Driggs v. Commissioner, 87 T. C. 759 (1986)

Nonrecourse notes lacking economic substance cannot be considered part of the principal sum for amortization deductions under Section 1253.

Summary

Driggs v. Commissioner involved a partnership's acquisition of a license to market a computer-assisted translation system. The partnership paid $5. 2 million in cash and was to issue $8 million in nonrecourse notes. The issue was whether these notes could be included in the "principal sum" for amortization deductions under Section 1253. The Tax Court held that the notes lacked economic substance and were too speculative, thus not includable in the principal sum. The court found the license's value to be no more than $5. 2 million, allowing only $520,000 per year in amortization deductions for 1979 and 1980. Additionally, the court disallowed deductions for "sponsor's fees" due to insufficient evidence.

Facts

Span-Eng Associates, a partnership, acquired a 20-year license from Weidner Communications Systems, Inc. , to market a computer-assisted translation system called the "Span-Eng System. " The partnership paid $2. 6 million in 1979 and $2. 6 million in 1980, and agreed to issue eight $1 million nonrecourse notes from 1985 to 1992. These notes could be satisfied at the partnership's option and were secured only by the partnership's assets. The license agreement could be terminated by the partnership without penalty upon 30 days' notice. The partnership also paid "sponsor's fees" to its general partner, Alta Communications, Inc. , totaling $308,000 in 1979 and $188,900 in 1980.

Procedural History

The Commissioner of Internal Revenue challenged the partnership's claimed deductions for the cash payments and sponsor's fees. The case was consolidated for trial, briefing, and opinion in the United States Tax Court. The court's decision focused on whether the nonrecourse notes constituted part of the "principal sum" under Section 1253 and whether the sponsor's fees were deductible.

Issue(s)

1. Whether nonrecourse notes can be considered part of the "principal sum" for purposes of computing amortization deductions under Section 1253?
2. Whether the nonrecourse notes have economic substance and are not too speculative or contingent?
3. Whether the "sponsor's fees" paid to the general partner are currently deductible?

Holding

1. No, because the nonrecourse notes lack economic substance and are too speculative and contingent to be considered part of the “principal sum” under Section 1253.
2. No, because the notes’ value was not supported by the underlying value of the license and were essentially payable only out of future revenues.
3. No, because petitioners failed to provide sufficient evidence to delineate the “sponsor’s fees” into deductible and non-deductible categories.

Court’s Reasoning

The court applied Section 1253, which governs the amortization of franchise and license fees, and considered whether the nonrecourse notes could be considered “payments” under the statute. The court referenced its prior decision in Jackson v. Commissioner, which allowed nonrecourse notes to be considered payments if they had economic substance. However, in this case, the court found the notes lacked economic significance because the stated purchase price of $13. 2 million far exceeded the license’s value, which was determined to be no more than $5. 2 million. The court also noted the notes were too contingent and speculative, as they were only payable out of future revenues, and the partnership could terminate the license agreement without penalty. For the “sponsor’s fees,” the court held that petitioners did not meet their burden of proof to show these were deductible expenses, as they failed to provide evidence to distinguish between syndication and organization costs.

Practical Implications

This decision underscores the importance of economic substance in tax transactions involving nonrecourse debt. Taxpayers cannot rely on nonrecourse notes to inflate the “principal sum” for amortization deductions under Section 1253 if the notes lack economic substance and are too contingent. Practitioners should carefully evaluate the underlying value of assets when structuring transactions involving nonrecourse debt. Additionally, this case highlights the necessity of maintaining detailed records to support the deductibility of fees, such as sponsor’s fees, to avoid disallowance. Subsequent cases have cited Driggs to emphasize the requirement for economic substance in nonrecourse debt transactions and the strict scrutiny of deductions related to partnership organization and syndication.