Follender v. Commissioner, 89 T. C. 943, 1987 U. S. Tax Ct. LEXIS 155, 89 T. C. No. 66 (1987)

A taxpayer's at-risk amount for borrowed funds under section 465 is the full amount of the principal they are personally liable for, without discounting to present value.

Summary

In Follender v. Commissioner, the U. S. Tax Court addressed whether a limited partner's at-risk amount should be discounted to present value when assuming the principal obligation of a recourse note without interest. David Follender assumed a portion of a $4. 6 million recourse purchase note for a motion picture investment, but not the nonrecourse interest. The court held that Follender's at-risk amount was the full $257,058 of principal assumed, rejecting the Commissioner's argument for discounting to present value. This decision clarified that section 465 does not require present value calculations for at-risk amounts, focusing instead on the actual liability for the borrowed amount.

Facts

David B. Follender and Irma R. Follender, as limited partners in Brooke Associates, invested in the motion picture "Body Heat. " Brooke Associates purchased the film from the Ladd Company for $9,940,000, financing it with a $4,600,000 recourse purchase note due in 1991. Follender assumed primary obligation for $257,058 of the note's principal but not the nonrecourse interest. The partnership's offering memorandum detailed the investment structure, including the recourse note and the limited partners' obligations.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the Follenders' 1981 federal income taxes, arguing that Follender's at-risk amount should be discounted to present value. The case was heard by the U. S. Tax Court, which issued its opinion on October 28, 1987, holding that the at-risk amount should not be discounted.

Issue(s)

1. Whether Follender's at-risk amount should be increased by the full $257,058 of the recourse purchase note's principal he assumed, without discounting to present value.
2. Whether nonrecourse interest on the recourse purchase note should be treated as contingent interest under section 483, affecting the partnership's basis in the motion picture.
3. Whether Follender would be liable for increased interest under section 6621(c) if the court decided the at-risk issue in favor of the Commissioner.

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Holding

1. Yes, because section 465 does not require discounting borrowed amounts to present value when determining at-risk amounts. Follender's at-risk amount was the full $257,058 he assumed.
2. No, because the nonrecourse interest was not contingent interest under section 483, as its liability and amount were determinable at the time of sale.
3. This issue was not reached because the court held for Follender on the at-risk issue.

Court's Reasoning

The court reasoned that section 465(b)(2) allows taxpayers to be considered at risk for amounts borrowed to the extent they are personally liable, without any statutory directive to discount these amounts to present value. The court rejected the Commissioner's argument that the difference between the face value and present value of the obligation constituted an amount protected against loss under section 465(b)(4). The court also found that the nonrecourse interest on the recourse note was not contingent under section 483, as its rate and due date were fixed, and the likelihood of payment was supported by pre-release revenue estimates. The court's decision was unanimous, with no dissenting opinions, and emphasized the legislative intent behind section 465 to limit deductions to amounts economically at risk.

Practical Implications

This decision provides clarity for tax practitioners and investors in structured financing arrangements, particularly those involving recourse and nonrecourse obligations. It confirms that at-risk amounts under section 465 should be calculated based on the full amount of the principal obligation, without applying present value discounting. This ruling impacts how partnerships and investors structure their financing to maximize tax benefits while ensuring compliance with at-risk rules. It also affects how the IRS assesses at-risk amounts in audits, potentially reducing disputes over valuation methods. Subsequent cases, such as Melvin v. Commissioner, have reinforced this principle, guiding practitioners in advising clients on the tax treatment of similar investment structures.

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