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Partnership Sales: When Nonrecourse Debt Exceeds Fair Market Value, Commissioner v. Tufts

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INCOME TAXATION

Partnership Sales: When Nonrecourse Debt Exceeds Fair Market Value

Commissioner v. Tufts, 103 S. Ct. 1826 (1983).

THE UNITED STATES SUPREME COURT has used its decision in *Commissioner v. Tufts*[1] to settle a conflict between circuits[2] and to fine tune an ambiguity which it created thirty-six years ago in *Crane v. Commissioner.*[3] The circumstances focus on a taxpayer who sells his partnership interest by having the purchaser assume nonrecourse debt[4] to which the partnership property is subject.

The Court addressed the issue of whether the "amount realized"[5] by the taxpayer on the sale included all of the nonrecourse debt assumed by the purchaser or whether such "amount realized" was limited to the fair market value of the partnership property transferred. In a unanimous decision,[6] the Court sided with the Commissioner of Internal Revenue and held that the amount realized by a taxpayer in such a transaction includes the full amount of debt assumed by the purchaser regardless of its nonrecourse characteristic and the lower fair market value of the property transferred.[7]

During 1970, a corporation and five individuals[8] became partners in a general partnership.[9] The partnership borrowed $1,851,500 on a nonrecourse mortgage loan from a savings association and used the proceeds to construct

[1]103 S. Ct. 1826 (1983).

[2]The Fifth Circuit had ruled in favor of the taxpayer in Tufts v. Commissioner, 651 F.2d 1058 (5th Cir. 1981) and the Third Circuit had ruled in favor of the Commissioner of Internal Revenue in Millar v. Commissioner, 577 F.2d 212 (3d Cir. 1978), *cert. denied,* 439 U.S. 1046 (1978).

[3]331 U.S. 1 (1947).

[4]The creditor of nonrecourse debt cannot proceed against the debtor personally for collection thereon. The property subject to the debt is the creditor's only security.

[5]The "amount realized" is defined by I.R.C. § 1001(b) (1983). Gain realized on a sale or other disposition is the excess of amount realized over the adjusted basis. I.R.C. § 1001(a) (1983).

[6]Mme. Justice O'Connor concurred in result but discussed a different analysis. 103 S. Ct. 1826 (1983), O'Connor, J., concurring.

[7]103 S. Ct. 1826, 1836 (1983).

[8]One of whome was respondent Tufts. *Id.* at 1828.

[9]*Id.*

an apartment complex.[10] During 1971 and 1972, after completion and occupancy of the complex, the partners took total income tax deductions of $439,972.[11] Contributions to capital of $44,212 were also made by the partners during this period, which resulted in an aggregate adjusted basis[12] in the partnership of $1,455,740.[13]

The apartment complex never reached a sufficient occupancy level, and the rental income was inadequate to cover expenses.[14] On August 28, 1972, each of the six partners sold their partnership interests to the same individual.[15] The consideration provided by the purchaser was basically the assumption of the nonrecourse debt.[16] At the time of sale, the fair market value of the property was determined to be $1,400,000.[17]

The partners reported a loss on each of their 1972 federal income tax returns which aggregated to $55,740.[18] The Commissioner of Internal Revenue reviewed the transaction and concluded that the partners had realized a gain on the sale of $395,760.[19] The difference in the two proposed treatments focused on the amount realized. The partners argued that section 752(c) of the Internal Revenue Code,[20] read in conjunction with footnote thirty-seven of *Crane v. Commissioner*,[21] limited the amount realized on the sale to the fair market value of the partnership property.[22] The Commissioner argued that this transaction warranted no departure from the general rule of section 1001(b) of the Code[23]

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[10]*Id.*

[11]*Id.* Deductions were attributed to ordinary losses and depreciation. *Id.*

[12]Adjusted basis is defined by I.R. C. § 1012 to be cost which is then increased by capital contributions and earnings and decreased by distributions and losses. I.R.C. § 1012 (1983).

[13]103 S. Ct. 1826, 1829 (1983).

[14]*Id.*

[15]*Id.* Fred Bayles, who was not related to any of the six partners, acquired 100% of the partnership interests. *Id.*

[16]*Id.* Fred Bayles also reimbursed each partner for their selling expenses up to $250. *Id.*

[17]*Id.*

[18]*Id.* Amount is calculated by subtracting the fair market value of $1,400,000 from the adjusted basis of $1,455,740. *Id.*

[19]*Id.* at 1829, n.2. Amount is calculated by subtracting the adjusted basis of $1,455,740 from the full liability assumed of $1,851,500.

[20]I.R.C. § 752(c) provides: "For the purpose of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property." I.R.C. § 752(c) (1983).

[21]331 U.S. 1, 14 (1947). Footnote 37 reads:

> Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not the case. 331 U.S. 1 at 14 n.37.

[22]Commissioner v. Tufts, 103 S. Ct. 1826 (1983).

[23]I.R.C. § 1001(b) provides in relevant part that "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received." I.R.C. § 1001(b) (1983).

and the now applicable Treasury Regulation[24] thereunder, which includes all liabilities assumed by a purchaser in the amount realized by the seller.[25]

The case was first heard in the Tax Court [26] where the partners sued for a refund based on the alleged loss. The Tax Court held that the fair market value of the propety was irrelevant in determining the amount realized, which included the full amount of nonrecourse liability assumed.[27] The Fifth Circuit reversed the Tax Court's decision and held that the fair market value of the partnership property limited the amount realized on the sale.[28]

Just before the Tax Court's decision in *Tufts,* the Third Circuit decided the case of *Millar v. Commissioner*[29] where it held that the fair market value of the property did not affect the amount realized.[30]

The Supreme Court had to reconcile these apparently conflicting lines of thought. In doing so, the Court first turned to the case of *Crane v. Commissioner.*[31] The taxpayer in *Crane* acquired rental property which was subject to a mortgage for which the taxpayer was not personally liable.[32] The taxpayer's basis in the property included, however, the full amount of liability on the property. The taxpayer took depreciation and other deductions against the adjusted basis for approximately seven years.[33] When the property was sold, the purchaser took over payments on the mortgage debt.[34] Even though the purchaser did not become personally liable for the debt, the taxpayer (seller) was completely discharged from making any further payments thereon.[35] The mortgage debt which the taxpayer had been paying off was less than the fair market value of the property.[36] The Supreme Court held that the taxpayer had to include the full amount of the liability discharged in the amount realized upon the sale.[37] The Court's rationale focused on the fact that the taxpayer

[24]Treasury Regulation § 1.1001-2(a)(1) provides:

> Except as provided in paragraph (a)(2) and (3) of this section, the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. Treas. Reg. § 1.1001-2(a)(1) (1980).

[25]Commissioner v. Tufts, 103 S. Ct. 1826 (1983).

[26]Tufts v. Commissioner, 70 T.C. 756 (1978).

[27]*Id.* at 769.

[28]Tufts v. Commissioner, 652 F.2d 1058 (5th Cir. 1981), *reh' denied* (October 19, 1981), *cert. granted,* 456 U.S. 960, No. 81-1536 (May 1, 1982).

[29]577 F.2d 212 (3d Cir. 1978), *cert. denied,* 439 U.S. 1046 (1978).

[30]*Id.* at 215.

[31]331 U.S. 1 (1947).

[32]The taxpayer acquired the property by devise from her deceased husband. The record was not clear as to whether or not he was personally liable for the mortgage debt. Nevertheless, the mortgagee allowed the taxpayer to continue to use the debt without becoming personally liable thereon. *Id.* at 3-4.

[33]*Id.*

[34]*Id.*

[35]*Id.*

[36]*Id.* The property sold for $257,000 while the outstanding principal balance of the mortgage debt was $255,000. *Id.*

[37]*Id.* at 13-14.

had received the benefit of including the liability in the adjusted basis of the property,[38] and therefore must also include it in the amount realized when the liability was discharged. The Court then entered into a hypothetical discussion in which it articulated footnote thirty-seven.[39]

It is the dictum in this footnote which appears to cause the confusion today. The *Tufts* Court refused to give any recognition to the dictum contained in footnote thirty-seven. "We are disinclined to overrule *Crane,* and we conclude that the same rule applies when the unpaid amount of the nonrecourse mortgage exceeds the value of the property transferred."[40] Thus, the Court reaffirmed the general rule of *Crane* and expressly overruled any application of footnote thirty-seven.

The *Crane* Court's analysis of adjusted basis versus amount realized with regard to a liability is now supported by Treasury Regulation section 1.1001-2. "Except as provided in paragraph (a)(2) and (3) of this section, the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition."[41] Furthermore, paragraph (a)(4)(i) makes it clear that when property subject to a nonrecourse debt is disposed of and such debt remains secured by the property, the discharge referred to in paragraph (a)(1) does indeed occur.[42] Finally, paragraph (a)(3) provides "In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property."[43] The converse of this regulation suggests that when a liability was taken into account in determining the transferor's basis, such liability should also be included in the amount realized upon disposition.

In *Millar v. Commissioner,*[44] the taxpayers had $500,000 of debt, for which they were not personally liable, discharged in a foreclosure action.[45] The debt had been borrowed by a corporation which had elected Subchapter S status.[46] The court of appeals noted that even though the taxpayers were not personally liable on the loan, they did use the money borrowed to increase the basis of

[38] *Id.* at 9-10.

[39] *Id.* at 14, n.37.

[40] Commissioner v. Tufts, 103 S. Ct. 1826 (1983), *supra* n. 39.

[41] Treas. Reg. § 1.1001-2(a)(1) (1980).

[42] Treasury Regulation § 1.1001-2(a)(4)(i) states that "[t]he sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability." Treas. Reg. § 1.1001-2(a)(4)(i) (1980).

[43] Treas. Reg. § 1.1001-2(a)(3) (1980).

[44] 577 F.2d 212 (3d Cir. 1978).

[45] *See* Millar v. Commissioner, 540 F.2d 184 (3d Cir. 1976) for full recital of facts in this case where the court of appeals had earlier remanded to the Tax Court.

[46] I.R.C. §§ 1361 through 1399 provide an election whereby corporate income or loss is not taxed at the corporate level, but rather passed through to the individual shareholders and taxed along with their other income and losses under I.R.C. § 1.

their stock. The taxpayers were then able to take deductions for losses that passed through from the corporation to the extent of their adjusted basis in the stock. When the taxpayers surrendered their stock and had their liability discharged in the foreclosure action, the Tax Court considered the transaction to be the same as selling the stock for the amount of the outstanding liability and then paying off the liability with the proceeds of the sale,[47] and the court of appeals agreed.[48] Thus, the liability would be included in the amount realized on the sale. Failure to include the liability in the amount realized would result in a "double deduction."[49]

The Supreme Court then turned to section 752 of the Internal Revenue Code. The purpose of sections 752(a) and 752(b) is to cause the partner's basis in his partnership interest to be adjusted for liabilities of the individual partner that are assumed by the partnership or liabilities of the partnership that are assumed by the individual partner.[50] The adjusted basis determines the maximum amount of partnership loss that a partner is entitled to deduct on his individual tax return. Section 752(c) then limits this adjustment to the basis, due to the assumption of a liability, to the fair market value of the property that is subject to the liability.[51] Section 752(d) provides that liabilities will not be given any special treatment when a partnership interest is sold or exchanged.[52] On the face of the statute, there is an apparent conflict between subsections (c) and (d). The Supreme Court resolved this conflict by reviewing legislative history[53] and holding that section 752(c) applied only to transactions between a partner and his partnership.[54] Thus, in a transaction between a partner and a third party, section 752(c) was inapplicable, and section 752(d) could be invoked without conflict.

The Supreme Court has clearly eliminated any uncertainty that existed in this area of the tax law. "When a taxpayer sells or disposes of property encum-

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[47] 67 T.C. 656, 660-662 (1970).

[48] 577 F.2d 212 (3d Cir. 1978).

[49] *Id.* at 215.

[50] I.R.C. § 752(a) and § 752(b) provide as follows:

(a) Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

(b) Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership. I.R.C. § 752(a), (b) (1983).

[51] I.R.C. § 752(c) provides:

For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property. I.R.C. § 752(c) (1983).

[52] I.R.C. § 752(d) provides:

In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships. I.R.C. § 752(d) (1983).

[53] H.R. REP. NO. 1337, 83d Cong., 2d Sess., 236 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess., 405 (1954).

[54] 103 S. Ct. 1826, 1835-1836 (1983).

bered by a nonrecourse obligation, the Commissioner properly requires him to include among the assets realized the outstanding amount of the obligation. The fair market value of the property is irrelevant to this calculation."[55] The amount realized on the sale of a partnership interest to a third party will be determined under the general rule of the Internal Revenue Code[56] and the related Treasury Regulation.[57] The Supreme Court has unequivocally decided that neither footnote thirty-seven in *Crane v. Commissioner,*[58] nor section 752(c) were intended to interfere with the application of the general rule in this context. When a nonrecourse liability is incurred, and the adjusted basis of the property subject thereto has been accordingly increased, the discharge of the liability in a disposition of the property must be fully reflected in the amount realized upon the disposition regardless of the fair market value of the property.

In conclusion, the result reached by the high Court is obviously unfavorable to the taxpayer, but it is also one that is supported by the greater weight of authority.[59] The basis for the result is logical and understandable. When a taxpayer has received the benefit of including loan proceeds in the adjusted basis of his property, he must correspondingly include the amount of a loan obligation which is discharged upon a disposition of such property in the amount realized. "Nothing in either section 1001(b) or in the Court's prior decisions requires the Commissioner to permit a taxpayer to treat a sale of encumbered property asymmetrically, by including the proceeds of the nonrecourse obligation in basis but not accounting for the proceeds upon transfer of the encumbered property."[60] Enforcing a consistent treatment on both sides of the "section 1001 coin"[61] in this context should not be regarded as the downfall of another significant tax shelter. Banks and other creditors typically do not lend money on a nonrecourse basis in amounts that are in excess of the fair market value of the property which secures the loan. Furthermore, investors typically do not acquire limited partnership interests in real estate with the expectation of a decline in the fair market value of the property. For those taxpayers, however, who find themselves selling a limited partnership interest by having the purchaser assume nonrecourse debt which is in excess of the fair market value of the partnership property, it will now take an act of the Congress to afford them special tax relief.

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[55] 103 S. Ct. 1826, 1836 (1983).

[56] I.R.C. § 1001(b) (1983). *See supra* note 23 and accompanying text.

[57] Treas. Reg. § 1.1001-2(a)(1) (1980). *See supra* note 24 and accompanying text.

[58] 331 U.S. 1, 14 n.37 (1947). *See supra* note 21 and accompanying text.

[59] *See, e.g.,* Millar v. Commissioner, 577 F.2d 212 (3d Cir. 1978), *cert. denied,* 439 U.S. 1046 (1978); Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane Case,* 33 TAX. L. REV. 277 (1978); *Tufts v. Commissioner: Amount Realized Limited to Fair Market Value,* 15 U.C. D. L. REV. 577 (1981); *The Resurgence of Footnote 37: Tufts v. Commissioner,* 18 WAKE FOREST L. REV. 1 (1982).

[60] 103 S. Ct. 1826, 1834 (1983).

[61] One side of the coin is the amount realized as defined in I.R.C. § 1001(b) and the other side is adjusted basis as defined in I.R.C. § 1012. The difference between the two is gain or loss realized under I.R.C. § 1001(a).