Nonrecourse Debt Revisited, Restructured and Redefined

Linda Sugin
Fordham University School of Law, lsugin@law.fordham.edu

Follow this and additional works at: http://ir.lawnet.fordham.edu/faculty_scholarship
Part of the Taxation-Federal Income Commons

Recommended Citation
Available at: http://ir.lawnet.fordham.edu/faculty_scholarship/55
Nonrecourse Debt Revisited, Restructured and Redefined

LINDA SUGIN*

I. INTRODUCTION

As the popularity of nonrecourse debt has risen and fallen in response to both market forces and opportunities offered by the tax law for its exploitation, the tax treatment of nonrecourse debt has changed, but in a remarkably haphazard way. Although the courts have struggled to define the tax nature of nonrecourse debt since the 1940’s, Congress stood by passively for three decades, finally entering the fray only when tax avoidance had become so widespread that the courts were unable to control it. Making matters worse, each time they addressed the issue, Congress and the courts did so narrowly, limiting their responses to the exigencies of the day. They treated only the particular symptoms they observed without curing the underlying problem. As a result, the law today is inconsistent and overly complex; each new use of nonrecourse debt produced new questions, whose resolutions were layered upon prior inadequate answers. Yet, despite numerous opportunities to revisit the issue, neither Congress nor the judiciary has ever sought to rebuild the foundation upon which all later constructions rest.

This Article suggests that the foundation for the tax treatment of nonrecourse debt under current law—the true debt approach—is unworkable. It does not reflect economic reality or correctly measure income. It leads to bizarre and unpredictable consequences, and invites abuse, such as inflated seller financing and deduction shifting from low bracket to high bracket taxpayers. Much has been written about the role of nonrecourse debt in making abusive tax shelters profitable, and while abusive tax shelters no longer abound as they

* Associate Professor, Fordham University School of Law. I am very grateful to Noel Cunningham, Jill Fisch, Constantine Katsoris, Deborah Schenk, Leo Schmolka and Steve Thel for their helpful comments, Allison Levey for her research assistance and Fordham University School of Law for its generous support.

once did, nonrecourse debt continues to pose serious problems, even in the post-Tax Reform Act of 1986\(^2\) era. If inflated seller financing were the only problem, nonrecourse debt would no longer be an issue.\(^3\) This Article argues that nonrecourse debt is not simply a tax shelter problem.

Restructurings are the nonrecourse debt disaster for the 1990's. This Article describes the tax consequences of restructuring undersecured nonrecourse debt to illustrate the continuing difficulties of the traditional approach to nonrecourse debt. It is one example that indicates that the vexatious tax treatment of nonrecourse debt is persistent, and suggests that future decades might suffer yet unknown hardship if nonrecourse debt continues to be treated as an unconditional obligation to pay. The issues arising from the workout of troubled nonrecourse debt bear little resemblance to those posed by the shelters for doctors and lawyers popular in the 1980's, but because the tax treatment of nonrecourse debt fails to reflect the economic bargain that such debt strikes, they create problems for taxpayers and administrators today. Perhaps the restructurings dilemma finally will convince Congress that addressing the manifestations of nonrecourse debt—with legislation such as §§ 465 and 469—is insufficient, and that the traditional approach to nonrecourse debt is essentially flawed and therefore will be a continuing source of confusion, if not tax avoidance.

This Article concludes that restructurings present a tax crisis for debtors holding property mortgaged for more than its value\(^4\) because current law requires such debtors to cede ownership for tax purposes or report cancellation of indebtedness income.\(^5\) To date, no rulings or cases analyze the restructuring of excessive nonrecourse debt in the circumstances described in this Article. This vacuum is not surprising because taxpayers have no incentive to bring this issue to the government's attention and the government has insufficient information to


Throughout this Article, I intend references to tax shelters to be in the colloquial sense, implying transactions entered into with the primary purpose of sheltering income produced by other activities from taxation, and not transactions described in IRC § 6111(c).

\(^{4}\) Throughout this Article, “value” is used to mean “fair market value,” which, in its classic formulation, and for all purposes of the Code, is defined by § 20.2031-1(b) of the regulations as “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.”

\(^{5}\) See Section II.
identify undersecured restructured debt. This Article explains that under current law, debt restructurings that allow nonrecourse debt to remain undersecured would be treated as foreclosures, that is, as transfers of property. Such treatment discourages restructurings that would be beneficial for both borrowers and lenders and creates a trap for the unwary.

This result arises from the flawed current treatment of nonrecourse debt, which treats the debt as a true obligation to pay. Alternatives to the traditional true-debt approach to nonrecourse debt would improve income measurement. Some would require more revolutionary changes in the law than others. This Article takes no position on the wisdom of the realization rule, and supports an approach that fits within the current realization-based system. It recommends redefining nonrecourse debt as an investment by the lender in the securing property, rather than as part of the borrower's current cost of the property.6

More specifically, I propose a system in which nonrecourse debt secured by depreciable property essentially is treated as a depreciable asset held by the lender, unlike other debt obligations which, under current law, are presumed not to waste by virtue of the repayment of principal. I suggest that the borrower and lender share depreciation deductions, relative to investment, on a temporal basis. Under this approach, the borrower and lender each would be entitled to depreciation deductions equal to the cash and recourse debt7 that each invested in the property. The borrower would be entitled to depreciate her investment first whenever it is subordinated to the lender's investment. Although this approach would require that lenders and borrowers keep running tallies of their respective investments in property, it also would simplify a complex body of law developed in response to the tax shelter phenomenon. These changes would be consistent with the concept of basis as investment in property, and thereby square with the cost recovery function of the Code's allow-

---

6 The Supreme Court considered this approach in Tufts, but rejected it because it would have meant overturning the approach taken in Crane, which the Court apparently was unwilling to do. See Commissioner v. Tufts, 461 U.S. 300, 308 n.5 (1983) (citing Diane M. Anderson, Note, Federal Income Tax Treatment of Nonrecourse Debt, 82 Colum. L. Rev. 1498, 1514 (1982)); see also Crane v. Commissioner, 331 U.S. 1, 10-11 (1946) (concluding that basis for depreciation "is the value of the property, undiminished by mortgages thereon").

7 This proposal is grounded in the observation that nonrecourse debt is more like an investment in property than an obligation of a borrower, and therefore should be treated as an equity investment rather than true debt. While there are differences between recourse debt and cash invested in property, those differences are not based on the subject of the investment, and, therefore, this Article takes no position with regard to recourse debt. Rather, it starts from the assumption that recourse debt is treated like cash for purposes of basis assignment.
ance for depreciation. It also would fit well with the other purpose of depreciation allowances, namely, to reflect the decline in value of property, by allocating deductions to the party who would suffer a loss if such deductions accurately measured the decline in the property's value. The proposal is intended to inform a way of thinking about nonrecourse debt, basis and depreciation without abandoning the realization requirement and without resolving every issue that a change in the approach to nonrecourse debt eventually could warrant.

Section II briefly reviews the history of the treatment of nonrecourse acquisition debt, and presents an example of a current challenge in the evolution of the law, real estate restructuring. Section III analyzes the restructuring under current law, asking the question that remains open: What happens to the basis in the property in the restructuring of an undersecured nonrecourse debt? It concludes that current law would treat a restructuring as a transfer of securing property to the lender in satisfaction of the debt whenever the value of the securing property is less than the outstanding amount of the debt after the restructuring. Section IV explains how the realization requirement forces the issue on a restructuring and considers whether manipulation of the realization event for the property would be a better solution to the restructuring problem than revising the basic approach to nonrecourse debt would be. Section V discusses why the true-debt approach is unacceptable, both in a restructuring and elsewhere. Section VI describes the debt as an investment and a temporal depreciation allocation approach, and demonstrates how this approach would work in practice.

II. DEVELOPMENT OF THE LAW

A. Crane v. Commissioner

Crane v. Commissioner, decided at a time when nonrecourse debt was not widely used, laid the foundation for the tax treatment of nonrecourse debt. The petitioner inherited a building subject to a mortgage, for which she never had any personal liability. At the time of the decedent's death, the building had a value equal to the encumbrance. The Supreme Court determined that Crane's basis in the building at the time of the inheritance, under a predecessor to § 1014, was the value of the building undiminished by the mortgage. It also held that on Crane's sale of the building, her amount realized included both the cash she received and the debt to which the property was

8 331 U.S. 1 (1947).
9 See id. at 3.
10 See id. at 6-11.
The critical legacy of *Crane* is the true-debt approach: A nonrecourse mortgage is treated like a recourse mortgage and, therefore, is included both in the taxpayer’s basis on acquisition and in the amount realized on disposition of the property.

One of the Court’s primary concerns in reaching its conclusion about basis was administrative. Because basis determines the depreciation deductions allowed on the property, the Court avoided the “tremendous accounting burden on both the Commissioner and the taxpayer” of an annually shifting basis. If the taxpayer were allowed basis only to the extent of principal payments on the obligation, her basis would increase as the payments were made. To avoid this problem, the Court instead chose to treat the taxpayer as though she already had satisfied the entire mortgage. The Court thus created a tidy rule that allowed all depreciation deductions to be taken by one, and only one person—the owner-obligor.

The *Crane* case was an easy one in which to conclude that basis should include the secured debt because the Court found that the encumbrance never exceeded the value of the property, and the nonrecourse debt, therefore, was, in fact, indistinguishable from recourse debt. It left open the question of whether a taxpayer should be entitled to depreciation deductions attributable to basis predicated upon nonrecourse debt in excess of the value of the securing property.

---

11 See id. at 13-14.

12 Id. at 10.

13 The Court also was troubled by the mismatch of income and related cost that would occur if the property economically depreciated more rapidly than the debt was amortized, presumably because the Court believed that only the borrower-owner could claim depreciation deductions. See id. at 10-11.

14 The virtue in assigning all depreciation deductions to one party is unclear; perhaps its simplicity is appealing. Nevertheless, it would be possible for all the property’s depreciation deductions to be utilized without assigning them solely to the owner-obligor. See Neil B. Cunningham & Deborah H. Schenk, *Taxation Without Realization: A “Revolutionary” Approach to Ownership*, 47 Tax L. Rev. 725, 751-74 (1992) (proposing that tax law recognize multiple interests, such as income and remainder interests in a single property, in order to tax the income from property more accurately); Anderson, note 6; Section V.

15 See, e.g., United States v. Hendler, 303 U.S. 564 (1938) (including debt for which purchaser is personally liable in cost basis); Brons Hotels, Inc. v. Commissioner, 34 B.T.A. 376 (1936) (same).

16 “Whatever may be the rule as to allowing depreciation to a mortgagor on property in his possession which is subject to an unassumed mortgage and clearly worth less than the lien, we are not faced with that problem and see no reason to decide it now.” *Crane*, 331 U.S. at 12. This language is broad enough to apply to property held in a declining market as well as property purchased subject to nonrecourse debt. *Crane* predated tax shelters based on nonrecourse debt and accelerated depreciation, and it is therefore significant that the Court recognized this issue as a matter of legal interpretation.

The issue of depreciation attributable to nonrecourse debt that is excessive upon acquisition finally was determined in 1976, when the Ninth Circuit decided that inflated acquisition debt does not support basis. See Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976). The Ninth Circuit did not resolve the entire depreciation question because
A close reading of *Crane* makes clear that the Court deliberately left open the possibility that a debtor, who correctly enjoys depreciation deductions on the acquisition of property because its value suggests that the debt will be treated as a personal liability, thereafter might be denied depreciation deductions as soon as the value of the property fell below the outstanding debt. This issue has never been resolved because, prior to being raised by the restructuring of nonrecourse debt, the realization requirement relegated it to the theoretical realm. Without a realization event, or at least a revaluation implicit in a default, the owner's rights and obligations with respect to property, and the value of the property, ordinarily are not redetermined periodically. Therefore, without a restructuring, there is no occasion to raise the issue of whether depreciation claimed in the ordinary course is excessive in relation to the property's value.

**B. Beyond Crane**

1. **Estate of Franklin: Curtailing Basis Abuses**

The premise of *Crane*—that nonrecourse debt is equivalent to recourse debt—fostered the proliferation of inflated nonrecourse acquisition debt and inspired tax avoidance schemes in seller-financed transactions, which were slowed finally by the Ninth Circuit's *Franklin* decision. In that case, a group of doctors entered into a purported sale-leaseback arrangement with the owners and operators of a motel. The doctors "paid" a price greatly in excess of the value of the motel, and under *Crane*'s true-debt rule, used that amount as their basis for determining depreciation. The Tax Court held that the doctors had acquired nothing more than an option to purchase the

---

*Franklin* did not involve property worth more than the related debt at the outset that later declined to a value less than the debt. This case is discussed in Sections II.D. and III.

17 See *Crane*, 331 U.S. at 12; see Section III.D.

18 See Section III.

19 See Bittker, note 1, at 283 ("By holding that nonrecourse liabilities are includable in the taxpayer's basis for property, *Crane* laid the foundation stone of most tax shelters . . . ."). Professor Bittker took a jab at the Service by proposing an essay contest for its staff attorneys on their "pyrrhic victories."

20 Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976).

21 The doctors "purchased" the motel for approximately twice its value and leased it back for rental payments that exactly matched the mortgage payments due to them from the doctors. See id. at 1047, 1048 n.4. The Tax Court made no finding as to the value of the motel, stating that the value of the property could not be determined on the record before it. Estate of Franklin v. Commissioner, 64 T.C. 752, 767-68 (1975). The Ninth Circuit interpreted this as the taxpayer's fatal failure of proof. 544 F.2d at 1048. A small amount of "prepaid interest" compensated the seller-operators for their trouble, but, otherwise, no money changed hands. Id. at 1047.

22 See Tufts v. Commissioner, 461 U.S. 300, 313 (1983) ("*Crane* also stands for the broader proposition, however, that a nonrecourse loan should be treated as a true loan.").
motel when the mortgage came due. The Ninth Circuit agreed with the Tax Court that the doctors were not entitled to depreciation deductions attributable to the inflated debt, but, rather than characterizing the transaction as an option (or anything else), simply reasoned that no sale had taken place. The inflated debt, therefore, was not a true "obligation" of the borrowers.

The Ninth Circuit refused to include the debt in basis because the doctors failed to prove that it represented an investment in the property. The debtors had no incentive to pay the debt, for they would gain no equity in the property until after one-half the obligation had been paid. The court observed that the arrangement constituted a "mere chance that a genuine debt obligation [might] arise."

Since the Franklin court found that the purported obligation was not a debt at all, one can argue for reconciliation of Franklin with the Crane rule, even though, most simply, the latter rule stands for the inclusion of acquisition debt, whether recourse or nonrecourse, in basis. The debt in Franklin was simply not of the same species as the debt in Crane. Because Crane's assumption that the debtor would treat the nonrecourse debt as though it were recourse did not apply to the doctors, the Franklin court sidestepped the issue of whether that general assumption about nonrecourse debt was warranted. Without defining the parameters, the Franklin court somewhat limited the Crane rule.

Nevertheless, if the rationale behind the Crane rule depended partly on administrative concerns (as the opinion suggests), Franklin undercuts that purpose. The major strength of Crane was that it provided a bright line rule that was easy to apply. Franklin destroyed that elegant simplicity by departing from the tidiness of giving all purchasers advance basis credit for purchase money debt and by requiring inquiry into the bona fides of a purported debt obligation. Franklin separated the sham from the valid by establishing a general rule whereby the debtor must prove the value of the property at the inception of the debt.

Professor Andrews believes that there is a value limitation inherent in Crane. See William D. Andrews, On Beyond Tufts, 61 Taxes 949, 959 (1983).

The opinion in Franklin is notable for failing to chastise the taxpayers for engaging in a tax avoidance scheme. See Section III.B. (discussing general applicability of Franklin principle).

---

23 See Franklin, 64 T.C. at 762.
24 See Franklin, 544 F.2d at 1049.
25 Id.
26 Professor Andrews believes that there is a value limitation inherent in Crane. See William D. Andrews, On Beyond Tufts, 61 Taxes 949, 959 (1983).
27 The opinion in Franklin is notable for failing to chastise the taxpayers for engaging in a tax avoidance scheme. See Section III.B. (discussing general applicability of Franklin principle).
2. Purchase Without Investment

Franklin changed the focus of the issues raised in Crane from the question of what constitutes the property to what constitutes the purchaser's investment in that property. This shift to the question of investment is crucial for the assignment of depreciation deductions. Where there is seller-financing, as in Franklin, a determination that the purchaser has made no investment in the property means, ipso facto, that the "seller" must continue to own the property after the "sale." This conclusion is consistent with the Crane court's interest in having the depreciation deductions assigned to one and only one person.

A harder case for identifying the owner is presented when the purchaser makes no investment in the property, and the seller has divested himself of all interest, such as when a purchaser receives 100% nonrecourse financing from a third party lender. Then, application of Franklin to nonrecourse debt creates a dilemma because there is no logical choice for assignment of depreciation deductions attributable to the property: If the lender is not the owner, who is? No other plausible candidate appears. Courts have avoided the problem of identifying the proper taxpayer in Franklin-type deals by concluding (or the Service conceding) that a sale has taken place, and treating the purchaser as the owner of the property for tax purposes. Nevertheless, the depreciation allowed to such purchasers has been tied to the Franklin determination, denying basis for excessive nonrecourse debt. While this approach identifies the taxpayer entitled to claim depreciation deductions, it does not necessarily allow anyone the full amount of depreciation that the property would have supported.

---

28 The restructuring situation presents this issue at a later stage in the holding period of the property, as does the acquisition of property subject to a pre-existing lien in excess of the value of the property. This is the position of the purchaser in the transaction at issue in Tufts v. Commissioner, 461 U.S. 300, 303 (1983). For a suggestion that the acquiror should be entitled to basis at least equal to the value of the property, see Andrews, note 26, at 953; Erik M. Jensen, The Unanswered Question in Tufts: What Was the Purchaser's Basis?, 10 Va. Tax Rev. 455, 500 (1991). For the counterargument, see Calvin Johnson, Play Money Basis: When is Nonrecourse Liability a Valid Cost?, 10 Va. Tax Rev. 631 (1992); Calvin H. Johnson, The Liability Was Also Not a Cost to Bayles, 11 Va. Tax Rev. 651 (1992).


30 In post-Franklin deals, the Service and the courts applied the Franklin principle to transactions respected as sales by comparing the value of the purchased property with the outstanding amount of the debt. See, e.g., Brannen v. Commissioner, 722 F.2d 695, 701 n.3 (11th Cir. 1984); Rev. Rul. 81-278, 1981-2 C.B. 159; Rev. Rul. 77-110, 1977-1 C.B. 58.

31 For example, where the downpayment is less than the value of the property, but the nonrecourse debt alone is greater than that value, the purchaser's depreciation is limited to the downpayment. One possible solution to the problem of purchase without investment is
C. Congressional Response

The *Franklin* approach, attacking nonrecourse debt on a case-by-case basis, was inadequate to stop all attempts at overvaluation and the resulting deduction creation and shifting. When Congress finally stepped in, the field had been left to the courts' and the Commissioner's case-by-case determinations for more than 30 years. By that time, the *Crane* rule had firmly established the true-debt approach for nonrecourse debt, and many cases had relied on it. Congress' first move was the adoption of § 465, which suspended deductions from an activity to the extent they exceeded the taxpayer's income from the activity, plus the taxpayer's amount at risk in the activity.

The legislature timidly entered into what had become the courts' arena, limiting the activities covered by § 465. While Congress subsequently expanded § 465 to include most activities, many real estate investments remain excluded from the at risk limitations because non-recourse borrowings from third party lenders with respect to real
property are considered amounts for which the taxpayer is at risk.\(^{36}\) Thus, far from leading the law's evolving treatment of nonrecourse debt, Congress only followed the courts, when abuses had become so widespread that the Service could not control them effectively.

The development of the tax law's response to nonrecourse debt thus can be broken into two active periods—the period defined by *Crane* and the courts, and the period of congressional action. The last decade—post-Tax Reform Act of 1986—has brought no significant legal developments on this front; § 469 essentially closed down the individual tax shelter industry, and with it Congress' incentive to focus on nonrecourse debt. During the early period, the courts had to determine the essential nature of nonrecourse debt, while during the tax shelter period, all three branches of government were consumed with trying to slow erosion of the tax base. In so doing, Congress extended the remedies of the at risk rules significantly beyond nonrecourse debt and halted legitimate, as well as abusive, loss taking by individual and small corporate taxpayers engaged in passive activities.\(^{37}\)

**D. Post-Tax Shelter Challenge: Restructuring Undersecured Debt**

Real estate restructurings present a new challenge to the law's treatment of nonrecourse debt. Real estate is an important industry in which nonrecourse debt continues to be used,\(^{38}\) and the decline in

\(^{36}\) IRC § 465(b)(6). It therefore comes as no surprise that real estate remained an attractive tax shelter vehicle after the demise of many other tax minimizing investments. The real estate industry was devastated by the 1986 Act because the passive activity loss rules included in that legislation did precisely what the at risk rules had failed to do in the real estate context—deny taxpayers the time value advantage of depreciation deductions attributable to debt-financed investments in real property.

If the at risk rules were intended to stop only transactions with inflated seller financing, the qualified nonrecourse financing exception in § 465(b)(6) should not have been limited to the activity of holding real property. The exception is better understood as a concession to the real estate industry, rather than a policy judgment about the general reliability of third party lenders in policing the reality of the purchase price. The adoption of § 469(c)(7) in 1993 exhibits a further concession to the power of the real estate lobby. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13, 143(a), 107 Stat. 312, 440 (allowing taxpayers who qualify as real estate "operators" to avoid the prior per se passive classification status ascribed to all rental activities and to treat their rental activities as nonpassive upon showing of "material participation").


\(^{38}\) Many of the incentives for using nonrecourse debt in real estate investments remain as they were in the tax shelter era due to §§ 465(b)(6) and 469(c)(7).
real estate values has led to a rash of workouts of nonrecourse debt secured by real estate.\textsuperscript{39} Determining the tax consequences of a re-
structuring requires returning to the issue left open in \textit{Crane} and never revisited—whether a debtor should be denied depreciation de-
ductions on property as soon as the value of the property falls below
the outstanding debt. A restructuring raises this issue squarely be-
cause it provides the realization event that could trigger an inquiry
into whether the amount of the debt exceeds the value of the securing
property, and therefore, whether a taxpayer, originally awarded basis
for a nonrecourse debt encumbering the property, should be entitled
to depreciation deductions that represent an economic loss suffered
not by her, but by the lender.

The following real estate restructuring illustrates the difficulty of
current law:\textsuperscript{40}

\textbf{Example 1:} Assume $B$ purchased a shopping center for $10
million, consisting of $1$ million in cash and $9$ million bor-
rowed on a nonrecourse basis from $L$, a third party lender in
the business of financing real estate. At the time of the
purchase, the real estate market was rising and there was no
question that the stated price approximated the property's
value. $B$'s $1$ million cash investment created an equity cush-
ion, and therefore no \textit{Franklin} issue arose on the acquisition.

In an era of constantly rising real estate prices, subsequent ques-
tions about the bona fides of the nonrecourse debt never arise. If,
however, the value of the real estate falls, $B$ can choose to put the
property to $L$ instead of satisfying the debt with cash.\textsuperscript{41} In the face of
falling real estate prices, $B$ may be unable to service the $9$ million

\textsuperscript{39} Of the commercial mortgage portfolios of the major life insurance companies, 7.44% were in workout status at the end of 1992. Kerry D. Vandell, Walter Barnes, David Hart-

\textsuperscript{40} This fact pattern forms the basic model for other examples used throughout the text.

\textsuperscript{41} Nonrecourse debt can be analogized to a loan plus a put option held by the borrower
at a price equal to the outstanding principal amount of the debt. If the borrower chooses
not to satisfy the debt, the lender's only remedy is to take the property in full satisfaction
of the outstanding amount. See Yishai Beer, Nonrecourse Loans: Do Not Forget to Tax
the Option, 53 Tax Notes 837 (Nov. 18, 1991) (arguing that current law's failure to tax the
loan and option components of nonrecourse debt separately distorts both borrower's and
lender's income); Cunningham & Schenk, note 14, at 787 (analogizing nonrecourse debt to
recourse debt plus put option and a call option held by the borrower). The equivalence of
nonrecourse debt with a put option provides the theoretical underpinning for Treasury's
decision to treat the entire amount of the debt as amount realized on foreclosure. Reg.
§ 1.1001-2(a)(4)(i), (c)(Ex. 7). Cf. Charles T. Terry, Option Pricing Theory and the Eco-
nomic Incentive Analysis of Nonrecourse Acquisition Liabilities, 12 Am. J. Tax Pol'y 273
debt with the cash flow from the property and also may be unwilling to invest additional cash from other sources. On the other hand, L, in the business of lending money, may not be interested in operating the property, and therefore may agree to renegotiate the debt, rather than foreclose on the property. In such a renegotiation, L may agree to reduce the principal amount of the debt, defer the interest payments, reduce the interest rate (with or without other compensation) or otherwise alleviate the debt service burden on B and the property.\textsuperscript{42}

If, for example, the value of the property has fallen to $5 million and the parties agree to reduce the principal amount below that, L will recognize an immediate loss for tax purposes\textsuperscript{43} and B will have COD income.\textsuperscript{44} This is unlikely to make the parties happy, but it is, at least, a reasonably predictable result that the parties (even in the absence of tax advice) may have expected. Reducing the principal amount of the debt, however, requires L to accept a real economic loss, which L is unlikely to do until unavoidable, and the parties might not want to take such a significant step at the first sign of trouble. Instead, they could reasonably agree to one of the following deals in order to make the workout a less significant event from a business perspective than a wholesale reduction of the principal:

1. The parties could reduce the interest rate by .5%, for example, from 10% to 9.5%.\textsuperscript{45}

(1995) (using option pricing theory to determine whether nonrecourse borrower has incurred genuine indebtedness).

The approach of this Article treats the nonrecourse borrower more like the holder of a call than a put because the put analogy treats the borrower as the owner ab initio (who may be replaced by the lender on exercise of the put) while the call analogy switches the order. See Section III.D.

\textsuperscript{42} A foreclosure sale would bring no more than the cash flow from the property.

\textsuperscript{43} The lender's loss is allowed under § 166(a), so long as there has been a realization event under § 1001. Such an event takes place when the restructured debt embodies "legally distinct entitlements" from the original debt. Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554, 566 (1991). Reduction in the principal amount of an obligation easily satisfies this standard, as well as the standard in the regulations under § 1001. See notes 45-47.

\textsuperscript{44} The borrower has income pursuant to § 61(a)(12), all or part of which might be excludable under § 108(a). See notes 65-66.

\textsuperscript{45} A change in the interest rate is a significant modification of the instrument under the § 1001 regulations if it exceeds the greater of .25% or 5% of the annual yield of the unmodified instrument. Reg. § 1.1001-3(e)(2)(ii). These regulations deem a modification of a debt instrument to be an exchange (and therefore a realization event) whenever the modified instrument differs materially in kind or in extent from the original instrument, Reg. § 1.1001-3(b), and describe various modifications that always will constitute realizations. Reg. § 1.1001-3(e) (listing significant modifications). If a modification is significant enough to be treated as a realization, it is a taxable event for the holder and the issuer of the debt, subject to various nonrecognition provisions. The approach taken by the regulations has been criticized. See ABA Tax Sec., Comm. on Sales, Exchanges and Basis, Comments on Proposed Treasury Regulation Section 1.1001-3 Relating to Modifications of
2. The parties could agree to extend the maturity of the obligation by six years, with interest payments continuing at the same rate during the extended period.\textsuperscript{46}

3. The parties could agree to defer the interest due for the next four years until the end of the sixth year, with interest compounding so that the yield on the instrument remained the same,\textsuperscript{47} which would address the immediate cash flow problems of a troubled property.

All of these workout agreements could relieve some pressure on the borrower temporarily in the hope that the property could be made more profitable (in other words, more valuable) and the debt satisfied. Parties to a workout might choose one of these options to avoid the much more dramatic economic effects of a foreclosure; these options offer lesser rearrangements of the parties' rights and obligations. These small changes to the debt instrument, however, can have disproportionately dramatic tax consequences; if the debt exceeds the value of the property after the workout, current law would deem each of these workouts to be a foreclosure for tax purposes.\textsuperscript{48} On a foreclosure, the debtor is treated as having transferred the property to the lender in satisfaction of the debt, resulting in gain or loss to the debtor under § 1001, rather than COD income. The lender suffers a bad debt to the extent the obligation remains unpaid, deductible under § 166.

Regardless of the terms of the restructured investment, the issue left open in Crane and only partially resolved in Franklin—whether the borrower should enjoy depreciation deductions on a basis attributable to nonrecourse debt exceeding the value of the property—is raised at the restructuring if the face amount of the restructured instrument exceeds the value of the securing property.\textsuperscript{49} At that point, the debtor either can continue to claim depreciation allowances from his original basis (that the market now judges to be inflated), relying

\textsuperscript{46} Such an extension would be a significant modification. See Reg. § 1.1001-3(e)(3)(i) (providing safe harbor for deferral periods not exceeding lesser of five years or 50\% of original term of instrument).

\textsuperscript{47} Such a deferral would be a significant modification. See Reg. § 1.1001-3(e)(2)(i); cf. Reg. § 1.1001-3(g) (Ex. 4) (illustrating significant modification for deferral of scheduled interest payments).

\textsuperscript{48} See Section III for an explanation of why minor modifications produce foreclosure consequences.

\textsuperscript{49} Theoretically, the issue would arise as soon as the value of property falls below the principal amount of the debt, but this issue has been ignored for lack of a realization event.
on the improbable likelihood (and hope of the lender) that he eventually will pay for that basis with after-tax dollars, or can be stripped of basis altogether, turning the restructuring into a calamitous tax event for both the lender and the borrower.\textsuperscript{50} Neither outcome is satisfying.

As the next Section explains, current law seems to require that the debtor lose all basis in the property. But the specific result for the restructuring under current law is not as important as the insight that analysis of the restructuring provides into the essential weakness of the \textit{Crane} rule. In considering the consequences of the restructuring, it becomes clear that \textit{Crane} supports a bulwark of the law by relying on the transparent fiction that nonrecourse debt represents an investment in property by the borrower for which the law should give advance basis credit. The restructuring is significant in that it provides a taxable event that requires analysis of the obligation and brings to light the contingent nature of an investment made with nonrecourse debt, thereby illustrating the failings of the \textit{Crane} approach.

\section*{III. Restructuring Under Current Law}

This Section analyzes the tax consequences of a nonrecourse debt restructuring to illustrate the consequences of the true-debt approach when the value of securing property falls below the outstanding amount of the debt. It shows that if the nonrecourse debt exceeds the value of the property after the restructuring, the most coherent reading of current law treats the debtor as though he transferred the securing property to the lender in satisfaction of the debt.\textsuperscript{51}

This conclusion is based primarily on the combined application of the rules governing debt modifications and the approach of \textit{Estate of Franklin}, which—if it establishes a general principle of law—requires that the restructured instrument not be respected as a debt. Under this analysis, the principle of \textit{Estate of Franklin} must be applied at the time of the restructuring to determine whether the restructured instrument constitutes a debt for tax purposes, because the restructured instrument is considered a “new” debt, and all new nonrecourse debt must pass that test. If the restructured instrument does not qualify as a debt for tax purposes, the statutory construct that governs debt modifications by assuming that the restructured instrument is a debt cannot apply to the workout and the restructured instrument must be characterized for tax purposes. The analysis also considers whether

\textsuperscript{50} The borrower could have immediate income recognition, IRC § 61(a)(12), and, as a result of the foreclosure, the lender could be assigned basis and depreciation deductions of no use to it. See Section V.
\textsuperscript{51} See Sections III.C-D.
\textsuperscript{52} See Section III.B.
an undersecured, restructured obligation can be treated as a debt with a reduced principal amount under either § 1274 or the Third Circuit's reasoning in *Pleasant Summit*, but concludes that the best reading of current law would treat it as an ownership interest of the lender in the property, meaning that the borrower would be treated as having transferred the securing property to the lender in satisfaction of the original obligation.

The restructuring thus is treated as a disposal of property with all the tax consequences of a foreclosure, rather than simply a modification in terms of indebtedness between borrower and lender, as the parties likely intended. This unexpected, and possibly economically devastating, result of a minor modification forces the question of whether an alternative framework for treating nonrecourse debt is possible so that the restructuring could be treated for tax purposes simply as a modification in the terms of indebtedness.

A. Modification of a Debt Instrument

As a first step, a restructuring requires that a modification in the terms of the original debt be evaluated under § 1001. Any significant

---


54 The results may be devastating if they produce immediate tax or strip the taxpayer of tax attributes necessary for profitability. Congress has recognized that a restructuring is not an ideal time for the debtor to pay tax because the restructuring indicates a troubled debt. In the 1993 Act, Congress addressed workouts of debt secured by real estate by adding §§ 108(a)(1)(D) and (c). *Omnibus Budget Reconciliation Act of 1993*, Pub. L. No. 103-66, § 13,150(a), (b), 107 Stat. 312, 446. Pursuant to those provisions, a debtor may reduce the basis of depreciable real property instead of currently including discharge of qualified real property business indebtedness in income to the extent that the debt discharged exceeded the value of the property. With these provisions, the Code now provides relief for certain taxpayers who incur COD income under § 61(a)(12). While § 108(a)(1)(D) provides direct relief to many taxpayers with troubled real estate indebtedness, it offers no help to those who have income characterized as gain (which arises from foreclosure characterization) rather than as income from discharge of indebtedness. Cf. *Estate of Delman v. Commissioner*, 73 T.C. 15, 31-33 (1979) (insolvent individual required to recognize gain on disposition of property).

The debate about nonrecourse debt has focused considerable attention on the issue of whether release from a nonrecourse liability should be treated as amount realized or as COD income. See *Commissioner v. Tufts*, 461 U.S. 300, 317-20 (1983) (O'Connor J., concurring); *Alice Cunningham, Payment of Debt With Property—The Two-Step Analysis After Commissioner v. Tufts*, 38 Tax Law. 575 (1985); Deborah A. Geier, *Tufts and the Evolution of Debt-Discharge Theory*, 1 Fla. Tax Rev. 115 (1992). Unfortunately, the discussion has revolved around *Tufts*, which did not lend itself to a traditional cancellation of indebtedness analysis since the lender did not forgive the liability. Cancellation of indebtedness stems from the relationship of lender and borrower and arises from an adjustment in the obligation between those parties. See *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931); Reg. § 1.61-12(a). While there are appropriate cases to consider cancellation of indebtedness attributable to nonrecourse debt, *Tufts* is not one of them.
change in terms is treated as a realization event, and the original debt instrument is deemed exchanged for the modified instrument, if the modified instrument "differs materially either in kind or in extent" from the original.55 The regulations under § 1001 also provide that "[a] modification is significant if it changes the [debt] instrument to an instrument . . . that is not debt for Federal tax purposes."56 In the context of a restructuring, these rules are significant because they create a taxable event during the holding period of the property that may affect its tax treatment. Unfortunately, the debt modification rules do not seem to appreciate that the modified debt has been included in the basis of property. If the realization event with respect to the debt can be divorced from the securing property, the tax consequences of the restructuring may be limited to the debt, so that the basis of the property is unaffected by the transaction.57 If not, the consequences for the securing property are unclear.58

55 Reg. § 1.1001-3(b). In Cottage Sav. Ass’n v. Commissioner, the Supreme Court established a standard that inquires whether an instrument is exchanged for one (pre- and post-modification) with different legal entitlements. 499 U.S. 554, 565-66 (1991). Commentators have referred to this standard as the "hair-trigger" test. See Richard L. Bacon & Harold L. Adrion, Taxable Events: The Aftermath of Cottage Savings (Part I), 59 Tax Notes 1227, 1229 (May 31, 1993).

Section 108(e)(10), which describes the amount of COD income recognized by a taxpayer on the modification of a debt instrument, also treats the modification as an exchange of the old instrument for a new instrument. That section treats a debtor as having satisfied the original debt instrument with an amount of money equal to the issue price of the new debt instrument. The Omnibus Budget Reconciliation Act of 1993 repealed former § 108(e)(10), and redesignated § 108(e)(11) as § 108(e)(10). Pub. L. No. 103-66, § 13,226(a)(1)(A), 107 Stat. 312, 487.

56 Reg. § 1.1001-3(e)(5)(i). Once there is a realization, a complete analysis of the deemed exchange is necessary. That analysis would have to consider the consequences of exchanging a debt instrument for an instrument that is not debt for tax purposes. This provision was among the most controversial in the proposed regulations under § 1001. See, e.g., IRS to Issue ‘Cottage Savings’ Rules in First Half of 1994, Official Says, Daily Tax Rep. (BNA), Nov. 16, 1993, at G-7.

57 For example, if third-party purchase money debt is reduced from $10 to $8 so that income to the debtor of $2 with respect to the debt is triggered by the modification, and if the modification does not affect the property, the basis of the property continues to reflect the original $10 debt. The value of the property would not matter in this case, and taxation of any built-in gain or loss on the property would remain deferred after the restructuring until a separate realization event occurs.

58 If the property is implicated in the restructuring, at least three results from the example in note 57 are possible: The basis of the property could be reduced in this example by $2; or assuming the lender forgave $2 but the value of the property had declined by $3, the basis might have been reduced to $7, or possibly zero. A fourth possible approach would require the borrower to include an amount equal to prior depreciation claimed that was not funded by the borrower’s cash.

Section 108(e)(5) authorizes reduction of basis where the lender was the seller of the property. But no similar rule applies where the purchase money was borrowed from a third party, since the application of Fulton Gold Corp. v. Commissioner, 31 B.T.A. 519 (1934), to such a scenario has been rejected. See Rev. Rul. 91-31, 1991-1 C.B. 19 (citing Gershkowitz v. Commissioner, 88 T.C. 984 (1987)).
1. **Effect of Changes in Debt on Basis in Securing Property**

Most debt transactions that occur while a taxpayer holds an asset do not implicate the realization rule, and therefore do not affect the owner’s basis in the securing property.\(^{59}\) This is so even if the debt was acquisition debt included in basis at the outset. For example, a debtor’s satisfaction of acquisition indebtedness while still holding the property has no tax consequences. The purchaser received advance basis credit for the investment represented by the debt, and satisfaction of the debt is consistent with that basis credit. Less obviously, a second mortgage on the property or a refinancing, even one that exceeds the taxpayer’s basis in the property, does not lead to immediate taxation, even when it represents a withdrawal of the appreciation in the property.\(^{60}\) That appreciation will be taxed as gain on a later realization with respect to the property, even though the cash already has been enjoyed. Because of the realization rule, economically significant events may take place during the holding period of property that do not lead to immediate taxability.\(^{61}\) Neither a precipitous decline nor a marked increase in the value of the property has immediate tax consequences.\(^{62}\)

Sometimes, the same event affects both the debt that encumbers property and the property itself. For example, on the acquisition of property with debt, the debt is treated as part of the purchaser’s cost. Similarly, the disposition of property subject to nonrecourse debt is treated as a disposition of the debt as well, and the amount realized on the disposition of the property includes the outstanding amount of the debt the purchaser takes subject to or assumes.\(^{63}\)

A swap of one debt instrument for another debt instrument, or a modification of a debt into another instrument that also constitutes debt, fits under the first system—the debt transaction does not affect the property. Debt modifications in which the post-workout instrument fails to constitute debt, however, do seem to implicate the property.\(^{64}\)

---

\(^{59}\) The realization rule, though distortive in measuring income, is likely to remain a permanent fixture of the income tax system, and this Article works within its constraint. For a proposal that would dramatically decrease its role in the system, see David J. Shakow, Taxation Without Realization: A Proposal for Accrual Taxation, 134 U. Pa. L. Rev. 1111 (1986); see also Cunningham & Schenk, note 14.

\(^{60}\) See Woodsam Assocs., Inc. v. Commissioner, 198 F.2d 357 (2d Cir. 1952).

\(^{61}\) Substitution of collateral does not automatically trigger realization, even under the hair-trigger test in the regulations. Reg. § 1.1001-3(e)(4)(iv).

\(^{62}\) See Reg. § 1.165-4(a) (disallowing deduction for decline in value of stock due to market fluctuation).

\(^{63}\) See Reg. § 1.1001-2(a); Commissioner v. Tufts, 461 U.S. 300 (1983).

\(^{64}\) See Section III.D.
2. Consequences of a Debt-for-Debt Exchange

A debt modification significant enough to be treated as a debt-for-debt exchange (a realization event under § 1001) is clearly a realization event with respect to the debt only, as long as the modified instrument is respected as debt for tax purposes. The property is not affected. The borrower's tax consequence of a debt-for-debt modification is COD income under § 61(a)(12), subject to various relief provisions.\(^{65}\)

A debt-for-debt exchange that produces COD income often will have no effect on the borrower's basis in the property.\(^{66}\) This is proper because taxation of COD income represents a tax cost to the borrower that continues to support the taxpayer's basis. At the same time, the lender is entitled to an immediate loss for the portion of the debt forgiven.\(^{67}\) These tax consequences of a deemed reissuance of the debt match the consequences of the economically identical transaction—a satisfaction of the mortgage for cash, in an amount less than the principal amount of the debt, followed by a new mortgage with a reduced principal amount.\(^{68}\) In this way, the statutory approach seems reasonably logical and practical.

B. Should Estate of Franklin Apply to Restructured Debt?

If the modification of a debt instrument cannot be characterized as a debt-for-debt exchange, it does not fit into the model of a satisfaction followed by a new mortgage. If the new instrument is something other than debt, the tax treatment under current law is not entirely clear, because the debt-for-debt exchange rules apply only if the old

---

\(^{65}\) Section 108 excludes COD income if the discharge of the debt occurs in a bankruptcy case, IRC § 108(a)(1)(A), if the discharge occurs when the taxpayer is insolvent, IRC § 108(a)(1)(B), if the discharged debt is qualified farm indebtedness, § IRC 108(a)(1)(C), or if the discharged debt is qualified real property business indebtedness, § 108(a)(1)(D). Under any of these provisions, a reduction in tax attributes (or basis) to the extent that COD income is excluded often operates to defer taxation rather than permanently forgive it. Section 108(e)(5) also avoids immediate income recognition by reducing the basis of property when seller financing is reduced.

\(^{66}\) Under § 108(b)(5), however, the debtor may elect to reduce basis rather than tax attributes as to income excluded under § 108(a).

\(^{67}\) IRC § 166. There are exceptions for seller financing. See, e.g., IRC § 1038 (providing that sellers recognize no gain or loss when foreclosing on property they had sold on credit).

\(^{68}\) The repeal of IRC § 1275(a)(4), which had allowed the taxpayer to carry the adjusted issue price of the original debt over to the restructured debt in recapitalization transactions, reflects this view. Since its repeal, taxpayers must recognize income on the restructuring of a debt instrument into a modified instrument with a lower issue price, as though the old instrument were satisfied with cash and a new, lesser obligation issued. See N.Y. St. Bar Ass'n Tax Sec., Report of Ad Hoc Committee on Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-for-Debt Exchanges, reprinted in 51 Tax Notes 79, 85 (Apr. 8, 1991).
Nonrecourse Debt

Debt is exchanged for something qualifying as debt for tax purposes. The securing property may be implicated in the debt transaction. A restructuring that leaves the nonrecourse obligation undersecured raises the question whether Franklin should apply at the time of modification so as to produce an instrument that does not constitute debt. If so, the restructuring would not fit within the statutory construct that depends on the equivalence of a modification and a satisfaction followed by a new mortgage, and therefore, the tax consequences of the exchange would not be governed by the debt-for-debt exchange rules. This Subsection argues that the restructured instrument must be evaluated under Franklin because the restructuring is a realization event for the debt, and the deemed new debt must be analyzed like any other new debt.

Even assuming that a traditional debt-equity analysis would identify more debt-like features than equity-like features, the inquiry is not finished. Since § 1001 treats the restructured obligation as a new instrument, and since the modified instrument is nonrecourse, it is not debt for tax purposes unless it passes muster under the Franklin test at the time of the restructuring. I argue that the Franklin principle

---

69 As long as there is a realization event for the debt, one must inquire as to whether the restructured instrument is debt—this is explicit under § 1.1001-3 of the regulations, but would be necessary even if those regulations did not contain § 1.1001-3(e)(5).

70 There are many reasons why the restructured instrument may no longer constitute a debt of the debtor. See Robert Cassanos, Alternatives to Disposition of Real Estate: Participating Loans, Convertible Loans, Net Leases and Joint Venture Arrangements, 48 Inst. Fed. Tax’n 31 (1990); Jack M. Feder, “Either A Partner or a Lender Be”: Emerging Issues in Real Estate Finance, 36 Tax Law. 191 (1983). Those articles consider the characterization of real estate mortgages as loans or joint ventures. Where sufficient equity elements are present in the restructured debt (such as shared appreciation and contingent interest dependent on profits from the activity), the restructuring may constitute a transformation similar to the one described in this Article.

71 IRC § 108(e)(10).

72 The determination of whether an instrument constitutes debt or equity for tax purposes depends on its characteristics. The case law, which primarily concerns corporate debt versus equity, relies on a wide variety of factors, including those listed in § 385(b). See, e.g., Hardman v. United States, 827 F.2d 1409 (9th Cir. 1987) (considering 11 factors: designation by parties, presence or absence of maturity date, source of payments, right to enforce payment, participation in management, status as compared with other creditors, intent of parties, adequacy of capitalization, identity of interest between creditor and stockholders, payment of interest out of dividend money only and ability of corporation to obtain loans from third parties). Only one case has held that a loan should be bifurcated into debt and equity elements. See Farley Realty Corp. v. Commissioner, 279 F.2d 701 (2d Cir. 1960). For an overview of debt-equity issues in the corporate context, see William T. Plumb, Jr., The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal, 26 Tax L. Rev. 369 (1971).

The Service has announced that it will scrutinize instruments containing both debt and equity characteristics to determine the proper tax treatment. Rev. Rul. 94-28, 1994-1 C.B. 86; Notice 94-48, 1994-1 C.B. 357; Notice 94-47, 1994-1 C.B. 357.

73 Estate of Franklin v. Commissioner, 544 F.2d 1045, 1049 (9th Cir. 1976). But see Pleasant Summit Land Corp. v. Commissioner, 863 F.2d 263 (3d Cir. 1988) (awarding basis
applies in this case and is not limited to seller-financed tax-shelter acquisitions.

On the narrowest reading of the facts of the case, the Franklin principle applies when property is acquired in return for nonrecourse seller-financing. Critics could argue, therefore, that a restructuring can be distinguished from Franklin on three factual distinctions: (1) Franklin involved a clearly abusive transaction; (2) it involved seller-financing, and (3) it was concerned with the inception of the debt. These differences do not provide a compelling reason to ignore Franklin on the restructuring because that decision creates a principled standard for debt entitled to respect, which recognizes the definitional contingency of nonrecourse debt. Because of the contingent nature of nonrecourse debt, the Franklin rule's assessment turns on the taxpayer satisfying his burden of proof as to the value of the property. None of the distinguishing facts are relevant to the question whether the taxpayer reasonably can be expected to satisfy the debt.

Furthermore, there is no indication in the opinion (and no compelling reason) that the Franklin standard depends on a taxpayer's involvement in an abusive tax shelter; the Ninth Circuit does not question Dr. Franklin's integrity. The court stated:

It is fundamental that "depreciation is not predicated upon ownership of property but rather upon an investment in property." No such investment exists when payment of the purchase price in accordance with the design of the parties yields no equity to the purchaser. . . . [A]ssuming no substantial increase in the fair market value of the property, the absence of personal liability on the debt reduces the transaction in economic terms to a mere chance that a genuine debt obligation may arise.


74 The Second Circuit has noted that it is improper to look to the subsequent value of the property after the creation of the debt in determining whether the debt initially should be respected. See Lebowitz v. Commissioner, 917 F.2d 1314 (2d Cir. 1990).

75 In fact, the court was not interested in discussing whether the transaction was a sham:

Petitioners spent a substantial amount of time at trial attempting to establish that, whatever the actual market value of the property, Associates acted in the good faith belief that the market value of the property approximated the selling price. However, this evidence only goes to the issue of sham and does not supply substance to this transaction. "Save in those instances where the statute itself turns on intent, a matter so real as taxation must depend on objective realities, not on the varying subjective beliefs of individual taxpayers."

544 F.2d at 1048 n.4 (quoting Lynch v. Commissioner, 273 F.2d 867, 872 (2d Cir. 1959) (emphasis in original).

76 Id. at 1049 (citations omitted) (emphasis in original).
The only part of the Ninth Circuit's opinion that might support an interpretation limiting the principle to abusive situations is the caveat at the end: "We intend our holding and explanation thereof to be understood as limited to transactions substantially similar to that now before us." It did not explain the characteristics essential to a "substantially similar" case. It is reasonable to infer that any case in which the taxpayer is unable to show that the value of the property gives the borrower an incentive to pay the debt is similar.

One could argue that a restructuring does not present the possibilities for abuse that occurred in Franklin due to the presence of a third party lender policing the transaction. A lender providing cash insures that the original purchase price of the property was not inflated and that the debt started as legitimate debt of the borrower. Nevertheless, the crucial conclusion reached by the court in Franklin was that the debtor had no incentive to pay the debt because he had no equity in the property. This conclusion does not depend on either abuse potential or the seller financing the transaction; by definition, a nonrecourse debtor always can walk away from the property, rather than satisfy the obligation. Therefore, the Franklin principle is potentially relevant to every nonrecourse debt.

The taxpayer's incentive to pay the debt is just as important on a restructuring as it was on the original issuance of the debt. Since the essential issue for nonrecourse debt is always whether the debt resembles an unconditional commitment to the property, the existence of abuse, the identity of the lender and the timing of the inquiry are irrelevant. To distinguish instruments based on irrelevant differences is bad policy. The theory behind the Franklin rule is enduring—to treat nonrecourse debt like real debt only when it has the characteristics of real debt.

---

77 Id.

78 The court did not want to evaluate "bad bargains"—where the purchaser is on the hook for an excessive purchase price. The troubling part of this reference is the court's citation of Commissioner v. Brown, 380 U.S. 563 (1965) and Union Bank v. United States, 285 F.2d 126 (Ct. Cl. 1961). Those cases were not bad bargains in which a taxpayer overpaid in cash to purchase property (a situation clearly outside the Franklin principle). The cases involved bootstrap sales of businesses to tax-exempt organizations, seeking to convert ordinary income into capital gain for the sellers, without producing taxable income to the exempt organizations. Congress responded to those clearly abusive transactions in 1969 by adopting § 514, which requires tax-exempt organizations to include income from debt-financed assets in unrelated business taxable income. Despite those citations, Franklin is better read as excluding the true bad bargain from its reach.

79 Estate of Franklin, 544 F.2d at 1049.

80 Professor Charles Terry has used option pricing theory to argue that, as the amount of nonrecourse debt increases, the value of the implicit put option decreases, suggesting that the nonrecourse obligor will default on the mortgage. See Terry, note 41, at 344-64.
to be applied to all nonrecourse debt, whenever it fails to resemble an unconditional obligation to pay.\textsuperscript{81}

The realization rule, however, imposes a practical limitation on the universal application of this principle. Theoretically, any time the value of the property falls, the \textit{Franklin} principle could apply and undermine the debt,\textsuperscript{82} because the debtor may choose to walk away from the property. Once debt is incurred, its treatment generally is not revisited again until its disposition, alone or with the property.\textsuperscript{83} If, however, the restructuring provides a realization event, the deemed new debt should be subject to the same scrutiny as any other new debt. If, after the restructuring, the value of the property is less than the new debt, the debtor has as little incentive to satisfy this now-excessive debt as did the debtor in \textit{Franklin}.\textsuperscript{84} Therefore, the restructured instrument should not be treated as debt.\textsuperscript{85}

Thus, if the $9 million debt in \textit{Example 1},\textsuperscript{86} is restructured when the value of the property is $5 million, \textit{Franklin} requires that the restructured instrument have an issue price not greater than $5 million in order to be respected as debt. Assuming the property is worth $5 million and is encumbered with $7 million of post-workout nonrecourse debt, the restructured instrument should not be treated as debt.\textsuperscript{87}

\textsuperscript{81} At the restructuring, the parties always can choose to satisfy the \textit{Franklin} standard and recreate an incentive for the borrower by reducing the principal amount of the debt.

\textsuperscript{82} This issue is an interesting one, but is beyond the scope of this discussion because I presume the creation of a new instrument on the restructuring, thus triggering the realization rule. Where a modification is not significant under § 1.1001-3 of the regulations, the old instrument continues to exist, and there is no realization event. Nevertheless, the \textit{Franklin} principle might apply. The potential for ignoring the existence of an obligation in the normal course of holding always has been lurking in the tax treatment of nonrecourse debt, but has never been resolved due to the general absence of realization events during the holding period. Cf. David C. Garlock, Federal Income Taxation of Debt Instruments 4-34 (3d ed. 1994) (discussing whether interest on nonrecourse debt may accrue when principal balance of obligation and all accrued but unpaid interest exceed the value of securing property).

\textsuperscript{83} On disposition of the property, it is clear that the debt is included in amount realized, Crane v. Commissioner, 331 U.S. 1, 14 (1947), even where the debt exceeds the value of the property, Commissioner v. Tufts, 461 U.S. 300, 311 (1983). Absent property disposition, forgiven nonrecourse debt can give rise to COD income, Rev. Rul. 91-31, 1991-1 C.B. 19, but may be excluded under § 108(a)(1)(D). See also § 108(c)(2). An exception is provided in § 108(e)(5).

\textsuperscript{84} The restructuring does not eliminate the borrower's ability to walk away from the property, even though it indicates that the borrower desires to remain in control of the property. If the terms of the debt are modified so that the current payments are reduced, the borrower reduces his commitment to the property by virtue of the restructuring, even as he chooses to continue in possession.

\textsuperscript{85} Once the property is worth less than the debt, from an economic perspective, the note represents an equity-like investment of the lender, and the only vestiges of the debtor-creditor relationship are the legal technicalities and tax consequences.

\textsuperscript{86} See text accompanying notes 39-47.
debt, the debt is not true debt because the rational debtor would rather walk away from the property than pay $7 million to keep it.\footnote{Excessive restructured debt is not as easy to ignore as excessive acquisition debt because the taxpayer rationally might intend to satisfy the excessive debt because of collateral considerations. For example, if the debt is secured by the taxpayer's business premises, which were constructed to meet the unique needs of the taxpayer's business, the taxpayer might be willing to pay a premium to retain those premises. This possibility turns on whether a property can have different values to different people. Cf. Leslie Co. v. Commissioner, 539 F.2d 943 (3d Cir. 1976) (finding that taxpayer had paid more for property than it was objectively worth in a sale-leaseback case); Shaviro, Risk and Accrual, note 1, at 428, and n. 130 (arguing that some taxpayers might legitimately and rationally pay more for property than its objective value).}

The conclusion under Franklin that the post-workout instrument is not debt is crucial under current law because the workout therefore is not a debt-for-debt exchange, and its tax consequences will differ from the simple COD income/bad debt deduction results. The next two Sections analyze the post-workout instrument.

\begin{itemize}
\item[C.] \textbf{Avoiding Franklin by Reducing the Principal Amount of the Debt}
\end{itemize}

This Section considers whether the problem of recharacterizing the new instrument on a restructuring can be solved either by rejecting the Franklin approach in favor of the Third Circuit's approach in Pleasant Summit,\footnote{Pleasant Summit Land Corp. v. Commissioner, 863 F.2d 263 (3d Cir. 1988), cert. denied sub nom. Commissioner v. Prussin, 493 U.S. 401 (1989).} or by interpreting Franklin more narrowly and manipulating the treatment of the restructured instrument under § 1274. Both solutions would be much less expansive than revamping the entire approach to nonrecourse debt because they would reduce the principal amount of the debt and thus the instrument would remain as debt. I conclude they are neither viable under current law nor desirable as a policy matter.

The principal argument is that it would be more sensible to treat the restructured instrument as a debt obligation with an issue price equal to the value of the property. That approach relies on the theory of Pleasant Summit (even if a statutory basis were found in § 1274) and accounts for the restructured instrument at its approximate value. The Pleasant Summit reasoning would lead to the conclusion that the principal amount of the restructured instrument was the value of the property. Thus, the new instrument would constitute debt, and would fit within the construct of the debt-for-debt exchange rules.

If the instrument were a new purchase money note, the principal amount might be deemed to be the value of the property, assuming...
the parties dealt at arm’s length. For example, if the value of property originally purchased for $10 fell to $5, it might make sense, from the perspective of a coherent law, to treat the debt as $5, even if its stated principal amount remained $9. Treating the instrument as a smaller debt might do the least violence to the parties’ intentions because it respects their expectations about tax ownership and entitlement to depreciation on the property. There is, however, no means under current law by which to reach that conclusion. Pleasant Summit is the nonstatutory route to this result, but it is fundamentally flawed; § 1274 is the potential statutory vehicle, but it cannot carry this burden.91

In Pleasant Summit, the court awarded basis credit for inflated non-recourse debt up to the value of the securing property because it reasoned that the purchaser would have an incentive to pay that much, although not the entire debt, when it came due.92 Similarly, the seller-lender would accept that lesser payment. After all, the court reasoned, why foreclose when to do so would yield no more than the

89 The current value of property presumably reflects the possibility that the price will rise or fall in the future. The right to choose whether to redeem the property at the face amount of the debt in the future requires the borrower to pay a premium interest rate. But see Babette B. Barton, Economic Fables/Tax-Related Foibles: On the “Cost” of Promissory Notes, Guarantees, Contingent Liabilities and Nonrecourse Loans, 45 Tax L. Rev. 471, 500 (1990) (asserting that excessive nonrecourse debt might be price paid by buyer for the privilege of nonrecourse financing, and thereby constitute valid cost of the property that is not in the nature of interest).

90 This treatment would require that the debtor include $5 of COD income under § 61(a)(12), subject to the exceptions in § 108.

91 Judicial examination of restructured instruments on a case-by-case basis might achieve this result; this generally was the approach of the Tax Court in Regents Park Partners v. Commissioner, 63 T.C.M. (CCH) 3131 (1992). The court allowed the purchasers a value basis in the property despite an excessive mortgage to which the property was subject at the time of acquisition. Two crucial factors in that case were: (1) the parties reasonably expected the principal amount of the obligation to be reduced after the end of the period during which HUD restrictions prevented reduction, and (2) the mortgage (held by HUD) bore interest at a rate significantly below market. The principal amount of the debt would have been reasonable if it had been adjusted in accordance with prevailing market interest rates. While § 1274 did not apply to that case, the result reached is consistent with its policy and Congress’ recognition that the payments on a debt obligation are fungible and can be designated as either principal or interest. Not all restructurings can fit into this precedent because adjustment of the interest rate is not always the solution to the problem of excessive principal.

92 The taxpayer, a participant in an abusive tax shelter transaction, claimed basis for a purchase price paid partly in cash and partly in inflated nonrecourse debt. Rather than ignore the debt and limit the basis in the property to the cash paid, which would have been consistent with the reasoning in Franklin, the Third Circuit allowed the taxpayer to claim a basis equal to the cash invested, plus the nonrecourse debt, up to the value of the property. See Pleasant Summit, 863 F.2d at 277.
value of the property that the purchaser, in any event, would offer in satisfaction of the debt?  

The Third Circuit's reasoning is flawed, and has not been adopted by any other circuit. Its approach missed the mark because it failed to focus on the significance of basis in the tax system and the assumptions that underlie the award of basis for debt prior to satisfaction. A focus on these issues would have revealed that any future deal the borrower and lender might make (assuming that they, in fact, would make a deal) is irrelevant to the determination of the true acquisition price, and hence the basis, at the outset of the transaction. For this reason, it is not desirable to choose the Pleasant Summit (rather than the Franklin) approach, which would treat the restructured instrument as debt with a reduced issue price. The principles of these two cases are irreconcilable and the Third Circuit's conclusion is perverse because it presumes that the purchaser overpaid for the property at the outset—whatever cash was paid necessarily was wasted because the purchaser still would have to pay at least future value to forestall foreclosure.

Reliance on § 1274 ultimately rests on the Pleasant Summit principle, and, therefore, is also undesirable in solving the restructuring puzzle. In a debt-for-debt exchange, the restructured debt is deemed issued in exchange for "property," the old debt. Section 1274 there-

---

93 See id. at 276. Of course, if the Third Circuit's vision of this minuet of self-interested rationality were accurate, the jurisprudence would not reflect a single case of foreclosure.

94 The Second, Fifth and Ninth Circuits have rejected Pleasant Summit explicitly. See Lebowitz v. Commissioner, 917 F.2d 1314, 1319 (2d Cir. 1990); Lukens v. Commissioner, 945 F.2d 92, 98-99 (5th Cir. 1991); Hildebrand v. Commissioner, 967 F.2d 350, 353 (9th Cir. 1992). The Tax Court once held similarly to the Third Circuit, but only where the facts were distinguishable from those of Pleasant Summit. Regents Park Partners, 63 T.C.M. (CCII) 3131; see note 91.

For a more complete discussion of the flaws in Pleasant Summit, see Johnson, Front End, note 3, at 593; see also Terry, note 41, at 388-93 (using option pricing analysis to argue that taxpayers in Pleasant Summit should have been allowed no tax basis for the nonrecourse debt).

95 Taxpayers are entitled to basis for acquisition debt as "advance credit" for an investment that the law presumes will be made in the future. See Mayerson v. Commissioner, 47 T.C. 340, 352 (1966). This explains an award of basis supported by nonrecourse debt as well as recourse debt. The Crane opinion gave basis for nonrecourse debt because the Supreme Court believed that the debtor would treat the nonrecourse debt as recourse debt encumbering the property—fairly representing a future investment in the property. See id. (citing Crane). When nonrecourse debt is inflated, it does not represent an investment that the purchaser will likely make in the future. Inflated nonrecourse debt is better characterized as an option to purchase the property at a future time, or perhaps as contingent debt, rather than a current commitment to the property. The Tax Court characterized the Franklin transaction as an option. See Estate of Franklin v. Commissioner, 64 T.C. 752, 762 (1975). But see Barton, note 89, at 501-05 (arguing that some inflated nonrecourse debt represents economic cost).

96 IRC § 108(e)(10); Reg. § 1.1274-1(a) (providing that "[f]or purposes of section 1274, property includes debt instruments").
fore controls the determination of issue price when neither the new debt nor the old debt is publicly traded. Under § 1274, the issue price of the debt is the stated principal amount of the obligation if it bears adequate stated interest. If not, the issue price is determined by reference to the imputed principal amount of the obligation. In certain “potentially abusive situations,” the statute equates the imputed principal amount with the value of the property for which the debt is exchanged. Among others, a potentially abusive situation can be “any . . . situation which, by reason of— . . . nonrecourse financing . . . is of a type which the Secretary specifies by regulations as having potential for tax avoidance.” The Secretary has not issued regulations that adequately define this category.

If the nonrecourse financing in the restructuring is a potentially abusive situation, the issue price of the new debt obligation is limited to the value of the old debt obligation, which is likely to approximate the value of the property since the lender is limited to the remedy of recovering the securing property on the debtor's default. If § 1274 could reduce the principal amount of the new debt obligation to the value of the securing property, the restructuring no longer would run afoul of the Franklin principle. The restructuring would be a debt-for-debt exchange, with COD income to the debtor in an amount equal to the difference between the face amount of the original instrument and the issue price of the new instrument. This result is not ideal for a debtor who is unable to exclude the income under § 108, but the vir
tue of this approach is its simplicity—the debt remains isolated from
the property and the transaction has no effect on the borrower's basis.

If this were the proper reading of "potentially abusive situations" in
§ 1274(b)(3), all nonrecourse debt instruments would be bootstrapped
into debt for tax purposes.\(^1\) This interpretation of the statute essen-
tially would codify the *Pleasant Summit* approach. Because of its
flaws, it would be unwise to import the holding of *Pleasant Summit*
into the interpretation of § 1274 or to advocate a change in the law
that would have such an effect.\(^2\)

Section 1274 is better read as a narrower provision, one that deter-
mines the issue price of a debt obligation only after the instrument is
independently determined to be a debt for tax purposes. This reading
of § 1274 is consistent with the congressional staff's understanding of
that section:

> The limitations on principal amount imposed by [§ 1274] do
> not override prior case law dealing with overstatement of ba-
> sis and other abuses in transactions involving nonrecourse
debt. As under prior law, an obligation must represent a
> bona fide indebtedness of the purchaser-issuer to be
> respected for purposes of the OID rules and other provisions
> of the Code. Thus, if a nonrecourse obligation is given in
> exchange for property having a value less than the principal
> amount of the purported debt obligation (determined in
> accordance with these new provisions), the obligation may
> be disregarded in whole or in part under general principles
> of tax law and basis, interest deductions, and other tax bene-

---

\(^1\) One exception might be instruments with adequate stated interest, which appear to
be outside the scope of the potentially abusive situation rules. This dichotomy easily could
be manipulated by taxpayers, however, choosing to issue either current pay or discount
obligations. For example, a taxpayer might issue an instrument with no stated interest.
Under § 1274(b)(1), the imputed principal amount of the instrument might exceed the
value of the property, so if that amount had been the stated principal amount, there would
have been a *Franklin* problem. By failing to state any interest, the taxpayer who could call
upon § 1274(b)(3) might bypass the *Franklin* inquiry (and its harsh consequences) and
might have the imputed principal amount reduced below the § 1274(b)(1) amount to the
value of the property. While this lower basis would provide fewer tax benefits in the way
of depreciation deductions, it would preserve the basis attributable to the debt up to the
value.

\(^2\) David Garlock has recognized the “technical circularity” possible in the potentially
abusive situation rules, and has concluded that the 1984 Senate Report and additional sub-
stantial authority would allow the Service to disregard a debt instrument, rather than sub-
ject it to the original issue discount rules. Garlock, note 82, at 4-33 to 4-34 (citing S. Rep.
No. 98-169, vol. 1, at 236 (1984)).
The reference to Franklin makes clear that § 1274 operates to determine the principal amount of an obligation only if the instrument is determined to be debt for tax purposes under the Franklin standard. Therefore, even if an obligation has adequate stated interest, if the principal amount of the obligation exceeds the value of the securing property, § 1274 has no application. Such an obligation is simply not debt. Therefore, in a restructuring, a determination that the instrument is debt for tax purposes must be made, and where the debtor has no equity in the property, Franklin teaches that the obligation will not be respected as a debt for tax purposes.

D. Recharacterizing Debt as an Interest in Property

The conclusion that reducing the principal amount of the debt is unsound leaves only one choice under current law for characterizing the restructured instrument. This Section argues that the restructured instrument is best characterized as an ownership interest in the property. If the new instrument is an ownership interest, restructuring strips the borrower of the tax attributes associated with ownership and frustrates the expectations of the parties.108


107 The effect of applying both the Franklin principle and the potentially abusive situation rules to an obligation without adequate stated interest is unclear. If the issue price of an obligation is determined by reference to the present value of all payments due under the obligation, per § 1274(b)(1), and the issue price exceeds the value of the property, an application of Franklin to that issue price leads to the conclusion that the obligation will not be respected as debt. This order of analysis—applying § 1274 first and then Franklin—minimizes the cases in which § 1274(b)(3) has any impact because the debt must be ignored rather than reduced. This is a harsh application of the law because the applicable federal rate (AFR) is lower than the rate at which many borrowers must finance their acquisitions. This problem arises in OID obligations, as well as restructured obligations.

On the other hand, application of § 1274(b)(3) prior to application of the Franklin principle means that there will never be an obligation that fails to meet the Franklin standard because the issue price necessarily will be reduced to the point at which it no longer exceeds the value of the property.

It is unclear what function the potentially abusive situation rules were meant to serve, but the most appropriate role for them is to designate a greater amount as interest than would be so designated under § 1274(b)(1). Such a result would be appropriate in situations where the AFR is not sufficiently high in light of either the borrower’s creditworthiness, or the risk of decline in value of the collateral securing a nonrecourse debt. If § 1274(b)(3) were limited to this role, both it and Franklin would retain lasting vitality.

108 If the new instrument is not debt, the purported obligor will not be entitled to interest deductions under § 163 for payments under the new instrument. Denial of interest deductions is independent of any effects on the taxpayer’s basis in the securing property.
From a traditional debt-equity perspective, the restructured instrument looks more like an interest in the property than an obligation of the debtor. The debtor would rather walk away from the property than satisfy the excessive debt, so the presumption about nonrecourse debt—that the instrument is debt of the borrower, rather than an obligation attaching to the property—is unfounded; without the property, the obligation would be totally unenforceable. In fact, the debtor has no reasonable expectation of developing an ownership interest in the property if the outstanding debt is sufficiently greater than the projected value of the property at the time the debt must be satisfied. The lender bears the risk of loss and, at this point, also has sole interest in any appreciation up to the principal amount of the debt.

If the restructured instrument must be treated as an ownership interest of the lender in the property, the borrower's basis in the underlying property is questionable. The debtor included the nonrecourse debt in basis at acquisition of the property on the assumption that the debt would be satisfied. A recharacterization of the debt as an ownership interest of the lender in the property proves that assumption to have been false. Even where the taxpayer satisfies the debt subsequent to the restructuring, characterization of the instrument as the lender's ownership interest on the restructuring is still correct under current law because advance credit for satisfaction of the new instrument is unwarranted where the taxpayer has no equity in the property at the time that instrument is created.

---

109 See note 72. While the legal standards for distinguishing debt and equity for tax purposes have developed in the context of corporate debt, some of the factors applied in that context are relevant to debt secured by property as well. For example, participation in both the success and failure of a venture indicates an equity participation, while a right to enforce payment of the entire sum of the obligation on default indicates indebtedness. Thin capitalization in the corporate context is comparable to a lack of equity cushion in the property context, and an obligation of contingent amount is comparable to a nonrecourse mortgage that is inadequately secured.

110 See Terry, note 41, at 325 (analogizing obligor of nonrecourse debt in excess of property's fair market value to holder of put option to sell property at exercise price equal to nonrecourse debt payable at maturity). While the borrower may have possession of the property, such possession is consistent with a simple lease arrangement and does not prove that the borrower has any ownership interest in the property. This was the government's contention in Mayerson v. Commissioner, 47 T.C. 340, 340 (1966). Any payment pursuant to the "debt" is, in this model, payment of rent. See text accompanying notes 171-73.

111 The Service has blessed the debt characterization of shared appreciation mortgages only in the context of residential, recourse indebtedness, see Rev. Rul. 83-51, 1983-1 C.B. 48, but will not rule on other types of mortgages, see Rev. Proc. 94-3, 1994-1 C.B. 447, 448.

112 This is similar to contingent debt, which is not included in basis until satisfied, whether recourse or nonrecourse. See Denver & Rio Grande W. R.R. v. United States, 505 F.2d 1266, 1269-71 (Ct. Cl. 1974); Albany Car Wheel Co. v. Commissioner, 40 T.C. 831, 841 (1963), aff'd per curiam, 333 F.2d 653 (2d Cir. 1964); Redford v. Commissioner, 28 T.C. 773, 778 (1957); Rev. Rul. 78-29, 1978-1 C.B. 62.
Once the new instrument is characterized as the lender's ownership interest, it would be inconsistent to allow the borrower to continue depreciating the property on an undiminished basis. Either the purchaser should be divested of basis (if he has sufficient basis) to the extent that the debt does not represent cost, or the purchaser should bear the tax cost of that basis by including the basis in income. If the restructuring did not affect the purchaser's basis in the property, the debt would be treated inconsistently—failing to exist for purposes of allowing interest deductions, while continuing to exist as part of the purchaser's investment in the property. If the instrument is not a debt, it is not a financial commitment to the property and it no longer can be part of the purchaser's cost of that property.

To be consistent, the new instrument must be treated as an ownership interest for all purposes. After the restructuring, the lender is considered the owner of the property for tax purposes and the purchaser is treated as having transferred the property to the lender in satisfaction of the debt. A transfer of property in satisfaction of a debt is always a realization event for both the property and the debt, and a transfer of collateral to the lender is equivalent to a foreclosure. Because the lender is not the seller, the foreclosure is not entitled to nonrecognition treatment. Instead, the creditor is treated as having received the value of the property in exchange for the note. Because that value is less than the note, the creditor is entitled to a loss equal to the difference.

Going forward, the creditor has a tax cost depreciable basis equal to the value of the property. The borrower has satisfied the indebtedness with the property in a transaction qualifying as a sale or exchange. Because the debt is nonrecourse, the debtor has no COD income, but includes the entire amount of the outstanding debt as

113 For example, if the purchaser had invested $1 in cash and the restructured debt is in the amount of $9 when the value of the property is only $5, the purchaser's basis should be reduced to $1, further adjusted down for depreciation already claimed. Because this Article does not advocate this solution, it does not resolve the difficulties associated with this approach, such as negative basis and depreciation recapture, which would arise if prior depreciation claimed had been in excess of $1.

114 This is the cancellation of indebtedness result: The borrower includes the forgiven amount in income, providing tax cost to the extent of the inclusion, and therefore, supporting continued depreciation deductions. Once included, the cancelled debt is the same as any other after-tax funds. Because of the time value of money, a taxpayer is not indifferent to inclusion now and deduction later (or deduction now and inclusion later).

115 The debt is extinguished and any gain or loss on the property is recognized. See United States v. Davis, 370 U.S. 65, 68-71 (1962); Kenan v. Commissioner, 114 F.2d 217, 219-20 (2d Cir. 1940).

116 See IRC § 1038(a).

117 See IRC § 166(a).
amount realized on the sale.\textsuperscript{118} The amount of the debtor's gain (or loss) depends on her § 1011 adjusted basis in the property at the time of the workout.\textsuperscript{119} In a foreclosure, all incidents of ownership are shifted to the lender; after foreclosure, the borrower owns nothing and is not entitled to basis in the property.\textsuperscript{120}

**IV. Separating the Realization Event for the Property from the Realization Event for the Debt**

In one sense, the results under current law are perfectly acceptable in that they bring the tax treatment of the lender-borrower relationship closer to measuring income more accurately after the restructuring than it was before. Foreclosure treatment recognizes that the loss has been borne by the lender.\textsuperscript{121} Using the restructuring to adjust the relative tax positions of the parties, however, makes the restructuring a major tax event, which may be burdensome to both borrowers and lenders.\textsuperscript{122} This Section considers the argument that can be made for treating the debt and the property separately, so that the restructuring is treated as a realization event for the debt, consistent with the conclusions reached in Section III, but without constituting a realization event with respect to the securing property. Since the realization with respect to the debt is the event that implicates the property, it would be possible legislatively to exclude the property from the realization event, despite the workout, without repudiating the entire realization

\textsuperscript{118} See Commissioner v. Tufts, 461 U.S. 300, 317 (1983); Reg. § 1.1001-2(a). As commentators have noted, it might be more appropriate to treat both sides of the transaction consistently and bifurcate the analysis into its asset and liability components for the borrower-transferor. Under a bifurcated approach, the debtor would realize the value of the property on the sale and COD income to the extent the debt exceeds the value of the property. See Cunningham, note 54, at 577-78; Geier, note 54, at 116-21.

\textsuperscript{119} See IRC § 1001(a).

\textsuperscript{120} While no longer entitled to depreciation, a borrower who remains in possession of the property may have deductions to the extent she compensates the lender-owner for use of the property and income to the extent she earns any from the property. For a further discussion of the tax consequences to a borrower in possession when the lender is treated as an owner of the property, see notes 171-76 and accompanying text.

\textsuperscript{121} The fact that the loss might be temporary does not change the accuracy of this characterization at the time of the restructuring. While it may be true that some critics of Crane have placed too much significance on the legal risk of loss, where a loss actually has occurred and a restructuring clearly allocates the loss, the economic burdens fall on the lender. Cf. Shaviro, Risk and Accrual, note 1, at 419 (arguing that no allocation of nonrecourse deductions can have substantial economic effect); Stephen G. Utz, Partners in Crane: Partnership Investment and Economic Risk, 31 Tax Notes 827 (May 26, 1986) (arguing that partnership regulations should take account of the fact that legal allocation of risk is not perfect proxy for determining who bears actual economic risk).

\textsuperscript{122} For lenders, the burden may arise from nontax consequences that may follow from the tax consequences, such as financial statement adjustments and regulatory restrictions about property ownership.
system. I conclude that there is no compelling policy justification for treating the debt and property inconsistently and therefore an overhaul of the treatment of nonrecourse debt is desirable.

The policies behind the realization requirement do not provide any persuasive reason to treat the restructuring as a realization event with respect to the debt, but not with respect to the property.\footnote{If the changes to the instrument are significant, a debt modification must be treated as a realization event to prevent manipulation of the realization rule. A realization cannot depend upon the formal distinction between exchanging new pieces of paper and modifying an existing one. In interpreting Cottage Sav. Ass’n v. Commissioner, 499 U.S. 554 (1991), which involved an actual exchange, Treasury recognized that the substantive standard for a realization had to be consistent for actual exchanges and deemed exchanges. See Preamble to Prop. Reg. § 1.1001-3, 57 Fed. Reg. 57,034 (1992). While a higher threshold for reissuance would reduce the frequency of the restructuring-as-foreclosure problem, it would not solve it completely because a significant modification to a debt instrument would constitute a reissuance under § 1001.} The current income tax is based on a realization rather than an accrual system—which would measure income more precisely—largely for reasons of administrability and cash flow.\footnote{This is the widely accepted justification for the realization requirement. Marvin A. Chirelstein, Federal Income Taxation: A Guide to the Leading Cases and Concepts 72 (7th ed. 1994).} Realization eases administration because it relieves taxpayers and the government from the burden of valuing all property every year to determine whether the property has increased or decreased in value, as would be required in an accrual tax. Delaying tax until realization, which most often occurs on the sale of property, also prevents the imposition of tax at an illiquid time. Assuming these policies are important,\footnote{Some commentators do not believe they are. See Deborah H. Schenk, Taxing Equity Derivatives: A Partial Integration Proposal, 51 Tax L. Rev. 571, 635-37 (1995); Shakow, note 59, at 1114 (both suggesting liquidity and valuation concerns are overblown).} neither would be promoted significantly by excluding the property in the restructuring from the realization event that affects the debt. The case for revisiting the basic approach to nonrecourse debt is not weakened by these interests.

The valuation burden at the time of the restructuring is not increased by treating the restructuring as a realization event for the property, because whenever a debt modification takes place, the parties must value the securing property to determine the terms of the restructured instrument. The lender must weigh restructuring against foreclosure, and both parties must calculate an appropriate reduction in the borrower’s obligation. Thus, in every restructuring, the value of the property at least must be approximated.

The cash flow justification for the realization requirement likewise fails to support arbitrary separation of the debt realization from the property realization. Under current law, even if the property were
protected from realization, the restructuring nevertheless might present a cash flow hardship to the taxpayer, since immediate COD income might result from the debt realization in the workout.\textsuperscript{126} Furthermore, the immediate tax resulting from a deemed disposition of the property in exchange for the debt might be less than the immediate tax from the COD on a deemed debt-for-debt exchange (or from treating the restructuring only as a realization event with respect to the debt).\textsuperscript{127}

In sum, the policies behind the realization rule do not make a compelling case for treating a restructuring as a realization event for the debt but not the property. The problem under current law arises because the restructuring presents an opportunity to correct prior mischaracterizations, not because the law mischaracterizes the workout itself. If the transaction had been treated accurately at the outset, the restructuring would not necessitate an abrupt adjustment of the tax consequences so they comport with economic reality.

V. PROBLEMS WITH CURRENT TAX TREATMENT OF NONRECOURSE DEBT

This Section explains why the current treatment of nonrecourse debt is unacceptable, both in the restructuring example and more generally. It argues that the treatment of a restructuring creates unnecessary hardship for debtors and unexpected consequences for lenders. It also surveys some of the classic difficulties presented by the use of nonrecourse debt. The vexation that has been caused by nonrecourse debt—the classic abuses and the restructuring problem highlighted here, as well as the uncertainty and complexity it has spawned—re-

\textsuperscript{126} COD income might be deferred under § 108. This does not affect the realization of discharge of indebtedness income under § 61(a)(12), although that income could be converted into gain on disposition of the property. See Kimberly S. Blanchard, Discharge of Nonrecourse Debt: A Reexamination of the Distinction Between Recourse and Nonrecourse Debt and Related Issues, 50 Tax Notes 773, 775 (Feb. 18, 1991).

\textsuperscript{127} For example, if the debt is $10, the borrower's basis in the property is $7, the value of the property has fallen to $5, and the issue price of the new debt is determined to be $5 under § 1274, the taxpayer has immediate taxable income of $5 ($10 debt deemed satisfied with payment of $5), which is ordinary income because it is characterized as COD income rather than gain. See IRC § 61(a)(12). On the other hand, if the debt is deemed cancelled by a transfer of the property to the creditor, the borrower only has income of $3 ($10 debt less $7 basis). The borrower has less tax on the transaction under the latter characterization because the deemed transfer nets the COD income against the disposition loss on the property. See IRC § 7701(g) (providing that fair market value of property subject to nonrecourse indebtedness shall not be less than amount of such indebtedness); Reg. § 1.1001-2(a) (including in amount realized from sale or other disposition of property the amount of liabilities from which transferor is discharged as result of sale or disposition).

The borrower is in a less advantageous tax position in the transfer example only in that he will not be entitled to future depreciation deductions with respect to the property.
lates back to the true-debt approach and its failure accurately to measure income.

A. Debt Into Equity

Current law deters restructurings because they terminate the favored tax treatment generally granted to nonrecourse borrowers. This deterrence effect exists regardless of whether the restructured instrument is characterized as the lender's equity interest in the property or debt, as in the straight-debt modification. Thus, a restructuring is only one of many examples in which the Crane rule, though advantageous for borrowers at first, eventually may lead to hardship. Whether the restructured instrument is treated as equity or debt, the tax consequences may be burdensome: If the restructured instrument is equity, the debtor will have gain or loss on the disposition of the property and will be divested of its tax ownership, including depreciation deductions. On the other hand, if the instrument is debt, the debtor may have significant COD income.

It is inefficient for the tax law to deter restructurings that the parties otherwise would accomplish. Debt must be restructured when the cost of servicing it leaves the debtor with insufficient funds to operate the property. Restructurings prevent foreclosures, and, therefore, keep property in the hands of those who have an interest in operating it. Furthermore, restructurings of troubled debt should be encouraged so that the financial statements of lenders properly reflect the value of their loan portfolios; a restructuring that reduces the amount of a loan should be reflected as a lesser asset on the financial institution's books.

128 See Subsection III.D.2.
129 The tax consequences to the debtor may be either more or less burdensome if the restructured instrument is characterized as lender's equity instead of debt, so the choice between debt and equity does not favor necessarily either the interest of taxpayers in minimizing tax or the interest of the government in maximizing revenue. The relative burdens depend upon when the restructuring takes place during the depreciable life of the property and the amortization schedule of the debt. For example, where the restructuring takes place early in the borrower's holding, before any mortgage amortization and little depreciation has been allowed, if the new instrument is characterized as equity, the gain may be small while the loss of future deductions may be large. Alternatively, if there has been significant mortgage amortization and depreciation allowed prior to the restructuring, there could be a loss realized on the restructuring, but little forgone depreciation, if the new instrument is characterized as equity. Conversely, if the restructured instrument is characterized as debt, the debtor will continue to be entitled to the depreciation deductions on the property, but may recognize COD income on the restructuring without any offsetting loss for the economic decline in the value of the property that necessarily would have occurred prior to the workout.
130 While foreclosure would achieve this goal as well, a restructuring can achieve this goal with far fewer consequences.
A restructuring shows how easily an instrument can be transformed from debt into equity, largely by operation of law, rather than by major change in the terms of the instrument. That transformation can take place so readily because there is little substance that distinguishes nonrecourse debt secured by property from an ownership interest in that property—the lender's interest was very much like an ownership interest all along. Nevertheless, the tax law places great importance on that distinction by awarding all depreciation deductions to the owner of the property. A restructuring is a major tax event because it must be treated as a foreclosure to bring the tax treatment into line with the economic relationship of the parties. A better reflection of income for the duration of the transaction would require less adjustment later, and a better system would provide for major tax consequences to flow from major business transactions and minor tax consequences to flow from less significant transactions.\footnote{If the non-recourse debt had been considered an investment by the lender, rather than by the borrower at the outset, as Section VI describes, a restructuring would have no tax consequences at all.} A restructuring is a major tax event because it must be treated as a foreclosure to bring the tax treatment into line with the economic relationship of the parties. A better reflection of income for the duration of the transaction would require less adjustment later, and a better system would provide for major tax consequences to flow from major business transactions and minor tax consequences to flow from less significant transactions.\footnote{If the non-recourse debt had been considered an investment by the lender, rather than by the borrower at the outset, as Section VI describes, a restructuring would have no tax consequences at all.}

A restructuring illustrates the breakdown of the true-debt approach to nonrecourse debt, but it certainly does not represent the entire extent of the problem with current law's treatment of nonrecourse debt. As the next Section describes, the tax treatment of nonrecourse debt has led to considerable abuse, uncertainty and complexity. A workout simply provides an additional reason to reject the \textit{Crane} rule's treatment of acquisition indebtedness as part of the purchaser's cost of acquired property.

\textbf{B. Implications Outside Restructurings}

This Section argues that the true-debt approach has none of the advantages that the \textit{Crane} court expected it would have and many disadvantages. First, the \textit{Crane} rule stimulated abusive avoidance behavior: Inclusion of nonrecourse debt in basis encouraged taxpayers to inflate nonrecourse debt in transactions involving seller financing, and to arrange their affairs so that tax benefits from property flowed to high bracket taxpayers.\footnote{The \textit{Crane} rule was acceptable for bona fide real estate deals in an environment of continually rising values in which it was easy to presume that a purchaser would have reasons to satisfy an excessive debt. See generally Martin B. Cowan, \textit{Is Any Part of a Nonrecourse Mortgage Greatly Exceeding FMV Includable in Basis?}, 77 J. Tax'n 260, 264 (1992); Utz, note 121, at 829 n.13. In an era of falling values, nonrecourse debt presents a real economic burden to lenders. See Vandell et al., note 39, at 451 (stating that in 1992 commercial mortgage foreclosures were at their highest levels since the Depression).} Second, the \textit{Franklin} test, which depends on a...
determination of value, negates the certainty of Crane's black letter rule that would treat all debt alike. And finally, Congress added considerable complexity to the treatment of nonrecourse debt with § 465, and more generally, § 469, undermining the simplicity and administrability of the Crane rule itself. These problems all could be alleviated by revisiting the true-debt approach and replacing it with a more accurate system of income measurement.

1. Cost Recovery and Deduction Shifting

The true-debt approach distorts income because it allows cost recovery where there has been no cost and thereby encourages deduction shifting among taxpayers.\(^{133}\) A taxpayer is entitled to basis equal to the cost of property.\(^{134}\) Depreciation is a corollary to cost basis

\(^{133}\) This is the traditional tax shelter debate. Preferences are purposeful, congressional enactments, and yet, certain uses of those preferences are considered abusive, and have been curtailed by both the courts and subsequent congressional action. For a discussion of the relationship between preferences and tax shelters, see Zelenak, note 37, at 588-89 (concluding that there is no justification for eliminating tax shelters while retaining preferences in Code). This Article takes no position on this issue.

\(^{134}\) IRC § 1012. Cost has been interpreted to mean the taxpayer's investment in the property—whether in the form of cash, other property exchanged or liabilities assumed with respect to the acquired property. See United States v. Hendler, 303 U.S. 564, 566 (1938) (holding that assumption and payment of debt obligation of transferor by transferee in corporate reorganization produces taxable income to transferor); Blackstone Theatre Co. v. Commissioner, 12 T.C. 801, 804-05 (1949) (holding that transferee's basis in property includes tax liens thereon); Reg. § 1.1012-1(a) ("In general, the basis of property is the cost thereof. The cost is the amount paid for such property in cash or other property.").

Cost includes recourse liabilities because they represent a commitment to the property that the purchaser is required to make, even though such liabilities do not represent a current cash cost (or tax paid cost) of the acquired property. Assignment of basis for any debt, therefore, provides the debtor a time value advantage that the purchaser for cash does not have. Depreciable basis attributable to recourse liabilities is a tremendous benefit to the taxpayer-borrower who is entitled to deductions prior to the payment of tax on the income used to satisfy the liabilities. See George Cooper, The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance, 85 Colum. L. Rev. 657, 716 (1985) (arguing that leverage is cause of tax sheltering activities and recommending that preferential deductions be allowed only for cash-supported basis); Michael T. Madison, Initial Pitfalls Associated With Use of the Limited Partnership 7, 8-11 (unpublished paper presented at 22d Marshall-Wythe School of Law Tax Conference (Dec. 4, 1976)) (describing how successful real estate venture can provide tax losses to investors); Martin J. McMahon, Jr., Reforming Cost Recovery Allowances for Debt Financed Depreciable Property, 29 St. Louis U. L.J. 1029, 1034 (1985) (arguing that depreciation deductions on all debt financed property should be suspended until debt is amortized).

The inequities and the opportunities for abuse, caused by the use of leveraging in general is beyond the scope of this Article. The proposal in this Article does not extend to recourse debt because the proposal stems from an observation about the character of non-
because it is the method by which investors recover their costs.\textsuperscript{135} Under current law, depreciation deductions serve a dual purpose: correct measurement of income from transactions that extend beyond one year in a system with annual accounting periods, and an incentive to invest in qualifying assets.\textsuperscript{136} Gradual cost recovery is appropriate in the name of accurate measurement of income, but a system that assigns basis to a taxpayer who does not bear the cost of the property (and may never bear that cost) fails to achieve that goal. Where there has been no cost for acquiring the property, as where there is no wast-

\textsuperscript{135} "The purpose of depreciation accounting is to allocate the expense of using an asset to the various periods which are benefited by that asset." Hertz Corp. v. United States, 364 U.S. 122, 126 (1960); see also Fribourg Navigation Co. v. Commissioner, 383 U.S. 272, 276-77 (1966) (discussing depreciation and tax-free cost recovery); Massey Motors, Inc. v. United States, 364 U.S. 92, 96 (1960) (same). Depreciation also can be understood as an exception to the realization requirement because it allows purchasers to account for the loss in their property piecemeal, rather than waiting for a disposition of the property. See United States v. Ludey, 274 U.S. 295, 301 (1927) ("The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it."); see also Cunningham & Schenk, note 14, at 742 (noting that, under current law, taxpayers are permitted to account for anticipated loss in value of certain assets resulting from depreciation before disposition).

\textsuperscript{136} A better approach than the one codified in § 168 would separate the two goals of the present accelerated cost recovery system—matching costs with revenues and fostering investment—and address each more precisely. A variation on the current schedular approach could be retained in order to achieve the first goal. Ideally, the rate of depreciation would be slower and less front-loaded. For a discussion of economic, or sinking fund, depreciation, see 2 Treasury Dep't, Tax Reform for Fairness, Simplicity, and Economic Growth 151-72 (1984); Chirelstein, note 124, at 145-49; Calvin H. Johnson, Soft Money Investing Under the Income Tax, 1989 U. Ill. L. Rev. 1019. The basic construct of § 168 could remain, however, categorizing assets by useful life and depreciating based on a formula. The second goal could be achieved more directly and simply by giving a one time subsidy to taxpayers to whom Congress desires to give incentives. For example, Congress could enact an investment tax credit that would give taxpayers an incentive to invest in certain assets and be measurable in present value terms. Of course, it is not necessary that the subsidy be administered through the tax system, rather than by direct expenditure.
ing of the property, there should be no depreciation because there cannot be any decline in the investment or recovery of cost.

Nonrecourse debt represents a contingent, rather than an irrevocable, commitment to make a future investment in the property. Courts consistently have looked for unconditional obligations in assigning basis for debt. Even if the taxpayer has equity in the property so that he currently has an incentive to treat the nonrecourse debt the same as recourse debt, without legal compulsion, there is no guarantee that subsequent market events will not eliminate that incentive. Because nonrecourse debt is only a possible future cost of the borrower, on acquisition, it is better characterized as a current cost of the lender, which may or may not be replaced by a later cost of the borrower.

The lender is the one who must produce the cash on acquisition, and must forgo all other opportunities for that investment. The economic cost of the property represented by the nonrecourse debt is

\[ \text{Economic Cost} = \text{Cost of Production} - \text{Opportunity Cost} \]

\[ \text{Opportunity Cost} = \text{Value of Alternatives} \]

\[ \text{Cost of Production} = \text{Cost of Labor} + \text{Cost of Materials} + \text{Cost of Overhead} \]

137 See Geneva Drive-In Theatre Inc. v. Commissioner, 67 T.C. 764, 771-72 (1977), aff’d, 622 F.2d 995 (9th Cir. 1980) (holding that depreciation on future interest does not begin until that interest becomes possessory, that is, when taxpayer, rather than tenant in possession, bears burden of economic decline). Section 167(a) authorizes depreciation deductions only for property that exhausts, suffers wear and tear or becomes obsolete. Certain property is not considered to do so. See Reg. § 1.167(a)-2 (land not depreciable); Rev. Rul. 68-232, 1968-1 C.B. 79 (works of art not depreciable). But see Liddle v. Commissioner, 65 F.3d 329 (3d Cir. 1995) (allowing musician to depreciate bass violin even though instrument increased in value while musician owned it); Simon v. Commissioner, 68 F.3d 41, 44 (2d Cir. 1995) (allowing musicians to depreciate antique violin bows because they proved that bows suffer wear and tear with use).

138 It is fundamental that the depreciation deduction is allowed upon a capital investment. Where a taxpayer has no capital investment in property it is not entitled to a depreciation allowance in respect of the capital asset. The essential requirements of a capital investment are the laying out of money or money's worth and the acquisition of something of permanent use or value in the business.

Detroit Edison Co. v. Commissioner, 45 B.T.A. 358, 361 (1941), aff’d, 319 U.S. 98 (1943).

139 See Anderson, note 6, at 1514-15 (arguing that nonrecourse debt is contingent and therefore should be governed by rules applicable to contingent debt). This Article takes that observation one step further by redefining the relationship of the lender and the borrower. See Section VI.

140 See Columbus & Greenville Ry. Co. v. Commissioner, 42 T.C. 834 (1964), aff’d per curiam, 358 F.2d 294 (5th Cir. 1966); Albany Car Wheel Co. v. Commissioner, 40 T.C. 831 (1963), aff’d, 333 F.2d 653 (2d Cir. 1964); Redford v. Commissioner, 28 T.C. 773 (1957). Similarly, guarantors are denied basis until they actually pay the debt and are unable to collect from the primary debtor. See Uri v. Commissioner, 949 F.2d 371 (10th Cir. 1991); Harris v. United States, 902 F.2d 439 (3rd Cir. 1990); Brown v. Commissioner, 706 F.2d 755 (6th Cir. 1983); Blum v. Commissioner, 59 T.C. 436 (1972). But see Selfe v. United States, 778 F.2d 769 (11th Cir. 1985) (remanding on instruction that guaranteed obligation should be included in guarantor's basis if creditor looks primarily to guarantor for repayment); cf. Estate of Leavitt v. Commissioner, 875 F.2d 420, 426-27 (4th Cir. 1989) (distinguishing Selfe).

141 Commentators have noted the borrower's opportunity costs in incurring a nonrecourse loan. See Barton, note 89, at 496; Utz, note 121, at 843.
allocated more accurately to the lender rather than the borrower, as is, therefore, the § 1012 cost basis. In its focus on ownership as a proxy for investment, the law has ignored the obvious investor.\textsuperscript{142}

Depreciation, by definition, measures loss rather than profit, and therefore, it is appropriate to look to the incidence of loss rather than opportunity for profit in assigning depreciation deductions. If an asset gives rise to depreciation deductions without actually declining in value (or "costing" the taxpayer anything), any amount of allowable depreciation provides the taxpayer with a tax advantage without economic detriment.\textsuperscript{143} Under the current system of cost recovery, tax depreciation can play an independent role in the marketplace, encouraging nontaxable lenders to sell the tax deductions associated with their economic losses to taxable borrowers. These arrangements\textsuperscript{144} are beneficial to both the borrower and the lender, at the expense of the fisc. They are attractive to the lender because it can charge a premium interest rate on the loan in exchange for the tax benefits to which the borrower becomes entitled under current law as a consequence of the arrangement. The borrower is willing to pay the premium for the tax benefits when those benefits more than offset the premium charged.

This shifting of tax benefits is contrary to congressional intent and is a problem when it undermines the progressivity of the income tax.\textsuperscript{145} Congress has made clear that it intended the Code's incentive to invest in capital assets to be a benefit primarily for targeted taxpayers, rather than simply an attempt to increase investment in capital assets.

\textsuperscript{142} See Tolins v. Commissioner, 22 T.C.M. (CCH) 137, 140-42 (1963) (rejecting seller-mortgagor's claim to depreciation deductions). The court stated that the mortgagee did not hold the property for production of income, and therefore, § 167(a) did not authorize a deduction. See id. at 140. This is an unnecessarily narrow reading of the statute—lenders do not hold mortgages for amusement.

\textsuperscript{143} This partially explains why, in a rising market, real estate was so attractive as a tax shelter although it had a depreciation schedule slower than that for other assets. Whether property actually is exhausting generally has been administratively determined. See Rev. Proc. 87-56, 1987-2 C.B. 674 (setting forth asset classes, class lives and recovery periods for property subject to depreciation under § 168).

\textsuperscript{144} Although investment in real estate in order to reap tax benefits has declined due to the operation of §§ 465 and 469, some investors continue to enjoy significant tax deductions with respect to real estate without economic exposure. See IRC § 465(b)(6) (providing that taxpayers shall be considered at risk with respect to their share of qualified nonrecourse financing), § 469(c)(7) (excluding from passive activity categorization certain rental real estate activities).

\textsuperscript{145} For a contrary view, see Shavros, Risk and Accrual, note 1, at 432-39 (arguing that misallocation of deductions among taxpayers allowed through use of nonrecourse debt is not problem worth addressing); Sims, note 3, at 298 (supporting free allocation of tax benefits in arm's length negotiation).
by providing a freely transferable subsidy.\textsuperscript{146} If Congress had intended to encourage investment in certain assets without regard to the identity of the recipient of the tax benefits, there would be no eligible taxpayer requirements, as there are in §§ 465(a)(1) and 469(a)(2). Those taxpayer limitations evince congressional intent to subsidize particular taxpayers involved in particular activities,\textsuperscript{147} and the restrictions as to eligible taxpayers may prevent the full capitalization of tax savings into the price of tax-preferred assets.\textsuperscript{148} Similarly, the repeal of safe harbor leasing is further evidence that Congress is unwilling to encourage investment by granting taxpayers freely transferable benefits.\textsuperscript{149} A system that allows well-advised taxpayers to buy and sell tax benefits misallocates the tax burden within income classes as well as across them.

2. Uncertainty

The current true-debt approach also creates uncertainty. The Franklin rule, which is necessary under current law to prevent the most blatantly abusive transactions, creates uncertainty because it relies on the audit and litigation process for enforcement. Even a con-

\begin{footnotesize}
\footnotesize
\begin{enumerate}
\item[\textsuperscript{146}] The desirability of placing preferences in the Code or limiting those preferences to certain taxpayers is beyond the scope of this Article, which simply observes that Congress has chosen to do so. For an economic analysis of this issue, see Daniel N. Shaviro, Selective Limitations on Tax Benefits, 56 U. Chi. L. Rev. 1189 (1989); see also Robert J. Peroni, A Policy Critique of the Section 469 Passive Loss Rules, 62 S. Cal. L. Rev. 1 (1988) (denouncing preferences).
\item[\textsuperscript{147}] Although particularly relevant for accelerated cost recovery benefits, taxpayer targeting is not unique to §§ 465 and 469; the Code also contains provisions directly prohibiting trafficking in tax benefits and gives the Commissioner tools to prevent shifting the incidence of tax. See, e.g., IRC § 382 (placing limitations on net operating loss carryforwards and certain built-in losses following corporate ownership change), § 482 (authorizing Secretary to allocate income, deductions, credits or allowances among two or more organizations, trades or businesses owned or controlled directly or indirectly by the same interests, if Secretary determines that such allocation is necessary to prevent evasion of taxes or to clearly reflect income).
\item[\textsuperscript{148}] See Sims, note 3, at 298-311 (concluding that capitalization of tax benefits is incomplete, and that restrictions that dampen desire for tax-favored assets are undesirable because they further impede complete capitalization). If tax benefits are fully capitalized into the price of the assets, they are not very effective incentives. The fact that there has been at least some capitalization of tax benefits creates a transition problem for the change of approach advocated here, as does any other change from the status quo.
\item[\textsuperscript{149}] The story of that provision, former § 168(f)(8), adopted in 1981 and quickly repealed, Tax Equity Fiscal Responsibilities Act of 1982, Pub. L. No. 97-248, 96 Stat. 324, 442-47, illustrates Congress' belief that the integrity of the tax system depends on the public's perception of the system's fairness and Congress' ability to control revenue loss. That provision stands out as the sole example of Congress' open invitation for the buying and selling of tax benefits. For further discussion, see Alvin C. Warren, Jr. & Alan J. Auerbach, Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing, 95 Harv. L. Rev. 1752 (1982).
\end{enumerate}
\end{footnotesize}
scientious and honest borrower cannot be certain that a nonrecourse obligation that represents a significant part of the purchase price will be respected as a true debt under the Franklin standard without an adjudication that determines the value of the property. Consequently, debtors cannot be sure that they are entitled to the tax benefits associated with a purported debt, an important element in predicting the cash flow from any property. In addition, Franklin's case-by-case approach is unsatisfactory as a general rule because of particular transactions like the restructuring described above: Taxpayers may be enjoying depreciation deductions on restructured Franklin-type debt with impunity because the government has not identified or challenged those taxpayers. A restructuring presents a significant enforcement problem because the government lacks access to the market valuation information that the parties have. The task of identifying those restructurings worth examining and then actually challenging them would be tremendous.

Without statutory guidance, taxpayers understandably choose the route of minimum liability and assume that the original borrower continues to be entitled to the tax benefits associated with the property. Given the lack of precedent, such an approach is reasonable. Even if these taxpayers are not engaging in the purposeful abuse that the prior generation of nonrecourse borrowers attempted, a restructuring creates the potential for tax avoidance. The problem is addressed best through legislation designed to protect the fisc and to provide predictability and equal treatment for all taxpayers.

3. Complexity

Finally, the true-debt approach has metamorphosed into a complex and cumbersome body of law. The simple Crane rule has grown into a three-tier system, with the rule that treats nonrecourse debt as true debt as the first tier, the Franklin rule as the second tier, and the at risk rules the third tier. The at risk rules are particularly complex. 150

---

150 Section 1.1274-3(b)(2) of the regulations provides that where the purchaser makes a 20% down payment, a nonrecourse debt will be protected from scrutiny under the potentially abusive rules of § 1274(b)(3), but the regulations do not apply in this context. See IRC § 1274(b)(3) (in case of potentially abusive situation, imputed principal amount of any debt instrument received in exchange for property shall be fair market value of such property adjusted to account for other considerations).

151 This, of course, was also a problem with acquisition debt, which explains why Congress had to adopt § 465. See Section II.

152 Although not directly addressing the issue of nonrecourse debt, the passive activity loss rules of § 469 represent an additional layer of analysis that must be applied after the at risk rules. The pressure on passive activities would be relieved to some extent if the problem of nonrecourse debt used in such activities (particularly real estate activities covered by the exception in § 465(b)(6)) were solved.
Under § 465, the owner is entitled to all the depreciation deductions attributable to the securing property, but is not allowed to shelter income from outside the activity with those deductions until they represent an economic loss actually suffered by the owner with respect to the property.\textsuperscript{153} Thus, in the final analysis, the at risk rules, in a clumsy stop-gap fashion, attempt to achieve the same goal as the proposal in this Article—to insure that the tax benefits of depreciation deductions are enjoyed only if the party claiming those deductions suffers an economic loss.\textsuperscript{154}

The at risk rules are also unnecessarily harsh in that they completely disallow depreciation deductions over time as the property deteriorates. If insufficient income from the property is realized by an owner with an insufficient amount at risk, as the property wastes, the loss must wait, denying all benefits of the cost recovery system and making the taxpayer wait until disposition of the property to recover cost. Clearly, during this period of decline, it is the lender's investment that is wasting, and suspension thwarts the Code's goal of matching deductions with income from the property.\textsuperscript{155}

\textsuperscript{153} IRC § 465(a). Although aggregation of activities is permitted in certain situations, the at risk rules apply on an activity-by-activity basis, so that at risk amounts invested in one activity do not allow the taxpayer to use the depreciation deductions from another venture financed with nonrecourse debt. IRC § 465(c)(2)(A), (B). The proposed regulations confirm that any gain recognized on disposition of an activity is treated as income from the activity, against which the taxpayer may offset suspended deductions. Prop. Reg. § 1.465-66(a), 44 Fed. Reg. 32,235 (1979).

\textsuperscript{154} Unfortunately, in the real estate context, the at risk rules do not achieve that goal because they exempt from their application qualified nonrecourse financing, which, by definition, includes most real estate financing provided by lenders in the business of making loans. See IRC § 465(b)(6) (providing that taxpayer shall be considered at risk with respect to his share of any qualified nonrecourse financing), § 49(a)(1)(D)(iv) (setting forth general limitations on type of person from whom taxpayers may borrow qualified nonrecourse financing). Neither the seller nor a lender related to the seller may provide qualified nonrecourse financing. IRC §§ 465(b)(6)(D)(ii) (referencing 49(a)(1)(D)(iv)(II) (defining "qualified person")).

\textsuperscript{155} Since lenders are never allowed to depreciate property they finance, even when they bear current losses, any depreciation of the property in excess of the income it yields offsets no one's income under the § 465 scheme. This overtaxes income from property financed by nonrecourse debt relative to property financed by recourse debt or cash.
VI. Redefining Nonrecourse Debt

One way to alleviate many of the problems posed by nonrecourse debt would be to revisit the Crane rule and reject the true-debt approach. Crane established this approach before computers revolutionized recordkeeping and before the law required taxpayers to keep track of a wide variety of complex data. Its holding relied on the Supreme Court's view that people would not be able to account for depreciation on a shifting basis. Those administrability concerns, while substantial in 1947, no longer provide a compelling reason to permit the tax consequences of nonrecourse debt to diverge so widely from its economic substance. Additionally, Crane's concern with matching the borrower's income with costs was misplaced because the nonrecourse lender is the taxpayer for whom there is a mismatch under the true-debt approach. The lender suffers the wear and tear on the property without a deduction, and includes all interest on the assumption that the principal amount of the loan is a nonwasting asset, which is simply false in the case of a nonrecourse loan secured by property that declines in value. While recourse loans and nonrecourse loans secured by nondepreciable property generally can be categorized as nonwasting assets, nonrecourse loans secured by depreciable property potentially are wasting assets. If the securing property does not waste, the problem is the availability of any depreciation allowance, not who claims it. Finally, the three-tier system shows that absolute simplicity is long gone from this area of the law.

---

156 See, e.g., IRC § 469 (passive activity loss and credit limitations), § 1272 (OID rules) and § 6038A (information required from foreign owned operations).
158 Presumably, it was also for administrative ease that the Supreme Court considered it important to choose one, and only one, taxpayer to whom all depreciation deductions would be assigned.
159 See note 31. The suspension of deductions under §§ 465 and 469 aggravates the distortion from mismatching that Crane tried to prevent because no one is permitted to account for the current costs of the property.
160 Of course, there is a risk of default in any loan, which might lead one to conclude that loans should always be included in income when received and deducted when repaid, on a consumption tax model, or that borrowed funds should never be included in basis. See note 134. This Article tries to address a somewhat more limited issue.
161 As Professor Bittker once wrote, "We are told, to be sure, that depreciation 'is a process of allocation, not valuation,' but if there is no decline in value, what is there to allocate?" Boris I. Bittker, A "Comprehensive Tax Base" as a Goal of Income Tax Reform, 80 Harv. L. Rev. 925, 957 (1967) (footnote omitted).

There is a certain irony in the fact that nonrecourse debt commonly is secured by buildings, which are deemed by statute to suffer "exhaustion [or] wear and tear."
Consistent with these concerns, this Section offers an alternative to the current law treatment of nonrecourse debt within a realization system of taxation that assigns basis to both a borrower and nonrecourse lender, allowing each depreciation over time, and treating the borrower as the full owner of the property only when his unconditional commitment to the property has replaced the lender's.

A. Description

I propose redefining nonrecourse debt so as to treat both the lender and the owner as “investors” in the purchased property.\(^2\) Under this approach, each would be entitled to basis for her “investment,” with that term having the broadest and most neutral connotation possible—encompassing both equity-type holders and debt holders. Anyone making an unconditional commitment to the property would be entitled to basis for that amount. Cash paid would be the most obvious investment. Recourse debt also would constitute an investment of the borrower because it is an unconditional obligation. Although the lender produces the cash in a recourse loan, it would be reasonable to treat the borrower as making an investment because she cannot change her mind later, and it would be too difficult to trace recourse debt to property accurately.\(^3\)

In a nonrecourse, third party purchase money loan, where the lender produces the cash and the borrower makes only a conditional promise to pay, it is more appropriate to treat the lender as the party making the investment.\(^4\) In contrast, when a seller finances a

\(^2\) See note 134.

\(^3\) Because the proposal treats nonrecourse lenders as investors in property, a substitution of the securing property would constitute a change in the investor's interest. This is the flip side of a restructuring, which, under the proposal, no longer would constitute a realization event. Consistent with the approach taken herein, a substitution of property should be an exchange for tax purposes because once nonrecourse debt no longer is conceived of as an interest of the lender in the debtor, the property is all there is. Similarly, a post-acquisition, nonrecourse loan secured by the property should be treated as the sale of an interest in the property, reducing the borrower's investment to the extent that the borrower extracts value out of the property, and giving rise to gain where the value withdrawn exceeds the borrower's basis. Compare Alvin D. Lurie, Mortgagor's Gain on Mortgaging Property for More Than Cost Without Personal Liability (Contentions of Taxpayer's Counsel in a Pending Case), 6 Tax L. Rev. 319 (1951) (arguing for immediate recognition of gain to mortgagor upon placing mortgage without personal liability for amount in excess of cost of property to be mortgaged), with Woodsam Assocs., Inc. v. Commissioner, 198 F.2d 357, 359 (2d Cir. 1952) (rejecting argument that taxpayer made taxable disposition of property
purchase on a nonrecourse basis, no investment would be made at that time by either party by virtue of the nonrecourse obligation, although the seller would continue her prior investment in the property.\footnote{This is the situation in \textit{Franklin}. Because the debtors in that case had no expectation of satisfying the debt, the amount of the debt was immaterial to the lenders and the borrowers. It was bounded only by the tax benefits that the purchasers could exploit. See notes 20-25 and accompanying text.} By characterizing all third party, nonrecourse lenders as investors in property, identifying an interest as a creditor’s interest or owner’s interest would lose some of its significance, helping to simplify the law and improve predictability in property transactions.\footnote{This proposal would make it unnecessary to distinguish some forms of debt and equity, because the lender’s interest would be treated the same whether interest was labelled as “debt” or “equity.” At the same time, it exacerbates the problem of distinguishing nonrecourse debt from recourse debt. While some nonrecourse debt may be very secure (for example, because the debtor has a substantial equity interest in the securing property), some recourse debt might be quite insecure (for example, because a debtor is a corporation holding no assets except the mortgaged property, or because the individual borrower has no current assets). Any rule that treats recourse and nonrecourse debt differently must distinguish the two. Current law already places significant pressure on the distinction between nonrecourse and recourse debt because deductions arising from nonrecourse debt are subject to the limitations in § 465, while recourse debt generally is exempt. A developed body of law weeding out debt that is recourse in name only could be called upon in resolving this issue. See, e.g., Porreca v. Commissioner, 86 T.C. 821 (1986); Davis v. Commissioner, 58 T.C.M. (CCH) 777 (1989); Lansburgh v. Commissioner, 54 T.C.M. (CCH) 691 (1987). One possible method for distinguishing recourse from nonrecourse debt would be to establish a rule that requires minimum assets for an individual or minimum capitalization for a corporation to enjoy the benefits of recourse debt. See Rev. Proc. 89-12, 1989-1 C.B. 798, 800-01 (specifying conditions under which Service will grant ruling that limited partnership will be treated as failing to satisfy conditions that characterize entity as corporation, including characteristic of limited liability). The greater the equity cushion on the purchase, the less important the distinction becomes because, for all practical purposes, very secure nonrecourse debt would be treated the same as recourse debt under this proposal. See note 196 and accompanying text. Perhaps the only way fully to resolve the problem of distinguishing recourse from nonrecourse debt is to change the tax law’s approach to cost recovery for all debt-financed property, as has been suggested by Professor McMahon, note 134.} With nonrecourse debt redefined as co-investment by the lender, both the lender and borrower would start with basis equal to their respective investments, consistent with § 1012’s understanding of cost as investment. The deductions would be allocated temporally, in the order in which the investment wastes.\footnote{This timing of depreciation deductions is consistent with current law treatment of a present purchase of a future interest in depreciable property. No depreciation is allowed until the future interest ripens; only then does the purchaser’s investment begin to suffer decline. See Geneva Drive-In Theatre, Inc. v. Commissioner, 67 T.C. 764 (1977), aff’d, 622 F.2d 995 (9th Cir. 1980).} If depreciation correctly measured the wasting of an asset, under this system, each investor

\footnote{This is the situation in \textit{Franklin}. Because the debtors in that case had no expectation of satisfying the debt, the amount of the debt was immaterial to the lenders and the borrowers. It was bounded only by the tax benefits that the purchasers could exploit. See notes 20-25 and accompanying text.} when she executed second mortgage for which she was not personally liable for amount in excess of her basis in such property.)
would be entitled to deductions equal only to the economic loss suffered. On the other hand, if depreciation allowed by the Code were faster than the actual decline in value of depreciable property because Congress intended to encourage investment in “capital assets”\(^{168}\) (such as current § 168), the acceleration would inure to the benefit of all investors, in relation to their respective costs and the timing of their losses in relation to one another. Although accelerated cost recovery itself is not neutral, this basis sharing would make the tax law more neutral in an investor's decision whether to use nonrecourse financing.\(^{169}\)

In allocating deductions temporally, this proposal would cause the tax law's measurement of decline to mirror the parties' allocation of the property's economic loss. Assuming accelerated depreciation, a collateral effect of this proposal sometimes would be that the borrower would have a rapid, front-loaded deduction for depreciation of her investment, providing her with the time value advantage of quickly deducting her entire investment in an asset that will not waste economically for a considerable period of time. This advantage would stem largely from the accelerated nature of depreciation deductions and would disappear if Congress moved to a system of accurate economic depreciation.\(^{170}\)

This proposal focuses on, and departs from, current law primarily with respect to depreciation because examination of the current treatment of nonrecourse debt reveals the greatest difficulty on the loss side. The dilemma identified in this Article only collaterally affects

\(^{168}\) I mean this in the capitalization sense, rather than the characterization sense—assets that Congress believes represent an investment in the economy.

\(^{169}\) While it is true that this proposal increases the relative attractiveness—from a tax perspective—of recourse debt, the risk of economic loss is an appropriate price. The tax benefits of ownership traditionally have depended, at least partially, on the corresponding risks. In the context of leasing transactions, courts have engaged in a benefits and burdens analysis to determine the owner of property, the lessor or the lessee, and whether the purported lessor should be allowed the depreciation deductions attributable to the property. See, e.g., Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Hilton v. Commissioner, 74 T.C. 305 (1980), aff'd, 671 F.2d 316 (9th Cir. 1982); Pacific Gamble Robinson v. Commissioner, 54 T.C.M. (CCH) 915 (1987); Smith v. Commissioner, 50 T.C.M. (CCH) 1444 (1985); Sanborn v. Commissioner, 46 T.C.M. (CCH) 1435 (1983).

\(^{170}\) Another effect of this system would be disparate treatment of taxpayers in economically equivalent positions, namely those holding property subject to nonrecourse debt and those holding options on property. This problem is addressed better by revising the treatment of options so that they are taxed in keeping with their economic properties, rather than taking an open transaction approach to nonrecourse debt. The option construct is not well suited to large downpayments or gradual amortization, while the approach advocated here accounts for variations in nonrecourse debt. The proper taxation of options is beyond the scope of this Article. For further discussion of options, see Bruce Kayle, Realization Without Taxation? The Not-So-Clear Reflection of Income from an Option to Acquire Property, 48 Tax L. Rev. 233 (1993).
the current scheme of income inclusion for property transactions. If nonrecourse debt was secured by nondepreciable property, neither the lender nor the borrower would be entitled to any deduction for wear and tear over the life of the property, and changes in value due to market fluctuations would be taxed on disposition.

Nevertheless, in modifying the approach to nonrecourse debt, some fundamental questions arise, apart from depreciation allowances. In particular, if lenders and borrowers are to be treated as co-investors, it must be determined how income and deductions will be taxed for the duration of that relationship. Since the co-investment approach does not affect the borrower's possession of the property, it is reasonable to treat the borrower the same as current law would treat any tenant in possession holding an option to purchase.\(^1\) As long as the borrower is free to operate the property, he should include all income from that operation. Like any tenant in possession, the borrower should be entitled to a deduction for amounts paid to the lender that are in the nature of rent for the use of the lender's property. The borrower would compensate the lender for use of the lender's portion of the property, with the amount depending on the initial investments made by the borrower and lender, and the principal amortization of the loan.

Furthermore, part of the so-called interest payment is an amount for the option to redeem the property at some time in the future. This is similar to the periodic payments towards that redemption if the loan is amortizing. The borrower, therefore, makes three different kinds of payments, which might be characterized individually for tax purposes.\(^2\) While the rent clearly should be deductible,\(^3\) the payments in the nature of premium for an option or further investment in the property should be capitalized.\(^4\) This is because the option premium would be paid for a benefit to be received in a year after the year in which it was incurred, in other words, the year in which the borrower

---

1. See note 41 (describing option aspect of nonrecourse debt). This proposed treatment of the borrower is consistent with the earlier characterization of the option as the borrower's option to purchase the property, rather than the borrower's option to put the property to the lender.

2. I am indebted to Noel Cunningham for this idea.

3. This assumes the rent was an ordinary and necessary expense of the borrower's business under § 162. Concededly, disputes would arise over the proper amount to be treated as rent. In order to avoid some of these disputes, a statutory or regulatory safe harbor for rent might be desirable. Such a provision would designate rent according to a published market rate for various communities and properties or as some percentage of value for different types of property.

4. This approach is consistent with the approach of § 263A(f)'s treatment of construction period interest as a capitalized cost, and the Supreme Court's decision in INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992), which required capitalization of expenses associated with one corporation's acquisition of another's shares.
chose to redeem or walk away from the property. Any payments in the nature of investment in the property should become part of the borrower's basis.

Despite the similarity of the option premium and the mortgage amortization, an argument also can be made that the premium keeps the option alive only for the current period, which would suggest that the option premium should be deductible currently.\textsuperscript{175} The advantage of this latter approach is that it is administered more easily than the bifurcation approach because the “interest” would be fully deductible and would not need to be separated into rent and option premium.\textsuperscript{176} Either approach to the treatment of the option premium is theoretically defensible.

The lender would include the rent in income, as the return on his investment in the property. While the option premium portion also might be included currently in the lender's taxable income, it could remain in suspense until the transaction is closed, following the current treatment of options.\textsuperscript{177} In either case, the option premium payment would be income to the lender, rather than return of capital, because it would fail to reduce the borrower's strike price for the property. Since all funds must pass through the borrower, the source of the funds is irrelevant. Any further investments made by the borrower would be a return of capital to the lender, reducing the lender's respective investment in the property along with the corresponding basis.

Accurately measuring the lender's income from a nonrecourse loan over time is difficult because the contingent nature of nonrecourse debt makes predictability of the lender's ultimate return on investment impossible to determine ex ante. This is true even if the lender's return is recharacterized as rent and option premium, instead of interest and principal. If the property value declines while the debt is outstanding and the borrower chooses to walk away from it, inclusion of interest payments at the stated rate of interest or rents at the market rate overstates the lender's rate of return with respect to the investment in the property.\textsuperscript{178} At the same time, the only truly accurate way

\textsuperscript{175} See Cunningham & Schenk, note 14, at 787-88.
\textsuperscript{176} For example, if B invests $40 as a downpayment on property, borrows $60 on a nonrecourse basis from L, and pays L $6 “interest” and $5 “principal” in Year 1, both approaches would treat the $5 as a capitalized expenditure by B. The first approach would allocate the $6 between rent and option premium, allowing a deduction only for the former, while the second approach would allow a deduction for the entire $6.
\textsuperscript{177} See IRC § 1234; Rev. Rul. 58-234, 1958-1 C.B. 279.
\textsuperscript{178} Undertaxing nonrecourse lenders is not a problem because the stated interest rate (or imputed interest rate determined under the OID rules) is the maximum rate of return to which a nonrecourse lender is entitled. The nonrecourse lender's upside is capped at the stated return, but her downside may be as large as her investment.
to measure a lender’s income from the property is to wait until the disposition of the property and determine the overall rate of return (if any) on the lender’s investment. This might require open transaction treatment, which allows deferral of tax on income that is currently enjoyed and would spawn a new generation of tax-avoidance transactions unless interest on the deferred tax liability were assessed. An alternative to the wait-and-see approach would reject the realization rule and mark to market, or apply the imputed return approach advocated by Professors Cunningham and Schenk. While discarding the realization rule would represent progress toward accurate income measurement on a broader scale, it is not necessary to take such a radical step in order to address the mismeasurement of income from nonrecourse debt within the realization system.

While not perfect, the proposal to treat the lender’s interest as an investment in the property goes a significant distance toward reducing the current distortion in the lender’s tax treatment. The lender’s return on a nonrecourse loan always depends on the value of the property at some time in the future. If the lender’s investment is treated as a debt, it is presumed to be a nonwasting asset and the law treats the stated return as the income in excess of the lender’s invested capital, and fully taxes it. This treatment is appropriate if the securing property does not suffer wear and tear. If, however, the lender’s interest were treated as an investment in the property, the lender’s stated return from the property would be offset by the statutory or administrative determination of the amount by which the property (and the lender’s investment) wasted. The co-investment approach recognizes that, like any investor in property, the lender who receives cash flow from the property is no richer to the extent that the sunk costs for the property will never be returned; even while the interest is paid, the principal wastes.

Whereas either current law or the proposed approach may require some adjustment (for losses) when the transaction is closed, the

---

179 See Burnet v. Logan, 283 U.S. 404 (1931) (allowing basis recovery prior to any income inclusion where amount realized was contingent); Underhill v. Commissioner, 45 T.C. 489 (1966) (allowing basis recovery prior to any income inclusion where interest-bearing obligations were speculative). Current law generally has rejected the wait-and-see approach. See Temp. Reg. § 15A.453-1(d)(2)(iii) (fixing price for installment sale gain recognition for contingent sales); Reg. § 1.1275-4(c)(4) (contingent debt instruments not treated as open transactions).

180 See IRC § 453A(c). Even that approach would not guarantee accurate measurement of income in present value terms because the lender’s return would have to be presumed to have accrued at a fixed rate over the course of the investment, but actually may arise, for example, from a sharp increase in the property’s value at the end of the investment.

181 See Cunningham & Schenk, note 14. While the issues discussed in this Article arise largely because of the realization rule, the proposal tries to work within the realization system.
lender’s loss under the true-debt approach arises from a theoretical flaw—completely failing to recognize the loan as a wasting asset. Under the co-investment approach, a loss on disposition would arise from a mismatch between schedular depreciation allowances and actual market depreciation. Under the true-debt approach, the lender’s income over the course of the investment more likely is overstated than it would be in the co-investment approach because the former approach taxes the lender’s maximum possible return. The flip side, of course, is that the borrower’s income is likely to be understated in the true-debt approach, which explains why so many tax shelters were built on nonrecourse debt.

B. Application

To illustrate the operation of this proposal, consider the following:

Example 2: B purchases depreciable real estate for $10 million, $1 million of his own money and $9 million borrowed from L on a nonrecourse basis. As the property is operated, L is entitled to periodic payments and B is entitled to whatever is left from the property after L is paid.

Each would include in income the amounts received from the property—L the rent and the option premium, and B the income in excess of current expenses. In order to produce that income, each has certain costs, including the investment that each originally made to finance the property and the periodic investments B makes towards complete ownership of the property. Depreciation on the property is the tax law’s way to measure those costs, and to allow for them over time.

If, on default, L is entitled to the first $9 million of value from the property, B’s $1 million investment is lost before L’s as the property

---

182 For simplicity of discussion, L and B are assumed to be individuals. A partnership of borrowers or lenders would be treated similarly, with participants claiming their allocable shares of income and deductions. Any pool of investors could allocate the tax attributes discussed here to the extent that they are shared in such an arrangement. The proposal would affect investments in mortgage-backed securities to the extent that nonrecourse debt no longer would constitute an acceptable investment, for example, a qualified mortgage under the REMIC rules. See IRC § 860G(a)(3). There is, however, no reason why the characterization of nonrecourse debt advocated here would preclude securitization.

183 For example, if B makes a $200 payment to L, $90 as rent, $10 as option premium and $100 as further investment, the payment could have the following consequences, consistent with the discussion above: B could deduct the $90 of rent as an ordinary and necessary current expense, and capitalize the option premium and the further investment, increasing B’s depreciable basis in the property by $110. L could include the $100 rent and premium in current income, and increase depreciable basis for the $100 investment.
suffers decline. Therefore, $B$ suffers the first $1$ million decline in value of the property, leading to the conclusion that whenever the lender's interest was superior to the borrower's, the borrower would be entitled to the first tranche of depreciation deductions. The first $1$ million is $B$'s cost of producing income because the contract allocates the first $1$ million economic decline to her.\footnote{The terms of each financing would determine the ordering of the parties' depreciation allowances. For example, if a nonrecourse loan were subordinate to a recourse loan, the recourse loan would be treated as the buyer's commitment to the property, but the nonrecourse lender would be entitled to the earlier tranche of depreciation deductions, because the proposal awards the first tranche of depreciation to the investor whose interest wastes first.} After $B$'s interest has fully depreciated, as the property continues to decline, $L$'s investment begins to waste, and therefore, $L$ would be entitled to all subsequent depreciation.

The most that $B$ can lose on this transaction is $1$ million so it is appropriate that $B$'s depreciation deductions should be capped at that amount. Any loss in the property's value beyond that is borne by the nonrecourse lender.\footnote{This concept is not new to the tax law. This is the theory underlying the regulations promulgated under § 704(b). See Rev. Reg. § 1.704-2(b)(1) (providing that allocations of losses or deductions attributable to partnership nonrecourse liabilities cannot have economic effect because creditor alone bears any economic burden that corresponds to those allocations). Nonrecourse debt in the partnership context has caused so much difficulty precisely because the treatment of nonrecourse debt has been noneconomic.} As long as the depreciation schedule accurately measured decline in value, the system would not allow deduction shifting because every deduction would be accompanied by an economic loss suffered by the party entitled to the deduction.\footnote{If the depreciation schedule were accelerated, $B$'s deductions would be allowed earlier than necessary to measure income accurately, but that does not affect the accuracy of the ordering suggested here. Pro rata deductions for both the lender and the borrower from the inception of the transaction would not measure income as accurately as temporal allocation. A pro rata system would overtax borrowers and undertax lenders because the lender's investment suffers no loss from a decline in the property until the property's value dips below the amount that the lender has invested; as long as the property is worth at least $9$ million, $L$ enjoys an undiminished asset. To allow $L$ immediately to begin claiming depreciation deductions would allocate a cost to $L$ that he would not bear at that time.} $L$ and $B$ would start with a $9$ million and a $1$ million basis, respectively. If, as under current law, the property has a 39-year recovery period\footnote{See IRC § 168(c)(1).} and the applicable recovery method is straight line,\footnote{See IRC § 168(b)(3)(A).} the total annual depreciation allowable is $256,410$ (ignoring conventions). The parties would share that allowance as follows:

\begin{itemize}
\item \textbf{1995] NONRECOGN DEBT 165}

\end{itemize}
$B$ would be entitled to all the depreciation until his investment was fully recovered, which would occur in Year 4. $L$ then would begin to depreciate her interest.\footnote{$L$ would have a deductible loss under § 165 (not a bad debt deduction under § 166) to the extent of any shortfall over her depreciated amount.} If the actual decline in value of the property matched the depreciation schedule and the property were sold at the beginning of Year 5, $B$ would receive none of the proceeds of the sale and $L$ would recover almost her full investment.\footnote{Annual adjustments in the depreciation schedule would be necessary to conform to the annual accounting period.} If, instead, the property were not sold and no payments were made on the debt for the rest of the recovery period, $L$ would be the only one entitled to future cost recovery because she would incur all further cost and loss in value of the property.

**Example 3:** Assume in **Example 2**, that $B$ pays $1$ million in principal in Year 2.

The depreciation schedule would change because $L$’s investment would be reduced to $8$ million before $L$ began to account for cost recovery. $B$ would be entitled to all cost recovery for Years 1-6, and $L$ only begins to recover her investment in Year 7, after $B$ has recovered his $2$ million investment.\footnote{$B$ would be entitled to a $256,410$ cost recovery deduction for Years 1-7 and a $205,130$ deduction in Year 8 for a total of $2$ million. $L$ would be entitled to a $51,280$ deduction in Year 8 and a $256,410$ deduction for Years 9-39 for a total of $8$ million.} Basis adjustments must be made for increases ($B$) and decreases ($L$) in investment due to principal payments made, as well as depreciation claimed.

As another possibility, $B$ might pay the principal after $L$ already had deducted the cost represented by that principal payment.

**Example 4:** No principal payments are made until Year 10, when $B$ repays the $9$ million loan in full.

The cost recovery allowances would be the same as in **Example 2**, but in Year 10, $L$’s investment would be extinguished and $B$ again would have an investment to recover. At the start of Year 10, $B$’s basis would be zero (since $B$ fully recovered his cost in the early years)
and $L$'s basis would be $7,692,310 ($9 million original basis reduced by depreciation of $1,307,690 claimed in Years 4-9). When $B$ paid $L$ $9 million, $L$ would have gain to the extent that the payment is greater than $L$'s unrecovered cost, or $1,307,690.\footnote{This gain would be in the nature of recapture and should have the same character as the depreciation allowances claimed.} Going forward, $B$ would have a $9 million investment to be recovered over the remaining 30 years of the property's useful life, at the rate of $300,000 per year.\footnote{The calculations get slightly more complicated if the loan is amortized every year. For example, if $100,000 of the principal is paid at the start of every year for the first nine years, with the balance paid at the start of Year 10, the depreciation schedule would be as follows:}

<table>
<thead>
<tr>
<th>Year</th>
<th>$B$ Basis</th>
<th>$B$ Recovery</th>
<th>$L$ Basis</th>
<th>$L$ Recovery</th>
</tr>
</thead>
<tbody>
<tr>
<td>start</td>
<td>$1,000,000$</td>
<td>$9,000,000$</td>
<td>$7,692,310$</td>
<td>$0$</td>
</tr>
<tr>
<td>1</td>
<td>$1,100,000$</td>
<td>$256,410$</td>
<td>$8,900,000$</td>
<td>$0$</td>
</tr>
<tr>
<td>2</td>
<td>$943,590$</td>
<td>$256,410$</td>
<td>$8,800,000$</td>
<td>$0$</td>
</tr>
<tr>
<td>3</td>
<td>$787,080$</td>
<td>$256,410$</td>
<td>$8,700,000$</td>
<td>$0$</td>
</tr>
<tr>
<td>4</td>
<td>$630,660$</td>
<td>$256,410$</td>
<td>$8,600,000$</td>
<td>$0$</td>
</tr>
<tr>
<td>5</td>
<td>$474,250$</td>
<td>$256,410$</td>
<td>$8,500,000$</td>
<td>$0$</td>
</tr>
<tr>
<td>6</td>
<td>$317,840$</td>
<td>$256,410$</td>
<td>$8,400,000$</td>
<td>$0$</td>
</tr>
<tr>
<td>7</td>
<td>$161,540$</td>
<td>$161,540$</td>
<td>$8,300,000$</td>
<td>$94,870$</td>
</tr>
<tr>
<td>8</td>
<td>$100,000$</td>
<td>$100,000$</td>
<td>$8,105,130$</td>
<td>$156,410$</td>
</tr>
<tr>
<td>9</td>
<td>$100,000$</td>
<td>$100,000$</td>
<td>$7,848,720$</td>
<td>$156,410$</td>
</tr>
<tr>
<td>10</td>
<td>$8,100,000$</td>
<td>$270,000$</td>
<td>$0$</td>
<td>$0$</td>
</tr>
<tr>
<td>11</td>
<td>$7,843,590$</td>
<td>$270,000$</td>
<td>$0$</td>
<td>$0$</td>
</tr>
</tbody>
</table>

In Year 10, $L$ would recognize $407,690 recapture gain because $L$'s basis at the beginning of Year 10 would be $7,692,310, and the payment of $8,100,000 would wipe out all remaining basis, plus require recapture of prior depreciation deductions claimed. At the same time, $B$'s investment would increase, and $B$ essentially would get to claim $L$'s recaptured amount as depreciation over the remaining recovery period of the asset.

During some years of amortization, both $B$ and $L$ would be entitled to depreciation deductions because $B$'s principal payments would give rise to immediate investment that is subject to loss. Because the total depreciation allowed in Years 7-9 would exceed $B$'s investment, including the payments made in those years, part of the depreciation in those years would be allocable to $L$. If $B$ had paid $350,000 of principal in Year 8, for example, $B$ would have sufficient investment to claim all the depreciation allowed that year, instead of sharing it with $L$.

Property subject to declining balance cost recovery also could be depreciated under this system. For example, if five-year property purchased with the same composition of debt and cash as the real property above, were to be depreciated under § 168(b)(1) (ignoring conventions), with $1 million principal paid each year and a balloon payment after the end of the recovery period, the depreciation schedule would be as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>$B$ Basis</th>
<th>$B$ Recovery</th>
<th>$L$ Basis</th>
<th>$L$ Recovery</th>
</tr>
</thead>
<tbody>
<tr>
<td>start</td>
<td>$1,000,000$</td>
<td>$9,000,000$</td>
<td>$7,692,310$</td>
<td>$0$</td>
</tr>
<tr>
<td>1</td>
<td>$2,000,000$</td>
<td>$2,000,000$</td>
<td>$8,000,000$</td>
<td>$2,000,000$</td>
</tr>
<tr>
<td>2</td>
<td>$1,000,000$</td>
<td>$1,000,000$</td>
<td>$5,000,000$</td>
<td>$1,400,000$</td>
</tr>
<tr>
<td>3</td>
<td>$1,000,000$</td>
<td>$1,000,000$</td>
<td>$2,600,000$</td>
<td>$440,000$</td>
</tr>
<tr>
<td>4</td>
<td>$1,000,000$</td>
<td>$1,000,000$</td>
<td>$1,200,000$</td>
<td>$100,000$</td>
</tr>
<tr>
<td>5</td>
<td>$1,000,000$</td>
<td>$1,000,000$</td>
<td>$100,000$</td>
<td>$100,000$</td>
</tr>
</tbody>
</table>
If the property became worthless in Year 20, the loss would fall entirely on B.

This system would allow B to manipulate the timing of his depreciation deductions because he could choose when to pay the principal amount of the loan. The Crane Court, in rejecting shifting basis was concerned that "the mortgagor would acquire control over the timing of his depreciation allowances."194 The Court, however, did not explain why this control would have negative consequences, and its concern seems to have been misplaced. While the treatment proposed here might lead B to pay part of the principal in a high-tax year, that is no different from B's choosing to place new property in service in a high-tax year. There seems to be nothing objectionable about B choosing the year in which to place property in service based on tax savings, as long as the property actually is placed in service. Similarly, B's control over the timing of his depreciation deductions is acceptable if the timing depends upon a real financial commitment. Perhaps Congress is not as concerned about B's control as was the Supreme Court, since B already can control the timing of his depreciation allowances by electing an alternative method under §168.195 As under all the §168 depreciation schedules, my proposal would never allow B to accelerate deductions more than the Code ordinarily allows, which, if possible, would be a valid concern because it would invite tax sheltering opportunities.

The proposal's effect would be felt most significantly in transactions with little investment by the borrower and large amounts of nonrecourse debt because the borrower's depreciation deductions would cease shortly after acquisition of the property, unless the principal of the debt were paid quickly. In a transaction with little nonrecourse debt and a large cash downpayment by the buyer, there would be little change from current law. The greater the owner's investment, the greater the proportion of the total depreciation deductions he would enjoy, and the longer the period between the purchase and the time when the lender's investment started to depreciate. In transactions with significant equity investment by the owner, the actual depreciation claimed might not differ at all from current law, because the lender's investment in the property is recovered from the borrower over time as principal payments are made. Concurrently, the purchaser's investment in the property would increase, along with his depreciable basis. If the loan were repaid before the lender began depreciating the property, the borrower would be entitled to all de-

---

194 Crane v. Commissioner, 331 U.S. 1, 10 (1947).
195 See IRC §168(b)(3), (c)(2), (g).
preciation deductions, as under current law, and basis would not shift.\textsuperscript{196}

In seller-financed transactions, nonrecourse debt issued to the seller-lender ("SL") would not support borrower's basis, but SL would continue to claim cost recovery allowances for any continuing investment in the property after the "sale." The seller-financed transaction is a good illustration of the co-investment approach because SL and the buyer may each have concurrent investments in the property.\textsuperscript{197} Unlike current law, which treats SL as having disposed of the property at the time of this transaction,\textsuperscript{198} this proposal would treat SL as having a continuing investment in the property until it was extinguished by payments received from the buyer. The proposal recognizes, however, that SL's interest in the property would change at the "sale" in that he no longer would be an owner of the property. Because the seller's relationship to the property would change at the sale, it would be appropriate to take stock of that interest on the "sale" and to adjust SL's depreciation schedule, even though he retained basis. After the "sale," SL really would be in the same position as the nonrecourse lender—a co-investor with a prior interest in the property. Consistent with the treatment of the third-party lender, SL's investment would remain constant while the buyer's interest declined, and would waste again as soon as the buyer's investment had been depreciated completely. At that time, SL would be allowed depreciation according to the temporal allocation of deductions described for the ordinary lender.

For example, assume SL originally had paid $3.9 million for the property, and therefore was entitled to $100,000 depreciation annually for that investment. If, after holding the property for 15 years, SL sold it for $1 million cash and a nonrecourse note from the buyer for

\begin{center}
\begin{tabular}{llll}
Year & Basis & Recovery & Basis & Recovery \\
1 & $5,000,000 & $256,410 & $5,000,000 & 0 \\
2 & 4,743,590 & 256,410 & 5,000,000 & 0 \\
3 & 4,487,180 & 256,410 & 5,000,000 & 0 \\
4 & 4,230,770 & 256,410 & 5,000,000 & 0 \\
5 & 3,974,360 & 256,410 & 5,000,000 & 0 \\
6 & 3,717,950 & 256,410 & 5,000,000 & 0 \\
7 & 8,461,540 & 256,410 & 0 & 0 \\
\end{tabular}
\end{center}

\textsuperscript{196} For example, if B borrowed only $5 of the $10 purchase price and paid the mortgage in Year 7, straight line depreciation would be allocated to B on the same schedule as if he had paid all cash.

\textsuperscript{197} This assumes that the buyer makes some irrevocable commitment to the property, unlike in \textit{Franklin}.

\textsuperscript{198} The realization event under § 1001 is clear, even though the seller probably would defer most of the gain under § 453.
$10.7 million, the buyer would start with a $1 million depreciable basis. SL would reduce his $2.4 million basis by the $1 million down-payment received from the buyer, representing a reduction in SL’s investment in the property. The total basis in the property, $2.4 million, would include the unrecovered investments of each—the buyer’s $1 million and SL’s $1.4 million. Assuming that the buyer’s interest was subordinate to SL’s and no principal payments were made on the note, the buyer would be entitled to claim all depreciation deductions going forward, until her $1 million was fully depreciated. At that time, SL would resume deductions until his $1.4 million interest was fully depreciated or replaced by the buyer’s investment in the property.

This proposal, particularly with respect to seller-financed transactions in which SL had a low basis at the time of the “sale,” would represent a significant change from current law, and would make seller-financed nonrecourse debt transactions considerably less attractive than third party-financed nonrecourse debt transactions. In the example just described, the pre-“sale” annual depreciation allowance was $100,000, while the post-“sale” annual depreciation allowance would be only $61,500. Therefore, the total depreciation allowed with respect to the property would go down as a result of the “sale.” A comparison with third party financing for the full $11.7 million purchase price only magnifies the disadvantages of seller financing.

This treatment is appropriate, however, because the seller-financed deal is not like a real sale, and therefore, should not support basis for the full purchase price, regardless of the allocation of depreciation deductions between the co-investors. Instead, the seller-financed “sale” described here is more like the formation of a new investment in property in which the buyer invests $1 million and SL invests $1.4 million. Because of the depreciation already claimed by SL, the total investment in the property is less at the moment of the sale than it was when SL first purchased the property for $3.9 million.

If the $11.7 million purchase price was the fair market value of the property, the greater part of SL’s investment in the property would be in the form of unrecognized appreciation, which should not support depreciation allowances until it became a tax paid amount. By con-

---

199 This is a total purchase price of $11.7 million, or three times SL’s original purchase price.

200 Assuming a 39-year recovery period, at the rate of $61,538 per year, the buyer would be entitled to 16.25 years of depreciation deductions before the seller’s interest would begin to waste again.

201 If the acquisition at $11.7 million had been bank financed, the annual depreciation allowance would have been $300,000 per year, or almost five times as great as the allowance produced by seller financing.
contrast, the third party lender would be entitled to basis because he invested tax-paid amounts in the property. \( SL \) is comparable to those lenders only to the extent that he has tax-paid amounts invested in the property.\(^{202}\) This treatment of the seller-financed transaction therefore is consistent with the general model proposed in this Article because it treats \( SL \) just like the third party lender wherever they have comparable interests. The lower basis on the "sale" in the example is the result of prior depreciation claimed by \( SL \) and the fact that the seller's appreciation has not yet been taxed.

This treatment of seller-financed transactions would remove the incentive to enter into inflated, nonrecourse debt-financed purchases. Since seller-financed transactions have been identified by some as the root of the abusive tax shelter,\(^{203}\) making these transactions less attractive, without provisions such as §§ 465 and 469, seems desirable.

\( SL \) would have gain on the transaction from any payments that otherwise would reduce his basis below zero.\(^{204}\) Until the buyer's investment completely replaced \( SL \)'s investment, however, principal payments would reduce \( SL \)'s basis in the property. This is consistent with the view that nonrecourse debt represents an inseparable investment in the property by the lender, and that \( SL \) would continue to have an investment subject to loss until that investment was extinguished. Waiting until the sale was completed to require gain recognition is consistent with continuing to allow \( SL \) to claim depreciation on his investment even after the buyer acquired an interest in the property. Requiring gain recognition prior to complete recovery of basis would presume that the nonrecourse debt is like true debt. Deferral of gain recognition recognizes that the buyer might still walk away from the property without satisfying the obligation.

In the example, if \( SL \) received only $1 million from the buyer, he would have no gain. \( SL \) must be taxed, however, to the extent of any payments representing investment by the buyer that do not replace investment by \( SL \) (that is, amounts in excess of \( SL \)'s original basis). These payments show that \( SL \), in fact, will make a profit on the sale of the property, despite the nonrecourse nature of the debt. By reducing basis for principal payments, \( SL \) essentially depreciates the property

\(^{202}\) Unlike the third party lender situation, seller financing under current law creates basis from amounts that are not tax-paid. Where there is a third party lender who produces cash, that cash is a tax-paid amount. While current law allows the borrower to claim basis credit for the tax-paid amount of the lender, the total depreciation allowed on the property is supported by tax-paid basis. Such is not the case with nonrecourse seller financing. Cf. Cooper, note 134, at 718 (suggesting that sellers should have to recognize gain attributable to any purchase price for which buyers claim basis).

\(^{203}\) See Shaviro, Risk and Accrual, note 1, at 441; Sims, note 3, at 264-72.

\(^{204}\) This is the open transaction model in Burnet v. Logan, 283 U.S. 404 (1931) (allowing basis recovery prior to any income inclusion where amount realized was contingent).
to zero, and all succeeding payments from the buyer would be recapture gain.\footnote{An alternative treatment of SL’s gain recognition would apply the contingent purchase price rules of the installment sale provisions. See Temp. Reg. § 15A.453-1(c). For purposes of determining gain from each payment, SL would be presumed eventually to receive the full purchase price. This is a bias towards overtaxation of the seller because the full purchase price is the maximum that the seller will receive. See note 178 and accompanying text. Although such an approach is necessary under current law to minimize the opportunities for abuse, I reject it because it treats nonrecourse debt in a manner fundamentally contrary to the treatment in this proposal by presuming that the debt is a true debt that will be fully satisfied by the buyer. It also would generate considerable complexity because the seller could have gain on the original transaction, but then be allowed further depreciation deductions before satisfaction of the debt, which would require recomputation of the gross profit percentage. Under current law, the installment sale rules must reject open transaction treatment because the inclusion of all purchase money debt in buyer’s basis created a win-win situation for buyers and seller-lenders, which promoted tax avoidance behavior. Because this proposal considerably reduces the tax advantages of seller financing, the overall incentives to abuse are minimal, despite the seller’s open transaction treatment.}

Each time the buyer made a further investment in the property, her depreciable basis would increase, regardless of SL’s treatment. As described above, the payments from buyer to SL would be characterized as rent, option premium replacement of SL’s investment in the property and gain.

C. Revised Analysis of a Restructuring

In a restructuring, modification of a nonrecourse debt would not affect the securing property. A reduction in the principal amount of the debt, for example, would simply be recognition that the property had declined in value and the economic loss had been suffered by the lender—just as the system proposed here reflects. If, in Example 1, $9 million of debt were restructured when the value of the property had fallen to $5 million, the borrower had no basis and the lender had a $7 million basis, no adjustment to basis would attend the restructuring. As the lender depreciated the next $2 million, he would be writing off a loss that he had suffered economically.\footnote{There is a timing gap in a restructuring in that the $7 million basis suggests that there is still $7 million of value while the restructuring suggests that there is only $5 million. The proposal requires that the $2 million difference be recovered over time, rather than at the restructuring. But that is a by-product of maintaining the realization rule and the nature of any schedular approach to depreciation.}

This approach would allocate the loss correctly as between the two taxpayers. It also would give the lender a clearer choice between restructuring and foreclosing than does current law. A lender who actually foreclosed, rather than restructured, would be entitled to a loss equal to the difference between the unrecovered cost (the outstanding amount of the debt that had not already been depreciated) and the
value of the property, $2 million in this example.\textsuperscript{207} A lender who could not wait for the scheduled deductions might choose to foreclose and trigger realization of loss on the property.

It is appropriate that the tax consequences of a restructuring and a foreclosure differ because the parties' rights with respect to the operation and potential appreciation of the property differ depending upon which course is followed. The lender always can choose foreclosure over restructuring, forcing a realization event, if the schedule of depreciation does not provide deductions soon enough.\textsuperscript{208} Under current law, a straight-debt restructuring yields COD income to the borrower, whereas a foreclosure is treated as a sale (at a gain, if the outstanding debt exceeds the borrower's basis in the collateral). In case of default, these tax consequences necessarily are factored into the negotiations between the borrower and lender, and necessarily will influence the economic outcome of any resulting bargain. The lender, of course, has all the leverage. My proposal would eliminate this tax distortion. Since the debt was never credited to the borrower as an investment, neither a foreclosure nor a restructuring has any tax effect on the borrower. Since the borrower is tax neutral, if the lender chooses to restructure, the parties are left to bargain based solely upon the economic prospects of the property.

\textbf{D. Conclusion}

This proposal to treat nonrecourse debt as an investment by the lender in securing property grows out of an examination of the nature of nonrecourse debt, and the observation that all nonrecourse debt can be characterized correctly as an investment in property by the lender. Contrary to the \textit{Crane} Court's belief, nonrecourse debt cannot always be characterized as true debt. The insistence on treating nonrecourse debt like true debt has created a system in which income from transactions in depreciable property is deliberately mis-measured. The resulting distortions encouraged the proliferation of abusive tax shelters, but the trouble with the true debt approach did not disappear with the decline of the individual tax shelter and the adoption of §§ 465 and 469.

The restructuring analyzed in this Article is but one example of the abiding inadequacy of the true debt approach, and it shows that the essential shortcomings of that approach will mean continuing uncertainty and complexity in the law, consequences diametrically opposed

\textsuperscript{207} \$7 - \$5 = \$2. IRC § 166.

\textsuperscript{208} Only a true mark-to-market system would prevent the recognition of gain or loss at this point.
to the Supreme Court's vision of administrability and certainty. If the
tax law is to continue to evolve in an attempt to measure income more
accurately within the constraints of a realization system, it is appropri-
ate to revisit the fundamental approach to nonrecourse debt and the
depreciation consequences that flow from that approach. Nonre-
course debt needs redefinition in accordance with its substance, which
bears little resemblance to debt at all, but behaves very much like an
ownership interest of the lender in the property that secures the debt.
While the proposal suggested here does not attempt to solve every
problem of taxing debt-financed property transactions, it recognizes
the inconsistencies and difficulties of current law and represents a step
in the direction of better income measurement.