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Anti-Basis

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ANTI-BASIS*

ETHAN YALE**

Anti-basis is the untaxed benefit enjoyed by a taxpayer when a liability or obligation is incurred. In the business context, the untaxed benefit is an increase in asset basis or a tax deduction. In the personal context, the untaxed benefit might take one of those forms, or it might be (nondeductible) personal consumption. A well-functioning income tax system must keep track of any such untaxed benefit. If the liability from which the benefit derived is avoided by the taxpayer, the prior untaxed benefit must be counted as income (or must reduce basis). If there was no prior untaxed benefit relating to a liability, exceptions are necessary to various rules requiring income recognition (or basis reduction) on discharge or shifting of liabilities.

Present law requires taxpayers to account for anti-basis, but it does so ad hoc. Various sections tacitly incorporate anti-basis—such as §§ 108(e)(2), 357(c)(3), and the partnership definition of “liabilities” in regulation § 1.752-1(a)(4), to take just a few of the many examples—but each section exists on an island. A few prior commentators have sensed that a common underlying concept ties these rules together. Prior to this Article, however, there has been no thorough investigation of this concept.

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INTRODUCTION

Determining the impact of nearly all transactions on a taxpayer's taxable income requires keeping track of and examining the relationship among a relatively small number of fundamental concepts, including: gross income, deductions, amount realized, tax basis, realization, recognition, capital expenditures, and depreciation. The thesis of this Article is that there is another, largely unappreciated, fundamental concept that feeds into the determination of taxable income. I will refer to this concept as "anti-basis."

A loan is at once an asset to the lender and a liability to the borrower. The lender's tax basis in the loan is set at inception. It equals the lender's cost of acquiring the borrower's promise to repay—that is, the lender's tax basis equals the loan proceeds disbursed to the borrower. The borrower's anti-basis in the loan equals its untaxed receipt of cash. Later, when the borrower repays principal, the lender has no income. Instead, the principal repayment is set off against and reduces the lender's tax basis in its asset. Likewise, the borrower has no deduction. Instead the principal repayment is set off against and reduces the borrower's anti-basis in its liability.

Thus, the amount paid by the borrower to discharge or settle a liability minus the borrower's anti-basis in the liability equals the

deduction (or, if negative, income) resulting from the liability. The arithmetic relationship among (a) the amount paid to discharge or settle a liability, (b) the borrower's anti-basis in the liability, and (c) the resulting deduction or income is parallel to the relationship among (a) the amount realized on the sale or other disposition of an asset, (b) the owner's basis in the asset, and (c) the resulting gain or loss. To see the analogy it is useful to set out the relationship in tabular form.

Table 1: The basis-anti-basis analogy		
	Asset disposition (§ 1001(a)) ¹	Liability discharge
(a)	amount realized	amount paid
(b)	<i>less</i> <u>basis</u>	<i>less</i> <u>anti-basis</u>
(c)	<i>equals</i> gain (loss)	<i>equals</i> deduction (income)

The simplest example of income relating to discharge of a liability with anti-basis is cancellation of debt (“COD”) income. When a borrower defaults or a lender forgives a loan, the resulting COD income equals the difference between whatever amount is paid (possibly zero) and the borrower's anti-basis. In the converse case—when the amount paid is more than anti-basis, and a deduction results—the terminology depends on the context. To take one example, if the liability is a bond, the excess over anti-basis paid by the borrower to repurchase the bond is called repurchase premium and is deductible.²

My goal is to convince you that anti-basis presently exists and is among the fundamental concepts in income tax law. I concede that defining and explaining the parameters of this concept is not strictly necessary. This is obvious given that the United States has been collecting income tax for over a century without officially acknowledging the anti-basis concept. I argue that recognizing the existence of anti-basis is useful nevertheless, for three reasons.

First, thinking through familiar problems using anti-basis reveals a connection among the many rules that depend on the concept. Comparing these rules shows that anti-basis is woven into the law in

1. I.R.C. § 1001(a)(2012). Unless otherwise noted, all references to sections are to the Internal Revenue Code, as amended.

2. Treas. Reg. § 1.163-7(c) (1994).

different ways in different domains. This invites the question whether various departures from the usual way of accounting for anti-basis represent good policy. I try to answer some of these questions.

Second, defining anti-basis facilitates a more concise explanation of doctrine. In this vein, consider that we could remove the term “tax basis” from the lexicon of income taxation and substitute in its place some (unavoidably long) phrase like “generally, except as otherwise provided or unless the context otherwise requires, the taxpayer’s original cost for the property reduced by amounts properly chargeable to capital and increased by capital expenditures made with respect to the subject property.” The exceptions (mostly for nonrecognition transactions) would then have to be tacked on. The increase in turgidity that would result from this change would be profound. Clarifying the role of anti-basis in evaluating the tax consequences of transactions involving liabilities will help to clarify speaking—and, therefore, hopefully clarify thinking—about the tax treatment of liabilities, particularly when they are shifted from one taxpayer to another.

Third, acknowledging the existence of anti-basis as a meaningful concept takes pressure off of the related question of how to define the term “liability” for tax purposes. (This third reason is an extension of and perhaps a subset of the second reason, mentioned in the prior paragraph, but it is sufficiently important that it deserves to be mentioned separately.) It is difficult to overstate the practical significance of how “liability” is defined. This has been the central focus of hundreds if not thousands of court cases and numerous important statutory and regulatory reforms.³ As detailed below, disputes about the precise meaning of “liability” are in most instances disputes about whether some “obligation” has anti-basis. (“Obligation” is a term tax lawyers use to define an umbrella category that encompasses “liabilities,” in the technical sense used in various code sections and regulations, as well as other debts or commitments that fall outside the agreed on or claimed definition of “liabilities.”) If the focus were placed on the question of whether a given obligation

3. See, e.g., Act of Nov. 6, 1978, Pub. L. No. 95-600, 92 Stat. 2763, 2854–55 (1978) (codified at I.R.C. § 365(a), (c) and amending § 357(c)); *United States v. Woods*, 134 S. Ct. 557, 563–65 (2013); T.D. 9207, 2005-26 I.R.B. 1344–68, <https://www.irs.gov/pub/irs-irbs/irb05-26.pdf> [<https://perma.cc/PVN2-6KGH>] (amending Treas. Reg. § 1.752-1(a)(4), the definition of “liability” for purposes of partnership taxation under Subchapter K); Warren Rojas, *Son-of-BOSS Settlement Nets \$3.2 Billion for IRS*, 106 TAX NOTES 1493, 1493 (2005) (reporting the IRS settlement initiative of cases centering on definition of liability nets \$3.2 billion).

has or lacks anti-basis, rather than on whether a particular obligation is a liability, conceptual mistakes would be avoided.⁴

I. BACKGROUND

I do not claim originality for the anti-basis idea. Though I know of no sustained discussion of anti-basis (or of the same concept by a different name) in tax policy literature, there have been a few references to the concept in prior scholarship. The earliest reference appears to be in the second edition of William Andrews's casebook, *Federal Income Taxation of Corporate Transactions*.⁵ He floated the idea in the notes following *Focht v. Commissioner*.⁶ In *Focht*, a cash-method shareholder transferred accounts payable to a controlled corporation in a transaction qualifying for nonrecognition under § 351.⁷ The question was whether the payables constituted "liabilities" under § 357(c).⁸ This question was crucial: the value of the payables outstripped the shareholder's basis in the contributed assets, so if the payables were liabilities, gain would result. The Tax Court disregarded the plain language of the statute and found that the payables were not liabilities.⁹

Andrews followed his analysis of the case with a question: "Would it help in *Focht* if there were some concept akin to basis for liabilities?"¹⁰ He answered the question by sketching out the useful role such a concept would serve in accounting for transactions that involve liability shifts and discharges.¹¹ He also presaged doctrinal developments relating to the concept, including the addition of

4. Perhaps the most well-known conceptual mistake of this type was made by the Tax Court in *Helmer v. Comm'r*, 34 T.C.M. (CCH) 727 (1975) (holding that a short option was not a "liability" for purposes of § 752). The holding in this case was the linchpin of the infamous Son-of-BOSS tax shelter. See I.R.S. Notice 2000-44, 2000-36 I.R.B. 255, <http://www.irs.gov/pub/irs-drop/n-00-44.pdf> [<http://perma.cc/NB6V-ALML>]. According to IRS figures, over 1,800 taxpayers participated in Son-of-BOSS, and approximately \$3.5 billion was collected in an IRS initiative to settle these cases. See I.R.S. News Release IR-2005-37 (Mar. 24, 2005), [https://www.irs.gov/uac/IRS-Collects-\\$3.2-Billion-from-Son-of-Boss%3B-Final-Figure-Should-Top-\\$3.5-Billion](https://www.irs.gov/uac/IRS-Collects-$3.2-Billion-from-Son-of-Boss%3B-Final-Figure-Should-Top-$3.5-Billion) [<https://perma.cc/ZM92-TG2D>].

5. WILLIAM D. ANDREWS, *FEDERAL INCOME TAXATION OF CORPORATE TRANSACTIONS* 183 (A. James Casner et al. eds., 2d ed. 1995).

6. *Id.*

7. *Focht v. Comm'r*, 68 T.C. 223, 224–25 (1977).

8. *Id.* at 224. The case arose before the 1978 amendment that added § 357(c)(3). Pub. L. No. 95-600, § 365, 92 Stat. 2763, 2854–55.

9. *Focht*, 68 T.C. at 227–29.

10. ANDREWS, *supra* note 5, at 183.

11. *Id.*

§§ 108(e)(2) and 357(c)(3), both of which are discussed at length below.¹²

Three years later, in 1982, Wayne Barnett filed his well-known amicus brief in *Commissioner v. Tufts*,¹³ which included reference to the concept (with proper credit given to Andrews).¹⁴ Barnett argued that just as taxpayers must keep track of prior expenditures relating to an asset, so too must they keep track of “unaccounted-for prior receipts with respect to a liability.”¹⁵ Barnett explained that on the asset side the concept has a name—basis—which has statutory imprimatur, so the need for the account is familiar and the conceptual framework for determining and adjusting basis is well understood.¹⁶ Barnett argued that the cognate concept with respect to liabilities was no less necessary to a well-functioning system but the necessity was obscured by lack of a name.¹⁷

Exaggerating somewhat, Barnett claimed, “Andrews has suggested that it can similarly be referred to simply as the taxpayer’s ‘basis’ for the liability.”¹⁸ As I read Andrews, he was not suggesting that the term “basis” be assigned double duty (for both assets and liabilities); rather, Andrews posited that the law would be improved if everyone recognized the existence of “some [unnamed] concept akin to basis for liabilities.”¹⁹ I have chosen “anti-basis” rather than perpetuating Barnett’s suggested convention of referring to the liability accounting concept as “basis” for the simple reason that the name “basis” is already taken. Asking “basis” to do double duty for

12. See *infra* Sections III.B.1, III.B.3. Andrews also discussed the concept in his article, *On Beyond Tufts*. He explained that the face amount of the debt in *Crane* and *Tufts*

is exactly like basis except for its sign; it is a mirror image of asset basis. Just as asset basis represents something spent but not yet deducted, the debt in *Crane* and *Tufts* represents something received but not yet reflected in income. As such, it is an element of the taxpayer’s tax history that needs to be taken into account . . .

William D. Andrews, *On Beyond Tufts*, 61 TAXES 949, 954 (1983).

13. 461 U.S. 300 (1982).

14. Brief for Wayne G. Barnett as Amicus Curiae Supporting Respondents at 8, *Comm’r v. Tufts*, 461 U.S. 300 (1983) (No. 81-1536) [hereinafter Barnett Brief]. This amicus brief is well-known to tax lawyers and law students because it formed the basis for the concurring opinion of Justice O’Connor in *Tufts*, 461 U.S. 300, 317 (O’Connor, J., concurring), which is reproduced in most basic federal income tax casebooks.

15. Barnett Brief, *supra* note 14, at *4.

16. *Id.*

17. *Id.*

18. *Id.*

19. ANDREWS, *supra* note 5, at 183.

historical accounting with respect to assets and liabilities would be more confusing than using a different term.

There are a few other scattered references to the concept. The most interesting of these, and the only one to use the term “anti-basis” in print, is a 2008 article in *Tax Notes*.²⁰ Calvin Johnson argued in favor of closing what he referred to as “deferred revenue accounts” by adding a new code section to mandate this result.²¹ Johnson explained that the credit balance of a liability or deferred revenue account can be referred to as “antibasis.”²² He gives credit for the term to Wayne Barnett, acknowledging that, although Barnett did not use the term “antibasis” in his *Tufts* amicus brief, the logic of the concept is sketched out in the brief, and Barnett used the term “antibasis” when teaching “a generation of his students at Stanford Law School”²³ (including Johnson). There is some minor overlap between Johnson’s article and this one, but the thesis of Johnson’s article is that a statutory clarification would be desirable (to shut down a certain class of abusive tax shelters, in particular transactions in which taxpayers seek to avoid including deferred income),²⁴ whereas my goal is to explore anti-basis more fundamentally and systematically.²⁵

Some readers will wonder how anti-basis relates to negative basis, sometimes referred to as subzero basis. Adjusted basis is the tax accounting of a property owner’s after-tax net investment in some unit of property.²⁶ If investment exceeds disinvestment then basis is positive. When things are flipped around, basis could—in concept—go below zero. Under present law, however, when basis hits zero, disinvestment is suspended or gain is triggered. For example, depreciation deductions (tracking disinvestment) stop when basis hits

20. Calvin H. Johnson, *Closing Deferred Revenue*, 121 TAX NOTES 965, 967 (2008).

21. *Id.*

22. *Id.* at 967.

23. *Id.* at 967 n.9.

24. *Id.* at 969.

25. At least two practice treatises come close to recognizing anti-basis. Both treatises recognize interrelationships among disparate doctrinal rules and that “similar principles” run through these rules, but neither explores these principles in any systematic way. See 1 BORIS I. BITTKER, MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 4.05[3][f] (3d ed. 2003) (noting the conceptual link between §§ 108(e)(2) and 357(c)(3)); see also WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMORE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶¶ 7.01–.05 (4th ed. 2007) (recognizing the connection between the partnership definition of “liability” and cognate issues under Subchapter C, including situations implicating §§ 357(c)(3) and 358(h)).

26. 2 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, & GIFTS ¶ 41.1 (3d ed. 2000) [hereinafter TAXATION OF INCOME vol. 2].

zero; in a transfer of encumbered assets to a controlled corporation in a nonrecognition transaction under § 351, when the liabilities shifted to the corporation are greater than the shareholder's basis in the contributed assets, § 357(c) requires the shareholder to report gain. The gain reported under § 357(c) tops up the owner's after-tax investment in the property just enough to avoid negative basis. It doesn't have to be this way. Negative basis is an idea with a respectable conceptual foundation and academic pedigree, but, again, it has been ruled out doctrinally, except in very limited circumstances.²⁷

Viewed in this way, negative basis is just the natural extension of tax basis beyond the (artificial) zero bound, not a conceptually distinct idea. Anti-basis, in contrast, is an entirely distinct idea. Indeed, as I describe in the next Part, anti-basis is the polar opposite of basis.

II. GENERAL DEFINITION AND TEST

Anti-basis is a largely unacknowledged tax accounting concept. Anti-basis measures and tracks the untaxed benefit that a taxpayer enjoys as a concomitant of an increase in the liabilities (or obligations) to which the taxpayer is subject. Anti-basis is the polar opposite of tax basis: tax basis measures costs, anti-basis measures benefits; tax basis is always associated with an asset, anti-basis is always associated with a liability.

To test whether there is anti-basis associated with a particular liability, ask whether payment of the liability would be nondeductible and noncapital (that is, not capitalized into basis). If the answer is that paying the liability is both nondeductible and noncapital, the liability has anti-basis. If, on the other hand, paying the liability either generates a deduction or increases tax basis, the liability lacks anti-basis.

The reason this test works is that it sorts cases into two types: (a) cases where the taxpayer has already enjoyed a benefit related to the liability (yes anti-basis); and (b) cases where the benefit has not yet accrued (no anti-basis). In the business context, the benefit will be a tax attribute, either a deduction or an increase in tax basis. In the personal context, the benefit will be either an increase in tax basis or

27. See generally George Cooper, Comment, *Negative Basis*, 75 HARV. L. REV. 1352 (1962) ("exploring many of the major negative basis problems"). One area where negative basis exists in present law is the consolidated return regulations. See Treas. Reg. § 1.1502-19(a)(2)(ii) (2015).

consumption. In both contexts, when a benefit has already accrued but the liability that generated the benefit has not yet been discharged, it is necessary to keep track of the benefit that was enjoyed prior to payment of the liability so that the benefit can be reversed if the liability is discharged or somehow sidestepped without payment. When the benefit associated with a liability has not yet been taken into account, however, there is nothing to reverse if the liability is discharged or shifted without payment, and hence there is no anti-basis.

As I mentioned in Part I, the paradigmatic example of a liability with anti-basis is a bank loan. The borrower is subscribing to an asset-liability package comprised of loan proceeds and a commitment to repay principal in the future. The loan proceeds have basis equal to the amount borrowed, and the commitment to repay—the liability—has anti-basis in the same amount. Confirm this by applying the suggested test: Would payment of the liability give rise to a deduction? Here the answer is no; ergo the liability has anti-basis.

A basic counterexample involves a liability for some amount that the taxpayer is bound to pay as a matter of law but which has not yet ripened into a deduction. For instance, suppose the taxpayer, a shopkeeper, is the defendant in a slip-and-fall tort suit brought by a customer injured in the taxpayer's shop. The claim against the shopkeeper has been resolved—meaning the legal liability has been established for a known amount—but the claim has not been paid. The claim is not yet deductible, but it will be when it is paid.²⁸ Because the claim is deductible, there is no anti-basis.

Sometimes a claim begins without anti-basis and then acquires anti-basis as time goes by. Consider our shopkeeper's liability related to purchasing inventory. The shopkeeper's ability to claim a deduction must wait until "economic performance" occurs, which is generally when the inventory is delivered.²⁹ Thus, if we suppose, for example, that the shopkeeper agreed to purchase some minimum quantity of inventory over a certain term from one of its suppliers, the shopkeeper's obligation to live up to the terms of the contract (a "liability" in my usage) came into existence at the inception of the contract, but lacked anti-basis at inception. Later, when the supplier

28. No deduction is permitted yet without regard to the shopkeeper's method of accounting. If the shopkeeper is on the cash method, the deduction is deferred until payment. If the taxpayer is on the accrual method, the deduction is deferred until economic performance occurs. In this case, economic performance occurs when payment is made. See I.R.C. § 461(h)(2)(C)(ii).

29. See § 461(h)(2)(A)(ii).

delivered inventory to the taxpayer and economic performance occurred, the liability acquired anti-basis in an amount equal to the accrued deduction.

The test for and definition of anti-basis sometimes (at least apparently) contradict each other. This occurs, for instance, when the taxpayer never received a benefit with respect to a given liability, yet would be denied a deduction (or other favorable tax attribute) if the liability were paid. In cases of this type, the test suggests the existence of anti-basis, the definition suggests the opposite.

Consider a fine for breaking the law. Say our shopkeeper's sign was larger than the local zoning law permits. If the shopkeeper pays a fine, no deduction is allowed.³⁰ If having a larger sign earned the shop more income, the incremental income would be taxed; hence there would be no "untaxed benefit," which, under the definition, is necessary to the existence of anti-basis. Yet payment of the fine would not give rise to a deduction owing to the statutory rule precluding deductions for fines and penalties.³¹ Thus the test implies that there is anti-basis.

In cases of this sort, the contradiction between definition and test is evidence of tension between fundamental theoretical concepts, such as the meaning of income under the Haig-Simons conception, or some other ideal,³² and present-law rules such as § 162(f).³³ Results of the definition and test diverge because theory and doctrine diverge. How one mediates conflicts of this sort depends on the goal of the analysis at hand. If the goal is accurately to account for theoretical concepts then the test can be rewritten so it is in harmony with the definition.³⁴

Alternatively, if the goal is to conform the definition of anti-basis to existing law, then the conflict between the general definition and

30. § 162(f).

31. *Id.*

32. 1 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, & GIFTS ¶ 3.1.1 (3d ed. 1999) [hereinafter TAXATION OF INCOME vol. 1] ("Among contemporary American economists, the so-called Haig-Simons definition of 'income' is the most widely accepted: 'Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question,'" (quoting HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938))).

33. I.R.C. § 162(f) (precluding deduction for fines and penalties).

34. To mesh with Haig-Simons, the test would take the following form: would the liability in question give rise to a deduction (or be capitalized into basis) under a set of rules designed to implement a system conforming to the Haig-Simons ideal? If yes, then no anti-basis, and conversely.

the test will persist and the test must be given precedence.³⁵ Little damage is done to the usefulness of anti-basis by the existence of cases of this type; indeed, anti-basis is useful precisely because it helps to identify instances where the present-law rules and general concepts are pulling in opposite directions, which has been a fixture of tax-policy scholarship for decades.³⁶

The problem of mediating theoretical purity and fidelity to present-law rules arises for other fundamental concepts in tax, not just anti-basis. Take a taxpayer who purchases IBM stock for \$100 and sells in one year for \$110. During the year, inflation was 4%. How much income does the taxpayer have? The answer is the excess of \$110 over the taxpayer's basis in her IBM stock, which is either \$100 (under present law)³⁷ or \$104 (if tax basis were indexed for inflation). Everyone who has considered the question agrees that if the capital gains tax were indexed for inflation, the change would be implemented through an adjustment to tax basis.³⁸ Everyone agrees, moreover, that the failure to index basis under present law results in systematic mismeasurement of real income.³⁹ Whether one formulates the definition of basis as under present law (basis equals historical cost simpliciter) or with indexing (basis equals historical cost adjusted periodically for inflation) depends on the objective. The existence of more than one plausible objective does not undermine the existence or usefulness of the concept of tax basis, even though the concept takes different forms in service of different objectives. So it is with anti-basis.

35. If the goal is to conform to present law, it is conceivable (but not realistic) that the general definition could be modified so that it would in all cases match the output of the test. The difficulty with this approach is that the test is, by its nature, both concise and sensitive to the innumerable special rules under present law. In contrast, the special rules under present law would have to be written into the definition one-by-one. The definition would quickly become so unwieldy that it would be useless in explaining or understanding the basic underlying concept.

Articulating the concept in terms of the test, without an accompanying definition, is the approach taken by the partnership tax rules implemented in 2005, as discussed below. See *infra* Section IV.E.

36. See, e.g., STANLEY S. SURREY, *PATHWAYS TO TAX REFORM* 175–76 (1973) (discussing the difficulties in tax-policy reform).

37. I.R.C. § 1012.

38. See, e.g., VITO TANZI, *INFLATION AND THE PERSONAL INCOME TAX: AN INTERNATIONAL PERSPECTIVE* 27–28 (1980); Reed Shuldiner, *Indexing the Tax Code*, 48 *TAX L. REV.* 537, 548 (1993); Emil M. Sunley, *Indexing the Income Tax for Inflation*, 32 *NAT'L TAX J.* 328, 328 (1979).

39. See sources cited *supra* note 38.

III. BASIC EXAMPLES

Liabilities can be categorized according to whether the claim is fixed or contingent and, further, whether payment would give rise to a deduction (or be capitalized into basis)⁴⁰ when paid or accrued. To demonstrate the existence and usefulness of anti-basis I will consider four basic liability types: (A) fixed, nondeductible; (B) fixed, deductible; (C) contingent; and (D) noncapital, nondeductible. For each category, I will explain the conventional doctrine regarding the treatment of the obligor and then explain how the doctrine can be reformulated—or, in some instances, should be revised—to reflect the presence or absence of anti-basis.

A. *Fixed, Nondeductible Liabilities*

1. Discharged by Payment

Under the conventional understanding, loan proceeds are not taxable income when received by the borrower on the theory that the borrower is no richer. The borrower's obligation to repay the loan decreases the borrower's wealth by an amount that offsets the wealth increase from the loan proceeds. It follows that repayment is nondeductible. Repayment is costly to the borrower from a cash flow standpoint, but repayment extinguishes the obligation to repay and, hence, is not costly, all things considered.⁴¹

The tax consequences of this transaction can be explained using anti-basis. The borrower's receipt of the loan proceeds—cash receipt without income—generated anti-basis. When the loan is repaid, the repayment is set off against and extinguishes the borrower's anti-basis in the liability. No deduction is permitted; if one were allowed, the tax benefit of the deduction would duplicate the benefit of excluding the loan proceeds from income at the inception of the loan.

Just as tax basis is always associated with some asset owned by the taxpayer, so too is anti-basis always associated with some liability for which the taxpayer is responsible.⁴² Thus, extinguishing a liability

40. An expense is deductible in the sense that the expense either gives rise to a deduction presently or is capitalized into basis that can be recovered at some later time; likewise, "nondeductible" refers to costs that generate neither deductions nor basis. Current deductions and capital expenditures will be explicitly distinguished when the context requires.

41. TAXATION OF INCOME vol. 1, *supra* note 32, ¶ 6.1; William D. Popkin, *The Taxation of Borrowing*, 56 IND. L.J. 43, 43 (1980).

42. The liability might be an encumbrance on the taxpayer's property but not be a liability of the taxpayer personally, as is true for nonrecourse debt. The tax treatment of nonrecourse debt is examined below. *See infra* Section IV.C.

necessarily implies that anti-basis associated with the liability, if it exists, will be extinguished too.

2. Cancelled by the Creditor

Under the conventional understanding, if the lender cancels some or all of the debt—for example by accepting partial or no repayment in satisfaction of the borrower’s original commitment—the borrower will have COD income equal to the excess of the original amount lent over the amount repaid, if any. The prevailing theory explaining this outcome is related to the treatment of the borrower when the loan proceeds were transferred to the borrower. The borrower didn’t have income because of the expectation that the borrower would live up to her obligation to repay the loan. When the borrower defaults, it is necessary to correct the tax accounting for the loan transaction because the future did not unfold as expected.⁴³

Again, the result can be explained using anti-basis. As noted above, because the liability is being extinguished, any associated anti-basis must also be extinguished. The anti-basis is extinguished by payment to the extent thereof, and the balance is converted into COD income. To state things more directly, the borrower’s COD income equals the excess of anti-basis over the amount repaid to the lender, if any.⁴⁴

3. Transferred in Asset Sale

Under the conventional understanding, if an asset (Blackacre) secures a loan and the asset is sold to a buyer who takes ownership subject to the lender’s claim, the seller (the original borrower) includes the amount of the loan in her amount realized.⁴⁵ The buyer gets tax basis for the price paid, including the portion of the purchase price paid in the form of debt assumption.⁴⁶

43. See TAXATION OF INCOME vol. 1, *supra* note 32, ¶¶ 7.1–7.7 (discussing income from a discharge of indebtedness); Boris I. Bittker & Barton H. Thompson, Jr., *Income From the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber Co.*, 66 CALIF. L. REV. 1159, 1165 (1978). The theory explaining COD income identified in the text is referred to as the “prevailing theory” because there is another theory that has some judicial support, but is widely regarded as defective: the “freeing of assets” theory, which can be traced back to *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170, 174–75 (1926). The (dubious) continuing vitality of the freeing of assets theory is discussed in *Taxation of Income* vol. 1, *supra* note 32, ¶ 7.1.

44. See *supra* Table 1.

45. *Crane v. Comm’r*, 331 U.S. 1, 6–14 (1947).

46. I.R.C. § 1012.

The buyer does not get a deduction if she repays the loan as expected.⁴⁷ The buyer has already been given basis in Blackacre on account of the loan. To give the buyer a deduction for paying this same liability would be double counting. The buyer should, however, be permitted to deduct interest paid on the loan.

A useful way to think about these rules—useful analytically and also because it has been endorsed by the Supreme Court—is to imagine an alternative transaction in which the buyer purchases Blackacre purely for cash (no debt assumption), and the parties find themselves in identical commercial positions immediately following the sale. These results would follow if (a) the buyer took out a new loan from the original lender in the amount of the outstanding loan to the original borrower-seller, (b) the buyer transfers to the seller the proceeds of this loan plus the cash that was paid in the original transaction, and (c) the seller uses a portion of the sales proceeds to repay her loan.⁴⁸

In net effect, the buyer, seller, and lender all wind up in the same positions after this more arduous, three-step transaction. In other words, the two transactions being compared are commercial substitutes. To avoid giving preference to form over substance, and the resulting inefficient tax planning, it is desirable that the transactions be taxed the same. So they are under present law.

An unstated assumption in the example to this point is that the interest rate is a market rate at the time of the sale (so there is no bond premium or market discount). If this assumption is false, everything is much more complicated conceptually. Present law largely ignores the important issues raised by premium and discount liabilities. I discuss these issues below.⁴⁹

Explained using anti-basis, the seller's amount realized equals both the sales proceeds received from the buyer and the seller's anti-basis in the liability shifted to the buyer. The buyer's cost basis in Blackacre equals the cash paid plus the face amount of the liability shifted from seller to buyer. Because the shifted liability generates asset basis for the buyer, the liability has anti-basis in the buyer's

47. *Macgruder v. Supplee*, 316 U.S. 394, 398 (1942) (“Payment by a subsequent purchaser is not the discharge of a burden which the law has placed on him, but is actually as well as theoretically a payment of purchase price . . .”).

48. *Comm'r v. Tufts*, 461 U.S. 300, 312 (1983) (“From the [seller's] point of view, when his obligation is assumed by a third party who purchases the encumbered property, it is as if the [seller] first had been paid with cash borrowed by the [buyer] from the mortgagee on a nonrecourse basis, and then had used the cash to satisfy his [own] obligation to the mortgagee.”).

49. See *infra* Section IV.B.

hands. The buyer gets no deduction on payment of the principal amount of the liability (which, if allowed, would be a windfall considering the liability shift generated asset basis). The buyer does, however, get a deduction for interest paid on the liability.

4. Transferred to Controlled Corporation

Continue the example with a loan that encumbers Blackacre. Assume, however, that rather than selling Blackacre in an arm's length transaction, the owner contributes Blackacre to a corporation she controls in a transaction qualifying for nonrecognition under § 351. The shareholder does not have to treat the liability shift to the corporation as cash received, contrary to the usual rule applicable to taxable sales.⁵⁰ As illustrated above, in a taxable asset sale the principal amount of the loan shifted to the buyer forms a part of the seller's amount realized, akin to the receipt of cash.⁵¹ Departing from this logic for transfers to controlled corporations is justified by the idea that triggering boot gain on contributions of encumbered property would frustrate the goal of removing tax impediments to corporations.⁵² But the departure necessitates a basis reduction in the shareholder's shares by the amount of the liability assumed.⁵³ Otherwise the shareholder would enjoy a windfall.

To make this concrete, assume Blackacre, worth \$10, is security for a bank loan worth \$3. The contributing shareholder's basis in Blackacre prior to the contribution is \$4. Blackacre is contributed in exchange for stock worth \$7 (Blackacre's net value considering the bank loan). The shareholder takes a basis in her shares of \$1, equal to her basis in Blackacre less the liabilities shifted to the corporation. Compare the taxpayer's positions before and after the contribution:

50. § 357(a) (reversing the rule in *United States v. Hendler*, 303 U.S. 564, 565 (1938)); see Stanley S. Surrey, *Assumption of Indebtedness in Tax-Free Exchanges*, 50 YALE L.J. 1, 14–15 (1940).

51. See *supra* note 48 and accompanying text.

52. 1 BORIS BITTKER & JAMES EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 3.06[1] (7th ed. 2014).

53. § 358(a)(1)(A)(ii), (d)(1).

Table 2: Transfer to Controlled Corporation			
Fixed, nondeductible liability			
Taxpayer's position before the contribution: direct ownership of Blackacre		Taxpayer's position after the contribution: indirect ownership of Blackacre	
Blackacre value	10	Stock value	7
Basis	4	Stock basis	1 (4 – 3)
Bank loan	3	Bank loan	0
Net value	7 (10 – 3)	Net value	7
Unrealized gain	6 (10 – 4)	Unrealized gain	6 (7 – 1)

As this example illustrates, the value of the stock the shareholder receives is the net value she transfers to the corporation. If the shareholder took a basis in her stock equal to her basis in Blackacre (\$4), her unrealized gain would shrink by \$3, the value of the liability transferred (unrealized gain would drop from \$6 to \$3). This would be a coherent result if the \$3 liability shift were treated as boot and triggered tax on \$3 of the shareholder's precontribution gain. As explained above, however, liability assumptions are generally not treated as boot in transfers to controlled corporations.⁵⁴

Suppose, alternatively, that the principal balance on the bank loan shifted to the corporation were \$5, rather than \$3. In this case the rules just illustrated break down. Under these rules the liability shift is not considered boot and the shareholder's basis in her stock is her basis in the contributed property reduced by shifted liabilities. Thus, she would end up with a basis of negative \$1 (\$4 less \$5). At least in this context, there is nothing wrong in theory with assigning a negative basis to the shareholder's shares, but the rules are designed to prevent this.⁵⁵ In particular, there is an exception to the rule that liability shifts are not boot; when shifted liabilities exceed the basis of transferred assets, the excess is treated as boot.⁵⁶ In this case, the liability shift would result in a basis reduction of \$3 (from \$3 to \$0, a reduction in basis "to the extent thereof") and boot gain for the remainder of \$1.

54. See *supra* note 50 and accompanying text.

55. See *supra* note 27 and accompanying text.

56. See § 357(c).

Here, for the first time, restating present doctrine using anti-basis simplifies things dramatically. The shareholder's basis in her shares is her basis in the asset transferred reduced by her anti-basis in the liabilities shifted, leaving her with a basis in her stock equal to her pre-contribution gain in the transferred property. In the first example sketched out above, the shareholder's asset basis was \$4 and her anti-basis in shifted liabilities was \$3, so her stock basis is $\$4 - \$3 = \$1$. In the alternative, anti-basis in shifted liabilities (\$5) outstrips stock basis (\$4) in transferred assets, and the shareholder has gain equal to the \$1 difference. The use of anti-basis simply and elegantly accounts for the boot gain that is, under current law, the result of an ad hoc exception to a general rule.

B. Fixed, Deductible Liabilities

To illustrate the treatment of fixed, deductible liabilities under present law and using anti-basis, suppose that, rather than a bank loan, the liability is a tort liability of the owner of Blackacre. Blackacre is rented out for use as a playground. A child was injured when she fell and landed on a large rock that the owner should have removed. Although the liability is fixed and determinable,⁵⁷ it is not yet deductible because it has not yet been paid.⁵⁸

If and when the liability is paid, the tax consequence is a deduction. This is so straightforward that thinking about the transaction using anti-basis is counterproductive. Thinking about the transaction as a liability realization, however, confirms that anti-basis logic is compatible with basic doctrine.⁵⁹ Things are considerably more interesting, however, if the liability is cancelled by the creditor or transferred to another taxpayer, such as an arm's length buyer or controlled corporation.

57. Those versed in tax accounting will recognize this as the test for deductibility by an accrual method taxpayer, taken to mean that the legal obligation is fixed and the amount can be determined with reasonable accuracy. See § 461(h)(4). In 1984 this test was codified and embellished so that in addition to meeting the fixed and determinable standard, economic performance must also occur before a deduction may be accrued. § 461(h)(1).

58. If the taxpayer is an accrual method taxpayer, the deduction must await payment because payment constitutes economic performance. See § 461(h)(2)(C) and sources cited *supra* note 57. If the taxpayer is on the cash method of accounting, then deduction is not permitted until payment. See 5 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 105.3.4 (3d ed. 2000).

59. See *supra* Table 1, for the basis-anti-basis analogy and its link to realization doctrine.

1. Cancelled by the Creditor

Section 108(e)(2) provides that COD income does not arise “to the extent that payment of the liability would have given rise to a deduction.”⁶⁰ This rule requires the taxpayer to consider the counterfactual, “if I paid this liability that is being cancelled, would I get a deduction?” If, as in our example, the answer is “yes,” then no COD income results.

Section 108(e)(2) was added to the Code in the Bankruptcy Tax Act of 1980.⁶¹ The rationale for this rule is described obliquely in the legislative history as relating to “‘lost’ deductions.”⁶² The House Report includes a useful example that clarifies the basic premise: “[A]ssume a cash-basis taxpayer owes \$1,000 to its cash-basis employee as salary and has not actually paid such amount. If later the employee forgives the debt . . . then the discharge [would] not give rise to income or require any reduction of tax attributes.”⁶³

In the example, two aspects of the debtor’s tax position change when a deductible debt is cancelled, and they offset one another. First, there is the debt cancellation, which normally generates gross income. Second, the taxpayer loses the deduction that would have been permitted if the debt had been paid. The lost deduction exactly equals the gross income resulting from nonpayment. Because these amounts are equal and offsetting, there is no effect on net income.⁶⁴

The counterfactual inquiry required by § 108(e)(2) is the same as the test for anti-basis, articulated above. Thus, this is the first example we have seen where present law clearly (though tacitly) incorporates anti-basis. If payment of the liability would give rise to a deduction, then the liability has zero anti-basis. If anti-basis is zero, then no income should arise if the debt is cancelled by the creditor.

What happens if payment of a cancelled liability would (counterfactually, if not cancelled) be classified as a capital expenditure, rather than a deductible cost? The statute does not address this situation, and I find no cases or rulings addressing the question. In an analogous context involving corporate tax, discussed below, the Treasury concluded in a published ruling that “the same principle applies to liabilities that give rise to capital expenditures.”⁶⁵ Anti-basis logic confirms this approach. If the taxpayer would

60. I.R.C. § 108(e)(2).

61. Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389.

62. H.R. REP. NO. 96-883, at 16 (1980).

63. S. REP. NO. 96-1035, at 20 (1980).

64. BITTKER ET AL., *supra* note 26, ¶ 4.05[3][e].

65. Rev. Rul. 95-74, 1995-2 C.B. 36; *see also infra* note 105 and accompanying text.

(counterfactually) be entitled to capitalize the cost corresponding to the liability into basis, then anti-basis must be zero. Just as with deductible liabilities, if anti-basis is zero then no income should arise on cancellation.

2. Transferred in Asset Sale

Return to the example involving Blackacre, a misplaced rock, and an injured child. If Blackacre is sold to a buyer who agrees to assume the seller's obligation to pay the tort judgment, the tax consequences are well settled but more intricate than in prior examples.

The seller's amount realized equals the sum of the cash received from the buyer plus the value of the tort liability assumed by the buyer. The seller is deemed to make a payment on the liability (a fiction), which triggers the seller's ability to claim a deduction.⁶⁶ The buyer is given basis credit for the cash actually paid and also for the liability assumed (or, equivalently, for the sum of the cash the buyer actually pays plus the cash she notionally pays).⁶⁷ The buyer is not permitted to claim a deduction when she satisfies the liability. A deduction is denied to the buyer when she pays the tort claim, even though it would have been permitted to the seller if the seller had paid the claim, because the buyer is given basis credit for assuming the liability, and allowing a deduction in addition to this tax basis would be double counting.⁶⁸

To make this concrete, suppose Blackacre is worth \$10, has a tax basis of \$6 in the seller's hands, and that the liability to the victim is worth \$3. If Blackacre were sold in a taxable transaction, the seller's amount realized would be \$10 (\$7 cash received plus \$3 liability shifted to the buyer), resulting in gain of \$4 (\$10 amount realized less \$6 tax basis).⁶⁹ Meanwhile, the seller would get a deduction for the

66. *James M. Pierce Corp. v. Comm'r*, 326 F.2d 67, 69 (8th Cir. 1964); *Commercial Sec. Bank v. Comm'r*, 77 T.C. 145, 149 (1981) (“[B]y accepting less cash for its assets in exchange for the assumption of its liabilities, [the seller] effectively paid the accrued liabilities at the time of the sale.”); *cf.* *Treas. Reg. § 1.461-4(d)(5)* (2015) (declaring an exception to the economic performance prerequisite for deduction accrual when, in the sale of a business, the shifted liability is included in the seller's amount realized).

67. *TAXATION OF INCOME* vol. 2, *supra* note 25, ¶ 41.2.2; *cf.* *Crane v. Comm'r*, 331 U.S. 1, 14 (1947) (noting the reality that a buyer of property subject to a mortgage must treat the mortgage as if it were his own personal obligation because he would realize a benefit if the mortgage were discharged); *Treas. Reg. § 1.1012-1(g)* (2015) (“[I]f a debt instrument is issued in exchange for property, the cost of the property that is attributable to the debt instrument is the issue price of the debt instrument . . .”).

68. *See supra* note 47 and accompanying text.

69. *I.R.C. § 1001(a), (b)*; *Crane*, 331 U.S. at 14.

“payment” of the \$3 liability, leaving net income of \$1.⁷⁰ The net income might be a composite of capital gains and ordinary deductions, given that the \$4 gain might be classified as a capital gain,⁷¹ whereas the \$3 deduction for the tort liability would probably be set off against ordinary income.⁷²

The buyer’s basis in Blackacre would be \$10, the combination of cash paid by and liability shifted to the buyer. The buyer wouldn’t get to deduct the \$3 liability when payment was ultimately made to the tort victim. If, however, interest has accrued on the obligation to the tort victim after the sale but before the tort victim is paid, the interest will be deductible by the buyer, just as interest on the bank loan encumbering Blackacre would have been deductible by the buyer. Post-purchase interest was not consideration paid to the seller of Blackacre for the property, but a time charge imposed on the buyer in the first instance, and one for which the buyer has received no favorable tax attributes.

Now think about the transaction using anti-basis. The act of selling Blackacre *cum* liability imposes a cash cost on the seller—foregone sales proceeds attributable to the liability shift. Incurring this cost triggers the seller’s ability to claim the deduction. This deduction, in turn, generates anti-basis in the liability. At this point, given that the liability has anti-basis, the analysis degenerates into the earlier, simpler case of a fixed, nondeductible obligation such as a bank loan: The seller’s amount realized equals the cash received by the seller plus anti-basis in liabilities shifted from seller to buyer. From the buyer’s perspective, the assumption of a seller’s fixed liability always generates tax basis in the acquired asset—and thus anti-basis in the associated liability—so there is never any difference between liabilities that would and those that would not have been deductible by the seller. The buyer never gets a deduction when she pays the liability.

There is a complication worth discussing. The example used to illustrate the present law treatment of fixed, deductible liabilities was chosen with care. I purposefully chose an example that did not involve surrogate taxation—the practice of denying one party to a transaction a deduction for an expense of a type ordinarily deductible because the other party to the transaction is not required to report

70. See *supra* note 65 and accompanying text.

71. This will be true if Blackacre is a “capital asset” under § 1221, or is treated as a capital asset under § 1231.

72. See § 165 (permitting deduction for losses).

the corresponding income. Deferred compensation is the classic example.⁷³

Suppose, in a world of uniform 40% tax rates and 10% pre-tax returns, an employee renders services at time 0 worth \$100. In lieu of \$100 of current compensation, the employer promises to pay the employee \$106 at time 1.⁷⁴ The now familiar tax policy insight is that, for income to be measured accurately, the employer can be allowed (a) a deduction of \$100 at time 0 or (b) a deduction of \$106 at time 1, \$106 being the future value equivalent (at time 1) of a \$100 payment at time 0. But if the employer is allowed a deduction of \$100 at time 0, it may not be permitted to deduct the \$6 increment between the amount of its deduction and the ultimate payment. This would result in a windfall to the employer.⁷⁵

Now suppose that the liability transferred with Blackacre is not a tort liability but rather this deferred compensation obligation. So it will mesh with the attributes assigned to Blackacre in the running example (market value \$10, seller basis \$4)—assume the deferred compensation obligation is for \$3 (time 0 value, as of the sale), which is equivalent to $\$3 \times \$1.06 = \$3.18$ (time 1 value, when payment is due to the employee). If the buyer purchases Blackacre for total consideration of \$10 (\$7 cash plus \$3 of liability assumption) some aspects of the tax treatment are clear and others are unsettled. It is clear that the seller's amount realized is \$10, so gain is \$6. It is also clear that the buyer's basis is \$10. The unsettled questions are, first, whether the seller gets a compensation deduction at the time of the sale and, second, whether the buyer may deduct (or claim additional basis for) the \$0.18 time value increment that is the difference between the value of the debt at the time of the sale (\$3) and when the buyer pays the employee (\$3.18).

The answer to the first question—deductibility by the seller—is that the seller should in concept be allowed a \$3 deduction but is denied a deduction under present law. As noted above, the regulations governing accrual of deductions deem economic performance—usually the gating item for deductibility by the seller—to be satisfied when the seller includes the transferred liability in her

73. See generally Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money"*, 95 YALE L.J. 506 (1986) (exploring transactions designed to avoid taxation as a mechanism to understand the time value of money).

74. This example is taken from Daniel Halperin, *Assumption of Contingent Liabilities on Sale of a Business*, 2 FLA. TAX REV. 673, 678–81 (1996).

75. *Id.* at 678–83.

amount realized.⁷⁶ In the context of employee compensation, however, § 404(a)(5) supersedes this regulation.⁷⁷ Section 404(a)(5) delays the deduction for deferred compensation paid by an accrual method taxpayer until the employee is required to include the income.⁷⁸ Some commentators believe that the seller may claim a deduction at the time of the sale under present law, but even the most optimistic acknowledge that this position carries considerable risk of a successful IRS challenge.⁷⁹ Delaying the seller's deduction is unwarranted as a matter of policy, and the statutory rule should be modified to permit the deduction.⁸⁰

The second question—deductibility of the \$0.18 difference between the time value of the liability when it is assumed and when it is paid—implicates anti-basis. Surrogate taxation of the employee requires that no deduction be permitted to the buyer for the \$0.18. Thinking through this question using anti-basis, however, suggests a different answer. If the buyer is only given basis credit of \$3 on account of the liability assumption, the implication is that the buyer's anti-basis is \$3. Payment of any greater sum should give rise to a deduction of the excess. If no deduction is permitted, the implication is that the buyer has anti-basis of \$3.18, rather than \$3. An anti-basis of \$3.18, in turn, implies that the buyer's basis in Blackacre should be \$10.18, rather than \$10.

The apparent contradiction between the results—consistency with surrogate taxation on the one hand and proper accounting for anti-basis on the other—is illusory. The \$0.18 deduction is denied to the buyer because the seller should have been permitted to deduct the \$3 liability at time 0, which amounts to a complete tax accounting for the claim based on its value at that time. Allowing the buyer a further deduction for the difference between the time 0 and time 1 value of the claim would replicate part of the seller's deduction. This is the correct justification for denying the buyer a deduction for the \$0.18. The buyer's anti-basis in the liability—and the corresponding portion of asset basis in Blackacre—is simply \$3, just as with the tort liability.

76. See *supra* note 66 and accompanying text.

77. § 404(a)(5).

78. See *id.*

79. Robert H. Wellen, *Contingent Consideration and Contingent Liabilities in Acquisitions*, 45 WM. & MARY ANN. TAX CONF. li, 24 (1999); see also MARTIN D. GINSBURG, JACK S. LEVIN & DONALD E. ROCAP, *MERGERS, ACQUISITIONS, AND BUYOUTS* ¶ 304.3 (Mar. 2014 ed.) (referring to the Service's position that no deduction is permitted to the seller as "ridiculous").

80. In this regard I agree with Halperin. See Halperin, *supra* note 74, at 710.

To further illustrate the point, consider that deferred compensation obligations accrue interest at after-tax rates, whereas tort judgments accrue interest at before-tax rates (this is true in theory, if not in practice).⁸¹ If this is true here, the buyer of Blackacre who takes the property and the tort judgment must set aside \$3 to satisfy her obligation to the tort victim at time 1, considering the assumed 10% yield on the set aside and the corresponding deduction for interest paid on the judgment.⁸² The buyer of Blackacre subject to the deferred compensation obligation must likewise set aside \$3 considering the assumed 6% yield on the set aside and the lack of any corresponding deduction for interest paid on the deferred compensation.⁸³

3. Contributed to Controlled Corporation

The rules governing shifts of fixed, deductible liabilities to a controlled corporation in a nonrecognition transaction are well settled. Unfortunately they are also complicated. Let's begin with the playground-tort judgment variation of the running example, using the same values and tax attributes (Blackacre is worth \$10, the owner's tax basis in Blackacre is \$4, and the liability to the victim is \$3). Consistent with the rule discussed above for shifts of fixed, nondeductible liabilities to controlled corporations (illustrated using the bank loan),⁸⁴ the liability shift to the corporation in this case would not be treated as boot, but contrary to that earlier example, the shareholder would not be required to reduce her stock basis on account of the liability assumption. The facts and outcome under current law are collated in the following table:

81. Even if this is false in practice, the distinction between deferred compensation obligations and tort judgments should be true in principle, and my goal here is to thresh out a conceptual understanding of the tax policy issues assuming the rest of the legal system has a coherent structure. *See, e.g.*, Halperin, *supra* note 74, at 678–81 (demonstrating that an employer supplying a pre-tax rate of return is tantamount to increasing the amount of deferred compensation).

82. Setting aside \$3.00 will return \$3.30, a pre-tax yield of \$0.30, and payment will generate a deduction of \$0.30 (the excess of the \$3.30 payment over the \$3.00 anti-basis). Thus there will be no net income on the set aside, which can be funded at time 0 for \$3.00.

83. Setting aside \$3.00 will return \$3.30, a pre-tax yield of \$0.30, and payment will generate no deduction for the reasons described in the text. Thus the pre-tax yield will be reduced to $\$0.30 \times (1 - .4) = \0.18 after-tax, just enough to fund the \$3.18 deferred compensation obligation at time 1.

84. *See supra* Section III.A.4.

Table 3: Transfer to a controlled corporation			
Fixed, deductible liability			
Shareholder's position before the contribution: direct ownership of Blackacre		Shareholder's position after the contribution: indirect ownership of Blackacre	
Blackacre value	10	Stock value	7
Basis	4	Stock basis	4
Fixed, deductible liability	3	Fixed, deductible liability	0
Net value	7	Net value	7
Unrealized gain	6 (10 – 4)	Unrealized gain	3 (7 – 4)
Inchoate net income (unrealized gain less inchoate deduction)	3 (6 – 3)	Inchoate net income (unrealized gain less inchoate deduction)	3 (3 – 0)

The difference between this case and the earlier case involving a transfer of a fixed, nondeductible liability is that the contributing shareholder in this case exchanges her asset basis for her stock basis *without any reduction on account of the corporation's assumption of the fixed, deductible liability*.⁸⁵ In the earlier case, such a reduction was required.⁸⁶ A reduction in tax basis in the contributor's stock is required for nondeductible liabilities because the gain to be preserved for future recognition is the difference between the *unencumbered value* of Blackacre and the contributor's tax basis in Blackacre; when Blackacre is swapped for stock, the stock's value equals the value of Blackacre *reduced by the liability shifted to the corporation*. It follows that the shareholder's tax basis in the stock must be ratcheted down by the amount of the liability. With this adjustment, the difference between the value and tax basis of the contributor's stock is the same as the difference between the value and tax basis of Blackacre prior to the contribution. In sum, a step down in stock basis equal to liabilities shifted to the corporation replicates in the contributor's

85. See I.R.C. §§ 357(c)(3), 358(d)(2).

86. See § 358(d)(1).

stock (no more and no less than) the contributor's precontribution asset gain in Blackacre.

In the case of fixed, deductible liabilities, the contributor has unrealized gain *and also an inchoate deduction*. In the example, the gain and deduction net to \$3 (\$6 unrealized gain less \$3 inchoate deduction). If the contributor's gain in Blackacre is replicated in her shares without an accounting for the lost deduction, the outcome would be punitive from the contributor's point of view. She would go from inchoate net income of \$3 before the contribution to inchoate net income of \$6 afterwards. If she is not required to reduce her basis in her shares on account of the liability shifted to the corporation, then the contributor's inchoate net income is the same after the contribution as it was before. This is the correct outcome and is required under present law.⁸⁷

This rule treating liability shifts to controlled corporations differently depending on whether they would give rise to a deduction for the contributing shareholder tacitly incorporates anti-basis.⁸⁸ In other words, the more favorable result under present law for the tort claim (compared with the bank loan) depends on the counterfactual deductibility of the liability by the contributor. Thus, the test for anti-basis is key to the operation of the rule.

It would be simpler to state the rules for liability shifts to controlled corporations if the role of anti-basis in the analysis were made explicit: if a liability shifted to a corporation *has anti-basis* (the bank loan) then the contributor's stock basis is the excess of basis in

87. See *supra* note 85 and accompanying text.

88. Section 357(c)(3), which defines the scope of the rule, reads as follows:

(3) Certain liabilities excluded

(A) In general

If a taxpayer transfers, in an exchange to which section 351 applies, a liability the payment of which either—

- (i) would give rise to a deduction, or
- (ii) would be described in section 736(a),

then, for purposes of paragraph (1), the amount of such liability shall be excluded in determining the amount of liabilities assumed.

(B) Exception

Subparagraph (A) shall not apply to any liability to the extent that the incurrence of the liability resulted in the creation of, or an increase in, the basis of any property.

the contributed assets over anti-basis in shifted liabilities;⁸⁹ if a liability shifted to a corporation *lacks anti-basis* (the tort claim) then the contributor's stock basis is the same as the basis in the contributed assets, not reduced by the liability shift.⁹⁰

C. *Contingent Liabilities*

1. The Problem

Unlike fixed liabilities that might be either nondeductible (e.g., bank loan) or deductible (e.g., tort liability), as a first approximation all contingent liabilities are deductible.⁹¹ It is the nature of most contingent liabilities that no value was received by the obligor at the time the contingent liability arose. The tort claim in the earlier example was a fixed, deductible liability because the claim by the victim was resolved by settlement or judgment (making the liability fixed and determinable, in tax jargon). The claim began, however, as a contingent liability when the victim was injured and had a potential cause of action against the owner of Blackacre. When the accident happened, the owner of Blackacre received no value (no sum analogous to the proceeds on the bank loan) correlating to the liability. In general, there is no receipt of value correlating to contingent liabilities when they arise. It follows that contingent liabilities have zero anti-basis.

The tax treatment of contingent liabilities is straightforward when the taxpayer originally liable remains liable through resolution of the claim by payment, default, or a determination that no amount is due. If the contingent liability is paid, then the taxpayer takes a deduction when the liability is paid or accrued. There is no anti-basis to absorb the payment as there is for nondeductible liabilities like the bank loan. If the contingent liability has value but the taxpayer defaults, there is no tax consequence. Recall that there is no COD income on discharge of a liability with zero anti-basis.⁹² If it is ultimately determined that no amount is due, evaporation of the potential claim has no tax consequence. Essentially, in every case, the

89. If anti-basis in shifted liabilities is greater than basis in contributed assets, the excess is gain and stock basis is zero. *See* § 357(c).

90. *See* §§ 357(c)(3), 358(d)(2).

91. There is a small class of contingent liabilities that are nondeductible (that is, have anti-basis). An example is a contingent liability to pay a fine or penalty that is nondeductible because of § 162(f). This class of liabilities is discussed below. *See infra* Section IV.D.

92. *See* § 108(e)(2); *see also supra* Section III.B.1 (discussing § 108(e)(2)).

passage of time resolves the contingency and the proper tax treatment follows automatically.

On the other hand, when contingent liabilities are shifted—either in an asset sale or a contribution to a controlled corporation—the tax treatment of the liability shift is confused as a matter of doctrine.⁹³ This is not surprising given that the underlying tax policy issues are complicated in the abstract and become even more complicated when administrative considerations are factored into rule design.

The fundamental issue is one of categorization. Contingent liabilities lie on a continuum between fixed, deductible liabilities on the one hand and potential future costs on the other. “Potential future costs” refers to a category even more attenuated than contingent liabilities. Everyone agrees that potential future costs shifted in asset sales are (and should be) ignored in figuring the tax consequences for both the seller and the buyer.⁹⁴

The large number of articles and bar association reports regarding the treatment of contingent liabilities represent a seemingly interminable tug-of-war between (a) those who favor treating contingent liabilities like fixed, deductible liabilities and (b) those who favor treating contingent liabilities like potential future costs, which is to say those who favor ignoring them.⁹⁵ No commentator or policymaker has, to my knowledge, raised the possibility of fashioning a new regime applicable only to contingent liabilities.

93. An enormous literature exists on this subject. *See, e.g.*, Charlotte Crane, *Accounting for Assumed Liabilities Not Yet Accrued by the Seller: Is a Buyer's Deduction Really Costless?*, 48 TAX NOTES 225, 225–26 (1990); Charlotte Crane, *More on Accounting for the Assumption of Contingent Liabilities*, 3 FLA. TAX REV. 615, 636–41 (1997) [hereinafter Crane, *More on Accounting*]; Halperin, *supra* note 74, at 675; Kevin M. Keyes, *The Treatment of Liabilities in Taxable Asset Acquisitions*, 50 INST. ON FED. TAX'N § 21.01, at 21–2 (1992); Richard L. Reinhold, New York State Bar Ass'n Tax Section, *Report on Federal Income Tax Treatment of Contingent Liabilities*, 49 TAX NOTES 883, 884 (1990); Robert R. Wootton, *Mrs. Logan's Ghost: The Open Transaction Doctrine Today*, 71 TAXES 725, 725 (1993); Alfred D. Youngwood, *The Tax Treatment of Contingent Liabilities in Taxable Asset Acquisitions*, 44 TAX LAW 765, 782 (1991).

94. *See, e.g.*, Crane, *More on Accounting*, *supra* note 93, at 636–37; Halperin, *supra* note 74, at 700; Keyes, *supra* note 93, § 21.04[2][a][i]–[ii]; Wootton, *supra* note 93, at 740; Youngwood, *supra* note 93, at 784–85.

95. Compare Halperin, *supra* note 74, at 700 (advocating for ignoring contingent liabilities), with Youngwood, *supra* note 93, at 784–85 (arguing for granting a deduction for the buyer “at the time the seller would have received the deduction had the sale not taken place”). If option (a) is chosen, further specification is necessary: if accounting is potentially required before the liability becomes fixed such accounting can be made based on estimated values or instead can be deferred until valuation is established (a wait-and-see approach referred to as “open transaction” accounting).

Assuming, consistent with the thrust of the debate, that these three types of obligations are to be split into two groups, arbitrary line drawing along the continuum is unavoidable. Anti-basis sheds no light on where to draw the line. It is nevertheless useful to walk through the permutations using anti-basis as a guide. Doing so highlights the policy implications of the choice between available options.

2. Shifted in Asset Sale

To see what turns on the classification in a taxable asset sale, recall the basic facts of the running example: Blackacre is worth \$10 and the owner's basis is \$6. Now let's suppose that due to the grading of the Blackacre's slope, water is running off the land and damaging the neighbor's property. The neighbor has a potential cause of action against the owner of Blackacre. The neighbor's claim relates to prior events but the liability, if any, is not fixed and determinable. All things considered, the contingent liability has an expected value of \$3.⁹⁶

If Blackacre is sold for cash, the buyer will pay \$7, assuming the contingent liability follows the land. Assume initially that the contingent liability is accounted for under the rules for fixed, deductible liabilities. If the liability were accounted for at the time of the sale rather than under a wait-and-see approach,⁹⁷ the seller should have total net income of \$1, considering both gain and deductions. Observe that the seller came to the transaction with property with a built in gain of $\$10 - \$6 = \$4$ and a liability representing an inchoate tax deduction with an expected value of \$3. Here is a summary:

<u>Item</u>	<u>Amount</u>	<u>Computation</u>
1. Cash received	7	
2. Contingent liability shifted	3	
3. Amount realized	10	line 1 + line 2
4. Adjusted basis	6	
5. Gain realized	4	line 3 – line 4

96. By "all things considered" I mean the probable remedy, the likelihood of success, the time value of money, and so forth.

97. See *supra* note 95; see also Wootton, *supra* note 93, at 738–42 (evaluating the unsettled question of whether the transaction would be treated as closed or open under present law).

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6. Deduction	3	line 2
7. Net income	1	line 5 – line 6

Accounting for the contingent liability as though it were fixed means that the buyer's basis in Blackacre will be \$10. The buyer will have anti-basis in the liability of \$3. This anti-basis derives from the \$3 of tax basis in Blackacre generated by the liability assumption. Permitting the buyer to claim this basis and to deduct the liability when it comes due would be double counting; if the liability has anti-basis no deduction is allowed, so there is no double counting.

If, instead, the contingent liability is ignored, then the seller's amount realized is the \$7 cash received. Hence, gain is $\$7 - \$6 = \$1$. This is the same as the seller's net income when the liability was factored in; however, depending on the nature of the property and taxpayer type, when the liability is factored into the amount realized and deducted, there might be a character shift. Specifically, the incremental gain might enjoy the capital gains rate preference, whereas the deduction will set off ordinary income. Thus, for at least some sellers, accounting for liability explicitly is better than ignoring it.

If the contingent liability is ignored, the buyer takes a tax basis of \$7 in Blackacre—which is worse than the \$10 tax basis under the alternative characterization—but the buyer is now permitted to deduct the liability when paid. The liability was consideration paid by the buyer in an economic sense, but no basis credit was given to the buyer; ergo, no anti-basis. This deduction is allowed if and when the claim is paid and in the amount ultimately determined.

As a general proposition, whether buyers are helped or hurt by one approach or the other depends on the relative pace of (a) the cost recovery deductions the buyer would have been allowed if the contingent claim were added to basis and (b) the deductions the buyer is allowed when the contingent claim is paid. Given that the amount deducted will be equal (at least in expectation) either way, whichever results in earlier deduction is better. In our example, ignoring the contingent claim unambiguously provides a benefit because Blackacre is nondepreciable, but it could go either way in other cases where the property is eligible for cost recovery deductions.

Thus, sometimes the seller and buyer stand on opposite sides of the issue with one preferring to account for the contingent liabilities and the other preferring to ignore them. This would be true of an

individual seller eligible for the preferential character flip (capital gain and ordinary deduction) and a buyer, when, as with Blackacre, the property is nondepreciable. If it is usually true that buyer and seller have contradictory preferences, there is an argument—from a practical standpoint—for treating contingent liabilities like fixed, deductible liabilities since the parties’ competing interests will encourage accurate valuation of contingent liabilities when accounting for the transaction. This approach also avoids the hard question of where to set the boundary between fixed, deductible liabilities and contingent liabilities.⁹⁸

If buyers and sellers do not ordinarily have conflicting interests regarding valuation, then lumping contingent liabilities in with fixed, deductible liabilities might open up avenues of abuse. Sellers and buyers could conspire to lower their effective marginal tax rates by exaggerating (or minimizing) the value assigned to contingent claims; the only loser in the bargain would be the fisc.

3. Contributed to Controlled Corporation

To summarize current law, described above at length using conventional terminology,⁹⁹ the contributing shareholder’s stock basis is the excess of her asset basis over her anti-basis (if any) in liabilities shifted to the corporation.¹⁰⁰ The recipient corporation takes a transferred asset basis and liability anti-basis from the contributing shareholder.¹⁰¹ To this extent, the rules make sense and usually work well—they are clear, administrable, and well understood. With the help of anti-basis, they are also easy to state.

I say these rules *usually* work well. They broke down in spectacular fashion in the mid-1990s when several taxpayers tried to exploit the rule that liabilities without anti-basis can be transferred to a controlled corporation without ratcheting down the contributing shareholder’s stock on account of the liability shift.¹⁰² In a prototypical exploitative transaction, the shareholder (usually itself a corporation) would contribute \$100 of cash and \$99 of contingent

98. Wootton, *supra* note 93, at 741 (noting the difficulty of distinguishing between contingent and fixed liabilities).

99. *See supra* Sections III.A.4, III.B.3.

100. If anti-basis exceeds basis then § 357(c) gain results. I.R.C. § 357(c)(1).

101. § 358(a)(1).

102. *See, e.g.*, WFC Holdings Corp. v. United States, 728 F.3d 736, 739–42 (8th Cir. 2013); Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1343–45 (Fed. Cir. 2006); Black & Decker Corp. v. United States, 436 F.3d 431, 433–34 (4th Cir. 2006). *See generally* Ethan Yale, *Reexamining Black & Decker’s Contingent Liability Tax Shelter*, 108 TAX NOTES 223 (2005) (analyzing Black & Decker’s “contingent liability tax shelter”).

(deductible) liabilities to a newly formed corporation in exchange for stock. The contributing shareholder would then sell its stock for its market value of \$1 (equal to the \$100 cash held by the corporation set off by the \$99 negative expected value of the contingent liabilities). The contributing shareholder would argue that its basis in the stock was \$100—equal to its basis in the contributed cash not reduced by the contingent deductible liabilities—and thus would claim a \$99 loss.¹⁰³

No reduction in share basis is required on account of the liabilities shifted to the new corporation, the argument goes, because under the plain terms of the Code, the shareholder is not required to step down basis on account of deductible liability shifts.¹⁰⁴ Later, when the new corporation pays the liability, it is permitted a deduction of \$99, or the future value equivalent (assuming the liability was valued accurately). The contributing shareholder argues that the corporation's deduction for the claim is correct under the Service's official position, articulated in a revenue ruling.¹⁰⁵ Thus the main benefit of the transaction is that it duplicates the tax benefit inherent in the transferred liability.

In terms of anti-basis, why does the transferee corporation take the contingent liability with anti-basis of zero? Put in conventional terminology, why is it true that the transferee corporation may deduct the contingent liability when it is paid or accrued? The reason to doubt this is true is that if the liability were shifted to a buyer in a taxable sale as part of an asset-liability package (like our Blackacre examples), the buyer would count the liability shift as part of its cost and factor this cost into its basis in the purchased assets. This, in turn, implies the liability has anti-basis for the buyer-transferee and is nondeductible. If the analysis is different for § 351 exchanges, one would expect to find a persuasive rationale or legal authority—hopefully both.

The rationale that has been offered by the Service for allowing the transferee a deduction even though the shifted liability represents part of its cost for the acquired property is “the specific congressional intent of § 351(a) to facilitate the incorporation of an ongoing business by making the incorporation tax free.”¹⁰⁶ The Service has concluded that this intent would be frustrated if liabilities that would

103. See I.R.S. Notice 2001-17, 2001-9 I.R.B. 730 (designating the “Contingent Liability Tax Shelter” as a listed transaction).

104. See §§ 357(c)(3), 358(d)(2).

105. Rev. Rul. 95-74, 1995-2 C.B. 36, 38.

106. *Id.*

have been deducted by the transferor cannot be deducted by the transferee.¹⁰⁷ This might be true in some situations, but it is not self-evident.¹⁰⁸

Importantly, the proffered rationale is emphatically *not* convincing in the prototypical exploitative transaction sketched out above. In that transaction, the taxpayer went into the § 351 transaction with an inchoate \$99 deduction for the contingent liability and walked out with a \$99 built-in-loss in its subsidiary stock. The built-in-loss is an adequate (indeed, seemingly perfect) substitute for the inchoate deduction, and the contributor would not be impeded from doing the transaction for nontax business reasons if the transferee corporation were not permitted to deduct the liability.

The legal authority supporting the transferee-corporation's ability to deduct the contingent liability when it is paid or accrued is Revenue Ruling 95-74, which articulates the (sometimes unconvincing) rationale discussed above.¹⁰⁹ The facts of the ruling involve a taxpayer who contributes substantially all of the assets and liabilities associated with a manufacturing business, including land contaminated by hazardous waste.¹¹⁰ The obligation to remediate this waste is the contingent liability shifted in the ruling.¹¹¹ The ruling is clear that the transfer of the manufacturing business (including the contingent liability) is made "for bona fide business purposes" unrelated to tax avoidance.¹¹²

107. *Id.*

108. There is another rationale supporting the conclusion that the recipient corporation should not have anti-basis in the shifted liability, but it has not been raised before to my knowledge. Although it is true that the liability shift is consideration paid by the transferee corporation for the assets transferred, the transferee corporation gets no basis credit for the liability shift. *See* § 362(b). Rather, basis transfers from the contributing shareholder to the transferee corporation under § 362(b). If asset basis carries over, maybe liability anti-basis should carry over too. This argument is conceptually sound: Asset basis would be the benefit to the transferee from which anti-basis would derive, and here no asset basis is created; however, this argument is not supported by the statute. *See Holdcroft Transp. Co. v. Comm'r*, 153 F.2d 323, 324–25 (8th Cir. 1946) (pointing out that deductibility by the transferee even if theoretically appropriate would require statutory support, which is lacking).

109. *See* Rev. Rul. 95-74, 1995-2 C.B. 36, 38.

110. *Id.* at 36.

111. *See id.*

112. *Id.* Though the ruling is somewhat vague, a reasonable inference is that the Service had in mind a transaction in which built-in-gain assets were being contributed alongside the contingent liability so, in toto, as many or more gains were duplicated as losses, so there was no net tax benefit.

Case law does not support this ruling.¹¹³ In *Holdcroft Transportation Co. v. Commissioner*,¹¹⁴ the Eighth Circuit held that payments by a transferee corporation of liabilities that had been shifted in a § 351 transaction were not deductible by the transferee corporation even when they would have been deductible if they had been paid or accrued by the transferor.¹¹⁵ The *Holdcroft* court reasoned that assumption of the transferred liability was “part of the consideration for the acquisition” by the transferee corporation of the assets transferred, and must be accounted for as “part of the cost of acquisition.”¹¹⁶ The court thus concluded that the transferee corporation was not permitted to deduct the assumed liabilities when paid.¹¹⁷ In terms of anti-basis, the court reasoned that the transferee corporation had anti-basis in the assumed liability.

Thus, when the cases involving contingent liability tax shelters arose, the Service had good legal support for denying the transferee corporation a deduction on the transferred claim and weak or no technical support for denying the transferor corporation the ability to harvest the built-in-loss on its subsidiary stock. Faced with this scenario, one might have expected the Service to pursue the transferee corporation when it sought to deduct the transferred claim. Instead, in every case, the government made losing technical arguments against the transferor in an attempt to deny its ability to deduct the built-in-loss on the subsidiary stock, but ultimately won by convincing the courts that the economic substance doctrine applied.¹¹⁸

Congress ultimately amended the statute in 2000 to add § 358(h), which requires the contributing shareholder to step down its stock basis in transactions taking the form of our prototype.¹¹⁹ More specifically, if a liability without anti-basis is shifted in a § 351 transfer and the contributor winds up with a built-in-loss in its stock, stock

113. Indeed, the Service ruled on the issue of the transferee’s deductibility to voice its disagreement with the *Holdcroft* court.

114. 153 F.2d 323 (8th Cir. 1946).

115. *Id.* at 325.

116. *Id.* at 324.

117. *Id.* at 325.

118. See *WFC Holdings Corp. v. United States*, 728 F.3d 736, 745–46 (8th Cir. 2013); *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1349, 1359 (Fed. Cir. 2006); *Black & Decker Corp. v. United States*, 436 F.3d 431, 436–37, 441–42 (4th Cir. 2006). Very generally, the economic substance doctrine is a common law doctrine that courts apply to deny tax benefits from arguably technically compliant transactions that were undertaken solely or primarily to avoid taxes. See generally Joseph Bankman, *Economic Substance Doctrine*, 74 S. CAL. L. REV. 5 (2000) (providing an overview of the economic substance doctrine).

119. Act of Mar. 9, 2009, Pub. L. No. 107-147, § 412(c), 116 Stat. 21.

basis must be reduced by the amount of the liability or the built-in-loss, whichever is less.¹²⁰ The rule is shut off when the facts are like those assumed in revenue Ruling 95-74—that is, when the liability is associated with the business or assets being contributed.¹²¹

Thinking through this rule with anti-basis reveals this statutory fix to be a convoluted solution to the problem. Rather than fall back on the basic rule for taxable exchanges and assign anti-basis to the transferee corporation, which would be an elegant and complete solution, in affected transactions the liability that began without anti-basis for the contributing shareholder apparently remains without anti-basis for the recipient corporation (on the strength of Revenue Ruling 95-74, the domain of which should, as a conceptual matter, be expanded by § 358(h)). The statute converts the anti-basis that would arise for the transferee corporation in a taxable exchange into share-basis reduction for the transferor. When applied, this rule prevents the abuse at which it was aimed, but it is divorced from basic principles and is more complicated than need be.

D. *Noncapital, Nondeductible Costs*

Most liabilities related to noncapital, nondeductible costs arise in the personal context. To begin with an example that will be familiar to most readers, suppose a taxpayer signs a note with a value ultimately determined to be \$500,000 in exchange for gambling chips at a casino and then loses all the chips at the craps table.¹²² The taxpayer walks out of the casino without tax basis in any asset financed with the loan.¹²³ Neither are any of her gambling losses deductible.¹²⁴ Yet she has anti-basis in the liability. Payment of the \$500,000 debt is a consumption expense, and consumption was the benefit related to the liability in question.

Next, consider a taxpayer who is a debtor on a judgment debt of \$100 stemming from a (non-business) tort suit. Say the taxpayer was at fault in a car wreck, and the \$100 is the amount of the judgment or settlement in favor of the victim. Does the taxpayer have anti-basis in the judgment debt? Superficially, it appears that no benefit was received, which would imply that there is no anti-basis. Functionally

120. I.R.C. § 358(h)(1).

121. § 358(h)(2); see Rev. Rul. 95-74, 1995-2 C.B. 36, 38.

122. These are the basic facts of *Zarin v. Comm'r*, 916 F.2d 110, 111–12 (3d Cir. 1990).

123. The position that the taxpayer took tax basis in the gambling chips in the amount of the loan is logically coherent, but it is ruled out (at least in the Third Circuit) by *Zarin*. *Id.* at 114 (holding that gambling chips are not “property”).

124. § 165(d).

this is the wrong answer. If the judgment debt is discharged without payment, current law would assign COD income of \$100, which, in a system articulated in terms of anti-basis, only follows if the judgment debt has anti-basis. So we must dig deeper.

Plainly the taxpayer did not get basis in any asset as a consequence of the victim's damages. Hence there is only a benefit in this example if the \$100 judgment debt represents consumption. This turns out to be the correct way to think about cases of this type, but the analysis is admittedly a bit tortured. Consider that if the taxpayer had insured the risk that ripened into the judgment, the premium for insurance would have been just another nondeductible cost tethered to operating her personal-use vehicle, like gas. Going uninsured (or underinsured) subjects the taxpayer in our example to some chance of having to self-insure, and the judgment debt in our example is the cost of such self-insurance (valued *ex post*, when the risk has already come home to roost), which is a form of consumption.

Though unusual, at least some noncapital, nondeductible costs arise in the business context. Imagine that Blackacre, property used in a trade or business, is subject to a lien securing payment of a fine relating to the owner's use of the property in contravention of local zoning laws. The fine is nondeductible,¹²⁵ which implies it has anti-basis. Where did the anti-basis come from? Anti-basis is the untaxed benefit that a taxpayer enjoys as a concomitant of an increase in the liabilities (or obligations) to which the taxpayer is subject. Here there was no untaxed benefit (at least none that is obvious).

The best answer is that anti-basis in noncapital, nondeductible costs comes from the public policy underpinning the particular rule rendering the cost noncapital and nondeductible. As a functional matter, fidelity to the policy choice that supports the rule of nondeductibility means the liability must be assigned anti-basis. This is an inelegant explanation, but it should be no surprise that defining net income for tax purposes in service of nontax regulatory goals requires unsightly patchwork.

As others have argued, in a system conforming to the accepted economic definition of income, the fine would be deductible when paid.¹²⁶ This would put the output of the anti-basis test (no anti-basis) and the conceptual underpinning of the test (no untaxed benefit related to the liability) in harmony with one another. As noted in the

125. § 162(f).

126. See David I. Walker, *Suitable for Framing: Business Deductions in a Net Income Tax System*, 52 WM. & MARY L. REV. 1247, 1251–57 (2011).

introduction, the contradiction between definition and test in cases of this sort is evidence of tension between fundamental theoretical concepts and present-law rules. It is not evidence of a wrinkle in the anti-basis concept itself.

Finally, some noncapital, nondeductible costs arise at the business-personal borderline. Take, for example, the rule that only one-half of business-related expenses for meals and entertainment are deductible.¹²⁷ The Ways and Means Committee explained that “some portion of business meal and entertainment expenses represent personal consumption (even if the expenses serve a legitimate business purpose) [D]enial of some part of the deduction is appropriate as a proxy for income inclusion of the consumption element of the meal or entertainment.”¹²⁸ Suppose that the cost of a meal is paid on credit and the resulting liability is discharged without payment. Think of Artie Bucco cancelling the tab for Tony Soprano’s many “business” meals at Artie’s Italian restaurant. One-half of Tony’s tab was at least arguably deductible (zero anti-basis) and, to this extent, cancellation should not generate income.¹²⁹ The other half of the liability (the nondeductible half, i.e., the half with anti-basis) should generate income when cancelled.

IV. ADVANCED EXAMPLES

Thus far I have defined anti-basis and given a test for its existence. I have also illustrated how the concept is woven into the present law rules regarding transactions involving discharge of liabilities, default on liabilities, and shifting of liabilities from one taxpayer to another. Now I will turn to some more sophisticated situations in which anti-basis arises, beginning with the original issue discount (“OID”) rules.

A. *OID Rules*

The concept underlying anti-basis is fundamental to the OID rules. The OID rules function by setting at issuance a debt’s “issue price” and the schedule of calibrated, periodic increases to the issue

127. § 274(n).

128. H.R. REP. NO. 103-111, at 645 (1993). Boris Bittker put it better when he explained that “[b]y joining in the merriment, the taxpayer who pays the bill usually derives personal benefits from the activity.” TAXATION OF INCOME vol. 1, *supra* note 32, ¶ 21.2.1.

129. I am assuming that Tony has not claimed any deduction yet at the time the tab is cancelled. If he has claimed his one-half deduction, then this generated anti-basis in the liability equal to the amount deducted, and cancellation would generate income in the full amount of the tab.

price set to occur through maturity to reflect accretion of compound interest.¹³⁰ Each increase is treated for tax purposes as accrued interest for both borrower and lender. The sum of a debt's issue price and the cumulative scheduled increases to a given date is referred to as the debt's "adjusted issue price."¹³¹

At issuance, a debt's issue price, and thereafter the debt's adjusted issue price, is identical to the borrower's anti-basis in the debt. This identity exists because adjusted issue price is the sum of (a) issue price, equal to the borrower's receipt of cash without income, and (b) the borrower's deductions for "phantom interest" payments—that is, deductions for accrued but unpaid interest accreting on the debt.¹³² The sum of these two items equals the benefit to the borrower of incurring the debt. This is the definition of anti-basis.

Borrowers will sometimes be able to cancel OID debts at a discount if interest rates rise or if creditworthiness deteriorates while the debt is outstanding. In the context of a bond or loan bearing periodic interest at market rates (like the bank loan in the earlier examples), I explained that the borrower would have COD income on repayment if the borrower's anti-basis exceeds the cost to the borrower of extinguishing the debt.¹³³ For OID bonds, this rule is articulated in regulations under § 61 in virtually identical terms if one substitutes "adjusted issue price" for "anti-basis." The relevant language is set out in the footnote.¹³⁴

In the converse scenario—if rates fall or if creditworthiness improves—the borrower might be required to pay a premium if it wishes to cancel its debt before maturity. The regulations provide that "if a debt instrument is repurchased by the issuer for a price in excess

130. § 1272(a).

131. § 1272(a)(3), (4).

132. Here I am imagining a debt that calls for neither any payments of stated redemption price at maturity ("SRPM") before the debt is extinguished in full nor any payments of qualified stated interest ("QSI"). In other words, I am imagining a zero-coupon bond that is not an installment obligation. Anti-basis and adjusted issue price are still identical if the debt is an installment obligation, or if it pays QSI in addition to OID, or if both of these things are true, but the explanation becomes more tedious. See DAVID C. GARLOCK, *FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS* ¶¶ 505, 507 (6th ed. 2010).

133. See *supra* text accompanying note 44.

134. Treasury Regulation § 1.61-12(c)(2)(ii) provides as follows: "An issuer realizes income from the discharge of indebtedness upon the repurchase of a debt instrument for an amount less than its adjusted issue price The amount of discharge of indebtedness income is equal to the excess of the adjusted issue price over the repurchase price." Treas. Reg. § 1.61-12(c)(2)(ii) (as amended in 1997).

of its adjusted issue price . . . , the excess (repurchase premium) is deductible as interest for the taxable year in which the repurchase occurs.”¹³⁵ For an OID loan, the exclusion of the loan proceeds from income and the allowance of a deduction for accrued but unpaid interest are both justified by the expectation that, in the end, the borrower will repay the adjusted issue price (which equals the loan proceeds plus the accrued but unpaid interest).¹³⁶ If the borrower pays more than this, a deduction is proper and is permitted by the quoted regulation. Again this rule is implemented using anti-basis in concept, though not in name.

B. Premium and Discount Liability Shifts

The OID rules would form the basis of a conceptually coherent approach to accounting for asset sales where the consideration paid by the buyer includes accepting a liability shift. Congress originally envisioned that the OID rules would be used for this purpose. In 1984 Congress overhauled the time value of money rules, creating the modern OID regime.¹³⁷ In the original legislation, Congress explicitly authorized the Treasury to write regulations that would have applied the OID rules to transactions involving debt shifts.¹³⁸ This provision proved controversial, however, and, bowing to pressure from the real estate lobby, Congress amended the statute in 1985 to rule out the use of OID concepts when accounting for debt shifts unless “the terms and conditions of such debt instrument are modified (or the nature of the transaction is changed) in connection with the assumption (or acquisition).”¹³⁹

135. Treas. Reg. § 1.163-7(c) (as amended in 2001).

136. Technically, the expectation is that the borrower will repay the “[s]tated redemption price at maturity[.]” which always equals the adjusted issue price of the debt at maturity. I.R.C. § 1273(a)(2); GARLOCK, *supra* note 132, ¶ 505.

137. For a first-hand account of the history of the OID legislation, see GARLOCK, *supra* note 132, ¶ 514.

138. § 1275(d).

139. See § 1274(c)(4); GARLOCK, *supra* note 132, ¶ 310.01 (“Almost before the ink was dry on the 1984 Act, [the provision authorizing regulatory extension of the OID rules to assumptions] became controversial. The real estate lobby argued, in effect, that § 1274 should be limited to ‘abusive’ transactions and that selling property subject to a below-market debt was not an abuse, at least when the debt bore a market interest rate when the initial loan was made.”).

1. Present Law

The decision not to apply the OID rules to liability shifts (barring a modification)¹⁴⁰ means both the portion of the seller's amount realized and the buyer's basis attributable to the liability shift are determined based on the liability's face amount, not its value.¹⁴¹ In other words, premiums and discounts on liabilities are usually ignored when liabilities are shifted in asset sales. This results in systematic character and timing errors for both the buyer and seller; on the bright side, ignoring premiums and discounts on liability shifts makes tax administration simpler.

First consider a premium loan. Suppose that Blackacre (worth \$10 with a basis to the seller of \$4) is encumbered by a liability with a market value of \$3 and a face amount of \$2.70.¹⁴² If the lender agrees to permit a shift of the liability from the seller to a buyer paying an arm's length price, the buyer would pay \$7 cash, Blackacre's net value.

Under current law, the seller's amount realized and the buyer's basis both would be $\$7 + \$2.70 = \$9.70$.¹⁴³ Thus the seller's tax gain would be $\$9.70 - \$4 = \$5.70$. This is \$0.30 (5%) less than the seller's economic gain. The shortfall equals the seller's financing loss on the loan shifted to the buyer.¹⁴⁴ The \$0.30 excess of the buyer's economic cost for Blackacre over her tax basis will be written off over the term of the loan in the form of above-market interest deductions.

In this example, ignoring the loan premium probably hurts the seller and helps the buyer. The seller is hurt because the financing loss would be ordinary and the offsetting gain on Blackacre would likely be capital.¹⁴⁵ The buyer is helped because basis in Blackacre is

140. "Modification" is a term of art. See Treas. Reg. § 1.1001-3 (2011) (codifying the holding in *Cottage Sav. Ass'n v. Comm'r*, 499 U.S. 554, 560–68 (1991)).

141. See generally Treas. Reg. §§ 1.1001-1(g), 1.1012-1(g) (1996) (specifying the amount realized attributable to the debt assumption and the cost basis attributable to the debt, respectively). For a discussion of the exceptions to this rule, see *id.* § 1.1274-5; GARLOCK, *supra* note 132, ¶ 310.02. See generally Alvin H. Shrago, *The Uncertain Tax Treatment of Liabilities in Corporate Acquisitions*, 52 N.Y.U. ANN. INST. FED. TAX'N, §§ 19.01–19.07 (1994) (discussing the complexity of OID rules and confusion surrounding the nature of the seller's indebtedness and face-amount bias).

142. Interest rates have fallen since the loan was extended, creditworthiness has improved, or some combination.

143. See I.R.C. § 274(n); see also *supra* note 130 and accompanying text.

144. Had the seller's basis in Blackacre been \$9 rather than \$4, the \$0.30 reduction in gain would have been 30% less than her economic gain. If her basis were \$9.70, the percentage reduction in her gain would be 100%.

145. A corporate seller might be indifferent, given the lack of a corporate capital gains preference.

nondepreciable, but the incremental interest cost attributable to the premium loan can be written off over the remaining term of the loan.

Next consider a discount loan. Blackacre (worth \$10 with a basis to the seller of \$4) is encumbered by a liability with a market value of \$3 and a face amount of \$3.30.¹⁴⁶ Just as in the prior example, if the lender agrees to permit a shift of the liability from the seller to a buyer paying an arm's length price, the buyer would pay \$7 cash, Blackacre's net value.

Under current law, the seller's amount realized and the buyer's basis both would be $\$7 + \$3.30 = \$10.30$. Thus the seller's tax gain would be $\$10.30 - \$4 = \$6.30$. This is \$0.30 cents (5%) more than the seller's economic gain. The excess is attributable to the seller's financing gain on the loan. The \$0.30 excess of the buyer's tax basis over her real cost should, in concept, be deductible interest, but it is locked up in her nondepreciable basis in Blackacre.

Here, ignoring the loan discount probably helps the seller and hurts the buyer. The seller is helped because her financing gain is likely mischaracterized as capital gain.¹⁴⁷ The buyer is hurt because what is economically interest cost (usually deductible) is treated as cost basis in nondepreciable property. In other examples, buyers might be helped if the asset gives off depreciation deductions that are allowed more quickly than interest deductions.

2. Hidden in Plain Sight

The present-law practice of ignoring premiums and discounts of shifted liabilities is underappreciated. This is attributable, at least partly, to a lack of adequate terminology. If the term anti-basis (or some other term of equivalent meaning) were available, then the analogy between liability gains and losses and asset gains and losses would be more obvious. The obviousness of the analogy raises the question why, in concept or in practice, there should be a different standard for realizing liability gains and losses than for realizing asset gains and losses.

When a lender (think bondholder) trades a loan in the market, no one questions that the determination of her realized gain or loss should be based on the difference between her basis in the liability (corresponding to the price paid in the past) and the amount realized

146. Interest rates have risen, creditworthiness has declined, or some combination.

147. As before, this assumes that the underlying asset is capital and that the seller is noncorporate. *See supra* note 145.

on disposition. When a borrower trades her loan in the market as part of an asset-liability package, why should the rules be different?¹⁴⁸

In concept, the determination of the borrower's realized gain or loss should be the difference between her anti-basis (corresponding to proceeds received in the past) and the amount she is required to pay another to take her place as obligor on the debt. Although this is the approach that produces symmetrical treatment for loans as assets and as liabilities to the lender and borrower, respectively, ordinarily tax lawyers do not conceptualize the borrower's exchange in these terms. The most likely explanation I think, is the lack of a key term in the language of tax law: anti-basis.

3. Should the Rule Be Changed?

Before I move past the OID rules, I will digress briefly to explain why I don't think the current law treatment of discount and premium loan shifts should be changed. I think anti-basis is useful because it makes more obvious the policy implications of the present structure and alternative approaches. In this context, though, the arguments in favor of the present-law approach are stronger than those in favor of reform. Administrative considerations trump conceptual tidiness.

<u>Item</u>	<u>Amount</u>
1. Blackacre gross value	10
2. Seller basis	4
3. Liability value	3
4. Liability face amount	2.70
5. Cash paid by buyer	7

148. Charlotte Crane asked a similar question in her article *More on Accounting for the Assumption of Contingent Liabilities on the Sale of a Business*. See Crane, *More on Accounting*, *supra* note 93, at 631. She posited a hypothetical where A is a roofing contractor who promises to repair any problems that arise for some interval of time after replacing a roof. *Id.* B is also a roofing contractor who sells similar services in a neighboring state, with the same warranty. *Id.* Both A and B have booked all of the income from the roofs sold, and neither is allowed any tax reserve for future repairs that might be necessary. *Id.* Crane asks: If A and B swap territories, including warranty obligations, has there been a realization event with respect to the exchanged liabilities? *Id.*

If all of these facts are known and readily observable, then the total consideration paid is worth \$10, implying economic income of \$6, yet only \$5.70 of gain is realized under present law.¹⁴⁹ The \$0.30 that is missing—the part not taxed—is the excess of value of the debt over the seller’s anti-basis. Present law does not have a term for the historical tax account for liabilities in the same way it does for assets, so the exclusion of this increment of asset gain (and corresponding exclusion liability loss) goes unnoticed. This theoretical objection, explained above, illustrates the usefulness of anti-basis.

In real world transactions fewer facts are apparent. Items 1 and 3 (gross value and the liability value) are not observable directly and cannot be deduced from the parties’ agreement. The parties’ agreement reveals only the net value of Blackacre. Although exact figures for gross asset value and liability value cannot be deduced, the difference between them must equal \$7 (net asset value). If left unchecked, the seller could operate under this constraint and still vary the character of her income within a wide range.¹⁵⁰ Giving taxpayers flexibility in contexts like this is often a mistake. Tax burdens ordinarily ought not to vary on account of facts that have no non-tax economic significance for the parties to a given transaction.¹⁵¹

In some instances, when pressed to do so, policymakers have developed solutions to problems of this type. The best example is the very elaborate system of rules for allocating the price paid in a bulk sale of assets under § 1060,¹⁵² the so called “residual method.” If a farm is sold for cash, then the seller’s gain on cows, horses, tractors, and land depends on the value assigned to each of them; and the buyer’s basis (which has important implications for the timing of cost recovery deductions) also depends on this same allocation. The price paid sets the wide parameters for the allocation exercise, but the allocation among asset classes and assets within each class depends on

149. The result described in the text is over-determined. Blackacre’s gross value, the liability value, and the cash paid by the buyer are like the angles of a triangle—if you know any two, you can figure out the value of the third.

150. She could say, for instance, that Blackacre was worth \$7 and that the liability was worthless, implying asset gain of \$3 and liability gain of \$2.70. Or she could say that Blackacre and the liability were worth \$15 and \$8 and that her asset gain was \$11, and her liability loss \$5.30. Either way her net income is \$5.70, but the tax characterization changes.

151. Andrews, *supra* note 12, at 955. Valuation related penalties would check discretion to some extent, but even if the Service wins a few skirmishes, taxpayers will win the war as they always do when tax burdens are made to depend on questions of value and the facts are unclear.

152. I.R.C. § 1060.

fair market value.¹⁵³ Just as when an asset-liability package is acquired, the value of the component assets, referred to collectively as the farm, cannot be inferred from the terms of the bargain. Taxpayers are required to proceed based on estimates. This system has proven workable.

In the context of premium and discount liability shifts, however, pursuing this approach is not worthwhile. Part of the conceptual underpinning of the residual method of purchase price allocation is the likelihood of divergent interests for the seller and buyer as to the allocation and the requirement that they report for tax purposes, consistent with any agreement they reach with regard to allocation.¹⁵⁴ In the context of liability shifts, the parties' interests are as likely to align as they are to diverge.

One way to cabin taxpayer discretion in assigning value would be to estimate the value of shifted liabilities by requiring taxpayers to figure an imputed principal amount for the shifted debt as under § 1274,¹⁵⁵ using the applicable federal rate or some other proxy for market interest rates. The estimate of value would be added to the cash consideration when fixing the seller's amount realized and the buyer's basis. The buyer would then have anti-basis in the liability equal to the estimated value of the debt, resulting in either OID deductions¹⁵⁶ (if the debt was valued at less than face value) or bond issuance premium (if the debt was valued at more than face value). This OID (or bond issuance premium) would be allocated over the remaining term of the debt and would increase (or decrease) the amount of deductible interest allowed to the buyer.

Though feasible, making this adjustment to present law would be ill advised for at least three reasons. First, the determination of commuted value of shifted liabilities using this approach would very often assign a lower estimate of value than accepting that value equals face amount, as under present law. When lender and borrower agree to the terms of the loan at the outset, they have conflicting commercial interests and a much better ability than the tax collector

153. For a thorough description of the residual method, see *TAXATION OF INCOME* vol. 2, *supra* note 26, ¶ 41.6.8.

154. § 1060(a) ("If in connection with an applicable asset acquisition, the transferee and transferor agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on both the transferee and transferor unless the Secretary determines that such allocation (or fair market value) is not appropriate.").

155. § 1274.

156. These OID deductions would be in addition to any deduction permitted for qualified stated interest owed on the debt.

to adjust loan terms based on the particular facts. If those facts haven't changed much between loan inception and when the loan is shifted, using a one-size-fits-all discount factor to reset the terms seems unlikely to improve accuracy in valuation. On the other hand, when the liability in question has remained outstanding during an interval when market interest rates or creditworthiness (or both) have changed meaningfully, reappraisal, even if by crude proxy, might be an improvement. Yet I speculate that this is likely the exception, not the rule.

Second, when debts are issued in connection with the acquisition of property—purchase money debts—the parties have wide discretion to set the interest rate by contract. So long as the contracted rate falls between Applicable Federal Rates and “clearly excessive,” it is respected for tax purposes.¹⁵⁷ Forcing results to conform to a proxy rate in liability shifts would create a schism between newly created and shifted liabilities, which could be gamed with wraparound debt.¹⁵⁸

Third, administration of the OID rules works by requiring the lender to send a Form 1099-OID to the borrower. The system is set up this way because in most cases the lender is well equipped to perform the necessary computations of accrued OID and has an incentive to do so in a fully transparent way that ensures accountability: if the lender defaults on this chore, its OID deductions are unavailable. In liability shifts, the lender is a bystander to the transaction and has no claim to OID deductions that can be used as a carrot to coopt the lender to act as de facto compliance officer for the Service.

On the other hand, a seller who wishes to reckon her financing gain (or loss) separately from her asset gain (or loss) has a de facto election. She may settle the liability with the lender in a separate transaction. The existence of this de facto election means that present law spuriously penalizes sellers unable to disaggregate their asset and liability realizations for commercial reasons unrelated to tax. This seems unfair. It also encourages disaggregation for tax reasons even when it would be desirable to shift the asset and liability together, taxes aside. This is inefficient.

157. § 1274(b)(3); Treas. Reg. § 1.1274-3 (2012); Halperin, *supra* note 74, at 712–14.

158. See GARLOCK, *supra* note 132, ¶ 310.03. Wraparound debt “is seller financing with respect to property on which there is existing debt.” *Id.* If the seller is debtor on the existing debt and creditor on the wraparound debt owed by the buyer to the seller, the seller’s net exposure can be reduced or eliminated without shifting the existing debt to the buyer.

To sum up, from a conceptual standpoint, present law is deficient in that liability gains and losses that should be recognized by the tax system when liabilities are shifted are (usually) mischaracterized as asset gains or losses. This results in some ordinary income being misclassified as capital gains income and creates timing differences. When the mischaracterization helps taxpayers, they will accept the benefit uncritically; when it hurts them, self-help is frequently available by disaggregating the liability shift from the asset sale. The conceptual deficiencies in present law might be difficult to correct practically. Reliable liability valuation is difficult to estimate (frequent errors should be anticipated) and the third-party reporting system that undergirds periodic accounting for debts with OID or bond premium would be difficult to deploy.

C. Nonrecourse Debt in Excess of Value

Nonrecourse debt in excess of the value of the collateral is a particular (and sometimes extreme) example of a discount liability. This suggests that, in concept, the issues here are the same as those described in the preceding part. However, the issues have been resolved differently in this context, at least in some respects. The issue, familiar to all tax lawyers, was confronted by the Supreme Court in *Tufts*.¹⁵⁹ True, *Tufts* (and *Crane v. Commissioner*,¹⁶⁰ too) dealt only with nonrecourse debt, but it is important to recognize that when shifted liabilities are underwater it is commercially inevitable that the liability in question is nonrecourse *to the buyer*, even if the seller is personally liable.¹⁶¹

Suppose that a seller owned Blackacre free of debt with a tax basis of \$4. When Blackacre was worth \$10 the seller pledged Blackacre as collateral for a loan of \$8. Over time Blackacre declined in value to \$7, and the seller then transferred ownership of Blackacre to a buyer, subject to the loan of \$8 (full principal still outstanding) for nominal consideration of, say, \$0.10. The buyer took Blackacre subject to the debt but did not pledge her own credit.

The seller's treatment is well settled, though more complicated than need be. If the loan was nonrecourse to the seller (a point intentionally not specified in the preceding paragraph), *Tufts* holds

159. *Comm'r v. Tufts*, 461 U.S. 300, 317 (1983).

160. *Crane v. Comm'r*, 331 U.S. 1, 3 (1947).

161. No rational buyer would commit her personal credit to an underwater asset-liability package; it would be like burning money. The debt in *Crane* might have given the lender recourse to Mrs. Crane's deceased husband, but the Supreme Court never said one way or the other.

that the seller's amount realized is \$8, implying the seller's gain is $\$8 - \$4 = \$4$. If the loan was recourse to the seller, on the other hand, then the seller's amount realized is \$7 (Blackacre's value), gain is $\$7 - \$4 = \$3$, and the seller has COD income of $\$8 - \$7 = \$1$.¹⁶²

Either way the seller's overall income is \$4, but in the first version it is all classified as gain on sale of Blackacre, and in the second it is divided between gain and COD income, which has character implications that portend rate differences and possibly excludable COD income.¹⁶³ Thus the argument I made above in the context of garden-variety discount loans applies here, too: In transfers involving asset-liability packages, gain or loss on the asset and liability aspects of the transaction should be reckoned separately; if they are combined, income is mischaracterized, and some taxpayers harmed by the mischaracterization will have a de facto option to change the characterization by settling the debt in a separate transaction. If combined accounting is defensible it must be on administrative grounds.¹⁶⁴

The buyer's treatment under present law is unsettled. The leading view among commentators and the few courts to have considered the question is that the buyer's tax basis in Blackacre should be set equal to the fair market value of Blackacre on the date of the transaction.¹⁶⁵ There is a division of authority on exactly how this rule should be implemented. Under one approach, the buyer's basis in Blackacre is \$7.00, and under the other approach the buyer's basis is \$7.10. The question is whether basis is simply set equal to the fair market value of the property or, instead, whether basis should be increased for the additional \$0.10 of consideration paid by the buyer. The buyer won't have an incentive to pay significant consideration in addition to accepting the liability shift, so the distinction here is usually trivial.¹⁶⁶

162. See Treas. Reg. § 1.1001-2(a)(2) (2011).

163. See I.R.C. § 108.

164. This is related to the argument, first made by Boris Bittker, that the taxation of liability settlements cannot be made to depend on the use to which the proceeds have been put. He argued that "[i]f the tax consequences of the borrowing are tied into the transaction in which the borrowed funds are used, confusion is the very best that can be expected." TAXATION OF INCOME vol. 1, *supra* note 32, ¶ 7.1.

165. I am assuming here that the transaction is not a tax shelter in the pattern of *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976). If the situation is akin to *Estate of Franklin*, the buyer's basis is likely to be zero.

166. GARLOCK, *supra* note 132, ¶ 311; *supra* text accompanying note 144. The more defensible approach is to give the buyer a basis of \$7.00. The \$0.10 paid by the buyer is a sunk cost. Hence an economically rational buyer will treat \$7.00 of debt as genuine (up to the value of the collateral) and should be given basis credit to this extent.

Under present law it is uncertain when the buyer may adjust her basis in Blackacre subsequent to the date of the sale. Two things potentially reduce the extent of the undercollateralization: principal payments on the debt and an increase in the market value of the collateral. When undercollateralization is reduced by either method, it implies that some fraction of the principal balance not yet factored into the buyer's basis must now be respected by the buyer as a genuine liability. Arguably, a basis increase is therefore justified in these circumstances. This result depends on the conclusion that, from the buyer's perspective, the transaction remains open until the liability encumbering the property is resolved, even though the transaction was closed for the seller when the property was sold to the buyer.

It is also possible to view the transaction as closed for both the seller and the buyer. Under this view, the buyer's basis is fixed when ownership is acquired. If the buyer pays down principal after the purchase, or if the value of the collateral increases and partially resolves the collateral shortfall, no adjustment to basis would be appropriate. If basis is fixed at the time of the sale, it is logical, though not supported by any authority, that payments of principal in excess of the principal that generated basis credit at closing would give rise to a deduction. If this is not correct, a business-related expense will simply be ignored, an alternative that is difficult or impossible to justify.

Regardless of whether the transaction is treated as open or closed for the buyer, if the lender agrees to reduce the outstanding principal balance on the loan, the buyer should not have COD income if the reduction in principal eliminates only principal in excess of that for which the buyer has been given basis credit. If additional principal is eliminated—i.e., principal that generated tax basis—then COD income should result. This is the likely result under present law.

Now consider the problem with the help of anti-basis. Under the leading view, the buyer would take a basis of \$7 in Blackacre and would take anti-basis of \$7 in the liability shifted in the transaction. If the transaction is left open (so the buyer's basis can be adjusted subsequent to the transfer), payments of interest would be deductible and payments of principal would increase in the buyer's hands both basis in Blackacre and anti-basis in the liability. At the limit, if the debt were paid in full, basis and anti-basis would increase to \$8. On the other hand if the transaction is closed, then payments of interest would be deductible, payments of principal would offset anti-basis to

the extent thereof, and those payments would then be deductible. As usual, present law is easier to explain using anti-basis.

Anti-basis also sheds light onto the exact scope of the issue. The Supreme Court and some commentators have explained that the problem under consideration exists when the face amount of the debt is greater than the fair market value of the property serving as collateral.¹⁶⁷ This is not the correct specification of the problem, at least conceptually. The correct approach is to compare (a) the discounted present value of all remaining principal and interest payments on the debt (commuted value) with (b) the fair market value of the property. Unless the commuted value of the debt exceeds the market value of the property, the buyer will have an incentive to honor the debt. This is true even if the face amount of the debt exceeds the fair market value of the property.

If the debt's commuted value (for emphasis, *not* the debt's face amount) is greater than the property's value, then my suggestion would be to give the buyer a basis in the property equal to the property's fair market value on the date of the transaction and to use this figure also as the issue price of the debt. Some market index or proxy rate of interest would then be selected or imposed. The debt's stated redemption price at maturity ("SRPM") would be set so that accrual of stated interest and OID (combined to equal the chosen rate) would, over the remaining term of the debt, increase adjusted issue price to SRPM at maturity. To the extent that the face amount of the debt exceeds the SRPM, as so computed, the debt would be treated as contingent. If the buyer ever had an incentive to pay any amount over the SRPM (owing to a change in collateral value or pay-down of principal), such payment would either be capitalized into basis in the underlying asset or deducted, depending on whether one prefers an open- or closed-transaction approach to accounting for liability shifts.

D. Options as Contingent Liabilities

Suppose a short-seller ("S") writes a call option purchased by a long ("L") over 100 shares of IBM stock for a premium of \$10. Does S's commitment to sell IBM to L at the strike price have anti-basis? The answer is plainly yes. The act of writing the option gave rise to basis in the option premium (cash) received. The option premium is

167. See *Crane v. Comm'r*, 311 U.S. 1, 15 n.42 (1974); Daniel N. Shaviro, *Risk and Accrual: The Tax Treatment of Nonrecourse Debt*, 44 TAX L. REV. 401, 409 (1989) ("The holding in *Crane* does not apply if, upon the acquisition of property subject to nonrecourse debt, the face amount of the debt exceeds the fair market value of the property.").

like the proceeds of a peculiar contingent loan, where S is the borrower, L is the lender, and the obligation to repay depends on the future price of IBM stock. Viewed this way, S must have anti-basis given the similarity to the paradigmatic loan example.

This approach also maps onto the tax treatment of S under present law. S has income if the option expires out of the money.¹⁶⁸ This income is conceptually similar to COD income on a loan default, except here default is replaced by good fortune (an unfulfilled contingency that would have required payment). If the option settles in the money or is exercised, payment by S is required. S's loss (or income) would be (a) the amount the option was in the money (the excess of the price of IBM over the strike price of the option on the date of exercise) less (b) the option premium. In other words, loss (income) equals (a) payment minus (b) anti-basis.¹⁶⁹

E. Partnership Tax

Those versed in the intricacies of Subchapter K will have recognized that the anti-basis test articulated above is congruent with the definition of "liability" now embodied in the regulations under Subchapter K, which reads as follows:

An obligation is a liability for purposes of section 752 and the regulations thereunder . . . , only if, when, and to the extent that incurring the obligation—

- (A) Creates or increases the basis of the obligor's assets (including cash);
- (B) Gives rise to an immediate deduction to the obligor; or
- (C) Gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.¹⁷⁰

Think back through examples used in this article. Category (A) deals with the bank loan.¹⁷¹ Category (B) deals with the inventory

168. See Rev. Rul. 78-182, 1978-1 C.B. 265, 267. This ruling comes close to mentioning anti-basis when it explains that "[t]he premium received for writing the call is not included in income at the time of receipt, but is carried in a deferred account . . ." *Id.* "Deferred account" is a synonym for anti-basis.

169. See *id.* at 268-69. The same analysis holds for put options *mutatis mutandis*. The option writer is making a long bet on the underlying security, but the written put is a contingent liability with anti-basis equal to the premium received. The option writer's loss equals the amount that must be paid to settle the option minus anti-basis (if the difference is negative, it represents income).

170. Treas. Reg. § 1.752-1(a)(4) (as amended by T.D. 9207, 2005-26 I.R.B. 1344).

171. See *supra* text accompanying note 41.

delivery example and similar cases: the shopkeeper's obligation is not a liability for purposes of § 752 unless and until a deduction accrues and is classified as a liability only to that extent.¹⁷² Category (C) deals with nondeductible fines and penalties, and other similar cases where, in my usage, anti-basis is derived from public policy aspects of the definition of income, rather than fidelity to underlying economic concepts.¹⁷³

The identity between this definition of “liability” and the output of my test for anti-basis is explained by their common function. The Subchapter K definition of “liability” is a rule grounded in the aggregate theory of partnership taxation. In other words, the definition (and its interaction with related operational rules) is designed to ensure that the partners are treated in the same way vis-à-vis the partnership's business activities as if they had undertaken their share of those activities on their own.

To illustrate why each category in the litany must be treated as a partnership liability, consider the following three examples. In each example X and Y are fifty-fifty partners in XY. Y always contributes \$5 cash and the facts vary for X from one example to the next. Whenever X shifts a liability to the partnership, X remains personally liable, so the liability is allocated solely to X under the § 752 regulations.¹⁷⁴ Whenever the partnership incurs a liability in the first instance, X alone is guarantor so, again, the liability is allocated all to X, none to Y.¹⁷⁵

First, X borrows \$5 and purchases for \$10 (using the borrowings and \$5 of savings) a \$10 widget machine. X contributes the machine, subject to the liability, to the XY partnership. X's outside basis in XY equals \$10, derived from X's \$10 precontribution basis in the widget machine.¹⁷⁶ If instead X and Y formed the XY partnership, each contributing \$5 cash, and caused XY to borrow \$5, for which X was ultimately liable, and purchased the same widget machine, X's outside basis in XY would only be \$5 if (contrary to present law) the partnership's commitment to repay the loan were not a “liability” in the technical sense used in § 752.¹⁷⁷ To ensure parity between cases of these types is the reason why a liability that “creates or increases the

172. *See supra* text accompanying note 29.

173. *See supra* Section III.D.

174. Treas. Reg. § 1.752-2(a) (2011).

175. *Id.*

176. I.R.C. § 722.

177. Under current law the borrowing is a liability and it is allocated to X, so X is treated as contributing \$5 cash, increasing X's outside basis from \$5 to \$10. *See* § 752(a).

basis of the obligor's assets" (category (A)) must be included within the § 752 definition of liabilities.

To put it in general terms, partnership tax accounting endeavors to maintain equality between the partners' bases in their partnership interests and the partnership's basis in its assets (outside-inside basis conformity). When the partnership makes a leveraged asset purchase (or simply borrows and holds cash) it is the partnership's basis in the asset that the rules seek to replicate in outside basis, not the liability itself. Thus the definition of liability must be restricted to those obligations that correspond to assets with tax basis created or increased by the obligation.

Next, to demonstrate the need for category (B) in the definition—defining “liability” to include an obligation that “gives rise to an immediate deduction to the obligor”—suppose that X is an accrual method taxpayer who contributes to the partnership \$10 cash and an accrued but unpaid debt of \$5. The debt is later paid by the partnership. If the debt is not a “liability” then X's outside basis in her stake in XY is \$10, and will remain \$10 even after the debt is discharged by the partnership.¹⁷⁸ X's interest in XY is worth only \$5, and so assigning a basis of \$10 must be incorrect. If the debt is a “liability” then X's outside basis in XY is \$10 so long as the debt remains unpaid. Until the partnership pays the debt, X's \$10 outside basis plus Y's \$5 outside basis equal the \$15 basis XY has in its cash. When the debt is paid, the decrease in X's share of partnership liabilities forces X to step down her basis to \$5,¹⁷⁹ denying X the artificial tax loss she would otherwise enjoy. Thus category (B), like category (A), is tailored to ensure outside-inside *asset* basis conformity.

What results in this example if the debt in question had not been paid *or accrued* (so that the debt lacked anti-basis)? It would not be treated as a partnership liability. On formation, X's outside basis in her partnership interest would be \$10. When the deduction attributable to the debt accrued, the deduction would be allocated to X, and the allocation of this deduction would trigger a reduction in X's outside basis from \$10 to \$5, so, again, X's and Y's outside bases would sum to the partnership's cash on hand. This illustrates that debts that do not “[g]ive[] rise to an immediate deduction to the

178. *Id.*

179. §§ 752(b), 733(1).

obligor”¹⁸⁰ need not be included because the basis adjustment on the deduction accrual will preserve outside-inside basis conformity.

Finally, consider category (C): debts that are nondeductible and noncapital. X contributes \$10 cash and an obligation to pay a \$5 fine to XY, everything else unchanged. If the fine is a liability then when it is discharged by XY, X’s outside basis will drop to \$5,¹⁸¹ so outside basis and cash inside the partnership will both sum to \$10; if the fine is *not* a liability, then X will have an outside basis of \$10 throughout (even after the fine is paid), which means X could then sell her stake in XY for its value (\$5) and claim a loss corresponding to the nondeductible fine. This would contradict the rule that fines are not deductible.

Recall the definition of anti-basis: Anti-basis is the untaxed benefit that a taxpayer enjoys as a concomitant of an increase in the liabilities (or obligations) to which the taxpayer is subject. For category (A) partnership liabilities, the untaxed benefit that makes the obligation a partnership liability is tax basis in the asset, which corresponds to liability. Partnership tax law attempts to ensure that this debt-financed (inside) asset basis is reflected in the partners’ outside bases. Restricting the definition of “liability” to debts that generate basis means that outside basis is created to this extent, but no more.

For category (B) partnership liabilities, the untaxed benefit is a tax deduction without payment. Outside basis must be given for the cash or other property that backstops the partnership’s obligation to make payment during the interval between when the liability is deducted and when it is paid; then, on payment, the backstopping asset and associated outside basis both disappear simultaneously. Again, partnership tax law is not attempting to give outside basis credit for the “liability” in its own right, but rather compensating for the associated asset that exists in its reflection. The explanation for category (C) partnership liabilities is similar, so I relegate it to the margin.¹⁸²

180. Treas. Reg. § 1.752-1(a)(4)(i)(B) (2011).

181. See I.R.C. § 705(a)(2).

182. A nondeductible fine or penalty (or other debt that is both nondeductible and noncapital) is similar to a debt that is deducted before it is paid when both are viewed from some time after the deduction is claimed but still prior to payment. For either type of debt, payment will trigger no tax consequences. Thus if X transfers \$10 cash and a fine of \$5 to XY, X’s outside basis should be \$10 and then \$5 before and after the fine is paid, just as it was \$10 and then \$5 before and after payment of the debt for which the deduction had accrued in the past.

Thus Subchapter K tacitly incorporates anti-basis. Unlike §§ 108(e)(2) and 357(c)(3), both of which articulate the test for anti-basis (“would payment of this obligation give rise to a deduction?”) as part of the formal rule, the § 752 regulations reticulate all of the instances where the answer to the test question would be no, implying the existence of anti-basis. The same result could be reached in any of these cases using either approach to defining the scope of the rule.

CONCLUSION

Anti-basis is the untaxed benefit enjoyed by a taxpayer when a liability or obligation is incurred. In the business context, the untaxed benefit takes the form of an increase in asset basis or a tax deduction. In the personal context, the untaxed benefit might take one of those forms, or it might also be (nondeductible) personal consumption. A well-functioning income tax system necessarily must keep track of the presence or absence of any such untaxed benefit. If the liability is avoided by the taxpayer, any prior untaxed benefit must be taken into income (or be set off against basis); or, if there was no prior untaxed benefit, exceptions are necessary to various rules requiring income recognition (or basis reduction) on discharge or shifting of liabilities.

The Internal Revenue Code requires taxpayers to account for anti-basis, but it does so ad hoc. Various sections tacitly incorporate anti-basis—such as §§ 108(e)(2), 357(c)(3), and the partnership definition of “liabilities” in regulation § 1.752-1(a)(4), to take just a few of the many examples—but each section exists on an island. A few prior commentators have sensed that some common underlying principle ties these rules together conceptually. Prior to this Article, however, there has been no thoroughgoing treatment of the concept.

In the end, recognizing and assigning a label to the concept that ties together various rules for accounting for transactions in liabilities is not likely to reshape doctrine or the language of tax law, other than peripherally. It is useful and interesting, nevertheless, to understand that within the baroque conceptual structure of income taxation built up over the past hundred-plus years, there exists a dark star that explains and justifies various liability-accounting rules, and reveals their connection to each other and to the deep structure of our tax system.

