Gershkowitz v. Commissioner, 88 T. C. 984 (1987)

The insolvency exception to the recognition of discharge of indebtedness income applies at the partner level, not the partnership level.

Summary

In Gershkowitz v. Commissioner, the Tax Court held that the insolvency exception to the discharge of indebtedness income doctrine applies at the individual partner level, not the partnership level. The case involved limited partners in four partnerships that marketed computer programs for tax preparation and financial planning. The partnerships were insolvent and liquidated, with debts forgiven or settled by returning assets to creditors. The court determined that partners must recognize ordinary income from debt discharge unless they are personally insolvent, and that the full amount of nonrecourse debt discharged must be recognized as income, not just the value of the assets securing the debt. Additionally, the court found that amendments to the partnership agreements lacked substantial economic effect.

Facts

The petitioners were limited partners in four limited partnerships formed in 1972 to market computer programs for tax preparation, estate planning, and financial planning. The partnerships purchased programs with nonrecourse notes and obtained nonrecourse loans from various entities, including COAP, COAP Planning, Inc. , Digitax, Inc. , and Prentice-Hall. By 1977, all partnerships were insolvent and liquidated. The debts were discharged either through forgiveness or by reconveying the security for the loans back to the creditors. Amendments were made to the partnership agreements to allocate gains and losses in a specific manner during liquidation.

Procedural History

The Commissioner of Internal Revenue issued notices of deficiency to the petitioners for their 1977 federal income taxes, asserting that the discharge of the partnerships' nonrecourse debts resulted in taxable income to the partners. The petitioners challenged these deficiencies in the United States Tax Court. The court considered the issues and rendered its decision in 1987.

Issue(s)

1. Whether the cancellation of nonrecourse debts of the partnerships resulted in taxable income to the partners under section 61(a)(12) of the Internal Revenue Code, and whether it resulted in a deemed distribution of money under section 752(b) taxable as capital gain under section 731(a)(1)?
2. Whether the partnerships realized gain upon the reconveyance of computer programs and systems in exchange for the extinguishment of nonrecourse debt, and

the character of such gain?
3. Whether the partners realized a loss under section 1001 upon the exchange of COAP stock for the extinguishment of nonrecourse debt owed by the partnership?
4. Whether the 1977 amendment to the partnership agreement had substantial economic effect within the meaning of section 704(b)?

Holding

1. Yes, because the insolvency exception applies at the partner level, and the partners were solvent in 1977, they must recognize ordinary income from the discharge of indebtedness.
2. Yes, because the reconveyance of property to creditors in satisfaction of indebtedness is a sale or exchange on which gain or loss must be recognized, and the gain is characterized as ordinary income to the extent of depreciation recapture.
3. Yes, because the exchange of COAP stock for the extinguishment of debt is a sale or exchange, and the partners realized a capital loss to the extent their basis in the stock exceeded the debt extinguished.
4. No, because the amendments to the partnership agreement did not have substantial economic effect and were designed solely for tax avoidance purposes.

Court's Reasoning

The court applied the discharge of indebtedness doctrine under section 61(a)(12) and the partnership distribution provisions under section 752(b). It rejected the application of the insolvency exception at the partnership level as suggested in Stackhouse v. Commissioner, finding that the exception should apply at the partner level, consistent with the Bankruptcy Tax Act of 1980. The court also held that the full amount of the nonrecourse debt discharged must be recognized as income, not just the value of the collateral, to prevent abuse by tax shelter partnerships. The reconveyance of computer programs to creditors was treated as a sale or exchange under section 1001, with the gain characterized as ordinary income to the extent of depreciation recapture. The exchange of COAP stock for debt extinguishment resulted in a capital loss. The amendments to the partnership agreements were found to lack substantial economic effect because they were designed to manipulate tax liabilities without reflecting the economic reality of the partnerships.

Practical Implications

This decision clarifies that the insolvency exception to discharge of indebtedness income applies at the individual partner level, affecting how partners in insolvent partnerships must report income from debt forgiveness. It also establishes that the full amount of nonrecourse debt discharged must be recognized as income, which impacts the tax planning of partnerships with nonrecourse liabilities. The ruling on the reconveyance of property as a sale or exchange, and the treatment of the 1977 amendments, underscores the importance of ensuring that partnership agreements reflect economic reality and are not solely for tax avoidance. This case has influenced subsequent court decisions and IRS guidance on the treatment of partnership debt and the application of section 704(b) regarding substantial economic effect.

