2006

Respect for Statutory Text Versus 'Blithe Unconcern': A Reply to Professor Coverdale

Erik M. Jensen

Respect For Statutory Text Versus "Blithe Unconcern": A Reply to Professor Coverdale

Erik M. Jensen

Response to Professor Jensen

John F. Coverdale

Reprinted from
TULANE LAW REVIEW
Volume 72, Number 5

Respect for Statutory Text Versus "Blithe Unconcern": A Reply to Professor Coverdale

Erik M. Jensen*

In a recent article, John F. Coverdale calls for judicial adherence to the text of the Internal Revenue Code.[1] Professor Coverdale discusses a number of cases in which judges proceeded as if actual statutory language were irrelevant, and it is not the judiciary's function, he reasonably argues, to redirect congressional determinations of appropriate tax policy.

I am generally sympathetic to the Coverdale position; courts ought not to act as if they were unconstrained by text. But Professor Coverdale overestimates the extent to which statutory text leads to unequivocal results. And he gives short shrift to one critical question: if years, maybe decades, of judicial decisions have added a generally accepted gloss to statutory language, is it really appropriate for a court, even the Supreme Court, to try to reclaim first statutory principles?

In these brief comments I focus on the well-known case of *Tufts v. Commissioner*[2] because Professor Coverdale suggests that some commentators on *Tufts*, including me, have shown "blithe unconcern for the text of [a] statute."[3] I apparently did that by concluding that the result in *Tufts* was "unexceptionable."[4] In fact, I was neither blithe nor unconcerned. I used that term because the result was consistent with (even though not absolutely required by) judicial precedent and common understanding. Professor Coverdale seems to be—dare I say it?—blithely unconcerned about judicial developments that inevitably affect statutory interpretation.

I. *TUFTS* IN BRIEF

Tufts and its history are known to most law students.[5] In 1947, the United States Supreme Court had concluded, in *Crane v.*

* Professor of Law, Case Western Reserve University, Cleveland, Ohio.

1. *See* John F. Coverdale, *Text as Limit: A Plea for a Decent Respect for the Tax Code*, 71 TUL. L. REV. 1501 (1997).
2. 461 U.S. 300 (1983).
3. Coverdale, *supra* note 1, at 1554 n.230.
4. *See id.* (quoting Erik M. Jensen, *The Unanswered Question in* Tufts: *What Was the Purchaser's Basis?*, 10 VA. TAX REV. 455, 471 (1991)).
5. Those who prepare for class, that is.

Commissioner, that the "amount realized" on the transfer of property encumbered by a nonrecourse liability generally includes the amount of the liability.[6] Sell a $200,000 parcel subject to a $130,000 liability for $70,000, and your amount realized is $200,000.[7] The statutory definition of "amount realized" does not specifically include relief from liabilities within its scope—"[t]he amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received"[8]—but the Court gave some generally plausible justifications for including the liability. One is the economic benefit that a seller usually receives from transferring encumbered property, even if he is not personally liable on the obligation. You will not risk losing a $200,000 property by not making payments on a $130,000 debt. You will therefore treat a nonrecourse debt as if you were personally liable,[9] and, if you sell the property, you will no longer have to make those nasty debt-service payments.

But that economic-benefit rationale goes only so far, and, in *Crane*'s famous footnote 37, the Supreme Court left open whether "amount realized" ought to include the full amount of a nonrecourse liability in special (but not unheard of) circumstances: when the value of the securing property has dropped below the amount of the liability at the time of transfer.[10] Suppose that the value of property that secures an initially fully secured nonrecourse liability of $1.85 million drops to $1.4 million (actual numbers, rounded off, taken from *Tufts*)[11] and the property is transferred subject to the debt. With a nonrecourse debt, the borrower has no obligation to come up with the $450,000 difference; he can walk away from the property without personal liability. In that famous footnote in *Crane*, the Court suggested that the economic benefit attributable to relief from a nonrecourse liability on the disposition of property might—just might—be limited to the fair market value of the property.[12]

Nearly thirty-six years later, in 1983, *Tufts* answered the footnote 37 question. Somewhat disingenuously, the Court denied that the

6. 331 U.S. 1 (1947).

7. If your basis in the property is $50,000, you therefore have a gain of $150,000. If your basis is $250,000, you have a $50,000 loss.

8. I.R.C. § 1001(b) (1997). Regulations issued under section 1001 in 1980, while *Tufts* was before the Fifth Circuit, provided for the treatment of liabilities, *see* Treas. Reg. § 1.1001-2 (1980), but the statute itself is silent.

9. *See Crane*, 331 U.S. at 14.

10. *See id.* at 14 n.37.

11. *See* Commissioner v. Tufts, 461 U.S. 300, 302-03 (1983).

12. *See Crane*, 331 U.S. at 14 n.37.

Crane Court had relied on an economic-benefit rationale.[13] But whether or not that rationale was really part of *Crane*, the *Tufts* Court was right that it did not have to be—at least not in the way that I described the rationale above. The real justification is straightforward: a taxpayer should not be able to borrow dollars tax-free, under the long-accepted doctrine that borrowed dollars are not "income,"[14] and also avoid tax liability if he does not repay the borrowed funds.[15] That deferred-tax theory—borrowed funds should be taxed if and when the obligation to repay expires—justifies the result in *Crane*.[16]

And it also justifies requiring the *Tufts* partners to include the full amount of the liability in amount realized. They had borrowed $1.85 million at the time of the property's acquisition. Later, on transfer of the property, the partners were relieved of any obligation to repay the full $1.85 million, even though the value of the property had fallen to $1.4 million. Not having to pay back all of the borrowed (and previously untaxed) dollars, they should certainly have been taxed on the debt relief. In *Tufts*, that relief was reflected in additional gain on disposition of the property (amount realized of $1.85 million less basis of $1.45 million,[17] resulting in gain of about $400,000), most of which would have been taxed at capital gains rates.[18]

Crane had concluded that the amount of a nonrecourse liability encumbering transferred property should be included in the amount realized. *Tufts* simply extended that principle to a slightly more difficult set of facts. Viewed in that way, and given *Crane*, the result in *Tufts* was "unexceptionable."

---

13. *See Tufts*, 461 U.S. at 307.

14. Presumably because of the offsetting obligation to repay.

15. *See Tufts*, 461 U.S. at 311-12. In another section of *Crane*, the Court concluded that the liability at issue had properly been included in the taxpayer's depreciable basis in the property. *See Crane*, 331 U.S. at 10-11. (That is, the case is generally understood as standing for that proposition, whether or not the facts fully support that understanding.) A taxpayer should not be able to take depreciation deductions measured by a basis heightened by debt—as if the debt is a "cost" of the property—and then treat relief from that debt as creating no taxable accession to wealth. *See id.* at 15-16.

16. On the *Crane* facts, capturing the debt relief required including the liability in amount realized. Because there was no discharge of indebtedness—Mrs. Crane transferred property with value equal to or greater than the amount of the liability—the *Crane* Court had no reason even to consider a bifurcated approach to transfers of encumbered property. *See* Deborah A. Geier, Tufts *and the Evolution of Debt-Discharge Theory*, 1 FLA. TAX REV. 115, 123 (1992); *infra* notes 17-44 and accompanying text.

17. The original basis had included the full $1.85 million liability, but depreciation deductions taken before the time of disposition had reduced the basis to about $1.45 million. *See Tufts*, 461 U.S. at 303.

18. *See id.* at 312.

II. THE COVERDALE CRITICISM

Professor Coverdale does not challenge the proposition that Tufts and his friends should have been stuck with a larger tax bill than they wanted, but he nevertheless argues that the Court was wrong to do what it did in *Tufts*. Instead, it should have revisited the statutory language, which says nothing about liabilities. After taking a fresh look, the Court should have adopted an approach different from that in *Crane*—or different from the way *Crane* had usually been interpreted—to insure that relief from indebtedness does not escape taxation.[19]

The alternative analysis that Coverdale now promotes—what is usually called "bifurcation"—had been urged by Professor Wayne Barnett in an amicus brief filed in *Tufts*, and it was picked up on by Justice O'Connor in a concurring opinion. Barnett and O'Connor suggested that a transfer of property encumbered by an undersecured nonrecourse obligation ought to be treated in part as (1) relief from the liability, which under traditional law would generate discharge-of-indebtedness income (equal to the difference between the amount of the obligation and the value of the property transferred to satisfy the obligation), and in part as (2) a disposition of property, which would give rise to either gain or loss (depending on the difference between the property's value and basis at time of disposition).[20] On the *Tufts* facts, that would have meant about $450,000 of discharge-of-indebtedness income (with a $1.85 million debt satisfied by transferring a $1.4 million property), and a loss of about $50,000 (basis of $1.45 million less amount realized of $1.4 million).[21]

Easy enough.

The bifurcation analysis recommended by O'Connor, Barnett, and Coverdale was not radically new: it is routine for property dispositions that involve *recourse* liabilities.[22] We treat relief from indebtedness generally as income to the debtor; why can we not straightforwardly do the same thing when an undersecured *nonrecourse* liability happens to be released through transfer of the property securing the liability?[23] Furthermore, bifurcation does not

19. *See* Coverdale, *supra* note 1, at 1552-56.

20. *See Tufts*, 461 U.S. at 317-18 (O'Connor, J., concurring).

21. *See id.* (O'Connor, J., concurring).

22. *See* Treas. Reg. § 1.1001-2(a)(2) (1980); Geier, *supra* note 16, at 123, 125, 129. Unfortunately, the regulations do not explicitly distinguish between recourse and nonrecourse liabilities, but the understanding has been that different rules apply in the two cases.

23. The government had no reason to think of bifurcation in *Crane*, because there would have been no discharge of indebtedness income, and the government's primary

affect the net amount of income or loss recognized on the transfer of encumbered property: if more is characterized as discharge-of-indebtedness income, there is correspondingly less gain (or more loss) attributable to the disposition of property. With the numbers used above—income of $450,000 and a loss of $50,000—the net effect is $400,000, the same as that decided upon by the Supreme Court.

Of course, the bifurcation analysis is not just a more sophisticated way to get to the same result as treating the liability as part of amount realized; if it were, no one would care about this stuff.[24] The alternative analysis could very well affect the character of gain or loss recognized—and thus the tax bill. In *Tufts* itself, the result of bifurcation would have been substantial, potentially highly taxed ordinary income—from the discharge-of-indebtedness—and a loss of a less useful character.[25] How bad (or good) those different characterizations are depends on a taxpayer's particular circumstances.[26]

III. WHAT'S WRONG WITH BIFURCATION?

The O'Connor/Barnett/Coverdale analysis is a defensible position, maybe the best way to treat the transfer of encumbered property in an income tax system. If we were trying to develop a system from scratch, it might very well be the way to go. But Professor Coverdale is quite wrong in suggesting that bifurcation fits the existing statutory text more easily than does a "collapsed" approach. And we are not starting from scratch.

A. *Fidelity to Text*

Coverdale writes: "On the sale of the property [i.e., the second part of the bifurcated transaction], the amount realized would be the $1.4 million fair market value of the property."[27] Huh? Reread the statutory definition of "amount realized": "the sum of any money

---

concern was to ensure that Mrs. Crane's accession to wealth did not altogether escape taxation. *See* Geier, *supra* note 16, at 123.

24. As it is, few do anyway.

25. I assume that the loss would have been covered by I.R.C. § 1231. Suffice it to say that such character is not necessarily as desirable as having a straightforwardly ordinary loss.

26. Lots of discharge-of-indebtedness income might not have been such a bad result for some taxpayers because, at the time of *Tufts*, section 108 permitted nonrecognition of such income in circumstances that are not available today—for so-called "qualified business debt" in situations beyond insolvency and bankruptcy. It is better, that is, to have unrecognized ordinary income than to have actually-taxed capital gain. The scope of section 108 is much narrower today, however.

27. Coverdale, *supra* note 1, at 1554-55.

received plus the fair market value of property (other than money) received."[28] In this deemed disposition—and there is a lot of deeming going on here—what is the amount of the cash and the fair market value of the property *received*? For that matter, *is* any cash or property received?

Professor Coverdale can answer those questions, but doing so requires an expansive reading of statutory language. He accepts the *Crane* result:

> Although relief from the mortgage is not cash or property in a narrow technical sense, taken in context, the statutory language "money received plus the fair market value of the property (other than money) received" can plausibly be read to include items of value that do not meet the technical definitions of cash or property.[29]

The term "amount realized" can be read, that is, as referring to "things of value."[30]

OK, that is "plausible." It is as if cash were received and used to pay off the liability, and we conceptualize transactions using deemed-cash steps all the time. But that interpretation is hardly *required* by statutory language; it is a matter of time-honored understanding, supported by precedent.

In any event, we treat the relief as "property" up to the fair market value of the transferred property.[31] But, writes Coverdale, we do not treat debt relief as "property" to the extent of any excess over fair market value: "It is not . . . possible to treat the seller as having received cash in the full amount of the mortgage and as having then paid off the mortgage with the cash."[32]

Not possible?[33] Come on; I just did it in my head. Tufts and his partners, the sellers, had an obligation to repay the cash that they had borrowed tax-free. On the disposition of the property, that obligation was discharged. As far as the sellers were concerned, the transaction was, in substance, exactly as if they had received dollars equal to the amount of the mortgage and had then paid off the mortgage in full.[34]

28. I.R.C. § 1001(b).

29. Coverdale, *supra* note 1, at 1551.

30. *Id.* at 1552.

31. *See id.* at 1551.

32. *Id.* at 1552.

33. In my earlier article, I noted that, "to the extent of the excess of principal amount over property value, it may be impossible to fit 'relief' from the liability within the statutory definition of 'amount realized.'" Jensen, *supra* note 4, at 468 n.54, *quoted in* Coverdale, *supra* note 1, at 1553 n.226. I now wish that I had not used the word "impossible."

34. *See* Commissioner v. Tufts, 461 U.S. 300, 312 (1983). The treatment of the transaction to the buyer presents different questions. *See generally* Jensen, *supra* note 4.

This is the analysis that justifies the result in *Crane*: borrowed dollars that had not yet been taxed should not escape taxation if the obligation to repay disappears.[35] As far as I can see, nothing in the language of section 1001(b), the definition of "amount realized," supports the distinction that Professor Coverdale wants to draw between the *Crane* and *Tufts* situations.

In short, I see no reason to conclude that the Coverdale analysis is clearly mandated by statutory text—at least not by section 1001(b)—and that the Supreme Court's result in *Tufts* is clearly incompatible with that text. The bifurcation analysis makes sense, but not because the statutory definition of "amount realized" requires it.

B. *Fidelity to Prior Understanding*

Even if the bifurcation analysis fits the statute better than a collapsed approach—a proposition I will accept only for the sake of argument—I question whether the *Tufts* Court was in a good position to return to (or to create) first principles. Rightly or wrongly, *Crane* had defined the controlling conceptualization of transfers of property encumbered by nonrecourse liabilities: any liability was to be treated as part of the amount realized. And courts and almost everyone else had come to accept that understanding.

I concede that, read narrowly, *Crane* did not mandate the *Tufts* result: *Crane* had no discharge-of-indebtedness component, because the transferred property's value was greater than or equal to the amount of the liability, and *Crane* therefore did not necessarily govern the treatment of the last $450,000 of the *Tufts* debt.[36] But as far as the real world was concerned, thirty-six years of learning and practice had followed the general understanding of *Crane*. And, by the time *Tufts* was resolved by the Supreme Court, some of that learning had been reflected in regulations issued under section 1001(b): subject to some amorphous exceptions, "the amount realized from the sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition."[37]

35. Indeed, if we do not view Tufts and his partners as having received value in connection with the transfer of property, there is no reason to consider the possible application of the discharge-of-indebtedness prong of the bifurcation approach. Under one theory or another, Tufts and his partners received value in connection with the disposition of the property.

36. *See supra* note 16.

37. Treas. Reg. § 1.1001-2(a)(1) (1980); *see also Tufts*, 461 U.S. at 310 n.9 (noting that the regulation "merely formalized the Commissioner's prior interpretation"). One exception is that the rule does not apply to the extent that income is characterized as discharge-of-indebtedness income, *see* Treas. Reg. § 1.1002-2(a)(2), but the regulation does

Indeed, the *Tufts* controversy was framed in terms of *Crane*: should the "same rule" that applied in *Crane* apply in *Tufts*?[38] With the issue characterized in that way, how could the analysis not be driven by the *Crane* understanding?

It just will not do to suggest that a theory of statutory interpretation ought to be able to ignore decades of contrary understanding, especially when that understanding is not off-the-wall.[39] This is not, strictly speaking, a question of stare decisis, because the facts of *Crane* and *Tufts* could have led to a technically justifiable distinction between the two cases, but deference to accepted interpretation walks and quacks a lot like stare decisis.[40] Statutory language deserves respect, but time sometimes passes language by.[41] And the Republic will not grind to a halt if courts are getting the statutory analysis fundamentally wrong: Congress can undo the damage by modifying the statute.[42]

In addition, it is a little otherworldly to expect a generalist Court, in a technical tax case, to adopt a position that was advanced by neither party.[43] It is especially unrealistic to expect a generalist Court to reject a plausible position advanced by the Commissioner when that

---

not spell out when that would be the case. The understanding is that it applies to undersecured *recourse* liabilities that are discharged in connection with the transfer of securing property.

38. *See Tufts*, 461 U.S. at 302.

39. I reemphasize that in this section I am assuming *arguendo* that statutory language requires the Coverdale result.

40. Stare decisis is not merely a matter of convenience; it has principle behind it. *See* Henry Paul Monaghan, *Stare Decisis and Constitutional Adjudication*, 88 COLUM. L. REV. 723 (1988).

41. The Constitution, for example, may forbid paper money, but we cannot ignore more than a century of history and reclaim a world in which that original understanding makes sense. *See id.* at 744 ("Many constitutional issues are so far settled that they are simply off the agenda."). Professor Monaghan cites the post-Civil War *Legal Tender Cases* that sustained the use of paper money despite the understanding that "under the 1789 constitution only metal could constitute legal tender." *Id.*; *see* U.S. CONST. art. I, § 8, cl. 5 (giving Congress the power "[t]o coin Money"). Notes Monaghan, "[N]o Supreme Court would now reexamine the merits, no matter how closely wedded it was to original intent theory and no matter how certain it was of its predecessor's error." Monaghan, *supra* note 40, at 744.

42. I am not arguing that Congress had implicitly acquiesced in, or ratified, prior interpretations of the statute. I do not want to get bogged down in that debate. *Cf.* Coverdale, *supra* note 1, at 1520-21. I mean to suggest only that congressional power to correct mistakes ought to make us feel more comfortable in following judicial precedent and common understanding.

43. Indeed, such a result might be unfair. The *Tufts* litigation had proceeded to the Supreme Court as a fight between taxpayer Tufts and the Commissioner of Internal Revenue, each of whom had staked out his position at some length. Litigants' expectations may have to give way to grand theoretical concerns in some cases, but the garden-variety tax case does not seem to me to be one of them.

position seemed to be consistent with precedent. Maybe the government bamboozled the Court in *Tufts* by not addressing the bifurcation questions directly,[44] but the Court had no reason to question the Commissioner's good faith. The only urging for striking out in a new direction came from a fuzzy-headed academic or two.[45]

Under the circumstances, it is not surprising that *Tufts* came out the way it did. It would have been amazing if anything else had happened.

IV. CONCLUSION

All of which brings me back to what I originally wrote about *Tufts*. I did not express "blithe unconcern" about text. What I said was that, "*[a]s an extension of Crane*, which was not under challenge, *Tufts* was an unexceptionable decision."[46] I repeat: *as an extension of Crane*. Including the liability in amount realized was not necessarily the incontrovertibly correct result in *Tufts*, but it was unexceptionable given what had gone before.

Professor Coverdale may well be able to answer these criticisms, but I do not think he has done so yet. If his argument in favor of respecting the Code's text is to be persuasive, he has to provide a clearer basis for determining whether an interpretation does, or does not, fit statutory language. And he has to explain how we should deal with interpretations, and precedent, of long standing.

---

44. *See* Geier, *supra* note 16, at 125. As Geier points out: "[T]he government . . . neither fully alerted the Court that the bifurcated method was used for recourse debt nor, consequently, defended using *different* approaches for different types of debt . . . ." *Id.* Furthermore:

> From the petition of writ of certiorari onward, the government characterized the case as presenting only a single issue, thus allowing the Court to conclude easily that if relief from nonrecourse debt in excess of the fair market value of the property was properly considered an accession to wealth, the *sole* method to ensure its taxation was to include it in the amount realized on the property disposition.

Id. at 129-30 (emphasis added). The government might have taken the position that it did in *Tufts*, rather than recommending bifurcation, in order to protect itself against taxpayers in positions similar to Tufts. *See id.* at 127-29. The section 108 election was apparently not available to Tufts himself, however, because he had not made an election on a timely basis.

45. The Barnett brief in *Tufts* attracted the attention it did because it was seen as such a pathbreaking change in direction. Whether it should have been seen that way or not is another question, because Barnett was arguing, in effect, that the treatment of nonrecourse liabilities should simply be conformed to the treatment of recourse liabilities.

46. Jensen, *supra* note 4, at 471 (emphasis added).