

“What keeps you up at night?”

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Commonwealth Court Decision Provides Costly Reminder of the Importance of State Tax Planning

By Stanley J. Kull

SUMMARY

Last week, the Pennsylvania Commonwealth Court failed to reverse the imposition of a substantial amount of Pennsylvania personal income tax on a nonresident taxpayer who had suffered the loss of his entire investment in a partnership that owned the US Steel Building in Pittsburgh. This unfortunate and costly result could have been avoided with proper tax planning.

State tax planning is often overlooked when investors enter into or exit real estate investments. The Pennsylvania Commonwealth Court's decision in *Marshall v. Commonwealth*, released on January 3, 2012, shows that this oversight can be extremely costly. In *Marshall* (and companion cases involving the same partnership), out-of-state investors lost their entire investments in a partnership that owned the US Steel Building in Pittsburgh, yet nevertheless ended up owing Pennsylvania personal income tax, penalty and interest *in an amount greater than the amounts they invested and lost in the venture*.

In 1985, Robert Marshall, a Texas resident, invested a net amount of \$142,705 to acquire a small limited partnership interest in 600 Grant Street Associates Limited Partnership, a limited partnership organized to own and manage the US Steel Building in Pittsburgh. To acquire the building, the partnership borrowed \$308 million on a nonrecourse basis. During the next 20 years, the partnership generated substantial tax losses, largely because of the accrual of interest on the partnership's debt, but these tax losses provided no state tax benefit to Mr. Marshall because he had no Pennsylvania income in the same "class" of income (and Texas does not have a state income tax). By 2005, when the lender foreclosed on the partnership's mortgage, the balance of the partnership's debt had ballooned to more than \$2.6 billion as the result of accrued and unpaid interest. As a result of the foreclosure, the partnership was deemed to sell its property for the balance of the outstanding debt (including accrued interest) and Mr. Marshall was allocated a "phantom" (i.e., cashless) taxable gain of nearly \$4 million. The Pennsylvania Department of Revenue (DOR) assessed tax, penalty and interest of \$165,055.24 on Mr.

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Marshall as a result of the foreclosure. The Board of Appeals subsequently abated the imposition of penalties, but the Board of Appeals, Board of Finance and Revenue, and Commonwealth Court all upheld the remainder of the assessment (with the minor caveat that the Commonwealth Court remanded the case for a further determination of the partnership's adjusted basis in the real estate).

In sum, Mr. Marshall invested \$142,705, lost his entire investment, and received no state tax benefits, yet was treated for Pennsylvania personal income tax purposes as realizing a taxable gain of nearly \$4 million and was assessed tax, penalty and interest of \$165,055.24. For federal income tax purposes, Mr. Marshall likely had suspended losses to shelter the phantom income from the foreclosure of the real estate (or he was able to claim tax losses in the years prior to the foreclosure). No such offsets exist in Pennsylvania, however, because the operating losses were in a different “class” of income and could not be carried forward in any event. Moreover, under Pennsylvania law, the gain from foreclosure of the property was treated as Pennsylvania “source” income whereas any offsetting loss from the liquidation of Mr. Marshall's interest in the partnership was deemed to be non-Pennsylvania income.

The tax assessment in *Marshall* bears no relationship to the economic realities of the transaction and might strike most people as inequitable. The DOR could have reached a more reasonable result by applying the tax benefit doctrine, by reducing the “amount realized” from foreclosure by the interest that did not generate any state tax benefit, or permitting the nonresident partners to offset their gain from the foreclosure of the real estate by a loss from the liquidation of their partnership interests. The DOR refused to take any of these alternatives, however, and the Commonwealth Court then deferred to the DOR's exercise of discretion. The Commonwealth Court noted that “we can envision alternative ways for Revenue to apply the Code and Regulations to this particular transaction that could be characterized as more taxpayer-friendly” but then stated that it would defer to the DOR's “reasonable interpretations” of the Code and Regulations. The reasonableness of the DOR's interpretation in this case could perhaps be questioned. Two judges on the court dissented in a well reasoned opinion.

Marshall is a vivid reminder of the importance of getting appropriate federal and state income tax advice, both when entering into an investment and when planning for a foreclosure or other exit event. In the case at hand, Mr. Marshall and other nonresident partners could have avoided paying any Pennsylvania taxes had they sold or abandoned their partnership interests prior to the foreclosure.

It is likely that *Marshall* will be appealed to the Pennsylvania Supreme Court, but there is no assurance that this decision will be overturned. Saul Ewing will continue to monitor this case and further developments. If you have questions about how you can properly plan for the federal and state income tax consequences of a pending real estate investment, foreclosure or sale, please do not hesitate to contact Stanley Kull at skull@saul.com or at 215.972.7105.

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