His P/S Interest</th>
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<tr>
<td>Jackson’s Amount Realized</td>
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<tr>
<td>(reduction in share of P/S liabilities)</td>
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<tr>
<td>Jackson’s Basis in his P/S Interest</td>
</tr>
<tr>
<td>Jackson’s Taxable Gain</td>
</tr>
</tbody>
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42 T.C.M. at 1418.
84. 42 T.C.M. at 1423.
85. Id. at 1420-21. The joint venture agreement had to be in writing to obligate the joint venture to pay the debt upon which Jackson was personally liable. The written agreement was not yet effective when the loans were secured and the lenders were not notified in writing of the agreement as required by section 1624(2) of the California Civil Code. See Cal. Civ. Code § 1624(2) (West 1982). Thus, under California law, Jackson remained personally liable to the lenders.
86. 42 T.C.M. at 1423.
87. Id. at 1421.
88. Id. at 1423; see infra note 118 and text accompanying notes 111-18.
89. See 708 F.2d 1402, 1404-05 (9th Cir. 1983).
90. Id. at 1404.
91. 708 F.2d at 1404. Although the joint venture had contractually agreed to pay off the loans, under California law, Jackson retained liability to the lenders as guarantor. See infra text accompanying notes 97-103.
92. 708 F.2d at 1404.
This decision allowed Jackson to transfer his encumbered partnership interest tax-free. Because a loan is not a taxable transaction, Jackson received the benefit of the tax-free use of the borrowed funds. He also received larger individual depreciation deductions while involved with the partnership because he was allowed to include the liabilities as part of the adjusted basis of the partnership property. In both instances, the tax benefits stemmed from the assumption that Jackson would repay the loans. Consequently, when Jackson transferred his partnership interest he should have been required to account to the government for the earlier benefits in the form of taxable gain.

*Jackson* may have potentially serious ramifications. Investors in tax shelters will attempt to apply *Jackson* to avoid taxes on tax shelters that have begun to produce income. Investors could retain guarantor liability on the shelter debt and transfer the shelter assets to a controlled corporation, thus escaping taxation. Before analyzing *Jackson* and the specific statutory provisions available, an overview of the pertinent general partnership tax provisions is necessary.

**An Overview of the Partnership Taxation Statutory Framework**

Early provisions regarding partnership taxation were superficial and ambiguous. In 1954 Congress significantly expanded and codified the rules regarding partnership transactions in Subchapter K of the Internal Revenue Code. To calculate the gain or loss on the sale or exchange of partnership interests, Subchapter K adopts an entity approach. The transferor does not compute his gain or

93. Upon the sale or exchange of a partnership interest, section 741 of the Code specifically provides that gain or loss will be recognized to the transferor partner. See I.R.C. § 741 (1982).
96. A. Willis, *Willis on Partnership Taxation*, § 1.03 (1971). The conflict of whether to view the partnership as an aggregate of individuals who have pooled their property or as a separate distinct entity has continued for several hundred years. Subchapter K adopts neither theory exclusively. Rather, Subchapter K takes a result-oriented approach and applies the theory that produces the desired result.

Subchapter K predominantly employs the entity concept of partnership but recognizes
loss separately for each partnership asset. Rather, he treats his partnership interest as a single intangible asset with an adjusted basis separate from the basis of the individual partnership assets.97

Sections 741 and 1001 of the Code govern the income tax consequences of the sale or disposition of a partnership interest. Section 741 provides that a partner will recognize a gain or loss upon the sale or exchange of his partnership interest. Section 752 provides specifically for the treatment of liabilities in connection with the sale of a partnership interest. Section 752(d) states that liabilities should be treated the same as liabilities associated with the sale or exchange of any other property.

Generally, gain or loss from the sale or disposition of property equals the difference between the amount realized from the sale and the adjusted basis of the property transferred.98 The amount realized upon the sale of a partnership interest is calculated in the same manner as on the sale of other property. The amount realized includes the sum of the money paid by the purchaser and the fair market value of any other property received by the selling partner.99 Further, a Treasury Regulation100 mandates treating a liability of the transferor that is assumed by the purchaser as an amount realized.101

When a partner calculates his gain or loss upon sale or exchange of his partnership interest, he also must include his share of partnership liabilities to determine the adjusted basis of his partnership interest.102 Thus, partnership liabilities are symmetrically ac-

97. W. McKee, W. Nelson & R. Whitmire, supra note 75, at ¶ 6.03[6].
99. Id. § 1001(b).
100. Treas. Reg. § 1.1001-2(a)(4)(v) (1982). More specifically, an example in section 1.752-1(d) of the Treasury Regulations illustrates that the amount a partner realizes from the sale of his interest is increased by his share of partnership liabilities transferred. See Treas. Reg. § 1.752-1(d) (1982).
101. See supra note 83.
counted for on both sides of the gain or loss equation. The basis of a partnership interest ordinarily consists of the value of property contributed, $103$ less any distributions, $104$ plus the distributive share of partnership income or loss. $105$ Any increase in partnership liabilities is treated as a contribution of money by the partners, thus increasing their basis under section 722. $106$ Conversely, any decrease in partnership liabilities amount to a distribution of money to the partners which decreases their basis under section 733. $107$

These provisions provide the statutory base for determining the appropriate tax treatment of a transfer of a partnership interest. Integrating these provisions with other specific partnership provi-

103. Id.
104. Id. § 732.
105. Id. § 705(a) (West 1982 & Supp. 1984).
106. Id. § 752(a). The partner is "contributing" to the partnership by assuming liability for his share of the additional partnership liabilities. The House Report on the Internal Revenue Act of 1954 stated:

Section 752. Treatment of certain liabilities:

Frequently, a partner will assume partnership liabilities or a partnership will assume a partner's liabilities. In some cases this occurs as the result of a contribution of encumbered property by the partner to the partnership or as the result of a distribution of such property by the partnership to the partner. The provisions of this section prescribe the treatment for such transferred liabilities. Whenever a partner's individual liabilities are increased because of the assumption by him of partnership liabilities, the amount of the increase shall be treated as a contribution of money by the partner to the partnership. Similarly, when the liabilities of the partnership are increased, thereby increasing each partner's share of such liabilities, the amount of the increase shall be treated as a pro rata contribution by the partners, thereby raising the basis of each partner's interest in the amount of his share of the increase.

Conversely, when a partner's personal liabilities are decreased because a portion of them have been assumed by the partnership the amount of the decrease shall be treated as a distribution of money by the partnership to the partner. Similarly, when the liabilities of the partnership are decreased, thereby decreasing each partner's share of such liabilities, the amount of the decrease shall be treated as a pro rata distribution by the partnership, thereby reducing the basis of each partner's interest in the amount of his share of the decrease.

The transfer of property subject to a liability by a partner to a partnership, or by the partnership to a partner, shall, to the extent of the fair market value of such property, be considered a transfer of the amount of the liability along with the property.

sions is the better way to address the *Jackson* problem.

**Analysis of Jackson**

An analysis of *Jackson* requires an understanding of the liabilities of the parties in relation to the joint venture and the banks. Even though the joint venture made the payments, Jackson remained primarily liable to the Wells Fargo Bank because he personally signed the loan agreement.

The joint venture's books reflected the balance of the note as a liability and the joint venture's payments extinguished the debt.\(^{108}\) Additionally, the joint venture agreement provided that the loan was for joint venture purposes and constituted a joint venture obligation. The banks received no notice of the agreement because the agreement was not written when the parties obtained the loan. Therefore, under California law, the joint venture agreement was not effective against the banks.\(^ {109}\)

The larger, $795,000, loan from Gilbralter Savings & Loan was signed both by Jackson and by Del Castillo in their capacity as presidents of HSI and LEI respectively.\(^ {110}\) As with the Wells Fargo loan, the bank was not aware of the joint venture agreement and had no reason to know that HSI was acting merely as Jackson's agent.\(^ {111}\) Agency law in California provides that an agent is responsible as a principal when a lender extends credit to him personally without knowledge of any agency relationship.\(^ {112}\) Because HSI acted as an agent for Jackson, the agency relationship rendered HSI primarily liable on the Gilbralter obligation. Jackson assumed secondary liability as guarantor by his personal endorsement.\(^ {113}\)

Nevertheless, the written agreement between the joint venturers acknowledged that the loans were on behalf of the joint venture and constituted a joint venture obligation.\(^ {114}\) The joint venture agreement governed Jackson's transfer of the loan proceeds to the

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109. Id. at 1421 (citing CAL. CIV. CODE § 1624(2) (West 1954)).
110. Jackson, 42 T.C.M. at 1414.
111. Id. at 1421.
112. CAL. CIV. CODE § 2343 (West 1954).
114. 42 T.C.M. at 1414-15.
joint venture and dictated that the joint venture assume liability among the venturers for repayment of the loans. The distinction between Jackson’s continuing potential liability to the lenders and his relative liability within the formal partnership structure is critical to unraveling the attempts of the Tax Court and the Ninth Circuit to solve Jackson.

The Commissioner determined that a taxable sale or exchange occurred on the transfer of Jackson’s joint venture interest to HSI because HSI concurrently “assumed” Jackson’s liabilities. Jackson argued that no taxable event occurred upon transfer of his interest in the joint venture to HSI because HSI assumed no joint venture liabilities. Accordingly no reduction of his share of liabilities occurred and no income was realized. Jackson based his argument on three assertions. First, he asserted that the formation of the joint venture relieved him of liability on the Wells Fargo loan because the joint venture became solely liable. Thus, he was not relieved of the Wells Fargo liability when he transferred his joint venture interest because the joint venture held and retained the obligation before and after the transfer. Second, Jackson argued that because he personally had guaranteed the Gilbralter loan, HSI could not legally assume the loan. Finally, Jackson contended that the transfer of his partnership interest to HSI was a non-taxable capital contribution of a partnership interest to a wholly owned corporation.

The Tax Court analyzed the problem in two steps. First, the court determined whether Jackson’s joint venture interest actually was transferred so that HSI replaced Jackson as a joint venturer. Second, the court analyzed whether Jackson was relieved of his share of the joint venture liabilities, triggering the rules concerning a taxable sale or exchange.

The Tax Court held that HSI became a new partner in the joint venture with a capital interest and an interest in the profits. The facts indicated that Jackson purposely transferred his interest to

115. *Id.* at 1418.
116. *Id.*
117. *Id.*
118. Relief from liability constitutes amount realized. If the relief from liability exceeded Jackson’s basis in the joint venture, the excess would be taxable gain.
119. 42 T.M.C. at 1420.
sever his direct relationship with the joint venture. Further, HSI and Jackson agreed that HSI would assume Jackson's place in the venture and would include all income from the venture in its income. HSI exercised control over the joint venture and, most importantly, the joint venture agreement expressly stated that the assignees of the partnership interests assumed the obligations of the original parties to the agreement. In short, the transaction went far beyond a paper transfer; HSI's role as a joint venturer was substantial.

The Tax Court then analyzed the status of the transfer as a sale or exchange under section 741. The court rejected Jackson's argument that no consideration existed because he was not relieved of personal liability. The court stated that although Jackson remained potentially liable to Gilbralter on the $795,000 note, the joint venture agreement made HSI responsible for repayment. As a result, Jackson's liabilities decreased, and this decrease was adequate consideration to support a taxable sale or exchange. The Tax Court held, therefore, that a taxable sale or exchange occurred based on HSI's assumption of a share of joint venture liabilities.

Gain was recognized to the extent that the amount realized on the transfer exceeded Jackson's basis in his partnership interest. The Tax Court rejected Jackson's argument that the joint venture assumed the Wells Fargo obligation, thereby relieving him of liability at the time of its formation rather than when he transferred his partnership interest. The court ruled that, under California law, Jackson's primary liability as maker of the note did not

120. Id. at 1415.
121. Id. at 1414 (referring to section 1.26 of the joint venture agreement).
122. Id. at 1420-23. Section 741 of the Code states:
   In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of capital asset, except as otherwise provided in Section 751 (relating to unrealized receivables and inventory items which have appreciated substantially in value).
123. Jackson, 42 T.C.M. at 1421-22.
124. Id. at 1423.
125. Id. The $18,111 recognized gain related exactly to Jackson's allocated share of partnership loss claimed on his 1972 income tax return.
126. Id. at 1421.
end when the joint venture agreed to pay the loan. The court characterized Jackson's original contribution of the loan proceeds to the joint venture as a loan to the joint venture, creating a joint venture liability to Jackson. Accordingly, Jackson's liabilities did not decrease when he signed the joint venture agreement because the decrease in his personal liability on the loan was offset by the increase in his share of the joint venture's liability on the note under section 722 and 752(a). When Jackson transferred his joint venture interest to HSI, his relief from liability within the joint venture at that time constituted an amount realized subject to taxation.

Although the Tax Court's decision may have been correct, its reasoning was unclear. The court recognized that the transaction should be viewed within the partnership context, but then applied a mixed analysis. The court focused on the notion that a release from liability created gain. This view explains the court's characterization of the transaction as a liability arising "due to Jackson" upon his transfer of the loan proceeds to the joint venture, rather than as a capital contribution.

The United States Court of Appeals for the Ninth Circuit reversed the Tax Court, holding that no taxable transaction had occurred because Jackson remained liable on the loans and because he had received no other consideration The court was misled by Crane's economic benefit fiction. In the court's mind, Jackson's continued potential liability, both on the Gilbert loan due to his personal guarantee and on the Wells Fargo loan due to his effective status as guarantor, prevented any economic benefit from accruing to him. Because the court could not find any concrete economic benefit nor any other substantive consideration running to Jackson

127. Id.
128. Id. at 1422.
129. Although primary liability to pay the Wells Fargo loan remained with Jackson, a collateral agreement was formed between Jackson and the joint venture when the joint venture agreed to make the loans obligations of the joint venture. Such a collateral agreement is permitted under California law as between the joint venture and the joint venturers as individuals, although the joint venture could not replace the parties to the primary loan.
130. Id. at 1421. The Gilbert loan was treated similarly.
131. 708 F.2d 1402, 1404 (9th Cir. 1983).
it failed to find a taxable transaction.\textsuperscript{132}

The court erred by failing to distinguish Jackson's continued potential liability to the lenders as a guarantor and his relief from liability within the partnership context.\textsuperscript{133} Because the court was concerned only with economic benefit, it focused too narrowly on the Tax Court's recognition that Jackson technically retained personal liability on the loans.\textsuperscript{134} Consequently, the court ignored the Tax Court's crucial ruling that the transfer to HSI represented sufficient consideration because it relieved Jackson of liability in his capacity as joint venturer.\textsuperscript{135}

The court of appeals's decision was imprudent because it allows partners to transfer their partnership interests free from any tax. The court attempted to mechanically apply the economic benefit rationale of \textit{Crane} to the facts of \textit{Jackson}. When a taxpayer transfers an asset encumbered by debt, he should account for prior tax benefits. Otherwise a taxpayer will have received both untaxed income at the time the loan was extended and an unwarranted increase in the basis of his property.

\textit{Crane}'s provision for large depreciation deductions through the inclusion of debt as a part of basis elated tax shelter investors. But \textit{Crane} counterbalanced this depreciation by requiring the inclusion of debt in the amount realized upon sale of the property. Thus, taxpayers knew that when they disposed of their property, they then would have to account for earlier tax benefits in the form of taxable gain. \textit{Jackson} effectively circumvents this framework. Retention of some form of guarantor liability upon transfer of the shelter's assets will enable tax shelter investors to dispose of their shelters with no tax penalty. Similarly, on a narrower scale, partners desiring a tax-free escape from tax shelters can contribute property to a controlled corporation and not recognize taxable income as long as they guarantee any note to which the property is subject.

\textsuperscript{132} \textit{Id.}

\textsuperscript{133} The court correctly asserted that Jackson could not be relieved by HSI of his liability to the lenders. But HSI did relieve Jackson of his liability in his capacity as a joint venturer. This relief produced sufficient consideration to trigger recognition of gain. See \textit{supra} text accompanying notes 98-106.

\textsuperscript{134} 708 F.2d at 1404.

\textsuperscript{135} 42 T.C.M. at 1422-23.
A proper analysis of the transaction in *Jackson* should focus on liability within the formal structure of the partnership, as governed by the joint venture agreement. This "formalistic" approach at first may appear anomalous. Standard tax and accounting conventions focus on the substance of a transaction rather than its form. However, several sources support a formalistic approach in the *Jackson* context.

In *Jackson*, both the Commissioner and the Tax Court analyzed the transaction within the partnership structure. Additionally, *Raphan v. United States*, a recent Court of Claims case, held that a partner is not individually allowed basis for a partnership debt that he guarantees if the guarantee is outside the partnership structure because it was not called for by the partnership agreement. Revenue Ruling 69-223 also implicitly suggests that the focal point for liability should be at the partnership level.

Considering the transaction within the joint venture context more accurately reflects the substance of the *Jackson* transaction. The joint venture agreement provided that the loans were obtained for the benefit of the joint venture and that the joint venture was obligated to pay the loans even though Jackson remained potentially liable. The agreement also indicated that the agreement was binding on the venturers' assignees. Thus, HSI became a party to the joint venture obligations. Although still a party to the debts, Jackson was not obligated to pay on the notes unless the

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136. 42 T.C.M. at 1422, 708 F.2d at 1404.
138. Id.; see also Block v. Commissioner 41 T.C.M. (CCH) 546 (1980); Brown v. Commissioner, 40 T.C.M. (CCH) 725 (1980) (holding that the partner's guarantee of partnership debts did not entitle them to basis because the guarantee was not required by the partnership agreement). The Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (codified as amended in scattered sections of 26 U.S.C.), directs the Treasury to prescribe regulations concerning the inclusion of partnership liabilities in the basis of the partner's partnership interests. The regulations will specify that a partnership debt for which a partner is personally liable, either primarily or secondarily, whether in his capacity as a partner or otherwise, is not a nonrecourse debt, and thus generally does not provide limited partners with additional basis for their partnership interests.
140. 42 T.C.M. at 1422. Although the Tax Court stated that HSI assumed the partnership liabilities upon receipt of Jackson's partnership interest, no evidence of this exists in the written transfer agreement.
141. Id.
joint venture ceased payment. Even then, Jackson could sue the joint venture for breach of contract.

HSI's taking of the joint venture interest subject to the liabilities was inconsistent with the assumptions underlying the tax treatment of the transaction. Both *Crane* and section 752 gave Jackson a basis in his partnership interest that included the debt under the assumption that, as a partner, he would be responsible for payment. Upon the transfer of his interest to HSI, Jackson was no longer a partner in the joint venture, and HSI, not Jackson, was obligated to pay off the liabilities unless insolvency occurred. The relatively low probability of insolvency minimized Jackson's potential liability.\(^{142}\) Because the underlying assumption of the provision failed, Jackson should have included the outstanding liabilities in his amount realized. Because the shelter had begun to produce income, an arm's length transfer in the future was unlikely. Jackson nonetheless transferred the shelter without tax. The court of appeals thus permitted a tax-free escape from leaky tax shelters.\(^{143}\)

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142. Guarantor liability traditionally has been considered de minimis for tax purposes. *See* proposed Treas. Reg § 1.465-6(d) (guaranty of another person's note does not increase the guarantor's amount at risk); cf. Santa Anita Consol., Inc. v. Comm'r, 50 T.C. 536 (1968) (shareholder guarantee of bank loan to third-party does not represent contributed capital); Tonopah & T.R.R. v. Comm'r, 39 B.T.A. 1043 (1939) (interpreting Treas. Reg. § 1.861-2(a)(1) (1975) to mean that residence of the obligor, rather than that of the guarantor, is dispositive for purposes of determining the source of interest income), rev'd on other grounds, 112 F.2d 970 (9th Cir. 1940); I.R.C. § 453(f)(3) (1982) (third-party guarantee of purchaser's note in an installment sale does not recharacterize the note as payment in the year of sale).

143. Jackson's tax position after HSI pays off the loan raises an interesting issue. Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929), held that when a corporation discharges legal obligations for the personal benefit of a shareholder, the shareholder realizes income. *Id.* at 729. Maher v. Commissioner 469 F.2d 225 (8th Cir. 1972), held, in a similar context, that a transferor receives no income until principal and interest payments are made. *Id.* at 229. If applied to Jackson, *Maher* suggests that Jackson would not recognize any income until HSI actually paid the loans through the joint venture.

*Jackson*, however, is distinguishable from *Old Colony* and *Maher*. As a shareholder in HSI, Jackson would receive only an indirect benefit, relief from potential liability, when HSI ultimately paid the debt. Jackson merely was relieved from an obligation that he may never have been required to fulfill. The taxpayer in *Old Colony* benefited directly because his employer paid his tax liability, thereby relieving him from the obligation. In *Maher*, the taxpayer received income either upon assumption of the liability or subsequently when it was paid. The issue was whether to tax the individual now or later. In contrast, if Jackson escaped taxation when he transferred his joint venture interest, he would avoid taxation entirely because he would never realize income on the transaction.
Suggested Approaches to "Solving" Jackson

When solving tax problems, courts should apply existing legislative provisions rather than create new judicial doctrines. Sections 351 and 752 of the Code provide better solutions to the problem presented by Jackson. Section 752 specifically addresses partnership liabilities and the transfer of a partnership interest. Section 351 concerns any transfer of property to a controlled corporation.

Crane includes liabilities assumed in a sale or exchange as part of a seller's amount realized and a purchaser's basis. Section 752(d) explicitly extends this rule to sales or exchanges of partnership interests. Because partnership interests are treated in the same as any other property interests, a purchaser's initial basis in his partnership interest includes his share of partnership liabilities. Increases in a partner's share of partnership liabilities increase his basis; decreases in a partner's share of partnership liabilities decrease his basis. When a partner sells or exchanges his partnership interest, section 752(d) balances the taxpayer's account by treating the seller's share of partnership liabilities as an amount realized. Section 752(d) applies directly to Jackson's transfer of his partnership interest.

Jackson contributed no cash when the joint venture was formed. His transfer of the loan proceeds constituted either a contribution to the capital of the joint venture or a loan. In either case, the

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144. E.g., Crane, 331 U.S. 1; Tufts, 103 S. Ct. 1826.
145. Section 752(d) of the Code provides as follows:

SALE OR EXCHANGE OF AN INTEREST. In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.

I.R.C. §§ 752(a), 752(b) (1982).
146. Id. The rationale behind these provisions appears to be that a partner's acceptance of an increased share of partnership liabilities is an obligation undertaken by the partner that benefits the partnership in the same manner as a contribution of capital. Similarly, a decrease in the share of partnership liabilities that a partner is responsible for is treated analogously to a distribution of capital. See Treas. Reg. § 1.752-1 (1960).
148. The minutes of a special board of directors meeting stated that Jackson's transfer of loan proceeds to the joint venture represented a contribution of capital. 42 T.C.M. at 1415. The Tax Court's creation of a "due to Jackson" liability upon transfer indicated the court's preference for viewing the transaction as a loan. Id. at 1421.
transfer created a partnership liability.149 Jackson's half share150 of the partnership liabilities created by the Gilbralter and Wells Fargo loans provided him with a $422,450 basis in the partnership.151 The only change in Jackson's basis in his partnership interest before the transfer to HSI resulted from the joint venture's 1972 operating loss. This loss decreased his basis by $18,111 resulting in an adjusted basis at the time of transfer of $404,339. Under section 752(d), therefore, Jackson's gain upon transfer of his joint venture interest should be calculated as follows:

149. If the transaction is viewed as a loan by Jackson, the joint venture is liable to him for repayment of the proceeds. If the transaction is treated as a contribution of capital, section 752 still would apply even though the joint venture failed to assume liability to the lenders for repayment of the loan and Jackson remained liable as guarantor. See I.R.C. § 752 (1982). Section 752(c) expressly provides that liabilities to which property is subject are considered to be liabilities of the property owner. See I.R.C. § 752(a) (1982). Additionally, section 1.752-1(f) states that the amount of debt only can be taken into account once for purposes of section 752, even though a partner may be separately liable in a capacity other than as partner. Treas. Reg. § 1.752-1(f) (1960). These provisions, when read together, make it clear that a liability to which property contributed to a partnership is subject, is considered as a liability assumed by the partnership for purposes of section 752, notwithstanding that the contributing partner remains personally liable for repayment of the obligation. Treas. Reg. § 1.752-1(c) (1960).

150. Partners share recourse partnership liabilities in accordance with the ratio for sharing partnership losses. Liabilities are classified as recourse if any partner is personally liable. See supra note 4.

151. Under section 752(a) of the Code, Jackson's share of the additional partnership liabilities is treated as a contribution of money to the partnership, increasing the basis of his partnership interest under section 722 as follows:

50% SHARE OF PARTNERSHIP LIABILITIES

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/2 of the Gilbralter loan</td>
<td>$397,500</td>
</tr>
<tr>
<td>1/2 of the Wells Fargo loan</td>
<td>24,950</td>
</tr>
</tbody>
</table>

CASH CONTRIBUTED: -0-

JACKSON’S INITIAL BASIS IN HIS PARTNERSHIP INTEREST: $422,450

See I.R.C. § 752(a) (1982).
AMOUNT REALIZED FROM RELIEF FROM LIABILITY AS JOINT VENTURER ON THE:

<table>
<thead>
<tr>
<th>Loan Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wells Fargo loan</td>
<td>24,950</td>
</tr>
<tr>
<td>Gilbralter loan</td>
<td>397,500</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$422,450</strong></td>
</tr>
</tbody>
</table>

ADJUSTED BASIS OF JACKSON’S PARTNERSHIP INTEREST AT THE TIME OF TRANSFER TO HSI: $404,339

RECOGNIZED GAIN: $18,111

The major obstacle to analyzing Jackson under section 752(d) is whether the transaction qualifies as a “sale or exchange.” This in turn depends upon whether Jackson’s relief from liability was sufficient consideration to make the transaction a sale or an exchange. Some commentators and the Internal Revenue Service have advocated interpreting section 752(d) broadly to include all dispositions of partnership interests. The strongest argument in favor of a broad interpretation is that, when Congress enacted section 752(d), Crane applied only to sales or exchanges. Crane now applies to a broader range of transactions. Therefore, courts should interpret section 752 as a historical accident rather than as a deliberate attempt to restrict Crane.

If section 752(d) is read narrowly and Jackson’s transfer is not considered a sale or an exchange, section 752(b) should determine the tax consequences of the transfer. Section 752(b) treats a decrease in the partner’s share of partnership liabilities as an automatic distribution of money from the partnership to the partner. If a partner receives a section 752(b) constructive distribution in excess of the adjusted basis of his partnership interest, the partner

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152. A partnership interest is a capital asset, so any gain upon transfer is capital gain. I.R.C. § 741 (1982).


has a recognized gain under section 731(a)(1).\textsuperscript{155}

An analysis of the transfer under section 752(b) produces the same result as the section 752(d) approach. Under section 752(b), Jackson's relief from joint venture liabilities upon transfer of his interest to HSI constitutes an automatic cash distribution to him of $422,450. Section 731(a)(1) then requires Jackson to recognize gain to the extent that the distribution exceeds the adjusted basis of his partnership interest:

\begin{center}
\begin{tabular}{|c|c|}
\hline
CASH DISTRIBUTION & $422,450 \\
\hline
UNDER SECTION 752(b) & \\
\hline
ADJUSTED BASIS OF JACKSON'S PARTNERSHIP INTEREST AT THE TIME OF TRANSFER TO HSI & 404,339 \\
\hline
RECOGNIZED GAIN & $18,111 \\
\hline
\end{tabular}
\end{center}

As with the section 752(d) approach, this approach effectively balances Jackson's account with the Service by requiring him to include the amount of the debt in both basis and amount realized.

The third statutory alternative available is to regard Jackson's transaction as a transfer to a controlled corporation under section 351.\textsuperscript{156} Revenue Ruling 81-38 held that the transfer of a partner-

\textsuperscript{155} Section 731(a)(1) of the Code provides:

In the case of a distribution by a partnership to a partner — gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution. . . .


\textsuperscript{156} Section 741 of the Code provides that in the case of a sale or exchange of a partnership interest, gain or loss will be recognized to the transferor partner. I.R.C. § 741 (1982). But section 1.741-1(c) of the Treasury Regulations refers to section 351 for nonrecognition of gain or loss upon the transfer of a partnership interest to a corporation controlled by the transferor. See Treas. Reg. § 1.741-1(c) (1980); Rev. Rul. 1981-1 C.B. 386.

Section 351(a) provides: "No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation." I.R.C. § 351(a) (1982). Section 368(c) defines "control" as the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. I.R.C. § 368(c) (1982). As a 100% owner of HSI, Jackson was in control after the transfer to HSI for purposes of section
ship interest is an exchange under section 351.\textsuperscript{157} Correspondingly, if the liabilities to which the transferred property is subject exceed the partnership basis for the properties transferred, the excess is taxable gain under section 357(c).\textsuperscript{158} Both the Tax Court and the Ninth Circuit recognized the availability of this alternative in Jackson.\textsuperscript{159}

Arguably, section 351 applies to Jackson's transfer of his partnership interest, even though no exchange of stock occurred, because the transfer was to a wholly owned corporation. The issuance of new stock would have been a meaningless gesture because the stock Jackson held at the time represented the total value of HSI's assets.\textsuperscript{160} Using this approach, the liabilities to which Jackson's partnership interest was subject exceeded the basis of the partnership interest transferred to HSI, Jackson's wholly owned corporation, by $18,111. This excess is taxable gain under section 357(c).

These three statutory provisions—sections 752(d), 752(b) and 351(a)—provide alternative methods to calculate Jackson's taxable gain upon the transfer of his partnership interest. Each approach produces the same result. Section 752(d) is preferable because it specifically addresses the transfer of partnership interests. If section 752(d) is construed narrowly, however, the other two analyti-
cal routes are equally acceptable. The court of appeals was sidetracked by its mechanical application of Crane's economic benefit theory. The propriety of taxing Jackson's transfer becomes clear, however, under a balancing entry analysis. The simplicity and logic of those statutory alternatives make them the appropriate methods for calculating the tax.

**Conclusion**

The United States Court of Appeals for the Ninth Circuit erred in allowing Jackson to avoid taxation upon transfer of his partnership interest. Jackson originally received the proceeds of the loans tax free on the assumption that he incurred an obligation to repay. Crane allowed Jackson to include the amount of the debt in his basis for depreciation on the same assumption. Therefore, inclusion of the outstanding debt in Jackson's amount realized is necessary to balance the tax benefits he received. Otherwise, Jackson will have received untaxed income at the time the loans were extended and will have obtained an unwarranted increase in the basis of his partnership interest. The court disregarded the substance of the transaction by failing to analyze the transfer within the partnership structure. Further, Jackson's retention of guarantor liability is insignificant for income tax purposes. Jackson opens the door for tax free escape from shelters that have begun to produce income. The Service and the courts should close the door swiftly by applying existing statutory alternatives when analyzing future transactions similar to that in Jackson.

Michael J. Baader