ORIGINAL

OFFICIAL TRANSCRIPT
PROCEEDINGS BEFORE

SUPREME COURT OF THE UNITED STATES

DKT/CASE NO. 81-1536

TITLE COMMISSIONER OF INTERNAL REVENUE, Petitioner
v.
JOHN F. TUFTS ET AL

PLACE Washington, D. C.

DATE November 29, 1982

PAGES 1 thru 45

ALDERSON REPORTING

(202) 628-9300
440 FIRST STREET, N.W.

IN THE SUPREME COURT OF THE UNITED STATES

- -x

COMMISSIONER OF INTERNAL REVENUE, :

Petitioner, :

v. : No. 81-1536

JOHN F. TUFTS ET AL :

:

- -x

Washington, D.C.

Monday, November 29, 1982

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 10:01 a.m.

APPEARANCES:

STUART A. SMITH, ESQ., Office of the Solicitor General, Department of Justice, on behalf of the Petitioner.

RONALD M. MANKOFF, ESQ., Dallas, Texas; on behalf of the Respondents.

- - -

ALDERSON REPORTING COMPANY, INC.

440 FIRST ST., N.W., WASHINGTON, D.C. 20001 (202) 628-9300

C O N T E N T S

P R O C E E D I N G S

CHIEF JUSTICE BURGER: The Court will hear arguments first this morning in Commissioner of Internal Revenue against Tufts. Mr. Smith, you may proceed whenever you are ready.

ORAL ARGUMENT OF STUART A. SMITH, ESQ.,

ON BEHALF OF PETITIONER

MR. SMITH: Mr. Chief Justice, may it please the Court:

This federal income tax case comes here on a writ of certiorari to the United States Court of Appeals for the Fifth Circuit. It presents an important question dealing with the tax consequences of the disposition of property subject to a mortgage. The Court of Appeals in this case allowed a loss, based upon a cost that Respondents did not incur and turned out never would incur, and thereby reached a result that we believe to be totally at odds with the economic reality of the transaction.

The facts are relatively simple and can be summarized as follows:

In 1970 Respondents formed a general partnership for the construction of an apartment project in Duncanville, Texas. They obtained a nonrecourse mortgage loan of $1.85 million. By "nonrecourse," that

meant that none of the borrowers on the note bore any personal liability for the loan but that the lender bank could look only to the security of the property secured by the mortgage.

In 1971 and 1972 the partners, of which Mr. Tufts was one, contributed approximately $40,000 in cash to the general partnership. And they included under the applicable tax rules, which the parties stipulate to be correct, a proportionate share of their $1.85 million debt in each of their bases of their partnership interests.

In 1970 through 1972, when the partners held the project, they claimed approximately $440,000 of the tax deductions which represented depreciation and other losses in connection with the operation of the apartment project. Those deductions were entirely proper and are not at issue in this case.

In August 1972 the partners disposed of the property subject to the mortgage to an unrelated third party. At the time of this disposition there never had been any amortization of the principle balance on the mortgage debt. That mortgage debt remained throughout the entire period of their ownership at $1.85 million. And at the time of disposition, the basis of the taxpayers' partnership interests had been reduced

because of depreciation to $1.45 million.

Now, this transaction came under audit by the Commissioner of Internal Revenue, and he determined that Respondents had realized gain of approximately $400,000 as a result of the disposition of the property. The computation of gain was by reference to the amount realized by the Respondents in this case, the $1.85 million loan, which the unrelated party picked up on the transfer of the property subject to the mortgage minus their bases of $1.45 million, which yields approximately $400,000 in gain.

This case came to the Tax Court on Respondent's petition for review, and the Tax Court upheld the Commissioner's determination and, in so doing, followed a uniform line of authority above the Tax Court and of the other appellate courts. And in a situation like this, a disposition of property subject to a mortgage requires that when the mortgage has never been amortized down at all, that the amount realized on the disposition of property include the unpaid mortgage balance.

The Court of Appeals, however, in this case reversed. It limited the amount realized to the value of the property that happened to be at the time of disposition, which was $1.4 million. And it did so

despite the fact that the property was transfered subject to a debt well in excess of this amount; that is, $1.85 million.

But the value of the property, we submit, has absolutely no significance to the tax consequences of such a transaction. As I shall develop, once the taxpayer's determined to transfer the property along with the debt, the value of the property is only relevant to the new owner and the lender who must look to that value of the property for satisfaction of his loan.

QUESTION: Mr. Smith, isn't what the Court of Appeals did quite consistent with the intimation in the Crane footnote?

MR. SMITH: No, we don't -- no, Mr. Justice Rehnquist, we don't think it is consistent with the intimation in the Crane footnote, as I shall point out in greater detail. All we think that Crane footnote did was to, by way of dictum, express a reservation that they weren't dealing with the facts of the case that is now before the Court.

I don't think that the intimation in that footnote is necessarily tantamount to a rule of law that when the value of the property --

QUESTION: No.

MR. SMITH: Yes.

QUESTION: No, I agree with you, but how much practice and usage among the tax bar and the courts that decide tax cases, more often than we, has grown up in reliance on the idea that what you have described as "a dictum" is at least --

MR. SMITH: Absolutely not. The practice and usage is directly to the contrary. I think that it's fair to say that the tax bar, both public and private, has always regarded that footnote, as I shall point out in greater detail, as simply a response to the economic benefit analysis that the court engaged in, in part, in Crane.

But we submit, and the Courts of Appeals, apart from the court below as well as the Tax Court, has consistently held both before Crane and since Crane that the fundamental aspect of the Crane principle is the relationship, the functional relationship, between basis and amount realized. And basically, our submission here is that since that basis is cost and it requires -- that implies an economic outlay. And in this particular case, the Respondents borrowed $1.85 million on a nonrecourse basis.

Crane, the principle of Crane allows you to include that loan balance in basis for purposes of

depreciation or any other purpose, purposes of computing gain on ultimate disposition.

But the quid pro quo of including that in basis is that at the other end of the transaction, that mortgage balance has never been paid, you have to account for it at the other end of the transaction. In other words, the notion is that basis is economic outlay; that is, cost. And while we permit someone to borrow money and count it as basis, if they never pay any of that money, there has to be a reconciliation of the accounts at the other end.

The footnote in Crane didn't dispute what we think is the logic of that. And in fact, the Crane decision, the rationale of the Crane decision, we submit; that is, putting, establishing a functional relationship between basis and amount realized requires that there be this reconciliation of accounts at the disposition of property the way it occurred in this case.

QUESTION: Why do you think Footnote 37 is there?

MR. SMITH: Well, I think footnote -- there has been a lot of ink spilled on this, Mr. Justice Blackmun, and I could only perhaps summarize it, you know, in a few sentences. I suspect that the reason Footnote 37 is there, I mean I think what happened in

Crane is that the court engaged, in part, in what the commentaries refer to as an "economic benefit analysis." And they, one of the things that the Chief Justice wrote was that, well, that Mrs. Crane got some kind of economic benefit. And in so doing that, what the court, in order to arrive at that result, the court had to equate her nonrecourse mortgage with some sort of recourse liability.

And it was able to do this because she conceded in the case that if the amount had been recourse, if the liability had been recourse, of course she would have been required to take it into account. But she strenuously urged that the nonrecourse aspect of the debt made the case different.

Well, what the court said was, well, that wasn't really true in this particular case because the value of the property exceeded the mortgage balance. So in a situation like that, the court equated recourse and nonrecourse debt. And then because of this aspect of the analysis, the court wanted to indicate that perhaps that wouldn't be the case, that aspect of the analysis wouldn't apply if the numbers were reversed.

But I think that everyone since that time has indicated that the economic benefit analysis of Crane is really not the heart of Crane, and it's not -- the Crane

principle stands on the logical bedrock of a relationship between basis and amount realized, and that if the code permits you to be deemed to have made an economic outlay and you get basis for this outlay even though you borrowed funds and you haven't actually put a dime out of your pocket, but implicit in that notion is that you will ultimately pay some money and if you don't ultimately pay some money the way Respondents did in this case, well, then -- then there has to be a reconciliation.

And in fact, in thinking about this case, it seemed to me, if you sort of strip it of all its essentials, what it really boils down to is suppose one were to buy a suit from a department store and charge it, the $200, and then you wear it a couple of times --

QUESTION: Now, you are at the level we understand.

(Laughter.)

MR. SMITH: And it doesn't fit you anymore; perhaps the excesses of the holiday season. But you have a brother-in-law who's actually much slimmer and he likes the suit. And you say, well, I haven't paid the bill yet, and he says, give me the bill and I'll pay it and I'll take the suit off your hands.

At that time the suit is worth $100 because

it's not a new suit anymore. Well, under the Court of Appeals rationale, which limits amount realized to value, you would have $100 loss, putting aside the question as to whether you could deduct --

QUESTION: That isn't quite fair, because he owed the bill for the suit.

MR. SMITH: Sure. But under our system, under our system recourse, since --

QUESTION: Well, everybody agrees, everybody agrees you realize an amount if you have one of your obligations assumed.

MR. SMITH: Well, but, Mr. Justice White, under our system, since Crane, we have been equating recourse and nonrecourse liabilities. The example is not exact, but I think what --

QUESTION: No, you're just bootstrapping.

MR. SMITH: No.

QUESTION: You're saying the Crane principle just covers this case like a blanket even though it was reserved.

MR. SMITH: I am suggesting, and I think that the decisional laws, apart from the decision in this case, is uniformly to the effect that really the reservation in the case only dealt with the economic benefit aspect of the analysis.

QUESTION: You're bound to get around to saying, why is -- why did this seller here, why did this seller realize anything?

MR. SMITH: Well, he --

QUESTION: What did he realize? You've got to say what, determine what amount he realized.

MR. SMITH: Right. We say he realized $1.8 million.

QUESTION: And why?

MR. SMITH: He realized $1.8 million because he borrowed $1.8 million, the code gave him basis for that.

QUESTION: Yes.

MR. SMITH: At the other end of the transaction, he had not amortized that debt, he had not paid out one bit, and somebody else is going to pay that debt. The property goes along with the debt. And at that point the tax law has to say, well, how do we reconcile these accounts? We've been assuming, we've given you basis during the stewardship of your ownership on the assumption that you were going to pay out something.

QUESTION: So what you're really saying is that he realized something when he took the deduction?

MR. SMITH: Well, I don't think I am really

saying that because --

QUESTION: But you want to get it back, anyway. You want to get it --

MR. SMITH: Well, we don't want to get the deductions back. In fact --

QUESTION: You're going to pay gain on the deduction.

MR. SMITH: Well, I think the response to that is that the numbers here are fairly comparable, given the fact that the property is practically 100 percent financed, and the debt has not been amortized one penny. In a situation like that, of course there's going to be a rough comparability between the deductions taken, which represent, quote, a recovery of capital, so to speak, and --

QUESTION: Mr. Smith, suppose there'd been no deductions taken at all. What would your position be?

MR. SMITH: It'd be exactly the same. It'd be exactly the same. And in fact --

QUESTION: Would there be any gain realized? And if so, what would it be?

MR. SMITH: There would -- well, I suppose if there were no deduction, if there were no deductions taken, there would be no -- then in that case, the taxpayers' partnership bases would be $1.85 million.

QUESTION: Yes.

MR. SMITH: But -- and his amount realized would be $1.85 million, in which case there would be gain or loss.

QUESTION: So you are saying that the deductions constitute the gain, in effect? In effect.

MR. SMITH: Well, we don't think -- in effect, in a rough way. But let me emphasize the fact that we're not recapturing deductions. And I think that the best way to illustrate this is by assuming that there were no -- that there were no deductions and that, for example, let's assume that the property in this case was nondepreciable. Suppose the property was just a parcel of raw land, which they got a $1.85 million nonrecourse note. We set this out in our brief and in our reply brief as well. The property then declines to $1.4 million, as occurred in this case. The partners then can't make a go of it. They transfer the property subject to a mortgage.

Under the Court of Appeals opinion in this case, and I don't think there can be any quarrel about that, they, the Respondents would have a $400,000 loss because their basis would be 1.85 and their amount realized would be 1.4.

Now, it is absolutely bizarre, to say the

least, how people in a situation like that could have a $400,000 loss. They haven't expended a single penny. And in fact, in this particular case, the error of the court below, it seems to us, is confirmed by the fact that the Court of Appeals gave the Respondents an extra $50,000 of loss; that is, equal to the difference between their $1.45 million basis and the $1.4 million fair-market value.

This is the modern equivalent of the miracle of the loaves and the fishes. How can there be a loss here? And in fact, the Respondents no longer have the temerity even to claim that loss, although they did claim it in the courts below, and their support of the decision below necessarily supports the rationale that upholds such a loss.

In our view, this is an aberration that doesn't fit with Crane and doesn't really fit with any -- anything logical that one can imagine the code to allow.

QUESTION: Mr. Smith, why wouldn't the approach taken by the amicus Barnett solve your problem?

MR. SMITH: It would solve the problem to an extent, Justice O'Connor, but our response to that simply is that over the last 45 years, property transfered with liabilities has always -- has always

been considered by -- by the Treasury to be transfers of the property along with the liability. You don't bifurcate these things in that way.

QUESTION: Do you take the position that the Treasury Department could subsequently decide to approach it exactly that way; that that's within --

MR. SMITH: I think it would --

QUESTION: -- the framework of the statute?

MR. SMITH: I think it would be a radical transformation. It would -- it would -- I think it would be contrary to -- to all the assumptions that have proceeded from this Court's Crane case.

QUESTION: Would it be --

MR. SMITH: And that's why --

QUESTION: -- consistent with the statutory structure to take that view?

MR. SMITH: One can read the statute the way the amicus reads the statute. However, the Treasury has for the last 50 years read the statute to impose capital gains in a situation like this one. And we feel that Treasury's reading of the statute is a permissible one, and given the fact, the deference that the -- such administrative constructions are given to -- by the courts in general and by this Court, we feel that the proper result here is the imposition of capital gains on

the $400,000.

QUESTION: Let me ask you a hypothetical. If the purchaser here had paid the taxpayer $1.4 million in cash for this property free and clear --

MR. SMITH: Uh-huh.

QUESTION: -- and the taxpayer had then taken that $1.4 million and paid the secured party the 1.4 in full satisfaction of the $1.8 million debt, I assume you would recognize then that the amount realized on the property was the 1.4 million, not the 1.8?

MR. SMITH: No.

QUESTION: No?

MR. SMITH: I think it would still be 1.8. Essentially, and in fact, it seems to me that the income there -- I mean, you know, there's obviously gain in the situation like that when you discharge a $1.8 million liability with a $1.4 million piece of property. Our view is that that's --

QUESTION: But it doesn't occur on the sale of the property, does it?

MR. SMITH: Well, but you know, it's part and parcel of -- I mean I think the Commissioner would take the position that since the liability secured the debt, it's part and parcel of the same thing, without meaning to make a pun, and that that would still be -- I mean

there's obviously, in your example, still gain. The amicus would take the position that it was gain from cancellation of indebtedness, it would be ordinary income.

But the important thing, it seems to us, the significance that I draw from the amicus presentation is that we both agree that there's gain in the transaction like this. It seems to us that the consistent administrative position as to the kind of gain it is, from Crane and from all the cases like Millar, have always been capital gain and not ordinary income.

I cannot -- I cannot say that there cannot be a situation where the transaction, the two transactions, the liability aspect of the transaction and the asset aspect of the transaction, might be so separate and unrelated that there might be a determination of ordinary income.

But this case before the Court is not such a case. The Commissioner's determination of capital gain we think is correct.

QUESTION: The professor would give you more than you asked for.

MR. SMITH: The professor would give us more than we asked for; that is true.

QUESTION: Let me ask you one other question

about Crane. And that is, that -- so I am sure that I know your position -- do you feel that this case can be affirmed without overruling Crane?

MR. SMITH: No. We think that it's -- we think that the --

QUESTION: Leaving Footnote 37 aside, I take it then that it is your position that Crane controls this case?

MR. SMITH: That the rationale and teaching of Crane controls this case, and that the Court of Appeals -- in fact, if there need be any evidence of that, it's the fact that the Court of Appeals denied, explicitly denied, a connection between basis and amount realized. I think it's on page -- page 35a, note 9 of the appendix. The Court of Appeals said, there is simply no relationship between basis, adjustments to basis, and amount realized. And Crane establishes a functional relationship. I cannot see any more disparate view, you know, views, more contrary views.

It seems to us that the logic of the decision below cannot be squared with what Crane held, and what it seems to us that all responsible practitioners both of the public and private tax law have assumed that Crane has held.

QUESTION: May I ask you one question about

your position as applied to Crane itself? Supposing on the facts of Crane, where you have inherited property, the property had been disposed of at a time when its fair-market value was below the amount of indebtedness. You would still say there that the heir would have a full gain as to the extent of the indebtedness? The measure -- you would apply it, Crane itself, you would say, would have been decided the same way if the property --

MR. SMITH: Exactly. And I think then they would have had to have faced up. There wouldn't have been a Footnote 37, and we wouldn't have -- I wouldn't have --

QUESTION: In fact, about half the opinion couldn't have been written.

MR. SMITH: -- and I wouldn't be standing here, because presumably all of this would have been solved.

The problem -- the problem simply is that there are a lot of strands in Crane. Although Crane --

QUESTION: But your loaves-and-fishes argument is not very persuasive when you have inherited property.

MR. SMITH: Yes.

QUESTION: Someone inherits property and inherits no obligation, but the property is encumbered,

and then they dispose of it by just abandoning it. They suddenly realize a gain in the amount of the encumbrance, under your view?

MR. SMITH: Well, right, although tax lawyers have no problems with that sort of thing only because -- but the point is that --

QUESTION: No, but --

MR. SMITH: -- if you get -- if you get basis in something, then it has to be -- it has to be considered -- it has to be -- there has to be a reconciliation at the other end and --

QUESTION: Maybe tax lawyers don't, but taxpayers do, wouldn't you say?

MR. SMITH: That's true -- that's simply -- that's true, although we think -- we think in this particular case where the concept of basis requires an economic outlay either now or sometime, here where the Respondents have paid not a penny other than the small cash contributions that they made to the partnership, it seems absolutely anomalous, to say the least, that they could -- that they could achieve permanent exclusion of $400,000 of gain. This is not simply deferral in this context; this is permanent exclusion of gain.

QUESTION: Now, the basis that the purchaser has in this property is only $1.4 million?

MR. SMITH: Yes, that is true, Justice O'Connor. And the reason for that is simply that the Internal Revenue Service has, I think soundly, taken the position that when value of property is way below a nonrecourse debt, there have been a lot of tax-shelter activity in which the nonrecourse debt bears no relationship to the property. Under those circumstances, the Internal Revenue Service has taken the position that at the very most, you get basis equal to the value of the property.

QUESTION: It's just a little hard to understand how the basis of the property would be the lower figure but what the seller received is a higher figure.

MR. SMITH: Well, I don't think it really is hard to understand if one -- if one looks at it from the seller's point of view, the seller put $1.8 million in his pocket. He then bought this building. The fact that it declined in value has absolutely no significance to him economically if he's allowed, if he's permitted, if he does, transfer the property along with the debt so that the debt is of no interest to him and the value of the property is of no interest to him.

And it really is very much like the suit in the department store; you're just not interested in the

whole transaction anymore. And but what the Court of Appeals would say here is that your amount realized is $1.4 million. Now, how is it possible for you to have a $400,000 loss in a situation like that when you haven't expended a penny?

And going back to my example, we talked -- I think I got off on a tangent when we were talking about depreciation, Mr. Justice Powell. In answer to your question, if the property had just been raw land, there would be a $400,000 loss, and there isn't -- there would be no loss in a situation like that. There's been no economic expenditure. The taxpayers here are not poorer by a penny. And in our view, that really -- that fact glaringly calls for the reversal of the judgment below.

QUESTION: Mr. Smith, let me ask you one other question. Am I correct in understanding that under your view the basis for the transferee -- in this case, Bayles -- is limited by the fair-market value, so his basis is different from the amount realized --

MR. SMITH: His basis is $1.4 million.

QUESTION: So that what you're saying is that if fair-market value puts a ceiling on it, then it puts a ceiling on at both ends of the transaction; if the amount of the indebtedness is the major basis, it is at both ends of the transaction?

MR. SMITH: Well, the reason for that at the Bayles end of the transaction is simply because -- and there's case law to support this -- that when the value -- when the value of property is greatly -- it has great disparity between that and nonrecourse debt, that basis ought not to be the nonrecourse, the value of the nonrecourse debt because it's almost like not real debt in the sense that it has -- there's only a fanciful aspect of that, a loan you pay, very much like a contingent debt, and the courts have uniformly rejected inclusions of basis in that circumstance.

QUESTION: So going back to my Crane question earlier, if the value of the property at the time of the death of the person from whom it was inherited, had a fair-market value of less than the indebtedness, that would have been her basis at the time?

MR. SMITH: Yes.

QUESTION: Yes.

CHIEF JUSTICE BURGER: Mr. Mankoff.

ORAL ARGUMENT OF RONALD M. MANKOFF, ESQ.,

ON BEHALF OF RESPONDENTS

MR. MANKOFF: Mr. Chief Justice, may it please the Court:

The -- let me start by setting at rest a couple of questions that Mr. Smith has raised. First,

we agree there should be no deductible loss without economic detriment. Similarly, there should be no taxable gain without economic benefit. The way the tax system deals with this is to say there may be loss realized but not recognized and not allowed. And we agree with counsel for the government that the taxpayers did not suffer a deductible loss in a situation where they suffered no economic detriment. And the cases consistently so hold.

So that to the extent the government contends that is an issue in this case, we have not raised that issue except in the Tax Court.

QUESTION: Well, is it fair to say has your position been consistent on that all the way through?

MR. MANKOFF: Your Honor, we raised the issue at the opening of the Tax Court case. We lost in the Tax Court. We did not raise it in the Fifth Circuit, and it was not ruled on by the Fifth Circuit. The Fifth Circuit did not hold that we had a deductible loss.

QUESTION: So your position has not been consistent all the way through?

MR. MANKOFF: No, Your Honor, it was not consistent in the Tax Court below.

We have tried to abandon that issue consistently, by letters and representations and

statements to the government. But now that they find it the most, the strongest handle they have to waggle at us, they waggle it at us again and again. We agree there is no deductible loss.

QUESTION: I would like to waggle it at you, too, because --

(Laughter.)

QUESTION: -- it seems to me that if the statute, you just read the words, the definition of "amount realized" and all the rest of it, how can it have one meaning in the loss situation and a different meaning when you're looking at the amount realized that's claimed to be a gain?

MR. MANKOFF: Because losses and deductions are a matter of legislative grace. They are not given to taxpayers unless the Internal Revenue Code allows it. Income, on the other hand, is constitutionally taxed, and we pay taxes on virtually all income.

QUESTION: But even if it's a matter of legislative grace, and maybe you don't want it in this case but the next taxpayer comes along and says, well, if these words mean what the Fifth Circuit said they mean in this case, we're entitled to take the loss. And why wouldn't that be correct?

MR. MANKOFF: Because there is no economic

detriment.

QUESTION: But what in the statute requires an economic detriment?

MR. MANKOFF: Section 165 of the Internal Revenue Code says that losses shall be allowed unless compensated for by insurance or otherwise. It's our feeling that the "or otherwise" constitutes a broad range of negative economic effect. That is, any time the taxpayer doesn't truly suffer the loss, and he may -- and the insurance analogy, I think, is very strong -- when our car is damaged, we suffer a loss, but we're not allowed to deduct it because the insurance company reimburses us for it.

But the loss has been suffered. Just as I think the government's illustration of a piece of property that we own going down in value from $1.8 million to $1.4 million, I think a loss has occurred. I think something has happened in the world that shrinks the assets of the world by $400,000. So I think to say there's no loss begs the question.

To go further and say that by -- we will manipulate the Internal Revenue Code to prove there's no loss by increasing the amount realized on this $1.4 million piece of property, we therefore demonstrate there's no loss. Now, that to me is the ultimate of

alchemy, because a loss really has been suffered. It's not deductible because the taxpayer has not suffered a true economic detriment. The cases say that in situations like that, taxpayers are not allowed to deduct a loss even though the loss is experienced, is suffered, is realized.

QUESTION: When you say somebody, by the depreciation of the property somebody has suffered a loss, but is it the taxpayer if he hasn't suffered any economic harm?

MR. MANKOFF: No. No.

QUESTION: It's probably the bank.

MR. MANKOFF: Probably. Probably.

QUESTION: But it isn't the taxpayer's loss?

MR. MANKOFF: Clearly not. Therefore, no deductible loss.

QUESTION: Let me put this hypothetical to you. First, I would assume you would agree that it would make no difference if this were a partnership or an individual.

MR. MANKOFF: I would prefer to reserve -- actually, it should make a difference, sir, because --

QUESTION: Let's assume for --

MR. MANKOFF: All right.

QUESTION: -- to simplify the hypothetical,

it's an individual, and the transaction is exactly the same. Now, the taxpayer is making up a statement for his bank before this transaction occurred; that is, after he had acquired the property but before disclosing. And then assume after the transaction is completed, he makes up the financial statement for the bank for other purposes. Can you suggest how the transaction would be treated in terms of assets and liabilities in his financial statement?

MR. MANKOFF: Well, he certainly has suffered -- he has realized no gain. That is to say, he is not a richer man by having disposed --

QUESTION: Well, in the first place --

MR. MANKOFF: -- of the property.

QUESTION: In the first place, he wouldn't list this liability --

MR. MANKOFF: Exactly.

QUESTION: -- as a liability on his first statement because it was nonrecourse.

MR. MANKOFF: Exactly.

QUESTION: Do you agree?

MR. MANKOFF: Yes, sir.

QUESTION: Now, after the transaction is completed, would you make that comparison for me?

MR. MANKOFF: Well, actually, I think at the

start of the transaction, there would be balancing entries; that is, there would be an asset and a liability in equal amount, whatever those amounts were, $1.8 million of asset, $1.8 million of liability. On the disposition of the asset, both would disappear from his balance sheet.

Now, that is the simple fact of it. His assets are not enriched; that is, we don't have $400,000 of assets freed up by virtue of the disposition of the property, which would have been the case had this been liability debt. That is to say, if he had -- if there had been cancellation of $400,000 of liability debt, then other assets -- stocks, bonds, and cash -- would have been freed up and he would have had gain.

But in a situation like this, it's as though the man owned only one asset and owed only one debt.

QUESTION: Well, in the Chief Justice's example, though, when you're making up your statement to the bank after you purchase the property and build the building and complete the loan and you close it -- but this is before the sale --

MR. MANKOFF: Yes.

QUESTION: -- before you sell. How do you enter it on your balance sheet?

MR. MANKOFF: I would say we have $1.8 million

asset and $1.8 million of liability.

QUESTION: Well, he doesn't owe the liability. The property is subject to it. So it reduces his asset.

MR. MANKOFF: Well, are you saying, sir, that it would be appropriate to say zero asset because it's on a --

QUESTION: Well, that's what I am asking you. What do you think the accounting --

MR. MANKOFF: Let me say I am free of any misconceptions because I am not an accountant. I know that a loss --

QUESTION: Your tax accountant knows.

MR. MANKOFF: The -- the accountants, you know, when faced with this situation, say, my goodness, if something has happened on the left side, we must act on the right side.

The answer that I give is that this is federal taxation, this is not double-entry bookkeeping, that the tax system very often allows entries on the left side with no effect on the right side.

We give a lot of deductions, in the oil industry, for example, that are never offset anywhere else in the system. And notwithstanding Mr. Smith's statement, there is in many situations no reconciliation

of cost basis. We get cost basis in a number of situations that don't require that we give it back later on.

For example, in the case of individuals who go through bankruptcy, we have cancellation of debt, we have no income, and yet that debt may well have produced deductions, it may well have acquired assets that produce depreciation deductions. We don't go back and recapture it.

Notwithstanding what Mr. Smith says, the Crane case did not hold that anything included in basis must find its way into amount realized. The only reference to functional relationship was a common definition of property. What the court was saying was property must mean the same thing in the basis section as property means in the amount realized section because we use these two concepts in computing gain. Therefore, we must use apples and apples. But it didn't -- they were not saying that anything that's included in basis must find its way into amount realized, because they are not related, because basis is cost in one situation, or basis is value. In Mrs. Crane's situation, there was no cost element.

QUESTION: Mr. Mankoff, in the corporate reorganization context, I assume you would concede,

though, that the cancellation of the indebtedness is the amount received for tax purposes under sections 357(c) and 358?

MR. MANKOFF: 357(c), which has to do with the contribution of assets subject to liability, does not appear to have a limitation on it based upon the value of assets. As indicated in the brief, however, 311(c), which describes assets coming out of a corporation, does have that kind of limitation.

I don't know why there's an inconsistency. Generally, the code and the courts have treated fair-market value and economic benefit as being real concepts that must be part of our tax system, because without them we don't have a touchstone with which to measure the consistency and fairness of our system.

QUESTION: May I ask you a question?

MR. MANKOFF: Yes.

QUESTION: Supposing we have a transaction similar to this, but before the owner of the property disposed of it, they realized the fair-market value declined from $1.8 million to $1.4 million, and the owner went to the bank and said, we can't carry the $1.8 million loan, would you reduce the indebtedness to a more realistic figure? And they agreed to reduce the indebtedness, say, to $1.5 million. Then he continued

to own it for a while. But he never is on the note.

Would he realize any tax -- would there be any taxable consequences in changing the principle amount of the note when it's a nonrecourse note?

MR. MANKOFF: I would say first there should be no immediate tax consequence. No. I think very often that's treated as an adjustment of the purchase price if you're talking about the seller. In the situation you're describing, talking about the bank, I don't think it would be treated as adjustment of sale price. And clearly, there would be no tax at that time, no.

QUESTION: And suppose if they did that, and then after owning it for 2 or 3 years, and then after another year or so then he disposed of it, as he did in this case, fair-market value at $1.5 million. You would still say -- in that case, what would be the tax --

MR. MANKOFF: We'd have exactly the situation we have here --

QUESTION: What we have here.

MR. MANKOFF: -- which is, there is no gain realized without economic benefit.

QUESTION: And even though the liability was reduced in amount, that that still didn't result in any taxable benefit of any kind to the owner of the property

who was not on the note?

MR. MANKOFF: Not if he's not liable for the note, Your Honor, no. This gets back to what Crane was talking about. And the question was asked, must we overrule Crane in order to affirm the Fifth Circuit? And the answer is no. Crane dealt with only those situations which resemble recourse debt. They properly announced the law as to recourse debt and said that where nonrecourse debt fits that same situation, then we're going to apply the recourse debt rule.

And I understand what the court was saying. I, notwithstanding the government's inability to understand this concept, I own some property subject to nonrecourse debt. It has a value higher than that mortgage, and I treat it as though I owe that debt, every penny of it. And I will pay that debt rather than lose that property. And that's all the court was saying in Crane, that in a case where the nonrecourse debt is going to be treated as recourse debt, there's nothing wrong with treating the entire situation as though there was liability.

But they did say, this will -- this probably is not the rule, obviously is not the rule, where you don't have a similarity of situation; where you have a situation where an individual will not treat the debt as

his own, then it should not be treated the same. Because we don't have economic benefit, we don't have any advantage to the taxpayer. Certainly, our system is based upon that.

At no time was the Crane court saying that there must be an inclusion or a paying up at the end of the transaction for the advantage of utilizing basis or cost, because, you know, mortgage debt was not really in Mrs. Crane's cost, as such. Her cost was the value of the property. It happened the court said, the value of the property is the total property, unreduced by any debt.

And so we're not talking here or in Crane about a situation where we must replace that at the end of the transaction. All the court was saying was that where there is a similarity and a resemblance that will cause people to treat these transactions identically, then there is nothing inappropriate about the tax consequences being identical.

And if we -- a similar situation -- if we were at risk in this transaction so that we were in default and a foreclosure sale occurred and a third party bought in this property at $1.4 million, and the bank then said to us, well, we want the other $400,000, and we said, well, we'll try to get it for you, certainly no one

would say at that moment that we had any gain in excess of $1.4 million.

No one would talk to us about the depreciation deductions we had enjoyed in years past. No one would talk to us about the necessity of the quid pro quo, if you please, of replacing that -- the cost basis incident to mortgage. We haven't yet paid it, we may pay it in the future, or we may not. But in that taxable year, certainly no one would talk of a tax consequence including that as part of our gain. And why should someone who is in a nonrecourse position be treated less favorably than someone who owes the debt?

QUESTION: I am not sure, Mr. Mankoff, whether you had completed your response to my hypothetical or whether you did complete it and I didn't follow you. What's the difference in these two statements in terms of the net worth of this individual in the hypothetical before and after?

MR. MANKOFF: Mr. Chief Justice, in my opinion, the net worth --

QUESTION: If you're making a statement form, how would you make it up?

MR. MANKOFF: Yes. In -- I would make it up showing a liability and an asset in identical amount.

QUESTION: In the first statement?

MR. MANKOFF: That's right, in the first statement. And I would then show a cancellation of both items on the disposition of the property. Period. I can't conceive --

QUESTION: He's neither richer nor poorer?

MR. MANKOFF: Exactly. Exactly. It's as though the man owned no other assets. Yes. He is neither richer nor poorer. He has used all of the assets available to pay this debt to pay this debt. He has walked away from the transaction with nothing that he didn't have before.

QUESTION: Of course, on the first statement, he has no personal liability for the obligation, does he?

MR. MANKOFF: No, he does not, Your Honor.

QUESTION: Well, what if his income from the property, though, the rental income from the property, just paid the -- was such that it didn't earn any income but he had a cash flow equal, net cash flow that he could put in his pocket equal to the depreciation.

MR. MANKOFF: He would have gross income measured by the rental income. He would have a deduction equal to the depreciation --

QUESTION: Yes. And he would have cash then that he didn't have before.

MR. MANKOFF: Yes. That'd be relevant to the

rental income.

QUESTION: Yes. And so that -- so he would walk away from the transaction with the -- with money equal to the amount of the deductions.

MR. MANKOFF: He would also have, if I may submit --

QUESTION: Isn't that right?

MR. MANKOFF: Yes.

QUESTION: He'd have that much --

MR. MANKOFF: Given those two situations.

QUESTION: -- more money afterwards than he had before.

MR. MANKOFF: Yes. That is absolutely correct. This is the transaction in 1970 and 1971. This is the transaction to which the government has no complaints, and their question now is --

QUESTION: Well, I know, but -- I know, but that's the very amount of money that they would like to tax on.

MR. MANKOFF: The question then becomes, can we rewrite section 1001(b) to correct earlier undeserved deductions? I think the answer is clearly no. The "amount realized" definition has never been rewritten to pick up earlier errors. It says merely, amount realized is the cash received and property other than cash

received to the extent of its fair-market value.

That definition has never been distorted or rewritten in order to recover amounts which might have been distorted in previous years. And it should not be done in this case.

I would like to mention however briefly the implication of the partnership sections because in addition to 1001(b) there is another section that clearly applies, carefully written by the Congress in its section 752(c). It is allegedly a rewriting or a repetition of the Crane rule, and it limits itself to fair-market value. Therefore, we believe it must be a description or an enactment of Footnote 37.

And it says that in the case of a partnership, which is what was involved here, that liability shall be deemed to be liabilities of the owner of property where there is no recourse only to the extent of the value of that property.

Now, the Tax Court below said that clearly the language of this statute covered our situation. They said, however, that the legislative history suggests that the 752(c) was to apply only in two situations; that is, where property is contributed to a partnership or withdrawn from a partnership.

We submit that that kind of result limits

section 752(a) and (b) so unnecessarily as to be absolutely ridiculous, because there are other situations in which liabilities of a partnership may increase the basis of partners.

For example, this would mean, as was found by the Tax Court subsequently in the Brontes case, that if a partnership acquires an asset subject to a liability in excess of its basis, that section is not within 752(c) because it does not involve a contribution of property or the withdrawal of property. And therefore the partners would get increased basis in a situation like that.

Now, that case was reversed subsequently on the grounds that there was no true debt involved. But had there been true debt in a situation like that, the ruling of the Tax Court below would have destroyed the efficacy of 752(c) in virtually all situations other than the contribution and the receipt of properties.

And we think that we all want a fair and consistent taxing treating system. We don't believe that the rewriting of two sections of the code which contain clear and explicit language -- that is, section 1001(b) and section 752(c) -- so as to recover what the government perceives to be improper earlier deductions taken at a time when there was no risk, is a proper

method of achieving a fair and consistent tax system.

Thank you.

CHIEF JUSTICE BURGER: Do you have anything further, Mr. Smith?

ORAL ARGUMENT OF STUART A. SMITH, ESQ.,

ON BEHALF OF PETITIONER -- Rebuttal

MR. SMITH: I just have a brief point. The taxing system -- in this particular case, the Respondents borrowed $1.8 million, they put it in their pocket, and then they went and bought -- and constructed this building. The value of the building, during it, their ownership went down to $1.4 million. But then they transfered that property along with the debt. They don't have to worry about the debt anymore. Although at one time they had $1.8 million, which they spent, they were not taxed on that. The code gave them basis for that.

QUESTION: When you say they don't have to worry about the debt anymore, they never did have to worry about it.

MR. SMITH: They never had to worry about the debt anymore, Mr. Justice Rehnquist, but at the time, if they wanted to hold on to the property, they had to worry about the debt. Now they have given the property away. The debt is not their concern nor is the value of

the property their concern. That is the concern, as Justice White pointed out, of the bank because the bank has to look to the value of the property, which is the crime.

The Respondents -- the value of the property has absolutely no relevance to Respondents' economic position. If they were to, for example, buy a piece of land for $1 million, subject to a nonrecourse mortgage, and then the value of that property would go down to 900,000, to two, to $100,000, they haven't amortized the debt one penny. They then walk away from it, they abandon it. The Court of Appeals would say they have a $900,000 loss because the amount realized is only $100,000.

That -- that is, to say the least, absolutely bizarre. As Judge Friendly says --

QUESTION: But Mr. Smith, why couldn't -- I mean your opponent says that in Crane the court read something into the statute that wasn't perfectly clear that was there, why couldn't the court, in effect, say, well, looking at the code as a whole, a loss is not recognized unless there's an economic detriment. That is, I understand, his bottom line. Why couldn't we do that?

MR. SMITH: A loss is not recognized --

QUESTION: No; a loss is not recognized. You're saying there would be a loss if the fair-market value went down and --

MR. SMITH: Well, I mean one can do lots of things. The point is that --

QUESTION: But I mean would it be inconsistent with the way the court has construed the code in the past?

MR. SMITH: Well, what these statutes mean the same, you know, what's sauce for the goose is sauce for the gander. I mean these statutes mean the same in the gain context as in the loss context. I mean the statute talks about amount realized less basis equals gain or loss.

QUESTION: Well, is he right in saying there are no cases in which a loss has been recognized for tax purposes without an economic detriment?

MR. SMITH: I think that's asbsolutely right. It seems to me that the tax law -- the tax law -- I mean the tax law doesn't give losses without economic detriment.

I mean in this particular case, they had no economic detriment at the end of the -- at the end of the transaction. In fact, as Judge Friendly said in another context, any other course would render the

concept of basis nonsensical by permitting sellers of mortgage property to register large tax losses stemming from the inflated basis and a diminished realization of gain.

We submit that the diminishment, the diminution of the realization of gain executed by the decision below is improper and should be reversed.

CHIEF JUSTICE BURGER: Thank you, gentlemen. The case is submitted.

(Whereupon, at 10:51 a.m., the case in the above-entitled matter was submitted.)

CERTIFICATION

Alderson Reporting Company, Inc., hereby certifies that the attached pages represent an accurate transcription of electronic sound recording of the oral argument before the Supreme Court of the United States in the Matter of:
COMMISSIONER OF INTERNAL REVENUE v. JOHN H. TUFTS
81-1536

and that these attached pages constitute the original transcript of the proceedings for the records of the court.

BY _____
(REPORTER)