The Untold Story of Crane V. Commissioner Reveals an Inconvenient Tax Truth: Useless Depreciation Deductions Cause Global Basis Erosion to Bait a Hazardous Tax Trap for Unwitting Taxpayers

I Jay Katz

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THE UNTOLD STORY OF CRANE V. COMMISSIONER REVEALS AN INCONVENIENT TAX TRUTH: USELESS DEPRECIATION DEDUCTIONS CAUSE GLOBAL BASIS EROSION TO BAFT A HAZARDOUS TAX TRAP FOR UNWITTING TAXPAYERS

I. Jay Katz

Facts not discussed in the Supreme Court’s decision in Crane v. Commissioner (much better known for Footnote 37) reveal an inconvenient tax truth of a hazardous tax trap for unwitting taxpayers (the “Basis Reduction Tax Trap”). For seven years, Beulah Crane operated an apartment building at a loss. For that reason, the substantial amount of allowable depreciation deductions on the building produced minimal tax benefits for her. Notwithstanding the lack of tax benefits, the basis of the apartment building was reduced by the depreciation deductions pursuant to section 1016(a)(2) of the Internal Revenue Code. Under threat of foreclosure, Beulah sold the apartment building for less than its original value. Thus in spite of realizing a loss, she was compelled to recognize phantom gain attributable to those useless depreciation deductions.

In her unsuccessful challenge of the gain she was obligated to

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The author dedicates this article to his ever-supportive wife Peggy who through countless hours over a ten-month period endured the author’s scores of editing and re-editing of the article.
recognize, Beulah did not question the propriety of the basis reduction. Yet, even had she done so, there was long-standing judicial precedent holding basis reduction was mandatory even if the corresponding depreciation deduction produced no tax benefits for the taxpayer. The underlying rationale of this judicial precedent, however, was that the mandatory basis reduction is necessary to prevent taxpayer abuse of the depreciation deduction. Conversely, in the context of the Basis Reduction Tax Trap, the abuse goes the other way, as the mandatory basis reduction causes the conversion of useless depreciation deductions into punitive phantom taxable gain.

Thus, the purpose of the article is to expose the inequities of the Basis Reduction Tax Trap and to advocate the amendment of the Code by incorporating tax benefit components to eliminate it without compromising the integrity of the depreciation deduction. This could be accomplished by creating a new Gain Basis to be reduced only by those depreciation deductions that produced tax benefits. By utilizing the Gain Basis as the subtrahend in the gain computation formula, the Basis Reduction Tax Trap would be eliminated as no gain attributable to useless depreciation deductions would ever be triggered. Because current law basis would continue to serve all of its other functions, the integrity of the depreciation would be preserved from taxpayer abuse.

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The untold story of a legendary vocabulary tax law case reveals an inconvenient tax truth. Pursuant to section 1016(a)(2) of the Internal Revenue Code (Code), the basis of depreciable property is reduced by all depreciation deductions including those that produce no tax benefits for the taxpayer. The following events illustrate the baiting and then the closing of a hazardous tax trap for unwitting taxpayers. Over the course of the ownership period of a depreciable asset, the taxpayer is engaged in a business activity that generates little or no income. Because of the limited income, most or all depreciation deductions the taxpayer is entitled to claim are wasted, as they produce no tax benefits for her. Notwithstanding the lack of tax benefits produced by the depreciation deductions, section 1016(a)(2) requires a basis reduction of the underlying property by the full amount of the allowable depreciation deductions.

Then, perhaps due to economic circumstances beyond the taxpayer’s control (such as an imminent foreclosure), the taxpayer is compelled to sell the depreciable property for an amount between its original cost and adjusted basis. So, in spite of realizing no economic gain (if the selling price were equal to the original cost) or possibly an economic loss (if the selling price were less than the original cost), the sale would result in the taxpayer recognizing phantom taxable gain. This is because all the recognized gain would be attributable to the useless tax depreciation deductions that reduced the asset’s basis below its original cost (hereinafter referred to as the “Basis Reduction Tax Trap”).

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1. I.R.C. § 1016(a)(2)(A)-(B) provides in pertinent part:

General rule. Proper adjustment in respect of property shall in all cases be made ...(2) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization ...to the extent of the amount (A) allowed as deductions in computing taxable income ... and (B) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer’s taxes ... but not less than the amount allowable under this subtitle ... .

2. Unless otherwise indicated, all citations to provisions codified in Title 26 of the United States Code and sections from prior law comparable to the current law version are cited herein as sections of the Internal Revenue Code (Code).

3. I.R.C. § 1001(a) (stating that the gain is the difference between the amount realized and the adjusted basis). In this case, the spread between the amount realized and the adjusted basis is attributable to allowable depreciation deductions.

4. Of course, some of the gain could be potentially offset with a net operating
Although *Crane v. Commissioner* is best known for a footnote that "laid the foundation stone of most tax shelters," facts missing from the Supreme Court's decision divulge that Beulah Crane (Beulah) was a victim of the Basis Reduction Tax Trap. For approximately seven years, Beulah operated an apartment building devised to her by her husband at a loss. At the time of her husband's death, the property was valued at $262,000. Because the apartment building generated minimal rental income over that period, only $3,307 of the $28,000 of allowable depreciation deductions actually produced any tax benefits for Beulah. Notwithstanding the lack of tax benefits, pursuant to section 1016(a)(2), the basis of the apartment building was reduced to $234,000. Faced with imminent foreclosure by the mortgagee, Beulah was compelled to sell the apartment building for $257,500 — $4,500 less than its original value. In spite of realizing an economic loss of $4,500 from the sale, reducing the apartment building's basis by the full amount of tax depreciation deductions resulted in Beulah recognizing $23,500 of taxable gain — more than 85% of which was attributable to useless depreciation deductions. Consequently, due to economic circumstances beyond Beulah's control, such as the lack of sufficient income to prevent the foreclosure of the apartment building that led to its inevitable sale, the

loss deduction from prior tax years. The magnitude of the offset would depend on the amount of the net operating loss available for carryover from those prior tax years. For example, if the depreciable asset were commercial or residential real estate much of the net operating deduction might have been incurred in tax years well prior to the carry forward tax years.

7 *Id.* at 3. This was the unencumbered fair market value of the apartment building. It was secured by a nonrecourse mortgage in the principal amount of $255,000 plus approximately $7,000 of interest arrears.
8 See Tax Court Petition at 7, *Crane v. Commissioner*, 153 F.2d 504 (2d Cir. 1946) (No. 110361).
9 *Crane*, 331 U.S. at 4.
10 *Id.* at 3. The purchase price included the buyers taking the property subject to the principal balance of the nonrecourse mortgage ($255,000) plus net monetary consideration ($2,500).
11 *Id.* at 4. The selling price was actually allocated between the building and the land. With respect to the building, there was a taxable gain of approximately $24,000. As to the land, there was a capital loss of approximately $264. The net effect was a taxable gain of approximately $23,500. For purposes of this article, however, the allocation between the building and the land is ignored and $23,500 is deemed to be the taxable gain from the sale of the entire property.
basis reduction via useless depreciation deductions — as mandated by section 1016(a)(2) — made Beulah a victim of the Basis Reduction Tax Trap.

Despite having all of the components to establish it as a preeminent Supreme Court case showing the harsh punitive tax consequences caused of the Basis Reduction Tax Trap, this aspect of Crane is the case’s untold story. One explanation for this phenomenon is that Beulah’s novel reporting position (rejected by the Supreme Court) completely nullified the role of depreciation and basis reduction in the computation of her taxable gain. In reporting the sale, Beulah rejected the notion that she actually owned, and thus could sell, the physical structure of an apartment building devised to her completely encumbered by mortgage debt. Instead, Beulah viewed the fully encumbered property she sold as a mere nondepreciable equity interest in the apartment building with a zero basis, for net monetary consideration of $2,500 (not treating the nonrecourse debt relief as consideration). Consequently, in computing her gain on the sale, section 1016(a)(2) was not applicable because there were no depreciation deductions to reduce the basis of the zero basis nondepreciable equity interest. So, none of the $2,500 of gain Beulah reported (the amount realized of $2,500, minus the adjusted basis of $0) was attributable to her previously claimed useless depreciation deductions. Therefore, the Supreme Court’s opinion addressed the merits of her reporting position with no reason to delve into the propriety of the section 1016(a)(2) basis reduction by useless depreciation deductions.

Another explanation is that in its disapproval of Beulah’s reporting position, though inconsistent with the facts contained in the Record of the case, the Supreme Court cast Beulah as a tax villain creating the myth that her ultimate purpose was to enjoy the unwarranted benefit of double depreciation deductions. More than thirty years after Crane was decided, two prominent court decisions perpetuated this myth by pronouncing the prevention of the double deductions Beulah was seeking as the essence of the Supreme Court’s

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12 There were ample facts throughout the record of the case indicating Beulah’s enjoyment of minimal tax benefits from the apartment building’s depreciation deductions. None of those facts, however, were discussed or even mentioned in the Supreme Court decision. Transcript of Record, Crane v. Commissioner, 331 U.S. 1 (1947) (No. 68).

13 See infra Part III.A.

14 See supra note 12.

15 See infra Part III.B.1.
decision. As a result, the myth of double deductions became the face of Crane and obscured the ironic truth of the exact opposite: Beulah's receiving minimal tax benefits from depreciation deductions on the apartment building and her victimization by the Basis Reduction Tax Trap.

Yet, even if Crane had been viewed as a Basis Reduction Tax Trap case, there was long-standing judicial precedent including two landmark Supreme Court cases decided prior to Crane, holding that the section 1016(a)(2) basis reduction was mandatory whether or not the depreciation deductions produced tax benefits (hereinafter the "No Tax Benefit Decisions"). Considering this negative precedent, it is unlikely that the Supreme Court would have been any more sympathetic to Beulah's victimization by the Basis Reduction Tax Trap or that the outcome of the case would have been any different.

On the other hand, notwithstanding the likelihood of an adverse decision against Beulah, a closer examination of the No Tax Benefit Decisions reveals their main focus was to thwart taxpayer attempts to

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16 See infra Part III.B.2.

17 See United States v. Ludey, 274 U.S. 295 (1927) (holding that taxpayer could not preserve the initial cost basis of depreciable equipment and recognize a loss upon sale of the underlying property); Virginian Hotel Corp. v. Commissioner, 319 U.S. 523 (1943) (holding basis reduction was mandatory for allowed and allowable depreciation deductions). See infra Part IV.A. and Part IV.D. for a detailed discussion of these two cases.

18 See Kittredge v. Commissioner, 88 F.2d 632 (2d Cir. 1937); Beckridge Corp. v. Commissioner, 129 F.2d 318 (2d Cir. 1942). These are two Second Circuit cases (the circuit in which Beulah resided) in which the taxpayer was snared by the Basis Reduction Tax Trap. Although not specifically raised in the decisions, in both cases useless depreciation deductions were transformed into taxable gain. See infra Part IV.C. for a detailed discussion of these two cases.

Also, in the Crane decision, without directly referencing the mandatory section 1016(a)(2) basis reduction, the Supreme Court stated as follows: "The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain. We have already showed that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets." Crane, 331 U.S. at 15–16 (emphasis added). This quote is very similar to the following statement made by the Supreme Court in Ludey in which it held that the depreciation deduction and corresponding basis reduction were not optional. "The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties. Any other construction would permit a double deduction from the same capital assets." Ludey, 274 U.S. at 301 (emphasis added). So even though the Supreme Court in Crane did not directly address the propriety of the section 1016(a)(2) basis reduction by useless depreciation deductions, its paraphrasing of the Ludey quote provides an indication of its reaching a similar conclusion had the issued been raised in the case.
manipulate the timing of the depreciation deduction and the corresponding basis reduction in efforts to achieve the optimal tax benefit from it. For example, in United States v. Ludey,\(^1\) the first of the No Tax Benefit Decisions, the taxpayer chose not to claim depreciation deductions or reduce the cost basis\(^2\) of depreciable equipment used to extract oil. By virtue of the unreduced cost basis, the taxpayer reported a loss upon the subsequent sale of the equipment.\(^2\) Conversely, if the equipment’s cost basis had been reduced by the allowable depreciation deductions, the taxpayer would have recognized a gain. In deciding the case against the taxpayer, the Supreme Court declared depreciation was not an optional deduction; regardless of whether the taxpayer claimed it, the corresponding section 1016(a)(2) basis reduction was mandatory.\(^2\) So in Ludey, the Supreme Court correctly recognized the importance of the mandatory section 1016(a)(2) basis reduction in preventing the taxpayer from redirecting the timing of the depreciation deduction by not claiming it in its properly deductible year and, thus, not reducing the basis of the underlying property in order to recognize a tax loss in the subsequent tax year of sale.

In Virginian Hotel Corp. v. Helvering,\(^3\) the other Supreme Court No Tax Benefit Decision decided prior to Crane, the taxpayer claimed depreciation deductions early in the depreciation recovery period that were in excess of the allowable amount. Those excessive depreciation deductions, however, produced no tax benefits. The issue presented was whether, in the absence of corresponding tax benefits, a basis reduction by excessive but wasted depreciation deductions was required. If a basis reduction were required, the aggregate amount of depreciation deductions the taxpayer would be able to claim over the remaining tax years of the depreciation recovery period would be correspondingly less than the amount of otherwise allowable depreciation deductions. Citing Ludey, the Supreme Court emphasized that the section 1016(a)(2) basis reduction was not contingent on whether depreciation deductions produced any tax benefits.

\(^1\) Ludey, 274 U.S. 295 (1927).
\(^2\) Although the facts in the case are not entirely clear, it appears that the taxpayer claimed approximately 50% of the allowable depreciation deductions, but totally failed to reduce basis by any amount. In any event, the primary position of the taxpayer was that depreciation deductions were not mandatory.
\(^2\) Ludey, 274 U.S. at 296.
\(^3\) Id. at 300.
\(^3\) Virginian Hotel Corp. v. Helvering, 319 U.S. 523 (1943).
benefits for the taxpayer.\textsuperscript{24} Thus, the excessive depreciation deductions inappropriately claimed in earlier tax years were forever lost and could not be recouped (for example, by not reducing basis) in later tax years.

In contrast to the No Tax Benefit Decisions, in which the taxpayer seeks to defer the depreciation deduction, in the Basis Reduction Tax Trap scenario the taxpayer is the passive victim of the harsh tax consequences of phantom taxable income. Moreover, unlike the No Tax Benefit Decisions in which the taxpayer acted affirmatively to manipulate the depreciation deduction and/or basis reduction to her tax advantage, the taxpayer has no control over the sequence of events leading to the baiting and ultimate closing of the Basis Reduction Tax Trap. For example, Beulah had no control over the limited amount of rental income generated by the apartment building or that most of the much larger amount of allowable depreciations would produce no tax benefits. Yet, the Basis Reduction Tax Trap was baited by the reduction of the basis of the apartment building by those useless depreciation deductions. When Beulah was compelled to sell the apartment building as a last resort to avoid foreclosure, the Basis Reduction Tax Trap snapped shut on her because most of her taxable gain was attributable to those useless deductions. Accordingly, the mandatory section 1016(a)(2) basis reduction that prevents taxpayer abuse of the depreciation deduction in the No Tax Benefit Decisions goes too far when it causes the transformation of useless depreciation deductions into phantom taxable gain for an unwitting taxpayer.

This article fully exposes the inconvenient tax truth and the Basis Reduction Tax Trap's punitive nature by retelling the Crane story from that perspective, relying on relevant facts from the Record of the case that were missing from the Supreme Court's opinion. Because of the punitive tax consequences it causes, the article advocates the elimination of the Basis Reduction Trap by incorporating tax benefit components into the amendment of the basis-related provisions of the Code. Recognizing the importance of the mandatory section 1016(a)(2) basis reduction to prevent taxpayer abuse, however, any such amendments must not compromise the integrity of the depreciation deduction protected by the No Tax Benefit Decisions.

The article begins with a discussion in Part I of the four ways (other than the Basis Reduction Tax Trap) in which the section

\textsuperscript{24} \textit{Id.} at 525–26.
1016(a)(2) basis reduction effectively protects the integrity of the depreciation deduction; and, thus, to which no change to the basis rule should be made. Part II explains the two-step process that ultimately led to Beulah falling victim to the Basis Reduction Tax Trap. Subpart A delves behind the numbers to reveal the minimal tax benefits produced by the allowable depreciation deductions and the corresponding basis reduction of Beulah’s apartment building by mostly useless depreciation deductions that baited the Basis Reduction Tax Trap. Subpart B then explains how the Basis Reduction Tax Trap snapped shut on Beulah when she was compelled to sell the apartment building to avoid foreclosure, only to endure the adverse tax consequences of a mostly phantom gain attributable to useless depreciation deductions.

Part III discusses two reasons why Crane has never been considered a preeminent Supreme Court case to show the punitive tax consequences of the Basis Reduction Tax Trap. Subpart A analyzes Beulah’s novel reporting of the transaction as the sale of a zero-basis, nondepreciable equity interest in the apartment building, devoid of any depreciation deductions and basis reductions. Because the reduction of the basis was not relevant in Beulah’s computation of gain, there was no reason for the Supreme Court to consider the propriety of the section 1016(a)(2) basis reduction by Beulah’s previously claimed, useless depreciation deductions in its opinion. Subpart B explains how the Supreme Court’s disapproval of Beulah’s reporting position created the myth of her so-called quest for the unwarranted benefits of double deductions and tracks the perpetuation of this myth in two subsequent court holdings. The myth of double deductions has obscured the reality of Beulah’s minimal tax benefits from depreciation deductions, as well as her victimization by the Basis Reduction Tax Trap.

Part IV tracks the judicial development of the No Tax Benefit Decisions. In the course of this discussion, it demonstrates how the mandatory section 1016(a)(2) basis reduction that appropriately prevents taxpayer abuse of the depreciation deduction goes too far when it causes the transformation of useless depreciation deductions into phantom taxable gain for the unwitting taxpayer.

Part V recommends that a tax benefit principle approach be implemented in the Code amendments to eliminate the Basis Reduction Tax Trap without compromising the integrity of the depreciation deduction. In doing so, Subpart A examines two examples of current Code sections dealing with depreciation deductions that successfully incorporate tax benefit components. The
proposed amendments to the Code would involve the creation of a new gain basis to be used as the subtrahend in the computation of gain on the sale of depreciable property. Unlike the current law's adjusted basis, however, the new gain basis would be reduced by only those depreciation deductions that produce tax benefits. Accordingly, no portion of the gain recognized upon the sale of the underlying asset would be attributable to useless depreciation deductions. Subpart B.1 explains how using the new gain basis would have saved Beulah from the clutches of the Basis Reduction Tax Trap. Finally, Subpart B.2 shows how continuing unaltered use of the current law's adjusted basis — for purposes of tracking the declining balance of depreciation deductions and of serving as the minuend in loss computation — would preserve the integrity of the depreciation deduction.

I. THE FOUR WAYS THE SECTION 1016(A)(2) BASIS REDUCTION PRESERVES THE INTEGRITY OF THE DEPRECIATION DEDUCTION

As alluded to in the introduction, this article does not wholly dismiss the rationale of the No Tax Benefit Decisions or advocate the wholesale repeal of section 1016(a)(2). Whereas the article advocates an amendment to the Code in order to eliminate the Basis Reduction Tax Trap, it also recognizes the important functions the codependency of depreciation deductions and the section 1016(a)(2) basis reduction serve in preserving the integrity of the depreciation deduction. Specifically, the section 1016(a)(2) reduction of basis by depreciation deductions serves the vital functions of (1) tracking an asset's declining balance available for depreciation deductions over the remaining tax years of the recovery period; (2) precluding the taxpayer from having a second opportunity to receive the tax benefit of a depreciation deduction that did not produce a tax benefit in a prior tax year(s); (3) preventing the taxpayer from enjoying the tax benefit of a nonexistent loss; and (4) preventing the taxpayer from claiming depreciation deductions in excess of the underlying asset's original cost.

A. Tracking the Declining Balance of Depreciation Deductions over the Remaining Tax Years of the Recovery Period

Section 167(a) (authorizing the depreciation deduction) and section 1016(a)(2) (requiring a basis reduction for depreciation deductions) are codependent Code sections. In a landmark case, the Supreme Court defined depreciation as follows:
Depreciation is an accounting device which recognizes that the physical consumption of a capital asset is a true cost, since the asset is being depleted. As the process of consumption continues, and depreciation is claimed and allowed, the asset's adjusted income tax basis is reduced to reflect the distribution of its cost over the accounting periods affected.\(^2\)

Simply stated, depreciation is a means of deducting the cost of an asset utilized to generate taxable income over the multiple years the asset is used up or consumed.\(^3\) The initial cost of the depreciable asset\(^4\) or the taxpayer's after-tax investment\(^5\) is the starting point from which to claim depreciation deductions over the recovery period of the asset.\(^6\) Pursuant to section 1016(a)(2), basis is reduced by each tax year's depreciation deduction. The declining balance of basis reflects the total amount of allowable depreciation deductions over the remaining tax years of the recovery period. Once the adjusted basis reaches zero, depreciation deductions and the corresponding basis reduction cease because the taxpayer has then recovered her entire after-tax investment in the asset.\(^7\)

**B. Precluding a Second Opportunity to Receive the Tax Benefit of a Depreciation Deduction that Did Not Produce a Tax Benefit in Prior Tax Years**

Another important function of the section 1016(a)(2) basis


\(^{26}\) See Liddle v. Commissioner, 103 T.C. 285, 289 (T.C. 1994) ("The primary purpose of allocating depreciation to more than 1 year is to provide a more meaningful matching of the cost of an income-producing asset with the income therefrom; this meaningful match, in turn, bolsters the integrity of the taxpayer's periodic income statements.") (citations omitted).

\(^{27}\) Section 1012(a) defines basis as its cost.

\(^{28}\) See Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184, 188 (Ct. Cl. 1954) (noting that basis represents the taxpayer's after-tax investment in property).

\(^{29}\) Section 167(c)(1) provides "the basis on which exhaustion, wear and tear, obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011." Section 1011 is the adjusted basis of property, i.e., the section 1012 basis as reduced by depreciation deductions per section 1016(a)(2). Section 168(a) sets forth the three essential components necessary in the computation of depreciation deductions, i.e., the applicable depreciation method, the applicable recovery period, and the applicable convention.

\(^{30}\) Obviously, at that point, there is no more basis from which to take any further depreciation deductions.
reduction by all allowable depreciation deductions is to prevent a taxpayer from having a second chance to receive the tax benefit of a depreciation deduction that did not produce a tax benefit in the tax year it was properly deductible. Consistent with the rationale of the No Tax Benefit Decisions, the allowable depreciation deduction in a given year must be taken in that year or be lost forever.31

So if a depreciation deduction would not produce a tax benefit in its properly deductible tax year, the taxpayer does not have the option of skipping the deduction for that year; thus, not reducing the underlying asset's basis. Otherwise, that tax year's unclaimed depreciation deduction would be preserved for later deductibility in the unreduced adjusted basis.

To illustrate this point, assume a taxpayer acquires a depreciable asset for $100. Further assume that in the first year, the taxpayer is entitled to an allowable depreciation deduction of $20. Because the taxpayer lacks income from which to offset the depreciation deduction, she decides not to claim it in that tax year. Subsequently, in the second year, the taxpayer sells the asset for its fair market value of $80. If the asset's basis was not reduced by the $20 unclaimed depreciation deduction, the taxpayer would recognize a $20 loss (adjusted basis $100 minus amount realized $80).32 In essence, the depreciation deduction that did not produce a tax benefit in the first year would re-emerge as a $20 loss in the subsequent tax year of sale. Although Congress has enacted a Code section allowing the depreciation deduction, there is no corresponding guarantee the taxpayer will receive a tax benefit commensurate to the deduction.33 So, whether or not the depreciation deduction produces a tax benefit, section 1016(a)(2) requires a basis reduction to preclude a second opportunity to enjoy the tax benefit of an otherwise lost deduction.

C. Preventing a Taxpayer from Receiving the Tax Benefit of a Nonexistent Loss when Tax Depreciation Exceeds Economic Depreciation

Unlike the harsh punitive tax consequences of the Basis Reduction Tax Trap, if tax depreciation deductions that produce corresponding tax benefits exceed the economic depreciation of the underlying depreciable asset, the section 1016(a)(2) basis reduction

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32 Section 1001(a) defines a loss as the excess of the adjusted basis over the amount realized.
33 See Commerce Co. v. United States, 171 F.2d 189, 192 (5th Cir. 1948).
precludes the taxpayer from enjoying the unwarranted tax benefit of a
deduction for a nonexistent economic loss. Although tax depreciation
is a means to account for the declining value of an asset through wear
and tear, there is no necessary correlation between the tax
depreciation and the economic depreciation of the asset. Even if the
tax depreciation of an asset exceeds its economic depreciation, for as
long as the asset is used in a trade or business, the taxpayer is
nonetheless entitled to claim the full amount of the tax depreciation
deductions with a corresponding basis reduction by the same
amount. The ultimate reckoning of the correlation between tax
depreciation and economic depreciation is determined when the
underlying asset is sold or exchanged for a gain, a loss, or no gain or
loss.

To illustrate this point, consider the following fact pattern: a
taxpayer acquires a depreciable asset for $100 and claims in the first
year a $20 depreciation deduction that reduces her taxable income by
a like amount; in the second year, the taxpayer sells the asset for its
original cost of $100. In retrospect, the $20 tax depreciation deduction
was not economically justified because there was no decline in the
asset’s monetary value. If the basis of the asset were not reduced to
account for the tax depreciation deduction, however, the taxpayer
would not recognize any taxable gain. Consequently, the taxpayer
would have enjoyed the tax benefit of a $20 depreciation deduction
for a nonexistent economic loss.

The section 1016(a)(2) basis reduction prevents the taxpayer,
however, from enjoying such a windfall. Because the asset’s basis was
reduced by the $20 tax depreciation deduction, the subsequent sale of
the asset resulted in a taxable gain of $20. Thus, the unwarranted tax

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34 See Fribourg Navigation Co. v. Commissioner, 383 U.S. 272, 277 (1966) ("In
so defining depreciation, tax law has long recognized the accounting concept that
depreciation is a process of estimated allocation which does not take account of
fluctuations in valuation through market appreciation.") (footnotes omitted).
35 See Simon v. Commissioner, 103 T.C. 247, 262 (T.C. 1994) (stating that violin
bows that were treasured works of art used in taxpayer’s trade or business were
depreciable regardless of whether they actually lost value over the recovery period);
Liddle v. Commissioner, 103 T.C. 285, 293–94 (T.C. 1994) (noting a similar holding in
case involving the depreciation of a 17th-century Ruggeri bass viol used by a full time
musician).
36 This is because the amount realized ($100) would be offset by the adjusted
basis ($100) resulting in no gain or loss.
37 Section 1001(a) provides that “[t]he gain from the sale or other disposition of
property shall be the excess of the amount realized therefrom over the adjusted basis
provided in section 1011 for determining gain . . . ."
benefit of a depreciation deduction for a nonexistent economic loss would be effectively reversed or offset by a corresponding amount of gain triggered by the sale of the depreciable asset.

D. Preventing a Taxpayer Who Claims Excessive Depreciation Deductions that Produce Tax Benefits from Over-Depreciating the Property's Original Cost

A taxpayer who claims depreciation deductions in excess of the allowable amount that reduces taxable income receives an unwarranted tax benefit. In spite of the impropriety of the deductions, any excessive depreciation deductions unchallenged by the Government within the applicable limitations period are treated as being "allowed." Accordingly, if basis were not reduced to account for such allowed depreciation deductions, the aggregate amount of depreciation claimed by the taxpayer over the recovery period would be greater than the cost of the property.

To illustrate the point, assume the taxpayer acquires an asset for $100 depreciable over a five-year recovery period. Further assume that in the first four years of the recovery period, the taxpayer claimed an aggregate amount of $100 of depreciation deductions (all of which reduced taxable income by a like amount) or $20 more than the allowable amount of $80 over that period. If the basis reduction of the asset were limited to the amount of the allowable depreciation deductions, its adjusted basis entering the final year of the recovery period would be $20 — even though the total amount of depreciation deductions claimed by the taxpayer had to this point already equaled the asset's original basis ($100). Moreover, with a remaining adjusted basis of $20, the taxpayer could also claim the final year's allowable depreciation deduction of $20. If this were permitted, the aggregate amount of depreciation deductions claimed by the taxpayer ($120) over the recovery period would have exceeded the asset's original basis ($100) by the $20 of excessive allowed depreciation deductions.

To prevent this abuse, section 1016(a)(2) also requires a basis reduction for all allowed depreciation deductions that produce tax benefits. In the above illustration, as of the end of the fourth year of the recovery period, the original basis of $100 would have been reduced by the $80 of allowable depreciation deductions plus the $20 of allowed depreciation deductions. Consequently, entering the final

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39 For purposes of the illustration, the half-year convention is ignored. See I.R.C. § 168(a)(3).
year of the recovery period, the asset’s basis would be zero. No further depreciation deductions could be claimed. Therefore, even if the Government was barred by the expiration of the applicable limitations period from challenging the excessive depreciation deductions taken in any of the first four recovery years, it could nonetheless challenge an “allowable” depreciation deduction claimed in the final recovery year.40

II. HOW THE BASIS REDUCTION TAX TRAP SNARED BEULAH CRANE

As discussed in Part I, with the exception of the Basis Reduction Tax Trap, the codependency of the depreciation deduction and the section 1016(a)(2) basis reduction is vital to protecting the integrity of the depreciation deduction. Part II, however, discusses the circumstances by which the basis reduction of useless depreciation deductions made Beulah Crane a victim of the Basis Reduction Tax Trap.

A. Step One: Over the Seven Years in Which Beulah Operated the Apartment Building, the Allowable Depreciation Deductions Produced Minimal Tax Benefits for Beulah and Her Husband’s Estate

On January 11, 1932, William M. Crane died and was survived by his wife, Beulah.41 His will named Beulah as the executrix of his estate42 (the Crane Estate) and devised the residuary estate to her, including an apartment building located at 395 Clinton Avenue in Brooklyn, New York (the Brooklyn Apartment Building).43 The Brooklyn Apartment Building’s date-of-death unencumbered fair market value was $262,000.44 It was secured, however, by a

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40 This assumes, however, the final year was an open year for examination.
41 Crane v. Commissioner, 331 U.S. 1, 3 (1947).
42 Id.
44 Although the unencumbered fair market value of the Brooklyn Apartment Building was appraised at $55,000.00 for the land and $207,042.00 for the building, for purposes of this article, the apportionment of the fair market value to the land is ignored. Thus, it is always assumed that the fair market value of the building was the full $262,000. Transcript of Record at 15, Crane v. Commissioner, 331 U.S. 1 (1947) (No. 68).
nonrecourse mortgage in an equivalent amount, comprised of the principal amount of $255,000 plus interest arrears of approximately $7,000.\footnote{45 These amounts appeared on Schedule A and J of the Federal estate tax return, respectively. \textit{Id}.}

Also, because the nonrecourse mortgage was in default at the time of William Crane's death, the mortgagee, Bowery Bank (Bowery) was seriously considering foreclosure.\footnote{46 \textit{Id}. at 8.} Beulah, however, wanted to retain the Brooklyn Apartment Building in the Crane Estate, and, ultimately, to acquire it outright. Taking swift action the day after her husband's will was admitted to probate,\footnote{47 William's will was probated on January 31, 1932. \textit{Id}. at 6.} Beulah persuaded Bowery to allow the Crane Estate to retain ownership of the Brooklyn Apartment Building subject to the outstanding debt. She also promised to pay all of the net rental income it generated (computed without taking into account the depreciation deduction) to Bowery to be applied to the delinquent loan.\footnote{48 \textit{See} Crane v. Commissioner, 331 U.S. 1, 3 (1947).}

On December 31, 1936, the Crane Estate terminated, and the Brooklyn Apartment Building was transferred to Beulah.\footnote{49 \textit{See} Transcript of Record at 6, Crane v. Commissioner, 331 U.S. 1 (1947) (No. 68).} Thereafter, until November 29, 1938,\footnote{50 \textit{See} Crane, 331 U.S. at 3.} when she sold the property, Beulah continued to operate the Brooklyn Apartment Building in her individual capacity. Moreover, true to Beulah's earlier promise, she honored her commitment to pay whatever net rental income was generated to Bowery.

Throughout the entire ownership period of the Brooklyn Apartment Building (between 1932 and 1938), Beulah claimed depreciation deductions in the aggregate amount of $25,200\footnote{51 \textit{See} Transcript of Record at 15–16, Crane v. Commissioner, 331 U.S. 1 (1947) (No. 68). For some unexplained reason, the Supreme Court stated the depreciation deductions claimed by the Crane Estate and Beulah was $25,500. \textit{See} Crane, 331 U.S. at 3, n. 2.} on the Crane Estate's and her own federal income tax returns. Apparently, in claiming those depreciation deductions on the Brooklyn Apartment Building, Beulah utilized the date-of-death unencumbered fair market value as her original section 1014(a) basis.\footnote{52 Although the Record is silent on the point, considering the large amount of the depreciation deductions claimed by Beulah, it would appear that she utilized the unencumbered date-of-death fair market value of the Brooklyn Apartment Building.}
Although absent from the Supreme Court’s opinion, the Record reveals that the relatively large amount of allowable depreciation deductions produced only minimal benefits for the Crane Estate and Beulah. This is because the Brooklyn Apartment Building generated little income to be offset by those depreciation deductions. For example, in 1932 and 1933, the first two years the Brooklyn Apartment Building was held by the Crane Estate, the property generated pre-depreciation deduction net rental income of approximately $3,439 and $1,570, respectively. Of the $7,000 depreciation deductions claimed on the estate’s income tax returns for those years, only $3,113 was needed to eliminate all of the Crane Estate’s tax liability. Then, from 1934 through 1936, the final three years the Crane Estate held the Brooklyn Apartment Building, the property generated zero or negative net rental income, even without considering the depreciation deductions. So, for the final three years, none of the depreciation deductions produced any tax benefits for the Crane Estate. In total, over the five year period the Crane Estate held the Brooklyn Apartment, only $3,113 of the $18,500 depreciation deductions actually produced any tax benefits for the estate. This means most of the estate’s allowable depreciation deductions were wasted.

Similarly, in 1937 and 1938, the two years Beulah operated the Brooklyn Apartment Building in her individual capacity, she claimed the aggregate amount of $6,700 of depreciation deductions on her personal income tax returns. For those years, the Brooklyn Apartment Building generated pre-depreciation deduction net rental income of $1,294 and $1,036, respectively. Only a nominal amount of approximately $194 of the $6,700 of depreciation deductions was needed to reduce the net rental income to achieve zero tax liability. The balance of the depreciation deductions, $6,506, produced no tax benefits.

In summary, due to the limited amount of net rental income generated by the Brooklyn Apartment Building, of the $25,200 of depreciation deductions claimed by the Crane Estate and Beulah,
only $3,307 of those deductions was needed to reduce net rental income to eliminate all tax liability. Consequently, the balance of the depreciation deductions, $21,893, produced no tax benefits. With the addition of $2,800 of allowable depreciation deductions Beulah did not claim, the total amount of wasted depreciation deductions was $24,693. For reasons explained in Part III, none of these facts detailing the minimal tax benefits enjoyed by Beulah and the Crane Estate contained in the Record were addressed — and, in fact, they were misrepresented — in the Supreme Court’s decision.

B. Step Two: Sale of the Brooklyn Apartment Building Triggered the Transformation of Useless Depreciation Deductions into Taxable Gain

The minimal tax benefits Beulah and the Crane Estate received from the allowable depreciation deductions did not, on their own, cause Beulah’s harsh tax consequences. Because the depreciation deductions were more than enough to wipe out the entire tax liability of Beulah and the Crane Estate, the wasted depreciation deductions were simply lost with no other tax significance. It was the second part of the equation, the sale of the Brooklyn Apartment Building with an adjusted basis reduced by those wasted depreciation deductions, however, that caused Beulah to be snared by the Basis Reduction Tax Trap.

Approaching the end of the second year of her individual ownership of the Brooklyn Apartment Building, it was clear Beulah had failed in her efforts to cure the default on the nonrecourse mortgage. In October 1938, Bowery notified Beulah of its intention to bring a foreclosure action against the Brooklyn Apartment Building. Beulah responded by offering to execute a deed in lieu of foreclosure in favor of Bowery. Bowery, however, refused Beulah’s offer. Ultimately, Beulah managed to avoid foreclosure by entering into a “Contract of Sale” with Avenue C Realty, pursuant to which the title of the Brooklyn Apartment Building was transferred from Beulah to Avenue C Realty subject to the outstanding balance of the mortgage.

Id. This would be the sum of the Crane Estate’s $3,113 of tax beneficial depreciation deductions plus Beulah’s $194 of tax beneficial depreciation deductions.

See Crane v. Commissioner, 331 U.S. 1, 4 (1947). Neither the Record nor the Supreme Court decision provided any explanation as to why Beulah failed to claim all of the allowable depreciation deductions.

See Transcript of Record at 7–8, Crane v. Commissioner, 331 U.S. 1 (1947) (No. 68).

Id. at 26–32.
nonrecourse mortgage and interest arrears in exchange for Beulah’s receipt of net monetary consideration of $2,500.63

In the computation of Beulah’s gain upon the sale of the Brooklyn Apartment Building, the Supreme Court (agreeing with the Government’s position) determined the amount realized to be the sum of the principal balance of the nonrecourse mortgage ($255,000 remaining as an encumbrance on the property) treated as liability relief plus the net monetary consideration ($2,500) — at total of $257,500. As to the Brooklyn Apartment Building’s adjusted basis, the Supreme Court applied section 1016(a)(2) and reduced the original section 1014(a) basis of $262,000 by the $28,000 of allowable deductions, arriving at a final adjusted basis of $234,000. Thus, the difference between the amount realized and the adjusted basis resulted in a taxable gain of $23,500.64

Although the Supreme Court correctly applied all relevant Code sections in the computation of Beulah’s taxable gain, it is inconceivable from an equitable perspective that Beulah should have been compelled to recognize such a large amount of taxable gain. First, assuming the amount realized was also the fair market value of the Brooklyn Apartment Building,65 over the seven-year ownership

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63 On the eve of the sale, the principal balance of the nonrecourse mortgage was $255,000 and the interest arrears had increased from $7,000 to approximately $16,000. Id. at 16.
64 See supra note 11.
65 The Supreme Court’s decision assumed the fair market value and purchase price of the Brooklyn Apartment Building was $257,500. Although not relevant to the ultimate holding in the case, the fair market value of the Brooklyn Apartment Building was more realistically $273,500. The particulars of the sale of the Brooklyn Apartment Building to Avenue C Realty tend to support the higher amount. According to the Contract of Sale, Avenue C Realty purchased the Brooklyn Property

[s]ubject to a first mortgage now a lien on said premises, held by Bowery Savings Bank, upon which there is due the principal sum of Two Hundred Fifty Five Thousand Dollars ($255,000) and arrears of interest in the sum of Fifteen Thousand Eight Hundred Fifty-seven 71/100 Dollars ($15,857.71) and interest to accrue after this date.

See Transcript of Record at 29, Crane v. Commissioner, 331 U.S. 1 (1947) (No. 68).

Based on the foregoing provision of the Contract of Sale, in addition to net monetary consideration of $2,500, Avenue C Realty purchased the Brooklyn Apartment Building subject to the principal balance of the nonrecourse mortgage ($255,000) plus interest arrears of approximately $16,000. Simple math indicates the purchase price and likely fair market value of the Brooklyn Apartment Building was the sum of the principal balance of the nonrecourse mortgage, the interest arrears,
period the property actually lost $4,500 of its date-of-death value (from $262,000 to $257,500). Second, virtually all of the taxable gain Beulah was compelled to report was attributable to useless depreciation deductions that reduced the basis of the Brooklyn Apartment Building. In total, there was $28,000 of allowable depreciation deductions on the Brooklyn Apartment Building. Because the amount realized ($257,500) was also $4,500 less than the original basis of the Brooklyn Apartment Building ($262,000), that portion of the allowable deductions on the Brooklyn Apartment Building did not factor into her taxable gain. All of Beulah’s taxable gain of $23,500 (amount realized $257,500 minus $234,000), however, was attributable to the section 1016(a)(2) basis reduction of depreciation deductions. Only $3,307 of those depreciation deduction produced tax benefits for Beulah and the Crane Estate. Thus, $20,193 ($23,500 less $3,307) of Beulah’s taxable gain was the consequence of the basis reduction of useless depreciation deductions.

The following charts set forth a year-by-year breakdown of: net rental income generated by the Brooklyn Apartment Building, the amount of depreciation deductions claimed by the Crane Estate and Beulah, the net income as reduced by depreciation deductions, the section 1016(a)(2) basis reductions, the tax savings the depreciation deductions produced, and the amount of the useless depreciation deductions transformed into taxable gain upon the sale of the Brooklyn Apartment Building.

and the net monetary consideration, or $273,500. In the final analysis, however, whether the fair market value of the Brooklyn Apartment Building was $257,500 or $273,500 would have made no difference in the Supreme Court’s decision. Although the amount realized on the disposition of property subject to nonrecourse liability includes principal and interest arrears, see Allan v. Commissioner, 856 F.2d 1169, 1172 (8th Cir. 1988); Catalano v. Commissioner, T.C. Memo 2000-82, *3 (T.C. 2000), rev’d on other grounds 279 F.3d 682 (9th Cir. 2002), the transferor of the property is deemed to have sold the property for “cash equivalent to the amount of the debt and had applied the cash to the payment of the debt.” Unique Art Mfg. Co. v. Commissioner, 8 T.C. 1341, 1342 (T.C. 1947) (citing Peninsula Prop. Co. Ltd. v. Commissioner, 47 B.T.A. 84 (1942)). So the potential inclusion of an additional $16,000 of interest arrears in the amount realized that would have increased Beulah’s taxable gain would have been offset by an equivalent interest deduction she would have been entitled to take. In fact, in footnote 6, the Supreme Court noted its agreement with the Government’s determination not to include the $16,000 of interest arrears in the amount realized because of the offsetting interest deduction. See Crane, 331 U.S. at n. 6.

For purposes of the illustrations below, it is assumed that the taxable rental income generated each year by the Brooklyn Apartment Building was either zero or a negative number.
### Table 1. The Seven-Year Ownership Period of the Brooklyn Apartment Building (1932-1938)\(^{67}\)

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Rental Income Excluding Depreciation Deduction</th>
<th>Claimed Depreciation Deduction</th>
<th>Net Income as Reduced by Depreciation Deduction</th>
<th>$1016(a)(2) Brooklyn Apartment Building Basis Reduction</th>
<th>Depreciation Deduction Necessary to Achieve Zero Tax Liability</th>
<th>Depreciation Deductions Producing No Tax Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1932</td>
<td>$3,439</td>
<td>$3,500 ($61)</td>
<td>$3,500</td>
<td>$2,243</td>
<td>$1,257</td>
<td></td>
</tr>
<tr>
<td>1933</td>
<td>$1,570</td>
<td>$3,500 ($1,930)</td>
<td>$3,500</td>
<td>$870</td>
<td>$2,630</td>
<td></td>
</tr>
<tr>
<td>1934</td>
<td>-0-</td>
<td>$3,800</td>
<td>At least $3,800</td>
<td>$3,800</td>
<td>-0-</td>
<td>$3,800</td>
</tr>
<tr>
<td>1935</td>
<td>-0-</td>
<td>$3,800</td>
<td>At least $3,800</td>
<td>$3,800</td>
<td>-0-</td>
<td>$3,800</td>
</tr>
<tr>
<td>1936</td>
<td>-0-</td>
<td>$3,900</td>
<td>At least $3,900</td>
<td>$3,900</td>
<td>-0-</td>
<td>$3,900</td>
</tr>
<tr>
<td>1937</td>
<td>$1,294</td>
<td>$3,500 ($2,206)</td>
<td>$3,500</td>
<td>$194</td>
<td>$3,306</td>
<td></td>
</tr>
<tr>
<td>1938</td>
<td>$1,026</td>
<td>$3,200 ($2,464)</td>
<td>$3,200</td>
<td>-0-</td>
<td>$3,200</td>
<td></td>
</tr>
<tr>
<td>Plus Unclaimed Allowable Depreciation Deductions All Years</td>
<td>N/A</td>
<td>$2,800</td>
<td>N/A</td>
<td>$2,800</td>
<td>-0-</td>
<td>$2,800</td>
</tr>
<tr>
<td>Total</td>
<td>$7,329</td>
<td>$28,000</td>
<td>$28,000</td>
<td>$3,307</td>
<td>$24,693</td>
<td></td>
</tr>
</tbody>
</table>

### Table 2. Computation of Taxable Gain upon Sale of the Brooklyn Apartment Building

<table>
<thead>
<tr>
<th>Amount Realized</th>
<th>Allowable Depreciation Deductions</th>
<th>Economic Depreciation That Reduced the Amount Realized</th>
<th>Adjusted Basis as Reduced by All Allowable Depreciation Deductions</th>
<th>Taxable Gain</th>
<th>Depreciation Deductions That Produced Tax Benefits</th>
<th>Useless Depreciation Deductions Transformed Into Taxable Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>$257,500</td>
<td>$28,000</td>
<td>$4,500</td>
<td>$234,000</td>
<td>$23,500</td>
<td>$3,307</td>
<td>$20,193</td>
</tr>
</tbody>
</table>

In summary, despite suffering an economic loss of $4,500, Beulah was compelled to recognize a taxable gain of $23,500 on the sale of the Brooklyn Apartment Building. As demonstrated above, $20,193 of Beulah's $23,500 taxable gain was attributable to the indiscriminate section 1016(a)(2) basis reduction that included depreciation deductions producing no tax benefits for Beulah and the Crane Estate. Ultimately, the Basis Reduction Tax Trap snared Beulah

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\(^{67}\) See Transcript of Record at 6-7, Crane v. Commissioner, 331 U.S. 1 (1947) (No. 68).
because of her misfortune in lacking sufficient taxable income to absorb all of the allowable depreciation deductions, most of which were transformed into taxable gain.

III. WHY CRANE HAS NOT EMERGED AS THE PREEMINENT SUPREME COURT CASE TO SHOW THE HARSH TAX CONSEQUENCES OF THE BASIS REDUCTION TAX TRAP

Part II describes how the Basis Reduction Tax Trap baited and then snapped shut on Beulah. Considering the harsh tax consequences suffered by Beulah were caused by the transformation of useless depreciation deductions into taxable gain, it may seem surprising that Crane did not become a landmark Supreme Court case about the Basis Reduction Tax Trap. Part III submits two possible explanations why this did not occur.

A. Depreciation Deductions and Corresponding Basis Reduction Played No Part in Beulah’s Creative Reporting Position

The dispute between Beulah and the Government involved the computation, and thus the amount of taxable gain, to be reported from Beulah’s sale of the Brooklyn Apartment Building to Avenue C Realty. As discussed below, on her 1938 federal income tax return, Beulah reported the transaction as the sale of a nondepreciable equity interest in the Brooklyn Apartment Building with a zero basis, rather than the physical property itself in exchange for $2,500 (not treating the nonrecourse debt relief as an economic benefit). In the process she disavowed the depreciation deductions she had previously claimed. Because Beulah reported a modest gain of $2,500 — none of which, as computed by her, was attributable to depreciation deductions — the minimal tax benefits produced for her by the prior tax years’ depreciation deductions were probably of no concern to her. Consequently, the Supreme Court’s opinion addressed the merits of her reporting position with no reason to expound on the propriety of the section 1016(a)(2) basis reduction by useless depreciation deductions.

1. Beulah Reported the Transaction as the Sale of a Nondepreciable Equity Interest in the Brooklyn Apartment Building for Net Monetary Consideration of $2,500

Beulah’s novel reporting of the taxable gain from the sale of the Brooklyn Apartment Building to Avenue C Realty was based upon
the following three components: (a) the property sold was a nondepreciable equity interest in the Brooklyn Apartment Building; (b) the original date-of-death basis and the date-of-sale adjusted basis of the nondepreciable equity interest in the Brooklyn Apartment Building were zero; and (c) the amount realized on the sale included only the net monetary consideration of $2,500 she had received from Avenue C Realty.

a. Nondepreciable Equity Interest in the Brooklyn Apartment Building

On the date of her husband’s death, the Brooklyn Apartment Building was encumbered by a nonrecourse mortgage in an amount equal to the fair market value of the property. Consequently, from an equity perspective, the Brooklyn Apartment Building devised to Beulah was worthless. For this reason, Beulah did not perceive the “property” devised to her as being the physical structure of the Brooklyn Apartment Building. Instead, Beulah viewed the devise as a mere equity interest in a property having no value.6 Moreover, as the next part will discuss, an equity interest with no value was nondepreciable. Based upon that premise, Beulah reported the transaction as the sale of a nondepreciable equity interest in the Brooklyn Apartment Building to Avenue C Realty.

b. The Date-of-Death Fair Market Value and Basis of the Nondepreciable Equity Interest Was Zero

Beulah concluded a devise of a worthless, nondepreciable equity interest in the Brooklyn Apartment Building had a date-of-death fair market value — and, thus, a section 1014(a) basis — of zero. Consistent with her view that an equity interest with a zero basis was inherently nondepreciable, Beulah disavowed her right to have previously claimed any depreciation deductions on the property. Consequently, with no basis reductions for nonexistent depreciation deductions, the adjusted basis of her equity interest in the Brooklyn Apartment Building at the time of the sale was also zero.69

66 See Crane, 331 U.S. at 11–12.
69 Id. at 3. Obviously, Beulah had a change of heart as she had previously claimed depreciation deductions on the date-of-death unencumbered fair market value ($262,000) basis of the Brooklyn Apartment Building.
c. The Amount Realized Was Limited to the Net Monetary Consideration Beulah Received from the Buyer

As explained in more detail below, in determining the amount realized from the sale of the Brooklyn Apartment Building, the Government included the relief of the nonrecourse liability ($255,000) remaining as an encumbrance on the property, in addition to the net monetary consideration ($2,500), as economic benefits Beulah received in the exchange. In retrospect, it is highly unlikely that Beulah, in reporting the sale on her 1938 income tax return long before the Government ever challenged it, would have conceived that her transfer of the Brooklyn Apartment Building subject to a nonrecourse liability was debt relief, much less an economic benefit she had received. From Beulah’s perspective, it was a liability that she never had a personal obligation to pay and that would simply remain as an encumbrance on the Brooklyn Apartment Building after the property was transferred to the new owner, Avenue C Realty. 

Beulah more likely viewed the liability as an albatross, since, in spite of her best efforts to cure the delinquency over the seven-year ownership period, the loan remained in default and the interest arrears continued to increase.

So, in arriving at the amount realized, Beulah included the net $2,500 cash in hand as the only economic benefit she received from the sale of the nondepreciable equity interest in the Brooklyn Apartment Building to Avenue C Realty. The following language from the Contract of Sale between Beulah and Avenue C Realty was consistent with Beulah’s perception of the sale: “The purchase price is . . . $3,000 for the equity conveyed by the seller.”

Therefore, Beulah reported her taxable gain as the difference between the amount realized ($2,500) and the adjusted basis of the equity interest ($0), which would have been $2,500. 

70 In response to the Government’s challenge to her exclusion of the nonrecourse liability in the amount realized, Beulah stated, “Nothing could be clearer than that [Beulah] was not obliged to pay interest on the mortgage. The sale of her interest in the real estate did not relieve her of any obligation arising under the mortgage or the mortgage bond because she was never under any such obligation.” Brief for the Petitioner at 24, Crane v. Commissioner, 331 U.S. 1 (1947) (No. 68).

71 See Transcript of Record at 29, Crane v. Commissioner, 331 U.S. 1 (1947) (No. 68) (emphasis added).

72 Crane, 331 U.S. at 3-4.
$2,500 of taxable gain was the true measure of her profit from the sale of an initially valueless equity interest in the Brooklyn Apartment Building. Moreover, considering the modest gain from a nondepreciable equity interest with a zero adjusted basis, the minimal tax benefits Beulah received from the depreciation deductions, as well as any adverse tax consequences caused by a section 1016(a)(2) basis reduction by depreciation deductions she had disavowed (and, thus, believed should never have been taken) were of no relevance to her case.

2. Beulah’s Defense of Her Reporting Position Did Not Focus on the Inequity of the Section 1016(a)(2) Basis Reduction by Useless Depreciation Deductions

Not surprisingly, the Government disputed Beulah’s reporting position as to the nature of the property sold, the adjusted basis, the amount realized, and, therefore, the amount of her taxable gain. As to the property sold to Avenue C Realty, the Government considered it to be the depreciable physical structure of the Brooklyn Apartment Building. In determining its adjusted basis, the Government applied section 1016(a)(2) to reduce the original section 1014(a) basis (the date-of-death unencumbered fair market value of approximately $262,000) by all allowable depreciation deductions (approximately $28,000). Finally, as to the amount realized, the Government included the two economic benefits it deemed Beulah to have received in the transaction: the nonrecourse principal debt relief ($255,000) and the net monetary consideration ($2,500). The resulting taxable gain was approximately $23,500.73

Based on the Government’s computations, the total amount realized was more than 100 times greater than the $2,500 of net monetary consideration Beulah had included on her tax forms. Although the adjusted basis computed by the Government was obviously much higher than Beulah’s computation, the differential between the amount realized ($257,500) and the adjusted basis ($234,000) far exceeded the differential between the amount realized ($2,500) and adjusted basis ($0) computed by Beulah. Ultimately, the most significant disparity between the computations was the $23,500 of taxable gain computed by the Government as compared to the $2,500 of taxable gain computed by Beulah.

Even though the large taxable gain computed by the Government

73 See id. at 4.
was mostly attributable to the section 1016(a)(2) basis reductions by useless depreciation deductions, Beulah's defense of her position did not address that issue. Instead, Beulah attributed the large amount of taxable gain to the inclusion of the nonrecourse liability relief in the amount realized. Her opposition to the Government's position was based on the unconstitutionality of such inclusion and her insistence that the basis of the nondepreciable equity interest in the Brooklyn Apartment Building was zero.

As to the so-called nonrecourse liability relief included in the amount realized, Beulah contended the approximately $24,000 of taxable gain (when she had only received net monetary consideration of $2,500) was not income within the meaning of the 16th Amendment meaning such a calculation violated Article I, Section 9, of the U.S. Constitution, as well as the 5th Amendment. In making this argument in her Supreme Court briefs, Beulah equated the concept of income in the constitutional sense with the receipt of an economic benefit. She asserted she could not receive an economic benefit from the relief of a nonrecourse liability she had no obligation to repay. Accordingly, Beulah argued the inclusion of phantom debt relief in the amount realized created a fictitious gain. Because the resulting gain was not income within the meaning of the 16th Amendment, the tax levied on such income was also unconstitutional.

Ironically, Beulah could have, but did not, advance a similar constitutional argument with respect to the phantom gain triggered by the section 1016(a)(2) basis reduction by useless depreciation deductions. For example, Beulah could have argued that a spurious taxable gain with no corresponding economic benefit was not income in the constitutional sense.

74 See Brief for the Petitioner at 50, Crane v. Commissioner, 331 U.S. 1 (1947) (No. 68).

75 Petition for Writ of Certiorari and Brief in Support Thereof at 8, Crane, 331 U.S. 1 (No. 68), available at http://taft.law.uc.edu/taxstories/chap07/crane04.pdf; Brief in Behalf of Petitioner at 26–28, Crane, 331 U.S. 1 (1947) (No. 68); Brief for the Petitioner at 50–52, Crane, 331 U.S. 1 (No. 68); Petitioner’s Reply Brief at 4, Crane, 331 U.S. 1 (1947) (No. 68).

76 See Brief for the Petitioner, supra note 70.

77 See supra note 75.

78 However, in her Supreme Court brief, Beulah apparently raised the possibility of challenging the propriety of the transformation of useless depreciation deductions into taxable gain. In Paragraph (5) of the Assignment of Errors in her brief, Beulah indicated she intended to urge the Supreme Court to consider as an alternate argument, "whether depreciation on the building should be included in the 'amount
Beulah only referred to the minimal tax benefits from previously claimed depreciation deductions in defense of the apparent hypocrisy of reporting the transaction as the sale of a nondepreciable equity interest in the Brooklyn Apartment Building. As previously discussed, Beulah’s reporting of the transaction in this way was inconsistent with having previously claimed depreciation deductions on the physical structure of the Brooklyn Apartment Building throughout the ownership period, including the year of sale. This inconsistency was noted in the Second Circuit’s decision against her and in the Government’s Supreme Court briefs. In essence, the Second Circuit and the Government accused Beulah of attempting to enjoy the benefit of double deductions — taking depreciation deductions on the Brooklyn Apartment Building to her advantage and then, in reporting her gain from its subsequent sale, disavowing them to eliminate any accountability for those deductions. Moreover, as of the date Beulah filed her Tax Court petition, with the exception of one tax year, the statute of limitations for the disallowance of those depreciation realized upon the sale in 1938 and if so, whether the amount to be included was depreciation ‘allowed or allowable’, or only the depreciation which resulted in tax benefit for [Beulah].” Brief for the Petitioner, supra note 70, at 6. There is nothing in the Record to indicate whether Beulah took any further steps to advance this argument. The Supreme Court never considered it.

70 This includes the $3,200 depreciation deduction Beulah claimed in the year of the sale. See Tax Court Petition VI at 11, Crane, 3 T.C. 585 (1944) (No. 110361) available at http://taft.law.uc.edu/taxstories/chap07/crane01.pdf. The fact that Beulah claimed a depreciation deduction in the tax year of the sale makes her reporting position seem more disingenuous. Having determined she was selling a nondepreciable equity interest in the Brooklyn Apartment Building, Beulah should have claimed no depreciation in that year.

80 See Crane v. Commissioner, 153 F.2d 504, 505 (2d Cir. 1945) (“In the years 1932-1936, inclusive, she had filed income tax returns as executrix of the devisor, in each of which she had claimed and had been allowed deductions for depreciation upon the building; and in the years 1937 and 1938 she had claimed and been allowed similar deductions in her individual income tax return.”); Brief for the Respondent at 6, Crane, 331 U.S. 1 (1947) (No. 68) (“She claimed and was allowed depreciation on the basis of the full value of the apartment building with any reduction on account of the mortgage.”).

81 Apparently, 1938, the tax year of the sale, was the only tax year open for examination by the Government. Interestingly, the Tax Court agreed with Beulah’s contention that the equity interest in the Brooklyn Apartment Building was nondepreciable. For that reason, the Tax Court disallowed the $3,200 depreciation deduction Beulah claimed in 1938. See Crane, 3 T.C. at 591. As to the prior tax years’ depreciation deductions, the Tax Court declined to address the question since those tax years were not before it. Id.
deductions had expired.\(^8\) Even if the Government had acquiesced to her treatment of the sale of a nondepreciable equity interest and disavowal of the previously claimed depreciation deductions, it would have been powerless to make any correlative adjustments for the closed tax years (1932–1937). Therefore, Beulah’s “eleventh hour” renunciation of her right to claim depreciation deductions could be viewed as being self-serving and disingenuous.

In a defensive response to the apparent inconsistency of her reporting position, Beulah discounted any impropriety by noting how miniscule the tax benefits were as compared to the claimed depreciation deductions. Thus, in spite of Beulah claiming depreciation deductions she subsequently disavowed and the Government’s inability to challenge them, Beulah countered that the Government had not really been harmed by the small amount of tax she had saved from the depreciation deductions.\(^8\) Interestingly, in emphasizing the minimal tax benefits she had received from the depreciation deductions in defense of her reporting position, Beulah failed to link the much higher taxable gain they had morphed into as a result of the Government’s inclusion of the nonrecourse liability in the amount realized less an adjusted basis reduced by mostly useless depreciation deductions.

**B. The Double Deduction Myth Becomes Reality**

1. The Supreme Court’s Disapproval of Beulah’s Reporting Position Created the Double Deduction Myth

Another reason why *Crane* did not become a landmark case to show the Basis Reduction Tax Trap is the myth created by the Supreme Court that Beulah’s ultimate purpose was to enjoy the unwarranted benefit of double deductions (the Double Deduction Myth). The Supreme Court’s pronouncement of the Double Deduction Myth was made toward the end of the opinion after it had essentially decided the case against Beulah. Basically, it was an after-the-fact admonishment of Beulah’s reporting position. It followed the Supreme Court’s initial response to Beulah’s constitutional challenge

\(^8\) See Brief for the Petitioner at 42, *Crane*, 331 U.S. 1 (1947) (No. 68).

\(^8\) See id. at 46 (“The double deduction in [Beulah’s] case, if it exists at all, was due only to the error of [Beulah] in claiming depreciation which she was not entitled to and the error of the Commissioner in failing to disallow it. The evidence showed that the actual amount of tax loss to the Treasury was between $150 and $200.”).
of a $24,000 taxable gain when she received only $2,500. As discussed above, Beulah asserted the so-called "relief" of a nonrecourse debt she was not obligated to repay was fictitious income so the tax created by its inclusion in the amount realized was unconstitutional.

In response to Beulah's argument, the Supreme Court rejected Beulah's concept of "income in the constitutional sense" as too narrow. Then, as a further criticism of Beulah's reporting position, the Supreme Court made the following infamous pronouncement:

She was entitled to depreciation deductions for a period of nearly seven years, and she actually took them in almost the allowable amount. The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain. We have already showed that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets.

Clearly, the tone of the Supreme Court's pronouncement was consistent with the criticism of Beulah's reporting position by the Second Circuit and the Government. Moreover, it suggested the following presumptions. During the ownership period of the Brooklyn Apartment Building, Beulah enjoyed the tax benefits from the significant amount of depreciation deductions she had claimed against a section 1014(a) basis of $262,000. Then, in reporting her gain from the sale of the Brooklyn Apartment Building, Beulah manipulated the amount realized and the adjusted basis to eliminate any accountability for those depreciation deductions. Accordingly, the resulting limited amount of gain she recognized enabled her to enjoy the tax benefit of those depreciation deductions a second time.

Of course, as documented in Part II, above, those presumptions were simply not true. In fact, the Double Deduction Myth is wholly unsupportable because, as noted in Beulah's Supreme Court briefs and reflected by the income tax returns that were part of the Record, in the tax years when depreciation deductions were taken, they produced minimal tax benefits for Beulah and the Crane Estate.

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84 See *Crane*, 331 U.S. at 12–13.
85 See, e.g., Brief for the Petitioner, *supra* note 70, at 50; Petition for Writ of Certiorari and Brief in Support Thereof, *supra* note 75, at 8.
86 See *Crane*, 331 U.S. at 13.
87 *Id.* at 15 (internal citation omitted).
88 See *id.*
Moreover, from the text of the entire opinion, however, it is difficult to discern where in it the Supreme Court had "already showed" that Beulah would have enjoyed a double deduction on the same loss of assets.\(^8^9\) Although the first sentence of the Supreme Court's pronouncement accurately recounted the depreciation deductions Beulah claimed on the Brooklyn Apartment Building, it also erroneously presumed Beulah had actually enjoyed tax benefits commensurate to those deductions.

Thus, the Supreme Court's admonishment of Beulah's reporting position was without merit when considering the ample documentary evidence in the Record demonstrating the depreciation deductions claimed by Beulah produced minimal tax benefits.\(^9^0\) Accordingly, there was no way the taxable gain Beulah was compelled to recognize could have reversed nonexistent tax benefits from depreciation deductions. For no apparent reason other than its disapproval of Beulah's novel reporting position, the Supreme Court was oblivious to the true facts and created the erroneous myth of her quest for the unwarranted tax benefits of double deductions.\(^9^1\)

\(^8^9\) See Petition for Writ of Certiorari and Brief in Support Thereof, supra note 75, at 4 (noting the Tax Court made no finding with regard to Beulah's lack of tax benefit); see Brief for the Petitioner at 46, Crane, 331 U.S. 1 (1947) (No. 68).

As discussed supra note 17, it is possible the Supreme Court was paraphrasing the following statement from Ludey: "The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties. Any other construction would permit a double deduction from the same capital assets." Ludey, 274 U.S. at 301 (emphasis added) (footnote omitted). Even though the Supreme Court did not attribute its "double deduction" statement to Ludey, it is possible the Supreme Court was advancing the No Tax Benefit Decisions rationale as an alternate reason to decide the case against Beulah. If this was the Supreme Court's intention, what it "already showed" could have been a reference to the Ludey case in which it held that the depreciation deduction and corresponding basis reduction were mandatory. This would be a plausible interpretation of that language considering in the defense of her reporting position, Beulah did not directly raise the section 1016(a)(2) basis reduction the real cause of her harsh tax consequences. Even so, the Supreme Court misconstrued the minimal tax benefits the depreciation deductions actually produced for Beulah and the Crane Estate.

\(^9^0\) See supra notes 51–60 and accompanying text.

\(^9^1\) One explanation for the Supreme Court's failure to mention Beulah's minimal tax benefits might be due to the Tax Court making no finding of fact on this point. See supra note 89.
2. Two Courts Seize upon the Double Deduction Myth as Being the Rationale for the Crane Decision

Ironically, two courts desperately seeking to find a rationale to deny taxpayers who unlike Beulah were actually attempting to enjoy the unwarranted tax benefit of double deductions further validated the Double Deduction Myth by declaring it to be the rationale for the *Crane* decision. The potential for this abuse was attributable to the Supreme Court’s analysis of whether nonrecourse liability relief was an economic benefit to be included in the amount realized. In determining the amount realized, the first step in the computation of taxable gain, the Supreme Court faced a problematic dilemma of deciding whether in addition to the monetary consideration paid to Beulah by Avenue C Realty, the relief of a nonrecourse liability for which Beulah had no personal obligation to repay could be construed as an economic benefit. If not, the amount realized would have been limited to the $2,500 of cash Beulah had received. In that case, the Supreme Court would have been faced with “the absurdity that [Beulah] sold a quarter-of-a-million dollar property for roughly one percent of its value.”

The “absurdity” feared by the Supreme Court did not materialize, however, because the purchase price and fair market value of the Brooklyn Apartment Building ($257,500) exceeded the outstanding balance of the nonrecourse mortgage ($255,000). On that basis, the Supreme Court deemed the economic consideration Beulah received in the exchange for the property to include both the $2,500 of cash plus the nonrecourse debt relief. In other words, the Supreme Court reasoned both elements of the consideration were real economic benefits because Bowery, the mortgagee, would have never permitted Beulah to sell and transfer the Brooklyn Apartment Building encumbered with nonrecourse liability to Avenue C Realty for any monetary consideration unless Avenue C Realty had also agreed to take the property subject to the liability. Accordingly, the Supreme Court viewed the transaction as if Avenue C Realty had purchased the Brooklyn Apartment Building from Beulah by paying off the $255,000 of nonrecourse liability on her behalf (i.e., taking the property subject to it) in addition to paying her net monetary

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92 See *Crane*, 331 U.S. at 12-13.
93 *Id.*
94 See *id.* at 12-14.
95 See *id.*
96 See *id.*
consideration of $2,500.97

Then, perhaps as the result of judicial afterthought, in Footnote 37, the Supreme Court pondered whether it might have reached a different conclusion regarding the economic benefit of nonrecourse debt relief if the principal balance had exceeded the fair market value of the property. In such a scenario, it would be highly unlikely that a mortgagee would permit, and/or a buyer would be willing to pay, any monetary consideration to the seller/mortgagor in exchange for property worth less than the nonrecourse mortgage that encumbered it. Accordingly, in a Footnote 37 scenario, the bootstrapping of the nonrecourse debt relief with the monetary consideration the Supreme Court was able to rationalize in the case before it would be lacking. In spite of the Supreme Court's failure to directly answer the question, it certainly seemed to imply that if presented with a Footnote 37 scenario, it would probably not have treated the nonrecourse debt relief as an economic benefit and would have thus excluded it from the amount realized by the seller.

For more than thirty years following the decision, whether the Supreme Court's likely response to its hypothetical query would be followed in subsequent judicial decisions remained an open question. If the Supreme Court's inclination toward noninclusion of nonrecourse liability in the amount realized were followed, it would lead to taxpayer windfalls with devastating consequences to the Government.98 For example, a taxpayer who utilized nonrecourse acquisition indebtedness to finance the purchase of depreciable property would receive a basis in the property equal to the purchase price. Over the course of the ownership period of the property, the depreciation deductions taken against that basis would provide the taxpayer with a tax benefit by reducing taxable income, resulting in significant tax savings. Then, at a time when the outstanding balance of the nonrecourse debt exceeded the property's fair market value, with no personal obligation to repay the shortfall, the taxpayer could simply abandon the property or "sell" it to a third party subject to the liability for no other consideration. If the amount realized were limited to the fair market value of the underlying depreciable property,99 the nonrecourse liability in excess of fair market value —

97 Id. at 12–14.
98 One scholar noted in footnote 37 it "laid the foundation stone of most tax shelters." Bittker, supra note 6, at 283.
99 See Parker v. Delaney, 186 F.2d 455, 458 (1st Cir. 1950) (holding that the Crane decision established that the amount realized on the sale of property included the amount of the encumbering nonrecourse liability to the extent of the property's
never to be repaid by the taxpayer — which had provided the basis for the substantial tax benefits the taxpayer had enjoyed, would be eliminated from the taxable gain consideration. Stated differently, under these circumstances the taxpayer would have reaped the tax benefits of depreciation deductions without ever expending any after-tax dollars (i.e., the equivalent of double deductions).

Approximately thirty years after Crane was decided, two analogous Footnote 37 scenarios played out in the Third Circuit\footnote{See Millar v. Commissioner, 577 F.2d 212 (3d Cir. 1978.), cert. denied, 439 U.S. 1046 (1978).} and in Tax Court.\footnote{See Tufts v. Commissioner, 70 T.C. 756 (1978), rev'd, 651 F.2d 1058 (5th Cir. 1981), rev'd, 461 U.S. 300 (1983).} In Millar,\footnote{See Millar v. Commissioner, 577 F.2d 212 (3d Cir. 1978.), cert. denied, 439 U.S. 1046 (1978).} the Third Circuit faced a situation where the taxpayers contributed the proceeds of a nonrecourse loan to the capital of an S Corporation, thereby increasing the basis in their stock from which to take flow-through deductions.\footnote{Millar, 577 F.2d at 213.} Similarly, in Tufts,\footnote{Tufts, 70 T.C. at 758-60.} the Tax Court had to decide a case where nonrecourse acquisition debt securing rental real estate owned by a partnership provided the taxpayers with basis in their partnership interests from which to take flow-through depreciation deductions.\footnote{Millar, 577 F.2d at 214-15.}

In both cases, over a number of tax years, bases in entity interests increased with nonrecourse liability, allowing the taxpayers to enjoy the tax benefit of a corresponding amount of flow through deductions. Subsequently, at the time of the disposition of the underlying property, the outstanding balance of the nonrecourse liability was much greater than the fair market value of the underlying property and the taxpayers' adjusted bases.\footnote{Id. at 214.} In computing the potential gain, the taxpayers contended that the amount realized was limited to the fair market value of the property.\footnote{Id. at 214.} Relying on Footnote 37, the taxpayers argued that in the absence of any monetary consideration, they could not receive an economic benefit from the relief of nonrecourse liability in excess of the underlying property's fair market value, and, for that reason, it should not be included in the amount realized.
If the taxpayers had prevailed in these cases, the Government would have been severely whipsawed. In *Millar*, the investment of the $245,000 loan proceeds in the capital of the S Corporation had correspondingly increased the value and bases in the taxpayers' stock by a like amount. Over a number of tax years preceding the lender's foreclosure of the stock that secured the loan, the value of the S Corporation declined by $205,508, reflected in an equivalent amount of deductions that had flowed through to the taxpayers. The outstanding balance of the nonrecourse liability, however, remained at $245,000. If consistent with Footnote 37, the amount realized upon the foreclosure of the taxpayers' stock would have been limited to the much lower fair market value of the stock. Because the fair market value was less than its adjusted basis, the taxpayers would have realized a loss.

Thus, a taxpayer victory would have achieved a huge windfall from the unwarranted tax benefit of double deductions. The $205,508 of operating loss deductions that flowed through to the taxpayers-shareholders would have been the first set of deductions. In addition, the fair market value of the stock and, thus, the amount realized also reflecting the $205,508 loss, would have been the equivalent of a second deduction of the same loss (economically borne by the mortgagee, not the taxpayers). Stated differently, if *Millar* and the analogous *Tufts* case had been decided in favor of the taxpayers, the courts would have essentially approved the use of "Monopoly Money" — borrowed nonrecourse proceeds never to be repaid with after-tax dollars and not taxed when forgiven — to generate deductions to offset taxable income and reduce or eliminate a substantial amount of tax liability.

In spite of this potentially devastating result to the Government, the Supreme Court's suggested likely holding in a Footnote 37 scenario appeared to support the taxpayers' position. On the other hand, even though Footnote 37 was dictum having no binding precedential value, a rejection of the Footnote 37 rationale in these cases could have been construed as two lower courts appearing to "overrule" the Supreme Court. Obviously, both courts understood the only way to eliminate the unwarranted tax benefit of double deductions was the inclusion of the full outstanding balance of the

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108 *Id.* at 215.
109 *Id.*
110 See *Parker v. Delaney*, 186 F.2d 455, 458 (1st Cir. 1950).
111 The *Tufts* case involved a similar scenario. See *Tufts*, 70 T.C. 756.
nonrecourse liability in the amount realized regardless of the fair market value of the property. Its inclusion in the amount realized would eliminate the possibility of double deductions by triggering sufficient taxable gain to cancel out or offset the tax benefits of the previously claimed deductions.

To solve this dilemma, the two courts seized upon the Double Deduction Myth to reach the desired result without appearing to overrule the Supreme Court. In portraying Beulah as a tax villain who sought the unwarranted tax benefit of double deductions, the courts further perpetuated the Double Deduction Myth by declaring it to be "the rationale of the Supreme Court's principal reasoning, analysis and holding." Spinning the Crane holding in this manner, the Third Circuit and the Tax Court were able to justify the inclusion of the full outstanding liability in the amount realized as a way to eliminate the double deductions by explicitly adopting the Supreme Court's rationale. It was also a judicially correct way to circumvent the devastating consequences a pro-taxpayer Footnote 37 outcome would create for the Government by downplaying the footnote's significance as dictum and as a "hypothetical observation with respect to a hypothetical set of facts not before the Court." In the process of two courts seeking a rationale to reach the correct result without appearing to overrule the Supreme Court, however, the Basis Reduction Tax Trap that victimized Beulah remained an untold story while she was vilified as the archetype of the greedy taxpayer.

IV. THE RATIONALE OF THE NO TAX BENEFIT DECISIONS SHOULD BE LIMITED TO PRESERVING THE INTEGRITY OF THE DEPRECIATION DEDUCTION

Part III explains the various reasons why Crane was never viewed as showcasing the inequities of the Basis Reduction Tax Trap. One of those reasons, documented in Part III.A., was Beulah's novel reporting position that eliminated the relevance of depreciation deductions and corresponding basis reductions. Nevertheless, even if

112 Millar, 577 F.2d at 215 ("A finding that the taxpayers did not realize gain as a result of this exchange, after having realized the full economic benefit of this transaction, would entitle them to the type of double deductions of which the Supreme Court so clearly disapproved in Crane."). In coming to the same conclusion, the Tax Court cited this part of the Millar decision with approval. Tufts, 70 T.C. at 765.

113 Millar, 577 F.2d at 215.

114 Id.
the Supreme Court had addressed the inequities of the Basis Reduction Tax Trap, however, the weight of the No Tax Benefit Decisions, including two Supreme Court cases\(^\text{115}\) and three cases in the Second Circuit,\(^\text{116}\) would not have likely changed the result. Yet, the rationale of the No Tax Benefit Decisions was that the section 1016(a)(2) basis reduction prevented the taxpayer from opting not to claim a depreciation deduction in its properly deductible tax year and, thus, not reducing the basis of the underlying property so as to preserve the tax benefit of that deduction for a subsequent tax year. Conversely, in the Basis Reduction Tax Trap, the taxpayer is the passive victim of the section 1016(a)(2) basis reduction because depreciation deductions that never produced a tax benefit for the taxpayer are transformed into phantom taxable gain. Accordingly, in the course of the following discussion of the development of the No Tax Benefit Decisions, the abuse of the depreciation deduction prevented by the section 1016(a)(2) basis reduction in those cases is distinguished from the harsh tax consequences it visits upon the taxpayer caught by the Basis Reduction Trap.

\[\text{A. United States v. Ludey Launches the No Tax Benefit Decisions}\]

United States v. Ludey\(^\text{117}\) was the first of the No Tax Benefit Decisions. In that case, the Supreme Court held a taxpayer could not preserve the initial cost basis of depreciable equipment by failing to claim depreciation deductions in their properly deductible tax years and, consequently, recognize a loss upon the sale of the underlying property in a subsequent tax year.\(^\text{118}\) In Ludey, the taxpayer sold oil mining properties and equipment with an original cost of approximately $96,000 for approximately $81,000.\(^\text{119}\) Although over the course of the ownership period of the equipment the taxpayer claimed approximately 50% of the amount of allowable depreciation deductions,\(^\text{120}\) the taxpayer had not reduced the equipment's basis by

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\(^{116}\) See Beckridge Corp. v. Commissioner, 129 F.2d 318 (2d Cir. 1942); Kittredge v. Commissioner, 88 F.2d 632 (2d Cir. 1937); Hardwick Realty Co. v. Commissioner, 29 F.2d 498 (2d Cir. 1928). Beulah was a resident of New York located in the Second Circuit.

\(^{117}\) 274 U.S. 295 (1927).

\(^{118}\) Id. at 304.

\(^{119}\) Id. at 296–97.

\(^{120}\) Id. at 303.
any amount.

More specifically, the issue presented was whether depreciation deductions were mandatory, and thus whether the cost basis in the equipment had to be reduced by the allowable depreciation deductions. If the basis were reduced, the taxpayer would recognize a gain rather than the loss the taxpayer sought to claim. In this landmark decision, the Supreme Court held that depreciation deductions and a corresponding basis reduction were not optional, denying the taxpayer a loss in the subsequent tax year of sale.121

B. The Second Circuit Explains that Ludey Mandated a Basis Reduction by Depreciation Deductions Even if they Produced No Tax Benefits

Although in Ludey the Supreme Court held that the section 1016(a)(2) basis reduction by allowable depreciation deductions was not optional, the facts before the Court did not specifically address a situation in which the underlying depreciation produced no tax benefit for the taxpayer. In Hardwick Realty Co. v. Commissioner,123 a Board of Tax Appeals case decided shortly after Ludey, this issue was raised. In that case, the taxpayer argued the depreciation deduction was dependant on income from which it was to be deducted against — thus, without income, the depreciation deduction could not be taken.124 Accordingly, in the absence of a valid depreciation deduction, no basis reduction of the depreciable asset could be made. Relying on Ludey, the Board of Tax Appeals rejected the taxpayer’s position and stated as follows: “Depreciation is not made dependent on income or the lack of it, but is a sum which should be set aside each year, in order that at the end of the useful life of a building, the aggregate sums will provide an amount equal to the original cost.”125

On appeal to the Second Circuit, the taxpayer attempted to distinguish the case from Ludey by noting that in the latter case, the taxpayer had income from which depreciation could have been

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121 Id. at 296. Although not explained in the opinion, in spite of claiming approximately $5,000 of depreciation deductions, the taxpayer failed to decrease the basis of the equipment by even that amount.

122 Id. at 304.

123 7 B.T.A. 1108 (1927).

124 Id. at 1110.

125 Id.
Not swayed by the taxpayer’s attempt to distinguish the case, the Second Circuit held that *Ludey* mandated a basis reduction regardless of whether an allowable depreciation deduction was claimed or provided a tax benefit to the taxpayer in the properly deductible tax year. Thus, consistent with *Ludey*, depreciation deductions that did not produce a tax benefit for the taxpayer could not be preserved for another tax year by not reducing basis.127

C. Kittredge v. Commissioner and Beckridge Corporation v. Commissioner: Two Second Circuit No Tax Benefit Decisions in Which the Taxpayer Was Snared by the Basis Reduction Tax Trap

*Kittredge v. Commissioner*128 and *Beckridge Corporation v. Commissioner*129 were two significant No Tax Benefit Decisions decided by the Second Circuit between the *Ludey* and *Virginian Hotel* Supreme Court decisions. They were hybrid cases because in those cases the section 1016(a)(2) basis reduction not only prevented the taxpayers from resurrecting the tax benefit of unclaimed allowable depreciation deductions in the form of a tax loss (No Tax Benefit Decisions), but also caused the transformation of some of those depreciation deductions into phantom taxable gain (the Basis Reduction Tax Trap). They also demonstrate how the No Tax Benefit Decisions go too far in being punitive to the taxpayer particularly in hybrid cases.

In *Kittredge*, the taxpayer purchased a winery that, including improvements, had a total cost basis of approximately $37,000.130 Although the taxpayer initially leased the winery to a tenant who was to operate it as a grape juice plant, for the most part, it remained idle.131 Because the winery did not generate any income in those tax years, the taxpayer did not claim any of the approximately $25,000 of allowable depreciation deductions or reduce the winery’s basis by that amount.132 As a consequence of not reducing basis, the taxpayer reported a $25,000 tax loss upon the sale of the winery for $12,000.133 The Commissioner challenged the taxpayer’s failure to reduce the

126 Hardwick Realty Co. v. Commissioner, 29 F.2d 498, 500 (2d Cir. 1928).
127 Id.
128 88 F.2d 632 (2d Cir. 1937).
129 129 F.2d 318 (2d Cir. 1942).
130 Kittredge, 88 F.2d at 633.
131 Id.
132 Id.
133 Id.
winery's basis by the $25,000 of allowable depreciation deductions, and thus disallowed the loss. By reducing the winery's basis by the allowable depreciation deductions, the amount realized exceeded the correspondingly reduced adjusted basis, effectively converting the loss into a taxable gain.

Similarly, in *Beckridge*, over the entire ownership period of an apartment building, the taxpayer continuously sustained losses and failed to claim any of the allowable but useless depreciation deductions or reduce basis by those deductions. Subsequently, upon the sale of the apartment building, the taxpayer reported a loss because the adjusted basis of the apartment building — unreduced by unclaimed allowable depreciation deductions — exceeded the amount realized. As in *Kittredge*, the Commissioner's reduction of the apartment building's basis by the full amount of the unclaimed allowable depreciation deductions converted the taxpayer's loss into a taxable gain.

In both cases, the Second Circuit agreed with the Commissioner's application of the mandatory section 1016(a)(2) basis reduction and found in his favor. However, in essence, the mandatory basis reduction had two consequences to the taxpayers. First, to the extent the basis was reduced to the amount realized, the taxpayers were denied a loss. Second, to the extent the basis was reduced below the amount realized, taxpayers had to recognize a phantom taxable gain.

As to the first consequence, by failing to reduce basis, the tax loss the taxpayers sought to recognize was the difference between the original cost basis of the property and the sales price. This spread reflected the economic depreciation of the property unmatched with a basis reduction for the unclaimed allowable depreciation deductions. Therefore, consistent with the rationale of the No Tax Benefit Decisions, the Second Circuit correctly reduced the basis of the underlying property by the unclaimed, albeit useless depreciation deductions so to prevent the taxpayers from recognizing a loss.

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134 Id.
135 To further explain this point, the difference between the initial cost of $37,000 and the selling price of $12,000, or $25,000 reflects an economic loss for which the corresponding depreciation deductions produced no tax benefits. To the extent depreciation deductions reduced the basis of the winery below the selling price of $12,000, the resulting gain was attributable to their transformation into taxable gain.
136 *Beckridge Corp. v. Commissioner*, 129 F.2d 318, 318 (2d Cir. 1942).
137 Id.
138 Id.
139 See *Beckridge*, 129 F.2d at 319; *Kittredge*, 88 F.2d at 633.
In contrast, as to the second consequence, the phantom taxable gain the taxpayers were compelled to recognize was attributable to the basis reduction by an amount of useless depreciation deductions that caused the adjusted basis to fall below the amount realized (the selling price). So, in spite of receiving no tax benefits from the depreciation deductions and realizing an economic loss (and being denied a corresponding tax loss) on the sale of the depreciable property, the taxpayers were saddled with phantom taxable gain.

In the final analysis, this is a clear-cut example of the No Tax Benefit Decisions going too far. Although it was appropriate for the court to deny a tax loss attributable to a basis reduction by unclaimed allowable (but useless) depreciation deductions; it was inappropriate to impose a phantom taxable gain attributable to useless depreciation deductions that reduced basis below the selling price of the depreciable asset. Accordingly, the correct result in both circumstances would have been to deny the taxpayers the loss but not compel the taxpayers to recognize the gain.

D. Virginian Hotel Provides the Final Validation of the Rationale of the No Tax Benefit Decisions

Into the 1940s, as evident from Kittredge and Beckridge, the rationale of the No Tax Benefit Decisions was broadly applied to mandate basis reductions of all allowable depreciation deductions without regard to whether they provided corresponding tax benefits. In 1943, the Supreme Court's Virginian Hotel Corp. v. Commissioner case served as the final validation of the No Tax Benefit Decisions even though it involved "allowed" rather than "allowable" depreciation deductions.

In Virginian Hotel, over a number of years the taxpayer claimed depreciation deductions in excess of the allowable amount. The excessive depreciation deductions, however, did not produce any tax benefits for the taxpayer. In any event, within the applicable limitations period, the Commissioner did not contest the taxpayer's excessive depreciation deductions. Subsequently, in an examination of other tax years, the Commissioner reduced the taxpayer's basis in the underlying property by the excessive allowed depreciation

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140 319 U.S. 523 (1943).
141 Id. at 524. Of course since the excessive depreciation deductions produced no tax benefits for the taxpayer, the Commissioner would have had nothing to gain by challenging them.
deductions.\footnote{Id. The depreciation deductions not challenged by the Commissioner during the applicable limitations period are considered to be “allowed.”}

At stake in the case was the amount of depreciation deductions the taxpayer would be entitled to claim over the remaining tax years of the recovery period. If the adjusted basis of the underlying property were “over” reduced by the excessive depreciation deductions that should have never been claimed, there would be a lower resulting adjusted basis from which subsequent legitimate allowable depreciation deductions could be taken. On the other hand, if the basis reduction were limited to the allowable depreciation deductions, the taxpayer would be entitled to claim the full, undiminished amount of remaining allowable depreciation deductions over the balance of the recovery period.

The resolution of the issue turned on the meaning of the phrase “to the extent allowed (but not less than the amount allowable)” in the predecessor of section 1016(a)(2), as it applied to a basis reduction of depreciation deductions.\footnote{Id. at 525 (emphasis added) (quoting I.R.C. § 113(b)(1)(B) (1939)).} According to the Commissioner’s interpretation of the phrase, an excessive depreciation deduction not successfully challenged during the limitations period was “allowed” within the meaning of the phrase.\footnote{Id. at 526.} Therefore, section 1016(a)(2) mandated a basis reduction by the full amount of the depreciation deductions (both “allowed” and “allowable”).

In disputing the Commissioner’s interpretation of the phrase, the taxpayer contended the word “allowed” connoted the receipt of a tax benefit.\footnote{Id.} In other words, an excessive “allowed” deduction could only harm the Government if it produced a tax benefit for the taxpayer. In that case, a basis adjustment would be appropriated because if not, the taxpayer would be in a position to “over” depreciate the cost of the asset or receive an unwarranted tax benefit of a loss from the subsequent sale of the asset. Conversely, in this case, the excessive amount of allowed depreciation deductions taken in the earlier tax years that produced no tax benefits were a tax nullity. Therefore, lacking the receipt of an unwarranted tax benefit, the taxpayer contended the Commissioner’s basis reduction inappropriately limited the depreciation deductions it could take over the remaining tax years of the recovery period.

\footnote{Id.}
In an opinion written by Justice Douglas, the Supreme Court refused to read a tax benefit concept into the word "allowed." Citing the Beckridge case, the Supreme Court held the basis reduction of the predecessor of section 1016(a)(2) was mandatory for allowed and allowable depreciation deductions alike, even if the deductions produced no tax benefits for the taxpayer. So, in light of the Supreme Court's emphatic holding in Virginian Hotel just four years prior to the Crane decision, as well as its obvious approval of the holding in Beckridge, it is highly unlikely the Supreme Court would have been receptive to an argument based on the inequitable transformation of depreciation deductions into taxable gain.

V. SEARCHING FOR A TAX BENEFIT PRINCIPLE APPROACH TO ELIMINATE THE BASIS REDUCTION TAX TRAP

As demonstrated in Parts I and IV of this article, the mandatory section 1016(a)(2) basis reduction achieves the desired result of preserving the integrity of the depreciation deduction by limiting its deductibility to the proper tax year. That, however, is not the case in the Basis Reduction Tax Trap. In Kittredge and Beckridge, the Second Circuit would have achieved an equitable result by denying the taxpayer a second opportunity to receive the tax benefit of unclaimed allowable depreciation deductions in the form of a tax loss without compelling the taxpayer to recognize phantom taxable gain attributable to useless depreciation deductions. Yet, without statutory authority, no court would have the power to make this equitable distinction. Amendment of the applicable Code sections, by

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146 Justice Douglas's decision was a major statutory interpretation of the predecessor of section 1016(a)(2) with a significant negative tax impact for taxpayers. Ironically, thirty-one years later, in Commissioner v. Idaho Power, 418 U.S. 1, 19 (1974) (Douglas, J., dissenting), a case in which the Supreme Court decided that the cost of equipment utilized to construct a capital asset could not be depreciated but instead was to be capitalized as part of the cost of the capital asset, Justice Douglas stated: "This Court has, to many, seemed particularly ill-equipped to resolve income tax disputes between the Commissioner and the taxpayers.... Indeed, we are called upon mostly to resolve conflicts between the circuits which more providently should go to the standing committee of the Congress for resolution." Obviously, Justice Douglas had a change of heart late in life regarding the propriety of the Supreme Court resolving tax issues.

147 Beckridge Corp. v. Commissioner, 129 F.2d 318 (2d Cir. 1942).

148 Virginian Hotel, 319 U.S. at 528 (citing Beckridge Corp. v. Commissioner, 129 F.2d 318 (2d Cir. 1942)).

149 This assumes a constitutional challenge to the Basis Reduction Tax Trap would be unsuccessful. In addition, the tax benefit rule does not apply to depreciation
implementing tax benefit components into their application, would provide the statutory authority to achieve the desired result.

A. Tax Benefit Components Have Been Incorporated in Code Sections Relating to Depreciation Deductions

In current tax law, several Code sections involving depreciation deductions have prudently incorporated tax benefit components into their application. The presence and effectiveness of these Code sections provides precedence for Congress to implement similar tax benefit components into the amendment of other Code sections so as to eliminate the punitive harsh tax consequences of the Basis Reduction Tax Trap. In this Subpart A, two such Code sections are discussed.

1. No Harm No Foul — No Basis Reduction for Excessive Allowed Deductions that Fail to Reduce Tax

Ironically, section 1016(a)(2) itself incorporates tax benefit components into the basis reduction for allowed depreciation deductions. As discussed in Part V.D., above, the Virginian Hotel case held that section 1016(a)(2) mandated a basis reduction by allowed deductions in excess of the amount of allowable deductions regardless of whether they produced corresponding tax benefits. In 1952, nine years after the case was decided, however, Congress reversed the Virginian Hotel holding by amending section 1016(a)(2) to allow for an upward adjustment to basis with respect to excessive depreciation not resulting in a tax benefit. Then, in 1954, Congress modified its prior amendment of section 1016(a)(2) to its current version by simply not requiring a basis adjustment for excessive depreciation deductions that did not reduce the taxpayer’s taxes.

By reversing Virginian Hotel, Congress must have recognized the inequity and unnecessary punitive consequences caused by a basis reduction of excessive but useless allowed depreciation deductions.
Accordingly, there is no reason why Congress should not extend the same relief to prevent useless allowable depreciation deductions from being transformed into phantom taxable gain.

2. Section 1245: Depreciation Recapture from a Tax Benefit Perspective

Section 1245 is another Code section that incorporates a tax benefit component in the characterization of taxable gain attributable to depreciation deductions as ordinary income. Specifically, the purpose of section 1245 is to require a taxpayer who enjoyed the tax benefit of ordinary depreciation deductions from section 1245 property\(^{153}\) to "recapture" the gain attributable to those deductions as ordinary income ("Recapture Income") upon the disposition of such property.\(^{154}\)

Sequentially, if the disposition of section 1245 property results in recognized gain, section 1245 is then applied to determine the characterization of all or part of such gain as Recapture Income. Recapture Income is the difference between the "recomputed basis" and the adjusted basis of the section 1245 property.\(^{155}\) Simply stated, the recomputed basis is the adjusted basis increased by the amount of all previously taken depreciation deductions.\(^{156}\)

For example, assume that a taxpayer acquires section 1245 property with an original basis of $1,000. Further assume that during the first tax year in which the section 1245 property is placed in service, the taxpayer claims a $200 allowable depreciation deduction. Pursuant to section 1016(a)(2), the original basis of the section 1245 property would be reduced to $800. If the taxpayer were to sell the section 1245 property for $1,000, the taxpayer's recognized gain of $200 would be attributable to the previously taken depreciation deduction that reduced the section 1245 property's basis.\(^{157}\) For purposes of characterizing all or part of the taxable gain as Recapture Income, the recomputed basis would be $1,000 (the adjusted basis of $800 plus the previously claimed depreciation deduction of $200). Then, subtracting the adjusted basis of $800 from the recomputed basis of $1,000, the entire $200 of taxable gain would be characterized.

\(^{153}\) I.R.C. § 1245(a)(3).
\(^{154}\) I.R.C. § 1245(a).
\(^{155}\) I.R.C. § 1245(a)(1).
\(^{156}\) I.R.C. § 1245(a)(2).
\(^{157}\) I.R.C. § 1001(a).
as Recapture Income.\(^\text{158}\)

In the big picture, due to the valuable tax benefit that a depreciation deduction taken against ordinary income provides for the taxpayer, there is a need for symmetry so any gain attributable to those deductions is also characterized as ordinary income. To illustrate this point, consider the following fact pattern. Assume a taxpayer acquires section 1245 property for $1,000. Further assume in the first two tax years, the taxpayer claims $400 of depreciation deductions offsetting a like amount of ordinary income. Assuming a marginal tax bracket of 35\%, the tax savings produced by the ordinary depreciation deductions offsetting ordinary income would be $140. Then, assume that in the third year the taxpayer sells the section 1245 property for $1,000 (meaning the asset did not decline in value). The entire recognized gain of $400 would be attributable to the previously claimed depreciation deductions that had reduced ordinary income in a like amount.

If, instead of being characterized as ordinary income, the $400 gain were characterized as long-term capital gain taxed at 15\%, the resulting tax liability would be $60. Thus, an overly taxpayer favorable differential of $140 tax savings to $60 tax liability would whipsaw the Treasury. By characterizing the taxable gain as Recapture Income, however, the playing field is level, as the tax savings of a deduction against ordinary income is offset by the tax liability of ordinary gain.

Up to this point in the section 1245 analysis, the computations of Recapture Income and gain on the disposition of depreciable property pursuant to section 1001(a) are seemingly identical. Conceptually, the recomputed basis and the amount realized are similar. Both amounts are utilized as the minuend from which the adjusted basis of the underlying property is subtracted. If, for example, the underlying section 1245 property were to be sold for an amount equal to its original basis, the difference between the respective minuends and the adjusted basis of the underlying property accounts for the total amount of prior tax years' depreciation deductions in the computation of gain and Recapture Income, respectively. The two computations part ways, however, with respect to the tax benefit component built into the computation of the recomputed basis that is not factored into the section 1016(a)(2) reduction of the adjusted basis.

More to the point, in the computation of taxable gain, section 1016(a)(2) requires a basis reduction by all allowable depreciation deductions including those that did not produce tax

\(^{158}\) I.R.C. § 1245(a).
benefits. This means the resulting taxable gain accounts for all depreciation deductions including those that produced no tax benefits for the taxpayer. Conversely, although in the computation of Recapture Income, the same adjusted basis is utilized as the subtrahend, in arriving at the recomputed basis, the minuend of the formula only depreciation deductions actually claimed are added to the adjusted basis. The flush language of section 1245(a)(2) adds this tax benefit component as follows: “[I]f the taxpayer can establish by adequate records or other sufficient evidence that the amount allowed for depreciation... for any period was less than the amount allowable, the amount added for such period shall be the amount allowed.”

Thus, due to the tax benefit component incorporated in section 1245(a)(2), only depreciation deductions actually claimed by the taxpayer are transformed into Recapture Income. For example, assume a taxpayer sold section 1245 property with an adjusted basis of $500 for $1,500. Further, assume over the period in which the taxpayer utilized the section 1245 property in her trade or business, the allowable depreciation deductions were $1,000 of which she claimed only $800.

In spite of recognizing $1,000 of taxable gain from the sale of the 1245 property, the amount characterized as Recapture Income would be limited to depreciation deductions actually claimed by the taxpayer. Here, the recomputed basis of the section 1245 property would be $1,300, the taxpayer’s adjusted basis ($500) plus only the depreciation deductions actually claimed by the taxpayer ($800). Finally, subtracting the adjusted basis ($500) from the recomputed basis ($1,300) would result in $800 of Recapture Income. Thus, the remaining taxable gain of $200 could potentially be characterized as capital gain.

The above example demonstrates how section 1245(a)(2) achieves tax symmetry, without causing punitive tax consequences, because only the portion of gain attributable to previously claimed depreciation deductions is characterized as Recapture Income. In this case, the taxpayer claimed only $800 of the $1,000 of allowable depreciation deductions. Obviously, an unclaimed depreciation

160 Pursuant to section 1001(a), the taxpayer’s taxable gain would be $1,000, the difference between the amount realized ($1,500) and the adjusted basis ($500).
161 I.R.C. § 1245(a)(2).
162 See generally I.R.C. § 1231.
deduction cannot reduce ordinary income and, with a tax benefit component built into its application, section 1245 never causes the harsh tax consequences of transforming unclaimed depreciation deductions into ordinary income.

Unfortunately, the computation of gain upon the disposition of depreciable property does not invoke a similar tax benefit component. So, if in the above example, the facts were modified to assume the taxpayer actually claimed allowable depreciation deductions of $1,000, of which only $800 produced tax benefits, the taxpayer would nonetheless be compelled to recognize the entire realized gain of $1,000. This would include the amount attributable to the $200 of depreciation deductions that produced no tax benefits. This is because unlike section 1245(a)(2), section 1016(a)(2) requires a dollar for dollar depreciation basis reduction with no consideration of whether those deductions produced equivalent tax benefits.

As a matter of tax policy, there is no rational reason why a tax benefit component similar to that built into the computation of Recapture Income should not also be incorporated into the computation of taxable gain upon the disposition of depreciable property. Both computations are intended to prevent the taxpayer from enjoying unwarranted tax benefits. Although section 1245 achieves this purpose with tax equity, the rigid, no exception depreciation basis reduction of section 1016(a)(2) creates a Basis Reduction Tax Trap for the unwitting taxpayer. In all instances, the ultimate result should be an equal match of the tax benefits of the depreciation deductions with the tax detriment of the taxable gain.

For purposes of computing gain, unless and until the gain attributable to useless depreciation deductions are excluded from gross income, tax symmetry will never be achieved.

B. The Solution to Ending the Basis Reduction Tax Trap: Create a New Gain Basis for Purposes of Computing Gain

One way to incorporate a tax benefit component to eliminate the Basis Reduction Tax Trap would be to create a new “Gain Basis” to be utilized solely for purposes of computing taxable gain upon the disposition of depreciable property. For purposes of tracking depreciation deductions over the recovery period and computing loss on the disposition of depreciable property, the current law adjusted basis would continue to be utilized as it is today.

The creation of a gain basis and a loss basis is not a novel concept in tax law. Section 1015(a) provides that if the fair market value of
gifted property is less than the donor's basis in the property, for purposes of computing loss, the donee's basis in the property is the date of gift fair market value. Conversely, for purposes of computing gain, the donee's basis in the property is the same as the donor's basis. The purpose of a separate loss basis is to prevent the donee from taking advantage of the donor's basis in order to claim the donor's pre-gift transfer loss on a subsequent sale of the gifted property. On the other hand, for purposes of computing gain, the carryover gain basis provides the donee with the full benefit of the donor's basis as an offset against the amount realized, and thus resulting gain, from the subsequent disposition of the gifted property.

In an analogous way, the new Gain Basis would assure that no gain attributable to useless depreciation deductions would ever be triggered upon the sale of the underlying property. Each tax year, unlike the current version of section 1016(a)(2), the Gain Basis would be reduced only by those depreciation deductions that produced tax benefits for the taxpayer. Therefore, utilizing the Gain Basis as the subtrahend in the gain computation formula would eliminate any potential gain attributable to depreciation deductions that did not produce tax benefits for the taxpayer.

Conversely, the current law adjusted basis would be utilized for purposes of tracking the declining balance available for depreciation deductions over the remaining years of the recovery period as well as in the computation of loss. By reducing basis by the full amount of allowable depreciation deductions (as well as allowed depreciation deductions that produce tax benefits for the taxpayer), the integrity of the depreciation deduction would be preserved. So, just as it does today, utilizing the current law basis as the minuend in the computation of loss would prevent the taxpayer from having a second opportunity to receive the tax benefit of unclaimed allowable

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163 As an illustration, consider the following example: Assume a donee received a gift of property with a fair market value of $800 and a basis to the donor of $1,000. If the donor had sold the property for $800, the donor would have recognized a $200 loss. Conversely, if the donee were to sell the property for $800, the donee would not recognize a loss because the fair market value loss basis of $800 would offset the selling price. Accordingly, the fair market value loss basis prevents the donee being able to take advantage of the donor's pre-gift built in loss.

164 To modify the illustration in supra note 163, assume the donee were to sell the gifted property for $1,200. Since for purposes of computing gain, the donee takes the donor's basis of $1,000 in the gifted property (as compared to the $800 fair market value loss basis), the donee would recognize a gain of $200 ($1,200 minus $1,000). So unlike the loss scenario, the donee's taxable gain would be exactly the same as the donor's would have been if the donor had sold the property.
depreciation deductions in the form of a tax loss whether or not they provided tax benefits.

1. How Utilizing the Gain Basis Would Have Saved Beulah from the Clutches of the Basis Reduction Tax Trap

Under current law, the basis of depreciable property is reduced by all depreciation deductions including those that produced no tax benefits for the taxpayer. So, even if the taxpayer were to realize an economic loss (if the selling price were less than the original cost), the disposition of depreciable property would trigger the recognition of phantom taxable gain, all of which would be attributable to those useless tax depreciation deductions that reduced the asset's basis. This is exactly what happened to Beulah. Although she realized a $4,500 economic loss from the sale of the Brooklyn Apartment Building and had received minimal tax benefits from the allowable depreciation deductions, she was compelled to recognize $23,500 of gain attributable to useless depreciation deductions that reduced the basis of the property.

On the other hand, if the Gain Basis had been utilized, Beulah would have been saved from the Basis Reduction Tax Trap, as no gain from the sale of the Brooklyn Apartment Building would have been recognized. Starting with $262,000 as the original Gain Basis of the Brooklyn Apartment Building and limiting the basis reduction of the Gain Basis to the $3,307 of tax productive depreciation deductions, the "adjusted" Gain Basis of the Brooklyn Apartment Building at the time of the sale would have been $258,693 ($262,000 minus $3,307). Thus, because the amount realized ($257,500) — i.e., the total consideration Beulah was deemed to have received from the sale of Brooklyn Apartment Building — did not exceed her Gain Basis ($258,693), no gain would have been recognized. Thus, the utilization of Gain Basis would have prevented Beulah from falling victim to the Basis Reduction Tax Trap.¹⁶⁵

¹⁶⁵ The purpose of the Gain Basis is to prevent the transformation of useless depreciation deductions into taxable gain. Pursuant to sections 1001(a) and (c), the taxpayer recognizes taxable gain only if the amount realized exceeds the adjusted basis. So as long as the Gain Basis is equal or greater than the amount realized, no gain would ever be recognized. In this case, upon the sale of the Brooklyn Apartment Building, Beulah realized an economic loss of $4,500. Only $3,307 of that loss, however, was reflected in depreciation deductions that produced tax benefits for her over the course of the ownership period of the property. This was also the amount of depreciation deductions that reduced the Gain Basis from $262,000 to $258,693. Thus, the negative difference between the amount realized ($257,500) and the Gain Basis
2. Utilizing the Conventional Current Law Basis for Purposes of Computing Loss Would Have Prevented Beulah from Transforming Useless Depreciation Deductions into a Tax Loss

Just as utilizing the Gain Basis would have prevented Beulah from falling into the Basis Reduction Tax Trap, utilizing the conventional current law adjusted basis as the minuend in the computation of loss would have prevented her from transforming those useless depreciation deductions into a tax loss. In other words, although Beulah's Gain Basis would have been $258,693, her conventional adjusted basis would have been $234,000 ($262,000 minus $28,000, the amount of all allowable depreciation deductions). Because loss is the excess of the adjusted basis over the amount realized,\(^\text{166}\) there would have been no loss because the conventional adjusted basis of $234,000 would not have exceeded the amount realized of $257,500.

Consistent with the rationale of the No Tax Benefit Decisions, this is the correct result. Although over the course of the ownership period of the Brooklyn Apartment Building Beulah and the Crane Estate received the tax benefit of only $3,307 of the $28,000 allowable depreciation deductions, she was not entitled to a second chance to receive the tax benefit of those unproductive depreciation deductions. Because the conventional current law basis would function as the minuend in the computation of loss, it could never exceed the amount realized and result in the recognition of a tax loss. Thus, had the Gain Basis been in effect during the Crane years, Beulah would have escaped the recognition of phantom gain upon the disposition of the Brooklyn Apartment Building without a second opportunity to transform depreciation deductions that did not produce tax benefits for her and the Crane estate in the tax year of sale.

CONCLUSION

The untold story of Beulah Crane reveals an inconvenient tax truth of the Basis Reduction Tax Trap. The combination of economic

\(^\text{166}\) I.R.C. § 1001(a).
circumstances beyond the taxpayer's control, such as little or no income generated from her trade or business, unproductive wasted depreciation deductions and the mandatory section 1016(a)(2) basis reduction resulting from those useless depreciation deductions, bait this hazardous trap for unwitting taxpayers. The trap snaps shut if the taxpayer were to sell the underlying depreciable property for an amount between the property's adjusted basis and original cost. All gain triggered by the sale would be attributable to useless depreciation deductions that reduced the basis of the property. So, in spite of realizing no economic gain, or perhaps realizing an economic loss, the taxpayer is compelled to recognize phantom taxable gain.

In the vocabulary tax law case, *Crane v. Commissioner*, facts not discussed in the Supreme Court's decision reveal that Beulah was the victim of the Basis Reduction Tax Trap. In that case, Beulah operated the Brooklyn Apartment Building at a loss for seven years. Because she was entitled to claim a substantial amount of allowable deductions, the basis of the Brooklyn Apartment Building was reduced by a like amount. Due to the limited income generated by the Brooklyn Apartment Building, however, only a small portion of those allowable depreciation deductions actually produced tax benefits for her. Subsequently, when she was compelled to sell the Brooklyn Apartment Building for less than its original value in order to avoid foreclosure, the large amount of phantom gain triggered by the sale was attributable to the useless depreciation deductions that had reduced the basis of the building.

In unsuccessfully challenging the gain she was obligated to recognize, Beulah did not question the propriety of the section 1016(a)(2) basis reduction by useless deductions. Even had she done so, the result would have surely been the same. This is because of the long-standing judicial precedent of the No Tax Benefit Decisions, holding the section 1016(a)(2) basis reduction was mandatory even if the corresponding depreciation deductions produced no tax benefits to the taxpayer.

A closer examination of the No Tax Benefit Decisions, however, reveals the purpose of the mandatory section 1016(a)(2) basis reduction is to preserve the integrity of the depreciation deduction. For the most part, those cases involved taxpayers attempting to manipulate the timing of the depreciation deduction. The mandatory basis reduction prevented the taxpayer from effectively deferring a depreciation deduction from its properly deductible year by not

\[167\] 331 U.S. 1 (1947).
reducing the basis of the underlying property in order to receive the
tax benefit of the deduction in a subsequent tax year of sale.
Conversely, in the Basis Reduction Tax Trap, the mandatory basis
reduction is punitive because it causes the transformation of
depreciation deductions that would never provide a tax benefit for the
taxpayer into phantom taxable gain. In many instances, economic
circumstances beyond the taxpayer's control (such as the imminent
foreclosure Beulah faced) compel the taxpayer to dispose of a
depreciable asset. Consequently, perhaps after experiencing multiple
tax years of generating little or no income in which the depreciation
deductions provided no tax benefits, a fire sale might trigger
substantial and unexpected taxable income.

Thus, incorporating tax benefit components in amending the
Code would be a prudent way to eliminate the Basis Reduction Trap
without compromising the integrity of the depreciation deduction.
This could be accomplished by creating a new Gain Basis, utilized
solely as the subtrahend in the computation of gain from the
disposition of depreciable property. Unlike the current law basis, the
Gain Basis would be reduced only by those depreciation deductions
that produced tax benefits. That way, no gain attributable to useless
depreciation deductions would ever be triggered.

On the other hand, the current law basis would continue to serve
its functions of tracking the balance of an asset's basis available for
depreciation deductions over the remaining tax years in the recovery
period as well as being the minuend in the computation of loss. Because basis would be reduced by all allowable deductions for
purposes of computing loss, a taxpayer would never have a second
opportunity to resurrect a depreciation deduction that did not
produce a tax benefit in the given tax year, when it was properly
deductible, and take a tax loss in the subsequent tax year of sale.

In the final analysis, the best of both tax worlds would be
achieved. The basis reduction rules should protect the integrity of the
depreciation deduction without triggering punitive tax consequences
for the unsuspecting taxpayer.

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168 As under current law, basis would also be reduced by allowed depreciation
deductions that produced tax benefits for the taxpayer.