Economic Fables/Tax-Related Foibles: On The “Cost” of Promissory Notes, Guarantees, Contingent Liabilities and Nonrecourse Loans

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I. INTRODUCTION

In 1947 the Supreme Court via Crane elevated to national prominence a new form of tax gambit, one in which purchase money debt that a taxpayer had no personal obligation to repay could be counted as part of the taxpayer's own stake in the purchase, generating tax writeoffs attributable to this unfunded “investment.” The decision became the inspiration for a plethora of tax schemes, if not an entire tax shelter industry. It likewise provoked an outpouring of high level criticism and commentary, which, however, failed to bring about a reversal of Crane's teachings. In 1983 the Supreme Court reaffirmed its earlier decision, while Congress for some 40 years thereafter targeted miscellaneous assaults at tax shelters but left Crane and its progeny intact.

In more recent years, as a resigned acceptance of Crane displaced earlier criticisms, attention turned to still open questions about the impact of liabilities on the size of a taxpayer's investment—on the taxpayer's "basis" in the lexicon of the tax law. Aspects considered deeply per-

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1 Crane v. Commissioner, 331 U.S. 1 (1947).
5 Much of the newly found interest stems from the partnership area, stimulated by two areas of recent regulatory output: (1) the effect on a partner's basis in the partnership interest attributable to partnership recourse and nonrecourse borrowings and side guarantees by partners, and (2) the effect of various borrowings on the pass through of income and loss of a
plexing and even "intractable" were to garner the attention of leading academicians and other renowned critics, including accountants and members of the practicing bar.

The challenging issue of the interplay between liabilities and basis materializes in a wide array of everyday contexts. It spans such events as a contribution to a business of debt-encumbered property and a contributor's own promissory note or guarantee, nonrecourse financing of a highly leveraged acquisition, and the negotiation of contingent liabilities.

Partnership to the partners under the statutory mandate that such pass through have "substantial economic effect" per § 704(b).

In the corporate area, the upsurge of interest in the tax effects of liabilities can be traced in part to the frenzy of corporate takeovers in the 1980's involving acquisitions of liabilities as well as assets, and in part to new unsettled areas of the law:

The treatment of the transfer of contingent liabilities has become increasingly important in corporate restructurings, in large part due to the proliferation of litigation, claims, and other disputes arising from third-party actions, as well as environmental, ERISA, and other governmental regulations. For example, items such as environmental claims, pension and other employment-related liabilities, litigation claims, and unresolved federal and state tax issues for open years will frequently give rise to contingent liabilities that the parties to a corporate restructuring transaction will need to be considered in the overall economics of the transaction.

The tax issues surrounding the assumption of fixed and determinable liabilities in various types of corporate restructuring transactions are relatively well settled. However, the assumption of contingent liabilities is a vastly more complex area and has given rise, in some occasions, to inconsistent results. Moreover, the existence of conflicting authorities has made this area frustratingly unpredictable and complex.


Coven, Limiting Losses Attributable to Nonrecourse Debt: A Defense of the Traditional System Against the At-Risk Concept, 74 Calif. L. Rev. 41 (1986). "The proper treatment of transactions involving debt remains one of the most perplexing issues in the federal income tax system." Id. See also Shaviro, note 4, at 420: "The bewildering variety of nonrecourse debt rules do not so much beg as demand the question of how it should be treated by the tax system."

Shaviro, note 4, at 404.


See, e.g., Sheppard, Reading Section 357(c) Out of the Code, 47 Tax Notes 1556 (June 25, 1990).

(for example, clean-up costs of environmental hazards) incident to a sale of property or a corporate takeover. The questions created are all too commonly contested, clogging court dockets, law review pages and the agenda of the Treasury Department. Surprisingly, given the longstanding presence of Crane, neither cases nor commentators have yet been able to agree on the appropriate analysis.\textsuperscript{11}

At the root of the analytical turmoil lurks a remarkably simple catalyst: the disregard or misconstruction of the basic concept of "cost." As the title to the article implies, controversial tax doctrine on the relationship between liabilities and basis typically derives from a base of economic fictions: that a promised future payment to a controlled corporation or partnership is "costless" to the promisor,\textsuperscript{12} as is an enforceable guarantee on behalf of that entity;\textsuperscript{13} and that a nonrecourse borrowing can count as a cost of purchase to one having no intention of paying off the debt, while contingent yet binding commitments or even nonrefundable cash payments can be completely ignored as though noncost shams.\textsuperscript{14} The upshot is the all-too-ready principle of a zero or fictional-sized investment (read "basis") arising from such obligations, results sufficiently troubling to have induced several recent defections\textsuperscript{15} which, while abandoning the teachings of precedents, have not yet pinpointed the source of the problem.

This article takes issue with and proposes to replace traditional dogma with a unifying analytical framework that focuses on a realistic approach to "cost." Its thesis is that the cost of acquisition indebtedness ought to affect basis commensurately with the economic burden of that debt. It proposes this as a congruent theme for determining basis in all the aforementioned diverse areas.

The analysis begins in Section II with an inquiry into the rarely examined question of what meaning the tax law asserts by its statutory reference to "cost basis." The balance of the article attempts to demonstrate how adherence to this concept could have prevented the problematic decisions and dogma that developed. Section III examines the tax treatment of a taxpayer's own note or promise, and the accompanying doctrine of a zero cost basis—the root of much mischief. Section IV...
turns to nonrecourse loans, the subject of Crane, examining the impact of a cost analysis on such debt, and the resulting implications for highly leveraged nonrecourse transactions of a type that recently climaxed in two conflicting appellate decisions growing out of the very same facts.\textsuperscript{16} Section V uses the same analytical emphasis on cost in a fresh approach to determining the effect on basis of an array of contingent liabilities, including debts keyed to environmental infractions, and guarantees by shareholders of third party loans to an S corporation.\textsuperscript{17} The article goes on to suggest why differences in cost justify less favorable tax results for guarantors than for debtors of the kind discussed in earlier sections of the article. The analysis at the end thus comes full circle.

\section*{II. "Cost" Basis Concept: Its Meaning and Relevance}

"The basis of property shall be the cost of such property, except as otherwise provided . . . ."\textsuperscript{18} So reads the starkly brief statutory exposition on "cost basis" found in § 1012. Whereas succeeding sections amplify the concept and components of basis, the Code remains silent as to the meaning and reckoning of "cost." Nor are the regulations of meaningful assistance in their observation that: "In general, the basis of property is the cost thereof. The cost is the amount \textit{paid} for such property in cash or other property."\textsuperscript{19} But do some liabilities constitute "payments" of "other property," and, if so, which liabilities?\textsuperscript{20}

Despite the dearth of statutory guidance on the meaning of cost, an oft-cited canon of statutory construction establishes that the everyday dictionary definition of a nontechnical term, such as cost, coincides with its tax meaning, absent an indication that Congress intended an artificial construction.\textsuperscript{21} In this vein, the court observed in \textit{Silverstein v. United States}:\textsuperscript{22}

\begin{itemize}
\item \textsuperscript{17} An S corporation is a corporation that is entitled to the special federal tax treatment spelled out in Subchapter S. IRC §§ 1361-1379. Unlike other corporations, it is sometimes referred to as a "pass through entity" in that its income or loss is reported directly by its shareholders for federal tax purposes, on the condition that the shareholders elect such treatment and comply with the necessary conditions thereto.
\item \textsuperscript{18} IRC § 1012.
\item \textsuperscript{19} Reg. § 1.1012-1(a) (emphasis added).
\item \textsuperscript{20} Compare Prop. Reg. § 1.1012-2(a) and (b), which slightly amplifies the definition by implication in referring to "the \textit{value} of the consideration provided by the buyer [emphasis added]," and by explicitly acknowledging that the consideration can be in the form of debt instruments.
\item \textsuperscript{21} See, e.g., Malat v. Ridell, 383 U.S. 569, 571 (1966) (per curiam).
\item \textsuperscript{22} 349 F. Supp. 527 (E.D. La. 1972).
\end{itemize}
The word "cost" is not defined in a technical sense in the Internal Revenue Code, although it is widely used. Wherever used, it appears to denote the dictionary meaning, "the amount or equivalent paid or charged for something" [Webster's Seventh New Collegiate]; "The outlay in expenditure (as of effort or sacrifice) made to achieve an object," or "the loss or penalty incurred in gaining something." [Ibid.] Webster's Third International treats "cost" more broadly as meaning "the amount or equivalent paid or given or charged or engaged to be paid or given for anything bought or taken in barter or for service rendered." (emphasis added)

The dictionary indicates, then, that the term "cost" includes both what has been paid and what has been engaged to be paid. Immediate economic outlay is not essential to cost. Goods bought on credit cost as truly as those purchased for cash—unless the buyer has no intention of paying for them. The focus is on the reality of the obligation, the substance of the transaction, not on whether the exchange of money is past or future.23

The lesson from the dictionary is that the tax law's concept of cost encompasses all amounts that a purchaser engages to pay so long as reality, but not necessarily enforceability, underlies the purchaser's undertaking. The term is not co-extensive, as it would be in a primitive barter society, with out-of-pocket payments and sacrifices of sweat-equity, not even as supplemented by credit resources available to the purchaser in our modern day economy. It also includes all that a purchaser realistically can be expected to pay.

Economists capture a comparably broad meaning by treating cost as comprised of so-called "opportunity cost"24—the amount by which one's resources are foregone or must be deflected from other opportunities/uses as a result of being tied up in the instant transaction. The critical test is not the size of the current payments or even the legal enforceability of the commitment, but rather the practical scope of the undertaking.

23 Id. at 530. Ironically, after that thoughtful discussion, the court in Silverstein concluded that the taxpayer's contribution of his own promissory note to his wholly-owned S corporation was ineffective to increase the taxpayer's basis in the corporation. Id. at 532. The court reasoned that the creditors of earlier loans to the corporation which this shareholder had guaranteed were already able to look to the shareholder-maker's resources for repayment of their debts, so that the note promising a future payment allegedly imposed no further cost on the maker. Id. at 530. What this disregards, however, is that the note encumbered the maker's resources over and above the amount already committed to satisfying creditors of earlier guaranteed corporate borrowings.

The pertinent Supreme Court decisions, both *Crane v. Commissioner*\(^2\) and the follow-up case of *Commissioner v. Tufts*,\(^2\) lend further support to the proposition that the tax law concept of cost comports with this economic precept and everyday meaning. True, in the seminal *Crane* decision, discussed in detail in Section IV of the article,\(^2\) cost basis was not, in fact, at issue.\(^2\) Yet the Court's reasoning induced the Court later in *Tufts* to conclude that a taxpayer's cost basis at acquisition includes in addition to the mere equity in the acquired property the nonrecourse debt that the purchaser reasonably can be expected to repay.

On occasion, the timing of a basis adjustment may be all that is at stake in a controversy about whether and which indebtedness deserves to be reflected in cost basis. That is, a refusal to allow a basis increase initially to reflect a debt at acquisition typically will be offset by inclusion in basis once the obligation is paid, just as inclusion of debt in basis at the outset will mean no further increase in basis at the date of actual payment of the debt. Yet, the relevance of the inquiry should not be so marginalized.

Other logically disturbing repercussions are also possible.\(^2\) First, the refusal to acknowledge an acquisition cost as part of a taxpayer's cost basis could mean a taxable gain even in the absence of economic gain. Such has been the reported result where a taxpayer contributes a promissory note that matches the amount of (and hence precludes any economic gain from) the assumption of the taxpayer's liabilities by a corporation\(^3\) or partnership,\(^3\) or a cash distribution by either.\(^3\) Likewise, a sale of a corporate or partnership interest prior to payment of the seller's original

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\(^2\) 331 U.S. 1 (1947).
\(^2\) See text at notes 120-36.
\(^2\) Mrs. Crane had acquired the encumbered property as devisee under her husband's will, at a time when the realty was valued at $262,042.50, the exact amount of the mortgage and accrued interest on the property. 331 U.S. at 3-4. As a result, her basis for the property was determined by fair market value at death (IRC § 113(a)(5) (1939) (the predecessor to current § 1014)) rather than by the cost basis principles of IRC § 1012. Id. at 6. The issue before the Court, as in *Tufts*, was the amount of taxable gain on the taxpayer's disposition. This required the Court to determine the difference between the proceeds of the sale and the basis of the property sold, in accordance with § 1001(a), a determination that led the Court to discuss why a nonrecourse liability should be included in calculating basis.

\(^2\) In addition to the consequences cited in the text, refusal to acknowledge a cost effect on basis attributable to the contribution of a promisor's own obligation could affect the basis assigned to assets later distributed in kind from a partnership. See IRC § 732.


\(^3\) See W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners §§ 4.03[2] (2d ed. 1990) (contribution of one's own note will not succeed in preventing income recognition when a partnership takes over "excess" liabilities, due to the zero basis of a maker's own note). As to the calculation of that income, see Temp. Reg. § 1.752-2T(b) Ex. 2.

\(^3\) A cash distribution to a partner or shareholder is taxable to the extent that it exceeds the distributee's basis. IRC §§ 301(c)(3), 731(a)(1), 1368(b).
acquisition indebtedness could artificially generate or magnify reportable gain by understating the economic cost and basis of the interest sold. Second, an improper measure of the impact of obligations on cost basis could mean misallocated depreciation deductions, either denied to a promisor entitled thereto by virtue of having economically borne the cost of the depreciated property, or granted to a taxpayer having no intent of incurring the cost of paying off the depreciable property's encumbrance. Third, tax write offs of partnership or corporate losses inappropriately could be denied to a partner \(^{33}\) or an S corporation shareholder \(^{34}\) who in fact shoulders the economic brunt of such losses by covering them with a promissory obligation that the tax law treats as costless. \(^{35}\) Fourth, a debt instrument that has been assigned a zero basis in disregard of its obligor's cost could trigger unwarranted income to the transferee at the time of later collection or other disposition of the instrument. \(^{36}\) Finally, the Treasury also could be affected improperly if refusal to recognize an obligor's note at contribution were to culminate in an undeserved escape from discharge of indebtedness income by the obligor in the event the obligation were eventually cancelled.\(^ {37}\)

In turn, these distortions introduce inefficiencies in the tax system and the economy at large. A refusal to recognize the cost of a taxpayer's obligation when embodied in the form of a promissory note or guarantee creates incentives for alternative financing arrangements with third-party creditors that yield the desired, yet expensive-to-arrange, tax outcomes. These outside credit arrangements also could exacerbate downturns in the economy by creditors less willing patiently to wait out a debtor's default than might a related party creditor. It is even possible that inadequate basis adjustments (for example, reflective of costly contingent liabilities) could have a chilling lock-in effect on turnover. Finally, fictional economic premises are not likely to be adopted uniformly or permanently, free from costly instability of precedents, conflicts among circuits and forum shopping by taxpayers. A willingness by administrators and courts to abandon flawed doctrine and return to realistic principles of cost could prove to be startlingly salutary on all these counts.

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\(^{33}\) Section 704(d) authorizes a pass through of partnership losses which do not exceed the basis of a partner's partnership interest.

\(^{34}\) Section 1366(d)(1) authorizes a pass through of losses of an S corporation which do not exceed the basis of a shareholder's stock in, or loan to, that corporation.


\(^{36}\) See discussion in text at notes 81-82.

III. Cost of a Taxpayer’s Own Promissory Obligation

A. The Doctrine of Zero Cost-Zero Basis

The assertion that a taxpayer's own promissory note has a zero cost and hence zero basis made its first appearance in Revenue Ruling 68-629. The taxpayer transferred appreciated assets to his controlled corporation and at the same time caused the corporation to take over liabilities which totalled more than the basis of those assets. In an effort to prevent the liabilities from exceeding the basis of the appreciated assets, which difference would have created a reportable gain, the taxpayer contributed his own promissory note equal to the excess. The ruling preemptorily rejected the success of the plan and assigned a zero basis to the taxpayer's contributed promissory note.

Since the taxpayer incurred no cost in making the note, its basis to him was zero. Therefore, the transfer of the note to the corporation did not increase the basis of the assets transferred. . . . Accordingly, section 357(c) of the Code applies to the transaction and gain is recognized to the taxpayer. . . .

Based on its pronounced reasoning that the taxpayer “incurred no cost in making the note,” the ruling concluded that the basis of the note to its maker was zero. A dozen years later another ruling replicated this result and reasoning in denying a basis to a partner who contributed his own note to his partnership.

Although the doctrine of a zero basis for a bona fide unconditional promissory note that is contributed to the promisor's related business entity has been repeatedly reaffirmed by cases and commentators with nearly lockstep unanimity, its supporting rationale of “no cost” to the

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39 Section 351(a) provides for nonrecognition of gain or loss on the transfer of assets in kind to a corporation which the transferor(s) “control.” Control is in turn defined in § 368(c) as meaning ownership of at least 80% of the voting power and 80% by number of all other classes of stock.
40 IRC 357(c).
42 Id.
44 Id. at 230.
45 [T]he contribution of a partner's written obligation, its personal note, to the partnership does not increase the basis of the partner's interest under section 722 of the Code because the partner has a zero basis in the written obligation. Payments on the written obligation are added to the partner's basis in the partnership as the payments are actually made.
46 Id. at 230.
maker cannot be right. A valid promissory debt reduces the net worth of its maker by the present value of that obligation; it commits the obligor to make repayment, and to that extent renders the maker's resources and creditworthiness unavailable for other uses. As such, that debt precisely meets the test of economic cost. It likewise satisfies the everyday dictionary sense of the term. Only under an out-of-pocket approach to cost, inappropriate to the tax law's meaning, is a valid promissory debt "costless."

In view of the cost incurred in executing an enforceable note or promise, it is fallacious to assign a zero basis to the very note that is the property interest embodying the maker's promise. The revenue ruling that was the progenitor of the zero basis doctrine does not question that a bona fide note is property, as rightly it should not, but only the cost of that property, which it wrongly determines to be zero.\textsuperscript{45} Strictly from the perspective of cost, it follows that a maker's own enforceable promissory obligation\textsuperscript{46} should create a basis tantamount to that ascribed to borrowed cash of a like value. The maker's own bona fide note, like the cash proceeds of a third party loan, does, after all, represent the fruits as well as burdens of incurring an obligation. Whatever cost basis attaches to borrowed cash should likewise pertain to its economic equivalent of the promissory note (generated from self-borrowing); that note should, in other words, warrant a basis known hereafter as a "cash-equivalent basis." In sum, just as a taxpayer earns a cost basis of $100 on contributing $100 of borrowed cash to a corporation or partnership in exchange for an ownership interest,\textsuperscript{47} a contribution of one's own promissory note that in fact has a $100 value also should produce a $100 basis.

\textsuperscript{45} For criticism to the effect that assignment of a zero basis for a maker's own note ignores its economic cost, see Bernstein, Avoiding Zero Basis Problems in Capital Contributions of Debt Obligations, 50 J. Tax'n 302 (1979); McGuire, Tax Shelters: Partners' Capital Contributions Notes, 12 J. Real Est. Tax'n 170 (1985).

\textsuperscript{46} If the obligation is illusory, a different result would obtain; an economic cost would not arise and therefore neither would a cost basis. See Perry v. Commissioner, 54 T.C. 1293 (1970), aff'd per curiam, 71-2 U.S.T.C. ¶ 9502 (8th Cir. 1971).

\textsuperscript{47} The partner or shareholder receives basis equal to the cash contributed. IRC §§ 358(a), 722. Those sections make no inquiry as to the source of the cash.
B. Supplementary Rationales for Perpetuating the Zero Basis Doctrine

I. To Prevent Illusory Credit Transactions Between Debtor and Related Business Organization

Although Revenue Ruling 68-629\(^48\) and Revenue Ruling 80-235\(^49\) espoused a costless concept for a note contributed by its maker to a controlled corporation or partnership, both appear to be result-oriented pronouncements designed for limited application. The denial of a cost basis in other transactions in which a maker’s note is exchanged for a property interest would contravene the Supreme Court’s decisions in *Tufts*\(^50\) and *Crane*\(^51\) which called for the basis of acquired property to include the encumbrances on that property at acquisition and not merely the taxpayer’s out-of-pocket equity interest in that property.

No doubt a driving force for the rulings was a desire to prevent tax benefits from unreal transactions between related parties. This very concern prompted Professor Elliot Manning in a leading article to advocate characterizing the contribution of one’s own note to a related entity as an open transaction, with the note denied property status\(^52\) and basis suspended until actual payment.\(^53\) Such an analysis obviously accepts the fiction that a truly bona fide note is not property. Yet, even Revenue Ruling 68-629,\(^54\) which launched the zero basis doctrine, failed to share this thesis. It acknowledged that such a note constituted property, and determined only that such property had a zero basis.

The characterization of a contribution of a maker’s own promissory note as a costless or fictional transaction certainly reflects reality in many instances, and yet a conclusive presumption to that effect may well exceed the bounds of congressional intent. Congress’ attitude on dealings between related parties (and not merely between partners or shareholders and their entities) finds expression in a number of deliberately prophylactic statutory provisions,\(^55\) none of which assumes that promises to pay by one related party to another automatically should be disregarded. Section 1.1012-2(a) of the proposed regulations seems more in step with the Code in observing that dealings between related parties may not be at arm’s length, and therefore calling for special scrutiny of those dealings, but not for automatic disallowance of their integrity.\(^56\) Nothing in the


\(^{50}\) Commissioner v. Tufts, 461 U.S. 300 (1983).

\(^{51}\) Crane v. Commissioner, 331 U.S. 1 (1947).

\(^{52}\) Manning, note 8, at 161, 195.

\(^{53}\) Id. at 195.

\(^{54}\) 1968-2 C.B. 154.

\(^{55}\) See, e.g., IRC §§ 267; 453(e), (g); 707(b); 1031(f).

\(^{56}\) The proposed regulation provides that where a sale is not necessarily an arm’s length transaction, because of the relationship between the buyer and seller “the transaction shall be
Code appears to warrant singling out this one context and treating a
promissory debt of one related party as automatically compromised
upon its contribution to a related entity.57

The Service and the courts frequently are called on to proceed in an ad
hoc manner with the task of plumbing the substance of transactions be-
tween owners and their related businesses.58 These tribunals are cer-
tainly not strangers to contests challenging the legitimacy of notes issued
by entities to their owners, or vice versa.59 Indeed, recent statutory en-
actments demand increased factual inquiries to determine the true nature
of ostensible contributions and distributions, or purchases and sales, in-
cluding those culminating in the issuance of securities.60

Although a risk of abusive tax planning strategies and manipulative
schemes arises from a contribution of a promissory note to a related en-
tity, the same is true of other transactions between related taxpayers
which necessitate special scrutiny on an ad hoc basis to assure that they
are, in substance, what they claim to be.61 For example, a taxpayer
might contribute a promissory note to a related entity, perhaps in order
to create an eventual bad debt deduction for the related party by default
on the note at maturity (albeit at the price of cancellation of indebted-
ness or dividend income to the excused debtor), or to obtain an imme-
diate increased basis so as to avoid a current gain, or to achieve a basis
from which to claim a pass through of losses.62 This could also be true,

57 See, e.g., Dean v. Commissioner, 35 T.C. 1083 (1961), in which the government at-
ttempted to collect imputed dividend income on funds of over $2 million loaned interest-free by
a closely-held corporation on a shareholder’s own personal notes, without the legitimacy of
these large loans being subjected to question.

In the corporate area, the recent deletion of “securities” from § 351 means that a controlled
corporation’s issuance of securities in a § 351 transaction could now cause reportable boot,
unless the securities are found to be disguised equity. Implicitly this invites factual determina-
tions that formerly were not required.
however, of a taxpayer who arranges a cash loan from a related party for precisely the same purposes and with the same expectation as in the case of the putative obligation where no cash changes hands. Despite the very real specter of such planning efforts, related statutory curbs evidence Congress' intent not to rein in potential abuses by treating all such obligations as automatically void. If a direct contribution of a valid promissory note is to be treated as sui generis, should not Congress so provide?

2. To Prevent Avoidance of Gain Otherwise Due

Several years following the emergence of the zero basis doctrine and its zero cost rationale, courts began to voice a second after-the-fact justification for the doctrine: its effectiveness in combatting the device of a promissory note being executed intentionally in an effort to avoid reportable gain under § 357(c) (that is, upon a contribution of other assets having bases lower than the amount of liabilities taken over by the corporate transferee). Such an analysis was explicit for the first time in Alderman v. Commissioner. In the words of the court, were the doctrine otherwise: "It would be a relatively simple matter to execute a note so that the adjusted basis would always exceed liabilities." Successor cases have agreed.

The evil of deliberately planning to escape from § 357(c) seems one that is more fabled than real, however. No congressional purpose appears offended by this tactic. Legislative history indicates that one reason Congress enacted the provision was to prevent a taxpayer who had enjoyed tax benefits from a borrowing, either by pocketing the tax-free loan proceeds or by obtaining tax savings from depreciation deductions based on a cost basis increased by the borrowing, from shifting tax free to another the cost of and responsibility for repayment of the borrowing. Such a shift in responsibility fails to develop, however, if the transferor immediately incurs a substitute liability by executing an enforceable promissory note. Contrary to the suggestion in Alderman, this contribution of one's own note is not a "simple" way to avoid gain. The price of this technique is the opportunity cost of utilizing one's creditworthiness for this rather than another purpose, including the potentially costly toll

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68 Id. at 665.
69 See, e.g., Lessinger v. Commissioner, 85 T.C. 824, 837 (1985), rev'd, 872 F.2d 519 (2d Cir. 1989); Smith v. Commissioner, 84 T.C. 889, 909 (1985); see also Comment, Taking Section 357(c) Out of the Scheme of Things: Has the Second Circuit Stranded This Section of the Internal Revenue Code?, 65 Tul. L. Rev. 663 (1990).
71 55 T.C. at 665.
from exposure of the promisor's resources to the vicissitudes of corporate creditors.

Neither is Congress' second apparent purpose for § 357(c)—preventing a negative basis for stock received on a transfer in which liabilities exceeded the basis of the contributed assets\(^2\)—offended by deliberately planning some supplementary contribution that can function to prevent the result of negative basis. That is, the Code evidences no intent to restrict taxpayers from deliberately contributing cash or other assets as a means to keep liabilities from exceeding the basis of transferred assets. Section 357(c) contains neither an "anti-stuffing" provision\(^3\) nor a ban on tax avoidance plans\(^4\) which are the means Congress has at its disposal, and frequently employs, when it intends to foreclose such planning. Just as the contribution of borrowed cash prevents a gain, so too should the economic equivalent of a contribution of a promissory obligation of like value.

3. To Prevent Artificially Inflated Basis

Another likely explanation for the evident reluctance of authorities to assign basis to a maker's own contributed obligation may be the accurately perceived risk of valuation difficulties. Exaggeration of self-proclaimed values may indeed be more likely in the absence of the tempering influence of corroboration by objective third parties, or the constraining influence of a creditor motivated to enforce an unrelated debtor's payment.

Once again, however, just as the validity of a debt is a legitimate target of judicial and administrative inquiry, so too is the subject of its size within the bailiwick of ad hoc judicial and administrative resolution. A sweeping denial of cost basis to a bona fide loan because of doubts about its size again seems unduly draconian. If an obligation is not, in fact, legitimate the transaction will be costless and yield no basis, while magnification of basis is forestalled by the fact that a note must carry adequate interest if its face amount is to be honored and the debt assigned more

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\(^2\) Rosen, 62 T.C. at 19 n.3.
\(^3\) Compare, e.g., IRC §§ 336(d); 341(c)(2), (e)(7); 751(d)(1)(B).
\(^4\) Compare, e.g., IRC §§ 336(d), 357(b). Section 357(b) treats the assumption of a shareholder's liability by a corporate transferee as boot where the liability either was incurred or is assumed in a tax-avoidance transaction. The paradigm is a borrowing on appreciated assets immediately before they are contributed in an effort by the contributing shareholder to accomplish a tax-free cashing out of the gain. The contribution of one's own note or obligation (e.g., in an effort to avoid having to raise cash by selling off the appreciated assets) is outside the scope of the section, both literally (as a contribution of an asset rather than a liability) and on policy grounds (insomuch as a contribution of one's own promissory obligation does not relieve the contributor of having to raise cash to pay off the debt). Accord Fleming, The Highly Avoidable Section 357(c): A Case Study in Traps for the Unwary and Some Positive Thoughts About Negative Basis, 16 J. Corp. Law 1, 12 (1990).
than a minimal present value. A promissory debt payable in the future will, in the absence of adequate interest, produce a significantly lesser present value than an immediate cash payment of that same promised face amount.\textsuperscript{75}

Nor will a taxpayer who contributes a promise found to have a minimal present value, due to its inadequate interest, problematic payment schedule or conditional features, succeed in claiming a more exaggerated value on the theory that the contribution could just as well have been otherwise arranged, perhaps as a cash contribution borrowed from another, and in this way salvage the tax results that could have obtained had the transaction in fact been structured that way. A taxpayer is bound by the form chosen for a transaction.\textsuperscript{76} For example, in \textit{Estate of Leavitt v. Commissioner},\textsuperscript{77} the court refused to allow a shareholder to include in the basis of his interest in an S corporation the proceeds of a third party loan which he had guaranteed (and thus conditionally promised to pay), notwithstanding that the shareholder could have obtained an increased basis in the company by unconditionally borrowing the cash himself and transferring it to the corporation.\textsuperscript{78} The two forms of transaction are simply not economic equivalents; the guarantee is only a con-

\textsuperscript{75} This is because of the time value of money. A dollar in hand today is worth more than a dollar sometime in the future; the present value of that debt payable in the future is a discounted figure that varies according to the interest rate that the loan bears. See, e.g., Carolina, Clinchfield & Ohio Ry. Co. v. Commissioner, 823 F.2d 33 (2d Cir. 1987) (per curiam) (discounting at 6%, a promise to pay $23 million some 950 years hence had a present value of only 2 quadrillionths of a cent).

\textsuperscript{76} See, e.g., Don E. Williams Co. v. Commissioner, 429 U.S. 569 (1977). The Court held that the contribution of the maker's own note to a pension plan was not a "payment" justifying a current deduction, and notwithstanding that the taxpayer could have secured a current deduction by borrowing and then contributing the loan proceeds. As the Court observed, a taxpayer is bound by what was done, not what might have been done. Notice, however, that what the taxpayer did was the substantive equivalent to either: (1) borrowing from another and paying over the loan proceeds (in which case the end result would have left the taxpayer personally liable as was true of the structure chosen), or (2) contributing a cash "payment" to the pension plan and thereafter "borrowing back" that cash from the plan, which would have given the same result in substance as the plan pursued by the taxpayer.

Although the thesis of this article would argue that these are distinctions without differences, which should culminate in the same impact on basis regardless of the chosen route, the issue in \textit{Don E. Williams} was whether for tax accounting purposes (i.e., the timing of the taxpayer's deduction) the transfer deserved to be treated as a payment. Whether the policies underlying tax accounting provisions warrant a distinction between property in the economic sense and payment in the tax accounting sense is beyond the scope of this article. It is, however, an important issue that deserves to be addressed, particularly in view of the proposed regulations under IRC § 461(h) which deny that an obligor's own note constitutes a payment that makes current deductibility appropriate under that section's economic performance test. Prop. Reg. § 1.461-4(g)(1)(ii)(A).

\textsuperscript{77} 875 F.2d 420 (4th Cir. 1989), cert. denied, 110 S. Ct. 376 (1989).

\textsuperscript{78} Id. at 424.
ditional obligation. If, however, a legitimate unconditional obligation was created, it should be irrelevant for basis purposes under the doctrine of substance over form whether the debt generated cash or a cash-equivalent in the form of the obligor's own note or promise bearing adequate interest. In either case a cost results equal to the present value of that promise.

C. Countervailing Reasons for Abandoning No Cost-No Basis Doctrine

1. Reality of Obligor's Cost

Quite simply, to permit a cost basis to an obligor commensurate with the cost of the acquisition debt complies with the literal statutory dictates of § 1012 relating to cost basis. The doctrine of zero basis for a contribution to a partnership or controlled corporation of a maker's own promissory obligation lacks statutory foundation.

2. Unwarranted Tax Problems Caused by Zero Basis

a. Tax Problems Imposed by Literal Statutory Language

An insistence on a cost-free, zero basis doctrine tends to set in motion a chain reaction of adverse and unrealistic tax consequences that, although in conflict with the economics of the transaction, would follow from the literal terms of various Code sections, such as carryover basis to the transferee. For example, upon the contribution of a maker's own promissory note having a zero basis, the Code dictates that the transferee takes a reciprocal zero basis. As a result, the transferee literally faces reportable income on a later sale or taxable disposition of that promissory note, even though no income would have resulted had borrowed cash instead been contributed.

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79 The idea that a conditional obligation should generate basis is explored in the text at notes 225-258.


81 IRC §§ 362, 723; see Alderman v. Commissioner, 55 T.C. 662, 665 (1971). But compare the analysis in Lessinger v. Commissioner, 872 F.2d 519 (2d Cir. 1989), discussed at notes 104-11, allowing a corporation a basis on policy grounds even while agreeing that the shareholder's contribution had a zero basis and that literally § 362 called for a different result.

82 Bogdanski, Shareholder Debt, Corporate Debt: Lessons from Leavitt and Lessinger, 16 J. Corp. Tax'n 348, 354 (1990); McGuire, note 45, at 171 n.7; Sheppard, note 9, at 1559. Compare Manning, note 8, at 195, which discusses the three problems produced by not treating the initial contribution as an open transaction. First, if the corporation has a zero basis for the note, any collection is gross income. Second, since the payment is in discharge of an obligation and not in exchange for stock, it apparently does not increase the shareholder's stock basis. Third, if a note is issued to an S corporation or partnership for stock or as a contribution to capital, the income that the corporation or partnership recognizes on collection is taxable, at least in part, to the shareholder or partner making the payment.
Nor is the obligor of a zero basis obligation spared from reportable, yet illusory, income upon a literal reading of the statutory language, as for example when encumbered assets are transferred to a controlled corporation bringing § 357(c) into play.\textsuperscript{83} Gain can literally result even though a taxpayer who transfers encumbered assets to a controlled corporation simultaneously obligates herself to pay off some or all of those debts, and the corporation assumes no responsibility for the debts.

In the illustrative case of \textit{Owen v. Commissioner},\textsuperscript{84} the taxpayer retained ongoing personal obligation for the liabilities which encumbered the assets transferred to a controlled corporation, while the corporation merely took subject to, but did not assume, the debts.\textsuperscript{85} The taxpayer argued that he ought not to be taxed on the transfer because he had not enjoyed either income, gain or economic benefit in the form of relief from liability in view of his ongoing personal obligation for the debts.\textsuperscript{86} The argument was rejected. The court decided, as had several earlier lower court decisions, in calculating whether liabilities exceed basis that literally § 357(c) draws no distinction between cases where the corporation took subject to rather than assuming the debt.\textsuperscript{87} It found nothing in the statutory language to suggest that a necessary condition to recognition of income is the enjoyment of a measurable benefit\textsuperscript{88}

The court went on to support its anti-taxpayer result by relying on the then relatively new Supreme Court decision\textsuperscript{89} in \textit{Tufts},\textsuperscript{90} which held that a transfer of property encumbered by a nonrecourse loan in excess of the property's basis produced taxable gain to the transferor. The Court had so held even though the loan was not one for which the transferor was personally liable and therefore not one that, when transferred, relieved the taxpayer from debt. This holding does not, however, dictate the result reached in \textit{Owen}. The rationale for the \textit{Tufts} decision was that the taxpayer had properly included the nonrecourse loan in basis at acquisi-

\textsuperscript{84} 881 F.2d 832 (9th Cir. 1989), cert. denied, 110 S. Ct. 1113 (1990).
\textsuperscript{85} Id. at 835. At one point in the opinion, the trial court indicates that the taxpayer merely guaranteed repayment and was not primarily and unconditionally obligated to pay the debts, but then goes on to assume that the taxpayer had ongoing and presumably unconditional liability. 53 T.C.M. (CCH) 1480, 1484-85 (1987). If that were not so, the analysis of (and in) the case should instead proceed in accordance with the discussion of guarantees in Section V of this article, at notes 225-32, 242-58.
\textsuperscript{86} \textit{Owen}, 881 F.2d at 835.
\textsuperscript{87} Id.; see also, e.g., \textit{Rosen v. Commissioner}, 62 T.C. 11, 19 n.3 (1974), aff'd without published opinion, 515 F.2d 507 (3d Cir. 1975).
\textsuperscript{88} \textit{Owen}, 881 F.2d at 835. But compare \textit{Lessinger v. Commissioner}, 872 F.2d 519 (2d Cir. 1989), in which the court ignored the literal reading of the section, and managed not to reach the result of taxable gain in view of the absence of gain and appreciation on any of the contributed assets. Id. at 525-26 n.4.
\textsuperscript{89} \textit{Owen}, 881 F.2d at 836.
\textsuperscript{90} 461 U.S. 300 (1983).
tion, like a loan on which that borrower had personal liability, so that relief from that liability released him from the burden of having to repay this debt just as if the debt were his own. No like benefit obtains in a case such as *Owen* in which, rather than receiving relief from liability, the taxpayer continues to be personally liable.

An easy escape from the dilemma created by the court's literal reading of § 357(c) in *Owen*, that drew no distinction between liabilities assumed and those merely taken subject to, would have been to acknowledge the taxpayer's economic cost and resulting cash-equivalent basis traceable to the ongoing costly obligation to the transferor. His continuing responsibility on the debts to which the transferee-corporation took subject was tantamount to an implicit promise from that transferor to the corporation to pay off the debts. A cash-equivalent basis attributable to that taxpayer's promise would have offset the amount of the liabilities that the corporation took subject to, and so prevented any measurable gain. Instead, the court and the parties implicitly proceeded on the now-familiar assumption that the taxpayer's own liability/continuing promissory obligation had a zero basis. This is, of course, hardly surprising in view of the precedents on zero basis for one's own promissory note plus the support for the court's position by no less eminent authorities than the authors of the leading treatises on taxation of partnerships and S corporations.

An analysis which attributed a cost to the taxpayer, in line with the thesis of this article, would have eliminated the problematic result of a tax on a transfer that produced no economic benefit. The liabilities to which the corporation took subject would have been matched by acknowledging a cash-equivalent basis to the shareholder's own promissory obligation that was implicitly contributed as part of the transaction.

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b. **Lack of Viable Alternatives for Preventing Tax on Unreal Gain**

It is not only courts that have unanimously followed the zero basis premise in analyzing the tax consequences of a contributed promissory note. Nearly all treatises and commentaries share this same starting point, although they diverge in analyzing the resulting implications.

Efforts to avoid untoward tax results have produced several distinct and competing lines of analysis. At one extreme, the government in-
sists on a zero basis to the obligor, but apparently in practice, and without any explanation, ignores the consequent carryover zero basis to the obligee and resulting gain in the event that the obligee disposes of this obligation by sale or exchange. In the interim, as payments are made on the debt, the governmental position (apparently unsupported by statute) is that a corresponding increase takes place in the basis of the payor, and presumably in reciprocal fashion in the payee's basis for the debt. This same approach has been adopted by several cases.

In *Oden v. Commissioner*, the court followed the standard view in refusing to allow the contribution of a partner's note to increase that partner's basis in his partnership interest, on the grounds that the partner had a zero basis in his own note, but then approved a concomitant increase in basis on later payment of the note. Unfortunately, however commendable the result in permitting basis to reflect actual economic costs, a deferred increase in basis lacks statutory authorization. What occurred at the original date was a contribution of property in the form of a note; a later payment on the note is not a contribution and therefore the basis rules of §§ 722 and 723 literally do not apply.

Another proposed approach for relieving the obligor's and obligee's tax problems appears in a recent article by Professor Bogdanski. While loyal to the fiction that a maker's own promissory note is not itself property, Professor Bogdanski parts company with the open transaction analysis by assigning a basis in the note to the transferee. His analysis begins by acknowledging a cost to the maker in executing the note, which in turn, he concludes, warrants an immediate basis to that maker for the stock interest received in exchange for the contributed note. This assertedly results in a derivative carryover basis to the transferee. The upshot is an immediate basis for the note in the hands of the corporate transferee and for the stock to the shareholder. What this approach does not explain, however, is how, if the maker's note is not property with a

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97 41 T.C.M. (CCH) 1285 (1981), aff'd without published opinion, 679 F.2d 885 (4th Cir. 1982).
98 41 T.C.M. (CCH) at 1290.
99 Bogdanski, note 82.
100 See text accompanying notes 52-53.
101 Bogdanski, note 82, at 353-56.
102 Id. at 355.
103 Id.
basis, the stock received in exchange by the maker obtains a positive cost basis free of tax. Nor does this analysis logically permit the obligor, who is confined to a zero basis for his own promissory obligation, to avoid taxable gain under § 357(c) where liabilities taken over by a controlled corporation from a transferor are matched economically by a contribution of that transferor's own promissory obligation with a zero basis.

Yet another line of reasoning is pursued in Lessinger v. Commissioner.\textsuperscript{104} This case reaffirms the notion of a zero basis for a maker's own promissory note, but then applies its own unique analysis in straining for its pro-taxpayer outcome. Rather than relying on the cost-free rationale used by others, Lessinger reasons that:

"Basis," as used in the tax law, refers to assets, not liabilities. Section 1012 provides that "[t]he basis of property shall be the cost of such property. . . ." Liabilities by definition have no "basis" in the tax law generally or in section 1012 terms specifically. . . . The taxpayer could, of course, have no "basis" in his own promise to pay the corporation $255,000, because that item is a liability for him.\textsuperscript{105}

The reasoning is only half correct. It ignores a basic lesson derived from principles of double entry accounting: Although the taxpayer's own promise did give rise to a liability, at the same time it also gave rise to an offsetting property interest—the promissory note (as even the revenue ruling that was the genesis of the zero basis concept\textsuperscript{106} recognized). It was the property component that the taxpayer transferred to the corporation, for which he should have been credited with a cash-equivalent basis just as if he had borrowed cash (thereby creating a concurrent liability), and then contributed the cash proceeds of the borrowing.

Notwithstanding its conclusion that the maker had no basis for the contributed promise, the Lessinger court managed to reach a pro-taxpayer conclusion on facts strongly appealing for the taxpayer. Here was a case in which an insolvent proprietorship was incorporated out of financial need in order to borrow funds at higher interest than could be charged to individual borrowers. Its liabilities exceeded both the value and basis of the assets taken over. The taxpayer-incorporator attempted to forestall reportable gain under § 357(c) by obligating himself to make up this difference between liabilities and assets.

The court's novel tack interpreted the language in § 357(c), relating to the difference between liabilities and basis of contributed assets, as referring to the corporation's basis for those assets rather than the share-

\textsuperscript{104} 872 F.2d 519 (2d Cir. 1989).
\textsuperscript{105} Id. at 525.
holder's.107 The court attributed to the shareholder’s promissory obligation a basis in the corporation’s hands equal to the face value of that promise even though that same promise had a zero basis in the hands of its maker. The court theorized that the corporation had incurred a cost in taking over the shareholder’s debts that entitled it to a basis for the acquired assets, including the shareholder’s promissory obligation, that reflected this cost.108 While conceding that § 362(a) seems literally to dictate a carryover rather than cost basis to the corporate-transferee in this context, in that the shareholder’s transfer was governed by the non-arm’s length principles of §§ 351 and 357, the court reasoned that the policy underlying the carryover basis rule does not apply to the incorporation of an insolvent business in which the assets have values that do not exceed basis.109

Undoubtedly, others would be loathe to take such liberties with clearly applicable statutory language on the grounds of a policy misfit with the facts. Furthermore, the court’s construction of § 357(c), as applying to the corporation’s basis for the note rather than the shareholder’s, also stretches the statutory scheme. On its face § 357 is addressed to tax treatment of the transferor-shareholder; if subsection (c) shifted its focus to the corporate transferee, presumably Congress would have said so. Finally, if an arm’s length cost analysis is correct for the corporation, correlative this same arm’s length analysis would seem applicable to the shareholder, causing income to that shareholder-debtor from his relief from liabilities to the extent that they exceeded the assets that he “paid” to secure this release.110

Although the court’s result of no taxable gain is instinctively appealing, given the absence of any economic benefit or gain to the taxpayer-obligor, it is not surprising that the reasoning has not won adherents. Indeed, universal criticism has been its lot.111 Once again, a more promising and convincing route to a decision of no taxable gain would be to discard the premise that the obligor’s promise had a zero basis, and replace it with a basis reflecting the obligor’s very real economic cost.

107 Lessinger, 872 F.2d at 525-26.
108 Id. at 525.
109 Id. at 525 n.4.
111 The critics who have commented on the case all assail its reasoning as flinty erroneous. See Bodganski, note 82, at 351, 356 (“stretches the words and structure of the Code beyond their breaking point;” “acceptable result but for the wrong reasons”); Fleming, note 74, at 18 (“Although . . . an appealing result, the reasoning is problematic on several grounds”); Megaard & Megaard, Can Shareholder’s Note Avoid Gain on Transfer of Excess Liabilities?, 71 J. Tax’n 244, 248 (1989) (“Lessinger is a classic example of the old saw that bad facts make bad law”); Sheppard, note 9, at 1556 (“That the Second Circuit’s decision in Lessinger is the right result for the wrong reasons seems to be the prevailing view outside government.”) Comment, note 69, at 685 (“proof positive of the familiar saying that bad facts make bad law”).
A recent analysis by Lee Sheppard sets out on still another analytical path to overcome the troublesome tax effects that follow from the traditional premise of a zero basis for a maker's own note. It argues for avoiding gain under § 357(c) by assigning a contributing shareholder a negative basis for stock received in exchange for such a note. Arguably, this proposal would be at odds with the congressional intent underlying the section. Moreover, it certainly disregards the economic cost incurred by the contributor of the note. Ms. Sheppard apparently eschews Professor Manning's open transaction approach because of the unresolved problems it portends should the transferee dispose of the note before being paid by the maker. She goes on to dismiss Professor Bogdanski's approach, as presumably she would the thesis of this article, by characterizing as "premature" the allowance of a basis before any payments are made on a promissory note. Does this not ignore, however, that it is economic cost rather than the act of payment that is the necessary condition for a cost basis?

3. Deterrence of Unnecessary Transaction Costs and Distortions

To single out and deny a basis for a maker's promise only in the narrow circumstances of a contribution to a controlled corporation or partnership seems to be logically unsound as well as unwise. Authors who observe that one's note does not create any basis on a contribution have a ready list of suggestions of how to plan around that "costless" result. The upshot is a rule that encourages unnecessary costs and complications—loan fees to obtain third party financing, attorneys' fees to arrange alternative planning—all of which could have been avoided by direct obligations that are likewise less threatening to the health of the economy in times of economic downturn.

IV. INTERRELATIONSHIP OF BASIS AND NONRECOURSE DEBT

A. Introduction

The preceding discussion argues that valid, unconditional acquisition indebtedness imposes a cost on the obligor that creates an entitlement to

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112 Sheppard, note 9.
113 Id. at 1557-60.
114 See discussion in text at notes 70-72, and authorities there cited. Indeed, Ms. Sheppard calls for a statutory amendment to implement her proposal. Id. at 1560. An analogous proposal for statutory repeal of § 357(c) so as to permit negative basis appears in Fleming, note 74, at 27-31.
115 Sheppard, note 9, at 1559.
116 Id.
117 See, e.g., J. Eustice & J. Kuntz, note 44, at ¶ 10.03[2][k]; Megaard & Megaard, note 111, at 250.
basis whether that obligation is self-generated or the result of borrowing from another. A parallel conclusion of entitlement to cost basis is not necessarily true of nonrecourse debts—that is, borrowings in which the creditor has no recourse against the assets of the debtor other than those that secure the debt. The difference is that a taxpayer’s lack of personal liability makes the economic cost of a nonrecourse loan more conjectural, perhaps even illusory, given the debtor’s option as to whether to pay off such a loan. How then is the cost of a nonrecourse loan to be measured and reflected in basis?

B. Cost of Acquiring Property Encumbered by Nonrecourse Debt of Lesser Value

1. Governing Doctrine

Thanks to the Supreme Court’s decision in *Tufts*, it is now firmly established doctrine that a nonrecourse debt warrants full reflection in a purchaser-debtor’s cost basis at least when that debt is not in excess of the encumbered property’s value at the time of purchase. The rule acknowledges the presence of cost to the debtor despite the absence of any legally enforceable obligation to pay, and without discount for the possibility that changed circumstances might induce the debtor to abandon payment. The Court so decided only after observing that it was not writing on a clean slate, i.e., construing the much earlier decision in *Crane* as compelling its decision to include such nonrecourse liabilities in cost basis. In reality, however, it was *Crane’s* reasoning rather than outcome that carried precedential force, for cost basis was not at issue in *Crane*. Mrs. Crane had acquired her encumbered property from her husband at his death, not by a purchase producing a cost basis. The Court’s consequent inattention to cost principles per se in *Crane* is therefore understandable, although the omission may be the unfortunate source of a similar lapse in later analyses in which cost basis was in fact the point at issue.

The justification for inclusion of a nonrecourse purchase money debt in the purchaser’s basis is captured in an oft-quoted excerpt from *Crane*:

[A]n owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations.

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119 331 U.S. 1 (1947).
120 See note 28.
121 *Crane*, 331 U.S. at 14 (footnote omitted).
To paraphrase this statement, a nonrecourse acquisition debt fitting the description in this excerpt (that is, of an amount less than the value of the encumbered property) does indeed constitute a cost—an undertaking to pay (albeit legally unenforceable against the debtor's other assets) that satisfies the everyday meaning of cost for the debtor as well as an economic/opportunity cost equal to that of a recourse obligation.

Although the reasoning behind the Court's observation about nonrecourse debt continues to be of more than academic interest, as potentially instructive to the outcomes of subsequent nonrecourse cases, the force of its logic is not self-evident. Indeed, adverse criticism of the Court's logic has been a common reaction.122

Some have apparently mistakenly construed the Court's observation that a debtor "must and will" honor a nonrecourse debt that is smaller than the value of the property it encumbers as implying that a debtor would necessarily lose the excess value of the encumbered property over the nonrecourse mortgage were the debtor to default.123 This is neither so today under local law124 nor was it true at the time of the Crane decision.125 In theory, local law generally entitles the debtor at foreclosure to the full excess value of foreclosure proceeds over the amount applied to discharge any encumbrances and liens. Despite this troublesome implication, in practice the Court's observation was and is quite sound: A debtor will no doubt strive to service a nonrecourse debt encumbering property of a greater value in order to avoid a foreclosure sale with its attendant transaction costs and generally depressed price structure.

Many have criticized this same passage, based on Professor Bittker's lead,126 for its apparent predicate that a debtor will treat a nonrecourse and recourse loan with the same ongoing fealty. In the words of Professor Bittker,

122 The most telling and common criticism is that Crane facilitates magnified depreciation deductions due to artificially inflated prices and nonrecourse debts that do not represent a cost to the taxpayer. Epstein, The Application of the Crane Doctrine to Limited Partnerships, 45 S. Cal. L. Rev. 100, 103-05 (1972). The most powerful defenses of Crane to date have been along the lines of the economic argument raised by Professor Shaviro's recent article, see Shaviro, note 4, at 433-35, as well as Professor Simmons' argument as to the importance of matching depreciation deductions with income from the property, see Simmons, note 2, at 4.

123 "[I]f the fair market value exceeds the amount of the lien ... a rational investor may be expected to satisfy the obligation in order to protect his equity, regardless of whether he is formally obligated to pay the debt by the instrument itself or whether he is obligated in fact because the value of the property exceeds the amount of the obligation." Perry, note 2, at 529 (footnote omitted) (citing Crane). Compare Note, Federal Income Tax Treatment of Nonrecourse Debt, 82 Colum. L. Rev. 1498, 1501 (1982): "[T]he mortgagor will not want his equity in the property to be determined under the compulsion of a foreclosure sale."


125 See generally, G. Nelson & D. Whitman, note 124, at §§ 7.31-.32.

126 Bittker, note 2, at 281-82.
If you crave gourmet meals, you must pay for them so long as your addiction continues; but once you break the habit, you need pay only for those you bought on credit in the past, not for those that you will skip in the future. So it is with mortgages. Nonrecourse obligations can be disregarded as soon as the property is sold, given away, or abandoned; personal liability persists even after the property has been disposed of. . . .

Indeed, it is not only the changing tastes of Professor Bittker's now-cured addict, or the still-compulsive suitor to every new attractive tax shelter, who may spurn yesterday's nonrecourse loan. So would the constant-hearted rational investor who finds that changed circumstances cancel out the original attraction. She will continue to treat the loan as binding only so long as the benefits less the opportunity cost of servicing this loan are greater than moving on to another. This calculation depends on a multitude of factors—a balancing of the projections about the net value of continuing to service the loan that takes into account such factors as the potential gain/spread between projected fair market value and debt (that is, the upside and downside risks of positive debtor equity) along with the debtor's tastes, including risk preference or aversion.

In defense of the Court, however, its reasoning as to a debtor's loyalty to a nonrecourse debt was predicated on a positive spread between the value of the encumbered property and the loan at the time of the acquisition, which is, after all, the critical date for determining basis. True, an accurate assessment of cost at that date should have factored in a discount to take account of possible changed future circumstances that might have reduced the spread and with that tolled the debtor's loyalty to devoting resources to a nonrecourse debt. At the time of Professor Bittker's critique, this was indeed a vulnerable aspect of Crane's reasoning. However, with Tufts having settled that a defaulting debtor would be equally accountable for tax consequences at sale or abandonment whether the debt were recourse or not, Tufts provides after-the-fact support for the reasoning in Crane that justifies the same basis at acquisition for recourse and nonrecourse loans.

127 Id.
129 Others have criticized Crane on the theory that the quoted passage indicates approval for a basis that looks to the encumbered property's value rather than to the debtor's investment or cost. Note, note 123, at 1503, 1511-13. Of course, in Crane the basis should have been determined by reference to value rather than cost. See note 28. Moreover, the emphasis on value in Crane was for the purpose of explaining why the nonrecourse loan should be regarded on a par with a recourse loan, which critics agree should be included in basis.

Another common criticism is that Crane permits deductions "up front," prior to an investment by the taxpayer adequate to support those deductions. Id. at 1519-23, 1528-29; accord, Epstein, note 122, at 103 ("[T]he Crane rule provides substantial tax benefits to individual
Crane further rationalized counting a non recourse encumbrance in basis, rather than including only the taxpayer's net, fluctuating equity, on the dual grounds that this would facilitate the calculation of depreciation deductions as well as the correlation of those deductions with income yielded by the property. The former concern about fluctuation of basis if it were keyed to equity payments is obviously of somewhat diminished importance in today's world. Complex and shifting calculations are a common tax feature under the at-risk rules of § 465, as well as in the area of partnerships and real estate ventures where allocations of basis from non recourse liabilities depend upon calculations of "minimum gain," which in turn depend upon principal repayments.

Crane's point about the desirability of correlating deductions with income remains highly valid. The idea of matching income and deductions by including non recourse debt in basis closely tracks an emphasis in modern day thinking. Upon a purchase of property, the price/resultant cost of the property is the present value of its projected income flow; if this amount, instead of merely the taxpayer's equity, is fully capitalized in basis, this cost (present value of the income stream) can be spread ratably via depreciation deductions over the period of use and income from the property. To exclude the debt from basis, and hence taxpayers because it allows them, at the front end, a tax basis greater than their economic investment would warrant. However, such criticism appears to equate the concept of investment with out-of-pocket outlays, in contrast to the thesis here that investment depends on economic cost and not payments.

130 See also discussion in text accompanying notes 143-46.
131 See Temp. Reg. § 1.752-1T(a)(2).
132 Minimum gain is a concept that emerges from the decision in Tufts. It refers to the fact that, on disposition of property subject to a non recourse debt, Tufts requires that a minimum amount of gain be reported which is equal to the excess of the debt over the adjusted basis of the property. Any repayments of principal on the debt correspondingly reduce the difference between the debt and adjusted basis and therefore, the amount of minimum gain. The Temporary Regulations acknowledge that partnership minimum gain is not a static figure, see Temp. Reg. § 1.704-1T(b)(4)(iv)(c), and that allocation of basis attributable to non recourse debt will shift over time, see Temp. Reg. § 1.752-1T(a)(2)(iii).
133 Matching deductions against income is at the heart of the passive loss rules. IRC § 469. Compare the restrictions on deductibility of expenses prior to economic performance, as codified in IRC § 461(h).
134 Contrast the purchase of an option discussed in text accompanying notes 165-67. The right to depreciate the property remains with the optionor-owner who is also chargeable with the taxable income from the property until such time as the optionee exercises the option. In the event of a sale of a right to share in that income, the seller will report those surrogate proceeds from the property as income, while the purchaser of that right to share will amortize the cost of purchasing that right, but will not be entitled to depreciate the property per se. See, e.g., Bailey, Jr. v. Commissioner, 912 F.2d 44, 47-48 (2d Cir. 1990).
from depreciation deductions, would stagger and thus distort the matching of income and associated deductions.\textsuperscript{136}

2. \textit{Supplementary Justifications for Nonrecourse Debt as Cost}

Two additional reasons underscore the conclusion that nonrecourse acquisition debt logically can comprise a cost component of basis. It is likely, even if not inexorably true, that having deliberately chosen this purchase transaction in preference to others, the debtor will have developed some loyalty to it ("cognitive affirmation"), including an ongoing commitment to pay off this loan instead of applying the debtor's resources to some other. This is particularly so in light of the loan fees and other transaction costs that would be duplicated if the loan were replaced with a new commitment. Furthermore, the maintenance of personal or professional/business reputation for honoring one's debts may provide the debtor with reputational reasons for satisfying an outstanding liability deliberately incurred at purchase.\textsuperscript{137} Together these offer added grounds for treating the nonrecourse debt similarly to a recourse debt, in other words, as an economic cost in the debtor's perception and in the ledgers of life even if not so in an exacting tally of enforceable "dues and debts."

3. Noncost Policy Grounds

Apart from the predicate of economic cost, several other policy reasons favor treating a nonrecourse debt which was incurred at a purchase as part of the purchaser-debtor's basis. First, as espoused in \textit{Mayerson v. Commissioner},\textsuperscript{138} such inclusion promotes competition by creating parity between a taxpayer who borrows to purchase with full intent of later paying off the debt, and a purchaser who is immediately allowed depreciation deductions on the full price by paying that amount up front.\textsuperscript{139} A

\textsuperscript{136} Compare Professor Utz's observation that \textit{Crane}'s decision to assign the basis of nonrecourse financed property to the debtor can be explained "at least in part [on the ground] that the user of business or investment property should be allowed to claim deductions associated with that property, regardless of economic risk of loss, because the deductions should be matched with the business or investment income, and the user of the property is the income recipient." Utz, Partnership Taxation, note 8, at 716. Professor Utz's general point is well taken. To allow the debtor rather than creditor to claim depreciation deductions does tend to match the tax return on which income and expenses from the property are reported. Accord, Simmons, note 2, at 57-59.

\textsuperscript{137} Shaviro, note 4, at 428.

\textsuperscript{138} 47 T.C. 340 (1966), acq.

\textsuperscript{139} Taxpayers who are not personally liable for encumbrances on property should be allowed depreciation deductions affording competitive equality with taxpayers who are personally liable for encumbrances or taxpayers who own unencumbered property. The effect of such a policy is to give the taxpayer an advance credit for the amount of the mortgage. This appears to be reasonable since it can be assumed that a capital investment
second consideration, also related to competition, is that adoption of an anti-Crane rule would impose a toll charge on the risk averse who might be dissuaded from a purchase which they would otherwise have willingly made if financed with nonrecourse debt that would lessen their exposure to risk.\textsuperscript{140} Third, there is Crane's earlier-mentioned notion to the effect that the assignment of basis must be sensitive to what will yield a reasonable scheme for depreciation deductions, including matching those deductions against income from the same property.\textsuperscript{141}

Finally, there is the pragmatic consideration that no other treatment of the nonrecourse debt is so inherently more logical or practical so as to trump the above-cited reasons for assigning the full liability as part of cost basis to the purchaser-debtor. It would, of course, be possible to follow another regimen, such as shifting basis away from the seller to the purchaser coterminous with payments. Indeed, some have proposed this on the assumption that payments constitute the true measure of a purchaser's investment or cost,\textsuperscript{142} thereby ignoring or discounting the economic/opportunity cost arising when a debtor signs on to one nonrecourse loan rather than another. Others, at a much earlier time, explored tying basis to payments as an antidote to the hospitable breeding grounds for tax shelters created by Crane's authorization of nonrecourse debt in basis.\textsuperscript{143} Congress has since responded to the tax shelter problem by statutory stopgaps,\textsuperscript{144} and in so doing at least partially rehabilitated the force of the earlier-noted objections voiced by the Court in Crane to assigning basis according to payments\textsuperscript{145}—an expressed concern over a possible administrative quagmire were depreciation to be calculated on an ever-shifting basis, as well as the manipulative potential this would afford the borrower if timing of payments could control yearly basis and concomitant depreciation deductions.\textsuperscript{146}

Obviously, there are other alternatives. One is to leave the original basis with the previous owner until all payments are made. This would create an extreme distortion by mismatching the depreciation deductions in the amount of the mortgage will eventually occur despite the absence of personal liability.

\textsuperscript{140} Shaviro, note 4, at 446.
\textsuperscript{141} Crane v. Commissioner, 331 U.S. 1, 9-10 (1947).
\textsuperscript{143} See, e.g., Cooper, note 8, at 716; Del Cotto, note 2, at 98-99; Epstein, note 122, at 105.
\textsuperscript{144} See in particular IRC §§ 465, 469.
\textsuperscript{145} Crane, 331 U.S. at 9-10.
\textsuperscript{146} But see Johnson, Front End, note 8, at 604-05, for a modern day account of why the anti-shelter legislation, including its statutory exceptions, could be inadequate to the task. On a more abstract level of criticism aimed at overinclusions in basis, see generally Cooper, note 8; Johnson, Soft Money, note 142.
eventually allowable (for using up the property in producing income) against the income actually produced over the life of the property. Another possibility is to pursue a scheme analogous to that followed in the temporary regulations applicable to nonrecourse debt of partnerships,\textsuperscript{147} which has its own set of unique and artificial assumptions as to who ultimately bears the economic risk of loss on property encumbered by nonrecourse debt.\textsuperscript{148} These latter solutions discount the reasons for treating the debtor as having made an economic investment warranting a full cost basis. These departures from the usual rule assume respective economic risks of debtor and creditor that are no more, and probably less, persuasive than the assumption that the debtor will bear the full cost. As others have forcefully argued,\textsuperscript{149} no theoretical rationale supports these approaches over allocating the basis by a method that more nearly tracks Crane's approach.\textsuperscript{150}

C. The Case of Over-Encumbered Property

1. Is Crane's Theory Inapposite?

At least at first blush, the reasoning of Crane, endorsed and adopted by Tufts, as well as the policies discussed above favoring inclusion of certain nonrecourse debt in a purchaser's basis seem ill-suited as justifications where the debt at acquisition is larger than the objectively appraised value of the property that it encumbers.\textsuperscript{151} Crane and Tufts pointed to the excess of a property's value at acquisition over the nonrecourse debt

\small
\begin{itemize}
  \item 147 Temp. Regs. §§ 1.704-1; 1.752-1T, -2T, -3T, -4T.
  \item 148 See generally Abrams, Long-Awaited Regulations Under Section 752 Provide Wrong Answers, 44 Tax L. Rev. 627 (1989); Utz, Partnership Taxation, note 8, at 698-703, 708-09, 710-14.
  \item 149 Professor Shaviro explains the impossibility of determining which party is theoretically entitled to claim depreciation deductions for suffering a drop in the economic worth of the property, and that even if this could be determined, there is no reason to believe that assigning basis and depreciation deductions to the "right" taxpayer will benefit the tax system or prevent the parties from bargaining to achieve a different result. Shaviro, note 4, at 432-39. He therefore concludes:

  \begin{quote}
  The Crane rule, despite all the criticism it has received through the years, can reasonably be defended. Economic depreciation of an asset that is subject to nonrecourse borrowing is extremely difficult to locate properly, and preferential depreciation has no correct location. Thus, Crane's application of a simple, black letter rule assigning depreciation deductions to the owner-borrower is far from unreasonable.
  \end{quote}

  Id. at 445.
  \item 150 Compare Coven, note 6, at 48-49; Utz, Partnership Taxation, note 8, at 697.
  \item 151 The court in Crane expressly declined to pass on the results in such a case because "[W]e are not faced with that problem and see no reason to decide it now." Crane v. Commissioner, 331 U.S. 1, 12 (1947).
  
  The facts in Commissioner v. Tufts, 461 U.S. 300 (1983), presented just such a situation for the purchaser in the transaction before the Court. Unfortunately, basis to the purchaser was not at issue. Nor did the Court's reasoning, as to why the full nonrecourse debt in excess of the property's value must be included in the seller's sale proceeds, shed any light on whether
\end{itemize}
that encumbered it as the reason to assume that a debtor would pay off the nonrecourse debt and equate it to a recourse obligation, implying that the same would not hold true if the spread were the other way. As paraphrased by others, Crane's rule for inclusion of a nonrecourse liability in basis does not pertain unless "it is presently reasonable from an economic point of view for [the borrower] to make a capital investment in the amount of the unpaid purchase price." This is certainly an unlikely expectation if, at the acquisition date when basis is determined, the debt exceeds the value of the underlying property. In such a circumstance, the debt creates at most an option to pay, but neither a genuine limitation on the use of resources nor implicit engagement to pay as contemplated by the concept of cost.

2. Relationship of Cost to Circumstances Prompting Over-Encumbered Property

Although a nonrecourse debt at acquisition that exceeds an objectively determined appraisal value for the property will not, in the usual case, constitute a cost to the purported debtor, under the four sets of circumstances described below, all or a part of an apparently excessive nonrecourse acquisition debt may fit the tax law's definition of cost and, hence, warrant a cost basis. A basis arises even though, as a result of Congress' separately imposed at-risk limits, current deductions founded on nonrecourse debt may not be forthcoming.

Consider first, the case of a debtor whose mistake, bad bargaining or special wants account for the gap between nonrecourse acquisition debt and the property's objectively appraised value. If, at the date of the con-

\[\text{that loan should also be included in the new buyer's cost basis. See Andrews, On Beyond Tufts, 61 Taxes 949, 956-57 (1983).}\]

\[152\] Estate of Franklin v. Commissioner, 544 F.2d 1045, 1049 (9th Cir. 1976).

\[153\] Property received as a gift or by a testamentary disposition, that is over-encumbered by a nonrecourse debt at the date of transfer, might culminate in the full or partial inclusion of the debt in basis but certainly not on the theory of economic cost. The decision by a transferee to accept rather than disclaim the over-encumbered gift or legacy can be perfectly rational, and hence a bona fide acquisition, because of the lack of downside risk in accepting the property; i.e., if a rise in value fails to materialize, the nonrecourse nature of the debt would protect the taxpayer from adverse results on nonpayment. The tax law may or may not honor the transaction as transferring ownership of the property for tax purposes, rather than conferring a mere option to acquire, but in either case the donee/legatee would not take a cost basis. Rather, property acquired from a decedent obtains a fair market value basis pursuant to § 1014; the basis of gifted property is usually the donor's basis under § 1015. If, prior to the gift, the nonrecourse encumbrance exceeded the donor's basis in the encumbered property, then the gift (if recognized for tax purposes) would be treated as a partial gift/partial sale, resulting in gain recognition to the donor equal to the excess of the debt over basis. This would in turn impact on the donee's basis for purposes of determining the amount of reportable gain (but not loss) on a later sale by the donee.

\[154\] IRC § 465.
tract, the purchaser views the full price, including nonrecourse debt, as the property’s cost, is that not a fair measure of its cost basis? The fact that the buyer might later discover the error or undergo a change of heart, leading to rescission of the contract or abandonment of the property and debt, should not preclude the earlier cost basis, any more so than when, after a purchase with recourse debt, rescission based on mistake is forthcoming, or later circumstances cause a change in the buyer’s original plans or a reduction of the original debt.\footnote{See \textit{Tufts}, 461 U.S. at 308-09, equating the tax treatment of debtors on nonrecourse and recourse loans at eventual disposition of the encumbered property. Nonetheless, some differences may pertain, and, at the least, some uncertainties remain in eventual tax consequences. See \textit{Gershkowitz v. Commissioner}, 88 T.C. 984 (1987); \textit{Estate of Newman v. Commissioner}, 59 T.C.M. (CCH) 543 (1990). See generally Bramson, \textit{Tax Consequences of Cancellation of Nonrecourse Debt Remain Unsettled}, 73 J. Tax’n 86 (1990).}

A second circumstance, also qualifying the seemingly excessive nonrecourse acquisition indebtedness as a cost to the debtor, is where both parties deliberately agree to a boosted price to reflect the special financing terms of the contract.\footnote{Compare Prop. Reg. § 1.1012-2(b)(3): In determining whether the value of the consideration furnished by the buyer exceeds the value of the property, the value of the property shall be determined by reference to the price that an unrelated buyer (having the same creditworthiness as the actual buyer) would be willing to pay for the property in an arm’s length transaction if seller financing (taken into account at its issue price) were offered on the same terms as those offered to the actual buyer.} This might happen, for example, where the higher rates and other costs entailed in renegotiating the financing may justify preserving the apparently higher price attached to the preexisting loan. Or, the principal of a new nonrecourse loan might be set at a high level to reflect the disproportionately high nonrecourse financing of the transaction.\footnote{Compare Prop. Reg. § 1.1012-2(c) Exs. 3 & 4.}

To illustrate, if property has a fair market value of $100 million—meaning that the seller could expect $100 million in cash or other benefits in kind with a present value of that amount—the seller would not agree to sell for $100 million in nonrecourse debt (i.e., debt with a present value of $100 million given an interest rate adjusted to reflect the risk of nonpayment). If the property plummeted in value, say to $75 million, the buyer could abandon the asset and the seller would bear the $25 million loss, while the buyer would get the benefit of an increase in value. The seller would, therefore, demand some other payment as a buffer: cash, property or even added nonrecourse debt. The buyer, in turn, may be willing to agree to this amount, and intend full payment, in order to purchase using unconventional financing with a minimum of out-of-pocket resources. A price over $100 million, say $115 million to be financed almost exclusively with nonrecourse debt, might be a valid purchase price and cost to the buyer.
A third possibility, a variation of the second, arises where the price and principal of the nonrecourse debt may have been adjusted upward to compensate for a corresponding decrease in interest charges, either in an effort to comply with usury laws, or to maximize the seller's capital gain in exchange for sacrificed interest charges.\footnote{By maximizing capital gain, a seller might, in addition to enjoying a preferential tax rate, facilitate the absorption of otherwise nondeductible capital losses that, for corporations, can be written off only against capital gains, and for noncorporate taxpayers can offset no more than $3,000 of ordinary income. IRC § 1211. This allocation could be quite adverse to the purchaser, however, who might sacrifice potential current interest deductions, in exchange for, at best, deferred depreciation deductions.}{158} Statutory curbs somewhat constrain a taxpayer's attempt to magnify principal and understate interest by calling for imputation of interest when there is inadequate stated interest in the contract.\footnote{IRC §§ 483, 1274.}{159} However, once an allocation passes muster under these statutory tests, the resulting congressionally approved level of principal apparently is the tax law's measure of the purchaser's cost, (even though, from an economic perspective, the fungibility of money means that the present value of all charges, regardless of whether designated as principal or interest, in reality constitutes the economic cost).

Fourth, the nonrecourse debt might exceed the value of the purchased property due to an ancillary transaction concurrent with the purchase, in which case the cost of purchase is only that portion of the nonrecourse debt net of this ancillary amount.\footnote{Prop. Reg. § 1.1012-2(a): "If the value of the consideration exceeds the value of the property, this excess shall not be treated as relating to the sale or exchange and will be recharacterized according to the relationship between the parties." See also Collins v. Commissioner, 22 T.C.M. (CCH) 1467 (1963).}{160} For example, a gift or compensation\footnote{Compare Prop. Reg. § 1.1012-2(c) Exs. 3 & 4.}{161} or a disguised dividend\footnote{Prop. Reg. § 1.1012-2(c) Exs. 1 & 2.}{162} conferred by the buyer on the seller could account for the increased debt. If so, the net economic cost of the acquisition should become the purchaser's cost basis, even though the latter expects to pay off the full amount of the nonrecourse loan.

Now compare the different outcome and analysis appropriate for a transaction where, at the date of the negotiations, none of the circumstances explored above exists, yet both parties know that the present value of the debt exceeds an objectively ascertained fair market value of the encumbered property—that is, the debt is inexplicably inflated.\footnote{This term is used hereafter to refer to a nonrecourse debt having a principal amount in excess of the property's fair market value, which excess value cannot be explained by any of the four circumstances discussed in the text.}{163} What could be the reason for this transaction, and how is it to be analyzed for tax purposes?

A nonrecourse debt that is inexplicably inflated over the value of the underlying property lacks the attributes of economic cost, for a pur-
A rational actor would not rationally intend or feel committed to pay either the full debt, or even an amount equal to the value of the property at the date of the transaction. By way of illustration, assume that a piece of property has a current value (based on market predictions) of $100 million, and an encumbrance on it of $165 million at the date of acquisition. The debtor at that date surely would not intend to pay the full $165 million, nor even $100 million equal to the acquisition date value of the property, for such latter payment would still leave the debtor indebted by the remaining $65 million balance on the original $165 million loan. Upon a foreclosure sale of the property, the creditor could rightfully claim $65 million of the foreclosure proceeds as payment on the still outstanding debt. If the market had stayed constant and the property were therefore still worth $100 million, the sale would leave the debtor with only $35 million net proceeds rather than the full $100 million worth of property that he could have claimed had he initially spent his $100 million on this or other property worth $100 million, but encumbered only to that extent. Furthermore, the debtor is no better off, and could indeed be worse off, by paying an amount equal to what was the fair market value of the property at the date of the transaction, for if the property drops $100 million in value by the date of the foreclosure sale, the debtor would be out of pocket his entire investment. Therefore, this historic market value figure ($100 million in the illustration) bears absolutely no relationship to how much, if anything, the debtor will be willing to pay on the loan, and, therefore, how much should be included in the debtor’s cost basis.

At the outset of the transaction, when basis is determined, the maximum that a rational actor should be willing to pay on an inexplicably inflated nonrecourse loan is only that amount essential to preserve and achieve whatever goals motivated that party in the first instance to engage in the transaction. In the absence of any of the circumstances described above, an awareness that the debt inexplicably exceeds the property’s value is proof that the debtor had no intent to pay the full debt and did not regard it as an economic cost for acquiring the property.

There appear to be three possible explanations, not mutually exclusive, as to why a nominal purchaser would enter into a contract to purchase property subject to an inexplicably inflated nonrecourse loan. The possibilities include an intent by the “buyer” to obtain an enforceable option to purchase the property at these terms should changed conditions so warrant, an interest in obtaining mere temporary possession, and a desire to claim tax deductions associated with ownership of the property.

164 The larger the initial debt, the more the debtor stands to lose; for example, a debt of $185 million originally would have left the debtor merely $15 million to pocket from the foreclosure proceeds.
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(1) An option to purchase at a future date. If what transpired was a not purchase, but merely an option to buy in the future, then notwithstanding the paper storm of deeds, title searches and escrow closings of the subject property, none of the nonrecourse debt would succeed in imposing an economic cost until, at the earliest, changed market conditions warranted a purchase at those terms. In the interim, the "purchaser" should be entitled to a cost basis only for what amounts to the economic cost of obtaining an enforceable opportunity to buy; in turn, the cost of this option would become part of the basis of the property if and when exercised in conjunction with a later purchase.

(2) Acquisition of physical possession. If the purchaser's goal was to obtain temporary physical possession, in the nature of a rental under an unconventionally worded and structured leasehold, cost basis should not exceed that amount attributable to securing the leasehold interest. This obviously would be less than the full nonrecourse debt that purportedly finances the

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165 Goodstein v. Commissioner, 267 F.2d 127, 131 (1st Cir. 1959); Beck v. Commissioner, 53 T.C.M. (CCH) 1406, 1412-14 (1987); see also Bailey, Jr. v. Commissioner, 912 F.2d 44 (2d Cir. 1990).

166 Estate of Franklin v. Commissioner, 64 T.C. 752, 771 (1975), aff'd on other grounds, 544 F.2d 1045 (9th Cir. 1976); accord Pleasant Summit Land Corp. v. Commissioner, 54 T.C.M. (CCH) 566, 575 (1987), aff'd per curiam sub nom. Estate of Issacson v. Commissioner, 860 F.2d 55 (2d Cir. 1988).

167 Once the value of the encumbered property increases to such extent that the debt is no longer inexplicably inflated, it may be appropriate to conclude that the debt is one that the "optionee" reasonably may be expected to pay, and hence one entitled to inclusion in cost basis under Tufts. Such inclusion should not follow automatically, however. In addition to the consideration of administrability, a second reason for denying automatic inclusion is that in the interim since the "option" was first acquired, factual changes may have occurred (such as the optionee having undertaken other obligations) that now preclude a reasonable expectation that the optionee will pay off this nonrecourse debt. Some affirmative evidence might therefore be required as a condition to inclusion: for example, continued payments by the "optionee" after the value of the property exceeded the debt.

The fact that under some circumstances increases in value of the underlying encumbered property can be relevant to cost basis, as suggested in the preceding paragraph, does not indicate that declines in value likewise constitute reportable tax consequences. Tufts decided by implication that the debtor undergoes a realization event only upon disposition of the property, and not upon downward fluctuations in its value that undermine the initial assumption about payment of the debt. Accord Lebowitz v. Commissioner, 917 F.2d 1314, 1318 (2d Cir. 1990).

As to the purchaser's treatment on the sale or lapse of an option, see generally IRC § 1234(a); Rev. Rul. 72-198, 1972-1 C.B. 223. For acknowledgement of the possibility that if the option lapsed without exercise, the optionee might be entitled to report a loss, see Estate of Franklin, 64 T.C. at 762 n.7 (dictum), apparently disapproved on appeal, 544 F.2d 1045 (9th Cir. 1976).

168 See Mayerson v. Commissioner, 47 T.C. 340, 352-53 (1966), acq., in which the government argued that the ostensible purchase was in essence a disguised rental. See also Rev. Rul. 69-77, 1969-1 C.B. 59, 59, warning that despite its acquiescence in Mayerson, "[t]he Service will continue to review transactions involving purported purchases of depreciable property
price of the entire underlying property rather than a shorter term possessory interest. The tax law is no stranger to transactions structured to resemble purchase-sales, although in substance treated for tax purposes as disguised leases, and vice versa.\footnote{169} Statutory language makes clear that Congress intended that a purchase not masquerade as a rental;\footnote{170} cases have reached the same conclusion on congressional intent as to disguised purchases that are in essence rentals.\footnote{171}

(3) Purchase of tax writeoffs. If the real goal of the "buyer" was to purchase tax deductions associated with a basis inflated with the nonrecourse loan, then a legion of precedents establishes that none of the taxpayer's economic cost produces tax deductions\footnote{172} nor constitutes a part of any cost basis.\footnote{173} Beyond the avalanche of reported and docketed cases, countless taxpayers appear to fit this pattern based on the contents of promotion literature that apparently prompted their outlays.\footnote{174} True, trafficking in properties for this purpose may well have been dampened by the enactment of § 465\footnote{175} and other changes

where, in the light of all the facts and circumstances, it appears that the transactions were designed to improperly create or inflate depreciation deductions."


\footnote{170} IRC § 162(a)(3) authorizes a deduction for: "(3) rentals or other payments required to be made as a condition to the continued use or possession . . . of property to which the taxpayer has not taken or is not taking title or in which he has no equity." Id.

\footnote{171} See, e.g., Look v. United States, 80-2 U.S.T.C. ¶ 9579 (D.C. Haw. 1980); Pike v. Commissioner, 78 T.C. 822, 837 (1982), aff'd without published opinion, 732 F.2d 164 (9th Cir. 1984). Compare Mayerson v. Commissioner, 47 T.C. 340, 352 (1966): "Contrary to respondent's asserted position, we do not believe that this transaction was in reality or substance a lease with an option to purchase."

\footnote{172} See, e.g., Knetsch v. United States, 348 F.2d 932, 939-41 (Ct. Cl. 1965), cert. denied, 383 U.S. 957 (1966), denying any deductible loss for the expenses incurred by the taxpayer in an unsuccessful effort to obtain interest deductions on nonrecourse borrowings that the Supreme Court had earlier held, 364 U.S. 361 (1960), did not constitute bona fide debts. But compare Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 95-96 (4th Cir. 1981), allowing deductions for interest paid on recourse debt. See generally I B. Bittker & L. Lokken, note 169, at ¶ 4.43.

\footnote{173} See, e.g., Durkin v. Commissioner, 872 F.2d 1271, 1278 (7th Cir.), cert. denied, 110 S. Ct. 84 (1989); Estate of Isaacson v. Commissioner, 860 F.2d 55, 56 (2d Cir. 1988), aff'g per curiam sub nom. Pleasant Summit Land Corp. v. Commissioner, 54 T.C.M. (CCH) 566 (1987).

\footnote{174} For an empirical account of the size and general features of the backlog of cases in the tax shelter arena, see Johnson, Front End, note 8, at 596.

\footnote{175} The section was enacted in response to the tax shelter phenomenon in which taxpayers, thanks to Crane, claimed depreciation deductions on properties far in excess of what those taxpayers had economically at stake in the venture. Section 465 now limits an individual taxpayer's deductions generally to the amount the taxpayer is personally at risk in the venture, which does not include most nonrecourse financing. However, there are exceptions to the at risk rules: They do not apply to most corporations, nor to nonrecourse borrowing constituting qualified nonrecourse indebtedness in connection with real estate. Furthermore, any reporta-
in the law.\textsuperscript{176} However, the changes have not entirely eliminated the incentive to magnify basis and concomitant depreciation deductions.\textsuperscript{177}

It is a question of fact as to which one or more of these three possibilities characterizes the purchaser's goals, once an intent to purchase has been eliminated by proof of an inexplicably inflated price. For example, serious efforts to upgrade the property or its productivity would be probative of the acquisition of an option rather than mere tax writeoffs. Use of the property for storage purposes may point to a desire to acquire mere temporary possession. Whatever is in fact the most suitable characterization, it is clear that in none of these three circumstances does the taxpayer's actual economic cost incorporate the nonrecourse debt.\textsuperscript{178}

The best arguments for allowing a purchaser to include in a cost basis part or all of the inexplicably inflated encumbrance appear in a recent article by Professor Daniel Shaviro.\textsuperscript{179} He suggests that a distinction be drawn between cases in which the taxpayer takes property subject to an excessive loan and those where an excessive loan is newly negotiated. He would allow a basis in the former situation at least equal to the fair market value at the date of the transaction.\textsuperscript{180} He is certainly supported by authority\textsuperscript{181} and is in outstanding company in taking this position.\textsuperscript{182}

Professor William Andrews, for example, in part justifies this inclusion of

\textsuperscript{176} Investment in tax shelters has dropped off precipitously since the 1986 Act. The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085. Among the disincentives introduced by that legislation were: (1) an extension of the at risk rules of § 465 to real estate transactions; (2) enactment of § 469, limiting the current allowance of passive losses (for example, from tax shelters) against non-passive income; (3) a drop in the marginal rate structure which lessened the tax savings to be gained from tax deductions (IRC § 1); (4) repeal of preferential tax rates on capital gains, the kind of income typically generated on disposition of interests in real estate shelters; and (5) revised depreciation schedules that curtail the rate at which a property's basis can be written off. IRC § 168(c).

\textsuperscript{177} Section 465 itself contains numerous exceptions to its application. See note 175. Moreover, the time value of money remains a powerful attraction to claiming artificial deductions even though offsetting income will have to be reported at a later time. See generally Johnson, Front End, note 8; Johnson, Soft Money, note 142, at 1052-71.

\textsuperscript{178} But see Rev. Rul. 77-110, 1977-1 C.B. 58, and Rev. Rul. 78-29, 1978-1 C.B. 62, allowing the down payment to be included in basis where the property is overencumbered. Query: Why so?

\textsuperscript{179} Shaviro, note 4. For a different set of potential justifications, see the hypothetical opinions of the fictional Supreme Court justices in Adams, note 2.

\textsuperscript{180} Shaviro, note 4, at 412, 442, 450.

\textsuperscript{181} See, e.g., Webber v. Commissioner, 47 T.C.M. (CCH) 32, 55 (1983), aff'd, 790 F.2d 1463 (9th Cir. 1986).

\textsuperscript{182} M. Chirelstein, note 135, at § 13.04; Andrews, note 8, at 953-54, 957-58; cf. Pleasant Summit Land Corp. v. Commissioner, 863 F.2d 263, 276-77 (3d Cir. 1988), cert. denied, 110 S. Ct. 260 (1989), which included the preexisting debt in basis up to the value of the property at
the preexisting excessive loan in the purchaser's basis on the pragmatic
ground that there is no more appropriate party to claim the depreciation
inasmuch as the prior owner has no continued interest and the lender is
not an owner of the property.\footnote{Andrews, note 8, at 953-54.} If, however, the purported buyer is sub-
stantively just a seeker of tax deductions who has not undertaken any
costs of acquisition, why should that party's entitlement to depreciation
be superior to all others, such as the prior owner's, or the lender's?

Professor Shaviro's first reason for distinguishing between debtors of
existing and newly negotiated nonrecourse loans in excess of value is that
the former debtor presents a more appealing case for sympathetic treat-
ment than does the other debtor\footnote{Shaviro, note 4, at 412.}—a reason which remains unproven to
this cold-hearted author.\footnote{Professor Andrews seems to share Professor Shaviro's sympathetic attitude toward the
allegedly "innocent" purchaser who takes subject to a nonrecourse debt that exceeds the prop-
erty's value:}

\begin{quote}
[T]he contrast between true debt and unreasonable, artificial, inflated prices has a sound
of misbehavior or abuse about it that may prevent its application to innocent transac-
tions. Moreover, it has an all-or-nothing quality that may make it rather harsh to apply
if a taxpayer's conduct has not been blameworthy. It makes no provision, in particular,
for cases in which one might feel that the best solution would be to recognize nonre-
course debt but only to the extent of the value of the securing property.
\end{quote}

Andrews, note 8, at 953 [footnote omitted].

\footnote{To illustrate, assume that property at the date of a transaction is worth $100 million and
encumbered by a loan of $325 million. By not insisting on a renegotiation of the existing,
above-value ($325 million) debt down to the $100 million current value, the purchaser who
takes subject to the preexisting debt would be irrational to pay off even $100 million, for every
dollar that is paid will be lost along with the property on subsequent foreclosure unless the
property eventually is sold for more than the still outstanding debt—that is, more than $225
million (if the original debt was $325 million and the debtor had already paid $100 million.)}

\footnote{Shaviro, note 4, at 442, 450.}
respective tax brackets of the parties, result in a larger revenue loss than permitting depreciation deductions to the other party at some future date based on including part or all of the original principal in basis.

However, even if this solution generates more revenue, it deliberately sidesteps the cost basis approach worked out by Congress. It would seem preferable to let Congress provide for this if it is so persuaded. Consider, for example, the possible revenue drain under this substitute approach which seems to endow the parties with the power to decide whether or not to finance with a renegotiated loan. This, in turn, provides them with a constructive option to select the best-of-all-worlds tax results and to share the resulting tax savings: If the current loss saved the most taxes, the outstanding debt would be retired; if depreciation deductions to the other party would create greater tax savings, then the buyer would take subject to the existing debt.

3. Doctrinal Clash Between the Circuits: the Pleasant Summit Saga

The question of whether cost basis includes a nonrecourse mortgage that at acquisition exceeded the property's value was at issue in Pleasant Summit Land Corp. v. Commissioner.\(^{188}\) Two appellate courts accepted the basic facts as found: A corporation purchased an apartment complex for $4,200,000 and within a short time frame resold it to a related party. Shortly thereafter a limited partnership acquired the buildings without the land in exchange for nonrecourse loans totalling $7,259,200 plus $500,000 cash. The appeals were taken by partners who challenged deficiency assessments based on the disallowance of depreciation or interest deductions attributable to the nonrecourse acquisition indebtedness, plus disallowance of deductions for the $500,000 cash outlay.

The findings of the Tax Court, affirmed per curiam by the Second Circuit,\(^{189}\) were that the price was "unreasonably excessive" and the nonrecourse debt "substantially" in excess of the property's value, so that, in line with a number of precedents,\(^{190}\) there was neither an investment in the property nor any genuine indebtedness to support depreciation and interest deductions.\(^{191}\) The Tax Court based these conclusions on the fact that the properties had been acquired just six weeks before the partnership's acquisition for $4,200,000, including the land, so that the


\(^{189}\) 54 T.C.M. (CCH) 566 (1987), aff'd per curiam sub nom. Estate of Isaacson v. Commissioner, 860 F.2d 55 (2d Cir. 1988).

\(^{190}\) See, e.g., Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976); Odend'hal v. Commissioner, 80 T.C. 588 (1983), aff'd, 748 F.2d 908 (4th Cir. 1984), cert. denied, 471 U.S. 1143 (1985).

\(^{191}\) Pleasant Summit, 54 T.C.M. (CCH) at 575.
$7,759,200 price had to be far in excess of the property’s fair market value.\textsuperscript{192}

The logic of this reasoning is hardly self-evident. No attempt was made to define what constitutes an “unreasonably or substantially excessive” figure, or why this leads to a conclusion that no investment or indebtedness took place. Presumably, unless void or voidable under local law, some economic transaction took place. Also left unaddressed was the issue of when if ever the acquisition would occur.

An appeal to the Third Circuit\textsuperscript{193} by another partner produced a vastly different and unprecedented outcome which allowed the taxpayer a basis equal to the fair market value of the property at the date of the transaction, although not the full amount of the nonrecourse debt.\textsuperscript{194} It reached this conclusion ostensibly on the authority of Crane. It reasoned that so long as the property was worth less than the full debt, the creditor would abstain from foreclosing and permit the taxpayer, by payment of fair market value, to remain in possession.\textsuperscript{195}

This competing analysis by the Third Circuit does avoid problems created by the result in the Second Circuit, uncertainties as to what is to be disregarded as a sham, of what constitutes an overly “excessive” price, and just when a delayed date of acquisition will if ever arrive—but sorely suffers substitute defects. It treats the transaction as a purchase, but by its reasoning strayed from what is probative of the purchaser’s cost. Although the creditor may be not only willing, but required not to foreclose so long as the debtor goes on servicing the debt, the reasoning of Crane that supports inclusion of nonrecourse debt in basis does not go to how long the debtor can stay in possession, but rather to whether it is reasonable to expect that that party pay off the full debt.\textsuperscript{196}

The Second Circuit and trial court in Pleasant Summit were obviously closer to the correct mark in disallowing the nonrecourse debt in basis due to their conclusion that the debt was so excessive that the purchaser had no incentive to pay it off. To paraphrase, the “purchaser” did not

\textsuperscript{192} Id.

\textsuperscript{193} Pleasant Summit, 863 F.2d 263 (3d Cir. 1988).

\textsuperscript{194} Id. at 276-77.

\textsuperscript{195} Id. at 276. Compare Lebowitz v. Commissioner, 917 F.2d 1314, 1318-1319 (2d Cir. 1990), disapproving the Third Circuit’s decision that a note is genuine for tax purposes to the extent of the value of the underlying security even where that value is below the principal of the note. Lebowitz concludes instead that a nonrecourse debt can be valid for tax purposes if the value of the property equals or is not “unreasonably” less than that debt, and even though the purchase price far exceeded that value. Compare the discussion somewhat to the contrary in the text at notes 153-77.

\textsuperscript{196} In Pleasant Summit, such an expectation was not reasonable. Even by paying off the nonrecourse loan up to the value that the property had at the date of the transaction, a debt would remain that would justify foreclosure proceedings at which the debtor’s payments to that point would be forfeited to satisfy any still remaining excess debt.
regard the debt as an economic cost that committed the debtor's resources.

However, several troubling aspects cloud the Second Circuit's opinion. First was its view that because the price was overly excessive, what occurred had no economic vitality nor tax significance. The conclusion is unfortunate, even though it has become the standard characterization for transactions viewed as tax motivated and incorporating an inflated, artificial price.\(^\text{197}\) The transaction in *Pleasant Summit* apparently was not void or voidable under local law; the sizeable cash payment by the taxpayer-debtor could not be recouped; the seller-creditor could sell off the buyer's note, but could not dispose of the property to another so long as that debtor serviced the loans. These facts indicate that some costs were present to account for the enforceable incidents of the transaction, the implications of which deserved attention rather than the court's dismissal of everything that occurred as a sham lacking any tax significance. Also troubling was the court's vagueness as to the correct standard for determining when a price would be unacceptable as unreasonably or substantially excessive.

Had the court utilized the analysis proposed in this article, it would have looked to whether the nonrecourse debt was inexplicably inflated contrasted to the value of the underlying encumbered property. That is, it would have turned its inquiry to whether the debt exceeded the value that would have been set at a sale between a willing buyer and willing seller on these precise terms (that is, at this rate of interest and financed with nonrecourse debt), and, if so, whether the excess price could be accounted for by mistake or as a deliberate overpayment to cover an ancillary nonpurchase event.

4. **Identifying Excessive, Inexplicably Inflated Debt**

To determine what value a willing buyer and willing seller would have struck obviously will require something more than testimony from the parties to the transaction as to what price they were willing to agree to, for their dealings may never have focused on a price for the property itself. A buyer motivated only by a rainbow of tax deductions and without expectation of paying off the debt would rationally look to the sky, no other limit. Nor can the seller be relied on to quote any less fanciful a price, for what rational self-interested party could be expected to insist on or testify to a lower figure than the price actually offered and accepted? (Obviously the seller might have agreed to a lower price from

\(^{197}\) The Tax Court and Second Circuit cite a number of such cases. They are virtually legion in the tax shelter area. See, e.g., Perrson v. Commissioner, 58 T.C.M. (CCH) 409 (1989). For a criticism of the disallowance in some of these cases, see Blum, *Knetsch v. United States*: A Pronouncement on Tax Avoidance, 40 Taxes 296 (1962).
another buyer genuinely interested in obtaining and paying a fair price for the property, but once the seller accepts a higher price and a concomitant real risk of nonpayment, the seller would have no interest in admitting that the price was excessive and thereby risk grounds for reformation.) Thus, the seller and buyer may well have a shared desire to testify to a falsely exaggerated value for the property.

Proof of a fair market value benchmark, as distinguished from an inexplicably inflated or excessive price, should depend on a multifactor showing, such as projected income and expenses from operating the property, upside and downside risks of changing values, expert appraisals, prices of comparable properties and even the price at which this property last turned over, along with any other factors probative of an arm’s length price determined by a willing buyer and willing seller. Although price levels generally are inflated by tax considerations no discount should be applied: The relevant issue is the economic cost to the buyer, and this must be set by taking into account all factors that might have entered into negotiations over value by a willing buyer and seller.

Neither proof of the buyer’s intent to pay off the entire debt nor proof of substantial out-of-pocket payments by the buyer should be determinative that the agreed-upon price and debt corresponded to fair market value. As to the first point, although the buyer may have intended to pay off the entire loan, this may have been at least in part for another reason, such as a desire to confer compensation, a gift or even a dividend, bearing no correlation to the property’s fair market value. Nor does the fact that the buyer incurred significant out-of-pocket payments tell anything of the property’s value or of the buyer’s intent to pay off the loan. Although earlier advances could be lost at foreclosure by not satisfying the full amount of the loan, the fact of those payments neither proves the property’s value at acquisition nor the ostensible buyer’s cost. Instead, the payments may have already secured the benefits for which they were paid—a temporary option to buy in the future or temporary possession of the subject property.\footnote{Note, note 123, at 1525.} Later payments can at best postpone, but will not prevent, eventual foreclosure for failure to pay the entire debt. Nor will additional payments improve the buyer’s likelihood of recouping the earlier installments or cash down payments, or of securing a refund at foreclosure. Rather, the property’s value at the time of foreclosure in relation to the outstanding debt will determine how much, if any, of the overall payments the buyer can recoup.

At least in part because of the inherent unreliability of the price negotiated by the parties in a seller-financed transaction, and partly out of concern for tax-inflated values in the market, in two recent articles Professor Johnson suggests that a price be deemed excessive not only if it exceeds...
an objectively determined fair market value, but also if the present value of the tax writeoffs to the purchaser(s) exceeds the present value of the cash to be paid for the property. The value of this scheme is its potential for ease of administrability. This will depend, of course, on whether the tax savings to the purchaser or multiple purchasers are readily determinable, as well as whether the selection criteria for identifying the situations to which this approach should be applied are straightforward. Even if intended to apply automatically to all seller-financed acquisitions, and not merely to those where the price appears to exceed fair market value, (a standard that would reintroduce the complexity of identifying fair market value), the question remains as to whether this test would prove overly broad in its reach. It could bring within its sweep those transactions in which the Crane rationale or other circumstances warrant including the full debt in basis on the theory of its economic cost to the buyer. Given the reasons discussed earlier for including nonrecourse debt in basis when it is lower than the property's fair market value, is the difficulty of proof as to fair market value that Professor Johnson correctly identifies a strong enough concern to warrant abandoning the Crane doctrine in seller-financed transactions?

The framework of analysis proposed in this article would build on the concept of economic cost, requiring an objective determination into what was acquired for the cash and other economic costs that the taxpayer incurred. Its inquiry would parse the price to determine its components, and accord them their respective due. Once a determination is made that a price is inexplicably inflated, some of the costs may nonetheless prove deductible. First, by bifurcating the price into its proper components, an aliquot part of the debt could be allowed as basis attributable to the actual purchase, with the balance of the debt and price treated according to its essence, for example, gift, compensation, or dividend. Second, even if no part of the excessive price is an economic cost of purchasing the property, it does not follow that all that transpired was a sham, and that real economic costs were nonexistent. Some charges might be salvaged for tax purposes as representing the cost of an option to purchase at a future date when the price no longer is excessive, or as a payment of disguised rent to secure possession of the premises. Only if the transaction's true characterization is found to be a failed attempt to purchase tax deductions would denial of all writeoffs for the costs be appropriate.

Facile claims that heavy costs were incurred in acquiring property encumbered by huge nonrecourse loans brings to mind the familiar fable

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199 Johnson, Front End, note 8, at 599, reprised in Johnson, Seeking Shelter, note 8.
200 See discussion of four such circumstances in text at notes 155-62.
201 See text at notes 118-50.
of the Emperor who strode about naked, claiming to be garbed in fashionable clothing visible only to the virtuous. In “The Emperor’s New Clothes,” at last the pretension was pierced by words of simple truth from an innocent child: “Look, the Emperor is wearing no clothes!” Here that simple truth may be: “Look, the purchaser is bearing no cost!”

V. COSTS OF CONTINGENT LIABILITIES AND GUARANTEES, AND THEIR RELATIONSHIP TO BASIS

The focus in this section is on an obligation contingent on future events, for example, a debt in an amount contingent on future profits/productivity or another’s nonpayment of a guaranteed loan, or a debt contingent on unknown liabilities from already established facts, for example, clean-up costs of environmental pollution. Once again the law has developed with insufficient attention to economic cost.

A. Basis Attributable to Contingent Liabilities

Traditional doctrine excludes from a buyer’s initial cost basis the contingent portion of a purchase price. Only when the resulting debt becomes either “fixed and determinable” or actually “paid,” is it added to the buyer’s basis. The Service, courts and commentators treat the rule as settled beyond question.

A first reason for this treatment stems from a misplaced reliance on the statement in Crane that a reasonable expectation of payment by the debtor justifies including a nonrecourse loan in basis. Authorities drew the negative implication that an inability to make a like prediction with respect to “speculative” liabilities contingent on future facts required exclusion of the liabilities from initial basis. This reasoning, however, misconstrues the purpose for Crane’s reference to the likelihood of a debtor’s payment of a nonrecourse loan. That language was meant to explain why a nonrecourse loan on property encumbered below value should be treated as though it were a recourse loan personally owed by the debtor which would be included in that debtor’s basis. The Court in Crane was concerned with the question of why a nonrecourse debt should be included in basis, not with the issue of what amount to include for an obligation that clearly will be owed once events occur that impose re-


204 Id. See generally Epstein, note 122, at 107-10 (1972). But see Lynch, note 5, speculating as to the impact of contingent liabilities on basis as well as on their deductibility.

205 See also text at notes 119-25.
sponsibility on the buyer. Although the exact drain on resources may be uncertain, that uncertainty does not negate the presence of an acquisition cost includable in basis any more than did the uncertainty in the future value of the nonrecourse-encumbered property, or the debtor's ability or willingness to pay the nonrecourse debt, induce either the Crane or the Tufts Court to exclude the speculative future payments from basis.

A second tenuous obstacle to including contingent liabilities in basis is the purported impossibility of valuing something dependent on uncertain future events, an outmoded concern that traces back to an early development in the tax law when valuation difficulties were considered an intolerable obstacle to administration. The 1930 Supreme Court decision in Burnet v. Logan was a product, as well as a promoter, of that early thinking. The Court refused to assign, at the date of the sale of a mining interest, a present value to sales proceeds which were contingent on the future output of the mine, instead holding “open” the calculation of the seller’s gain until actual receipt. Recently, Congress has called for an end to this open transaction approach.

According to Congress, only in a “rare and extraordinary” case is it not reasonably possible to ascertain the fair market value of contingent payments, and in those rare instances a guesstimate should be made. In response, the regulations now make clear that almost no interest is to be considered too contingent in valuing the proceeds of a sale.

Finally, there is the problematic, yet established, view that debts must be either “paid” or “fixed and determinable” as a condition to their in-

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206 283 U.S. 404 (1931).
207 See IRC § 453(2). The congressional committee report which accompanied the enactment of § 453(2) provided:

Contingent payments must . . . be included in the seller's income in the year of disposition. Under the Act, in the rare and extraordinary case in which the fair market value of contingent payments may not be reasonably ascertained, basis shall be recovered ratably.

The so-called "open transaction" cost-recovery method of reporting sanctioned in Burnet v. Logan, 283 U.S. 404 (1931) may not be used.


209 See Temp. Reg. § 15A.453-1(a)(I) which requires that "contingent payment sales are to be reported on the installment method" unless the taxpayer elects not to use the installment method. If the seller makes such an election, Temp. Reg. § 15A.453-1(d)(2)(iii) provides inter alia that: "Only in those rare and extraordinary cases involving sales for a contingent payment obligation in which the fair market value of the obligation . . . cannot reasonably be ascertained will the taxpayer be entitled to assert that the transaction is 'open.'"

210 Cf. Temp. Reg. § 1.338(b)-1T(f)(2) (in determining grossed-up basis under § 338, the amount of a "contingent or speculative obligation" is not included).
clusion in basis, a principle that mistakenly introduces tax accounting concepts as to when the time is ripe for deductions of expenses, into the determination of what represents an economic cost of that expense. There is no reason to merge these issues. The linkage stems partially from a concern over leakage from the tax system unless tax accounting rules, which permit a seller to defer the reporting of gain attributable to a buyer’s obligation to make future payment, are applied correlative to exclude these same obligations from the buyer’s basis. It is within Congress’ exclusive province to forestall any potential mismatch. Aside from a few specific statutory exceptions that curb deferral of gains by sellers, the general rule persists that unconditional obligations to pay in the future for property purchased at a nonexcessive price are part of the cost basis at purchase, regardless of when payment is made on the obligation, or the buyer’s method of accounting, or the fact that the seller can defer reporting gain until collection of the buyer’s obligation. Nothing in the statutory provision on cost basis suggests a different outcome for acquisition costs in the nature of contingent liabilities consciously undertaken as a commitment by the buyer. Recently promulgated regulations to the contrary are theoretically unsound. As purchases of prepaid expenses (insurance, leasehold interests, supplies) or of other assets (like buildings) demonstrate, costs give rise to basis even though de-
ductions therefor may be premature under the taxpayer's method of accounting or concepts of economic performance.\textsuperscript{219}

Nor should depreciation deductions associated with a buyer's economic cost of incurring contingent liabilities be denied on the grounds that the cost has not yet been paid or is not yet fixed and determinable, for depreciation is calculated independently of a taxpayer's tax accounting method, in accordance with a schedule reflecting the presumed rate at which the taxpayer's costs are being used up/depleted in income production.\textsuperscript{220} Theories of economic performance that may postpone deductibility of other costs seem inappposite to congressionally scheduled depreciation.

If a contingent liability were included in initial cost basis, then later as events unfold and the contingent liability either materializes or fails to develop, corrective adjustments would be required.\textsuperscript{221} Examples of later developments that often require revisions in tax treatment include: Depreciation schedules that were drawn from earlier mistaken projections about the rate at which properties are used up in income production, or false predictions about a debtor's commitment to a nonrecourse loan eventually abandoned. Speculation about eventual adjustments once the future event occurs has been addressed in several recent articles,\textsuperscript{222} as well as a report by the Tax Section of the New York State Bar Association.\textsuperscript{223}

In theory, although contingent liabilities consciously undertaken by a buyer represent a cost includable in basis, consonant with Congress' expressed view that the open transaction doctrine has outlived its utility, some prestigious analysts resist this result on grounds of the difficulty of calculating that cost. Largely on account of administrative concerns, the N.Y.S.B.A. report advocates postponed inclusion in basis except in two limited circumstances dictated by case law.\textsuperscript{224} The apparent premise is that precise calculations of the eventual liabilities are well-nigh impossible to make. That premise may, however, be wide of the mark. The measure of cost depends on a buyer's sense of the toll of the transaction on the buyer's resources, a calculation that the buyer must surely have

\textsuperscript{219} See IRC § 461(h).
\textsuperscript{220} IRC §§ 167, 168.
\textsuperscript{221} Compare the adjustments for the seller suggested by Congress for cases of contingent payment sales in which the contingency fails to materialize. S. Rep. No. 1000, 96th Cong., 2d Sess. 23 (1980); accord Reg. § 1.1060-1T(f).
\textsuperscript{222} E.g., Crane, Accounting for Assumed Liabilities Not Yet Accrued by the Seller: Is a Buyer's Deduction Really Costless?, 48 Tax Notes 225 (July 9, 1990); Lynch, Transferring Assets Subject to Contingent Liabilities in Business Restructuring Transactions, 67 Taxes 1061 (1989).
\textsuperscript{223} N.Y.S.B.A. Report, note 5.
\textsuperscript{224} Id. at 884, 894, 898.
made before agreeing to engage in the purchase. A precise measure of the likelihood of occurrence of a contingency is irrelevant.

In summary, the assignment of a cost basis to property in theory calls for inclusion of contingent liabilities in a purchaser's basis at a value that fairly reflects, from the purchaser's perspective, the toll of that liability on the purchaser's resources. Whether and when the costs of such liabilities are deductible is a wholly distinct question, as is the treatment of those liabilities by the seller.

B. Cost and Basis Attributable to Guarantees

One form of contingent liability is a guarantee which both imposes a conditional obligation on the guarantor to pay the debt if the primary debtor fails to do so, and then moderates this with a right to repayment through subrogation and indemnification (that is, to step into the creditor's shoes and recoup from the primary debtor any payments made on the guarantee). If fully recourse, a guarantee can be satisfied from any resources of the guarantor, while if nonrecourse, only the guarantor's property that was furnished as security is at risk. If fully recourse, a guarantee can be satisfied from any resources of the guarantor, while if nonrecourse, only the guarantor's property that was furnished as security is at risk. If fully recourse, a guarantee can be satisfied from any resources of the guarantor, while if nonrecourse, only the guarantor's property that was furnished as security is at risk. If fully recourse, a guarantee can be satisfied from any resources of the guarantor, while if nonrecourse, only the guarantor's property that was furnished as security is at risk.

Even when fully recourse, a guarantee of the debt of a solvent debtor will not, in the usual case, impose an opportunity cost or commitment of the guarantor's resources in an amount equal to the full stated amount of the guarantee. This is because the guarantor's obligation is both conditional on the primary debtor's nonpayment and subject to reduction by an offsetting right of subrogation and indemnity. The exact encumbrance of the guarantor's resources therefore depends on the probability that the primary obligor will not pay the debt when due, reduced by the present value of the probability of an offsetting repayment from that primary debtor. The sounder the financial profile of the primary debtor, the lower the likelihood that the guarantor's resources will be depleted.

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226 If the guarantee is nonrecourse, limited to providing a mere security interest in some of the guarantor's property, the nonrecourse nature might well affect the value assigned to the guarantee, but should not produce other tax distinctions from the fully recourse guarantee.

227 If, as of the date of execution of the guarantee, repayment from the primary debtor is not expected, the guarantee should be viewed as what it realistically is: a benefit to the primary debtor in the nature of compensation, or a gift, or even an added investment constituting a contribution to that primary debtor. See Putnam, 352 U.S. at 88-89 (dictum); Collins v. Commissioner, 22 T.C.M. (CCH) 1467 (1963) (by implication); LTR 9113009 (Dec. 1990); see also Casco Bank & Trust Co. v. United States, 544 F.2d 528, 534-35 (11th Cir. 1976) (guarantee may be tantamount to an investment in debtor-corporation), cert. denied, 430 U.S. 907 (1977); accord Santa Anita Consol. v. Commissioner, 50 T.C. 536 (1968).

228 Compare Commissioner v. Wragg, 141 F.2d 638 (1st Cir. 1944), and Rev. Rul. 84-42, 1984-1 C.B. 194, on the amount deductible under § 2053(a)(3) for estate tax purposes where an estate makes payment on a decedent's guarantee that gives rise to a right of reimbursement against the primary debtor.
In terms of economic cost, the encumbrance of the guarantor’s resources varies inversely with the financial health of the primary debtor. The guarantor implicitly extends a contingent loan to the primary debtor in an amount equal to the present value of the guarantor’s right of indemnification.

The execution of a guarantee is thus the substantive equivalent of loaning cash or other property as security for another’s loan and warrants parallel tax treatment. To the guarantor, this means a basis equivalent to that derived from providing cash security for another’s loan. As to the primary debtor whose loan is guaranteed, the guarantee should likewise have no more nor less tax effect than if the security had been furnished by the guarantor in the form of cash.\(^2\)

Practical acknowledgement of the theoretical tax effects of a guarantee would entail the difficult, although not impossible, task of valuing the guarantor’s cost of providing security for the primary debtor’s loan. In economic terms, one indication of that cost may be the interest forgone by a third-party creditor on a loan to the primary debtor at lesser interest than would have been charged absent the security of the guarantee.\(^2\) If, for example, a third-party creditor were willing to loan to the primary debtor at a 12% rate if the loan were guaranteed, but at an 18% interest rate otherwise, that differential represents at least one creditor’s view of the value of the risk of nonpayment by the primary debtor. The present value of this differential offset by the present value of the guarantor’s right of indemnification and subrogation, would be one measure of the guarantor’s cost.\(^2\) These are speculative matters, to be sure, but arguably are capable of valuation just as are other contingent debts, particularly if the cost is measured from the vantage of the guarantor’s perspective as to the toll on her resources. Evidence exists that at least Treasury views valuation of guarantees as a feasible undertaking.\(^2\)

Developments in the partnership area demonstrate that a guarantee is more than a financing device, and potentially an ingredient of a transaction involving an acquisition of basis. The precise effect of a guarantee of partnership debts is, however, still controversial. In theory, a partner’s

\(^2\) See note 227 for an indication of the unusual circumstances in which execution of a guarantee might be construed as creating compensation, a dividend, or a gift.
\(^2\) See LTR 9113009 (Dec. 21, 1990).
\(^2\) Such a forgone charge is normally ignored by the tax law except to the extent that the provision of a below-market interest loan creates imputed income and costs under IRC § 7872.
\(^2\) See Notice 89-99, 1989-2 C.B. 422, which, at the end of the lengthy notice on implementation of the former version of IRC § 2036(c), indicates that a guarantee could be treated as a taxable transfer for purposes of estate taxation under circumstances in which “(4) amounts borrowed from persons other than the transferor are deemed to be acquired or received from the transferor to the extent the transferee’s repayment obligation is directly or indirectly guaranteed or collateralized by the transferor for less than full and adequate consideration in money or money’s worth. . . .” Id. at 434; accord LTR 9113009 (Dec. 21, 1990).
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A guarantee of a partnership debt represents a promissory obligation by the guarantor to make a contribution to the partnership in the future, which equals the present value of the guarantor's secondary liability on the debt less the present value of that guarantor's right of indemnification. As such, the guarantee warrants a correlative increased basis in the guarantor's partnership interest, but only to the extent that it imposes ultimate economic responsibility on the guarantor for that debt should the partnership fail to repay. For a recourse debt, the right of subrogation typically creates a claim by the guarantor against the partnership (and therefore proportionately against other general partners) that moderates the guarantor's ultimate cost and increased basis, unlike the guarantee of a nonrecourse debt. This is, in general, the scheme of the temporary regulations.

Where the authorities in the partnership area digress from economic theory is in not attempting to value the probability of the primary debtor's failure to pay, with the resulting misstatement of the present value of the undertaking by the guarantor and hence the cost. One such litigated case prompted a congressional mandate for Treasury to reconsider the regulatory provisions on the matter. This has led to the promulgation of temporary regulations with a new set of artificial assumptions and results that now attempt to determine who would bear the economic risk of loss in a worst case scenario of catastrophic events that leave the partnership without any assets with which to satisfy its liabilities, all of which have become due. These assumptions do not attempt to identify the true economic cost and present value of the guarantor's net obligation. The regulations do not take cognizance of principles of economic/opportunity cost that reflect probabilities of nonpayment and resulting present values. Whether the artificial approach of the regulations is preferable to an attempt to implement theories of economic cost or even some other artificial scheme has not been forthrightly addressed.

234 Because of the nonrecourse nature of the debt, depending upon the partnership agreement, conceivably the guarantor alone might be economically responsible for the debt in the event of nonpayment by the partnership. See Abramson v. Commissioner, 86 T.C. 360 (1986).
237 For criticism of this overvaluation under former regulations, on the grounds that the guarantee is not likely to have any practical effect in view of the financial health of the primary debtor, see Coven, note 6, at 53-57; Epstein, note 204, at 100, 106-07, 112.
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with the disquieting outcome that the artificial development of the law in
the partnership context continues subject to severe criticism.241

In the corporate area, prevailing doctrine builds on the economic fic-
tion that shareholder guarantees of corporate loans are costless transac-
tions.242 Not until out-of-pocket payments are made is the guarantor
treated as loaning to or investing funds in the debtor corporation,243 the
announced justification being that until that time no economic outlay has
occurred.244

Recent decisions and commentators245 have begun to question the
precedents that disclaim any economic outlay from the making of a guar-
antee, starting in 1985 with the widely noted (and appropriately titled)
Selfe v. United States.246 The trial court granted summary judgment for
the government against a shareholder who had guaranteed his S corpo-
ration’s debts. That guarantor deducted the corporation’s losses under
§ 1366(d), which permits this pass through treatment up to the basis of
stock or debt held by a shareholder of an S corporation. The Eleventh
Circuit reversed and remanded. It instructed the lower court to decide if
the loans from a third-party creditor that in form were made to the cor-
poration and guaranteed by the taxpayer-shareholder were in substance
loans for which the creditor looked primarily to the shareholder for re-
payment.247 If so, the implication was that the shareholder would have
been entitled to a pass through of losses in the amount of the third-party
loan,248 a result completely in accord with the thesis of this article that
the economic cost to the shareholder of primary responsibility for repay-

241 See, e.g., Abrams, note 148; Utz, Partnership Taxation, note 8, passim.
242 See generally, J. Eustice & J. Kuntz, note 44, at ¶ 10.03[2][i] & [m].
C.B. 319; Rev. Rul. 70-50, 1970-1 C.B. 178. See also Hunt v. Commissioner, 59 T.C.M.
(CCH) 635 (1990), espousing the distorted notion that a guarantee is not a true liability: “The
situation of a guarantor is not like that of a debtor who as a result of the original loan obtains
a nontaxable increase in assets. The guarantor obtains nothing except perhaps a taxable consid-
eration for his promise.” Id. at 649 (quoting Landreth v. Commissioner, 50 T.C. 803, 813
(1968)). Compare Rev. Rul 75-144, 1975-1 C.B. 277, treating a guarantor as incurring a cost
equal to the face value of a note given by the guarantor to a third-party lender to pay off a pre-
existing guarantee by the maker of that note. See generally, J. Eustice & J. Kuntz, note 44, at
¶ 10.03[2][i].
244 Brown, 706 F.2d at 756, and cases cited therein.
245 See August, “Selfe” Reflections: The Search for Basis for S Shareholder Guarantees of
Corporate Indebtedness, 3 J. Partnership Tax’n 260 (1986); Bogdanski, Shareholder Guarantee-
tes, Interest Deductions, and S Corporation Stock Basis: The Problems With Putnam, 13 J.
Corp. Tax’n 264 (1986); Powell, Will $ Shareholder Guarantees Ever Increase Basis?, 69 J.
Tax’n 12 (1988). But see August, Basis Traps Under Subchapter S: Competing in the Basis
an actual economic outlay by the shareholder.”
246 778 F.2d 769 (11th Cir. 1985).
247 Id. at 775.
248 Cf. Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir.), cert. denied, 409
ment of this loan should control. The even more noteworthy aspect of the case as it relates to the article's thesis is the court's suggestion of a pro-taxpayer outcome even if it were factually determined that the taxpayer had merely guaranteed the loan.

The novel theory put forward by the appellate decision is that "a guarantor who has pledged stock to secure a loan has experienced an economic outlay to the extent that the pledged stock is not available as collateral for other investments." This suggestion obviously resonates with notions of opportunity cost, even though economic cost of tying up collateral so that it cannot be pledged for other purposes, which is the focus of this quotation, as a practical matter adds little to the economic cost of giving one's own fully recourse promissory obligation/guarantee. Nonetheless, the observation of the court is a worthy addition to tax jurisprudence in acknowledging that the execution of a guarantee can produce a tax-established cost.

In a subsequent case, the Fourth Circuit expressly left open whether to endorse the suggestion in Selfe that a pass through of S corporate losses be permitted up to the value of the collateral furnished as a guarantee, and went on to conclude that the mere guarantee by a shareholder of an S corporation's debt does not warrant any pass through of the corporation's losses. The court acknowledged that the shareholder could have obtained basis by borrowing from an outsider and either contributing or loaning the borrowed proceeds to the S corporation. However, it upheld the finding of fact that the loan was made to the corporation rather than to the shareholder. It cited the shareholder's failure to report income when the corporation repaid the loan as a reason in support of its finding that the loan was not to the shareholder.

The court's analysis in Leavitt is right in holding the taxpayer to the form chosen for the transaction, but dubious in concluding that the chosen form produced no increase in basis to warrant a pass through of the S corporation's losses. For one thing, the conclusion depends on the court's refusal to attribute any economic cost to the guarantee itself, despite its likely significant value on the facts due to the primary debtor's insolvency.

249 See J. Eustice & J. Kuntz, note 44, at ¶ 10.03[2][i] and n.184, acknowledging this as a "plausible argument" in instances in which the creditor looks to the guarantor for repayment, yet noting that cases uniformly are to the contrary unless the loan is found to be to the shareholder directly from the third-party creditor rather than to the corporation.

250 Selfe, 778 F.2d at 772-73 n.7.


252 Id. at 422, 424, 427 n.19.

253 Id. at 423-24; see Don E. Williams Co. v. Commissioner, 429 U.S. 569 (1977).

254 Leavitt, 875 F.2d at 422.

255 Id. at 421.
Second, the analysis also falls short by assuming that although a corporate repayment of a shareholder's loan would be income to the shareholder, the same would not be true of relieving a shareholder's responsibility under a guarantee, thereby allegedly proving that the guarantor's nonentitlement to a pass through of corporate losses. This begs the question. If a guarantor had been permitted basis to reflect cost, as well as passed through corporate losses that reduced basis, then, upon the corporation's later repayment of the debt, the guarantor should have reportable income in an amount equal to the tax benefit enjoyed from the previously claimed (now cost-free) losses. Stated otherwise, the corporation's repayment would eliminate the guarantor's continuing obligation on the guarantee and accompanying right to a cost basis. Therefore, this would require the guarantor, whose basis had dropped from a pass through of corporate losses, to restore that reduced basis by an income inclusion.

C. Miscellaneous Tax Consequences of Guarantees

The preceding discussion is meant to demonstrate that, in theory, it is fallacious to adhere to the economic fiction that guarantees are costless to their makers. The execution of a guarantee should be conceded to be a meaningful economic event, albeit one that can create difficult valuation problems. If so recognized, and if a willingness to value accompanies the recognition, its implications would extend to several of the areas covered elsewhere in this article, and even beyond (for example, to estate and gift taxation, or the § 465 at risk rules).

As discussed above, one obvious consequence of acknowledging the economics of a guarantee for tax purposes is the potential pass through of S corporate losses to the guarantor. Under the statutory language,

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256 Id. at 424.
258 The result should be analogous to what would have been the outcome had cash been advanced as security for the primary debtor's loan, or had cash earlier been loaned to the corporation, justifying a pass through of losses up to the value of that cash advance. In those cases, the corporation's repayment of the guaranteed loan should cause income to the shareholder to the extent that the cash advance that produced an earlier pass through of losses (with a correlative reduction in basis) is now refunded to the guarantor. See Brown v. Commissioner, 42 T.C.M. (CCH) 1460 (1981), aff'd on other grounds, 706 F.2d 755 (6th Cir. 1983). The basis of debt may have already been restored by subsequent income pass through. IRC § 1366. In that case, income need not be reported on the corporation's repayment.
259 Recognition of a guarantee as generating basis could affect other matters mentioned earlier, such as taxability of partnership cash distributions or the basis of property distributed by a partnership.
260 But see Rev. Rul. 81-187, 1981-2 C.B. 167, refusing to allow a pass through of losses as a result of a shareholder's contribution of his own promissory note (until paid), on the theory...
only a shareholder can report a pass through of losses, and limited to the adjusted basis of the shareholder's stock and debt in the S corporation. Since a guarantee is a form of loan to the debtor (reflecting the guarantor's right of subrogation), it theoretically warrants an adjusted basis as a loan on which losses can pass through. Thereafter, if the corporation as primary debtor pays off the loan, and thereby eliminates the guarantor's conditional obligation as well as potential right of subrogation, this may or may not produce income to the guarantor depending upon whether there has been a pass through of losses attributable to the guarantee that resulted in a pro tanto reduction of the guarantor's basis.

If, instead, the corporation fails to pay its own loan, the guarantor on making payment on the guarantee should be entitled to a loss equal to the cash-equivalent basis remaining after earlier pass through of losses. This would produce parity with someone who had extended a cash loan to an S corporation that had generated a pass through of losses, and who thereafter made a supplementary payment on the guarantee upon the corporate debtor's failure to repay its loan.

By analogy, a partner's guarantee of partnership debts also should create a potential for a pass through of losses, although the calculation of the amount would be different from that for the S corporation shareholder. The reason is that partnership losses pass through only up to the basis of a partner's ownership interest in the partnership, whereas a shareholder of an S corporation can deduct losses up to the basis of that shareholder's stock as well as loans to the company. Since a guarantee represents a conditional loan from the guarantor to the primary debtor, any basis for that guarantee would warrant a concomitant pass through of an S corporation's losses. This is not so for a partner. Only if a guarantor-partner's right of subrogation and indemnification is deemed valueless does an increase in the basis of that partner's ownership interest occur, and then only to that extent can losses pass through. This obviously yields a smaller figure than the present value of the full right of

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261 See IRC § 1366(a). Therefore, as a planning matter, J. Eustice & J. Kuntz, note 44, at § 10.03[2][c], suggests that in order to preserve the opportunity for a loss pass through, a third-party creditor (who cannot claim a pass through on a loan to the corporation) ought to make the loan to a shareholder who can re-loan the funds to the corporation and thereby qualify for pass through of losses.

262 IRC § 1367(a).

263 See Brown v. Commissioner, 42 T.C.M. (CCH) 1460, aff'd on other grounds, 706 F.2d 755 (6th Cir. 1983); discussion in the text accompanying notes 257-58.


265 IRC § 704(d).

266 IRC § 1366(d)(1)(B).
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subrogation on which, in theory, a shareholder in an S corporation should have been entitled to claim a pass through of losses.

Third, in view of the present value of a guarantee and its cash equivalent cost basis to the guarantor, it is even possible that a guarantee might serve to reduce the gain otherwise due under § 357(c) should a guarantor have a controlled corporation assume or take subject to liabilities guaranteed by that shareholder. However, in theory a guarantee should be less effective in allaying gain on such a transfer than would be a contribution of a maker’s own promissory note or ongoing primary obligation. This is because a guarantee typically creates a right of indemnification against the debtor-corporation, effectively negating the presence of any net contributed basis to offset the liability taken over by the corporation. However, if all rights of subrogation and indemnity are waived, or are not of a value equal to the guarantor’s liability, the guarantee also represents an implicit contribution with a cash equivalent basis that should theoretically be offset against the liabilities taken over by the primary debtor.

Fourth, if a corporation that is serving as a guarantor becomes the subject of a takeover, its guarantee of another’s debt represents a contingent liability that comprises part of the buyer’s cost in acquiring the guarantor’s assets. In theory, therefore, the buyer ought to increase the basis of the acquired assets correspondingly, to reflect the cost of this contingent liability.

Fifth, the execution of a guarantee could represent a sufficient personal commitment by the guarantor to satisfy the at risk requirements of § 465, depending upon the improbability that the primary debtor will satisfy the debt. A guarantor who is deemed to bear some ultimate responsibility for the guaranteed debt should theoretically qualify as having a concomitant amount at risk.

Rigid adherence to the notion that contingent liabilities and guarantees are without value in the eyes of the tax law leads to a final fable:

In a very long-ago time, before the era of golden credit cards and women’s liberation, lived a young maiden named Guinevere and her twin brother Goliath. The twins were raised according to traditional values, each learning skills thought essential to fulfill their respective destinies. Goliath spent his

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267 See discussion in text at notes 99-116.

268 See text accompanying notes 38-47.

269 Abramson v. Commissioner, 86 T.C. 360 (1986). But see Prop. Reg. § 1.465-22(a) and Brand v. Commissioner, 81 T.C. 821 (1983), concluding that the presence of a right of subrogation precludes an at risk status by the guarantor. 81 T.C. at 828-29. Should this be so if the right of subrogation is of distinctly lesser value than the amount of the guarantor’s secondary liability?
days hunting and jousting, strengthening his body and competitive nature to befit him to become an able knight of the kingdom. Guinevere passed her time studying philosophy, psychology, history and logic, all the better to endow her with the wisdom that she would at minimum need for nurturing and raising a family.

When Guinevere and Goliath reached age 21, the good king, in accordance with the custom of the realm, summoned them to appear before him in order to bestow on each advance compensation for the good that they would thereafter contribute to the kingdom. He bade each twin to make a single choice: either select all that could be carried off from the table set before them, resplendent with sparkling jewels, bars of gold and coins of the realm, or, in lieu, select any other solitary item. Goliath had no difficulty in making his choice. He eagerly filled his husky arms with rich treasures from the table. At her turn, Guinevere softly said: “Good Sire. I am not strong enough to carry away much from your glorious table. I humbly ask that you grant me, as you offered, but one single item—my very own, inexhaustible guarantee that I might use forever after to assure my loved ones of all material goods whatsoever that they might ever desire.” The good king smiled and nodded approvingly at her wise choice. And as the tax collector approached to collect his due from each twin, the good king waved him away from Guinevere. After all, was her chosen compensation not simply a valueless guarantee, of nothing but contingent debts?

V. Conclusion

Encrusted with myth and erroneous concepts, the basic notion of economic cost has been relegated to near obscurity from its rightful role as the principal determinant in the measurement of a taxpayer's cost basis. The fault lies, in part, with misconceived early developments in the tax law, including faulty premises about enforceable personal commitments constituting costless transactions, and contingent debts being too difficult to value. The Supreme Court's early landmark opinion in Crane further compounded the problem, first, by not discussing cost principles per se (understandably since cost was not in issue before it), thereby implicitly leading later cases to replicate this approach even where cost was the central issue, and, second, by quotable passages in the opinion that when lifted out of context developed into popularized misinterpretations.
Analyses have also tended to evaluate transactions not for what they are, but for what they are not. True, one's own promissory note or guarantee of another's debt is not the same as a third-party loan; a nonrecourse debt is not a personal obligation, nor a contingent debt equivalent to an unconditional obligation. Yet, all are events of economic significance. They need not be identical to warrant consistent tax treatment. Inapt comparisons and labels of sham only tend to obfuscate.

Finally, perpetuation of erroneous doctrine on the relationship of liabilities to cost basis artificially deters certain productive straightforward economic activity, instead inspiring contrived schemes to achieve by circumlocution what should have been allowed directly,\(^\text{270}\) with rewards only for complexity, wasteful transaction costs and the coffers of tax planners. Simplification is only one of the desirable goals promised by a return to first principles on cost.

\(^{270}\) See authorities cited at notes 62-66, 261; see also J. Eustice & J. Kuntz, note 44, at ¶ 15.02(7); Megaard, No Stock Basis for Shareholder Guarantee of S Corporation Debt: Tax Court Elevates Form Over Substance in Leavitt, 15 J. Corp. Tax'n 340, 349-52 (1989); and Powell, note 245, at 12, 13-16, for suggestions on how to secure a pass through of an S corporation's losses despite the refusal of courts to take account of a shareholder's guarantee or promissory note.