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THE APPLICATION OF THE CRANE DOCTRINE TO LIMITED PARTNERSHIPS

RICHARD A. EPSTEIN*

INTRODUCTION: CRANE V. COMMISSIONER

The limited partnership has in recent years been the preferred vehicle for real estate development. As a business matter, it permits, as does the corporation, a number of persons to pool the capital necessary for acquiring and developing real estate while enabling them to limit their losses to the assets committed to the venture. Moreover, the limited partnership offers tax advantages to its partners that are not available to corporate shareholders, since each partner may apply against income from outside sources his portion of the partnership losses. The corporate shareholder does not receive the benefit of this pass-through because the corporation is generally treated as a distinct taxable entity under the Internal Revenue Code.

The ability to pass through losses from the partnership to the individual tax return is crucial in real estate development because of the rules governing the depreciation of partnership improvements constructed or purchased with borrowed capital. These rules were first developed in cases which raised no issues of partnership taxation. The

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1. 331 U.S. 1 (1946).
2. Section 701 of the Internal Revenue Code of 1954 [hereinafter cited as I.R.C.] lays down the basic rule that a partnership is not a taxable entity. Sections 702-04 of the Code set out the basic rules for the determination of the income or loss of each partner. If there is a loss for a particular partner, he may use it to offset income from other sources.
3. Section 11 (a) of the Code imposes a tax at the corporate level on the income of the Corporation. Subchapter C of the Code, §§ 301-85, sets out most of the basic rules peculiar to the taxation of the corporation and its shareholders. Under Subchapter S, it is possible in a limited set of cases for the shareholders of a corporation to file an election which removes the tax at the corporate level, provided that all gains and losses are taken into account on the shareholder's returns, even if there is no distribution from the corporation to the shareholders. I.R.C. §§ 1971-79. Subchapter S, however, is not of use in most real estate projects, except perhaps during the construction period, because any election under Subchapter S is terminated for any taxable year in which "passive investment income," of which rents are a form, exceeds 20% of the gross receipts of the corporation. I.R.C. § 1372(e)(5)(A) and (C).
celebrated case of *Crane v. Commissioner* held that an individual taxpayer was entitled to include in his cost basis an amount equal to the mortgage placed upon the property. The decision also held that the taxpayer should treat the balance of the mortgage left undischarged at the time of sale "as part of the amount realized" under Section 1001 of the Code, at least in those cases in which the value of the property exceeded the amount of the lien.

4. 331 U.S. 1 (1946).

5. *Id.* at 14 n.37. The Court indicated that it would not pass on a case where the value of the property was less than that of the lien. The only reason why such a case causes difficulty is that the courts cannot fit it into the framework of "constructive" realization. In the usual case in which the value of the property exceeds the amount of the lien, it is always possible to treat the transaction as though the taxpayer received the full amount and used part of those proceeds to pay off the loan. On that view, the full value of the property is realized on the transaction, while the repayment of the debt provides no deduction. See, e.g., Simms v. Comm'r, 28 B.T.A. 988, 1050 (1933). But that rationale cannot be adopted where the property does not cover the amount of the lien. Nonetheless, the taxpayer should be taxed, even under *Crane*, on the full amount of the unpaid balance of the mortgage. In effect, he has received depreciation deductions at the outset which have exceeded the amortization of the loan. Even though he has "realized" nothing reducible to his possession or control, it is nonetheless only proper that he bring his accounts into balance when the property is surrendered, because there will be no convenient time in the future to set matters correct. *See Adams, Exploring the Outer Boundaries of the Crane Doctrine; An Imaginary Supreme Court Opinion*, 21 *Tax L. Rev.* 159 (1966), where the point is made quite well by the Chief Justice, when he says:

If we were correct in allowing the mortgage to become a part of the taxpayer's basis in the first place when he is not personally liable, are we not equally warranted in saying that he should be charged with the gain attributable to the use of this basis when the property is disposed of and the transaction is closed?

This question must be answered in the affirmative. By doing so we rid ourselves with one clean stroke of the unfortunate shackles which the reasoning in *Crane* imposed upon us. No longer are we required to say that the taxpayer has realized an economic benefit when the mortgage on which he was not liable follows the property into the hands of its new owner. We find ourselves on firmer ground when we say that the taxpayer's economic benefit stems from the deductions which we have allowed him to take on the unassumed mortgage. These deductions arose by reason of the tax law and not because of what the taxpayer paid for the property. Hence, when the property is disposed of—whether by sale, abandonment, charitable gift, or otherwise—the tax law must be interpreted as requiring the taxpayer to account for these deductions.

*Id.* at 169-70. Similarly, when Mr. Justice Magruder invokes the concept of negative basis in *Parker v. Delany*, 186 F.2d 455, 459-60 (1st Cir. 1950) (concurring opinion), *cert. denied*, 341 U.S. 926 (1951), he has only attempted to make the taxpayer take back into income the $31,000 difference between the amount of depreciation taken by the taxpayer (approximately $45,000) and the amortization of the loan (approximately $14,000). The difficulty with the negative basis is a theoretical one: a taxpayer should not be allowed to take depreciation where he has no investment, and hence no basis. Moreover, even if the taxpayer were entitled to depreciation, there is no way, given the rationale of Justice Magruder, to decide that the appropriate amount of depreciation is $45,000. That figure can be determined only if the loan is treated as part of the cost, which Justice Magruder was not prepared to allow. *See generally Cooper, Negative Basis*, 75 *Harv. L. Rev.* 1352 (1962).
Where the property in question is non-depreciable, the *Crane* rule has little practical significance; it only requires that both the cost and the amount realized on any piece of property be increased by the same amount.\(^6\) Where the balance of the loan remains constant over the period for which the property is held, the very same figure must be added to both the cost of the property and the amount realized upon its disposition. Where part of the loan is paid off before disposition the calculations are only slightly more complicated. Even though the balance of the note is reduced, the taxpayer will nonetheless realize the same amount on disposition because the decrease in the balance of the mortgage will be offset by an increase in the amount of the boot he receives.\(^7\) Hence in all cases, the tax treatment of non-depreciable property remains the same whether or not the *Crane* rule is adopted. However, if the property in question is depreciable, the impact of the *Crane* rule is immense. Under the Internal Revenue Code the initial basis for depreciation is cost.\(^8\) Where a taxpayer is permitted to include borrowed capital in his cost basis, whether or not secured by real property, he will be able from the outset to increase the amount of his depreciation deductions. An individual taxpayer will be able to claim the benefit of these deductions even where he is under no personal liability to repay a loan, e.g., one secured only by a lien on the specific property of the taxpayer. Moreover, given the enlarged cost basis, the benefits in the early years of accelerated depreciation are accordingly increased.\(^9\)

The unattractive features of the *Crane* rule reveal themselves, if at all, upon the ultimate disposition of the property. At that time, the taxpayer will be required to treat as part of his "amount realized" the


\(^7\) For example, assume that the original loan was $100.00 and total purchase price $150.00. If the taxpayer pays off $20.00 of the loan before he sells, say, for $175.00, then his boot upon disposition will be $95.00 ($175.00 less $80.00). If no portion of the mortgage is paid off, then there is only $75.00 in boot ($175.00 less $100.00), but the gain is still $25.00. Moreover, the results upon sale would be the same even if both amount realized and cost were computed on the taxpayer's actual contributions to equity. Thus, where $20.00 of the loan is paid off, the amount realized would be $95.00 (the boot), and the cost $70.00, yielding a gain of $25.00. If no payment of principle has been made, then both boot and cost are reduced by $20.00. Their difference still yields a gain of $25.00.

\(^8\) I.R.C. § 1012.

\(^9\) Under the recent amendments to the Internal Revenue Code, the opportunity for accelerated depreciation has been reduced, for depreciation can be taken on 200% of the declining balance only in the case of new residential rental property. I.R.C. §§ 167(b)(2), 167(j)(2)(A). Section 167(j)(1)(B) restricts the taxpayer to 150% of declining balance in all other § 1250 property. With used residential property, only 125% of the declining balance is allowed under I.R.C. § 167(j)(5)(B).
unpaid balance of the mortgage. Since his adjusted basis has been substantially reduced by the depreciation deductions, usually to the point where it is much less than the unpaid balance of the mortgage, it follows that the taxpayer will at that point in time have taxable income in excess of the cash (or property in lieu thereof) which he actually receives upon disposition.\textsuperscript{10} Nonetheless, even the taxpayer faced with this unhappy prospect at the time of disposition has much to console him. First, the tax may well be imposed years after the depreciation deductions were allowed, giving him in effect interest-free use of the money during the intermediate period. Secondly, upon sale he will have capital gain, except to the extent that the recapture rules require him to treat all or part of the gain attributable to the recapture of accelerated depreciation as ordinary income.\textsuperscript{11} Again, the taxpayer may be able to shelter much of the gain recognized upon sale by reinvesting his proceeds in other real estate projects.\textsuperscript{12} Finally, if the original taxpayer dies before realization, his heir or devisee enjoy the costless step-up in basis provided for under Section 1014 of the Code.\textsuperscript{13}

Therefore, the Crane rule provides substantial tax benefits to individual taxpayers because it allows them, at the front end, a tax basis greater than their economic investment would warrant.\textsuperscript{14} The rationale behind the Crane rule, however, remains unclear even if most of its consequences have been worked out. On the one hand it is said that an alternative rule would require taxpayers to compute, at great ad-

\textsuperscript{10} In Crane, the taxpayer had only $2,500 in hand at the end of the transaction, but was taxed on over $23,000. 331 U.S. at 3-4.

\textsuperscript{11} See I.R.C. § 1250. Again, the recent amendments to the Code have reduced to some extent the degree of shelter, because the taxpayer must now wait for 100 months (and not 20) before he can begin to exclude a portion of the accelerated depreciation from recapture. I.R.C. § 1250(a)(1)(C)(iii)-(iv).

\textsuperscript{12} Like-kind transactions do not enable a taxpayer to postpone recognition of all of his gain if the property acquired is raw land suitable for further development because the mortgage placed on the property is treated as boot, and hence recognized at the time of exchange unless the taxpayer assumes some liabilities of the transferee as part of the exchange. I.R.C. § 1031; Treas. Reg. § 1.1031(d)-2 example (2) (1956).

Moreover, even where there is no mortgage upon the improvement, there will in many cases be recapture on accelerated depreciation in a like-kind exchange. The regulations require the recapture of accelerated depreciation where the taxpayer does not receive § 1250 property in the exchange. Even if no boot is received, the Code does not allow the taxpayer to defer recapture until the property acquired in a § 1031 exchange is disposed of in a recognition transaction. I.R.C. § 1250(d)(4); Treas. Reg. § 1.1250-3(d) (1971).

\textsuperscript{13} I.R.C. § 1014.

\textsuperscript{14} Here the basis to the heir or devisee is equal to the fair market value of the property, not reduced by a mortgage still upon it. See 331 U.S. at 6-8. The taxpayer here is not hurt under the estate tax, because he is allowed to deduct in the computation of his net estate the amount of the lien. I.R.C. § 2053(a)(4); 331 U.S. at 7.
ministrative inconvenience, their depreciation deductions for each year only after they take into account the increase in equity attributable to the amortization of the loan. But even if the administrative difficulties arising from the use of a "shifting" equity were substantial, other alternatives to the Crane rule could be adopted to reduce, though not to eliminate, the disparity between the legal and the economic consequences. For example, it is possible to compute depreciation deductions throughout solely by reference to the taxpayer's initial investment. In each future year he will not be required to take into income those receipts which he applies to the amortization of the loan, but neither will he be able to increase his basis in order to reflect the increase in his investment. In effect, such a scheme declares that the taxpayer will be bound and entitled to assign a one-year useful life to that portion of his investment attributable to the amortization of the loan, even though its useful life in economic terms is much greater. Here the taxpayer still enjoys some timing benefits, but not to the extent that they are available to him under Crane.

It is also argued in support of the Crane rule that it would be unfair to limit depreciation to the taxpayer's equity because the actual wear and tear to the structure is far in excess of that amount. But depreciation on the economic cost of the structure would be permitted if the taxpayer took the amount of the loan into income at the outset of the transaction. Here the restriction of the depreciation deductions to invested equity would reflect only the same policy followed elsewhere in the Code. For example, Section 109 of the Code provides that a taxpayer does not take into income at the termination of the lease the fair market value of an improvement erected at his lessee's expense. But under Section 1019 he must accept a zero basis for the improvement, even though its economic value is much greater. In each subsequent year the taxpayer cannot take into account depreciation for the eco-

17. Under these provisions, if the mortgagor's equity were the § 113(a) [I.R.C. § 1014(a)] basis, it would also be the original basis from which depreciation allowances are deducted. If it is, and if the amount of the annual allowances were to be computed on that value, as would then seem to be required, they will represent only a fraction of the cost of the corresponding physical exhaustion, and any recoupment by the mortgagor of the remainder of that cost can be affected only by the reduction of his taxable gain in the year of sale.

331 U.S. at 9 (footnotes omitted). See also Del Cotto, supra note 15, at 72.
nomic wear and tear because the forebearance in the collection of tax at some earlier point is made on condition that the taxpayer forego, pro tanto, an increase in basis. Similarly, where a structure greatly appreciates in value, a taxpayer must still calculate his depreciation deductions by reference to basis and not value since he did not take that appreciation into income because of the realization requirement. In the classic Crane situation, the depreciation of the borrowed capital could well be denied for the same reasons that it is denied in the two cases discussed above: depreciation should be allowed on invested capital only after it has been taken into income, and not before.

I. APPLICATION OF CRANE TO LIMITED PARTNERSHIPS

A. THE PROBLEM

Thus far we have examined the general Crane doctrine. Even if its rationale is unsatisfactory, its benefits are now available to an individual taxpayer who uses borrowed money for his real estate investments. For the rest of this paper, the soundness of the rule will be assumed in order to examine its application to situations in which limited partnerships have received the loans in order to acquire depreciable property. Once the loans are made to a partnership, the accounts for the partnership and all the partners must be kept in order, even though the partnership itself is not a taxing entity under the Internal Revenue Code.20 In the standard case of real estate development, each of the partners contributes part of the cash necessary for the undertaking, but the bulk of the construction costs are financed by a loan secured by a lien on both the land and the structure. Under the influence of Crane, the Code treats the loan to the partnership as a contribution to the partnership by one or another of its members.21 The only issue of importance concerns the allocation among the partners of the increase in basis attributable to the loan to the partnership. On the question of allocation, Section 752 of the Code provides that an increase in a partner’s share of the liabilities of the partnership shall be treated as his contribution to the partnership. The regulations in turn seek to amplify the basic statutory provisions. In the simplest case each of the partners is personally liable for the partnership indebtedness. Under those circumstances, the regulations provide that each partner is en-

20. Here it is assumed that there is no association for tax purposes under I.R.C. § 7701.
titled because of the loan to a pro rata increase in the basis of his partnership interest.\textsuperscript{22} Again, if the loan is secured only by a lien on the real estate, such that no partner is personally liable on the note, each partner is then entitled to increase his basis in his partnership interest by his pro rata share of the indebtedness.\textsuperscript{23}

It is, however, the hybrid case which causes the greatest concern. If the loan agreement provides that only some partners shall be personally liable for repayment, then those partners must allocate among themselves, pro rata, all the increase in basis, even if the loan is secured on partnership property in which all the partners have an interest.\textsuperscript{24} This situation arises frequently with limited partnerships. Assume, for example, that a limited partner makes a cash contribution of $10.00 to a partnership. Assume further that the general partner, who has made no contribution of either cash or property has procured a loan of $100.00 secured by the partnership assets, for which he is personally liable. Under Regulation § 1.752-1(e), the limited partner has a basis of $10.00 for his partnership interest, while the general partner has a basis of $100.00. If the partnership uses the initial cash contributions by the limited partner to purchase the land, and the loan to finance the purchase or construction of the improvement, the partnership's basis in the land will be $10.00 and its basis in the improvement $100.00. Given the low basis of the limited partner's interest, much of the depreciation allowable under the Crane rule may not be passed through to the limited partner, because he is entitled to take into account his share of partnership losses only to the extent of the basis of his interest.\textsuperscript{25}

In most real estate negotiations it is difficult to secure for the limited partners a step-up in basis by making them, along with the general partners, personally liable for the construction loans. Men who

\textsuperscript{22} Treas. Reg. § 1.752-1(a) (1956).
\textsuperscript{23} Treas. Reg. § 1.752-1(e) (1956).
\textsuperscript{24} Id. § 1.752-1(e) provides that:
A partner's share of partnership liabilities shall be determined in accordance with his ratio for sharing losses under the partnership agreement. In the case of a limited partnership, a limited partner's share of partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement. However, where none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits.
\textsuperscript{25} I.R.C. § 704(d).
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B. REGULATION § 1.752-1(e)

1. The Argument from Principle

At the outset, the soundness of the Regulation is best examined in light of the general rules for determining cost. It is settled that cash actually paid by a taxpayer for the acquisition of an asset is properly includible in his cost basis. Again, there is no real dispute that a taxpayer is entitled to include the fair market value of property surrendered as part of the cost basis of the asset acquired. Further, the Crane rule itself suggests that indebtedness incurred in order to acquire an asset also provides the taxpayer with a step-up in basis. But it is equally well settled that not all obligations are includible in cost. Where obligations are contingent in nature and indefinite in amount they cannot be treated as a part of cost at the time they are incurred, even if they are to be taken into account at some subsequent point in time either as an increment to basis or as the source of an immediate deduction. The cases lend clear support to this proposition, and it is helpful briefly to review them.

26. 3A MERTEN'S, LAW OF FEDERAL TAXATION ch. 21, § 21.10, at 31 (1968) [hereinafter cited as MERTEN'S].
In *Albany Car Wheel Co. v. Commissioner*, the taxpayer acquired the assets of a corporation engaged in the manufacture and sale of chilled iron wheels. Under the terms of the purchase agreement, the taxpayer agreed to pay his vendor $15,000 in cash and to assume approximately $75,000 of fixed obligations previously incurred by the transferor. Both the Commissioner and the taxpayer agreed that both of these items properly were treated as part of the taxpayer's cost. At issue was the treatment of the taxpayer's contractual obligations towards his vendor's employees. These obligations required the taxpayer to make severance payments to the employees it dismissed after it took over the business. No severance pay was required for those employees who left of their own accord, for those who died before employment was terminated, or for those dismissed only after they received the notice required by contract. It was impossible to predict whether, and if so to what extent, the taxpayer would be called upon to make payments in order to honor these obligations. The Court held that these obligations could not be included as part of the cost of the assets because they were, as it clearly seems, too indefinite and uncertain as to both time and amount of payment.

The contingent nature of these obligations was highlighted by the artificial method which the taxpayer used to estimate their extent in determining his cost basis. It valued them at an amount equal to the difference between the book value of the transferor's assets and the amount received from their sale, claiming in effect that the fair market value of those assets was precisely equal to their book value, a doubtful assumption given the shaky condition of the chilled iron wheel industry. The proper treatment of such obligations, as indicated by the Court, is to permit the taxpayer a deduction for these expenses if, as and when they occur. At that later point in time, there could be no problem in estimating their cost. They could be treated in the same manner as all other business expenses under the rules that govern the treatment of deductions for either accrual or cash basis taxpayers, as the case may be. At stake, of course, was the time at which the taxpayer could enjoy the tax benefits attributable to the economic burdens of these obligations. If he were permitted to include them in basis at the time they were incurred, then he could, once the proper allocation has been made among assets, increase the extent of his depreciation deductions on the one hand, and the cost of goods sold on the other. But

29. *Id.* at 841.
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Once these obligations are not taken into account in determining cost, they can generate a tax benefit in the form of a business deduction only when the passage of events removes their contingencies and converts them to fixed obligations.\textsuperscript{30}

Similar issues are also raised in \textit{Walter Hoblitzell}.\textsuperscript{31} There the taxpayer purchased his father's interest in an automobile dealership in which they were both partners. At the time of the purchase, the taxpayer agreed to pay his father $20,000 at a time certain in the future, if in the interim the father did not compete with the automobile dealership with which the son was associated. The taxpayer was to be released from all his obligations under the contract if the father committed even one act in breach of the promise he made not to compete in the son's business. Before the period of the covenant had run, the taxpayer sold his interest in the partnership and claimed that the $20,000 should be included in his basis. The Court, on facts which are much stronger for the taxpayer than those in \textit{Albany Wheel}—for here the amount of the cost was fixed—held that the $20,000 obligation on the covenant could not be included in the basis since payment on the covenant was contingent upon the future conduct of the taxpayer's father.\textsuperscript{32} Again, an obligation can be included in basis only if it is regarded as fixed.

\textit{Lloyd H. Redford}\textsuperscript{33} is the last of the cases to be mentioned on the question of cost. There the taxpayer purchased land to develop and to subdivide. Under the terms of the purchase he gave his vendor a prom-

\textsuperscript{30} If in fact the taxpayer had been permitted to value the contingent obligations as he wished, then at some future time he would have to make corrections, either to income or to basis, where the initial estimate proved inaccurate. If the actual cost of the obligations turns out less than expected, then the taxpayer must, once the contingency is resolved, take into income an amount equal to the difference between the estimate and the payment, or reduce basis by that amount. If, however, the initial estimate proved too low, then a step up in basis or an immediate deduction would be in order.


\textsuperscript{32} The court left unanswered how the eventual payments under the covenant should be treated in later years. On the above analysis, the taxpayer should be entitled to some tax benefit by virtue of the payments, since the contingent nature of the obligation should determine only the time it is taken into account. Nonetheless under the current Code it is possible that those payments would be treated as personal, living or family expenses, on the grounds that they are not ordinary and necessary expenses paid or incurred for the conservation of property held for the production of income, as that phrase was construed in United States v. Gilmore, 372 U.S. 39 (1963). The Tax Court, however, decided not to comment in the subsequent treatment of the question. 29 P-H Tax Ct. Mem. 60-1398; 19 CCH Tax Ct. Mem. 1197 (1960). Perhaps if the taxpayer lost on his claim for a deduction upon payment of the $20,000, he could persuade the service to re-open the return for the year in which the sale took place.

\textsuperscript{33} 28 T.C. 773 (1957).
issory note for $61,000 secured on the property and payable in all events at a future time. There was no dispute that this note was part of the cost of acquiring the land. In addition, the taxpayer gave a second note which required him to pay his vendor a sum equal to the lesser of $25,000 or one-half the profits, computed in a stipulated manner, derived from the resale of the land after its development. The taxpayer sold off part of the land so acquired and sought to include in his cost basis the appropriate portion of the $25,000 covered by the second note, even though the exact sum due between the taxpayer and his vendor had not been settled in an accounting. The taxpayer used the $25,000 figure because no accurate calculations of the amounts owing could be made at that time if the alternate figure was used. In line with the rationale of the two cases previously discussed, the Tax Court held that the contingent nature of this obligation required that it not be included in the taxpayer's cost of the land, leaving for later determination the proper treatment for any payments made on the second note.

These cases seem to fully support the conclusion that it is improper to include contingent and uncertain obligations in cost. This principle should apply with equal force to the area of partnership taxation, and, if it does, then Regulation § 1.752-1(e) is open to serious question. In the case of a mortgage with personal liability, the mortgagee has two sources to look to for the satisfaction of the mortgage debt. In the first place he may look to the personal assets of his debtor; in the second, he may look to the property which serves as collateral under the terms of the loan agreement. As a matter of general commercial practice, most secured loans are made for an amount less than the fair market value of the property used as the security. In the typical real estate project, the partnership will receive a loan sufficient to cover the costs of the improvement. But, as a condition of the loan, the partnership will have to subject the land as well as the improvement to the lender's lien. Even if the mortgagor with personal liability is a party with substantial assets, most mortgagees rest much more easily if the property used to secure payment of the note has a value in excess of the outstanding balance on the loan. Indeed, in the successful (or even marginal) real estate development there will never be a need for the mortgagee to demand that those persons with personal liability make good out of their own pockets the payments due on the note, for the rentals derived from the operation of the project should be sufficient to cover the principal and interest due on the mortgage, even after expenses.

Under these circumstances, it is proper to treat the situation as
though the primary obligation rests upon the property, leaving those with personal liability subject only to contingent obligations. The situation is thus similar to that in which one person is liable for the payment of a debt which has been guaranteed by another. The uniform rule is that if the guarantor is on a cash basis he cannot take a deduction for the debt unless he has paid it. Similarly, taxpayers on an accrual basis may only take deductions for debt when they come under a fixed obligation to pay.\textsuperscript{34} The extension of the principle to cases of mortgages secured on partnership property for which only some partners are personally liable is clear in theory. There is every expectation at the outset that the income derived from the operation of the partnership assets will be sufficient to make the payments on the loan. The personal liability of some of the partners should be treated therefore as though they were contingent obligations, subject to the general rules that govern these obligations.\textsuperscript{35} Where the existence and not the allocation of a division is in question, the general rule is that the property is liable for the payment of the debt, which liability as between the grantee and the mortgagor is primary. Therefore, to the extent of the value of such security applicable to the mortgage debt, the original mortgagor, subject to the mortgage stand in a relation one to another, which, while not a true suretyship, is nevertheless equitably analogous thereto and subject to the operation of the same principles.

\textsuperscript{34} "Where the taxpayer is on the cash basis he will not be permitted a deduction for loss upon a contract of guaranty until he actually makes payment under the guaranty." Merten's, supra note 26, at ch. 28, § 28.70, at 355 (1969). Accord, Robert S. Farrell, 44 B.T.A. 238, 240-41 (1941). "Taxpayers on the accrual basis may take losses when a liability is definitely established, even though there has been no actual payment." Id. at ch. 28, § 28.71, at 356. Though the sentence does not make it explicit, it appears that these remarks apply with full force to obligations incurred on a contract of guarantee.

\textsuperscript{35} Here, the private law of mortgages also uses the language of primary and secondary liability and principal and surety in the closely analogous situation where a mortgagor, personally liable on the mortgage, transfers the property to another person who takes subject to the mortgage which he does not, however, assume. In this context, it is said:

\textquote{\textit{...the land is the principal and the transferor is only in the position of a surety or one secondarily liable.}} G. Osborne, \textit{Handbook on the Law of Mortgages} 700 (1951) (footnote omitted). These statements are restricted to cases where property is transferred after the creation of the mortgage only because the point in issue is the continued liability of the original mortgagor for the debt after the mortgagor forbears on the collection of the debt from the transferee. That issue cannot arise where a partnership is still in possession on the original mortgage because there is no question of third party rights at all. Nonetheless, the language of principal and surety describes, in an economic sense, the relationship of a party personally liable on the mortgage to the property used as security. Indeed, the application of this equitable notion of suretyship to the tax problems at hand is exact when the general partner, personally liable on the mortgage, transfers the property subject to the mortgage to the partnership, provided that the general partner and the partnership are treated as distinct legal persons, even in the face of the step-transaction doctrine.
cation of contingent obligations is in issue there is no question that the Commissioner would argue, and with success, that the contingent obligations play no role in the determination of basis, even if they may have to be taken into account at some other time. The same result should follow here.

The situation under consideration here is in reality little different from one in which the loan agreement requires the lender as a matter of contract to look first to the partnership property for repayment, and then to the personal assets of the general partner only if that property is insufficient to satisfy the debt. Under those circumstances, the contingent nature of the personal obligations is made explicit by the terms of the loan agreement. Even if that relationship is not made explicit by contract, it is nonetheless the invariable practice to repay the loan from the personal assets of the general partner only if the revenues generated from the partnership property are insufficient to discharge them. There is no express provision of the Regulation which covers the situation where the lender is required by contract to look first to the partnership assets for the repayment of the loan. Accordingly, that situation should be governed by the principles derived from *Crane* and *Albany Wheel*, which means that the allocation of basis among the partners on account of the loan should be made at the outset without regard to the personal obligations—here expressly contingent—of the general partner. It is hard to believe that a radical readjustment of basis in accordance with the mandate of Regulation § 1.752-1(e) should be required in the typical case where the personal liability of the general partner remains contingent *in fact* even if it is no longer contingent *in form*. There is no reason why such minute differences in the economic position should produce such divergent tax consequences. If the analysis of contingent obligations is sound, then the regulation is not.

Thus far it has been argued that a limited partner should be entitled to his pro rata increase in the basis for his interest when the general partner alone is personally liable to repay the loan secured on the partnership assets. But even if the limited partner is initially allowed his pro rata share of the increase in basis, he may not be able to retain his benefit in full in all events. Assume, for example, that contrary to general expectations, the real estate subject to the mortgage does not in any given year provide enough cash to satisfy the mortgage obligations, requiring the general partner to make out-of-pocket payments to honor the partnership obligations. Once that contingency has oc-
curred, each partner must readjust the basis of his interest. The general partner must increase the basis in his partnership interest by an amount equal to that portion of his out-of-pocket payment used to discharge that part of the partnership indebtedness initially treated as the limited partner’s contribution to capital under Section 752 of the Code. Similarly, the limited partner must reduce the basis in his partnership interest by the same amount since neither his personal assets nor his interest in the partnership property have generated the funds necessary to pay off that portion of the partnership indebtedness which was initially treated as his capital contribution. The discharge of the limited partner’s portion of the indebtedness by the general partner is thus treated as a return of capital to the limited partner. Indeed, if the portion of the indebtedness initially assignable to the limited partner and subsequently discharged by his general partner exceeds (after the pass-through of partnership losses to the limited partner in prior years) the basis which the limited partner has in his interest, then the limited partner should be required to take the difference between those two figures into income, for otherwise he will be permitted over the life of the partnership to take net losses in excess of his actual investment.

To illustrate this point, consider again the case in which a limited partner makes a $10.00 cash contribution to a partnership, and in which the general partner signs for a $100.00 loan, secured by the partnership assets. Assume that the partners have agreed on an equal division of profits and losses. If the Regulations are disregarded in light of the arguments just made, the limited partner should have at the outset a basis of $60.00 for his interest, and the general partner one of $50.00. Assume, further, that after the partnership has been in operation for two years, the general partner is required to make out of his personal assets a payment of $10.00 on the note. If the basis of the limited partner were at that time $40.00 (after adjustments for the pass through of his share of partnership losses), and that of the general were $30.00, then after payment the limited partner’s basis must be reduced to $35.00 and the general partner’s increased to $35.00, because $5.00 (or one-half of the payment) must be regarded as made in discharge of obligations originally attributed to the limited partner in order to allow him his initial step-up in basis from $10.00 to $60.00. If, in the alternative, the general partner had made from his personal assets a payment of $90.00 on the note, then the limited partner would have a
zero basis and $5.00 in income, while the general's basis would be increased by $45.00 to $75.00.\textsuperscript{36} Thus once the contingencies have been resolved it is possible to make all the necessary adjustments to income and basis to reflect the actual economic contributions to the partnership. There is no need to take into account the prospect of future failure when the partnership is created, particularly if remote and uncertain.

2. The Cases

The arguments from principle thus far advanced suggest that contingent personal liability should be ignored at the outset in the allocation of increases in basis attributable to secured loans to a partnership. There have been only a few official decisions on the question, and these do not reveal any consistent approach to the problem. \textit{Manuel v. Mayerson}\textsuperscript{37} is of interest because of its discussion on non-recourse loans to a taxpayer. There the taxpayer paid $10,000 down in cash to purchase real estate worth in excess of $300,000. The remainder of the purchase price had to be paid within the next 99 years. Until paid, the taxpayer was required to make interest payments on the outstanding balance of the loan which was secured by a non-recourse mortgage on the property. The question before the tax court was whether the taxpayer could claim the benefits of the \textit{Crane} doctrine in the computation of his depreciation.\textsuperscript{38} The Commissioner argued that the trans-

\textsuperscript{36} In the alternative, it is possible to treat the limited partner as though he received no income when the general partner made the payment on the loan, if the limited partner receives a negative basis for his interest, here of $-5.00. See note 5 supra. Note, once the general partner is required to make out-of-pocket payments on the loan, it is possible that the initial division of profits and losses would no longer apply, either reducing or eliminating the limited partner's share of future depreciation deductions.

\textsuperscript{37} 47 T.C. 340 (1966).

\textsuperscript{38} The Commissioner might have argued as well that the mortgage loan could not be included in cost on the grounds that it created only contingent obligations to pay. See Del Cotto, supra note 15, at 79-82. But that argument succeeds only if the courts extend the concept of contingent obligations beyond its current limits in a manner inconsistent with the decision in \textit{Crane}. In all cases considered in the text, the form of the obligation was critical, and in all it was conditional. The severance payments in \textit{Albany Car} were due, as a matter of contract, if men were dismissed under conditions; the payments on the covenant not to compete were due in \textit{Hoblizell} only if covenantor conformed to certain contractual conditions; payments under the second note in \textit{Redford} were due only if the improved property, when sold, yielded a certain profit. In \textit{Mayerson} the obligation to pay is contingent only in the sense that the taxpayer might choose at some point to \textit{breach} it. But in that sense most obligations are contingent, even if a taxpayer is subject to personal liability, because there is always the prospect that creditor will not receive payment in full in the ordinary course of business. Nonetheless, the possibility of breach is usually disregarded until it has occurred. Similarly, the scope and nature of the creditor's remedies should not be taken into account in determining whether an obliga-
action in effect was a lease coupled with an option to purchase because the taxpayer was not obligated to pay off the principal on the loan for 99 years. Under this interpretation the taxpayer could only amortize the $10,000 down payment over the life of the lease. The Court, however, rejected this contention on the grounds that the Commissioner had to respect the taxpayer's characterization of the transaction as a sale because it represented an arm's length transaction between strangers. In the course of its opinion, the Court commented on the Commissioner's further contention that the transaction had to be regarded as a sham because the taxpayer was not personally liable for the payment of the loan.

The element of the lack of personal liability has little real significance due to common business practices. As we have indicated in our findings it is not at all unusual in current mortgage financing of income-producing properties to limit liability to the property involved. Taxpayers who are not personally liable for encumbrances on property should be allowed depreciation deductions affording competitive equality with taxpayers who are personally liable for encumbrances or taxpayers who own unencumbered property. The effect of such a policy is to give the taxpayer an advance credit for the amount of the mortgage. This appears to be reasonable since it can be assumed that a capital investment in the amount of the mortgage will eventually occur despite the absence of personal liability.

39. Under this interpretation, it is not quite clear how subsequent payments on the mortgage should be treated. It could be argued that all of those payments should be treated as rent, regardless of when made, and hence deductible as paid. But if a large portion of the principal of the loan is paid in a given year, it might be proper to treat it either as a prepayment of rent and require the taxpayer to write it off only over a period of years, or, under other circumstances, as a delayed payment of rent to be deducted when paid. In any case, it seems odd that the tax treatment of rentals on a 99 year lease should so differ from mortgage payments on the fee, when the value of the revision is so negligible. But despite the kinship between the mortgage of the fee and the lease for a long term of years, the precedents in the former area are not carried over to the latter.

40. 47 T.C. at 351-52.
It is hard to see why these remarks do not apply with equal force to the case where only one member of a partnership is liable on a note secured by the partnership property. Nonetheless, *Curtis W. Kingbay* decided shortly before *Mayerson*, makes it clear that the Tax Court relies more on specific Regulations than upon principle in assessing the role of personal liability in cases of secured loans made to partnerships. In *Kingbay*, the taxpayer and his wife created a limited partnership in which they were the only limited partners. The general partner was his wholly owned corporation with a net worth, apart from its interest in the real estate, of about $1,000.00. The partnership received several substantial loans for the construction of the real estate secured on its assets, for which the corporate general partner alone was personally liable. For the tax years in question, the taxpayer sought to take his pro rata share of the partnership losses on his individual tax return. These losses were disallowed, in part, by the Commissioner on the grounds that the taxpayer's basis in his partnership interest had to be determined solely by reference to his initial capital contributions. The court accepted the contention of the Commissioner that Regulation § 1.752-1(e) required all of the basis in respect to that debt to be allocated to the corporate partner since it alone was liable on the note, although the corporate dummy did not have any assets apart from its interest in the real estate partnership. Thus, the decision in *Kingbay* appears to stand for the proposition that the security will be disregarded in the allocation of basis, and that the note will be given paramount importance even where the former is of crucial business importance and the latter is quite immaterial.

The proper response to the problems raised by *Kingbay* has been indicated earlier in the article. The taxpayer should be allowed to claim his pro rata portion of the debt as an addition to the basis. Should corporate funds not derived from the real estate venture be used to reduce that debt, then the appropriate adjustments to income and basis can be made at that time in the matter previously described.

41. 46 T.C. 147 (1966).
42. The opinion does not state why the taxpayer chose, as a business matter, to adopt this form of transaction given the adverse tax consequences. It is quite possible, however, that he did so because of the impact of a state Regulation rule which required some person to be personally liable before a secured loan could be made. It would be harsh indeed if the use of the dummy to comply with state law had an adverse impact on the tax position of the limited partners, but as a matter of planning, one must always be aware of the collateral consequences that can follow from compliance with state law, however unwise it may be.
43. See text accompanying note 36 *supra.*
Should there be a default upon the loan which requires repossession by the lender, then the taxpayer should have at that time income to the extent that his depreciation deductions exceed his contributions to equity. But under no circumstances does it make any sense to have the allocation of basis follow the personal liability of the corporate dummy.

The arguments made thus far are designed to show the weakness in principle of Regulation § 1.752-1(e). But even if unsound, the Commissioner has sought to expand its scope in Revenue Ruling 69-223.45 There, a limited partnership was formed with one limited and one general partner. The general partner was personally liable on the real estate mortgage assumed by the partnership. The limited partner, however, agreed in effect to indemnify the general partner for his pro rata share of the partnership losses if the general partner had to use his personal assets to satisfy the mortgage. Given these facts, the Commissioner ruled that the limited partner was entitled to no increase in the basis of his partnership interest on account of the mortgage, holding that his contractual duty to indemnify the general partner for his pro rata share of the losses could not be treated as a contribution to the partnership.46 Hence the general partner received an increase in his basis for the full amount of the mortgage.

The position taken by the Commissioner in the Revenue Ruling does not seem to be in accordance with the general principles governing contingent obligations already discussed. In the first place, all the arguments used to attack Regulation § 1.752-1(e) apply with equal force to this case, for it is still proper to treat the liability of the general partner as contingent upon the inability of the partnership assets to satisfy the partnership debts. Moreover, the position of the Commissioner is further weakened by the presence of the pro rata indemnity agreement, which makes it even more unlikely that the general partner's personal assets alone will be used to discharge the obligation to the lender. Here there is not only the condition precedent that the revenues from the partnership property are insufficient to cover the loan, but also the condition subsequent that the general partner is un-

44. Parker v. Delany, 186 F.2d 455 (1st Cir. 1950).
46. Id. at 184-85. Here it is not quite clear why the limited partner could not claim the benefits of the step-transaction doctrine in order to make his obligation to indemnify in effect a contribution to the partnership, even though one that must pass through the hand of the general partner.
47. See text accompanying notes 33-35 supra.
able to recover the pro rata share of his loss from the limited partner by suing on the indemnity agreement. Thus if the arguments made earlier based upon the proper tax treatment of contingent obligations are sound, it follows that the case for the taxpayer is stronger given the facts of Revenue Ruling 69-223 than it is when the general partner, without benefit of the indemnity, is liable on a note secured by partnership assets.

This argument can be set firmly into framework of the general tax law by an examination of the rules which govern bad debt deductions. These rules provide that a guarantor cannot take a deduction for payments on the guarantee unless he can show that his action over against the primary obligor is worthless. Here, in effect, the general partner, by virtue of the indemnity agreement, has a position analogous to a guarantor. True, the limited partner is not in the exact position of a primary obligor. Nonetheless, it is to him that the general partner is entitled to look for payment on the indemnity agreement in the same fashion that a guarantor is entitled to look to a primary obligor. It is immaterial that the rules governing guarantees apply in terms only to cases of immediate deductions, while here an increase in the basis of a partnership interest is the point in issue. The difference between an immediate deduction and an increase in basis only determines the time when a taxpayer receives his tax benefit. It should not determine which taxpayer receives the benefit. Unless it can be shown that the action on the contract is worthless to the general partner, the limited partner should receive his pro rata portion of tax benefits under Section 752 on the grounds that he is the person most likely, all things considered, to bear in due course the economic burden which generated that portion of the tax benefit in the first instance.

The matter can be put in a slightly different way. There is no doubt that the limited partner would receive his pro rata increase in basis if he too were personally liable on the mortgage. Yet the situation described in Revenue Ruling 69-223 differs only in certain limited respects from one in which both partners are jointly liable on the mortgage. Under most circumstances the exposure of the limited partner will approach that of the general partner, even though the limited

48. "Where the guarantor pays the debt pursuant to his contract, he cannot per se deduct the debt, but rather must show that he is unable to collect the debt from the primary debtor." 5 MERTEN'S, supra note 26, at ch. 30, § 30.52, at 119 (footnotes omitted). See also Morris Sass, 7 B.T.A. 557 (1927), aff'd on rehearing, 17 B.T.A. 261 (1929); Otto P. Heyn, 4 B.T.A. 1256 (1926).
partner may enjoy some protection because he has no direct relationship with the lender. True, the limited partner, if he does not sign on the loan to the partnership, cannot be liable for the entire partnership debt even if the partnership assets are worthless and the general partner bankrupt. The general partner is, of course, subject to such liability if the partnership assets are worthless and the limited partner bankrupt. Moreover, if the indemnity agreement between the partners serves to protect the limited partner against direct actions by partnership creditors, then the limited partner by virtue of the indemnity can be held liable only for the pro rata share of the loss actually suffered by the general partner.\footnote{It is quite possible that under state law, a creditor of the general partner will be able to claim as an involuntary assignee or subrogee, all the rights of the contract of indemnification, even in the face of language that seeks to deny him those rights. For example, it is stated that: "[t]he fact that a contract contains an express cause against assignability will not prevent the clause of action from vesting in the trustee." \textit{4a} Collier, \textit{On Bankruptcy} § 70.28, at 408-09 (14th ed. 1969). \textit{See also} Bankruptcy Act § 70a (5)-(6), 11 U.S.C. § 110 (1964).} For example, if the general partner is forced to pay $50.00 from his own pocket in order to discharge the loan obligations, his indemnity will net him $25.00 if the partners agreed to an equal division of profits and losses. Only where the limited partner proves unable to pay the $25.00 will there be any need for further basis adjustments, and those can be made in precisely the same manner discussed earlier in this article: the general partner increases his basis by $25.00 while the limited partner reduces the basis of his interest by $25.00.

These arguments suggest that it is incorrect to allocate initially all of the increase in basis attributable to the loan to the general partner’s interest, even where there is only an indemnity agreement covering partnership losses, for that agreement suggests that, in the ordinary course of events, the cost of the loan will be shared pro rata by the two partners. This conclusion holds even when no partnership property is used to secure the loan. The arguments made earlier suggest that it is also incorrect to allocate all of this increase in basis to the general partner’s interest when partnership property is in fact used to secure the loan, even if the general partner has no right of indemnification against his limited. Revenue Ruling 69-223 presents a situation in which the personal liability of the general partner is limited by both a security arrangement and an indemnity agreement. The combined effect of these two forms of protection suggest that if Regulation § 1.752-1(e) is unsound, then, a fortiori, the limited partner should

\footnote{49. It is quite possible that under state law, a creditor of the general partner will be able to claim as an involuntary assignee or subrogee, all the rights of the contract of indemnification, even in the face of language that seeks to deny him those rights. For example, it is stated that: "[t]he fact that a contract contains an express cause against assignability will not prevent the clause of action from vesting in the trustee." \textit{4a} Collier, \textit{On Bankruptcy} § 70.28, at 408-09 (14th ed. 1969). \textit{See also} Bankruptcy Act § 70a (5)-(6), 11 U.S.C. § 110 (1964).}

\footnote{50. \textit{See} pages 112-14 \textit{supra}.}
in this case as well share equally at the outset in the increase in basis to the partnership interests attributable to the loan.

3. **Guarantees of Completion**

The principles already developed may be used to analyze the tax consequences of a guarantee of completion. In many cases, the general partner may guarantee the lender that he will complete the construction of the proposed project even if the funds advanced by the lender to the partnership prove insufficient for the task. A guarantee of completion differs from personal liability on the note because once the project is completed, the lender will be able to look only to the rentals derived from its operation for satisfaction of the loan. The personal assets of the general partner are beyond his reach in case of its financial failure after completion.

There is no definitive statement as yet on the tax treatment of an obligation to complete. Nonetheless, it does not seem proper to treat the general partner as making a contribution to the partnership in excess of his pro rata share of the indebtedness. It is hard to characterize an obligation to complete as a debt, for it speaks in terms of indefinite performance, and does not call for the payment of a sum certain at a future time. There is no reason why Section 752 and the regulations thereunder should require general partners to increase their basis at the expense of the limiteds. That guarantee comes into play only if the funds initially committed to the project are insufficient to complete it. If the general partner makes additional contributions to the partnership in order to complete the structure, then he will be entitled to the corresponding increase in basis. But this increase in basis represents only an increase in the total investment in the project; it should not serve to reduce the basis of the limited partners attributable to the original loan. In effect, the guarantee of completion raises the question of the relationship between basis and contingent obligations in the usual case where the existence of basis and not its allocation is in issue. While the obligation lies dormant, it generates no tax benefit. But once it is settled that the general partner will have to make payments from his own pocket to discharge the obligation to complete, then, but only then, will he have the benefit of an addition to basis on his account. The rule laid down in *Albany Wheel* thus applies with full force to the case of the guarantee to complete.

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51. The requirement of a fixed sum due at a fixed time derives from the medieval actions in debt. See, C. Fiep, *History and Sources of the Common Law, Tort and Contract* 229 (1949).

52. See text accompanying notes 28-30 *supra*. 
C. Tax Consequences of § 1.752-1(e) Under Current Law

Thus far this article has attacked the soundness in principle of Regulation § 1.752-1(e). Even if it is assumed that the Regulation properly interprets the law, there are still serious questions that must be answered. The Regulation only requires an initial allocation of basis between the limited and the general partner; it does not indicate what adjustments to basis should be made as the partnership over the years amortizes the loan with the revenues derived from the operation of the property.

There are, in principle, two possible treatments of the amortization payments on the loan. In the first instance, they may serve to increase the basis of the limited partner to the extent of his pro rata share of those payments, and, at the same time, to reduce the basis of the general partner by a like amount. Under such a view, the limited partner will be entitled to take on his own individual return his share of the depreciation deductions taken in respect to the partnership improvement, though he may not be able to do so in the year the losses are created. On the other hand, the amortization payments could be treated as providing the general partner's actual investment in the partnership asset to justify, after the fact, the assignment to him of all the basis attributable to the loan in the first instance. On this interpretation, the limited partner will be able to take depreciation deductions attributable to the partnership improvement only to the extent of his initial cash investment, since none of the payments on the loan will be treated for tax purposes as increasing his cash investment in the partnership. Both these views must be examined in greater detail.

1. The first view: amortization requires reallocation

On the first possible view of the Regulation, basis adjustments should be made to the interests of both the general and limited partner as the loan is amortized. The Regulation in effect has assumed in its initial assignment of basis that the general partner will, in the ordinary course of events, provide all the cash necessary to pay off the loan when it increased the basis in his interest by its full amount. If, as has already been argued, a pro rata allocation of basis between the general and limited partner is appropriate at the outset for loans to the partnership, then readjustments in basis are required in principle when the general partner is forced to make out-of-pocket payments to satisfy the loan obligations. Here, when the Regulation assigns basis at the outset on the assumption that the entire loan will be paid out of the personal assets of the general partner (a much more unlikely assumption), then it also
follows that basis readjustments must in principle be made as that prediction is falsified by events. Accordingly, as the amortization payments are made from partnership revenues, the limited partner should be allowed to increase the basis in his interest by his pro rata share of the payments, since his actual investment in the partnership property is increased by that amount. Similarly, the basis of the general partner must be reduced by an equal amount, because it is now clear that, to the extent of the fresh contribution by the limited partner, the general partner can no longer be expected to repay the entire loan.

On these assumptions, the rate of basis readjustment can be crucial because the Code permits the pass through of losses to the individual return in a given tax year only to the extent of a partner's basis in his interest.53 Some of those losses allocable under the terms of the partnership agreement to the limited partner therefore may have to be held in suspense at the partnership level until his investment in the partnership is increased at some subsequent time. Whether in any particular case the limited partner will have losses attributable to him suspended at the partnership level is a function of many variables: the ratio of equity to debt; the amount of prepaid interest; the expected life of the structure; the method used to take depreciation; the interest and the period of the loan. Nonetheless it is possible to construct a case which requires the suspension at the partnership level of losses allocable to the limited partner, even on fairly modest assumptions.

These points can be illustrated by a case of a simple two-man partnership. The limited partner contributes $10.00 in cash to the partnership; under the terms of the agreement he takes into account three-fourths of the partnership's profits and losses. The general partner makes no cash contribution to the partnership, but receives for his efforts one-fourth of the partnership profits. Upon formation of the partnership, the general partner extends his personal credit in order to secure a loan for $108.00 to be secured on the partnership assets. Under the terms of the loan, the first year's interest—for convenience sake, say, $8.00—is to be prepaid. The loan is for a period of 15 years, and is for eight per cent interest. Ten dollars of partnership funds are used to purchase land, and the remaining $100.00 are used to erect an apartment house with a 20 year useful life. The depreciation on the structure is taken on the double declining balance method.

At the outset, Regulation 1.752-1(e) provides that the limited

53. I.R.C. § 704(d)
partner will have a basis of $10.00 in his interest, and the general partner a basis of $100.00 in his. Once the deductions for the prepaid interest are taken into account, the limited partner's basis will be reduced from $10.00 to $4.00 since he will be entitled to three-fourths of the $8.00 deduction. In the first year in which the structure is completed, the limited partner's share of the depreciation deductions should be $7.50, while his share of the amortization of the loan should be about $2.92. Hence, it follows that the amount of his depreciation deductions ($7.50) exceeds the basis of his partnership interest ($4.00) even when augmented by his share of the amortization ($2.92). Under the partnership provisions of the Internal Revenue Code, the limited partner will be entitled to take a deduction on his individual return equal to $6.92, leaving $0.58 worth of losses in suspense at the partnership level. The amount of losses so held in suspense will increase as long as the depreciation deductions exceed the amortization on the loan. Only when the amortization payments exceed the depreciation will those suspended deductions be passed through, bit by bit, to the limited partner, until he receives his full share of the depreciation. At issue is the question of timing, and here many years will pass between the time the depreciation deduction was created and the time that the limited partner takes it into account. Indeed, on the assumptions just given, the limited partner will be able to reduce the amount of losses held in suspense at the partnership level starting only in the seventh year of operation, while only in the twelfth year will there be no losses allocable to the limited partner held in suspense at the partnership level.

Moreover, the losses suspended in the partnership provide a deferred tax benefit as well if the real estate in question is sold before the mortgage has been discharged in full. Under those circumstances the amount realized by the partnership will be determined, under Crane, by adding the unpaid balance of the mortgage to the boot received by the partnership. The adjusted basis, of course, will be the original cost of the partnership assets, including the borrowed funds. 

54. REALTY BLUEBOOK 114 (rev. 3d ed. 1970).
55. Id. at 116.
56. Id. at 114, 116. In the seventh year the total depreciation is only $5.30, while the total amortization is $6.27.
57. Id. at 114, 116. By the twelfth year the limited partner has had available, after all increases attributable to his portion of the amortization, about $56.50 in investment to permit the pass through of depreciation deductions. His pro rata share of the depreciation through the twelfth year is about $54.00. Hence, on the assumptions in the text, there should be no more losses suspended at the partnership level after the twelfth year.
as reduced by the amount of the depreciation deductions. The gain, equal to the difference between these two figures, must be allocated in accordance with the partnership agreement; hence, three-fourths of the gain goes to the limited partner. Nonetheless, he will not be taxed on his full share of the gain, because he can set off against that gain those losses still suspended at the partnership level. Thus the sale operates as a kind of instantaneous amortization which immediately permits the pass through of all the suspended partnership losses.\(^{58}\) If the property is sold before the loan is repaid, the taxpayer still makes the requisite investment; only now the investment is made because he is required to take into income the unpaid balance of the mortgage.

Hence, whether the property be held or sold, the Regulations to Section 752 require in effect the tax benefits from depreciation be passed to the individual return only when there is satisfaction of the loan. But the decision in *Crane* rejected the argument that depreciation of borrowed capital should be deferred until satisfaction of the loan, at least in the case of the individual taxpayer.\(^{59}\) It is not to the point here to contend that the arguments in *Crane* are defective in principle. Once it is settled that depreciation deductions should not be tied to the repayment of loans, that decision should govern partnership as well as individual property because the timing of these deductions should not be a function of the form of the investment vehicle.

The reallocation of basis with amortization requires an examination of the tax consequences to the general partner as well. The individual taxpayer who does not enter into any partnership receives his step up in basis because he is expected to make an investment equal to his basis in the property over the life of the loan. In effect, he receives at the outset the tax benefits from a cash investment expected to be made in the future. In the case of the ordinary limited partnership, the general partner cannot be expected to make contributions to the partnership in an amount equal to the basis in his interest as determined by the Regulations. Consider again the case where the mortgage is for $100.00, with one-fourth of the profits and losses allocable by agreement to the general partner. Here only one-fourth the amortization of the loan, and no more, will be assignable to him.\(^{60}\) Seventy-five dollars in

58. On sale, of course, Section 1231 should permit the gain to be capital, except to the extent that recapture of the accelerated portion of the depreciation is required. I.R.C. §1231. The losses presumably would be set off only against the portion of the gain which would otherwise be subject to the tax under Section 1231.

59. See note 6, supra.

60. In this example, the question of prepaid interest is eliminated for simplicity.
basis, therefore, cannot be attributed to the future investment of the general partner, and only the most careful treatment of the basis in his interest will here prevent $75.00 of his income from being treated as a return of capital at some point in the future. Here the general partner must be required to reduce the basis in his interest as the rental income of the limited partner is used to repay the loan. Over the life of the loan, then, the net effect of the regulations is to step up the general partner's basis at the outset only to require it to be reduced at some later point in time by an amount in excess of his pro rata share of the partnership losses. That excess amount is, of course, equal to the amortization payments available to the limited partner, for which he, the limited, receives a step-up in basis. Thus, even if the general partner received a basis of $25.00 at the outset, he could still receive all the benefits of depreciation to which he was entitled under the agreement. Moreover, the $25.00 basis figure for his share in the loan would not alter the gain or loss recognized upon the sale of the property, for he is not required to include the entire balance of the mortgage in his portion of the gain, three-fourths of which under the terms of the agreement goes to the limited partner.\(^6\)

The initial assignment of the full $100.00 in basis to the general partner, then, affects neither the amount of his depreciation deductions nor his gain upon sale. In short, it never affects his tax position at any point in time over the life of the project, unless his personal liability is called into play. In the normal case, the sole impact of the assignment of basis under the Regulation is to insure that the limited partner will not, on the question of timing, be able to derive the same benefits under the Crane rule available to either general partners or individual owners.

2. The second view: no reallocation upon amortization

The arguments just made appear to be sound in principle, but the Commissioner might nonetheless argue that there should be no reallocation of basis from the general to the limited partner as the revenues derived from the operation of the partnership property are used to amortize the loan. As a corollary to this position, it follows that the terms of the partnership agreement must be disregarded insofar as they purport to govern the allocation of the partnership income used for amortizing the loan, in order to insure that the general partner will make an actual investment over the life of the loan equal to the increase

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61. See text accompanying note 58 supra.
in basis awarded to him in the first instance. If this treatment is adopted there is no need to reduce by fiat the basis of the general partner as the loan is paid off. Similarly, the limited partner will be unable to increase his basis on account of the amortization of the loan from partnership revenues.

In effect the provisions of Regulation § 1.752-1(e) can be respected over the life of the loan only if the Commissioner is prepared to override the allocation of profits and losses called for by the partnership agreement. Moreover, once it is decided that the partnership income applied to the amortization of the loan shall be assigned to the general partner even in the face of the terms of the partnership agreement, there will be a need to require the two partners to abandon as well the pro rata allocation of depreciation deductions to which they agreed. The limited partner will be able, on this view, to claim depreciation deductions only to the extent of his initial cash investment. The general partner will then take all remaining depreciation deductions on the structure. In effect, once Regulation § 1.752-1(e) is allowed to govern all aspects of the transaction, all the borrowed funds allocable to the improvement are treated as the investment of the general partner. Moreover, since the cash contribution of the limited partner is allocated to the improvement, the purchase price of the land in its entirety must be attributed to the general partner's loan contribution.

These points can be clarified by an example. Consider again the case where the limited partner contributes $10.00 to the partnership and the general partner signed on a note for $100.00 secured on the partnership assets. The partnership uses the funds to purchase land worth $10.00 and an improvement worth $100.00. The limited partner can take losses, including depreciation deductions up $10.00, under the terms of the partnership agreement. But the general partner has $90.00 in depreciation deductions over the life of the structure and must take into income, on a different time schedule, the $90.00 in project income used to amortize the loan. Once the loan is discharged

62. I.R.C. §§ 702, 704(c)(1). Here the limited partner could take his portion of the depreciation to the extent of his investment in the partnership. There is no way that the Commissioner could argue that allocation under the partnership agreement should be disregarded when the limited partner has a basis in his interest which permits the pass through of at least some of the depreciation deductions. In effect, the Commissioner cannot demand that the partners proceed on the assumption that the limited partner contributed the funds allocable to the land, and the general partner those allocable to the depreciable improvement. See Treas. Reg. § 1.704-1(c)(2) example 1 (1956), as amended, T.D. 6771, 1964-2 CUM. BULL. 177.
and the amortization completed, the general partner will have a basis of $10.00 in his interest equal to the basis of the land in the hands of the partnership.

In the example just put, 90 percent of the timing benefits of the Crane rule, under this interpretation, would inure to the benefit of the general partner, leaving only 10 percent of these benefits for the limited partner, whose depreciation deductions would be limited to his initial $10.00 cash contribution. The limited partnership would have little appeal as a tax shelter device for limited partners if this treatment were required by the Commissioner and the Courts.63

But it is by no means clear that the Commissioner’s powers under current law are sufficient to enable him to disregard the terms of partnership agreement on the strength of § 1.752-1(e). The Internal Revenue Code provides that the partnership allocation of profits and losses is entitled to respect for tax purposes unless it can be shown to be without “substantial economic effect.”64 The application of that term is difficult even in the simplest of cases. Consider just one of the several examples set out in the Regulations. Assume that a partnership agreement calls for an equal division of partnership profits between each of two partners, but assigns the first $10,000 of tax-exempt income to one partner, and an equal amount of taxable income to the other partner, with the balance divided equally between them. In this case, no segregation of profits by source would be required as a business matter if there were no taxation of partnership income. Hence, in such a case it is possible for the Commissioner to respect the percentage division of profits even if he disregards the provisions which seek, solely for tax reasons, to assign the first $10,000 from tax exempt securities to one of the partners. In other words, it is possible to decide what the partners would have done between themselves as an economic matter if there had been no tax at all. If the partners elaborate their business arrangements in order to satisfy tax needs, then the Commissioner can, under his statutory authority, revise the agreement consistent with the business purpose of the partnership.65

In the case of real estate partnerships, however, the case for reallocation is much more difficult. Here, the Commissioner should not be able to disregard the partnership agreement insofar as it governs the

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63. Here it is assumed that the only losses passed through are due to depreciation.
The taxation of spendable cash generated by the partnership operations. The division of the cash flow is crucial to the business position of all of the partners, and would remain so even if the income tax were repealed on the morrow. But the Commissioner must argue that the partnership allocation cannot be respected to the extent that it governs some of the amortization payments made on the loan on the grounds that the allocation of income to be applied to the discharge of partnership obligations is without substantial economic effect. But this argument proves too much, because there is no alternative allocation of this income which as an economic matter better captures the interests of the partners. There is no way in which a business bargain can be reconstructed over an issue on which the partners are economically indifferent. If there were no federal income taxation, or a system of taxation without the Crane decision, the partners would have no concern whatsoever about the allocation of those profits which had to be returned to the business. Crane makes the issue of the allocation of income and depreciation crucial only because the depreciation deduction is taken in advance of the investment. But in the case of an immediate deduction, such as that for interest, the issue of allocation is quite immaterial. If one partner received $100.00 in rental income and an immediate deduction for $100.00, he is no better or worse off than another partner who receives no income and who in consequence is entitled to no deduction. In the case of the securities treated in the Regulations, there was a business standard to which the Commissioner could turn in order to reconstruct the partnership agreement. But in this case that standard is simply unavailable.66

66. Note, both interpretations of the regulation are, though to different degrees, unfavorable to limited partners. Hence, there is a strong planning incentive to avoid the application of Treas. Reg. § 1.752-1(e) (1956). For example, it has been suggested that the general partner may purchase the real property in his own name, using, at least in part, funds from a mortgage in which he is personally liable. Then, he could transfer the property subject to the mortgage to the limited partnership, which does not, however, assume it. But, here, the Commissioner no doubt would apply the step-transaction doctrine, and hold that in substance the partnership acquired the property directly in a transaction in which the general partner is personally liable on the mortgage. In an attempt to avoid the step-transaction doctrine, it has been suggested that, "If there are two or more general partners, and only one of them has personal liability on the indebtedness, it cannot be said that the initial step involving only one general partner was all form and no legal substance. It does make a difference of some significance whether one general partner or all general partners have personal liability on the indebtedness." 67 A. Willis, On Partnership Taxation 181-82 (1971). True, there is a difference, but not one which should help the limited partners. In effect, the arrangement proposed (but by no means warranted) should, if the Regulation is valid, require the one general partner to step-up his basis for the full amount of the mortgage to the exclusion of the other, leaving the positions of the limiteds unchanged.
There is one further obstacle that would stand in the path of the Commissioner if he sought to disregard the partnership allocation of profits and losses in the manner just indicated. The Regulations make it clear that the Commissioner is entitled to disregard those special allocations contained in the partnership agreement which are designed to avoid or minimize the tax. But once those special provisions are disregarded, the item which received special treatment must be allocated in the manner generally provided for the treatment of profits and losses. Here, the taxpayer would insist upon the application of the general partnership provisions to both the project income applied towards amortization and the depreciation deductions dependent upon that allocation. But it would be the Commissioner who would seek to disregard the general terms of the agreement. No case has yet been decided on this question, but the language of the Regulations makes it difficult to believe that the Commissioner would prevail if he tried to argue that Regulation 1.752-1(e), even if valid, required anything more that a postponement of the pass through of partnership losses to the limited partner.

CONCLUSION

This article cannot claim to raise issues whose resolution carries with it profound implications of social policy. Quite to the contrary, all of the arguments contained in the text proceed on a technical footing, but though technical, they would, if accepted by the courts, have a substantial import on the use of limited partnerships for real estate development. Once the Crane rule, with all of its implications, is used to compute the cost of property acquired with borrowed funds, then it follows as a matter of principle that the Commissioner's position in Regulation § 1.752-1(e) and Revenue Ruling 69-223 cannot be supported. Given the generally accepted treatment of contingent obligations, the increase in the basis of partnership interests attributable to the mortgage placed upon the real property should be allocated at the

In the alternative, however, it might be possible to both satisfy the lender and preserve the step-up in basis to the limited partners by providing that the general partners are personally liable for the interest but not the principal due on the loan. In the early years, when the danger of failure is greatest, the lender can look to the general partners' personal assets for the bulk of the loan payments. Should the generals be required to make out-of-pocket payments on the interest, they should be able to claim an immediate deduction under either Section 162 (business expenses) or Section 163 (interest) of the Code. Moreover, since the lender can only look to the property for repayment of the principal, the limiteds should, presumably, be able to claim their pro rata share of the step-up in basis due to the mortgage indebtedness.

outset in a manner that seeks to anticipate the source of funds used to repay the loan. In the usual case, those funds will be generated from the operation of the property itself. The personal liability of the general partner comes into play only in the unusual situation where the project does not produce funds sufficient to meet the mortgage obligations. From these premises, it follows that each of the limited partners should, on a proper interpretation of Section 752 of the Code, be entitled at the outset to a pro rata increase in the basis of his partnership interest on account of the loan to the partnership. Only in those cases where the personal liability of the general partner is brought into play will there be need to readjust the basis of partnership interests. Finally, it is argued that even if the Regulation is held valid the limited partner should be permitted to increase the basis in his interest as the general partner is required to reduce his basis when the loan, in fact, is amortized with partnership funds. Once this reallocation of basis takes place, the limited partner should be able, though perhaps with suspension of losses at the partnership level, to take the full share of depreciation deduction allocated to him by the terms of the partnership agreement. These, in brief, are the major arguments advanced in the body of this article. Only time will tell whether they will meet with success in the courts.