M. O. Rife, Jr., and Maidee W. Rife, Petitioners, v. Commissioner of Internal Revenue, Respondent, 41 T.C. 732 (1964)

A cash basis partner cannot deduct partnership expenses charged to their drawing account until the partnership's fiscal year ends and the account is settled, as these charges are considered advances, not payments, for tax purposes.

Summary

M.O. Rife, Jr., a cash-basis taxpayer and partner in Rife Drilling Co. (an accrual basis partnership), sought to deduct intangible drilling expenses in the year they were charged to his partnership drawing account. The Tax Court held that Rife, as a cash-basis taxpayer, could only deduct these expenses in the year the partnership's fiscal year ended (March 31), when his drawing account was settled against his partnership income. The court reasoned that charges to a drawing account are considered partnership advances, not payments, for a cash-basis partner until the end of the partnership's fiscal year. The court also upheld the validity of a second IRS examination, finding no evidence it was conducted without the taxpayer's knowledge or consent.

Facts

M.O. Rife, Jr. was a partner in Rife Drilling Co. (Drilling), holding a five-sixths interest. Drilling operated on an accrual basis with a fiscal year ending March 31.
Rife individually operated Rife Production Co. (Production) as a sole proprietorship on a cash basis, using a calendar year.
Production engaged Drilling to perform drilling services for oil wells, often in joint ventures with other co-owners.
Drilling paid all drilling expenses and billed Production, charging these amounts to Rife's drawing account in Drilling.
Production then billed co-owners their share of expenses. Payments from co-owners were credited to Rife's drawing account.
Rife deducted intangible drilling and development expenses in the calendar year Drilling charged them to his drawing account.

Procedural History

The IRS determined deficiencies for 1954, 1955, and 1956, disallowing deductions for intangible drilling expenses claimed by Rife in 1955, 1956, and 1957.
Rife petitioned the Tax Court, contesting the disallowance and arguing a second IRS examination for 1955 was invalid under Section 7605(b) of the Internal Revenue Code.
The Tax Court upheld the IRS's determination, finding the deductions were not properly taken in the years claimed and the second examination was valid.

Issue(s)

1. Whether a cash basis taxpayer can deduct intangible drilling and development expenses in the year a partnership charges such expenses to the partner's drawing account, or only in the taxable year in which the partnership's fiscal year ends.

2. Whether the deficiency determined by the IRS for 1955 is invalid due to a second examination of the taxpayer's books without written notice under Section 7605(b) of the Internal Revenue Code.

Holding

1. No. The Tax Court held that a cash basis partner can deduct partnership expenses charged to their drawing account only in their taxable year in which falls the end of the partnership's fiscal year, because charges to a drawing account are considered advances until the partnership year closes.

2. No. The Tax Court held the deficiency for 1955 was valid because there was no showing that the second examination was conducted without the taxpayer's knowledge or consent, thus not violating Section 7605(b).

Court's Reasoning

Issue 1 (Deductibility of Expenses): The court emphasized Rife's cash basis accounting. It cited Treasury Regulation § 1.731-1(a)(1)(ii), which states that "advances or drawings of money or property against a partner's distributive share of income shall be treated as current distributions made on the last day of the partnership taxable year." The court reasoned that charging expenses to Rife's drawing account was akin to an advance distribution from the partnership. As a cash basis taxpayer, Rife could only deduct expenses when paid. Payment, in this context, occurred when the drawing account was settled at the end of Drilling's fiscal year (March 31), when Rife's share of partnership income offset the debits in his drawing account. The court distinguished cases involving actual loans, noting the transactions here were treated as advances on partnership books.

Issue 2 (Validity of Second Examination): The court noted Section 7605(b) protects taxpayers from "unnecessary examination or investigations" and limits inspections of books to one per year unless the taxpayer requests otherwise or the IRS provides written notice. However, this protection is waived if the taxpayer knows of and consents to the second examination. The court found no evidence Rife was unaware of or objected to the second examination. The court inferred consent from Rife's signing Form 872 extending the statute of limitations for 1955 and the fact that the second examination was related to a net operating loss carryback claimed by Rife, which inherently involves reviewing prior years. The court stated, "*Section 7605(b) does not protect a taxpayer from the use which may be made by the respondent of information obtained through a second examination of his books when the taxpayer requests such further examination or makes no objection thereto.*"

Practical Implications

Rife v. Commissioner clarifies the timing of deductions for cash basis partners regarding partnership expenses charged to drawing accounts. It establishes that such charges are not considered

