Fall 2015

Of More Than Usual Interest: The Taxing Problem of Debt Principal

Charlene Luke
University of Florida Levin College of Law, lukec@law.ufl.edu

Of More Than Usual Interest: The Taxing Problem of Debt Principal

Charlene D. Luke[*]

ABSTRACT

Leverage is an essential but often troubling component of the U.S. market. The financial crisis highlighted the risks and complexity of a leverage web that includes flesh-and-blood people from all walks of life and paper people from all corners of the business and investment world. In the tax area, the potentially problematic incentive effects of interest deductibility have long engaged a wide array of tax commentators and policymakers. While interest deductibility rightly receives widespread scrutiny, a more comprehensive approach to leverage is needed. This Article focuses on the surprisingly complicated tax treatment of cash (and cash equivalent) borrowings. This Article highlights that the current tax treatment of debt principal used to finance business and investment deductions yields favorable tax timing mismatches for taxpayers and thereby theoretically amplifies any distortions caused by the deductibility of debt interest.

The tax system's current approach to debt-financed tax benefits reflects reactive responses to particular forms of tax avoidance. The current system's reliance on a factor drawn from tax avoidance case law—likelihood of repayment—has led to an inherently flawed set of tax rules. For example, the at-risk rules identify nonrecourse debt as problematic and then impose timing limitations on tax benefits financed only with that debt type even though potential timing distortions are embedded in all cash borrowings. Thus, the at-risk rules treat nonrecourse debt as simultaneously bona fide and suspect, yet whether an agreement consti-

[*] Professor, University of Florida Levin College of Law. I am grateful for the comments and support provided by Bradley Borden, Yariv Brauner, Karen Burke, Diane Lourdes Dick, John Eason, Alyson Craig Flournoy, Michael K. Friel, Brian Galle, Lily Kahng, Omri Marian, Grayson McCouch, Martin J. McMahon, Jr., Shu-Yi Oei, Adam Rosenzweig, Sharon E. Rush, and to the participants at the Seattle University School of Law faculty workshop and the Association of Mid-Career Tax Professors conference where this work was presented. I also thank my research assistants, Andrew Buddemeyer and Tyler LeFevre. Any errors and omissions are mine.

tutes bona fide debt still must be determined using a facts-and-circumstances, case-by-case analysis. The resulting tax rules relating directly to debt principal are confusing and inconsistent. The rules also invite extensive tax planning, whether legitimate or avoidant.

The main tax problems relating to debt principal—the timing distortion and the possibility of sham debt—should be addressed as distinct issues with priority given to the timing issue. Giving renewed attention to resolving the timing distortion would facilitate a comprehensive approach to debt and would also have the likely side benefit of making sham debt less attractive. This Article examines multiple proposals for directly limiting timing benefits. Solving timing distortions for even simple cash debt is quite difficult. Thus, this Article details a more accurate, more complex reform avenue but also suggests a simpler, rougher justice one as well. The more complex approach rations the use of borrowed basis while the simpler approach utilizes a deferral charge. In addition, this Article briefly reviews (and rejects) two other possibilities—treating all debt as lacking basis and treating cash equivalent debt as income on receipt. If it is not currently possible to implement broader reform proposals, incremental reform that distinguishes more carefully between the underlying timing distortion and tax avoidance behavior could bring greater coherence to the taxing problem of debt principal.

CONTENTS

INTRODUCTION

Leverage is an essential but often troubling component of the U.S. market.[1] The financial crisis highlighted the risks and complexity of a leverage web that includes flesh-and-blood people from all walks of life and paper people from all corners of the business and investment world.[2] The recent crisis will fuel economic, financial, and legal scholarship and debate for decades—perhaps centuries—to come.[3] In the tax area, a central concern has been whether the tax system improperly persuades taxpayers to take leveraged positions that they would not take in the absence of tax incentives.[4] To put it another way, the question is whether the tax system's treatment of leverage causes significant and problematic economic distortions.[5]

Much of the analysis of this question focuses on the tax treatment of the interest on debt.[6] Under current federal tax law, all or a portion of

---

1. *See, e.g.*, Margaret M. Blair, *Financial Innovation, Leverage, Bubbles and the Distribution of Income*, 30 REV. BANKING & FIN. L. 225, 227 (2011) (pointing out that financial services "facilitate productive investment up to a point" but that the U.S. financial system is "using too much debt [and] creating too much credit").

2. Various business and investment taxpayer entities are paper people or artificial people. *See* Dana Milbank, *A Ruling for the People, At Least the "Artificial" Ones*, WASH. POST, July 1, 2014, at A02 ("Mitt Romney said it, and on Monday the Supreme Court upheld it: 'Corporations are people, my friend.'"); *see also* Burwell v. Hobby Lobby Stores, Inc., 134 S. Ct. 2751, 2768 (2014) ("But it is important to keep in mind that the purpose of this fiction [that corporations are persons] is to provide protection for human beings."). Video of Mitt Romney's (in)famous comment is available at *Mitt Romney- Corporations are People!*, YOUTUBE, https://www.youtube.com/watch?v=E2h8ujX6T0A (uploaded Aug. 11, 2011).

3. *See, e.g.*, ALAN S. BLINDER, AFTER THE MUSIC STOPPED: THE FINANCIAL CRISIS, THE RESPONSE, AND THE WORK AHEAD (2013); FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT (2011); Blair, *supra* note 1; Christine Hurt, *The Duty to Manage Risk*, 39 IOWA J. CORP. L. 253 (2014). Consider that writers across disciplines continue to analyze the Great Depression and its aftermath. *See, e.g.*, BEN S. BERNANKE, ESSAYS ON THE GREAT DEPRESSION (2004); INTERPRETING AMERICAN HISTORY: THE NEW DEAL AND THE GREAT DEPRESSION (Aaron D. Purcell ed., 2014).

4. *See, e.g.*, TAXATION AND THE FINANCIAL CRISIS 3 (Julian S. Alworth & Giampaolo Arachi eds., 2012); Martin A. Sullivan, *Economic Analysis: Deleveraging the Tax Code*, 120 TAX NOTES 1241 (2008).

5. This is not to suggest a causative linkage between the tax treatment of debt and the financial crisis. *See* Julian S. Alworth & Giampaolo Arachi, *Introduction* to TAXATION AND THE FINANCIAL CRISIS, *supra* note 4 (noting that "taxation and fiscal policy do not appear in the list of major culprits responsible for the financial crisis" but that "the tax system appears to have played a secondary role").

6. *See, e.g.*, TAXATION AND THE FINANCIAL CRISIS, *supra* note 4; Sullivan, *supra* note 4.

interest paid on debt used to finance investment assets, business operations, and home ownership is deductible.[7] The potentially problematic incentive effects of this deductibility have long engaged a wide array of tax commentators and policymakers.[8] For example, proposals regularly emerge suggesting the reduction or elimination of the deductibility of home mortgage interest.[9] Recently, the ability of U.S. corporations to deduct cross-border interest payments has drawn attention in the debate about corporate tax inversions.[10]

While interest deductibility rightly continues to receive widespread scrutiny, this Article highlights the need for a more comprehensive approach to leverage. The tax issues surrounding leverage are highly varied and complex with key decisional frameworks—such as which financial obligations should be treated the same as cash debt—remaining unresolved.[11] This Article focuses on just one aspect of the leverage web, but one that is foundational to crafting a more comprehensive tax approach: the surprisingly problematic tax treatment of simple cash borrowings.[12] If leverage is to be addressed in a principled way by the tax system, an ob-

---

7. I.R.C. § 163 (2012). A small amount of interest on qualifying student loans is also deductible. I.R.C. §§ 163(h)(2)(F), 221.

8. *See, e.g.*, Ilan Benshalom, *How to Live with a Tax Code with Which You Disagree: Doctrine, Optimal Tax, Common Sense, and the Debt-Equity Distinction*, 88 N.C. L. REV. 1217, 1228–34 (2010) (discussing interest deductibility); *Ending the Debt Addiction: A Senseless Subsidy*, THE ECONOMIST, May 16, 2015, at 36, *available at* http://www.economist.com/news/briefing/21651220-most-western-economies-sweeten-cost-borrowing-bad-idea-senseless-subsidy (discussing interest deductibility); *see also* sources cited *infra* notes 9–10.

9. *See, e.g.*, Roberta F. Mann, *Home Mortgage Interest Deduction Ultimately Helps Few Reach American Dream: Recent Proposals Would Be More Equitable*, 19 J. TAX'N INVESTMENTS 189 (2003); Dennis J. Ventry, Jr., *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest*, 73 LAW & CONTEMP. PROBS. 233 (2010). The issue of home mortgage interest deduction is only one component of the overall tax benefits afforded home ownership. *See* Lily Kahng, *Path Dependence in Tax Subsidies for Home Sales*, 65 ALA. L. REV. 187 (2013).

10. *See* Edward D. Kleinbard, *"Competitiveness" Has Nothing To Do With It*, 2014 TAX NOTES TODAY 169-6 (Sept. 2, 2014); Stephen E. Shay, *Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations*, 144 TAX NOTES 473 (2014); *see also* J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Getting Serious About Cross-Border Earnings Stripping: Establishing an Analytical Framework*, 93 N.C. L. REV. 673 (2015).

11. *See* Jasper L. Cummings, Jr., *Searching for Indebtedness*, 2015 TAX NOTES TODAY 33-6 (Jan. 29, 2015).

12. As used in this Article, cash borrowing includes not only borrowing cash but also buying goods or services on credit if the value of the goods or services equals the amount of the debt (plus any amount paid out of pocket by the borrower). In other words, cash borrowing also includes financing when an exchange of checks is omitted. For example, if a taxpayer buys equipment worth $20,000 by making a $5,000 down payment and financing $15,000, the $15,000 would be a cash borrowing as the term is used in this Article even if the taxpayer does not get a $15,000 check from lender and then write a $15,000 check to the seller. This does, however, beg the question of what to do if the debt is larger than the value. For a brief discussion of this problem, see *infra* notes 102–106 and accompanying text.

vious place to start is ensuring that cash (and cash equivalent) borrowings are treated accurately.

Under well-established tax authorities, taxpayers do not include borrowed cash in income; they generally are, however, still able immediately to use borrowed money to finance business or investment tax benefits.[13] In tax parlance, taxpayers receive basis when they borrow cash, and they are able immediately to use that basis to generate tax benefits.[14] This opens up avenues for significant time-value-of-money benefits and for tax avoidance.[15] Congress and the courts have acted to curtail obvious tax avoidance techniques that rely for power on pumped-up debt principal,[16] but taxpayers' basic ability to use borrowed money to fund deductible expenses or purchase depreciable assets remains largely intact. To borrow money from a banker, taxpayers must pay interest, but a taxpayer may, in effect, borrow deductions from the Treasury without making any interest-like remuneration to the government.[17]

This Article emphasizes that the current tax treatment of debt principal used to finance business and investment deductions continues to yield favorable tax timing mismatches for taxpayers and thereby theoretically amplifies any distortions caused by the deductibility of debt interest.[18] The ability, in effect, to borrow basis has also proven to be a temptation to taxpayers looking to accelerate deductions.[19] The tax system's approach to debt-financed deductions has been to deal reactively and in a

---

13. *See* MARVIN A. CHIRELSTEIN & LAWRENCE ZELENAK, FEDERAL INCOME TAXATION 48, 362–63 (12th ed. 2011).

14. *See infra* Part I.

15. *See, e.g.*, Glenn E. Coven, *Limiting Losses Attributable to Nonrecourse Debt: A Defense of the Traditional System Against the At-Risk Concept*, 74 CALIF. L. REV. 41 (1986); Martin J. McMahon, Jr., *Reforming Cost Recovery Allowances for Debt Financed Depreciable Property*, 29 ST. LOUIS U. L.J. 1029 (1985); Theodore S. Sims, *Debt, Accelerated Depreciation, and the Tale of a Teakettle: Tax Shelter Abuse Reconsidered*, 42 UCLA L. REV. 263 (1994); George K. Yin, *The Story of* Crane*: How a Widow's Misfortune Led to Tax Shelters*, *in* TAX STORIES 207 (Paul Caron ed., 2003). The problems associated with reaching timing distortions have received considerable attention and have resulted in concrete changes to the Internal Revenue Code ("Code"), including enactment and revisions to rules for handling original issue discount, market discount, and below-market interest. *See, e.g.*, Peter C. Canellos & Edward D. Kleinbard, *The Miracle of Compound Interest: Interest Deferral and Discount After 1982*, 38 TAX L. REV. 565 (1983); Daniel I. Halperin, *Interest in Disguise: Taxing the Time Value of Money*, 95 YALE L.J. 506 (1986); Lawrence Lokken, *The Time Value of Money Rules*, 42 TAX L. REV. 1 (1986).

16. I.R.C. § 465 (2012) (at-risk rules); Estate of Franklin v. Comm'r, 544 F.2d 1045, 1048–49 (9th Cir. 1976).

17. As will be explained in detail in Part I *infra*, borrowed cash is infused with tax basis; this tax basis may be used to support tax deductions immediately.

18. Whether and to what extent a particular tax treatment factually induces distortive behavior requires empirical analysis and is beyond the scope of this Article.

19. *See infra* Part II.

piecemeal fashion to particular avoidant behavior.[20] Rather than deal directly with the timing benefits, tax statutes and regulations categorize debt according to likelihood of repayment and use the resulting categories to implement various restraints on taxpayer behavior.[21] This Article recommends a renewed focus on the underlying timing temptation to advance a more comprehensive, principled approach to borrowing deductions.[22] Resolving the timing temptation requires greater attention to the tax concept of basis and less to the likelihood of repayment—a non-tax concept—in determining tax consequences.

The concept of likelihood of repayment in the tax system does, however, make sense when it is utilized as one factor for distinguishing bona fide cash (or cash equivalent) debt from sham debt.[23] Tax avoiders are likely inclined to limit economic risk and are thus more apt to use structures reducing their potential for true economic costs.[24] Congress seized on likelihood of repayment to implement a specific set of rules, the at-risk rules, in an effort to limit tax avoidance without the need to resort to case-by-case resolution.[25] The at-risk rules operate by using two rough, proxy categories for likelihood of repayment. These categories, recourse debt and nonrecourse debt, persist within the at-risk rules and also are used in partnership taxation.[26]

This use of proxies for repayment likelihood has, however, led to an inherently flawed set of tax rules. For example, the at-risk rules identify nonrecourse debt as problematic and then impose timing limitations on deductions (and credits) financed only with that debt type, even though potential timing distortions are embedded in all cash borrow-

---

20. *See infra* Part II.

21. I.R.C. § 465 (2012); Treas. Reg. § 1.752-1 (as amended in 2005).

22. During the lead up to the enactment of the at-risk rules and into the 1980s, the problem of debt-financed deductions received considerable attention. For examples, see *supra* note 15. Since then, the amount and complexity of debt and of business configurations have only increased.

23. *See infra* Part II. It also makes sense for purposes of distinguishing bona fide obligations that are still too contingent to be treated the same as cash borrowings. *See* Treas. Reg. § 1.752-7 (as amended in 2005).

The term "sham," like "tax shelter," is a loaded one in tax law. This Article uses it to indicate an arrangement that is formally debt but that a court would have no trouble viewing as substantively lacking any economic reality. *See* Charlene D. Luke, *The Relevance Games: Congress's Choices for Economic Substance Gamemakers*, 66 TAX LAW. 551, 558 (2013).

24. *See* Daniel N. Shaviro, *Risk and Accrual: The Tax Treatment of Nonrecourse Debt*, 44 TAX L. REV. 401, 405 (1989) (arguing that tax avoiders are risk averse and hence are more likely to use nonrecourse debt; thus, targeting nonrecourse debt will net the worst offenders).

25. *See infra* Part II.

26. *See* I.R.C. § 465 (2012); Treas. Reg. § 1.704-2 (as amended in 2011); Treas. Reg. § 1.752-1 (as amended in 2005).

ings.[27] Thus, the at-risk rules treat nonrecourse debt as simultaneously bona fide and suspect, yet whether an agreement constitutes bona fide debt still must be determined using a facts-and-circumstances, case-by-case analysis.[28] Perhaps not surprisingly, the current tax rules relating directly to debt principal are confusing and inconsistent. The rules also invite extensive tax planning, whether legitimate or avoidant, while they still formally maintain a potential timing benefit for all cash borrowings.[29] The main tax problems relating to debt principal—the timing distortion and the possibility of sham debt[30]—should instead be addressed as distinct issues with priority given to the timing benefits of all debt. Giving renewed attention to resolving the timing distortion would facilitate a comprehensive approach to debt and would also have the likely side benefit of making sham debt less attractive.

This Article examines multiple proposals for addressing the timing distortion directly. As will become apparent, solving the timing distortion for even simple cash debt is quite complex. Thus, this Article details a more accurate, more complex reform avenue but also suggests a simpler, rougher justice one as well. The more complex approach rations the use of borrowed basis while the simpler approach utilizes a deferral charge. In addition, this Article briefly reviews (and rejects) two other possibilities—treating all debt as lacking basis and treating cash debt as income on receipt. If it is not currently possible to implement broader reform proposals, incremental reform that distinguishes more carefully between the underlying timing distortion and tax avoidance behavior could bring greater coherence to the taxing problem of debt principal.

This Article is organized as follows: Part I uses examples to explain the current tax treatment of debt principal and explore the potential benefit to taxpayers of borrowing deductions. Part II provides a summary of three approaches to debt principal already embedded in the tax system: the at-risk rules, the subchapter S corporate debt rules, and tax partnership debt rules. Part III outlines a proposal that uses features of the at-risk rules and subchapter S rules to require taxpayers to wait to access the benefits of borrowed deductions. Part IV briefly considers the possi-

---

27. I.R.C. § 465 (2012). Some nonrecourse debt is permissible. *See* discussion of qualifying nonrecourse debt *infra* notes 125–129.

28. *See* Regents Park Partners v. Comm'r, 63 T.C.M. (CCH) 3131 (1992).

29. For example, the Treasury continues to struggle to implement partnership tax rules relating to both basis assignment for debt and for allocations relating to debt. *See infra* notes 166–168 and accompanying text.

30. A bona fide economic arrangement labeled as debt may also be present but be better categorized as something else—as equity or as a contingent obligation, for example. *See infra* notes 31–32.

bility of three alternative avenues for limiting access to borrowed deductions: zero basis for debt, income acceleration for debt, and nondeductible deferral payments on borrowed deductions.

I. THE MECHANICS OF BORROWING DEDUCTIONS

The tax advantage accorded to interest rightly raises concerns about overuse of leverage and about deadweight loss from avoidant manipulation of the debt-equity line and the interest-principal line.[31] Similar, albeit more variable, tax advantages stem from the current tax treatment of debt principal, thus amplifying the distortive potential of interest deductibility. The first section of this Part illustrates these tax advantages using a series of examples involving debt-financed investments. The second section of this Part contains a more detailed analysis of the various cash flows and explores how the tax treatment of the cash flow threads could be altered to reduce the problematic tax advantages afforded debt principal.

A. Illustrations of Debt-Financed Deductions

This section uses examples to explain the basic tax treatment of debt principal and to explore the potential for tax timing mismatches. Some background assumptions are required to ensure focus on debt principal (rather than on the interest component) and to provide continuity across examples. Each investment is purchased with borrowed cash[32] and

31. The line between debt and equity is notoriously problematic. *See, e.g.*, I.R.C. § 385 (2012); I.R.S. Notice 94-47, 1994-1 C.B. 357; David P. Hariton, *Distinguishing Between Equity and Debt in the New Financial Environment*, 49 TAX L. REV. 499 (1994); William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971); Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055 (2000). It is difficult (and arguably impossible) to provide a principled rationale for distinguishing the tax treatment of payments made to provide a return on equity from the tax treatment of payments made to provide a return on debt. It is beyond the scope of this Article to discuss whether and how to draw the line between debt and equity.

The Code contains fairly workable solutions to dividing principal payments from interest payments, accruing interest, and imputing interest. *See* I.R.C. §§ 163(e), 483, 1271–1275, 7872 (2012); Walter C. Cliff & Phillip J. Levine, *Interest Accrual and the Time Value of Money*, 34 AM. U. L. REV. 107 (1984); Canellos & Kleinbard, *supra* note 15; Halperin, *supra* note 15; Lokken, *supra* note 15.

32. Just as it is difficult to draw a line between debt and equity, it is also difficult to draw a line between basis-conferring debt and more inchoate forms of leverage, such as some of the highly contingent obligations found in various derivative contracts. *See, e.g.*, Treas. Reg. §§ 1.752-1, 1.752-7 (as amended in 2005). It is beyond the scope of this Article to address the preliminary issue of distinguishing liabilities that provide borrowers with basis from bona fide obligations that have not yet provided the obligee with such basis.

The at-risk rules and other rules governing debt basis were formulated well before the expansion of more complex leverage tools. *See* NIALL FERGUSON, THE ASCENT OF MONEY: A FINANCIAL

it should be assumed that there is no question as to whether the debt really is debt. The reader should assume that all the example investments provide an identical rate of return. In addition, the reader should assume that the annual return on each investment and the annual interest payment on the debt financing that investment exactly cancel each other out, taking into account not only the pre-tax amounts but also the tax on the return and the deductibility of the interest.[33] Further, it should be assumed that the creditor charges an interest rate adequate to forestall any application of interest imputation rules. In each example, the investment lasts five years, and the debt principal is repayable in full through a balloon payment at the conclusion of the investment.

Example 1. Investor A borrows $100,000 and places all of it into a simple savings account, Account Z. Investor A does not have taxable income upon borrowing the $100,000. Under well-established federal income tax principles, the borrowing is not taxable because it does not increase Investor A's wealth.[34] The cash is precisely offset by an obligation to repay the $100,000 at the end of the five years.[35] At the end of the five years, Investor A closes Account Z and uses the $100,000 still in the account to pay off the debt principal.[36] Well-established federal income tax principles provide that repayment of the debt principal is not deductible.[37] The explanation for non-deductibility of debt principal is the mirror image of that for not including the original borrowing in income: The repayment of the debt principal does not diminish Investor A's wealth; Investor A is simply returning what was borrowed.[38] In this example,

---

HISTORY OF THE WORLD 5 (2008) (noting that "[b]efore the 1980s, [derivatives] were virtually unknown").

33. There are practical difficulties of such a precise matchup because of, for example, restrictions on the deductibility of interest on debt used to finance investments. *See* I.R.C. § 163(d).

34. *See* Comm'r v. Tufts, 461 U.S. 300, 307 (1983) ("When a taxpayer receives a loan, he incurs an obligation to repay that loan at some future date. Because of this obligation, the loan proceeds do not qualify as income to the taxpayer.").

35. The present value of $100,000 due in five years is, of course, not $100,000. The creditor charges interest to take into account time-value-of-money considerations. From a tax point of view, in a business or investment context, the money to be used to pay the interest will generally have been taxed followed by deduction of the interest—the two matching each other economically, at least in broad terms. *But see* I.R.C. § 163(d) (limiting deduction of investment-related interest to net investment income). As described above, the examples assume adequate interest and further assume that the annual return and the payment of interest exactly match.

36. Again, it should be assumed that annual interest payments on the debt and annual return on Account Z cancel each other out, even after tax.

37. *See* J. MARTIN BURKE & MICHAEL K. FRIEL, TAXATION OF INDIVIDUAL INCOME 54 (10th ed. 2012).

38. *See id.*; McMahon, Jr., *supra* note 15, at 1041.

because the borrowed cash did not change form and was maintained in a separate account, that relationship is readily apparent.

Example 2. Investor B also borrows $100,000, and again, as provided under well-established tax principles, B does not pay taxes on any of the $100,000 because B has not increased her wealth.[39] Investor B uses the borrowed money to purchase Asset Y. Imagine that a special tax incentive applies to Asset Y such that purchasing it gives rise to an immediate tax deduction equal to its purchase price.[40] Under well-established tax rules, Investor B will still receive the deduction even though the investment is paid for with borrowed funds.[41] In tax jargon terms, Investor B has been able to borrow not only cash but also something known as tax "basis."[42]

Tax basis is a measuring tool that is needed to ensure a taxpayer is not taxed twice on the same income or gain and to prevent a taxpayer from taking more than one deduction (if one is permitted at all) for the same dollars.[43] The tax basis concept is pervasive in the U.S. income tax system and is the subject of numerous complex rules.[44] For purposes of this example, it is sufficient to know that the starting tax basis of an asset purchased with cash in a commercial transaction is the value of the purchased asset.[45] Asset cost basis is adjusted downward for deductions tied to that asset and, in the future, any remaining basis will provide the baseline for measuring gain or loss on the disposition of an asset.[46] Negative basis is, through a complex set of rules, implicitly anathema in the federal income tax system.[47] As a result, any downward basis adjustments will

39. *Tufts*, 461 U.S. at 307.

40. This may seem unusual but, in recent years, 100% bonus depreciation has been available for the purchase of certain assets. I.R.C. §167(k). Code section 179 still affords expensing for certain asset purchases. While more generous expensing and bonus depreciation expired at the end of 2014, these provisions may be extended again, as they were for 2014 at the end of 2014. *See* Tax Increase Prevention Act of 2014, Pub. L. No. 113-295, §§ 125, 127, 128 Stat. 4010, 4016–17 (2014).

41. *Tufts*, 461 U.S. at 307. As will be discussed *infra* Part II, the deduction may be held in suspension under various gatekeeper provisions such as the at-risk rules, I.R.C. § 465, or suspended loss rules, I.R.C. §§ 704(d), 1366(d).

42. *See, e.g.*, I.R.C. §§ 1011–1012.

43. *See* JOSEPH M. DODGE, J. CLIFTON FLEMING, JR. & ROBERT J. PERONI, FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY 45–46 (4th ed. 2012).

44. *See, e.g.*, I.R.C. §§ 358, 362, 704(d), 705, 1011–12, 1014–16, 1366(d), 1367.

45. I.R.C. § 1012; Phila. Park Amusement Co. v. United States, 126 F. Supp. 184, 188 (1954).

46. I.R.C. §§ 1001, 1011, 1016.

47. *See, e.g.*, Peracchi v. Comm'r, 143 F.3d 487, 491 (9th Cir. 1998). *But see* MARTIN J. MCMAHON, JR., DANIEL L. SIMMONS & PAUL R. MCDANIEL, FEDERAL INCOME TAXATION OF CORPORATIONS 96 (4th ed. 2014) ("[N]egative basis, unlike Bigfoot, does exist.").

stop at zero, and starting basis acts as a maximum deduction amount.[48] Borrowing basis through the use of debt is, however, broadly available, essentially allowing taxpayers the same type of timing opportunities as would be available if the tax system allowed negative basis.[49]

Through application of the basis rules discussed above, when Investor B purchased Asset Y, she took a tax basis in the asset equal to its cost of $100,000. The immediate deduction for the purchase price would then reduce Investor B's tax basis in Asset Y to $0.[50] After five years, the debt principal is due, and Investor B sells Asset Y to raise the necessary funds. Assume that the investment is still worth $100,000, and she sells it for that amount.[51] Because Investor B's basis is $0, her taxable gain is $100,000, the full amount received on the sale.[52] As in the first example, repayment of the loan principal will not be deductible.

In this first pair of examples, the end result may appear to be identical; both Investor A and Investor B invested for a term of years and then paid back the debt principal using the value of the original account or asset. Yet, Investor A and Investor B may have significantly different after-tax outcomes. The extent to which Investor B will have a better after-tax return than Investor A will depend primarily on two factors: (1) the differential, if any, between the tax rate applicable to the deduction and that applicable to the investment gain; and (2) the after-tax return Investor B earns by investing the tax savings obtained by immediately deducting the cost of purchasing Asset Y.[53]

---

48. *See* I.R.C. §§ 167(c), 197(a), 1016; J. Clifton Fleming, Jr., *The Highly Avoidable Section 357(c): A Case Study in Traps for the Unwary and Some Positive Thoughts About Negative Basis*, 16 J. CORP. L. 1, 26–29 (1990).

49. *Cf.* McMahon, Jr., *supra* note 15, at 1034–35 (discussing that debt-financed property may give rise to a "negative tax").

50. I.R.C. § 1016.

51. The ability to deduct immediately the purchase price of Asset Y even though Asset Y's end value does not decline from its initial value may seem overly artificial. In fact, depreciation deductions frequently outpace economic decline in value. *See id.* § 168; McMahon, Jr., *supra* note 15, at 1035–39, 1046–51. In addition, bonus depreciation and immediate expensing may be available for many assets. *See supra* note 40.

52. I.R.C. § 1001. The amount of tax owed will depend on how Investor B was holding the asset and on Investor's B's overall rate bracket. *Id.* §§ 1, 1221, 1222, 1231. This example further assumes that no nonrecognition provision is available. *See, e.g.*, *id.* § 1031 (like-kind exchanges).

53. *See* McMahon, Jr., *supra* note 15, at 1057–75. The two factors—tax rate and after-tax investment return—echo the two assumptions needed for the Cary Brown theorem to hold true. Brown demonstrated that providing an immediate deduction for the cost of an asset would be equivalent to exempting the yield on a fully taxed asset purchase. E. Cary Brown, *Business-Income Taxation and Investment Incentives*, *in* INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN 301–02 (1948), *reprinted in* READINGS IN THE ECONOMICS OF TAXATION 525 (Richard A. Musgrave & Carl S. Shoup eds., 1959); *see* McMahon, Jr., *supra*, at 1052. The Cary Brown theorem is generally used to demonstrate the equivalence between a pre-paid

A tax rate differential could emerge as a result of a change in the applicable rate bracket because of fluctuations in the taxpayer's overall earnings, or a differential could occur because of a tax preference for a particular type of income stream (e.g., capital gains or exempt income).[54] Thus, the rate differential factor raises a whole host of additional lines of scholarly inquiry regarding various tax rate preferences inherent in the tax law.[55] In order to keep the discussion of debt principal to a manageable length, this Article focuses primarily on the timing advantage inherent in the second factor: The after-tax return on investing any tax benefit obtained through debt-financed basis. That is, even if the taxpayer is subject to the same tax rate for both the debt-financed deduction and for the income available to pay the debt, there will be a present value advantage inherent in the ability to borrow deductions or credits.[56]

For example, if the tax rate is 30% for both the deduction on the purchase of Asset Y and the investment gain on the sale of Asset Y, in

---

and post-paid consumption tax. *See* Reuven S. Avi-Yonah, *Risk, Rents and Regressivity Revisited*, 24 AUSTL. TAX F. 41, 53 (2009). The theorem only holds true, however, if two assumptions are present: tax rates are the same throughout, and the tax savings is invested so as to equalize the pre- and post-paid after-tax outcomes. *Id.*

An argument could be made that the ability to enhance deductions through debt-financed expensing acts to reduce the saving disincentive theoretically present in an income tax. *See, e.g.*, JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES 212–14 (4th ed. 2008) (discussing savings disincentives under income tax). That is, it could be argued that the current treatment of debt moves tax outcomes closer to those under a consumption tax. This Article does not take a position on the desirability of a consumption tax, but because the current tax treatment of debt has not been constructed to align with a consumption tax (and is far removed from certain consumption tax forms) the outcomes are sure to vary significantly and erratically from what would be the result in a planned consumption tax. *See* EDWARD J. MCCAFFERY, FAIR NOT FLAT 19–20 (2002) (discussing need for borrowing inclusion in the context of implementing a post-paid consumption tax); Brown, *supra*, at 536 (noting that if interest on debt is deductible then immediate expensing, "[i]f applied to debt-financed assets [ ] would raise investment incentives *above their pretax level*") (emphasis added).

54. For a sense of the range of other types of tax reductions or exclusions for other income streams, see I.R.C. § 101 (life insurance exclusion); I.R.C. § 102 (gift and inheritance exclusion); I.R.C. § 103 (interest exclusion for certain governmental bonds); I.R.C. § 121 (exclusion for gain on sale of principal residence). This Article will discuss briefly the exceptions relating to cancellation of indebtedness. *See infra* notes 68–77 and accompanying text.

55. For discussion of the capital gains preference, see, for example, Calvin H. Johnson, *Taxing the Consumption of Capital Gains*, 28 VA. TAX REV. 477 (2009); Richard Schmalbeck, *The Uneasy Case for a Lower Capital Gains Tax: Why Not the Second Best?*, 48 TAX NOTES 195 (1990). This preference also feeds into a broader debate about unequal distributions of wealth. *See* THOMAS PIKETTY, CAPITAL IN THE TWENTY-FIRST CENTURY (Arthur Goldhammer trans., 2014). Code section 1014 provides a fair-market-value basis for the assets, thereby exacerbating the potential for a large tax rate differential. I.R.C. § 1014. For example, an asset that would otherwise have generated a tax gain could be held until death then sold at no income tax gain by the estate to pay the debt. This could be viewed as a tax rate differential example or as the ultimate deferral mechanism. To manage the discussion, this Article classifies section 1014 as relating to the rate differential problem.

56. *See* McMahon, Jr., *supra* note 15, at 1069–70.

absolute value terms the $30,000 tax reduction from deducting $100,000 and the $30,000 tax owed from earning $100,000 exactly offset one another. Because of Investor B's ability to take the deduction five years before recognizing the investment gain, Investor B will, however, have five years to invest the $30,000 tax reduction obtained from the borrowed deduction. $30,000 invested at 5% compound interest would be worth roughly $38,400 at the end of 5 years.[57] If the earnings on this side investment are not taxed until the end of 5 years,[58] a 30% tax on the $8,400 increase would be $2,520 for a total $35,880 after-tax amount.[59] After payment of the $30,000 tax on the gain from selling Asset Y, Investor B would have $5,880 after-tax to pocket.[60] By way of contrast, Investor A would not have any after-tax increase derived from investing the tax saved through a borrowed deduction. It is Investor B's ability to borrow current deductions while delaying paying taxes on the offsetting income that has the potential to yield tax timing benefits.

Example 3. Consider next Investor C, who, like Investor B, also purchases Asset Y using $100,000 of borrowed funds and then immediately deducts the $100,000 purchase price. Investor C, however, decides he does not want to sell Asset Y at the end of five years even though, as a result, he will not have sufficient cash flow to pay the debt principal due. Investor C is not insolvent in the tax sense; he simply does not want to part with any assets to pay off the debt. Investor C will, in the long run, have the same absolute value result as Investor B because either the lender will foreclose on Asset Y or the debt will eventually be cancelled. Without getting too far into the technical details, either event will, ultimately, cause Investor C to have $100,000 of income.[61] The time horizon

57. *See* DODGE, FLEMING & PERONI, *supra* note 43, at 731 (compound interest table).

58. Because appreciation in value is not taxed until a sale, exchange, or other similar realization event, it is quite possible to invest in an appreciating asset while maintaining control over when the appreciation is taxed. *See, e.g.*, Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX L. REV. 355, 356–60 (2004). A taxpayer able to hold the asset until death will grant the recipient of that asset a basis stepped up to the asset's fair market value. As a result, the appreciation accruing during the decedent taxpayer's lifetime would avoid all income tax. I.R.C. § 1014. *See supra* note 55.

59. Only the increase would be taxed because of the ability of the taxpayer to offset the amount realized on the sale of the investment with basis. I.R.C. § 1001.

60. Its present value in the year of taking out the loan would be approximately $4,610, again assuming a 5% discount rate with annual compounding. *See* DODGE, FLEMING & PERONI, *supra* note 43, at 732 (present value table).

61. If the property is foreclosed on and is worth the full $100,000 debt principal owed, the taxpayer will have $100,000 of gain because basis would be $0. *See* Comm'r v. Tufts, 461 U.S. 300, 308–10 (1983); Gehl v. Comm'r, 102 T.C. 784, 785–86 (1994). If, instead, the property is worth less than $100,000 at foreclosure and the debtor continues to have personal liability, any debt not paid for

between the original loan and the ultimate earning of the offsetting income may, however, be significantly stretched out, with the extent of the delay depending on state foreclosure rules and the terms of the loan.[62] As the length of time between the tax deduction and the tax inclusion increases, the more likely it is that the taxpayer will reap the benefits of a tax timing mismatch;[63] the taxpayer simply will have more time to invest the original tax savings from the borrowed tax deduction.

Example 4. Sole Proprietor D borrows $100,000 in order to pay her employees. Once again, the receipt of the loan principal is not treated as income, but the costs of paying reasonable wages will be deductible by Proprietor D whether or not she pays them with borrowed funds.[64] Although the term "basis" is more commonly used in connection with the acquisition of specific assets or groups of assets rather than in connection with the payment of expenses, the same concept is at work. Proprietor D receives borrowed dollars, and those borrowed dollars are treated the same as earned dollars for purposes of determining her tax deduction for paying her employees. When Proprietor D repays the debt principal at the end of five years, the money used for the repayment will likely have been earned over time through the operation of the business. The repayment itself is nondeductible, but earning the $100,000 needed for repayment will have been taxed.

This example illustrates that earning the money to be used for repayment may not happen all at once as in the previous examples, but instead may occur over time, thereby lessening the timing mismatch between the borrowed deductions and the income offset. This will, of

---

through the foreclosure will (1) have to be paid through other earned dollars, (2) discharged by the creditor directly yielding cancellation of indebtedness income, or (3) discharged through operation of law (e.g., if the creditor is unable to collect before the expiration of any applicable statute of limitation), again yielding cancellation of indebtedness income. *See* I.R.C. §§ 61(a)(12), 108; *Gehl*, 102 T.C. at 789–90. The value assigned to the property in the foreclosure proceedings and applied against the debt may, however, be less (often considerably less) than the market value of the property; as a result, the example provides only a simplified version of the facts and analysis that would be required in a real-world foreclosure.

For nonrecourse-debt foreclosure, the value of the property is irrelevant; the full amount of the debt will go into calculating the gain (or loss) on the foreclosure. *Tufts*, 461 U.S. at 317. If the debtor is allowed to keep the property, the debt, whether recourse or nonrecourse, could be directly discharged by the creditor or eventually cancelled through operation of law, with either eventually resulting in cancellation of indebtedness income. *See* Rev. Rul. 91-31, 1991-1 C.B. 19.

62. Debt principal would, of course, not be the only money at issue. But, for the sake of maintaining the focus on debt principal, assume that any additional penalties, interest, and/or foreclosure costs will still exactly equal the annual return on Asset Y.

63. *See* Coven, *supra* note 15, at 68.

64. I.R.C. § 162(a)(1).

course, also be true as to many debt-financed asset purchases; not only may the income for repayment be earned closer in time to the deductions, but the deductions themselves may instead be taken over period of time instead of all at once.[65] The opportunity for tax timing savings may be substantial or it may be nonexistent depending on the use to which the debt is put, the available means of investing any tax savings, and the origins and timing of accumulating the nonborrowed basis.[66] The ability of taxpayers to repay debt with money that is traceable to newly borrowed cash instead of to newly earned basis will increase the variability between taxpayers of the timing benefit.[67]

Although this Article's primary focus is on the above illustrated timing benefit rather than on any tax rate differential, one tax benefit provided to bankrupt and insolvent debtors is particularly relevant to debt and also has significant bearing on the issue of timing.[68] To illustrate, consider what will happen if Proprietor D fails to pay off the debt principal; like Investor C, she will eventually have income in the amount of the unpaid debt principal. Assume, however, that unlike Investor C, Proprietor D is unable to repay the debt because her business has taken a sudden downturn. Assume further that Proprietor D has filed for bankruptcy, and the debt is discharged in the bankruptcy proceedings. In such a situation, Proprietor D will not have to pay tax on the $100,000 of debt discharge income.[69]

The exclusion is not entirely free; she must reduce her other tax attributes, including tax basis in other assets owned by Proprietor D.[70] In theory, the reduction of tax attributes will mean that, in the future, Proprietor D will have higher taxable income through, for example, reduced depreciation deductions or higher gain on the sale of assets. The reduction will have the effect of further delaying the time for reconciling any

---

65. Although expensing is often available, *see supra* note 40, it is still more common to have a cost recovery period that extends over a period of years. I.R.C. § 168(c) (showing recovery periods for tangible assets ranging from three to fifty years); I.R.C. § 197 (requiring cost recovery period of fifteen years applicable to most amortizable intangibles).

66. *See* McMahon, Jr., *supra* note 15, at 1079 (noting variability of debt-financed tax benefits).

67. *See id.*

68. I.R.C. § 108(a)(1)(A)–(B). The Code also provides additional exclusions in section 108, but these are not explored in this Article. *See* I.R.C. § 108(a)(1)(C)–(E) (qualified farm indebtedness, qualified real property business indebtedness, qualified principal residence indebtedness). For a discussion of Code section 108 and its history, see Howard E. Abrams, *Partnership COD Income and Other Debt Issues*, 126 TAX NOTES 845 (2010); Deborah H. Schenk, *The Story of* Kirby Lumber*: The Many Faces of Discharge of Indebtedness Income*, *in* TAX STORIES 137 (Paul Caron ed., 2003). For a more general discussion of the intersection of tax and bankruptcy law, see Diane Lourdes Dick, *Bankruptcy's Corporate Tax Loophole*, 82 FORDHAM L. REV. 2273 (2014).

69. I.R.C. § 108(a)(1)(A).

70. I.R.C. § 108(b).

borrowed deductions with an offsetting inclusion.[71] Thus, the reduction of tax attributes will have the effect of enhancing the tax timing benefit. Frequently, however, full tax attribute reduction simply does not occur. In that case, the borrowed deductions attributable to the discharged debt will never be matched with an offsetting inclusion of new basis.

Full tax attribute reduction is unlikely because the reduction is made at a single point in time.[72] Thus, even if at the reduction time a taxpayer has few (or zero) tax attributes, there is no mechanism for carrying the required reduction into future time periods when the taxpayer may have an increased supply of tax attributes.[73] For example, if Proprietor D has $100,000 of debt discharged in bankruptcy but has only $50,000 of reducible tax attributes at the testing date, those tax attributes will be reduced to $0, but the additional $50,000 needed to match the original $100,000 borrowed deduction will never be required. In addition, bankrupt and insolvent taxpayers are eligible for a more generous tax attribute reduction rule when it comes to property basis.[74]

The inclusion of income on failure to repay a debt is generally explained as following from the original exclusion for the borrowing.[75] What had not been an accession to wealth because it was offset by a repayment obligation becomes such an accession when the taxpayer keeps the money.[76] This Article aims to suggest a slightly different rationale: the income resulting from failure to repay a debt can also be explained in terms of the assurance it provides that borrowed basis will ultimately be matched by nonborrowed basis, even if that happens much later and only at failure to repay. This Article will take as a working assumption that the bankruptcy and insolvency exclusions, including the leaky tax attrib-

71. *See supra* Part I Example 3 and accompanying discussion.

72. I.R.C. §§ 108(b)(4), 1017(a).

73. Taxpayers may be able to plan for this by using up tax attributes before the testing date or delaying the receipt of new tax attributes until after the testing date. *See* Gregory E. Stern, *Tax Aspects of Restructuring Financially Troubled Businesses*, 541-4th Tax Mgmt. (BNA) U.S. Income, § II.G (2015). Such planning is made considerably easier by the statutory rule that tax attributes are measured and reduced only after the tax has been determined for the year of the discharge. I.R.C. § 108(b)(4)(A).

74. I.R.C. § 1017(b)(2). These taxpayers may be able to avoid reducing aggregate property basis to zero through application of a liability floor formula. Treas. Reg. § 1.1017-1(b)(3) (as amended in 2006) (reduction is not to exceed excess of (1) aggregate property basis plus money held after the discharge over (2) the aggregate liabilities remaining after the discharge). In effect, this formula permits taxpayers to retain borrowed basis to the extent of any debt remaining after the discharge.

75. *See* BURKE & FRIEL, *supra* note 37, at 54.

76. *See supra* Part I Example 1.

ute reduction rules, can be justified in terms of policies outside of the tax law, such as the "fresh start" goal inherent in a bankruptcy discharge.[77]

Consideration of this web of rules and exceptions suggests that the more likely debt is to be repaid, the more likely it is that any borrowed basis will eventually be matched by offsetting new basis. Likelihood of repayment thus may seem intuitively like a useful trait for crafting and organizing tax rules dealing with debt principal.[78] Indeed, that is what the current tax system tends to do; in multiple areas, additional or distinct rules are imposed when the characteristics of a particular debt suggest it is one that a taxpayer may be more willing to walk away from without paying.[79] For example, the at-risk rules, discussed in greater detail below,[80] are organized around proxies for likelihood of repayment, and the Supreme Court has explained that the ability to borrow basis is appropriate in light of the taxpayer's obligation to repay.[81] This Article argues that while organizing tax rules around the characteristics of a taxpayer's repayment obligation may halt some of the abusive and avoidant use of borrowed deductions,[82] such a system deals with the timing advantages of borrowed basis in only a limited, haphazard way. On the other hand, dealing directly with the timing advantage has the potential to curb abusive behavior more comprehensively as a collateral consequence.

The source of the timing advantage is revealed through close examination of the four potential cash flows related to debt[83]: (1) receipt of loan proceeds; (2) use of loan proceeds; (3) earning (or otherwise amassing) the funds needed for repayment; and (4) actual repayment of loan principal.[84] The tax treatment as to each of these four strands can be summarized as follows: (1) the receipt of loan proceeds is not included in income but (2) the use of borrowed dollars is treated the same as earned

77. Whether bankruptcy laws provide such a fresh start is highly debatable. *See* ELIZABETH WARREN & AMELIA WARREN TYAGI, THE TWO-INCOME TRAP 123–62 (2003). The tax rules raise equity concerns but full discussion will have to wait for another article.

78. *See* McMahon, Jr., *supra* note 15, at 1057 ("There is nothing, however, to indicate that the tax bias in favor of leveraged depreciable assets was created by design. It is, rather, the result of the evolution and growth of the income tax.").

79. *See infra* Part II.

80. *See infra* Part II.

81. Comm'r v. Tufts, 461 U.S. 300, 307 (1983).

82. *See* Shaviro, *supra* note 24, at 405 (arguing that tax avoiders are risk averse and hence are more likely to use nonrecourse debt; thus targeting nonrecourse debt will net the worst offenders).

83. Additional examples and variations could, of course, be proffered, but all would tinker with one or more of these cash flows. And it perhaps goes without saying that real-life cost recovery is much more complicated than that utilized in the examples in this Article. *See* I.R.C. §§ 167, 168, 179, 197 (2012).

84. Of course, actual cash may or may not be passed back and forth. The result is the same if the taxpayers forgo exchanging checks with each other. *See* Coven*, supra* note 15, at 66–67.

dollars for purposes of computing deductions and asset basis. The taxpayer will be under an obligation to repay the debt, thereby triggering plans for repayment in the form of (3) funds from taxable or nontaxable sources. To put these potential sources of repayment in terms of basis, over time, earned basis, gifted basis, or newly borrowed basis will be amassed equal to the original borrowed basis amount. The (4) repayment itself will not give rise to any deduction.

Looking at debt principal in this fashion conceptually separates the income exclusion for borrowed money from the borrowing of basis. The tax system contains multiple situations whereby taxpayers can realize in-kind wealth accessions without having to pay current tax on the accession but without obtaining a corresponding basis increase.[85] If denying current basis is appropriate for certain unrecognized wealth accessions, it is surely possible to separate the treatment of basis from an event that is a *non*-wealth accession.

Similarly, repayment of debt principal can be viewed as separate from repaying borrowed basis. That is, the nondeductibility of debt principal repayment is not what squares the original basis borrowing; instead, it is the taxpayer's earning (or other receipt) of basis-laden dollars available for paying the debt principal that offsets the original basis borrowing.[86] Isolating the basis timing distortion from the accession to wealth arguments can be used to design reform; this Article will explore the details of potential specific reforms in later sections.[87]

B. Why Fix Borrowed Basis?

Creditors require debtors to pay interest for the use of borrowed money, but the tax system does not require payment for the use of borrowed basis. Because of the very real opportunities for tax avoidance associated with borrowed basis, the tax system has had to respond. These responses have, however, produced a jumble of reactive, inconsistent provisions that are difficult for the government to administer and that generate deadweight costs as taxpayers spend resources to follow (or strategically avoid) the limitations.[88] The tax system lacks a coherent,

85. *See, e.g.*, I.R.C. §§ 358, 1031.

86. *Cf.* McMahon, Jr., *supra* note 15, at 1106–07 (proposing solution that draws on the rate of loan amortization).

87. *See infra* Parts III–IV.

88. *See infra* Part II.

comprehensive approach to borrowed basis, even though such borrowing is pervasive.[89]

Although the set of rules dealing with debt principal is internally inconsistent, one common theme emerges: The rules tend to divide the universe of loans into only two basic categories, recourse and nonrecourse.[90] The tax system then uses these categories to make assumptions about the taxpayer's likelihood of repayment.[91] Finally, likelihood of repayment, as filtered through the categories of recourse and nonrecourse, is used to set some boundaries on the use of borrowed basis. The details will be explored in a later section.[92] At this stage, the critical point is that even if one would prefer to target only tax avoidance rather than run-of-the-mill timing mismatches, the current system fails. The division of tax-world debt into two categories is problematic given the numerous nontax economic arrangements and nontax prioritization rules, such as those embodied in secured transactions codes and bankruptcy rules.[93] Sophisticated, wealthy taxpayers are more likely to have the resources to structure arrangements to obtain both the desired economic arrangement and the desired tax classification.

There are, of course, tax standards that require a focus on the substance rather than on the form of debt financing,[94] but such standards are difficult to administer, particularly in this area where it may be difficult for government actors to uncover the true economics of a transaction.[95] An approach that focuses directly on the underlying benefit would limit the need for the tax system to categorize debt (though, admittedly, it would not alleviate the problem of figuring out what constitutes outright

89. For other commentators making this point, see, for example, Patricia A. Cain, *From* Crane *to* Tufts*: In Search of a Rationale for the Taxation of Nonrecourse Mortgagors*, 11 HOFSTRA L. REV. 1 (1982); Coven, *supra* note 15; McMahon, *supra* note 15; Yin, *supra* note 15.

90. *See infra* notes 108–112 and accompanying text for definitions of these two types.

91. As will be discussed in greater detail in Part II, the at-risk rules, for example, apply only to nonqualifying, nonrecourse debt while the *Estate of Franklin* line of cases addresses sham debt more directly.

92. The details of which will be explored *infra* Part II.

93. Perusal of the table of contents of any casebook devoted to Article 9 will give some sense of the multitude of rules. *See, e.g.*, LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH ix-xxx (7th ed. 2011).

94. I.R.C. § 465(b)(4) (2012) (requiring analysis of guarantees, stop loss arrangements, and other similar arrangements in determining whether a taxpayer is at risk); Treas. Reg. § 1.752-2 (as amended in 2006) (requiring evaluation of facts and circumstances to determine whether partner has economic risk of loss, though then providing generous assumption regarding meeting of obligations); Section 707 Regarding Disguised Sales, Generally, 79 Fed. Reg. 4826 (proposed Jan. 30, 2014) (attempting to import more reality into the difference between partnership recourse and partnership nonrecourse debt).

95. Attempts to do so are also rebuffed. *See infra* notes 166–168 and accompanying text for discussion of proposed partnership recourse debt regulations.

sham debt[96]). The current, sloppy debt-categorization system leads to manipulation of the categories and the usual under- or over-inclusiveness problem present in poorly designed anti-avoidance rules.[97]

For taxpayers that are not engaged in tax avoidance, the ability to borrow basis should be part of the discussion regarding the tax system's incentivizing of debt financing. The tax system should not privilege one form of investment over another (at least not in the absence of compelling reasons to use tax law to attempt to change behavior).[98] In the case of financing, it is well accepted that the concepts of debt and equity present a false dichotomy.[99] Rather, there is a continuum of economic strategies for financing business and making investments; attempting to impose tax consequences based on artificial, manipulable distinctions is highly problematic. This Article does not aim to solve the debt-equity conundrum but argues that the timing advantage resulting from borrowing basis contributes to distortive incentives for taxpayers engaged in run-of-the-mill business and investment decisions.[100]

---

96. *See* discussion of the sham debt problem *infra* notes 102–107 and accompanying text.

97. *See, e.g.*, Charlene D. Luke, *Beating the "Wrap": The Agency Effort to Control Wraparound Insurance Tax Shelters*, 25 VA. TAX REV. 129, 184–94 (analyzing particular set of anti-avoidance rules relating to certain insurance products).

98. *See, e.g.*, SLEMROD & BAKIJA, *supra* note 53, at 131.

99. *See supra* note 31.

100. *See* McMahon, Jr., *supra* note 15, at 1075–98. Although the ability to borrow basis does confer an advantage, *see supra* Part I.A, the scope of the incentive should not be overstated. Equity financing also receives various tax-related benefits. Business entities are generally able to raise equity capital in a manner that is tax-free to both the entity and to the equity owners. *See* I.R.C. §§ 351, 368, 721 (2012); *see also* Victor Fleischer, *Taxing Founders' Stock*, 59 UCLA L. REV. 60 (2011). Assets contributed to a business entity in such tax-free transactions will, however, enter the business with the same basis that the taxpayer had in the asset. *See* I.R.C. §§ 362, 723. That is, asset contribution is not an opportunity for the business to borrow new basis but only affords it the opportunity to utilize contributed basis. A doubling of basis is also created because the equity owner will also have a basis in her equity position. This basis doubling effect has given rise to avoidance techniques, which have been the subject of congressional and judicial intervention. *See* I.R.C. §§ 362(e), 704(c)(1)(C).

Corporations do, however, enjoy an additional advantage; a corporation that pays for services or assets with its own stock in a transaction that is taxable to the other party will not itself be taxed and will also be able to take a market value basis in purchased assets or a market value deduction in the case of services. I.R.C. § 1032; *see* Neil R. Blecher, *Section 1032: Are We There Yet?*, 2 HASTINGS BUS. L.J. 307 (2006). Nontax constraints likely keep a corporation from simply paying for everything with its own stock to avoid a tax, but the availability of this rule may temper the incentive for corporations to borrow basis. For example, management may want to assert a particular form of control; shareholders may be concerned about dilution; or vendors and service providers may be unwilling to be paid in stock. *See* Mira Ganor*, The Power to Issue Stock*, 46 WAKE FOREST L. REV. 701 (2011) (discussing management decisions regarding whether to issue new stock). For a discussion of nontax frictions, see, for example, Leigh Osofsky, *Who's Naughty and Who's Nice? Frictions, Screening, and Tax Law Design*, 61 BUFF. L. REV. 1057 (2013); David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312 (2001). Of course, the interest deduc-

Taxpayers' ability to borrow basis contributes both to tax avoidance and to incentivizing debt. Quantifying the contributions in each area would be highly difficult, if not impossible. Yet, the current structure of inconsistent and reactive rules for dealing with debt principal is becoming untenable, as recent efforts to rein in partnership debt and corporate multinational debt suggest.[101] This Article recommends taking a step back from the current structure to look more closely at the underlying source of the distortion; this Article then outlines multiple possible avenues for broad-based reform. Even if a comprehensive solution is not on the legislative horizon, paying more attention to the mechanics of the temptation to borrow basis may yield better incremental anti-avoidance rules than those currently in place. The next Part details some of those anti-avoidance rules before moving to potential choices for reform.

II. A TOUR OF THE AT-RISK RULES AND PASS-THROUGH ENTITY DEBT

The most obvious way to make evasive or avoidant use of the ability to borrow deductions is to engage in sham borrowing (evasion) or near-sham borrowing (avoidance).[102] In the simplest approach, a taxpayer could borrow a larger amount than necessary to buy an asset that provides deductions. For example, a taxpayer could buy an asset whose cost is immediately tax deductible and whose value is $100,000 but purport to purchase it with $200,000 of debt financing and claim a $200,000 deduction. A veneer of respectability could be added by finding a lender willing to create jointly a large paper debt subject to a tacit understanding that only a portion of the debt is plausibly real. The easiest way for two parties to use a formal debt as cover for a tax avoidant purpose would be for the lender to take a secured interest in the purchased asset on which the lender could foreclose—thereby protecting the lender for the "real" debt portion[103]—and for the taxpayer to have no personal liability to re-

---

tion is in itself still a distorting incentive because the returns a corporation pays on equity are not deductible. *See also* McMahon, Jr., *supra* note 15, at 1081–83.

101. *See supra* note 10 and accompanying text; *infra* notes 166–168 and accompanying text.

102. *See* SLEMROD & BAKIJA, *supra* note 53, at 173–74; Assaf Likhovski*, The Duke and the Lady:* Helvering v. Gregory *and the History of Tax Avoidance Adjudication*, 25 CARDOZO L. REV. 953, 1001–02 (2004) (discussing distinction between "illegitimate evasion and legitimate avoidance").

103. "Real" is in quotes because, from the taxpayer's view, if the debt is greater than the fair market value of the asset there is no reason to ever make payments on such a debt; there is also little reason to invest in the property purchased because, if it is plausibly held for investment, depreciation deductions will be available even on a see-through building. Whether the codified economic substance doctrine would reach such a debt is beyond the scope of this Article. For a discussion of the codified doctrine, see Charlene D. Luke, *The Relevance Games: Congress's Choices for Economic Substance Gamemakers*, 66 TAX LAW. 551 (2013).

pay the debt—thereby protecting the taxpayer if (when!) the asset's value at foreclosure turned out to be insufficient to cover the debt principal.[104]

Government actors did not sit idly by as taxpayers aggressively made use of similar arrangements to increase borrowed deductions.[105] For the most fraudulent variations, courts eventually had little trouble holding that arrangements of this type should be disregarded as substantive shams.[106] Even as cases were winding their way through audits and court proceedings, Congress added and then expanded rules in an attempt to bring legislative certainty in this area; Congress framed the new rules—the "at-risk" rules—so that they would have their greatest effect on deductions financed through one category of debt: nonrecourse debt.[107]

In tax parlance, a debt as to which the creditor's only remedy is foreclosure or repossession is a nonrecourse debt.[108] Because the particu-

---

104. *See* Shaviro, *supra* note 24, at 405 (discussing the role of risk aversion in explaining the use of nonrecourse debt in tax shelters). A commercial, U.S. lender would be less likely to accommodate such a tax avoidance scheme, which is likely why the at-risk rules contain exceptions relating to qualified, nonrecourse debt borrowed from certain sources and on certain terms. *See infra* notes 126–127 and accompanying text.

105. The Internal Revenue Service, for example, issued informal rulings tied specifically to the use by limited partners of nonrecourse debt and to maintain its position that only bona fide debt could give rise to basis. *See* Rev. Rul. 72-135, 1972-1 C.B. 200; Rev. Rul. 72-350, 1972-2 C.B. 394; Rev. Rul. 69-77, 1969-1 C.B. 59 (emphasizing that acquiescence in a taxpayer-favorable case could be relied on only "in situations where it is clear that the property has been acquired at its fair market value in an arm's length transaction creating a bona fide purchase and a bona fide debt obligation"). *See also* STAFF OF J. COMMITTEE OF TAX'N, 94TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, (Comm. Print 1976) [hereinafter EXPLANATION OF TAX REFORM ACT], *available at* 1976 WL 352398 (discussing nonrecourse debt tax shelters).

106. *See e.g.*, Estate of Franklin v. Comm'r, 544 F.2d 1045 (9th Cir. 1976); Marcus v. Comm'r, 30 T.C.M. (CCH) 1263 (1971); May v. Comm'r, 31 T.C.M. (CCH) 279 (1972). In one case, a circuit court allowed basis for nonrecourse debt up to the fair market value of the property. Pleasant Summit Land Corp. v. Comm'r, 863 F.2d 263, 276–77 (3d Cir. 1988). Several courts have disagreed with the decision, and no other circuit court has followed the *Pleasant Summit* case. *See* Hildebrand v. Comm'r, 967 F.2d 350, 353 (9th Cir. 1992); Lukens v. Comm'r, 945 F.2d 92, 98–99 (5th Cir. 1991); Lebowitz v. Comm'r, 917 F.2d 1314, 1319 (2d Cir. 1990). The Tax Court has, however, allowed basis for a large nonrecourse debt when other hallmarks of tax avoidance were absent. *See* Regents Park Partners v. Comm'r, 63 T.C.M. (CCH) 3131 (1992).

107. Tax Reform Act of 1976, Pub. L. No. 94-455, § 204, 90 Stat. 1520, 1531; *see* EXPLANATION OF TAX REFORM ACT, *supra* note 105, at 2 ("[I]ndividuals were combining provisions of the law, or leveraging them through nonrecourse borrowings, in a way which multiplied severalfold any possible advantages intended by Congress. Such activities reduce citizens' respect for the income tax and represent an inefficient allocation of resources."); U.S. v. Woods, 134 S. Ct. 557, 568 (2013) (discussing relevance of Joint Committee on Taxation Reports); *see also* Cole Barnett, United States v. Woods *and the Future of the Tax Blue Book as a Means of Penalty Avoidance and Statutory Interpretation*, 66 FLA. L. REV. 1791 (2014).

108. Rev. Rul. 91-31, 1991-1 C.B. 19. Tax law does, however, recognize that limited liability for the debt of tax partnerships is nonrecourse as to the partners even if a creditor has formal remedies against the entity beyond foreclosure on specific assets. As will be briefly discussed *infra*, for

lar tax shelters of concern to Congress utilized nonrecourse debt, it must have seemed self-evident to use this debt category in constructing the at-risk rules.[109] Debt that is other than nonrecourse is instead termed recourse debt, even if the creditor's ability to get at taxpayer assets may actually be lower because of the operation of nontax prioritization rules.[110] So long as the creditor has a remedy besides foreclosure—even if the creditor does not have foreclosure as an option because the debt is unsecured—the debt is recourse.[111] The tax law simply does not further categorize debt into more nuanced layers.[112]

The nonrecourse and recourse categories roughly distinguish more suspect debt from less suspect debt, but the at-risk rules still require a preliminary determination that a particular debt is bona fide and not merely a sham economic arrangement.[113] As a result, the case law decided before implementation of the at-risk rules remains good law,[114] and the at-risk rules only indirectly operate to limit the original problem of sham debt.[115] The at-risk rules use the nonrecourse debt label as a proxy for repayment likelihood to impose a timing rule appropriate to all debt.

---

tax partnerships, the method for assigning borrowed basis among the partners turns primarily on whether the debt is categorized as recourse or nonrecourse at the partner level.

A tax partnership would include domestic multimember limited liability companies that have not elected a different tax status. Treas. Reg. § 301.7701-3(b)(1) (as amended in 2006). Single-member LLCs are treated as disregarded entities, unless an election is made. *Id.* The unintended consequences of this default entity classification regime (the "check-the-box rules") are still unfolding. *See* Treas. Reg. § 1.752-2(k) (as amended in 2006) (applying distinct rule for allocating borrowed basis to disregarded entities); Steven A. Dean, *Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification*, 34 HOFSTRA L. REV. 405 (2005); Gregg D. Polsky, *Can Treasury Overrule the Supreme Court?*, 84 B.U. L. REV. 185 (2004).

109. *See* EXPLANATION OF TAX REFORM ACT, *supra* note 105, at 35 ("The opportunity to deduct tax losses in excess of the amount of the taxpayer's economic risk had arisen under prior law primarily through the use of nonrecourse financing . . . ."). The Joint Committee's explanation of the 1976 Act also suggests a congressional concern that taxpayers were being led into the tax shelters without regard to potential long-term economic consequence. *Id.* ("Taxpayers, ignoring the possible tax consequences in later years, can be led into investments which are otherwise economically unsound and which constitute an unproductive use of investment funds."); *see also* McMahon, Jr., *supra* note 15, at 1034; Yin, *supra* note 15, at 250.

110. *See* LOPUCKI & WARREN, *supra* 93, at 3–20 (discussing unsecured creditors).

111. For example, unsecured credit card debt is recourse debt, but a debt secured by a valuable office building would be nonrecourse if the creditor's remedies were limited to foreclosing on the building.

112. Tax partnership debt categorization rules do draw a distinction between partner nonrecourse debt and partnership nonrecourse debt. *See* Treas. Reg. § 1.752-1 (as amended in 2005).

113. As perhaps does not need to be restated, it must also be decided whether there is bona fide economic arrangement other than cash equivalent debt—such as equity or a contingent obligation.

114. *See supra* note 106 and accompanying text.

115. Sham debt is more likely to be formally structured as nonqualifying, nonrecourse debt. *See supra* notes 102–104 and accompanying text.

As a result, a debt's label becomes highly significant, which introduces the potential for gamesmanship and the need for careful planning.[116]

The at-risk rules specify that a taxpayer's deductions relating to a particular activity are limited to the amount that the taxpayer has "at risk" in the activity.[117] The taxpayer's at-risk amount for any particular activity will roughly equal (1) the taxpayer's basis in the assets of the activity, (2) plus the net income produced by the activity during the year, (3) minus nonqualifying, nonrecourse debt allocable to the activity, and (4) minus amounts already deducted or distributed.[118] Originally, the at-risk rules applied only to five specific activities that had been viewed as the most popular vehicles for tax avoidance; real estate, for instance, was not in the original five.[119] Currently, the rules apply to all business or investment activities of individuals and closely-held corporations.[120] Other business entities are not subject to the rules, but individuals who own interests in tax partnerships and S corporations are subject to the at-risk rules with respect to their interests in these entities.[121]

The heart of the at-risk rules relates to debt principal. The rules specify that borrowed amounts increase a taxpayer's at-risk amount only to the extent the taxpayer "is personally liable for the repayment of such amounts" or "has pledged property, other than property used in such activity, as security for such borrowed amount."[122] For example, assume a taxpayer purchases an interest in a partnership using $0 of his own money and borrowing $100 in such a way that the taxpayer is not personally liable on the debt. The taxpayer would still have a $100 basis in the activity but his at-risk amount would be $0. As a result, any deductions

116. The at-risk rules do embed a substance-over-form requirement. *See infra* notes 130–131 and accompanying text.

117. I.R.C. § 465 (2012). Similar rules limit certain tax credits. I.R.C. § 49.

118. I.R.C. § 465(b), (d).

119. The five historic activities were "(A) holding, producing, or distributing motion picture films or video tapes, (B) farming . . . (C) leasing any section 1245 [non-real estate] property . . . (D) exploring for, or exploiting, oil and gas resources as a trade or business or for the production of income, or (E) exploring for, or exploiting, geothermal deposits." I.R.C. § 465(c)(1). For a more detailed account of the evolution of the at-risk rules, *see* Lisa Marie Starczewski, *At-Risk Rules*, 550-3rd Tax Mgmt. (BNA) U.S. Income (2015).

120. Legislation expanding the rules to activities other than real property was enacted in 1978. Revenue Act of 1978, Pub. L. No. 95-600, § 201(a), 92 Stat. 2763. The real property exception was removed by 1986 legislation. Tax Reform Act of 1986, Pub. L. No. 99-514, § 503, 100 Stat. 2085, 2243. But an exception for qualified nonrecourse financing relating to real estate activities was added. *Id.* For a discussion of the 1986 reform as it relates to real estate borrowed basis shelters, see JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM 10, 140 (1987).

121. I.R.C. § 465(a)(1)(A); Prop. Treas. Reg. § 1.465-24, 44 Fed. Reg. 32242 (June 5, 1979).

122. I.R.C. § 465(b)(2).

allocated by the partnership to the taxpayer would be suspended by the at-risk rules.[123] The at-risk rules thus operate to restrict the timing of borrowed deductions.

The at-risk rules, however, are not as strong as they may first appear. An exception allows taxpayers to avoid reducing their at-risk amounts for qualified nonrecourse financing.[124] The exception only applies "in the case of an activity of holding real property" and the debt must be secured only by "real property used in such activity."[125] Nonrecourse debt used in a qualifying activity must be obtained only through certain lenders and on certain terms.[126] The overall characteristic of the approved lenders is that they appear to be ones less likely to act as accommodation parties to a tax shelter transaction; in other words, the requirements relating to lenders and loan terms help increase the likelihood that the debt is real.[127] The limitation relating to real property may also have been seen as assuring higher quality collateral, making the debt

123. I.R.C. § 465(a), (d).

124. I.R.C. § 465(b)(3)(6).

125. I.R.C. § 465(b)(3)(6)(A). Some incidental personal property holdings and services are tolerated. I.R.C. § 465(b)(3)(6)(E); Treas. Reg. § 1.465-27(b)(2)(i) (1998).

126. The list of approved loans includes "a loan from any Federal, State or local government or instrumentality thereof, or is guaranteed by any Federal, State, or local government." I.R.C. § 465(b)(6)(B)(ii). In addition, loans obtained from a "qualified person" are acceptable. A qualified person is "any person which is actively and regularly engaged in the business of lending money and which is not (I) a related person with respect to the taxpayer, (II) a person from which the taxpayer acquired the property (or a related person to such person), or (III) a person who receives a fee with respect to the taxpayer's investment in the property (or a related person to such person)." I.R.C.§ 49(a)(1)(D)(iv); I.R.C. § 465(b)(6)(D)(i). The last two exceptions help prevent structured, tax shelter-like transactions in which, for example, a promoter would package the deal and provide the nonrecourse financing. The related person restriction is suspended "if the financing from the related person is commercially reasonable and on substantially the same terms as loan involving unrelated persons." I.R.C. § 465(b)(6)(D)(ii). "Related persons" is defined with reference to Code sections 267(b) and 707(b)(1), which include, for example, parents, grandparents, siblings, spouse, children, and grandchildren as well as certain entities.

127. *See* H.R. REP. NO. 99-841, Vol. 2, at 135–36 (1986) (Conf. Rep.), *reprinted in* 1986 U.S.C.C.A.N. 4075, 4223–24 (explaining that "arms' length terms" better limit "the opportunities for overvaluation of property and for the transfer of tax benefits attributable to amounts that resemble equity"); S. REP. NO. 99-313, at 748 (1986) ("In the case of commercial financing . . . the lender is much less likely to make loans which exceed the property's value or which cannot be serviced by the property; it is more likely that such financing will be repaid and that the purchaser consequently has or will have real equity in the activity."), *reprinted in* 4 TAX REFORM 1986: A LEGISLATIVE HISTORY OF THE TAX REFORM ACT OF 1986, at 748 (Bernard D. Reams, Jr. & Margaret H. McDermott eds., 1987); *see also* Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695 (2007) (exploring how third-party oversight, such as information reporting, improves compliance).

more likely to be repaid[128] (or perhaps, more cynically, the real estate lobby was stronger than other groups[129]).

Numerous other rules operate to ensure that taxpayers are not able to circumvent the classification system. For example, the statute provides that "a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements."[130] This rule is likely difficult to police but is in line with the overall goal of the at-risk rules—to limit the ability of taxpayers to get immediate tax benefits funded through debt that taxpayers are less likely to repay.[131] The at-risk rules do not, however, depart from long-accepted conventions of permitting borrowed basis. Indeed, the at-risk rules do not affect basis at all. Instead, the at-risk rules operate to slow down taxpayers' access to deductions that are funded by nonqualifying, nonrecourse debt.[132]

The at-risk rules are, however, generally perceived to be problematic on their own terms and redundant given the operation of other anti-avoidance rules.[133] A separate set of anti-avoidance rules—known as the passive activity loss rules—often have greater impact than the at-risk rules in targeting tax shelters designed to generate large quantities of pa-

---

128. *See* S. REP. NO. 99-313, at 748 (1986) (emphasis added) (noting the need to extend the at-risk rules to real estate because of the "opportunity for overvaluation" but also stating that such overvaluation is less likely "[i]n the case of commercial financing secured *solely* by the real property"), *reprinted in* 4 TAX REFORM 1986: A LEGISLATIVE HISTORY OF THE TAX REFORM ACT OF 1986, at 748 (Bernard D. Reams, Jr. & Margaret H. McDermott eds., 1987).

129. *See* BIRNBAUM & MURRAY, *supra* note 120, at 140 (reporting comment by member of Congress on 1986 act: "I was just outgunned by a real estate lobby that knows no limit to its greed."); Kahng, *supra* note 9, at 209–12 (discussing real estate lobby in context of tax benefits for housing).

130. I.R.C. § 465(b)(4). A related rule specifies that a taxpayer may not count amounts "borrowed from any person who has an interest" in the activity or "from a related person to a person (other than the taxpayer) having such an interest." I.R.C. § 465(b)(3)(A). These rules do not, however, apply if the "interest" the other person has is only that of being a creditor. In addition, corporations may borrow from their shareholders without this limitation applying. I.R.C. § 465(b)(3)(B). These rules prevent shifting of at-risk amounts and also prevent a taxpayer from claiming the at-risk amount when someone else in the same activity has a higher risk of loss as to the same dollars (although the lender in this situation would not be able to increase her at-risk amount in the activity through lending the money).

131. S. REP. NO. 99-313, at 747 (1986) ("The [at-risk rules are] designed to prevent a taxpayer from deducting losses in excess of the taxpayer's actual economic investment in an activity. . . . [A] taxpayer's deductible losses . . . are limited to the amount the taxpayer has placed at risk (i.e., the amount the taxpayer could actually lose) . . . ."), *reprinted in* 4 TAX REFORM 1986: A LEGISLATIVE HISTORY OF THE TAX REFORM ACT OF 1986, at 747 (Bernard D. Reams, Jr. & Margaret H. McDermott eds., 1987).

132. Similar rules apply to restrict access to certain tax credits. I.R.C. § 49.

133. They were also criticized as failing to improve on the pre-enactment treatment of debt. *See* Coven, *supra* note 15, at 79.

per deductions (e.g., depreciation) for taxpayers with little economic exposure (e.g., limited partners).[134] In addition, because the at-risk rules were enacted, judicial substance-over-form doctrines have become better developed and the economic substance doctrine has been codified.[135] Because the at-risk rules only impact deductions financed by nonqualifying, nonrecourse debt and because various other anti-avoidance rules and standards are in place, the at-risk rules are unlikely to be a significant aid to efficient, fair tax administration.

While it is debatable whether the at-risk rules are doing much heavy lifting, their timing mechanism for delaying deductions and their system for categorizing debt are reflected in other areas of the tax law. The timing mechanism of the at-risk rules appears to have been borrowed from the treatment of shareholder basis in S corporations.[136] And the use of likelihood of repayment to set tax consequences is heavily utilized in tax partnerships to allocate debt basis among the tax partners.[137]

---

134. I.R.C. § 469.

These rules categorize taxpayer activities as passive or nonpassive, with the key determination made by reference to the quantity and quality of time the taxpayer devotes to the activity—that is, whether a taxpayer "materially participates" in the activity. I.R.C. § 469(c)(1), (h); Treas. Reg. § 1.469-5T (as amended in 1996). Deductions and losses that are generated by passive activities are only deductible to the extent of a taxpayer's income and gains from passive activities. I.R.C. § 469(a)(2). Certain types of income streams (e.g., wages, dividends, and similar) are classified as nonpassive, with the result that the taxpayer's deductions from passive activities is essentially limited by the amount of operating income from the taxpayer's passive activities. I.R.C. § 469(e). Thus, the passive-activity-loss rules, like the at-risk rules, slow down a taxpayer's access to deductions. Unlike the at-risk rules, where the loss limitation operates on the activity level, the passive-activity rules apply the limitation by aggregating all passive activities. I.R.C. § 469(d)(1).

Also unlike the at-risk rules, the passive-activity-loss rules are more likely to apply to certain rental real estate transactions. I.R.C. § 469(c)(2) (any rental activity is presumed passive). *But see* I.R.C. § 469(c)(7) (providing exception from presumption for taxpayers who spend substantial time in a real estate property business); I.R.C. § 469(i) (limited deduction for up to $25,000 of rental real estate deductions but with a phaseout beginning at $100,000 of adjusted gross income). The odd combination of exceptions for certain qualifying real estate debt in the at-risk rules and the broader inclusion for real estate in the passive-activity-loss rules may be explainable by the history of the reforms attempted through the 1986 Act. Chroniclers of the 1986 reform efforts note a strong real estate lobby was able to preserve real estate tax breaks in an earlier phase of the proposals. BIRNBAUM & MURRAY, *supra* note 120, at 140. Later in the process, when there was a need to find an offset for a lower rate, the passive activity loss rules were added to the main tax provisions. *Id.* at 218-19 (noting that "[t]he screams from real estate interests to a similar proposal in the House" caused the proposals to be shelved but that the proposal later "seemed the perfect political solution to the puzzle that the 25-percent [rate] plan created").

135. *See* Luke, *supra* note 103 (article discussing codification history of the economic substance doctrine).

136. *See* EXPLANATION OF TAX REFORM ACT, *supra* note 105 (noting that basis limits the deductions for both S corporation shareholders and partners but that S corporation shareholders are unable to increase basis for corporate debt).

137. Treas. Reg. § 1.752-1 (as amended in 2005).

Thus, before turning to this Article's main proposal, this Part briefly sketches out the rules for Subchapter S corporate debt and for tax partnership debt.

Subchapter S corporations are generally not themselves subject to taxation;[138] instead, the shareholders of the S corporation are allocated a pro rata portion of the S corporation's income, expenses, and similar items.[139] For example, a taxpayer owning 10% of an S corporation would have to pay tax on 10% of the S corporation's income. In order to be an S corporation, an entity must not have more than one class of stock.[140] As a result, determining an S corporation shareholder's pro rata portion of the tax items generated by the corporation is relatively straightforward. If the S corporation generates net losses rather than net income, these expense and loss items are similarly allocated pro rata among the shareholders.[141]

The S corporation may, of course, borrow money. Even though the S corporation does not itself pay taxes, the S corporation must calculate the entity's income and deduction items before these are allocated to its shareholders.[142] The S corporation will, for example, have tax basis in its assets and will use that tax basis to calculate depreciation on those assets;[143] in turn, the depreciation deductions will be allocated to the shareholders. Shareholders will, however, be able to utilize allocated deductions immediately only if they have either sufficient basis in their ownership interest or sufficient "basis in indebtedness."[144] These limitations operate before the at-risk rules[145] and act as an initial limitation on the ability of S corporation owners to use borrowed S corporation deductions.

---

138. I.R.C. § 1363(a).

139. I.R.C. § 1366(a). In order to elect to be an S corporation, an entity must meet various requirements relating to the number of shareholders, the type of shareholders, and the rights of shareholders. I.R.C. § 1361.

140. I.R.C. § 1361(b)(1)(D). An exception exists relating to differences in voting rights. Treas. Reg. § 1.1361-1(l)(1) (as amended in 2008) ("Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have [voting differences].").

141. I.R.C. § 1366(a).

142. I.R.C. § 1363(b) (requiring that the taxable income of an S corporation "be computed in the same manner as in the case of an individual" with certain exceptions, several of them relating to personal deductions that are irrelevant to business entities).

143. *See* I.R.C. § 168 (computation of depreciation on tangible assets); I.R.C. § 197 (computation of amortization on certain intangible assets).

144. I.R.C. § 1366(d).

145. And the at-risk rules operate before the passive activity loss rules. Treas. Reg. § 1.469-2T(d)(6) (as amended in 1993).

S corporation shareholders increase basis in their shares by making contributions to the S corporation and upon receiving pro rata allocations of income items.[146] Critically, even though the S corporation will incorporate borrowed basis into its calculations of depreciation and other deductions, the borrowed basis is not accessible to the shareholders.[147] As a result, shareholders do not have access to basis borrowed by the S corporation even though the shareholder will be allocated deductions funded in part by that borrowed basis.[148] The shareholder will have to wait to use the deductions until the shareholder has personal basis in his or her interest. It is this delay in gaining access to borrowed deductions that is similar to the at-risk amount computing rules found in the at-risk rules. Of course, a large difference is that the at-risk rules only apply the delay to deductions deemed funded by nonqualifying, nonrecourse debt.

For example, consider an S corporation with two fifty-percent owners, Shareholders E and F, who currently each have a basis of $1,000 in the S corporation. Assume the S corporation borrows $100,000 to purchase Asset Y, which gives rise to an immediate $100,000 deduction owing to a special tax incentive tied to this asset. The S corporation itself does not utilize the deduction because it is not a taxpayer; instead it will allocate the deduction equally between Shareholders E and F. Shareholders E and F will, however, only be able to take a $1,000 deduction each and will also have to reduce stock basis to $0; each would have $49,000 of suspended deduction. The $100,000 basis attributable to the bank debt is not available to the shareholders to increase stock basis, and therefore is not available to increase the amount available to support deductions. If the shareholders want to gain access to their suspended deductions, they would have to make further contributions to the S corporations or be allocated additional income from the S corporation.[149]

---

146. I.R.C. § 358 (basis in shares received in qualifying exchange with corporation); I.R.C. § 1367(a)(1).

147. Treas. Reg. § 1.1366-2(a)(2) (as amended in 2014).

148. The at-risk rules apply to the shareholder's ownership interest; thus, if the shareholder uses nonqualifying, nonrecourse debt to purchase the interest, the shareholder's at-risk amount in the activity will be $0.

149. Shareholders are not able to transfer these suspended losses on transfer of the interest, with the only exception being qualifying transfers to spouses or ex-spouses. I.R.C. § 1366(d)(2).
The original "small business corporation" election rules, enacted in 1958, contained rules for adjusting shareholder basis. Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64, 72 Stat. 1606, 1650. This first attempt required shareholders to increase basis for gross income shares, "but only to the extent to which such amount is included in his gross income in his return," and to decrease basis (but not below zero and without a carried forward suspended loss) by the shareholder's portion of the entity's net operating loss. *Id.* at 1655. Provision was made for basis in indebtedness and appears to be the same basic requirement as is in place today: "The basis of any indebtedness of an electing

S corporation shareholders may only get access to entity-level debt basis by being the lender on such debt.[150] This is the concept of "basis in indebtedness."[151] Returning to the previous example, if the S corporation had borrowed the $100,000 from Shareholder E instead of from a bank, Shareholder E would still have had only $1,000 of basis in his stock, but he would also have had $100,000 of basis in indebtedness. As a result, Shareholder E would not run into a limitation caused by lack of basis until more than $101,000 of deductions was allocated to him.[152] All creditors take a basis in the loans they make equal to the principal amount

---

small business corporation to a shareholder of such corporation" was reduced, again not below zero, and only after basis in stock had been reduced. *Id.*

Because of technical flaws (for example, the lack of a carryforward for suspended losses), the first set of rules was eventually repealed and replaced in 1982 by rules that are substantially similar to those in place today. *See* Samuel P. Starr et al., *S Corporations: Formation and Termination*, 730-3rd Tax Mgmt. (BNA) U.S. Income, § I (2015). The 1982 legislation used the same phrase for basis in indebtedness used in the current Internal Revenue Code. Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669, 1678 ("[T]he shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder . . . .").

The limitation on S corporation shareholders' access to entity-level borrowed basis appears not to have its origin in concerns about timing but instead seems the accidental byproduct of the original goal of Subchapter S, which was to provide pass-through treatment for shareholders in certain small corporations. *See* President Dwight D. Eisenhower, Budget Message to the 83d Congress (1954) ("Small businesses should be able to operate under whatever form of organization is desirable for their particular circumstances . . . I recommend that corporations with a small number of active stockholders be given the option to be taxed as partnerships . . . ."); Starr et al., *supra*, § 1.A. For a general discussion of the evolution of Subchapter S, see Mirit Eyal-Cohen, *When American Small Business Hit the Jackpot: Taxes, Politics, and the History of Organization Choice in the 1950s*, 6 PITT. TAX REV. 1 (2008). As discussed *infra* Part III.C, corporate level debt is not accessible to shareholders.

150. The debt must be "bona fide." Treas. Reg. § 1.1366-2(a)(2)(i) (as amended in 2014). The regulations also now expressly provide that a loan guarantee is insufficient; payment on the guarantee must actually be made before a shareholder can increase basis in indebtedness. *Id.* § 1.1366-2(a)(2)(ii). Even before the regulations, most courts to consider the issue determined that a guarantee of the S corporation's debt was not sufficient to increase basis. The one outlier decision, *Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985), was repeatedly criticized and limited to its facts by the Eleventh Circuit. *See* Estate of Leavitt v. Comm'r, 90 T.C. 206, 216–17 (1988), *aff'd*, 875 F.2d 420, 421 n.8 (4th Cir. 1989); Maloof v. Comm'r, 456 F.3d, 645, 650–51 (6th Cir. 2006); Sleiman v. Comm'r, 187 F.3d 1352, 1356–59 (11th Cir. 1999); *see also* Basis of Indebtedness of S Corporations to Their Shareholders, 79 Fed. Reg. 42675 (2014) (preamble to 2014 regulations adopting requirement of performance on guarantee in order to obtain basis in indebtedness).

151. I.R.C. § 1366(d).

152. The pro rata allocation rules will, however, prevent the shareholders from allocating a larger portion to Shareholder E. I.R.C. § 1366(a)(1). In other words, the $80,000 loan will not increase Shareholder E's ownership stake or his pro rata share of allocated items. He could still only be allocated $50,000 of the deduction attributable to the purchase of Asset Y.

loaned; the S corporation rule allows the lender-shareholder to use that basis to offset S corporation allocations.[153]

The partnership tax system is drastically different from the S corporation system when it comes to borrowed deductions.[154] Tax partners are able to allocate partnership tax items by agreement rather than by pro rata share, though this ability is subject to a host of anti-abuse rules.[155] Tax partners are also assigned a portion of the partnership's debt basis to support the use of allocated deductions.[156] Indeed, in direct contrast to the rules governing S corporation debt, if an obligation is treated as a partnership liability, then the basis attached to that liability *must* be assigned among the partners.[157] Borrowed basis is assigned to the partner who bears the economic risk of loss of the debt, as determined through running a hypothetical scenario in which it is assumed that the partnership fails to pay its debts, which have all been accelerated, because all the partnership's assets are valueless (including cash).[158] If, after running the scenario, no partner bears the economic risk of loss, the liability is termed partnership nonrecourse debt and the borrowed basis must be as-

---

153. The lender-shareholder will not, however, benefit twice; if the loan is repaid at a time when the lender-shareholder has a basis lower than the repayment amount on account of prior allocations, the shareholder will have a gain. Rev. Rul. 64-162, 1964-1 C.B. 304.

154. The difference between partnership debt and S corporation debt has received attention from various tax writers, with some arguing that the S corporation rules should be expanded to allow access to basis. *See, e.g.*, GEORGE K. YIN & DAVID J. SHAKOW, TAXATION OF PRIVATE BUSINESS ENTERPRISES 206–14 (American Law Institute 1999); James S. Eustice, *Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm (Some Preliminary Proposals)*, 39 TAX L. REV. 345, 397–400 (1984); Martin D. Ginsburg, *Maintaining Subchapter S in an Integrated Tax World*, 47 TAX L. REV. 665, 669–70 n.35 (1992); Roberta Mann, *Subchapter S: Vive le Difference!*, 18 CHAP. L. REV. 65 (2014); Walter D. Schwidetzky, *Integrating Subchapters K and S – Just Do It*, 62 TAX LAW 749 (2009).

For a brief period of time, partners were not permitted to enjoy basis increases for "any partnership liability with respect to which the partner has no personal liability." Tax Reform Act of 1976, Pub. L. No. 94-455, § 213, 90 Stat. 1520, 1548. This was put in place at the same time as the initial round of at-risk rules. *See* discussion of enactment history *supra* note 107. When the at-risk rules were expanded in 1978 to cover all non-real estate activities, this partnership-specific provision was dropped. Revenue Act of 1978, Pub. L. No. 95-600 § 201, 92 Stat. 2763, 2814–15.

155. *See* I.R.C. § 704.

156. I.R.C. § 752.

157. I.R.C. § 752.

158. Treas. Reg. § 1.752-2 (as amended in 2006). Some property secured directly by nonrecourse debt will be treated as having value. Although partnership-level debt is reflected in a partner's basis in her partnership interest, partnership-level debt assigned under Code section 752 does not increase a partner's book value account. Treas. Reg. § 1.704-1(b)(2)(iv)(*b*)–(*c*) (as amended in 2015). This makes logical sense as the partners' capital account book values are proxies for partner equity stakes. Because debt does not increase partner wealth, it does not increase these accounts. Allocation of tax items to partners with negative capital account book values will still be respected under certain conditions. The regulations laying out those conditions are some of the most complex in all of the tax system. *Id.* § 1.704-1.

signed using a different rubric—one that generally assigns the basis according to partner profit share.[159]

Deductions attributable to borrowed basis are generally also allocated by agreement, although partnership nonrecourse deductions are subject to limitations that increase the likelihood that the partner benefiting from the deduction will also be the partner having to pay the tax on any gain arising on disposition of the property securing the debt.[160] Detailing the nuances and complexities of partnership distributive share allocations is beyond the scope of this Article. Suffice it to say that the rules not only permit partners to gain access to borrowed deductions but also permit partnership earnings that could be viewed as paying for such borrowed deductions to be allocated differently from the original assignment of borrowed basis.[161] In other words, the timing benefit available for borrowed deductions may be expanded through strategic agreement on allocations.

The at-risk rules do, of course, apply to individual partners, but they do not apply at the partnership level. Partnership debt that is nonqualifying, nonrecourse debt and is assigned to a partner decreases that partner's at-risk amount in the partnership activity.[162] Courts interpreting the at-risk rules do not necessarily accept the determination of recourse or nonrecourse under the partnership tax rules.[163] For example, the Tax Court has held that a partner's obligation to restore a deficit in his capital account did not make the partner's debt share recourse for purposes of the at-risk rules, even if it was sufficient for purposes of the partnership tax rules.[164] Even so, it seems likely that the partnership definition of recourse debt influences how the at-risk rules work in practice and, as a result, may further diminish the role of the at-risk rules. As discussed above, the partnership tax rules make use of a highly stylized,

159. Treas. Reg. § 1.752-3 (as amended in 2000).

160. *See* Treas. Reg. § 1.704-2 (as amended in 2011).

161. The minimum gain chargeback rules do mitigate this for nonrecourse deductions. *Id.*; *see also* Coven, *supra* note 15, at 60–62.

162. I.R.C. § 465(b)(2), (6); Prop. Treas. Reg. § 1.465-24(a)(2), 44 Fed. Reg. 32242 (June 5, 1979).

163. For qualified, nonrecourse debt, however, the statute provides a special rule requiring that the partner's share of the qualifying debt will be determined using the partnership rules. I.R.C. § 465(b)(6)(C).

164. Hubert Enterprises, Inc., v. Comm'r, 95 T.C.M. (CCH) 1194 (2008) (decision on remand). The *Hubert* case triggered a wave of commentary regard in the interactions between the at-risk rules and the partnership debt assignment rules. *See, e.g.*, Abrams, *supra* note 68; Ajay Gupta, *Who's at Risk? Abbott and Costello Take on Section 465, Part 1*, 120 TAX NOTES 335 (2008); Richard M. Lipton, *At-Risk Rules and DROs: Did the Tax Court Err in* Hubert Enterprises*?* 103 J. TAX'N 325 (2005); Richard M. Lipton & Todd D. Golub, Hubert Enterprises *Part II: We Can 'Guarantee' a Better Result*, 109 J. TAX'N 14 (2008).

unrealistic hypothetical liquidation and ask whether in such a situation any partner would be required to contribute money for debt repayment.[165] Recently, the Treasury has issued proposed regulations that would make these rules more meaningful by requiring partnerships to examine more closely actual financial capacity of the partners.[166] These regulations have been met by practitioners with dismay and sharp criticism.[167] It seems probable that the proposed regulations will be revised.[168]

To summarize, the at-risk rules are a chimera, consisting of an analysis tied to the nature of the debt and a timing delay system only applicable in the presence of a single type of debt. S corporation debt basis is subject principally to a timing delay system.[169] Tax partnership debt basis is required to be assigned to partners using, again, a system tied to the nature of the debt.[170] As discussed in Part I, the two main concerns associated with debt principal are (1) the possibility of sham or near-sham debt, and (2) the ability to gain timing benefits through the use of borrowed basis. The temptation to engage in the first is largely driven by the attempt to super-size the timing benefits.[171] Yet, the at-risk rules and the partnership tax rules use a rough approximation of the nature of a particular debt before tackling the issue of timing (at-risk rules) or borrowed deduction gamesmanship (partnership tax). Using debt status does alleviate avoidant uses of borrowed basis, but the current model is unnuanced and, as the debate over the proposed partnership debt regulations illustrates, it would be difficult to administer and enforce a system

---

165. *See supra* notes 158–159 and accompanying text.

166. Prop. Treas. Reg. § 1.752-2, 79 Fed. Reg. 4826-01 (Jan. 30, 2014). Proposals were also made regarding other aspects of the partnership liability rules, including overlapping obligations and related partners. Section 752 and Related Party Rules, 78 Fed. Reg. 76092 (proposed Dec. 16, 2013); *see also* Canal Corp. v. Comm'r, 135 T.C. 199, 211–17 (2010) (taxpayers used indemnities and guarantees to attempt to manipulate the assignment of economic risk of loss, and thereby basis, of LLC debt).

167. *See* Blake D. Rubin et al., *A "Guaranteed" Debacle: Proposed Partnership Liability Regulations*, 2014 TAX NOTES TODAY 73-6 (Apr. 16, 2014); New York State Bar Association, *NYSBA Members Address Regs on Allocating Partnership Liabilities*, 2014 TAX NOTES TODAY 221-60 (Nov. 14, 2014).

168. *See* Matthew R. Madara, *Partnership Debt Allocation Changes May Reflect NYSBA Comments*, 2014 TAX NOTES TODAY 234-3 (Dec. 4, 2014) (calling the proposed regulations "much maligned"); David van den Berg, *Official Says Treasury May Split Up Partnership Regs*, 2014 TAX NOTES TODAY 203-4 (Oct. 20, 2014) (Treasury may use "faster track" for less controversial, disguised sale portion than the debt-related proposals).

169. Again, this does not appear originally to have been by design. *See supra* note 150.

170. Treas. Reg. § 1.752-1 (as amended in 2005); Treas. Reg. § 1.752-2 (as amended in 2006); Treas. Reg. § 1.752-3 (as amended in 2000).

171. In partnership tax, there is, of course, also a strong temptation to shift the debt-financed deductions to those who can make the most use of them.

that used a finer gradient for distinguishing debt.[172] An alternative, and the one highlighted in this Article, is to implement a more precise treatment of basis borrowing in the first instance.[173] The subsequent Parts discuss possible methods for doing so.

III. RATIONING BORROWED BASIS

This Part explores solving the timing distortion through use of a delayed benefit rule, similar to that used already by S corporations and as a component of the at-risk rules. As touched on above, a system for rationing access to borrowed basis requires a separate tracking mechanism, here termed "nonborrowed basis." In such a system, the amount of nonborrowed basis would be calculated by increasing it for taxable income and for certain tax-exempt items (e.g., tax-exempt interest on qualifying municipal bonds), then reducing it by borrowed basis. Deductions would only be permitted to the extent of this nonborrowed basis, with deductions then also reducing the available nonborrowed basis amounts. Decreases to nonborrowed basis would also need to be reduced for payments that are nondeductible for various reasons but that represent true economic outlays (e.g., distributions to owners, nondeductible bribes).[174]

A simple system can be illustrated by returning to an example from Part I. In that part, Investor B used $100,000 borrowed dollars to purchase Asset Y, which, in the absence of a restriction on the use of borrowed basis, generated an immediate $100,000 deduction. Under a rationing system, the $100,000 deduction would still be calculated at the time Asset Y is purchased, but Investor B would not get to use the tax deduction on her tax return until she had obtained offsetting nonborrowed basis. In the example, that would not happen until she sold the asset to repay the debt at the end of Year 5. The $100,000 taxed gain would generate nonborrowed basis that would allow Investor B finally to use the $100,000 deduction held in suspension since the original purchase. The overall economics of the rationing system are the same as under current law in absolute value terms – in both cases a $100,000 deduction and a $100,000 gain cancel each other out, assuming equal tax

172. *See supra* notes 166–168 and accompanying text.

173. In the tax partnership area, the temptation to shift deductions to others would remain, though resolving the timing benefit should also act as a significant restraint on that problem.

174. This system has obvious parallels to how shareholder basis operates in subchapter S and to the calculation of the "at risk" amount. *See supra* Part II. For a proposed deferral system that is more closely tied to repayment and purchase money debt, see McMahon, Jr., *supra* note 15, at 1104–30.

rates at both times—but with a rationing system, the timing advantage has been removed.[175]

The example, however, suggests further questions; for instance, to what extent should Investor B's taxable income from other sources be treated as increasing nonborrowed basis and to what extent should Investor B's other debt reduce nonborrowed basis? The examples in this Article have generally assumed a single asset and a direct and obvious relationship between the source of the nonborrowed basis and the use of the debt principal. That is, offsetting, earned basis was all sourced from the investment purchased with the borrowed money (or the debt was unpaid, so nonborrowed basis was funded through the operation of the cancellation of indebtedness rules). But of course, taxpayers may have numerous other investments and business activities generating deductions and funded, in whole or in part, through numerous other debts.

At one extreme, a rationing system could be implemented at the individual asset level, with the taxpayer required to utilize multiple asset baskets. As to each asset basket, deductions would be allowed out only to the extent that nonborrowed basis had accrued in excess of borrowed basis. The use of multiple baskets is fairly common in the tax system, including, as discussed in the previous part, in the current at-risk rules.[176] But attempting to impose a basketing regime at such a granular level would raise obvious administrative problems. At the other extreme, the rationing system could apply at the taxpayer level. All nonborrowed dollars (without regard to whether there is any likelihood that they will be used to repay the debt or whether there is any relationship to the borrowed deductions) could be treated as valid substitutes, so long as the nonborrowed basis in the aggregate exceeds the borrowed basis in the aggregate.

If a rationing system is used, an aggregate measurement appears to be the best choice because money is fungible and it may be difficult to assign debt to a particular asset.[177] Two key difficulties, however, are present. First, a simple aggregate measurement, in the case of individual taxpayers, would need to account for personal consumption and personal debt. Second, an economically rational debtor would never repay certain

---

175. A rate differential may still exist depending on the terms of the deduction and how the basis is earned. For example, the deduction might be an ordinary deduction, while the earned basis might be long-term capital gain eligible for a preferential tax rate.

176. The at-risk rules apply at an activity level; an activity may consist of a single asset or may consist of multiple assets supporting the activity. I.R.C. § 465 (2012). *See supra* notes 117–135 and accompanying text; *see also* Leandra Lederman, *A Tisket, A Tasket: Basketing and Corporate Tax Shelters*, 88 WASH. U. L. REV. 557 (2011) (discussing concept of basketing and providing examples).

177. *See infra* Part IV.A for a more extended discussion of these points.

types of debt (raising the specter of needing to categorize debt). The next two subsections explore these issues, while a third subsection discusses the problem of applying a rationing rule to all corporations. Alternative approaches to a rationing system will be briefly taken up in Part IV.

A. Personal Consumption and Personal Debt

The issues raised by personal consumption are explored through examples. Consider Investor B who spends $100,000 on Asset Y, a cost that is immediately deductible. Assume that during the same year, Investor B also has $100,000 of wage income and spends $100,000 on nondeductible personal living costs (e.g., rent, vacation, clothing, food, etc.). Instead of borrowing money to purchase Asset Y, Investor B could use his wages to buy Asset Y and fund his personal living expenses with $100,000 of debt. In spite of the formal change, Investor B could, however, still be viewed as paying for Asset Y with borrowed basis because of the fungibility of cash. A system for rationing the use of borrowed basis would need to construct rules for handling consumer debt and nondeductible consumer costs.

One possible approach would be to cast the net as widely as possible so that nonborrowed basis is increased for all taxable income, including wages, and then decreased for all debt, including consumer debt. The excess of nonborrowed basis over borrowed basis would then have to be apportioned between nondeductible and deductible costs, including consumer expenses.[178] To illustrate, consider again Investor B and assume that this time she has $200,000 of wage income and $100,000 of credit card debt. This would leave $100,000 of nonborrowed basis. If Investor B both purchases Asset Y for $100,000 and has $100,000 of nondeductible consumer costs, a broadly set, pro rata system would require Investor B to allocate the nonborrowed basis between the two types of outlays; as a result, $50,000 of the cost of Asset Y would be deductible and the nonborrowed basis would be reduced to $0. Alternatively, a prioritization rule could be selected; for example, consumer costs could reduce nonborrowed basis before business or investment costs (or vice versa). To illustrate such a prioritization variation, in the preceding the example, the nonborrowed basis of $100,000 could instead be reduced to $0 by all $100,000 of the nondeductible consumer costs, thereby requiring Inves-

178. Most consumer expenses are not deductible, with some exceptions provided expressly by Congress. I.R.C. § 262. *See, e.g.*, I.R.C. § 163(h)(3) (home mortgage interest); I.R.C. § 165(c)(3); I.R.C. § 170 (charitable contributions).

tor B to wait to use the deduction for Asset Y until she accrued new nonborrowed basis.

While casting the net widely would be more accurate, as the examples above suggest, such an approach would give rise to a whole host of administrative problems, not to mention create ugly optics and political fallout. Thus, a rationing system would have to devise a more palatable approach to consumer debt and expenses. The obvious alternative would be to ignore some combination of consumer earnings, costs, and debt.

The at-risk rules suggest a possible avenue, which is to increase nonborrowed basis only for contributions to investments or businesses and for returns on investments and businesses. As a result, wages would only increase nonborrowed basis if those wages are invested.[179] So long as consumer debt does not exceed consumer costs, a rationing system could also simply ignore both consumer debt and consumer costs as a matter of administrative convenience.[180] The difficulty is that formal consumer debt could exceed consumer costs, thereby facilitating a larger nonborrowed basis than would be appropriate. Introducing exceptions to a rationing system would broaden the possibilities for avoidance. The risk may be fairly low, given that there are some natural, nontax limits on the amount and types of consumer debt.[181] Substance-over-form judicial solutions would, of course, also be available.

Should Congress ever seriously consider a rationing system, legislation could set limits as to consumer debt. Consumer debt up to certain limits could be ignored; for example, home equity debt up to a particular amount,[182] all home acquisition debt,[183] all student loans, all automobile

---

179. Line-drawing rules would be required here; for example, whether and when amounts deposited in a simple checking or savings account should be treated as invested. *See* David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627 (1999). One possibility is to treat cash and cash equivalents as noninvestments. The tax system already makes use of the concept of cash equivalents in other contexts. *See* BURKE & FRIEL, *supra* note 37, at 651–53 (discussing cash equivalents with respect to cash method of accounting).

180. This would provide a prioritization rule that would cause the nonborrowed basis amount to be available first for business and investment costs.

181. The need for consumer protection against predatory lending practices, however, points to failures in the consumer credit market. *See* Christopher L. Peterson, *"Warning: Predatory Lender"—A Proposal for Candid Predatory Small Loan Ordinances*, 69 WASH. & LEE L. REV. 893 (2012) (discussing background of usurious lending and discussing market failure in high-cost, "payday" type loans). Sham consumer debt used to inflate personal, itemized or above-the-line deductions is unlikely to be a problem because of the limitations inherent in taking personal deductions.

182. For example, double the $100,000 limitation on home equity debt already in place for purposes of determining the deductibility of home equity debt interest. I.R.C. § 163(h)(3)(C).

183. If the same definition for acquisition debt already found in the Code is used, home acquisition debt would automatically be offset by consumer cost outlay. I.R.C. § 163(h)(3)(B) (defining "acquisition indebtedness").

acquisition debt, and all other consumer debt up to some set amount.[184] Such limits would still allow taxpayers some limited ability to use borrowed basis for business and investment deductions (and could also create new opportunities for avoidance), but the tradeoff would likely be worthwhile in light of the potential administrative costs of policing a more accurate system.

B. Nonrecourse Debt Considerations

This Article has argued that, when it comes to debt principal, the tax system should focus first on timing rather than on likelihood of repayment. This section explores whether a system emphasizing timing may still need to take into account the likelihood of repayment in designing its rules. The pervasiveness of the recourse/nonrecourse dichotomy counsels cautious analysis rather than casual dismissal.[185] The first subsection below addresses the case of individuals (whether held directly by the individuals or through a disregarded entity) holding assets secured by nonrecourse debt. The second subsection considers the particular case of tax partnerships.

1. Nonrecourse Debt Directly Owed by Individuals

In the course of rendering its decision in *Crane*, the Supreme Court suggested that the tax system's treatment of debt might be different in the event the amount of a nonrecourse debt came to exceed the value of the property securing it because of declining property values; an economically rational taxpayer would not pay such a debt.[186] Later, in *Tufts*, the Supreme Court determined that this fact did not require a different result, and in the process also reaffirmed the current tax system's approach to borrowed basis.[187] This subsection asks whether the recourse or nonrecourse nature of a debt should change the operation of the rationing sys-

---

184. This Article does not propose resetting the boundaries of human capital vs. investment—thus, home mortgages and student loans are treated as consumer debts. *See generally* Louis Kaplow, *Human Capital Under an Ideal Income Tax*, 80 VA. L. REV. 1477 (1994).

185. *See supra* notes 108–112 and accompanying text.

186. Crane v. Comm'r, 331 U.S. 1, 14 n.37 (1947); *see* Cain, *supra* note 89, at 2–7 (discussing footnote 37 of *Crane*).

187. Comm'r v. Tufts, 461 U.S. 300, 311–13 (1983). *Crane* and *Tufts* have been the subject of numerous articles. *See* William D. Andrews*, On Beyond* Tufts, 61 TAXES 949 (1983); Cain, *supra* note 89; Richard Epstein, *The Application of the* Crane *Doctrine to Limited Partnerships*, 45 S. CAL. L. REV. 100 (1972); Deborah A. Geier, Tufts *and the Evolution of Debt-Discharge Theory*, 1 FLA. TAX REV. 115 (1992); Martin D. Ginsburg, *The Leaky Tax Shelter*, 53 TAXES 719 (1975); Calvin H. Johnson, *Play Money Basis: When Is Nonrecourse Liability a Valid Cost?*, 11 VA. TAX. REV. 631 (1992), Linda Sugin, *Nonrecourse Debt Revisited, Restructured and Redefined*, 51 TAX L. REV. 115 (1994); *see also* Yin, *supra* note 15.

tem suggested in this Part, and it concludes that for individual investors and sole proprietors, the nature of the debt should not change the operation of a broad-based rationing system.[188]

The reason is that the tax system already has a set of rules (albeit perhaps also in need of reform) to deal with debtors who do not pay their debts. As discussed in Part I, if a debtor fails to make actual payments, eventually the tax system will require an accounting.[189] So long as all nonconsumer debt reduces nonborrowed basis and all business and investment outlays also reduce such nonborrowed basis, the proposed system could forego additional exceptions or rules tied to the recourse or nonrecourse rules as to individuals.

This can be illustrated through yet again considering the ubiquitous Asset Y. In Part I, Investor C purchased Asset Y but refused to repay the debt used to finance its purchase even though Investor C had the resources to do so. As discussed in Part I, Investor C, in the absence of a system delaying borrowed basis, had been able to exploit the time it would take for the tax system to remedy this (whether through gain at foreclosure or debt reduction triggering cancellation of indebtedness income) to wring further tax timing benefits from the original deduction for the purchase of Asset Y.

First, consider what would occur if Asset Y retains its value and was purchased with nonrecourse debt. Assume that Asset Y is Investor C's only investment asset and the debt his only nonconsumer debt.[190] Investor C's nonborrowed basis would be zero—$100,000 investment purchase minus the $100,000 nonrecourse debt. Investor C would thus not be permitted to use the deduction for the purchase until Investor C could increase nonborrowed basis. Whether Investor C sells Asset Y, loses Asset Y through foreclosure, or negotiates for a reduction in the debt, the deduction will be permitted only as Investor C increases his nonborrowed basis through recognizing income.[191]

Of course, this example focuses only on a single asset; a related question is the advisability of a broad-based rationing system that would allow for aggregation across activities and investments when only some involve nonrecourse debt. To place this in the context of a particular fact

---

188. As is also the case under current law, the need for provision against sham debt would remain. *See supra* notes 105–106, 113–115 and accompanying text; *see also* McMahon, Jr., *supra* note 15, at 1068 (observing that timing advantage applies to both recourse and nonrecourse debt).

189. *See supra* notes 68–77 and accompanying text; Coven, *supra* note 15, at 67–69.

190. This example assumes a system such as that proposed *supra* Part III.A in which consumer debt and consumer costs are excepted.

191. Because the debt is nonrecourse, Investor C will not be able to sell Asset Y without also ending his obligation to repay the debt. *See* Comm'r v. Tufts, 461 U.S. 300, 317 (1983).

pattern, consider whether Investor C, who purchased Asset Y with nonrecourse debt, should gain access to the deduction for the cost of Asset Y if he buys Asset X with $100,000 of his earnings from his regular employment.[192] In other words, the question is whether the purchase of a different investment should increase the nonborrowed basis amount when the property providing the deduction is secured by nonrecourse debt.

Assume that Asset X's purchase price is not immediately deductible but does yield yearly depreciation deductions of $20,000 for five years. Running through five years of ownership of both Asset Y and Asset X suggests that even with an expansive aggregate view of nonborrowed basis and debt, the timing advantages would be addressed.[193] In the first year, Investor C would get a $100,000 deduction, but his nonborrowed basis would be reduced to $0 and he would have a $20,000 suspended deduction. During Years 2–5, the suspended deductions would increase by $20,000 each year, until there was a total of $100,000 of suspended deduction. If Investor C chooses not to repay the nonrecourse debt, Investor C would not be able to gain access to those suspended deductions. Eventually, foreclosure would assure the needed increase,[194] but Investor C's initial decision to delay repayment does not work in his favor.

As with any set of new tax rules, taxpayers would undoubtedly devise novel avoidance tactics[195] (or lobby Congress for various exceptions that would make such developments more possible). The aim of this Article is, however, to illustrate that at least in the absence of tax avoidance, such a system has the ability to address the timing mismatch between borrowing basis and earning an equivalent amount of basis.

2. Pass-Through Entities with Limited Liability

This subsection addresses the extent to which likelihood of repayment would still matter in partnership taxation if a broad-based rationing

---

192. This again assumes a system that ignores consumer debt and consumer costs.

193. As with the examples of Part I, it should be assumed that annual returns and interest offset each other and no other investment activities occur during the five years.

194. The full amount of the debt would be included in amount realized; Investor C would have a zero basis in the asset because of the depreciation deductions. Thus, sale would yield the $100,000 of gain needed to increase nonborrowed basis to $100,000. The same result would occur if Investor C negotiated a reduction of debt through the increase to cancellation of indebtedness income. Addressing the gaps in the tax attribute reduction rules relating to bankruptcy, insolvency and other exclusions is beyond the scope of this Article. *See supra* notes 68-77 and accompanying text.

195. *See* Luke, *supra* note 97 (article discussing taxpayer adaptation of wraparound annuity structure in response to new rules).

system were enacted. The problem is more complex than for individuals holding assets directly because of the basis shifting opportunities available inside partnerships.

Tax partnerships, including limited liability companies, may provide liability protection to their owners, with the result that the entity-level debt is effectively nonrecourse as to those owners. As discussed above, the partnership tax rules assign borrowed basis among the owners, with more stringent rules applicable if no partner has the economic risk of loss as to that debt.[196] Because partners may be able to manipulate the economic risk of loss, tax partners not only have access to the timing benefits inherent in borrowed basis but also may attempt to shift the borrowed basis to those who can most benefit from the associated deductions.[197] S corporations provide similar limited liability to their shareholders, but as discussed above, an S corporation's borrowed basis is not directly available to the shareholders. Further, S corporations are unable to make special allocations to particular shareholders, which limits S corporation shareholders' access to basis-shifting techniques.[198]

One possibility would be to maintain the current partnership tax rules that assign basis to partners for partnership debt and impose additional scrutiny on deductions deemed traceable to nonrecourse debt.[199] A rationing system could require that the amount of borrowing assigned to that partner under partnership tax rules would then become the amount that would be used to compute that partner's nonborrowed basis amount. While this approach would seem to limit the need to amend the already complex partnership tax rules, it appears likely to open up other avenues for gamesmanship. For example, partners with ample nonborrowed basis from other sources could continue to use the relatively permissive economic risk of loss rules to increase their share of partnership debt; a partner with excess nonborrowed basis (or a partner indifferent to U.S. tax law) might be willing to increase his or her borrowing amounts in order to accommodate partners who wanted a temporary lowering of their borrowed basis amounts. To be sure, substantiality requirements are already in place, but these are generally perceived as problematic[200] and in any case would arguably need to be expanded to encompass allocations lack-

196. *See supra* notes 154–168 and accompanying text.

197. Recent regulation proposals aim to make this more difficult. *See supra* notes 166–68 and accompanying text.

198. *See supra* Part II.

199. *See supra* Part II.

200. *See, e.g.*, Bradley T. Borden, *The Allure and Illusion of Partners' Interests in a Partnership*, 79 U. CIN. L. REV. 1077 (2011); Gregg D. Polsky, *Deterring Tax-Driven Partnership Allocations*, 64 TAX LAW. 97 (2010).

ing substantiality on account of shifting, underlying borrowed basis assignments.[201]

The most administratively straightforward solution would be to use the one already utilized for subchapter S debt: no partner-level basis for partnership debt.[202] The partnership would continue to keep track of basis at the entity level, and partnership deductions would, of course, continue to be allocable by agreement.[203] Removing the ability to use immediately deductions funded through borrowing would further lessen the ability to turn partnerships into markets for tax attributes. Partnership tax rules could likely be simplified (though always with an eye toward possible new avenues for tax avoidance); if partners are unable to bolster basis with partnership borrowed basis,[204] the debt-basis-assignment rules could be eliminated and the need for rules regarding nonrecourse deductions would be reduced.[205] Such a change would also have the benefit of moving Subchapter S and partnership taxation somewhat closer together,

---

201. Perhaps this should happen even in the absence of broader debt reform, possibly as an alternative to attempts to police recourse debt more directly. *See supra* notes 166–168 and accompanying text

202. Professor Calvin Johnson has made a proposal that would have a similar effect in certain situations but operates on the partner capital accounts rather than on partners' basis in their interest. Calvin H. Johnson, *Don't Let Capital Accounts Go Negative*, 129 TAX NOTES 127 (2010). The presence of negative capital accounts indicates that a partner has been assigned deduction allocations paid for with borrowing.

203. Subject to the limitations that already apply—e.g., that the allocations have substantial economic effect. I.R.C. § 704(b) (2012).

204. Just as for S corporation shareholders, partners who purchased their partnership interests with borrowed money would still have to adjust their nonborrowed amounts by that use.

205. The extremely complex partnership nonrecourse deduction allocation and minimum gain chargeback regulations relate to the economic effect requirement of Code section 704(b). Specifically if deductions are financed with nonrecourse debt, the already stylized and problematic economic-effect test of the Code section 704(b) regulations becomes impossible to utilize, prompting the Treasury to implement safe harbors as to nonrecourse deductions in order to provide greater certainty to taxpayers. Treas. Reg. § 1.704-2 (as amended in 2011). The economic effect test depends on the pretense that at some date in the future, the partners' capital accounts will be meaningful; that is, at some future date, partners with negative accounts will have to pay in and partners with positive accounts will be rewarded. *See* Treas. Reg. § 1.704-1(b)(2)(ii) (as amended in 2015); Michael J. Close & Dan A. Kusnetz, *The Final Section 704(b) Regulations: Special Allocations Reach New Heights of Complexity*, 40 TAX LAW. 307 (1987) (article containing overview of 704(b) regulations, as revised in 1986); Andrea Monroe, *Too Big to Fail: The Problem of Partnership Allocations*, 30 VA. TAX REV. 465 (2011) (article discussing evolution of allocation rules and the flaws of the current system). If no partner faces the possibility of having to make good on a debt, that ultimate reconciliation becomes impossible and the allocations financed by such nonrecourse debt lack economic effect—hence the need for the nonrecourse deduction regulations. If, as proposed in this Article, partners did not get basis for debt in the first instance, the allocation problem relating to nonrecourse debt would be significantly less important. For example, if a partner were allocated $10,000 of partnership-level depreciation deductions but had a $0 basis because all the deductions were financed through debt (whether recourse or nonrecourse), the partner would have a much stronger incentive to agree to an allocation of $10,000 of income in order to increase basis.

thereby potentially reducing inefficiencies tied to choice-of-entity decisions. Even if a rationing system were not enacted, eliminating partner access to partnership borrowed basis is low-hanging fruit when it comes to incremental partnership tax reform and could even permit repeal of the at-risk rules.[206]

C. Corporate Taxpayers

This Article has so far not directly addressed whether and how a broad-based rationing system should apply to C corporations. The taxation of these entities is likely to be most familiar to readers because virtually all name-brand corporations are C corporations.[207] C corporations are potentially subject to having their earnings taxed twice—once when earned (taxed to the entity) and once when distributed as dividends

---

206. An aggregate theory of partnerships suggests that the goal should be maintaining parity between partnerships that borrow and partners who borrow and then contribute borrowed funds to the partnership. Denying basis to partners for partnership debt arguably moves partnerships too close to an entity approach. *See* Bradley T. Borden, *Aggregate-Plus Theory of Partnership Taxation*, 43 GA. L. REV. 717 (2009) (discussing the aggregate and entity theory of partnership and proposing an aggregate-plus theory). Full consideration of the extent to which partnerships should be governed by an aggregate approach or an entity approach is beyond the scope of this Article, though the incremental-reform proposal suggested in the main text does tacitly utilize an entity approach. With respect to partnership debt specifically, use of an entity approach facilitates an administratively simpler path to reduce the timing distortion. The combination of partnership tax rules relating to debt basis and nonrecourse deductions, when combined with the at-risk rules, already lead indirectly to reducing the timing distortion in some cases. If finalized, the proposed regulations would move more partnership debt onto the nonrecourse track and, if the at-risk rules were interpreted so as to follow, would further mitigate the timing problem. Yet, until a direct, more comprehensive approach is enacted, multiple opportunities for gamesmanship and traps for the unwary would remain.

In addition (albeit at the risk of raising shades of the likelihood of repayment rationale), the debt structures of S corporations and partnerships are closer together than they may at first seem. The corporate form generally provides protection to shareholders from corporate creditors. The current partnership rules were written with general partnerships in view and well before the widespread use of limited liability companies or other limited liability options for partners and partnerships—including, for example, the use of disregarded entities by partners to limit state law liability. *See* Susan Pace Hamill, *The Story of LLCs: Combing the Best Features of a Flawed Business Tax Structure*, *in* BUSINESS TAX STORIES 295 (Steven A. Bank & Kirk J. Stark eds., 2005) (chapter discussing history and evolution of LLCs). While tax regulations have begun to adapt (for example, special debt-basis-assignment rules for disregarded entities and the proposed regulations on partnership debt), partners still have multiple avenues to achieve corporate-like insulation against creditors, including as to debt qualifying as recourse under the partnership debt rules. *See* Treas. Reg. § 1.752-2(k) (as amended in 2006) (rules limiting ability to obtain recourse debt status using disregarded entities); Prop. Treas. Reg. § 1.752-2, 79 Fed. Reg. 4826-01 (Jan. 30, 2014). If the at-risk rules were repealed and partnership debt treatment moved closer to S corporation debt treatment, it would, of course, create pressure for formalistic borrowing by partners to be used within entities.

207. It is, however, possible to carry on large business operations inside of the S corporation framework. *See* Mirit Eyal-Cohen, *Down-Sizing the "Little Guy" Myth in Legal Definitions*, 98 IOWA L. REV. 1041 (2013); Eyal-Cohen, *supra* note 149.

(taxed to the shareholder and nondeductible by the entity).[208] As recent press coverage has made abundantly clear, multinational corporations have a host of methods at their disposal to reduce overall taxation on their earnings.[209] In addition, the U.S. tax system now imposes a lower tax rate on qualifying dividends[210] and, of course, corporations financing through debt rather than equity are able to deduct the interest, whereas dividend payments are not deductible.[211] Multinational corporations may also be able to borrow from subsidiaries or affiliates operating in low-tax jurisdictions, enabling deduction by the parent but low or zero payment of tax on the interest inclusion by the subsidiary or affiliate.[212]

The sprawling nature of the modern multinational corporation makes adapting and expanding a borrowed basis rationing system to such behemoths highly difficult. At a minimum, such a system would need to take into account the relationships among subsidiaries and affiliates. Applying a rationing system only at each taxpayer level—that is, at each separate C corporation box—would likely provide more fodder for gaming the nonborrowed and borrowed amounts.[213] Further, at the level of each separate corporation, the net operating loss rules already provide a somewhat similar rationing function, yet have been inadequate to prevent debt-related tax avoidance by C corporations.[214]

The nonborrowed and borrowed amounts could instead be computed at some entity-plus level, building on, for example, the consolidated return rules, and then re-apportioned out to the individual entities.[215] Crafting such an overarching set of rules would be complex to say the least, and this Article will not devote space to running through the possible permutations of such an extensive line-drawing exercise. An alternative possibility, as will be discussed in the next Part, would be to give up

208. I.R.C. §§ 11, 1(h) (providing lower rate to certain qualifying dividends).

209. *See, e.g.*, Yariv Brauner, *What the BEPS?*, 16 FLA. TAX REV. 55 (2014).

210. I.R.C. § 1(h)(11).

211. I.R.C. § 163; MCMAHON, JR., SIMMONS & MCDANIEL, *supra* note 47, at 122.

212. *See supra* note 10 and *infra* note 231 (subpart F considerations).

213. A similar issue is raised by tax partnerships, including tiered entity groups, but because partnerships are not themselves subject to tax, it may be possible to cut through much of the complexity by denying partners access to debt basis. *See supra* Part III.B.

214. I.R.C. § 172. These rules also apply to all individuals, but because individuals can aggregate net operating losses (NOLs) across activities and also apply NOLs against all income types, including wages, the NOL provisions do not already act as a sufficient rationing system, although they do clearly provide additional limitations on the ability of taxpayers to use borrowed deductions. Embedded within the NOL rules are, for example, further limitations on the ability of individuals to treat investment losses and capital losses as NOLs. I.R.C. § 172(d)(2)–(4). The NOL rules provide another analogy to the rationing system explored herein and could be mined for additional implementation ideas.

215. *See* I.R.C. § 1501.

precision for a deferral charge, though this would still require adopting rules for related corporations.

IV. ALTERNATIVE APPROACHES

This Part examines other possible approaches to limiting the timing benefits of borrowed deductions. The first such method would be to deny basis in the first place for borrowed dollars and require actual repayment of debt principal for basis to arise. The second would remove the exclusion for debt principal, thereby accelerating income. Finally, the Article discusses the use of a deferral charge. These three alternatives are evaluated because they represent likely alternative proposals given the existing literature in this area, assuming one agrees that doing nothing is not an alternative.[216]

A. Direct Basis Limitation

The difficulty with directly denying basis for borrowed cash, as has been enumerated by others, lies with the problem of tracing fungible dollars as well as with cost recovery and credit computational difficulties.[217]

---

216. Additional alternatives are, of course, also possible. For example, this Article has not addressed the taxation of the lender and whether the treatment of the lender diminishes the problems identified in this Article, or whether the lender's tax treatment could instead be altered to account for the timing benefits to the borrower. Using the treatment of lenders to justify or balance the treatment of borrowers would, however, raise additional concerns. The first, obvious issue is that lenders and borrowers are separate taxpayers and will have a separate basis. The lender has a loan basis obtained by providing funds for the use of the borrower. The lender is able to use the basis to offset loan principal repayments. If the lender sells the loan, the lender will use the basis to generate a gain or loss; the lender will not, however, be able to amortize the basis it has in the loan. If repayment is not made by the borrower, the lender will be able to take a loss deduction. I.R.C. §§ 165, 166, 1271; *see also supra* notes 150153 and accompanying text (discussing basis in indebtedness of S corporations).

Solving a distortion available to one taxpayer by targeting the tax treatment of another taxpayer raises equity concerns. When taxpayers are related to each other or are engaged in a common enterprise (including tax shelter accommodation), there is, however, greater likelihood that formal taxpayer boundaries are misleading and should be redrawn. Unsurprisingly, multiple tax rules attempt to ensure that the overall tax burden of a particular group has not been reduced through allocation gaming by individual members. *See, e.g.*, Treas. Reg. § 1.704-1(b)(2)(iii) (as amended in 2015) (substantiality requirement for partnership allocations). The lender and borrower relationship does involve a common investment but does not require a shared business relationship, such as is experienced by partners in a partnership or corporate shareholders in a corporation. *See* Bradley T. Borden, *Residual-Risk Model for Classifying Business Arrangements*, 37 FLA. ST. U.L. REV. 245 (2010) (discussing classification of business relationships under the Code and economic theory). In the case of sham debt, where the lender is essentially an accommodation party, lender-side solutions would be most easy to justify. Finding a lender-side solution for the commonplace timing benefit highlighted in this Article would be more problematic. Alternatives that focus on the creditor side of the transaction should be explored, but it is beyond the scope of this Article to do so in greater detail.

217. *See* DODGE, FLEMING, JR. & PERONI, *supra* note 43, at 451–54. *See also* Coven, *supra* note 15.

The tracing problem can be illustrated by returning briefly to Investor B and Asset Y of Example 2 above. Assume that a rule applies providing that the tax deduction is available only if Asset Y is purchased with nonborrowed dollars. Investor B could get around this problem by borrowing the $100,000 to fund some other expenses or asset purchases, including personal consumption expenses, and then buying Asset Y with nonborrowed dollars. Because dollars are fungible, Investor B will still have, for all practical purposes, borrowed money to purchase Y. Denying basis for debt-financed assets and operating costs would require an elaborate combination of tracing and apportionment rules to determine whether a particular item is funded with borrowed dollars.

The Internal Revenue Code (the "Code") does contain templates for such tracing rules. In addition to the technical rules outlined in Part II, the Code contains a miscellany of rules relating to debt principal and debt interest that rely for their operation on deeming particular tax benefits to be derived from particular loans. For example, the Code requires tracing debt used to purchase bonds bearing tax-exempt interest in order to deny deductibility of the interest on such debt.[218] As explained above, regulations governing tax partnerships contain rules that treat certain deductions as allocable to nonrecourse debt; the label in turn triggers various restrictions on the assignment of those deductions to the partners.[219]

Rules that attempt to trace tax benefits to particular loans will almost certainly suffer from coverage gaps and complexity.[220] A system that simply eliminated the ability to borrow basis would not only need rules for determining whether particular tax benefits were traceable to debt but would also need rules for ensuring that payments on debt are not themselves traceable to new debt; otherwise, the basis gained by payment would be tainted.

Simply eliminating borrowed basis directly instead of acting on the benefits would also have the effect of causing some U.S. dollars to have

---

A related, but more workable, alternative would be to disallow deductions until debt is repaid. Such a proposal, along with suggested approaches to the tracing issue, has been advanced by Professor McMahon, Jr., *supra* note 15. The deferral proposal made in this Article attempts to limit the tracing problem by expanding the at-risk mechanism and focusing on the earning of offsetting basis rather than on the repayment of the underlying debt. *See supra* Part III.

218. I.R.C. § 265; *see also* Treas. Reg. § 1.163-8T (as amended in 1997) (allocating interest expenses across capital expenditures for purposes of applying passive activity loss rules and limitations on nonbusiness interest deductions).

219. Treas. Reg. § 1.704-2(d) (as amended in 2011).

220. *See* McMahon, Jr., *supra* note 15, at 1120 (noting the limits of drawing on Code section 265(2) for tracing rules for his deferral proposal); Philip D. Oliver, *Section 265(2): A Counterproductive Solution to a Nonexistent Problem*, 40 TAX L. REV. 351 (1985); David J. Shakow, *Confronting the Problem of Tax Arbitrage*, 43 TAX L. REV. 1, 19, 44–46 (1987).

a basis different than their current value.[221] Having U.S. cash (whether in physical or digital form) with a basis of $0 or some other amount different from face amount would raise consequences that would be confusing, to say the least. The IRS recently ruled that virtual currency, such as bitcoin, should be treated as property, with all the ramifications that carries with it, including requiring taxpayers who use bitcoin to make purchases to treat that as an exchange of the bitcoin for the purchased item, triggering any gain or loss inherent in the bitcoin.[222] Imagine trying to apply such a system to U.S. dollars. Apart from the practical difficulties, the ripple effects in the Code would be astounding, as an argument can be made that a significant portion of the Code's structure is dedicated to ensuring that U.S. cash tracks basis equal to its face amount.[223]

Solving tax distortions through denying basis for borrowed dollars would also trigger a need to reconsider the computational rules for cost recovery deductions, various credits, and any other tax benefits tied to tax basis. For example, depreciation schedules run on assumptions about the economic decline in value from the purchase price of an asset.[224] And the tax system assumes that in taxable transactions starting basis and purchase price are the same number.[225] It would, of course, be possible to redesign the systems, but it would require the addition of a second measuring concept. Once a secondary concept is needed, and given the other complexities of attempting direct elimination of borrowed basis, one may as well use an overarching intermediary concept, such as the nonborrowed basis proposed in the prior part.

B. Accelerating Basis Inclusion

A second alternative to a system focused on rationing the benefits of borrowed basis would be a system accelerating the substitution of nonborrowed basis for borrowed basis. Because the benefits of the timing distortion relate to the ability of taxpayers to pay for deductions with borrowed basis while delaying the time when the income available to pay the debt will be earned, a possible alternative is to force earned income at the same time that basis is borrowed.[226] That is, receipt of borrowed money could be taxed and repayment of the debt could be deductible.[227]

---

221. *See* DODGE, FLEMING, JR. & PERONI, *supra* note 43, at 451.

222. I.R.S. Notice 2014-21, 2014-1 C.B. 938. For a discussion of bitcoin, see Omri Marian, *Are Cryptocurrencies Super Tax Havens?*, 112 MICH. L. REV. FIRST IMPRESSIONS 38 (2013).

223. *See, e.g.*, I.R.C. §§ 358(a), 1031(d), 1033(b).

224. *See* I.R.C. §§ 167, 168, 197.

225. *See* Phila. Park Amusement Co. v. United States, 126 F. Supp. 184, 188 (1954).

226. *See* BURKE & FRIEL, *supra* note 37, at 54; Coven, *supra* note 15, at 68 ("With perfect foresight, the Commissioner could subject only the amount of the loan that would not be repaid to

A borrowing inclusion would help resolve the problem of cancellation of indebtedness income and the various exceptions to inclusion required to deal with insolvent and bankrupt taxpayers.[228] The tax would be collected at a time when taxpayers had the resources to borrow cash to make the tax payment; under the current system, the government must instead attempt to collect from taxpayers unable (or unwilling) to repay their debts.[229] Taxpayers who failed to repay on debt that had already been included in income would simply lose their repayment deduction, thus ending the need to measure insolvency or determine eligibility for a similar exception. For pass-through entities, such as partnerships, the inclusion of borrowed funds could be allocated directly to the partners (though still subject to the broad distributive share restrictions, such as substantial economic effect) without the need for more complicated assignment of borrowed basis.[230] In the international context, instituting a borrowing inclusion would help limit the ability of U.S. businesses to defer tax by borrowing from cross-border entities.[231] A borrowing inclusion could also more generally counter the current system's tax preferences for debt financing since owing a tax at the time of borrowing would likely act as a disincentive.

Requiring inclusion in income for borrowed dollars and allowing deduction for repayment would, however, still cause a timing distortion, albeit one that would be more likely to operate in the Treasury's favor.

---

current taxation."); McMahon, Jr., *supra* note 15, at 1100–02 (discussing merits of inclusion rule for purposes of handling the problem of borrowed deductions). For a discussion of requiring such a borrowing inclusion in the context of implementing a postpaid consumption tax, see MCCAFFERY, *supra* note 53, at 19–20.

227. *See* BURKE & FRIEL, *supra* note 37, at 54.

228. *See supra* notes 68–77 and accompanying text.

229. Failure to repay triggers cancellation of indebtedness; of course, taxpayers may not have to pay a tax because of the operation of various exclusions under Code section 108. *See supra* notes 6877 and accompanying text.

230. The repayment deduction would, of course, still need to be allocated; anti-abuse rules linking that deduction to the original inclusion of the borrowing might be required.

231. Under Subpart F, some forms of lending by a "controlled foreign corporation" (CFC) to certain U.S. persons may trigger tax for the CFC's U.S. shareholders. *See* I.R.C. §§ 951(a)(1)(B), 956(c)(1)(C); I.R.C. § 956(c)(2)(A), (C), (F), (L); Treas. Reg. § 1.956-2T (as amended in 2015). In such circumstances the lent amounts are effectively treated as taxable repatriation of previously untaxed foreign earning to the United States. *See* Merck & Co. v. United States, 652 F.3d 475, 480 (3d Cir. 2011). Subpart F is intended to limit the ability of U.S. businesses to channel passive earnings inside non-U.S. entities or to avoid repatriation of active foreign earnings into the United States. Lawrence Lokken, *Whatever Happened to Subpart F? U.S. CFC Legislation after the Check-the-Box Regulations*, 7 FLA. TAX. REV. 185, 191 (2005). Subpart F is notoriously complex yet still filled with numerous gaps; well-advised taxpayers are often able to circumvent the intended effect of this set of rules. *See, e.g.*, Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 720 (2011); Lokken, *supra*, at 187–88.

Once such a rule were in place, taxpayers would also no doubt use their new ability to accelerate income at will to craft new tax reduction techniques such as, for example, borrowing money in order to have income to offset expiring net operating losses. A borrowing inclusion would put more pressure on the line between basis-infused debt (includible in income) and contingent, basis-free obligations (not includible in income).[232] Exceptions for consumer debt would also have to be made, not just for the obvious political reasons, but also because consumer debt generally funds either nondeductible consumer costs or a select, congressionally blessed set of deductions.[233]

A borrowing inclusion introduced for purposes of ending borrowed deductions would have much to recommend it, but it would also introduce new uncertainties. Even if restricted to business and investment debt, such an inclusion would, almost certainly, be distasteful to business interests and to Congress. It would almost certainly be decried as punitive given that there is no wealth increase.[234] Further, the constitutionality of such an approach has never been tested.[235] It would also be argued, correctly, that a rule requiring tax to be paid on borrowing would be over-inclusive with respect to timing because it would apply to all business or investment borrowing, even if not traceable to tax benefits. Tailoring a borrowing inclusion more narrowly would raise the same tracing and administrative problems discussed in the immediately preceding sec-

---

232. *See* Treas. Reg. § 1.752-1 (as amended in 2005); *see also* Cummings, *supra* note 11.

233. *See supra* Part III.A. Such exceptions would trigger the need to trace consumer debt; the same is true for the proposal in this Article, which suggests handling the problem by excluding consumer debt. *See supra* Part III.A.

234. *See supra* Part I Example 1.

235. An argument can be made that the Sixteenth Amendment's use of "income" is broad enough to include cash flow accompanied by a deductible obligation to repay. A serious proposal to require immediate inclusion of debt would undoubtedly generate additional scholarship on the contours of the taxing power. The "shared responsibility payment" of the health care legislation, for example, generated concerns regarding its constitutionality. *See* Brian Galle, *Conditional Taxation and the Constitutionality of Health Care Reform*, 120 YALE L.J. ONLINE 27 (2010); Edward D. Kleinbard, *Constitutional Kreplach*, 128 TAX NOTES 755 (2010); Steven J. Willis & Nakku Chung, *Constitutional Decapitation and Healthcare*, 128 TAX NOTES 169 (2010). The precise scope of Congress's taxing powers remains unclear even after the Supreme Court held that the required payments were constitutional taxes; the Court declined to address more precisely the boundaries of Congress's taxing power. Nat'l Fed'n Indep. Bus. v. Sebelius, 132 S. Ct. 2566, 2600 (2012) ("[T]he shared responsibility payment's practical characteristics pass muster as a tax under our narrowest interpretations of the taxing power. Because the tax at hand is within even those strict limits, we need not here decide the precise point at which an exaction becomes so punitive that the taxing power does not authorize it.") (citation omitted). For more discussion of Congress's taxing power, see, for example, Erik M. Jensen, *The Taxing Power, the Sixteenth Amendment, and the Meaning of "Incomes"*, 33 ARIZ. ST. L.J. 1057 (2001); Ruth Mason, *Federalism and the Taxing Power*, 99 CALIF. L. REV. 975 (2011).

tion.[236] While a broad-based borrowing inclusion merits further scholarly attention, a broad-based rationing system would be more accurate. A deferral charge, discussed next, would provide a rough but more practicable alternative.

C. Deferral Toll Charge

Borrowing money requires paying the lender for the use of that money, whether or not the label "interest" always gets attached to that payment.[237] When taxpayers finance deductions with debt—when they, in effect, borrow basis from the government—there is no corresponding interest-like payment to the government.[238] The main proposal of this Article has focused on forcing a match between borrowed deductions with the receipt of nonborrowed basis. Such a focus has the advantage of operating through an expansion of an existing set of rules and also provides significant, though far from perfect, opportunities for precision in eliminating the timing advantage.[239] At the same time, a broad-based rationing system would clearly require significant changes to the current system and would be administratively difficult to implement both with respect to C corporations and also with respect to tax partnerships, if partners were still assigned basis for partnership debt. A simpler, if less accurate, alternative would be for the government to charge for the timing benefit through imposition of a deferral charge on business and investment activities.[240] The use of "toll" charges to take back timing advantages is fairly common in the Code, though such charges often apply to more narrowly defined situations.[241]

Even a deferral charge would still require taxpayers to report on the amount of debt principal. Because the concern is the debt financing of tax benefits, multiple rules would be required to determine the extent of the taxpayer's borrowed tax benefits.[242] If a rough timing remedy were enacted, it would, however, be possible to make further rough-justice

---

236. *See supra* Part IV.A.

237. Of course, in related party situations, a lender may choose not to charge interest in order to further some other aspect of the relationship—for example, to make a gift to a family member or a dividend to a shareholder equal to the foregone interest. *See* I.R.C. § 7872 (2012) (deeming interest on certain below market loans).

238. *See supra* Part I.

239. *See supra* Part II.

240. The same result could be obtained by reducing the deduction available for interest—or any other deduction given the fungibility of dollars. *See* McMahon, Jr., *supra* note 15, at 1103-04 (discussing possibility of denying interest to resolve borrowed deduction timing benefit).

241. *See, e.g.*, I.R.C. §§ 72(t)(4), 453A, 7519.

242. See Part III *supra* for a discussion of specific situations, including consumer debt. Similar decisions would be required.

assumptions in calculating the amount of the charge. For example, formulas could be used to assign debt and tax benefits of subsidiaries to a corporate parent. A deferral charge could also be used as a substitute for a broader-based rationing system with respect only to certain taxpayers; for example, a deferral charge system could apply to multinational C corporations instead of a more administratively complex rationing system.

CONCLUSION

The tax system's treatment of both debt interest and debt principal is problematic. This Article emphasizes the need to reexamine the ability of taxpayers to borrow basis to fund tax benefits and presents four possible reform alternatives. An overarching requirement that the benefits of deductions and credits be rationed to account for borrowed basis has the attraction of being better tailored to the distortion but would be more complex to implement.[243] The government could instead enact a more rough-hewn but arguably more serviceable interest-like charge on taxpayers who borrow basis. Simply denying basis for borrowed cash would likely be even more administratively complex than attempting a rationing system; accelerating inclusion of borrowed money would introduce new distortions.

Even if there is skepticism regarding the benefits to be achieved by solving the timing distortions associated with borrowed basis, the failures of the tax system in providing consistent, principled handling of debt principal are readily apparent. The tangle of current tax rules regarding borrowed basis presented in this Article represents a portion of the conundrum of dealing with obligations. This Article focused only on simple cash (and cash equivalent) borrowing; beneath this is another convoluted layer to explore, including, for example, the contradictions and problems associated with taxing contingent obligations, debt-like equity, and debt-like derivatives. Moving design focus toward the underlying timing temptation provides a starting point for a more coherent approach to debt—one that could pave the way for simplifications in the tax rules, reductions in deadweight costs associated with tax avoidance, and innovations in the tax treatment of contingent obligations and other debt-like financial assets.

243. The examples in this Article focused on deductions; for a discussion of the problem of debt-financed credits, see McMahon, Jr., *supra* note 15.