Proesel v. Commissioner, 77 T. C. 992 (1981)

A partner's adjusted basis in a partnership includes their pro rata share of partnership liabilities, including those incurred before their admission, if they assume such liabilities.

Summary

James Proesel, a partner in Chico Enterprises, claimed a loss deduction for 1972 based on the worthlessness of his interest in a film production partnership, Benwest. The Tax Court held that Proesel could include his pro rata share of Benwest's liabilities in his basis, even those incurred before Chico joined Benwest, due to an express assumption of liability in the partnership agreement. However, the court denied the loss deduction for 1972 because Proesel failed to prove the film's rights became worthless that year, as efforts to exploit the film continued until 1977.

Facts

James Proesel invested in Chico Enterprises in 1971, which became a partner in Benwest, a partnership producing the film "To Catch a Pebble. " Benwest had contracted with Gavilan Finance Co. to produce the film, with payment due upon delivery, not contingent on the film's commercial success. By the end of 1972, Gavilan had not paid Benwest, and efforts to find a distributor were unsuccessful. Proesel claimed a loss deduction in 1972, arguing the film's rights were worthless.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Proesel's taxes for 1971 and 1972. Proesel petitioned the U. S. Tax Court, which upheld the deficiencies for 1971 due to Proesel's concession that production costs should be capitalized. For 1972, the court found that Proesel could include his share of Benwest's liabilities in his basis but denied the loss deduction, ruling the film's rights did not become worthless until 1977.

Issue(s)

1. Whether a partner's adjusted basis in a partnership includes their share of partnership liabilities incurred before their admission as a partner.
2. Whether Proesel was entitled to a loss deduction in 1972 for the worthlessness of his interest in the film's production rights.

Holding

1. Yes, because the partnership agreement expressly provided for the incoming partners to assume preexisting liabilities, allowing Proesel to include his pro rata share of all Benwest liabilities in his basis.
2. No, because Proesel failed to prove that the film's rights became worthless in

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1972, as efforts to exploit the film continued until at least 1977.

Court’s Reasoning

The court applied section 752(a) of the Internal Revenue Code, which considers an increase in a partner’s share of partnership liabilities as a contribution to the partnership, thus increasing their basis. The court found that the Benwest partnership agreement’s language clearly indicated an express assumption of preexisting liabilities by incoming partners, including Chico, thus allowing Proesel to include his share of all Benwest liabilities in his basis. Regarding the worthlessness of the film’s rights, the court emphasized that a loss must be evidenced by closed and completed transactions, fixed by identifiable events. Proesel failed to prove that the film’s rights became worthless in 1972, as efforts to exploit the film continued until 1977, when Mercantile foreclosed on the film. The court also noted that the mere breach of a contract by Gavilan was insufficient to establish a loss without showing that litigation would be fruitless.

Practical Implications

This decision clarifies that a partner’s basis can include their share of partnership liabilities incurred before their admission if the partnership agreement expressly assumes such liabilities. Practitioners should ensure that partnership agreements clearly state the assumption of preexisting liabilities by incoming partners. For loss deductions, taxpayers must demonstrate that property became worthless in the year claimed, not merely that its value diminished. This case illustrates the importance of documenting efforts to exploit assets and the potential futility of litigation before claiming a loss. Subsequent cases have followed this precedent in determining a partner’s basis and the timing of loss deductions.

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