Melvin v. Commissioner, 88 T. C. 63 (1987)

A taxpayer is considered at risk under section 465 for borrowed amounts only up to their personal liability and not protected against loss.

Summary

Marcus W. Melvin, through his partnership Medici, invested in ACG, a limited partnership, and claimed a loss based on his at-risk amount. The court held that Melvin was at risk for his $25,000 cash contribution and his pro rata share of a $3. 5 million bank loan to ACG, but not for amounts exceeding his pro rata share due to his right of contribution from other limited partners. Additionally, the court ruled that Melvin and his wife were taxable on the fair rental value of their personal use of corporate automobiles, less reimbursements, as a constructive dividend.

Facts

Marcus W. Melvin was a general partner in Medici, which invested in ACG, a California limited partnership, by paying a $35,000 cash downpayment and issuing a $70,000 recourse promissory note. ACG obtained a $3. 5 million recourse loan from a bank, pledging the promissory notes of its limited partners, including Medici's, as collateral. ACG used the loan to purchase a film. Melvin claimed a $75,000 loss on his 1979 tax return, including his share of the bank loan. Additionally, Melvin and his wife used corporate automobiles for personal purposes, reimbursing the corporation at a rate based on IRS guidelines.

Procedural History

The Commissioner issued deficiency notices to Melvin and his wife for 1979 and to Melvin's professional corporation. The cases were consolidated and tried before the U. S. Tax Court, which issued its decision on January 12, 1987.

Issue(s)

1. Whether Marcus W. Melvin was at risk under section 465 for the portion of the $3. 5 million bank loan to ACG that exceeded his pro rata share thereof?
2. Whether Melvin and his wife properly reported income from their personal use of corporate automobiles?
3. Whether Melvin's professional corporation was entitled to deduct the cost of providing the automobiles for Melvin's and his wife's personal use?

Holding

1. No, because Melvin was protected against loss for amounts exceeding his pro rata share by a right of contribution from other limited partners.
2. No, because the fair rental value of their personal use of the corporate automobiles, less reimbursements, constituted a constructive dividend taxable to

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Melvin.
3. No, because the corporation could not deduct costs attributable to personal use of the automobiles that exceeded reimbursements.

Court’s Reasoning

The court applied section 465 to determine Melvin’s at-risk amount, focusing on his personal liability and protection against loss. The court found Melvin personally liable for his pro rata share of the bank loan but not for amounts exceeding this share due to his right of contribution under California law. The court emphasized the substance over form of the financing, noting that the limited partners’ recourse obligations were the ultimate source of repayment if ACG failed to repay the loan. For the personal use of corporate automobiles, the court treated the fair rental value as a constructive dividend to Melvin, less reimbursements, following established precedents on the valuation of personal benefits from corporate property.

Practical Implications

This decision clarifies that investors in partnerships are at risk only for amounts they are personally liable for and not protected against loss, affecting how similar investments should be analyzed for tax purposes. It underscores the importance of understanding state partnership laws regarding rights of contribution among partners. The ruling also affects how corporations and shareholders handle personal use of corporate property, reinforcing the need to report the fair market value of such use as income. Subsequent cases have cited Melvin for guidance on at-risk rules and the taxation of personal benefits from corporate assets.

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