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Purchaser's Obligations —When Nonrecourse Debt Exceeds the Value of the Property

By: Ronald A. Morris and David E. Kahen

A type of transaction that has given rise to much tax litigation and a considerable number of reported cases is the acquisition of property for consideration that consists primarily of nonrecourse financing, either provided by the seller or taken subject to by the purchaser, that exceeds the fair market value of the property.

Generally, debt incurred or taken subject to in connection with the purchase of property is includible in the "cost" of the property for tax purposes and therefore in its "basis." Where the debt is nonrecourse and exceeds significantly the fair market value of the property securing the debt, however, it is well established, under *Estate of Franklin v. Commissioner* (544 F.2d 1045 (9th Cir. 1976)) and later cases, that the purchaser of the property cannot include the full amount of the debt in basis, because the taxpayer has no investment in the property and no economic incentive to pay the debt.

One question that was not addressed by *Estate of Franklin*, and that has since been answered differently in various decisions, is whether, in such circumstances, the nonrecourse debt may nonetheless be taken into account to the extent of the value of the underlying property, or must be disregarded in its entirety. The Court of Federal Claims has, in *Bergstrom v. United States* (Dkt. No. 94-45 T (1996)), come down squarely in favor of disregarding the debt in its entirety, thus supporting the disallowance of depreciation and interest deductions attributable to the debt.

The Bergstrom Case

The plaintiffs purchased partnership interests in three limited partnerships owning interests in real property. Each of the partnerships had been promoted by Sol Finkelman, the general partner, and followed a similar pattern.

Duluth Properties Company ("Duluth") purchased, in 1977, a one-half interest in a post office in one location and a group of post office buildings in another location. The one- half interest was acquired for a stated purchase price of $2,301,000, of which $260,000 was payable as a cash down payment. The balance was to be paid over a 27-year period with interest at rates varying between 5% and 10%.

The other post office property was purchased by Duluth for a stated purchase price of $453,400, of which $62,000 was payable as a cash down payment and the balance over a 13-year period with interest at rates within the same range.

Tucson Properties Company ("Tucson") and Bethlehem Properties Company ("Bethlehem") purchased interests in office buildings in 1978 and 1979, respectively. Tucson acquired its interest for a stated purchase price of $4,237,500, of which $535,000 was payable as a cash down payment and the balance over a 25-year period with interest at rates in the same 5% to 10% range.

Finally, Bethlehem acquired its interest in an office building for a stated purchase price of $12,500,000, of which $2,435,000 was payable in cash during the first 1-1/2 years and the balance was payable over a 22-year period with interest at rates varying between 6.5% and 11%.

In each case the seller financing was nonrecourse and substantially exceeded the fair market value of the property, which as stated in the opinion ranged from 51% to 76% of the stated purchase prices of the several properties.

All of the properties were leased to others under long-term leases or "master leases" and each partnership incurred net losses from rental operations in each of the years at issue, with interest and other expenses apart from depreciation being substantially in excess of rental income in almost all years. In general, the debts were structured so that the bulk of the principal would be due in balloon payments at or about the time of expiration of the leases.

The IRS disallowed losses claimed by the plaintiffs for the years 1977 through 1981 with respect to their interests in the partnerships.

Finkelman v. Commissioner

In an earlier memorandum decision of the Tax Court (affirmed by the Ninth Circuit Court of Appeals in an unpublished decision) concerning the general partner of the partnerships, the IRS prevailed in its disallowance of that partner's shares of losses from Duluth, Bethlehem, and certain other partnerships, with the court finding that no sale occurred for income tax purposes, that there was no bona fide profit objective apart from tax savings, and that no genuine indebtedness was incurred (*Finkelman v. Commissioner*, T.C. Memo 1989-72). The expert opinions offered by the Commissioner and the petitioner regarding property values were consistent in indicating that the value of each property when acquired was substantially less than the stated purchase price, and also less than the portion of the total stated consideration that was deferred for more than two years through the seller financing.

The Tax Court considered and rejected Finkelman's argument that the terms of the seller financing—generally, at market rates for the first three years, dropping to below market rates thereafter, with balloon payments of principal more than 10 years after the purchase—enhanced the values of the properties. The court refused to take into account in valuing the properties any special benefit to the purchasers from the terms of the purchase money notes, and did not address whether the present value of the payments required under the notes, if computed based on market rates at the time of purchase, would approximate the values of the related properties—which might in turn suggest that there was some realistic potential for profit and that the notes should have been treated as debt of the partnerships for tax purposes.

Perhaps because of this background, the case before the Court of Federal Claims arose in the form of cross motions for summary judgment, with the plaintiffs seeking summary judgment to the effect that nonrecourse purchase money debt that exceeds the value of the property securing the debt is disregarded for income tax purposes only to the extent the debt exceeds the value of the property.

Specifically, the plaintiffs argued that the court should follow the decision of the Third Circuit in *Pleasant Summit Land Corp. v. Commissioner* (863 F.2d 263 (1988)). In that case the Court of Appeals concluded that nonrecourse financing that exceeded the value of property owned by a partnership should nonetheless be taken into account for tax purposes to the extent of the property's value.

The Court of Appeals observed that, although the holder of property in such circumstances may have no incentive to pay off any portion of a debt which exceeds the value of the property, the creditor has no incentive to foreclose if the holder is prepared to pay, in satisfaction of the debt, an amount equal to that value. The court apparently concluded from this that the property owner in this situation should be viewed as having an investment in the property subject to depreciation to the extent of the property's value at the time of acquisition.

Other cases, including decisions of the Second, Fifth, and Ninth Circuits discussed in the *Bergstrom* opinion, have criticized and refused to follow this holding of *Pleasant Summit*, and the Court of Federal Claims sided with the majority view that, where nonrecourse debt exceeds a reasonable approximation of the value of the property, the debt should be disregarded in its entirety for tax purposes. The court found this result to be mandated by the basic concept, stated in *Estate of Franklin* and much of its progeny, that a purchaser of property through nonrecourse financing in excess of the property's value has no investment in the property, and therefore no incentive to pay the debt.

The *Bergstrom* court also rejected the plaintiffs' argument that the court should follow *Regents Park Partners v. Commissioner* (T.C. Memo 1992-336), in which nonrecourse debt taken subject to by a partnership was found to exceed the value of the property which secured the debt, but the debt was nonetheless treated as debt for tax purposes to the extent of the property's value. *Regents Park* involved circumstances that the *Bergstrom* court characterized as unique, including an acquisition in accordance with a workout agreement with the U.S. Department of Housing and Urban Development ("HUD") and an undertaking by HUD's counsel that the debt would be restructured in a manner that would permit it to be paid without placing the partnership in default, and that would provide the partnership with a return on its investment.

The *Bergstrom* opinion states that these unusual circumstances would suffice to distinguish that case from the circumstances at issue in *Bergstrom* even if the Court of Federal Claims agreed with the reasoning of the Tax Court in *Regents Park*, to the effect that the debt should be taken into account to the extent of the property's value where the circumstances made it likely that the partnership would not abandon the property and would continue to make payments on the debt.

Conclusions

Logically, the holding of *Bergstrom* appears to be more sound than the contrary holding of *Pleasant Summit*. If a nonrecourse debt incurred in connection with the acquisition of property substantially exceeds the value of the property at the time of acquisition, absent unusual circumstances the purchaser has no equity in the property and little or no economic incentive to acquire such equity by amortizing the debt. It is therefore difficult to conclude that the debt should be treated to any extent as an obligation of the purchaser for purposes of determining the purchaser's basis in the property. *Regents Park* may be distinguished as a case where the lender had committed at the time of acquisition to modify the debt in a manner that would permit the purchaser to service it and retain the property.

It is somewhat disturbing, however, that the Court of Federal Claims was unwilling to analyze in depth the effect of special financing provisions, such as below-market interest rates, that appeared to make the present value of the payments required to be made on each debt obligation substantially less than the stated principal amount. If the present value of the debt as so computed approximated the value of the property securing the debt, the case for respecting the debt for tax purposes seems much stronger.