CRANE'S FOOTNOTE THIRTY-SEVEN GETS THE BOOT

INTRODUCTION

Without question one of the most persistent problems in tax law involves the determination of the character of a transaction. Even though a taxpayer has not so much as placed a "for sale" sign on his property, a gift or abandonment of the property may be deemed a sale for income tax purposes.[1] When a taxpayer incurs a loss, sale classification can be disastrous because the taxpayer may be denied the added benefits of ordinary loss treatment.[2]

The abandonment versus sale problem revealed itself in *Freeland v. Commissioner.*[3] In *Freeland* the Tax Court held that the voluntary return of devalued nonrecourse property to a mortgagee was essentially equivalent to a sale.[4] The decision reversed caselaw dating to the 1940's, relying on the oft-cited *Crane v. Commissioner*,[5] and rejected the taxpayers' plea that *Crane*'s footnote 37 provided an exception to sale classification.[6] This comment will attempt to aid the tax practitioner by explaining the basis for the Tax Court's decision in *Freeland* and clarifying a narrow yet confusing area of tax law.

THE BEGINNING OF THE END: *CRANE V. COMMISSIONER*

Perhaps more than any tax decision since the ratification of the sixteenth amendment, the *Crane* case has earned a reputation as an unending source of law review commentary, tax law debate, and judicial ulcers. *Crane*'s notoriety is derived not only from the judicially determined fate of poor widow Crane, but also from the very questions raised by the court that was supposed to answer them.[7] In the course of espousing the doctrine that the amount realized upon the sale of property includes the nonrecourse liability to which the property is subject,[8] the Supreme Court opened the proverbial Pandora's box by giving birth to the infamous footnote 37.[9]

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1 *E.g.*, Freeland v. Commissioner, 74 T.C. 970 (1980); Rev. Rul. 70-626, 1970-2 C.B. 158.

2 I.R.C. §§ 1211, 1222.

3 74 T.C. 970 (1980).

4 *Id.* at 982.

5 331 U.S. 1 (1947).

6 74 T.C. at 981-82.

7 *Id.* at 975.

8 331 U.S. at 14.

9 *Id.* at 14 n.37. Professor Bittker recognizes note 37 as "the most famous footnote in tax history." Bittker, *Tax Shelters, Non Recourse Debt, and the* Crane *Case*, 33 TAX L. REV. 277, 277 (1978). In its entirety, note 37 reads as follows:

Although the ramifications of *Crane* and footnote 37 may at times appear muddled, the pertinent facts giving rise to the controversy are clear. When Mr. Crane died in 1932, he left to his wife an apartment building and lot subject to a principal mortgage of $255,000 and interest in arrears.[10] Mrs. Crane held the property for seven years during which time she claimed depreciation deductions on the apartment building totaling $28,045.10, effectively adjusting the basis of the building to $178,997.40.[11] When Mrs. Crane sold the property for $2,500 subject to the unassumed mortgage, she reported only the cash received as capital gain.[12] Mrs. Crane failed to give effect to the transfer of the mortgage, reasoning that she sold in 1938 that which she had acquired in 1932—the equity in her husband's property.[13]

The Commissioner disputed Mrs. Crane's computations.[14] He maintained that Mrs. Crane's taxable gain amounted to $23,767.03, and argued that the property which she possessed was the tangible property and not simply the equity.[15] Treating the sale of the land and the building as separate transactions, the Commissioner computed Mrs. Crane's gain on the sale of the building by subtracting the adjusted basis of the property from the sum of the principal amount of the mortgage and the cash received, less the amount of the selling price allocable to the land.[16] The Commissioner determined that the

> Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.

331 U.S. at 14 n.37.

[10] 331 U.S. at 3. The unpaid interest amounted to $7,042.50.

[11] *Id.* at 3-4. The appraised value of the property in 1932 was $262,042.50, with $55,000 allocable to land. The remaining amount of $207,045.50 was allocated to the building. For the actual calculations, see note 16 *infra*.

[12] 331 U.S. at 3. Mrs. Crane treated the transaction as a sale of a capital asset pursuant to Int. Rev. Code of 1939, ch. 289, § 117(a)-(b), 52 Stat. 447 (currently I.R.C. § 1221). Accordingly, she reported only 50% of the realized gain as taxable income. 331 U.S. at 3-4.

[13] 331 U.S. at 3. Mrs. Crane contended that the equity had a zero basis. *Id.* at 3-4. The Court noted, however, that Mrs. Crane's claim that she owned only the equity in the property was manifestly inconsistent with her depreciation of the property, since anything containing a zero basis cannot be depreciated. *Id.* at 3 n.2.

[14] *Id.* at 4.

[15] *Id.*

[16] *Id.* The computations are as follows:

207,042.50	original basis of building
− 28,045.10	depreciation
178,997.40	adjusted basis of building

[(mortgage + boot = $257,500) − ($54,471.15 sale price of land)] − [$178,997.40 adjusted basis] = ordinary gain of $24,031.45.

building was not a capital asset, thus the gain realized on the sale of the building was ordinary income.[17] By including the value of the mortgage debt in the amount realized, the Commissioner reasoned that Mrs. Crane sustained an ordinary gain of $24,031.45 on the sale of the building.[18] In addition, he determined that Mrs. Crane realized a loss of $528.85 with respect to the sale of the land, 50 percent of which was recognizable as a capital loss because the land was characterized as a capital asset.[19]

The rest is history. The Supreme Court determined that Mrs. Crane inherited not merely the equity in the property, but "the land and buildings themselves, or the owner's legal rights in them, undiminished by the mortgage."[20] Accordingly, the Court concluded that the unadjusted basis of the property was the 1932 appraised value of $262,042.50.[21] Finding that the apartment building was property subject to adjustment for exhaustion and wear and tear, the Court also agreed with the Commissioner that depreciation deductions allowed during the seven years Mrs. Crane held the property reduced its adjusted basis to $178,997.40 at the time of sale.[22]

Addressing the problem that made the *Crane* decision famous, the Court held that the amount realized by Mrs. Crane included not only the $2,500 cash received on the sale, but also the amount of the nonrecourse mortgage to which the property was subject.[23] Noting first that the property sold by Mrs. Crane must have been the same property she inherited in 1932, the Court termed absurd Mrs. Crane's claim that she realized only $2,500 on the sale of property worth one hundred times that value.[24] Recognizing "the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations," the Court determined that

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[17] *Id.* at 5.

[18] *Id.*

[19] *Id.* In an order expunging a deficiency assessed against Mrs. Crane, the Tax Court found principally for the taxpayer, concurring with the Commissioner only with respect to the non-capital nature of the building. *Id.* On appeal by the Commissioner, the Court of Appeals for the Second Circuit reversed after considering the merit of the Tax Court's decision that Mrs. Crane was taxable only on the $2,500 she received when she sold the property. Commissioner v. Crane, 153 F.2d 504, 505 (2d Cir. 1945), *cert. granted*, 331 U.S. 1 (1947).

[20] 331 U.S. at 6.

[21] *Id.* at 11. The Court supported its conclusion by differentiating between the definitions of "property" and "equity," and by determining that an equity basis would be inconsistent with principles of tax depreciation. *Id.* at 8-11.

[22] *Id.* at 11.

[23] *See id.* at 14.

[24] *Id.* at 12-13. Since the Court had already rejected Mrs. Crane's contention that what she inherited was merely the equity in the property, it would have been anomalous for the Court to accept her argument that she sold only the equity in the property. *See id.* at 13.

upon the sale of property, an owner realizes an economic benefit equal to the sum of the mortgage and additional consideration or boot paid.[25]

Although the Court's position is consistent with tax law's fondness for symmetry, the means chosen to reach the end has been the subject of repeated criticism and debate.[26] More than one commentator has viewed the Court's economic benefit rationale as extraneous to the decision,[27] particularly in light of the Court's admission that the real issue in the case was "whether the law permits [Mrs. Crane] to exclude allowable deductions from consideration in computing gain."[28] Applied in the context of a sale in which the fair market value of property sold has fallen below the value of its nonrecourse mortgage, the economic benefit theory yields confusing results.[29] It is difficult to conceive of a taxpayer benefiting from a discharge of liability when no personal liability ever existed.[30]

Without addressing the issue specifically, in footnote 37 the *Crane* Court acknowledged a potential problem in situations where property is abandoned or disposed of subject to a mortgage and without boot.[31] In its celebrated but puzzling footnote, the Court recognized that a seller of nonrecourse property "cannot realize a benefit equal to the mortgage" if the mortgage debt is greater than the property's fair market value.[32] Whether this observation was intended as a general exception to the *Crane* rule or merely intended as a demonstration of the Court's understanding of *Crane*'s far-reaching ramifications cannot be gleaned from the opinion. It is clear, however, that *Crane* opened as many doors as it closed, leading the way for endless judicial and scholarly speculation.

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[25] *Id.* at 14.

[26] *See, e.g.*, Adams, *Exploring the Outer Boundaries of the* Crane *Doctrine: An Imaginary Supreme Court Opinion*, 21 TAX L. REV. 159 (1966); Bittker, *supra* note 9; DelCotto, *Basis and Amount Realized Under* Crane: *A Current View of Some Tax Effects in Mortgage Financing*, 118 U. PA. L. REV. 69 (1969).

[27] *See* Bittker, *supra* note 9, at 284; DelCotto, *supra* note 26, at 84-85. Professors Bittker and DelCotto, while agreeing with *Crane's* result, have separately attacked the economic benefit theory set out by the Court. Both have suggested that the quandary created by *Crane's* reliance on a taxpayer's receipt of an economic benefit upon the disposition of property could be resolved by replacing the economic benefit theory with one based entirely on tax benefit principles. Bittker, *supra* note 9, at 284; DelCotto, *supra* note 26, at 85. *See also* Adams, *supra* note 26, at 169-70.

[28] 331 U.S. at 15.

[29] *See* Bittker, *supra* note 9, at 282, 284; DelCotto, *supra* note 26, at 85.

[30] Bittker, *supra* note 9, at 284.

[31] *See* note 9 *supra*.

[32] *Id.*

THE REALIZATION PROBLEM

While some have viewed footnote 37 as a last chance escape from the iron-fisted grasp of the *Crane* rule, others see it as little more than dictum.[33] When the fair market value of property falls below that of its nonrecourse mortgage, the problem of whether the amount realized from a sale or other disposition includes the full value of the debt, or as hinted at by footnote 37, merely the value of the land, has never been resolved by the Supreme Court. The Treasury Department and the Tax Court, however, have quietly ended much of the debate by dismissing taxpayers' footnote 37-styled arguments.[34]

The Service's concern that footnote 37 not be made an exception to the *Crane* rule is understandable. Footnote 37, read literally, would provide a two-fold opportunity for taxpayer windfall.[35] If the amount realized by a taxpayer selling or disposing of depreciable property subject to a nonrecourse mortgage were limited to the value of the property, the taxpayer could enjoy the benefit of a tax loss when the property value falls below the face amount of the mortgage, irrespective of prior depreciation deductions.[36] A comparable situation develops if a taxpayer is entitled to deduct losses incurred through ownership of the property.[37] Both situations permit a taxpayer to include the mortgage in the property's basis and take depreciation or loss deductions on the mortgaged property, while never requiring the taxpayer to include those deductions in income.[38]

Similar taxpayer windfall will result when the taxpayer is allowed to borrow cash against appreciated property by increasing the face value of his nonrecourse mortgage debt.[39] If the property's market value should reverse its upward climb and fall below the value of the mortgage, application of footnote 37, upon the transfer of the property subject to the outstanding mortgage, would permit the taxpayer to avoid ever paying tax on the borrowed cash.[40] In either case of taxpayer windfall, if the property's mortgage is greater than its adjusted basis, the taxpayer has profited from the property's devalua-

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[33] *Compare* Cleveland, *Foreclosure abandonment and settlement: the tax effects on mortgagors*, THE TAX ADVISOR, Feb. 1978, at 70 *with* Woodsam Assocs., Inc. v. Commissioner, 16 T.C. 649, 655 (1951), *aff'd*, 198 F.2d 357 (2d Cir. 1952).

[34] *See* Millar v. Commissioner, 577 F.2d 212 (3d Cir. 1978); Estate of Delman v. Commissioner, 73 T.C. 15 (1979); Rev. Rul. 76-111, 1976-1 C.B. 214; Treas. Reg. § 1.1001-2 (1981).

[35] *See* Bittker, *supra* note 9, at 284.

[36] *Id.*

[37] *Id.*

[38] *Id.*

[39] *Id.*

[40] *Id.*

tion by indefinitely postponing recognition of accrued economic gain.[41]

Thus, while footnote 37 made sense in the context of *Crane's* economic benefit theory,[42] its application as a general exception to the *Crane* rule creates obvious problems.[43] Recognizing the possible ramifications of footnote 37, the Internal Revenue Service treated the problem by avoiding it. The Commissioner took the position that in transfers where the value of property is below that of its nonrecourse mortgage the amount realized nevertheless includes the full amount of outstanding debt attached to the property.[44] The Service's position was not without some support. In *Woodsam Associates, Inc. v. Commissioner*,[45] the Tax Court questioned the validity of the *Crane* footnote by referring to it as dictum, though the Court concluded that footnote 37 did not apply to the situation before it.[46]

Twenty years after the Tax Court's cursory reference to footnote 37 in *Woodsam Associates*, the judiciary has finally elevated the Service's position to something more than an opinion.[47] In *Millar v. Commissioner*,[48] the Court of Appeals for the Third Circuit rejected

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[41] *See generally id.*

[42] 331 U.S. at 14.

[43] Bittker, *supra* note 9, at 283-84.

[44] *See* Rev. Rul. 76-111, 1976-1 C.B. 214. In Revenue Ruling 76-111 the Service commented on the federal income tax consequences of a buyer's transfer of cattle to a seller in return for cancellation of debt owed to the seller. Even though the value of the herds had fallen below that of the amount owed to the seller, the Service concluded that:

> Whatever inference may be drawn from footnote 37 in the *Crane* case, the unpaid balance on the sales contracts, which indebtedness was cancelled upon the transfer of the herds . . . is the amount realized by the taxpayers on such sales . . . regardless of the fair market value of the herds at the time of their return to the seller.

Id.

[45] 16 T.C. 649 (1951), *aff'd*, 198 F.2d 357 (2d Cir. 1952).

[46] *Id.* at 655.

[47] *See* Estate of Delman v. Commissioner, 73 T.C. 15 (1979). *See also* Millar v. Commissioner, 67 T.C. 656 (1977), *aff'd*, 577 F.2d 212 (3d Cir. 1978); Tufts v. Commissioner, 70 T.C. 756 (1978); Treas. Reg. § 1.1001-2 (1981). Prior to the Treasury Department's promulgation of § 1.1001-2 and the Tax Court's decisions in *Estate of Delman*, *Millar*, and *Tufts* it was still feasible for taxpayers to rely on footnote 37 as a justification for using fair market value rather than the outstanding amount of nonrecourse debt as a measure of the taxpayer's amount realized when the taxpayer transferred the property subject to the mortgage without additional consideration. *See* Cleveland, *supra* note 33, at 70. Although the Service's long standing position has been that the amount realized from a sale or disposition always includes the full amount of debt attached to the property, *see* Rev. Rul. 76-111, 1976-1 C.B. 214; note 44 *supra*, revenue rulings are not authoritative. The Treasury Regulations point out that "Revenue Rulings . . . do not have the force and effect of Treasury Department Regulations . . . but are published to provide precedents to be used in the disposition of other cases, and may be cited and relied upon for that purpose." Treas. Reg. § 601.601(d)(2)(v)(d) (1981).

[48] 577 F.2d 212 (3d Cir. 1978).

the taxpayers' reliance on footnote 37.[49] In that case the taxpayers' nonrecourse obligations were secured by stock in a Subchapter S corporation.[50] They argued that upon foreclosure and surrender of the stock in exchange for cancellation of the indebtedness, their amount realized was limited to the value of the stock.[51] The taxpayers reasoned that because the amount of the debt was greater than the value of the stock pledged against it, footnote 37 shielded them from realization of gain on the transaction.[52]

Affirming the decision of the Tax Court,[53] the Court of Appeals for the Third Circuit found that footnote 37 failed to provide taxpayers with their hoped-for exception to the *Crane* rule.[54] The court looked to the rationale of *Crane* for support, determining that the Commissioner's calculation of taxpayers' gain was consistent with the primary motivation underlying *Crane*.[55] Since the taxpayers were permitted to include the loans in the basis of their stock for purposes of deducting losses and expenses, the court recognized that it would be incongruous for the taxpayers to exclude the amount of the loans from their amount realized.[56] Furthermore, while the court acknowledged that the taxpayers had indeed presented a footnote 37 situation, it refused to perceive the footnote as anything more than a "hypothetical observation" lacking the authority or color of law.[57]

The court was once again challenged by the dilemma of footnote 37 in *Tufts v. Commissioner*.[58] Battling from his familiar corner of

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[49] *Id.* at 215-16.

[50] Millar v. Commissioner, 67 T.C. 656, 657 (1977).

[51] 577 F.2d at 214.

[52] *Id.* The basis of the stock, which was zero, was increased by the amount of the loans borrowed by the taxpayers and subsequently contributed as capital in the corporation, resulting in a basis of $245,000 for the taxpayers' stock. *Id.* at 215. The basis of the stock was further adjusted by net operating losses and deductions claimed by the taxpayers, consequently establishing $39,492 as the stock's final adjusted basis. *Id.* The Commissioner calculated a gain of $205,508 by treating the total outstanding nonrecourse debt as the amount realized and subtracted from it the adjusted basis of the stock. *Id. See* I.R.C. § 1001. Taxpayers, conversely, claimed they realized no gain because the value of the stock was less than the amount of debt outstanding. 577 F.2d at 214.

[53] Millar v. Commissioner, 67 T.C. 656 (1977), *aff'd*, 577 F.2d 212 (3d Cir. 1978). The court of appeals affirmed the Tax Court's decision on all points except for the Tax Court's imposition of a penalty for failure to recapture investment credits. 577 F.2d at 216.

[54] 577 F.2d at 215-16.

[55] *Id.* at 215.

[56] *Id.*

[57] *Id.*

[58] 70 T.C. 756 (1978). *Tufts* involved the sale of taxpayers' interests in a partnership which owned a Texas apartment complex. *Id.* at 757-58, 761. At the time of sale the apartment complex was valued at $1,400,000 although it was subject to liabilities of $1,851,500. The contributed capital totaled $44,212. *Id.* at 761. In addition, from 1970 through 1972 the individual partners had reported depreciation expenses and ordinary losses in connection with partnership assets totaling $439,972, effectively resulting in the partnership having an adjusted basis of $1,455,740 when sold. *Id.* at 762.

the ring, the Commissioner argued that upon the sale of partnership interests the amount realized by the taxpayers included partnership nonrecourse liability, the fair market value of the property sold being inconsequential.[59] The taxpayers relied on *Crane* and footnote 37, maintaining that no economic benefit accrues beyond the fair market value of the property sold.[60] In its decision the court avoided the catch-22 presented by the economic benefit analysis of *Crane* by emphasizing the taxpayers' prior realization of tax benefits through loss deductions connected with the property.[61] The court observed that but for the taxpayers' inclusion of the loans in the partnership basis, the taxpayers would not have been entitled to most of the claimed deductions since their distributive shares of partnership losses were confined to the adjusted basis of their interest in the partnership.[62] Consequently, the court held that the amount realized by the taxpayers included the full amount of the nonrecourse liability to which the partnership interests were subject regardless of the interests' fair market value.[63]

Recently adopted treasury regulations in accord with the decisions in *Millar* and *Tufts* have undoubtedly buried the dispute concerning the amount realized in a footnote 37 situation.[64] Consistent with the Service's long standing position, the regulations state simply that the fair market value of property has no effect on the amount realized from a sale or disposition.[65] By noting that the rule prevails even where the fair market value of property is less than the debt it secures, the regulations have effectively eliminated the footnote 37 defense in the context of realization.[66] Although one might have presumed that the saga of footnote 37 had come to an abrupt and

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[59] *Id.* at 763.

[60] *Id.* at 764.

[61] *Id.* at 765. *See also* notes 28 & 30 *supra*.

[62] 70 T.C. at 769-70. I.R.C. § 704(d) provides that "[a] partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred."

[63] 70 T.C. at 770. The decisions in *Millar* and *Tufts* were followed by the Tax Court in Estate of Delman v. Commissioner, 73 T.C. 15, 29 (1979). In *Delman* the court rejected the taxpayers' contention that footnote 37 shielded the taxpayers from realizing gain from the repossession of equipment subject to nonrecourse liabilities. *Id.* at 28-29. The taxpayers argued that footnote 37 applied because the fair market value of the repossessed equipment was less than the amount of the outstanding nonrecourse debt. *Id.* The court found, however, that the rationales of *Millar* and *Tufts* applied and held that the amount realized from the repossession of the equipment included the full amount of nonrecourse indebtedness. *Id.* at 30.

[64] Treas. Reg. § 1.1001-2(a)-(b) (1981).

[65] *Id.* § 1.1001-2(b).

[66] *Id.*

timely halt, it did not end here. The Commissioner would have to enter the ring once more to erase the spindly aftermath of a few fleeting comments uttered by the Court in 1947.[67]

SALE OR EXCHANGE CLASSIFICATION AND THE DEMISE OF THE FOOTNOTE 37 DEFENSE

A taxpayer transferring property to a mortgagee or a third party in order to avoid liability must take into account not only his amount realized, but also whether the transaction is a sale or exchange.[68] If the taxpayer experiences gain on the transfer he will naturally be eager to classify the conveyance as a sale or exchange.[69] In a footnote 37 situation in which the value of nondepreciable property has dropped below the amount of its outstanding nonrecourse mortgage, the taxpayer will frequently incur a loss since the devaluation of the property is the very reason for disposing of it.[70] Sale or exchange classification in that case is obviously undesirable.[71]

When the *Crane* Court decided that Mrs. Crane's amount realized included the value of the outstanding nonrecourse mortgage covering her property, sale or exchange was not at issue because it was clear that Mrs. Crane has received additional consideration for the property which had been sold subject to the mortgage.[72] Consequently, when the Court observed in footnote 37 that it might have confronted an entirely different situation had Mrs. Crane abandoned or transferred her property without receiving boot, the Court spoke primarily in the context of determining Mrs. Crane's amount realized.[73] In the years following *Crane*, commentators mused over *Crane*'s effect on sale or exchange[74] because it remained unclear whether the *Crane* rule also provided a basis for sale or exchange classification, particularly in footnote 37 situations in which property was abandoned or transferred without boot.[75] *Tufts*, *Millar*, and

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[67] *See* Freeland v. Commissioner, 74 T.C. 970 (1980).

[68] *See* I.R.C. §§ 1202, 1211, 1222.

[69] *Id.* § 1202.

[70] *Cf.* [1977] TAX MNGM'T (BNA) A-9 (result similar to that of foreclosure sale; taxpayers abandoning or transferring property without consideration do so because property cannot be sold profitably). *See also* Freeland v. Commissioner, 74 T.C. 970 (1980); Jamison v. Commissioner, 8 T.C. 173 (1947).

[71] *See* I.R.C. § 1211.

[72] 331 U.S. at 3; 74 T.C. at 978.

[73] 74 T.C. at 978.

[74] *E.g.*, Ginsburg, *The Leaky Tax Shelter*, 53 TAXES 719, 733 (1975). "In light of the *Crane* decision . . . it is fair to question whether the voluntary conveyance of encumbered property escapes sale or exchange characterization." *Id.*

[75] *Compare* Pratt & Oestreich, *The Voluntary Transfer of Real Estate to Creditors: Is It Treated Like "Abandonment" or Foreclosure?*, 57 TAXES 293, 296, 300 (1979) *with* Cleveland, *Voluntary Conveyances: Sales or Exchanges?*, 57 TAXES 287, 291, 292 (1979).

recently promulgated Treasury Regulations ended the debate about whether footnote 37 provided a general exception to *Crane*'s realization rule.[76] Additional clarification of the *Crane* doctrine was required, however, to determine whether the rationale of *Crane* provided the consideration needed to classify a transaction as a sale or exchange, and whether footnote 37 would provide a general exception to such a finding.[77]

*A. Pre-*Crane *Decisions*

Prior to its decision in *Crane,* the Supreme Court held in *Helvering v. Hammel*[78] that a loss sustained from the foreclosure of property was a capital loss.[79] In *Hammel* and its companion case *Electro-Chemical Co. v. Commissioner,*[80] the Court refused to acknowledge any distinction between a voluntary and involuntary sale.[81] Recognizing that it was not Congress' intention to allow a deduction in full for losses sustained upon a foreclosure sale while permitting only partial taxation of gains similarly incurred,[82] the Court concluded that losses resulting from involuntary foreclosure were subject to sale or exchange classification.[83] Shortly thereafter the Court in *Helvering v. Nebraska Bridge Supply & Lumber Co.,*[84] extended the *Hammel* rationale to a forced tax sale[85] even though the taxpayer bore no personal liability for the delinquent taxes and received no consideration in return.[86]

During the period preceding *Crane* in which the Supreme Court decided *Hammel* and *Nebraska Bridge,* the Board of Tax Appeals and later the Tax Court decided a series of cases holding that losses sustained from the abandonment or voluntary transfer of property subject to nonrecourse debt were deductible in full from ordinary in-

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[76] Millar, 577 F.2d at 215-16; Tufts, 70 T.C. at 770; Treas. Reg. § 1.1001-2(a)-(b).

[77] 74 T.C. at 978.

[78] 311 U.S. 504 (1941).

[79] *Id.* at 512.

[80] 311 U.S. 513 (1941).

[81] 311 U.S. at 508.

[82] *Id.* at 509.

[83] *Id.* at 511.

[84] 312 U.S. 666 (1941) (per curiam).

[85] *Id.* at 667.

[86] *See* Helvering v. Nebraska Bridge Supply & Lumber Co., 115 F.2d 288, 291 (8th Cir. 1940), *rev'd per curiam,* 312 U.S. 666 (1941). The Court of Appeals for the Eighth Circuit held there was no sale or exchange. *Id.* at 290. The taxpayer neither received consideration nor was relieved of an indebtedness since under Arkansas law property owners were not personally liable for property taxes. *Id.* In reversing the decision of the court of appeals, the Supreme Court cited *Hammel* and *Electro-Chemical.* 312 U.S. at 667.

come.[87] As long as the taxpayer received no consideration upon the transfer of the property, the taxpayer succeeded in avoiding sale or exchange classification which would surely have followed had the taxpayer waited for foreclosure of his property.[88] In *Jamison v. Commissioner*,[89] a case which exemplifies the sentiments of the Tax Court during that time, the Commissioner tenaciously argued that such transfers were essentially equivalent to the foreclosure sale of *Hammel*.[90] The Tax Court differed with the Commissioner, however, distinguishing *Hammel* and holding that the taxpayer incurred ordinary rather than capital losses.[91]

In *Jamison*, the taxpayer transferred property subject to outstanding nonrecourse liability to the appropriate taxing authorities because he no longer believed the property to be worth the taxes.[92] The conveyances were voluntarily made and the taxpayer accepted no consideration.[93] Cognizant of differences between the facts in *Hammel* and the instant case, the *Jamison* court observed that while in *Hammel* title passed by means of a forced foreclosure sale, in *Jamison* title was voluntarily passed.[94] In addition, the actual occurrence of a sale, which the Supreme Court found to be critical in *Hammel*, was missing in *Jamison*.[95]

Once the *Jamison* court distinguished *Hammel*, it was free to rely on the precept, first established by the Board of Tax Appeals in *Commonwealth, Inc. v. Commissioner*[96] and followed thereafter by various circuit courts,[97] that losses sustained from the voluntary conveyance of property were deductible in full from ordinary income.[98] Citing *Commonwealth*, the Tax Court concluded that since the owners of the property were not personally liable for the indebtedness

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[87] Jamison v. Commissioner, 8 T.C. 173, 181 (1947); Lapsley v. Commissioner, 44 B.T.A. 1105, 1110 (1941); Baird v. Commissioner, 42 B.T.A. 970, 976 (1940); Commonwealth, Inc. v. Commissioner, 36 B.T.A. 850, 853 (1937). *Accord*, Stokes v. Commssioner, 124 F.2d 335, 338 (3d Cir. 1941).

[88] Jamison v. Commissioner, 8 T.C. 173, 177 (1947).

[89] 8 T.C. 173 (1947).

[90] *Id.* at 176, 181. In *Jamison* the court traced the development of the sale or exchange exception in the context of abandonment and effectively contrasted abandonment with foreclosure. *Id.* at 176-81. As a result, the decision has been often cited by both courts and commentators when discussing the "voluntary conveyance v. sale or exchange" issue. *E.g.*, Fox v. Commissioner, 61 T.C. 704, 715 n.7 (1974); Cleveland, *supra* note 75, at 291.

[91] 8 T.C. at 177.

[92] *Id.* at 174-75.

[93] *Id.*

[94] *Id.* at 176-77.

[95] *See id.* at 177.

[96] 36 B.T.A. 850 (1937).

[97] *E.g.*, Stokes v. Commissioner, 124 F.2d 335 (3d Cir. 1941).

[98] 8 T.C. at 178-81.

and the properties were not exchanged for a dollar value, the transactions were without consideration.[99] The failure of consideration precluded a finding that the voluntary conveyance of the property constituted a sale or exchange.[100] Accordingly, the court held that the taxpayer sustained ordinary losses upon the transfer of property.[101]

The determination in *Jamison* was relied upon by the Tax Court as recently as 1974,[102] but its precedential value has often been questioned in the wake of *Crane*.[103] Since *Crane* held that the taxpayer's amount realized included the value of nonrecourse liabilities attached to the property, critics have argued that it would be inconsonant not to treat that same amount as consideration for purposes of determining sale or exchange.[104] While the Internal Revenue Service and commentators took the position that *Crane* had vitiated the authority of *Jamison*,[105] the Tax Court stood patiently in the wings, waiting perhaps for the resolution of footnote 37's validity.[106]

The sale or exchange issue ordinarily surfaces when the taxpayer experiences a loss upon the disposition of property subject to nonrecourse debt, which incidentally is also the setting of a footnote 37 problem.[107] Had the Tax Court reevaluated the *Jamison* issue prior to its decisions in *Millar* and *Tufts*, the court would have been placed in the precarious position of also having to decide whether footnote 37

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[99] *Id.* at 177.

[100] *Id.*

[101] *Id.* at 181.

[102] Fox v. Commissioner, 61 T.C. 704, 715 n.7 (1974).

[103] Lenway v. Commissioner, 69 T.C. 620, 628 n.9 (1978). "It is arguable whether these cases continue to have their original vitality in light of the subsequent decision of the Supreme Court in *Crane v. Commissioner*. . . ." *Id.* (citation omitted). *See* Ginsburg, *supra* note 74.

[104] Lenway v. Commissioner, 69 T.C. 620, 637 (1978) (Fay, J., dissenting). *See* Pratt & Oestreich, *supra* note 75, at 296.

[105] *See* Pratt & Oestreich, *supra* note 75, at 296. *See also* Rev. Rul. 78-164, 1978-1 C.B. 264; Rev. Rul. 76-111, 1976-1 C.B. 214. Although in two Revenue Rulings the Internal Revenue Service failed to specifically mention *Jamison*, Rev. Rul. 78-164, 1978-1 C.B. 264; Rev. Rul. 76-111, 1976-1 C.B. 214, the Service analyzed the sale or exchange issue in the aftermath of *Crane*, noting that "[i]t is well established that, for Federal income tax purposes, the transfer of assets in consideration of a cancellation of indebtedness is equivalent to a sale upon which gain or loss is recognized." *Id.* at 215.

The Service concluded that when a taxpayer purchased cattle herds and remained indebted to the seller for the balance of the purchase price only to the extent of the value of the herds pledged as security, the voluntary return of the herds to the seller constituted a sale. *Id.* at 214-15. The Service gave no credence to the possibility that *Crane's* footnote 37 created exceptions where the value of the security transferred was less than the debt owed, nor did the Service acknowledge case law which was directly contra to the Service's ruling. *Id.*

[106] Although *Crane* was decided in 1947, the sale or exchange debate was not resolved until the Tax Court decided *Freeland*.

[107] *E.g.*, Stokes v. Commissioner, 124 F.2d 335 (3d Cir. 1941); Freeland v. Commissioner, 74 T.C. 970 (1980); Jamison v. Commissioner, 8 T.C. 173 (1947).

provided an exception to the *Crane* rule, and as a result, created an exception to a finding of sale or exchange in a *Jamison* situation.

No doubt when the Tax Court in *Freeland* reexamined the *Jamison* issue in light of *Crane, Millar,* and *Tufts,* its task was eased by the prior judicial resolution that the amount realized upon the disposition of property included the value of nonrecourse debt to which the property was subject, regardless of the property's fair market value.[108] At the same time, while the Commissioner discounted the footnote 37 defense,[109] *Crane* and its famous footnote had yet to be tested in the context of a judicial determination of the character of a transaction and case law weighed in the taxpayer's favor.[110]

B. Freeland v. Commissioner: *Resolution of the Sale or Exchange Dilemma*

Freeland resolved the last of a succession of problems innocently created by the Supreme Court in 1947.[111] In 1968 taxpayers Eugene and Mary Freeland purchased unimproved land in California for $50,000, making a downpayment of $9,000 and providing for the balance with a note ensured by a purchase money deed of trust.[112] By 1975, however, the value of the land had dropped to $27,000 while the outstanding balance on the note remained $41,000.[113] For all practical purposes the taxpayers considered the property worthless, thus they conveyed the land to the seller.[114] The taxpayers received no consideration for the transfer and at that time a foreclosure sale was not pending.[115] Eugene and Mary Freeland reported an ordinary loss in connection with the transfer of the property on their 1975 federal income tax return. The Commissioner disputed not the amount of the loss, but rather its characterization.[116]

In *Freeland* the sole issue before the Tax Court was whether the taxpayers' voluntary conveyance of their nonrecourse property to the seller amounted to a sale.[117] The Commissioner argued that since there is no substantive distinction between a situation in which the

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[108] *See* Millar, 577 F.2d at 215; Tufts, 70 T.C. at 770.
[109] Rev. Rul. 78-164, 1978-1 C.B. 264; Rev. Rul. 76-111, 1976-1 C.B. 214.
[110] *See* Stokes v. Commissioner, 124 F.2d 335 (3d Cir. 1941); Jamison v. Commissioner, 8 T.C. 173 (1947); Commonwealth, Inc. v. Commissioner, 36 B.T.A. 850 (1937).
[111] 74 T.C. at 975, 982-83.
[112] *Id.* at 971.
[113] *Id.* at 972.
[114] *Id.*
[115] *Id.*
[116] *Id.* at 973.
[117] *Id.* at 974.

creditor forecloses upon the property and one in which he takes the property by voluntary conveyance in lieu of foreclosure, the transfer by the taxpayers ought to be treated as a sale under the authority of *Hammel*.[118] Conversely, the taxpayers argued that case law precedent required a finding of ordinary loss.[119]

Although the court initially acknowledged that not every transaction is a sale or exchange, it confirmed the well established rule that a sale is imputed when a taxpayer who is personally liable for an outstanding mortgage debt conveys his property in satisfaction of the mortgage.[120] Examining the Supreme Court's *Hammel* and *Nebraska Bridge* decisions, the court also noted the attribution of a sale when a taxpayer's property is disposed of by foreclosure or tax sale.[121] Moreover, the court observed that *Hammel's* interpretation of congressional intent required that the terms "sale or exchange" be liberally construed rather than confined "to the standard transfer of property by one person to another in exchange for a stated consideration in money or in money's worth."[122]

As much as the outcome of Mr. and Mrs. Freeland's conveyance resembled the result of a foreclosure sale, the court still had to contend with the series of pre-*Crane* decisions which held that voluntary conveyances were not sales or exchanges.[123] The rationale of pre-*Crane* authority emphasized the lack of requisite consideration when property subject to nonrecourse debt had been voluntarily transferred without boot.[124] Accordingly, the Tax Court in *Freeland* approached the problem from the perspective of ascertaining whether sufficient consideration existed to support a sale or exchange.[125] After reviewing *Crane* and the qualifications presented in *Tufts* and *Millar*, the *Freeland* court concluded that the rationale of *Crane* provided the necessary consideration for a finding of sale or exchange which was missing in *Jamison* and similar decisions.[126] *Crane's* realization principle established that "relief from indebtedness" was sufficient consid-

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[118] *Id.* at 974; Brief for Respondent at 7, 11, Freeland v. Commissioner, 74 T.C. 970 (1980).

[119] 74 T.C. at 974; Brief for Petitioners at 18, 20, Freeland v. Commissioner, 74 T.C. 970 (1980).

[120] 74 T.C. at 974-76.

[121] *Id.* at 976-77.

[122] *Id.* at 980.

[123] *See id.* at 977.

[124] *Id.*

[125] *Id.* at 980-81. The court noted, however, that in Russo v. Commissioner, 68 T.C. 135 (1977), the Tax Court held that consideration was irrelevant for purposes of sale or exchange. 74 T.C. at 980-81. Even though this conclusion may have followed from *Hammel*, the *Freeland* court analyzed the sale or exchange issue in terms of finding consideration since case law on the subject had traditionally done so. *Id.* at 981.

[126] 74 T.C. at 980.

eration to warrant classifying the transaction as a sale.[127] As long as there was an amount realized there was consideration.[128]

The Freelands' reliance on footnote 37 as an exception to sale or exchange classification was also without avail.[129] The court, categorizing the footnote as mere dictum, explained that *Tufts* and *Millar* had disposed of the argument that there is no amount realized where the value of property is less than the amount of the nonrecourse mortgage attached to it.[130] Because footnote 37 failed to reduce the amount of indebtedness included in the calculation of gain or loss, footnote 37 could not be depended upon to avoid having that same amount support a "sale or exchange."[131] The Freelands failed to persuade the court that footnote 37 created an exception to a finding of sale or exchange.[132] Accordingly, the court held that since the Freelands' voluntary conveyance of land subject to nonrecourse debt was essentially equivalent to a foreclosure sale,[133] the transfer was a sale governed by the capital assets provision of the Internal Revenue Code.[134] Thus, the court specifically overruled *Jamison* and three other pre-*Crane* decisions.[135]

Given the tenor of tax law in current years, the *Freeland* court was correct in remarking that their decision was not unexpected.[136] Whether or not one agrees with *Freeland's* outcome, the court's introduction of clarity into a field of disorder is surely welcome. The *Freeland* decision follows a uniform approach to the sale or exchange aspect of the *Crane* rule and has effectively laid to rest all traces of a very confusing Supreme Court footnote. In the process of achieving its desirable result, however, the court glossed over some relatively important points.

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[127] *Id.* at 981.

[128] *Id.* at 981-82.

[129] *Id.* at 978-79, 981-82.

[130] *Id.* at 978-79.

[131] *Id.* at 981.

[132] *See id.* at 978, 981.

[133] *Id.* at 981. The three other cases reversed by the *Freeland* court were Lapsley v. Commissioner, 44 B.T.A. 1105 (1941); Baird v. Commissioner, 42 B.T.A. 970 (1941) and Commonwealth, Inc. v. Commissioner, 36 B.T.A. 850 (1937).

[134] 74 T.C. at 982-83.

[135] *Id.* at 982.

[136] *Id.* The court stated:

> [T]here has been sufficient change in the judicial thinking on this subject, as evidenced by the cases decided since 1941, to cast considerable doubt on the validity of those decisions, and it would be wrong for us to ignore the more recent approaches to this issue simply to adhere to that doctrine, . . . the vitality of those cases has been sapped before this, and the handwriting has been on the wall long before today.

Id.

Although the rationale in *Crane* was based in part on an economic benefit theory,[137] the Court's primary intention was to avoid the effect of double tax benefits that resulted when a taxpayer included nonrecourse debt in his basis for depreciation purposes but failed to include it in his amount realized upon the disposition of the property.[138] Consistent with the substance of *Crane, Millar* and *Tufts* both held that footnote 37 did not present an exception to the *Crane* determination.[139] Accordingly, taxpayers could no longer receive a windfall by including nonrecourse debt in their basis for depreciation purposes and excluding that debt from their amount realized upon the disposition of their devalued property.[140] In *Freeland,* however, where the dispute involved the conveyance of land, no double benefits or tax windfall could be expected from disposition of the property.[141] Still, the court applied the precepts of *Crane* as interpreted by *Millar* and *Tufts* in holding that the transaction was a sale.[142] When *Millar* and *Tufts* rejected the position that there is no amount realized when the fair market value of the taxpayer's property is less than the nonrecourse mortgage to which it is subject, strict adherence to *Crane*'s economic benefit theory was bypassed enabling the courts to defer to *Crane*'s abhorrence of double tax benefits.[143] There being no possibility of taxpayer windfall in *Freeland,* the reason for the court's reliance on *Millar* and *Tufts* in rejecting footnote 37 as an exception to sale classification and its failure to address the economic benefit theory espoused in *Crane* is obscure. Perhaps the Tax Court's avoidance of *Crane*'s economic benefit theory indicates a tacit rejection of an oft criticized concept in favor of an uncomplicated generalized rule.

As questions remain and debate no doubt continues surrounding the application of *Crane*'s dual rationales, it is at least clear that *Freeland* has ended one chapter in the continuing saga of *Crane.* The taxpayer is forewarned that a voluntary conveyance of property subject to nonrecourse debt, even if the taxpayer receives no economic advantage, will result in sale or exchange.

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[137] *See* notes 26-28 *supra* and accompanying text.

[138] *See* note 29 *supra.*

[139] 74 T.C. at 979.

[140] *Id. See also* notes 55 & 64 *supra* and accompanying text.

[141] Since the basis in the Freeland's property remained unchanged from the time of purchase until the time of reconveyance to the seller and no additional funds were borrowed by utilizing the property as collateral, the Freeland's transfer did not resurrect the evil that the *Crane* Court intended to prevent. *See* 74 T.C. at 973 n.2. *See also* notes 36-42 *supra* and accompanying text.

[142] 74 T.C. at 981.

[143] *See* Millar, 577 F.2d at 215; Tufts, 70 T.C. at 764-66.