Davis v. Commissioner, 88 T. C. 122 (1987)

A foreclosure sale followed by a resale to a related entity does not result in a deductible loss if it is part of a prearranged plan to retain economic interest in the property.

Summary

Frank C. Davis, Jr. , sought to claim an ordinary loss from the foreclosure of Brookwood Apartments, a partnership in which he was a general partner. The Tax Court disallowed the loss, finding that the foreclosure and subsequent resale to a related partnership, C, D & G, were part of a prearranged plan to retain economic interest in the property without realizing a genuine economic loss. The court also ruled that Lewis E. Gaines, not Gaines Properties, was the general partner in seven other partnerships, and Davis failed to prove entitlement to a bad debt deduction for guaranteed payments.

Facts

Frank C. Davis, Jr. , and Grace K. Davis filed joint federal income tax returns for 1974-1976. Davis invested in a limited partnership, Gaines Properties (Properties), where Lewis E. Gaines was the managing partner. Davis was also a general partner in Brookwood Apartments, which faced financial difficulties leading to a foreclosure by Third National Bank. Prior to the foreclosure, an agreement was reached to resell the property to a new partnership, C, D & G, formed by Davis, Gaines, and another individual. The court also considered whether Properties or Gaines was the general partner in seven other partnerships.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Davis's taxes for 1974-1976. Davis petitioned the Tax Court, which held that: (1) Lewis E. Gaines, not Properties, was the general partner in the seven partnerships; (2) the foreclosure and resale of Brookwood Apartments did not result in a deductible loss; and (3) Davis failed to prove entitlement to a bad debt deduction for guaranteed payments from Brookwood.

Issue(s)

1. Whether Lewis E. Gaines, individually, or Gaines Properties was the general partner in the seven limited partnerships during the years in issue.
2. Whether Davis is entitled to a claimed ordinary loss in 1975 due to the foreclosure and resale of Brookwood Apartments.
3. Whether Davis is entitled to a bad debt deduction in 1975 for amounts accrued by Brookwood as guaranteed payments in 1973 and 1974.

Holding

© 2025 SCOTUSreports.com. All rights reserved.

1. No, because the court found that Gaines, not Properties, was the general partner in the seven limited partnerships due to lack of compliance with partnership agreement restrictions and consistent documentation by Gaines as the general partner.
2. No, because the foreclosure and resale were part of a prearranged plan to retain economic interest in the property, resulting in no genuine economic loss to Davis.
3. No, because Davis failed to provide sufficient evidence of the existence of a debt, its worthlessness, and his efforts to collect it.

Court's Reasoning

The court applied the legal principle that a loss from a sale between related entities is disallowed if it is part of a prearranged plan to retain economic interest in the property. The court found that the foreclosure and resale of Brookwood Apartments were prearranged, evidenced by bank finance committee minutes and the ultimate result of the same parties retaining economic interest in the property. The court also applied the Uniform Limited Partnership Acts, finding that Gaines, not Properties, was the general partner in the seven partnerships due to non-compliance with partnership agreement restrictions on assignment of the general partnership interest. For the bad debt deduction, the court required Davis to prove the existence of a debt, its worthlessness, and efforts to collect it, which he failed to do.

Practical Implications

This decision impacts how foreclosure sales and resales to related entities should be analyzed for tax purposes. It establishes that a prearranged plan to retain economic interest in property can disallow a claimed loss. Tax practitioners should carefully document the economic realities of transactions and ensure compliance with partnership agreements. The ruling also highlights the importance of proving the elements of a bad debt deduction. Later cases have applied this ruling to similar situations involving related entities and prearranged plans.

© 2025 SCOTUSreports.com. All rights reserved.