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The Taxation of Borrowing

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The Taxation of Borrowing

WILLIAM D. POPKIN*

Borrowed funds, as we all know, are not income. The Supreme Court has held that funds subject to a consensual agreement recognizing the obligation to repay are not taxable, and saw no need to justify that conclusion. The doctrinal foundation for the exclusion of loans from income suggests, however, that a justification is necessary. Loans are excluded from income because they do not provide the taxpayer with accretion to net wealth, the zero accretion being recognized by accruing the obligation to repay the debt in the future to the year the loan proceeds are received. A strict application of the net wealth accretion definition of income by accruing debt is hardly a foregone conclusion, however. First, obligations to pay in the future are often not accrued and, in any event, the Commissioner is thought to have wide discretion in determining whether such accrual would distort income. Second, the exclusion of a loan from income defers tax since the loan must be repaid out of after-tax funds. The exclusion's resulting in deferral suggests that the outcome is far from inevitable, given the uncertainty of timing rules in tax law.

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3 Spartan Petroleum Co. v. United States, 437 F. Supp. 733, 736 (D.S.C. 1977) ("his net worth being unchanged, there is no taxable economic gain").


6 I.R.C. § 446(b).

7 If the loan had been taxable, the repayment would be deductible and tax would not be deferred until the year of repayment. James v. United States, 366 U.S. 213, 220 (1961); McKinney v. United States, 574 F.2d 1240 (5th Cir. 1978); Rev. Rul. 65-254, 1965-2 C.B. 50. When a farmer elects under I.R.C. § 77 to include a loan in income, repayment is deductible by adding the repayment to the cost of property pledged as collateral for the loan. Rev. Rul. 80-19, 1980-1 C.B. 9.

The failure to perceive that this exclusion is only deferral accomplished by accruing unpaid debt has produced serious distortions in the tax law which could be avoided if the doctrinal foundations for taxing borrowing were better understood. The first section of this article will explain why tax deferral of loans is not inherently objectionable in an income tax. The second section will discuss the criteria by which payments are taxed in the year of receipt notwithstanding the existence of an obligation to repay, and will compare these situations to loans. The third section will explain when the accrual of unpaid debt to defer taxation of loans cannot be justified. The final section will then compare the taxation of borrowing in a consumption tax with the income tax rules.

TAX DEFERRED LOANS—THE LOGIC OF THE INCOME TAX

The deferral of tax on borrowing is not inherently objectionable in an income tax, absent the special circumstances discussed later in this article. In an income tax, the rate at which current consumption can be substituted for future consumption by saving is higher than in the absence of a tax. For example, if an individual has $100 in year 1 in a no-tax world which he can invest at 15%, he has a choice between consuming $100 in year 1 or $115 in year 2, a 10/10.5 ratio. If the individual is subject to a 40% income tax, he needs $166.66 in year 1 to obtain $100 consumption. If he defers that consumption to year 2, he must pay a further 40% tax on the $15 gain, leaving him with $109, a 10/10.9 ratio.

The deferral of tax on borrowing also has the effect of favoring the borrower's decision to consume in the earlier year. This is illustrated in Table I, which describes two taxpayers, each with an opportunity to consume $100 in year 1 or defer consumption until year 2. Both taxpayers are in the 40% bracket in both years. Taxpayer A obtains the opportunity to consume $100 by earning $166.66 taxable income; Taxpayer B can borrow $100 tax-free at 15% interest. To make the two taxpayers equal in all other respects, we assume that they both obtain $191.66 of taxable income in year 2; this will be more than sufficient to allow the borrower to repay the loan with interest. In addition, we assume that Taxpayer A, who has $166.66 taxable income, can earn a 15% return if he saves rather than consumes in year 1, because that is the amount the borrower can retain for his own use if he defers consumption by not borrowing, thereby avoiding payment of 15% interest. Table I shows that both taxpayers can increase consumption by the same amount ($109) if they defer consumption to year 2. If the loan had been taxed in year 1,

the borrower would not receive the same advantage for early consumption. This is illustrated by Taxpayer C, who receives a taxable loan of $166.66 to obtain $100 for consumption in year 1. Taxing the loan in year 1 increases to $115 the amount by which the taxpayer can increase consumption by not borrowing and deferring consumption until year 2. The basic decision to defer tax on borrowing in an income tax is, therefore, an implementation of the inherent bias in an income tax for current over future consumption, and raises no problems other than those raised more generally by the decision to adopt an income rather than a consumption tax.

### Table I

<table>
<thead>
<tr>
<th></th>
<th>Consumption in Year Received</th>
<th>Deferral of Consumption Until Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year 1</td>
<td>Year 2</td>
</tr>
<tr>
<td><strong>TAXPAYER A:</strong></td>
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<td></td>
</tr>
<tr>
<td>Taxable Income</td>
<td>166.66</td>
<td>191.66</td>
</tr>
<tr>
<td>Tax</td>
<td>66.66</td>
<td>76.66</td>
</tr>
<tr>
<td>Opportunity to Consume</td>
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<td>115.00</td>
</tr>
<tr>
<td><strong>TAXPAYER B:</strong></td>
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<td></td>
</tr>
<tr>
<td>Taxable Income</td>
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<td>176.66</td>
</tr>
<tr>
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<td>Opportunity to Consume</td>
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<td>6.00</td>
</tr>
<tr>
<td><strong>TAXPAYER C:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxable Income</td>
<td>166.66</td>
<td>0.00</td>
</tr>
<tr>
<td>Tax</td>
<td>66.66</td>
<td>0.00</td>
</tr>
<tr>
<td>Opportunity to Consume</td>
<td>100.00</td>
<td>0.00</td>
</tr>
</tbody>
</table>

*All taxpayers are subject to a 40% income tax.

* $100.00 (after-tax income of year 1) + $15.00 (15% return) + $191.66.

* $191.66 = $15.00 (15% interest on $100.00 debt).

* $191.66 = $115.00 (15% interest and debt repayment) + $70.66 (income tax).

* $191.66 = [($115.00 (15% interest on $166.66 debt) + $166.66 (debt repayment)]. Debt repayment is deductible because the loan is taxable.

Adoption of a consumption tax would put the borrower taxed in year 1 in the same position as the taxpayer with taxable receipts sufficient to finance the same amount of consumption, with respect to the advantage they obtain by deferring consumption until year 2. If only consumption is taxed, the taxpayer with taxable receipts of $166.66 in year 1 and $191.66 in year 2, can consume $100 in year 1 and $115 in year 2. If he delays year 1 consumption until year 2, earning the same 15% as we assumed in Table I, he would have $230 to consume in year 2, which is $115 more than in year 1. The $230 is the result of $383.32 of taxable receipts ($166.66 plus 15% of $166.66 plus $191.66) minus a 40% tax on those receipts ($153.32).
TAXING RECEIPTS SUBJECT TO AN OBLIGATION TO REPAY

Tax is not always deferred on funds which the taxpayer is obligated to repay. An embezzler, for example, must pay tax in the year money is embezzled. In so holding, the Supreme Court rejected the use of a net wealth accretion theory to explain why embezzled funds were taxable but loans were not, presumably because the value of the obligation to repay some loans does not equal the loan, and the obligation to repay embezzled funds is not always worthless. Instead, the Court emphasized a different doctrine, that of dominion and control, as the reason for taxing embezzled funds. Use of this doctrine allowed the Court to take an all or nothing approach to the taxation of money received subject to an obligation to repay. When there was sufficient dominion and control, the entire amount of the receipts would be taxable, subject to an offsetting deduction in the year of repayment. Absent sufficient dominion and control, as is presumably true of loans, the money would not be taxable when received, but would be taxed at a later date if the repayment did not occur. This application of the dominion and control doctrine, requires an explanation as to why embezzlement differs from borrowing so significantly that embezzled funds should be taxed but loans should be tax-free.

The critical distinction between embezzlement and borrowing is that the embezzler usually has much greater control over whether and when to repay the funds. There are three significant tax policy reasons why such control argues for taxation in the year of receipt. First, the increase in the likelihood that the funds will have to be reported as income sometime argues for including them at the most convenient time, which is the year cash is received. Delaying tax until repayment becomes unlikely places a heavy burden on the government to identify whether and when such an event has occurred. Second, control over the timing of repayment allows the taxpayer to choose a low tax year to repay, thereby enjoying use of the borrowed funds in a high tax year.

12 This position was urged by the government in the Brief for the United States at 23, James v. United States, 366 U.S. 213 (1961).
13 James v. United States, 366 U.S. 213, 217 (1961). The doctrine of dominion and control is far more pervasive in the tax law than is the net wealth accretion doctrine. It recurs in doctrinal settings as varied as determining who the taxpayer is, see, e.g., Helvering v. Clifford, 309 U.S. 331, 335 (1940); Corliss v. Bowers, 281 U.S. 376, 378 (1930), what constitutes income, see, e.g., Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955), and when income arises, see, e.g., North Am. Oil Consol. v. Burnet, 286 U.S. 417, 422-23 (1932).
15 United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931) (corporation's purchase of its own bonds for less than par value results in taxable gain to the extent that par exceeds purchase price).
but paying tax on the funds used to repay the loan in a low tax year. Third, the discretion to postpone payment gives the embezzler a psychological affinity to the taxpayer who obtains funds not subject to repayment. This point has been made most effectively in a case dealing with an accrual basis taxpayer who sought to accrue a debt payable some twenty or more years in the future. The court disallowed accrual, noting that the taxpayer lacked “invisible strings” on the use of the money; he did not even have “an eye to the upcoming expenses.” This case embodies the idea that the future is uncertain; as the time for repayment recedes into the future, the burden of payment weighs so lightly on the taxpayer that it is unfair to taxpayers in receipt of taxable income to distinguish them from other taxpayers in receipt of funds because of a future obligation to repay. The embezzler, even more than the taxpayer who must pay in twenty or more years, lacks “invisi-

Another distinction between the embezzler and the borrower is the undesirability of the embezzler’s activity. Any doubts that might exist on the question of dominion and control in the year of receipt are, therefore, likely to be resolved against the embezzler. By contrast, the effect of taxing borrowing in the year of the loan would seriously disrupt a common commercial activity.

The relevance of these considerations emerges clearly in cases in which a taxpayer improperly receives funds which he then agrees to repay. In Buff v. Commissioner, the taxpayer had embezzled over $20,000 from his employer. When he was caught later the same year he agreed to repay the funds, signed a note to that effect, borrowed $1,000 from a bank to begin repayment and agreed to have $25 per week withheld from his salary until the money was repaid. The tax court was very impressed with the steps taken to repay the funds and held that the taxpayer did not have to include the embezzled funds in income. The Second Circuit disagreed, stressing that the obligation to repay had no value. Given the fact that the employer, rather than the employee, terminated the wage withholding agreement, this finding surely understated the value of the debt. Still, by the standards discussed earlier, Buff was properly taxed in the year he received the money. The chances of his not making good on the debt were considerable, and the fifteen years it would have taken, at $25 per week, to pay the debt was a long

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18 Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1969).
17 Id. at 409.
16 496 F.2d 847 (2d Cir. 1974).
20 496 F.2d at 848-49.
21 58 T.C. at 226, 232.
22 See text accompanying notes 16-17 supra.
time. Any doubts were understandably resolved against Buff, given the circumstances under which he obtained the money.

Similar considerations prevailed in *Gilbert v. Commissioner.* The taxpayer, a major stockholder of a corporation, withdrew funds so that he could acquire another company to be merged into the original corporation. Only one officer of the corporation knew of the withdrawal of funds at the time it was made; the board of directors subsequently refused to ratify the taxpayer's actions. Within two weeks of acquiring the funds, the taxpayer signed a note for repayment and pledged security, the value of which substantially exceeded the loan. After the taxpayer's fortunes suffered reversal a few weeks later, he left for Brazil and the debt was never repaid. The tax court, operating under the rule which requires it to follow decisions of the appellate court to which an appeal lies, ruled in favor of the government, citing the Second Circuit reversal of its decision in *Buff.* The tax court had not reckoned, however, with the appellate court's willingness to examine closely the extent of dominion and control retained by the taxpayer over repayment and the policy implications of the acquisition of funds. The taxpayer won on appeal because he had backed up his promise to repay with adequate security and because the funds had been acquired to help the corporation.

Finally, in *United States v. Merrill,* the taxpayer was not taxed on trustee commissions which he agreed to repay after discovering that he did not have a right to keep them. He did not pledge security, but his good faith was unquestioned and he made restitution in two years. The

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23 552 F.2d 478 (2d Cir. 1977).
24 Id. at 479.
25 Id. at 479-80.
26 Id.
27 Id. at 480.
30 Id. at 456 (citing Buff v. Commissioner, 496 F.2d 847 (2d Cir. 1974)).
31 552 F.2d at 481. In Quinn v. Commissioner, 524 F.2d 617, 619 (7th Cir. 1975), an unauthorized payment had been obtained from a corporation for the benefit of a controlling employee. The court in *Gilbert* stated that the difference between *Quinn* and *Gilbert* was that, in *Quinn,* there had been no contemporaneous acknowledgement of the obligation to repay, 552 F.2d at 481 n.8. In *Quinn,* the acknowledgement occurred in the form of a note and security of unspecified value about three months after the money had been received, 524 F.2d at 619; but in *Gilbert,* the acknowledgement occurred within about two weeks of the receipt, 552 F.2d at 479. A better way to distinguish *Quinn* from *Gilbert* would have been the fact that, although Quinn gave a note, he apparently did not give adequate security.
32 552 F.2d at 481.
33 211 F.2d 297 (9th Cir. 1954).
34 Id. at 304.
35 Id.
absence of illegality in the acquisition of these funds was probably rele-
vant not only in indicating the likelihood of repayment, but also as a fac-
tor inclining the court towards a decision in favor of the taxpayer.\textsuperscript{36}

The case law dealing with funds received subject to an obligation to
repay can be summarized as follows. The distinction between embezzle-
ment and borrowing is usually so clear, both in terms of dominion and
control and the desirability of the taxpayer's acquisition of the funds,
that the court need not be self-conscious in applying these criteria.
When there is a consent to repay improperly acquired funds, however,
courts deal with the relevant criteria more explicitly. Close cases are
decided by examining how much control over repayment the taxpayer
retains and what social value attaches to the acquisition of the funds.
The next section will discuss instances of borrowing in which an explicit
focus on the dominion and control and the social value of the loan would
make the tax-free status of the loan very questionable.

**TAXABLE LOANS?**

The circumstances under which some borrowers obtain loans make
them much closer to the embezzler than to the typical borrower. Three
such situations are borrowing from related entities, nonrecourse loans
secured by appreciated property and nonrecourse purchase money loans
in tax shelters.

*Borrowing from Related Entities*

When an owner of a corporation or other business obtains a loan from
the business, tax deferral depends on the loan's having economic reality,
demonstrated by the taxpayer's solvency or pledge of adequate securi-
ty,\textsuperscript{37} and on an "intent to repay" the loan.\textsuperscript{38} The "intent to repay" test
will be examined here because its interpretation is insufficiently in-
fluenced by the considerations which should determine whether the tax-
ation of funds received subject to an obligation to repay ought to be
defered.\textsuperscript{39}

\textsuperscript{36} Cf. I.R.C. § 1341(a) (repayments of funds received under a claim of right can be
deducted at the higher of the tax rates in the year of receipt or repayment).
\textsuperscript{37} See, e.g., Fisher v. Commissioner, 54 T.C. 905, 910-11 (1970) ("loan" to insolvent
general manager was "salary"; general manager was father of 100% shareholder). In Estate
of Helene Simmons v. Commissioner, 26 T.C. 409, 424 (1956), the court noted that the tax-
payer was a wealthy woman able to repay the debt.
\textsuperscript{38} Haber v. Commissioner, 52 T.C. 255, 266 (1969), aff'd, 422 F.2d 198 (5th Cir. 1970);
Chism's Estate v. Commissioner, 322 F.2d 956, 960 (9th Cir. 1963); Fisher v. Commissioner,
\textsuperscript{39} The loan status of a transfer may also be doubtful in settings other than a distribution
of cash by a business to a controlling owner. Contributions to a business may be equity con-
The following example illustrates the difficulty with the “intent to repay” test. The taxpayer has a controlling interest in a corporation. He finds that his salary is too low for his personal needs in year 1 and he borrows $10,000 from the corporation. He gives the corporation a note, but there is no interest or security pledged, and no time is specified for repayment. In both years 4 and 6, the taxpayer repays $2,000. At first glance, it seems very strange to exclude the $10,000 from income in year 1 merely because the taxpayer intends to repay. The taxpayer need not follow up on his intent, can choose to repay in a low tax year and can postpone repayment for a long time. Moreover, low interest consumer loans by a business to a controlling owner are not the typical loans which would be disrupted if loans were generally taxable. In other contexts, the Internal Revenue Code is not sympathetic to loans between a taxpayer and a related entity.\textsuperscript{40}

These considerations have, in fact, combined with the vagueness of the “intent to repay” test to produce “special scrutiny” of such transactions.\textsuperscript{41} In an extreme case—when there is no note, no interest, no security, no repayment and no time limit on repayment—the taxpayer is very likely to be taxed in year 1 on the distribution.\textsuperscript{42} But it remains to be determined whether special scrutiny of such transactions strikes the right balance in deciding when to tax the “borrower.” The key question should not be whether the taxpayer ever intends to repay, but...
whether the control over repayment is so substantial that deferral is inappropriate. The test should be whether the taxpayer "intended to use [corporate] funds as her own financial needs and conveniences dictated."*43

It is difficult to be certain that such a refinement would make a difference, but several factors would probably be applied differently in determining "intent to repay." First, the debtor's giving a note to the corporation would make very little difference if the test focused on taxpayer control over repayment. The only effect of the note would be to increase the ability of corporate creditors to enforce payment in the unlikely case that the corporation was unable to pay these creditors.44 Second, partial repayments would lose much of their significance if they were determined primarily by the personal convenience of the debtor.45 Such a modification falls well within the courts' discretion to develop tax doctrine sensitive to the underlying rationale for the rule,46 barring a complete restructuring of the law to tax loans to individuals who control the lender.47

**Nonrecourse Debt Secured by Appreciated Property**

Debtors often pledge appreciated property as an additional guarantee that they will repay a loan, but a nonrecourse debtor promises to do no

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*43 Roschuni v. Commissioner, 29 T.C. 1193, 1203 (1958). If the debtor has a business partner who can enforce the debt, the debtor's control may be too uncertain to deny loan status, at least if loans are not made to both owners in proportion to their ownership interests. White v. Commissioner, 17 T.C. 1562, 1567-68 (1952).

*44 For example, in Haber v. Commissioner, 52 T.C. 255 (1969), the court placed excessive emphasis on whether the debt was enforceable in bankruptcy, id. at 267, even though that is not relevant to the question whether the debtor intends to repay, and whether repayment will be deferred for an extended period.

*45 Partial repayment is presently an important factor in determining loan status, see Estate of Helene Simmons v. Commissioner, 26 T.C. 409, 424 (1956), unless the payments are insubstantial, see Roschuni v. Commissioner, 29 T.C. 1193, 1203-04 (1958), are occasional, see Wilson v. Commissioner, 10 T.C. 251, 253, 256 (1948), or are made after tax proceedings have begun, see Spheeris v. Commissioner, 284 F.2d 928, 931 (7th Cir. 1961); Roschuni v. Commissioner, 29 T.C. at 1203.

If distributions are taxable dividends, repayments are either deductible as capital losses under Arrowsmith v. Commissioner, 344 U.S. 6 (1952), or are nondeductible contributions to capital. If the distributions are taxable salary, the repayments are probably deductible under I.R.C. § 162(a).

*46 Sensitivity to these considerations is evident in Estate of Franklin v. Commissioner, 544 F.2d 1045, 1048 n.4 (9th Cir. 1976). The court went so far as to forbid a nonrecourse debtor from proving that he thought the purchase price approximated the value of the property, even though the issue of value was relevant, precisely because it indicated whether the debtor was likely to repay the debt.

*47 H. GUMPEL, TAXATION IN THE FEDERAL REPUBLIC OF GERMANY § 9/2.2e(2) (Harvard Law School World Tax Series 2d ed. 1969) (loan to shareholder may be a constructive dividend); M. NORR, TAXATION IN FRANCE § 9/2.3 (Harvard Law School World Tax Series 1968) (rebuttable presumption that loan to shareholder is a dividend).
more than pay the debt or give the security to the creditor, at the debtor's option. For example, an individual who paid $100 for stock which has appreciated to $140, may borrow $125, pledging the stock as security without risking any other assets. Or an employee may borrow money, pledging as security a retirement annuity for which he has paid nothing and which has been provided tax-free by the employer, with no risk other than a reduction of the annuity at some future date. Unlike the recourse debtor, the nonrecourse debtor can retain cash equal to the loan if the security becomes worthless. The nonrecourse borrower will have an incentive to repay the debt if the value of the property is at least equal to the loan, but his option to avoid repayment if the security declines in value puts him in a very different psychological position from the recourse debtor. The strings on the nonrecourse debtor's money, though not "invisible," are certainly much less visible than in the case of the recourse debtor.

The nonrecourse debtor is also in a position to avoid ever paying tax on the loan. The law requires an unpaid nonrecourse debt to be included in income when property securing the debt is transferred to the creditor. Thus, if the debtor still owes $125 on the pledged stock when the stock is transferred to the creditor to repay the loan, the $125 debt should be taxed in the year of the transfer. Similarly, if the employee who borrowed on his retirement annuity does not repay the loan, he should include the loan in income when he collects his annuity. It will be easy for the taxpayer and the government to overlook these events as taxable transactions, however, because cash is not transferred to the taxpayer. Like the embezzler, the nonrecourse borrower who pledges appreciated property may never pay tax on the loan.

Finally, the tax advantages enjoyed by the borrower who pledges appreciated property accrue to taxpayers who already enjoy a substantial amount of untaxed economic security. We may not want to adopt a wealth tax in this country, but the absence of such a tax argues

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48 See, e.g., Woodsam Assocs. v. Commissioner, 198 F.2d 357, 358-59 (2d Cir. 1952).
50 See text accompanying notes 16-17 supra. If the taxpayer is personally liable, however, the strings are quite visible and the loan should not be taxed. See Arlen v. Commissioner, 48 T.C. 640, 647-48 (1967).
52 The court expressed some doubt on this point in Minnis v. Commissioner, 71 T.C. 1049, 1056-57 (1979).
strongly for not adopting income tax rules that favor taxpayers with significant wealth advantages. These considerations have not prevailed under current law, however. In Woodsam Associates v. Commissioner,\textsuperscript{55} the court held that taxpayers who pledge appreciated property pay no tax on the loan even when the debt is nonrecourse and the loan exceeds the basis of the pledged property. Also, in Minnis v. Commissioner,\textsuperscript{56} the tax court declined an opportunity to tax nonrecourse loans secured by retirement annuities funded by tax-free employer contributions. There are doctrinal weaknesses in these opinions which suggest that a bias against taxing loans distorted the decisions. In Woodsam Associates, the court required a disposition of property as a condition of taxing gain,\textsuperscript{57} even though the Internal Revenue Code section cited as authority merely described how to compute gain in a taxable disposition, while another section taxed gain without regard to whether there was a disposition.\textsuperscript{58} In Minnis, the tax court was influenced by the fact that Congress had already dealt with the problem of tax-free loans in the case of owner-employees,\textsuperscript{59} even though drawing negative inferences from selective legislative action is a highly questionable practice.\textsuperscript{60} The tax court was also persuaded that legislative policy favored insurance policy loans, even though the tax statute favors such loans only when the taxpayer has already invested after-tax funds.\textsuperscript{61} Other courts, more sensitive to the considerations that should govern the taxation of loans, might reach a different result.\textsuperscript{62}

\textbf{Nonrecourse Debt in Tax Shelters}

In a tax shelter, the purchase of investment property is financed by a

\textsuperscript{55} 198 F.2d 357 (2d Cir. 1952).
\textsuperscript{56} 71 T.C. 1049 (1979).
\textsuperscript{57} 198 F.2d at 359.
\textsuperscript{59} 71 T.C. at 1056.
\textsuperscript{60} See, e.g., United States v. Midland Ross Corp., 381 U.S. 54, 60 (1965); Knetsch v. United States, 364 U.S. 361, 367 (1960).
\textsuperscript{62} There were also special facts which might distinguish these cases. In Woodsam Associates, the taxpayer rather than the government argued for taxing the loan to obtain a higher basis. 198 F.2d at 359. In Minnis, an IRS employee had told the taxpayer that the loan was tax-free, and the loan was in fact repaid the next year. 71 T.C. at 1051.
nonrecourse purchase money mortgage. The equity and policy considerations in allowing tax deferred loans to finance investments may seem very different from those applicable to embezzlers and borrowers who enjoy the unrestricted use of funds. However, the inclusion of unpaid debt in basis, which is available for depreciation and other accelerated deductions, allows the tax shelter investor to convert the loan into a tax deferred consumer loan available for unrestricted use, with significant equity and policy implications. This is illustrated in Table II. An individual makes a $1,000,000 investment, using $150,000 of his own funds and borrowing the remaining $850,000 by a nonrecourse loan (column 1). The loan is repayable in level payments over 10 years, with interest computed at 10% on unpaid debt (column 2); total annual payments of debt and interest are $138,334. Accelerated depreciation is available (column 3) and receipts from the venture are $100,000 per year (column 4). The conversion of the tax deferred investment loan to a tax deferred consumption loan is apparent from a comparison of columns 3 and 5, summarized in column 6. Column 5 records the depreciation available if the depreciation deductions are limited to out-of-pocket investment, thereby eliminating the deduction for unpaid debt. For example, in year 1, the total undeducted investment of $203,334 exceeds the $200,000 depreciation deduction (column 3), which is therefore fully available with or without the limit. In year 2, however, there is a difference between allowing depreciation with and without the limit. In year

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\[ \text{See generally text accompanying notes 11-62 supra.} \]

\[ \text{See Mayerson v. Commissioner, 47 T.C. 340, 351-52 (1966).} \]

\[ \text{An investor typically puts up 10-30\% of the cost of the venture. CONGRESSIONAL BUDGET OFFICE, REAL ESTATE TAX SHELTER SUBSIDIES AND DIRECT SUBSIDY ALTERNATIVES 3-5, 14 (1977) [hereinafter cited as CBO]; McDaniel, Tax Shelters and Tax Policy, 26 NAT'L TAX J. 353, 378 (1973).} \]

\[ \text{Level payments are computed by determining the debt repayment for year 1 and adding the interest on unpaid debt (10\% of the $850,000 unpaid debt in Table I). The debt repayment for year 1 is then subtracted from unpaid debt and the interest in year 2 is 10\% of remaining unpaid debt. The interest for year 2 is then subtracted from the level payment already computed for year 1 to determine the debt repayment for year 2. This process is repeated to determine interest for year 3 and so on. The formula for debt repayment for year 1 is Total Debt = \sum_{n=1}^{i} x (1 + i)^{n-1}x + (1 + i)^{n}x + \ldots (1 + i)^{n}x, where i equals the interest rate, n equals the number of payment periods, and x equals the debt repayment in year 1. Solving for x and rounding to the nearest dollar in Table I results in x = $53,334. The last payment in year 10 is adjusted so that the total debt payments are $850,000. The reduction is necessary due to rounding. The level payment in Table I is $138,334, except in year 10.} \]

\[ \text{The double declining method used in Table I is not available in all cases. The major exception is certain real estate investment. See I.R.C. \S\ 167(a)-(b), (j). Other tax benefits that may be available in the early years of the shelter are: first, the investment credit, I.R.C. \S\ 38 (land and buildings are not usually eligible for this credit, id. \S\ 48(a)(1); second, the deduction for interest and taxes related to construction of an asset, id. \S\ 163(a), 164(a); but see id. \S\ 189 (limiting deduction of such expenses when they involve real estate construction); third, fees paid to general partners, but see Rev. Rul. 75-204, 1975-1 C.B. 185 (requiring such fees to be capitalized); fourth, intangible drilling costs to find oil and gas, I.R.C. \S\ 263(c).} \]
<table>
<thead>
<tr>
<th>Year</th>
<th>1 Equity Payments&lt;sup&gt;a&lt;/sup&gt;</th>
<th>2 Interest Payments</th>
<th>3 Accelerated Depreciation—Including Unpaid Debt&lt;sup&gt;b&lt;/sup&gt;</th>
<th>4 Venture Receipts</th>
<th>5 Accelerated Depreciation—Limited to Investment</th>
<th>6 Income Sheltered by Deducting Unpaid Debt&lt;sup&gt;c&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$150,000</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>1</td>
<td>53,334</td>
<td>85,000</td>
<td>200,000</td>
<td>100,000</td>
<td>200,000</td>
<td>97,999</td>
</tr>
<tr>
<td>2</td>
<td>58,667</td>
<td>79,667</td>
<td>160,000</td>
<td>100,000</td>
<td>62,001</td>
<td>+ 3,834</td>
</tr>
<tr>
<td>3</td>
<td>64,534</td>
<td>73,800</td>
<td>128,000</td>
<td>100,000</td>
<td>64,534</td>
<td>+ 3,834</td>
</tr>
<tr>
<td>4</td>
<td>70,987</td>
<td>67,347</td>
<td>102,400</td>
<td>100,000</td>
<td>70,987</td>
<td>+ 31,413</td>
</tr>
<tr>
<td>5</td>
<td>78,086</td>
<td>60,248</td>
<td>81,920</td>
<td>100,000</td>
<td>78,086</td>
<td>+ 31,413</td>
</tr>
<tr>
<td>6</td>
<td>85,895</td>
<td>52,439</td>
<td>65,536</td>
<td>100,000</td>
<td>85,895</td>
<td>+ 20,359</td>
</tr>
<tr>
<td>7</td>
<td>94,484</td>
<td>43,850</td>
<td>65,536</td>
<td>100,000</td>
<td>94,484</td>
<td>+ 28,498</td>
</tr>
<tr>
<td>8</td>
<td>103,933</td>
<td>34,401</td>
<td>65,536</td>
<td>100,000</td>
<td>103,933</td>
<td>+ 38,397</td>
</tr>
<tr>
<td>9</td>
<td>114,326</td>
<td>24,008</td>
<td>65,536</td>
<td>100,000</td>
<td>114,326</td>
<td>+ 48,790</td>
</tr>
<tr>
<td>10</td>
<td>125,754</td>
<td>12,575</td>
<td>65,536</td>
<td>100,000</td>
<td>125,754</td>
<td>+ 60,218</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>1,000,000</td>
<td></td>
<td>1,000,000</td>
<td>0</td>
</tr>
</tbody>
</table>

<sup>a</sup>The year 10 debt payment is $5 less than is required if the level payment of $138,334 is to be made. Rounding made this adjustment necessary to prevent total debt from exceeding $550,000.

<sup>b</sup>The taxpayer switches from double declining balance to straight-line depreciation in year 6 because the 20% depreciation rate applied to the declining balance produces no greater depreciation than the remaining basis available for depreciation divided by the 5 years of remaining useful life.

<sup>c</sup>Column 3 minus column 5.
2, the $58,667 investment (column 1) is added to the $3,334 of undeducted investment from prior years, but the total is well below the $160,000 depreciation allowed without a limit (column 3). Existing law without a limit therefore allows unpaid debt to shelter $97,999 (column 6) from tax in year 2, even though this amount of cash is available for unrestricted use. The cash flow sheltered by deducting unpaid debt in the early years is exactly offset, however, by the excess of debt payments over depreciation deductions in later years, as the zero sum in column 6 shows. The deduction of unpaid debt through depreciation is therefore the precise equivalent of accruing unpaid debt to offset a consumer loan in the amount of the previously sheltered cash, a loan which is repayable at a later date out of after-tax income.

The equity and policy implications of deferring tax on such loans are questionable. First, repayment out of after-tax income may never occur. Tax shelter investors are suspected of underreporting income in the year they dispose of encumbered property, thereby failing to include the previously sheltered cash in income.65 Second, the investor can choose when he transfers the property to the creditor, thereby controlling the year in which the tax is due. Third, tax shelters favor well-off investors because they have the risk capital to put up the initial investment, thereby obtaining what are in effect low interest consumer loans.66 Policies favoring consumer loans can hardly be meant to have that result. Fourth, the investments made with these nonrecourse loans are of questionable social value because the tax incentives are inefficient.70 In sum, the tax shelter encourages investments of questionable social value which provide high income taxpayers with the equivalent of unrestricted low interest consumer loans in which the debtor can control the year of repayment and can often avoid repaying the debt out of after-tax income. The closest analogy to these loans is the homeowner's loan, which is available with an investment of a small amount of the original purchase price at interest rates less than typical consumer loans, and under circumstances in which the creditor expects to look primarily to the home for collection of any unpaid debt. There are important differences, however, between the homeowner's loan and the tax

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65 See U.S. Dep't of the Treasury, supra note 53.
66 See CBO, supra note 65, at 112 (assuming 7 1/2% interest rate); McDaniel, supra note 65, at 378 (assuming 8% interest rate). Small Loans Acts generally allow interest rates well over 18% per year. See 1 Cons. Cred. Guide (CCII) ¶ 540 (1980). These loans are completely unrestricted in use. Open end credit, which is the typical revolving credit arrangement with a retail store or bank credit card purchase, is usually available at about 18% interest. See id. ¶ 630.
70 CBO, supra note 65, at 37; Panel Discussion on General Tax Reform Before the House Comm. on Ways and Means, 93d Cong., 1st Sess., pt. 4, 553, 556-58 (1973) (statement of Jerome Kurtz); McDaniel, supra note 65, at 360-61, 369-71, 373-76.
shelter loan. The homeowner’s loan is not limited to high bracket taxpayers and the policy considerations have always been thought to favor homeowners.\textsuperscript{71}

This analysis suggests that Congress should re-examine the availability of tax deferred consumer loans provided through the deduction of unpaid nonrecourse debt. Current legislation is extremely inadequate; the law prevents such debt from creating deductible operating losses to shelter nonventure income,\textsuperscript{72} but does not apply if the debt shelters venture income, if the taxpayer is a corporation that is not closely held\textsuperscript{73} or if the venture is a real estate investment.\textsuperscript{74} Allowing the deduction to shelter venture income might rest on the theory that tax abuse arises primarily from sheltering a large amount of nonventure income. However, the tax advantage is derived from sheltering both venture and nonventure income. If an incentive to invest in ventures with a substantial amount of income is desirable because such ventures are productive without regard to tax losses, the correct provision is to allow unpaid nonrecourse debt to shelter venture income only if that income is substantial. Allowing corporations that are not closely held to shelter nonventure income might rest on the mistaken assumption that the sheltered cash cannot be made available to shareholders tax-free;\textsuperscript{75} but, in fact, shareholders will often be able to obtain the use of such cash without paying tax.\textsuperscript{76} Finally, allowing real estate activity to retain tax shelter advantages is difficult to justify on policy grounds because of the inefficiencies of such incentives.\textsuperscript{77}

The disallowance of a deduction for unpaid debt should be compared with other approaches to dealing with tax shelter abuses. The disallowance of such a deduction, although it has its advocates,\textsuperscript{78} is the less

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\textsuperscript{71} See, e.g., I.R.C. § 461(g)(2) (allowing a deduction for prepaid interest on homeowner loans).

\textsuperscript{72} Id. § 465(a), (d).

\textsuperscript{73} Id. § 465(a)(1).

\textsuperscript{74} Id. § 465(c)(3)(D)(i).

\textsuperscript{75} The possibility of a tax on a corporate distribution exists because the excess of accelerated over straight-line depreciation shelters cash from corporate tax but does not eliminate earnings and profits for dividend distribution. See I.R.C. § 312(k)(1).

\textsuperscript{76} First, the opportunity to obtain unrestricted cash persists if the sheltering deductions are expensed costs, not depreciation. Second, unrestricted cash is available to the investors by borrowing on the value of the corporate stock inflated by cash sheltered from tax at the corporate level. Third, if corporate retention of cash coincides with the investors’ expenditure decisions, retention does not impose undesired restrictions on the use of the cash. See generally McDaniel, supra note 65, at 354-66.

\textsuperscript{77} See text accompanying note 70 supra.

\textsuperscript{78} See, e.g., S. Surrey, Pathways to Tax Reform 250-51 (1973); Panel Discussion, supra note 70, at 571 (statement of Jerome Kurtz); Andrews, supra note 9, at 1137, 1153-55, 1181-83. The importance of the deduction of unpaid debt to tax shelters is explained in Analyses Prepared by the Staff of the Joint Committee on Internal Revenue Taxation, Special Supp. No. 17, pt. II to 63 Stand. Fed. Tax. Rep. (CCH) (Mar. 31, 1976) at 7, 20, 38, 46, 63, 71, 82-83.
familiar approach to dealing with tax shelters. It is more common to emphasize the tax advantages which provide a deduction for savings, either temporarily, by accelerating deductions, or permanently, by inadequate recapture. Both approaches focus on improper deductions which, as the consumption tax literature has shown, are the equivalent of taxing the income shielded by the deductions and exempting the return on the after-tax income. This equivalence prompts a third suggestion, which is disallowing the interest deduction to the extent the loan is invested to produce the equivalent of tax exempt income. These approaches are not identical. Eliminating the deduction for savings ends the exemption of income to the extent the savings deduction provided the equivalent of tax-exempt income. Disallowing the deduction of unpaid debt permits the equivalent of exempting income only to the extent the income is earned on out-of-pocket investment. Disallowing interest deductions on loans invested to produce the equivalent of tax-exempt income prevents the exemption of income in the amount of the interest, but allows the equivalent of an exemption on out-of-pocket investment, and on the leveraged gain earned on the investment financed by borrowing. Table III illustrates these approaches more fully.

7 See, e.g., CBO, supra note 65, at 121-40 (accelerated deductions and inadequate recapture); Tax Reform Hearings before the House Comm. on Ways and Means, 94th Cong., 1st Sess. 1473-87 (1975) (statement of Jerome Kurtz) (same); McKee, The Real Estate Tax Shelter: A Computerized Exposé, 57 VA. L. REV. 521, 541-42 (1971) (accelerated deductions). McKee further states that disallowing the deduction for unpaid debt is a “far less precise” solution than eliminating accelerated deductions. Id. at 565.

8 U.S. DEP’T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 123-24 (1977); Andrews, supra note 9, at 1126. For a discussion of the conditions under which this equivalence might not hold, see Graetz, Implementing a Progressive Consumption Tax, 92 HARV. L. REV. 1575, 1598-1611 (1979).

9 Andrews, supra note 9, at 1139.

10 Table III assumes that the taxpayer borrows $85 at 7% interest in year 1. He invests the loan plus $15 of his own, for a total of $100 savings, which produces a 10% return in year 2. The loan is repayable in year 2. The taxpayer is in the 40% bracket in both years. The “correct” depreciation method allows no deduction in year 1 and a $100 deduction in year 2. Accelerated depreciation is allowed, however, so that $100 can be deducted in year 1 and nothing is left over to deduct in year 2. Thus, $100 savings is deductible in year 1. To provide the cash necessary to cover these expenditures, we assume other income of $25 in year 1 (to allow the taxpayer another $15 after tax, in addition to the loan, so that $100 can be saved) and $141.66 in year 2 (to allow the taxpayer sufficient after-tax income to repay the $85 loan).

Column 1 describes current law which places no tax on borrowing, allows a deduction for accelerated depreciation which includes unpaid debt and allows a deduction for interest. The next three columns show the effect of selective withdrawal of benefits. Column 2 eliminates the deduction for saving, allowing only “correct” depreciation. Column 3 limits depreciation to out-of-pocket investment. Column 4 disallows the deduction of interest to the extent the loan finances the equivalent of a tax-exempt return through the deduction of savings.

Eliminating the savings deduction (column 2) costs the taxpayer $2.40, which is the equivalent of 40% tax payable on $6. Six dollars is the tax-exempt return equivalent of allowing the deduction of $100 savings, because the deduction is the equivalent of taxing
### Table III

**Alternative Ways to Limit Tax Benefits in Tax Shelters**

<table>
<thead>
<tr>
<th>COLUMN 1</th>
<th>COLUMN 2</th>
<th>COLUMN 3</th>
<th>COLUMN 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Accelerated depreciation; interest deduction; no tax on borrowing)</td>
<td>(No accelerated depreciation)</td>
<td>(Accelerated depreciation limited to out-of-pocket investment)</td>
<td>(No interest deduction attributable to exempt return)</td>
</tr>
<tr>
<td><strong>Return</strong></td>
<td><strong>Interest</strong></td>
<td><strong>Other</strong></td>
<td><strong>Income</strong></td>
</tr>
<tr>
<td>Year 1</td>
<td>Year 2</td>
<td>Year 1</td>
<td>Year 2</td>
</tr>
<tr>
<td>+ $ 10.00</td>
<td>+ 5.95</td>
<td>+ $ 25.00</td>
<td>+ 141.66</td>
</tr>
<tr>
<td>+ $ 10.00</td>
<td>+ 5.95</td>
<td>+ $ 25.00</td>
<td>+ 141.66</td>
</tr>
</tbody>
</table>

*Sixty percent of the return is, in effect, exempt when savings are deducted at a 40% rate. See note 80 supra. The interest attributable to the 40% of the return which is taxable is deductible. Forty percent of the $5.95 interest is $2.38.*

*40% of the tax paid; a minus (-) is a tax refund.*

### Comparison of Alternative Ways to Limit Tax Benefits

<table>
<thead>
<tr>
<th>(Column 2 v. Column 1)</th>
<th>(Column 3 v. Column 1)</th>
<th>(Column 4 v. Column 1)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Year 1</strong></td>
<td><strong>Year 2</strong></td>
<td><strong>Year 1</strong></td>
</tr>
<tr>
<td>+ 10.00</td>
<td>+ 18.284</td>
<td>+ 4.00</td>
</tr>
<tr>
<td>-(-30.00)</td>
<td>- 58.284</td>
<td>-(-30.00)</td>
</tr>
<tr>
<td>+ 40.00</td>
<td>- 40.006</td>
<td>+ 34.00</td>
</tr>
</tbody>
</table>

*Loss of $40.00 for one year at a 10% return and a 40% tax rate results in a loss of $4.00 minus 40% tax on the $4.00 ($1.60). Thus, the loss is $2.40 in year 2.*

*The loss of $34.00 for one year at a 10% return and a 40% tax rate results in a loss of $3.40 minus the 40% tax on the $3.40 ($1.36). Thus, the loss is $2.04 in year 2.*
Despite the variations among these three approaches, they all focus on borrowing as the major problem. The argument for eliminating the deduction of savings in tax shelters is that investments heavily financed by loans do not deserve tax incentives. The disallowance of the deduction for interest must also be based on the undesirable incentive effects of borrowing, because the deduction for interest simply treats borrowers and investors who make out-of-pocket investments alike. Finally, the disallowance of the deduction of unpaid debt rests on a judgment that the consumer loans thereby created do not deserve tax deferral. Identifying borrowing as the central problem suggests, at the very least, that the solution which explicitly focuses on the effects of tax deferred borrowing by disallowing the accrual of a deduction for unpaid nonrecourse debt deserves very careful consideration. There is, however, another important advantage to emphasizing the problem of deducting unpaid debt. Eliminating the savings deduction and the deduction of interest requires legislative action.

Although the deduction of unpaid nonrecourse debt could also be disallowed by Congress, there are judicial doctrines available to limit such deductions. First, courts allow taxpayers to include unpaid nonrecourse debt in basis, deductible against cash flow, only if the initial debt at least approximates the value of the purchased property.

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the savings, leaving $60 to be invested, and exempting the 10% return ($6) from tax. See note 80 supra. Eliminating the deduction of unpaid debt costs the taxpayer $2.04, which is 85% of $2.40. Eighty-five percent is the portion of the exempt return financed by the loan. In effect, the exempt return attributable to out-of-pocket investment (15%) retains its tax advantage. Eliminating the deduction of interest attributable to the exempt return financed by the loan costs the taxpayer $1.428, which is 70% of 85% of $2.40. In effect, the exempt return is retained on the investment attributable to out-of-pocket investment (15% of the total investment) and on the leveraged gain, which is 30% of return on the 85% of the investment financed by the loan (return of 10% minus 7% interest yields 3% leveraged gain, which is 30% of the 10% return).

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80 McDaniel, supra note 65, at 360-61, 369-71, 373-76.
84 This point can be readily seen by considering how the disallowance of the interest deduction works under I.R.C. § 265(2). If an investor earning a taxable 7% return shifts his investment to a 10% tax-exempt return, he increases his real rate of return to 10% but gives up 7%. The same is true of the investor who, instead of shifting his investment, retains the investment but borrows at 7% interest. He also increases his return to 10%, but gives up the 7% return to pay interest. The investor who shifts his investment to obtain tax-exempt income ends up with no taxable income. The borrower would be in the same tax position if he could deduct the interest, but I.R.C. § 265(2) forbids it. See Denman v. Slayton, 282 U.S. 514, 519-20 (1930) (discrimination between borrower and self-financer constitutional).
85 See text accompanying notes 63-77 supra.
86 Estate of Franklin v. Commissioner, 544 F.2d 1045, 1048 (9th Cir. 1976); Rev. Rul. 78-29, 1978-1 C.B. 62; Rev. Rul. 77-110, 1977-1 C.B. 58; see Marcus v. Commissioner, 30 T.C.M. (CCH) 1263, 1273 (1971); Rev. Rul. 69-77, 1969-1 C.B. 59. This treatment of nonrecourse debt is an application of a broader principle which is that contingent and speculative debt cannot be included in the debtor's basis. Lemery v. Commissioner, 52 T.C. 367 (1969), aff'd per curiam, 451 F.2d 173 (9th Cir. 1971) (net profit obligation); Albany Car Wheel Co.
that case, the equity will build up quickly as the debt is paid and the
purchaser will be unlikely to abandon the property. If the debt exceeds
value, however, the debtor may be tempted to walk away from the prop-
erty and not pay the debt, an arrangement very much like an option
which the taxpayer might or might not exercise. For example, if prop-
erty is worth $900,000 and the taxpayer has made an out-of-pocket in-
vestment of $200,000, incurring an $800,000 nonrecourse debt, the
$100,000 equity in the property sufficiently increases the likelihood of
future debt payment that the debtor is allowed to include the debt in
basis. If, on the other hand, the property is worth only $700,000, the
payment of the $800,000 debt is too uncertain to allow it to be accrued
and included in basis. Because this rule is well-established, it is not im-
mediately apparent what difference it would make if the courts were
sensitive to the equity and policy considerations that should underlie
the rule. The point is that such considerations shape the law not only by
affecting the interpretation of tax rules, but also by indicating how
strictly they are applied. The rule including unpaid nonrecourse debt in
basis depends on the value of the purchased property, the determina-

v. Commissioner, 40 T.C. 831 (1963), aff'd per curiam, 333 F.2d 653 (2d Cir. 1964) (obligation
conditional); Redford v. Commissioner, 28 T.C. 773 (1957) (obligation to pay lesser of $25,000
or one-half of net profits); Hoblitzell v. Commissioner, 19 T.C.M. (CCH) 1197 (1960) (obliga-
tion conditional); Rev. Rul. 55-675, 1955-2 C.B. 567 (transferee assumed the transferor-
lessee's lease obligations). If the obligation is contingent but can be valued, as in the case of
a family annuity, the basis for computing depreciation includes the present value of the
future payments promised by the buyer, but basis includes only actual payments for com-

See Estate of Franklin v. Commissioner, 544 F.2d 1045, 1048 (9th Cir. 1976).

When there is no equity in the property initially, the court must decide what to do if
equity arises at a later date through increases in value or debt payments. This issue was
left open in Estate of Franklin v. Commissioner, 544 F.2d 1045, 1048 (9th Cir. 1976). See also
Columbus & Greenville Ry. v. Commissioner, 42 T.C. 834, 849 (1964), aff'd per curiam, 358
F.2d 294 (5th Cir. 1966), in which the court was apparently willing but unable to find that
later events fixed the obligations that they should be included in basis at that time. In
Redford v. Commissioner, 28 T.C. 773 (1957), the dissent argued that events after the
original purchase had fixed the obligation and that the debt should therefore be included in
basis at that time. Id. at 779 (Kern, J., dissenting). The majority did not comment explicitly
on this argument.

See Crane v. Commissioner, 331 U.S. 1 (1947). The rule itself is an arbitrary line inso-
far as it distinguishes debtors who will pay off a debt from those who will not. Payment is
not a function of current equity but of the debtor's prediction of future equity. A debtor
might make payments on a nonrecourse debt if he thinks the value will rise in the future,
whether or not there is currently equity in the property.

Estate of Franklin v. Commissioner, 544 F.2d 1045, 1048 (9th Cir. 1976) (purchase price
at least approximately equal to value of purchased property); accord, Rev. Rul. 77-110, 1977-1 C.B. 58; Rev. Rul. 78-29, 1978-1 C.B. 62.

Whether the agency will look closely at the taxpayer’s claims about value, and whether courts will be tolerant of the agency’s fact determination, should depend on a careful evaluation of the equity and policy considerations raised by the transaction.93

Similar considerations should influence the court’s scrutiny of the basis of recourse debtors whose solvency is doubtful. When a taxpayer is personally liable but is not solvent, there is good reason to suspect that the parties do not expect the debtor to pay off the debt and that, whatever their expectations, payment is unlikely.94 Courts are sometimes reluctant to consider financial solvency in applying the tax law,95 but in the context of tax shelters, the court should carefully examine the economic reality of personal liability before concluding that basis includes debt.96

93 If unpaid debt is not included in basis initially, the courts must decide how to treat each debt payment, assuming the debt continues to be excluded from basis. There are three ways to deal with future debt payments. First, unpaid debt could be included in basis for depreciation, but depreciation deductions would not be allowed to exceed out-of-pocket investment. This approach is taken in column 5 of Table II and, less severely, by I.R.C. § 465. See generally Adams, Exploring the Outer Boundaries of the Crane Doctrine: An Imaginary Supreme Court Opinion, 21 TAX. L. REV. 159, 174 n.22 (1966); sources cited in note 78 supra. It is not clear that courts could apply this approach without guidance from regulations.

Second, each payment could be added to basis when the payment was made. This is apparently the Commissioner’s position. See Denver & R.G.W. R.R. v. United States, 505 F.2d 1266, 1270 (Ct. Cl. 1974); Rev. Rul. 55-119, 1955-1 C.B. 352, 353-54. Presumably, this means that there is a new basis in the acquired asset to which the depreciation percentage is applied, computing the percentage on the assumption that the asset has a useful life commencing in the year of the new payment. A slightly different approach would treat each debt payment as a new depreciable cost with its own useful life.

Third, each debt payment could be a depreciation deduction. This is the result when the debt depends on future sales. Holden Fuel Oil Co. v. Commissioner, 479 F.2d 613, 616 (6th Cir. 1973); National Util. Prods. Co. v. Commissioner, 37 T.C.M. (CCH) 1851-18 to 1851-22 (1978); Newton Insert Co. v. Commissioner, 61 T.C. 570, 587-89 (1974), aff’d per curiam, 545 F.2d 1259 (9th Cir. 1976) (deductions recaptured under I.R.C. § 1245); see Marcus v. Commissioner, 30 T.C.M. (CCH) 1263, 1274 (1971); cf. Rev. Rul. 78-30, 1978-1 C.B. 133 (debt payments not treated as made by taxpayer when taxpayer not personally liable and third party personally guaranteed payment; taxpayer mere conduit); Rev. Rul. 77-125, 1977-1 C.B. 130 (same). Analytically, this result has much to recommend it when the debtor has no equity in the property. In such cases, the creditor appears to be taking the risks of an owner and the debt payments are similar to an owner’s return on equity, with the “debtor” simply passing the profit along to the creditor. As long as the debtor cannot manipulate the debt payments by prepaying them or paying them in a high tax bracket year, a full deduction for the debt payments as depreciation deductions seems proper. The analytical justification for this approach is diminished, however, if the taxpayer has equity in the property.


96 The Supreme Court’s concern with allowing basis to include unpaid obligations is also apparent in United States v. Chicago, Burlington & Quincy R.R., 412 U.S. 401 (1973). The Court interpreted the law under the 1939 Code to conform to the 1954 Code, so that the
Second, the rules determining taxation when the debtor disposes of encumbered property should not favor further deferral. A tax is imposed if the buyer assumes the liability or takes the property subject to the debt. The tax court's definition of these terms, however, has given taxpayers an opportunity to defer tax beyond the year of disposition. The following example illustrates the problem. A taxpayer owns property with an adjusted basis of $40, encumbered by a $100 debt and worth $150. He has found a buyer who is willing to pay $50 cash in 5 equal annual installments beginning in year 1, giving his negotiable notes to evidence his obligation. The buyer realizes that he will have to pay off the $100 debt and is willing to take over the seller's obligation, which calls for 5 annual $20 installments over the next five years, beginning in year 1. The buyer is also willing to pay the $20 debt payments directly to the seller, along with the annual $10 installments of the purchase price, and let the seller pay the mortgagee. The taxpayer wants very much to avoid paying tax in year 1 on the $60 gain ($100 of unpaid debt minus $40 basis), as well as on the $50 evidenced by the buyer's notes. To that end, the seller suggests to the buyer that the buyer promises to pay the seller $30 per year and the seller promises the buyer that he will pay the creditor the $20 annual payments necessary to extinguish the debt. The seller hopes that this will be neither an assumption of liability by the buyer, because the buyer's obligation runs solely to the seller and not to the creditor, nor a transfer subject to debt, because the seller promises the buyer that the creditor will be paid. Under the law in effect prior to October 20, 1980, there is a double benefit for the seller if he is successful. The $100 unpaid debt will not be an amount realized, with the result that the $60 gain will not be recognized in year 1, and the $60 debt in excess of basis will not be a "payment" in excess of 30% of the $150 selling price, thereby allowing the seller to qualify for the installment sale provisions deferring tax on the payments from the buyer over the 5 year pay-out period. Under the new law, the seller is eligible for the installment method even if payments in the year of sale exceed 30% of the selling price. Nevertheless, deferral of the $60 debt in excess of basis is allowed only if the $100 unpaid debt is not a "payment."
It is difficult to understand how the taxpayer could succeed in this effort to defer tax on the prior loan even longer than he already has. If he was not personally liable to the creditor prior to this transaction, nothing in the arrangement creates a likelihood that the seller will spend his own funds to pay the creditor. All he has promised the buyer is that he will be a conduit to pass along the buyer’s $20 to pay the debt. Even if the seller had been personally liable to the creditor, he remains little more than a conduit, with the power to enforce payment of the $100 debt in the creditor’s behalf. Personal liability will require the seller to pay if the buyer defaults, but that likelihood is not so great that the buyer is denied a basis for his unpaid debt, and that should be sufficient to end deferral for the seller.

Surprisingly, the seller has had some success with this strategem. It turns out that “assuming liability” and taking property “subject to debt” have a customary nontax meaning. A buyer does not “assume liability” if his promise runs only to the seller and he does not take property “subject to debt” if the seller promises to pay the debt. In the first case to deal with this problem, Stonecrest Corp. v. Commissioner, a taxpayer who was personally liable on a note and had structured a sale in the above fashion was found by the court to be eligible for the installment sale provisions. In a later case, this benefit was extended to a nonrecourse debtor who promised the buyer that he would pay the mortgagee. The opportunity afforded by these cases for nonrecourse debtors in tax shelter situations has not gone unnoticed.

The Commissioner argued in these cases that, for tax purposes, there was an assumption of liability or taking subject to debt, whatever the niceties of property law, but the court simply incorporated nontax meaning into tax doctrine. It is unlikely that the court was unaware of its authority to reject nontax meaning to prevent violations of tax
It is more likely that the court was too tolerant of tax deferral and insensitive to the fact that sheltering cash flow with unpaid debt had already given the taxpayer a significant and controversial benefit. Greater sensitivity to these considerations should lead to overruling the *Stonecrest* doctrine and should, in any event, prevent the use of that doctrine by tax shelter investors disposing of tax shelter property.

**LOANS IN A CONSUMPTION TAX**

There are no theoretical uncertainties about how to tax loans in a consumption tax. A loan should be included in taxable receipts and deducted if the proceeds are saved. The accrual of unpaid debt, which results in the exclusion of loans from income in an income tax, is entirely inappropriate in a consumption tax. Accrual of an obligation is a deduction for an anticipated loss in savings, which is arguably proper in an income tax in which increases and decreases in savings are included in computing the tax base. In a consumption tax, however, an increase in savings is deductible and a decrease in savings is a signal for taxation, not a reason for a reduction in the tax base. Unless the taxpayer can show that the savings reduction did not result in consumption, either because it was matched by another investment or because it resulted from a casualty loss, a decline in savings results in an increase in the consumption tax base. In a consumption tax, therefore, taxpayers who borrow for consumption, pledging appreciated property, cannot defer tax; and purchase money debtors who acquire property would pay no tax at the time of the loan, but would have no basis to offset later cash flow. This taxation of borrowing is consistent with the effect of the consumption tax in remaining neutral between current and future consumption. Table IV shows the proper treatment of loans in a consumption tax. The taxpayer is in the 40% bracket and borrows $100 in year 1 at 7% interest, which he invests to yield a 10% return. The year 2 repay-

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110 Cf. *Focht v. Commissioner*, 68 T.C. 223 (1977) & cases cited therein (interpreting “liability” in I.R.C. § 357(c) to exclude the accounts payable of a cash basis taxpayer).

111 In *United Pac. Corp.*, 39 T.C. at 727-28, the tax court emphasized the policies of the installment sale provisions, completely neglecting the problem of deferring tax on past income.

112 The tax court has shown an increasing concern for these problems in *Voight v. Commissioner*, 68 T.C. 99 (1977), *aff'd per curiam*, 614 F.2d 94 (5th Cir. 1980), in which the Commissioner persuaded the court that a buyer's guarantee to the creditor followed by direct payments to the creditor was an “assumption of liability” under the *Stonecrest* doctrine, whether or not it was technically an assumption under state law. *Id.* at 110-14. *Voight* might be a harbinger of an overruling of *Stonecrest*. But see *Levinton, Use of Wrap-Around Mortgages Can Expand Installment Sales Despite IRS Opposition*, 51 J. Tax. 169 (1979).

113 Andrews, *supra* note 9, at 1167-69; see note 10 supra.
ment is deductible because the loan was taxable. The gain is consumed in year 2.

**TABLE IV**

**TAXATION OF BORROWING IN A CONSUMPTION TAX**

<table>
<thead>
<tr>
<th>Real Cash Flow</th>
<th>Tax Computation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year 1</td>
</tr>
<tr>
<td>Borrowing</td>
<td>+ $100.00</td>
</tr>
<tr>
<td>Investment</td>
<td>- 100.00</td>
</tr>
<tr>
<td>Return</td>
<td>+ $ 10.00</td>
</tr>
<tr>
<td>Interest</td>
<td>- 7.00</td>
</tr>
<tr>
<td>Sale of</td>
<td></td>
</tr>
<tr>
<td>Investment</td>
<td>+ 100.00</td>
</tr>
<tr>
<td>Repayment</td>
<td></td>
</tr>
<tr>
<td>of Loan</td>
<td>- 100.00</td>
</tr>
<tr>
<td>Gain</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>+ 3.00</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax</td>
<td></td>
</tr>
<tr>
<td>After-tax</td>
<td></td>
</tr>
<tr>
<td>Consumption</td>
<td></td>
</tr>
</tbody>
</table>

This theoretical simplicity is not always matched by administrative convenience, however. The recording of the loan as a taxable receipt in year 1 may create so many problems that taxpayers will not accept such a requirement. The major difficulty is with consumer loans. For example, if a taxpayer takes out a loan to buy a consumer durable or a home, he may be reluctant to record the loan in taxable receipts for several reasons. If the investment is not deductible, he may have difficulty paying the tax, even with an averaging provision. If the investment is deductible, the taxpayer may be so unfamiliar with including loans in taxable receipts that this method of computing the tax base will not be acceptable. The easiest solution seems to be to ignore both the borrowing and the investment and not require the taxpayer to take into account the future consumption value of the investment. To compensate for not reporting the consumption value, the interest would not be deductible. Exempting the consumption return financed by the loan

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115 See id. at 1154-59.
116 See id. at 1156-57.
117 Graetz, *supra* note 80, at 1618-19.
118 Andrews, *supra* note 9, at 1156, 1158; Graetz, *supra* note 80, at 1618.
might seem nothing more than an implementation of the established relationship between deducting savings, which is permitted in a consumption tax, and disallowing the deduction but exempting the return. Exempting the entire return financed by the loan is not the correct result, however, as Table V shows. Table V assumes that $100 is borrowed to finance a $100 investment in a consumer durable in year 1. Interest and loan payments are $17 in year 2. They are paid out of $17 other income. The real return in consumption value before interest and repayment of debt is $20. The taxpayer is in the 40% bracket in both years. The correct, though unfamiliar, way to tax the transaction under a consumption tax is in column 1. The loan is reported, the investment and interest are deducted and the imputed return on the investment is reported annually. The column 1 approach is therefore unfamiliar in two respects—the loan and an imputed return are reported on the tax return. Column 2 assumes borrowing, investment, imputed return and interest are all not taken into account. The difference between the two methods of dealing with the consumer loan is $1.20, favoring the column 2 “omission” approach. This amount is equal to the tax that would have been paid on the $3 of leveraged gain financed by the loan. The disallowance of the interest deduction did not result in that gain being taxed.

The error which leads to this result is the assumption that disallowing the deduction of savings, which is deductible in a consumption tax, is the equivalent of exempting the full 10% return on the $100 investment. As shown in column 3 of Table V, the equivalence is achieved by exempting the 10% return on only $60, the amount that would be left after paying a 40% tax on the savings. If the taxpayer includes the loan in taxable receipts and pays $40 tax because the savings are not deductible, the remaining $60 could be invested to produce a $12 return. The taxpayer in column 3, who receives that return tax free, ends up in the same position as the taxpayer in column 1, which is the correct consumption tax result. This correct result is achieved without having to be concerned with the difficult administrative task of imputing and taxing the $20 return in year 2, as is required by the column 1 approach.

119 Andrews, supra note 9, at 1126.
120 Andrews, supra note 9, at 1157; see Graetz, supra note 80, at 1614; U.S. Dep’t of the Treasury, supra note 80, at 121.
121 Graetz, supra note 80, at 1619, 1622, notes that disallowing the interest deduction only “approximates” the correct result.
122 See column 4 of Table III, supra, and the related discussion of the shortcomings of disallowing an interest deduction.
123 Andrews would allow the taxpayer to elect this result, but would not require it. Andrews, supra note 9, at 1156.
**Table V**

**TREATMENT OF CONSUMER LOANS IN CONSUMPTION TAX**

<table>
<thead>
<tr>
<th></th>
<th>Column 1 (Borrowing and imputed return taxable; savings and interest deducted)</th>
<th>Column 2 (Borrowing, savings, return and interest left out of account)</th>
<th>Column 3 (Borrowing taxable; interest deducted; savings not deducted; imputed return not taxed)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Real Consumption</strong></td>
<td><strong>Tax Computation</strong></td>
<td><strong>Real Consumption</strong></td>
<td><strong>Tax Computation</strong></td>
</tr>
<tr>
<td><strong>Year 1</strong></td>
<td>+ $100.00</td>
<td><strong>Year 2</strong></td>
<td>+ $100.00</td>
</tr>
<tr>
<td><strong>Year 2</strong></td>
<td>- 100.00</td>
<td><strong>Year 1</strong></td>
<td>- 100.00</td>
</tr>
<tr>
<td><strong>Return</strong></td>
<td>+ $20.00</td>
<td><strong>Year 2</strong></td>
<td>+ $20.00</td>
</tr>
<tr>
<td><strong>Interest</strong></td>
<td>- 7.00</td>
<td><strong>Year 2</strong></td>
<td>- 7.00</td>
</tr>
<tr>
<td><strong>Loan Repayment</strong></td>
<td>- 10.00</td>
<td><strong>Year 2</strong></td>
<td>- 10.00</td>
</tr>
<tr>
<td><strong>Other Income</strong></td>
<td>+ 17.00</td>
<td><strong>Year 2</strong></td>
<td>+ 17.00</td>
</tr>
</tbody>
</table>

**Consumption Value**

- 0.00 + 20.00  0.00 + 20.00  0.00 + 20.00  0.00 + 17.00  12.00 + 100.00  0.00

	× 40%

**Tax**

- 8.00 + 8.00  - 6.80 + 6.80  - 40.00  0.00 + 40.00

**After-Tax Value**

+ 12.00  + 13.20  + 12.00
The tax benefit of not taking into account the consumer loan and the imputed return (column 2) is not objectionable if social policy favors the result. Many would argue for the favorable treatment of borrowing to finance consumption, at least in regard to homes. However, this result might unduly encourage borrowing in an increasingly inflationary economy. The incentive to borrow is aggravated by the fact that taxpayers who invest their own funds would not receive such favorable treatment unless they could defer tax until the time of consumption without imputing a correct return on the investment. The taxation of consumer loans and the exemption of the return on after-tax investment (column 3) may therefore be a desirable approach. The only exception might be ordinary consumer credit financing of current consumption, such as that financed by bank credit cards. In theory, there should be no delay until payment of the debt to tax the consumption. But the delay is usually so short, and the interest rate sufficiently high, that disallowance of the interest deduction is an acceptable result.

Even if the imperfection in the taxation of consumer loans is acceptable, it is important to understand that an imperfection exists. The United States Treasury Department analysis of a consumption tax seems to be indifferent between, on the one hand, taxing the loan and deducting the investment and, on the other hand, allowing the taxpayer to elect to leave out of account the loan, the investment, the return and the interest (the column 2 approach), even when there is no reason to exempt the leveraged gain from tax. Absent a good reason for such exemption, the proper treatment of borrowing in a consumption tax is to include the loan in taxable receipts. Only after including the loan should consideration be given to allowing the taxpayer a choice of deducting the investment, or electing not to deduct the investment, paying the tax and excluding the return on the after-tax investment from the tax base.

This discussion of the proper taxation of borrowing in a consumption tax is also relevant to the definition of income in an income tax. One

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124 See id. at 1159-60.
125 This is especially true of luxury consumption assets that could produce speculative gain, such as jewelry and antique cars. Prepayment of tax on investments in such assets should, in theory, result in excluding the gain from the tax base under a consumption tax. But see Andrews, supra note 9, at 1156, 1158-60; Graetz, supra note 80, at 1616-18. Whatever the result when investors use their own funds, the imperfection of excluding both borrowing and the gain when the purchase of the asset is financed by borrowing would unduly favor speculation in such assets.
126 The taxpayer who invests $60 of his own funds after paying a $40 tax would receive an exempt 12% return, which is the correct consumption tax result. If the taxpayer could postpone tax until the year of consumption, he would be in the same position only if a $20 return were imputed to his investment, leaving him with $12 after paying a 40% tax.
127 Andrews, supra note 9, at 1154-55.
result of considering a consumption tax seriously is to highlight the existing imperfections in the taxation of the savings component of income. An awareness of these imperfections promotes a concern with accurately defining consumption, even if savings are not always taxed. In the context of borrowing, this concern suggests that a tax on consumer loans should not be deferred because of the possibility that savings, so often untaxed when they are clearly present, might decline in the future as a result of repaying the loan. At least in close cases, loans should be taxed under an income tax when they are received, and the repayment should be deducted when savings are depleted to repay the loan in a later year.

CONCLUSION

The exclusion of borrowing from the tax base is a serious error in a consumption tax if the loan finances consumption, and is more problematical in an income tax than is commonly supposed. The issue is not only of concern to Congress. Courts have been insufficiently sensitive to the relevant equity and policy considerations in allowing deferral of tax on loans by owners who borrow from controlled entities, by nonrecourse debtors who pledge appreciated property as security and by tax shelter investors who deduct unpaid nonrecourse debt to obtain low interest consumer loans. Such loans provide an opportunity to consume that is often indistinguishable from the receipt of taxable funds received subject to an obligation to repay. The analogy of such loans to these receipts and the adoption of a consumption tax perspective on income tax problems would end tax deferral for many consumer loans.

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130 See notes 97-112 & accompanying text supra.