## *George F. Smith, Jr. , Petitioner v. Commissioner of Internal Revenue, Respondent, 84 T. C. 889 (1985)*

An individual partner's assumption of partnership debt does not entitle the partner to deduct interest payments as personal interest, but may increase the partner's basis in the partnership interest.

### Summary

In Smith v. Commissioner, the court addressed two key issues related to a partner's tax treatment upon assuming partnership debt. George F. Smith, Jr. , assumed a nonrecourse mortgage liability of his partnership, which he argued entitled him to deduct interest payments made on the debt. The court disagreed, holding that the payments were not deductible as personal interest because they were not made on Smith's indebtedness. However, the court did allow that the assumption increased Smith's basis in the partnership for purposes of calculating gain upon the subsequent incorporation of the partnership. The case underscores the distinction between direct liability for debt and the tax implications of assuming another's liability, impacting how partners should structure and report such transactions.

### Facts

George F. Smith, Jr. , and William R. Bernard formed a partnership to purchase real property in Washington, D. C. , financed by a nonrecourse note secured by a deed of trust on the property. In 1978, amid legal disputes, Smith assumed the partnership's obligation to pay the note and interest. Following this assumption, the partners exchanged their interests for corporate stock in a transaction qualifying under Section 351 of the Internal Revenue Code. Smith made interest payments on the note after the incorporation and sought to deduct these as personal interest expenses. He also argued that his basis in the partnership should not reflect the partnership's liabilities as he had assumed them personally.

### Procedural History

The Commissioner of Internal Revenue determined deficiencies in Smith's federal income taxes for the years 1976-1978, including disallowing his interest deductions and assessing gain on the incorporation transaction. Smith petitioned the U. S. Tax Court for redetermination of these deficiencies. The case was submitted fully stipulated under Rule 122 of the Tax Court.

### Issue(s)

1. Whether Smith may deduct as interest payments made during 1978 on the nonrecourse note assumed from the partnership.
2. Whether Smith must recognize gain on the transfer of his partnership interest in exchange for corporate stock under Section 357(c) of the Internal Revenue Code.

 

## Holding

1. No, because the payments were not made on indebtedness; the obligation was between Smith and the partnership, not Smith and the creditor.
2. Yes, because the corporation acquired the partnership interests subject to the note, and the liability was Smith's as among the partners, resulting in a gain of $197,344 under Section 357(c).

## Court's Reasoning

The court reasoned that to deduct interest under Section 163(a), the payment must be made on the taxpayer's own indebtedness, which Smith's payments were not. They were made pursuant to his agreement with the partnership, not directly to the creditor. The court rejected Smith's argument that his assumption transformed the nonrecourse obligation into a personal debt, citing the lack of direct liability to the creditor. However, for purposes of calculating his basis in the partnership interest before the incorporation, the court found that Smith's assumption increased his basis under Section 752(a) because he took on ultimate liability for the debt. This increased basis affected the calculation of gain under Section 357(c) upon the transfer of the partnership interests to the corporation. The court also clarified that the corporation's acquisition of the partnership interests was subject to the note, despite Smith's assumption, because the property remained liable to the creditor.

## Practical Implications

This decision highlights the importance of structuring debt assumptions carefully in partnership agreements and understanding their tax implications. Partners who assume partnership liabilities may not deduct interest payments unless they are directly liable to the creditor. However, such assumptions can increase the partner's basis in the partnership, affecting gain calculations upon disposition of the interest. Practitioners should advise clients to document clearly the nature of any debt assumption and its intended tax treatment. The case also reinforces that in corporate formations, liabilities encumbering partnership property will be considered for Section 357(c) purposes, even if assumed by an individual partner. Subsequent cases have followed this reasoning, emphasizing the need for careful tax planning in partnership transactions involving debt.

 