

SECTION 108 OF THE I.R.C. AND THE INCLUSION OF *TUFTS* GAIN: A PROPOSAL FOR REFORM

Abstract: The 1983 U.S. Supreme Court decision in *Commissioner v. Tufts* established the modern rule that requires a taxpayer to include the full amount of a nonrecourse note in the amount realized on the disposition of a property, notwithstanding the fair market value of the property. Although not fully understood at the time, this holding has had a large impact on the ability of a financially troubled debtor to defer cancellation of indebtedness income under § 108 of the Internal Revenue Code. Presently, § 108 allows a borrower who is insolvent or in a title 11 bankruptcy proceeding to defer the recognition of COD income, rather than recognize it as a gain. Under *Tufts*, when a property is transferred with a fair-market value below the nonrecourse debt used to purchase the asset, the taxpayer realizes a non-deferrable gain to the extent of the difference between the fair-market value of the property and the taxpayer's basis in the property. This Note argues that the Internal Revenue Service's treatment of nonrecourse debt and its application to § 108 is unworkable. By allowing an insolvent taxpayer to defer COD income while not allowing an identical taxpayer to defer gain from the discharge of indebtedness, the Service has disregarded the statutory purpose of § 108 and has violated the fundamental principles of equity and fairness in the administration of our tax system.

INTRODUCTION

Between October 2007 and 2008, home prices in the United States declined by a staggering 23.4% according to the twenty-city Case-Shiller Home Price Index.¹ This marked twenty-seven consecutive months the index posted a loss, and prices have now fallen back to March 2004 levels.² The record number of foreclosures in 2007 and 2008 have been

¹ *Standard & Poor's Case-Schiller Home Price Index*, Dec. 30, 2008, available at http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_csmahp/2,3,4,0,0,0,0,0,0,0,0,0,0,0,0.html; Les Christie, *Home Prices Post Record 18% Drop*, CNNMONEY.COM, Dec. 30, 2008, http://money.cnn.com/2008/12/30/real_estate/October_Case_Shiller/?postversion=2008123014 (last visited Sept. 18, 2009).

² See Christie, *supra* note 1.

cited as a contributing factor to the decline in home prices.³ In many of the worst markets, the majority of real estate sales involve foreclosed properties, which typically sell at a steep discount from the rest of the market.⁴ With the level of foreclosures expected to increase in 2009, prices are likely to fall even lower as additional vacant inventory is added to an already overburdened market.⁵

Although the macroeconomic issues regarding the real estate crisis have been well-documented, the tax implications of foreclosure combined with rapidly declining home values are commonly overlooked, despite the devastating effects they can have on individual taxpayers.⁶ Consider, for example, a taxpayer who borrowed \$200,000 to purchase an investment property with a fair-market value of \$200,000. Several years later, the combination of economic recession and crumbling real estate values have led the taxpayer into financial ruin and she has defaulted on the loan. She still owes \$150,000 of principal and interest on the loan and her remaining basis in the property after depreciation is \$100,000.⁷ What are the tax consequences to the borrower if the bank forecloses on the property in full satisfaction of the outstanding loan?

Although a conveyance is taxable as a sale regardless of whether it is voluntary or involuntary, the Internal Revenue Service (the "Service") applies different rules depending on whether the borrower is personally liable for the debt and whether the loan balance exceeds the value of the property at the time of foreclosure.⁸ Suppose for the moment that the fair market value of the property is \$160,000, or \$10,000 above the outstanding loan balance. In this situation, the gain realized from the sale or other disposition of property is the excess of the

³ *Id.* About 1.5 million foreclosures occurred in 2007, and an additional 1.2 million occurred in the first half of 2008. Michelle J. White, *Bankruptcy: Past Puzzles, Recent Reforms, and the Mortgage Crisis*, 14 (Nat'l Bureau of Econ. Research, Working Paper No. 14549, 2008).

⁴ Christie, *supra* note 1.

⁵ *Id.*

⁶ See Stephen P. Milner et al., *Foreclosures, Private Sales and Deeds-in-Lieu in California: Understanding and Planning for the Debtor's Tax Consequences*, 22 CAL. BANKR. J. 161, 161 (1994).

⁷ A taxpayer's basis in property is the investment in that property for tax purposes and is the maximum amount a taxpayer can receive in payment for an asset without realizing a gain. DOUGLAS A. KAHN & JEFFREY H. KAHN, *FEDERAL INCOME TAX: A STUDENT'S GUIDE TO THE INTERNAL REVENUE CODE* 31 (5th ed. 2005). The concept of basis is most frequently used in determining the amount of gain or loss realized on the sale, exchange, or other disposition of an asset. *Id.*

⁸ See *Comm'r v. Tufts*, 461 U.S. 300, 307, 310 n.11 (1983); Milner, *supra* note 6, at 161.

amount realized over the taxpayer's adjusted basis.⁹ If upon foreclosure, the bank receives the full value of the home (equal to \$160,000) in full satisfaction of the loan, the taxpayer would realize a gain of \$60,000.¹⁰ This result is the same whether the taxpayer is personally liable for the debt or not.¹¹

Now suppose that because the economy and real estate market have weakened, the fair-market value of the property has plunged to \$110,000. Where the debtor is personally liable for the debt (recourse debt), the Service bifurcates the transaction into part gain and part cancellation of indebtedness ("COD").¹² The difference between the fair-market value of the property and the taxpayer's basis is treated as gain, while the difference between the outstanding amount of recourse debt and the value of the property is treated as COD income.¹³ In this example, the taxpayer realizes a gain of \$10,000 and COD income of \$40,000 upon foreclosure.¹⁴

Generally, however, § 108 of the Internal Revenue Code (the "Code") allows a borrower who is insolvent or in a title 11 bankruptcy proceeding to defer the recognition of COD income.¹⁵ Thus, an insolvent taxpayer in this example would face a current tax liability only to

⁹ KAHN & KAHN, *supra* note 7, at 595. The Service treats a foreclosure as a sale or other disposition of property. See *Helvering v. Hammel*, 311 U.S. 504, 510–11 (1941). The amount realized from a sale or other disposition of property is the sum of the money received plus the fair market value of any property (other than money) received. I.R.C. § 1001(b) (2006); KAHN & KAHN, *supra* note 7, at 600.

¹⁰ See I.R.C. § 1001(a); *Crane v. Comm'r*, 331 U.S. 1, 13–14 (1947); see also KAHN & KAHN, *supra* note 7, at 595, 600. In the absence of clear and convincing proof to the contrary, the fair market value of the collateral will be the amount bid in the foreclosure proceeding. See Treas. Reg. § 1.166-6(b)(2) (2009). The \$60,000 gain is computed by subtracting from the amount realized, \$160,000, the taxpayer's \$100,000 basis in the property. I.R.C. § 1001(a); KAHN & KAHN, *supra* note 7, at 595.

¹¹ See *Crane*, 331 U.S. at 13–14. *Crane v. Commissioner* codified the treatment of nonrecourse debt as "true debt" or recourse debt. *Id.* at 11–14.

¹² See *Tufts*, 461 U.S. at 310 n.11. A debt that the debtor is personally liable to repay is known as a recourse debt. KAHN & KAHN, *supra* note 7, at 601. Cancellation of indebtedness income is a creditor's discharge of a debtor's financial obligation for less than the full amount that is due, consequently increasing the debtor's net worth. KAHN & KAHN, *supra* note 7, at 43.

¹³ See *Tufts*, 461 U.S. at 310 n.11; KAHN & KAHN, *supra* note 7, at 601–02.

¹⁴ See *Tufts*, 461 U.S. at 310 n.11; KAHN & KAHN, *supra* note 7, at 601–02. Taxpayer's gain is calculated by subtracting from the \$110,000 fair market value of the property her \$100,000 basis in the property. See *Tufts*, 461 U.S. at 310 n.11; KAHN & KAHN, *supra* note 7, at 601–02. COD income is calculated by subtracting from the \$150,000 outstanding debt the \$110,000 fair market value of the property. See *Tufts*, 461 U.S. at 310 n.11; KAHN & KAHN, *supra* note 7, at 601–02.

¹⁵ See I.R.C. § 108(a) (West Supp. 2008 & Supp. III 2009).

the extent of the \$10,000 gain.¹⁶ Congress enacted § 108 to provide relief for financially strapped debtors by temporarily relieving them of the burden of taxation that would ordinarily be imposed on the cancellation of debt.¹⁷ The purpose of § 108 was to spread the immediate tax burden from a cancellation of indebtedness over a subsequent period in which the debtor has actual cash flow.¹⁸

Unfortunately, a borrower who is not personally liable for the debt (nonrecourse debt) is precluded from taking advantage of § 108.¹⁹ Assuming the value of the property is still \$110,000, the Service, upon foreclosure, sale, or other disposition, collapses the two component parts (gain and COD income) into a single disposition of property, characterized only by gain.²⁰ Gain is computed by subtracting from the amount realized—here equal to the full value of the outstanding debt—the taxpayer's basis in the property.²¹ Accordingly, the taxpayer realizes a gain of \$50,000.²² Because taxpayers cannot use § 108 to defer the recognition of gain, the taxpayer here must immediately pay tax on the entire \$50,000.²³

This Note argues that the Service's treatment of nonrecourse debt and its application to § 108 is unworkable.²⁴ By allowing an insolvent taxpayer to defer COD income, but not allowing an identical taxpayer to defer gain from the discharge of indebtedness, the Service has disre-

¹⁶ See *id.*

¹⁷ See I.R.C. § 108(a); H.R. REP. NO. 96-833, at 8-9 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7024-25; KAHN & KAHN, *supra* note 7, at 52.

¹⁸ See H.R. REP. NO. 96-833, at 8-9.

¹⁹ See *Danenberg v. Comm'r*, 73 T.C. 370, 384-86 (1979). A debt that the debtor has no personal liability to repay and for which the creditor can collect, upon default, only by foreclosing on the property securing the debt is known as nonrecourse debt. KAHN & KAHN, *supra* note 7, at 600.

²⁰ See *Tufts*, 461 U.S. at 309-10 & n.11. For an explanation of the component parts, see *infra* notes 114-117 and accompanying text.

²¹ I.R.C. § 1001(a) (2006); *Tufts*, 461 U.S. at 309-10; KAHN & KAHN, *supra* note 7, at 595.

²² I.R.C. § 1001(a); *Tufts*, 461 U.S. at 309-10. The taxpayer's gain is calculated by subtracting from the \$150,000 outstanding debt the \$100,000 basis in the property. See *Tufts*, 461 U.S. at 309-10.

²³ See I.R.C. § 61(a) (3) (2006); I.R.C. § 108(a) (West Supp. 2008 & Supp. III 2009); *Danenberg*, 73 T.C. at 384-86. Section 61(a) of the Code states that gross income includes gains derived from dealings in property as well as income from discharge of indebtedness. I.R.C. § 61(a). Section 108(a) of the Code provides an exception to the rule in § 61(a) only for income from the discharge of indebtedness. I.R.C. § 108(a)(1). Section 108(a) states that gross income does not include income by reason of the discharge of indebtedness where, among other things, the discharge occurs in a title 11 proceeding or when the taxpayer is insolvent. *Id.*

²⁴ See *Tufts*, 461 U.S. at 309-10 & n.11; H.R. REP. NO. 96-833, at 8-9 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7024-25.

garded the statutory purpose of § 108 and has violated the fundamental principles of equity and fairness in the administration of our tax system.²⁵

Part I of this Note discusses the historical development of the Service's treatment of nonrecourse debt, exploring the U.S. Supreme Court's 1983 decision in *Commissioner v. Tufts* and its resolution of the taxation of a transfer of property involving nonrecourse debt with a value in excess of the collateral securing the debt.²⁶ Part II examines the impact of the Court's decision in *Tufts* and the resulting irregularities involving the Service's treatment of nonrecourse debt.²⁷ Part III presents the codification of the *Tufts* approach along with the several methods resourceful taxpayers have developed to avoid the realization of income from a transfer of property with a fair market value less than that of the nonrecourse debt securing it.²⁸ Part IV delves into the statutory history of § 108 and explores the policy behind allowing the deferral of income from the discharge of indebtedness.²⁹ Ultimately, Part V suggests that the Service's treatment of nonrecourse debt is unsound and recommends that Congress amend § 108 to allow for the deferring the recognition of gains from the discharge of indebtedness.³⁰

I. DEVELOPMENT OF THE LAW SURROUNDING TREATMENT OF NONRECOURSE DEBT

In general, gross income does not include the receipt of borrowed funds.³¹ Section 61(a) of the Code defines gross income broadly as "all income from whatever source derived."³² The U.S. Supreme Court, interpreting § 61(a), has held gross income to mean an accession to wealth, clearly realized, over which the taxpayer has complete dominion.³³ A debtor does not realize an accession to wealth upon receipt of

²⁵ See H.R. REP. NO. 96-833, at 8-9; David Elkins, *Horizontal Equity as a Principle of Tax Theory*, 24 YALE L. & POL'Y REV. 43, 44-45 (2005).

²⁶ See *Tufts*, 461 U.S. at 307-10.

²⁷ See Deborah A. Geier, *Tufts and the Evolution of Debt-Discharge Theory*, 1 FLA. TAX REV. 115, 162 (1992).

²⁸ See I.R.C. § 7701(g) (2006); Treas. Reg. § 1.1001-2(a), (c) (ex.7) (2008).

²⁹ See H.R. REP. NO. 96-833, at 8-9.

³⁰ See *Tufts*, 461 U.S. at 309-10 & n.11; H.R. REP. NO. 96-833, at 8-9. See *infra* note 227 for a definition of gain from the discharge of indebtedness.

³¹ See, e.g., *Comm'r v. Tufts*, 461 U.S. 300, 307 (1983); *Milenbach v. Comm'r*, 318 F.3d 924, 930 (9th Cir. 2003).

³² I.R.C. § 61(a) (2006).

³³ *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

borrowed funds because the debtor's increase in assets is offset by a corresponding liability to repay the borrowed amount.³⁴

Nevertheless, if a lender cancels a debt, relieving the borrower of the duty to repay the loan, the liability ceases and the debtor realizes income.³⁵ Three theories support the taxation of a discharge of indebtedness: (1) the taxpayer's net worth has increased; (2) the earlier receipt of cash without realization of income must be offset; and (3) the debtor would receive a tax-free return on investment if the discharged debt was not taxed.³⁶ In most cases, the Service taxes the discharge of indebtedness as ordinary income under § 61(a)(12) of the Code.³⁷

The Service's treatment of discharged debt becomes more complicated, however, where a borrower transfers or disposes of an asset in recognition of an outstanding debt.³⁸ Whenever a borrower transfers or disposes of an asset, § 1001 of the Code determines the taxpayer's gain or loss from the transaction.³⁹ Unlike income from the discharge of indebtedness, which enters gross income under § 61(a)(12), the Service accounts for gains in gross income under § 61(a)(3) of the Code.⁴⁰ The tax consequences of a gain can vary drastically from the treatment of income from a cancellation of indebtedness.⁴¹ Principally, § 108 of the Code may allow tax deferral of income from the cancellation of indebtedness, whereas debtors cannot defer gains from dealings in property under § 108.⁴² For this reason, the classification of income as either cancellation of indebtedness or as a gain is critical in determining the nature of a debtor's tax liability.⁴³

In a transaction involving the sale or other disposition of property, the categorization of income as either gain or cancellation of indebtedness primarily depends upon whether the borrower is personally li-

³⁴ See, e.g., *Tufts*, 461 U.S. at 307; *Glenshaw*, 384 U.S. at 431; *Milenbach*, 318 F.3d at 930.

³⁵ See *United States v. Kirby Lumber*, 284 U.S. 1, 3 (1931).

³⁶ See *Kirby*, 284 U.S. at 3; Fred T. Witt, Jr. & William H. Lyons, *An Examination of the Tax Consequences of Discharge of Indebtedness*, 10 VA. TAX. REV. 1, 6 (1990).

³⁷ I.R.C. § 61(a)(12) (defining gross income as all income from whatever source derived, including, but not limited to, income from discharge of indebtedness).

³⁸ See *Tufts*, 461 U.S. at 308-11.

³⁹ See I.R.C. § 1001(a) (2006) (defining gain from the sale or other disposition of property as the excess of the amount realized therefrom over the adjusted basis). The seller's total receipts, or amount realized, include the value of any obligation of which the seller was relieved through the transfer. See *Crane v. Comm'r*, 331 U.S. 1, 11-14 (1947).

⁴⁰ I.R.C. § 61(a)(3) (2006) (defining gross income as all income from whatever source derived, including, but not limited to, gains derived from dealings in property).

⁴¹ See I.R.C. § 108(a) (West Supp. 2008 & Supp. III 2009); *Tufts*, 461 U.S. at 307-10 & n.11.

⁴² See I.R.C. § 108(a).

⁴³ See *id.*; *Tufts*, 461 U.S. at 307-10 & n.11.

able for the debt and whether the value of the property is less than the loan balance.⁴⁴ A debt for which the debtor is personally liable to repay is known as recourse debt.⁴⁵ Alternatively, a debt the debtor has no personal liability to repay is known as nonrecourse debt.⁴⁶ Generally, as long as the property securing the obligation has a value equal to or in excess of the liability, the Service treats recourse and nonrecourse debt equally and it is of no consequence that the borrower is not personally liable for the debt.⁴⁷ When the property's sale value exceeds the borrower's debt obligation, the borrower does not realize cancellation of indebtedness income upon the sale or other disposition of the property.⁴⁸ Thus, upon default of a debtor, the entire liability can be satisfied through the sale of property securing the debt.⁴⁹ Accordingly, the entire transaction is categorized as gain (or loss).⁵⁰

Differences arise in the Service's treatment of recourse and nonrecourse debt where a taxpayer transfers an asset with a fair market value below that of the outstanding debt, in full recognition of the debt.⁵¹ In this situation, a debtor holding property encumbered by a recourse debt will realize part cancellation of indebtedness income and part gain (or loss).⁵² A debtor who is insolvent or has filed for title 11 protection may be able to defer the recognition of the cancellation of indebtedness income under § 108 of the Code.⁵³

The Service provides alternative rules for a debtor holding property encumbered by nonrecourse debt.⁵⁴ When a debtor transfers property encumbered by nonrecourse debt and the amount of the encumbrance is greater than the value of the property, the Service classi-

⁴⁴ See *Tufts*, 461 U.S. at 307-10 & n.11; Milner, *supra* note 6, at 161.

⁴⁵ KAHN & KAHN, *supra* note 7, at 601.

⁴⁶ *Id.* at 600.

⁴⁷ See *Crane*, 331 U.S. at 11-13; Daniel N. Shaviro, *Risk and Accrual: The Tax Treatment of Non-recourse Debt*, 44 TAX L. REV. 401, 409 (1989).

⁴⁸ See KAHN & KAHN, *supra* note 7, at 595.

⁴⁹ *Id.*

⁵⁰ See I.R.C. § 1001(a) (2006); KAHN & KAHN, *supra* note 7, at 595. The taxpayer will realize a gain if his basis is less than the fair market value of the property. I.R.C. § 1001(a). Alternatively, a taxpayers will realize a loss if the basis is greater than the fair market value of the property. *Id.*

⁵¹ See *Tufts*, 461 U.S. at 307-10 & n.11.

⁵² *Id.* at 310 n.11. The difference between the amount of the recourse debt outstanding and the value of the property is treated as cancellation of indebtedness income whereas the difference between the value of the property and the taxpayer's basis is treated as gain (or loss). KAHN & KAHN, *supra* note 7, at 601.

⁵³ See I.R.C. § 108(a) (West Supp. 2008 & Supp. III 2009).

⁵⁴ *Tufts*, 461 U.S. at 307-10; KAHN & KAHN, *supra* note 7, at 600-01.

fies the entire transaction as gain (or loss).⁵⁵ Because § 108 does not allow the taxpayer to defer the recognition of a gain, a financially strapped debtor utilizing nonrecourse debt may be taxed disproportionately, and in excess of an identical taxpayer utilizing recourse debt.⁵⁶ The origins for this treatment of nonrecourse debt lie in the U.S. Supreme Court's 1947 decision in *Crane v. Commissioner*.⁵⁷

A. Nonrecourse Debt as "True Debt": The Crane Doctrine

The 1947 U.S. Supreme Court decision in *Crane v. Commissioner* established the treatment of nonrecourse debt as "true debt."⁵⁸ *Crane* was decided at a time before nonrecourse debt was widely used.⁵⁹ Prior to this decision, a tremendous amount of uncertainty surrounded the proper characterization of nonrecourse debt for federal income tax purposes.⁶⁰ Some courts questioned whether nonrecourse debt should be treated as "true debt" because the taxpayer is never under any personal obligation to pay the liability.⁶¹ Because the lender's sole recourse is to the property securing the debt, the lender-mortgagee, rather than the borrower-mortgagor, bears most of the risk of the value of the property declining.⁶²

Although nonrecourse debt may appear to disadvantage lenders, banks have become more willing to provide such financing over the years.⁶³ One reason for the spread of nonrecourse financing is the surge in real estate investment by limited partnerships combined with the structure of the federal tax system.⁶⁴ Under federal tax law, in order for limited partners to obtain a depreciable basis in financed partnership assets, the debt used to acquire such assets must be nonrecourse.⁶⁵ Because the most common investment vehicle for commercial real estate is the limited partnership, over time lenders have come to accom-

⁵⁵ *Tufts*, 461 U.S. at 307-10; KAHN & KAHN, *supra* note 7, at 600-01.

⁵⁶ See I.R.C. § 108(a); *Tufts*, 461 U.S. at 307-10 & n.11.

⁵⁷ See 331 U.S. 1, 11-13.

⁵⁸ See *Tufts*, 461 U.S. at 307; *Crane*, 331 U.S. at 11-14.

⁵⁹ Linda Sugin, *Nonrecourse Debt Revisited, Restructured and Redefined*, 51 TAX L. REV. 115, 118 (1995).

⁶⁰ Diane M. Anderson, *Federal Income Tax Treatment of Nonrecourse Debt*, 82 COLUM. L. REV. 1498, 1498 (1982).

⁶¹ See *Crane v. Comm'r*, 3 T.C. 585, 590 (1944), *rev'd*, 153 F.2d 504 (2d Cir. 1945), *aff'd*, 331 U.S. 1; Frederick H. Robinson, *Nonrecourse Indebtedness*, 11 VA. TAX REV. 1, 12 (1991).

⁶² See Robinson, *supra* note 61, at 4.

⁶³ See James A. Fellows & Michael A. Yuhas, *Nonrecourse Debt and Real Estate: The Issue of Tax Basis*, 26 REAL EST. L.J. 270, 271 (1998); Robinson, *supra* note 61, at 4.

⁶⁴ See Robinson, *supra* note 61, at 5.

⁶⁵ *Id.*

moderate the investment community by providing the nonrecourse financing these debtors demand.⁶⁶

Beyond the tax benefits and limited liability nonrecourse financing confers, the use of nonrecourse debt also has important advantages to sellers of property.⁶⁷ Nonrecourse debt makes it easier for parties to agree on loan terms, and sellers are often able to obtain better prices than in a sale for cash or on a fully recourse basis.⁶⁸ Purchasers may be willing to take greater risk when utilizing nonrecourse debt because if the value of the property or its earnings do not prove to be as high as anticipated, purchasers can simply surrender the property without any personal liability above their initial investment.⁶⁹

The Court's acceptance of the legitimacy of nonrecourse financing in real estate transactions has also contributed to its attractiveness.⁷⁰ Although the Court's decision in *Crane* was not the first to consider the treatment of nonrecourse indebtedness,⁷¹ the general principle that nonrecourse debt is to be treated in the same fashion as recourse debt for federal income tax purposes has come to be called the *Crane* doctrine.⁷²

Crane concerned a taxpayer who had inherited an apartment building subject to a nonrecourse mortgage equal to the property's fair market value of \$255,000.⁷³ During the seven years *Crane* held the building, she took a total of \$25,500 in depreciation deductions.⁷⁴ *Crane* subsequently sold the building to a third party, who paid *Crane* \$2,500 in cash and agreed to take the property subject to the \$255,000 mortgage.⁷⁵ *Crane* reported a capital gain of \$2,500 from the transaction, which she computed by subtracting zero, her asserted basis in the

⁶⁶ *Id.*

⁶⁷ *See id.*

⁶⁸ *See id.* Note, however, that the purchase price cannot exceed a demonstrably reasonable estimate of the fair market value of the property. *Estate of Franklin v. Comm'r*, 544 F.2d 1045, 1048 (9th Cir. 1975). The test under *Estate of Franklin v. Commissioner* is whether payments on the nonrecourse liability would produce equity in the property. *Id.* at 1049.

⁶⁹ *See Robinson*, *supra* note 61, at 5.

⁷⁰ *See Crane*, 331 U.S. at 14; *Robinson*, *supra* note 61, at 10.

⁷¹ *See Lutz & Schramm Co. v. Comm'r*, 1 T.C. 682, 688-89 (1943) (addressing the realization of gain upon the disposition of property encumbered by nonrecourse debt); *Robinson*, *supra* note 61, at 11.

⁷² *See Crane*, 331 U.S. at 11-14 (holding generally that nonrecourse debt is to be treated the same as recourse debt for federal income tax purposes); *Robinson*, *supra* note 61, at 11.

⁷³ *Crane*, 331 U.S. at 3.

⁷⁴ *Id.* at 3 n.2.

⁷⁵ *Id.* at 3-4.

property, from the \$2,500 net cash proceeds she received.⁷⁶ The Service assessed a deficiency judgment of nearly \$25,000, arguing that the full amount of the nonrecourse debt should have been included in both the taxpayer's basis and amount realized.⁷⁷

The Tax Court disagreed with the Service, holding that it would be improper to include any portion of the nonrecourse mortgage liability in the amount realized or basis.⁷⁸ With regard to amount realized, the Tax Court reasoned that because Crane was never under any personal obligation to pay the debt, she never received any benefit or consideration by reason of her transfer of the property subject to the mortgage, except for the \$2,500 cash.⁷⁹ The Tax Court further concluded that because Crane had no equity in the property (as it was inherited), her basis in the property was zero.⁸⁰

The U.S. Supreme Court reversed, determining that Crane's basis in the building was equal to the property's full value, undiminished by the mortgage, less any depreciation deductions she had taken.⁸¹ The Court reasoned that if the taxpayer's equity were equal to basis, depreciation deductions would represent only a fraction of the cost of the corresponding physical exhaustion of the property.⁸² This result is contrary to the Service's practice, which requires depreciation to be charged off over the useful life of the property.⁸³ In addition, if depreciation deductions were computed on the value of the property and then deducted from an equity basis, the Service would have to accept deductions from a negative basis, which is an unacceptable result.⁸⁴ Having decided the basis issue, the Court then turned to amount realized, concluding that it includes both the cash Crane received from the sale and the full value of the nonrecourse debt.⁸⁵ Although Crane was not personally liable for the mortgage, the Court reasoned when a person transfers property subject to a mortgage, the benefit to them is as

⁷⁶ *Tufts*, 461 U.S. at 3-4.

⁷⁷ *Id.* at 4.

⁷⁸ See *Crane*, 3 T.C. at 590-91.

⁷⁹ *Id.* at 590.

⁸⁰ See *id.* at 591.

⁸¹ *Crane*, 331 U.S. at 6-11.

⁸² *Id.* at 9-10.

⁸³ *Id.* at 9 n.27.

⁸⁴ *Id.* at 9-10.

⁸⁵ *Id.* at 13-14 (determining that, although not personally liable, a debtor "who sells property subject to a mortgage and for additional consideration, realizes a benefit in the amount of the mortgage as well as the boot"). Section 1001 defines "amount realized" from the sale or other disposition of property as "the sum of any money received plus the fair market value of the property (other than money) received." I.R.C. § 1001(b) (2006).

real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.⁸⁶

Crane conclusively established that the value of a nonrecourse debt is included both in the taxpayer's basis on acquisition and the amount realized on disposition of a property.⁸⁷ The Court noted, however, that the analysis may differ in a situation where the value of the property is less than the amount of the nonrecourse mortgage.⁸⁸ Thus, the question left unanswered by *Crane* was how to treat the disposition of debt-encumbered property having a value less than the outstanding value of the nonrecourse debt.⁸⁹ Thirty-six years later, the U.S. Supreme Court confronted this issue in *Commissioner v. Tufts*.⁹⁰

B. Value of Nonrecourse Debt in Excess of Collateral: The Tufts Decision

The 1983 U.S. Supreme Court decision in *Tufts* resolved the long-standing dispute concerning the calculation of amount realized from the sale of property with a fair market value substantially less than the amount of nonrecourse debt encumbering the property.⁹¹ The holding established the modern rule that requires a taxpayer to include the full amount of a nonrecourse note in both the amount realized and in basis on the disposition of property, notwithstanding the fair market value of the property.⁹² In *Tufts*, the taxpayer acquired property in 1970 for \$1,851,500, and financed the transaction entirely with a nonrecourse mortgage.⁹³ During the years 1971 and 1972, Tufts deducted a total of \$439,972 for depreciation, leaving him with an adjusted basis of \$1,455,740.⁹⁴ Unfortunately, by August 1972, the value of the property had fallen to \$1,400,000.⁹⁵ Tufts subsequently transferred the property to a buyer, who took the property subject to the nonrecourse mortgage.⁹⁶ At the time of the sale, Tufts had not made any payments on the \$1,851,500 loan.⁹⁷ On his federal income tax return, Tufts claimed a loss of \$55,740, which he computed by taking the difference between

⁸⁶ *Crane*, 331 U.S. at 14.

⁸⁷ *Id.* at 6-11, 13-14.

⁸⁸ *Id.* at 14 n.37.

⁸⁹ *Id.*

⁹⁰ See 461 U.S. at 307-10.

⁹¹ *Id.*; *Crane*, 331 U.S. at 14 n.37.

⁹² *Tufts*, 461 U.S. at 307-10.

⁹³ *Id.* at 302.

⁹⁴ *Id.*

⁹⁵ *Id.* at 303.

⁹⁶ *Id.* at 302-03.

⁹⁷ *Id.*

the fair market value of the property and his adjusted basis.⁹⁸ Tufts argued that the economic benefit he received by being relieved of the nonrecourse indebtedness was not the full amount of the liability, but some lesser amount, which could not exceed the fair market value of the property.⁹⁹ The Commissioner of Internal Revenue (the "Commissioner") disagreed and, on audit, determined that the sale resulted in a capital gain of approximately \$400,000.¹⁰⁰ The Commissioner's calculations proceeded on the theory that the amount realized must always include the full amount of the nonrecourse obligation.¹⁰¹ The question raised to the U.S. Supreme Court was whether a taxpayer must include the unpaid balance of a nonrecourse mortgage in the computation of amount realized when the unpaid amount of the mortgage exceeds the fair market value of the property sold.¹⁰²

The Court held first that the taxpayer's basis includes the full amount of the nonrecourse loan.¹⁰³ This treatment, the Court reasoned, is consistent with *Crane's* holding that nonrecourse debt be treated as a "true loan."¹⁰⁴ When a taxpayer receives a loan, whether recourse or nonrecourse, and applies the proceeds to the purchase price of property used to secure the loan, that amount is included in the taxpayer's basis.¹⁰⁵

In computing amount realized, the *Tufts* Court resolved the uncertainty left by *Crane* and held that the amount realized upon the sale or other disposition of property includes the outstanding amount of the nonrecourse obligation, notwithstanding the fair market value of the property.¹⁰⁶ The Court concluded that when a debtor sells or disposes encumbered property to a purchaser who assumes the mortgage, the associated extinguishment of the obligation must be accounted for in

⁹⁸ *Tufts*, 461 U.S. at 303 & n.1. The difference between the fair market value of the property on the date of transfer, \$1,400,000, and Tufts' adjusted basis of \$1,455,740 equals the \$55,740 loss Tufts claimed on the transfer. *Id.*

⁹⁹ See *Comm'r v. Tufts*, 651 F.2d 1058, 1059 (5th Cir. 1981), *rev'd*, 461 U.S. 300. The Fifth Circuit agreed with Tufts and held that the fair market value of the property securing a nonrecourse debt limits the extent to which the debt can be included in the amount realized on disposition of the property. *Id.* at 1063.

¹⁰⁰ *Tufts*, 461 U.S. at 303. The Commissioner determined Tufts' gain on the sale by subtracting the adjusted basis of \$1,455,740 from the \$1,851,500 nonrecourse liability assumed by the buyer. *Id.* at 303 n.2.

¹⁰¹ See *id.*; *Crane*, 331 U.S. at 13-14.

¹⁰² *Tufts*, 461 U.S. at 301-02.

¹⁰³ *Id.* at 307.

¹⁰⁴ See *id.*; *Crane*, 331 U.S. at 11-14.

¹⁰⁵ See *Tufts*, 461 U.S. at 307.

¹⁰⁶ See *id.* at 309.

the computation of amount realized.¹⁰⁷ The fact that a borrower is not personally liable for the note does not erase the fact that he received the loan proceeds tax-free and included them in his basis on the understanding that he had an obligation to repay the full amount.¹⁰⁸ When the obligation is canceled, mortgagors are relieved of their responsibilities to repay the sum they originally received and thus realize value to the extent of the relieved debt.¹⁰⁹ If the Court were to exclude the full amount of the nonrecourse debt from amount realized, the mortgagor would receive untaxed income at the time the loan was extended as well as an unwarranted increase in the basis of the property.¹¹⁰ Because the amount realized bears a functional relation to basis, the Court concluded that any debt included in basis must be included in the amount realized on disposition of the property.¹¹¹

Applying the holding to the facts of the case, the Court determined that upon transfer of the property, the taxpayer realized a gain of \$395,760, which is the difference between the full \$1,851,500 nonrecourse debt and Tufts' adjusted basis of \$1,455,740.¹¹² The method codified in *Tufts* is known as the "collapsed approach" because the Service collapses the two component parts of the transaction—the discharge of debt and the disposition of the property—into one element, analyzing the transaction as if it solely constituted a taxable sale of property.¹¹³

In the alternative, the Court could have, but chose not to, utilize the two-step, or "bifurcated approach," to analyze the transaction.¹¹⁴

¹⁰⁷ *Id.* at 308–09.

¹⁰⁸ *Id.* at 312.

¹⁰⁹ *Id.* Note, however, that the Court does not classify this debt as cancellation of indebtedness income. See *id.* Rather, the Court concluded that the relieved obligation constituted a benefit received by the taxpayer upon transfer of the property, the value of which entered into the computation of amount realized under § 1001(b) of the Code. See *id.*; I.R.C. § 1001(b) (2006).

¹¹⁰ *Tufts*, 461 U.S. at 307–09.

¹¹¹ See *id.*

¹¹² See *id.* at 302–03, 317.

¹¹³ See *id.* at 307–10 & n.11. The discharge of debt is the difference between the amount of the outstanding debt and the value of the property received in full recognition of that debt: \$451,500 (\$1,851,500 – \$1,400,000). See KAHN & KAHN, *supra* note 7, at 43. Assuming the amount realized is equal to the fair market value of the property, the disposition produces a loss of \$55,740, which is the difference between the fair market value of \$1,400,000 and the adjusted basis of \$1,455,740. See *id.* at 595. The collapsed approach combines these individual components into the computation of gain on the disposition. *Tufts*, 461 U.S. at 307–10 & n.11.

¹¹⁴ *Tufts*, 461 U.S. at 310 n.11. Because the Court held that the collapsed approach was a justifiable mode of analysis, the Court deferred to the Commissioner's judgment in

Under the bifurcated approach, the transaction would be treated as two separate components—a taxable disposition of property and a separately taxable discharge of debt.¹¹⁵ The termination of the \$1,851,500 obligation in consideration for the property worth \$1,400,000 would result in cancellation of indebtedness income of \$451,500.¹¹⁶ The disposition of the property would result in a capital loss of \$55,740, representing the difference between the sale price of \$1,400,000 and the adjusted basis of \$1,455,740.¹¹⁷ Although the bifurcated approach is utilized in identical situations involving recourse debt, the Court in *Tufts* deferred to the Commissioner's judgment in employing the collapsed approach.¹¹⁸ The Court noted that even though the bifurcated approach was justifiable, it was not the proper role of the Court to decide which method was best.¹¹⁹ Rather, it was the job of the Court to decide whether the rule applied by the Commissioner was a reasonable one.¹²⁰

The relatively quick dismissal of the bifurcated approach by the U.S. Supreme Court is likely due to the fact that the federal income tax consequences of the collapsed and bifurcated approaches are identical under the facts of *Tufts*.¹²¹ Utilizing the collapsed approach, Tufts realized a taxable gain of \$395,760.¹²² Similarly, under the bifurcated approach, Tufts realized gross income of \$395,760.¹²³ The two approaches achieve far different results, however, when determining whether a taxpayer may defer the recognition of such income.¹²⁴ Under § 108, a taxpayer with COD income may be able to defer tax on such income, while an identical taxpayer with gain does not qualify for deferral and must immediately pay tax on the gain.¹²⁵ Thus, what appears to be a relatively arbitrary decision to utilize the collapsed approach and clas-

choosing to utilize that approach. *Id.* The Court did note, however, that the bifurcated approach could be an acceptable mode of analysis. *Id.*

¹¹⁵ *Id.*

¹¹⁶ *See id.* at 302–03, 310 n.11.

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ *Tufts*, 461 U.S. at 302–03, 310 n.11; *see also* Geier, *supra* note 27, at 125.

¹²¹ *See Tufts*, 461 U.S. at 310 n.11, 317; Geier, *supra* note 27, at 127; *supra* notes 112–117 and accompanying text.

¹²² *See Tufts*, 461 U.S. at 307–10, 317.

¹²³ *Id.* at 310 n.11. The \$451,500 COD income is offset by the \$55,740 capital loss, producing net income of \$395,760. *See KAHN & KAHN, supra* note 7, at 287.

¹²⁴ *See* I.R.C. § 108(a) (West Supp. 2008 & Supp. III 2009).

¹²⁵ *Id.* If a debt is discharged in a bankruptcy proceeding or if the debtor is insolvent when the discharge occurs, the amount discharged is excluded from gross income under § 108(a)(1). *Id.*

sify the entire transaction as gain can have devastating effects on a taxpayer who otherwise would have qualified under § 108 to defer the recognition of COD income.¹²⁶ Although the Court considered the overall income effect of the different approaches, it failed to scrutinize the impact each approach would have on the classification of income as either gain or COD and its interaction with § 108.¹²⁷

II. CONSEQUENCES OF HOLDING IN TUFTS

The U.S. Supreme Court's decision in *Commissioner v. Tufts* to utilize the collapsed approach and classify the transaction as gain has resulted in several irregularities involving the treatment of nonrecourse debt.¹²⁸ The following principles and rules are largely a product of the interaction of the Code with the holding in *Tufts*: first, COD income realized under § 61(a)(12) may be deferred under § 108 by financially strapped debtors, whereas no such deferral is available for gain realized under § 1001 and § 61(a)(3);¹²⁹ second, the cancellation of nonrecourse debt is treated differently depending upon whether the property securing the debt is transferred or retained upon the discharge of debt;¹³⁰ and third, the cancellation of recourse debt is treated differently than nonrecourse debt when the security transferred in satisfaction of the debt has a value below the outstanding balance on the loan.¹³¹

A. Section 108 Exception for COD Income

Section 108 creates an exception to the realization requirement of gross income under § 61(a) for certain income from the discharge of indebtedness.¹³² To qualify for deferral under § 108, a taxpayer must first realize discharge of indebtedness income.¹³³ Section 108(a)(1) further requires that, among other things, the discharge occur when the

¹²⁶ See *Tufts*, 461 U.S. at 310 n.11; see also I.R.C. § 108(a).

¹²⁷ See *Tufts*, 461 U.S. at 307-10 & n.11; Geier, *supra* note 27, at 125.

¹²⁸ See 461 U.S. 300, 307-10 & n.11 (1983); Geier, *supra* note 27, at 162.

¹²⁹ See *Danenberg v. Comm'r*, 73 T.C. 370, 386 (1979); Geier, *supra* note 27, at 162.

¹³⁰ See *Gershkowitz v. Comm'r*, 88 T.C. 984, 988-90, 999-1000, 1016 (1987); Geier, *supra* note 27, at 162.

¹³¹ *Tufts*, 461 U.S. at 307-10 & n.11; Geier, *supra* note 27, at 162.

¹³² I.R.C. § 108(a)(1) (West Supp. 2008 & Supp. III 2009).

¹³³ *Id.* In order to realize income from the discharge of indebtedness, there must first exist an item of indebtedness for which the taxpayer is liable subject to an unconditional obligation to repay. See *Milenbach v. Comm'r*, 318 F.3d 924, 930 (9th Cir. 2003); Robert Willens, *The Elusive Notion of "Income from Discharge of Indebtedness,"* 18 J. BANKR. L. & PRAC. 1, art. 4. In general, the elimination or reduction of such indebtedness produces income from discharge of indebtedness. See *United States v. Kirby Lumber*, 284 U.S. 1, 3 (1931).

taxpayer is in a title 11 bankruptcy proceeding, or is insolvent.¹³⁴ Section 108 does not completely eliminate the taxation of income from the discharge of indebtedness.¹³⁵ Instead, it defers recognition until the taxpayer is able to recover financially by reducing future tax benefits to the extent of the income that was deferred under § 108(a)(1).¹³⁶

Despite the fact that Congress enacted § 108 to allow financially strapped debtors to defer the recognition of income from a discharge of indebtedness, the rule does not apply to income or gain derived from the sale or transfer of property in satisfaction of a debt, even if the debtor is insolvent or bankrupt at the time of the discharge.¹³⁷ In the 1979 decision in *Danenberg v. Commissioner*, the Tax Court held that the insolvency exception under § 108 did not relieve the taxpayer of the requirement that he recognize a gain or loss on the disposition of property.¹³⁸ Danenberg, the taxpayer, was insolvent when he sold various items of property securing an outstanding loan to a third party and arranged for the proceeds to be forwarded directly to the bank that issued the loan.¹³⁹ After crediting the cash proceeds from the sale and liquidating Danenberg's remaining collateral against the outstanding debt, the bank forgave the remaining balance of the loan.¹⁴⁰ The court concluded that Danenberg realized a gain on the sale of the property amounting to the difference between the net proceeds paid to the

¹³⁴ I.R.C. § 108(a)(1). For the purposes of § 108, the term "insolvent" means the excess of liabilities over the fair market value of assets. I.R.C. § 108(d). The term "title 11 case" means a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court. *Id.*

¹³⁵ I.R.C. § 108(b).

¹³⁶ *Id.* In general, the amount excluded from gross income shall be applied to reduce the following tax attributes in the following order: (1) net operating losses and carryovers; (2) tax credits and carryovers; (3) capital loss carryovers; and (4) the basis of the taxpayers assets. *Id.* Instead of reducing the foregoing factors, the taxpayer may elect to apply any portion of the reduction to decrease the basis of depreciable property held by the taxpayer. *Id.*

¹³⁷ I.R.C. § 108(a); see *Danenberg*, 73 T.C. at 384-86; H.R. REP. NO. 96-833, at 8-9 (1980), reprinted in 1980 U.S.C.C.A.N. 7017, 7024-25. Gain or loss results whenever there is a sale or other disposition of property. I.R.C. § 1001(a) (2006). For a discussion of the statutory history of § 108, see *infra* notes 214-219 and accompanying text.

¹³⁸ 73 T.C. at 384-86. The question of whether a transfer of property for the cancellation of indebtedness is simply a sale rather than forgiveness of indebtedness is important where the debtor is insolvent. *Id.* at 386. Insolvency would not eliminate the gain arising from a sale of property, whereas a taxpayer's insolvency would eliminate income from the cancellation of indebtedness under § 108. See *id.*

¹³⁹ *Id.* at 380-81.

¹⁴⁰ *Id.* at 376.

bank on behalf of Danenberg and his basis in such property.¹⁴¹ Because there is no insolvency exception that precludes recognition of gain or loss from the sale or other disposition of property, the court held that Danenberg must immediately pay tax on the gain realized from the transfers.¹⁴² In regard to cancellation of indebtedness, the court determined that the remainder of the debt which was not satisfied through the sale of property constituted COD income that did not have to be recognized on account of Danenberg's insolvency.¹⁴³

Why did the Tax Court in *Danenberg* classify part of the taxpayer's income as COD while the taxpayer in *Tufts* realized only non-deferrable gain?¹⁴⁴ In *Tufts*, the sale of the property accompanied the discharge of the nonrecourse obligation in excess of the fair market value of the property.¹⁴⁵ There, the Court applied the collapsed approach and characterized the entire transaction as gain, which is not deferrable under § 108.¹⁴⁶ Yet, in *Danenberg*, the Tax Court held that the taxpayer's sale of assets to a third party was completely separate from the bank's cancellation of the remaining debt.¹⁴⁷ Upon the sale of assets to the third party, the court held that Danenberg realized a non-deferrable taxable gain.¹⁴⁸ Danenberg then applied the proceeds from the sale (cash) in consideration for the bank's forgiveness of the remainder of the loan.¹⁴⁹ This, the court held, resulted in COD income that did not have to be recognized on account of Danenberg's insolvency.¹⁵⁰ The only recognizable difference between *Tufts* and *Danenberg* is that in *Danenberg*, instead of transferring the bank property in consideration of the cancellation of debt, Danenberg transferred the proceeds from the sale of property securing the debt.¹⁵¹ Nevertheless, the discharged debt in *Tufts* was labeled gain whereas the discharged debt in *Danenberg* was labeled cancellation of indebtedness, which is deferrable under § 108.¹⁵²

¹⁴¹ *Id.* at 376.

¹⁴² *Id.* at 384–86.

¹⁴³ *Id.* at 389.

¹⁴⁴ See *Tufts*, 461 U.S. at 317; *Danenberg*, 73 T.C. at 389.

¹⁴⁵ *Tufts*, 461 U.S. at 302–03, 307–10.

¹⁴⁶ I.R.C. § 108(a) (West Supp. 2008 & Supp. III 2009); *Tufts*, 461 U.S. at 307–10 & n.11.

¹⁴⁷ 73 T.C. at 384–86, 388–89.

¹⁴⁸ *Id.* at 376, 384–86.

¹⁴⁹ *Id.*

¹⁵⁰ *Id.* at 388–89.

¹⁵¹ See *Tufts*, 461 U.S. at 302–03; *Danenberg*, 73 T.C. at 380–81.

¹⁵² See *Tufts*, 461 U.S. at 317; *Danenberg*, 73 T.C. at 388–89.

The impact and scope of the holding in *Tufts* is even broader when applied to foreclosures or other involuntary "sales."¹⁵³ Long before its decision in *Tufts*, the U.S. Supreme Court's 1941 decision in *Helvering v. Hammel* established that foreclosures and other involuntary sales constitute a sale or disposition of property under the predecessor to § 1001.¹⁵⁴ In *Helvering*, the respondent argued that because a foreclosure is beyond the control of the taxpayer, it cannot constitute a sale under § 1001.¹⁵⁵ The Court disagreed, and held that there was no basis in the Act, its purpose, or its legislative history to treat sales differently if they are forced and involuntary.¹⁵⁶ A voluntary sale and a mortgage foreclosure are both dispositions under the meaning of § 1001.¹⁵⁷ In 1984, the U.S. Court of Appeals for the Fifth Circuit in *Yarbro v. Commissioner* further extended the *Helvering* ruling to include abandonment of property as a "sale or disposition."¹⁵⁸ Holding otherwise, the court noted, would allow taxpayers to manipulate the character of their gains and losses and frustrate the purpose of § 1001.¹⁵⁹ Through these decisions, courts have widened the scope of § 1001 and restricted a poverty-stricken taxpayer's ability to defer income from a cancellation of indebtedness under § 108.¹⁶⁰

B. Security Retained Versus Transferred upon Debt Discharge

The cancellation of nonrecourse debt is treated differently depending on whether the property securing the debt is transferred or retained upon discharge of the debt.¹⁶¹ Where a taxpayer sells or disposes of an asset upon the discharge of a debt, § 1001 applies and the taxpayer may realize a non-deferrable gain from the transaction.¹⁶² Alternatively, because § 1001 is inapplicable where an asset is retained upon the discharge of a debt, § 108 may allow a taxpayer to defer the recognition of COD income generated by the transaction.¹⁶³ The 1987 Tax Court decision, *Gershkowitz v. Commissioner*, decided four years after

¹⁵³ See *Tufts*, 461 U.S. at 307-10 & n.11; *Helvering v. Hammel*, 311 U.S. 504, 510-11 (1941).

¹⁵⁴ See *Helvering*, 311 U.S. at 510-11.

¹⁵⁵ *Id.* at 507.

¹⁵⁶ *Id.* at 510.

¹⁵⁷ I.R.C. § 1001(a) (2006); *Helvering*, 311 U.S. at 510.

¹⁵⁸ See *Helvering*, 311 U.S. at 510; *Yarbro v. Comm'r*, 737 F.2d 479, 486 (5th Cir. 1984).

¹⁵⁹ *Yarbro*, 737 F.2d at 486.

¹⁶⁰ See *Tufts*, 461 U.S. at 317; *Helvering*, 311 U.S. at 510; *Yarbro*, 737 F.2d at 486.

¹⁶¹ See *Gershkowitz*, 88 T.C. at 988-90, 999-1000, 1016.

¹⁶² I.R.C. § 1001(a); see *Tufts*, 461 U.S. at 317.

¹⁶³ See I.R.C. §§ 108(a) (West Supp. 2008 & Supp. III 2009), 1001(a) (2006).

Tufts, demonstrated the impact of this rule.¹⁶⁴ *Gershkowitz*, in much simplified form, concerned the discharge of two nonrecourse loans by an insolvent partnership known as Digitax.¹⁶⁵ One loan involved a forgiveness of indebtedness without surrender of the securing property and the other was a discharge of indebtedness upon surrendering the securing property that, as in *Tufts*, had a fair market value that was less than the extinguished debt.¹⁶⁶ With regard to the first loan, the Tax Court held that the discharge of the \$250,000 nonrecourse debt for \$40,000 cash, without surrender of the securing property worth \$2,500, produced COD income of \$210,000.¹⁶⁷ Even though the partnership was insolvent, the court did not apply § 108 to allow it to defer recognition of COD income because none of the individual partners were insolvent.¹⁶⁸ Nevertheless, it is significant that the individual partners would have been able to defer the recognition of COD income had they been insolvent.¹⁶⁹

With respect to the second nonrecourse loan, because the partnership surrendered the security interest in satisfaction of the debt, the transaction was treated as a sale arising under § 1001.¹⁷⁰ The court, consistent with the U.S. Supreme Court's decision in *Tufts*, held that the amount realized included the entire amount of the indebtedness to which the property was subject, including the portion in excess of the property's fair market value.¹⁷¹ Thus, the partnership was forced to recognize gain to the extent that the outstanding indebtedness exceeded the partnership's adjusted basis in the re-conveyed property.¹⁷² Because the entire transaction was classified as gain, the partnership did not realize any COD income with respect to the second nonrecourse loan and the insolvency exception under § 108 was unavailable.¹⁷³

¹⁶⁴ *Gershkowitz*, 88 T.C. at 984, 1005–06, 1015–16.

¹⁶⁵ *Id.* at 988–90, 999–1000.

¹⁶⁶ *Id.* at 1005–06, 1015–16.

¹⁶⁷ *Id.* at 1004–14.

¹⁶⁸ *See id.* at 1009.

¹⁶⁹ *See id.* Had the discharge of indebtedness occurred while the taxpayers were insolvent or in a title 11 proceeding, § 108 would have applied to defer the recognition of the \$210,000 of COD income. *See* I.R.C. § 108(a) (West Supp. 2008 & Supp. III 2009); *Gershkowitz*, 88 T.C. at 1009.

¹⁷⁰ *Gershkowitz*, 88 T.C. at 1016.

¹⁷¹ *Id.*

¹⁷² *Id.* Gain under the analysis in *Tufts* is calculated by taking the difference between the outstanding amount of the nonrecourse note and the taxpayer's basis in the property. *Tufts*, 461 U.S. at 307–10.

¹⁷³ *Gershkowitz*, 88 T.C. at 1016.

The Service codified the holding in *Gershkowitz* in Revenue Ruling 91-31, which looked at the effect of a reduction in the principal amount of an under-secured nonrecourse debt.¹⁷⁴ The facts of the ruling concerned a debtor who, in 1988, borrowed \$1,000,000 on a nonrecourse basis from a creditor.¹⁷⁵ The debtor had no personal liability with respect to the note, which was secured by an office building the debtor acquired for \$1,000,000.¹⁷⁶ Subsequently, the value of the office building fell to \$800,000 and none of the \$1,000,000 outstanding principal had been paid off when the creditor agreed to modify the terms of the note, reducing its principal amount to \$800,000.¹⁷⁷ In its ruling, the Service determined that the debtor realized \$200,000 in COD income.¹⁷⁸ Citing *Gershkowitz*, the Service reasoned that when a taxpayer is discharged from all or a portion of a nonrecourse liability with no disposition of the collateral, COD income is realized.¹⁷⁹ An identical taxpayer who is unable to restructure his or her debt, however, is likely to face foreclosure by the bank.¹⁸⁰ In such a case, the taxpayer is saddled with the double burden of losing his or her property along with a non-deferrable gain upon the transfer.¹⁸¹

C. Cancellation of Recourse Versus Nonrecourse Debt

The cancellation of recourse debt is treated differently than nonrecourse debt when the security transferred in satisfaction of the debt has a value below the outstanding balance on the loan.¹⁸² As illustrated in *Tufts*, the transfer of collateral in satisfaction of a nonrecourse debt generates a gain for the taxpayer where the value of the collateral is less than the balance of the debt owed.¹⁸³ In the case of recourse debt, however, the transfer of property to satisfy or discharge a debt will be treated in part as a cancellation of indebtedness, to which § 108 may

¹⁷⁴ Rev. Rul. 91-31, 1991-1 C.B. 19. A nonrecourse debt becomes under-secured when the property securing the debt has a fair market value below the outstanding amount of the nonrecourse debt. See *id.*

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

¹⁷⁹ *Id.*

¹⁸⁰ See Rev. Rul. 91-31, 1991-1 C.B. 19.

¹⁸¹ See *id.* Because foreclosure constitutes a "sale or other disposition" under § 1001, the taxpayer will realize gain under *Tufts* analysis of the difference between the full value of the nonrecourse note and the taxpayer's basis in the property. See *Tufts*, 461 U.S. at 307-10; *Helvering*, 311 U.S. at 510.

¹⁸² *Tufts*, 461 U.S. at 307-10 & n.11.

¹⁸³ *Id.* at 307-10.

apply, and in part as a sale under § 1001.¹⁸⁴ This distinction represents the difference between the collapsed and bifurcated approaches.¹⁸⁵

The 1979 Tax Court decision in *Estate of Delman v. Commissioner* demonstrated the treatment of nonrecourse debt upon foreclosure under the *Tufts* analysis.¹⁸⁶ In *Delman*, an insolvent taxpayer transferred property with a fair market value of \$400,000 and an adjusted basis of \$500,000 to a creditor in foreclosure of a \$1,200,000 nonrecourse loan.¹⁸⁷ The Tax Court held that repossession of the property by the lender constituted a sale or other disposition under § 1001.¹⁸⁸ Because the taxpayer utilized nonrecourse debt, the entire transaction was characterized as gain, equal to the difference between the outstanding amount of the nonrecourse loan and the taxpayer's adjusted basis in the property.¹⁸⁹ Although insolvent, the taxpayer was not able to defer the recognition of the gain because § 108 only allows the deferral of COD income.¹⁹⁰

Had the debt been recourse, the result of this case would have been much different.¹⁹¹ With recourse debt, the Service bifurcates the transaction into a taxable disposition of property and a separate disposition of debt.¹⁹² The taxpayer's amount realized upon disposition of the property would be limited to the property's fair market value of \$400,000.¹⁹³ The taxpayer's adjusted basis of \$500,000 would then be subtracted from the amount realized to produce a deductible loss under § 1001 of \$100,000.¹⁹⁴ The taxpayer would also realize \$800,000 of COD income, which is the difference between the outstanding debt of \$1,200,000 and the fair market value of the property transferred in sat-

¹⁸⁴ *Id.* at 310 n.11.

¹⁸⁵ See *id.* at 307–10 & n. 11. For a discussion of the distinction between the collapsed and bifurcated approaches, see *supra* notes 106–117 and accompanying text.

¹⁸⁶ See 73 T.C. 15, 33 (1979). Although *Delman* was decided before the U.S. Supreme Court came down with its decision in *Tufts*, the Tax Court presided over the original *Tufts* litigation and held that the amount realized upon the disposition of property included the balance due on a nonrecourse liability, even if it exceeded the fair market value of the property. *Tufts v. Comm'r*, 70 T.C. 756, 763–66 (1978).

¹⁸⁷ See *Delman*, 73 T.C. at 27–28.

¹⁸⁸ See *id.* at 33.

¹⁸⁹ See *id.* The taxpayer realized a gain of \$700,000 upon foreclosure, representing the difference between the \$1,200,000 nonrecourse debt and his adjusted basis of \$500,000. *Id.*

¹⁹⁰ *Id.* at 33, 37–40.

¹⁹¹ See *Tufts*, 461 U.S. at 307–10 & n.11; Treas. Reg. § 1.1001-2(a)(2), (c) (ex. 8) (2008).

¹⁹² See *Tufts*, 461 U.S. at 307–10 & n.11; Treas. Reg. § 1.1001-2(a)(2), (c) (ex. 8).

¹⁹³ See *Tufts*, 461 U.S. at 307–10 & n.11; *Delman*, 73 T.C. at 27–28; Treas. Reg. § 1.1001-2(a)(2), (c) (ex. 8).

¹⁹⁴ See I.R.C. § 1001 (2006); *Tufts*, 461 U.S. at 307–10 & n.11; *Delman*, 73 T.C. at 27–28.

isfaction of the debt.¹⁹⁵ The COD income would be deferrable here because the debtor falls under the insolvency exception to § 108.¹⁹⁶

III. CODIFICATION OF *TUFTS* AND AVOIDANCE BY TAXPAYERS

Despite the idiosyncrasies produced by the interaction of the Code with the holding in *Commissioner v. Tufts*, the analysis in *Tufts* has been codified through several statutory provisions.¹⁹⁷ As part of the Tax Reform Act of 1984, § 7701(g) of the Code provides that for the purposes of determining the amount of gain or loss with respect to any property, the fair market value of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which the property is subject.¹⁹⁸ Similarly, Treasury Regulations §§ 1.1001-2(a) and 1.1001-2(c) (ex. 7) require that upon sale or other disposition of property securing a nonrecourse debt, the amount realized from the sale or exchange shall equal the face amount of the nonrecourse debt without regard to the underlying fair market value of the property securing the debt.¹⁹⁹ Thus, §§ 7701(b) and 1.1001-2 have effectively closed the door to any argument that the bifurcated approach should apply in a *Tufts* scenario.²⁰⁰

Nevertheless, because of the incongruous treatment of nonrecourse debt in a *Tufts* scenario, resourceful taxpayers and lawyers have crafted several ways in which an insolvent taxpayer might avoid realization of income from a transfer of property with a fair market value less than that of the nonrecourse debt securing it.²⁰¹ One technique is to convert the nonrecourse debt into recourse debt prior to the disposition of collateral and then transfer the property to the original seller in satisfaction of the debt.²⁰² Because the transaction involves recourse

¹⁹⁵ See I.R.C. § 108(a)(1)(B) (West Supp. 2008 & Supp. III 2009); *Tufts*, 461 U.S. at 310 & n.11; *Delman*, 73 T.C. at 27-28; Treas. Reg. § 1.1001-2(c) (ex.8).

¹⁹⁶ I.R.C. § 108(a)(1)(B).

¹⁹⁷ I.R.C. § 7701(g) (2006); Treas. Reg. § 1.1001-2(a), (c) (ex.7) (2008).

¹⁹⁸ I.R.C. § 7701(g). There is no mention of any difference in treatment when fair market value of the property securing the note falls below the outstanding value of the nonrecourse debt. See *id.*

¹⁹⁹ Treas. Reg. § 1.1001-2(a), (c) (ex.7).

²⁰⁰ See e.g., Geier, *supra* note 27, at 144-62; Milner, *supra* note 6, at 175-76. A "*Tufts* scenario" occurs when the fair market value of property held by the taxpayer falls below the value of the outstanding nonrecourse debt securing such property. See *Comm'r v. Tufts*, 461 U.S. 300, 302-03 (1983).

²⁰¹ See Witt & Lyons, *supra* note 36, at 61.

²⁰² *Id.*

debt, a court would apply the bifurcated approach and any resulting COD income would be deferrable under § 108.²⁰³

A second approach is to sell the collateral to a third party with the lender's consent and use the proceeds to satisfy the nonrecourse debt.²⁰⁴ This is the same approach utilized by the taxpayer in *Danenberg v. Commissioner*.²⁰⁵ The sale of the property securing the nonrecourse debt to a third party would produce a taxable gain (or loss) under § 1001 and the payment of the proceeds to satisfy the debt would result in COD income, which is deferrable under the insolvency exception of § 108.²⁰⁶

The third method involves negotiating a discharge of the nonrecourse debt down to the fair market value of the property by making a partial payment, and subsequently transferring the property to the original lender in satisfaction of the remaining debt.²⁰⁷ The partial payment would produce deductible COD income to the extent of the debt discharged.²⁰⁸ After the cancellation of debt, the fair market value of the property should equal the value of the outstanding debt.²⁰⁹ Now, upon sale or other disposition of the property, the amount realized would be equal to the fair market value of the property and the taxpayer's gain (or loss) on the transfer would be equal to the difference between the fair market value of the property and the taxpayer's adjusted basis in the property.²¹⁰ This result is identical to the Service's treatment of recourse debt under the bifurcated approach where the lender discharges the value of the outstanding debt that exceeds the fair market value of the property securing the debt.²¹¹

In each example, by creatively structuring transactions to avoid the disparate treatment of nonrecourse debt, taxpayers are able to utilize the nonrecognition benefits of § 108 while avoiding the classification of

²⁰³ See I.R.C. § 108(a)(1)(B) (West Supp. 2008 & Supp. III 2009); Treas. Reg. § 1.1001-2(a)(2), (c) (ex. 8).

²⁰⁴ Witt & Lyons, *supra* note 36, at 61.

²⁰⁵ 73 T.C. 370, 376, 380-81, (1979); see *supra* notes 138-143 and accompanying text.

²⁰⁶ I.R.C. §§ 108(a)(1)(B), 1001(a) (2006); *Danenberg v. Comm'r*, 73 T.C. 370, 380-81, 389 (1979). Under the stipulated facts, because the fair market value of the security is less than the outstanding nonrecourse debt, the proceeds from the sale of the property would be insufficient to satisfy the full debt. See *Danenberg*, 73 T.C. at 376. Thus, if the creditor agrees to accept the proceeds in full satisfaction of the remaining debt, the taxpayer realizes COD income to the extent the debt exceeds the proceeds from the sale. *Id.* at 389.

²⁰⁷ Witt & Lyons, *supra* note 36, at 61.

²⁰⁸ See I.R.C. § 61(a)(12) (2006); I.R.C. § 108(a)(1)(B).

²⁰⁹ See Witt & Lyons, *supra* note 36, at 61. The purpose of the negotiations with the bank was to reduce the outstanding amount of debt to the fair market value of the property. *Id.*

²¹⁰ I.R.C. § 1001(a)-(b) (2006).

²¹¹ *Tufts*, 461 U.S. at 307-10 & n.11.

the entire transaction as § 1001 gain.²¹² Looking to the statutory history of § 108, these tactics arguably create a result that is more in line with the purpose of § 108.²¹³

IV. STATUTORY BACKGROUND OF § 108

Congress enacted § 108 of the Code to benefit financially troubled taxpayers by providing temporary relief from the recognition of discharged debt.²¹⁴ Adopted in 1954, § 108 substantially extended the availability of relief from income arising from the discharge of indebtedness.²¹⁵ Income from the cancellation of indebtedness is unique in that nothing is actually received at the time the liability is incurred.²¹⁶ Long before the statutory exception for COD income had been codified in § 108, Congress took note of the fact that taxation of income from the cancellation of indebtedness was particularly burdensome in that it might be incurred long after the initial transaction that provided the taxpayer with funds.²¹⁷ There was much concern that it was unjust to impose a large tax upon the theoretical profit resulting from the modification or liquidation of the indebtedness of the debtor.²¹⁸ Because the taxable event does not produce cash for the tax payment, Congress reasoned that it made little sense to force an insolvent or bankrupt debtor to immediately pay tax on the amounts the debtor had been unable to pay his creditors.²¹⁹

Thus, § 108 was intended to allow Congress to defer, but eventually collect tax on, ordinary income realized from the discharge of indebtedness.²²⁰ Under the statute, a taxpayer who is insolvent or in a title 11 proceeding will not immediately pay tax on income from a discharge of

²¹² See I.R.C. §§ 108(a)(1)(B), 1001; Witt & Lyons, *supra* note 36, at 61.

²¹³ See H.R. REP. NO. 96-833, at 8-9 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7024-25.

²¹⁴ See *id.*

²¹⁵ *Estate of Delman v. Comm'r*, 73 T.C. 15, 39 n.19 (1979). Prior to 1954, §§ 22(b)(9) and 113(b)(3) of the Internal Revenue Code of 1939 permitted corporations in unsound financial condition to exclude from income a gain resulting from the discharge of indebtedness evidenced by a security. H.R. REP. NO. 76-855, at 23-25 (1939). Individuals were not able to exclude income from the discharge of indebtedness under §§ 22(b)(9) or 113(b)(3) of the Internal Revenue Code of 1939. *Id.*

²¹⁶ William T. Plumb, Jr., *The Tax Recommendations of the Commission on the Bankruptcy Laws—Reorganizations, Carryovers and the Effects of Debt Reduction*, 29 TAX L. REV. 227, 255 (1974).

²¹⁷ Norris Darrell, *Discharge of Indebtedness and the Federal Income Tax*, 53 HARV. L. REV. 977, 977-78 (1940).

²¹⁸ Plumb, *supra* note 216, at 260.

²¹⁹ See *id.* at 277.

²²⁰ H.R. REP. NO. 96-833, at 8-9 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7024-25.

indebtedness.²²¹ Instead, the amount of discharged debt which is excluded from gross income is applied to reduce certain tax attributes specified in § 108(b).²²² The attribute-reduction provisions of the statute give flexibility to the debtor to account for a debt discharge amount in a manner most favorable to the debtor's tax situation.²²³

The deferral rules of § 108 apply with respect to discharge of any indebtedness for which the taxpayer is liable or arising from property the taxpayer holds.²²⁴ The legislative history and the statutory language of the act provide no additional explanation about what constitutes "indebtedness of the taxpayer."²²⁵ Nevertheless, as interpreted over the years, the words "indebtedness . . . subject to which the taxpayer holds property" have been understood to mean nonrecourse debt.²²⁶ One might have deciphered from this interpretation an intent to include gain attributed to the discharge of indebtedness under § 108.²²⁷ Yet, in spite of this option, subsequent decisions by the Service and the Court have limited the scope of § 108 and precluded gain from the discharge of indebtedness.²²⁸ This relatively arbitrary determination conflicts with

²²¹ *Id.* at 9. For a definition of "insolvent" and "title 11 case" as it applies to § 108, see *supra* note 134. A debtor is allowed to defer taxation of COD income up to the amount he or she is insolvent. I.R.C. § 108(d) (West Supp. 2008 & Supp. III 2009). Any COD income that exceeds the insolvency of the debtor is taxed as ordinary income. *See id.*

²²² I.R.C. § 108(b). Unless the taxpayer elects first to reduce the basis of depreciable assets, the debt discharge amount is applied to reduce the taxpayer's tax attributes in the following order: (1) net operating losses and carryovers; (2) tax credits and carryovers; (3) capital loss carryovers; and (4) the basis of the taxpayer's assets. *Id.* Where the taxpayer elects to reduce the basis of depreciable assets instead of reducing future tax attributes, a subsequent disposition of the reduced-basis property will be subject to "recapture" in order to ensure that the debt discharged amount is eventually taxed as ordinary income. *See* H.R. REP. NO. 96-833, at 8. Section 1245 of the Code governs recapture and ensures that, upon disposition, the amount of gain attributable to depreciation or a reduction in basis is taxed as ordinary income and not capital gain. I.R.C. § 1245(a) (2006).

²²³ H.R. REP. NO. 96-833, at 8.

²²⁴ I.R.C. § 108(d)(1).

²²⁵ *Id.*; *see* S. REP. NO. 96-1035 (1980).

²²⁶ *See* *Crane v. Comm'r*, 331 U.S. 1, 14 (1947); *see also* Witt & Lyons, *supra* note 36, at 44 n.190. A basic tenet of statutory construction is that statutory language should be ascribed its plain and ordinary meaning. *See* *Old Colony R.R. Co. v. Comm'r*, 284 U.S. 552, 560 (1931); *see also* Witt & Lyons, *supra* note 36, at 44 n.190.

²²⁷ *See* *Crane*, 331 U.S. at 14. Gain attributed to the discharge of indebtedness, or "Tufts gain," is the difference between the outstanding amount of nonrecourse debt and the fair market value of the property securing the debt. *See* *Comm'r v. Tufts*, 461 U.S. 300, 307-10 & n.11 (1983). Tufts gain is equal to the amount of COD income produced from an identical transaction involving recourse debt. *Id.*; *see supra* notes 114-118 and accompanying text.

²²⁸ *See* *Tufts*, 461 U.S. at 307-10 & n.11; Treas. Reg. § 1.1001-2(a), (c) (ex.7) (2008).

the original objective of § 108, which is to provide relief for financially troubled debtors.²²⁹

The purpose of deferral under § 108 was to spread the immediate tax burden from a discharge of indebtedness over a subsequent period in which the debtor has actual cash flow.²³⁰ It was intended to provide a "fresh start" for insolvent or bankrupt debtors.²³¹ Congress justified this leniency because of the belief it would help preserve a business enterprise's ability to be economically productive.²³² Accordingly, the financial burden on the government was thought to be minimal as greater tax revenues were anticipated from the sustenance and economic prosperity of individuals and corporations.²³³ Nor was deferral of COD income under § 108 thought to be unfair to creditors because in a simple insolvency or bankruptcy case, the creditors receive nothing once their claims have been canceled or discharged.²³⁴ Instead, the rules of the statute allow for debtors to recover from their financial difficulties while preserving the congressional intent of collecting, within a reasonable period, tax on the ordinary income realized from debt discharge.²³⁵

V. SECTION 108 AND THE INCLUSION OF TUFTS GAIN

No rational explanation can be advanced as to why gain attributable to a discharge of indebtedness is not covered under § 108.²³⁶ In light of the consequences of *Commissioner v. Tufts*, the structures taxpayers have utilized to exploit this disparity, and the statutory history of § 108, it is apparent that a deficiency exists in the treatment of nonrecourse debt cancellation that needs to be corrected.²³⁷

²²⁹ See H.R. REP. NO. 96-833, at 8-9 (1980), reprinted in 1980 U.S.C.C.A.N. 7017, 7024-25. For example, a bankrupt or insolvent debtor who wishes to retain net operating losses and other carryovers will be able to elect to reduce asset basis in depreciable property. *Id.* at 9. On the other hand, a debtor having an expiring net operating loss which otherwise would be "wasted" can apply the debt discharge amount first against the net operating loss. *Id.*

²³⁰ Plumb, *supra* note 216, at 277.

²³¹ See H.R. REP. NO. 96-833, at 9.

²³² H.R. REP. NO. 75-1409 (1937).

²³³ See *id.*

²³⁴ Plumb, *supra* note 216, at 278.

²³⁵ See H.R. REP. NO. 96-833, at 9 (1980).

²³⁶ See *Tufts v. Comm'r*, 461 U.S. 300, 307-10 & n.11 (1983); H.R. REP. NO. 96-833, at 8-9 (1980); Plumb, *supra* note 216, at 260, 277. For a definition of "gain attributed to the discharge of indebtedness," see *supra* note 227.

²³⁷ See *Gershkowitz v. Comm'r*, 88 T.C. 984, 988-90, 999-1000, 1016 (1987); *Danenberg v. Comm'r*, 73 T.C. 370, 386 (1979); *Estate of Delman v. Comm'r*, 73 T.C. 15, 37-40 (1979).

A. *No Rational Explanation for § 108 Exclusion of Gain Attributed to a Discharge of Indebtedness*

The Service currently applies a different analysis depending on whether the property securing the nonrecourse debt is transferred or retained upon the discharge of debt.²³⁸ Where an asset is retained upon the discharge of debt, § 108 may apply to defer the recognition of COD income.²³⁹ On the other hand, if the taxpayer sells or otherwise disposes of the asset, § 108 is inapplicable and the taxpayer recognizes gain (or loss) from the transaction.²⁴⁰ Because the only difference between these two scenarios is the conveyance of the property, the act of transferring property must somehow hold the key to the Service's treatment of gain attributable to the discharge of indebtedness.²⁴¹ Where property is transferred, § 1001 governs in order to determine the gain or loss from the transaction.²⁴² Because the debtor is not personally liable for the nonrecourse note, any debt forgiven is done so involuntarily on the part of the creditor.²⁴³ Where the property is retained, any discharge of indebtedness is voluntary and the result of negotiations between the debtor and creditor.²⁴⁴

There is no rational explanation for why the voluntariness of a creditor's actions in foregoing the collection of a deficiency should have an impact on how the transaction is taxed.²⁴⁵ Both transactions are indistinguishable, whether viewed from the side of the debtor or the creditor.²⁴⁶ In each situation, the debtor is taxed simply because of the failure to repay the amount previously received from the lender tax-free and subject to the obligation of repayment.²⁴⁷ From the creditor's perspective, it is irrelevant whether the discharge was voluntary or involuntary because the amount of debt discharged in each transaction is identical.²⁴⁸ It follows that whether the discharge was voluntary (the fact that the security was retained) should have no impact on how the debtor is taxed.²⁴⁹

²³⁸ *Gershkowitz*, 88 T.C. at 988–90, 999–1000, 1016.

²³⁹ *Id.* at 1004–14.

²⁴⁰ *Id.* at 1016.

²⁴¹ See Geier, *supra* note 27, at 171–72.

²⁴² I.R.C. § 1001(a) (2006).

²⁴³ KAHN & KAHN, *supra* note 7, at 602–03.

²⁴⁴ *Id.*

²⁴⁵ Geier, *supra* note 27, at 172.

²⁴⁶ *Id.*

²⁴⁷ *Id.*

²⁴⁸ *Id.*

²⁴⁹ See *Gershkowitz*, 88 T.C. at 988–90, 999–1000, 1016; Geier, *supra* note 27, at 172.

Nor can § 108's exclusion of gain from the discharge of indebtedness be justified due to the distinction between recourse and nonrecourse debt.²⁵⁰ The Service taxes the cancellation of recourse debt differently than nonrecourse debt where the security transferred has a value below the outstanding balance on the loan.²⁵¹ This practice is a violation of the very principles established in *Crane v. Commissioner*, which laid the foundation for the treatment of nonrecourse debt as a "true loan."²⁵² As the Court observed in *Tufts*, the only difference between a nonrecourse debt and one for which the borrower is personally liable is that with nonrecourse debt, the creditor's remedy is limited to foreclosing on the securing property.²⁵³ This merely shifts the risk of any potential loss caused by devaluation of the property from the borrower to the lender.²⁵⁴ The use of nonrecourse debt has no effect on the nature of the debtor's obligation and does not erase the fact that the debtor received the loan proceeds tax-free and included them in basis on the understanding that there was an unconditional obligation to repay the full amount.²⁵⁵ When a debt is canceled, the debtor is relieved of his or her responsibility to repay the sum originally received and thus realizes value to the extent of the canceled debt.²⁵⁶ Nevertheless, with nonrecourse debt, the canceled amount is included in the amount realized on disposition and enters into the computation of the debtor's gain (or loss) on the transaction.²⁵⁷ With recourse debt, a discharge of indebtedness produces COD income, which may be deferred under § 108.²⁵⁸

Whether deliberate or unintentional, the *Tufts* ruling created a substantial divergence in how § 108 applied to different debt discharge scenarios involving recourse and nonrecourse debt.²⁵⁹ Yet, as the Court in *Tufts* noted, not only is the nature of the obligation the same as between recourse and nonrecourse debt, the rationalization for taxing a discharged obligation is the same as well.²⁶⁰ Adhering to the Court's reasoning that recourse and nonrecourse debt be treated equally, gain

²⁵⁰ See *Tufts*, 461 U.S. at 307-10 & n.11.

²⁵¹ *Id.*

²⁵² See *Crane v. Comm'r*, 331 U.S. 1, 11-13 (1947).

²⁵³ 461 U.S. at 311-12.

²⁵⁴ *Id.* at 312.

²⁵⁵ *Id.*

²⁵⁶ *United States v. Kirby Lumber*, 284 U.S. 1, 3 (1931).

²⁵⁷ *Tufts*, 461 U.S. at 307-10.

²⁵⁸ *Id.* at 310 n.11.

²⁵⁹ See *id.* at 307-10 & n.11.

²⁶⁰ See *id.* at 311-12.

attributed to the discharge of indebtedness should be deferrable under § 108 for nonrecourse as well as recourse debt.²⁶¹

B. *Statutory and Equitable Support for Amendment of § 108*

The statutory history of § 108 provides additional support for the conclusion that gain attributed to the discharge of indebtedness should be covered under § 108.²⁶² Congress enacted § 108 to allow insolvent or bankrupt debtors to defer the immediate recognition of discharged debt.²⁶³ Congress believed that the imposition of a large tax upon the theoretical profit resulting from the modification or liquidation of a debt was unjust and contrary to the policy of promoting successful business enterprises.²⁶⁴ Nevertheless, by excluding gain from the discharge of indebtedness from § 108, Congress is ignoring the very policies that form the backbone of the rule.²⁶⁵ Gain from the discharge of indebtedness is identical to COD income in that it produces no cash for the payment of the tax liability.²⁶⁶ Thus, as is the case with COD income, it is illogical for the Service to tax an insolvent or bankrupt taxpayer on the discharged amounts he or she had been unable to pay his or her creditors.²⁶⁷ Rather, deferring the gain under § 108 and taxing it over a subsequent period in which the taxpayer has cash flow is a more reasonable approach.²⁶⁸

The fundamental goals of equity and fairness in the administration of the tax system provide additional justifications for the inclusion of a *Tufts* gain under § 108.²⁶⁹ Horizontal equity is the principle that similarly situated taxpayers should face similar tax burdens.²⁷⁰ In many respects, horizontal equity is a fundamental criterion of a "good tax" and its violation, while not fatal, indicates that tax burdens are not fairly distributed.²⁷¹

In applying the horizontal equity principle, income is a common measure used to group "similarly situated" taxpayers.²⁷² Thus, two insol-

²⁶¹ *Id.*

²⁶² See H.R. REP. NO. 96-833, at 8-9 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7024-25.

²⁶³ *Id.*

²⁶⁴ Plumb, *supra* note 216, at 260.

²⁶⁵ See *id.*

²⁶⁶ *Id.*

²⁶⁷ See *id.*

²⁶⁸ See *id.* at 260.

²⁶⁹ See Elkins, *supra* note 25, at 43.

²⁷⁰ *Id.* at 43.

²⁷¹ *Id.* at 43-44.

²⁷² See *id.* at 44-45.

vent taxpayers, one with COD income and one with gain from the disposition of indebtedness, are similarly situated if they have similar incomes.²⁷³ It is irrelevant whether the borrower is personally liable for the debt or whether the property is transferred upon disposition of the debt.²⁷⁴ By allowing the insolvent taxpayer to defer COD income while not allowing the identical taxpayer to defer gain from the discharge of indebtedness, horizontal equity is violated.²⁷⁵ Theories of social justice and morality require equity in our legislative and judicial system.²⁷⁶ It is apparent, however, that § 108 is seriously flawed in this regard.²⁷⁷ In the interests of complying with the purpose of § 108 as well as equity principles, Congress must amend § 108 to include gain from the disposition of indebtedness.²⁷⁸

C. Economic Justifications for Inclusion of Gain from the Discharge of Indebtedness in § 108

Given the worsening economic environment, it is unsound from an economic policy standpoint to preclude gain from the disposition of indebtedness from the reach of § 108.²⁷⁹ Tumbling real estate values combined with the record number of foreclosures mean that many more debtors will realize *Tufts* gains.²⁸⁰ Taxing these gains is irresponsible in a financial crisis of this magnitude as it saddles struggling taxpayers with additional debt they cannot afford to pay.²⁸¹ This further perpetuates the financial collapse and puts additional pressure on the real estate market and banks.²⁸² Consider, for example, the tax implications of Deutsche Bank's attempts to foreclose on the \$482 million loaned to

²⁷³ See *id.*

²⁷⁴ See *id.*

²⁷⁵ See Elkins, *supra* note 25, at 44-45.

²⁷⁶ *Id.*

²⁷⁷ See *id.*

²⁷⁸ See *id.* at 44-45; Plumb, *supra* note 216, at 260.

²⁷⁹ See H.R. REP. NO. 75-1409 (1937); Milner, *supra* note 6, at 161; Christie, *supra* note 1. For an interesting discussion of the economic incentives of the federal income tax system generally, compare Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993 (2004) (arguing that an economic benefit would result from reducing income inequality through the tax system), with Richard Schmalbeck, *The Death of the Efficiency-Equity Tradeoff? A Commentary on McMahon's The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 1143 (2004) (suggesting that only moderate rate adjustments would be desirable).

²⁸⁰ *Tufts*, 461 U.S. at 317; Milner, *supra* note 6, at 161.

²⁸¹ See Plumb, *supra* note 216, at 260.

²⁸² See Christie, *supra* note 1.

develop the Drake Hotel site in New York City.²⁸³ Harry Macklowe bought the Drake in 2006 for \$418 million using money borrowed from Deutsche Bank.²⁸⁴ For demonstration purposes, assume that the fair market value of the property has fallen to \$300 million and that Macklowe has a basis of \$250 million in the property. Under the *Tufts* analysis, Macklowe would realize a non-deferrable gain of \$232 million.²⁸⁵ Currently, Macklowe is experiencing significant financial difficulties and is in default on several other loans totaling well over \$1 billion.²⁸⁶ Requiring Macklowe to immediately pay tax on a \$232 million gain will do nothing but push him further into economic arrears with his creditors by depriving them of this additional cash.²⁸⁷ This, in turn, puts added strain on the banks that provided the financing to Macklowe to purchase these properties.²⁸⁸ Thus, by taxing Macklowe's gain on the disposition of indebtedness, the Service is essentially hurting the very financial institutions that are presently near collapse and have been forced to turn to the government for aid.²⁸⁹ Applying § 108 to defer this immediate tax payment over a subsequent period where the debtor has actual cash flow is a sensible step for Congress to take.²⁹⁰

CONCLUSION

The disparate treatment of nonrecourse debt in situations involving the transfer of property worth less than the debt, in full satisfaction of the debt, has no justification. The U.S. Supreme Court in *Commissioner v. Tufts* was correct in concluding that the full amount of a non-recourse debt should be included in the amount realized on sale, notwithstanding the fair market value of the debt. Nevertheless, the Court

²⁸³ Adam Pincus, *Macklowe Faces Foreclosure on Drake Site*, THE REAL DEAL, Sept. 3, 2008, <http://ny.therealdeal.com/articles/macklowe-faces-foreclosure-on-drake-site> (last visited Sept. 18, 2009).

²⁸⁴ Adam Pincus, *Macklowe Claims \$250M Personal Equity in the Drake Site*, THE REAL DEAL, Mar. 18, 2009, <http://ny.therealdeal.com/articles/macklowe-claims-250m-personal-equity-in-drake-site> (last visited Sept. 18, 2009).

²⁸⁵ See *Tufts*, 461 U.S. at 310 & n.11. Macklowe's gain is computed by taking the difference between \$482 million, the full amount of the outstanding loan, and \$250 million, Macklowe's adjusted basis in the property. See *id.*

²⁸⁶ See David M. Levitt, *Macklowe May Lose \$500 Million Site on Park Ave*, BLOOMBERG.COM, Sept., 11, 2009, <http://www.bloomberg.com/apps/news?pid=20601206&sid=aRGcQNjJWmJ8&refer=realestate> (last visited Sept. 18, 2009).

²⁸⁷ See *id.*

²⁸⁸ See *id.*

²⁸⁹ See *id.*

²⁹⁰ See *Tufts*, 461 U.S. at 307-10 & n.11; H.R. REP. NO. 96-833, at 8-9 (1980), reprinted in 1980 U.S.C.C.A.N. 7017, 7024-25; Plumb, *supra* note 216, at 260; Christie, *supra* note 1.

failed to consider the impact this conclusion would have on the ability of a financially troubled debtor to defer COD income under § 108. The statutory history of § 108 demonstrates that the policy reasons for allowing the deferral of COD income directly apply and implicitly authorize § 108 to cover gain from the cancellation of indebtedness. The overriding principles of equity and fairness in the administration of our tax system lend additional support for this conclusion. Given the current economic environment, the need for such a change has never been more relevant or pressing.

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