***Hulter v. Commissioner, 91 T. C. 371 (1988)***

Nonrecourse debt significantly exceeding property value and transactions lacking economic substance do not allow for tax deductions.

**Summary**

In Hulter v. Commissioner, the Tax Court held that Tudor Associates, Ltd. , II (Tudor II), a limited partnership, did not acquire ownership of North Carolina real property due to the lack of economic substance in the transaction. The partnership used a nonrecourse debt of $24. 5 million, which far exceeded the property's $14. 5 million fair market value. The court also found that Tudor II's activities were not engaged in for profit, thus disallowing deductions for depreciation and operating expenses. This case underscores the scrutiny applied to inflated nonrecourse debt and the importance of a genuine profit motive in tax shelter arrangements.

**Facts**

OCG Enterprises, Inc. , controlled by George Osserman and Paul Garfinkle, negotiated to purchase real property from C. Paul Roberts. OCG then planned to sell these properties to Tudor II, a limited partnership, at an inflated price. The partnership executed a $24. 5 million nonrecourse promissory note to OCG, secured by a wraparound mortgage. The properties' fair market value was appraised at approximately $14. 5 million. Tudor II's financial records were poorly maintained, and it filed late or incorrect tax returns. The partnership eventually filed for bankruptcy, and the properties were sold off at a significant loss.

**Procedural History**

The Commissioner of Internal Revenue issued notices of deficiency to the Hulters and Bryans, investors in Tudor II, disallowing their claimed deductions. The Tax Court consolidated these cases with others involving Tudor II. The court heard arguments on whether the sale of the properties to Tudor II was a sham, the validity of the nonrecourse debt, and whether Tudor II's activities were engaged in for profit.

**Issue(s)**

1. Whether, and if so when, the sale of real property to Tudor II occurred for tax purposes.
2. Whether the $24. 5 million nonrecourse debt obligation represented genuine indebtedness.
3. Whether the activities of Tudor II with respect to the acquisition and management of real property constituted an activity engaged in for profit.

**Holding**

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1. No, because the transaction lacked economic substance and the stated purchase price significantly exceeded the fair market value of the properties.
2. No, because the nonrecourse debt was inflated and did not represent genuine indebtedness.
3. No, because Tudor II's activities were not engaged in for profit, as evidenced by the lack of businesslike operations and the inflated debt structure.

**Court's Reasoning**

The court applied the economic substance doctrine, emphasizing that the form of a transaction does not control for tax purposes if it lacks economic reality. The court found that the $24. 5 million nonrecourse debt, nearly double the property's fair market value, precluded any realistic profit for Tudor II. The court also noted the backdating of documents, failure to record deeds timely, and the use of a fabricated office fire excuse for missing documents as evidence of bad faith. The lack of businesslike operation, including the hiring of an inexperienced general partner and retention of the properties' former owner as manager despite his history of mismanagement, further supported the finding that Tudor II lacked a profit motive. The court relied on the principle that for debt to exist, the purchaser must have a reasonable economic interest in the property, which was absent here due to the inflated debt.

**Practical Implications**

This decision highlights the importance of ensuring that transactions have economic substance beyond tax benefits. Practitioners should be cautious when structuring deals with nonrecourse debt significantly exceeding property value, as such arrangements may be disregarded for tax purposes. The case also emphasizes the need for partnerships to operate in a businesslike manner with a genuine profit motive to claim deductions. Subsequent cases involving tax shelters and inflated debt have often cited Hulter to support disallowance of deductions. Legal professionals advising clients on real estate investments should ensure that all transactions are well-documented and that the partnership's operations are consistent with a profit-making objective.

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