

## **The Story of *Crane*: How a Widow's Misfortune Led to Tax Shelters**

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October 30, 2002 revision

### Abstract

This chapter presents the story of *Crane v. Commissioner*, 331 U.S. 1 (1947), the case described by Professor Bittker as having “laid the foundation stone of most tax shelters.” The usual understanding of the facts and significance of this famous case is something like the following: Beulah Crane inherited an apartment building when it was encumbered by a sizable debt which she had no personal obligation to repay. She operated the building for several years and depreciated it for tax purposes. Eventually, she sold the building subject to the still existing debt and calculated her gain based on the position that neither her initial basis in the property nor her amount realized upon disposition should include the amount of the debt. Although this position was arguably inconsistent with her prior claim of depreciation deductions, it was too late for the government to deny those prior deductions. The government therefore challenged her attempted whipsaw by asserting that the debt should be included in both amount realized and basis, and the Supreme Court agreed. This “victory,” however, turned out to be a big mistake, for the inclusion of nonrecourse debt in basis became one of the principal features of tax shelters. Only after much litigation and legislative and administrative activity have *Crane*-based shelters finally been put to rest.

Drawing upon newspaper stories, briefs and other court documents, unpublished judicial opinions and memoranda, and other sources, this chapter provides a fuller and more nuanced account of Mrs. Crane’s story and its aftermath. From a policy standpoint, the story provides valuable lessons about the development of the tax law through the litigation process.

One often overlooked fact is that Mrs. Crane owned her building during the Great Depression when she, along with many others, had fallen on hard times. As a result, her tax savings from all of the depreciation deductions only amounted to about \$122. This fact certainly suggests that there may have been more behind the government’s decision to litigate than merely a desire to deny the advantage from her attempted whipsaw. Bear in mind that the *position* she urged upon the courts was an internally consistent one, and did not authorize any whipsaw of the government.

Another interesting aspect of Mrs. Crane's story was the significant role played by Judge Learned Hand. The Tax Court had voted 14-2 in favor of Mrs. Crane based on a straightforward interpretation of the statute. But in a 2-1 decision, the Second Circuit reversed. Writing for the majority, Judge Hand argued that the government should prevail in order to prevent the taxpayer from getting a "double deduction." Although his opinion is a bit unclear as to exactly what he meant by this, an unpublished draft reveals that his principal concern was apparently the inconsistency in Mrs. Crane's tax reporting positions. Again, this concern is curious, given the internal consistency of the legal rule she urged upon the court and the meagerness of her personal advantage from the whipsaw. Nevertheless, Judge Hand's reasoning was characteristically persuasive to the Supreme Court, whose opinion closely tracked his.

Indeed, Judge Hand may have played an even more important role in this case. From the unpublished drafts of the other judges on the Second Circuit panel, we know that the initial vote was 2-1 in favor of Mrs. Crane. For reasons unknown, Judge Frank changed his mind, permitting Judge Hand to write for the majority. According to Professor Gunther, the friendship between Judges Hand and Frank was "one of the court's most affectionate and intimate."

Following the Supreme Court's decision, courts continued to grapple with whether nonrecourse debt used to acquire property must be included in basis and amount realized. In *Crane*, the Court did not directly answer the basis question because Mrs. Crane acquired her property by devise. Nevertheless, the case's most lasting influence is in resolving that issue. In contrast, although the Court's holding with respect to amount realized continues to be the law today, the analysis it used to reach its conclusion did not stand the test of time. Subsequent courts very quickly either misunderstood or began to disregard the "economic benefit" theory relied upon by the Court. This process culminated with *Commissioner v. Tufts*, 461 U.S. 300 (1983), where Justice Blackmun, in a bit of revisionist history, announced that this theory really hadn't been critical to the *Crane* holding after all. The chapter describes these decisions, their relationship to tax shelters, and the enactment of subsequent legislation muting the impact of the *Crane* rule.

The chapter concludes by considering how events might have turned out if the Supreme Court had decided *Crane* differently. In her appeal, the taxpayer presented the Court with a law review note that urged adoption of a rule essentially equivalent to the "at risk" limitation in the law today. What might have happened if the Court had heeded the advice of this note, or had otherwise reversed the Second Circuit and reinstated the holding of the Tax Court? Would the lengthy war on tax shelters, and all of its adverse effects, have been avoided?

Perhaps not. The question is whether there would have been general acceptance of an "anti-*Crane*" rule adopted by the Supreme Court. If not, the Congress and/or subsequent courts presumably would have tried to circumvent or limit the Court's holding. It is quite possible that an anti-*Crane* decision by the Court would have been viewed as "before its time."

To understand why, it is important to remember the underlying policy reason to treat cash and debt-financed investments similarly for tax purposes. As long as debt proceeds are not treated as income when received, a taxpayer who acquires property in exchange for a debt obligation should presumably bear the same tax consequences as one who makes a cash investment with borrowed funds. Part of the *Crane* rule, then, is simply establishing this basic equivalency between cash and debt.

*Crane*, of course, extended the tax treatment of debt to include nonrecourse borrowing. But recourse and nonrecourse debt differ only in degree and not in kind. In the ordinary case, where the amount of the debt remains less than the fair market value of the property serving as security for the debt, nonrecourse debt is fully repaid by the borrower. Conversely, recourse debt may not be repaid in a variety of circumstances such as when the debtor becomes insolvent. If either recourse or nonrecourse debt is not repaid, the tax system in each case requires the debtor to recognize income equal to the amount of the debt discharged. Thus, it is not obvious that a sharp distinction should be drawn for tax purposes between recourse and nonrecourse debt.

In addition, although the *Crane* rule became an integral part of tax shelters, the rule, on its own, was not the cause of shelters. Other tax rules -- the allowance of tax depreciation deductions in excess of economic depreciation, the taxation of *Tufts* gain at preferential tax rates, the failure to distinguish interest from principal payments for tax purposes, the deferral permitted by the installment sale rules, to name a few -- were necessary to produce the shelters in conjunction with the *Crane* rule. The flaw of the *Crane* rule -- a not insignificant one in retrospect -- is that it did nothing to restrain tax shelter activity once the economic, tax, and other conditions in this country made it ripe for such activity. Instead, it magnified the inadequacies of the other tax rules. In order to prevent shelters, it relied upon a degree of perfection among the other rules, and a level of compliance among taxpayers, that were probably unrealistic expectations of any tax system.

But would this weakness have been generally recognized in 1947? The government did not demonstrate any particular awareness of it and it seems unlikely that the public would have been any more cognizant. Thus, adoption of an anti-*Crane* rule by the Court may well have encountered opposition because of its deviation from normative income tax principles, and led to efforts to reverse or limit the effect of the Court's holding. As they say, some lessons simply have to be learned the hard way.