

1 WRITTEN DECISION - NOT FOR PUBLICATION

2

3 ENTERED 5/15/07

4 FILED

5 MAY 15 2007

6 CLERK, U.S. BANKRUPTCY COURT

7 SOUTHERN DISTRICT OF CALIFORNIA

8 BY 104 DEPUTY

9 UNITED STATES BANKRUPTCY COURT

10 SOUTHERN DISTRICT OF CALIFORNIA

11 In re ) Case No.94-01921-B7

12 )

13 ROBERT KIRK ADAMS, ) ORDER ON TRUSTEE'S OBJECTION

14 ) TO CLAIM NO. 50 (REMAINING

15 Debtor. ) DISPUTED ITEMS)

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16 The parties to whom this Order is directed well know

17 who they are and what this matter is about. However, in

18 case this should fall into the hands of an uninitiated, a

19 brief summary. The primary<sup>1</sup> parties to this matter are

20 Trail Associates, Ltd. (Partnership) which owned an

21 apartment complex in Texas (Property); Judith S. Adams, the

22 limited partner in the Partnership; Robert K. Adams, the

23 husband of Judith and the debtor in this bankruptcy case;

24 Richard M. Kipperman, the Trustee in this bankruptcy case;

25 and the Franchise Tax Board of the State of California

26

<sup>1</sup> Bit players will be introduced below as needed.

1 (FTB), which asserts various state income tax claims in this  
2 case. The dispute involves the sale of the Property by the  
3 Partnership in 1993, and the disposition of three promissory  
4 notes secured, at one point or another, by the Property --  
5 the First Note, Second Note and Wraparound Note.

6 At a prior hearing the Court held that the Wraparound  
7 Note and Second Note had been extinguished prior to 1993.  
8 In response to a subsequent inquiry by the Court the FTB  
9 explained that two additional issues remained to be resolved  
10 - (1) the taxability of the extinguishment in 1993 of the  
11 First Note and (2) the taxable amount of the gain on  
12 termination in 1993 of the Partnership to the Adams.

13 This Court has subject matter jurisdiction pursuant to  
14 28 U.S.C. § 1334 and General Order No. 312-D of the United  
15 States District Court for the Southern District of California.  
16 This is a core proceeding under 28 U.S.C. § 157(b)(2)(A)&(B).  
17

#### 18 **BACKGROUND**

19 The first of the remaining disputes concerns the  
20 modification of the First Note (reduced from approximately \$2.9  
21 million to \$900,000), and the sale of the Property by the  
22 Partnership to Jerrol L. McLeod and the subsequent sale by McLeod  
23 to the holder of the First Note, which resulted in the  
24 cancellation of the remainder of the First Note. The other  
25 concerns the taxable gain to Judith in 1993 on the termination of  
26 the Partnership. The parties, the Trustee and Judith Adams on

1 the one hand and the FTB on the other, have stipulated to most  
2 of the relevant facts as set out in the Stipulation of Facts  
3 filed on September 12, 2006. The Stipulation of Facts provided a  
4 detailed account of the transactions:

5 35. On or about January 25, 1993, Metropolitan  
6 assigned the First Note to Swartz Equities, Inc., a  
7 Texas corporation ("Swartz Equities").

8 36. On or about January 25, 1993, Swartz Equities  
9 assigned the First Note to Northern Trails Apartments,  
10 Ltd. ("NAT"), a limited partnership. Hubbard Lake  
11 West, Inc., was the managing partner of NTA. Anthony  
12 Swartz was the president of Hubbard Lake West, Inc.,  
13 and Swartz Equities.

14 39. Pursuant to a Third Modification of  
15 Promissory Note and Liens Agreement dated February 10,  
16 1993, entered into between the Partnership and NTA,  
17 then holder of the First Note, in consideration of the  
18 payment by the Partnership in the amount of \$50,000  
19 plus accrued interest in the amount of \$50,280.03, or a  
20 total of \$100,280.03, among other consideration, the  
21 principal amount of the First Note was reduced to the  
22 estimated fair market value of the Property, \$900,000.

23 40. Prior to the exercise of the Option, McLeod  
24 had no legally binding obligation to purchase the  
25 Property.

26 41. On or about January 26, 1993, NTA, the then  
owner of the First Note, filed an Application for  
Appointment of Receiver and for Temporary Injunction  
(the "Application") in the District Court for Dallas  
County, Texas (the "Court") requesting that a receiver  
be appointed to collect rents and otherwise manage the  
Property.

42. On February 1, 1993, the Court issued An  
Agreed Order (Temporary Injunction) in response to the  
Application.

43. On February 10, 1993, McLeod exercised his  
Option to purchase the Property from the Partnership  
pursuant to the Option Agreement. Pursuant to the  
Option Agreement, McLeod paid consideration for the  
purchase of the Property in the form of cancellation of  
the Adams Note in the amount of \$50,000 and took

1 subject to the principal and interest due under the  
2 First Note.

3 44. On February 10, 1993, McLeod conveyed the  
4 Property to STA Investments, Inc. the new (that day)  
5 then owner of the First Note, in exchange for \$70,000  
6 and cancellation of the First Note. The above Anthony  
7 Swartz was the president of STA Investments, Inc.  
8 McLeod paid the Partnership eighty-five percent (85%)  
9 of his profit from the resale of the Property.

10 45. On March 2, 1993, the Property was acquired  
11 by NTA pursuant to a Substitute Trustee's Deed.

12 46. The Partnership reported cancellation of  
13 indebtedness income in the amount of \$12,395,989 for  
14 1992 (representing its reported cancellation of the  
15 Wraparound Note) and in the amount of \$2,626,121 for  
16 1993 (representing its reported reduction of the First  
17 Note) in its 1992 and 1993 federal income tax returns.  
18 In addition, for the year 1993 the Partnership reported  
19 a loss for California income tax purposes in the amount  
20 of \$2,969,403 attributable to the sale of the Property.  
21 Robert and Judith reported their 90% share of these  
22 amounts on their California joint personal income tax  
23 returns for 1992 and 1993, as applicable.

24 47. [Partnership's calculation of cancellation of  
25 indebtedness income for 1992.]

26 47. [Partnership's calculation of cancellation of  
indebtedness income for 1993.]

18 Stipulation of Facts, 5:16-6:28.

19 The Stipulation goes on to explain that the Adams took the  
20 position that they were insolvent in 1992 and 1993, and lists  
21 their stipulated assets and liabilities. ¶¶ 51 and 52. It also  
22 explains that the FTB conducted an audit of the Adams' 1992 and  
23 1993 tax returns:

24 55. As a result of the audit, the FTB determined  
25 that no cancellation of debt had occurred in 1992 and  
26 1993, that the Partnership had sold the Property to  
McLeod in 1993, that the amounts due on Note 1, Note 2,  
and the Wraparound Note at the time of such sale had

1           been \$2,919,518, \$4,772,005, and \$8,775,000  
2           respectively, that such three amounts were parts of the  
3           amount realized by the Partnership on its sale of the  
4           Property to McLeod in 1993, and that, minus the basis  
5           of the Property, such amount realized had generated a  
6           gain of \$13,017,612 for the Partnership.

7           56. The FTB assessed a tax deficiency in the  
8           amount of \$1,361,746 (excluding interest and penalty)  
9           against Robert and Judith for Judith's 90% share of the  
10          \$13,017,612 amount described in paragraph 55, above....

11         Stipulation of Facts, 9:24-10:5. The California State Board of  
12         Equalization (CBE) sustained the action of the FTB.

13         On February 22, 1994 Robert Adams filed his petition  
14         commencing this bankruptcy case. The Trustee filed a proof of  
15         claim on behalf of the FTB and filed an objection thereto.

16         Numerous briefs have been filed and hearings held.

17         At the continued hearing on October 25, 2006, the Court  
18         resolved perhaps the most critical issue, holding that the  
19         Wrap-Around Note and the Second Note were cancelled prior to 1993  
20         and thus did not give rise to income (either as realized on the  
21         sale of the Property or as cancellation of indebtedness) in 1993.  
22         This resolved those assertions by the FTB with respect to the  
23         Wraparound and Second Notes. However, the Court recognized there  
24         were likely additional issues with respect to the 1993 tax year:

25                 SO, WE'RE BACK TO THE QUESTION, I SUPPOSE, OF WHAT  
26                 IF ANYTHING REMAINS OF THE TRUSTEE'S OBJECTION TO THE  
27                 19- - THE PROOF OF CLAIM THAT THE TRUSTEE FILED FOR  
28                 1993 WITH RESPECT TO SOMETHING OTHER THAN THE SECOND  
29                 TRUST DEED AND THE WRAP. SPECIFICALLY, INSOFAR AS I  
30                 CAN TELL, WE'RE TALKING ABOUT (A) WHETHER OR NOT THERE  
31                 WAS SOME OTHER TAX CONSEQUENCE THAN HAS BEEN ULTIMATELY  
32                 RESOLVED WITH RESPECT TO THE TREATMENT OF THE FIRST IN  
33                 '93. WE ALL AGREE THAT IN '93 WAS THE EVENT AS TO THE  
34                 FIRST WHEN THE PROPERTY WAS SOLD, AT LEAST SO FAR AS  
35                 I'VE HEARD. I HAVE NOT HEARD ANY CONTENTION WITH

1 RESPECT TO INTEREST AND PENALTIES WHICH ACCRUED AFTER  
2 THE DATE OF FILING OF THE PETITION, AND I ASSUME THERE  
3 IS NONE. BUT SO IT'S THAT ONE QUESTION: DO WE HAVE  
4 SOME TAX ISSUE TO RESOLVE WITH RESPECT TO THE TREATMENT  
5 OF THE FIRST?

6 NOW, WE HAVE THIS PECULIAR CIRCUMSTANCE IN THAT  
7 THIS WHOLE THING WAS TEED UP BY THE TRUSTEE, TRYING TO  
8 GET AT THE 1992 ISSUE IN TERMS OF WHAT DID OR DID NOT  
9 OCCUR AND COMPLETION OF THAT; AND THE FOCUS HAS BEEN ON  
10 THAT, IT'S NOT REALLY BEEN ON THE FIRST OR HOW IT'S  
11 BEEN HANDLED EXCEPT WHEN WE GOT TO MR. BASNEY'S  
12 DECLARATION AND - AND THE FTB'S RESPONSE IN THE  
13 PLEADINGS TO IT. BUT THAT TO ME IS, AT LEAST AS I READ  
14 IT, OUTSIDE THE SCOPE OF THE CURRENT OBJECTION FILED BY  
15 THE TRUSTEE.

16 October 25, 2006 Transcript at 48:19-49:16. The Court set the  
17 matter for a subsequent status conference and then instructed the  
18 parties to file briefs on the issue.

19 The FTB responded with its February 12, 2007 "Supplemental  
20 Trial Brief On Remaining Disputed Items (First Note and Gain on  
21 Termination of Partnership) of Claimant Franchise Tax Board on  
22 Objection of Trustee and Other Party in Interest to Claim No.  
23 50," (FTB Supp. Trial Brief). The FTB explained that the  
24 "disputed items remaining before the Court are (1) the taxability  
25 of the extinguishment in 1993 of the First Note and (2) the  
26 taxable amount of the gain (resulting from the extinguishment in  
1987 or 1992 of the Second Note and the Wraparound Note) on the  
termination in 1993 of the partnership in question." FTB Supp.  
Trial Brief at 1:11-15.

A hearing was held on these remaining issues, and the Court  
took the matters under submission.

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1 DISCUSSION

2 **Extinguishment of the First Note**

3 As set forth above, pursuant to the Third Modification of  
4 Promissory Note and Liens Agreement dated February 10, 1993, the  
5 First Note was written down from approximately \$2.9 million to  
6 \$900,000 (the estimated fair market value of the Property). The  
7 Partnership and the Adams treated the write-down of the First  
8 Note as cancellation of indebtedness income (CODI). On the same  
9 date McLeod exercised his option to purchase the Property from  
10 the Partnership. He then sold the Property to STA.

11 The FTB urges the Court to ignore the various transactions  
12 and treat them all, including the write-down of the First Note,  
13 as one sale of the Property. See Transcript, 26:1-2. Using this  
14 approach, the FTB contends that the extinguishment of the First  
15 Note in 1993 was not CODI, but rather taxable income to the  
16 Partnership as additional consideration received on the sale of  
17 the Property.

18 In support of its position the FTB argues that the  
19 Stipulation of Facts establishes that the Partnership transferred  
20 the Property subject to the First Note to the holder of the First  
21 and that that conveyance extinguished the Note:

22 Paragraphs 35, 36, and 39 through 45 of the  
23 STIPULATION OF FACTS ... show how the Partnership  
24 conveyed the Property encumbered by the First Note to  
25 the holder of that note and how the conveyance  
26 extinguished that note. The various steps and  
intermediaries are irrelevant. The holder of the First  
Note received the Property, and the First Note was  
extinguished.

1 FTB Supp. Trial Brief at 3:3-8.<sup>2</sup>

2 The Court finds that the stipulated facts do not establish  
3 that the various transactions were merely a part of one sale of  
4 the Property.<sup>3</sup> The stipulated facts establish no connection  
5 between the Partnership and STA save as creditor/debtor. The  
6 holder of the First Note and the Partnership had the divergent  
7 interests which would be expected of a creditor and debtor --  
8 prior to the write-down of the First Note and McLeod's exercise  
9 of his option, the holder of the First Note had applied for a  
10 receiver to take over the Property and the state court had issued  
11 a TRO on February 1, 1993.

12 In its Brief, the FTB provides no other evidence or argument  
13 to support its single transaction argument. However, at the  
14 hearing, counsel for the FTB explained that additional evidence  
15 of this being a single transaction "exists by way of admission by  
16 the Trustee and by Mrs. Adams in this lawsuit. That admission  
17 is contained in the joint opening brief for the hearing that was  
18 held on September 20<sup>th</sup>, 2006." Transcript at 26:4-7. Counsel  
19 argued that the admission was on page 7 of the Trustee's August  
20 9, 2006, trial brief which reads:

21 At the time at which the transactions described  
22 above were entered into, the value of the Property was

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23 <sup>2</sup> At the September 20, 2006 hearing counsel for the FTB explained "there's no issue of  
24 burden of proof. All the facts have been stipulated."

25 <sup>3</sup> The FTB does not use the term "step transaction," however, that is what in essence it asks  
26 the Court to find.

1 less than the amount of the First Note. Because the  
2 Partnership was not able to stay current on either the  
3 First Note, the Second Note or the Wraparound Note, the  
4 Partnership's interest in the Property went more  
5 "underwater" each month. As such, there was almost no  
6 possibility that the Partnership would ever make any  
7 money from the Property. By entering into the  
8 transaction as structured, the Partnership retained the  
9 possibility of enjoying 85% of any upside (any sales  
10 proceeds in excess of \$900,000), realized by McLeod  
11 upon a sale of the Property for a period of one year.  
12 Even if McLeod did not sell the Property within that  
13 period, the Partnership was relieved of dealing with  
14 the problem real estate. From McLeod's standpoint,  
15 there are a couple of reasons why the transaction, as  
16 structured was the preferred form. First, if the  
17 Partnership, as the debtor, had a legal defense against  
18 McLeod's predecessor owner of the Second Note or the  
19 Wraparound Note, that defense would have been  
20 enforceable against McLeod. By structuring the  
21 transaction as it was structured, any defenses  
22 available to the Partnership against McLeod were wiped  
23 out. Further, if the amount of the First Note had been  
24 reduced following a foreclosure by McLeod, McLeod could  
25 have been exposed to the adverse tax consequences of  
26 the cancellation of indebtedness. Because the First  
Note was reduced to \$900,000 prior to the transfer to  
McLeod, any tax consequences of the reduction of the  
First Note remained the Partnership's problem. In  
addition, any adverse effect on the credit record from  
the reduction of the First Note, would impact the  
Taxpayers, rather than McLeod. Finally, prior to the  
transaction, the Second Note and the Wraparound Note  
were worthless. By accepting the Adams Note, which was  
with full recourse to Judith Adams, McLeod had the  
possibility of pursuing Judith Adams personally for the  
amount of the Adams Note. Accordingly, there was a  
strong business purpose for the transaction, aside from  
avoidance of tax on the disposition of the Property.

21 Trustee's Opening Brief at 7:1-24.

22 The brief explains the Partnership's and McLeod's interests  
23 in the various transactions, but provides no evidence that ties  
24 the write-down of the First Note to the ultimate sale to STA.  
25 The description of the various interests does not establish that  
26 the Partnership had any involvement in McLeod's sale of the

1 Property to STA. The Partnership sold an option to McLeod and he  
2 was free to do what he would with the option and, after exercise  
3 thereof, with the Property. There is no evidence that he was  
4 acting for, on behalf or at the direction of the Partnership or  
5 the Adams.

6 At the February 26, 2007 hearing counsel for the Taxpayers  
7 explained, to the satisfaction of the Court, that the term  
8 "transaction" in the brief referred to the Cancellation  
9 Agreement, not to all of the various transactions resulting in  
10 the sale to STA.

11 The Court has reviewed the trial brief, including page 7  
12 upon which The FTB most strongly relied, and finds no admission  
13 or evidence that the various transactions were designed, from the  
14 perspective of the Partnership, to be a single transaction. From  
15 the Partnership's perspective, it received a write-down of the  
16 First Note to the fair market value of the Property for a payment  
17 of \$100,280.13. That was a simple discharge of indebtedness and  
18 was properly treated as CODI to the Partnership and passed  
19 through to the Taxpayers. The FTB provides no other evidence or  
20 explanation for why the Court should ignore the "various steps"  
21 and treat the write-down of the First Note and the sale of the  
22 Property to STA as a single transaction. The Partnership and the  
23 Adams properly treated the write-down of the First Note under the  
24 Third Modification as CODI.

25 As a back up, the FTB argues that if write-down of the First  
26 Note is treated as CODI, the Adams still owe taxes for 1993

1 because they have not established that they were insolvent in  
2 1993.

3       It is not entirely clear to the Court from the papers filed  
4 and argument of counsel, but this issue appears to turn on  
5 whether the First Note is properly included as a liability of the  
6 Adams' for the purpose of determining their insolvency under  
7 § 108 of the Internal Revenue Code. The FTB appears to have  
8 taken the position that the Adams can receive CODI from the  
9 write-down of the First Note, but cannot include the First Note  
10 in their insolvency calculation. Not surprisingly the FTB  
11 provides no authority to support their position. The Court finds  
12 the argument to be internally inconsistent and the result  
13 nonsensical. The Court holds that the First Note, the write-down  
14 of which gave rise to the CODI, should be included in the § 108  
15 solvency calculation. The calculations set forth in the  
16 Trustee's "Reply to the Franchise Tax Board's Supplemental Trial  
17 Brief on Remaining Disputed Items" at page 17 appear to be  
18 accurate. However, as discussed below, the Court will leave to  
19 the parties to determine the actual figures based upon this  
20 ruling.

#### 21 **Tax on Termination of the Partnership**

22       As noted at the prior hearing, the Court ruled that the FTB  
23 was bound by its judicial admission that the Wraparound Note and  
24 the Second were discharged in 1987. Since the statute of  
25 limitations of that tax year had lapsed, the FTB was not entitled  
26 to assert a claim for any change to the tax liability for 1987 to

1 which the ruling may have otherwise given rise. The FTB  
2 recognized this. However, it was not giving up yet. The FTB now  
3 argues that the ruling of discharge in 1987 (or even 1992) meant  
4 that Judith's tax basis in her partnership interest in the  
5 Partnership was impacted. Thus, argued the FTB, Judith's gain on  
6 termination of the Partnership is impacted. The FTB alleges in  
7 its Supplemental Trial Brief in section III that if the  
8 Wraparound Note and the Second were discharged in 1992, then the  
9 taxpayers taxable distribution or gain on the termination of the  
10 Partnership would be \$1,954,923. The FTB in section IV of its  
11 brief alleges that if the Wraparound Note and Second were  
12 discharged in 1987, the gain on termination of the Partnership  
13 would be \$3,663,708. The Court finds that this argument is  
14 precluded by the Stipulation of Facts in which the FTB stipulated  
15 that the gain to Judith on termination of the Partnership was  
16 \$1,479.00.

17 As noted above, prior to the September 20, 2006 hearing on  
18 the Trustee's Original Objection, the parties filed the  
19 Stipulation of Facts. The Stipulation simply recited a number of  
20 facts to which the Trustee, Judith Adams and the FTB stipulated.  
21 Nothing in the Stipulation purports to limit the use to which the  
22 stipulated facts could be put. Both the Trustee and Judith on  
23 the one hand, and the FTB on the other have used the stipulated  
24 facts to support their contentions in opposition to and in  
25 support of Claim No. 50. The FTB cited to the Stipulation in its  
26 ///

1 October 17, 2006 Trial Brief (12:26-27) and at the October 25  
2 hearing (see Transcript at 36:11-22).

3 Paragraph 52 of the Stipulation provides:

4 The amount set forth on Exhibit Y hereto  
5 accurately reflects all of the liabilities of Robert  
6 and Judith at February 1993, which are properly  
7 included in determining insolvency for purposes of  
8 computing income from discharge if indebtedness ....

9 The first page of Exhibit Y is entitled "SECTION 108  
10 CALCULATION" for "ROBERT K. AND JUDITH S. ADAMS" as of February  
11 1993. The second page of Exhibit Y is entitled "Additional  
12 Information - Section 108 (Gain on Liquidation)" and includes the  
13 entry "Gain on Termination of Trail Partnership - 1,479."

14 The FTB argues that it did not stipulate to the truth of the  
15 matters set forth in Exhibit Y to the Stipulation of Facts, which  
16 is where the \$1,479 figure is found. The Court disagrees.

17 Paragraph 52 of the Stipulation provides that the "amount set  
18 forth on Exhibit Y hereto accurately reflects all of the  
19 liabilities of Robert and Judith at February 1993 ..." The last  
20 item included in the list of debts on page one of Exhibit Y is  
21 "Tax Liquidation Cost: Gain 2,199,122." That figure is the  
22 bottom line of the calculations included on page two of Exhibit Y  
23 which includes "Gain on Termination of Trail Partnership --  
24 1479." The FTB cannot stipulate to the total on page two, which  
25 is then used to determine the total debt on page one, without  
26 stipulating to the items which made up the total. Accordingly,  
the Court finds that the FTB did in fact stipulate that the  
///

1 amount of gain to taxpayers on termination of the Partnership is  
2 \$1,479.

3 In a final attempt to avoid being bound by the figures in  
4 Exhibit Y, the FTB makes the argument that if the facts set forth  
5 in Exhibit Y are to be accepted as stipulated facts, then so must  
6 those set forth in Exhibits EE, FF and GG. However, those  
7 exhibits are the FTB's notice's of Assessment, Action and the  
8 decision of the CBE. Unlike the recitation with respect to  
9 Exhibit Y, nothing in the Stipulation of Facts speaks to the  
10 accuracy of the allegations set forth in Exhibits EE, FF and/or  
11 GG.

#### 12 CONCLUSION

13 For the reasons set forth above, the Court rules as follows:

14 -- the income generated by the write down of the First Note  
15 to \$900,000.00 per the Third Modification of Promissory Note was  
16 properly treated as CODI;

17 -- the First Note is included as a liability for the  
18 purposes of determining the Taxpayers' solvency under Internal  
19 Revenue Code § 108 with respect to the write-down of the First  
20 Note; and

21 -- the gain to Judith on termination of the Partnership is  
22 \$1,479.00 as provided on Exhibit Y to the Stipulation of Facts.

23 Counsel for the FTB suggested at the February 26, 2007  
24 hearing that the actual hard numbers for the amount of the tax  
25 could not be determined until these overlying issues were  
26 resolved:

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I believe the reason that there have been no hard numbers, your Honor, is that there are a lot of issues and a lot of potential different permutations, and until those are resolved, the calculating attacks on the amount of the taxable income is speculation ....

The Court therefor directs the parties to calculate the tax owing for 1993 based upon the foregoing rulings. If the parties are able to agree on a number they may submit a consensual order. If they cannot, Counsel for the Trustee shall contact Marilyn Wilkinson and set a status conference.

The parties may also include in the order the taxes for years 1990 and 1991 (to which the parties have stipulated in paragraph 63 of the Stipulation of Facts) and any credit associated therewith.

IT IS SO ORDERED.

DATE:     MAY 15 2007    



PETER W. BOWIE, Chief Judge  
United States Bankruptcy Court