Cancellation of Indebtedness Is Income in Pennsylvania, Part III.

This post continues my coverage of *Wirth v. Commonwealth*, No. 82 MAP 2012 (Pa. June 17, 2014), in which a majority of the Supreme Court of Pennsylvania held that foreclosure of property securing a non-recourse loan gives rise to a taxable gain.

After concluding that an assessment of gain based upon *Tufts* was proper, the Court next turned to how to calculate the amount of the gain. The taxpayers argued that the amount of the gain should be limited to the principal amount of the mortgage plus the limited interest that had previously been deducted to offset the partnership's limited income. *Wirth v. Commonwealth*, No. 82 MAP 2012, majority slip op. at 36. This argument, premised on the tax benefit rule, would have limited the amount of gain realized by the partnership to $429.6 million, dramatically less than the $2.32 billion that served as the basis for the assessment issued to the taxpayers. The court rejected this contention, reasoning that the tax benefit rule required a prior deduction that did not result in lower tax liability. *Id.*, slip op. at 40-41. In a similar vein, the Supreme Court concluded that all of the interest accrued on the loan was properly included in determining the amount of gain under *Tufts*, relying upon *Allan v. Commissioner*, 856 F.3d 1169 (8th Cir. 1988).

After concluding that the assessments of Personal Income Tax were properly based on each taxpayer's share of the entire mortgage obligation, the court addressed whether the taxpayers could offset their losses on their investment in the partnership against the *Tufts* gain. Here, the Supreme Court concluded that the loss on the investment was sourced at each partner's domicile and therefore could not be used to offset gain. *Wirth v. Commonwealth*, No. 82 MAP 2012, majority slip op. at 48-51.

While the principal articulated by the Supreme Court is sound, the concept is a limit on a state's authority to *tax* a non-resident, not to grant a deduction. Given the economic realities of the situation, it seems manifestly unfair that the taxpayers could not offset their investment losses on their partnership interests against the *Tufts* gain, particularly since they never received any tax benefit in Pennsylvania as a consequence of the liabilities that the partnership incurred.

The final major issue addressed by the majority was related: having concluded that the taxpayers could not offset their investment loss on their partnership interests, the Supreme Court considered their contention that their inability to offset constituted discrimination against non-residents in violation of the Privileges and Immunities Clause, the Commerce Clause and Equal Protection Clause of the United States Constitution, and the Uniformity Clause of the Pennsylvania Constitution. I will address this issue in a separate post.

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